Recent Developments in Federal Income Taxation

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By

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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 it 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


• Normally, when automatic consent is sought from the IRS, there is no acknowledgment of the request.

2. **Is the Public Company Accounting Oversight Board in the intensive care unit?**  Free Enterprise Fund v. PCAOB, 537 F.3d 667 (D.C. Cir. 8/22/08) (2-1), cert. granted, 129 S. Ct. 2378 (5/18/09). Judge Rogers held that the Article II Appointments Clause was not violated by having members of the PCAOB appointed by the SEC commissioners, nor was the separation of powers doctrine violated by the for-cause limitation on removal of PCAOB members.

• Judge Kavanaugh dissented strongly, stating:

The two constitutional flaws in the PCAOB statute are not matters of mere etiquette or protocol. By restricting the President’s authority over the Board, the Act renders this Executive Branch agency unaccountable and divorced from Presidential control to a degree not previously countenanced in our constitutional structure. This was not inadvertent; Members of Congress designed the PCAOB to have “massive power, unchecked power.” 148 CONG. REC. at S6334 (statement of Sen. Gramm). Our constitutional structure is premised, however, on the notion that such unaccountable power is inconsistent with individual liberty. “The purpose of the separation and equilibration of powers in general, and of the unitary Executive in particular, was not merely to assure effective government but to preserve individual freedom.”  *Morrison*, 487 U.S. at 727 (Scalia, J., dissenting); see also  *Clinton v. City of New York*, 524 U.S. 417, 450 (1998) (Kennedy, J., concurring) (“Liberty is always at stake when one or more of the branches seek to transgress the separation of powers.”). The Framers of our Constitution took great care to ensure that power in our system was separated into three Branches, not concentrated in the Legislative Branch; that there were checks and balances among the three Branches; and that one individual would be ultimately responsible and accountable for the exercise of executive power. The PCAOB contravenes those bedrock constitutional principles, as well as long-standing Supreme Court precedents, and it is therefore unconstitutional.

a. Affirmed in part, reversed in part, and remanded. There is less to this decision than meets the eye because the PCAOB continues to operate as before but its members may be removed without cause by the SEC.  _U.S._ (6/28/10) (5-4, with the usual liberals dissenting). The Court held that the for-cause limitations on the removal of PCAOB members contravene the Constitution’s separation of powers but that the unconstitutional provisions are separable from the rest of the Sarbanes-Oxley Act. The consequence is that the Board may continue to function as before, but its members may be removed at will by the Commission.

3. **Just because you might have to perform work in the future and incur future costs doesn’t necessarily mean you have a long-term contract eligible for deferred reporting of income.**  *Koch Industries v. United States*, 603 F.3d 816 (10th Cir. 4/27/10). In connection with a contract to construct a highway for the State of New Mexico, the taxpayer and New Mexico entered into a “rehabilitation” contract under which the taxpayer provided a “pavement warranty” that required it to perform all work necessary to assure performance of the pavement for a period 21.5 years and a “structures warranty” to perform all work necessary to assure performance of the bridges, drainage, and erosion structures for 11.5 years, in consideration of a $62,000,000 payment. The taxpayer had no obligation to perform any work on the highway or structures unless and until the highway and/or structures failed to meet performance standards included in the warranty agreements. The taxpayer sought to use the percentage of completion method under § 460 to report the income, but the Court agreed with the IRS that the percentage of completion method was unavailable. Neither warranty was a long-term contract under § 460 because under Reg. § 1.460-1(b)(2)(i) “to be classified as a long-term
contract, "manufacture, building, installation, or construction of property [must be] necessary for
the taxpayer's contractual obligations to be fulfilled," which "necessarily entails a fixed and
definite obligation on the part of the contractor to provide specified construction services." This
standard was not met because even though it was virtually certain that some work would be
performed at some point, the taxpayer "had no obligation to perform any work on the highway
unless and until the highway and/or structures thereon failed to meet the performance standards
included in the warranty agreements." The contracts were "warranties" within the meaning of
Reg. § 1.460-1(d)(2), and thus the consideration was not eligible for reporting under the
percentage of completion method.

B. Inventories
C. Installment Method
D. Year of Inclusion or Deduction

1. The taxpayer won the substantive issue, but foot-faulted on seeking a
change in method of accounting, so most of the deficiency is upheld. But in future years, it's
"ooh la la" for the taxpayer! Capital One Financial Corp. v. Commissioner; 133 T.C. No. 8
(9/21/09). This case involved two issues and over $280 million — $175 million for one year
alone — (apart from penalties). The first issue was the time that third-party credit card issuers
are required to recognize credit card income known as interchange. Interchange is the difference
between the amount charged on a credit card and the lesser amount remitted to the merchant by
the issuing bank. Interchange resembles interest in that it is expressed as a percentage of the
amount lent, usually with an additional nominal fee, although it is not time-sensitive and does
not vary as interest rates fluctuate. The government argued that interchange income was credit
card fee income that was recognized under the all events test at the time the interchange accrued
— when the cardholder's credit card purchase was settled through either the Visa or MasterCard
system — while the taxpayer argued that the interchange income was original issue discount
(OID) that was properly recognized under § 1272(a)(6)(C)(iii), which was added to the Code in
1997, over the anticipated life of the pool of credit card loans to which the interchange related.
The Tax Court (Judge Haines) agreed with the taxpayer and held that the interchange income
was OID. Interchange is not a fee for any service other than the lending of money. However,
because the taxpayer failed to follow proper procedures to change its accounting methods, the
OID method was not available for credit card receivables creating or increasing OID in 1998 or
1999. With certain modifications, the method used by the taxpayer to compute the OID income
(using a model developed by KPMG) was reasonable.

- A second issue was whether the taxpayer could currently
deduct the estimated cost of future redemptions of "miles" it issued to cardholders that could be
redeemed for airline tickets, the cost of which would be paid by the taxpayer. The court held that
under § 461(h) and Reg. § 1.461-4, those expenses could not be deducted currently, but instead
were deductible only to the extent that the amounts were fixed and known under the all events test
and for which economic performance had occurred.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. This looks pretty good, but at first a few serious questions were
lurking. The 2009 ARRA, § 1231(a), added Code § 108(i), which defers and then ratably
includes income arising from business indebtedness discharged by the reacquisition of a debt
instrument. This new provision allows a taxpayer to irrevocably elect to include cancellation of
debt income realized in 2009 and 2010 ratably over five tax years, rather than in the year the
discharge occurs, if the debt was issued in connection with the conduct of a trade or business or
by a corporation. For partnerships and S corporations, the election is made by the partnership or
corporation, not by the individual partners or shareholders. I.R.C. § 108(i)(5)(B)(iii). Under the
§ 108(i) election, income from a debt cancellation in 2009 is recognized beginning in the fifth
taxable year following the debt cancellation; the income is recognized ratably in each of 2014
through 2018. Income from a debt cancellation in 2010 is recognized beginning in the fourth
taxable year following the debt cancellation; the income is recognized ratably in each of 2014 through 2018. If a taxpayer elects to defer debt cancellation income under § 108(i), the § 108(a) exclusions for bankruptcy, insolvency, qualified farm indebtedness, and qualified real property business indebtedness do not apply to the year of the election or any subsequent year. § 108(i)(5)(C). Thus, the election cannot be used to move the year of inclusion to a year in which it is expected that one of the exceptions will apply. Once the election is made, inclusion is inevitable; the statute requires acceleration of inclusion to the taxpayer’s final return in the event of the intervening death of an individual or liquidation or termination of the business of an entity. § 108(i)(5)(D). The acceleration rule also applies in the event of the sale or exchange or redemption of an interest in a partnership or S corporation by a partner or shareholder.

- Although the statute speaks in terms of cancellation of debt income arising from “reacquisition” of a “debt instrument,” the statutory definitions of “reacquisition” and “an applicable debt instrument,” respectively, are broad enough the provision applies to most situations in which the debt is cancelled. Section 108(i)(3)(B) broadly defines “debt instrument” to include a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness within the meaning of § 1275(a). Section 108(i)(4)(B) defines “acquisition” to include (1) an acquisition of the debt instrument for cash, (2) the exchange of the debt instrument for another debt instrument, including an exchange resulting from a modification of the debt instrument (which includes a reduction of the principal amount of the debt), (3) the exchange of the debt instrument for corporate stock or a partnership interest, (4) the contribution of the debt instrument to capital, and (5) the complete forgiveness of the indebtedness by the holder of the debt instrument.

- However, the statutory definition of “acquisition” appears to omit the cancellation of a debt in connection with a property transfer, for example, a deed in lieu of foreclosure, although the legislative history contains some indication that this type of debt cancellation is included.

- Query when and to what extent real estate ownership qualifies as a trade or business.

a. Many of the questions are answered. Rev. Proc. 2009-37, 2009-36 I.R.B. 309 (8/17/09). This revenue procedure provides the exclusive procedure for taxpayers to make § 108(i) elections. Debt cancellation in connection with a property transfer is included in § 108(i). Section 4.04(3) permits partial elections, with the partnership permitted to determine “in any manner” the portion of the COD income that is the “deferred amount” and the portion of the COD income that is the “included amount” with respect to each partner. Section 4.11 permits protective elections where the taxpayer concludes that a particular transaction does not generate COD income but fears that the IRS may determine otherwise. A partner’s deferred § 752(b) amount, arising from a decrease in his share of partnership liabilities, will be treated as a current distribution of money in the year that the COD income is included. Taxpayers are allowed an automatic one-year extension from the due date to make the election, and taxpayers who made elections before the issuance of the revenue procedure will be given until 11/16/09 to modify (but not revoke) their existing elections. Corporate taxpayers making a § 108(i) election are required to increase earnings and profits for the year of the election.

b. Temporary Regulations allocate deferred cancellation of debt income. T.D. 9498, Application of Section 108(i) to Partnerships and S Corporations, 75 F.R. 49380 (8/13/10). Section 108(i) provides an election to include cancellation of indebtedness income resulting from a reacquisition (broadly defined in § 108(i)(4)) of a debt instrument, issued by a C corporation or other person engaged in a trade or business, ratably over five years beginning with the fifth year following reacquisition occurring in 2009, and the fourth year following reacquisition in 2010. Under § 108(i)(5)(B)(iii) an election is made by the partnership, not the partners individually. Section 108(i)(6) requires a partnership to allocate the COD income to partners according to partnership share on the day immediately preceding reacquisition and provides that the discharge will not trigger § 752(b) recognition under § 731 because of a reduction in a partner’s share of partnership liabilities.

- Temp. Reg. § 1.108(i)-2T(d)(1) provides five safe harbors
where debt instruments issued by a partnership or S corporation will be treated as issued in a trade or business: (1) The gross fair market value of the trade or business assets of the partnership or S corporation represent at least 80 percent of the fair market value of all of its assets on the date of issuance, (2) trade or business expenses of the partnership or S corporation represent at least 80 percent of all expenditures, (3) at least 95 percent of the interest paid on the debt instrument is allocable to trade or business expenditures under the interest allocation rules of Reg. § 1.163-8T, (4) at least 95 percent of the proceeds from the debt instrument were used to acquire trade or business assets within six months of the issue of the debt, or (5) the partnership or S corporation issued the debt instrument to the seller of a trade or business to acquire the trade or business. Absent anchoring in one of the safe harbors, qualification of a trade or business debt is a matter of facts and circumstances.

- While § 108(i)(5)(B)(iii) requires the election to be made at the partnership level, Temp. Reg. § 1.108(i)-2T(b)(1), allows the partnership to allocate both deferred and included portions of COD income to the partners. The temporary regulations first require that COD income be allocated to the partners in the partnership immediately before the reacquisition in the manner the income would be included in distributive shares under § 704, then the partnership must determine the amount of COD income from the applicable instrument that is the deferred amount includible in the partner’s share and the amount that is immediately includible. With respect to deferred COD income of an S corporation, the Temp. Reg. § 1.108(i)-2T(c)(1) requires that on an election by the S corporation, deferred income must be shared pro rata on the basis of stock ownership immediately prior to the reacquisition.

- Temp. Reg. § 1.108(i)-2T(b)(2) provides that a partner’s basis is not adjusted under § 705(a) to account for the partner’s share of partnership deferred COD income until the deferred item is recognized by the partner. Likewise, § 1.108(i)-2T(c)(2) provides that neither an S corporation shareholder’s basis under § 1367 nor the shareholder’s accumulated adjustment account is adjusted for deferred COD income until the shareholder recognizes the deferred COD income.

- Following the rules of Rev. Proc. 2009-37, and applying the rules of § 108(i)(6), Temp. Reg. § 1.108(i)-2T(b)(3) provides that reduction in a partner’s share of partnership liabilities is determined under § 752(b) when a debt instrument is reacquired, but that the reduction in obligations is not treated as a distribution of money until deferred COD income is recognized by the partner. The temporary regulations provide additional rules for determining a partner’s deferred amounts where the partner would recognize § 731 gain in the year of the reacquisition.

- Partners’ capital accounts are adjusted as if no § 108(i) election were made.

- Temp. Reg. § 1.108(i)-2T(d)(3) provides that gain attributable to a reduction in a partner’s or S corporation shareholder’s amount at-risk under § 465(e) will not be taken into account in the year of reacquisition and will be deferred to the date the COD income is recognized.

- In the case of an acceleration event under § 108(i)(5)(D) that requires a partnership or S corporation to recognize deferred items, under Temp. Reg. § 1.108(i)-2T(c)(3) the partners or S corporation shareholders must account for deferred COD income in the year that the accelerating event takes place. In addition, the temporary regulations described various circumstances in which a partner or S corporation shareholder terminates the interest in the entity that will require acceleration of deferred COD income, including death, liquidation, sale or exchange, redemption, or abandonment.

- Identical proposed regulations were issued simultaneously.

REG-144762-09, Application of Section 108(i) to Partnerships and S Corporations, 75 F.R. 49427 (8/13/10).

c. Significant guidance on a soon to expire beneficial Code section that leaves a nasty hangover. T.D. 9497, Guidance Regarding Deferred Discharge of Indebtedness Income of Corporations and Deferred Original issue Discount Deductions, 75 F.R. 49394 (8/13/10). The IRS and Treasury have promulgated Temp. Reg. §§ 1.108(i)-0T through
1.108(i)-3T providing detailed rules for C corporations regarding the acceleration of deferred COD income and deferred OID deductions under § 108(i)(5)(D), and the calculation of earnings and profits as a result of an election under § 108(i). The regulations also provide rules applicable to all taxpayers regarding deferred OID deductions under § 108(i) as a result of a reacquisition of an applicable debt instrument by an issuer or related party.

- Identical proposed regulations were issued simultaneously. REG-142800-09, Guidance Regarding Deferred Discharge of Indebtedness Income of Corporations and Deferred Original Issue Discount Deductions, 75 F.R. 49428 (8/13/10).


B. Deductible Expenses versus Capitalization

1. Who says § 1060 prevents allocating basis in excess of fair market to tangible assets? Not Judge Kroupa of the Tax Court. West Covina Motors, Inc. v. Commissioner, T.C. Memo. 2009-291(12/16/09). The taxpayer purchased the assets of another corporation and paid various legal and other transactional fees in connection with the acquisition. Most, but not all, of the fees were related to a seller-financing arrangement for the purchased assets. The parties stipulated that the taxpayer paid $6,050,601 for specific assets, including (1) $250,001 for fixed assets, (2) $3.5 million for goodwill, and (3) $2,300,600 for the inventory of used vehicles, parts, and miscellaneous items, as well as acquiring $6,258,074 worth of new and demonstrator vehicle inventory that was subject to a $6,421,047 floor plan line of credit. Those legal and transactional fees that were attributable to inventory financing and physical inventory were allocated to the inventory to be taken into account in determining cost of goods sold. The IRS argued that because the acquisition was an “applicable asset acquisition” to which § 1060 applied, the remaining legal fees, which were not specifically related to any particular asset, were required to be allocated to goodwill and going concern value under § 1060 because the fair-market-value limitations of § 1060 precluded an allocation to any other assets. In a stunning decision, Judge Kroupa rejected the IRS’s position and held that even though the acquisition was an “applicable asset acquisition” as defined in § 1060, where the parties, i.e., the taxpayer and the IRS, have stipulated “the cost of each asset ... section 1060 does not apply.” Accordingly, she agreed with the taxpayer that the legal fees should be allocated proportionately among all of the acquired assets to increase their bases – 2.03% to fixed assets, 18.69% to used vehicles and parts inventory, 50.84% to new and demonstrator vehicles, and 28.44% to goodwill.

- Former Temp. Reg. § 1.1060-1T(e), which was the controlling regulation for the year of the transaction, specifically stated: “Allocation not to exceed fair market value. The amount of consideration allocated to an asset (other than Class IV assets) [defined therein as ‘intangible assets in the nature of goodwill and going concern value’] shall not exceed the fair market value of that asset on the purchase date.” Although Judge Kroupa’s opinion cited that provision, she somewhat mysteriously stated that “[the Commissioner] cites no authority requiring legal fees to be allocated under the fair-market-value limitations of section 1060 where the parties have stipulated the cost of each asset, and we find none.” We on the other hand believe that former Temp. Reg. § 1.1060-1T(e) does precisely what Judge Kroupa believed that no authority required. Former Temp. Reg. § 1.1060-1T(e) was mirrored in former Temp. Reg. § 1.338(b)-2T(c)(1), and that provision continues to apply in current Reg. § 1.338-6(c)(1). In addition, current Reg. § 1.338-6(a)(2)(ii) specifically provides that “[t]ransaction costs are not taken into account in allocating ADSP or AGUB to assets in the deemed sale (except indirectly through their effect on the total ADSP or AGUB to be allocated).” Even more to the point, current Reg. § 1.1060-1(c)(3) now clearly specifically precludes the result in West Covina Motors from occurring:

The seller and purchaser each adjusts the amount allocated to an individual asset to take into account the specific identifiable costs incurred in transferring that asset in connection with the applicable asset acquisition (e.g., real estate transfer costs or security interest perfection costs). Costs so allocated increase, or decrease, as appropriate, the total consideration that is allocated under the residual
method. No adjustment is made to the amount allocated to an individual asset for
general costs associated with the applicable asset acquisition as a whole or with
groups of assets included therein (e.g., non-specific appraisal fees or accounting
fees). These latter amounts are taken into account only indirectly through their
effect on the total consideration to be allocated.

- Although current Reg. § 1.1060-1(c)(3) post-dates the
transaction in West Covina Motors, and thus was not technically controlling, it is merely a more
specific statement of the rule in current Reg. § 1.338-6(a)(2)(ii), which in turn merely clarifies
current Reg. § 1.338-6(c)(1), which is identical to former Temp. Reg. § 1.338(b)-2T(e)(1), which
mirrored former Temp. Reg. § 1.1060-1T(e), which should have been controlling in West Covina.

- The bottom line: Don’t take the holding in this case too
seriously. Its reasoning is suspect.

2. 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)(iii)(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.

3. **Legal fees incurred resisting states’ attorney general challenges to the privatization of Blue Shield are capital expenses.** Wellpoint, Inc. v. Commissioner, 599 F.3d 641 (7th Cir. 3/23/10). The taxpayer provides health insurance coverage through operating subsidiaries that are licensees of the Blue Cross and Blue Shield Association and are a result of mergers with Blue Cross and Blue Shield organizations that were once characterized as tax-exempt charitable entities. Several state attorneys general brought cy-pres or charitable trust actions against the taxpayer claiming assets of the charitable organizations that were impressed with charitable trusts. The taxpayer made payments of nearly $114 million to settle these actions. The Circuit Court affirmed the Tax Court holding (T.C. Memo. 2008-236) that the taxpayer’s legal fees and settlement payments were incurred in a dispute over the equitable ownership of assets allegedly impressed with charitable trust obligations, and that the fees and payments were thus required to be capitalized. Judge Posner described an expenditure as a capital expense “if its ‘utility ... survives the accounting period’ in which it is made” (citing Sears Oil Co. v. Commissioner, 359 F.2d 191, 197 (2d Cir. 1966)) and added that “expense incurred to enhance the value of a capital asset must be capitalized, and thus amortized over the asset’s remaining life.” The court concluded that the settlement was based on claims involving Wellpoint’s title to the assets acquired from the formerly tax-exempt entities. The court rejected the taxpayer’s argument that the payments were incurred to protect its business practices.

4. **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.

**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?

2. **Multi-Pak Corporation v. Commissioner, T.C. Memo. 2010-139 (6/22/10).** In this case appealable to the Ninth Circuit, the Tax Court (Judge Goeke) allowed deductions for the full amount of compensation paid to the taxpayer’s sole shareholder/CEO and COO, for 2002 in the amount of $2,620,000, but reduced the allowable compensation deduction for 2003 from $1,284,104. Both amounts were greater than the $665,000 and $660,000 amounts that the IRS asserted as reasonable. The court applied the five factor test of Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1243-1245 (9th Cir. 1983): (1) The employee’s role in the company; (2) comparison with other companies; (3) the character and condition of the company; (4) potential conflicts of interest; and (5) internal consistency in compensation. The court rejected the opinions of dueling experts, noting that neither expert looked to companies comparable to the taxpayer. The court also faulted the taxpayer’s expert for not performing the “analysis, required in the applicable caselaw, of whether an independent investor would have been satisfied by his or her return on investment.” Noting that the Court of Appeals in Elliotts
found that a 20 percent return on equity would satisfy the hypothetical investor, the court indicated that the taxpayer's 2.9 percent return in 2002 supported the salary in light of an impressive growth in sales, but the -15.8 percent return in 2003 called into question the amount of compensation paid in that year. Finally, the court refused to apply a § 6662(a) accuracy penalty.

**D. Miscellaneous Deductions**

1. **The IRS responds to high gasoline prices.** Announcement 2008-63, 2008-2 C.B. 114 (6/23/08), modifying Rev. Proc. 2007-70. The IRS announced that the business mileage rate for the second half of 2008 will be 58.5 cents per mile – an increase of 8 cents per mile – and that the medical/moving rate will also increase by 8 cents per mile to 27 cents per mile. The statutory rate for charitable mileage under § 170(i) remains at 14 cents per mile.

   a. But **gas prices abruptly declined in fall 2008.** Rev. Proc. 2008-72, 2008-50 I.R.B. 1286 (11/24/08). The business mileage rate for 2009 will be 55 cents per mile – a decrease of 3.5 cents per mile – and that the medical/moving rate will decrease by three cents to 24 cents per mile. The statutory rate for charitable mileage under § 170(i) remains at 14 cents per mile.


2. **Throw another log on the fire! Loss of contemporaneous § 274(d) mileage log in a fire doesn’t cause loss of mileage deductions too.** Freeman v. Commissioner, T.C. Memo. 2009-213 (9/16/09). Judge Gustafson allowed the taxpayer a deduction, at mileage rates, for business use of his automobile on the basis of the taxpayer's credible testimony regarding the route he drove in connection with his auto parts delivery business. The taxpayer had maintained and at one time possessed adequate documentation, in the form of a daily log, to comply with § 274(d), but his failure to produce that daily log was the result of an accidental fire that destroyed his house and the logbook. Reg. § 1.274-5T(c)(5) allows a taxpayer to "substantiate a deduction by reasonable reconstruction of his expenditures or use" when records are lost through circumstances beyond the taxpayer's control, including a fire.

   a. But if you lose the mileage log books due to CRS [misplacing them], or they're just plain s****y [smudgy?], you're out of luck. Royster v. Commissioner, T.C. Memo. 2010-016 (2/1/10). The taxpayer was denied a deduction for claimed 2003 business mileage because he had "lost" his log books. But it probably didn't matter. He was also denied any deductions for 2004 and 2005 business mileage because his log books recorded only the odometer readings at the beginning and end of each day and had no indications of the business purpose of the trips or the destinations.

3. **Revised per diem rates for lodging, meal, and incidental expenses.** Rev. Proc. 2009-47, 2009-42 I.R.B 524 (9/30/09). The IRS has provided updated rules for employer provided per diem allowances that do not require substantiation, and which may be used by self-employed persons and employees who are not reimbursed for travel expenses. Per diem rates for travel within the U.S. are the rates for government travel set forth in 41 C.F.R. ch. 301, appx. A. Travelers may use the rates in effect for the first nine months of 2009 for all travel within 2009, or may use the updated rates for travel between October 1 and December 31, 2009. Rates for travel outside the continental United States (including Alaska and Hawaii) are published by the Secretary of Defense and the Secretary of State and are updated monthly. The rates are available at www.gsa.gov. A traveler may use per diem allowances for meals and incidental expenses along with actual lodging expenses. The revenue procedure also provides fixed high-low per diem rates of $258 for a high cost locality, with a list provided, and $163 for travel to any other locality.

4. **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 activates, 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.

5. The IRS rescues OID interest deductions for borrowers that recognize COD income under the Cottage Savings regulations as a result of loan modifications that don’t reduce principal. Notice 2010-11, 2010-4 I.R.B. 326 (12/24/09). Pursuant to § 163(e)(5)(f)(iii), the IRS has extended through 12/31/10 the suspension of the application of § 163(e)(5), which partially disallows interest deductions with respect to certain applicable high yield discount obligations (AHYDOs), for “qualified obligations.” An obligation is a “qualified obligation” only if: (1) the AHYDO is issued after December 31, 2009, and on or before December 31, 2010, in exchange (including an exchange resulting from a modification of the debt instrument) for an obligation that is not an AHYDO; (2) the issuer (or obligor) of the AHYDO is the same as the issuer (or obligor) of the obligation exchanged for the AHYDO; (3) the AHYDO does not pay interest that would be treated as contingent interest for purposes of § 871(h)(4) (without regard to § 871(h)(4)(D)); (4) the AHYDO is not issued to a related person (within the meaning of § 108(e)(4)); (5) the issue price of the AHYDO is determined under §§ 1273(b)(1), 1273(b)(2), 1273(b)(3), or 1274(b)(3), whichever is applicable, and the regulations thereunder; and (6) the AHYDO would not otherwise be an AHYDO if its issue price were increased by the amount of any discharge of indebtedness income realized by the issuer (or obligor) upon the exchange.

6. Restitution of insurance fraud proceeds is deductible. Cheating wife produces business losses. Cavaretta v. Commissioner, T.C. Memo. 2010-4 (1/5/10). The taxpayer dentist’s wife, who managed the billing for the taxpayer’s dental practice, billed an insurance company for work that had not been done. The dentist was unaware of his wife’s false claims, but unfortunately for her the insurance company figured it out. She subsequently pled guilty to criminal health-care fraud and received a prison sentence followed by supervised release. Restitution was not ordered in the criminal proceeding, but the wife had agreed to repay $600,000 in civil restitution before sentencing and compliance with the restitution agreement was required as condition or supervised release from prison. The repayment was made by the taxpayer over three taxable years. The Tax Court (Judge Holmes) held, first, that the restitution payments, which were made by the husband, were deductible because payment was compensatory, not punitive, and thus § 162(f) did not disallow the deduction. He agreed with the taxpayer’s claim that the repayments were deductible as losses incurred in a trade or business under § 165(c)(1) and rejected the IRS’s argument that the payments constituted restitution deductible as a loss in a transaction entered into for profit under § 165(c)(2), which is not eligible for carryback under § 172(d). The court refused to apply the holding of Stephens v. Commissioner, 905 F.2d 667 (2d Cir. 1990), that states that a payment constituting “restitution” is never deductible under § 162 and only sometimes deductible under § 165. The court concluded that the “restitution” label does not make a repayment automatically ineligible for deduction as a business expense. The court distinguished Stephens as involving restitution for criminal fraud and embezzlement without any connection to a separate trade or business. The court also rejected the IRS argument that because the payments were expenses of committing fraud they cannot be considered as business expenses. The court found that the repayment was an ordinary and necessary expense of the dental practice.

7. Multi-employer life insurance plan too good to be true? Yes, says the Tax Court. Curcio v. Commissioner, T.C. Memo. 2010-115 (5/27/10). This case consolidated
IRS assessments and penalties against three companies that had been involved in The Benistar 419 Plan and Trust, established by Daniel Carpenter and promoted in a book entitled A Professional’s Guide to 419 Plans. Participating companies contributed money to a trust account which in turn acquired cash rich life insurance policies covering employees insured by the plan. Benistar withdrew 9 percent of the surrender value of the policies to cover its expenses. Promotional materials promised unlimited deductions, contribution rates that are variable from year to year, benefits that could be provided to key employees on a selective basis, that contributions to the plan are not limited by qualified plan rules and will not interfere with qualified plans, funds inside the Benistar trust accumulate tax free, death benefits are income and estate tax free, arrangements can be made for later tax-free distributions, and the funds are secure from creditors. Section 419(a) provides that contributions to a welfare benefit fund are deductible, limited under § 419(b) to the plan’s qualified cost, but only if the contributions are otherwise deductible under Chapter 1 of the Code. Section 419(f)(6) provides that contributions to a multi-employer plan are not subject to the limit of § 419(b). The court (Judge Cohen) held that contributions to the plans were not deductible under § 162 because the taxpayers had the right to receive the value reflected in the underlying insurance policies in the Benistar plan, and that the taxpayers used the plan to funnel pretax business profits into cash-laden life insurance policies over which they retained control. The court also held that contributions to the plan were constructive dividends rather than deductible expenses. The court found that the costs of insurance policies under the plans claimed as deductions far exceeded the costs of providing term life insurance to the covered employees, that the taxpayers treated the underlying policies as their own, and that the policies could be withdrawn from the plan without cost.

With respect to S corporation employee shareholders in one of the cases, the court pointed out that deductions claimed and denied for 2002 would properly increase income under § 1366 and basis under § 1367 which would offset subsequent distributions. With respect to the S corporation shareholder involved, since the corporation claimed a deduction in 2002, a year not before the court, and the actual contribution was paid in 2003, there was no increase in income in 2003 to create basis. Absent evidence regarding basis at the end of 2002, the court presumed that the basis was zero.

The court also affirmed accuracy related penalties assessed under § 6662(a), rejecting both the taxpayers’ arguments that their positions were supported by substantial authority and that they reasonably relied on professionals. On the latter point the court found that the accountants on whom the taxpayers asserted reliance had no expertise in employee benefit rules and the insurance agents had no tax expertise on which reliance was reasonably warranted.

And another one goes down. McGehee Family Clinic, P.A. v. Commissioner, T.C. Memo. 2010-202 (9/15/10). Same book, same plan, same judge (Cohen, J), different taxpayer, same result with penalties.

This mountain does not blossom into cost of goods. D.L. White Construction, Inc. v. Commissioner, T.C Memo. 2010-141 (6/28/10). The taxpayer, a C corporation, purchased 80 acres in Idaho with plans to construct four houses for sale to customers. Unfortunately the access road to the property was owned by another who disputed in the Idaho courts the taxpayer’s right to an easement. As a consequence the taxpayer claimed the purchased land was worthless and claimed the loss as a cost of goods sold. The Tax Court (Judge Marvel) rejected the taxpayer’s argument that the purchased land represented a cost of goods sold. The court noted that § 471 generally prohibits inventory accounting for property that is not merchandise and added that that land is not merchandise. The court also rejected the taxpayer’s claim that it was entitled to a business loss under § 165(a) holding that the taxpayer’s claimed loss is not evidenced by a closed and completed transaction because the adjacent land owner’s lawsuit was not finally resolved.

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.

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

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. 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). I.R.C. § 179(c) 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.


c. **The tide is growing into a tsunami.** The Small Business Jobs Act of 2010 increases the § 179 increases 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 extends 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. **If that’s not enough, 50 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.

2. **Converting corn to ethanol is waste reduction and resource recovery, not a chemical process.** Notice 2009-64, 2009-36 I.R.B. 307 (8/24/09). The notice contains a proposed revenue ruling to classify tangible assets used to convert corn into fuel grade ethanol as belonging to asset class 49.5 of Rev. Proc. 87-56, 1987-2 C.B. 674, ten year property with a seven year MACRS recovery period. The IRS concludes that such assets are not properly assigned to asset class 28, manufacture of chemicals and allied products, which has a 9.5 year class life and five year MACRS recovery period.

3. **Stimulate the economy, buy a new car, light truck or van and claim $100 more depreciation.** Rev Proc 2010-18, 2010-9 I.R.B. 427 (2/18/10). The annual dollar limit on depreciation for passenger automobiles placed in service in 2010 is generally increased by $100 for the first year as follows: $3,060 for the placed in service year, $4,900 for the second tax year, $2,950 for the third tax year, and $1,775 for each succeeding year. The limits for light trucks and vans are: $3,160 for the placed in service year, $5,100 for the second tax year, $3,050 for the third tax year, and $1,875 for each succeeding year.

4. **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.

5. **Fiat Lux but only for seven years.** Street lights are not land improvements. Here, it’s better not to be assigned an asset class. PPL Corporation v. Commissioner, 135 T.C. No. 8 (7/28/10). The taxpayer public utility company claimed that streetlights were depreciable over seven years, as property for which there is no assigned
recovery period, while the IRS asserted that the proper recovery period for the streetlights was 20 years, as electric utility transmission and distribution plant, or alternatively 15 years, as land improvements. The Tax Court (Judge Halpern) held that street lighting, including lamps, poles and wiring, owned and installed by an electric utility for public and private customers were held to constitute property without a class life and were thus eligible for seven year MACRS recovery under § 168(e)(2) & (3). Judge Halpern found that the streetlights were neither (1) electric utility transmission and distribution plant, because they were "'primarily used' to make light, not to distribute electricity," and not used in the distribution of electricity for sale, nor (2) land improvements, because they were bolted to wood poles and buildings and not affixed to anything in an inherently permanent way. Judge Halpern applied the six factors of Whiteco Industries, Inc. v. Commissioner, 65 T.C. 664 (1975), which focus on the permanence of the depreciable property and the damage caused to it or to reality upon removal of the depreciable property: (1) "Is the property capable of being moved, and has it in fact been moved?" (2) "Is the property designed or constructed to remain permanently in place?" (3) "Are there circumstances which tend to show the expected or intended length of affixation, i.e., are there circumstances which show that the property may or will have to be moved?" (4) "How substantial a job is removal of the property and how time-consuming is it? Is it "readily removable"?" (5) "How much damage will the property sustain upon its removal?" and (6) "What is the manner of affixation of the property to the land?" Every factor suggested that street lights, including poles bolted to concrete foundations, which were easily moved, were not land improvements.


F. Credits

1. A credit for Vinny Gambini hiring disconnected "yutes." The 2009 ARRA, § 1221, added two new categories of eligible employees for 2009 and 2010 under the existing Code § 51 Work Opportunity Tax Credit: unemployed veterans and "disconnected youths." To qualify as an unemployed veteran, the employee (1) must have been discharged from active duty in the military (after serving at least 180 days or being discharged for a service-connected disability) during the five-year period ending on the hiring date, and (2) must have received unemployment compensation for at least four weeks during the one-year period ending on the hiring date. A disconnected youth is an individual certified by the designated local agency who is (1) at least age 16 but not yet age 25 on the hiring date, (2) not regularly attending any secondary, technical, or post-secondary school during the six-month period preceding the hiring date, (3) not regularly employed during the six-month period preceding the hiring date, and (4) not readily employable by reason of lacking a sufficient number of skills.

a. Disconnected yutes defined. Notice 2009-28, 2009-24 I.R.B. 1082 (5/28/09). 2009 ARRA amended § 51 to add two new targeted groups for purposes of the § 51 work opportunity credit: unemployed veterans and disconnected youths who begin work for an employer during 2009 or 2010. This provides guidance on the definition of "disconnected youth." It also provides transition relief for employers who hire unemployed veterans or disconnected youths after 12/31/08, and before 7/17/09.

b. The IRS is paying you not to fire newly hired people. Code §§ 38(b) and 39, as amended by the 2010 HIRE Act, provide a credit for retaining newly hired workers. The amount of the credit is the lesser of (1) $1,000 or (2) 6.2 percent of the wages paid to the worker during the 52 week period following the commencement of employment in a tax year ending after 3/18/10. The credit is not available unless the employee's wages (as defined for income tax withholding in § 3401(a)) during the last 26 weeks of the period are at least 80 percent of the wages for the first 26 weeks of that period. The credit is allowed in the year in which the 52 period ends. No portion of the unused business credit under § 38 for any tax year that is attributable to the increased credit under the 2010 HIRE Act may be carried to a tax year beginning before 3/18/10.
2. There is no research credit for foreign research, but foreign gross receipts do count in calculating the amount of the allowable credit. Deere & Company v. Commissioner, 133 T.C. No. 11 (10/22/09). As in effect for the year at issue, § 41(c)(4) provided that the § 41(a) increasing research credit was equal to the sum of 2.65 percent of so much as of the qualifying research expenses for the taxable year as exceeded one percent of the average annual gross receipts of the taxpayer for the 4 taxable years preceding the credit year, 3.2 percent of the amount of qualifying research expenditures that exceed 1.5 percent of the average gross receipts, and 3.75 percent of the qualifying research expenditures that exceed 2 percent of the average gross receipts for the four year period. The Tax Court (Judge Chiechi) rejected the taxpayer's assertion that average gross receipts under this provision is calculated by excluding the annual gross receipts from foreign branches. The court concluded that nothing in the structure of § 41 nor the legislative history indicates that Congress did not intend to include foreign gross receipts in the § 41(c)(4) calculation. The court indicated that if Congress had intended to exclude foreign gross receipts, it would have so mandated. The court also concluded that including the foreign gross receipts is not inconsistent with the focus of the research credit on increases in domestic research activities.

3. Property sold to customers is "supplies." Huh? TG Missouri Corporation v. Commissioner, 133 T.C. No. 13 (11/12/09). The § 41 research credit includes in qualified research expenses the cost of "supplies used in the course of qualified research." Under § 41(b)(2)(C) supplies include tangible personal property, but do not include property subject to the allowance for depreciation. The taxpayer manufactures automobile parts for customers. In the course of designing and producing new parts the taxpayer designs and engineers production molds that it purchases from a third-party tool maker. Once the production molds are ready for the production of parts for the customer the taxpayer sells the molds to the customer. However, the taxpayer retains possession of the molds as it produces parts for the customer. The IRS asserted that the molds are property of a character subject to the allowance for depreciation regardless of whether the molds are depreciable property in the taxpayer's hands. The Tax Court (Judge Marvel) accepted the taxpayer's interpretation of § 41(b)(2)(C) that the exclusion from supplies applies to property that is subject to the allowance for depreciation in the hands of the taxpayer. The court examined language in § 174(c) to conclude that for both purposes the exclusion applicable to depreciable property is applicable to property that is accounted for by the taxpayer as depreciable property. By virtue of its sale of the molds to customers, taxpayer did not retain an economic interest in the molds entitling it to claim depreciation deductions, notwithstanding the taxpayer's continued possession of the molds. The court also looked to §§ 1239 and 453 to conclude that references in the Code to depreciable property are not limited to the extrinsic nature of the property alone, but depend upon the property being depreciable in the hands of the holder.

4. The research credit is available for the whole boat. Trinity Industries, Inc. v. United States, 691 F. Supp. 2d 688 (N.D. Tex. 1/29/10). For purposes of the § 41 research credit, research undertaken for the discovery of technological information, substantially all of the research activities must constitute elements of a process that related to a new or improved function. The tests of § 41 are applied to each "business component" of the taxpayer, which is a product or process held for sale or used in the business. § 41(d)(2). A Trinity subsidiary designed and built six prototype "first in class" ships. The court rejected the IRS' argument that the special order ships were not held for sale because they were not sold out of inventory. The court also refused to accept the assertion that because each ship consisted of numerous existing subassemblies incorporated into a ship design that the total development cost of each ship does not constitute a qualified research expense. Citing Reg. § 1.41-4(a)(6), the court held that as long as the taxpayer can demonstrate that 80 percent of a first-in-class ship was part of a process of experimentation, the entire cost is a research expenditure. The court also indicated that the taxpayer failed to offer evidence from which the court could determine the amount of research expenditure relating to any business component smaller than the entire ship. The court then found that 80 percent of the costs of two of the six projects for which the taxpayer claimed the research credit represented qualified experimentation.
5. 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 after 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). This notice 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.

6. **It will be difficult for Alliantgroup to be retrospectively generating these new research credits for clients.** Section 48D, added by the 2010 Health Care Act, provides a 50 percent nonrefundable investment tax credit for qualified investments in qualifying “therapeutic discovery projects,” which is a term with a complicated definition. The credit is available only to companies having 250 or fewer employees, and the right to claim the credit must be awarded by the Treasury company-by-company, in consultation with HHS, to companies that apply. Oh, yeah, only a total of $1 billion can be awarded. The many small details will probably bore you.

   a. **The IRS creates the program.** Notice 2010-45, 2010-23 I.R.B. 734 (5/22/10). This notice establishes the qualifying therapeutic discovery project program and provides the procedures under which an eligible taxpayer may apply for certification from the IRS of a qualified investment with respect to a qualifying therapeutic discovery project as eligible for a credit, or for certain taxpayers, a grant under the program.

7. **Leveraging the new markets tax credit is OK!** Rev. Rul. 2010-17, 2010-26 I.R.B. 769 (6/24/10). Rev. Rul. 2010-17, 2010-26 I.R.B. 769 (6/8/10). Section 45D(b) provides that an equity investment in a qualified community development entity eligible for the new markets tax credit is a qualified equity investment in cash. The IRS ruled that, consistent with the holding of Rev. Rul. 2003-20, 2003-1 C.B. 465, that an equity investment by an LLC which is funded with a nonrecourse loan to the LLC qualifies for the new markets tax credit, an equity investment includes cash from a recourse loan obtained by an LLC.

