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Recent Developments in Federal Income Taxation

Ira B. Shepard

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# RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

For the William & Mary Tax Conference

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RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

By

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This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted — 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


2. Hindsight is poor sight when looking for § 9100 relief. Acar v.
Commissioner, 545 F.3d 727 (9th Cir. 9/23/08). The taxpayer was a financial planner and part-time securities trader. He attempted to make a § 475(f) mark-to-market election for 1999 and 2000 in 2002 by submitting amended returns. The election was untimely under Rev. Proc. 99-17, 1999-1 C.B. 503 and the IRS refused to grant relief under Reg. § 301.9100-3(c). The court upheld the IRS’s denial of § 9100 relief because he had used hindsight in making the late election and thus pursuant to Reg. § 301.9100-3(b)(3)(iii) did not satisfy the “good faith requirement.” The court of appeals distinguished the Tax Court’s decision in Vines v. Commissioner, 126 T.C. 279 (2006), granting § 9100 relief for a late § 475(f) election on the ground that in Vines, unlike in the instant case, there had been no trading between the time the election should have been made and the time it was made, and thus Vines obtained no hindsight advantage.

3. 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.

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

1. God didn’t answer this Trinity’s prayers. Trinity Industries, Inc. v. Commissioner, 132 T.C. No. 2 (1/28/09). The taxpayer, which was on the accrual method, built barges for customers, and part of the payment of the purchase price was contractually deferred until 18 months after delivery of each barge. The customers later claimed there were defects in other barges purchased previously and asserted common law rights to offset their claimed damages against the deferred payments. The taxpayer included only the payments actually received and excluded the deferred payments. The Tax Court (Judge Thornton) held that the full contract price was includable in the year the barges were delivered, and the amount could not be reduced by the amount withheld by the purchasers under their asserted right to offset claimed damages. The court reasoned that the offset claims affected only the timing of the taxpayer’s receipt of the sales proceeds, not its right to receive the proceeds, because the taxpayer subsequently received the withheld amounts when, pursuuant a settlement agreement, they were
applied in compromise of the purchasers' claims for damages. Furthermore, § 461(f) did not apply to allow the taxpayer to deduct the withheld amounts in the year of the sale because the withheld amounts were not “transferred” by the taxpayer, as required by § 461(f), and even if they were constructively “transferred,” as asserted by the taxpayer – an argument that the court did not accept – the transfer did not occur in the year the barges were delivered, but in a later year.

2. Thirty-five percent is not substantial here, even though it might be elsewhere in the Code. Nelson v. Commissioner, 130 T.C. 70 (2/28/08). Section 451(d) permits a cash method farmer who normally reports income from the sale of his crops in the year following crop production to elect to defer treating as income crop insurance proceeds received in a year until a following year. The taxpayers, who routinely reported only 65 percent of income realized from the sale of crops in the year of sale and 35 percent the following year [which the IRS stipulated was an acceptable accounting method], were not permitted to defer reporting 100 percent the proceeds of crop insurance until the following year. The Court (Judge Swift) applied Rev. Rul. 74-145, 1974-1 C.B. 113, which allowed deferred recognition of crop insurance proceeds under § 451(d) to a farmer who, under his normal method of accounting for crop income, deferred to the following year not all but more than 50 percent of his crop income, a percentage which the ruling referred to as a “substantial portion” of the farmer’s annual crop income, and concluded that the taxpayers did not normally defer a substantial portion of their crop income — 35 percent not being “substantial” for this purpose — § 451(d) was inapplicable.

a. Affirmed, 568 F.3d 662, 103 A.F.T.R.2d 2009-2621 (8th Cir. 6/10/09). The court of appeals also followed Rev. Rul. 74-145, stating as follows: “The legislative history, however, indicates Congress intended § 451(d) to ameliorate the effects of forcing farmers to report two years of income in a single tax year. Because of Congress’ clearly expressed intent, the IRS’s revenue ruling reasonably concludes only farmers who customarily defer all or a substantial portion of their crop income to the tax year following production were intended to benefit from a § 451(d) deferment of insurance proceeds.” The court also rejected the taxpayers’ alternative argument that they satisfied the substantial portion test because they deferred more than fifty percent of aggregate annual crop income. Reg. § 1.451-6(a)(2) requires a farmer who receives crop insurance proceeds from two or more damaged crops, and elects to defer insurance proceeds under § 451(d), to defer all insurance proceeds attributable to crops constituting a single trade or business. On the basis of this provision, the taxpayers claimed that the substantial portion test applies to the entire farming operation, not to a single crop. The court held that Reg. § 1.451-6(a)(2) did not apply because it only applies “in the case of a taxpayer who receives insurance proceeds as a result of the destruction of, or damage to, two or more specific crops... “ and the insurance proceeds in the instant case related only to one crop.

3. Is whether a purported sale is bona fide really a fact question for the jury rather than a question of law? “Yes,” says the Fourth Circuit. Volvo Cars of North America, LLC v. United States, 571 F.3d 373, 104 A.F.T.R.2d 2009-5248 (4th Cir. 7/9/09). Volvo sold excess parts inventory to a purchaser who would store the parts for up to 15 years in its own warehouses. Under the original 1981 contract, Volvo not only retained the right to repurchase the inventory at 90% of standard cost, but in addition, the purchaser was required to notify Volvo prior to any planned disposition of Volvo parts inventory to third parties, giving Volvo an opportunity to repurchase that inventory before it was sold to others. Either party had the right to cancel the arrangement unilaterally, upon 60 days written notice. An amended April 1983 agreement eliminated the right to prior notice before the inventory was sold to a third party. The IRS challenged Volvo’s loss deductions on the parts sales, asserting that the sales were not bona fide. Volvo conceded that under the test of Paccar, Inc. v. Commissioner, 85 T.C. 754 (1985), aff’d, 849 F.2d 393 (9th Cir. 1988), the sales pursuant to the first contract [1981 and 1982 sales] were not bona fide, but argued that all of the sales in 1983 and thereafter were governed by the April 1983 contract and that they were bona fide sales. In the district court refund suit, the district court instructed the jury on the four relevant factors set forth by the Tax Court in Paccar, and submitted two questions to the jury: (1) whether there was a bona fide sale of inventory
physically transferred before execution of the 1983 contract, and (2) whether there was a *bona fide* sale of inventory physically transferred after execution of the 1983 contract. The jury returned a verdict in Volvo's favor. However, the district court entered a judgment notwithstanding the verdict in favor of the government with respect to transfers of inventory made prior to execution of the amended contract, concluding as a matter of law that the amended contract did not address inventory previously transferred to the warehouser. On appeal, the Fourth Circuit (Judge Niemeyer) vacated the district court's judgment notwithstanding the verdict. He found that the jury had been properly instructed regarding the relevant law and could have reasonably concluded that the 1983 contract replaced the 1980 contract and covered not only inventory to be transferred after execution of the 1983 contract but also inventory that had been transferred under the 1980 contract and was still in the purchaser's warehouses or had been purchased by third parties.

- The four relevant factors set forth by the Tax Court in *Paccar* are: (1) Who determined what items were taken into inventory; (2) who determined when to scrap existing inventory; (3) who determined when to sell inventory; and (4) who decided whether to alter inventory.

4. 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 (9/21/08). This case involved two issues and over $280,000 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. *Pate v. Commissioner*, T.C. Memo. 2008-272 (12/9/08). The Tax Court (Judge Cohen) disregarded the taxpayer’s purported joint venture and S corporation as having no economic substance and held the taxpayer liable to report income from working as an "independent contractor" on the taxpayer’s individual return. The taxpayer was also responsible for employment taxes. Further, the court refused to treat the taxpayer’s cattle operation as having a profit motive.

2. **This looks pretty good but questions still remain.** The 2009 ARRTA, §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. §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 for the provision to apply 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.

- An omission, however, appears to be the cancellation of a debt in connection with a property transfer, for example, a deed in lieu of foreclosure. Perhaps the Treasury Department and IRS will provide by regulation or ruling that the statute applies in such a situation. Or, perhaps, they won’t; Congress was given the opportunity to include debt in connection with a property transfer and did not include it in the statute, 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. 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 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 November 16 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.

3. This arbitration award is income rather than a return of capital. Who
does he think he is, Richard Hatch? Bachmann v. Commissioner, T.C. Memo. 2009-51 (3/11/09). The taxpayer received an arbitration award of $1,369,729 against his employer, Salomon Smith Barney, Inc. based on the taxpayer’s claim that Smith Barney had failed to compensate him for the use of the taxpayer’s idea to create trust preferred stock. The trust preferred stock arrangement involved the issue by a group of banks of debt to a trust which in turn issued preferred securities to investors for cash. The court (Judge Morrison) rejected the taxpayer’s claim that the arbitration award was a return of capital. The court indicated that the taxpayer failed to prove that he had any basis in the idea. In addition, the court opined that the payment from Smith Barney for the taxpayer’s business idea was nothing more than a payment for services. The court further rejected the taxpayer’s reasonable cause and good faith arguments to impose substantial understatement penalties under § 6662.


a. The recommendation was accepted by the District Court. AT&T, Inc. v. United States, 104 A.F.T.R.2d 2009-6036 (W.D. Tex. 7/16/09).

5. Tax-free dollars to fight gypsy moths and southern pine beetles. Rev. Rul. 2009-23, 2009-32 I.R.B. 177 (7/27/09). The Forest Health Protection Program administered by the US Forest Service will be treated for purposes of § 126 is substantially similar, within the meaning of § 126(a)(9), to the type of programs described in § 126(a)(1) through (8). Cost sharing payments received by nonindustrial private forest landowners to establish an acceptable integrated pest management strategy that will prevent, retard, control, or suppress gypsy moth infestations, southern pine beetle infestations, spruce budworm infestations, or other major insect infestations are eligible for exclusion from gross income to the extent permitted by § 126. The extent of the exclusion is determined under § 126(b) and Reg. § 16A.126-1.

6. Pizza, the eighth deadly sin, and the ninth is stealing the sausage process, even if the damages are taxable. Joseph Freda v. Commissioner, T.C. Memo. 2009-191 (8/25/09). The taxpayer supplied Pizza Hut with pre-cooked sausage prepared with its 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.

B. Deductible Expenses versus Capitalization

1. Not all the “green in” the Emergency Economic Stabilization Act of 2008 is federal money. The Emergency Economic Stabilization Act of 2008, Division C, § 318, extends the deduction allowed by § 198 for environmental remediation expenses (which might otherwise be capital expenditures) to expenditures through 2009. To qualify, a site must be certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance; sites that are identified on the national priorities list under CERCLA do not qualify.

a. The Act, § 322 also extends the incentives for investment in the District of Columbia to expenditures in 2009.

2. Legal fees incurred resisting states’ attorney general challenges to the privatization of Blue Shield are capital expenses. Wellpoint, Inc. v. Commissioner, T.C. Memo. 2008-236 (10/27/08). 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 $200 million to settle these actions. The court (Judge Kroupa) held 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. The court rejected the taxpayer’s argument that the payments were incurred to protect its business practices.

3.  **West Covina Motors, Inc. v. Commissioner,** T.C. Memo. 2008-237 (10/27/08). Taxpayer was required to capitalize legal fees paid on behalf of its related party lessor in protecting the taxpayer’s interest in leased property on which the taxpayer’s auto dealership was located. The taxpayer’s related party lessor declared bankruptcy and the bank holding the mortgage on the leased property threatened to remove the taxpayer. The court (Judge Kroupa) held that the fees were incurred in defense of title and not subject to an exception that allows deduction of legal fees paid to benefit another where adverse consequences to the taxpayer’s business are direct and proximate. The court also required capitalization of legal fees incurred in the acquisition of the assets of another auto dealership consisting largely of inventory. The court also upheld accuracy-related substantial underpayment penalties.

4.  **Those fancy Pyrex® and Oneida® branded kitchen products are made by Robinson Knife Manufacturing,** which is required to capitalize license fees. **Robinson Knife Manufacturing Company, Inc. 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)(a), 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.

5.  **The increased cost of double-wide is affirmed.** **Load, Inc. v. Commissioner,** 559 F.3d 909, 103A.F.T.R.2d 2009-423 (9th Cir. 3/4/09), aff’g T.C. Memo. 2007-51 (3/6/07). The taxpayer sells manufactured homes purchased from the manufacturer by placing for sale and demonstration models on leased lots where they are sold by independent sales persons. The court adopted the Tax Court holding and its opinion that costs attributable to placement of model manufactured homes on leased retail sales lots were includible in inventory under §263A. The costs were not on-site storage costs under Reg. § 1.263A-1(e)(3)(iii)(I) because transfers to independent re-sellers prevented taxpayer from being considered as selling exclusively to retail customers.

6.  **The IRS discovers internet retail sales.** Notice 2009-25, 2009-15 I.R.B. 758 (4/13/09). Under Reg. §1.263A-3(c)(5) storage costs attributable to off-site storage of inventory must be capitalized, but storage costs attributable to the operation of an on-site storage
facility are not required to be capitalized. An on-site storage facility is defined as a facility that is physically attached to a retail sales facility, which is a facility where the taxpayer sells merchandise exclusively to retail customers in on-site sales. A facility that functions both as storage for an on-site retail facility and as storage for off-site sales is classified as a dual function storage facility with respect to which costs must be allocated between storage for the on-site retail sales and off-site sales, generally on the basis of gross sales. The IRS has recognized that the nature of retail sales has changed in that retailers may both sell merchandise on-site to walk-in customers and make sales over the internet or by facsimile orders from the same facility. The current regulations create problems by requiring these retailers to treat storage facilities attached to a retail sales facility as a dual function storage facility. The notice solicits comments about changed retail business practices resulting from technological advances and existing trends that affect the application of the existing regulations along with information about contemporary business models. The notice also solicits comments regarding changes in the regulations to reflect current business practices. Comments are requested before 7/13/09.

7. **Merger termination fee to defend business from hostile takeover is deductible and not a capital expense.** Santa Fe Pacific Gold Co. v. Commissioner, 132 T.C. No. 12 (4/27/09). As part of a strategy to thwart a hostile takeover attempt by Newmont USA Limited, a larger mining company, Santa Fe entered into a merger agreement with the Homestake Mining Company. The Homestake merger agreement contained a termination clause, which required Santa Fe to pay Homestake $65 million in the event the merger was terminated by either party. Following announcement of the Homestake merger agreement, several lawsuits were filed alleging that the Santa Fe board breached its fiduciary duties to shareholders for failing to negotiate further with Newmont and that the Homestake merger agreement was entered into to protect the interests of Santa Fe’s board and management. After negotiations and increased offers from both Newmont and Homestake, the Santa Fe board accepted Newmont’s stock-for-stock merger offer and indicated that it would pay the termination fee to Homestake. Santa Fe deducted the termination fee. The IRS asserted that the fee was a capital expenditure incurred to provide a long term benefit to Santa Fe. The Tax Court (Judge Goeke) concluded that the termination fee was deductible under §162 and alternatively that the fee was incurred by Santa Fe to abandon the merger transaction with Homestake and was therefore deductible as an abandonment loss under §165. The court rejected the IRS argument that the fee was incurred as part of an integrated transaction in which the termination fee was paid to extricate Santa Fe from one contract in order to enter into a more favorable contract and thus not attributable to an abandoned transaction.

8. **Intelligently pursuing wealth is not a trade or business.** Woody v. Commissioner, T.C. Memo. 2009-93 (4/30/09). Throughout 2004 the taxpayer investigated and took steps to establish a real estate business, including taking a course on real estate investing from the Wealth Intelligence Academy. The taxpayer purchased an unoccupied rental property on 12/30/04, which was not rented until after 2004. The court (Judge Gustafson) suggested that the taxpayer was not engaged in a trade or business in 2004 before the rental property was actually held out for rent in a subsequent year. In any event, the court held that all of the expenses incurred before the taxpayer acquired property on 12/30/04, were start-up expenses subject to §195. In addition, the court held that the taxpayer’s education expense was incurred to prepare for a new trade or business and therefore not deductible under §162.

9. **Leasehold improvements treated as a substitute for rent are currently deductible; the transaction did not lack economic substance even though the lessor was a tax indifferent party. Remember, §109 does have a parenthetical.** Hopkins Partners v. Commissioner, T.C. Memo 2009-107 (5/19/09). Hopkins Partners operated the Sheraton Cleveland Airport Hotel under a lease agreement with the City of Cleveland. The agreement provided that the hotel and related parking facilities were the property of the city. The partnership negotiated a modification to the lease agreement under which the cost of improvements to the hotel and parking facilities by the partnership above a specified level would result in reductions in the amount of rental payments due under the lease. The court (Judge Wells) noted that, under Reg. §1.162-11(b), the cost of improvements by a lessee to leased
property generally are recoverable through depreciation deductions. The court found an exception, however, in Reg. § 1.61-8(c), which requires a lessor to recognize as rental income the cost of improvements placed on real property as a substitute for rent. The court indicated that because the regulation is "clear" that improvements in lieu of rent are treated as "rent" to the lessor, the cost of improvements in lieu of rent are currently deductible by the lessee under § 162(a)(3). The court held that whether improvements are in lieu of rent depended upon the intent of the parties. The court found that the language of the lease agreement treating the cost of improvements as a rent credit, and the testimony of the parties established an intent to treat the cost of improvements as rent. The fact that the lessor was a tax indifferent party did not change the result. The court rejected the IRS's argument that the cost of improvements treated as rent must be limited in duration. The court also held that the immediate transfer of improvements to the city in exchange for rent were not illusory transactions, notwithstanding the fact that the partnership retained control over the improvements. The court also rejected the IRS's contentions that the rent credit agreement lacked economic substance, that the deduction for the improvements failed to clearly reflect income under § 446, and that the deduction was an accounting method change under § 446(e) that required adjustments under § 481.