8. **Mid-audit CCA changing the IRS’s view doesn’t cut the mustard as authority to support an asserted deficiency.** The Proctor & Gamble Co. v. United States, 106 A.F.T.R.2d 2010-5433 (S.D. Ohio 6/25/10). Section 41(a)(1) allows a credit of 20 percent of the amount by which the taxpayer’s qualified research expenditures for the year exceed the taxpayer’s “base amount” of qualified research expenditures. Generally speaking, the “base amount” is the company’s “fixed base percentage” — the percentage of the company’s gross receipts expended for research from 1984 through 1988(subject to a 16 percent ceiling) — multiplied by the company’s average annual receipts for the preceding four years (but the base will not be less than 50 percent of the qualified research expenses for the credit year). Section 41(f) provides that for purposes of computing the credit, all members of the same controlled group of corporations will be treated as a single corporation. Reg. § 1.41-6(b), as well Temp. Reg. § 1.41-6T(b), which was the controlling regulation for the years in question, provides that “[t]he group credit is computed by applying all of the section 41 computational on an aggregate basis.” Pursuant to § 41(f)(5), a “controlled group” is defined by a cross reference to § 1563(a), substituting 50 percent for 80 percent, and thus should include foreign group members. In computing its credit, P&G excluded from gross receipts from intercompany transactions within its group, including transactions with foreign members. This method was acceptable to the IRS under CCA 200233011, but during the course of the audit, the IRS issued CCA 200620023, which provided that only research expenditures and not gross receipts within a controlled group should be disregarded, the position that the government maintained in the litigation. The court held that P&G had properly computed the § 41 research credit by disregarding both research expenditures and gross receipts within its controlled group. The court rejected the government’s argument that Deere & Company v. Commissioner, 133 T.C. No. 11 (10/22/09), supported its position, concluding that Deere was not relevant because specific statutory and regulatory language was controlling.
G. Natural Resources Deductions & Credits

1. **HIRE tax credits explained.** Notice 2010-35, 2010-19 I.R.B. 660 (4/26/10). The Hiring Incentives to Restore Employment Act provides for an irrevocable election to receive direct payment of otherwise allowable tax credits to holders of new clean renewable energy bonds (§ 54C), qualified energy conservation bonds (§ 54D), qualified zone academy bonds (§ 54E), and qualified school construction bonds (§ 54F) that are issued after 3/18/10. Direct Pay Tax Credit Bonds provide a federal borrowing subsidy through payment of a refundable tax credit to issuers with respect to each interest payment. The credit is the lesser of (1) the amount of interest payable, or (2) 100 percent of the interest on school construction and qualified zone academy bonds and 70 percent of the interest on clean renewable energy bonds and qualified energy conservation bonds that would have been payable if the interest were determined at the tax credit bond rate under § 54A(b)(3). The notice describes requirements for qualifying an issue as a direct pay tax credit bonds and requires issuers to elect that status the day before issue. Issuers are required to file a revised Form 8038-CP to request payment of a refundable credit. The credit will be paid contemporaneously with the applicable interest payment date of fixed rate bonds. Payments will be made quarterly with respect to variable rate bonds. The notice also specifies reporting requirements.

H. Loss Transactions, Bad Debts, and NOLs

1. **Carry me back to those long ago days of yore, when there were profits to be offset by today's NOL.** The 2009 ARRA, § 1211(b), amended Code § 172 to permit an "eligible small business" to elect to extend the carryback period for a net operating loss arising in 2008 to any number of years greater than two or fewer than six – i.e., the elected carryback period may be five, four, or three years. (Absent an election the normal two year carryback rule still applies.) An "eligible small business" is defined in § 172(b)(1)(H)(iv) (through cross references to § 172(b)(1)(F)) as a corporation, partnership, or sole proprietorship with average annual gross receipts of $15 million or less. An election under § 172(b)(1)(H) must be made by the due date (including extensions) for filing the taxpayer's return for the year the net operating loss arose (i.e., 2008). If the taxpayer is on a fiscal year, the election can be made with respect to either the taxable ending in 2008 or the taxable year beginning in 2008, but not with respect to both taxable years. § 172(b)(1)(H)(ii),(iii). The election is irrevocable.

a. **And here's instructions on how to get back to those days of yore.** Rev. Proc. 2009-19, 2009-14 IRB 747 (3/16/09). This revenue procedure provides guidance under § 1211 of 2009 ARRA, which amended § 172(b)(1)(H) to allow a taxpayer that is an eligible small business to elect a 3-, 4-, or 5-year NOL carryback for a taxable year ending after 2007.


c. **Now the carryback is available to larger businesses as well.** Section 13 of the Worker, Homeownership, and Business Assistance Act of 2009 (WHABA) amends § 172 to permit larger businesses to make the 2009 ARRA 2008 and 2009 NOL carryback election of up to five years. The election applies with respect to NOLs incurred in either 2008 or 2009, but not both years. In addition, 2008 or 2009 NOLs can be used to offset only fifty percent of the taxable income earned in the fifth prior taxable year. This 50 percent limit does not apply to carrybacks of 2008 losses by "eligible small businesses." In addition, an "eligible small business" may take advantage of the extended carryback rules with respect to both 2008 and 2009 losses, rather than the losses of only one of those years. Generally, the extended NOL carry back election is not available for TARP recipients or corporations that, at any time during 2008 or 2009 were a member of an affiliated group including a TARP recipient.

- This provision also increases the use of NOLs to offset a corporation's alternative minimum taxable income by the NOLs the taxpayer elects to carry back up to five taxable years and removes the 90 percent AMT limit.
d. More instructions. Rev. Proc. 2009-52, 2009-49 I.R.B. 744 (11/20/09). This revenue ruling provides guidance regarding procedures for making the election and its effect. The revenue procedure explains which business can elect the net operating loss carry back periods provided by WHABA.

e. Notice 2010-58, 2010-37 I.R.B. ___ (8/20/10). This notice provides guidance in Q&A format regarding twenty particular issues that have arisen regarding the election to carryback NOLs for three, four, or five years under § 172(b)(1)(H), as amended by the Worker, Homeownership, and Business Assistance Act of 2009.

2. Life for those outside the Rev. Proc. 2009-20 Madoff safe-harbor rule is tough. Vincentini v. Commissioner, T.C. Memo. 2009-255 (11/9/09). Judge Marvel held that the taxpayer could not deduct any portion of a $511,500 theft loss incurred in fraudulent investment scheme because he failed to prove that he had no reasonable prospect of recovery. The taxpayer offered no evidence regarding (1) whether he had received or would receive any restitution, (2) the status of any restitution payments, (3) the availability of funds from the substantial forfeitures ordered by the state court, (4) whether the perpetrators were judgment proof or had insufficient assets to satisfy the restitution orders, (5) that the forfeitures did not occur as ordered, or (6) that it was otherwise improbable that he would receive restitution pursuant to the restitution orders.

I. At-Risk and Passive Activity Losses

1. Limited Liability Partnership and Limited Liability Company membership interests are not presumptively limited partnership interests under the passive activity loss rules. Garnett v. Commissioner, 132 T.C. No. 19 (6/30/09). The taxpayers held a number of direct and indirect interests in limited liability partnerships and LLCs that were engaged in agribusiness. Section 469(h)(2) provides that a limited partnership interest will not be treated as an interest with respect to which a taxpayer is a material participant, except as provided in regulations. Temp. Reg. § 1.469-5T(e)(3) provides that a limited partner materially participates in a partnership activity only if (1) the taxpayer devotes more than 500 hours to the activity in the year, (2) the taxpayer materially participates in the activity for five of the preceding ten taxable years, or (6) the activity is a personal service activity in which the taxpayer materially participated for any three preceding years. defines a limited partnership interest as an interest designated as a limited partner interest in a partnership agreement or an interest for which the partner has limited liability. Temp. Reg. § 1.469-5T(e)(3)(ii) has an exception from the material participation rule for an interest of a limited partner who also holds a general partner interest. The court (Judge Thornton) concluded that in the case of an interest in a limited liability partnership or a limited liability company, both of which the court describes as different from a limited partnership, the interests are not to be treated as limited partnership interests under § 469(h)(2). Holders of such interests are not barred by state law from materially participating in the affairs of the entity and thus hold their interests as general partners within the meaning of the temporary regulations. Thus, whether or not the taxpayer is a material participant requires a full factual inquiry and an LLC member can satisfy the material participation requirement under any of the seven tests in Temp. Reg. § 1.469-5T(a).

a. The Court of Federal Claims agrees. Thompson v. United States, 87 Fed. Cl. 728 (7/20/09). The court (Judge Block) granted summary judgment treating the taxpayer member/manager of an LLC as a material participant. The taxpayer’s degree of participation was stipulated and the only question was whether § 469(h)(2) precluded treating the taxpayer as a material participant in a Texas LLC. The court noted that § 469(h)(2) treats limited partners differently because of an assumption that limited partners do not materially participate in their limited partnerships. In an LLC, on the other hand, all members have limited liability but members may participate in management. The court noted that Temp. Reg. § 1.469-5T(e)(3) treats a partnership interest as a limited partner interest if the holder has limited liability “under the law of the State in which the partnership is organized.” The court held that the quoted language applies only to an entity that is a partnership under state law, which does not include an LLC that is a different state law entity that is treated as a partnership for tax purposes. The
taxpayer was both a member and manager of the LLC. Unlike a limited partner, a member manager does not lose limited liability by participation in the management of the LLC. The court also recognized that shareholders of an S corporation have limited liability as shareholders, but participate in management, and are not subject to being automatically treated as passive participants. The taxpayer, therefore, was “able to demonstrate his material participation in the activity by using all seven of the Temp. Reg. § 1.469-5T(a) tests.”


c. Ditto again. Newell v. Commissioner, T.C. Memo. 2010-23 (2/16/10). Relying on Garnett v. Commissioner, supra, Judge Marvel held that the interest of a managing member of a California LLC was not a limited a partnership interest for purposes of Reg. § 1.469-5T(c)(1). Taxpayer’s losses were not passive activity losses because the IRS conceded that the taxpayer met the “significant participation” test of Temp. Reg. § 1469-5T(a)(4).


2. Deciding on whether to uphold the Commissioner’s rejection of this horse lover’s losses is like pulling teeth. Cunningham v. Commissioner, T.C. Memo. 2009-194 (8/31/09). The taxpayer, a New York dentist, claimed losses from five partnership horse activities in California on returns prepared by a tax return preparer. The court (Judge Cohen) found that the taxpayer had no knowledge of whether or not the horse activities occurred as represented in the partnership returns. He relied on representations by the return preparer in deducting the partnership losses against their other income. The taxpayer’s suggestion that the court Google the return preparer to ascertain that the taxpayer was mislead by a charlatan and that paying the tax would result in financial hardship did not impress Judge Cohen, and the deficiency was upheld. The court also rejected the taxpayer’s argument that he had reasonable cause for failing to file a timely return and imposed penalties under § 6651(a)(1).

3. Reporting self-help slicing, dicing, gluing, and pasting of passive activities. Tell the IRS about grouping trade or business activities. Rev. Proc. 2010-13, 2010-4 I.R.B. 329 (1/6/10). This revenue procedure requires taxpayers to report to the IRS their groupings and regroupings of activities and the addition of activities within their existing groupings of activities under Reg. § 1.469-4(c) for purposes of § 469. A written statement must be filed with the original income tax return for the first taxable year in which two or more trade or business activities or rental activities are originally grouped as a single activity. The statement must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss under § 469. A similar statement must be filed with a return for first taxable year of a regrouping or the taxable year in which a new trade or business activity or a rental activity to an existing grouping. A partnership or S corporation must disclose as required on the entity’s tax return and by separately stating the amounts of income and loss for each grouping, and a partner or shareholder is not required to make a separate disclosure unless the partner or shareholder (1) groups together any of the activities that the entity does not group together, (2) groups the entity’s activities with activities conducted directly by the partner or shareholder, or (3) groups the entity’s activities with activities conducted through other entities.

A taxpayer is not required to file a report of groupings in existence prior to the 1/25/10 effective date of the revenue procedure.

a. Contrary to Jackie Gleason, this was not a “good group.” Grouping activities under § 469 requires an explicit election, not merely a reporting position. Trask v. Commissioner, T.C. Memo. 2010-78 (4/15/10). The taxpayer failed to make an explicit election on his return to aggregate rental real estate activities as required by Reg. § 1.469-9(g). the Tx Court (Judge Goeke) held that merely aggregating real estate rental activity losses on his returns was not an effective election. Thus, although the taxpayer established that he was a “real estate professional” as defined in § 469(c)(7), all of the claimed losses were disallowed because he failed to prove that he materially participated any of the rental activities on an activity-by-activity basis.

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b. Elect to aggregate, or be segregated. Shiekh v. Commissioner, T.C. Memo. 2010-126 (6/10/10). On facts substantially similar to the facts in Trask, the Tax Court (Judge Wells) reached a similar result. The taxpayer materially participated in the operation of rental properties in Miami Beach, Florida, and owned additional properties including properties in Ventura and Culver City, California. The taxpayer did not file the election required by § 469(c) which would have allowed the taxpayer, as a real estate professional, to aggregate all of his real estate activities into a single activity for purposes of treating all of the real estate income and losses as active. The Tax Court (Judge Wells) held that aggregating properties on a return filed in the year the taxpayer claimed ordinary loss on the sale of his Ventura property was not adequate notice of an election to aggregate properties under Reg. § 1.469-9(g)(3). The taxpayer was found not to be a material participant with respect to his Ventura and Culver City properties. The taxpayer was allowed to reduce capital gain in the year he sold the Ventura property by expenses incurred in the year of sale.

4. A song and a dance doesn't make the law practice a professional real estate business, but renting your building to the law practice is active. Langille v. Commissioner, T.C. Memo. 2010-49 (3/18/10). The taxpayer Deanna Langille, formerly known as Deanna Birdsong, worked long hours in her law practice and devoted somewhat less of her time to her rental real estate activities. Unfortunately for the taxpayer she resigned from her law practice in lieu of disciplinary proceedings implemented for misappropriation of funds from her firm's client trust accounts. To make matters worse, after an unsuccessful negotiation for the sale of her law practice, the potential buyer reported to the IRS that the taxpayer maintained two sets of books for the practice, which resulted in a criminal investigation and a guilty plea to one count of a tax fraud indictment. In the civil tax matter the Tax Court (Judge Gustafson) found that the taxpayer willfully failed to report income from her law practice and residential real estate rental activities (from which she had no profit). The taxpayer was unable to establish the number of hours she worked on her residential real estate activities and thus was unable to establish herself as a real estate professional under the 50 percent of all personal services requirement of § 469(c)(7)(B)(i) or that she satisfied the 750 hour requirement of § 469(c)(7)(B)(ii). In addition, the court held that income from the taxpayer's rental of office space to her law practice in which she was a material participant was not passive activity income under Reg. § 1.469-2(f)(6).

5. An activity log that reflects work days in excess of 24 hours isn't very credible (unless you were on an airplane to the West Coast). Goolsby v. Commissioner, T.C. Memo. 2010-64 (4/1/10). The taxpayers owned several rental real estate properties with respect to which they claimed net losses. The IRS disallowed the losses as passive activity losses, and the taxpayers claimed that one of them spent more than 750 hours a year managing the properties and that under the § 469(c)(7)(B) real estate professional rule, the losses were treated as active business losses. Judge Wells rejected the taxpayers' arguments. He found that the activity log purporting to document the hours of management activity was not credible. It was created after the taxpayers' return was selected for audit and solely for purposes of the case in controversy. The taxpayers “presented no evidence of contemporaneous records, such as appointment books, calendars, or narrative summaries, that would credibly support the ... activity log. Incredibly, the ... activity log lists days during which [the taxpayer] allegedly logged more than 24 hours of work.”

6. New market tax credits are not treated as passive activity credits. Rev. Rul. 2010-16, 2010-26 I.R.B. 769 (6/8/10). Section 45D provides a new market credit for an equity investment in a qualified community development entity, an entity that invests in or loans money to a qualified active low-income community business, purchases loans from another qualified community development entity, provides financial counseling to residents of low-income communities, or loans money or makes an equity investment in a qualified community development entity. A qualified community development entity does not itself need to be engaged in a trade or business. Thus, the Ruling concludes that when an individual acquires an equity investment in a qualified community development entity that is not in connection with the conduct of a trade or business by the individual, § 45D credits are not passive activity credits under § 469(d)(2) because a passive activity is defined in § 469(c) as an activity that is a trade or
business in which the taxpayer does not materially participate. The ruling also concludes that new market credits derived from acquisition of an equity interest in a qualified community development entity by a partnership that is not in connection with the partnership’s conduct of a trade or business are not passive activity credits.

7. Here’s an example of why Tax Court Summary Opinions aren’t and shouldn’t be precedential. Ajah v Commissioner, T.C. Summ. Op. 2010-90 (7/8/10). This otherwise unremarkable summary opinion, denying the taxpayer’s claim that he rental real estate losses from two properties were not subject to the § 469 passive activity loss rules because she was real estate professional under § 469(c)(7) is notable only for a glaring error of law that likely did not affect the outcome, but demonstrates that some decided cases contain statements that are just flat out wrong and should be ignored. The taxpayer was held not to qualify because her “method of calculating her time spent participating in the rental activities constitutes an impermissible ‘ballpark guesstimate’” that under Temp. Reg. § 1.469-5T(f)(4) was not an acceptable method of establishing her participation. She had no records and simply testified that she worked at least 20 hours a week for 52 weeks on the two rental properties. Not content to stop there, the judge continued by finding that the taxpayer had failed to properly aggregate the two rental properties into a single activity because merely aggregating items on Schedule E is insufficient – a point on which he was correct – and then concluding that because she had not aggregated the activities, to qualify as a real estate professional under § 469(c)(7)(B) she “would need to perform 750 hours of service for each rental real estate interest for a total of 1,500 hours to meet the test” – a conclusion that every kindergartner knows is not what is required by the statute.

- Section 469(c)(7)(B)(ii) requires that “such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.” This language clearly means that the 750 hours requirement refers to the aggregate number of hours in all real property trades or businesses in which the taxpayer materially participates and is not a property-by-property requirement. Only material participation is determined on a property-by-property basis, except with respect to those properties. Trask v. Commissioner, T.C. Memo. 2010-78 (4/15/10), which was cited in this case as the basis for the errant holding, did not so hold. A careful reading of Trask indicates that in that case the taxpayer who was able to prove that he devoted more than one-half of his time and more than 750 hours of total time to managing over thirty rental properties he was held to qualify as a real estate professional under § 469(c)(7)(B), but because he failed properly to elect to treat all of his rental properties as a single activity for purposes of § 469(c)(7)(A) and he “did not contend that he materially participated in each of his rental activities when viewed separately,” he did not qualify for the exception. Section 467(c)(7) removes from the passive activity basket only those rental activities in which the real estate professional materially participates.

8. Estate of K. Roberts v. Commissioner, T.C. Memo. 2010-165 (7/21/10). The deceased taxpayer was the sole owner of a leasing LLC organized for the purpose of leasing trucking equipment to the taxpayer’s solely owned S corporation. The taxpayer “lent” the LLC $425,000 for a promissory note. The LLC issued a cashier’s check in the same amount which was used to fund a portion of the $1.4 million purchase price of a luxury RV. The court (Judge Goeke) found that the RV was not used by the LLC in its leasing activity and therefore the taxpayer was not at-risk under § 465 for the contribution to the LLC because the funds were not borrowed for use “in an activity” as required by § 465(b)(2).

9. Stangeland v. Commissioner, T.C. Memo. 2010-185 (8/16/10). The deceased taxpayer was an investor in numerous business enterprises, all of which were independently managed. One of the businesses, R&L Air, L.L.C. was formed to own and lease two airplanes. The airplanes were managed by a third party under contract. The taxpayer also maintained a consulting business as a sole-proprietor to help manage his businesses. He worked approximately 50 hours per week for the consulting business. The taxpayer periodically leased the R&L airplanes for use in his consulting business and also used the airplanes in the course of charitable activities and in pursuit of private investment activities. The court (Judge Cohen) first held that the taxpayer’s consulting activities did not constitute a trade or business but described
the consulting activity as being engaged to increase the value of the taxpayer’s numerous investments. The court thus disallowed deductions of expenses incurred in the consulting activity. The court also rejected the taxpayer’s argument that the consulting business should be combined with the airplane leasing business as a single activity in which the taxpayer participated for more than 500 hours. To combine the two activities under Reg. § 1.469-4(c), both must be found to constitute a trade or business, a test which the consulting activity failed. The court also rejected the taxpayer’s argument that his participation in the two activities qualified under the significant participation test of Reg. § 1.469-5T(a)(4), again because the consulting activity failed to qualify as a trade or business. However, for one of the three tax years at issue, the court found that the taxpayer participated in activities of various businesses for more than 500 hours and in the activities of the airplane leasing activity for at least 100 hours, and that the losses from the airplane leasing activity were not passive activity losses for that year.

10. Time off from the nuclear power plant is not being a real estate professional. Moss v. Commissioner, 135 T.C. No. 18 (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.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. Gross income without cash upon surrender of life insurance policy with outstanding policy loans. Barr v. Commissioner, T.C. Memo. 2009-250 (11/3/09). When an insurance company withholds from the cash surrender value of a life insurance policy amounts necessary to repay policy loans, the withheld amount is constructively realized by the owner of the policy and is included in the amount taxable under § 1033.

2. 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 supplied Pizza Hut with pre-cooked sausage prepared with the taxpayer’s patented process. The taxpayer 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 who also sold pre-cooked sausage to Pizza Hut, the taxpayer recovered damages from Pizza Hut for misappropriation of trade secrets. The court (Judge Chiechi) held that the damages were received as compensation for lost profits, and thus were taxable as ordinary income. The court rejected the taxpayer’s argument that the damages were for injury to or destruction of the trade secret, a capital asset.

3. 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 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

5. Ex-post recharacterization is not an option for taxpayers. United States v. Bergbauer, 602 F.3d 569 (4th Cir. 4/16/10). The Fourth Circuit affirmed a summary judgment for the government in an erroneous refund suit. The taxpayer exchanged her

4. Question: When is the amount for which you could sell something much less than its value for determining a bargain purchase? Answer: When it's a whole life insurance policy sold from a pension plan to the insured plan participant. Matthies v. Commissioner, 134 T.C. No. 6 (2/22/10). Pursuant to a prearranged plan, the taxpayer rolled over approximately $1.3 million from an IRA to a profit sharing plan; the profit sharing plan then purchased a life insurance policy on the insured for $1.3 million and sold the policy to the taxpayer for approximately $300,000; and the taxpayer transferred the life insurance policy to a trust for estate planning purposes. At the time of the sale of the policy from the profit sharing plan to the taxpayer, the life insurance policy had an "account value" of approximately $1.3 million, but was subject to a "surrender charge" of approximately $1,000,000, thereby reducing its cash surrender value to approximately $300,000. The surrender charge would diminish over time and be completely phased out after 20 years. The IRS asserted that the taxpayer recognized $1,000,000 of income on the bargain purchase because it was not an arm's length transaction, and Judge Thornton agreed with the IRS. First, he found that on the facts, the transaction was not arm's length because the only trustees of the profit sharing plan were the taxpayer and his wife. Turning to the valuation issue, Judge Thornton rejected the taxpayer's argument that the value of the insurance policy was its cash surrender value, which was equal to the amount the taxpayer paid the profit sharing plan for the policy. He reached the same result as the IRS, but via a slightly different road. Judge Thornton concluded that under §§ 402 and 72(e), the amount of a distribution in the form of a life insurance policy is the cash surrender value determined without any surrender charges, rather than the new surrender value. Finally, he concluded that the excess of the cash surrender value determined without any surrender charges, minus the amount paid by the taxpayer - approximately $1,000,000 - was gross income under § 61.
partnership interest in Ernst & Young for stock of Cap Gemini, a corporation acquiring E&Y’s consulting business, in a transaction that was not a statutory nonrecognition event; however, the stock was held in escrow to enforce a forfeiture provision if the seller-taxpayer failed to perform certain services as an employee of the acquiring corporation. The taxpayer initially reported that all of the Cap Gemini shares received vested in the year 2000 (the year of the exchange), but after the stock declined in value took the position that income was realized in 2000 only to the extent of cash received in that year and the remainder of the income was recognized in 2003 (when the stock was worth less than one-fifth of its 2000 value). The court held that if a taxpayer exchanges one property for a different property, the gain realized on the exchange must be recognized in the year the exchange occurs, even though the property received in the exchange is forfeitable if contractual provisions or representations in the contract for exchange are not subsequently satisfied and even though the property received in the exchange is held in escrow to assure enforcement of the forfeiture provisions. Furthermore, the court refused to accept the taxpayer’s argument that the transaction could be recast into a form different than that which it had taken.

To put it plainly, we have bound taxpayers to “the ‘form’ of their transaction” when they attempt to recharacterize an otherwise valid agreement bargained for in good faith. [citation omitted] We have also refused to entertain arguments “that the ‘substance’ of their transaction triggers different tax consequences.” [citation omitted] This precept not only maintains the vital public policy of enforcing otherwise valid contracts, but also assures the reliability of agreed tax consequences to the public fisc. ...

There is no “disparity” in allowing “the Commissioner alone to pierce formal” agreements as “taxpayers have it within their own control to choose in the first place whatever arrangements they care to make.” [citation omitted]


6. **When does a debt instrument that has in effect become a proprietary interest because the creditor is insolvent remain a debt instrument?** REG–106750–10. Notice of Proposed Rulemaking and Notice of Public Hearing, 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 not 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 (e) (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)

7. Should the name of the promoter of this tax scam been “Devious,” instead of “Derivium?” Calloway v. Commissioner, 135 T.C. No. 3 (7/8/10) (reviewed). In 2001 the taxpayer entered into an agreement with Derivium Capital LLC pursuant to which he transferred 990 shares of IBM common stock to Derivium under its 90-percent-stock-loan program. The terms of the agreement characterized the transaction as a loan, with the IBM stock pledged as collateral. (Derivium was not registered with the New York Stock Exchange or the National Association of Securities Dealers/Financial Industry Regulatory Authority.) The purported loan was nonrecourse; interest accrued but was not payable until maturity; all dividends were applied against interest due; prepayment during the 3-year term of the purported loan was prohibited. The terms of the agreement allowed Derivium to sell the stock and retain the proceeds, which it did immediately upon receipt, receiving $103,918.18. The taxpayer received $93,586.23 from Derivium, the amount of the payment being determined, and payment being made, only after Derivium had sold the stock. Upon maturity of the ‘loan,” the taxpayer had the option of (1) paying the balance due and having an equivalent amount of IBM stock returned to him, (2) renewing the purported loan for an additional term, or (3) satisfying the “loan” by surrendering any right to receive IBM stock. At maturity in August 2004 the balance due was $124,429.09, which was $40,924.57 more than the then $83,318.40 value of the IBM stock. (Derivium had credited against the accrued interest the amount of dividends that would have been received had the stock not been sold, but the taxpayer never received a Form-1099-DIV or included any dividends in income.) The taxpayer elected to satisfy his purported loan by surrendering any right to receive IBM stock. The taxpayer never made any payments toward either principal or interest on the purported loan. Citing Commissioner v. Court Holding Co., 324 U.S. 331 (1945), and Gregory v. Haltering, 293 U.S. 465 (1935), for the proposition that substance controls over form, the Tax Court, in a reviewed opinion by Judge Ruwe (with no dissents but Judges Halpern, Wherry, and Holmes concurring in result only), held that the 2001 transaction between taxpayer and Derivium was a sale, not a loan, under the test factors set forth in Groot & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221(1981). The taxpayer had transferred all the benefits and burdens of ownership of the stock to Derivium. Legal and equitable title, as well as possession and control of the stock were transferred in exchange for $93,586.23 with no obligation to repay that amount. “At best [the taxpayer] had an option to purchase an equivalent number of IBM shares after 3 years at a price equivalent to $93,586.23 plus ‘interest.” The transaction was not a true loan because “[f]or a transaction to be a bona fide loan the parties must have actually intended to establish a debtor-creditor relationship at the time the funds were advanced.” There was no such intent. After the 2001 transaction the taxpayer never treated the transaction as a loan; in 2004 he did not report either a sale of the stock or cancellation of debt income, positions which were inconsistent with treating the transaction as loan. Because Derivium was not acting as a broker, the court also rejected the taxpayer's argument that the transaction was analogous to the securities lending arrangement in Rev. Rul. 57-451, 1957-2 C.B. 295, which held that no sale occurred when the owner of stock deposited shares with a broker who could lend the securities until such time as the shareholder received from the broker property other than identical securities. Nor was the transaction equivalent to a securities lending arrangement under § 1058, because the agreement did not meet the requirements of that provision, which under Samueli v. Commissioner, 132 T.C. 37 (2009), requires that the transferor of the stock retain “all of the benefits and burdens of ownership of the transferred securities” and the right to “be able to terminate the loan agreement upon demand.” Because the taxpayer could not regain possession of the stock for three years, his opportunity for gain was diminished.

- Section 6662 accuracy related penalties were sustained.
Judge Hapem's concurring opinion emphasized that the Grodt & McKay Realty, Inc. test, while appropriate for determining whether there had been a sale of property that was not fungible, were not useful in the of fungible property, such as corporate stock. It was enough for him that the taxpayer "gave Derivium the right and authority to sell the IBM common stock in question for its own account, which Derivium in fact did."

Holmes's concurring opinion emphasized that the majority's test for a sale was too broad and could be applied to treat too wide a range of collateralized nonrecourse loan arrangements as sales. He concluded that the majority erred in treating the taxpayer's transfer of the stock to Derivium and Derivium's subsequent sale of the stock as one integrated transaction, because Derivium had represented to its customers that it would hold the stock and never told them of the quick sale. Instead, he would have treated Derivium's sale of the stock as the event triggering recognition by the taxpayer, under the Tufts principle that "when a nonrecourse liability is discharged by sale of collateral, the borrower must recognize income at that point – the amount realized is the amount of nonrecourse liability discharged as a result of the sale," since Reg. § 1.1001-2(a)(4)(i) provides that "the sale ... of property that secures a nonrecourse liability discharges the transferor from the liability." He recognized that under his analysis, "the tax consequences to Calloway would be remarkably similar to those flowing from the result reached by the majority."

The Tax Court majority opinion noted in a footnote that other cases involving Derivium transactions are pending in the Tax Court. From 1998 to 2002 Derivium engaged in approximately 1,700 similar transactions involving approximately $1 billion. The Government estimated the total tax loss associated with Derivium's scheme to be approximately $235 million.


b. Does this case make Monty Python "substantial authority"?

Shao v. Commissioner, T.C. Memo. 2010-189 (8/26/10). As in Calloway v. Commissioner, 135 T.C. No. 3 (7/8/10), the taxpayer in this case engaged in transaction with Derivium Capital under its "90-percent-stock-loan program." In this case, however, the taxpayer conceded that she had sold her stock and the only issue was whether the § 6662 accuracy related penalty the IRS asserted would be upheld. The taxpayer asserted a reasonable cause and good faith defense to the penalty, and the Tax Court (Judge Holmes) agreed with the taxpayer. The court reasoned as follows.

In Shao's case we don't find the circumstances that led the Court to penalize Calloway – there is no evidence of a wink-wink-nudge-nudge-say-no-more arrangement with Derivium. See Monty Python's Flying Circus: How To Recognise Different Types of Trees From Quite a Long Way Away (BBC1 television broadcast Oct. 19, 1969). Shao had legitimate, nontax motivations for wanting to structure her deal as a loan instead of a sale-she wanted to reduce risk and use some of the stocks' value without selling her nest egg. Her naivete, but not (we expressly find) her negligence, is especially prominent in her renewal of the loan at a steep price after three years. Unlike Calloway, Shao treated her transaction like a loan throughout its existence, proving her good faith.

When all is said and done, the sum of the parts of the deal was really a current sale of stock. Anschutz Co. v. Commissioner, 135 T.C. No. 5 (7/22/10), An S corporation, through a Q-Sub (TAC) entered into transactions with Donaldson, Lufkin & Jenrette Securities (DLJ) involving appreciated stock that it owned. The agreements were memorialized by a master stock purchase agreement (MSPA) that included "Prepaid Variable Forward
Contracts” (PVFCs) and share-lending agreements (SLAs) with respect to the shares subject to the PVFCs. The PVFCs required DLJ to make an upfront payment to TAC in exchange for a promise by TAC to deliver a variable number of shares to DLJ in ten years. The amount of the payment was 75 percent of the fair market value of the shares subject to the PVFCs. If the stock subject to the PVFCs appreciated over the term of the contract, TAC was entitled to retain 50 percent of the appreciation, and the remainder accrued to DLJ. TAC pledged the shares of stock at issue in the PVFCs as collateral for the upfront payment and to guarantee TAC’s performance under the PVFC. The pledged shares were delivered to a trustee. Before each stock transaction DLJ executed short sales of that stock in the open market. After TAC lent shares to DLJ pursuant to the SLAs, DLJ used the shares to close out the short sales. TAC received upfront payments under the PVFCs totaling $350,968,652 and $23,398,050 in prepaid lending fees under the SLAs.

The taxpayer claimed that TAC executed two separate transactions—PVFCs and SLAs—and neither constituted a current sale for tax purposes, relying, in part, on § 1058. The Tax Court (Judge Goeke) agreed with the IRS that the shares subject to the PVFCs and lent pursuant to the SLAs were sold for income tax purposes. The transaction consisted of two integrated legs, one of which called for share lending, but the two legs were clearly related and interdependent. Analyzing the MSPA as a whole, in exchange for valuable consideration TAC transferred to DLJ the benefits and burdens of ownership, including (1) legal title to the shares; (2) all risk of loss; (3) a major portion of the opportunity for gain; (4) the right to vote the stock; and (5) possession of the stock. Although the SLAs provided that TAC could terminate share loans and recall the shares, in reality any share recalls were really TAC borrowing shares from DLJ. Because DLJ closed out its original short sales with the lent shares, the shares later transferred to TAC were in substance DLJ borrowing shares from third parties and delivering them to TAC. Gain was recognized with respect to the upfront cash payments received in the transactions. The taxpayer’s reliance on § 1058 was rejected because it relied on the argument that the PVFCs were separate from the SLAs. The MSPA violated the requirement of § 1058(b)(3) that the agreement not limit the lender’s risk of loss or opportunity for gain, because the agreements eliminated TAC’s risk of loss with regard to the lent shares.

On the bright side ©, Judge Goeke rejected the IRS’s alternative argument that the transactions were also either a constructive short sale by TAC under § 1259(c)(1)(A) or a constructive forward contract sale under § 1259(c)(1)(C). TAC did not enter into any short sale because DLJ was acting as a principal and not as an agent in making the short sales. The transactions were not forward contract constructive sales because they were not forward contracts as defined in § 1259(d)(1) in that they did not provide for delivery of a substantially fixed amount of property for a substantially fixed price.

9. **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 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.
B. Interest, Dividends, and other Current Income

C. Profit-Seeking Individual Deductions

1. Dang that AMT. Gralia v. Commissioner, T.C. Memo. 2009-219 (9/21/09). The taxpayer diverted funds from an S corporation in which another shareholder held a minority interest, and by which both shareholders were employed. When the minority shareholder sued him, the taxpayer settled the suit by paying substantial damages. Judge Halpern held that the damage payments, as well as the taxpayer’s attorney’s fees to defend the suit, were deductible only as either § 212 expenses or employee business expenses under § 162, and thus were miscellaneous itemized deductions. Because the taxpayer was in the AMT, no tax savings resulted from the deductions.

2. 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.

D. Section 121

1. “Congress intended the terms ‘property’ and ‘principal residence’ to mean a house or other dwelling unit in which the taxpayer actually resided.” Gates v. Commissioner, 135 T.C. No. 1 (7/1/10) (reviewed, 8-5). The married taxpayers had owned and occupied a house as a principal residence for at least two years. They wanted to enlarge and remodel the house but were advised by an architect that more stringent building and permit restrictions had been enacted since the house was built. In 1999, rather than remodel the house, they completely demolished it and constructed a new house on the property. The taxpayers never occupied the new house, and in 2000 they sold it for $1,100,000, realizing a gain of $591,406. They claimed that $500,000 of the gain was excludable under § 121, but the IRS took the position that they did not qualify for the § 121 exclusion because they had never occupied the new structure and it thus never was their “principal residence,” even though it occupied land on which had been located their former principal residence. The IRS’s argument interpreted “the term ‘property’ [in § 121(a)] to mean, or at least include, a dwelling that was owned and occupied by the taxpayer as his ‘principal residence’ for at least 2 of the 5 years immediately preceding the sale.” The taxpayers argued that the term “property” in § 121(a) includes not only the dwelling but also the land on which the dwelling is situated, and that the requirements of § 121(a) are satisfied if the taxpayer lived in any dwelling on the property for the required 2-year period, even if that dwelling is not the dwelling that was sold. Under this theory, because they used the original house and the land on which it was situated as their principal residence for the required term, the land and building that were sold qualified as their principal residence. Finding that the statute did not define the terms “property” and principal residence,” the Tax Court in a divided (8-5) opinion by Judge Marvel looked to dictionaries and the legislative history for guidance. After examining the background of § 121, including its statutory predecessors, former § 1034 and its predecessor in the 1939 Code, the majority held that:

Congress intended the term “principal residence” to mean the primary dwelling or house that a taxpayer occupied as his principal residence. ... Although a principal residence may include land surrounding the dwelling, the legislative history supports a conclusion that Congress intended the section 121 exclusion to apply only if the dwelling the taxpayer sells was actually used as his principal residence for the period required by section 121(a).

- The majority found further support for its conclusion in the case law under former § 1034.
- In a footnote the court’s opinion noted that Reg. § 1.121-1(b)(3), as currently in effect allows gain from the sale of land alone to qualify under § 121 if the
taxpayer also sells “a ‘dwelling unit’ that meets the requirements under sec. 121 within 2 years before or after the sale of the land.”

- A concurring opinion by Judge Cohen (in which 6 other members of the majority joined) noted that the taxpayers did not argue in the alternative for a partial exclusion of gain attributable to the sale of the land and did not introduce any evidence that would have permitted the court to allocate gain between the new house and the land.

- The dissent by Judge Halpern would have allowed the exclusion, treating the demolition and reconstruction no differently from a renovation. It expressed concern that drawing the line between a “remodeling,” which presumably would not start the 2-year clock running anew and a “rebuilding,” which under the majority opinion does start the 2-year clock running anew is a difficult line to draw: “is there some level of remodeling that does (1) terminate the use of the home as the taxpayer’s principal residence, and (2) set the temporal clock to zero?”

E. Section 1031

1. “[I]t appears that these transactions took their peculiar structure for no purpose except to avoid § 1031(f),” Teruya Bros., Ltd. v. Commissioner, 580 F.3d 1038 (9th Cir. 9/8/09), aff’g 124 T.C. 45 (2005). The taxpayer transferred properties to a qualified intermediary, who sold them to unrelated third parties and used the proceeds to purchase like-kind replacement property from a related party. In the Tax Court, Judge Thornton held that the transactions were economically equivalent to direct exchanges between the taxpayer and related party, followed by the related party’s sale of the properties to unrelated third parties, and that they were structured to avoid the purposes of § 1031(f). He further held that taxpayer failed to prove that avoidance was not one of the principal purposes of the transactions under the § 1031(f)(4) exception. The taxpayer argued that even though more gain was recognized by the related party on some of the properties, the only tax consequences of the gain recognition were reduction of the related party’s net operating loss — as opposed to current taxation for taxpayer. The Ninth Circuit affirmed the Tax Court’s decision, stating, “it appears that these transactions took their peculiar structure for no purpose except to avoid § 1031(f); “Teruya could have achieved the same property dispositions through far simpler means.”

2. Don Quixote tilted at the windmill and deflected only the penalty, not the deficiency. Ocmulgee Fields, Inc. v. Commissioner, 132 T.C. No.6 (3/31/09). This opinion by Judge Halpern applied § 1031(f) to deny tax-free like-kind exchange treatment in the following situation: (1) The taxpayer transferred appreciated real property (Wesleyan Station) to a qualified intermediary, who sold them to unrelated third parties and used the proceeds to purchase like-kind replacement property from a related party; (2) an unrelated third party purchased the Wesleyan Station property from the qualified intermediary for cash; (3) a partnership related to the taxpayer sold like-kind property (Barnes & Noble Corner) to the qualified intermediary for cash; and (4) the qualified intermediary transferred the like-kind Barnes & Noble Corner property to the taxpayer. But for the application of § 1031(f), the exchange with the qualified intermediary would have qualified for § 1031 nonrecognition. The taxpayer, who wanted the replacement property to be in the same general geographic area, i.e., middle Georgia, as the surrendered property, argued that the reason for the acquisition of replacement property from a related person was that it was unable to locate a suitable replacement property within the time limits imposed on deferred like-kind exchanges by § 1031(a)(3) and Reg. § 1.1031(k)-1(b). A careful reading of the facts, however, reveals that the taxpayer entered into the agreement to acquire the replacement property only five days after the relinquished property was sold and actually closed the purchase before the 45-day identification period had even lapsed. As argued by the Commissioner, Judge Halpern held that § 1031(f)(4) required recognition because the taxpayer had “structured” the transaction “to avoid the purposes” of the rule of § 1031(f) denying non recognition for an exchange to a related person if the transferee sells the property within two years. Based on the legislative history, he concluded that the “basis shifting” that resulted from the transaction “suppl[ied] the principal purpose of tax avoidance.” The basis shift effected an approximately $1.8 million reduction in taxable gain, because if the related party had acquired Wesleyan Station from the taxpayer in a like-kind exchange for Barnes & Noble Corner, the related party’s substituted basis in Wesleyan Station, which in the taxpayer’s hands was only around $716,164,
would have been $2,554,901 (equal to the related person’s basis in Barnes & Noble Comer). In addition, if § 1031 applied, the gain on the sale of Wesleyan Station would have been taxed at only 15 percent, the applicable rate for capital gains taxed to the partners of the related partnership, instead of the 34 percent rate that would have applied had the taxpayer sold the property. Judge Halpern further found the case to be substantially similar to Teruya Bros., Ltd. & Subs. v. Commissioner, 124 T.C. 45 (2005), in which the taxpayer transferred properties to a qualified intermediary, who sold them to unrelated third parties and used the proceeds to purchase like-kind replacement property from a related party. In Teruya Bros., Judge Thornton held that the transactions were economically equivalent to direct exchanges between the taxpayer and related party, followed by the related party’s sale of the properties to unrelated third parties, and that they were structured to avoid the purposes of § 1031(f). The taxpayer argued that unlike the taxpayer in Teruya Bros., it did not have a prearranged plan to use property from a related person to complete a like-kind exchange, but Judge Halpern found that the presence of the prearranged plan in Teruya Bros. was not a critical element of the holding in that case. Nevertheless, the taxpayer avoided the § 6662 negligence penalty because (1) the return reporting the transaction as a § 1031 like-kind exchange was prepared by an accountant with extensive experience in representing real estate developers, (2) the accountant was aware of all relevant facts, and (3) when the taxpayer filed its return, the Tax Court had not yet decided Teruya Bros., and while Rev. Rul. 2002-83, 2002-2 C.B. 927 (presaging the result in Teruya Bros.) had been issued, Judge Halpern did “not think that the ruling left the result free from doubt.”

a. “Congress enacted § 1031(f) because of its disapproval of taxpayers’ use of § 1031 to cash-in on a low-basis investment property, but to pay taxes as if it were cashing in on the high basis property; here, Ocmulgee Fields and Treaty Fields cashed in on the low-basis property, Wesleyan Station, but paid taxes only on the gains from Treaty Fields’ sale of the high-basis property, the Barnes & Noble Comer.” Ocmulgee Fields, Inc. v. Commissioner, 2010-2 U.S.T.C. ¶50,565, 106 A.F.T.R.2d 2010-___ (11th Cir. 8/13/10). In an opinion by Judge Ebel, the Eleventh Circuit affirmed the Tax Court’s decision. The court characterized the taxpayer’s argument as being based on the proposition that neither it nor the related party “had any intent to circumvent the purposes of § 1031(f),” which it described as a challenge to the Tax Court’s fact finding that the taxpayer “engaged in a series of transactions structured to avoid the related party rules, cash in on its investment in Wesleyan Station, and avoid taxation,” and affirmed because the Tax Court’s finding was not clearly erroneous. The court found evidence of the taxpayer’s intent in the use of the a qualified intermediary in a multi-cornered exchange, stating that,

[W]e can look to the unneeded complexity in the series of transactions to help us in inferring Ocmulgee Fields’ intent. ... Ocmulgee Fields could have achieved the same result by simply engaging in a direct exchange of property with Treaty Fields, and Treaty Fields could have then sold Wesleyan Station ... . If Ocmulgee Fields had taken this approach, however, § 1031(f)(I) would have automatically disallowed nonrecognition treatment for the exchange because Treaty Fields disposed of Wesleyan Station within two years of the exchange.