10. **In the scrum of foreign corporate takeovers, these management costs must be capitalized.** Canterbury Holdings, LLC v. Commissioner, T.C. Memo. 2009-175 (7/27/09). Taxpayers were partners in an LLC, which in turn formed a New Zealand corporation called Canterbury Holdings, to acquire New Zealand publicly held shares of LWR Industries, Ltd. LWR was a 104-year-old garment manufacturing company that owned the Canterbury brand, rugby shirts. Canterbury holdings entered into a management agreement with the 2/3 owner of LWR, from which it had an option to purchase LWR stock, and to manage LWR during the takeover. At a point, the U.S. LLC [in which the taxpayers were members] made direct payments to the former LWR stock holder which it claimed as deductible management expenses. The court (Judge Holmes) rejected the taxpayer's assertion that the expenses were incurred to protect the LLC's reputation and credit in its trade or business of acquiring, managing and turning around distressed companies. Instead, the court held that the expenditure was incurred to protect the LLC's investment in its New Zealand subsidiary and was thus a capital expense. The court noted that the only purpose of the LLC was the single acquisition of LWR and the only purpose of the expenditure was to protect the value of its investment in LWR stock. The court also rejected the taxpayers' argument that the payments to its New Zealand holding company were payments of the management fee through its agent. The court refused to allow the LLC to ignore its own organizational choices. The court also disallowed deductions for claimed interest expenses paid by the LLC on obligations of the New Zealand holding company. The court refused, however, to impose accuracy related penalties finding that the taxpayers reasonably relied on the advice of experienced CPAs in claiming the deductions.

C. **Reasonable Compensation**

1. **The price of a bail-out includes limitations on compensation.** Emergency Economic Stabilization Act of 2008, Act § 301(a), adding § 162(m)(5). The limit on deductible compensation is reduced to $500,000 for the CEO and CFO, plus the three highest paid employees of an employer for the tax year in which more than $300 million of troubled assets are acquired under the "troubled assets relief program" (TARP") under the bail-out act. The limitation includes deferred deductions for compensation to a covered executive for services during an applicable employer taxable year. Note that the limitation is not limited to corporations, but covers any employer who sells troubled assets under TARP.

   a. **And the rip-cord is pulled on golden parachutes that are replaced by a tarp.** The Emergency Economic Stabilization Act of 2008, Act § 301(b), added new § 280G(e). The deduction disallowance and 20 percent excise tax imposed on golden parachute payments (compensation contingent on a take-over exceeding three times an executive's average compensation in the preceding five years) has been extended to severance payments by reason of involuntary discharge from an employer participating in the troubled assets relief program.
b. Notice 2008-94, 2008-44 I.R.B. 1070 (10/14/08), provides detailed guidance and definitions regarding the application of new §§ 162(m) and 280G(e), enacted as part of the Emergency Economic Stabilization Act of 2008, to limit deductions on compensation paid to executives of employers accepting bail-out funds. Taxpayers may rely on the guidance in the notice until further guidance is issued. Any future guidance that is more restrictive will be prospective only.

2. But a provision in ARRA specifically permitted the AIG bonus payments. ARRA § 7001 (in Title VII - Limits on Executive Compensation) amends § 111 of EESA of 2008. EESA of 2008 § 111(b)(3)(D)(iii) specifically exempts from the prohibition “any bonus payment required to be paid pursuant to a written employment contract executed on or before February 11, 2009.” Senator Dodd (D-CT) – after weaseling around for a while – admitted that he added this exemption to the statute at the request of the Treasury Department.

a. In 2009, the Ides of March fell during an Orwellian “Hate Week” against AIG, culminating a House-passed 90-percent tax rate on AIG bonus recipients. H.R. 1586, “To impose an additional tax on bonuses received from certain TARP recipients,” was introduced on 3/18/09 by House Ways & Means Committee Chair Charles Rangel (D-NY) and passed by the House on the following day by a vote of 328 to 93. No legislative action has yet occurred in the Senate; this can only be attributed to a temporary reprieve from the mid-March madness.

- After all, Caesar was only stabbed to death on the Ides of March; his children’s lives were not threatened.

3. Tax Court distinguishes Exacto Spring in case appealable to Seventh Circuit. Menard, Inc. v. Commissioner, T.C. Memo. 2004-207 (9/16/04), reconsideration denied, T.C. Memo. 2005-3 (1/6/05). In this decision, appealable to the Seventh Circuit and presumably governed by the “hypothetical independent investor” test of Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (1999), the Tax Court (Judge Marvel) nevertheless applied the traditional factor of compensation for CEOs of comparable publicly-traded corporations to disallow deduction of $13 million of the $20 million of compensation (which included 5 percent of pre-tax profits) paid to the John R. Menard, the CEO and owner of 89 percent of taxpayer’s stock rather than applying solely the hypothetical independent investor test. The court focused on language in Treas. Reg. § 1.162-7(b)(3), which was not discussed in Exacto Spring, and which provides as follows:

In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.

a. On reconsideration, Judge Marvel made clear that two prongs are required, i.e., (1) that the amounts paid be intended as compensation and (2) that they be reasonable in amount. T.C. Memo. 2005-3 (1/6/05). In denying taxpayer’s motion for reconsideration, Judge Marvel reiterated – as an alternative ground for her decision – that the taxpayer did not intend that its payment be for services in light of (1) it never having paid dividends, (2) the CEO’s contractual obligation to repay any portion of the compensation found to be excessive, and (3) the failure of the board of directors to make any effort to evaluate whether the compensation was excessive.

b. Judge Posner is bullish on Menard, Inc., bearish on the Tax Court. No compensation is unreasonable for Judge Posner as long as shareholders are happy – even if it’s all in the family. By the way, was it only by chance that Judge Posner was on the panel for this case? Menard, Inc. v. Commissioner, 560 F.3d 620 (7th Cir. 3/10/09). In an opinion by Judge Posner, the Seventh Circuit reversed the Tax Court’s decision, T.C. Memo. 2004-207 (9/16/04), reconsideration denied, T.C. Memo. 2005-3 (1/6/05), and held that all of the compensation paid to Menard was reasonable. In 1998, the tax year at issue, the taxpayer was the third largest home improvement retailer in the United States, following Home Depot and Lowes. The founder and CEO of the taxpayer, John Menard, held all of the
company’s voting shares and 56 percent of the nonvoting shares. The remaining shares were held by family members. Menard was paid a base compensation of $157,000, a profit share participation of $3 million, plus a bonus equivalent to five percent of the taxpayer’s before tax net income that amounted to over $17 million. The compensation plan had been adopted by the company in 1973. In 1998 the taxpayer earned a return to shareholders of 18.8 percent. Judge Posner’s opinion reflects displeasure that the Tax Court (Judge Marvel) applied its traditional multi-factor test rather than the Seventh Circuit’s “hypothetical independent investor” test of Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (1999). In Exacto Spring, the Seventh Circuit created a presumption that “when ... the investors in his company are obtaining a far higher return than they had any reason to expect, [the owner/employee’s] salary is presumptively reasonable.” The court added that the presumption could be rebutted by evidence that the company’s success was attributable to extraneous factors or that the company intended to pay a dividend rather than salary. Judge Posner’s opinion found fault with the Tax Court’s reasoning in numerous respects.

(1) First, he found that although a comparison of the compensation of the shareholder/employee in question with the compensation of executives of other companies is “helpful only the comparison takes into account the details of the compensation package of each of the compared executives, and not just the bottom-line salary.” He concluded that the Tax Court failed to conduct such an analysis and because “the Tax Court acknowledged that the presumption of reasonableness had been established but thought it rebutted by evidence that corporations in the same business as Menards paid their CEOs substantially less than Menards paid its CEO.” He faulted the Tax Court for its “failure to consider the severance packages, retirement plans, or perks of the CEOs with whom it compared Menard (although it did take account of their stock options), even though such extras can make an enormous difference to an executive’s compensation.” Thus, the fact that the CEO of Home Depot was paid a mere $2.8 million, and the CEO of Lowes was paid $6.1 million (both of which were larger companies), did not suggest that the more than $20 million compensation paid to Menard was unreasonable. Menard’s compensation was subject to different risk, and the Tax Court did not consider the severance packages, retirement packages available to the CEO’s of Home Depot and Lowes, although the Tax Court did consider stock options. According to the court, the CEO of Home Depot hired two years after the tax year in issue, was paid $124 million in salary, exclusive of stock options, for the six years he held the post and received a severance payment of $210 million (including stock options) when he was fired in 2007.

(2) Second, and pointedly relevant to Exacto Spring Corp. as law of the circuit, Judge Posner emphasized that there was “no suggestion that any of the shareholders were disappointed that the company obtained a rate of return of ‘only’ 18.8 percent.” Furthermore, the company’s success was not due to windfall factors. “The Tax Court did not consider the possibility, which the evidence supports, that Menard really does do it all himself.”

(3) Third, Judge Posner criticized the Tax Court’s conclusion that Menard’s compensation, in addition to being excessive, was intended as a dividend, based on (1) his agreement to reimburse the corporation if the deduction for the bonus were disallowed by the IRS, and (2) a bonus of 5 percent of corporate earnings year in and year out “looked” more like a dividend than like salary. Judge Posner’s rejoinder was: “These are flimsy grounds.” He concluded that (1) it was prudent, even though not in Menard’s personal financial interest, for the corporation to require him to reimburse it if the IRS successfully disallowed the deduction, and (2) “5 percent of net corporate income [does not] look at all like a dividend.” The court also noted that it was prudent for the taxpayer to require as part of the bonus plan that Menard return the bonus if the taxpayer’s compensation deduction were challenged by the IRS.

(4) Fourth, Judge Posner addressed the Tax Court’s concern that the board of directors that approved the 5 percent bonus was controlled by Menard. Judge

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1 We note that Judge Posner seemed to gloss over the fact that Menard owned all of the voting stock and 89 percent of all of the stock, and thus was unlikely to complain.
Posner reasoned that since it could not be otherwise, because Menard was the only shareholder who is entitled to vote for members of the board of directors, the “logic of the Tax Court’s position is that a one-man corporation cannot pay its CEO (if he is that one man) any salary!” He went on sarcastically to state that:

The Tax Court has flirted with that strange logic, as we shall see. ... The Tax Court’s opinion strangely remarks that because Mr. Menard owns the company he has all the incentive he needs to work hard, without the spur of a salary. In other words, reasonable compensation for Mr. Menard might be zero. How generous of the Tax Court nevertheless to allow Menard to deduct $7.1 million from its 1998 income for salary for Menard!

(5) Fifth, Judge Posner criticized what he considered to be the Tax Court’s main focus on whether Menard’s compensation exceeded that of comparable CEOs, i.e., whether it was objectively excessive, and thus functionally, even though not intentionally a dividend rather than a bonus, instead of focusing on whether the corporation was acting in good faith in paying $17.5 million as a bonus rather than as a dividend).

For compensation purposes, the shareholder-employee should be treated like all other employees. If an incentive bonus would be appropriate for a nonshareholder-employee, there is no reason why a shareholder-employee should not be allowed to participate in the same manner. In essence, the shareholder-employee is treated as two distinct individuals for tax purposes: an independent investor and an employee.” Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315, 1328 (5th Cir. 1987) ...

Additionally, the fact that the next highest paid employee of the taxpayer received a salary of $468,000 was rejected as a factor because the “Tax Court did not consider the possibility, which the evidence supports, that Menard really does do it all himself.” The fact that the taxpayer paid no dividends was not influential because many corporations choose to retain earnings rather than distribute dividends. The court stated that a bonus based on five percent of profits doesn’t look like a dividend, which is normally calculated as an amount per share rather than a percentage of earnings.

D. Miscellaneous Deductions

1. The IRS responds to high gasoline prices. Announcement 2008-63, 2008-28 I.R.B. 114 (6/24/08), 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. The Emergency Economic Stabilization Act of 2008 [Division B], the Energy Improvement and Extension Act, § 303, extends the § 179D current deduction for installation of certain energy efficient property in a commercial building to property placed in service before 1/1/14.

3. 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(a), (e) requires substantiation for the deduction.

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

- Query whether there are employer reporting obligations with respect to cell phones furnished to employees who fail to keep records?
- But, simplified methods for reporting cell phone use are under consideration. Notice 2009-46, 2009-23 I.R.B. 1068 (6/8/09). IRS is considering methods to simplify treatment of employer-provided cell phones, including a (1) "minimal personal use method" (if the employee accounts to the employer that he has a personal cell phone for use during business hours); and (2) a safe harbor method under which an employer would treat 75 percent of each employee's use of the cell phone as business usage.

4. Wouldn't it just have been easier to cut rates in October 2004? No. Was it because that's what the French-looking Vietnam War veteran was proposing? No, it was a replacement for the FSC/ETI export subsidies. Section 102 of the American Jobs Creation Act of 2004 added new Code § 199, which provides a magical 9 percent deduction of a percentage of taxable income attributable to domestic manufacturing activities.

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

b. Finally, final regulations! Final § 199 regulations are out and are 247 pages long, but that is only 137 pages in Lexis and 55 pages in the Federal Register. T.D. 9263, Income Attributable to Domestic Production Activities, 71 F.R. 31268 (6/1/06). You have to be addlepated if you expect a summary.

c. Only a masochist would bother to read these regulations unless billable hours were involved. T.D. 9381, TIPRA Amendments to Section 199, 73 F.R. 8798 (2/15/08), corrected, 73 F.R. 16518 (3/28/08). The IRS has promulgated a raft of amendments of the already incomprehensible § 199 regulations.


e. Oil and gas producers had their benefits curtailed because gasoline prices were too high. The Emergency Economic Stabilization Act of 2008 [Division B], Act § 401, would freeze the § 199 domestic manufacturing deduction for oil and gas producers at 6 percent, rather than increasing to 9 percent in 2010 as scheduled under current law.

5. Yearout Mechanical & Engineering, Inc. v. Commissioner, T.C. Memo. 2008-217 (9/24/08). The taxpayer was a construction company that expanded into high-tech buildings during boom years in Albuquerque, New Mexico. Due to its financial position and the difficulty of reliably obtaining rental equipment, the taxpayer entered into rental equipment leases with its shareholders. The Tax Court (Judge Gale) rejected the Commissioner's assertion that rental payments under long-term lease contracts, which also contained actual use provisions, were excessive and allowed the taxpayer's deductions for the rental payments. The court found that the unique nature of equipment required for "clean room" construction and the general business climate in which the taxpayer operated established a business reason for the unique leasing arrangements.

6. Since we are not willing to pay school teachers a living wage, let's give
them a tax break worth less than $2 a week at their tax brackets. The Emergency Economic Stabilization Act of 2008 [Division C], Act §203, extended through 2009 the §62(a)(2)(D) above-the-line deduction for up to $250 paid by an eligible educator for books, supplies, computer equipment (including software), other equipment, and supplementary materials used by the eligible educator in the classroom.

7. *Ferguson v. Commissioner*, 568 F.3d 498, 103 A.F.T.R.2d 2009-2170 (5th Cir. 5/12/09). The court rejected the taxpayer’s argument that involuntary conversion of the taxpayer’s Chapter 11 bankruptcy to Chapter 7 constituted abandonment in that year of farm property within the bankruptcy estate. The taxpayer did not realize loss from abandonment of bankruptcy estate property until the following year when the property was sold at a foreclosure sale.

8. *Doherty v. Commissioner*, T.C. Memo. 2009-99 (5/14/09). The Tax Court (Judge Marvel) denied claimed deductions for depreciation, legal fees, and other expenses related to the taxpayer’s investment in pay phones and ATM’s through a program run by Alpha Telecom, Inc. The court found that other than bare legal title the taxpayer did not possess any of the incidents of ownership regarding pay phones and ATM’s.


9. *Kurtz v. Commissioner*, 575 F.3d 1275, 104 A.F.T.R.2d 5467 (11th Cir. 7/23/09), aff’d T.C. Memo. 2008-111 (4/22/08). Section 274(n)(2)(E) exempts from the 50-percent limitation on deductions for meal expenses any expenses for food or beverages “required by any Federal law to be provided to crew members of a commercial vessel.” The Eleventh Circuit affirmed Tax Court Judge Cohen’s holding that §274(n)(2)(E) did not apply to meal expenses incurred by the taxpayer as an independent contractor on the crew of a commercial fishing boat in the Bering Sea, because federal law does not require commercial fishing boats to provide meals to crew members. Accordingly, only 50 percent of the taxpayer’s shipboard meal expenses were deductible.

10. *Revised per diem rates for lodging, meal, and incidental expenses*. Rev. Proc. 2009-47, 2009-42 I.R.B ___ (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.

11. *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 Corrections 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.

E. Depreciation & Amortization


   a. The IRS says that the old regulations still apply. I.R. 2008-58 (4/11/08). The IRS has indicated that Reg. § 1.168(k)-1, promulgated under the earlier provision, will apply to bonus depreciation claimed for 2008. The IRS promises new guidance regarding additional issues raised under the current provision and covering increased first year deductions under § 179 (watch for the 2009 version of this outline).


      (1) How the Stimulus § 179 deduction interacts with the increased § 179 amounts provided under § 1400N(e) for certain § 179 GO Zone property.
      (2) How the Stimulus additional first year depreciation deduction interacts with the GO Zone additional first year depreciation deduction for GO Zone property.
      (3) How the Stimulus § 179 deduction interacts with the increased § 179 amounts applicable to the Kansas disaster area.
      (4) How the Stimulus additional first year depreciation deduction interacts with the 50-percent additional first year depreciation deduction applicable to the Kansas disaster area.

   c. And 50 percent bonus depreciation continues. The 2009 ARRTA, § 1201, extended the Code § 168(k) 50 percent additional first year depreciation allowance to qualified property placed in service before 1/1/10. (Aircraft and “long-production-period property” qualify if placed in service before 1/1/11.)

   d. And more guidance for extension property. Rev. Proc. 2009-33, 2009-29 I.R.B. 150 (6/30/09). The revenue procedure provides guidance regarding the election out of additional depreciation, which increases general business credits, for 2009 extension property. The additional first year depreciation is available for 2009 property if the taxpayer had previously elected out for property placed in service in previous years.

2. Farm machinery is treated as five-year recovery property. Emergency Economic Stabilization Act of 2008, Act § 505(a), amended § 168(e)(3)(B). Farm machinery, the original use of which commences with the taxpayer, and which is placed in service in 2009, is treated as five-year recovery property for MACRS. The provision does not apply to a grain bin, ginning equipment, fences or other land improvements.


   b. And for film lovers. The Emergency Economic Stabilization Act of 2008, Act § 502(b), extends the expensing option of § 181 for qualified film and television production to costs incurred in production commencing before January 1, 2010. In the case of production costs exceeding $15 million ($20 million for production in low income communities or in areas of distress [will this result in more episodes of The Wire]), the first $15 million (or $20 million) of production costs may be expensed.

3. The Emergency Economic Stabilization Act of 2008, Act § 305(a), amending § 168(e)(3)(E), extends fifteen-year amortization for qualified leasehold improvement property (improvements constituting § 1250 property made more than three years after a
nonresidential building is placed in service) and qualified restaurant property (more than 50% of square footage devoted to food preparation and seating) placed in service before January 1, 2010.

4. The Emergency Economic Stabilization Act of 2008, Division B, § 308, adds § 168(m) to provide a 50 percent first year depreciation allowance of the adjusted basis of qualified reuse and recycling property acquired after August 31, 2008, which is reuse and recycling property with at least a five year useful life the original use of which commences with the taxpayer. The allowance is available under the AMT.

5. The Emergency Economic Stabilization Act of 2008 extended through 2009 § 179E permits, which allows a taxpayer to elect to treat 50 percent of the cost of any "qualified advanced mine safety equipment" as a current expense.

6. On Boxing Day, the IRS privately provides for the creation of depreciable interests in land. PLR 200852013 (12/26/08). In this private letter ruling three sellers separately owned interests in a building with residential and commercial units, a parking structure and a surface parking lot. The sellers sold a remainder interest to an unrelated buyer, and a term interest in the land, buildings and other improvements and fixtures to the taxpayer. The sellers, the remainder interest holder, and the taxpayer are unrelated. Citing Reg. § 1.167(a)-1(b), Gordon v. Commissioner, 85 T.C. 309, 322-323 (1985), and Lomas Santa Fe, Inc. v. Commissioner, 74 T.C. 662, 683 (1980), aff'd, 693 F.2d 71 (9th Cir. 1982), the IRS held that the taxpayer may claim depreciation deductions for the cost allocated to the term interest in land over the term of the interest. The taxpayer is allowed to claim capital recovery for the buildings and parking structure under the rules of § 168.

7. Now that's a whole lotta expens'n goin' on! For taxable years beginning in 2008 and 2009, the 2009 ARRTA, § 1202, increases the Code § 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, Code § 1397(a)(1), and (b) qualified renewal community property acquired and placed in service after 2001 and before 2010. Code § 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. Code § 1397(a)(2). Code § 179(e) increases the maximum amount allowed to be deducted under § 179 by $100,000, and increases the phase-out threshold by $600,000, for qualified disaster assistance property placed in service after 2007 (with respect to disasters declared after that date) and before 2010. The increased expensing and ceiling limits under the 2009 ARRTA 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).

8. Rev. Proc. 2009-24, 2009-17 I.R.B. 885 (4/9/09). For automobiles placed in service in 2009 that do not qualify as § 168(k) property, the limits on depreciation deductions are $2,960 for the placed in service year, $4,800 for the second tax year, $2,850 for the third tax year, and $1,775 for each succeeding year; for automobiles that qualify as § 168(k) property, the limits are $10,960 for the first year, $4,800 for the second year, $2,850 for the third year, and $1,775 for each succeeding year; for light trucks or vans that are not § 168(k) property, the limits are $3,060 for the first year, $4,900 for the second year, $2,950 for the third year, and $1,775 for each succeeding year; for light trucks or vans that qualify as § 168(k) property, the limits are $11,060 for the first year, $4,900 for the second year, $2,950 for the third year, and $1,775 for each succeeding year).

9. 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, that have a 9.5 year
class life and five year MACRS recovery period.

F. Credits

1. Corporate taxpayers need spreadsheet net present value analysis to figure out this election. The Housing Assistance Tax Act of 2008, § 3081, provides for an increase in available § 38 credits for increased research activity in lieu of the § 168(k) 50 percent first year allowance for property placed in service in 2008. For property placed in service after 3/1/08, a corporation may elect to forgo the additional deduction under § 168(k) and increase the research credit or minimum tax credit limitation of §§ 38(c) and 53(c) (AMT credits are limited to the excess of regular tax over tentative tax) by 20 percent of the bonus depreciation amount. The increase in credits may provide refundable credits against regular tax liability. For eligible property the bonus depreciation amount is the amount of increased depreciation deductions available under § 168(k). The bonus depreciation amount is limited to the lesser of $30 million or six percent of the sum of research credit carryforwards from years beginning after 1/1/06 and minimum tax credits attributable to adjusted minimum tax for years after 1/1/06. Depreciation for eligible property for both regular tax and AMT purposes is computed under the straight line method. This provision is included in a section of the act entitled “Revenue Provisions.”

- This amendment allows corporate (but not individual) taxpayers to elect to accelerate the AMT credit and the research credit in lieu of claiming bonus depreciation.

a. Jesus Chrysler? And the Pork takes a drive in a new car – powered by corn. The Housing Assistance Tax Act of 2008, § 3081, also provides that “an applicable partnership” may elect to be treated as making a deemed tax payment in the amount of the least of (1) the bonus depreciation that would be allowed if an election were in effect for the partnership, (2) the amount of the partnership’s research credit for the year, or (3) $30 million (reduced by any deemed payment for a prior taxable year). An applicable partnership is “a domestic partnership that was formed on August 3, 2007, and will produce in excess of 675,000 automobiles during the period beginning on January 1, 2008, and ending on June 30, 2008.” There must be a lot of qualified partnerships out there. ©

b. And it’s all explained by the IRS. Rev. Proc. 2008-65, 2008-44 I.R.B. 1082 (10/10/08). Section 168(k)(4) allows an election to treat the 50 percent bonus depreciation amount (over regular depreciation) as an increase in the limitation of § 38(c) on the general business credit or as an increase in the § 53(c) limitation on the amount of credit against regular tax liability for lower tentative minimum tax (refundable). The increases are allowed to corporations and the Chrysler LLC (not identified by name in the revenue procedure). The election is available for qualified property placed in service between 3/31/08 and 1/1/10. The revenue procedure defines eligible property under the various provisions of the Housing and Economic Recovery Act of 2008, provides rules for making the election, determining the bonus depreciation amounts, and allocating the bonus depreciation amount between the limitations of §§ 38(c) and 53(c).

c. The IRS supplements the explanation. Rev. Proc. 2009-16, 2009-6 I.R.B. 449 (1/23/09). The revenue procedure contains rules for electing under § 168(k)(4) to claim an increase in the business tax credit limitation and the AMT credit limitation in lieu of claiming 50 percent first year depreciation allowances under § 168(k), and provides rules for allocating the increases among members of a controlled group and to corporate partners of a partnership allowed to make the election (Chrysler). The revenue procedure clarifies that an S corporation may make the election, but points out that any business or AMT credit limitation increases that result are applied at the corporate level, and not at the shareholder level. This means that the credit limitation increase will only affect credits allowed against tax due on recognized built-in gains under § 1374.

d. One more year! ARRTA § 2001 amended Code § 168(k)(4) to extend this election for one year to property placed in service in 2009.

2. How many tax professionals know what “lignocellulosic” and
“hemicellulosic” matter are? Section 40(b)(6), added by the Heartland, Habitat, Harvest, and Horticulture Act of 2008, adds the cellulosic biofuel producer credit as a new component of the §40 alcohol fuels credit. Generally, the amount of the credit is $1.01 for each gallon of qualified production after 12/31/08 and before 1/1/13. If a cellulosic biofuel is alcohol, the amount of the credit is reduced by the amount of credit allowable under other parts of §40. Cellulosic biofuel is liquid fuel which is derived from any renewable lignocellulosic or hemicellulosic matter; examples of such matter include dedicated energy crops, wood, plants, grasses, animal wastes, and municipal solid waste.

a. The Emergency Economic Stabilization Act of 2008 [Division B], the Energy Improvement and Extension Act, § 201, amends § 168(l)(3), which provides a 50 percent first year allowance for qualified cellulosic biomass ethanol plant property to provide a definition of cellulosic biofuel to include, “any liquid fuel which is produced from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis.” This definition replaces “cellulosic biomass ethanol.”

3. The Emergency Economic Stabilization Act of 2008 [Division B], the Energy Improvement and Extension Act, § 306, amends § 168(e)(3)(D) to treat qualified smart electric meters and a smart grid system, as defined in § 168(i)(18) and (19), as ten-year property, but limits the depreciation method in § 168(b)(2)(C) to 150 percent declining balance.

4. The “temporary” research credit that never sunsets is extended again. The Emergency Economic Stabilization Act of 2008, [Division C] § 301, extended the § 41 credit for increased research activities for amounts paid or incurred through December 31, 2009. The Act also increased the § 41(c)(5) alternative simplified credit to 14 percent for years ending after December 31, 2008, and amended § 41(c) to provide that the election to claim the § 41(c)(4) alternative incremental credit shall not apply to years beginning after December 31, 2008.

5. Indian credit. The Emergency Economic Stabilization Act of 2008 [Division C], § 314, extended the § 45A Indian Employment Credit for taxable years beginning on or before December 31, 2009.

6. Marketing credit. The Emergency Economic Stabilization Act of 2008 extended the § 45D New Markets Tax Credit through 2009, permitting up to 3.5 billion in qualified equity investments for that calendar year.

7. Schoolhouse credit. The Emergency Economic Stabilization Act of 2008 extended §1397E Qualified Zone Academy Bond Credit does not apply to any bond issued after October 3, 2008, but added new § 54E, which provides a virtually identical credit for, and authorizes issuance of, up to $400 million of new qualified zone academy bonds issued after October 3, 2008 and before 2010.

8. Katrina Employee credit. The Emergency Economic Stabilization Act of 2008 extended the Work Opportunity Credit through Aug. 28, 2009 for certain employees hired in the core disaster area of Hurricane Katrina. The credit for Katrina employees hired to a new place of employment outside of the core disaster area was not extended.

9. Historic New Orleans credit. The Emergency Economic Stabilization Act of 2008 extended §1400N(h) through December 31, 2009. Section 1400N(h), was added by the Gulf Opportunity Zone Act of 2005, to increase the 10 percent credit § 47 rehabilitation to 13 percent, and the 20 percent credit to 26 percent, for qualified expenditures incurred on or after August 28, 2005, and before January 1, 2009, with respect to structures and buildings located within the Katrina-related Gulf Opportunity Zone.

10. The Emergency Economic Stabilization Act of 2008 [Division C] contains other credit provisions:

   a. Section 302, extends the § 45D credit for equity investment in qualified active low-income community business.

   b. Section 316, extends the Railroad Track Maintenance Credit of § 45G to expenditures made in 2009 and allows the credit for AMT purposes.

   c. Section 320 extends the rehabilitation credit through 2009.

11. A credit for Vinny Gambini hiring disadvantaged “yutes” or “utes.”
The 2009 ARRTA, § 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 Youths Defined.** Notice 2009-28, 2009-24 I.R.B. 1082 (5/28/2009). 2009 ARRTA 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.

12. Will this myriad of new credits lead to an electric outlet on every parking meter even outside of the Arctic portions of the U.S.? Code § 30D, added to the Code by the Energy Improvement and Extension Act of 2008, was amended by § 1141(a) of the 2009 ARRTA, to provide a plug-in electric drive motor vehicle credit. The statute defines a credit-eligible “new qualified plug-in electric drive motor vehicle” as a motor vehicle, the original use of which is “by the taxpayer, that (1) draws propulsion using a traction battery with a capacity of at least 4 kilowatt hours, (2) recharges its battery with an external source of energy, (3) meets certain environmental standards, (4) is acquired by the taxpayer for use or lease (rather than for resale), and (5) is made by a manufacturer. The amount of the credit is $2,500 for each qualifying vehicle placed in service by a taxpayer during a taxable year, with an increase of $417 in the credit amount for each kilowatt hour of traction battery capacity in excess of 4 kilowatt hours. However, for vehicles acquired before January 1, 2010, the total amount of the credit for any one vehicle cannot exceed $7,500 if the vehicle weighs 10,000 pounds or less, cannot exceed $10,000 if the vehicle weighs more than 10,000 pounds but not more than 14,000 pounds, cannot exceed $12,500 if the vehicle weighs more than 14,000 pounds but not more than 26,000 pounds, and cannot exceed $15,000 if the vehicle weighs more than 26,000 pounds. For vehicles acquired after December 31, 2009, only vehicles with a gross vehicle rating of less than 14,000 pounds qualify, and the credit cannot exceed $7,500. Once the total number of qualified plug-in electric drive vehicles sold for use in the United States after December 31, 2009, reaches 200,000, the credit will be phased out, with the phase-out period beginning in the second calendar quarter following the calendar quarter in which the 200,000th sale occurs. During the first two calendar quarters of the phase-out period, the credit is 50 percent of the otherwise allowable amount; in the third and fourth calendar quarters, the credit is 25 percent of the otherwise allowable amount; and no credit is allowable after the end of the fourth calendar quarter.

- A taxpayer electing to claim the credit must reduce its basis in the vehicle by the amount of the credit. (Section 30D(f)(6) permits the taxpayer to elect not to claim the credit.) Any deduction or credit otherwise allowable with respect to the purchase of the vehicle must be reduced by the amount of the credit claimed. The statute directs the Treasury to promulgate regulations providing for the recapture of the credit with respect to any vehicle which ceases to be credit-eligible property (including the case of a lease period shorter than a vehicle's economic life). In the case of a qualifying vehicle used in the taxpayer's trade or business, the credit is part of the general business credit. In the case of qualifying personal use vehicle, the credit is treated as a personal credit, and is allowed against both the regular income tax and the AMT. The credit applies to taxable years beginning after 12/31/08, but will not be available for vehicles purchased after 12/31/14.

- If the vehicle is placed in service by a tax-exempt entity, the
person selling the vehicle to the tax-exempt entity may claim the credit, but only if the seller discloses to the entity the amount of the credit. § 30D(f)(3).

a. And just to make things simpler, a second, alternative credit for plug-in electric vehicles. The 2009 ARRTA, § 1142(a), significantly revised the Code § 30 renewable electricity production credit, which now applies only to “plug-in” vehicles. The revisions apply to vehicles acquired after 2/17/09. Revised § 30 allows an elective credit equal to 10 percent of the cost of any qualified plug-in electric vehicle placed in service in a trade or business or for personal use up to a maximum per-vehicle credit of $2,500. The statute defines a credit-eligible “qualified plug-in electric drive motor vehicle” as a motor vehicle, the original use of which is by the taxpayer, that (1) is propelled to a significant extent by an electric motor that draws power from a battery with a capacity of at least 4 kilowatt hours (2.5 kilowatt hours in the case of a 2-or 3-wheeled vehicle), (2) recharges its battery with an external source of energy, (3) has a gross vehicle rating of less than 14,000 pounds, (4) is acquired by the taxpayer for use or lease (rather than for resale), (5) is made by a manufacturer, and (6) and is either (i) a “low speed vehicle within the meaning of section 571.3 of title 49, Code of Federal Regulations” as in effect on 2/17/09 or (ii) is a 2-or 3-wheel vehicle. A taxpayer electing to claim the credit must reduce its basis in the vehicle by the amount of the credit. (Section 30(e)(6) permits the taxpayer to elect not to claim the credit.) Any deduction or credit otherwise allowable with respect to the purchase of the vehicle must be reduced by the amount of the credit claimed. The statute directs the Treasury to promulgate regulations providing for the recapture of the credit with respect to any vehicle which ceases to be credit-eligible property. In the case of a qualifying vehicle used in the taxpayer’s trade or business, the credit is part of the general business credit. In the case of qualifying personal use vehicle, the credit is treated as a personal credit, and is allowed against both the regular income tax and the AMT. The credit will not be available for vehicles purchased after 12/31/11. Furthermore, for any vehicle acquired after 2/17/09 and before 1/1/10, the § 30 credit is not available if a credit is allowed under § 30D.

b. Credit for figuring out how to plug in an old car. The 2009 ARRTA, s 1143(b), amended § 30B to extend the alternative motor vehicle credit to a “plug-in conversion.” The plug-in conversion credit is an amount equal to 10 percent of the first $40,000 of cost to convert a vehicle to “qualified plug-in electric drive vehicle,” as defined in § 30D. The plug-in conversion credit is allowed in addition to any other credits allowed with respect to the vehicle. The credit applies only to conversions placed in service after 2/17/09 and before 1/1/12. In addition, new § 30B(g)(2) permits the § 30B alternative motor vehicle credit to be claimed against the alternative minimum tax for years after 2008.