• The court rejected the taxpayer’s argument that the related party exchange was “merely a fall-back position,” because that argument was inconsistent with the fact that the taxpayer had examined only a small number of alternative properties and entered into the transaction after only six days.

3. I woulda completed my like-kind exchange, but the QI went belly-up. Can you help me Mr. Commish? No; unfortunately, there is no relief which would allow the taxpayer to complete the § 1031 exchange. Rev. Proc. 2010-14, 2010-12 I.R.B. 456 (3/5/10). This revenue procedure provides a safe harbor method for reporting gain or loss by taxpayers who are unable to complete deferred like-kind exchange solely because the QI has defaulted on its obligation to acquire and transfer replacement property as a result of the QI’s bankruptcy or receivership under federal or state law, provided three additional conditions have
been met. The taxpayer must have (1) transferred the relinquished property to a QI in accordance with Reg. § 1.1031(k)-1(g)(4); (2) properly identified replacement property within the identification period (unless the QI’s default occurs during that period); and (3) not actually or constructively receive any proceeds from the disposition of the relinquished property (excluding the QI’s assumption of debts on the relinquished property) before the QI entered bankruptcy or receivership. Under the safe-harbor, the taxpayer may report gain under a “safe harbor gross profit ratio method” provided in the revenue procedure, which is essentially the §453 installment method. However, unlike normal §453 installment reporting, §1245 and §1250 recapture gain may be reported under the “safe harbor gross profit ratio method”; however, depreciation recapture income is recognized before any §1231 or capital gain is recognized. Interest must be imputed under §483 or §1274, as appropriate. For this purpose, the taxpayer is treated as selling the relinquished property on the date of the confirmation of the bankruptcy plan or other court order that resolves the taxpayer’s claim against the QI. Thus, if the only payment in full satisfaction of the taxpayer’s claim is received by the taxpayer on or before the date that is six months after the safe harbor sale date, then no interest is imputed. If a loss is realized, the timing of a loss deduction is governed by normal §165 principles.

- We think this could result in open transaction treatment for loss recognition.

4. The April’s Fool joke is on the taxpayer. Goolsby v. Commissioner, T.C. Memo. 2010-64 (4/1/10). A residence acquired in an exchange was not property held for investment or for use in a trade or business and the exchange of the surrendered property did not qualify for nonrecognition under §1031, even though the taxpayer made minimal efforts to rent out the property before taking up residence. The taxpayer moved into the property within months after acquiring it, and the residence was more than temporary. The contract for purchase was contingent upon the sale of the taxpayer’s prior principal residence. The taxpayer’s interaction with the qualified intermediary evidenced a lack of investment intent at the time of the exchange. Before purchasing the property, the taxpayer sought advice regarding whether he could move into the property if renters could not be found, evidencing contemplation of use of the property as a personal residence. In addition, the taxpayer began preparations to improve the property as a personal residence within weeks of purchasing the property.

F. Section 1033
G. Section 1035
H. Miscellaneous

1. Sorting out derivatives in this “major/minor” transaction. The treatment turns on the nuances of the definitions. Summitt v. Commissioner, 134 T.C. No. 12 (5/20/10). An S corporation of which the taxpayer was a shareholder acquired reciprocal put and call foreign currency options that exactly offset each other. Subsequently, the corporation assigned a depreciated major currency (euro) call option and an appreciated minor currency (Danish krone) call option to a charity pursuant to an agreement in which the charity was substituted with respect to the obligations under the call options. The taxpayer took the position that the depreciated major currency call option was a “foreign currency contract” subject to the mark-to-market rules of §1256, which were triggered by §1256(c) upon the disposition, but that the appreciated minor currency call option was not so treated. The taxpayer argued that there are no economically significant differences among foreign currency forwards, futures, and options. The Tax Court (Judge Haines) held that foreign currency options are not “foreign currency contracts” as defined in §1256(b)(2) and (g)(2) and the mark-to-market rules of §1256 thus do not apply. The only options subject to §1256 are listed nonequity options, dealer equity options, and options on dealer securities futures, all of which are traded on a qualified board or exchange. An interbank market is not a qualified board or exchange, and because the options in question were purchased in an interbank market, they could not be “nonequity options” under §1256.
IV. COMPENSATION ISSUES
A. Fringe Benefits
1. Involuntarily terminated employees will receive assistance with their COBRA premiums for a while. The 2009 ARRA § 3001 (in Title III – Premium Assistance for COBRA Benefits) provides premium assistance for COBRA benefits to the extent of 65 percent of the otherwise applicable COBRA premium. Eligibility for this benefit is more restrictive than eligibility for COBRA, with elimination of the premium subsidy for high-income individuals as well as for those eligible for another form of medical coverage, e.g., retiree medical. The DOL has provided a model notice to individuals pursuant to ARRA § 3001.
   • The premium subsidy is only provided with respect to involuntary terminations that occur on or after 9/1/08 and before 1/1/10.
   a. And for a while longer. H.R. 3326, § 1010, extends the COBRA subsidy period from nine months to 15 months and extends the subsidy to terminations occurring in the first two months of 2010. Notification requirements are provided for individuals who may have previously lost assistance but became eligible for the extended subsidy period.
   b. Another COBRA subsidy extension is provided, but no more extensions will be needed as President Obama focuses with "laser-like intensity" on the jobs issue. The Temporary Extension Act of 2010 extends the COBRA subsidy for another month to cover terminations that took place from 9/1/08 through 3/31/10.
   d. A further extension of the COBRA subsidy is included in the pending Small Business Jobs Tax Relief Bill of 2010, H.R. 5486, which passed the House on 6/15/10.

2. New tax Code rules permeate every nook and cranny of health care reform: American Health Benefit Exchanges can’t work as substitutes for employer-provided health insurance without special tax rules. Pursuant to § 10108 of the 2010 Health Care Act, employers offering minimum essential health care coverage through an eligible employer-sponsored plan and paying a portion of that coverage must provide “qualified employees” with a voucher whose value can be applied to purchase a health plan through an American Health Benefit Exchange established under § 1311 of the Act. (An American Health Benefits Exchange must be established by each state (the cost of the establishment of which is subsidized by the U.S. Treasury) to facilitate the purchase of qualified health insurance plans.) “Qualified employees” are employees (1) whose (a) required contribution for employer sponsored minimum essential coverage exceeds 8 percent, but does not exceed 9.5 percent of the employee’s household income for the taxable year, and (b) total household income does not exceed 400 percent of the poverty line for the family, and (2) who do not participate in the employer's health plan. The value of a voucher equals the employer’s contribution to the employer's health plan. Vouchers can be used to purchase a qualified health plan in the Exchange. If the value of the voucher exceeds the premium, the employee receives cash for the excess value. Under new § 139D, added to the Code by the 2010 Health Care Act, the value of the voucher is not includable in gross income to the extent it is used for the purchase of a health plan. But any rebate received by the employee is includable in the employee's gross income. If an individual receives a voucher, the individual is disqualified from receiving any tax credit or cost sharing credit for the purchase of a plan in the Exchange. New § 162(g) allows the employer a deduction for the amount of the voucher. This provision is effective after 12/31/13.

3. A little added tax benefit to encourage the kids not to cut the apron strings. The Health Care and Education Reconciliation Act of 2010 amended § 105(b) of the Code to extend the exclusion for reimbursement of medical care expenses under an employer-provided accident or health plan to any child of an employee who has not attained age 27 by the close of the taxable year, without regard to whether the child is the taxpayer’s dependent. A similar amendment to § 162(l) to allows self-employed individuals a deduction for any such
child of the taxpayer. Similar amendments to §§ 401 and 501 apply to VEBAs and qualified plans providing retiree health benefits. The new rules are effective as of the date of enactment.

a. **With a little leeway for the year the kid turns 26.** Notice 2010-38, 2010-20 I.R.B. 682 (5/17/10). This notice provides guidance on the exclusion from employees' gross income under §§ 105 and 106 for employer-provided accident and health plan coverage for employees' children under age 27, on the employment tax treatment of these benefits, and on the parallel amendments to § 401(h) for retiree health accounts in pension plans, § 501(c)(9) for VEBAs, and the deduction under § 162(J) for self-employed individuals. The value of any employer-provided health coverage for an employee's child for the entire taxable year the child turns 26 may be excluded under § 105 if the coverage continues until the end of that taxable year. For example, if a child turns 26 in March, but stays on the plan past December 31st (the end of most individual's taxable year), the health benefits up to December 31st are a tax-free fringe benefit.

b. Healthcare insurance that covers dependent children is no longer a tax-free fringe benefit unless all of the employee's kids under age 27 are covered. T.D. 9482, Interim Final Rules for Group Health Plans and Health Insurance Issuers Relating to Dependent Coverage of Children to Age 26 Under the Patient Protection and Affordable Care Act, 75 F.R. 27122 (3/13/10). The Affordable Care Act amended the Public Health Service Act (PHS Act) to add § 2714, which requires group health plans and health insurance issuers that provide dependent coverage of children to continue to make such coverage available for an adult child until age 26. This requirement is incorporated by § 9815 of the Code. These interim final regulations, Reg. § 54.9815-2714T, provide that for a health insurance (or self-insured) plan that makes available dependent coverage of children to qualify under § 105, the plan may not deny or impose special requirements for coverage of either minor children or adult children under age 26. With respect to a child who has not attained age 26, a plan or issuer may not define dependent for purposes of eligibility for dependent coverage of children other than in terms of a relationship between a child and the participant. Thus, for example, a plan or issuer may not deny or restrict coverage for a child who has not attained age 26 based on the presence or absence of the child's financial dependency (upon the participant or any other person), residency with the participant or with any other person, student status, employment, or any combination of those factors. Nothing in the regulations requires an employer's plan to cover dependent as a condition for eligibility to be a tax-free fringe benefit. The regulation applies for plan years beginning on or after 9/23/10, and the regulation expires “on or before” 5/13/13. Transition rules are provided.

4. **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.

d. **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. 34 (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 (IIS)) 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. Rev. Rul. 2010-59, 2010-39 I.R.B. (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).

5. No more deduction for spending tax-free government subsidies on drugs for retirees. However, companies that made required balance sheet adjustments became subject to congressional hazing because they made Obama look bad. Section 139A excludes from gross income federal subsidy payments, made pursuant to 42 USC § 1395w-132, to a sponsor of a qualified retiree prescription drug plan. The 2010 Health Care Act amended § 139A to provide that for taxable years beginning after 12/31/12, the amount of any deduction allowable for retiree prescription drug expenses is reduced by the amount of the excludable subsidy payments received.

   a. Congress forces employees to pay more of the health care costs with after-tax dollars to fight rising health care costs. The 2010 Health Care Act amended § 125 by adding new § 125(i) (and renumbering former §§ 125(i) and (j) as §§ 125(j) and (k)) to limit allowable salary reduction contributions to a health flexible spending under a cafeteria plan to $2,500. The 2010 Reconciliation Act extended the effective date until years after 12/31/12. The $2,500 limitation is indexed for inflation after 2013. A plan that does not include the $2,500 ceiling does not qualify as a cafeteria plan under § 125.

   b. Employers can’t easily duck the responsibility to pay a healthy chunk on health insurance premiums by putting the whole kit and caboodle into a cafeteria plan. Section 125(f ) (3), added by the 2010 Health Care Act, restricts the ability of employers to provide reimbursement, or direct payment, under a cafeteria plan for the premiums for coverage under any qualified health plan offered through an American Health Benefits Exchange. Such a benefit qualifies only if the employer is a “qualified employer” as defined in § 1312(f)(2) of the Act. A “qualified employer” is a small employer that elects to make all its full-time employees eligible for one or more qualified plans offered in the small group market through an Exchange. For this purpose, a “small employer” (defined in § 1304(b)(2) of the Act) is an employer who employed an average of not more than 100 employees on business days during the preceding calendar year and who employs at least 1 employee on the first day of the plan year. Unless it qualifies under § 125(f)(3), reimbursement (or direct payment) for the premiums for coverage under any qualified health plan offered through an Exchange is not a qualified benefit under a cafeteria plan. Thus, any employer that is not a qualified employer cannot offer to reimburse an employee for the premium for a qualified plan that the employee purchases through the individual market in an Exchange as a health insurance coverage option under its cafeteria plan without disqualifying the plan. This provision applies to taxable years beginning after 12/31/13.

   c. To us, the new “Simple Cafeteria Plan” rules appear to be just as complex as the old, still generally applicable cafeteria plan rules. The 2010 Health Care Act amended § 125 by adding new § 125(j) (and renumbering former §§ 125(j) and (k) as §§ 125(k) and (l)) to provide for “simple cafeteria plans” for “eligible small employers,” to which the otherwise generally applicable nondiscrimination requirements, for both the cafeteria plan itself and benefits under the plan (e.g., group term life insurance, self-insured medical expense reimbursement plan, and dependent care assistance program), do not apply. Under the safe harbor, a cafeteria plan and the specified qualified benefits are treated as meeting the
nondiscrimination rules if the cafeteria plan satisfies special (1) minimum eligibility and participation requirements and (2) minimum employer contribution requirements. The eligibility requirement is met only if (1) all employees (other than excludable employees) are eligible to participate, and (2) each eligible employee may elect any benefit available under the plan under terms and conditions applicable to all participants. Excludable employees include employees who (1) have not attained the age of 21 before the close of a plan year, (2) have fewer than 1,000 hours of service for the preceding plan year, (3) have not completed one year of service with the employer as of any day during the plan year, or (4) are covered under a collective bargaining agreement if there is evidence that the benefits covered under the cafeteria plan were the subject of good faith bargaining. Shorter service and younger age requirements can apply only if the shorter service or younger age applies to all employees. The minimum contribution requirement requires the employer to make a contribution for each nonhighly compensated employee (employee who is not a highly compensated employee (as defined in § 414(q)) or a key employee (as defined in § 416(i)) in addition to any salary reduction contributions made by the employee. The minimum contribution may be either a matching contribution or a “nonelective contribution,” but the same method must be used for calculating the minimum contribution for all nonhighly compensated employees. The minimum matching contribution is the lesser of (1) 100 percent of the salary reduction contribution made by the employee for the year or (2) six percent of the employee’s compensation for the year. Matching contributions in excess of the minimum may be made only if matching contributions with respect to any highly compensated employee or key employee are not at a higher percentage than the matching contributions for any nonhighly compensated employee. Under the nonelective contribution method the employer must contribute is an amount equal to a uniform percentage (not less than two percent) of each eligible employee’s compensation for the year, whether or not the employees makes any salary reduction contribution. Generally speaking, an eligible small employer is an employer who employed an average of 100 or fewer employees on business days during either of the two preceding years. If an employer was an eligible employer and maintained a simple cafeteria plan, but subsequently employs more than 100 employees, it remains an eligible small employer until the year after which it employs an average of 200 or more employees during the year. There are aggregation rules for controlled groups and special rules treating leased employees as employees.

- The devil might be in the details that we have omitted in the name of quasi-brevity.

B. Qualified Deferred Compensation Plans
1. Section 72(t) has no catchall hardship exception. Dollander v. Commissioner, T.C. Memo. 2009-187 (8/19/09). There is no general exception to the § 72(t) penalty tax for premature withdrawals from a qualified retirement plan based on the need to withdraw funds due to general “financial hardship.”

C. Nonqualified Deferred Compensation, Section 83, and Stock Options
1. My employer cheated on me (and a lot of others) but it’s still income. Gourley v. United States, 104 A.F.T.R.2d 2009-6119 (Fed. Cl. 8/26/09). The taxpayer, a WorldCom employee, exercised nonqualified stock options for 90,300 shares of WorldCom stock valued at $42,125 per share on January 28, 2000. The value of the stock was reflected in a W-2 issued to the taxpayer by WorldCom. The taxpayer disposed of the stock during 2000 and 2001. On June 25, 2002, WorldCom announced a major restatement of its financials admitting that because of fraudulent accounting practices it incurred undisclosed losses from 2000 to 2001. The taxpayer thus claimed in a refund action that the stock he received in January 2000 was worth only $12.52 per share and that the W-2 issued by WorldCom was grossly inflated. The court rejected the refund action pointing out that the known fair market value of the WorldCom stock on the date of the taxpayer’s exercise formed the basis of the taxpayer’s gross income. The court pointed out that the market price based on imperfect information is nonetheless the prevailing market price.

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D. Individual Retirement Accounts

1. An employment tax penalty injury leads to an income tax insult. Swanton v. Commissioner, T.C. Memo. 2010-140 (6/24/10). The Tax Court (Judge Wells) held that $289,017 seized from taxpayer's IRA by the IRS in satisfaction of a § 6672 penalty tax liability constituted a distribution from the IRA includable in gross income.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. The government isn't mandating anybody have health insurance, it's just raising your taxes if you don't. Beginning in January of 2014, new § 5000A (which all by itself constitutes new Chapter 48 of the Code), added by the 2010 Health Care Act, imposes a penalty — that's exactly the concise and elegant statutory language — on any individual who does not maintain minimum essential health insurance coverage, unless the individual is exempt. Minimum essential health insurance coverage includes government sponsored programs, eligible employer-sponsored plans, plans in the individual market, grandfathered group health plans and other coverage as recognized by HHS in coordination with the Treasury. The penalty is phased in over the period 2014-2016 and becomes fully effective in 2016. The penalty applies month-by-month, but there is a once a year exception for a coverage gap of less than three consecutive months. The monthly penalty is 1/12 of an annualized penalty amount. Starting in 2016, the annualized penalty is the greater of: (1) 2.5 percent of the amount by which the taxpayer's household income for the taxable year exceeds the threshold amount of income requiring an income tax return to be filed for that taxpayer, or (2) $695 per uninsured adult in the household (indexed for inflation after 2016). (Household income is the sum of gross income (including all foreign earned income) and tax-exempt interest, minus trade and business deductions, allowable losses from sales of property, deduction attributable to rent and royalty income, and alimony. Note that deductions for contributions to IRAs, Archer MSAs, etc., are not allowed for this purpose.) The penalty for an uninsured individual under age 18 is one-half of the penalty for an adult. (If an individual without minimum essential health insurance coverage is a dependent of another taxpayer, the other taxpayer is liable for the penalty with respect to the individual.) During the phase-in, the flat sum adult penalty is $95 for 2014, and $325 for 2015; the household income penalty percentage is 1 percent for 2014 and 2 percent for 2015. The total household penalty may not exceed the lesser of (1) three times the adult penalty, or (2) the national average annual premium for bronze level health plan — exactly what is a bronze level health plan is way too difficult to explain here — offered through an American Health Benefits Exchange that year for the taxpayer's household size. (An American Health Benefits Exchange must be established by each state (the cost of the establishment of which is subsidized by the U.S. Treasury) to facilitate the purchase of qualified health insurance plans.) Individuals who cannot afford coverage because their required contribution for employer sponsored coverage or the lowest cost bronze plan in the local American Health Benefits Exchange exceeds eight percent ( indexed after 2014 for increases in health insurance premium costs) of household income for the year are exempt from the penalty. In years after 2014, the eight percent exemption is increased by the amount by which premium growth exceeds income growth. (Members of a recognized religious sect exempt from self-employment taxes and members of Indian tribes also are exempt, as are prisoners.) The penalty is due upon notice and demand, and is subject to normal assessment procedures. However, it cannot be collected by lien and levy. There are no criminal or civil penalties for failure to pay, and interest does not run on late payment.

2. Even though it's domiciled in new Chapter 2A, and titled ‘Unearned Medicare Contribution,” it feels like an income tax surtax on investment income. New Code § 1411 of the Code, added by the Health Care and Education Reconciliation Act of 2010, imposes a 3.8 percent tax on investment income of individuals, estates, and trusts in taxable years beginning after 12/31/12. For individuals (except nonresident aliens), the tax applies only to the lesser of (1) net investment income or (2) the excess of adjusted gross income (increased by net foreign earned income excluded under § 911(a)(1)) over a threshold amount. The threshold amount is $250,000 for spouses filing a joint return or a surviving spouse, $125,000 for
married individuals filing separate returns, and $200,000 for single taxpayers (including heads of household). Modified adjusted gross income is adjusted gross income increased by the amount (net of the deductions and exclusions disallowed with respect to the foreign earned income). For estates and trusts, the tax is levied on the lesser of (1) undistributed net investment income, or (2) the excess of adjusted gross income (as defined in § 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins. The tax does not apply to a trust that is tax-exempt under § 501, is a charitable remainder trust tax-exempt under § 664, or all of the interests of which are devoted to charitable purposes. Net investment income is investment income reduced by the deductions allocable to that income. Investment income is the sum of (1) gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the tax does not apply), (2) other gross income derived from any business to which the tax applies, and (3) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply. The § 1411 tax applies to trade or business income from (1) a passive activity, and (2) trading financial instruments or commodities (as defined in § 475(e)(2)). It does not apply to any other trade or business income. Gain or loss from the disposition of a partnership interest or stock in an S corporation is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus there is a deemed basis adjustment that has results in taking into account only the net gain or loss attributable to the entity’s property that is not attributable to an active trade or business. However, all income, gain, or loss on working capital is subject to the tax. Investment income does not include any distributions from a qualified retirement plan or any income subject to self-employment tax. Unlike self-employment taxes, no part of the § 1411 tax is deductible in computing taxable income under Chapter 1.

3. Domestic partners = one; breeders = zero. PLR 201021048 (5/5/10).
Registered California domestic partners must each report one-half of the combined income earned from the performance of personal services and one-half of the combined income derived from their community property assets. The resulting income is then taxed to each of the domestic partners at the more favorable § 1(c) single rates, as opposed to the higher rates paid by married couples. Also, no federal gift tax is payable on the vesting of earnings of one partner in the other partner under California law.

- See also, ILM 201021049 (5/6/10) (holding that the IRS could consider the assets of taxpayer’s registered domestic partner when determining whether to accept an Offer in Compromise); and ILM 201021050 (5/5/10) (the treatment of a registered domestic partner who reported earned income in accordance with CCA 200608038 in years beginning before 6/1/10).

B. Miscellaneous Income

1. Treasury proposes to reverse a principle established in a Supreme Court decision that the government won. REG-127270-06, Damages Received on Account of Personal Physical Injuries or Physical Sickness, 74 F.R. 47152 (9/15/09). The Treasury has published proposed regulations (Prop. Reg. § 1.104-1(c)) under § 104(a)(2) to reflect amendments to § 104 enacted since the current regulations were promulgated and certain judicial decisions. The proposed regulations provide that the § 104(a)(2) exclusion applies to personal physical injuries or physical sickness. Emotional distress is not considered a physical injury or physical sickness. However, the proposed regulations provide that damages for emotional distress attributable to a physical injury or physical sickness are excludable under § 104(a)(2). Under the proposed regulations, the term damages means an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution. Notably, the proposed regulations eliminate the requirement in the current regulations that to be excludable under § 104(a)(2) the damages must be “based upon tort or tort type rights.” Thus, damages for physical injuries may qualify for exclusion under § 104(a)(2) even though the injury giving rise to the damages is not defined as a
tort under state or common law. The reason for the change was the Treasury Department's concern that the Supreme Court's interpretation of the tort type rights test in United States v. Burke, 504 U.S. 229 (1992), limiting the § 104(a)(2) exclusion to damages for personal injuries for which the full range of tort-type remedies is available, could precluded an exclusion under § 104(a)(2) for redress of physical personal injuries under a "no-fault" statute that does not provide traditional tort-type remedies.

- Taxpayers may apply the proposed regulations to amounts paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995 and received after August 20, 1996.

2. Some bad tax news for over-burdened consumer credit card debtors who beat the bank. They don't beat the IRS! Forgiven accrued but unpaid interest on a consumer loan is COD income. Payne v. Commissioner, T.C. Memo. 2008-66 (3/18/08). Judge Haynes held that the compromise of credit card debt, including interest, incurred for personal living expenses resulted in recognition of COD income for a cash method taxpayer. The § 108(e)(5) exception for cancellation of purchase money debt did not apply because the only relationship between the debtor and creditor was the debtor-creditor relationship and there was no property sale and purchase between the creditor and debtor that gave rise to the debt.

a. The result must have been so obvious that the Tax Court was affirmed per curiam. Payne v. Commissioner, 104 A.F.T.R.2d 2009-7783 (8th Cir. 12/22/09).

3. The out of pocket cost of compromising consumer debt does not reduce the amount of COD income. Melvin v. Commissioner, T.C. Memo. 2009-199 (9/8/09). The taxpayers owed Chase Manhattan Bank $13,084 on a consumer credit cards, and Chase agreed to accept $4,579 to settle the debt. The taxpayers paid a third party (Arbitronix) 25 percent of the $8,505 savings, or $2,126 to negotiate the compromise. The Tax Court (Judge Halpern) held that the taxpayers recognized COD income in the full amount of the cancelled debt. The "[taxpayers] received goods and services (and cash advances) on credit; when Chase relieved them of their corresponding obligation to pay, petitioners without question received an 'accession to income.'" The court rejected the taxpayer's argument that under § 61(a)(12) itself only the net benefit of the debt cancellation was includable in gross income — that is they should have been allowed to offset their "phantom' income" with the "loss" they suffered when they paid the fee. Judge Halpern held that § 61(a)(12) "manifestly does not provide for any kind of deduction." The taxpayers did not argue for a deduction under § 162 because they acknowledged that the amount was not paid with respect to a business, and they did not argue for a § 212 deduction because they were in the AMT.

b. One of our colleagues who specializes in consumer law commented, "What a rip-off. If the people had called Chase themselves they probably could have gotten an even better deal than the third party did, and saved 25 percent."

4. The IRS was not entitled to rely on a naked Form 1099-C to show cancellation of indebtedness income occurred in a particular year. Linkugel v. Commissioner, T.C. Summ. Op. 2009-180 (12/1/09). The taxpayer's house was foreclosed upon in 2000, and the mortgagee secured a deficiency judgment in the amount of $35,247, which it made no effort to collect. Citigroup acquired the mortgagee in late 2000 and also engaged in no efforts to collect upon the judgment. In 2007, a Citigroup subsidiary issued a Form 1099-C in the deficiency amount for the 2006 taxable year. The taxpayer failed to include the cancellation of indebtedness income on his 2006 return, and IRS determined a deficiency. The taxpayer asserted that the cancellation of debt income occurred in an earlier year. Special Trial Judge Armen held that taxpayer was entitled to a shift in the burden of proof under § 6201(d), which required the IRS to present other evidence to support the incidence of the cancellation of debt income in 2006. The IRS failed to meet its burden of production.

b. The court relied on Portillo v. Commissioner, 932 F.2d 1128 (5th Cir. 1991), which was codified as § 6201(d) in the 1996 second Taxpayer Bill of Rights.

5. Police arrest procedures did not result in "physical injury." Stadnyk v. Commissioner, T.C. Memo. 2008-289 (12/22/08). The Tax Court (Judge Goeke) held that damages received on account of false imprisonment were not excludable under § 104(a)(2), even
though the taxpayer was detained, handcuffed and searched, because she suffered no physical harm. The damages received in the settlement compensated the taxpayer for "the ordeal ... suffered as a result of her arrest, detention, and indictment" as the result of her bank erroneously stamping a check "NSF" when it had been stopped for "dissatisfied purchase." The damages were "stated in terms of recovery for nonphysical personal injuries: Emotional distress, mortification, humiliation, mental anguish, and damage to reputation." Judge Goeké also rejected summarily the taxpayer's claim that damages received for personal injuries are not gross income within the meaning of § 61(a) and that "section 104(a)(2) conflicts with section 61(a) and violates the Sixteenth Amendment to the extent that it taxes compensatory damages received for personal injuries."

a. The Sixth Circuit agrees that police arrest procedures did not result in "physical injury." Stadnyk v. Commissioner, 105 A.F.T.R.2d 2010-1130 (6th Cir. 2/26/10), aff'g T.C. Memo. 2008-289 (12/22/08). In an nonprecedential opinion, the Sixth Circuit affirmed the Tax Court opinion (Judge Goeké) holding that damages received on account of false imprisonment were not excludable under § 104(a)(2), even though the taxpayer was detained, handcuffed and searched, because she suffered no physical harm. The Tax Court found that the damages received in the settlement compensated the taxpayer for "the ordeal ... suffered as a result of her arrest, detention, and indictment" as the result of her bank erroneously stamping a check "NSF" when it had been stopped for "dissatisfied purchase." The damages were "stated in terms of recovery for nonphysical personal injuries: Emotional distress, mortification, humiliation, mental anguish, and damage to reputation." The Court of Appeals declined "to create a per se rule that every false imprisonment claim necessarily involves a physical injury," stating as follows:

To be sure, a false imprisonment claim may cause a physical injury, such as an injured wrist as a result of being handcuffed. But the mere fact that false imprisonment involves a physical act—restraining the victim's freedom—does not mean that the victim is necessarily physically injured as a result of that physical act.

- Section 104(a)(2) did not apply, because the taxpayer "unequivocally testified that she suffered no physical injuries as a result of her physical restraint." thus she had not suffered personal physical injuries or physical sickness.
- The Court of Appeals also rejected as meritless the taxpayer's claim that damages received for personal injuries are not gross income within the meaning of § 61(a) and that "§ 104(a)(2), as amended by Congress in 1996, violates the Sixteenth Amendment to any extent that it purports to subject compensation for personal injuries to income tax."

- Apparently the government did not cross appeal the Tax Court's failure to impose penalties. In the Tax Court Judge Goeké had refused to uphold the penalties asserted by the IRS because taxpayers had received "disinterested advice" that the damages were not includable in income. The advice came from taxpayer's lawyer, the defendant's lawyer, and the mediator who negotiated the settlement. He concluded that the taxpayers "acted reasonably and in good faith when following their advice and preparing their own return as they have done for over 40 years, because "[a]lthough though none of those individuals had specialized knowledge in tax law, they were experienced in personal injury lawsuits and settlements."

6. It looks like damages for physical sickness caused by emotional distress can be excluded if they go beyond mere symptomatic manifestations of the underlying emotional distress. Domeny v. Commissioner, T.C. Memo. 2010-9 (1/13/10). The taxpayer received approximately $33,000 in settlement of a claim for claims for wrongful termination of employment one-third of amount received in settlement of claims for wrongful termination of employment and violations of various civil rights statutes. The taxpayer's former employer paid approximately $8,000 to her that was reflected on a Form W-2 as employee compensation, $8,000 to the taxpayer's lawyer, for which no information return was filed, and $17,000 to the taxpayer that was reflected on a Form 1099-MISC as "nonemployee
compensation.” The Tax Court (Judge Gerber) held that the $8,000 paid directly to the taxpayer was includable wage compensation, and the remaining amount was excludable under § 104(a)(2) as damages for physical injuries attributable to exacerbation of multiple sclerosis caused by a hostile work environment. The payor-former employer’s intent in settlement of the claim was evidenced by the issuance of separate checks and different information returns; these facts indicated that the former employer intended amount in excess of wages due to be in settlement of tort claims for physical injuries attributable to the exacerbation of multiple sclerosis.

- The legislative history indicates that physical manifestations of emotional distress, such as insomnia, headaches, and stomach disorders, are not to be treated as physical injuries. H.R. Rep. No. 737, 104th Cong., 2d Sess. 143, n.56 (1996).

7. When the taxpayer lives in Florida, the gross income tax a/k/a the AMT doesn’t bite as hard. Campbell v. Commissioner, 134 T.C. No. 3 (1/21/10). The taxpayer recovered a gross award of $8.75 million as a relator in a qui tam action on behalf of the United States government against a military contractor, and paid $3.5 million of attorney’s fees, which amount was retained by the taxpayer’s attorney to whom the $8.75 million had been remitted; the taxpayer received only $5.25 million from his attorney. The Tax Court (Judge Wells) held that entire gross award of $8.75 million was includable in gross income, and the $3.5 million of attorney’s fees was deductible as a miscellaneous itemized deduction.

- “Qui tam” is an abbreviation of the Latin phrase “qui tam pro domino rege quam pro se ipso in hac parte sequitor,” which means “who pursues this action on our Lord the King’s behalf as well as his own.”
- The tax year involved in this case (2003) pre-dates the effective date of 2004 amendments to § 62(a), which now permits attorney’s fees in a False Claims Act case to be an above-the-line deduction.

8. Protecting the tax-free treatment of Indian medical care provided from casino profits. The 2010 Health Care Act added new § 139D, which expressly excludes from gross income the value of certain Indian tribe health care benefits.

- These benefits might have been excludable in any event under the “common law” general welfare exclusion, but Congress was concerned by statements of some IRS officials to the effect that the general welfare exclusion might not apply universally to Indian tribe health care benefits. Although the exclusion extends only to specified, benefits, it broadly covers most health insurance, medical benefits, and accident coverage.

9. BP is gonna have to send out a whole lot of Form 1099s. This will result in some claimants having to file tax returns for the first time in their lives. IR-2010-078 (6/25/10), http://www.irs.gov/newsroom/article/0,,id=224886,00.html. The IRS has published guidance for individuals and businesses affected by the oil spill in the Gulf of Mexico. (1) Taxpayers must include in gross income payments received for lost business income, lost wages or lost profits. (2) Self-employed individuals who receive a payment that represents compensation for lost income of the individual’s trade or business must include the amount of the payment in calculating of the self-employment tax. (3) A payment to an individual to compensate for lost wages is subject to the social security tax Medicare taxes, and generally is not subject to income tax withholding, unless backup withholding applies. (4) A person making payments to an individual or partnership (including an LLC) for lost business income, lost wages, or lost profits must report the payments on a Form 1099-MISC, Miscellaneous Income, if the payments aggregate $600 or more. The document also describes the standard rules regarding casualty loss deductions and involuntary conversions, and the inclusion in gross income of damages for emotional distress.

- The obvious remedy is for BP to gross up its payments for the taxes claimants would not have paid absent the oil spill.

10. Having a heart attack can improve your tax health. Parkinson v. Commissioner, T.C. Memo. 2010-142 (6/28/10). The Tax Court (Judge Thornton) held that one-half of the amount received by the taxpayer in settlement of suit for intentional infliction of emotional distress was excludable under § 104(a)(2), because the payor intended it to be compensation for a heart attack suffered as a result of the emotional distress. He reasoned that “a
heart attack and its physical aftereffects constitute physical injury or sickness rather than mere subjective sensations or symptoms of emotional distress.” The other one-half of the settlement was not excludable because it was compensation for the emotional distress itself.

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

1. Mucking stalls for 60 horses helps avoid the hobby loss limitations. Helmick v. Commissioner, T.C. Memo. 2009-220 (9/22/09). The taxpayers’ conducted a horse breeding activity involving 40-60 horses on property on which they lived. They incurred substantial losses for eleven consecutive years and never made a profit. Their other income was a modest salary. Judge Gustafson allowed the claimed losses, and stated:

Although their intention to make the activity eventually profitable was objectively unreasonable, it was their genuine subjective intention. By the time of the years in issue, the Helmicks had invested so much time and effort in this failing activity that they could see no way out except to somehow make the thing work. No other possible purpose explains their willingness to persist in an activity that had become so frustrating and unpleasant.

2. She bet that the ball wouldn’t stop on § 183 and won the right to deduct gambling losses on schedule C instead of on Schedule A. Chow v. Commissioner, T.C. Memo. 2010-48 (3/18/10). Judge Cohen applied Reg. § 1.183-2(b) to determine that the taxpayer’s gambling activity was engaged in for profit. Accordingly, the taxpayer was a professional gambler, and her losses were deductible on Schedule C, rather than as itemized deductions. Nevertheless pursuant to § 165(d), her losses were not deductible to the extent they exceeded her gambling winnings.

D. Deductions and Credits for Personal Expenses

1. Helping entry-level homebuyers invest in the bear housing market. Code § 36, added by the Housing Assistance Tax Act of 2008, provides a refundable credit for a “first-time homebuyer” who purchases a principal residence on or after 4/9/08, and before 1/1/09. The amount of the credit is the lesser of 10 percent of the purchase price or $7,500 ($3,750 in the case of a married individual filing a separate return). If two or more unmarried persons purchase a principal residence together, the total amount of the credit will be allocated among them as prescribed by the IRS. The credit is phased out over the modified adjusted income range of $75,000 to $95,000 ($150,000 to $170,000 in the case of a joint return). A person qualifies as a “first-time homebuyer” if neither the person nor the person’s spouse (if any) owned a principal residence at any time during the three-year period ending on the date of purchase of the credit-generating residence. The credit is not available if the taxpayer purchased the property from a related person or acquired it by gift, or if the taxpayer’s basis in the property is determined under § 1014. (Persons are related for this purpose if they are related for purposes of § 267 or § 707, except that the family of an individual under § 267(c)(4) is limited for this purpose to his spouse, ancestors, and lineal descendants.) The credit is also not available: (1) if a credit under § 1400C (relating to first-time homebuyers in the District of Columbia) has ever been allowable to the taxpayer; (2) if the taxpayer’s financing is from tax-exempt mortgage revenue bonds; (3) if the taxpayer is a nonresident alien; or (4) if the taxpayer disposes of the residence or ceases to use it as his principal residence before the close of the taxable year.

The amount of the credit is recaptured ratably over the 15-year period beginning with the second taxable year following the taxable year in which the credit-generating purchase was made. For example, if a taxpayer properly claimed a credit of $7,500 for a purchase in 2008, the recapture amount would be $500 in 2010, with another $500 recapture amount in each of the next 14 years. Thus, the credit actually functions as an interest-free loan from the government to the taxpayer. If, prior to the end of the 15-year recapture period, a taxpayer disposes of the credit-generating residence or ceases to use it as his principal residence, the recapture of any previously unrecaptured credit is accelerated. In the case of a sale of the principal residence to an unrelated person, the recapture amount is limited to the amount of gain (if any) on the sale. There is no recapture (either regular or accelerated) after the death of a taxpayer, and there is no accelerated recapture following an involuntary conversion of a residence if the taxpayer
acquires a new principal residence within the next two years. If a credit-generating residence is transferred between spouses or incident to a divorce, in a transaction subject to § 1041, any remaining recapture obligation is imposed solely on the transferee.

- Although the credit is ordinarily allowed with respect to the year in which the credit-generating purchase occurred, a taxpayer purchasing a home in 2009 (before July 1) may elect to treat the purchase as having been made in 2008, for the purpose of claiming the credit on his 2008 tax return. If the election is made, the first year of the recapture period will be 2010, rather than 2011.

a. The homebuyer credit started out as an interest-free loan, but now it's outright free money from the federal government. Section 1006 of the 2009 ARRA amended Code § 36(h) to extend the life of the first-time homebuyer credit through November 30, 2009, and to increase the amount of the credit to $8,000 for 2009. It also amended § 36(f) to eliminate the recapture of the credit for a home purchased in 2009, unless the home is sold or ceases to be the taxpayer’s principal residence within 36 months of the date of purchase.

b. Extended and modified in the Worker, Homeownership, and Business Act of 2009. Section 11 of the WHABA of 2009 amends Code § 36 to extend the credit for homes purchased before 5/1/10 (before 7/1/10, if subject to a binding contract before 5/1/10).

- An individual (and, if married, the individual's spouse) who has maintained the same principal residence for any five-consecutive year period during the eight-year period ending on the date of the purchase of a subsequent principal residence is treated as a first-time homebuyer. The maximum allowable credit for such taxpayers is $6,500. This provision applies to residences purchased after 11/30/09.

- There are, of course, income limitations for the credit, with phaseouts between $225,000 and $245,000 of AGI, as well as a purchase price limit of $800,000.

c. Closing deadline extended to give banks (and Congress) time to do the paperwork. The Homebuyer Assistance and Improvement Act of 2010 extended the closing deadline for the § 36 homebuyer's credit from 6/30/10 to 9/30/10 for any eligible homebuyer who entered into a binding purchase contract on or before 4/30/10 to close on the purchase of the home on or before 6/30/10. The new law addresses concerns that many homebuyers might be unable to meet the original 6/30/10 closing deadline because of circumstances beyond their control. One of these circumstances is the failure of Congress to provide for the extension of federal flood insurance after the former program expired.

2. 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?

3. Taxpayer whose blood contained 0.09 percent alcohol was not drunk enough to be grossly negligent. At least he drove more than 400 yards before crashing. Rohrs v. Commissioner, T.C. Summ. Op. 2009-190 (12/10/09). The Tax Court (Judge Gerber) held that a taxpayer who totaled his 2½-month-old $40,000 pickup truck was entitled to a $33,629 casualty loss deduction because driving with a blood alcohol content of 0.09 percent is not "willful negligence" for purposes of Reg. § 1.165-7(a)(3). The court held that taxpayer took care to secure transportation to and from a party he attended, and believed he was not impaired when he drove to his parents’ house and failed to successfully negotiate a turn resulting in his truck sliding off an embankment and rolling over. The court saw no reason to rely on public policy to deny the loss deduction, and the court held that taxpayer was not liable for the § 6662(a) accuracy-related penalty.