13. Let’s not give all the credit to electric cars, save something for the oil patch and the corn belt. Section 30C, added to the Code by the Energy Tax Incentives Act of 2005, and amended by § 1123(a) of the 2009 ARRTA, provides a credit equal to 50 percent (30 percent for years before 2009) of the cost of any qualified alternative fuel vehicle refueling property placed in service by the taxpayer. Qualifying fuels are ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, mixtures of diesel and biodiesel containing at least 20 percent biodiesel, and electricity. For a business taxpayer, the credit may not exceed $50,000 ($30,000 for years before 2009) with respect to all qualified property placed in service by the taxpayer during the taxable year at a particular location, but if the vehicle uses hydrogen as a fuel the maximum credit is increased to $200,000. The credit is also available to a taxpayer installing a refueling facility on the grounds of his personal residence for personal use, but the maximum amount of the nonbusiness credit is $2,000 ($1,000 for years before 2009). The business credit aspect is part of the general business credit, and the personal credit is allowed only to the extent of the excess of the regular tax (reduced by certain other credits) over the tentative minimum tax. The credit is not available for property placed in service after 2010 (or after 2014, in the case of property relating to hydrogen).

14. And some tax credit help for homebuilders. Section 45L, which previously had been scheduled to expire at the end of 2008, provides a credit, in the amount of either $2,000 or $1,000, to an eligible contractor (including the producer of a manufactured home) who constructs and sells an energy efficient home to a person who will use the home as a
residence. The 2009 ARRTA extended the life of the § 45L credit through 2009.

15. Pick, choose, and apply a combination of proposed and final regulations. FedEx Corp. v. United States, 103 A.F.T.R.2d 2009-2722 (W.D. Tenn. 6/9/09). Federal Express claimed $11.6 million of § 41 research credits for years 1997-2007 for a business software development project initiated in 1996 and abandoned as not technologically feasible in 2001. The discovery test of § 41(d)(1)(B) requires that to be eligible for the credit qualified research must be undertaken for the purpose of discovering information which is technological in nature, is useful in the development of a new or improved business component, and the activities must be experimental in nature. Reg. § 1.41-4(a)(3) of regulations finalized in 2001, but applicable to expenditures for internal use software incurred after 1985, defined the discovery test as requiring that “research be undertaken to ‘obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.’” Under § 41(d)(4)(E), internal use software is qualified for the research credit only to the extent provided in regulations. Regulations § 1.41-4(c)(6)(vi) provided that internal use software is qualified for the research credit if the software is innovative, development requires significant economic risk, and the software is not commercially available. Regulations proposed in 2001 and finalized in 2003, applicable to taxable years ending after 12/26/01, revised the discovery test to apply to research that, “is intended to eliminate certain uncertainty concerning the development or improvement of a business component.” The preamble to the 2001 proposed regulations stated that the IRS generally will not challenge return positions consistent with the proposed regulations. (66 F.R. 66362.) The 2003 finalized regulations did not adopt the internal use software test, marking that section of the regulations as reserved. In Ann. 2004-9, 2004-6 I.R.B. 441, the Service indicated that taxpayers could continue to rely on the internal use software test of the 2001 regulations, but if they did so, they were also subject to the discovery test of those provisions. Granting summary judgment, the court (Judge Mays) accepted Federal Express’ assertion that it could rely on the broadened discovery test of the 2003 regulations and the internal use software test of the 2001 regulations. The court rejected the IRS argument that the taxpayer cannot “cut and paste” portions of the 2001 and 2003 regulations to produce a favorable result. The court concluded that deference to administrative regulations under Chevron U.S.A. Inc., v. Natural Res. Def. Council, 467 U.S. 837 (1984), requires that taxpayers be permitted to rely on promulgated regulations. The Treasury statements in the preamble to the 2003 regulations that indicate that those provisions better reflect legislative history, precludes the IRS from forcing the taxpayer to apply the earlier and modified provision. The IRS announcement as an interpretation of regulations did not merit Chevron deference over the promulgated regulations. The taxpayer was allowed to rely on the internal use software provisions of the 2001 regulations as those provisions were the only regulatory provisions in existence with respect to the taxpayer’s expenditures.

16. With “a little song, a little dance,” the Fifth Circuit holds that the Cohan rule permits courts to estimate qualified research expenditures. United States v. McFerrin, 570 f.3d 672, 103 A.F.T.R.2d 2009-2566 (5th Cir. 6/9/09). Through a clerical error, the IRS granted the taxpayer’s claim for a refund that was based on § 41 research credits previously unclaimed on taxpayer’s return. In the IRS suit to recover the refund the burden of proof fell on the IRS. Reversing Judge Atlas’s decision in the District Court for the Southern District of Texas, the Fifth Circuit held that under the rule of Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930), if the taxpayer can demonstrate that his activities were qualified research, then the trial court can estimate the expenses associated with those activities. In addition, the court held that the District Court erred in not reviewing the claimed research activities under the 2003 final regulations defining “discovery.” The taxpayer’s claim for refund was based on language of regulations proposed in 2001, the preamble to which indicated that taxpayers could rely on the test of the proposed regulations. The case was remanded to the District Court for reconsideration under the 2003 regulations.

17. REG-130200-08, Election of Reduced Research Credit under Section 208C(c)(3), 74 F.R. 34523 (7/16/09). These proposed regulations would “simplify” how taxpayers make the election to claim the “reduced research credit” under § 280C(c)(3).
G. Natural Resources Deductions & Credits

1. Safer mines credit. The Emergency Economic Stabilization Act of 2008, Act § 310, extended through 2009 the $10,000 § 45N credit for expenses incurred in training "qualified mine rescue team employees."

2. The Emergency Economic Stabilization Act of 2008, Act § 311, extends the § 179E 50 percent expensing provision for mine safety equipment to include equipment placed in service before 1/1/10.

3. The Emergency Economic Stabilization Act of 2008 [Division B], the Energy Improvement and Extension Act, § 209, extends the 50 percent expensing allowance by two years for qualified refinery property to property placed in service before 1/1/11. The definition of a qualified refinery in § 179C(d) is expanded to the refining of fuel directly from shale or tar sands.

4. The Emergency Economic Stabilization Act of 2008 [Division B], the Energy Improvement and Extension Act, extended several credits and added a few new twists.
   a. Section 101 extends the § 45 credit for wind and refined coal facilities for property placed in service before 1/1/10. The credit is extended for certain other facilities to include property placed in service in 2009 and 2010.
   b. The energy credit contains special rules for energy produced from refined coal. Section 101(b) changes the definitions of qualified refined coal to eliminate the requirement of § 45(c)(7)(A)(i)(IV) that the fair market value of refined coal be increased by 50 percent over the value of feedstock coal, and increases the requirement of § 45(c)(7)(B) for emissions reduction from 20 percent to 40 percent. Section 108 of the Act amends the § 45(c)(7)(A) definition of refined coal to include fuel produced from coal that is sold with a reasonable expectation that the fuel will be used to produce steam, is certified as resulting in a qualified emission reduction, and is produced in a manner that results in a 50 percent increase in value over feedstock coal or is steel industry fuel. Steel industry fuel is produced by liquefying coal waste sludge and distributing it on coal that is used for the manufacture of coke.
   c. Section 101(c) changes the definitions of trash facilities, biomass facilities, and facilities for hydropower production of § 45(c) and (d).
   d. Section 102 adds facilities for production of electricity from waves, tides and ocean currents.
   e. Section 103 extends the solar energy credit to include property placed in service in periods ending before 1/1/17, for fuel cell property and microturbine property in periods ending after 12/31/16.
   f. Section 103(b) allows the § 46 energy credit as an offset against the AMT, adding § 38(c)(4)((B)(v).
   g. Section 103(c) expands the § 48 energy credit to include power systems that combine power generation with steam generation for heat.
   h. Section 103(d) increases the credit limitation of § 48(c) for qualified fuel cell property from $500 for each 0.5 kilowatt capacity to $1500.
   i. Section 103(f)(2) allows the § 48 energy credit as an offset against the AMT, adding § 38(c)(4)((B)(v).
   j. Section 104(a) adds qualified small wind energy property to the 30 percent energy credit of § 48.
   k. Section 105 adds geothermal heat pump to the list of energy property available for the § 48 energy credit.
   l. Section 106 expands the credit for residential energy efficient property by extending the credit to 12/31/16, eliminating the $2,000 limitation for solar electric property expenditures, adding a 30 percent credit for small wind energy property limited to $500 for each half kilowatt of capacity not to exceed $4,000, adding geothermal heat pump property to the list of eligible expenditures (limited to $2,000), and allows the credit against the alternative minimum tax.
   m. Section 111 expands the investment credit under § 48 for qualifying advanced coal projects. The credit is allowed for projects certified by the IRS in
consultation with DOE under a competitive bidding process. Amended § 48A(d)(3)(A) expands the amount of available credits from $1.3 billion to $2.55 billion. Section 48A(a)(3) is added to provide a 30 percent credit for projects described in § 48(d)(3)(B), which include greenhouse gas capture capability, increased by-product utilization, applicants who have a partnership with an educational institution, and other benefits. The IRS is also directed in § 48A(d)(3)(B) to direct specified amounts to particular types of projects. Section 48A(e)(1) is amended to direct the IRS to give priority to projects that capture and sequester carbon dioxide emissions.

n. Section 112 increases the coal gasification credit of § 48B from 20 percent to 30 percent and expands the total amount of available credits to $3.5 billion. Section 48B(f) is added to provide for recapture of the credit for any project that fails to meet the carbon dioxide separation and sequestration requirements of § 48B(d)(1).

o. And the scientists are to tell us whether any of this works to reduce hot air. Section 117 requires the Secretary of the Treasury to enter into an agreement with the National Academy of Sciences to undertake an audit of the Code to determine which provisions have the greatest affect on carbon dioxide and other greenhouse gas emissions.

p. Section 202 increases the § 40A credit for biofuel from 50 cents to $1 for each gallon of biofuel used in the production of a qualified biodiesel mixture. The credit is extended to biofuel used in the production of aviation jet fuel. (Southwest may find a new use for its peanuts, gas production.) The credit is not available for fuel produced using feedstock that is not biomass.

q. Section 203 restricts the fuels credits under §§ 40 (alcohol), 40A (biodiesel), 6426 (excise tax), by excluding fuels produced outside of the United States for use outside of the United States.

r. Section 210 extends exclusion from the 100 percent of income limitation on percentage depletion that is provided for production from marginal properties for one year to include production in a tax year beginning before 12/31/09.

s. Section 304 extends the energy efficient home credit of § 45L through 2009.

t. Section 305 extends the § 45M credit (part of the § 38 investment credit) for production of energy efficient dishwashers, clothes washers, and refrigerators to products manufactured in 2009, with different dates for different products.

5. Notice 2008-72, 2008-43 I.R.B. 998 (10/27/08). The § 43 enhanced oil recovery credit for taxable years beginning in the 2007 calendar year is phased out completely, because the reference price for the 2006 calendar year ($66.52) exceeds $28 multiplied by the inflation adjustment factor for the 2006 calendar year ($41.06) by $25.45.

6. Section 115 of the Emergency Economic Stabilization Act of 2008 [Division B], the Energy Improvement and Extension Act, adds a new credit to § 38 business credits for carbon dioxide sequestration. Section 45Q provides a credit of $20 per metric ton of qualified carbon dioxide which is captured by the taxpayer and disposed of in secure geological storage and $10 per ton of captured carbon dioxide that is used as a tertiary injectant in a qualified enhanced oil or natural gas recovery project.

a. Guidance on determining eligibility for carbon dioxide sequestration credits. Notice 2009-83, 2009-44 I.R.B. ___(10/8/09). Section 45Q provides a credit equal to $20 per metric ton of carbon captured by a taxpayer at a qualified facility and disposed of in a secure geological storage within the United States, or $10 per metric ton of captured CO₂ captured and used as a tertiary injectant in a qualified enhanced oil or natural gas recovery project. Section 45Q(d)(6) requires recapture of the credit for CO₂ that leaks back out. The notice contains several definitions with respect to the credit including—

1) Industrial facility defined as a facility that produces a CO₂ stream from a fuel combustion source, but not including a facility that produces CO₂ from CO₂ production wells,

2) Qualified carbon dioxide as CO₂ captured from an industrial source that would have been released, which is measured at the source and verified at the point of disposal or injection, and
3) Qualified facility as a facility that is owned by the taxpayer where carbon capture equipment is in place and where at least 500,000 metric tons of CO\(_2\) is captured during the taxable year.

- The amount of CO\(_2\) claimed for a credit must be measured by weight at the source and at the disposal point and is the lesser of the two figures. A partnership that owns a qualified industrial facility will be treated as the taxpayer for purposes of the credit. However, if a partnership that has made a § 761(a) election, each of the partners will be considered the taxpayer, and each may claim the credit in accordance with its portion of the total amount of CO\(_2\) that is commensurate with its undivided ownership in the qualified facility. The credit will cease to be available at the end of the taxable year that the IRS certifies in consultation with the EPA that 75,000,000 metric tons of CO\(_2\) has been taken into account for purposes of the credit.

- To claim the credit the CO\(_2\) must be stored in a secure geologic storage which includes storage at deep saline formations, oil and gas reservoirs, and unminable coal seams under such conditions as the Secretary may determine under regulations that have yet to be issued. The notice provides interim procedures to determine whether a storage facility is secure including a requirement for procedures to assure that CO\(_2\) does not escape into the atmosphere. The notice also sets out annual reporting requirements.

7. Notice 2008-89, 2008-43 I.R.B. 999 (10/27/08). The applicable percentage under § 613A to be used in determining percentage depletion for marginal oil and gas properties for the 2007 calendar year is 15 percent.

8. And they call the wind Maria. The 2009 ARRTA, § 1302(a), added to the 30 percent energy credit (investment credit) under Code § 46, wind facilities eligible for the § 45 renewable electricity production credit placed in service in 2009 through 2012, and any other facility eligible for the § 45 renewable electricity production credit placed in service in 2009 through 2013 (except small irrigation power facilities, refined coal production facilities, and Indian coal production facilities). If the § 48(a) energy credit is claimed for any such facility, the § 45 renewable electricity production credit cannot be claimed. The Act also added to the § 46 credit the § 48C qualifying advanced energy credit.

- Wind power is capable of completely replacing oil as an energy source if only the wind industry would deploy its back-up gerbils on calm days.

9. Another green energy credit. The 2009 ARRTA, § 1302(b), added the § 48C "qualifying advanced energy project" credit as part of the § 46 investment credit. The credit amount is 30 percent of the investment, measured by basis, in eligible property placed in service in a qualified advanced energy manufacturing project after 2/17/09. A qualified advanced energy manufacturing project is defined as a project that re-equip, expands, or establishes a manufacturing facility for the production of (1) property designed to be used to produce energy from the sun, wind, or geothermal deposits or other renewable resources, (2) fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric motor vehicles, electric grids to support the transmission of intermittent sources of renewable energy, including storage of that energy, (4) property designed to manufacture equipment for use for carbon capture or sequestration, (5) property designed to refine or blend renewable fuels to produce energy conservation technologies (including energy-conserving lighting technologies and smart grid technologies), (6) new § 30D qualified plug-in electric drive motor vehicles, (7) § 30(d) qualified plug-in electric vehicles or components that are designed specifically for use with these vehicles, including electric motors, generators, and power control units, or (8) other advanced energy property designed to reduce green house gas emissions. Only (1) depreciable tangible personal property, and (2) "other tangible property (not including a building or its structural components)" — presumably meaning fixtures — used in a qualified advanced energy manufacturing project qualify for the credit. Property used in the refining or blending of any transportation fuel, other than renewable fuels, does not qualify. Although the accompanying committee report states that the basis of qualified property must be reduced by the amount of credit, the statute does not so provide; presumably a technical correction will be necessary to implement any requirement of a basis reduction. If a credit is allowed under § 48C, no credit is allowed for the expenditure under §§ 48, 48A, or 48B. Section 48C(b)(3) limits the credit to
qualified advanced energy manufacturing projects certified as eligible by the Treasury Department, after consultation with the Secretary of Energy. The maximum amount of credits that may be certified is $2.3 billion. The statute sets time frames for applying for certification and certain procedures and criteria that the Treasury Department should apply in determining whether any particular project should be certified. The Treasury Department is required to review projects for which credits have been allocated, and may reallocate credits under certain circumstances.

H. Loss Transactions, Bad Debts, and NOLs

1. Duh! Stock that is still trading is not worthless yet. Rendall v. Commissioner, 535 F.3d 1221 (10th Cir. 8/5/08), aff'g T.C. Memo. 2006-174. The taxpayer lent $2 million to a publicly traded company that he had founded. The loan was secured by stock of the company held by the lender, Merrill Lynch. The loan proceeds were used to partially fund construction of a plant in Canada to extract crude oil from oil shale. In 1997 the corporation declared bankruptcy in Canada and the United States. Merrill Lynch sold a portion of the taxpayer's pledged stock to satisfy the debt. The company arranged to sell most of its assets, but retained rights to certain of its patented technologies. At the close of the 1997 tax year the company stock was traded over-the-counter for $3 per share. The court affirmed the Tax Court holding denying a deduction in 1997 for worthless debt. The court agreed with the Tax Court's conclusion that at the end of 1997 the taxpayer had not met the standard for treating the debt as worthless, which it described as "fixed by identifiable events that form the basis of reasonable grounds for abandoning any hope of recovery."

* A debt owed to the taxpayer by a bankrupt corporation, that possibly was insolvent and which had agreed to sell all of its operating assets, was not worthless where the stock was still trading for $3 per share and the corporation still owned numerous technologies, patents, office space, a research facility, and land and continued to employ a team of engineers. "Where a debtor company continues to operate as a going concern the courts have often concluded that its debts are not worthless for tax purposes despite the fact that it is technically insolvent." (quoting Roth Steel Tube Co. v. Commissioner, 620 F.2d 1176, 1182 (6th Cir. 1980)).

* The court also rejected the taxpayer's claim that it realized no gain on the disposition of its pledged stock. The taxpayer argued that Merrill Lynch sold the stock without permission and that any income should be taxed to Merrill Lynch which obtained the stock by theft. The court also upheld the Tax Court's allocation of basis to the sold shares on a FIFO basis.

a. But optimism doesn't always pay when selecting the year to claim a worthless stock loss. Bilthouse v. United States, 553 F.3d 513, 103 A.F.T.R.2d 2009-429 (7th Cir. 1/15/09), aff'g 100 A.F.T.R.2d 2007-6191 (N.D. Ill. 9/28/07). The taxpayers were passive investors (they did not materially participate) in an S corporation that had passed-through losses that were suspended. The taxpayers asserted that cancellation of indebtedness income realized by the insolvent S corporation in 1997 increased the taxpayers' stock basis and that the stock became worthless in 1997, thereby allowing the taxpayers to treat the worthlessness as a disposition, permitting deduction of the passive activity losses. The taxpayers filed a refund claim based on the theory that the stock became worthless in 1997, and that the worthlessness was a complete taxable disposition under § 469(g) that allowed the losses to be claimed. The Court of Appeals affirmed the district court's denial of the refund claim on the ground that the stock had become worthless in 1995, not 1997, as claimed by the taxpayer, and that 1995 thus was the year of the disposition. As of 1995, the stock of the corporation had no liquidating value. Although it was pursuing a lawsuit from which the shareholders claimed that the corporation expected a large financial recovery that would have allowed it to stay in business, the record did not demonstrate that the lawsuit represented a reasonable possibility that the corporation would remain in business after 1995, because there was no evidence proving any basis for why anyone thought the lawsuit would be successful. The suit was settled in 1997 with no damages being awarded to the corporation. The court stated "a taxpayer relying on the potential value of a company to put off the year of worthlessness must provide objective evidence of this value; merely asserting his self-serving hopes will not do."
2. Ordinary gain and loss on sale of Fannie Mae and Freddie Mac Preferred Stock. The Emergency Economic Stabilization Act of 2008, Act § 301, contains an off-code provision allowing an applicable financial institution to treat losses on the sale of Fannie Mae or Freddie Mac preferred stock held on September 6, 2008, as ordinary losses. The EESA allows the Secretary to treat transferred basis stock as held on the requisite date. Applicable financial institutions are defined in § 582(c)(2) and include banks, savings banks, a small business investment company, and a business development corporation. The EESA also allows depository institutions to treat losses as ordinary.

   a. Benefits extended to partners and subsidiaries. Rev. Proc. 2008-64, 2008-47 I.R.B. 1195 (10/29/08). The ordinary loss treatment is extended to the distributive share of loss of a qualified financial institution partner in a partnership that held qualified Fannie Mae or Freddie Mac preferred stock on 9/6/08, and sold the stock after that date, and to the sale of a partnership interest by a qualified financial institution if 95% of the partnership's assets consisted of qualified preferred stock or cash equivalents. A qualified financial institution that receives a distribution of qualified preferred stock from a partnership 95% of whose partnership's assets consisted of qualified preferred stock or cash equivalents, is treated as holding the qualified preferred stock on 9/6/08. Sales of qualified preferred stock of subsidiaries of a qualified financial institution are treated as ordinary gain or loss. Qualified preferred stock held by a qualified financial institution whose basis is determined from the basis of the person who transferred the stock and who held the stock on 9/6/08, is also treated as having held the stock on 9/6/08.

3. Jojoba partnership investment may have been worthless from the outset, but not enough to claim a loss deduction. Helbig v. Commissioner, T.C. Memo. 2008-243 (10/29/08). The taxpayer invested in Contra Costa Jojoba Research Partners, an investment in jojoba beans promoted by Charles B. Toepfer. Deductions from the partnership investment were denied for 1983, 1984, and 1985 in Utah Jojoba I Research v. Commissioner, T.C. Memo. 1998-6, to which the taxpayer had agreed to be bound. The court (Judge Wherry) denied taxpayer's additional claim that the investment was worthless from the outset giving rise to loss deductions in 1983-1985. The court noted that the taxpayer continued to pursue the investment through 1993.

   • The court also upheld negligence penalties under § 6653(a) and substantial understatement penalties under § 6661.

   a. Heller v. Commissioner, T.C. Memo. 2008-232 (10/20/08). The court upheld negligence penalties under § 6653 and substantial understatement penalties under § 6661 on investors in the Contra Costa jojoba bean shelter. The court held that the Hellers had been negligent in their failure to consult a tax expert before taking the large deductions from Contra Costa's research and development efforts.

4. Worthless stock is not theft, even though it may feel like it. Electric Picture Solutions, Inc. v. Commissioner, T.C. Memo 2008-212 (9/8/08). The corporate taxpayer purchased publicly traded Novatek stock through a California broker. The SEC filed a civil complaint alleging massive fraud on Novetek investors. The taxpayer claimed a theft loss under § 165(a) (instead of a capital loss for worthless securities). In denying the deduction the court (Judge Thornton) observed that under California law that a purchaser of securities on the open market cannot support a claim of theft because there is no privity between the perpetrator and the victim.

5. A bad investment in an abusive shelter is a theft loss, but the taxpayer has to prove no possibility of recovery. Vincentini v. Commissioner, T.C. Memo 2008-271 (12/8/08). The taxpayer in 1999 invested in an international tax fraud scheme on the basis of listening to audio tapes produced by Keith Anderson, founder of Anderson Ark and attending an Anderson Ark conference in Costa Rica. In a petition challenging the IRS assessment of a deficiency for 1999 denying losses claimed from the taxpayer's Anderson Ark investment, the taxpayer claimed a theft and casualty loss from the investments in 2001 or 2002 that could be carried back to taxpayer's 1999 taxable year. In 2002 the Anderson Ark promoters were convicted of money laundering and/or conspiracy to commit money laundering by the District
Court for the Eastern District of California (United States v. Anderson, 391 F.3d 970, 974 (9th Cir. 2004).) In 2004 the same defendants were convicted in the Washington District Court on charges of conspiracy to commit wire and mail fraud and to defraud the United States. The judgment of the Washington District Court ordered the Anderson Ark defendants to provide restitution to Anderson Ark investors, including the taxpayer. The Tax Court (Judge Marvel) held that since the Government in the Anderson Ark criminal cases took the position that the taxpayer was a victim of fraud and was entitled to restitution, judicial estoppel prevented the Government from asserting in the Tax Court that the taxpayer did not suffer a theft loss. However, the court also held that the taxpayer failed to establish that it was reasonably certain at the end of 2001 that the taxpayer would not recover his loss from Anderson Ark. Thus, the casualty loss deduction was denied. In addition, the taxpayer was assessed penalties under § 6662 with respect to losses claimed from the Anderson Ark investment. The court rejected the taxpayer's assertion of reasonable reliance on the advice of a tax professional noting that, reliance on the advice of an accountant who was referred to the taxpayer by the promoter was not reasonable reliance.

6. Carry me back to those long ago days of yore, when there were profits to be offset by today's NOL. The 2009 ARRTA, § 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. (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 year 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 ARRTA, 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.


7. "Take your submarine sandwich shop and shove it" earns a loss deduction for the franchise fee. Alami v. Commissioner, T.C. Memo. 2009-042 (2/23/09). Judge Vasquez held that the taxpayer had established abandonment of Quiznos restaurant franchise (basis $25,000), and an associated corporate charter (basis $750). The taxpayer continually expressed intent to abandon the franchise by repeatedly expressing to Quiznos representatives his desire to have he franchise fee refunded because he no longer sought to open a Quiznos restaurant, he did not contribute the additional money needed to open a Quiznos restaurant or select a location within the 1-year limit in the initial franchise agreement, and he filed a complaint with the state attorney general when Quiznos failed to respond to repeated requests for a refund. There was no evidence that the taxpayer took any steps to use the corporation for purposes other than running a Quiznos franchise; rather, at trial the taxpayer was not even aware whether the corporation remained in existence.

8. The IRS comes to rescue the loss deductions of Bernie Madoff's Ponzi scheme victims. Rev. Rul. 2009-9, 2009-14 I.R.B. 735 (3/17/09). This Revenue Ruling, issued in response to the Bernie Madoff Ponzi scheme scandal, comprehensively addresses the tax treatment of losses to investors from criminally fraudulent "Ponzi" investment schemes. As for the proper treatment, the IRS ruled as follows:
1. A loss from a Ponzi scheme is a loss from a criminal fraud or embezzlement in a transaction entered in profit that is a theft loss, not a capital loss, under § 165. The loss is deductible under § 165(c)(2), not § 165(c)(3). (Rev. Rul. 71-381 is obsoleted to the extent that it holds that a theft loss incurred in a transaction entered into for profit is deductible under § 165(c)(3) rather than § 165(c)(2)).

2. The loss is an itemized deduction, but is not subject to the limitation on personal losses in § 165(h), or the limitations on itemized deductions in §§ 67 and 68.

3. The theft loss is deductible in the year it is discovered, to the extent that the loss is not covered by a claim for reimbursement, with respect to which there is a reasonable prospect of recovery.

4. The amount of a theft loss is the amount invested in the arrangement, less amounts withdrawn, if any, reduced by reimbursements or recoveries, and reduced by claims as to which there is a reasonable prospect of recovery. Where an amount is reported to the investor as income prior to discovery of the arrangement and the investor includes that amount in gross income and invests this amount in the arrangement, the amount of the theft loss is increased by the purportedly reinvested amount.

5. A theft loss in a transaction entered into for profit may create or increase a net operating loss under § 172 that can be carried back up to 3 years and forward up to 20 years; the three-year carryback for a theft loss is permitted under § 172(b)(1)(F). The investor can also qualify as an eligible small business under § 172(b)(1)(F)(iii) and § 172(b)(1)(H)(iv), and if the investor qualifies, under § 172(b)(1)(H)(iv), the investor may elect either a 3, 4, or 5-year net operating loss carryback for an applicable 2008 net operating loss.

   a. The ruling also holds that certain relief provisions do not apply:

      1. A theft loss in a transaction entered into for profit does not qualify for § 1341 treatment.

      2. A theft loss in a transaction entered into for profit does not qualify for the application of the mitigation rules in §§ 1311-1314 to adjust tax liability in years that are otherwise barred by the period of limitations on filing a refund claim.

   a. And a safe-harbor to ease the burden of calculating potential recoveries that affect the amount and proper year for the deduction. Rev. Proc. 2009-20, 2009-14 I.R.B. 749 (3/17/09). This Revenue Procedure provides an optional safe harbor under which qualified investors (as defined in the revenue procedure) may treat a Ponzi scheme loss as a theft loss deduction. Its purpose is to alleviate the problems that arise because highly factual determinations regarding Ponzi schemes that are required by Rev. Rul. 2009-9, which describes the proper treatment regarding claiming Ponzi scheme theft losses. The revenue procedure requires many qualifying conditions, and it does not include a person that invested solely in a fund or other entity that invested in the specified fraudulent arrangement (although it can apply to the fund or entity itself). Among the qualifying conditions are the lead figure (1) must have been either (a) charged by indictment or information with a crime that would have been theft if convicted, or (b) subject to a state or criminal complaint alleging such a crime, and (2) either (a) the complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or (b) a receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen. If the myriad of qualifying conditions is satisfied, the safe harbor deduction amount is computed under the following formula:

      1. Multiply the amount of the "qualified investment" by —

         a. 95 percent, for a qualified investor that does not pursue any potential third-party recovery; or

         b. 75 percent, for a qualified investor that is pursuing or intends to pursue any potential third-party recovery;

      2. Subtract from this product the sum of any actual recovery and any potential insurance and/or Securities Investor Protection recovery.

   a. Generally speaking, the amount of the "qualified investment" equals the sum of (1) the amount invested (money and the basis of property) in the arrangement, and
(2) amounts previously included in gross income by investor that were purportedly reinvested, minus any amounts withdrawn. The safe harbor “discovery year” for claiming the deduction is the investor’s taxable year in which the indictment, information, or complaint is filed.

- The amount of the deduction so determined is not further reduced by potential direct recovery or potential third-party recovery. However, the investor may have income or an additional deduction in a subsequent year depending on the actual amount of the loss that is eventually recovered. Special procedures must be followed in completing the investor’s tax return to flag that the investor is claiming a safe-harbor theft loss under the revenue procedure. The taxpayer must sign and attach to the return a statement agreeing: (1) not to deduct in the discovery year an amount in excess of the deduction permitted under the revenue procedure; (2) not to file returns or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year; (3) not to apply §1341 with respect to the theft loss deduction allowed by the revenue procedure; and (4) not to apply the doctrine of equitable recoupment or the mitigation provisions in §§1311-1314 with respect to income from the investment arrangement that was reported in taxable years that are otherwise barred by the period of limitations.

- A taxpayer that does not elect to use the safe harbor provided by the revenue procedures is subject to all of the generally applicable provisions governing the deductibility of losses under §165, including proof that a theft occurred, proof of the year of discovery, and proof that there is no reasonable prospect of recovery. A taxpayer that does not apply the safe harbor and files or amends income tax returns for years prior to the discovery year to exclude amounts reported as income from the investment arrangement must establish that those amounts were actually or constructively received (or accrued by a taxpayer using an accrual method of accounting).

9. In re Harvard Industries, 568 F.3d 444, 103 A.F.T.R.2d 2009-2701 (3d Cir. 6/17/09). Section 172(b)(1)(C) provides for a ten year carryback of specified liability losses, which are defined in §172(f) as product liability losses that arise out of physical or emotional injury or loss of use of property on account of a defect in products produced by the taxpayer, and liability that arose out of state or federal law, or out of any tort committed by the taxpayer. In a bankruptcy proceeding the taxpayer claimed Federal tax refunds based on carrybacks of specified liability losses. The taxpayer produced defective lock nuts for use in aircraft engines. No one was actually injured as a result of the defects, but the taxpayer suffered losses in actions by distributors who could not sell the defective lock nuts. The court concluded that ‘loss of property’ could refer to the loss of the defective product itself so that losses attributable to settlements with distributors who could not sell the defective product qualified under the definition of specified liability losses. The court also held that losses incurred in making payments to its pension plan as required by the PBGC were losses incurred under Federal law because of the minimum funding requirements of ERISA. Finally, the court affirmed lower court rulings that retrospective workers compensation insurance premiums, including the portion of the premiums representing the insurance company’s administrative costs, represented specified liability losses as they arose under state workers compensation laws.

I. At-Risk and Passive Activity Losses

1. A closing agreement does not override the passive activity loss rules. Shelton v. United States, 102 A.F.T.R.2d 2008-6287 (Fed. Cl. 9/23/08). The taxpayers entered into a closing agreement in a partnership audit that provided that, “Any losses disallowed under this agreement are suspended under I.R.C. § 465. Such suspended losses may be used to offset the taxpayers’ pro rata share of any income earned by the partnership and/or other income in accordance with the operation of I.R.C. § 465.” The taxpayer asserted that the closing agreement allowed deduction of suspended loss in a year that at-risk amounts are increased, regardless of the passive activity loss limitation of § 469. The Claims Court (Judge Miller) held on summary judgment that §469 always applies after the limitation of §465 is overcome and that any absence of a reference to §469 in the closing agreement does not eliminate its application.

2. You don’t need a real estate broker’s license from the state to be a
real estate broker for purposes of § 469. Agarwal v. Commissioner, T.C. Summ. Op. 2009-29 (3/2/09). The taxpayer, who worked full-time as a licensed real estate agent, but was not a licensed real estate broker, deducted losses from a real estate rental activity in which she materially participated against her compensation income. Under § 469(c)(7), if more than one half of the personal services performed by the taxpayer during the year are performed in one or more real property trades or businesses in which the taxpayer materially participates and the taxpayer performs more than 750 hours of services in such activities, then any real property rental activity in which the taxpayer materially participates is not treated as a per se passive activity, and losses are fully deductible against the taxpayer’s income from all sources. Section 469(c)(7)(C) defines a real property trade or business as any real property development, redevelopment, construction, acquisition, conversion, rental, management, leasing, or brokerage business. Special Trial Judge Dean held that for purposes of § 469(c)(7), the “business” of a real estate broker includes, but is not limited to: (1) selling, exchanging, purchasing, renting, or leasing real property; (2) offering to do those activities; (3) negotiating the terms of a real estate contract; (4) listing of real property for sale, lease, or exchange; or (5) procuring prospective sellers, purchasers, lessors, or lessees. Under this standard, a licensed real estate agent qualifies as a real estate broker for purposes of § 469(c)(7), even if the agent is not a licensed real estate broker under state law.