4. Sex reassignment surgery is not nondeductible cosmetic surgery, but the boob job is. O'Donnabhain v. Commissioner, 134 T.C. No. 4 (2/2/10). The taxpayer was a
genetic male who suffered from gender identity disorder, which is a condition recognized in medical reference texts, in which an individual experiences persistent psychological discomfort concerning his or her anatomical gender. Pursuant to medical advice the taxpayer underwent sex reassignment surgery, including breast augmentation surgery, and claimed a § 213 medical expense deduction for the cost of the surgeries, feminizing hormones, and other related expenses. The IRS disallowed the deductions. In a reviewed opinion by Judge Gale the majority (8 judges) held as follows: (1) Gender identity disorder is a "disease" within the meaning § 213(d)(1)(A) and (9)(B); (2) the taxpayer's hormone therapy and sex reassignment surgery were "for the ... treatment ... of" and "[treated]" disease within the meaning of § 213(d)(1)(A) and (9)(B); and (3) because they were for the treatment of disease, the procedures were not "cosmetic surgery" that is excluded from the definition of "medical care" by § 213(d)(9)(A). However, (4) the taxpayer's breast augmentation surgery was "directed at improving ... [her] appearance," because the taxpayer failed to prove that the breast augmentation surgery either "meaningfully [promoted] the proper function of the body" or "[treated] ... disease" within the meaning of § 213(d)(9)(B), the breast augmentation surgery was "cosmetic surgery" that is excluded from the definition of deductible "medical care."

- Judge Halpern concurred. Judges Goeke and Holmes concurred only in the result.
- Judge Foley, joined by Judges Wells, Vasquez, Kroupa, and Gustafson, concurred in disallowance of the deduction for the breast augmentation surgery and dissented with respect to allowing deductions for hormone therapy and sex reassignment. He reasoned that "the fact that a procedure treats a disease is not sufficient to exclude the procedure from the definition of 'cosmetic surgery,'” because § 213(d)(9)(A) provides that the term “medical care” includes "cosmetic surgery or other similar procedures” only if the “surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a disfiguring disease. “To yield a deduction, an appearance-improving procedure must treat ‘disease’ (as opposed to treating a patient or a symptom).”
- Judge Gustafson, joined by Judges Foley, Wells, and Kroupa, concurred in disallowance of the deduction for the breast augmentation surgery and dissented with respect to allowing deductions for hormone therapy and sex reassignment. He reasoned as follows: A procedure that changes the patient's healthy male body (in fact, that disables his healthy male body) and leaves his mind unchanged (i.e., with the continuing misperception that he is female) has not treated his mental disease. On the contrary, that procedure has given up on the mental disease, has capitulated to the mental disease, has arguably even changed sides and joined forces with the mental disease. In any event, the procedure did not (in the words of Havey v. Commissioner, 12 T.C. at 412) “bear directly on the *** condition in question”, did not “deal with” the disease (per Webster's), did not “treat” the mental disease that the therapist diagnosed. Rather, the procedure changed only petitioner's healthy body and undertook to "mitigate[e]" the effects of the mental disease.

5. The sun will never set on increased adoption credits, and the day gets permanently longer, unlike mere daylight savings time. The 2010 Health Care Act amended § 23(b) to raise the ceiling on the adoption credit from $10,000 to $13,170 (and adjusting the inflation adjustment rules) and to make the credit refundable for taxable years after 12/31/09. The Act also exempted all changes in § 23 adoption credit from the EGTRRA sunset rules.

6. Reducing health care costs by discouraging health care spending. The 2010 Health Care Act amended § 213 to increase the 7.5 of AGI threshold for deducting unreimbursed medical expenses to 10 percent of AGI for taxable years beginning after 12/31/12. However, the increased threshold does not apply for the years 2013 through 2016, if either the taxpayer or the taxpayer's spouse turns 65 before the end of the year. The 10 percent of AGI threshold for deducting medical expenses under the AMT remains unchanged.

7. How about a little consistency in tax-free drug use? The 2010 Health Care Act amended § 220(d)(2); dealing with individual Archer MSAs, to disallow
reimbursement from an Archer MSA for the cost of over-the-counter medicines unless the medicine is prescribed by a physician. 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 rule is effective after 12/31/10.

a. Notice 2010-59 2010-39 I.R.B. (9/3/10). Section 220(d)(2) does not apply to disallow 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).

8. Making it little bit more difficult to use an Archer MSA to save for that vacation trip of a lifetime you dreamed is in your future. The 2010 Health Care Act amended § 220(f)(4)(A), dealing with individual Archer MSAs, and § 223(f)(4)(A), dealing with HSAs (for individuals with high deductible health plans, whether through an employer or individually) to increase additional tax on distributions from an HSA or an Archer MSA that are not used for qualified medical expenses from 10 percent to 20 percent of the distribution. The new rule is effective after 12/31/10.

9. And now for the pièce de résistance — the tax Code pays for health insurance for poor, and much of the middle class, but only as long as they are not getting abortions. Section 36B, added by the 2010 Health Care Act provides a “premium assistance” credit for eligible individuals and families who purchase health insurance through an American Health Benefits Exchange established under § 1311 of the Act. (An American Health Benefits Exchange must be established by each state (the cost of the establishment of which is subsidized by the U.S. Treasury) to facilitate the purchase of qualified health insurance plans.) The credit is payable in advance directly to the insurer to subsidize the purchase of health insurance through an Exchange. The individual then pays the difference between the premium tax credit amount and the total premium charged for the plan. (Alternatively, an individual may elect to purchase health insurance out-of-pocket and apply to the IRS for the credit at the end of the taxable year). The amount of the reduction in premium is required to be included with each bill sent to the individual. For employed individuals who purchase health insurance through an Exchange, the premiums are paid through payroll deductions. The premium assistance credit is available for individuals (single or joint filers) with household incomes (as defined in the statute) whose income is less than 400 percent of the Federal poverty level for the family size involved and who do not received health insurance through an employer. The exact amount of the premium depends on household income, based on the percentage of income the cost of premiums represents. The baseline for the credit equals the full premium for a “second lowest cost silver plan” — whatever that might provide — but may be used to purchase any plan, including bronze, silver, gold and platinum level plans, through an Exchange. (We will not pretend to understand the details of the different plans; we don’t even understand our own health insurance plans.) The credit is phased out on a sliding scale for households whose income is above the poverty level and is completely phased out at 400 percent of the poverty level. We will not attempt to amuse you with the details of the complicated phase-out formula, except to note that it is linear. Married taxpayers must file a joint return to be eligible, and dependents are ineligible. An employee who is offered minimum essential coverage through an employer-provided health insurance plan is not eligible for the premium tax credit for health insurance purchased through an Exchange. But an employee for whom offered coverage is unaffordable is eligible for the credit. An employee also is eligible for the credit if the employer’s plan benefits are less than 60 percent, and the employee declines the employee coverage and satisfies the other conditions for receiving the credit. (An employer will be notified if an employee is eligible for a premium assistance credit

1 Some amount of health insurance premium credit is the health insurance premium credit probably will be available to over one-half of all households, because the credit is not fully phased out until median household income is 400 percent of the federal poverty level, which in many states, for many different size households, is an amount that exceeds median household income.
because the employer does not provide minimal essential coverage, or the employer does offer
minimum essential coverage but it is not affordable; the notice will explain the employer may be
liable for an “assessable payment” — Q: Is it an excise tax, a penalty, or merely an exaction? A;
It’s an excise tax — under § 4980H.) Individuals who apply for the credit must provide massive
amounts of personal information to the American Health Benefits Exchange, including copies of
their last two tax returns. If the credit received through an advance payment exceeds the amount
of credit to which the taxpayer is entitled, the excess is treated as an increased tax liability. For
individuals whose household income is below 400% of the federal poverty level, the increased
tax cannot exceed $400. If the advance payment credit is less than the amount of the credit to
which the taxpayer is entitled, the shortfall reduces tax liability. Premium assistance credits are
not available for months in which an individual has a free choice voucher. Premium assistance
credits, or any amounts that are attributable to them, cannot be used to pay for abortions for
which federal funding is prohibited. The provision is effective for taxable years ending after
12/31/13.

• There’s oh so much more that could be explained, but we ran out of time and space and, most of all, patience to explain the mind-numbing complexity of it all.

E. Divorce Tax Issues
F. Education
G. Alternative Minimum Tax

VI. CORPORATIONS

A. Entity and Formation
1. To check the box 75 days is extended to 3 years and 75 days. Rev.
an unincorporated entity to be taxed as an association is effective on a date specified in the
election on Form 8832, or on the date the form is filed if no date is specified. The effective date
cannot be more than 75 days before or twelve months after the date on which the Form 8832 is
filed. Under Reg. § 301.7701-3(d)(1), an election affecting a foreign entity is relevant when its
classification affects the tax liability of any person for federal tax or information purposes. The
revenue procedure extends the provisions for relief provided in Rev.
Proc. 2002-59, 2002-2 C.B.
615, to include both an election with respect to newly electing entities and a change in an
existing election. The revenue procedure provides for an application to an IRS service center for
relief from failure to timely file the form 8832 for up to three years and 75 days after the
effective date of the election. Relief is available if the entity can establish reasonable cause for its
failure to timely file its Form 8832, the application includes a completed Form 8832, and all tax
returns affected by the election have been filed consistently with the elected status. The revenue
procedure also provides that relief may be sought by an entity not eligible for relief under the
terms of the revenue procedure by filing a request for a letter ruling that includes a statement that
all required tax and information returns have been timely filed as if the entity classification
election had been in effect on the effective date requested.

B. Distributions and Redemptions
1. Section 162(k)’s bite is as loud as its bark. Ralston Purina Co. v.
Commissioner, 131 T.C. 29 (9/10/08). Ralston Purina claimed a deduction under § 404(k) for
payments made to its ESOP in redemption of Ralston Purina preferred stock owned by the ESOP
to fund distributions to employees terminating participation in the ESOP. The Commissioner
argued the redemption payments were not deductible under either § 404(k)(1) or (5), or
alternatively that the deduction was barred by §162(k). The Tax Court, in a unanimous reviewed
opinion by Judge Nims, held that because Ralston Purina’s payments were “in connection with
the redemption of its own stock,” § 162(k) applied to disallow the deduction. The Tax Court
refused to follow the contrary opinion on almost identical facts in Boise Cascade Corp. v. United
States, 329 F.3d 751 (9th Cir. 2003). In Boise Cascade the Ninth Circuit interpreted the phrase
“in connection with” to include only expenses that have their origin in a stock redemption
transaction, excluding expenses that have their origin in a “separate, although related,
transaction.” The Tax Court previously had rejected the Ninth Circuit’s narrow interpretation of the phrase “in connection with” in Fort Howard Corp. v. Commissioner, 103 T.C. 345 (1994), and did so again in Ralston Purina. The court rejected Ralston Purina’s argument that because the payments were an applicable dividend under 404(k), the transaction was excepted from the application of § 162(k) under § 162(k)(2)(A)(ii). The Tax Court reasoned that the entire transaction potentially deductible as an applicable dividend under § 404(k) — payment from the corporation to the ESOP and the distribution to the ESOP participants — must also pass muster under § 162(k), and that the ‘otherwise allowable’ deduction was disallowed because the payment was ‘in connection with’ a repurchase of stock.

a. And the Third Circuit agrees with the Tax Court, not with the Ninth Circuit. Conopco, Inc. v. United States, 572 F.3d 162 (3d Cir. 7/13/09), aff’g 100 A.F.T.R.2d 2007-5296 (D. N.J. 7/18/07). The court held that assuming that Conopco’s payments were applicable dividends under § 404(k)(1) — an issue that it did not reach — “where a corporation makes payment to an ESOP trust in redemption of its stock, the otherwise allowable § 404(k)(1) deduction for an applicable dividend inevitably involves an ‘amount paid or incurred by a corporation in connection with the reacquisition of its stock’ and is therefore barred by § 162(k)(1).”

b. The dog food corporation precedent wasn’t the people’s food corporation’s best friend. General Mills v. United States, 554 F.3d 727 (8th Cir. 1/26/09). General Mills claimed a deduction under § 404(k) for payments made to its ESOP in redemption of General Mills stock owned by the ESOP to fund distributions to employees terminating participation in the ESOP. In a very brief opinion, the court (Judge Benton) held that §162(k) barred the deduction for the “applicable dividend” otherwise allowable under § 404(k). The court followed the Tax Court’s decision in Ralston Purina Co. v. Commissioner, 131 T.C. 29 (9/10/08), and refused to follow the contrary opinion in Boise Cascade Corp. v. United States, 329 F.3d 751 (9th Cir. 2003), because it disagreed with the reasoning of Boise Cascade.

c. And the people food precedent comes around to bite the dog’s tail. Nestle Purina Petcare Co. v. Commissioner, 594 F.3d 968 (8th Cir. 2/19/10). Following its holding in General Mills the court affirmed the tax court holding in Ralston Purina Co. v. Commissioner, 131 T.C. No. 4 (9/10/08), that §162(k)(1) barred a dividends paid deduction under §404(k) where payments are made to redeem stock from the distributors ESOP. In the Eighth Circuit the taxpayer asserted, in an argument not extensively considered by the Tax Court, that its distribution constituted a dividend under § 561 (dividends paid in determining accumulated taxable income, undistributed personal holding company income, investment company taxable income and REIT taxable income) that was subject to an exception from the limitation provided in § 162(k)(2)(A)(ii), allowing deductions of dividends paid within the meaning of § 561. The court rejected the argument pointing that § 404(k) does not reference dividends paid under § 561 and that the plain language of the statute does not incorporate § 404(k) distributions within the meaning of dividends paid under § 561.

2. Reducing E&P for nondeductible expenses. Rev. Rul. 2009-25, 2009-38 I.R.B. 365 (9/4/09). Interest paid by a corporation on a loan to purchase a life insurance policy on an individual for which a deduction has been disallowed under § 264(a)(4) reduces earnings and profits for the taxable year in which the interest would have been allowable as a deduction but for its disallowance under § 264(a)(4). It does not further reduce earnings and profits when the death benefit is received under the life insurance contract.

C. Liquidations
D. S Corporations

1. Roth IRA is not an eligible S corporation shareholder. Taproot Administrative Services, Inc. v. Commissioner, 133 T.C. No. 9 (9/29/09) (reviewed, 12-4). The taxpayer corporation’s sole shareholder was a custodial Roth IRA account. Eligible S corporation shareholders as defined in § 1361 include individuals, estates, certain specifically designated trusts and certain exempt organizations. With an effective date after the year involved in this case, § 1361(c)(2)(A)(iv) was enacted to allow a bank whose stock is held by an IRA or
Roth IRA to elect S corporation status. Reg. § 1.1361-1(e)(1) provides that a person for whom S corporation stock is held by a nominee, guardian, custodian or agent is deemed to be the S corporation shareholder. However, in Rev. Rul. 92-73, 1992-2 C.B. 224, the IRS ruled that a trust that qualifies as an IRA is not a permitted S corporation shareholder. Declaring the issue as one of first impression, and indicating that under Skidmore deference to revenue rulings depends upon their persuasiveness, the Tax Court (Judge Wherry) agreed with the IRS’s rationale in the ruling that IRAs are not eligible S corporation shareholders because the beneficiary of the IRA is not taxed currently on the trust’s share of corporate income unlike the beneficiary of a custodial account or the grantor of a grantor trust who is subject to tax on the pass-through corporate income. (The income of the corporation owned by a Roth IRA would never be subject to tax.)

Judge Holmes dissented in a beautifully-reasoned opinion which made the point that an IRA account is owned by a custodian for the benefit of an individual, who is to be treated as the shareholder, and any unwarranted tax benefits would not accrue because the income of the IRA would be taxed under § 511 as UBIT. His opinion concluded:

This case is a reminder that tax law does not cascade into the real world through a single channel. It meanders instead through a vast delta, and any general principles tugged along by its current are just as likely to sink in the braided and re-braided rivulets of specific Code provisions and the murk of regulations as they are to survive and be useful in deciding real cases. Taproot thinks it found a course through the confluence of the subchapter S and IRA rules that it could successfully navigate. Its route would be new, but the stakes are not that great, and the sky will remain standing if we had just read and applied the regulation as it is.

2. Revenge for Gitlitz? T.D. 9469, Section 108 Reduction of Tax Attributes for S Corporations, 74 F.R. 56109 (10/30/09). The Treasury Department has promulgated final regulations proposed in REG-102822-08, Section 108 Reduction of Tax Attributes for S Corporations, 73 F.R. 45656 (8/5/08). Section 108(d)(7)(A) provides that if an S corporation excludes COD income under § 108(a), the excluded amount reduces the S corporation’s tax attributes under § 108(b); section 108(b)(4)(A) provides that the reduction occurs after the S corporation’s items of income, loss, deduction and credit for the taxable year of the discharge pass through to its shareholders. Pursuant to § 108(d)(7)(B), Reg. § 1.108-7(d) treats any § 1366(d)(3) shareholder carryover losses from prior years and any passed through losses from the current year in excess of the shareholders’ bases as a “deemed NOL” of the S corporation that would be reduced under § 108(b). Where an S corporation has more than one shareholder during the taxable year of the discharge, a shareholder’s disallowed losses or deductions equal a pro rata share of the total losses and deductions allocated to the shareholder under § 1366(a) during the corporation’s taxable year (including losses and deductions disallowed under § 1366(d)(1) for prior years that are treated as current year losses and deductions with respect to the shareholder under § 1366(d)(2)). The regulations provide that the deemed NOL allocated to a shareholder consists of a proportionate amount of each item of the shareholder’s loss or deduction that was disallowed under § 1366(d)(1) in the year of the debt cancellation. The regulations were effective on 10/30/09.

3. Disregarded QSub is still a bank subject to reduced interest deductions for interest incurred to carry tax-exempt obligations. Vainisi v. Commissioner, 132 T.C. No. 1 (1/15/09). Sections 291(a)(3), (e)(1)(B), and 265(b)(3) disallow interest deductions of a financial institution incurred to carry tax-exempt obligations, but allow an 80 percent deduction for interest on tax-exempts acquired after 12/31/82, and before 8/7/86, and for certain qualified tax exempt obligations as defined in § 265(b)(3)(B). Section 1361 allows certain financial institutions to elect to be treated as an S corporation, and further allows an S corporation to treat a financial institution as a qualified S corporation subsidiary (QSub). Under § 1361(b)(3)(A), a QSub is not treated as a separate corporation except as provided in regulations. Reg. § 1.1361-4(a)(3) provides that in the case of a bank that is an S corporation or a QSub of an S corporation, any special rules applicable to banks will apply to an S corporation or
a QSub that is a bank. The court (Judge Foley) held that under these provisions the limitations of § 291(a)(3) are applicable to interest deductions claimed by a parent S corporation for interest expense generated by the S corporation’s QSub bank. The court also held that Reg. § 1.1361-4(a)(3) is consistent with the enactment of § 1361(b)(3)(A) and its legislative history.

a. But in the Seventh Circuit Judge Posner sees things differently, as he often does, and S corporation banks in Illinois, Indiana, and Wisconsin gain a competitive advantage over C corporation banks. Vainisi v. Commissioner, 599 F.3d 567 (7th Cir. 3/17/10). The Tax Court’s decision was reversed on appeal. Judge Posner noted that by virtue of § 1363(b)(4), § 291 applies to an S corporation only if it had been a C corporation within three years preceding the taxable year in question. Because the taxpayer’s S corporation had not been a C corporation within the preceding three taxable years, § 291 could not apply. Nothing in Reg. § 1.1361-4(a)(3) could change that result. He rejected the government’s argument that because § 291 was enacted before a bank could elect to be an S corporation or a QSub, Congress did not intend § 1363(b)(4) to prevent the application of § 291 to a bank, and that thus the Treasury was authorized to rescind that application by regulation. Instead, he concluded that the regulation “merely requires that the special banking rules be applied to banks that are S corporations or QSubs at the corporate level so that a bank’s S corporation status will not emasculate the rules. ... But nothing ... suggests that section 1363(b)(4) is to be overridden with regard to banks.” He went on to reject the government’s argument as follows:

Missing from the government’s analysis is recognition that the only S corporations to which section 291, the source of the special banking rule at issue in this case (the 80 percent rule), applies are S corporations that were C corporations in one of the three immediately preceding years. Nothing in the regulation suggests a purpose to change that rule. ...

Of course, unless abrogated, the privilege conferred by section 1363(b)(4) will perpetuate a competitive advantage enjoyed by S or QSub banks that have never been C corporations or that converted from C to S earlier rather than later. Later converters – not to mention all existing C corporation banks (the majority of all banks) – may be gnashing their teeth in fury at the additional interest deduction that many of their S or QSub bank competitors can take. But the difference in treatment, and whatever consequences flow from it, are built into section 1363(b)(4).

Finally, Judge Posner concluded:

The regulation was promulgated a decade ago and the Treasury Department has thus had ample time in which to decide whether the favored treatment of S and QSub banks is a bad idea. The Internal Revenue Service thinks it a bad idea, the Tax Court thinks it a bad idea, but the institutions authorized to correct the favored treatment of these banks – Congress by statute, and the Treasury Department (we are assuming without deciding), as Congress’s delegate, by regulation – have thus far left it intact.

b. On the reasoning, its game, set, and match, we think.

4. A Solomon-like valuation by Judge Wells. The Ringgold Telephone Company v. Commissioner, T.C. Memo. 2010-103 (5/10/10). This case involved valuation of the taxpayer’s assets on the date it converted from C corporation status to S corporation status, for the purpose of computing the built-in gain tax under § 1374 upon the subsequent sale of its assets within 10 years of electing S corporation status. The only asset in question was a minority partnership interest in a partnership that itself held a minority interest in a lower tier partnership. The taxpayer valued the partnership interest at $2,600,000 on the effective date of its election, but it sold the partnership interest less than a year later for $5,220,423 to Bell South, which indirectly controlled the lower tier partnership. Judge Wells found that the taxpayer’s expert witness’s testimony which valued the interest at $2,980,000, based on averaging $3,243,000 using a “distribution yield analysis” and $2,718,000 using a business enterprise analysis with a 5% minority discount, to be more persuasive than the IRS’s expert witness’s valuation of
$5,155,000. However, he also concluded that while Bell South had not paid a control premium for the partnership interest, the price paid by Bell South was "probative, but not conclusive evidence of the value if the [partnership] interest on the valuation date." Accordingly, he valued the partnership interest at $3,727,141, by weighing equally – that means averaging – (1) the $3,243,000 value using a "distribution yield analysis," (2) the $2,718,000 value using a business enterprise analysis, and (3) the $5,220,423 paid by Bell South.

5. Gitlitz by analogy? "Not," says the Tax Court. Nathel v. Commissioner, 131 T.C. 262 (12/17/08). Prior to 2001, the taxpayer had claimed losses passed-through from an S corporation in an amount that exceeded his stock basis but which were properly allowable under § 1366(d)(1)(B) because there were outstanding loans to the corporation from the taxpayer-shareholder. The taxpayer’s basis in the loans to the corporation was reduced under § 1367(d)(2)(A) to $112,547. In 2001 the corporation paid $649,775 on the loan, which exceeded the taxpayer’s $112,547 basis in the loan by $537,228. Later in 2001, pursuant to a restructuring of the ownership of the S corporation and two other corporations owned by the taxpayer, his brother, and a third party (which left the taxpayer with no ownership in the corporation), the taxpayer made a capital contribution of $537,228 to the S corporation, which equaled the amount by which the loan repayment exceeded the taxpayer’s basis in the debt. The consideration for the contribution was the assumption by another shareholder of the taxpayer’s obligation on guarantees of loans from banks to the corporation. In calculating the gain realized upon receipt of the loan repayment, the taxpayer treated the capital contribution as income under § 1366(a)(1) to the S corporation, although excludable income under § 118, and therefore as restoring or increasing under § 1367(b)(2)(B) his bases in the outstanding loans before repayment (rather than increasing his stock basis), thus eliminating any gain. Relying on Gitlitz v. Commissioner, 531 U.S. 206, 216 (2001), the taxpayer argued that because § 118 excludes capital contributions from the gross income of an S corporation, capital contributions are "permanently excludible" and are thus "tax-exempt income" under Reg. § 1.1366-1(a)(2)(viii), and that as such it is included as an item of the S corporation’s income to for purposes of § 1366(a)(1) and the resulting § 1367 basis adjustments. The Tax Court (Judge Swift) rejected the taxpayer’s argument and upheld the deficiency.

By attempting to treat petitioners’ capital contributions to [the corporation] as income to [the corporation], [taxpayers] in effect seek to undermine three cardinal and longstanding principles of the tax law: First, that a shareholder’s contributions to the capital of a corporation increase the basis of the shareholder’s stock in the corporation; ... sec. 1.118-1, Income Tax Regs.; second, that equity (i.e., a shareholder’s contribution to a corporation) and debt (i.e., a shareholder’s loan to the corporation) are distinguishable and are treated differently by both the Code and the courts ... ; and third, that contributions to the capital of a corporation do not constitute income to the corporation; sec. 118; ... sec. 1.118-1, Income Tax Regs.

We do not believe that the Gitlitz holding or the provisions of subchapter S, namely sections 1366(a)(1), 1367(a)(1)(A), and 1367(b)(2)(B), should be interpreted to override these three longstanding principles of tax law.

a. Affirmed, after a trip down memory lane reviewing classic Supreme Court decisions on the parameters of gross income. Nathel v. Commissioner, 105 A.F.T.R.2d 2010-2699 (2d Cir. 6/2/10). After a lengthy review of the classic case law dealing
with the parameters of gross income, ranging from *Eisner v. Macomber*, 252 U.S. 189 (1920), through *Edwards v. Cuba Railroad*, 268 U.S. 628 (1925), to *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), the Second Circuit (Judge Koeltl) held that capital contributions traditionally are not considered to be “income” and, therefore, should not be considered “items of income” under § 1366(a)(1)(A). Furthermore, in enacting § 118, Congress “has specifically recognized that capital contributions are not income” in that “the legislative history of § 118 indicates that the purpose of that section was to codify pre-1954 court decisions holding that certain payments to corporations by nonshareholders should be treated as capital contributions and not as income to the corporations, just as shareholder contributions were not treated as income to the corporations.” Furthermore, Reg. § 118-1, which provides that “‘voluntary pro rata payments’” to a corporation from its shareholders for the purposes of providing “‘additional funds for conducting [the corporation's] business ... do not constitute income’” to the corporation,” is entitled to deference and “is fatal to the [taxpayer's] position.”

* The court rejected the taxpayer’s argument that based on the reasoning of *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), there would be no reason for § 118 to exclude contributions to capital from gross income if they were not already included in gross income by § 118, concluding that the taxpayer’s view of § 118 was belied by its legislative history. The court also rejected other variations of the same argument. Finally, the court rejected the taxpayer’s alternative argument that they should have been allowed to deduct their capital contributions to the S Corporation under § 165( c )(2) as losses incurred in a transaction entered into for profit. The Tax Court had found that the taxpayers had not made the contributions for the “sole purpose of being released from their guarantees on the bank loans” and, as a result, it found that the contributions were not deductible pursuant to § 165(c)(2). The Second Circuit concluded that the Tax Court’s test was too stringent, holding instead that to be deductible as losses incurred in a transaction entered into for profit the capital contributions needed only to have been made for the primary purpose of obtaining the releases. Nevertheless, the Tax Court’s error was harmless because the taxpayers failed to prove that the primary purpose of the contributions was to obtain the releases from the guarantees.

6. 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.

E. Mergers, Acquisitions and Reorganizations

1. As the old saying goes, “There’s no tax free basis step-up without a funeral.” This “midco” tax shelter was rejected by the court. *Enbridge Energy Co., Inc. v. United States*, 553 F. Supp. 2d 716 (S.D. Tex. 3/31/08). In a transaction substantially similar to the transaction described in Notice 2001-16, 2001-1 C.B. 730, the taxpayer (Midcoast) acquired the assets of a selling corporation (Bishop) through an intermediary (K-Pipe). Midcoast desired to acquire the Bishop assets with a cost basis, but Bishop’s shareholder (Langley) was unwilling to engage in an asset sale, insisting on a stock sale and purchase. Midcoast’s tax advisor, PWC, arranged for the formation of an intermediary, K-Pipe Merger, and the financing necessary for K-Pipe Merger to purchase the Bishop stock, with the loan to K-Pipe Merger being secured by Midcoast assets. After a downstream merger of K-Pipe Merger into Bishop, Bishop, which changed its name to K-Pipe Group, sold the Bishop assets to Midcoast. (K-Pipe purportedly offset the gain with built-in loss on assets contributed to it by its shareholder in a pre-§ 362(e) year.) Thereafter, K-Pipe engaged in no business activity and was merely a shell. On cross motions for summary judgment, the District Court (Judge Harmon) upheld the IRS’s treatment of the transaction from Midcoast’s perspective as a stock sale followed by a § 332 liquidation, which resulted in denying the step-up in basis on which Midcoast’s claimed depreciation deductions were based. After disregarding K-Pipe because it had no substance other than as a vehicle to allow Midcoast to claim a cost basis in the Bishop assets in a stock sale transaction
without a § 338 election, the court addressed what was the real substance of the transaction: a sale of stock or a sale of assets. Because Langley would not agree to a direct sale of Bishop's assets, "the only way in which Midcoast could have obtained the Bishop Assets was to purchase the Bishop Stock and liquidate." Assessment of the § 6662(d) substantial understatement penalty was upheld, and because the transaction was a "tax shelter," neither the substantial authority nor adequate disclosure exceptions applied. Alternatively, there was not substantial authority because the weight of authority in Supreme Court and Fifth Circuit cases was held to have required disregarding K-Pipe.

a. Affirmed! Substance over form is alive and well in the Fifth Circuit. Enbridge Energy Co. v. United States, 104 A.F.T.R.2d 2009-7289 (5th Cir. 11/10/09). In a nonprecedential per curiam opinion, the Fifth Circuit applied the substance over form doctrine in affirming the District Court's decision upholding the IRS's treatment of a "midco" transaction arranged by the buyer as a stock purchase followed by a § 332 liquidation, which resulted in denying the step-up in basis on which the taxpayer's claimed depreciation deductions were based. Imposition of a 20 percent § 6662 penalty also was affirmed.

2. All cash (D) reorgs are now in the final regulations. T.D. 9475, Corporate Reorganizations; Distributions Under Sections 368(a)(1)(D) and 354(b)(1)(B), 74 F.R. 67053 (12/18/09). In 2006, the Treasury Department promulgated Temp. Reg. § 1.368-2T, providing that the distribution requirement under §§ 368(a)(1)(D) and 354(b)(1)(B) is deemed to have been satisfied despite the fact that no stock and/or securities are actually issued in a transaction otherwise described in § 368(a)(1)(D) if the same person or persons, directly or indirectly, own all of the stock of the transferor and transferee corporations in identical proportions. T.D. 9303, 71 F.R. 75879 (12/19/06). To a limited extent, the attribution rules in § 318 are invoked to determine whether the same person or persons own, directly or indirectly, own all of the stock of the transferor and transferee. An individual and all members of his family that have a relationship described in § 318(a)(1) are treated as one individual; and stock owned by a corporation is attributed proportionally to the corporation's shareholder without regard to the 50 percent limitation in § 318(a)(2)(C). Ownership in absolutely identical proportions is not required. A de minimis variation in shareholder identity or proportionality of ownership in the transferor and transferee corporations is disregarded. The regulations give as an example of a de minimis variation a situation in which A, B, and C each own, respectively, 34%, 33%, and 33% of the transferor's stock and A, B, C, and D each own, respectively, 33%, 33%, 33%, 1% and 1% of the transferee's stock. Stock described in § 1504(a)(4) - nonvoting limited preferred stock that is not convertible - is disregarded for purposes of determining whether the same person or persons own all of the stock of the transferor and transferee corporations in identical proportions. When a transaction qualifies as a § 368(a)(1)(D) reorganization under the regulations, a nominal share of stock of the transferee corporation will be deemed to have been issued in addition to the actual consideration. That nominal share of stock is deemed to have been distributed by the transferor corporation to its shareholders and, in appropriate circumstances, further transferred to the extent necessary to reflect the actual ownership of the transferor and transferee corporations. Identical proposed regulations were simultaneously published. The proposed regulations have been finalized, with certain modifications. As Reg. § 1.368-2(f). First, if no consideration is received, or the value of the consideration received in the transaction is less than the fair market value of the transferor corporation's assets, the transferee corporation is treated as issuing stock with a value equal to the excess of the fair market value of the transferor corporation's assets over the value of the consideration actually received in the transaction. If the value of the consideration received in the transaction is equal to the fair market value of the transferor corporation's assets, the transferee corporation will be deemed to issue a nominal share of stock to the transferor corporation in addition to the actual consideration exchanged for the transferor corporation's assets. In addition, Reg. § 1.358-2(a)(2)(iii) has been amended to provide that in a reorganization in which the property received consists solely of non-qualifying property equal to the value of the assets transferred, as well as a nominal share described in the regulations, the shareholder or security holder may designate the share of stock of the transferee to which the basis, if any, of the stock or securities surrendered will attach.
If an all-cash transaction subject to these regulations occurs between members of a consolidated group, the selling member (S) is treated as receiving the nominal share and additional stock of the buying member (B) under § 1.1502-13(f)(3), which it distributes to its shareholder member (M) in liquidation. Immediately after the sale, the B stock (with the exception of the nominal share which is still held by M) received by M is treated as redeemed in a distribution to which § 301 applies. M’s basis in the B stock is reduced under Reg. § 1.1502-32(b)(3)(v), and under Reg. § 1.302-2(e), any remaining basis attaches to the nominal share.

3. **Q:** What does the IRS do when Temporary Regulations expire?  
**A:** Allow taxpayers to rely on the identical proposed regulations. Notice 2010-25, 2010-14 I.R.B. 527 (3/18/10). Temp. Reg. § 1.368-1T(e)(2), T.D. 9316, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest, 72 F.R. 12974 (3/20/07), dealing with continuity of interest in corporate reorganizations, expired on March 19, 2010, pursuant to § 7805(e)(2). This notice permits taxpayers to rely on Prop. Reg. § 1.368-1(e)(2) until new regulations are promulgated. However, “the target corporation, the issuing corporation, the controlling corporation of the acquiring corporation if stock thereof is provided as consideration in the transaction, and any direct or indirect transferee of transferred basis property from any of the foregoing, may not apply the provisions of the proposed regulations unless all such taxpayers elect to apply the provisions of such regulations. This requirement will be satisfied if none of the specified parties adopts treatment inconsistent with this election.”

a. REG-146247-06, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest, 72 F.R. 13058 (3/20/07). Prop. Reg. § 1.368-1(e)(2) would amend Reg. § 1.368-1(e), as promulgated in 2005. (The proposed regulations are identical to now expired Temp. Reg. § 1.368-1T.) Under the 2005 regulations, the value of consideration received in a reorganization for purposes of determining whether shareholders received a sufficient proprietary interest in the acquiring corporation was to be determined as of the last business day before the contract is binding. The proposed regulations apply the signing date value only where the contract provides for a fixed consideration. The definition of fixed consideration is modified to provide that consideration is fixed where the contract specifies the number of shares of the issuing corporation to be exchanged for all or each proprietary interest in the target corporation. Definitions referring to the percentage of proprietary interests are deleted. The regulations treat transactions that allow for shareholder elections as providing for fixed consideration regardless of whether the agreement specifies a maximum amount of money or a minimum amount of stock of the issuing corporation. (In any event the shareholders are subject to the economic fortunes of the issuing corporation as of the signing date.) The rule that modifications of the contract that increase the number of shares to be issued does not change the signing date is broadened to also state that a modification that decreases the amount of cash or other property to be issued also does not change the signing date. The regulations also tighten the contingent consideration rules by providing that a contract will not be treated as providing a fixed consideration if provisions for contingent consideration prevent the target shareholders from being subject to the economic benefits and burdens of ownership of the issuing corporation as of the signing date. Finally the regulations provide that the signing date value must be adjusted to take into account the effect of any anti-dilution clause adjustments to reflect changes in the issuing corporation capital structure.

4. **Prepaid income is not recognized built-in gain.** T.D. 9487, Built-in Gains and Losses Under Section 382(h), 75 F.R. 33990 (6/16/10). Reg. § 1.382-7 provides that for purposes of computing § 382 limitations following an ownership change, prepaid income is not recognized built-in gain. Prepaid income is defined as “any amount received prior to the change date that is attributable to performance occurring on or after the change date.” Examples include, but are not limited to, income received prior to the change date that is deferred under § 455, Reg. § 1.451-5, or Rev. Proc. 2004-34, 2004-1 C.B. 991 (or any successor revenue procedure). This regulation applies to corporations that have undergone an ownership change on or after 6/11/10, but it merely mirrors former Temp. Reg. § 1.382-7T, which it replaced.
5. **Measuring owner shifts of loss corporations under § 382.** Notice 2010-50, 2010-27 I.R.B. 12 (6/11/10). This notice provides guidance under § 382 for measuring owner shifts of loss corporations that have more than one class of stock outstanding when the value of one class of stock fluctuates relative to another class of stock. The IRS will accept use of the “full value methodology,” under which all shares are “marked to market” on each testing date. Under this method, the percentage of stock owned by any person is determined with reference to “the relative fair market value of the stock owned by such person to the total fair market value of the outstanding stock of the corporation. ... [C]hanges in percentage ownership as a result of fluctuations in value are taken into account if a testing date occurs, regardless of whether a particular shareholder actively participates or is otherwise party to the transaction that causes the testing date to occur ....” The IRS also will accept use of the “hold constant principle.” Under this methodology, “the value of a share, relative to the value of all other stock of the corporation, is established on the date that share is acquired by a particular shareholder. On subsequent testing dates, the percentage interest represented by that share (the “tested share”) is then determined by factoring out fluctuations in the relative values of the loss corporation’s share classes that have occurred since the acquisition date of the tested share. Thus, as applied, the HCP is individualized for each acquisition of stock by each shareholder.” The “hold constant principle” has several variations that the notice identifies as acceptable. An acquisition is not an event upon which the acquiring shareholder marks to fair market value other shares that it holds under any HCP variation. To be acceptable, whichever methodology is selected must measure the increased percentage ownership represented by a stock acquisition by dividing the fair market value of that stock on the acquisition date by the fair market value of all of the outstanding stock of the loss corporation on that date. Any alternative treatment of an acquisition as inconsistent with §382(l)(3)(C) and is not acceptable. Any method selected, whether the full value methodology” or a particular variation of the “hold constant principle” must be applied consistently to all testing dates in a “consistency period.” With respect to any testing date, the consistency period includes all prior testing dates, beginning with the latest of: 1) the first date on which the taxpayer had more than one class of stock; (2) the first day following an ownership change; or (3) the date six years before that testing date.

6. **A district court decision, if followed, makes it much much more difficult ever to have personal goodwill as an employee-shareholder.** Howard v. United States, 2010-2 U.S.T.C. ¶50,542 (E.D. Wash. 7/30/10). The taxpayer was a dentist who practiced through a sole 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."

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

1. A controlled corporation is not a controlled corporation, except when it is controlled. REG-135005-07, Clarification of Controlled Group Qualification Rules, 74 F.R. 49829 (9/28/09). Section 1563(a) defines groups of controlled corporations based on ownership of voting control and value of stock in parent-subsidiary and brother-sister controlled groups (or a combination). Section 1563(b) excludes certain controlled corporations from being treated as component members, including, among others, a corporation that was a member of the group for less than half of the days of a testing period, foreign corporations that do not have effectively connected income. Section 1561(a) limits the component members of a controlled group to one application of certain benefits and limitations, such as one bite at the taxable income brackets of § 11. In addition, some provisions, such as § 41 which provides a credit for increased research expenditures, treat the members of a controlled group as a single corporation. Controlled group for these purposes is defined by reference to § 1563(a). Prop. Reg. § 1.1563-1(a)(ii) would provide that in determining whether two or more corporations are members of a controlled group under § 1563(a), an excluded member under § 1563(b)(2), while not a component member of a controlled group under § 1563(b)(1), nevertheless is a member of a controlled group under § 1563(a). This proposed regulation is intended to clarify that for purposes of Code provisions other than § 1561(a) that reference the definition of a controlled group under § 1563(a) for purposes of limiting tax benefits, all corporations meeting the ownership requirements are taken into account. The IRS indicates its belief that the provision is supported by clear statutory language.

- The preamble to the proposed regulation states that some taxpayers have taken the position that the limitation of § 41 and similar provisions is applicable only to component members of a controlled group.

2. More controlled group guidance. T.D. 9476, Apportionment of Tax Items Among the Members of a Controlled Group of Corporations, 74 F.R. 68530 (12/28/09). Reg. §§ 1.1561-1 through 1.1561-3 provide rules regarding the apportionment of tax benefit items among corporations that are (1) members of a consolidated group filing a life-nonlife income tax return (life insurance company included with a non-life insurance company) or (2) component members of a controlled group of corporations.

3. More help from the IRS for consolidated groups: Are they "too big to fail"? T.D. 9458, Modification to Consolidated Return Regulation Permitting an Election To Treat a Liquidation of a Target, Followed by a Reconversion to a New Target, as a Cross-Chain Reorganization, 74 F.R. 45757 (9/4/09). Temp Reg. § 1.1502-13T(f)(5)(ii)(B) modifies the election under which a consolidated group can avoid immediately taking into account an intercompany item after the liquidation of a member corporation that previously had been sold within the group. Under the regulations, if § 332 otherwise would apply to a target's liquidation into its parent and the parent transfers substantially all of targets assets to a new member, and if a direct transfer of substantially all of the target's assets to the new member corporation would qualify as a § 368(a) reorganization, i.e., a cross-chain type (D) reorganization, then the liquidation and transfer of substantially all of the assets be disregarded and instead, the transaction will be treated as if target transferred substantially all of its assets to the new corporation exchange for the new corporation's stock and the assumption of T's liabilities in a § 368(a)(1)(D) reorganization. The result is that target's deferred items are not triggered. The temporary regulations generally apply to transactions that occur on or after 10/25/07. The text of the temporary regulations also is text of the proposed regulations. REG-139068-08, 74 F.R. 45789 (9/4/09).