3. Rock, hammer, warehouse – these activities are not an economic unit. Senra v. Commissioner, T.C. Memo. 2009-79 (4/15/09). The taxpayer owned a warehouse through a disregarded LLC, which leased the warehouse to a C Corporation, 86.75 percent of which was owned by the taxpayer and which employed the taxpayer. The taxpayer deducted losses from the rental activity against his salary from the C Corporation, claiming that the warehouse leasing and employment by the C corporation was a single activity under Reg. § 1.469-4. The Tax Court (Judge Chabot) held that the warehouse activity could not be grouped with the C corporation activity. Reg. § 1.469-4(d)(5)(ii) permits an activity that a taxpayer conducts through a C corporation to be grouped with another activity only for the purposes of determining whether the taxpayer materially or significantly participates in the other activity. Otherwise, an activity conducted through a C corporation may not be grouped with another activity. Thus, the warehouse activity losses could not be deducted against the salary from the C corporation. The court also noted that although the taxpayers may have undertaken their activities with a different structure that would have permitted use of the losses, they are bound by the form of the business they adopted.

4. 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 shall not be treated as an interest with respect to which a taxpayer is a material participant. Temp. Reg. § 1.469-5T(e)(3) 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.

a. The Court of Federal Claims agrees. Thompson v. United States, 87 Fed. Cl. 728, 104 A.F.T.R. 2d 2009-5381 (7/20/09). The court 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.”

5. **Deciding on whether to uphold the Commissioner’s rejection of this horse lover’s losses is like pulling teeth.** Cunningham 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’s 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 misled 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).

III. **INVESTMENT GAIN AND INCOME**

A. **Gains and Losses**

1. **New rules for determining basis in securities.** The Emergency Economic Stabilization Act of 2008 [Division B], Act § 403, amends § 1012 to create new rules for determining the basis of securities acquired after December 31, 2010. 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 from 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 (stock acquired in a reorganization where basis can’t be identified). Covered securities include securities acquired through an account with the broker or transferred to the broker from another account on or after an applicable date. The applicable date for stocks is January 1, 2011, for stocks under the average basis method, January 1, 2012, and of any other security, January 1, 2013 or such later date as specified by the Secretary. 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.

2. **Taxpayer took the position that he was exchanging appreciated stock for a private annuity contract, while the IRS asserted that he was instead simply exercising his puts.** The IRS lost, but would have prevailed had proposed regulations applied. Katz v. Commissioner, T.C. Memo. 2008-269 (12/3/08). Taxpayer received publicly held UICI stock when his student-
loan business was acquired. Thereafter, he engaged in an equity swap transaction with Merrill Lynch to hedge some of that stock by purchasing 200,000 common stock put options at $23.09 per share and selling 200,000 common stock call options at $26.93 per share. These options were European-style options which could be exercised only on 2/3/00. This had the effect of collaring the taxpayer's UICI stock value between those two share prices. Pursuant to an arrangement facilitated by Merrill Lynch on the morning of 2/3/00, taxpayer exchanged the equity swap [i.e., 200,000 shares of UICI stock and the put options] for a single lump-sum private variable annuity from a successful Canadian businessman's wholly-owned Bahamian corporation (SJA). Five days later, Merrill Lynch settled the sale of the UICI stock and (after some typical Merrill Lynchish fumbling around) deposited most of the $4.6 million proceeds in SJA's account. The Tax Court (Judge Foley) held that pursuant to Rev. Rul. 69-74, 1969-1 C.B. 43, when a taxpayer exchanges appreciated property for a private annuity, the "gain should be reported ratably over the period of years measured by the annuitant's life expectancy and only from that portion of the annual proceeds which is includable in gross income by application of section 72."

- The Commissioner argued that the equity swap was exercised before the purchase of the private annuity, which would result in taxpayer being taxed immediately on the gain. Judge Foley held that stipulations entered into in this case negated the Commissioner's position that the substance of the transaction [i.e., realization of the gain before the purchase of the annuity] trumped the form of the transaction [i.e., transfer of the equity swap to SJA in exchange for the annuity].

a. Note that the result set forth in Rev. Rul. 69-74 would be reversed when proposed regulations [which will treat taxpayers who exchange property for an annuity as if they had sold the property] become final. REG-141901-05, Exchanges of Property for an Annuity, 71 F.R. 61441 (10/18/06). The Treasury has published proposed regulations that provide a single set of rules for the taxation of an exchange of property for an annuity contract. Essentially, the proposed rules will treat the transaction as if the property was sold for cash equal to the value of the annuity contract [as determined under § 7520] and the proceeds were used to buy an annuity contract; however, taxpayers may continue to structure transactions as § 453(b) installment sales. These proposed regulations do not change existing Reg. § 1.1011-2 for charitable gift annuities, but will change prior law on exchanges of appreciated property for private annuities to the extent it permitted open transaction treatment or ratable recognition as the annuities were paid. The effective date is 10/18/06, with a delayed effective date of 4/18/07 for non-abusive transactions. These proposed regulations would bring the current treatment of exchanges of appreciated property for private annuities into line with the tax treatment of exchanges for commercial annuities. Before these regulations are applicable, the law generally postponed tax on the exchange based on the assumption that the value of a private annuity contract could not be determined for federal income tax purposes.

3. Stimulating stock investments in small business corporations. The 2009 ARRTA, § 1241(a), amended Code § 1202 to provide special rules for qualified small business stock acquired in 2009 and 2010, regardless of when the stock is sold. For such stock, seventy-five percent of the gain (rather than fifty percent) is excluded under § 1202(a), and the special rules of § 1202(a)(2) for stock in a qualified empowerment zone business do not apply.

4. Gain is recognized on an exchange even if the taxpayer didn't yet have what she got and she might not have gotten to keep it. United States v. Culp, 99 A.F.T.R.2d 2007-618, 2007-1 U.S.T.C. ¶50,399 (M.D. Tenn. 12/29/06). The government was granted summary judgment in an erroneous refund suit. The taxpayer exchanged her partnership interest in Ernst & Young for stock of 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 court held that the open transaction doctrine was not applicable. 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 forfeitability provisions.

a. The Seventh Circuit affirmed taxable exchange treatment for an E&Y consulting partner in a Capgemini exchange. United States v. Fletcher, 562 F.3d 839 (7th Cir. 4/10/09), aff’g 101 A.F.T.R.2d 2008-588, 2008-1 U.S.T.C. ¶50,149 (N.D. Ohio 1/15/08). In this 2000 exchange of taxpayer’s partnership interest in E&Y for restricted stock of Capgemini, the Seventh Circuit (Judge Easterbrook) affirmed the summary judgment award to the government in this erroneous refund suit, and in the process “Fletcherized” the E&Y consulting partner involved because she initially took the position of the parties to the transaction that all of the Capgemini shares received vested in the year 2000 [the year of the exchange], but after the stock declined in value took the position that she received income in 2000 only to the extent of cash she received in that year and the remainder of her income was recognized in 2003 [when the stock was worth less than one-fifth of its 2000 value].

Judge Easterbrook did not appreciate the argument that she signed the “consulting partner transaction agreement” [which provided for taxable gain in 2000] only because she was afraid she would be fired if she did not do so. Both the district court and the Seventh Circuit held that under either Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967), or the alternative “strong proof” test, taxpayer was bound by the agreement she signed. he stated that

Fletcher argues that she didn’t “really” agree to the structure that Ernst & Young and Cap Gemini (and most of her partners) wanted in 2000. If she had voted no and refused to sign, she maintains, she would have been excluded from the economic benefits and might have been fired. If this is so, then she had a difficult choice to make; it does not relieve her of the choice’s consequences. Hard choices may be gut-wrenching, but they are choices nonetheless. Even naive people baffled by the fine print in contracts are held to their terms; a sophisticated business consultant who agrees to a multi-million-dollar transaction is not entitled to demand the deal’s benefits while avoiding its detriments. The argument that Fletcher can avoid the terms as a matter of contract law is frivolous. All that matters now are the tax consequences of the contracts she signed.

Judge Easterbrook concluded:

The more likely it is that the conditions will be satisfied, and all restrictions lifted, the more sensible it is to treat all of the stock as constructively received when deposited in the account. To see this, suppose that the parties had wanted to defer the recognition of income and had put $ 2.5 million in each partner’s account, with the condition that the whole amount would be forfeited if the temperature in Barrow, Alaska, exceeded 80 [degrees] F on January 1, 2005. Would the remote possibility of an Arctic heat wave enable the partners to defer paying taxes? Surely not. See Cemco Investors, LLC v. United States, 515 F.3d 749 (7th Cir. 2008). If, on the other hand, the parties agreed that the ex-partners would receive $ 2.5 million only if the temperature in Barrow on January 1, 2005, exceeded 80 [degrees] F, then none of the partners would constructively receive income in 2000; everything would depend on events in 2005.

The sort of contingencies that could lead to forfeitures were within the ex-partners’ control. That implies taxability in 2000, for control is a form of constructive possession. And the agreement to discount the stock by only 5% tells us that the parties deemed forfeitures unlikely. Fletcher’s acknowledgment that the risk of forfeiture was small shows that the conditions of constructive receipt in 2000 have been satisfied.

Thus although we agree with Fletcher that the ex-partners are entitled to contest the tax treatment called for by the 2000 contracts, we hold that the shares are taxable in 2000 at their value on the date of deposit to the accounts at Merrill

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2 Horace Fletcher (1849–1919), a health food faddist, argued that food should be chewed thirty-two times before being swallowed. “Nature will castigate those who don’t masticate.”

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Lynch. Income was constructively received in that year not because the contract said that everyone would report it so to the IRS, but because the parties were right to think that this transaction’s actual provisions made the income attributable to 2000. That the price of Capgemini stock dropped in 2001 and later does not entitle the parties to defer the recognition of income. Fletcher must repay the refund (and amend her returns for later years to reflect receipt of the income in 2000).

5. The IRS gives insureds a partial pass on the “substitute for ordinary income” limitation on capital gains treatment when they sell their life insurance policies. Rev. Rul. 2009-13, 2009-21 I.R.B. 1029 (5/1/09). This revenue ruling addresses the amount and character of income recognized with respect to the disposition by the insured of a life insurance policy in three different factual situations. First, upon the surrender by owner of a life insurance contract to the issuer for its cash surrender value, amount of income is the amount received minus the investment in contract, and the income is ordinary income. Second, if a life insurance contract is sold to unrelated person who would not suffer loss if beneficiary died, the amount of income realized is the amount received on sale minus the adjusted basis in contract (adjusted to properly reflect “cost of insurance,” which is excluded from the contract’s basis in determining the gain realized on the sale); the portion of the gain reflecting inside build-up immediately prior to the sale is ordinary income, but any excess amount is capital gain, which is long term if the contract has been held for more than one year. Third, if a term-life contract with no cash surrender value is sold to an unrelated person who would not suffer a loss if beneficiary died, the amount of income recognized is the excess of the amount realized over the adjusted basis of contract; because the cost of insurance each month is presumed to equal to monthly premium paid, there is no inside build-up under contract, and thus the entire amount recognized is long-term capital gain.

a. Let the life insurance gambling tax shelter wave begin. The IRS gives a third-party purchaser of life insurance who buys the insured’s contract a full pass on the “substitute for ordinary income” limitation on capital gains treatment when he sells the life insurance policy instead of waiting for ordinary gain on the payout. Rev. Rul. 2009-14, 2009-21 I.R.B. 1031 (5/1/09). This revenue ruling deals with the treatment in three different situations of a cash method taxpayer who purchases a life insurance contract from the insured. In all three situations, the contract was a level premium fifteen-year term life insurance contract without cash surrender value. The purchaser had no insurable interest or relationship to the insured. At the time of purchase, the remaining term of the contract was 7 years, 6 months, and 15 days. The monthly premium for the contract was $500, due and payable on the first day of each month. The purchaser named itself beneficiary under the contract immediately after acquiring the contract.

• In the first situation, the purchaser paid the insured $20,000 for the contract, paid premiums totaling $9,000 to keep the contract in force, and received $100,000 under the life insurance contract upon the insured’s death. The ruling concludes that although the life insurance contract was not property described in § 1221(a)(1)-(8), and thus was a capital asset in the purchaser’s hands, “neither the surrender of a life insurance or annuity contract nor the receipt of a death benefit from the issuer under the terms of the contract produces a capital gain.” Accordingly, the $71,000 income recognized by the purchaser upon the receipt of the death benefit was ordinary income.

• In the second situation, prior to the insured’s death the purchaser sold the life insurance contract to another person for $30,000, after paying the insured $20,000 for the contract and premiums totaling $9,000. The ruling held that $9,000 of premiums paid by the purchaser to keep the contract in force were capital expenditures that were added to the original $20,000 basis in the contract. The purchaser recognized a $1,000 gain, which was a capital gain because the life insurance contract was not property described in § 1221(a)(1)-(8), and thus was a capital asset.

• The third situation was the same as the first situation, except
the purchaser was a foreign corporation that was not engaged in any U.S. trade or business. The purchaser again recognized $71,000 of income upon the receipt of death benefits. This income is "fixed or determinable annual or periodical" income subject to U.S. under § 881(a)(1), see Reg. § 1.1441-2(b); Rev. Rul. 64-51, 1964-1 C.B. 322; Rev. Rul. 2004-75, 2004-1 C.B. 516.

6. Small-time, one-time real state developer gets capital gain treatment. Rice v. Commissioner, T.C. Memo. 2009-142 (6/16/09). The taxpayers purchase a 14.4 acre parcel of land on which to build their "dream home." They originally planned to keep the entire property and build a single home for them and their children. When Mrs. Rice became concerned about being too "isolated," they subdivided a portion of the property and sold eight lots (only six suitable for construction) to six different buyers, over nine years, reserving one lot for their daughter and keeping the remaining land for their residence, on which they built a home with 8,000 square feet of interior space and 4,000 square feet of garages and porches. They had never before (or subsequently) engaged in real estate development and sales activities, and both had full-time jobs. Judge Kroupa held that the taxpayers realized capital gains, not ordinary income on the sales of the three lots sold during the year at issue. The total number of lots sold in all years was small, and the substantiality and frequency of sales is among the most important factors in determining whether sales were to customers in the ordinary course of business. The lots were sold primarily to friends, friends of friends, and relatives. Other than posting a sign outside the subdivision, petitioners did not advertise or promote the sale of lots. Their efforts were "more characteristic of those of investors than of dealers." Finally, although the taxpayers made significant improvements to develop and sell the lots, many of those improvements would have been necessary merely to build their own residence.

B. Interest, Dividends, and other Current Income

1. Billions and billions of new private activity tax-free bonds. Code § 1400U-2, added by § 1401(a) of the 2009 ARRTA, creates a new category of tax-exempt private activity bonds, which are termed "recovery zone facility bonds." Generally speaking recovery zone facility bonds are subject to the rules that apply to qualified private activity bonds, except that they are not subject to the aggregate annual State private activity bond volume limits in Code § 146 and the Code § 147(d) restriction on acquisition of existing property does not apply. Under § 1400U-1, $15 billion in recovery zone facility bonds can be issued during 2009 and 2010. Each state will receive a share of the national allocation based on that state's job losses in 2008 as a percentage of national job losses in 2008, although each state will receive a minimum allocation of each of these bonds that is not less than 0.9 percent of the total bonds to be issued. These allocations will be, in turn, sub-allocated to local municipalities in proportion to job losses within the state. Municipalities receiving an allocation of these bonds can use the proceeds of the bonds to invest in infrastructure, job training, education, and economic development in areas within the boundaries of the State, city or county. To be designated as an economic recovery zone an area must have significant poverty, unemployment, general distress, or home foreclosures, or be an area for which a designation as an empowerment zone or renewal community is in effect. To qualify as a recovery zone facility bond, 95 percent or more of the net proceeds of the bond issue must be used for "recovery zone property" and the issue must be designated by the issuer as a recovery zone facility bond. "Recovery zone property" is any depreciable property to which § 168 applies (or would apply but for § 179): (1) that was purchased by the taxpayer after the designation of the recovery zone took effect; (2) the original use of which in the recovery zone commences with the taxpayer; and (3) substantially all of the use of which is used in the active conduct of a qualified business by the taxpayer in the recovery zone. A "qualified business" is any trade or business except residential rental property or the operation of a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or liquor store. Apparently bars and nightclubs qualify.

a. Code § 7871, added by § 1402(a) of the 2009 ARRTA, allows Indian tribal governments to issue "tribal economic development bonds," the interest on which is tax exempt under Code § 103. Tribal economic development bonds issued by an Indian tribal
government are treated as if such bonds were issued by a State, except that Code § 146 (relating to State volume limitations) does not apply. A tribal economic development bond is any bond issued by an Indian tribal government (1) the interest on which would be tax-exempt if issued by a State or local government, and (2) that is designated by the Indian tribal government as a tribal economic development bond. The aggregate face amount of bonds that may be designated by any Indian tribal government cannot exceed the amount of national tribal economic development bond limitation allocated to such government. There is a national ceiling of $2 billion, which will be allocated by the Treasury Department, in consultation with the Department of the Interior. Tribal economic development bonds cannot be used to finance any portion of a casino or any facility located outside of the Indian reservation.