H. Miscellaneous Corporate Issues

1. Timing is everything to budget windows. Under the Corporate Estimated Tax Shift Act of 2009, as amended by the HIRE Act and the Health Care and
Education Reconciliation Act of 2010, for corporations with at least $1 billion in assets, in determining the estimated tax otherwise due after 12/31/09, the percentages of estimated tax liability of required by the Tax Increase Prevention and Reconciliation Act of 2005 for the third quarters of 2010 through 2013 do not apply. Prior to enactment of the Health Care and Education Reconciliation Act of 2010, payments due in July, August, or September, 2014, were increased to 157.75 percent of the payment otherwise due, and the next required payment was to be reduced accordingly. The Health Care and Education Reconciliation Act of 2010 increases the required payment of estimated tax otherwise due in July, August, or September, 2014, by 15.75 percentage points.

2. They were "engineers" under the IRC, even if not under state law. Kraatz & Craig Surveying, Inc. v. Commissioner, 134 T.C. No. 8 (4/13/10). The Tax Court (Judge Dawson) upheld the validity of Temp. Reg. § 1.448-1T(e)(4)(i), under which "engineering" includes surveying and mapping, even though the services were not required by state law to be performed by licensed engineers and were not performed by licensed engineers. Whether a corporation is a qualified personal services corporation, as defined in § 448(d)(2), and be subject to a flat 35 percent tax rate under § 11(b)(2), is determined under all of the facts and circumstances and is not controlled by state licensing laws.

3. 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 is 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.

- Comments and love letters should have been submitted by 3/29/10, but see immediately below.


b. 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?

c. 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.

4. ARRA funds nonshareholder contributions? Rev. Proc. 2010-34, 2010-14 I.R.B. (9/23/10). The American Recovery and Reinvestment Act of 2009 (ARRA) appropriated $2.5 billion to the Rural Utilities Service of the Department of Agriculture under the Broadband Initiatives Program (BIP) and the National Telecommunications and Information Administration (NTIA) of the Department of Commerce under the Broadband Technology Opportunities Program (BTOP) to expand broadband capabilities. Grants under the various programs will be treated as nonshareholder contributions to capital under § 118(a) subject to the basis reduction requirements of § 362(c)(2).

VII. PARTNERSHIPS

A. Formation and Taxable Years

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

1. If you lose it once, you can't claim it again. LeBlanc v. United States, 104 A.F.T.R.2d 2009-7611 (Fed. Cl. 12/4/09). The taxpayers invested as limited partners in an agriculture limited partnership that produced farming expense deductions in its first year of operation. In a TEFRA audit proceeding, the partnership agreed to the disallowance of a portion of the deductions from transactions lacking economic substance. In a separate Tax Court proceeding, while the partnership proceeding was still pending, the taxpayers agreed to a settlement disallowing the same deductions on the partners’ return. Several years later the taxpayers claimed a loss deduction from abandonment of the partnership interest in a refund suit. The taxpayers claimed that as a result of the settlements with the IRS they retained a substantial basis in their partnership interest which resulted in a loss on abandonment of the partnership interest. First, the court rejected the IRS assertion that it lacked subject matter jurisdiction because disallowance of the partners’ losses was determined in the partnership proceeding. The court concluded that allowance of an abandonment loss deduction is an affected item subject to determination in a partner’s refund action. The court stated that the partnership prong, allowance of an item, must be determined in the partnership proceeding; then the second prong, the impact of the affected item on the partners’ individual tax liabilities, may be determined in a subsequent partner level proceeding. The court thus held that the sham transaction nature of the investment was determined in the partnership level proceeding, and that determination was not affected by the taxpayers' partner level settlement agreement, but that the court had jurisdiction to determine the partners’ remaining bases for purposes of claiming their § 165 abandonment losses. The
taxpayers asserted that their bases were reduced to zero, and no lower, by losses in the first year of the investment, but that additions to basis in subsequent years, not offset by the first year reductions to basis below zero, created a positive basis in the year of abandonment. The court held that calculation of basis under § 705 is cumulative and reflects a partner’s entire period of ownership. Thus income and loss in the current year and prior years is summed in making the calculation. The statutory direction that basis cannot fall below zero does not mean that the history of profits and losses over the history of the partnership is permanently set to zero. Further, the basis at the end of one year set at zero does not preclude a calculation of basis at any other time that includes all preceding distributed income and losses. The court also pointed out that the taxpayers’ claim would allow them to recover as abandonment losses the loss deductions previously disallowed in the partnership proceeding.

2. 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 parties 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.]

3. Expanded anti-abuse rules look at the tax attributes of indirect owners to test allocations of built-in gain or loss. T.D. 9485, Contributed Property, 75 F.R. 32659 (6/9/10). Reg. § 1.704-3(a)(10) provides that an allocation with respect to contributed built-in gain or loss property under § 704(c) (or a reverse allocation in the case of a book-up) is not reasonable if the contribution of property and the allocation is made with a view of shifting built-in gain or loss among partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. The Treasury has finalized amendments to Reg. § 1.704-3 that adopt without substantial change the proposed regulations in REG-100798-06, Contributed Property, 73 F.R. 28765 (5/19/08). As amended, the regulations provide that in testing for a reduction in aggregate tax liability, the tax consequence to both direct and indirect partners must be considered. Indirect partners include the owners of an entity that is a partner and is a partnership, S corporation, estate, trust, or controlled foreign corporation that is a ten percent partner. Indirect partners include the members of a consolidated group in which the partner is a member. Furthermore, as amended, Reg. § 1.704-3(a)(1) provides that the use of allocation methods with respect to built-in gain or loss property only apply to contributions to a partnership that "are otherwise respected." Even though an allocation may comply with the literal language of Reg. § 1.704-3(b), (c), or (d) (traditional method, curative allocations, or remedial allocations), "the Commissioner can recast the contribution as appropriate to avoid tax results inconsistent with the intent of subchapter K." The regulations identify remedial allocations among related partners as one factor that may be considered.

- Effective date. The amendments to the regulations apply to taxable years beginning after 6/9/10, but the preamble specifically notes that "[n]o inference should be drawn from this effective date with respect to prior law."

4. Family farm is a partnership. Holdner v. Commissioner, T.C. Memo. 2010-175 (8/4/10). When his son Randal expressed little interest in going to college, William Holder, an accountant, invested in developing a small family farm for his son to operate with an agreement to divide the profits with an undefined equity interest in the property. As the farming operation expanding, father and son took title to property as tenants in common. On his returns William reported one-half of the income and claimed deductions for all operating expenses. The court held (Judge Marvel) held that the arrangement was a partnership, rejecting the taxpayer's arguments that they each operated as independent sole-proprietors. The court noted that both William and Randal contributed properties and labor to the venture which conducted business activities. The court also found that the taxpayers failed to rebut a presumption that the partners shared equal per capital interests in the partnership that applied to all items of income and expenditure and that differing capital contributions did not justify an allocation of all expenditures to William. The court sustained an accuracy related penalty under § 6662 finding that William failed to make a reasonable attempt to ascertain the correctness of his reporting positions.

C. Distributions and Transactions Between the Partnership and Partners

1. Forfeitable for decades and thus not guaranteed payments as annually accrued, but 100 percent a guaranteed payment when received. Wallis v. Commissioner, T.C. Memo. 2009-243 (10/27/09). The taxpayer (a tax lawyer) retired as an equity partner in Holland & Knight, and among other amounts received $240,000 in twelve $20,000 payments over four taxable years. The $240,000 represented accumulated amounts that had been awarded to him as an equity partner over many years, but which were neither currently distributable as awarded nor recorded in the partner's capital account; rather, the amounts, which were determined annually without regard to partnership income, were payable over a period of time after the partner reached age 68, but were forfeitable if the partner left the firm before that date.
The Tax Court (Judge Cohen) held that the payments were a guaranteed payment under § 707(c) and § 736(a), taxable as ordinary income, and were not received as distributions under § 731.

a. Affirmed. Tax lawyers have a high standard of “good faith” and “reasonable cause.” Wallis v. Commissioner, ____ Fed. Appx. ___, 106 A.F.T.R.2d 2010-5755 (11th Cir. 2010). The Tax Court was affirmed in an unpublished per curiam opinion. There was sufficient evidence to support the Tax Court’s conclusion that the payments’ were § 707(c) guaranteed payments. The court also affirmed the imposition of a § 6662(a) negligence penalty, rejecting the taxpayer’s “good faith” and “reasonable cause” argument, stating as follows: “Given that Donald Wallis has 35 years of experience as a tax lawyer, the Tax Court reasonably could conclude that Wallis should have been aware there were inconsistencies between (1) his not reporting the Schedule C payments at all to the IRS and (2) the income Form 1099 he received from H&K.”

2. A contribution in sales clothing, in a case of first impression a Bankruptcy Court identifies a contribution as a disguised sale, but all to no avail for the IRS. In Re: G-I Holdings, Inc., 105 A.F.T.R.2d 2010-697 (D. N.J. 12/14/09). In a set of transactions conducted on the same date in 1990, GAF Chemicals and Alkaril Chemicals, Inc. transferred property valued at $480 million to Rhone-Poulenc Surfactants & Specialties, L.P. (“RPSSLP”) in exchange for a 49 percent limited partner interest. GAF transferred its limited partner interest to a trust, which in turn pledged the limited partnership interest to Credit Suisse as security for a nonrecourse loan of $460 million. The trust re-distributed the loan proceeds to GAF. RPSSLP was required to pay a priority return in an amount sufficient to pay interest on the Credit Suisse loan, with any surplus proceeds distributable to GAF. The loan was guaranteed by the French parent of the RPSSLP general partner. In a claim against GAF in a bankruptcy proceeding the IRS assessed a tax deficiency claiming that the transaction was a taxable disguised sale under § 704(a)(2)(B) rather than a contribution resulting in nonrecognition under § 721. The court first held that the transaction created a valid partnership. The court held that § 704(a)(2)(B) expressly authorized the court to collapse the contribution and loan transactions into a single transaction. Looking at the history of the negotiations, the court found that GAF had agreed to accept $30 million less cash and incur $12 million of transaction costs than a sale transaction in order to avoid $70 million of tax. Thus GAF’s “true intent in restructuring the asset sale transaction was to sell its assets using a structure that would minimize taxation.” The court described the following factors to support its conclusion: “As to the $450M transaction, the absence of a risk of loss, the absence of an expectation of profits that exceeded the increased transaction costs, the historical context in which the transaction occurred, and the evidence from the disguised sale analysis all support the conclusion that it was not a bona fide equity contribution to the partnership.” Citing substance over form, the court indicated that the existence of a $480 million partnership capital account does not change the economic substance of the transaction. The court found that the interest payments to GAF based on its $480 million capital account had little real economic substance to GAF and merely represented loan payments to Credit Suisse. The court also concluded that the fact that GAF may have a bona fide equity interest in the partnership does not overcome the disguised sale language of § 704(a)(2)(B). After an extensive analysis of § 704(a)(2)(B) the court agreed with the IRS characterization that, following the principles of legislative history, the Credit Suisse loan constituted an indirect transfer of money from the partnership to the partner and the transfers constituted a sale of assets. With respect to whether the transaction is properly characterized as a sale under the statutory language, looking at the factors listed in the legislative history, the court stated:

As to the first factor, the $450M that GAF received from the 1990 Transactions was subject to no risk whatever. It walked away from the closing on February 12, 1990 with $450M free and clear. Because this was a nonrecourse loan, GAF could never lose anything other than the collateral for the loan, its interest in RPSSLP. This factor weighs in favor of finding that GAF did not participate in the $450M transactions as a partner. As to the second factor, GAF's continuing partner status does not weigh in either direction. As to the third factor, the fact that the $450M
transaction occurred on the same day weighs in favor of finding that GAF did not participate in the $450M transaction as a partner. As to the fourth factor, this Court finds that GAF’s primary motivation for participating in the $450M transaction was to receive tax benefits. This too weighs in favor of finding that GAF did not participate in the $450M transaction as a partner. Thus, three of four factors weigh in favor of finding that GAF did not participate in the $450M transaction as a partner, and none weighs in favor of finding that GAF participated in this transaction as a partner.

Finally, the court indicated that its analysis is informed under Reg. § 1.707-5, enacted after the date of the transactions and therefore not applicable, and concluded that under the regulations the transaction would be treated as a sale. Ultimately the court found that GAF made a $30 million equity contribution and a $450 million sale to the partnership. At the end of the day, however, the court concluded that the omission from gross income represented by the disguised sale did not constitute more than 25 percent of GAF’s gross income so that the IRS was not entitled to invoke the six-year statute of limitations under § 6501 and that the government’s claims were time barred.

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.

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 F3d 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.

2. Partnership audit rules extend the statute of limitations. Curr-Spec Partners L.P. v. Commissioner, 579 F.3d 391 (5th Cir. 8/11/09). Section 6501(a) provides a three-year statute of limitations for assessing tax deficiencies. Section 6229(a) provides that the period for assessing a deficiency attributable to a partnership item does not expire until three years after the later of the date a partnership return or the due date for the partnership return. The IRS issued an FPAA disallowing claimed partnership losses four years after the partnership return was filed, and assessed deficiencies against the partners for years into which the losses were carried forward. The assessment to individual losses disallowing the loss carryforwards were within the three-year statute of limitations applicable to the partners' returns. The Fifth Circuit affirmed the Tax Court holding that § 6229(a) does not establish an independent three-year statute of limitations with respect to partnership items, but merely extends the limitations period of § 6501(a). Thus, assessment of a deficiency against partner's whose individual return remains open is not barred by any limitation period in § 6229(a).

a. The Tax Court agrees. LVI Investors, LLC v. Commissioner, T.C. Memo. 2009-254 (11/9/09). The court (Judge Nims) followed its holding in Curr-Spec Partners as affirmed by the Fifth Circuit. Section 6501(a) provides a three year assessment period after an individual's return is filed. Section 6229(a) provides that the period for assessing any tax attributable to a partnership item or an affected item expires three years after the latter of the due date of the partnership return or the date the partnership return was filed. The court held that § 6229 does not override § 6501 and instead sets a minimum limitations period that may extend the § 6501(a) period.


(1) In another motion decided on the same day, Magistrate Judge Bush decided that taxpayer's expert witness David Weisbach may testify as to whether the tax opinions received complied with applicable tax opinion standards and whether they complied with Circular 230, but not as to whether taxpayer's action were reasonable (which is a matter for the court).

3. Basis in a closed year is a partnership item that may be redetermined in an FPAA for an open year. Wilmington Partners L.P. v. Commissioner, T.C. Memo. 2009-193 (8/26/09). The IRS issued an FPAA for the partnership's 1993 year that was closed without adjustment. In an FPAA issued for 1999, the IRS determined that the partnership's basis in a reset note contributed in 1993 was zero. The court (Judge Kroupa) held that nothing in TEFRA prevents the court from considering events in a closed year to determine the proper adjustments for a docketed year. The court also held that the basis of the contributed note was a partnership item in the closed year of contribution, and remained a partnership item in each subsequent year.
The court rejected the taxpayer’s argument that the fact that § 6228(a)(5) expressly empowers the court to look back at non-docketed items as an offset to an administrative adjustment requested by a tax matters partner under § 6227, does not bar the court from looking at the facts of a non-docketed year in another matter.

4. **Filing a refund claim before paying the $150 million, rather than paying first, filing second, left the taxpayer out the $150 million on procedural grounds.** Ackerman v. Commissioner, 104 A.F.T.R.2d 2009-5830 (D. D.C. 8/18/09). Following a TEFRA partnership proceeding, the IRS notified the taxpayers of the resulting adjustments to their tax liability — over $150 million. Within the required sixty days of receiving the notices, the taxpayers filed administrative refund requests to which the IRS never responded. Subsequently they filed the refund suit. However, the taxpayers did not pay the deficiency until after the administrative refund request was filed. The government argued that § 6230(c) requires that the taxes be paid in full before the administrative refund request is filed, while the taxpayers argued that under § 6230(c) — unlike under § 7422, which governs refund claims generally — it is not necessary to pay the taxes in full before the administrative refund request is filed, but merely before the suit is filed. The court held that, as argued by the government, for the court to have jurisdiction, the taxes must be paid in full before the administrative refund request is filed. The court found the long line of cases imposing the “pay first” rule under § 7422 to be controlling. The court further held that even though accuracy related penalties resulting from the partnership adjustments were partner-level items, § 6230(c) — and not § 6511— nevertheless controlled the period for filing a refund claim. Thus, the taxpayer’s refund claim was untimely because it was not filed within 60 days. The suit was dismissed.

5. **Be careful what you stipulate to.** LKF X Investments, LLC v. Commissioner, T.C. Memo. 2009-192 (8/25/09). The IRS issued a notice of final partnership administrative adjustment (FPAA) to the taxpayer partnership asserting that a LLC taxed as a partnership that was used to invest in market-linked deposit transactions (another form of abusive shelter using contingent offsetting payments to generate losses) should be disregarded for tax purposes and that the investors had zero basis in their partnership interest. In the partnership proceeding the parties contested the Tax Court’s jurisdiction to consider disregard of the partnership and the partners’ bases as partnership items and stipulated that if the court determined that it had jurisdiction the parties would not contest the determinations made in the FPAA other than whether the valuation misstatement penalty imposed under § 6662 applies to any underpayment resulting from the adjustments in the FPAA. The court (Judge Marvel) granted summary judgment to the IRS holding that a determination whether a partnership is a sham, lacks economic substance, or otherwise should be disregarded is a partnership item, following its prior decision in Petaluma FX Partners, LLC v. Commissioner, 131 T.C. 84 (2008). The court also held that when a partnership is disregarded for Federal income tax purposes, the court has jurisdiction in the TEFRA proceeding to determine that the partners have zero outside basis. The court added that when the taxpayer stipulates that it would not contest an issue other than on jurisdictional grounds, the court will treat the issue as conceded. Finally, the court also held that where the partnership is disregarded and the partners’ outside basis is zero the court had jurisdiction to determine as partnership items the applicability of accuracy related and valuation misstatement penalties under § 6662. The court rejected that taxpayer’s assertion that the valuation misstatement penalty in inapplicable because it was attributable to disregard of the partnership rather than an erroneous valuation.

6. **In a Son-of-Boss litigation the Tax Court has jurisdiction to determine partner level deficiencies related to affected items.** Hiding the loss through additional pass-throughs justifies taxpayer-level determinations. Desmet v. Commissioner, 581 F.3d 297 (6th Cir. 9/17/09). The taxpayers formed a partnership in a Son-of-Boss transaction, then transferred their partnership interests to an S corporation. In the TEFRA partnership proceeding, which became final, the IRS determined that the partnership’s basis in distributed property was zero. Rather than directly assessing tax against the taxpayers as computational adjustments resulting from the FPPA under § 6230(a)(1), the IRS sent notices of deficiency related to affected items that require partner level determinations under § 6230(a)(2). The taxpayers asserted that the IRS
was required to assess the tax directly because no additional partner level determinations were necessary and that the statute of limitations had run on the assessment of individual deficiencies. Affirming the Tax Court, the Sixth Circuit concluded that the partnership proceeding determined only that the partnership was required to reduce its basis on account of its contingent obligation to close the short sale leg of the Son-of-Boss transaction. The partnership proceeding did not address the taxpayers' claimed losses through their S corporation. The S corporation's loss was not addressed in the FPAA. The S corporation's loss arose from the sale of distributed stock, which could not be determined from the FPAA. Thus, the court held that the IRS was empowered to bring individual level proceedings to resolve issues regarding the losses passed-through from the S corporation. The court also rejected the taxpayers' assertion that the procedure allows duplicative proceedings contrary to the purpose of the TEFRA partnership provisions.

7. **Go figure the deposit and come back.** Russian Recovery Fund Ltd. v. United States, 90 Fed. Cl. 698 (Fed. Cl. 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(c)-1(a)(1) requires that if the petitioning partner 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.

8. **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).

9. **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, 103 AFTR 2d 2009-364 (Fed. Cir. 1/8/09), 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.

10. TMP’s sole shareholder doesn’t get to file a separate Tax Court petition. Devonian Program v. Commissioner, T.C. Memo 2010-153 (7/19/10). The taxpayer was the sole shareholder of Basin Gas Corp. which was designated as the tax matters partner in Devonian Program, a partnership. The Devonian subscription agreement indicated that Basin would receive a flat fee for its services and contribute $3,000 to Devonian for a 17 percent interest in Devonian’s revenues. After the IRS issued an FPAA to Devonian, Basin filed a petition with the Tax Court as the tax matters partner. Subsequently, the taxpayer, the sole shareholder of Basin, filed a second petition claiming that Basin was only an agent and not a partner in Devonian. The Tax Court (Judge Goeke) held that the court lacked jurisdiction to consider the second petition, finding that Basin was a partner in the partnership and the designated tax matters partner. The court rejected the taxpayer’s argument that Basin held only a contingent interest in the partnership, finding that Basin could assign the interest and that Basin’s interest in revenues was a partnership share rather than payment for services. The opinion does not indicate why Basin’s sole shareholder independently sought to file a petition with the Tax Court.

11. Son-of-Boss – the shelter that keeps on taking. Legal fees for creating a Son-of-Boss transaction are affected items. Domulewicz v. Commissioner, T.C. Memo. 2010-177 (8/5/10). The taxpayers entered into a BDO Seidman / Jenkens & Gilchrist Son-of-Boss transaction by creating a subchapter S corporation that held an interest in a partnership. The S corporation was owned by a grantor trust. The S corporation paid $1,053,400 of legal fees related to the transaction. Under an FPAA issued to the partnership the IRS determined that the partnership was a sham whose existence was disregarded. After the FPAA became final, the IRS issued an affected item notice of deficiency to the individual investors disallowing deduction of the legal fees passed-through from the S corporation. The court (Judge Laro) rejected the taxpayers’ argument that the deficiency was barred by the statute of limitations because the fees, incurred by the S corporation, were not affected partnership items. Citing Thomas v. United States, 166 F.3d 825 (6th Cir. 1999), the court held that the fees and the S corporation deduction were affected by the partnership item determination in that the fees were nondeductible given the lack of a profit or business motive flowing from the partnership level determination. The fact that the fees were not incurred or deducted by the partnership did not remove the fees from being treated as affected items. The court pointed out further that the relationship between the partnership, the fees, the S corporation, and the taxpayers could not have been determined at the partnership level but had to be determined at a partner level proceeding. Therefore, the running of the statute of limitations was suspended under § 6229(d) until 60 days after the decision in the partnership proceeding became final. The fees were affected items because they were related to the transaction and were related to the partnership in that they were paid, at least in part, to form the partnership and to effect the transaction as it related to the partnership. The fees were the type of affected item assessable only through the deficiency procedures, because they required partner-level determinations to ascertain the portion (if not all) of the fees related to the partnership and to the transaction which were thus nondeductible.

12. The IRS gets a second bite at this TEFRA apple even if the in-house rules were not followed. NPR Investments, LLC v. United States, 2010 U.S. Dist. LEXIS 87398 (E.D. Tex. 8/10/10). NPR was a partnership formed to execute a R.J. Ruble, Sidley Austin, Son of Boss abusive tax shelter deal. The three partners were partners in a plaintiffs contingency fee law firm, and two of them were the taxpayers in Klamath Strategic Investment Fund, LLC v. United States, 568 F.3d 537 (5th Cir. 5/21/09). When the partners withdrew from NPR, they
transferred the inflated basis foreign currency from NPR to their law firm partnership. On its tax return, NPR indicated that it was not a partnership subject to TEFRA audit procedures, when in fact it was a TEFRA partnership. In the initial audit of NPR’s returns, the IRS applied normal partnership audit procedures and issued a final no adjustment notice to the partnership. Rather than proposing adjustments to the NPR return, the IRS determined that it would deny loss deductions through the issue of notices of deficiency directly to the NPR partners. In a higher level review, the IRS determined that NPR was a TEFRA partnership and that the deficiency action required issue of an FPAA to the NPR partners adjusting NPR partnership items. Section 6223(f) provides that if the IRS mails a final partnership administrative adjustment, it may not mail another notice in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact. The taxpayers argued that the second notice was invalid. The court (Judge Ward) found that the initial notice to NPR met the statutory criteria for an FPPA, even though it was sent through the normal audit process. The court indicated that there is nothing in statute or case law that affects the validity of an FPPA by whether the IRS followed proper internal procedures in issuing the notice. However, the court also found that the taxpayer’s misrepresentation of the TEFRA audit status on NPR’s partnership return by failing to check the box indicating it was subject to the TEFRA provisions was a “misrepresentation of a material fact” invoking the exception in § 6223(f) that allows a second notice.

The court also held that the taxpayers reasonably relied on their tax advisors and declined to impose penalties under §§ 6662(b) and 6664(c)(1).

G. Miscellaneous

1. Oops. No, no, I’m OK after all. Rev. Proc. 2010–32, 2010–36 I.R.B. 320. (9/7/10). This procedure provides that if a foreign entity makes a check the box election to be a partnership, under the reasonable assumption that it has more than one owner, but then determines that it only had one owner, the original check the box election will be treated as an election to be a disregarded entity provided the requirements in the revenue procedure are satisfied. Similarly, it also provides that if a foreign entity makes a check the box election to be a disregarded entity, under the reasonable assumption that it has only one owner, but then determines it only had more than one owner, the original check the box election will be treated as an election to be a partnership provided the requirements in the revenue procedure are satisfied.

VIII. TAX SHELTERS


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

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

- Notice 2000-44 disallows the losses (under §§ 165(a) and (e)) produced by both of these Baby BOSS transactions as artificial, citing, in the case of individuals, Fox v. Commissioner, 82 T.C. 1001 (1984), holding that §165(c)(2) requires a primary profit motive for a loss from a particular transaction is to be deductible. The notice also cites Reg. §1.701-2 (the partnership anti-abuse rules). The IRS also announced that it was reexamining the partnership basis rules.

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

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

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

- The temporary regulations purport to be effective for transactions occurring after 10/18/99 and before 6/24/03. The cases which held them to be retroactively effective include: Cemco Investors, LLC v. United States, 99 A.F.T.R.2d 2007-1882 (N.D. Ill. 2007), aff'd, 515 F.3d 749 (7th Cir. 2008); and Maguire Partners – Master Investments, LLC v. United States, 103 A.F.T.R.2d 2009-763, 2009-1 U.S.T.C. ¶50,215 (C.D. Calif. 2/4/09). The cases which held them not to be retroactively effective include: Klamath Strategic Investment Fund, LLC v. United States, 440 F. Supp. 2d 608 (E.D. Tex. 2006), aff'd in part, vacated in part, and remanded, 568 F.3d 537 (5th Cir. 5/21/09); Sala v. United States, 552 F. Supp. 2d 1167 (D. Colo. 2008); Stobie Creek Investments, LLC v. United States, 82 Fed. Cl. 636 (Fed. Cl. 2008); and Murfam Farms LLC v. United States, 88 Fed. Cl. 516 (Fed. Cl. 7/30/09).

- **And the Court of Federal Claims sticks by its guns.** Murfam Farms, LLC v. United States, 106 A.F.T.R.2d 2010—, 2010 U.S. Claims LEXIS 598 (Fed. Cl. 8/16/10). The court denied a motion by the government to vacate its earlier holding that Temp. Reg. § 1.752-6T cannot be retroactively applied. The government argued that the holding
was moot following a stipulation by the parties that the transaction lacked economic substance. The court held that the possibility that its earlier ruling would weaken the governments litigating position in future cases did not warrant vacating the earlier decision. The court noted that debate among courts is helpful.

3. **District Court holds for the taxpayer on the merits in an options transaction for which R.J. Ruble provided the tax opinion.** Sala v. United States, 552 F. Supp. 2d 1167 (D. Colo. 4/22/08). The District Court (Judge Babcock) held that taxpayer was entitled to a $60 million ordinary loss on 24 long and short currency options entered into in November 2000 as part of a Deerhurst Program, in which the options were contributed to a partnership. The basis of that partnership interest was increased by the cost of the long options but was not reduced by the contingent liability on the short options under Helmer v. Commissioner, T.C. Memo. 1975-160 (1975). This was based upon Judge Babcock’s finding of fact that the long and short options were separate instruments for tax purposes. The court found that the regulations issued in 2003, Reg. § 1.752-6, retroactive to October 1999, which contained an “exception to the exception” for transactions described in Notice 2000-44, exceeded Treasury’s authority. Judge Babcock held that the regulations were not legislative because the “exception to the exception” was not comparable to the rules for corporations described in § 358(h). Judge Babcock concluded that the corporate rules were only “to prevent acceleration or duplication of losses,” which were not involved in the transactions described in Notice 2000-44. He refused to follow Cemco Investors, LLC v. United States, 515 F.3d 749 (7th Cir. 2008).

- Judge Babcock analyzed the complex transaction under the step transaction doctrine and found the doctrine inapplicable.
- He found the losses deductible under § 165(c)(2) because they were incurred in a transaction entered into for profit, which was to be determined at the time taxpayer entered into the transaction, and not in hindsight. In this, Judge Babcock credited Sala’s testimony that “he expected his investment in Deerhurst to be profitable above and beyond the expected tax loss . . .”
- He found the taxpayer was “an extremely cautious investor who invested a great deal of time and energy carefully researching and choosing his investments” and that he had a business purpose other than tax avoidance for structuring his investment as he did.
- Judge Babcock further held that Sala’s amended return filed on 11/18/03 was a “qualified amended return” because KPMG had not been contacted regarding Deerhurst prior to that date, although it had been previously contacted regarding transactions similar to Deerhurst.

a. Government motion on 6/10/08 for new trial based upon affidavit given in connection with decision not to prosecute investment manager. Andrew J. Krieger, a key witness for the taxpayer, stated in an affidavit dated 5/22/08 that a portion of the testimony he gave at deposition was false, in that there was no “test period” for an “investment program” but merely an effort to obtain tax savings. 2008 TNT 114-15. The motion was opposed by the taxpayer because Krieger gave his affidavit only after the government granted him immunity from prosecution by executing a non-prosecution cooperation agreement in connection with a criminal investigation unrelated to this case, i.e., the Coplan criminal case pending in the Southern District of New York. 2008 TNT 130-62, 7/1/08.

b. **Government motion for new trial denied.** 251 F.R.D. 614, 102 A.F.T.R. 2d 2008-5292 (7/18/08). Judge Babcock denied the motion, holding that the evidence submitted by the government was not new. He stated, “Rather than implying diligence, the timing of this ‘new’ evidence instead implies a deliberate attempt on the part of the Government to further delay and derail this case for tactical gain.”

c. **Tenth Circuit reverses Judge Babcock for his Sala’d days.** Sala v. United States, 106 A.F.T.R. 2d 2010-5406 (10th Cir. 7/23/10). The Tenth Circuit (Judge Murphy) reverses Judge Babcock’s ruling in favor of Sala on all issues by severing the year-2000 tax loss from the post-2000 Deerhurst Program and finding that the 2000 transaction lacked economic substance because “the economic substance doctrine requires ‘disregarding, for tax
purposes, transactions that comply with the literal terms of the tax code but lack economic reality.

Judge Murphy observed:
Indeed, rather than suffering any actual financial loss through Deerhurst GP, Sala actually profited from the transaction. Sala does not contest that the loss is fictional, but rather protests that the rule from Helmer should control. This argument does not, however, address the claimed loss’s absence of economic reality. The absence of economic reality is the hallmark of a transaction lacking economic substance. ...

Additionally, while the district court found the long and short options had a potential to earn profits of $550,000 over the course of one year, the expected tax benefit was nearly $24 million. That expected tax benefit dwarfs any potential gain from his participation in Deerhurst GP such that “the economic realities of [the] transaction are insignificant in relation to the tax benefits of the transaction.” ...

The existence of some potential profit is “insufficient to impute substance into an otherwise sham transaction” where a “common-sense examination of the evidence as a whole” indicates the transaction lacked economic substance.

4. Maguire Partners. Maguire Partners – Master Investments, LLC v. United States, 103 A.F.T.R.2d 2009-763 (C.D. Calif. 2/4/09). Two individuals, through various entities, in late 2001 entered into call options spreads, i.e., they sold short call options to AIG via an Arthur Andersen tax strategy and purchased offsetting long call options and promissory notes from the same company; the options were European options, with an Asian-style feature, in that they were to be exercised on a particular date based upon the average value of a REIT basket over a 90-day period. The partnerships received the long options and notes and assumed the short options. In finding for the government, the court (Judge Walter) held that the evidence demonstrated that the transactions did not have economic substance because the individuals received no economic benefit, other than an increase in basis, from the transactions. The court also held that the evidence demonstrated that the individuals were motivated by the increased basis and not by any purported hedging benefit. The court held that, under both the step transaction doctrine and the substance-over-form doctrine, the individuals’ actual cost basis was the original amount of their investment – not the increased basis reported by the partnerships, because they had no downside exposure, and only an extremely remote possibility of receiving a return. Judge Thomas further held that the obligation created by the short option is a liability for purposes of § 752, or alternatively, it had to be taken into account under Reg. § 1.752-6 which applies retroactively. He further found that the individuals had been placed on notice by Notice 2000-44, issued in August 2000.

The court also held that the partnerships made a gross valuation misstatement under § 6662, citing in support the fact that one of the individual’s partnerships reported an increase in its capital account equal to 67 times the actual economic outlay that the individual paid for the transaction.

a. The court amended its earlier opinion to hold that the partnerships were not liable for the gross valuation misstatement penalties, but were liable for negligence penalties instead. Maguire Partners – Master Investments, LLC v. United States, 104 A.F.T.R.2d 2009-7839 (C.D. Calif. 12/11/09). The court focused its discussion of penalties on the “negligence or disregard of rules or regulations” under 6662(a) and (b)(1) and did not mention the valuation misstatement issue.

5. Murfam Farms. Retroactive application of the partnership contingent liability regulation rejected again. Murfam Farms L.L.C. v. United States, 88 Fed. Cl. 516 (Fed. Cl. 7/30/09). The court (Judge Damich) granted the taxpayers’ motion for partial summary judgment in a COBRA tax shelter case (COBRA is a Son-of-Boss digital options shelter under another name) declaring that Temp. Reg. § 1.752-6T may not be applied retroactively. The court held that retroactive application of the temporary regulation was barred by the prohibition of § 7805(b)(1) on retroactive application of regulations because it was not issued pursuant to a
congressional grant of authority. The court further opined that the retroactive application of the regulation was not authorized by § 309(c) of the 2000 Act because the abuse it sought to prevent was not the same type of abuse that § 358(h) was designed to prevent, i.e., it "was not to combat the inflation of basis – artificial or otherwise – rather, to preclude the acceleration and/or duplication of losses."

6. **Castle Harbour.** The Second Circuit reverses a taxpayer victory in a self-liquidating partnership note transaction, in which the lion's share of income was allocated to a tax-indifferent party, on the ground that the tax-indifferent Dutch banks were not really equity partners. TFD 313, Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 11/1/04), rev'd, 459 F.3d 220 (2d Cir. 8/3/06), on remand, 104 A.F.T.R.2d 2009-5746 (D. Conn. 10/7/09), as amended. 2009 U.S. Dist. LEXIS 98884 (D. Conn. 10/23/09) ("Castle Harbour").

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

- The book income was net of depreciation and the tax income did not take depreciation into account (because the airplanes were fully depreciated for tax purposes). Depreciation deductions for book purposes were on the order of 60 percent of the rental income for any given year.
- Scheduled distributions in excess of book income would have resulted in the liquidation of the investment of the Dutch banks in eight years, with the Dutch banks receiving a return of approximately nine percent, with some "economically substantial" upside and some downside risk. Castle Harbour was terminated after five years because of a threatened change in U.S. tax law, but during that period about $310 million of income was shifted to the Dutch banks for a tax saving to the GECC subsidiaries of about $62 million.
- The court (Judge Underhill) held that satisfaction of the mechanical rules of the regulations under § 704(b) transcended both an intent to avoid tax and the avoidance of significant tax through agreed upon partnership allocations. In this partnership, 2 percent of both operating and taxable income was allocated to GECC, a United States partner, and 98 percent of both book and taxable income was allocated to partners who were Dutch banks. The Dutch banks were foreign partners who were not liable for United States taxes and thus were indifferent to the U.S. tax consequences of their participation in the partnership. Because the partnership had very large book depreciation deductions and no tax depreciation, most of the partnership’s taxable operating income, which was substantially in excess of book taxable income, was allocated to the tax-indifferent foreign partners, even though a large portion of the cash receipts reflected in that income was devoted to repaying the principal of loans secured by property that GECC had contributed to the partnership. The overall partnership transaction saved GECC approximately $62 million in income taxes, and the court found that "it appears likely that one of GECC’s principal motivations in entering into this transaction – though certainly not its only motivation – was to avoid that substantial tax burden.” The court understood the effects of the allocations and concluded that “by allocating 98% of the income from fully tax-depreciated aircraft to the Dutch Banks,” GECC avoided an enormous tax burden, while shifting very little book income. Put another way, by allocating income less depreciation to tax-neutral parties, GECC was able to "re-depreciate" the assets for tax purposes. The tax-neutrals absorbed the tax consequences of all the income allocated to them, but actually received only the income in excess of book depreciation.” Nevertheless, the court upheld the allocations. “The tax benefits of the *** transaction were the result of the allocation of large amounts of book income to a tax-neutral entity,
offset by a large depreciation expense, with a corresponding allocation of a large amount of taxable income, but no corresponding allocation of depreciation deductions. This resulted in an enormous tax savings, but the simple allocation of a large percentage of income violates no rule. The government does not — and cannot — dispute that partners may allocate their partnership’s income as they choose. Neither does the government dispute that the taxable income allocated to the Dutch Banks could not be offset by the allocation of non-existent depreciation deductions to the banks. And … the bare allocation of a large interest in income does not violate the overall tax effect rule.”

Judge Underhill concluded:

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

• Query whether § 704(b) was properly applied to this transaction?
  • This appears to be a lease-stripping transaction in which the income from the lease was assigned to foreign entities while the benefits of ownership were left with a domestic entity.

**b. Castle Harbour II: Second Circuit reverses.** 459 F.3d 220 (2d Cir. 8/3/06). The Second Circuit, in an opinion by Judge Leval, held that the Dutch banks were not partners because their risks and rewards were closer to those of creditors than partners. He used the facts-and-circumstances test of Commissioner v. Culbertson, 337 U.S. 733 (1949), to determine whether the banks’ interest was more in the nature of debt or equity, and found that their interest was overwhelmingly in the nature of a secured lender’s interest, “which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits.”

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

**c. Castle Harbour III: On remand in Castle Harbour, the District Court found a valid partnership to have existed under § 704(e) because the heading does not alter the clear language of a statute. A valid family partnership is found in the absence of a family. Additionally, in his contingent penalty findings, Judge Underhill stated that his 2004 taxpayer-favorable decision ipso facto means that the taxpayer’s reporting position was based upon substantial authority. 104 A.F.T.R.2d 2009-6746 (D. Conn. 10/7/09), as amended, 2009 U.S.
In a carefully-written opinion, Judge Underhill held that, while the Second Circuit opinion decided that the partnership did not meet the Culbertson totality-of-the-circumstances test ("whether ... the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise"), it did not address the § 704(e)(1) issue. He held that the Dutch banks satisfied the requirements of that paragraph, which reads:

**Family partnerships.**

(e) Family partnerships.

(1) Recognition of interest created by purchase or gift. – A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

- In so holding, he relied upon well-settled law that the title of a statute cannot limit the plain meaning of the text, and that the title is of use only when it sheds light on some ambiguous word or phrase. See also, I.R.C. § 7806(b).

- Some of the authors observe that it is worth noting that although Evans v. Commissioner, 447 F.2d 547 (7th Cir. 1971), aff'g 54 T.C. 40 (1970), which Judge Underhill relied upon extensively to reach his conclusion, held that the application of § 704(e)(1) was not limited to the context of family partnerships, Evans involved the question who, between two different persons – the original partner or an assignee of the original partner’s economic interest – was the partner who should be taxed on a distributive share of the partnership’s income. Although in the family context § 704(e) frequently has been applied to determine whether a partnership exists in the first place, Judge Underhill’s decision in Castle Harbour III is the very first case to discover that § 704(e)(1) applies to determine whether an arrangement between two (or more) otherwise unrelated business entities or unrelated individuals constituted a partnership.

- It has sometimes been adduced that the fact that a court of applicable jurisdiction subsequently upholds the tax treatment of a transaction should be a strong argument for the proposition that such tax treatment was based upon substantial authority. With respect to the applicability of penalties should be reversed on appeal, Judge Underhill stated:

  To a large extent, my holding in Castle Harbour I in favor of the taxpayer demonstrates the substantial authority for the partnership’s tax treatment of the Dutch Banks, as does my discussion above of the Dutch Banks’ interest in Castle Harbour under section 704(e)(1). In addition, the government’s arguments against the substantial authority defense are unavailing. (emphasis supplied)

- Judge Underhill also sought to place the application of the penalty provisions in a temporal context when he stated:

  The government argues that Culbertson and Second Circuit cases like Slifka and Dyer that interpreted Culbertson cannot provide substantial authority for the partnership’s tax position because the Second Circuit held in Castle Harbour II that the Dutch Banks were not partners under Culbertson. The government, however, has not pointed to any Second Circuit case or other authority, prior to 1997 and 1998 when the Castle Harbour partners took the tax positions at issue, where the parties’ good faith intention or valid business purpose in forming a partnership was not sufficient to support a conclusion of partnership status for tax purposes.

- In the context of the previous two bullet points, it is worth noting that Judge Underhill’s observations in the immediately preceding bullet point appear to be consistent with Reg. § 1.6662-4(d)(3)(iv)(C), which provides that whether a position is supported by substantial authority must be determined with reference to authorities in existence at the time. But, Judge Underhill’s observations in the second preceding bullet point appear to be inconsistent with

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2 One of us thinks the opinion is “carefully-written.” Dan and Marty, the only two of us who teach and regularly write about partnership taxation, do not so think. Ira, who has never taught a course in partnership taxation, appreciates the innovative logic underlying the opinion.
both Reg. § 1.6662-4(d)(3)(iii), and observations in the immediately preceding bullet point. However, we are not all in agreement with what Judge Underhill intended the observations in the second preceding bullet point to mean.

- Stay tuned for further proceedings on appeal to the Second Circuit, where the same panel that heard Castle Harbour II will hear Castle Harbour IV.

7. **Consolidated Edison.** Taxpayer victory in the Court of Federal Claims in a lease-in, lease-out (LILO) transaction with a Dutch utility. On appeal, the taxpayer is likely to hit a Dutch wall, i.e., a [Timothy] Dyk. Consolidated Edison Co. of New York v. United States, 90 Fed. Cl. 228 (10/21/09). The Court of Federal Claims (Judge Horn), in a long and careful opinion held that, under the particular facts of this case, the LILO transaction taxpayer entered into with a Dutch utility had economic substance, i.e., that no decision as to whether particular options would be exercised was “pre-ordained” and that taxpayer “bore the burdens and benefits of ownership.” In finding that taxpayer had shown that the transaction was a true lease and should be respected, she distinguished factually other LILO cases decided for the government, such as *BB & T Corporation v. United States*, 523 F.3d 461 (4th Cir. 2008), and *AWG Leasing Trust v. United States*, 592 F. Supp. 2d 953 (N.D. Ohio 2008).

- A large portion of the opinion consists of Judge Horn’s analysis of the expert evidence, with pointed criticism of one expert who “failed to conduct in-depth studies of the … [t]ransaction and gave almost automatic and generalized conclusions on the flaws of LILO and SILO transactions for tax purposes.”

- Alleged “spoliation of evidence” in 2000 by reason of a switch in e-mail systems without preserving all of the then-existing e-mails, and the desire to protect 1997 memoranda as work product, came into conflict with bad result for the credibility of an in-house lawyer. (“He was considered by the court an unreliable witness, perhaps willing to write or say whatever he thought would assist his then current assignment.”) The court found that litigation was not reasonably anticipated until 2002 at the earliest because negotiations in connection with the IRS audit were ongoing until at least that year. The 1997 memoranda were ordered disclosed.

8. **Palm Canyon X.** Another Son-of-Boss-type shelter bites the dust in the Tax Court and not even the Thighmaster can trim the tax bill. *Palm Canyon X Investments, LLC, et al. v. Commissioner*, T.C. Memo. 2009-288 (12/15/09). In a lengthy opinion the court (Judge Marvel) held that a Son-of-Boss investment in offsetting digital option contracts was to be disregarded under the economic substance doctrine. Taxpayers Alan and Suzanne Hamel ran a retail business that included the extremely successful “Thighmaster,” which featured Suzanne Hamel, a/k/a the actress Suzanne Somers, in its advertising. They incorporated Alan Hamel Investments (AHI), which in turn was the sole member of Palm Canyon, an LLC. Palm Canyon entered into a long digital option contract for a premium of $5 million an offsetting short option for which the counterparty paid a premium of $4.945 million, resulting in a net premium outlay of $55,000. An investment company formed by one of the promoters acquired a membership interest in the LLC, thereby allowing the LLC to be treated as a partnership. AHI claimed a basis in the LLC in the amount of the premium paid for the long position without reduction for the contingent liability represented by the short position assumed by the partnership. On the subsequent liquidation of the partnership, AHI claimed a high basis in a Canadian dollars position that was sold for a loss. The contracts were entered into through John Ivspan, a tax attorney with Cantley & Sedacca, LLP, who directed them to the Dallas branch of Deutsche Bank to implement the strategy, which created a $5 million ordinary loss. The court avoided the technical issues, and assumed that the transaction satisfied the literal language of § 752 and that under *Helmer v. Commissioner*, T.C. Memo. 1975-160, AHI’s partnership basis was not reduced by the contingent short option liability. The court also avoided the issue of retroactive application of Temp. Reg. § 1.752-6, which would have required AHI to reduce its basis by the LLC’s potential payment on the short option. Nonetheless, the court concluded that the transaction failed to satisfy the subjective prong of the economic substance test because the Hamels entered into the transaction for the sole purpose of avoiding federal income tax, and failed the objective prong because the taxpayers’ failed to demonstrate that the transactions had any reasonable prospect of earning a profit. The court noted that because of the marketing
agent’s ability to determine the spot market exchange rate on the option date, the marketing agent could assure that the option contracts would not hit the “sweet spot” that would make the transaction profitable. The court imposed accuracy related penalties concluding that the transaction qualified as a tax shelter and that the Hamels could not reasonably rely on the tax opinion of Pryor, Cashman, Sherman & Flynn, LLP, which was part of the promoter team and therefore had a conflict of interest in issuing the opinion.

9. **Wells Fargo. “The SILO transactions here are offensive to the Court on many levels.”** Wells Fargo & Co. v. United States, 91 Fed. Cl. 35 (1/8/10). Wells Fargo engaged in 26 SILO transactions, five of which were tried in this refund case in the Court of Federal Claims. Seventeen of the SILOs involved domestic transit agencies and nine involving qualified technological equipment. The trial dealt with four SILOs involving public transit agencies, and one involving cellular telecommunications equipment. The parties agreed that the court’s ruling with respect to the five transactions would guide the resolution of the remainder. The court’s fact findings are synopsized in the following passage from the opinion by Judge Wheeler:

In each transaction, the parties employed equity and debt “defeasance accounts,” which are types of escrow accounts intended to minimize the risks of non-payment. During the lease-back period, a return is generated from the equity defeasance account investments. The value of the equity defeasance account is expected to grow so that the tax-exempt entity can exercise the buy-out option at the end of the lease-back period without using any of its own funds. However, the equity defeasance account return is more than offset by the other costs of the transaction, including Wells Fargo’s cost of funds to engage in the transaction. The end result is that the trial transactions produce an overall loss without the tax benefits, and no rational person would engage in these transactions absent the tax benefits. This conclusion is borne out by Wells Fargo’s cessation of SILO transactions after the IRS began disallowing SILO tax deductions. Moreover, the profitable portion of the transactions could be realized simply by investing in the same portfolio as the equity defeasance account. The only reason to create the elaborate array of agreements comprising a SILO transaction is for Wells Fargo to obtain the tax benefits at minimal risk, and with complete assurance of the desired long-term outcome.

* The essence the court’s ultimate holding is captured in the following passages from the opinion:

The Court finds that Wells Fargo is not entitled to the claimed tax deductions on the five trial transactions. The SILO transactions did not grant to Wells Fargo the burdens and benefits of property ownership. The transactions lack economic substance, and were intended only to reduce Wells Fargo’s federal taxes by millions of dollars. Although well disguised in a sea of paper and complexity, the SILO transactions essentially amount to Wells Fargo’s purchase of tax benefits for a fee from a tax-exempt entity that cannot use the deductions. The transactions are designed to minimize risk and assure a desired outcome to Wells Fargo, regardless of how the value of the property may fluctuate during the term of the transactions. Indeed, nothing of any substance changes in the tax-exempt entity’s operation and ownership of the assets. The only money that changes hands is Wells Fargo’s up-front fee to the tax-exempt entity, and Wells Fargo’s payments to those who have participated in or created the intricate agreements. The equity and debt “loop” transactions simply are offsetting accounting entries not involving actual payments, or pools of money eventually returned to the original holder. If the Court were to approve of these SILO schemes, the big losers would be the Internal Revenue Service (“IRS”), deprived of millions in taxes rightfully due from a financial giant, and the taxpaying public, forced to bear the burden of the taxes avoided by Wells Fargo.
... The heart of these transactions is that Wells Fargo paid a fee to tax-exempt entities to acquire valuable tax deductions that the tax-exempt entities could not use. Wells Fargo also invested an amount with an equity undertaker that it could have done directly, without involving any tax-exempt entities or their equipment. Aside from these two elements, the circular flow of funds adds nothing to the transaction, except to eliminate any risk to Wells Fargo and to produce more claimed tax deductions. The involvement of lenders like AIG, appraisers like Ernst & Young, and law firms like King & Spalding is “window dressing” serving only to generate fees and lengthy documents to give the SILOs an appearance of validity. The Indiana district court hit the mark when it described the SILO as a “blatantly abusive tax shelter” that is “rotten to the core.” Hoosier Energy Rural Elec. Coop., Inc. v. John Hancock Life Ins. Co., 588 F.Supp.2d 919, 921, 928 (S.D. Ind. 2008), aff’d 582 F.3d 721 (7th Cir. 2009).

- After first holding that Wells Fargo was not entitled to depreciation deductions because it never obtained the benefits and burdens of ownership, and was not entitled to interest deductions, because the “loop nonrecourse debt was not genuine indebtedness — “the lenders did not relinquish the use of the money except for the brief one-day loop ... [and neither] Wells Fargo nor the tax-exempt entity ever had the use of the funds” — the court held alternatively that the transactions lacked economic substance under the standards of Coltec Industries v. United States, 454 F.3d 1340 (F3d. Cir. 2006), cert. denied, 549 U.S. 1206 (2007). The transactions lacked objective economic substance because the source of the non-tax economic benefit to Wells Fargo, when the SILOs terminated was merely the return of its investment, plus the interest earned.

... Wells Fargo could have realized this same return simply by investing in the portfolio of the equity defeasance arrangement, without involving the [counter-parties] ... in any way. ...

... Though the mountains of paper defy comprehension without careful study, the bottom line is that the SILOs provide no reasonable possibility of profit at all, absent a claim for the tax deductions. Wells Fargo’s cost of funds alone turns the SILOs into a losing proposition. Wells Fargo’s witness ... agreed that the cash-on-cash, non-tax return calculated is less than Wells Fargo’s cost of funds for its leasing business. ...

... [W]hen all transactional and funding costs are considered, the non-tax return is negative. Thus, if not for the tax deductions, no rational business entity would seriously contemplate a SILO transaction.

- The transactions failed the subjective branch of the economic substance test because they had no non-tax business purpose.

... Without the claimed tax benefits, and without the company’s tax capacity to use the claimed tax benefits, Wells Fargo would not have entered into the SILO transactions. ... The motivating reason for the Wells Fargo SILOs was the desire to reduce the company’s taxes as much as possible. There were no non-tax reasons that would justify Wells Fargo’s entering into these transactions. The lack of any arms’ length negotiations of many substantive terms is a further indication of a questionable transaction. The key terms of the SILOs were determined by tax considerations, and Wells Fargo’s constraints to eliminate risk. The transaction terms were more the product of a software model, than any negotiations or commercial realities.

- The court distinguished Consolidated Edison Co. of New York v. United States, 90 Fed. Cl. 228, 104 A.F.T.R.2d 2009-6966 (2009), as a “distinctly unique” case, and found the transactions in Wells Fargo to be like those in AWG Leasing Trust v. United States, 592 F. Supp. 2d (N.D. Ohio 2008), and BB&T Corp. v. United States, 523 F.3d 461 (4th Cir. 2008), aff’g 99 A.F.T.R.2d 2007-376 (M.D. N.C. 2007), in which deductions from LILO transactions were disallowed.
10. Confining the Frank Lyon Co. Result to its facts as understood by the Supreme Court. "The Court [in Frank Lyon Co.] also emphasized, in contrast to this case the transaction did not create any tax deductions, because Lyon and Worthen paid taxes at the same rate." Altria Group, Inc. v. United States, 694 F.3d 259 (S.D. N.Y. 3/16/10). In a refund suit involving several SILO and LILO tax shelters with respect to infrastructure originally owned by tax indifferent parties, a jury rendered a verdict for the government, finding that the transactions lacked economic substance. On the taxpayer's motion for judgment as a matter of law and, alternatively, for a new trial, Judge Holwell ruled in favor of the government. He generically described the four transactions as follows:

In each transaction, Altria immediately leased the asset back to its original owner using agreements with a number of unusual features, including complete defeasance (prepayment, in essence) of the lessee's rent and an owner's option to repurchase the asset. Altria then claimed depreciation, amortization, interest expense, and transaction expense deductions on its 1996 and 1997 corporate tax return based on its newly acquired assets, even though (i) its purchase money immediately was invested in securities that the nominal lessees could not access without providing substitute collateral, and (ii) the lessees could reacquire the assets without incurring any out-of-pocket costs.

- In the course of extensive discussion of the import of Frank Lyon Co. v. United States, 435 U.S. 561 (1978), Judge Holwell deftly confined that case to its facts as understood by the Supreme Court, stating, "The Court also emphasized, in contrast to this case the transaction did not create any tax deductions, because Lyon and Worthen paid taxes at the same rate." Referring again to the Supreme Court's Frank Lyon decision, he observed: "The Supreme Court, however, has expressly indicated that a transaction's effect on the U.S. Treasury must inform a federal court's analysis of whether a transactional form chosen selected by a taxpayer should be respected for federal tax purposes." Judge Holwell went on to discuss of the application of a flexible economic substance doctrine test under Second Circuit precedent, but he described it all as "dicta" in light of the jury's verdict. He described Second Circuit law as requiring "an analysis under which the fact finder must consider both aspects of the economic substance inquiry, and may (but need not) find against the taxpayer if a transaction lacks either a legitimate business purpose or an economic effect." On this basis, the court rejected Altria's argument that because the facts established that it expected to receive a non-taxbased return of 2.5% to 3.8% from the transactions it was entitled to judgment as a matter of law "[T]he jury's finding that Altria lacked a legitimate business purpose for entering the transactions, even if at the limits of what present doctrine allows, was sufficient to support its economic substance verdict."

- Note that under new § 7701(o), if a court applies the economic substance doctrine to transactions entered into after 3/30/10, it must apply a conjunctive test under which the claimed tax benefits must be disallowed unless (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.

11. Partnership anti-abuse rules are applied to eliminate losses in a transaction that lacked economic substance. Did this court initiate the use of Reg. § 1.701-2? NV Partners Fund, LLC v. United States, 105 A.F.T.R.2d 2010-830 (S.D. Miss. 4/30/10). The District Court upheld the IRS recharacterization of a tax shelter strategy involving KPMG, called the Family Office Customized Strategy (FOCus) in eleven separate actions challenging final partnership administrative adjustments (FPAs). The court agreed with the IRS that the transactions were subject to recharacterization under the anti abuse rules of Reg. § 1.701-2. The tax matters partner in all of the proceedings was James Kelly Williams who had substantial gains in tax years 2001 and 2002. The transaction developed by KPMG utilized a multiple tier structure, the creation of a fund of funds LLC, an alternative investment fund LLC and a third tier LLC that invested in collared long and short currency futures with Credit Suisse First Boston. Gains on long positions were invested in CDs with Credit Suisse, suspended losses on
short positions remained in the investment funds. The tax shelter investor then purchased the funds to acquire the suspended losses with a capital contribution, in the form of debt guarantees with Credit Suisse, to establish basis. The transaction was blessed with opinions from the Arnold Porter firm. The court recognized these transactions as artificial high basis transactions described in Notice 2000-44, 2000-36 I.R.B. 255 (BOSS and Son of BOSS type transactions). While noting that the BOSS type transactions had been challenged by the IRS, the court also indicated that KPMG hoped that the FOCUS strategy was structured in a way that would avoid IRS scrutiny and did not register the deal as an abusive tax shelter. The court found that "the central point in 2001 of following the strategy being promoted by KPMG was to ameliorate Williams’ tax situation, regardless of Williams’ investment activity." After a lengthy analysis of economic substance cases, the court stated that "the FOCUS steps were a series of transactions lacking economic substance and comprising an abusive tax shelter designed to permit an investor such as James Kelley Williams to purchase losses embedded in a tiered partnership structure and to reduce substantially, if not entirely, his federal tax liability for the 2001 tax year in a manner inconsistent with the intent of subchapter K." The court also refused to conflate the FOCUS generated losses with subsequent successful investments with the hedge fund, the NCR Bricolage companies, that managed the investments. Thus, the court held that the IRS appropriately recast the transaction under Reg. § 1.701-2 to deny the losses. With regard to the IRS assertion of penalties, the court held that James Kelly Williams was required to raise any reasonable cause and good faith defenses in a separate partner level refund action. The court sustained imposition of 20 percent understatement of income and 20 percent negligence penalties (which are not stacked) on the partnerships and rejected the partnerships’ assertions that the FOCUS positions were supported by substantial authority and that the partnerships could have reasonably relied on the advice of professionals.

a. Different District Court, same result. Fidelity International Currency Advisor A Fund LLC v. United States, 105 A.F.T.R.2d 2010-2403, 2010-1 U.S.T.C. ¶50,418 (D. Mass. 5/17/10). Richard Egan (a former ambassador to Ireland) was one of the founders of EMC Corporation, a large publicly traded entity that developed computer storage devices. In order to avoid tax on $200 million capital gain resulting from sales of EMC stock, Egan entered into paired options arrangements through partnership investments devised by KPMG, with opinions from Sidley, Austin, Brown & Wood, with Fidelity International Currency Advisors and Fidelity High Tech Advisor A Fund as general partners (Son-of BOSS type transactions), and a separate transaction designed to offset ordinary gains described as a financial derivatives strategy designed to generate U.S. losses offset with offshore gains attributed to a non-US taxpayer. In an opinion in excess of 350 pages, finding that the transactions were shams lacking economic substance the court (Judge Saylor) described the transactions as "entirely irrational; they were unnecessarily and extravagantly expensive, and did not hedge the purported risks effectively (or at all). . . . the transactions were designed and intended to lose money, and in fact did so." With respect to the taxpayer's argument that § 752 allowed a basis increase for the long option positions while not treating the short positions as liabilities, the court stated that, "If the tax system depended entirely on form over substance, the argument might well pass muster. [par.] But tax liabilities are not so easy to dodge. It would be absurd to consider offsetting options – purchased and sold at the same time, and with the same counterparties – as separate items, and to act as if the one item existed and the other did not. That is particularly true where (as here) the individual option positions were gigantic, and might bankrupt the taxpayer or the options dealer if no offset were in place." Rejecting the taxpayers' claim of reasonable reliance on tax opinions, the court described the opinions as "fraudulent" and indicated that "[t]he Egans knew that the opinion letters were simply part of the tax shelter scheme, and did not for a moment believe that they were receiving independent legal advice after a full disclosure of all underlying facts." The court ultimately held, among other things, that neither transaction had business purpose and both lacked economic substance, that the intermediate steps of the transactions should be disregarded under the step transaction doctrines and that the transaction should be treated as a single integrated transaction, and that the partnerships would be disregarded under the anti-abuse regulation § 1.701-2. Although the court found that there were
no grounds to assert reasonable reliance defenses to penalties, the court indicated that it lacked jurisdiction to determine whether specific penalties, determined in individual partners’ proceedings, should be assessed against members or partners.

12. The Court of Federal Claims denied retroactive application of the regulations, but slammed the door on the digital options strategy on economic substance grounds and upholds penalties. Stobie Creek Investments, LLC v. United States, 82 Fed. Cl. 636 (Fed. Cl. 7/31/08). The Welles family recognized substantial capital gain on disposition of 50 percent of the family residential entry door business for $455 million. Prior to sale the family transferred their stock holdings in the family corporation, Therma-Tru, to a family investment partnership, Stobie Creek. The partnership, through single member LLCs, participated in the Jenkens & Gilchrist digital options strategy, to no avail according to the Court of Federal Claims. In an extraordinarily detailed and lengthy opinion, the court held:

- Helmer v. Commissioner, T.C. Memo. 1975-160, establishes that the contingent nature of the short sold position in foreign currency prevents a reduction in basis for a reduction in partnership liabilities on distribution of property from the partnership. Thus the potential liability on the open currency option did not reduce the taxpayers’ basis in distributed Therma-Tru stock, whose basis was increased by the purchase price of the short options.

- Retroactive application of Reg. § 1.752-6 is not justified by § 309 of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 309, 114 Stat. 2763A-587, -638. That provision was aimed at corporate transactions and is focused on the use of contingent liabilities to accelerate or duplicate losses. The court opined that, “The transfers of the contingent liabilities in the cases at bar resulted in increasing each partner’s outside basis, but did not cause any acceleration or duplication of losses.”

- Judge Miller held that the long and short digital options were two options, not one as contended by the government.

- Judge Miller dismissed Notice 2000-44, which was issued in August 2000, after the transactions occurred but before they were reported by taxpayers in 2001, as follows:

  [The government’s] argument misunderstands the import of IRS notices. As a general proposition, IRS notices are press releases stating the IRS’s position on a particular issue and informing the public of its intentions; such notices do not constitute legal authority. .... Whether [taxpayers] had “notice” that their transactions would be subject to scrutiny has no bearing on whether a Treasury regulation, seeking retroactively to effect a change in the law, can serve to disallow [taxpayers’] reporting position.

- Nonetheless, under Coltec Industries, Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006), the partnership transaction in options lacked economic substance. The court indicated that in Coltec, “The Federal Circuit thus adopted a disjunctive test for determining whether a transaction should be disregarded as an economic sham: the doctrine should apply and a transaction should be disregarded either if the transaction lacks objective economic substance or if it is subjectively shaped solely by tax avoidance motivations.” After an exhaustive analysis of conflicting expert opinions, the court found that, “the weight of the evidence overwhelms plaintiffs’ claim that the transactions were investments motivated by a business purpose to return a profit.” The court also interpreted Coltec as holding that, “if a transaction was shaped solely by a tax-avoidance purpose, the fact that the transaction may have some objective economic reality cannot save it from being disregarded as an economic sham.” As to the taxpayers’ subjective purpose, the court found that, “Plaintiffs’ limited evidence of non-tax avoidance subjective motivation does not imbue the transactions with economic substance.”

- The court also applied the step transaction doctrine to deny the claimed tax benefits. The court stated, “Trial established that, under either the interdependence test or the end result test, the step transaction doctrine applies to plaintiffs’ transactions. Accordingly, the tax consequences must turn on the substance of the transaction and not on the form by which plaintiffs engaged in it. In disregarding the predetermined steps of the J&G strategy,
Stobie Creek is unable to claim a basis increase in the Therma-Tru stock, and the capital gains must be taxed according to the reality of the transaction."

- The court upheld accuracy and negligence penalties and rejected the taxpayers’ claims that they reasonably relied on the advice of counsel. The court concluded that because of the built-in conflict of interest of the lawyers promoting the transaction that was known to the taxpayers, reliance on the legal opinions was not reasonable.

The Federal Circuit (Judge Prost) affirmed the Court of Federal Claims on both the merits and on the penalty issue. The court found that the offsetting options, while separate transactions for tax purposes (under “a literal application of the tax code at that time”), were to be “properly treated as a single, unified transaction” for economic substance (“economic reality”) purposes. This led to the conclusion that “they similarly should not be separate for the purpose of calculating the taxpayers’ basis in Stobie Creek,” and the taxpayers’ claimed basis of $204,575,000 was disregarded “as lacking economic reality.”

The key paragraphs of the opinion relating to penalties are:

Similarly, the evidence supports the trial court’s conclusion that Jeffrey Welles knew or should have known that SLK was an agent of J & G, and thus could not reasonably rely on SLK’s advice. SLK’s agency relation-ship was apparent from the beginning. Waterman referred the Welleses to J & G, presented the strategy at the Vero Beach meeting, and recommended the strategy. As was true for J & G, SLK’s fee agreement made clear that SLK had a financial stake in the outcome, again tying compensation to the sheltered gain. SLK also helped implement the strategy by drafting and backdating documents for the different corporate entities. In-deed, SLK openly acknowledged its role in a letter to the Welleses. The letter stated that the lower taxable gain that would be reported on Stobie Creek’s return was “produced by the tax strategy that was developed by [J & G] and implemented with our [SLK’s] help earlier this year.” The trial court found that Jeffrey Welles received this letter. Based on that and other evidence presented at trial, it was reasonable for the trial court to infer that Jeffrey Welles (and thus Stobie Creek) knew or should have known about the conflicts of interest for J & G and SLK. It was not objectively reasonable for Jeffrey Welles to ignore evidence of these conflicts and continue to rely on the advice, regardless of the Welleses’ longstanding relationship with SLK or the reputations of both firms.

Even if Jeffrey Welles had not known about the conflicts of interest, his reliance on the advice of SLK and J & G was still unreasonable. Based on Jeffrey Welles’s education and experience, as well as the reason the Welleses pursued the J & G strategy, the trial court found that Jeffrey Welles should have known that the J & G strategy was “too good to be true.” Cf. Neonatology, 299 F.3d at 234. This determination is not clearly erroneous. Jeffrey Welles was a highly educated professional with extensive experience in finance, having worked as an investment banker and as the manager of his family’s complex finances. Stobie Creek, 82 Fed. Cl. at 715. In that managerial role, he had helped implement a number of sophisticated tax-planning strategies, giving him sufficient knowledge and experience to know when a tax-planning strategy was likely “too good to be true.” Jeffrey Welles knew that the J & G strategy was marketed as a “Basis Enhancing Derivatives Structure” and that the purpose of the strategy was to boost the basis in capital assets, “generating a reduced gain for tax purposes.” Moreover, Jeffrey Welles sought out and selected the J & G strategy because of a desire to avoid taxes that would otherwise be owed on the Therma-Tru deal, not because he wanted to structure the deal itself to minimize taxes.

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. No. 9 (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 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), because WISCO did not have any allocable share of the liability. 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.

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:

> Where, 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 substance3 – 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

3 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.
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.

- **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 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. I.R.C. § 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. ____ (9/13/2010). 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.”

b. 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).

C. Disclosure and Settlement
D. Tax Shelter Penalties, Etc.

1. **“Everyone's doing it” is not a legal principle.** 3K Investment Partners v. Commissioner, 133 T.C. No. 6 (9/3/09). In a partnership proceeding to determine whether the partnership reasonably relied on tax opinions in a Son-of-Boss tax shelter investment in order to avoid § 6662 accuracy related penalties, the partnership sought discovery of all of the Son-of-Boss tax shelter opinions and a list of firms providing opinions in order to bolster its argument that reliance on opinions of Jenkens & Gilchrist was reasonable. In denying the discovery motion, the court (Judge Thornton) observed that, “Petitioner's argument appears to be a variant of the refrain, familiar to parents of teenagers, that ‘Everyone's doing it.'” For the same reason that this does not constitute reasonable cause for teenagers, it would not constitute reasonable cause for petitioner.” The court held that the partnership must establish reasonableness based on the facts of its own case. The court also rejected the partnership's argument that the undisclosed opinions, which the court described as involving only a small subset of tax advisors, disclosed a general consensus of tax advisors supported good faith reliance. The court also ruled that the undisclosed tax opinions in the possession of the IRS represented confidential taxpayer information protected from disclosure under § 6103(a).

2. The Seventh Circuit jumps ship on penalties as partnership items. It affirmed a District Court holding that no accuracy-related penalties applied in a Son-of-Boss case because taxpayers were entitled to rely on tax opinions. American Boat Company,
LLC v. United States, 583 F.3d 471 (7th Cir. 10/1/09). David Jump transferred Mississippi river towboats to American Boat L.L.C. after an accident in which barges broke loose from a tow boat and nearly caused a disaster by floating into a casino moored in St. Louis. In a series of Son-of-Boss transactions, American Boat used Treasury note short sales to increase the basis of its tow boats and claim higher depreciation deductions. In a District Court proceeding brought by the partnership the trial court held that the Son-of-Boss transactions were shams, but upheld the partnership’s assertion of a reasonable cause defense under § 6664(c) to accuracy related penalties as a partnership item. The government appealed the penalty issue.

- The court stated that the vast majority of courts have held that a partnership may assert a reasonable cause defense as a partnership item on its own behalf based on the conduct of its managing or general partner. The court also noted that a partner may not raise the partner’s own reasonable cause defense in a partnership proceeding, but rejected the IRS argument that a reasonable cause defense is limited. The court concluded that a partnership may raise a reasonable cause defense on facts and circumstances common to all partners and which relies on neither an individual partner’s tax return nor his unique conduct. The court further concluded that, while it was a close case, the Seventh Circuit was not able to conclude that the District Court committed clear error in finding that American Boat, through David Jump, reasonably relied on the tax opinion of Erwin Mayer and Jenkens & Gilchrist in reporting the Son-of-Boss transaction.

3. Magistrate Judge Bush decided that valuation misstatement penalties are inapplicable in a Son of Boss tax shelter case in which the IRS determined that the transaction were shams that lacked economic substance. Bemont Investments LLC v. United States, 105 A.F.T.R.2d 2010-1338 (E.D. Tex. 3/9/10). Magistrate Judge Bush based his decision on Weiner v. United States, 389 F.3d 152 (5th Cir. 2004), which cited with approval a line of cases that held that valuation penalties are not applicable if the IRS’s disallowance of tax benefits is not “attributable to” a valuation misstatement.

4. The IRS states that it will suspend the collection of penalties under § 6707A from small businesses that “inadvertently” invested in listed tax shelters. 2009 TNT 128-15 (7/6/09). Letter from Commissioner Shulman, which reads in part, “Given your indication of a commitment to enact legislation to address this issue, and to provide the Congress that opportunity, we will not undertake any collection enforcement action through September 30, 2009, on cases where the annual tax benefit from the transaction is less than $100,000 for individuals or $200,000 for other taxpayers per year.”
   a. The IRS agrees to extend the moratorium through the end of 2009. Letter from Commissioner Shulman. 2009 TNT 184-23 (8/24/09).
   b. And again, to extend the moratorium through 4/1/10. 2009 TNT 245-1 (12/23/09).
      • With Congress focused “laser-like” on job creation, no legislation on this penalty issue had been enacted as of 8/5/10, although H.R. 5297, the Small Business Jobs and Credit Bill of 2010 is pending in the Senate.
   d. Relief from tax shelter penalties under § 6707A for small businesses. The § 6707A penalty is limited to 75 percent of the decrease in tax shown for any reportable transaction. Under § 2041 of the Small Business Jobs Act of 2010, the § 6707A penalty is limited to 75 percent of the decrease in tax shown for any listed or reportable transaction. Formerly, penalty imposed for failure to include information on a listed transaction by a taxpayer other than a natural person was $200,000 regardless of how small the claimed benefits from the transaction happened to be. The limitation applies to penalties assessed after 12/31/06.

5. If the tax advisor’s fee is big enough, it’s not a reliable opinion! Murfam Farms, Inc. v. United States, _ Fed. Cl. _, 2010 U.S. Claims LEXIS 598 (8/16/10). The taxpayers conceded that their Son-of-Boss tax shelters lacked economic substance, and the only issue was whether the 40 percent accuracy related penalty was properly assessable. The court held that the taxpayers had not established that acted with reasonable cause or in good faith, and that the penalty wals properly assessed. Reliance on the advice of E&Y was not
reasonable: “Because E&Y had a financial interest in having the Murphys participate in COBRA, the firm had an inherent conflict of interest in advising on the legitimacy of that transaction.” Furthermore, “[t]hat conflict of interest was exacerbated by the fee structure,” under which E&Y’s fee would be a percentage of the taxpayer’s desired tax loss. “The Murphys knew that E&Y stood to earn millions by advising them to participate in COBRA, and they therefore knew or should have known that E&Y’s advice lacked the trustworthiness of an impartial opinion.” Judge Damich also had a host of other reasons for finding that the taxpayers’ reliance was not reasonable or in good faith.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. The IRS gives small exempt organizations until 10/15/10 to comply with filing requirements. IR-2010-87 (7/26/10). The IRS has granted relief to small exempt organizations that failed to file required returns for 2007, 2008 and 2009 by extending to 10/15/10 the deadline for complying with filing requirements in order to keep tax exempt status. The information release provides for late electronic filing of the Form 990-N, Electronic Notice (e-Postcard) and for a voluntary compliance program to file the Form 990-EZ.

2. Tax Blues for Bluetooth. Bluetooth SIG, Inc. v. United States, 106 A.F.T.R.2d 2010-5163 (9th Cir. 7/8/10). The taxpayer sought tax exempt status under § 501(c)(6) as a “business league.” The corporation (1) develops, refines, and adapts the Bluetooth specification, (2) engages in marketing, public relations, and other promotional activities designed to influence the acceptance, understanding, and use of Bluetooth enabled products, (3) enforces its trademark both by ensuring that its members conform to the “Bluetooth Brand Book” and by detecting unauthorized use of the Bluetooth trademark, and (4) operates a certification and listing program. The taxpayer had 4,148 members, all of which independent businesses. It had three membership classes: Adopters, Associates, and Promoters. Adopters pay no annual fee, but pay a listing fee of $10,000 per product. Associates pay an annual fee of either $7,500 or $35,000 depending on the size of the manufacturer. They pay a reduced listing fee of $5,000 per product and have the right to participate in the continuing development of the Bluetooth specification. They receive certain marketing and promotional opportunities that may not be available to Adopters. Promoters pay no annual fee but enjoy the same benefits as Associates, plus a seat on the board of directors. Each of the original five companies involved with the technology has Promoter status. The court affirmed the district court’s summary judgment that the taxpayer did not qualify for tax exempt status, because it activities were activities ordinarily conducted for profit, which is not permitted under Reg. § 1.501(c)(6)-1. Further, the taxpayer’s activities were not directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. A benefit to nonmembers is a key characteristic of business leagues, but the taxpayer did not benefit nonmembers. Rather, the taxpayer engaged in particular services for particular member-manufacturers.

3. The exclusivity of a gated parking lot for the neighborhood beach club has a tax price. Ocean Pines Association v. Commissioner, 135 T.C. No. 13 (8/30/10). The taxpayer was a homeowners association that was tax-exempt under § 501(c)(4) as a not-for-profit organized to promote community welfare. In addition to enforcing zoning and providing roads and recreational facilities within Ocean Pines, funded by members’ dues (but which were open to both members and nonmembers), it operated a beach club and parking lots eight miles from the area (Ocean Pines) in which its members lived. The primary beach club facilities (e.g., pool, locker room, etc.) and parking lots were accessible only to the association’s members and their guests, but the snack bar, restaurant, and beach itself were open to the public. The taxpayer charged its members a separate fee for parking permits, and maintained a parking permit system and guards. It also leased the parking lots to third-party businesses at night and in the off season. The taxpayer did not report any of the income as subject to the unrelated business income tax (UBIT). The IRS issued a deficiency notice determining that the net income from the parking lots and beach club facilities was subject to UBIT, because their operation was not substantially
related to the promotion of community welfare. The Tax Court (Judge Morrison) upheld the deficiency. The court concluded that the operation of the beach club and the parking lots did not promote community welfare because they were not accessible to nonmembers, i.e., the general public. Therefore, unless an exception applied, the income was subject to UBIT. Finally, the court held that the § 512(b)(3)(A)(i) exception for rents from real property did not apply, because Reg. § 1.512(b)-1(c)(5) provides that income from the operation of a parking lot is not rent from real property.

B. Charitable Giving

1. The easement has to have some real effect to give rise to a charitable contribution deduction. Herman v. Commissioner, T.C. Memo. 2009-205 (9/14/09). Judge Gustafson held that a contribution to a charitable organization of an easement burdening developable air rights over a certified historic structure owned by another person did not qualify for a charitable contribution deduction under § 170(h). The easement did not preclude the taxpayer, the structure’s owner, or any subsequent purchaser of the property from altering or demolishing the structure. Thus, the conservation easement did not preserve an “historically important land area” or a “certified historic structure” within the meaning of § 170(h)(4)(A)(iv).

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 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 purposes 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 taxpayer to a higher level of enforcement than that provided by local law.

3. 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. No. 9 (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.

4. A personal sperm bank can’t qualify as a tax exempt organization. Was this foundation founder thinking he could get a tax deduction for producing sperm? Free Fertility Foundation v. Commissioner, 135 T.C. No. 2 (7/7/10). A not-for-profit corporation established for the sole purpose of providing the founder’s sperm free of charge to women seeking to become pregnant through artificial insemination or in vitro fertilization was held not to promote health for the benefit of the community, and thus did not operate for exempt purposes and did not qualify for an exemption under § 501(c)(3). The founder and his father were the only board members and decided in their sole discretion who would receive the founder’s sperm.

5. 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 $20,000 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.”

6. **Whitehouse Hotel Limited Partnership v. Commissioner**, 131 T.C. 112 (10/30/08). The Tax Court (Judge Halpern) held that, as a precondition to using the replacement cost approach to valuing real estate, the taxpayer must show that the property is unusual in nature and other methods of valuation, such as comparable sales or income capitalization, are not applicable. The income approach to valuation is favored only where comparable market sales are absent. On the facts, the value of the contribution of a conservation facade easement for an historic structure on the edge of the French Quarter in New Orleans was overstated. The accuracy-related penalty for gross overvaluation was proper because there was no good faith investigation into the value.

a. **Regardless of which valuation method is used, it still must relate to the property’s “highest and best use.”** **Whitehouse Hotel Limited Partnership v. Commissioner,** 2010-2 U.S.T.C. ¶50,564 (5th Cir. 8/10/10). In an opinion by Judge Barksdale, the Fifth Circuit vacated the Tax Court’s decision and remanded the case for a determination of the easement’s value, although it rejected the taxpayer’s arguments that the IRS’s expert was unqualified and that his report was unreliable and should not have been admitted. But the Court of Appeals agreed with the taxpayers’ argument that the Tax Court “miscomprehended the highest and best use” of the building subjected to the conservation easement, and thereby undervalued the easement.

In sum, the tax court erred in declining to consider the Maison Blanche and Kress buildings’ highest and best use in the light of both the reasonable and probable condominium regime and the reasonable and probable combination of those buildings into a single functional unit, both of which foreclosed the realistic possibility, for valuation purposes, that the Kress and Maison Blanche buildings could come under separate ownership. This combination affected the buildings’ fair market value.

- As result the court did not reach the Tax Court’s holding that the income and replacement-cost methods of valuation were inapplicable and directed the tax court to consider those methods, in addition to comparable sales method on remand. Because the holding on the valuation was vacated, the Tax Court’s holding that the gross overvaluation penalty also was vacated.

7. **“Praise the Lord, [but] pass the ammunition.” Or, is it that the judge was hypertecchnical?** **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.
X. TAX PROCEDURE

A. Interest, Penalties and Prosecutions

1. Increased penalty for failure to file on time. For returns required to be filed after December 31, 2008, the Heroes Earnings Assistance and Relief Tax Act of 2008 increases the minimum penalty failure to file a return on time to the lesser of $135 or 100 percent of the tax required to be shown on the return.

   a. Increased penalties for failing to timely file partnership and S corporation returns. Section 16 of the Worker, Homeownership, and Business Act of 2009 (WHABA) amends §§ 6698 and 6699 to increase the penalty for failing to file a partnership or S corporation tax return from $89 to $195.

2. No free trade agreement for SSNs. T.D. 9437, Amendments to the Section 7216 Regulations – Disclosure or Use of Information by Preparers of Returns, 73 F.R. 76216 (12/16/08). This Treasury Decision amends Reg. § 301.7216-3(b)(4) to permit disclosure by a tax return preparer of a taxpayer’s SSN to another tax return preparer located outside the United States only with the taxpayer's consent. The amended regulation applies to disclosures of tax return information occurring on or after 1/1/09.

   a. But there is some freedom for preparers to use taxpayer return information to increase their own profitability. T.D. 9478, Amendments to the Section 7216 Regulations – Disclosure or Use of Information by Preparers of Returns, 75 F.R. 48 (12/29/09). Temp. Reg. § 301.7216-2T(n) allows preparers to compile, maintain, and use a list containing solely the names, addresses, e-mail addresses, phone numbers, taxpayer entity classification, and income tax return form numbers of taxpayers whose tax returns the tax return preparer has prepared, if the list is used only to contact the taxpayers on the list either (1) to provide tax, general business, or economic information for educational purposes, or (2) for soliciting additional tax return preparation services. Temp. Reg. § 301.7216-2T(p) allows return preparers to disclose return information without penalty for the purpose of a quality or peer review, but only to the extent necessary to accomplish the review. The information also may be used to perform a conflict of interest check. Identical proposed regulations were published simultaneously. REG-131028-09, Amendments to the Section 7216 Regulations – Disclosure or Use of Information by Preparers of Returns, 75 F.R. 94 (12/29/09).

   (1) Rev. Rul. 2010-5, 2010-4 I.R.B. 312 (12/30/09). This revenue ruling provides further guidance and allows disclosure of return information to a return preparer’s malpractice carrier to the extent necessary to obtain insurance or to defend against claims; to defend claims, the tax return itself may be disclosed and it may be disclosed to attorneys engaged to defend against the claim.

   (2) Rev. Rul 2010-4, 2010-4 I.R.B. 309 (12/30/09). This revenue ruling provides further guidance and details circumstances that justify use of lists to contact clients and allowing disclosure of information to a third-party provider who prepares the mailings.

3. IRS gets addicted to announcing amnesty for offshore tax cheats. IRS News Release IR-2003-05, 2003 TNT 10-11 (1/14/03). An Offshore Voluntary Compliance Initiative provided that “eligible taxpayers,” who used offshore payment cards or other offshore financial arrangements to hide their income, may avoid civil fraud and information return penalties (but not failure to pay tax or accuracy-related penalties) if they come forward and pay up by 4/15/03 and provide full details on those who promoted or solicited the offshore scheme. Promoters and solicitors are not eligible. The information release contains the following example:

   For example, a taxpayer who understated his income to avoid $100,000 in taxes in 1999 would wind up paying $149,319 to the government. This includes the tax liability plus $29,319 in interest and an additional accuracy-related penalty of $20,000.
a. Rev. Proc. 2003-11, 2003-1 C.B. 311 (1/14/03). This revenue procedure contained detailed procedures for the Offshore Voluntary Compliance Initiative, including as an exhibit the "specific matters closing agreement" to be executed by the taxpayer.

b. Liechtenstein! IR-2008-26 (2/26/08). The IRS announced that it was initiating enforcement action involving more than 100 U.S. taxpayers in connection with accounts in Liechtenstein. According to a story in the 2/19/08 Wall Street Journal, (a) Heinrich Kieber, a former employee of Liechtenstein’s largest bank, LGT Group, has offered confidential client data to tax authorities on several continents over the past 18 months, and (b) the German government paid roughly €4.2 million ($6.4 million) to an unnamed individual for the same type of information.

c. UBS settles with the Justice Department for $780 million. On 2/18/09, the Swiss bank UBS agreed to pay $780 million under a deferred prosecution agreement over the bank’s offshore services to U.S. taxpayers. It also agreed to hand over the names and account information of some of these taxpayers; however, there were indications that only 250 client names out of 19,000 account holders were being disclosed. 2009 TNT 31-1.

d. The 2009 version is much less of an amnesty than the 2003 version. On 3/26/09, the IRS announced several programs relating to penalties on voluntarily disclosed offshore accounts. They have a 3/23/09 effective date, and are good for six months. Several internal memoranda explain how the IRS intends to process voluntary disclosure claims made regarding offshore accounts. 2009 TNT 57-2.