2. Code § 54AA, added by § 1531 of the 2009 ARRTA, provides a credit for holders of "build America" bonds on any interest payment date. The amount of the credit is 35 percent of the interest payable, and the credit can be claimed against the alternative minimum tax; unused credits can be carried over. A build America bond is any state or local obligation (other than a private activity bond), the interest received on which would otherwise be tax-exempt under § 103, which is issued before 2011 and which the issuer elects to be treated as a build America bond. Interest on build America bonds must be included in gross income, and the amount of the credit must be included as well. §§ 54AA(f)(2), 54A(f). The issuer of a "qualified build America bond" can elect to claim a refundable credit equal to 35 percent of the interest payable in lieu of the holder being entitled to the credit. To be a qualified build America bond, one hundred percent of the available project proceeds, less a reasonably required reserve (as defined in § 150(a)(3)), must be used for capital expenditures. For build America bonds that are "designated recovery zone economic development bonds," the credit rate for the issuer is 45 percent. Code §§ 1400U-2(a)(1) ; 6431(g). New Code § 1400U-2 creates tax credit bonds for investments in economic recovery zones. New Code § 1400U-1 authorizes $10 billion in recovery zone economic development bonds that can be issued during 2009 and 2010. To be designated as an economic recovery zone the area must have significant poverty, unemployment, general distress, or home foreclosures, or be any area for which a designation as an empowerment zone or renewal community is in effect. Each state will receive a share of the national allocation based on that state's job losses in 2008 as a percentage of national job losses in 2008, although each state will receive a minimum allocation of each of these bonds that is not less than 0.9 percent of the total bonds to be issued. These allocations will be, in turn, suballocated to local municipalities in proportion to job losses within the state. Municipalities that receive an allocation of these bonds can use the proceeds of the bonds to invest in infrastructure, job training, education, and economic development in areas within the boundaries of the State, city or county (as the case may be) that has significant poverty, unemployment or home foreclosures.

3. Credits for lenders who buy bonds to build schools. Code § 54F, added by § 1521(a) of the 2009 ARRTA, creates another new category of new category of tax-credit bonds for purposes of the § 54A credit: qualified school construction bonds. A taxpayer holding a qualified school construction bond on a credit allowance date is entitled to a tax credit at a rate [determined by the Treasury Department] that is the percentage rate that would permit issuance of such bonds without either discount or interest cost to the issuer. The amount of the tax credit is determined by multiplying the bond's credit rate by the face amount of the bond. The credit accrues quarterly, is includible in gross income as if it were an interest payment on the bond, and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits may be carried forward to succeeding taxable years. Credits may be separated from the ownership of the underlying bond in a manner similar to the manner in which interest coupons can be stripped from interest-bearing bonds. To qualify, a school construction bond must meet three requirements: (1) 100 percent of the available project proceeds of the bond issue is used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a bond-financed facility is to be constructed; (2) the bond is issued by a State or local government within which such school is located; and (3) the issuer designates such bond as a qualified school construction bond. The maturity of qualified school construction bonds is the
term that the Treasury Department determines will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified school construction bonds are issued. There is a national limitation on qualified school construction bonds of $11 billion for each of 2009 and 2010. The statute provides elaborate rules for allocating the allowable dollar volume of bonds among the states, the District of Columbia, United States possessions, Indian tribal government schools, and large local educational agencies. Qualified school construction bonds generally are subject to the arbitrage limitations of §148, with a number of modifications. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified school construction bonds are issued.

C. Profit-Seeking Individual Deductions

1. Hammering employees whose deferred compensation comes from offshore, i.e., hedge fund managers. The Emergency Economic Stabilization Act of 2008 added new Code §457A, which provides that any nonqualified deferred compensation (as defined in §409A) under a plan of a nonqualified entity must be included in gross income in the first year in which there is no substantial risk of forfeiture. Nonqualified entities include (1) a foreign corporation unless substantially all of its income is either: (a) effectively connected with the conduct of a U.S. trade or business; or (b) subject to a comprehensive foreign income tax; and (2) any partnership unless substantially all of its income is allocated to persons other than: (a) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax; or (b) tax exempt organizations. If the amount of the deferred compensation is not determinable when the right to it vests, the deferred compensation will be included when it becomes determinable, but an interest charge at the deficiency rate plus one percent will be added with respect to the period between the year when the compensation was deferred, or vested if later, and the year it becomes includible. To the extent provided in regulations if compensation is determined solely by reference to the amount of gain recognized on the disposition of an investment asset, the compensation will be treated as subject to a substantial risk of forfeiture until the disposition.

2. Judge Posner says that the distinction between a temporary and indefinite work location is untenable: “work can be, and usually is, both temporary and indefinite.” Wilbert v. Commissioner, 553 F.3d 544, 103 A.F.T.R. 2d 2009-485 (7th Cir. 1/21/09), aff’g T.C. Memo. 2007-152 (6/14/07). Taxpayer was a mechanic for Northwest Airlines, who was laid off at his work location in Minneapolis. He exercised seniority rights to bump a mechanic in Chicago, but he worked there for only a few days before being bumped by a more senior mechanic. Subsequently, he bumped a mechanic in Anchorage, and worked there for three weeks before being himself bumped. He then bumped a mechanic at LaGuardia Airport, but worked there for only a week before he was bumped again. Three weeks later the airline hired him back, outside the bumping system, to fill an interim position (maximum nine months) in Anchorage. He occupied that position for several months before being laid off again. He never had a realistic prospect of returning to work for Northwest in Minneapolis. He kept his home in Minneapolis, where his wife continued to live. Because he was working too far from home to be able to live there, he incurred living expenses of almost $20,000 that he would not have incurred had he remained in Minneapolis. The Tax Court denied the deduction. Because of the indefinite nature of the employment at the alternative locations, the taxpayer was not temporarily away from home. Although the Court of Appeals affirmed, the appellate court’s reasoning (Judge Posner) differed from that of the Tax Court. According to Judge Posner, “[t]he problem with the Tax
Court’s distinction is that work can be, and usually is, both temporary and indefinite...” Rather, Judge Posner looked to the principles of *Commissioner v. Flowers*, 326 U.S. 465 (1946), and *Hantzis v. Commissioner*, 638 F.2d 248 (1st Cir. 1981), that deny the deduction for travel expenses unless the taxpayer has a business rather than a personal reason to be living in two places if he decides not to move. He compared Wilbert’s situation to the common case of the construction worker who works at different sites throughout the country, never certain how long each stint will last and reluctant therefore to relocate his home, who is nevertheless denied a deduction. See *Yeats v. Commissioner*, 873 F.2d 1159 (8th Cir. 1989).

a. *Alami v. Commissioner*, T.C. Memo. 2009-42 (2/23/09). This case presented substantially the same factual situation as *Wilbert*, and the court reached the same conclusion.

D. **Section 121**

E. **Section 1031**

1. **Don Quixote [a/k/a David Aughtry] 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; (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)(4), 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 Corner). 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. “[I]t appears that these transactions took their peculiar structure for no purpose except to avoid § 1031(f).” *Teruya Bros., Ltd. v. Commissioner*, __ F.3d __, 104 A.F.T.R.2d 2009-6274 (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.”

F. Section 1033
G. Section 1035
H. Miscellaneous

1. **Tax protection for lenders to over-exuberant short-sellers.** Rev. Proc. 2008-63, 2008-42 I.R.B. 946 (9/26/08). Section 1058 provides nonrecognition to a person whose stock or securities is lent to another person to effect a short sale of that stock or securities. Technically, the transaction is a transfer of stock or securities in exchange for a contractual right to receive back identical stock or securities, together with any dividends, interest, or other payments receivable with respect to the stock or securities during the period between the initial transfer and the transfer back or replacement securities, which otherwise is a realization and recognition event. This revenue procedure provides that if a securities loan under § 1058 is terminated because of the bankruptcy of the borrower or an affiliate and the lender applies the collateral to the purchase of identical securities as soon as is commercially practicable (but in no event more than 30 days following the default), the IRS will treat the purchase as an exchange to which § 1058(a) applies.

IV. **COMPENSATION ISSUES**

A. **Fringe Benefits**

1. **Six more months to try to get away with buying beer and cigs at the pharmacy with health FSA and HRA debit cards.** Notice 2008-104, 2008-51 I.R.B. 1298 (12/5/08). Notice 2007-2, 2007-1 C.B. 254, provided that after 12/31/08, health FSA and HRA debit cards could not be used at stores with the Drug Stores and Pharmacies merchant category code unless: (1) the store participates in the inventory information approval system in Notice 2006-69, 2006-2 C.B. 107; or (2) 90 percent of the individual store’s gross receipts during the prior taxable year were from items that qualify as expenses for medical care under § 213(d) (including nonprescription medications as described in Rev. Rul. 2003-102, 2003-2 C.B. 559). This notice extends the deadline in Notice 2007-2 by six months. After 6/30/09, health FSA and HRA debit cards may not be used at stores with the Drug Stores and Pharmacies merchant category code unless the requirements are satisfied.

2. “A woman needs a fish like a man needs a bicycle.” Qualified transportation includes bicycles. The Emergency Economic Stabilization Act of 2008 [Division
B], Act § 211, adds to the qualified transportation fringe benefit excluded from income under § 132(f), a qualified bicycle commuting benefit. The provision excludes from income an employer reimbursement during the 15 month period beginning on the first day of the taxable year of up to $20 per month of bicycle commuting for the purchase, improvements, repair and storage of a bicycle. A qualified bicycle commuting month is any month during which an employee regularly uses the bicycle for a substantial portion of travel between the employee’s residence and work place and does not receive the benefit of any other qualified transportation fringe benefit. The bicycle benefit is not subject to the cash alternative escape from constructive receipt of § 132(f)(4).  

3. Economists say that everything happens on the fringes. Using fringe benefits to stimulate public transportation. The 2009 ARRTA, § 1151(a), amended Code § 132(f) to provide that the $175 ceiling (as adjusted for inflation) on tax free parking benefits also applies to transit passes and qualified commuter highway vehicle use for months beginning after February 2009 and before 1/1/11. The 2009 amount for the $175 ceiling on tax free parking benefits, as adjusted for inflation, is $230 per month.  

4. 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.  

B. Qualified Deferred Compensation Plans  
C. Nonqualified Deferred Compensation, Section 83, and Stock Options  
1. Section 409A added a new layer of rules for nonqualified deferred compensation. Section 885 of the American Jobs Creation Act of 2004 added new § 409A, which modifies the taxation of nonqualified deferred compensation plans for amounts deferred after 2004. Section 409A has changed the tax law governing nonqualified deferred compensation by making it more difficult to avoid current inclusion in gross income of unfunded deferred compensation. Nevertheless, § 409A has not completely supplanted prior law. The fundamental principles of prior law continue in force but have been modified in certain respects.  

a. Notice 2008-113, 2008-51 I.R.B. 1305 (12/5/08) This Notice provides procedures to obtain relief from the full application of the income inclusion and additional taxes requirements of § 409A with respect to certain operational failures to comply with the requirements of § 409A. Comments were also requested on whether procedures for the correction of a failure of a plan to comply with the plan document requirements of § 1.409A-1(c) should be adopted.  

2. Emergency Economic Stabilization Act of 2008 [Division C], Act § 504(c), provides that up to $100,000 of amounts received by a taxpayer engaged in the fishing business from the settlement of Exxon Valdez litigation can be contributed to retirement accounts in the year of receipt.  

3. 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.

D. Individual Retirement Accounts

1. Congress encourages retirees to drain their ravaged IRAs to benefit charities. The Emergency Economic Stabilization Act of 2008 extended through 2009 Code § 408(d)(8), which permits tax-free distributions up to $100,000 directly to charities that are publicly supported under § 509(a)(1) and (2) (but not § 509(a)(3)) from IRAs owned by individuals over 70½ years of age. These direct distributions to charities would be applied towards satisfying the § 401(a)(9) required minimum distribution amounts.

2. Us weary 70½+ geriatrics do not have to take RMDs for the 2009 year. WRERA, § 201, amends Code § 401(a)(9) to suspend required minimum distributions (“RMDs”) from 401(k) plans, IRAs and similar retirement accounts for 2009. RMDs for the year 2008 were not affected, including RMDs for 2008 that are permitted to be made in 2009 by reason of an individual’s required beginning date being 4/1/09.

3. A distribution not itself subject to the § 72(t) penalty tax does not trigger a modification of an existing series of substantially equal periodic payments. Benz v. Commissioner, 132 T.C. No. 15 (5/11/09). Section 72(t)(2)(A)(iv) provides an exception from the 10-percent penalty tax on premature IRA distributions for distributions that are part of a series of substantially equal periodic payments made for the life of the owner of an IRA (or the joint lives of the owner and a designated beneficiary). However, if the series of substantially equal periodic payments is modified within 5 years of the date of the first distribution (other than by reason of death or disability), or before the employee has attained age 59-1/2, the 10-percent penalty tax is imposed retroactively on prior distributions made before the taxpayer attains age 59-1/2, plus interest. Within five years of making an election to receive distributions from her IRA in a series of substantially equal periodic payments before attaining age 59-1/2, the taxpayer withdrew additional amounts to pay qualified higher education expenses as defined in § 72(t)(7) relating to her son’s college expenses. The Tax Court (Judge Goeke) held that a distribution that satisfies the statutory exception to the penalty tax on premature withdrawals under § 72(t)(2)(E) for payment of higher education expenses is not a modification of a series of substantially equal periodic payments. Such a withdrawal does not trigger the § 72(t) penalty tax where the taxpayer receives the distribution within 5 years after the taxpayer begins receiving distributions under a series of substantially equal periodic payments.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

1. Congress provides tax relief for sub-prime mortgage borrowers, e.g., "NINJA borrowers." The Mortgage Forgiveness Debt Relief Act of 2007 added new § 108(a)(1)(E), which excludes from gross income the discharge of “qualified principal residence indebtedness” (QPRI) that takes place on or after 1/1/07 and before 1/1/10. The provision is, of course, a legislative response to the sub-prime mortgage loan crisis. QPRI is defined as acquisition indebtedness, a loan on a taxpayer's principal residence, as defined in § 163(h)(3)(B), except that for purposes of § 108(a)(1)(E) the ceilings are $2,000,000 (for married couples filing joint returns) and $1,000,000 (for other taxpayers). QPRI does not include (1) indebtedness on a home that is not the taxpayer’s principal residence, or (2) home equity indebtedness. The exclusion is not available if the discharge is not on account of either (1) a decline in the value of the home or (2) the financial condition of the taxpayer. The taxpayer's basis in the principal residence must be reduced by the amount excluded under § 108(a)(1)(E). If only a portion of the cancelled debt is QPRI, the exclusion applies only to the extent the amount discharged exceeds the non-QPRI portion of the loan. If a taxpayer qualifies for both the QPRI exclusion and the insolvency exclusion of § 108(a)(1)(B), the QPRI exclusion applies unless the taxpayer elects the application of the insolvency exclusion.

a. Anticipating the tax consequences of the next wave of ARMs
and teaser-rate home mortgages that reset interest rates. Longer-term relief for sub-prime borrowers, and the way things are going South, also for folks who were not sub-prime borrowers when they took out the mortgage. The Emergency Economic Stabilization Act of 2008 extended § 108(a)(1)(E), excluding from gross income discharge of COD that is qualified principal residence indebtedness (QPRI) through 12/31/12. The provision, which was added in the Mortgage Forgiveness Debt Act of 2007, had been scheduled to expire after 12/31/09.

2. **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 Goeke 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.”

- The court did not impose taxpayer penalties because taxpayers had received “disinterested advice” that the damages were not includable in income. The advice came from taxpayer’s lawyer, the bank’s lawyer and the mediator who negotiated the settlement. In holding a § 6662 penalty inappropriate, Judge Goeke stated,

  Petitioners received unsolicited advice from three separate and independent individuals that the settlement would not be taxed. At least two of those individuals were disinterested parties with no relationship with petitioners. This advice confirmed petitioners’ previous understanding of the taxation of settlement awards. Although none of those individuals had specialized knowledge in tax law, they were experienced in personal injury lawsuits and settlements. Petitioners acted reasonably and in good faith when following their advice and preparing their own return as they have done for over 40 years.

3. **Helping the unemployed.** The 2009 ARRTA, 1107(a), amended Code § 85 to provide an exclusion for up to $2,400 of unemployment compensation received by an individual in 2009.

4. **Kerzner v. Commissioner,** T.C. Memo. 2009-76 (4/6/09). The taxpayers, who were equal partners in a partnership and equal shareholders of an S corporation, attempted to avoid the § 1366(d) limitation on passed-through losses from an S corporation by borrowing money from the partnership and re-lending the loan proceeds to the S corporation, which in turn paid equivalent amounts of rent back to the partnership. The Tax Court (Judge Nims) disallowed the pass-through losses, holding that the taxpayers did not acquire any basis in indebtedness from the S corporation from the transactions because they involved a circular flow of funds and there was no real expectation that they would ever repay the borrowed funds. Thus the taxpayers had not incurred any economic outlay.