- These memoranda include one on examinations of offshore transactions, 2009 TNT 57-32; one on the routing of voluntary disclosure cases, 2009 TNT 57-33; and one authorizing a new penalty structure for voluntary disclosures, 2009 TNT 57-34.

e. IR-2009-84 (9/21/09). The filing deadline for the voluntary disclosure was extended to 10/15/09, and the IRS announced there would be no further extensions.

f. 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.

g. 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.

h. 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 persons 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 persons 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.

4. Tax Court jurisdiction to review an otherwise unreviewable assessable penalty can’t piggyback on a related deficiency proceeding. *Smith v. Commissioner*, 133 T.C. No. 18 (12/21/09). Section 6707A, added to the Code by the American Jobs Creation Act of 2004, imposes a penalty for a taxpayer’s failure to include with his return required information with respect to a reportable transaction. The IRS assessed a § 6707A penalty against the taxpayer and issued a deficiency notice to his wholly owned corporation with respect to the transaction to which the § 6707A penalty applied. The taxpayer filed a timely petition with the Tax Court, but Judge Kroupa held that a penalty imposed under § 6707A is not reviewable by the Tax Court, even in a deficiency proceeding. Although the IRS issued a deficiency notice, the notice did not determine the § 6707A penalty. The § 6707A penalty was properly independently assessed without the IRS issuing a deficiency notice, and the penalty was thus not within the Tax Court’s deficiency jurisdiction. The taxpayer’s only redress is through a refund proceeding.

5. There’s no prepayment judicial review for the failure to pay penalty. *Burke v. Commissioner*, T.C. Memo. 2009-282 (12/8/09). The § 6651(a)(3) addition to tax for failure to pay is not subject to deficiency procedures, but may be collected administratively if it is not paid upon notice and demand.

6. Meeting five out of six criteria for being a “responsible person” buys a 100% penalty. *Erwin v. United States*, 591 F3d 313 (4th Cir. 1/13/10). The Fourth Circuit, in a majority opinion by Judge Motz, upheld the District Court’s finding on summary judgment that the taxpayer was liable for the § 6672 failure to withhold and pay-over penalty. To determine whether a particular individual is a “responsible person” liable for the § 6672 failure to withhold and pay-over penalty, the Fourth Circuit will examine whether he: (1) served as an officer or director of the company; (2) controlled the company’s payroll; (3) determined which creditors to pay and when to pay them; (4) participated in the corporation’s day-to-day management; (5) had the ability to hire and fire employees; and (6) possessed the power to write checks. Undisputed facts established that the taxpayer met the first five criteria, even though he delegated some responsibilities to others. Considering “the totality of the circumstances,” he was a responsible person even though he did not have check-writing authority.

- Judge Hamilton dissented, concluding that a “reasonable fact-finder, viewing the evidence in the light most favorable to Erwin and drawing all reasonable inferences from such evidence in his favor, could find that he was not a responsible person ...,” even though he did not believe that as a matter of law Erwin could not be a responsible person. Judge Hamilton thought that only the first factor cut in favor of the government, and he would have vacated and remanded for a trial, because it was a “close case.”

7. The District Court needs to justify home imprisonment in lieu of time in the big house for criminal tax evasion. *United States v. Engle*, 592 F.3d 495 (14th Cir. 1/13/10). The defendant pled guilty to tax evasion for 2004. Although he was charged with tax evasion only for 2004, the information alleged that he had evaded taxes for 16 years between 1984 and 2002 and owned taxes on more than $600,000 when interest and penalties were tacked on the amount exceeded $2 million. The District Court sentenced Engle to four years probation, conditioned on 18 months of home detention, with work release and international travel privileges. The district judge reasoned that it was more important that the back taxes be paid than that Engle be imprisoned and that if Engle were imprisoned he would be deprived of...
his livelihood and hence be unable to pay the taxes that he had evaded. The Fourth Circuit (Judge Traxler) vacated the sentence because the district court did not adequately explain its decision to vary significantly from the 18 U.S.C. § 3553(a) U.S. Sentencing Guidelines' recommendations in imposing the lenient sentence that did not include prison time. Judge Traxler noted, after requiring that further proceedings be in front of a different judge:

The district judge in this case [Judge Mullin] also presided over the tax evasion trials and sentencings in [other] cases that, though not formally consolidated with this case, were argued before this court seriatim with this appeal. In the sentencing hearing for [another criminal defendant], the district judge, who has taken senior status, stated that he no longer intended to handle criminal matters.

8. Yip[e]! United States v. Yip, 592 F.3d 1035 (9th Cir. 1/13/10). The Ninth Circuit held that under U.S.S.G. § 3C1.1, “[o]bstruction during an IRS audit justifies enhancing a defendant's sentence for obstruction ‘during the course of the investigation.”’

9. The defendant was a little bit too “Cheeky” for his own good; instead, he should have turned the other cheek(s). United States v. Phipps, 595 F.3d 243 (5th Cir. 1/25/10). The defendant’s conviction for tax evasion was upheld. His claim of good faith belief that he was not required to pay taxes on proceeds from a pyramid marketed tax evasion scheme was belied by his receipt of prior notice from the IRS regarding his tax liability coupled with his advice to participants in the scheme to plan a “reliance defense” based “on the advice of income tax professionals and other credible sources that could be used to convince a jury that the participant sincerely believed he or she was not liable for federal or state income tax.” Because he was advising others to employ calculated tactics to avoid paying income taxes ... a rational jury reasonably could have found that [he] ... willfully evaded paying income tax.”

10. “Abatement” is all or nothing. “Reduction” is not a lesser included option. It couldn’t have happened to a nicer union. Service Employees International Union v. United States, 598 F.3d 1110 (9th Cir. 3/17/10). SEIU filed its information return late and the IRS assessed a $50,000 penalty under § 6652(c)(1)(A). On appeal from an adverse CDP determination, the district court (which at the time had jurisdiction) concluded that there was no “reasonable cause” for the late filing, but nevertheless held that in its discretion the IRS should have reduced the penalty and entered judgment in favor of the IRS for only 25% of the $50,000 penalty. The Court of Appeals reversed. The penalty under § 6652(c)(1)(A) is “either fully enforceable or fully unenforceable,” citing In re Sanford, 979 F.2d 1511, 1513 (11th Cir. 1992). Section 6652(c)(4), providing for abatement of the penalty if there was “reasonable cause” for the late filing, is mandatory, not discretionary. “If a nonprofit fails to file the informational return on time for reasonable cause, the IRS has no discretion whether to impose or reduce the penalty; it is flatly prohibited from imposing any penalty at all.” Neither the IRS nor any reviewing court has discretion to reduce, rather than to abate for “reasonable cause,” a § 6652(c)(1)(A) penalty for late filing of an informational return.

11. 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

4 Cheek v. United States, 498 U.S. 192 (1991), held that Court held that a good-faith belief as to the law need not be objectively reasonable to be a defense to criminal tax fraud.
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.

12. T.D. 9488, Interest and Penalty Suspension Provisions Under Section 6404(g) of the Internal Revenue Code, 75 F.R. 33992 (6/16/10). Final Reg. § 1.6404-4(b)(5), replacing Temp. Reg. § 1.6404-4T(b)(5), provides guidance regarding the exception for any listed transaction as defined in § 6707A(e) or any undisclosed reportable transaction from the general rule of suspension of any interest under § 6404(g)(1) if the IRS does not contact the taxpayer regarding adjustments within the requisite period of time, generally 36 months after the later of the due date or the return filing date.

13. He might have played a DC cop in "Murder at 1600," but now he'll be a convict for real at an FCI thanks to 1111 Constitution Ave. United States v. Snipes, 106 A.F.T.R.2d 2010-5256 (11th Cir. 7/16/10). Snipes earned more than $27 million dollars in gross income from 1999 to 2004, but he did not file individual federal income tax returns for any of those years. Snipes was involved with co-defendant Eddie Ray Kahn’s organization, American Rights Litigators (ARL), which purported to assist customers in resisting the IRS. ARL employees, including co-defendant Douglas Rosile, and ARL members, including Snipes, sent voluminous letters to the IRS, challenging the IRS’s authority to collect taxes. The centerpiece of this resistance was the “861 argument” that the domestic earnings of individual Americans are not income subject to tax. Snipes personal arguments to the IRS over the curse of several years were described by the court, in part, as follows:

Snipes’s correspondence with the IRS advanced several arguments justifying his failure to file his personal tax returns, including that he was a “non-resident alien to the United States,” that earned income must come from “sources wholly outside the United States,” that “a taxpayer is defined by law as one who operates a distilled spirit Plant,” and that the Internal Revenue Code’s taxing authority “is limited to the District of Columbia and insular possessions of the United States, exclusive of the 50 States of the Union.” Snipes also claimed that as a “fiduciary of God, who is a ‘nontaxpayer,’” he was a “foreign diplomat” who was not obliged to pay taxes. When Snipes consulted his long-time tax attorneys about his resistance to paying federal income taxes, they advised him that his position was contrary to the law and that he was required to file tax returns. The firm terminated Snipes as a client when Snipes refused to file his tax returns.

• Snipes also integrated the ALR tax “teachings” into the accounting methodology of his film production companies. After June 2000, his companies stopped deducting payroll and income taxes from employees’ salary checks. Snipes began to proselytize this theory of tax resistance. Not surprisingly, The Eleventh Circuit upheld Wesley Snipes’s conviction of willful failure to file tax returns and the imposition of a 36-month prison sentence.

14. Cheatin’ tax advisor blinded by his own brilliance. United States v. Jewell, 106 A.F.T.R.2d 2010-5483 (8th Cir. 7/30/10). The defendant was a tax attorney who
concocted a scheme to assist his clients in underreporting several million dollars of income and was convicted of aiding and abetting tax evasion. Among the many issues he raised on appeal was that his clients ultimately had settled the tax deficiency with the IRS. The Court of Appeals affirmed the conviction. The court held that the fact that the taxpayer whose taxes were evaded eventually paid those taxes is not a defense to aiding and abetting tax evasion if the advisor had the intent to assist the taxpayer with evading taxes in the taxable year in question and at the time taxes were due for the year in question there was a deficiency.

B. Discovery: Summonses and FOIA

1. District Court finds tax accrual workpapers protected by the “work product privilege” and denies the IRS petition for summons enforcement. United States v. Textron Inc., 507 F. Supp. 2d 138 (D. R.I. 8/28/07). Textron engaged in six SILO transactions in 2001 before SILOs became listed transactions in 2005. Under IRS procedures, engaging in more than one listed transaction means that the IRS will request the entire tax accrual workpapers file. Textron produced all requested documents with respect to the SILO transactions but refused to turn over its entire workpaper file. Judge Torres held that the tax accrual workpapers were prepared “because of” anticipated litigation with the IRS. He refused to follow contrary authority from the Fifth Circuit in United States v. El Paso Company, 682 F.2d 530 (1982), which used the more stringent primary purpose test for determining whether documents were prepared “in anticipation of litigation.” He also held that work product protection was not lost when the tax accrual workpapers were provided to Ernst & Young for its audit of the company because the AICPA Code § 301 on confidential client information made it very unlikely that the accounting firm would provide them to the IRS.

a. This split decision has been taken to the banc. United States v. Textron Inc., 507 F. Supp. 2d 138 (D. R.I. 8/28/07), affirmed in part, vacated in part and remanded, 553 F.3d 87 (1st Cir. 1/21/09) (2-1), taxpayer’s petition for rehearing denied, (3/24/09), government’s petition for en banc rehearing granted, (3/25/09). The majority opinion (Judge Torruella) affirmed the holding that Textron’s tax accrual workpapers were protected by the work product doctrine on the ground that the First Circuit law is that “dual purpose” documents created because of the prospect of litigation are protected even though they were also prepared for a business purpose, i.e., E&Y’s audit of Textron. It distinguished United States v. El Paso Company, 682 F.2d 530 (5th Cir. 1982), as being part of an existing split between the circuits in the definition of “the anticipation of litigation.”

- The majority remanded the case for the District Court to consider the questions of whether Textron waived work-product protection by showing its tax accrual workpapers to E&Y and whether E&Y’s workpapers were within the “control” of Textron.
- Judge Boudin dissented on the ground that the proper test should be whether the tax accrual workpapers were prepared “in the ordinary course of business” or were otherwise independently required, and their preparation would not be chilled by lack of protection because they are required by “the financial statement obligations and accounting rules.” He based his opinion on the need for such documents “[i]n the wake of Enron and other corporate scandals ….” He later stated,

And, while it may seem one-sided to give the government Textron’s blue print to weaknesses in Textron’s tax returns, the return is massive – constituting more than 4000 pages; the government has an important interest in collecting taxes that are owed; and its inquiries into work papers were focused on a specific type of transaction that had been shown to be open to abuse. So context should be kept in mind before shedding too many tears for Textron.

- The government’s petition for rehearing en banc was granted.

b. Reversed by a divided First Circuit in an en banc rehearing. The First follows the Fifth to El Paso. United States v. Textron Inc., 577 F.3d 21 (1st Cir. 8/13/09) (3-2), cert. denied (5/24/10). The majority (Judge Boudin) held that the work product privilege protects only work done for litigation purposes (the “prepared for” test or the “primary purpose” test), and abandoned the prior First Circuit “because of” test, encompassing work done
in preparing financial statements that also is prepared in contemplation of litigation. The majority followed United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982),

Judge Boudin concluded:

Textron apparently thinks it is “unfair” for the government to have access to its spreadsheets, but tax collection is not a game. Underpaying taxes threatens the essential public interest in revenue collection. If a blueprint to Textron’s possible improper deductions can be found in Textron’s files, it is properly available to the government unless privileged. Virtually all discovery against a party aims at securing information that may assist an opponent in uncovering the truth. Unprivileged IRS information is equally subject to discovery.

The practical problems confronting the IRS in discovering under-reporting of corporate taxes, which is likely endemic, are serious. Textron’s return is massive — constituting more than 4,000 pages — and the IRS requested the work papers only after finding a specific type of transaction that had been shown to be abused by taxpayers. It is because the collection of revenues is essential to government that administrative discovery, along with many other comparatively unusual tools, are furnished to the IRS.

As Bentham explained, all privileges limit access to the truth in aid of other objectives, 8 Wigmore, Evidence § 2291 (McNaughton Rev. 1961), but virtually all privileges are restricted — either (as here) by definition or (in many cases) through explicit exceptions — by countervailing limitations. The Fifth Amendment privilege against self-incrimination is qualified, among other doctrines, by the required records exception, and the attorney client privilege, along with other limitations, by the crime-fraud exception.

To sum up, the work product privilege is aimed at protecting work done for litigation, not in preparing financial statements. Textron’s work papers were prepared to support financial filings and gain auditor approval; the compulsion of the securities laws and auditing requirements assure that they will be carefully prepared, in their present form, even though not protected; and IRS access serves the legitimate, and important, function of detecting and disallowing abusive tax shelters. (footnote and internal citations omitted)

c. Even after Textron, the government is still not home free when it wants to run barefoot through tax audit workpapers and tax opinions, and to run roughshod over work product protections. The D.C. Circuit accepted that dual-purpose documents could be covered by the work product doctrine, and it refused to find that disclosure to the auditing CPA firm constituted waiver of work product protection. United States v. Deloitte LLP, 106 A.F.T.R.2d 2010-5053 (D.C. Cir. 6/29/10). The government sought discovery of three documents in the possession of Deloitte, Dow Chemical’s independent auditor, that the taxpayer, claimed were attorney work product. One document was a draft memorandum prepared by Deloitte that summarized a meeting between Dow employees, Dow’s outside counsel, and Deloitte employees about the possibility of litigation over a partnership in which Dow was a member and the necessity of accounting for such a possibility in an ongoing audit. The district court had concluded that, although the document was created by Deloitte, it was nonetheless Dow’s work product because “its contents record the thoughts of Dow’s counsel regarding the prospect of litigation.” The second document was a memorandum and flow chart prepared by two Dow employees, an accountant and an in-house attorney. The third was a tax opinion prepared by Dow’s outside counsel. The district court held that all three documents were protected under the work-product doctrine. On appeal, the government contends that the Deloitte memorandum was not work product because it was prepared by Deloitte during the audit process. It conceded that the other two documents were work product, but argued that Dow waived work-product protection when it disclosed them to Deloitte.

• The Court of Appeals (Judge Sentelle) vacated the district court’s decision that the memorandum prepared by Deloitte was work product and remand for in
camera review to determine whether it is entirely work product. It affirmed the district court's holding that Dow did not waive work-product protection when it disclosed the other two documents to Deloitte. In analyzing whether the Deloitte memorandum could be work product, the Court of Appeals applied the "because of" test, asking whether, in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained because of the prospect of litigation." It rejected the government's argument that the memorandum was not protected work product under United States v. El Paso Co., 682 F.2d 530 (1982), reasoning that El Paso was decided under the "primary motivating purpose test," which is a different test than the "because of" test, as well as the government's argument that United States v. Textron Inc., 577 F.3d 21 (1st Cir. 2009), supported its position, reasoning that the holding in Textron was fact specific. In rejecting the government's argument that the Deloitte memorandum could not be work product because it was prepared in the course of a financial audit, the Court of Appeals held that a document can contain protected work-product material even though it serves multiple purposes, so long as the protected material was prepared because of the prospect of litigation.

- However, having determined that the Deloitte memorandum could be work product, when it turned to whether it was work product, the Court of Appeals concluded that the District Court lacked a sufficient evidentiary foundation for its holding that the memorandum was purely work product and remanded for further consideration. Turning to waiver issue with respect to the other two documents, the Court of Appeals held that there was no waiver. Deloitte was neither a potential adversary in the matter with respect to which the documents had been prepared nor a conduit to other adversaries — the only relevant adversary was the IRS. "Dow had a reasonable expectation of confidentiality because Deloitte, as an independent auditor, has an obligation to refrain from disclosing confidential client information."

- We note that one left coast tax professor vented on this case so vehemently that a casual observer might fear that he would burst a ventricle. 2010 TNT 125-1.

2. A stern warning against unwarranted blanket claims of privilege. Eulich v. United States, 104 A.F.T.R.2d 2009-6337 (N.D. Tex. 9/4/09). In connection with an audit, the IRS summoned certain documents relating to a Bahamian trust, and the taxpayer asserted attorney-client privilege and work product doctrine protection for "voluminous documents" that were submitted for in camera review. The court (Judge Lindsay) determined that hundreds — we lost count at over 400 — of documents were privileged in whole or in part, and that hundreds — we again lost count at over 400 — of documents were not privileged in whole or in part. The Judge Lindsay concluded as follows:

This review has placed an undue, and in many instances unjustified, burden on the court and its staff. It has stretched scarce judicial resources in a way never contemplated by the court. In many instances, the court does not believe that the claim of privilege was met seq.ade in good faith. Petitioner is put on notice that the court will not tolerate such blanket claims of privilege and will impose sanctions as appropriate if such conduct recurs. (Emphasis in original.)

C. Litigation Costs

1. Clarifying guidance on collecting attorney's fees from the IRS. REG-111833-99, Regulations Under I.R.C. Section 7430 Relating to Awards of Administrative Costs and Attorneys Fees, 74 F.R. 61589 (11/25/09). The Treasury Department has published proposed regulations relating to awards of administrative costs and attorneys fees under § 7430 to conform to the amendments made in the Taxpayer Relief Act of 1997 and the IRS Restructuring and Reform Act of 1998. Among the changes reflected in the proposed regulations are the following.

(1) A taxpayer has ninety days after the date the IRS mails to the taxpayer a final decision determining tax, interest or penalty, to file an application with the IRS to recover administrative costs. (2) A taxpayer has ninety days after the date the IRS mails to the taxpayer, by certified or registered mail, a final adverse decision regarding an award of administrative costs, to file a petition with the Tax Court. (3) Individuals filing joint returns should be treated as separate taxpayers for purposes of determining net worth. (4) Trusts are subject to the net worth
requirements. (5) Clarifying changes address the calculation of net worth. (6) Several amendments to § 7430 in the IRS Restructuring and Reform Act of 1998 are reflected in the proposed regulations: (a) the hourly rate limitation is increased to $125; (b) difficulty of the issues presented and local availability of tax experts may be considered to increase an attorney’s hourly rate; (c) a court should consider whether the IRS has lost cases with substantially similar issues in other circuit courts of appeal in deciding whether the IRS’s position was substantially justified; (d) if an individual who is authorized to practice before the Tax Court or the IRS is representing the taxpayer on a pro bono basis, the taxpayer may petition for an award of reasonable attorneys fees in excess of the amounts that the taxpayer paid or incurred, as long as the fee award is ultimately paid to the individual or the individual’s employer; (e) the period for recovery of reasonable administrative costs is extended to include costs incurred after the date on which the first letter of proposed deficiency (“30-day letter”) is mailed to the taxpayer, but the taxpayer may be eligible to recover reasonable administrative costs from the date of the 30-day letter only if at least one issue (other than recovery of administrative costs) remains in dispute as of the date that the IRS takes a position in the administrative proceeding.

D. Statutory Notice of Deficiency

1. 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.

2. The Tax Court loves its jurisdiction. Winter v. Commissioner, 135 T.C. No. 12 (8/25/10). The taxpayer reported passed-through losses from an S corporation in which he was a shareholder in excess of the amount reported on his Schedule K-1. Rather that treat the adjustment resulting from the inconsistency as correction of a mathematical error, as provided by
§ 6037, subject to summary assessment under § 6213(b), the IRS issued a deficiency notice with respect to both the adjustment resulting from disallowing the excess loss and the inclusion of unreported interest, dividends, and gambling income. The IRS issued a summary assessment based on the mathematical error only after the taxpayer had filed the Tax Court petition. The principal issue was whether the Tax Court had jurisdiction over the adjustment to the taxpayer’s distributive share of S corporation income or whether the IRS was required to assess the tax related to the adjustment as a math error under § 6213(b), precluding the inclusion in the notice of deficiency of the increase in tax relating to that adjustment. Both the taxpayer and IRS argued that the court had jurisdiction, but the court nevertheless addressed the question, and in a reviewed opinion (10-1-1) by Judge Goeke, the Tax Court held that it had jurisdiction to consider the taxpayer’s claim that his income from the S Corporation was less than the amount reported on the Schedule K-1 he received from it. The decision was based on two alternative grounds; first, the taxpayer assigned error to the entire deficiency and the alleged unreported income was one of the IRS’s adjustments contributing to that deficiency; second, pursuant to the Tax Court’s overpayment jurisdiction (which the taxpayer had invoked), the Tax Court has “authority to decide all the issues necessary to determine the correct amount of income tax for the taxable year in issue,” which even includes amounts that cannot be assessed because the statute of limitations on assessment and collection has expired.

- Judge Holmes, in a long 1 and lonely dissent, argued that the Tax Court lacked jurisdiction to review the deficiency attributable to the inconsistency between the taxpayer’s return and the S corporation’s Schedule K-1 with respect to the taxpayer. He reasoned that even though the IRS did issue a deficiency notice, it had no power to do so because § 6037 required that the IRS treat the inconsistency solely as a mathematical error. That treatment would leave the taxpayer in the position of being required to pay the assessed amount and seek a refund.

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). Overstated basis resulted 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). 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).

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1 The dissent was 43 typewritten pages, while the majority opinion was only 14 pages long.
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 FPA 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). 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. No. 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 Jenkins & 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). 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).”

l. 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). 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 shoehorns 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. No. 11 (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). 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.

2. Proposed Regulations provide an instruction manual on how to start running the otherwise endless statute of limitations on previously unreported listed transactions. Notice of Proposed Rulemaking, Period of Limitations on Assessment for Listed Transactions Not Disclosed Under Section 6011, REG-160871-04, 74 F.R. 55127 (10/7/09). The Treasury has published proposed regulations § 301.6501(c)-1(g) under § 6501(c)(10), which extends the statute of limitations when a taxpayer fails to disclose a listed transaction; the statute of limitations does not expire until one year after the earlier of (1) the date on which the taxpayer furnishes the required information, or (2) the date a material advisor (as defined in § 6111) satisfies the list maintenance requirements of § 6112 with respect to a request by the IRS. The proposed regulations specify the methods for subsequent disclosure of listed transaction that was not properly disclosed under § 6011. The extended statute of limitations applies only to the tax relating to the listed transaction, but the proposed regulations provide that tax with respect to the listed transaction includes, but is not limited to, adjustments made to the tax consequences claimed on the return plus interest, additions to tax, additional amounts, and penalties that are related to the listed transaction or adjustments made to the tax consequences, as well as any item to the extent the item is affected by the listed transaction even if it is unrelated to the listed transaction.

3. A listed transaction is a listed transaction, is a listed transaction, period. A partner's statute of limitations can be determined in a TEFRA partnership level proceeding. Blak Investments v. Commissioner, 133 T.C. No. 19 (12/23/09) (reviewed, 12-3). The taxpayers engaged in a Son of Boss type transaction in December 2001 and January 2002 that first became a reportable transaction on 2/28/03, when Reg. § 1.6011-4 was promulgated. As of that date, they had already filed their 2001 return, but they had not yet filed their 2002 return. Reg. § 1.6011-4(e)(2) required them to attach a statement to their 2002 return disclosing the listed transaction, but when they filed their 2002 return on October 15, 2003, they failed to include the required statement. The IRS issued an FPAA on October 13, 2006, challenging the transactions as shams. Section 6501(c)(10) was added by the American Jobs Creation Act of 2004 applicable to tax years “with respect to which the period for assessing a deficiency did not expire before” 10/22/04, and the statute of limitations with respect to the taxpayers' transactions was open on that date. Section 6707A, including the definition of listed transactions in § 6707A(c), imposes penalties on failure to provide required information on reportable transactions on returns due after 10/22/04. Temp. Reg. § 1.6011-4T (and Prop. Reg. § 1.6011-4),
requiring disclosure of defined listed transactions were first published in 2000. In a reviewed opinion by Judge Haines, the majority first held that although the Tax Court's jurisdiction in a partnership proceeding generally is limited to determining “partnership items,” an exception extends jurisdiction over whether the period of limitations has expired as to individual partners presents, because the expiration of the period of limitations can depend on facts that are peculiar to the individual partners, citing Poulenc Surfactants & Specialties, L.P. v. Commissioner, 114 T.C. 533 (2000), appeal dismissed and remanded, 249 F.3d 175 (3d Cir. 2001), and Curr-Spec Partners, LP v. Commissioner, T.C. Memo. 2007-289, affd. 579 F.3d 391 (5th Cir. 2009). The majority rejected the taxpayers’ argument that there are two types of listed transactions, those entered into before and those entered into after 10/22/04, and that extension of the period for assessment under § 6501(c)(10) only applied to transactions for which a return was due after that date. The court concluded that the extension of the statute of limitations under § 6501(c)(10) is effective for tax years for which the period of limitations had not expired on 10/22/04, and that the enactment of the penalty provisions in § 6707A has no bearing on the application of § 6501(c)(10). “It is of no consequence that the transaction in question became a reportable transaction after the transaction had already occurred. The legislative history expressly contemplated such a result.” The court also held that Temp. Reg. § 1.6011-4T was valid and required disclosure of the taxpayers’ transactions on their 2001 and 2002 returns. The court rejected the taxpayers’ arguments that the temporary regulation violated Executive Order 12866, which requires Office of Management and Budget review of proposed significant regulatory actions, or that the temporary regulation violated the notice and comment requirements of the Administrative Procedure Act. Thus, the statute of limitations remained open on the taxpayers’ transactions under § 6501(c)(10) until one year after the required disclosure was provided.

Judge Halpern (joined by Judges Foley and Holmes) dissented on the grounds that the Tax Court does not have the authority in a partnership-level proceeding to decide whether the statute of limitations bars the assessment of a resulting computational adjustment. The dissenters assert that the application of the statute of limitations to the subsequent assessment against the partners is neither a partnership item nor an affirmative defense to the FPAA.

4. The statute of limitations remains open for any tax return in connection with which required information about foreign transfers is not reported to the IRS. Section 513 of the 2010 HIRE Act amended I.R.C. § 6501(c)(8) by providing that the statute of limitations remains open for any tax return relating to which information about foreign transfers is not furnished to the IRS and Treasury. The statute of limitations remains open until three years after the required information is furnished. Section 511 and 512 of the 2010 HIRE Act also provide for extended limitations for tax returns that are not fully compliant with respect to foreign assets.

F. Liens and Collections

1. In this much-discussed case, taxpayer’s poverty trumps a proposed levy. Vinatieri v. Commissioner, 133 T.C. No. 16 (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

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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.

2. “I would gladly pay you Tuesday for a hamburger today.” T.D. 9473, Agreements for Payment of Tax Liabilities in Installments, 74 F.R. 61525 (11/25/09). The Treasury Department has promulgated final Reg. § 301.6159-1, dealing with rules governing the acceptance and rejection by the IRS of proposed installment agreements, the terms of installment agreements, modification or termination by the IRS, and appeal procedures when the IRS rejects or terminates an installment agreement. Among the provisions is a requirement that the IRS review partial payment installment agreements every two years to determine whether the financial condition of the taxpayer changed enough to warrant an increase in the payments. The IRS may terminate an installment agreement if the taxpayer provides materially inaccurate or incomplete information in connection with a requested financial update. The IRS will generally notify the taxpayer in writing at least 30 days prior to terminating an installment agreement and describe the reason for the termination, after which the taxpayer may provide information showing that the IRS’s reason is incorrect. Appeals procedures are provided. The IRS cannot levy during the time an installment agreement is pending, unless an installment agreement request was made solely to delay collection. The statute of limitations on collection under § 6502 of the Code is suspended for the period that a proposed installment agreement is pending, plus 30 days following a rejection, and during any appeal.

3. Nuanced differences in the statutory subsections result in different periods for suspending the statute of limitations on collections. Severo v. Commissioner, 586 F.3d 1213 (5th Cir. 11/20/09), aff’g 129 T.C. 160 (11/15/07). Section 6503(b) suspends the running of the period of limitations on collection from the date of the taxpayer’s bankruptcy petition was filed to the date six months after the bankruptcy court issues a discharge order. The more limited suspension of the period of limitations in § 6503(b), which applies to judicial proceedings generally when the taxpayer’s assets are under control of a court, does not apply in bankruptcy situations.

4. Ever-expanding Tax Court jurisdiction over CDP appeals. Michael v. Commissioner, 133 T.C. No. 10 (10/8/09). Judge Goeke held that a settlement of the government's counterclaim in a prior refund suit for § 6694 penalties does not preclude Tax Court jurisdiction to review a § 6330 CDP determination with respect to collection of the settlement amount. The District Court’s dismissal of the refund action with prejudice on the basis of the settlement agreement does not render the administrative statutory collection remedies unavailable. Nor does the District Court’s retention of jurisdiction for a 60-day enforcement period preclude the IRS from pursuing statutory collection remedies, such as a levy. Thus, the Tax Court had jurisdiction to review the IRS’s determination to sustain the levy and to determine whether respondent may collect the unpaid penalties by levy.

5. You only imagined that a discharge in bankruptcy from personal liability for back income taxes really got you off the hook. Wadleigh v. Commissioner, 134 T.C. No. 14 (6/15/10). This case involved a review of the IRS’s determination in a § 6330 CDP hearing not to release a levy on the taxpayer’s pension. The tax lien had not been perfected by filing a Notice of Federal Tax Lien, and prior to the IRS issuing its Notice of Intent to Levy, the taxpayer’s personal liability for the income taxes in question had been discharged in bankruptcy. The Tax Court (Judge Marvel) held that because the taxpayer’s pension was an excluded asset under 11 U.S.C. § 541(c)(2) that was never part of the bankruptcy estate – in contrast to an exempt asset, which initially is part of the bankruptcy estate but which is unavailable to satisfy creditor’s claims – the § 6231 unperfected tax lien on the taxpayer’s pension survived his bankruptcy and could be enforced notwithstanding his personal discharge. However, the lien was not enforceable until the pension entered payout status. Nevertheless, Judge Marvel remanded
the case to the Appeals Division, but retained jurisdiction, because the record was inadequate to
determine whether the IRS abused its discretion in levying on the taxpayer's retirement income,
in the face of the taxpayer's claim that the levy would result in economic hardship by leaving
him destitute.

6. Just because the IRS thinks it's not worth trying to levy on it doesn't
necessarily mean it's not a fraudulent conveyance if you give it away. Rubenstein v.
Commissioner, 134 T.C. No. 13 (6/7/10). The taxpayer's father, who was insolvent and had
substantial unpaid income tax liabilities of which the taxpayer was aware, transferred to the
taxpayer for little or no consideration the condominium in which they both resided, which was
worth approximately $44,000. In the course of evaluating an offer in compromise previously
submitted by the father, but which was rejected, the IRS had determined that the net realizable
equity value in the condominium was zero. After the transfer, the IRS asserted transferee liability
equal to the condominium's fair market value on the date of the transfer on the ground that the
transfer was constructively fraudulent under Florida's Uniform Fraudulent Transfer Act (FUFTA).
Under Florida law the condominium was the father's homestead, and thus was
generally exempt from creditor's claims under nonbankruptcy law. However, the FUFTA
excludes from the definition of "assets" property that is "generally exempt under nonbankruptcy
law." On this basis the taxpayer argued that the condominium was not an "asset" for purposes of
the FUFTA and its transfer to him thus was not avoidable. The Tax Court (Judge Thornton) held
that because a homestead property is reachable by the United States through judicial process to
enforce collection of unpaid income tax liabilities, even if it is exempt from the claims of other
creditors under state law, the homestead condominium was not "generally exempt under
nonbankruptcy law" within the meaning of the FUFTA. Thus, the condominium was an "asset"
for purposes of the IRS's claim under the FUFTA. Furthermore, because the care that the
taxpayer had provided for his father was not bargained for, but was provided out of love and
respect, it did not constitute "reasonably equivalent value" for the condominium within the
meaning of the FUFTA. Accordingly, the transfer was fraudulent. Finally, the IRS was not
equitably estopped from asserting transferee liability by virtue of having previously determined
that the condominium had zero net equity value.

7. Here's a case in which a partner's draw is "salary or wages," much to
his dismay. United States v. Moskowitz, Passman & Edleman, 603 F.3d 162 (2d Cir.
4/29/10). The Second Circuit held that a continuing levy on "salary" under § 6331(e) reached a partner's
"near-weekly" draw against the law firm's profits. Reg. § 301.6331-1(b)(1) defines "salary or
wages" to "include[] compensation for services paid in the form of fees, commissions, bonuses,
and similar items," (emphasis supplied by the court). Because the partner's draw was
"compensation for services," the court concluded that it was within the sweep of the Regulation,
and thus § 6331(e). The court rejected the law firm's argument that payments of partnership
draw to the partner were not "salary or wages" under § 6331(e) at the time of the levy because
"a partner only realizes income on the last day of the partnership's taxable year."

8. No need for actuarial values to decide how much of the entirety the
8/4/10). In an opinion by Judge Rogers, the Sixth Circuit held that to satisfy a husband's separate tax
liability, the government could levy on his one-half interest in a house owned with his wife in
tenancy by the entirety under Michigan law. The taxpayer's wife was entitled to only one-half of
the sales proceeds, despite her longer life expectancy.

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. No. 8 (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(t), 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. No. 10 (4/13/09). 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 of 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. No. 8 (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(t) 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 was 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). 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(b) 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.5

2. See no evil, hear no evil, but speak evil of ex-spouse – a perfect formula for § 6015 relief. Phemister v. Commissioner. T.C. Memo. 2009-201 (9/2/09). The taxpayer was entitled to relief from liability on a tax deficiency attributable to her ex-husband’s medical practice under § 6015(b) where she had no meaningful involvement with the business and the adjustments resulted from his failure to substantiate claimed expenses. Although his business income supported the taxpayer, it was more than sufficient to have provided support without regard to the disallowed expenses. Thus, the disallowed expenses did not result in any meaningful financial benefit to the taxpayer. The taxpayer also was entitled to § 6015(f)

equitable relief. She was divorced from her ex-husband, she had no meaningful involvement with the business, his adjustments resulted from his failure to substantiate claimed expenses; she did not know who kept her husband's books and records, and there was no evidence she reviewed any of his claimed deductions.

3. **One spouse pays and other spouse doesn’t and no one is innocent.** One is just more cooperative with the IRS. Jordan v. Commissioner, 134 T.C. No. 1 (1/11/10). The Tax Court (Judge Wells) held that spouses may separately agree to a waiver of the 10-year period of limitations on collections for a year with respect to which they filed a joint return. The waiver may be effective with respect to one spouse, but not with respect to the other spouse if the other spouse did not also execute the waiver or has the right to repudiate it.

4. **The statute might not have correctly articulated the statutory cross reference, but the Tax Court got the drift of congressional intent anyway.** Adkison v. Commissioner, 129 T.C. 97 (10/16/07). The Tax Court does not have jurisdiction to review a claim for apportioned liability relief under § 6015(c) when the tax liability in question relates to partnership income and the deficiency notice on which the jurisdiction was asserted to be based is invalid because the partnership items are subject to determination in a TEFRA partnership level proceeding that has not yet been resolved. Section 6230(a)(3)(A), which still refers to former § 6013(e), the statutory predecessor of § 6015, evidences congressional intent that the spouse of a partner can initiate a claim for innocent spouse relief with respect to a deficiency attributable to an adjustment of a partnership item only after the IRS issues a notice of computational adjustment following the completion of the partnership-level proceeding. Judge Cohen concluded that Congress simply overlooked the need to correct the cross references in § 6230 when it replaced § 6013(e) with § 6015.

a. **Affirmed on other grounds:** The Tax Court had jurisdiction, but cannot grant any relief until the TEFRA proceeding is concluded. Adkison v. Commissioner, 592 F.3d 1050 (9th Cir. 1/21/10). Judge Bybee’s opinion for the Ninth Circuit described the Tax Court’s holding as “dismiss[ing] for lack of jurisdiction, reasoning that because a separate partnership proceeding involving the transaction from which the deficiency arose was already pending, the Commissioner did not “assert” a deficiency against Adkison within the meaning of [§ 6015(e)(1)(A)].” However, Judge Bybee concluded that the Tax Court did have jurisdiction, because nothing in § 6320 divests the Tax Court of jurisdiction under § 6015. He found that “the Commissioner, joined by the Tax Court, has confused the availability of a remedy with the question of the Tax Court’s jurisdiction.” However, he continued to conclude that:

Although ... the Tax Court has jurisdiction over Adkison's § 6015 petition, the Tax Court's instincts were correct: in light of the ... TEFRA proceeding ..., there is no “appropriate relief available” to Adkison.” TEFRA plainly contemplates that when a partnership proceeding is pending, the Commissioner will not assert a deficiency against a taxpayer-partner until the partnership proceeding determines the liability of the partnership, and consequently, the partners. ... Once the TEFRA proceeding is concluded, the partners are entitled to a “final partnership administrative adjustment,” id. § 6223(a)(2), their tax deficiency is determined, and at that point, the spouse of a partner may file a petition for relief under § 6015.

- Thus, the judgment was affirmed on the grounds that no remedy was available, even though there was jurisdiction.
- We think Judge Bybee was confused by the phrase “in the case of an individual against whom a deficiency has been asserted” in § 6015(e) and concluded that the Tax Court has jurisdiction even though the deficiency notice is invalid. A long line of case law holds that the Tax Court does not have jurisdiction in every case in which a “deficiency is asserted,” to use Judge Bybee’s phrase, but only in those cases in which a valid deficiency notice has been issued. If the deficiency notice was issued prematurely, it was not valid, and if the deficiency notice
is not valid, although the Tax Court has no jurisdiction to "redetermine" the asserted deficiency, the IRS nevertheless is barred from assessing the tax.

5. The widow inherits the ability to make a standalone § 6015(c) election, even though § 6015(b) and § 6015(f) relief were foreclosed by the pleadings in the prior deficiency case. Deihl v. Commissioner, 134 T.C. No. 7 (2/23/10). The taxpayer and her late husband had contested deficiencies for 1996, 1997, and 1998 in Tax Court proceedings in 2004. The petition in that proceeding had raised the issue of § 6105 relief for 1996, but not for 1997 or 1998; however, in the stipulation of facts for the consolidated cases, the claim for relief from joint and several liability was withdrawn. Only the taxpayer's husband signed the petition in the deficiency proceeding. The taxpayer did not (1) sign any court documents in the case, (2) review the petitions or the stipulations of facts, or (3) agree to any of the stipulations. Her husband and their (his) lawyer did not discuss the documents with the taxpayer, and she saw them for the first time at trial in the instant case. The taxpayer did not meet with any IRS personnel, participate in any settlement negotiations with the IRS, or sit in on any such meetings between her attorneys and the IRS during the litigation in the earlier case, although she was called as a witness and testified briefly. The taxpayer's husband died after the trial but before a final order was entered. After the decision was entered, the taxpayer filed an administrative claim for relief from joint and several liability for all three years, which the IRS denied on the ground that the claim was barred by res judicata under § 6015(g)(2). The Tax Court (Judge Vasquez) held that § 6015(g)(2) applied because the Tax Court entered final decisions for 1996 through 1998. However, because § 6015 relief was raised only in the pleadings for 1996, § 6015 relief for 1997 and 1998 was not an issue in the prior proceeding, and because the taxpayer did not meaningfully participate in the prior proceeding, the exception in § 6015(g)(2) applied for 1997 and 1998 and the taxpayer was not barred from seeking relief for those years. Furthermore, because the petition in the 2004 proceeding did not specifically invoke § 6015(c), and the taxpayer was ineligible to make a § 6015 election at the time because her husband was alive, a § 6015(c) election was not an issue in the prior proceeding, the taxpayer was not barred from seeking § 6015(c) apportioned liability for 1996. However, relief from joint and several liability for 1996 was raised by the petition and thus was at issue in the earlier proceeding, and § 6015(g)(2) barred the taxpayer from claiming relief from joint and several liability under § 6015(b) and (f) for 1996.

6. Pyrrhic victory on the meaning of "no reason to know." Greer v. Commissioner, 595 F.3d 338 (6th Cir. 2/17/10). The taxpayer sought § 6015(b) relief with respect to a deficiency attributable to her husband's disallowed tax shelter deductions and credits. In the Tax Court, Judge Goeke found that "rather than having "no reason to know" of the tax understatement, as required for relief, she 'chose not to know,'" and denied relief. In affirming, the Sixth Circuit, in an opinion by Judge Moore, adopted the test of Price v. Commissioner, 887 F.2d 959 (9th Cir. 1989), under which "in erroneous-deduction cases, [a] spouse has "reason to know" of the substantial understatement if a reasonably prudent taxpayer in her position at the time she signed the return could be expected to know that the return contained the substantial understatement." The court rejected application of the knowledge of the transaction test, which applies to income omission cases, on the following reasoning.

The knowledge-of-the-transaction test leaves room for a taxpayer to claim innocent-spouse relief in omitted-income claims, because the understatement arises in such cases from information being left off a return, and the spouse otherwise may not have known or had reason to know that information. In erroneous-deduction cases, the understatement arises from information being included on the return, so a spouse who signs a tax return necessarily learns of the transaction. The knowledge-of-the-transaction test writes the innocent-spouse provision out of the law in such cases. A more nuanced approach is thus required, especially given that an understatement arising from a deduction usually is not obvious from the face of a tax return. A taxpayer who knows how much money the family earned will know that tax has been understated if income is omitted from the return, as it is common knowledge that income is taxable. ... By contrast,
a taxpayer who is aware of an investment may or may not know that tax benefits claimed on its basis are impermissible, depending on that taxpayer’s level of sophistication and how much he or she knows about the investment. The Price test takes account of this difference.

- Nevertheless, relief was denied because the Tax Court did not clearly err: “[T]he low level of taxes owed relative to the income reported ... should have given Mrs. Greer pause.” Section 6015(f) equitable relief also was denied, on the ground that the taxpayer failed to demonstrate economic hardship.

- Note that current Reg. §1.6015-3(c)(2)(i)(b)(1), which was effective for year in which the taxpayer sought relief but which was not cited by the court, expressly provides: “In the case of an erroneous deduction or credit, knowledge of the item means knowledge of the facts that made the item not allowable as a deduction or credit.”

7. **It's tough to get back money you never paid the IRS, even if you might be an innocent spouse.** Kaufman v. Commissioner, T.C. Memo. 2010-89 (4/27/10). The Tax Court held that — assuming for the sake of argument that the surviving spouse would be entitled to § 6015(f) relief — no relief was available because she was seeking a refund of amounts paid by her husband’s estate, not amounts paid by her.

### H. Miscellaneous

1. **Claims for a method for hedging risk in commodities trading are held not to concern patent-eligible subject matter.** This leads to the possible conclusion that tax strategies are not patentable. However, the Federal Circuit did not overrule the *State Street case* and the Supreme Court has granted certiorari in this case. In re Bilski, 545 F.3d 943 (Fed. Cir. 10/30/08) (9-3), cert. granted sub nom. Bilski v. Doll, 129 S. Ct. 2735 (6/1/09). The Federal Circuit (Judge Michel) affirmed a decision of the Board of Patent Appeals and Interferences that claims for a method for managing (hedging) the risks in commodities trading did not constitute a patent-eligible subject matter. The meaning of a patentable “process” under 35 U.S.C. § 101 [“Whoever invents or discovers any new and useful process, machine [etc.] ... may obtain a patent therefore ... ] includes only the transformation of a physical object or substance, or an electronic signal representative of a physical object or substance.”

   - **Federal Circuit is affirmed, in that the hedging method did not constitute a patent-eligible subject matter, but the Supreme Court’s long-awaited opinion leaves the law farkockteh [utterly messed up] and leaves tax practitioners farblonjet [completely confused]. Bilski v. Kappos, 130 S. Ct. 3218 (6/28/10). Tax method patents appear to be permissible under the Court’s opinion if they constitute a process related to a machine (and that test is not the exclusive test). Moreover, business method patents are not categorically excluded from patentability. There is much more, but it is patent law and not of interest to non-masochistic tax practitioners.**

2. **Two bites at the apple for the IRS, because the apples are different varieties.** Frank Sawyer Trust of May 1992 v. Commissioner, 133 T.C. No. 3 (8/24/09). The trust was the shareholder of four corporations that sold all of their assets for cash, resulting in large capital gains. Following the asset sales, the trust sold all of the stock of the corporations to a midco – actually named Midco – which purportedly sheltered the corporations’ capital gains with losses from newly contributed high basis, low value assets, following which the assets of the corporations were stripped. Initially, the IRS asserted a deficiency against the trust on the theory that the corporations had been constructively liquidated while still owned by the trust and the trust had received the cash balances held by the corporations. A docketed Tax Court case on this issue was settled with the IRS conceding that there was no deficiency. Subsequently, all four corporations entered into closing agreements with the IRS under which substantial taxes were due with respect to the asset sales. At that time, however, all four of the corporations were insolvent. The IRS asserted transferee liability against the trust, and the trust raised the defenses of res judicata and collateral estoppel. Judge Goekle held that neither res judicata nor collateral estoppel applied. The cause of action in the deficiency cases was different than the cause of action in the transferee liability case. The deficiency case dealt with the trust’s fiduciary income
tax liability on the sale of the stock in the corporations. That determination would not have
required the trust to pay the unpaid tax liabilities of the corporations. The trust’s liability as
transferee differs from the trust’s income tax liability. Collateral estoppel did not apply because
no facts were determined in the earlier proceeding that concluded with the IRS’s concession.
Because the question whether there were liquidating distributions to the trust was not litigated
and was not essential to the decisions in the deficiency actions, collateral estoppel did not bar the
IRS from asserting in the transferee action that there were liquidating distributions from the
corporations to the trust.

3. The taxpayer won the complex legal issue, inadvertently conceded the
critical factual issue, and thus lost the case. Ron Lykins, Inc. v. Commissioner, 133 T.C. No. 5
(9/2/09). A deficiency asserted against the taxpayer corporation for 1999 and 2000 was resolved
in a Tax Court case, Ron Lykins, Inc. v. Commissioner, T.C. Memo. 2006-35. The taxpayer
incurred an NOL in 2001, and the taxpayer requested and received a tentative refund attributable
to carrying back the NOL to 1999 and 2000 before the IRS issued the deficiency notice. The
deficiency notice did not refer to the NOL carrybacks from 2001 or take into account the refunds
in its computation of tax liability. Subsequently, the IRS disallowed the tentative NOL
carrybacks and taxpayer raised the issue of the NOL carrybacks, but the Tax Court held that
there was no deficiency without regard to the NOL carrybacks, neither party having put on
evidence as to the NOL carrybacks. After initially allowing the tentative refund attributable to
the NOL carrybacks, the IRS disallowed them and summarily assessed the amounts of the
tentative refunds pursuant to § 6213(b)(3). The IRS gave notice of intent to levy and the taxpayer
requested a CDP hearing. Following the CDP hearing the IRS issued a notice of determination
to proceed with collection, and the taxpayer appealed. The taxpayer did not attempt to prove
the merits of the 2001 NOL in either the CDP hearing or the Tax Court, but argued that under res
djudicata, the 2006 decision in the original deficiency case barred the IRS from asserting that it
owed more taxes for 1999 and 2000. The Tax Court (Judge Gustafson) first found that collateral
estoppel did not bar the taxpayer from raising the 2001 NOL carryback, because the merits of the
2001 NOL were not “actually litigated” in the prior deficiency case. More importantly, he held
that even assuming that either party could have litigated the NOL in the prior deficiency case, res
djudicata did not bar either the taxpayer or the IRS from raising or disputing the 2001 NOL
carryback and its effect upon the 1999 and 2000 tax liabilities. The reason res judicata did not
bar relitigation of the impact of the NOL carryback was that § 6511(d)(2)(B) explicitly permits
the taxpayer to pay the summary assessments and pursue an overpayment remedy for NOL
carrybacks without the bar of res judicata. On the other side of the coin, although § 6212(c)(1)
generally bars the IRS from issuing a second notice of deficiency after a taxpayer has filed a Tax
Court petition, § 6213(b)(1) and (3) expressly allow the IRS to determine an additional
deficiency that results from a tentative carryback refund even if the IRS has previously issued a
deficiency notice of for the carryback year and the taxpayer has filed a Tax Court petition. The
court emphasized that it was not holding simply that § 6212(c)(1) by itself trumps res judicata,
and that the IRS avoids res judicata whenever it is permitted by § 6212(c)(1) to determine an
additional deficiency, but that §§ 6411, 6212(c)(1), and 6213(b)(3) create a unique procedure for
tentative carryback refunds, because recapture of a tentatively allowed refund is not ordinarily
the subject of a taxpayer’s petition in a deficiency case. However, in the end the court held for
the IRS, concluding that because the taxpayer failed to carry the burden of proving its loss in
2001 and establishing the validity of the carrybacks to 1999 and 2000, having conceded the issue
by not raising it the CDP hearing, the proposed levy to collect the summary assessment would be
upheld.

4. Electronic filing to be required beginning in 2011. Section 17 of
WHABA mandates that the IRS require electronic filing by “specified tax return preparers” for
all tax returns filed after 12/31/10. Specified tax return preparers are “all return preparers except
those who neither prepare nor reasonably expect to prepare ten or more individual income tax
returns [including returns for estates and trusts] in a calendar year.”

5. Burton Kanter got in trouble again, and this time it followed him to
In a 600-page opinion, Burton Kanter was held liable for the § 6653 fraud penalty by reason of his being “the architect who planned and executed the elaborate scheme with respect to ... kickback income payments ...”

a. At first, he was unable to wriggle out, the way he did 25 years ago when he was acquitted by a jury. (His partner was convicted and imprisoned. See United States v. Baskes, 649 F.2d 471 (7th Cir. 1980), cert. denied, 450 U.S. 1000 (1981).) The taxpayers subsequently moved to have access to the special trial judge’s “reports, draft opinions, or similar documents” prepared under Tax Court Rule 183(b). They based their motion on conversations with two unnamed Tax Court judges that the original draft opinion from the special trial judge was changed by Judge Dawson before he adopted it. (Kanter’s attorney later revealed the names of the two judges, when asked at oral argument to the Seventh Circuit, as Tax Court Judge Julian Jacobs and Chief Special Trial Judge Peter J. Panuthos. See the text at footnote 1 of Judge Cudahy’s dissent in the Seventh Circuit Kanter Estate opinion, below.) They were turned down because the Tax Court held that the documents related to its internal deliberative processes. See, Tax Court Order denying motion, 2001 TNT 23-31 (4/26/00) and (on reconsideration) 2001 TNT 23-30 (8/30/00).

b. And the Tax Court’s procedures are vindicated and taxpayer Ballard loses on appeal on the fraud issue in the Eleventh Circuit. Ballard v. Commissioner, 321 F.3d 1037 (11th Cir. 2/13/03), aff’g T.C. Memo. 1999-407. The Eleventh Circuit affirmed the Tax Court decision and rejected the taxpayers’ argument that changes allegedly made to the original draft opinion from the special trial judge by Judge Dawson before he adopted it were improper. Judge Fay stated:

Even assuming Dick’s [taxpayers’ lawyer’s] affidavit to be true and affording Petitioners-Appellants all reasonable inferences, the process utilized in this case does not give rise to due process concern. While the procedures used in the Tax Court may be unique to that court, there is nothing unusual about judges conferring with one another about cases assigned to them. These conferences are an essential part of the judicial process when, by statute, more than one judge is charged with the responsibility of deciding the case. And, as a result of such conferences, judges sometimes change their original position or thoughts. Whether Special Trial Judge Couvillion prepared drafts of his report or subsequently changed his opinion entirely is without import insofar as our analysis of the alleged due process violation pertaining to the application of [Tax Court] Rule 183 is concerned. Despite the invitation, this court will simply not interfere with another court’s deliberative process.

The record reveals, and we accept as true, that the underlying report adopted by the Tax Court is Special Trial Judge Couvillion’s. Petitioners-Appellants have not demonstrated that the Order of August 30, 2000 is inaccurate or suspect in any manner. Therefore, we conclude that the application of Rule 183 in this case did not violate Petitioners-Appellants’ due process rights. Accordingly, we deny the request for relief and save for another day the more troubling question of what would have occurred had Special Trial Judge Couvillion not indicated that the report adopted by the Tax Court accurately reflected his findings and opinion.

c. And the Tax Court’s procedures are vindicated and taxpayer Kanter’s Estate loses on appeal on the fraud issue in the Seventh Circuit. Estate of Kanter v. Commissioner, 337 F.3d 833 (7th Cir. 7/24/03) (per curiam) (2-1), aff’g in part and rev’g in part T.C. Memo. 1999-407. The court found that the nondisclosure of the special trial judge’s original report was proper, following the Eleventh Circuit’s Ballard opinion. It affirmed the findings on deficiencies, fraud and penalties, but reversed on the issue of the deductibility of Kanter’s expenses for his involvement in the aborted sale of a purported John Trumball painting of George Washington because “Kanter has shown a distinct proclivity to seek income and profit through activities similar to the failed sale of the painting.”

- Burton Kanter died on October 31, 2001.
d. And the Tax Court's procedures are vindicated but taxpayer Lisle's Estate wins on appeal on the fraud issue in the Fifth Circuit. Estate of Lisle v. Commissioner, 341 F.3d 364 (5th Cir. 7/30/03), aff'g in part and rev'g in part T.C. Memo. 1999-407. The Fifth Circuit (Judge Higginbotham) followed the Eleventh and Seventh Circuit decisions upholding the nondisclosure of the Special Trial Judge's original report by the Tax Court.

e. Justice Ginsburg to Tax Court judges: "You Article I judges don't understand your own rules, so let me tell you what you meant when you adopted them in 1983." Ballard v. Commissioner, 544 U.S. 40 (3/7/05) (7-2), reversing and remanding 337 F.3d 833 (7th Cir. 7/24/03) and 321 F.3d 1037 (11th Cir. 2/13/03). Justice Ginsburg held that the Tax Court may neither exclude from the record on appeal nor conceal from the taxpayers the original draft reports of Special Trial Judges under Tax Court Rule 183(b) or under any statutory authority.

- Chief Justice Rehnquist's dissenting opinion, joined by Justice Thomas, states that the "Tax Court's compliance with its own Rules is a matter on which we should defer to the interpretation of that court."

f. The Eleventh Circuit orders that the Special Trial Judge's report be added to the record. Ballard v. Commissioner, 2005-1 U.S.T.C. ¶ 50,393 (11th Cir. 5/17/05).

g. Tax Court changes its rules. (9/20/05). The Tax Court adopted amendments to Tax Court Rules 182 and 183, relating to Special Trial Judges' reports in cases other than small tax cases. The Special Trial Judge's recommended findings of fact and conclusions of law are to be served on the parties, who may file written objections and responses. After the case is assigned to a regular Judge, any changes made shall be reflected in the record and "[d]ue regard shall be given to the circumstance that the Special Trial Judge had the opportunity to evaluate the credibility of witnesses, and the finding of fact recommended by the Special Trial Judge shall be presumed to be correct."

h. The Eleventh Circuit remands the case to the Tax Court -- after reinstating the Special Trial Judge's report. Ballard v. Commissioner, 429 F.3d 1026 (11th Cir. 11/2/05) (per curiam). The case was remanded to the Tax Court with the following instructions: (1) the "collaborative report and opinion" is ordered stricken; (2) the original report of the special trial judge is ordered reinstated; (3) the Tax Court Chief Judge is instructed to assign this case to a previously-uninvolved regular Tax Court Judge; and (4) the Tax Court shall proceed to review this matter in accordance with the Supreme Court's dictates and with its newly-revised Rules 182 and 183, giving "due regard" to the credibility determinations of the special trial judge and presuming correct fact findings of the trial judge.

i. And the Fifth Circuit remands it too. Estate of Lisle v. Commissioner, 431 F.3d 439 (5th Cir. 11/22/05) (per curiam). The case was remanded to the Tax Court with orders to: (1) strike the "collaborative report" that formed the basis of the Tax Court's ultimate decision; (2) reinstate Judge Couvillion's original report; (3) refer the case to a regular Tax Court judge who had no involvement in the preparation of the "collaborative report," who in dealing with the remaining issue of tax deficiency must give "due regard" to the credibility determinations of Judge Couvillion, presuming that his fact findings are correct unless manifestly unreasonable; and (4) adhere strictly hereafter to the amended Tax Court Rule in finalizing Tax Court opinions.

j. On remand, in a 458-page opinion Judge Haines of the Tax Court pours out Kanter and Ballard. Estate of Kanter v. Commissioner, T.C. Memo. 2007-21 (2/1/07). The Tax Court (Judge Haines) found that certain of the Special Trial Judge's findings of fact were "manifestly unreasonable" because they were "internally inconsistent or so implausible that a reasonable fact finder would not believe [the recommended finding]" or they were "directly contradicted by documentary or objective evidence." Judge Haines therefore found that the Kanter-related entities were shams, that "Kanter, Ballard, and Lisle participated in a complex, well-disguised scheme to share kickback payments earned jointly by Kanter, Ballard, and Lisle," and that they earned income during the years at issue which they failed to report.
Judge Haines found that — based upon factors such as (1) failure to report substantial amounts of income, (2) concealment of the true nature of the income and the identity of the earners of the income, (3) use of sham, conduit, and nominee entities, (4) reporting Kanter’s and Ballard’s income on IRAs [and another entity’s] tax returns, (5) commingling of Kanter’s and Ballard’s income with funds belonging to others, (6) phony loans, (7) false and misleading documents, and (8) failure to cooperate during the examination process by engaging in a “strategy of obfuscation and delay” — the Commissioner demonstrated by “clear and convincing evidence” that Kanter and Ballard filed false and fraudulent tax returns for each of the years at issue.

Judge Haines held that the Tax Court is “obliged to review the recommended findings of fact and credibility determinations set forth in the STJ report under a ‘manifestly unreasonable’ standard of review, and ... may reject such findings of fact and credibility determinations only if, after reviewing the record in its entirety, [it] conclude[s] that the recommended finding of fact or testimony (1) is internally inconsistent or so implausible that a reasonable fact finder would not believe it, or (2) is not credible because it is directly contradicted by documentary or objective evidence.” Furthermore, Judge Haines held that a special trial judge’s credibility determinations may be rejected under the “manifestly unreasonable” standard of review without rehearing the disputed testimony.

Judge Haines further found that the appropriate standard for determining whether the assignment of income doctrine should be applied had been appropriately articulated in United States v. Newell, 239 F.3d 917, 919-920, as follows:

To shift the tax liability, the assignor [taxpayer] must relinquish his control over the activity that generates the income; the income must be the fruit of the contract or the property itself, and not of his ongoing income-producing activity. ... This means, in the case of a contract, that in order to shift the tax liability to the assignee the assignor either must assign the duty to perform along with the right to be paid or must have completed performance before he assigned the contract; otherwise it is he, not the contract, or the assignee, that is producing the contractual income — it is his income, and he is just shifting it to someone else in order to avoid paying income tax on it.

And the beat goes on, with a judicial recognition that structural complexity is the norm for “a knowledgeable tax attorney.” Ballard v. Commissioner, 522 F.3d 1229 (11th Cir. 4/7/08). The Eleventh Circuit (Judge Fay) reversed, vacated and remanded T.C. Memo. 2007-21 (2/1/07) (Haines, J.), with instructions to “enter an order approving and adopting Judge Couvillion’s original report as the opinion of the Tax Court.” The reason assigned was that Judge Haines “did not presume Judge Couvillion’s findings to be correct or give Judge Couvillion’s credibility determinations their due deference,” concluding that

It is no surprise that a knowledgeable tax attorney would use numerous legal entities to accomplish different objectives. This does not make them illegitimate. Unfortunately such “maneuvering” is apparently encouraged by our present tax laws and code.

“One for all and all for one.” Estate of Lisle v. Commissioner, 541 F.3d 595 (5th Cir. 8/25/08), is to the same effect as Ballard.

A former member of the University of Chicago Law School faculty, members of which took a pro-Kanter stand during the entire litigation because the School was getting big bucks from Kanter and/or his estate, decided the last appeal in this matter in favor of Burton Kanter’s estate. Result: The late Burton Kanter = 1; the IRS = zero; the Tax Court = minus 1. Did we mention that the former faculty member was married to a current member of the faculty? Kanter v. Commissioner, 590 F.3d 410 (7th Cir. 12/1/09). The Seventh Circuit reversed, vacated and remanded T.C. Memo. 2007-21 (2/1/07), with instructions to “enter an order approving and adopting the STJ’s report as the decision of the Tax Court.” Judge Wood
found that the STJ's findings were not "clearly erroneous" but "freely acknowledge[d] that a rational person could just as easily have come to the opposite conclusion on this record."

- On his federal income tax returns for the years 1979 through 1989, Burton Kanter reported that he had no income tax liability. That return position has been vindicated. So it goes.

  n. Chutzpah on steroids by this influential Chicago family. According to Tax Analysts, the Kanter family has called for removal of several Tax Court judges. "Taxes, taxes, we don't have to pay no steenking income taxes." 2010 TNT 44-1 (3/8/10). "As attorneys for the Kanter family, we call on the president, who has the power to remove a Tax Court judge, to immediately institute an investigation on whether such removal is justified," Lanny J. Davis of McDermott Will & Emery told Tax Analysts. "We also call on the committees of Congress that have oversight of the Tax Court to institute an investigation of Judge Dawson and other Tax Court judges who appear to have been at least complicit in knowing about Judge Dawson's pattern of deception and not reporting him to senior authorities or, even worse, participated in a cover-up of his deception in the summer of 2005 after the Supreme Court forced the disclosure of Judge Couvillion's original opinion."

- The Kanter family is also upset because the IRS is auditing Burton Kanter's estate tax return. Why on earth would the IRS do something like that?

6. When the IRS says it's going negative on a private letter ruling you better withdraw it the way the Rev. Proc says to. Does this taxpayer really think that captioning the case as "Anonymous v. Commissioner" will help hide from the IRS? Anonymous v. Commissioner, 134 T.C. No. 2 (1/19/10). The Tax Court (Judge Goeke) held that it lacked jurisdiction to enjoin the issuance of private letter ruling after the taxpayer failed to withdraw the request following notification that the ruling would be adverse. (The Tax Court does have jurisdiction to determine whether certain items in a private letter ruling must be redacted prior to publication.) Judge Goeke summarized taxpayer's argument (before rejecting it) as follows:

Petitioner . . . argues that the [administrative Procedure Act] provides this Court with the authority to order respondent not to disclose the PLR at issue because the PLR was arbitrary, capricious, and an abuse of discretion. Petitioner alleges section 6110(f)(3) grants the Court the express authority to review written determinations open to public inspection like PLRs. Petitioner contends that the contents of the PLR are contrary to law and thus respondent acted arbitrarily, capriciously, and in bad faith in issuing it. Petitioner further argues that for the same reason the PLR should not be disclosed to Department of the Treasury officials.

7. "The whistleblower talks twice." Chief Counsel Notice CC-2010-004 (2/17/10). This Chief Counsel notice clarifies the limitations on contacts between IRS employees and informants, including informants who have filed claims under § 7623, by permitting more than one contact with informants [including those informants who are current employees of the taxpayer]. There are safeguards to prevent the informant from becoming an instrument or agent of the government, as well as a prohibition on accepting any information from an informant who is the taxpayer's representative in any administrative matter pending before the IRS.

8. 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 except 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.
There is a move in Congress to repeal this provision in exchange for tax increases on multinational corporations.

9. Reporting, reporting, there’s lots of health care reporting.
   a. Employer reporting, Act 1. The 2010 Health Care Act amended § 6051 of the Code to require reporting on each employee’s annual Form W-2 the value of the employee’s health insurance coverage sponsored by the employer for taxable years beginning after 12/31/10.
   b. Employer reporting, Act 2. The 2010 Health Care Act added new § 6056 to the Code and amended § 6724(d) to impose health insurance reporting requirements on employers. Applicable large employers subject to the employer responsibility provisions of new § 4980H, and other employers who offer minimum essential coverage to their employees under an employer-sponsored plan and pay premiums in excess of 8 percent of employee wages, must report specified health insurance coverage information to both its full-time employees and to the IRS. An employer who fails to comply with these new reporting requirements is subject to the penalties for failure to file an information return and failure to furnish payee statements, respectively. The new rules are effective for calendar years beginning after 2013.
   c. Insurer reporting. The 2010 Health Care Act added new § 6055 to the Code and amended § 6724(d). Insurers, including employers who self-insure, that provide minimum essential coverage to any individual must report certain health insurance coverage information to both the individual and to the IRS. An insurer who fails to comply with these new reporting requirements is subject to the penalties for failure to file an information return and failure to furnish payee statements, respectively. The new rules are effective for calendar years beginning after 2013.

10. Disclosure of return information is OK if the purpose is verify eligibility / ineligibility for cost-sharing benefits and an advance § 36B premium credit through an American Health Benefits Exchange. The 2010 Health Care Act amended § 6103 to the Code to allow the IRS to disclose to HHS certain return information of any taxpayer whose income is relevant in determining the amount of the tax credit or cost-sharing reduction, or eligibility for participation in the specified State health subsidy programs (i.e., a State Medicaid program under title XIX of the Social Security Act, a State’s children’s health insurance program under title XXI of such Act, or a basic health program under § 2228 of such Act).

11. 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 9/11/10. 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.** 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.

12. **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. No. 4 (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.

13. **Might this case lead to DOMA becoming the Twenty Eighth Amendment?** Gill v. Office of Personnel Management, 106 AFTR2d 2018-5184 (D. Mass. 7/8/10). District Court Judge Tauro held that § 3 of the Defense of Marriage Act, 1 U.S.C. § 7, which limits the meaning of the word “marriage” to “a legal union between one man and one woman as husband and wife,” and provides that “the word ‘spouse’ refers only to a person of the opposite sex who is a husband or wife” for purposes of all federal laws is an unconstitutional denial of equal protection in violation the equal protection principles embodied in the Due Process Clause of the Fifth Amendment. Joint return filing status under the Code was one of the issues addressed in the case; also addressed were government benefits available to married individuals, e.g., employee health benefits, social security benefits.

14. **The Constitution does not require Appeals Officers for CDP hearings to be appointed by the President.** Tucker v. Commissioner, 135 T.C. No. 6 (7/26/10). The taxpayer requested a CDP hearing after the IRS issued a notice of filing of a tax lien. After the
settlement officer had upheld the tax lien notice, the taxpayer requested a remand for a hearing to be heard by an officer appointed by the President or the Secretary of the Treasury, in compliance with the Appointments Clause of U.S. Const., art. II, sec. 2, cl. 2. Judge Gustafson held that an "officer or employee" or an "appeals officer" under § 6320 or § 6330 is not an "inferior Officer of the United States" for purposes of the Appointments Clause. They are instead properly hired, pursuant to § 7804(a), under the authority of the Commissioner of Internal Revenue. The taxpayer’s motion to remand was denied.

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. Dak. 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, 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. 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. FICA in paradise. Zhang v. United States, 89 Fed. Cl. 263 (Fed. Cl. 9/22/09). Nonresident aliens, Chinese nationals who were temporary contract workers in the Commonwealth of the Northern Mariana Islands, were subject to FICA taxes. The
Commonwealth is statutorily connected to Guam, which is a U.S. territory, through a covenant that causes the Commonwealth to be considered within the U.S. for FICA purposes. The court noted that the covenant mandates that, except for FICA tax proceeds, income and other tax revenues shall be remitted to the treasury of the Commonwealth instead of the U.S. Treasury.

3. REG-137036-08. Section 3504 Agent Employment Tax Liability, 75 F.R. 1735 (1/12/10). Proposed regulations include Federal Unemployment Tax Act (FUTA) withholding taxes within the scope of current regulatory authority that allows employers to meet their FICA tax obligations for domestic in-home services through an agent as provided in § 3401. The agent files a single return for multiple employers using the agent’s employer identification number.

4. The gamble doesn’t pay off and this tribe sings the blues. Blue Lake Rancheria v. United States, 105 A.F.T.R.2d 2010-683 (N.D. Calif. 1/7/10). Section 3306(c) excludes from employment for FUTA purposes “service performed . . . in the employ of an Indian tribe, or any instrumentality” thereof. Section 3309 also allows Indian tribes to opt out of paying state unemployment taxes if the tribe reimburses the state for actual costs of providing unemployment benefits to the tribe’s employees. Mainstay is in the business for providing leased employees. It provides over 39,000 employees to business in three states. Mainstay is controlled by Blue Lake Rancheria Economic Development Corporation, a tribal corporation. (The tribe has 53 members.) Mainstay sought refund of over $2 million of FUTA taxes claiming that its employees were employees of an Indian tribe. The court concluded that the tribal exception operates to eliminate the existence of statutory employment “where services performed in a common law relationship between an employer and employee would normally lead to the existence of ‘employment.’” The court then reasoned that “‘employment’ must be defined by reference to the common law employer, and that the statutory employer must be liable.” The court holds, “that the exception to the definition of ‘employment’ for ‘services performed ... in the employ of an Indian tribe, or any instrumentality’ thereof, § 3306(c)(7), is only available when an Indian tribe is the common law employer of the employees in question. When an Indian tribe is merely the statutory employer, the applicability of this exception depends upon the employee’s relationship with his or her common law employer. Where the common law employer is not an Indian tribe, and where no other exemption under § 3306(c) applies, the statutory employer will be liable under FUTA.” The court also rejected the taxpayer’s argument that the Indian tribe was not a common law employer of the leased employees and the exemption therefore did not apply.

5. We don’t need no steenking payroll taxes! New Code § 3111(d)(1), added by the 2010 HIRE Act, excuses employers from paying the employer’s share of OASDI taxes from 3/19/10 — sort of, see below — through 12/31/10 for wages paid to newly hired previously unemployed workers. However, unless employer elects out of the payroll tax holiday, wages paid to a qualified individual do not qualify for the § 51 work opportunity credit during the one-year period beginning on the date that the qualified employer hired the employee.

- A “qualified” employee is an individual who (1) starts employment after 2/3/10 and before 1/1/11; (2) provides an affidavit, under penalties of perjury, certifying that he has not been employed for more than 40 hours during the 60-day period ending on the date his employment begins; (3) has not been hired to replace another employee who was discharged without cause; (4) is not related to the employer or a more than 50 percent owner of the stock of a corporate employer, in a manner that would disqualify him for the work opportunity credit under § 51(i)(1), i.e., a long list of relatives, including, inter alia, all ancestors and descendants, brothers and sisters, nieces and nephews, and close in-laws; however aunts, uncles, cousins and outlaws appear to be OK.

- Wages paid during the first calendar quarter of 2010, i.e., between 3/19/10 and 3/31/10, do not actually qualify for complete forgiveness of the OASDI tax. Rather, the amount by which the OASDI tax for wages paid during the first calendar quarter of 2010 would have been reduced if the tax holiday had been in effect for that quarter is treated as a payment against the employer’s OASDI tax on other employees in the second calendar quarter of 2010.
• The tax waiver applies only to non-governmental employers except that it also applies to a public institution of higher education. The tax waiver ends on 12/31/10.

6. Funding health care by making the HI tax more progressive. Section 1301, as amended by the 2010 Health Care Act, increases the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages in excess of a threshold amount. The threshold amount is $250,000 of the combined wages of both spouses on a joint return ($125,000 for a married individual filing a separate return. The threshold is $200,000 for all other individuals. The employer must withhold the additional HI tax, but in determining the employer’s withholding requirement and liability for the tax, only wages that the employee receives from the employer in excess of $200,000 for a year are taken into account, and the employer disregards the employee’s spouse’s wages. I.R.C. § 3102(f). The employee is liable for the additional 0.9 percent HI tax to the extent the tax is not withheld by the employer. Section 1402(b), as amended, imposes an additional tax of 0.9 percent self-employment income above the same thresholds, The threshold amount is reduced (but not below zero) by the amount of wages taken into account in determining the FICA tax with respect to the taxpayer. No deduction under § 164(f) for the additional SECA tax, and the alternative deduction under § 1402(a)(12) is determined without regard to the additional SECA tax rate. The additional tax applies to wages received in taxable years after 12/31/12.

7. United States v. Quality Stores, Inc., 424 B.R. 237, 105 A.F.T.R.2d 2010-1110 (W.D. Mich. 2/23/10). Severance payments made to pre-petition and post-petition employees who were involuntarily terminated were treated as wage-replacement social benefits rather than taxable remuneration and wages subject to FICA tax. The court concluded that under § 3402(o) (which treats supplemental unemployment compensation benefits as wages for withholding) supplemental unemployment compensation was not “wages” and therefore was not taxable for purposes of FICA.

• The result is contrary to the holding in CSX Corp. v. United States, 518 F.3d 1328 (Fed. Cir. 2008).

8. S corporation “John Edwards gambit” dividends may be treated as wages. Watson v. United States, 105 A.F.T.R.2d 2010-2624 (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 law 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.

9. Contract workers are employees, and taxpayer gets no help from § 530 of the Revenue Act of 1978. *Bruecher Foundation Services Inc v. United States*, 105 A.F.T.R. 2d 2010-____ (5th Cir. 6/18/10). In 1999-2000 the taxpayer employed 13-16 workers as contractors in its foundation repair, landscaping and grading business. The taxpayer claimed deductions for the workers' compensation as "contract workers" but filed no Form 1099s for the workers. The IRS initiated an audit of employment tax liabilities without notifying the taxpayer and without informing the taxpayer of the § 530 safe harbor (Pub. L. No. 95-600, § 530, 92 Stat. 2763, 2885-86) as required by the statute. When the taxpayer was notified of the audit the taxpayer filed a Form 1099 for each of the workers. Section 530 bars reclassification of workers as employees if (1) the worker was not treated as an employee for any period, (2) the employer filed all returns, including information returns, in a manner consistent with treating the worker as an independent contractor, and (3) the employer had a reasonable basis under common law standards for treating the worker as an independent contractor. The court rejected the taxpayer's assertion that it complied with the § 530 requirement that it filed returns consistent treating the employees as independent contractors. Although the court was not willing to go as far as the IRS argument that timely forms were always required, the court indicated that the taxpayer's strategic filing of the required returns after the IRS assessed the tax was not compliance with the statute. The court also held that the IRS's failure to give early notice of its audit and the availability of § 530 did not shift the burden of proof to the government. Finally, the court accepted the IRS position that the workers were employees under common law standards.

10. The Tax Court follows the Sixth and Second Circuits to hold that pre-2009 employment tax liability of a disregarded LLC must be paid by the sole-member. *Medical Practice Solutions, LLC v. Commissioner*, 132 T.C. No. 7 (3/31/09). Following the decisions in *Littriello v. United States*, 484 F.3d 372 (6th Cir. 2007), and *McNamee v. Dept. of the Treasury*, 488 F.3d 100 (2d Cir. 2007) [both of which upheld the validity of the "check-the-box" regulations in the same context, applying *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984)], the Tax Court (Judge Cohen) held that the check-the-box regulations treating a single member entity that does not elect to be treated as a corporation as a disregarded entity, Reg. § 301.7701-3(b), are valid and as a result the sole member of a disregarded limited liability company is responsible for the L.L.C.'s unpaid employment taxes. After 1/1/09, under Reg. § 301.7701-2(c)(2)(iv), a disregarded entity is treated as a corporation for purposes of employment tax reporting and liability. The court rejected the taxpayer's argument that the amendment to the regulations, which reverses the prior rule, demonstrates that the prior regulation imposing employment tax liability on the sole-member of the disregarded entity was unreasonable. The court stated that, "In light of the emergence of limited liability companies and their hybrid nature, and the continuing silence of the Code on the proper tax treatment of such companies in the decade since the present regulations became effective, we cannot conclude that the above Treasury Regulations, providing a flexible response to a novel business form, are arbitrary, capricious, or unreasonable."
a. The First Circuit agrees. Britton v. Shulman, 106 A.F.T.R.2d 2010-__ (1st Cir. 8/24/10). In a one-paragraph memorandum opinion, the First Circuit finds no error or abuse of discretion in the Tax Court opinion in Medical Practice Solutions, LLC v. Commissioner.

B. Self-employment Taxes
C. Excise Taxes

1. Employers who aren't willing to pay health insurance premiums on their employees must pay Uncle Sam a very healthy nondeductible excise tax. Under § 4980H, added by the 2010 Health Care Act and effective after 12/31/13, an applicable large employer, i.e., an employer that employed an average of at least 50 full-time employees during the preceding calendar year, that fails to offer its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an employer sponsored health insurance plan is subject to an assessable excise tax if (1) there is a waiting period, or (2) any of its employees are certified to the employer as having enrolled in health insurance coverage purchased through an American Health Benefits Exchange with respect to which a premium tax credit or cost-sharing reduction is allowed or paid to such employee or employees. (An employee is eligible for the premium credit if the employer does not offer health insurance for all its full-time employees, it offers minimum essential coverage that is unaffordable ("unaffordable" means a premium required to be paid by the employee that is more than 9.5 percent of the employee's household income), or it offers minimum essential coverage under which the plan's share of the total allowed cost of benefits is less than 60 percent.) For an employer not offering coverage, the amount of the excise tax amount for any month equals the number by which full-time employees exceeds 30-employees (regardless of how many employees are receiving a premium tax credit or cost-sharing reduction) multiplied by $166.67 (one-twelfth of $2,000).

The amount is nothing to sneeze at. 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," 39-40 (JCX-18-10 3/21/10) gives the following example:

For example, in 2014, Employer A fails to offer minimum essential coverage and has 100 full-time employees, ten of whom receive a tax credit for the year for enrolling in a State exchange-offered plan. For each employee over the 30-employee threshold, the employer owes $2,000, for a total penalty of $140,000 ($2,000 multiplied by 70 ((100-30)). This penalty is assessed on a monthly basis.

• For each full-time employee receiving a premium tax credit or cost-sharing subsidy through an American Health Benefits Exchange for any month, the monthly excise tax equals one-twelfth of $3,000. The tax is capped, however, by the amount that would have been the excise tax if the employer had provided no coverage. 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," 39-40 (JCX-18-10 3/21/10) gives the following example:

For example, in 2014, Employer A offers health coverage and has 100 full-time employees, 20 of whom receive a tax credit for the year for enrolling in a State exchange offered plan. For each employee receiving a tax credit, the employer owes $3,000, for a total penalty of $60,000. The maximum penalty for this employer is capped at the amount of the penalty that it would have been assessed for a failure to provide coverage, or $140,000 ($2,000 multiplied by 70 ((100-30)). Since the calculated penalty of $60,000 is less than the maximum amount, Employer A pays the $60,000 calculated penalty. This penalty is assessed on a monthly basis.

• The excise tax is not deductible as a business expense under § 162. The restrictions on assessment under § 6213 do not apply.

2. Did Congress call them fees, instead of excise taxes, because there are no percentages in the formulae or because they are earmarked to fund PCORTF? New
§ 4375, added by the 2010 Health Care Act, imposes a fee on each health insurance policy, to be paid by the insurer, of $2 ($1 for years ending in U.S. fiscal year 2013) multiplied by the average number of lives covered under the policy, and new § 4376 imposes a like fee on self-insured health plans, to be paid by the employer. The fees are earmarked to fund the Patient Centered Outcomes Research Trust Fund (PCORTF), to carry out provisions in the Act relating to comparative effectiveness research.

3. That's not a ‘nice healthy" tan, it's a “dangerous pre-cancer glow.”

New § 5000B of the Code imposes a 10 percent sales tax on the amount paid for indoor tanning services. The tax is collected by the service provider and remitted to the IRS quarterly. The tax kicks in on 6/1/10, just in time for the summer tanning season.

4. A nondeductible tax on Cadillacs, and we’re not talking about any G.M. cars here. New § 4980I, added by the 2010 Health Care Act, imposes an excise tax on insurers if the aggregate value of employer-sponsored health insurance coverage and health benefits (except separate dental and optic coverage) for an employee (including former employees, surviving spouses and any other primary insured individuals) exceeds a threshold amount. The amount of the tax is 40 percent of the aggregate value that exceeds the threshold amount. For 2018, the threshold amount is $10,200 for individual coverage and $27,500 for family coverage, multiplied by the health cost adjustment percentage (a multiplier designed to increase the thresholds if the actual growth in health care between 2010 and 2018 exceeds the projected growth for that period), increased by an age and gender adjusted excess premium amount. The threshold amounts are increased for individuals who have attained age of 55 who are non-Medicare eligible and receiving employer-sponsored retiree health coverage or who are covered by a plan sponsored by an employer the majority of whose employees covered by the plan are engaged in a certain high risk professions. For a self-insured group health plan, a Health FSA or an HRA, the excise tax is paid by the entity that administers the plan. If the employer acts as the plan administrator, the excise tax is paid by the employer. Employer-sponsored health insurance coverage includes both insured and self-insured health coverage excludable from the employee's gross income; for a self-employed individual, the coverage for any portion of which a deduction is allowable under § 162(l). If an employer reports to insurers, plan administrators, and the IRS a lower amount of insurance cost subject to the excise tax than required, the employer is subject to a penalty equal to the sum of any additional excise tax that each such insurer and administrator would have owed if the employer had reported correctly and interest attributable to that additional excise tax. The excise tax is not deductible under the income tax.

- Although the Staff of the Joint Committee on Taxation did not score this provision for revenue effects, because its effective date is outside the 5-year window for scoring revenue effects, despite being in the “Revenue Provisions” of the Act, Congress does not really intend that provision raise much revenue. It intends to discourage employers from providing high cost, i.e., Cadillac, health plans.

XII. TAX LEGISLATION

A. Enacted

1. H.R. 3548, the Worker, Homeownership, and Business Act of 2009, P.L. 111-92 (“WHABA”), was signed by President Obama on 11/6/09.

2. H.R. 3326, the 2010 Defense Appropriations Act, P.L. 111-118, which contains the COBRA subsidy extension at § 1010, was signed by President Obama on 12/19/09.

3. H.R. 4462, P.L. 111-126, was signed into law by President Obama on 1/22/10. The law permits donors who itemize deductions on their 2009 tax returns to deduct on their 2009 returns any charitable contributions for the relief of victims of the Haitian earthquake made in cash after 1/11/10 and before 3/1/10.

4. H.R. 4691, the Temporary Extension Act of 2010, P.L. 111-144, was signed by President Obama on 3/2/10. The signing ceremony consisted of a “TEA party” at which the president was tea-bagged, i.e., tea bags were thrown at him.

5. The Hiring Incentives to Restore Employment (“HIRE Act”), P.L. 111-147, was signed by President Obama on 3/18/10. It is a $17.6-billion “jobs package.”
6. 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.

7. 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.


9. HR 3962, the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010, P.L. 111-192, was signed by President Obama on 6/25/10.

10. The Homebuyer Assistance and Improvement Act of 2010, P.L. 111-198, was signed by President Obama on 7/2/10.

11. The Small Business Jobs Act of 2010, P.L. 111-240, was signed by President Obama on 9/27/10. This Act will create millions upon millions of good paying jobs.

B. Pending
RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

For the William & Mary Tax Conference

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