5. **Judge Gale rescues a taxpayer who was trying to rely on the wrong exclusionary rule.** Watts v. Commissioner, T.C. Memo. 2009-103 (5/18/09). The taxpayer was injured in an automobile accident with an uninsured motorist, but her insurance company denied coverage under one of the two policies issued to the taxpayer and her husband, relying on anti-stacking provisions in the contracts. Eventually, as a result of the settlement of a class action suit against her automobile insurance company, she received a damage award. Both the taxpayer and the IRS argued the case on the basis of the applicability of § 104(a)(2). Judge Gale held that because the damage award was not received with respect to “tort or type rights,” it was not excludable under § 104(a)(2). However, notwithstanding the taxpayer’s apparent failure to raise the argument the damages were excludable under § 104(a)(3) as an amount received through
accident or health insurance for personal injuries or sickness. To be eligible to receive damages
the taxpayer was required to have been (1) insured under multiple insurance policies purchased
from the same company with uninsured motorist coverage, (2) injured through the fault of an
uninsured motorist, and (3) denied payment under one of the policies while receiving payment
under another. These prerequisites establish that the taxpayer received the settlement payment
"through" accident insurance, or under such a policy, for purposes of § 104(a)(3). Judge Gale
rejected the IRS's argument that because the class action lawsuit involved numerous claims
beyond those premised on personal injury (e.g., breach of contract, breach of covenant of good
faith and fair dealing, fraud, etc.) and sought compensatory damages, treble damages, punitive
damages, and interest, and because the settlement agreement did not expressly allocate any
portion of the payment to personal injury and the taxpayer executed a general release of all
claims, the taxpayer did not receive the payment "for" personal injury. The determining factor in
his decision was that the taxpayer's eligibility to receive a portion of the settlement fund
depended upon her showing that she had not been fully compensated for her injuries.

6. Even if the cop's CPA might have acted stupidly, the cop wasn't
penalized for an erroneous exclusion of a damage award. Longoria v Commissioner, T.C.
Memorandum 2009-162 (7/2/09). Judge Gustafson held that no portion of a $156,667 settlement award
in an employment discrimination suit by a [Puerto Rican] New Jersey state trooper was
excludable under § 104(a)(2), even though the taxpayer suffered physical injuries as a result of
acts of discrimination, because the complaint in the discrimination suit did not allege that he had
suffered any physical injuries as a result of discrimination during his employment. No penalties
were assessed, however, because the taxpayer reasonably relied on the erroneous advice of a
CPA in excluding the award from gross income.

• Should this case reach the Supreme Court, a "wise Latina"
would see that complete justice is done for Mr. Longoria.

helps homeowners who have defaulted, or are at risk of default, on their mortgages by providing
certain incentive payments to lenders/investors on the behalf of homeowner's that make timely
payments on modified loans that reduce the principal balance on the homeowner's mortgage
loan. This revenue ruling holds that the payments are excludable from the homeowner's income
under the general welfare exclusion.

8. 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.

9. The out of pocket cost of compromising consumer debt is not deductible. 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 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.

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

D. Deductions and Credits for Personal Expenses

1. The deduction for state and local property taxes is only semi-itemized for 2008. We bet this one becomes a permanent fixture in the annual extenders bill until it becomes permanent. Section 63(c)(1)(C), added by the Housing Assistance Tax Act of 2008, adds the “real property tax deduction” as a component of the standard deduction, effective only for taxable years beginning in 2008. The amount of the deduction is the lesser of (1) the amount the taxpayer could claim as a state and local real property tax deduction under § 164(a)(1) if he itemized his deductions, or (2) $500 ($1,000 in the case of a joint return).

   a. Congress extends another microscopic and complicating tax deduction. The Emergency Economic Stabilization Act of 2008 extended through 2009 the Code § 63(c)(1)(C) above-the-line deduction for a limited amount of real property taxes, The amount of the deduction is the lesser of (1) the amount the taxpayer could claim as a state and local real property tax deduction under § 164(a)(1) if he itemized deductions, or (2) $500 ($1,000 in the case of a joint return). The provision originally was effective only for 2008.

2. 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 ARRTA 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.


4. Making children more affordable. The Emergency Economic Stabilization Act of 2008 added Code § 24(d)(4), which provides that for 2008 (and only for 2008) the ceiling on the refundable child credit is 15 percent of the excess of earned income over $8,500 rather than $10,000 (indexed for post-2000 inflation). Because the 2008 inflation adjusted $10,000 amount would have been $12,050, this provision increases by $532.50 the refundable amount.

5. The Emergency Economic Stabilization Act of 2008 [Division B], the Energy Improvement and Extension Act, extends several credits and adds a few new twists.

a. Section 205 adds a new credit, under § 30D, for qualified electric drive motor vehicles. The credit amount is $2,500 plus $417 for each kilowatt hour of traction battery capacity in excess of 4 kilowatt hours (the minimum required for obtaining the credit). The credit is limited to $7,500 for vehicles weighing less than 10,000 pounds, $10,000 for vehicles weighing between 10,000 and 14,000 pounds, $12,500 for vehicles weighing between 14,000 and 26,000 pounds, and $15,000 for those electric plug-in SUVs in excess of 26,000 pounds. The credit begins to phase out after the first 250,000 vehicles are sold.

b. Section 302 extends the § 25C 10 percent credit (limited to $500 in a lifetime) for nonbusiness energy saving property to property placed in service in 2009. The provision contains several changes to the definitions of qualified energy property.

6. There's no constitutional right to deduct the cost of sexless procreation by a healthy man. The expenses of obtaining eggs from anonymous egg donors, and of the gestational carriers in whom the eggs - after being fertilized with taxpayer's semen - were implanted, were not deductible. Magdalin v. Commissioner, T.C. Memo. 2008-293 (12/23/08). The court (Judge Wherry) held that the costs of taxpayer's fathering two children by use of two egg donors and two gestational carriers were not § 213 medical expenses because taxpayer was medically able to father children, and had previously fathered twins with his ex-wife, born through natural processes and without the use of in vitro fertilization. Because (1) there was no
causal relationship between an underlying medical condition or defect — taxpayer’s sperm count and motility were found to be within normal limits — and the taxpayer’s expenses, and (2) the expenses at issue were not incurred for the purpose of affecting a structure or function of the taxpayer’s body, the expenses were not “medical care” as defined in § 213(d). Judge Wherry rejected the taxpayer’s argument that “it was his civil right to reproduce, that he should have the freedom to choose the method of reproduction, and that it is sex discrimination to allow women but not men to choose how they will reproduce.”

- The court refused to address the question of whether the fees would have been deductible had taxpayer suffered from a medical condition, e.g., infertility, that left him unable to have children except by use of in vitro fertilization.
- In PLR 200318017 (1/9/03), the IRS ruled that a woman who was unable to conceive using her own eggs and received an implanted fertilized egg was entitled to deduct as medical expenses under § 213 her unreimbursed expenses for the egg donor fee, the agency fee, the donor’s medical and psychological testing, the insurance for post-procedure donor assistance, and the legal fees for preparation of the egg donor contract.
- This case has no Da Vinci Code implications.

7. **A little help for the auto industry, but it's probably not enough.** Section 1008(b) of the 2009 ARRTA added Code § 164(b)(6) to allow taxpayers who do not elect to deduct state and local general sales taxes under § 164(b)(5) to deduct state and local sales and excise taxes paid on the purchase of new cars, light trucks, motorcycles, and recreational vehicles in 2009. The deduction is available only with respect to the first $49,500 of the purchase price, is phased out for taxpayers with adjusted gross incomes (with certain modifications) in excess of $125,000 ($250,000 in the case of a joint return), and is fully phased out when adjusted gross income (as modified) exceeds $135,000 ($270,000 in the case of a joint return). The deduction is allowed as a deduction in computing adjusted gross income and thus is allowable whether or not the taxpayer itemizes deductions.

8. **Pennies from heaven: the “making work pay” credit.** Code § 36A, added by § 1001(a) of the 2009 ARRTA, provides individuals a refundable tax credit for 2009, and only for 2009, equal to 6.2% of earned income. The maximum credit is $400 for a single individual and $800 for married taxpayers filing a joint return. The credit amount is reduced (but not below zero) by two percent of taxpayer’s adjusted gross income (with certain limited modifications relating to foreign income) in excess of $75,000 for single taxpayers, or in excess of $150,000 for married couples filing jointly. A taxpayer who is claimed as a dependent by another taxpayer is ineligible for the credit. The credit can be claimed through a reduction in income tax withholding or by claiming the credit on a tax return.

- All Social Security recipients are entitled to this payment, i.e., there is no income ceiling on it! Section 2201 of the 2009 ARRA (in the title called Assistance for Unemployed Workers and Struggling Families) provides for a one-time $250 payment to adults who were entitled to receive social security, etc. payments in any of the months of November 2008, December 2008, or January 2009. This payment will reduce the “making work pay” credit.

9. **“Go forth and propagate.” More kids, more EITC.** Section 1001(a) of the 2009 ARRTA added Code § 32(b)(3) to increase the EITC credit rate for taxpayers with three or more children to 45 percent of earned income up to $12,570 for taxable years 2009 and 2010. The Act also amended Code § 32(b)(2)(B) for 2009 and 2010 to increase the phase-out threshold for joint returns to $5,000 more than the phase-out threshold for single returns (subject to an inflation adjustment in 2010).

- Viva Viagra! More stimulating of propagation. Section 1004 of the 2009 ARRTA amended Code § 24(d) to allow the child tax credit to be refundable to the extent of 15 percent of the taxpayer’s earned income in excess $3,000 for 2009 and 2010.

10. **Credit for weatherproofing your house.** Code § 25C, added to the Code by the Energy Tax Incentives Act of 2005 and amended significantly by § 1121 of the 2009 ARRTA, provides a nonrefundable credit for certain expenditures to improve the energy efficiency of a taxpayer’s principal residence. As amended, the credit is available for property
placed in service in 2006, 2007, or 2009 (but not for property placed in service in 2008). In the case of "qualified energy efficiency improvements" (QEEIs), the credit equals 30 percent of the cost of the improvements (10 percent for years before 2009). A QEEI is any energy efficient building component (i.e., insulation, exterior windows and doors, certain coated metal roofs, and asphalt roofs with cooling granules) satisfying criteria established by the 2000 International Energy Conservation Code, if the original use of the component commences with the taxpayer and the component is expected to remain in use for at least five years. The other category of credit-eligible costs is "residential energy property expenditures" (REPEs). REPEs are expenditures for the following types of property, if they are installed in the taxpayer's principal residence and satisfy energy efficiency standards to be promulgated by the Treasury Department pursuant to detailed statutory instructions: (1) main air circulating fans, (2) natural gas, propane or oil furnace or hot water boilers, and (3) "energy efficient building properties" (electric heat pump water heaters; electric heat pumps; geothermal heat pumps; certain air conditioners; water heaters using natural gas, propane, or oil; and stoves burning biomass fuel). (The §25C credit is not available for geothermal heat pumps placed in service in 2009. Instead, a credit is available under §25D.) For REPEs the credit amount is established by schedule: the first $50 of the cost of a main air circulating fan, the first $150 of the cost of a natural gas, propane, or oil furnace or hot water boiler, and the first $300 of the cost of any item of energy-efficient building property. For years prior to 2008, there was a lifetime limit of $500 on the aggregate credits a taxpayer could claim under §25C, of which no more than $200 could be based on expenditures for windows. Section 1121(a) of the 2009 ARRTA amended §25C(b) to eliminate the lifetime limit and replace it with an aggregate limit of $1,500 for 2009 and 2010.

11. **Enlisting the tax Code to help stop funding both sides in the war on terror:** Credit for generating power at home. Code §25D, added by the Energy Tax Incentives Act of 2005, and modified by the Tax Relief and Health Care Act of 2006 and by the Energy Improvement and Extension Act of 2008, provides a nonrefundable credit for certain expenditures on residential energy-efficient property. Qualifying property is of five types: (1) solar electric property (which uses solar energy to generate electricity), (2) solar water heating property, (3) fuel cell property (which converts a fuel into electricity using electrochemical means), (4) small wind energy property (which uses a wind turbine to generate electricity for a residence), and (5) geothermal heat pump property (which uses the ground or ground water to heat or cool a residence). The property must be installed in a dwelling unit located in the United States and used by the taxpayer as a residence (principal residence, in the case of fuel cell property). Expenditures allocable to a swimming pool or hot tub are not eligible for the credit. The credit equals 30 percent of qualifying expenditures. For years prior to 2009, the credit was subject to annual ceilings (on the credit amount, not on credit-eligible expenditures) of $2,000 for solar electric property, $2,000 for solar water heating property, $500 per half kilowatt of capacity of fuel cell property, $500 per half kilowatt capacity (but not more than $4,000 in total) of small wind energy property, and $2,000 for geothermal heat pump property.

a. As amended by §1122(a)(1) of the 2009 ARRTA, Code §25D(b) provides that, for taxable years beginning after 12/31/08, there are no ceilings except the $500 ceiling on fuel cell property. The credit may be claimed against the AMT as well as the regular income tax, and unused credit amounts may be carried forward. The credit is available only for property placed in service before 2017.

12. **We guess DOMA doesn't apply to domiciles.** Notice 2009-12, 2009-6 I.R.B. 446 (1/15/09). This notice explains how to allocate the §36 first-time homebuyer credit between unmarried co-purchasers of a principal residence. Any reasonable method is allowed when two unmarried individuals purchase a first home as tenants in common. Under some circumstances a full $7,500 credit can be obtained even where one buyer would not qualify for any amount of credit under the phaseout rules, if both contribute to purchase and both are first-time home buyers.

13. **This CCA on deductible home mortgage interest will break a lot of hearts in California – almost as many as the voters broke in November 2008.** CCA 200911007 (11/24/08; released 3/13/09). This CCA addressed the amount of interest that was deductible as
"qualified residence interest" under § 163(h)(3)(A) when a residence encumbered by a purchase money mortgage of more than $1 million is co-owned by two unmarried taxpayers both of whom are obligated on the mortgage and for both of whom the residence is the principal residence. The CCA holds that the $1 million ceiling on "acquisition indebtedness," as defined in § 163(h)(3)(B), applies on a residence-by-residence basis as well as on a taxpayer-by-taxpayer basis. Its reasoning is as follows.

Under § 163(h)(3)(B)(i), acquisition indebtedness is defined, in relevant part, as indebtedness incurred in acquiring a qualified residence of the taxpayer — not as indebtedness incurred in acquiring taxpayer's portion of a qualified residence. The entire amount of indebtedness incurred in acquiring the qualified residence constitutes "acquisition indebtedness" under § 163(h)(3)(A)(I). In this case, the amount of indebtedness incurred in acquiring [the residence] exceeds $1,000,000. However, under § 163(h)(3)(B)(ii), the amount treated as acquisition indebtedness for purposes of the qualified residence interest deduction is limited to $1,000,000 of total, "aggregate" acquisition indebtedness. This is evident from the parenthetical in § 163(h)(3)(B)(ii).

- The CCA addressed only the tax consequences of one of the co-owners — the one who originally had owned the property in fee simple and was solely obligated on the mortgage and who subsequently conveyed an undivided ownership interest to a second person who also became obligated on the mortgage. The CCA concluded that the interest deductible by the taxpayer in question was to be determined by multiplying the amount of interest the taxpayer paid by a fraction: $1,000,000 divided by the amount of mortgage. Thus, for example, if the amount of the mortgage were $1,500,000 and the taxpayer paid $75,000 of interest, the amount of the taxpayer's interest deduction would be $50,000, i.e., $75,000 x ($1,000,000 ÷ $1,500,000).

- Many practitioners and tax professors had asserted prior to the issuance of this CCA that they assumed that unmarried co-owners could each deduct mortgage interest on $1 million of acquisition indebtedness, thus permitting deduction of interest on a $2 million mortgage on a home they owned in common. At least two of us believe that the reasoning and conclusion of the CCA limiting to $1 million the amount of "acquisition indebtedness" that can be taken into account collectively by all of the owners of the residence likely is correct; the third of us lives in California. A careful reading of the statutory language indicates that because § 163(h)(3)(B)(ii) omits any reference to a "taxpayer," it limits to $1 million the aggregate amount of "acquisition indebtedness" that maybe taken into account in determining the amount of "qualified residence interest" with respect to all of the taxpayers that might reside in that residential unit. If it does not do so, and each taxpayer who resides in the residence, is an owner, and is obligated on the "acquisition indebtedness" mortgage should be entitled to deduct interest paid on up to $1 million of acquisition indebtedness, then on a joint return each of the husband and wife, who are separate and distinct taxpayers (see, e.g. Frahm v Commissioner, T.C. Memo. 2007-351), would be entitled to deduct interest on up to $1 million of "acquisition indebtedness." But the statute clearly does not contemplate that result, as evidenced by the limitation on the deduction to the interest on $500,000 of acquisition indebtedness by married taxpayers who file separately. The parenthetical indicates, even though it does not expressly state, that a husband and wife who each own a one-half interest in the residence and are jointly and severally liable on the mortgage can deduct interest on up to only $1 million of acquisition indebtedness. An interpretation of the statute that applies the $1 million ceiling on "acquisition indebtedness," as defined in § 163(h)(3)(B), on both a residence-by-residence basis, and a taxpayer-by-taxpayer basis avoids this "marriage penalty" that would otherwise arise.

E. Divorce Tax Issues

1. A child who is not a dependent is a dependent for some purposes. Rev. Proc. 2008-48, 2008-36 I.R.B. 586 (8/18/08). If a child of parents who are divorced, legally separated, or living apart at all times for the last 6 months of the calendar year: (1) receives over one-half of the child's support from the parents, (2) is in the custody of one or both parents for more than one-half of the calendar year, and (3) is qualified as a qualifying child or qualifying relative of one of the parents, the child will be treated as a dependent of one or both parents for
purposes of (1) the exclusions of § 105 for medical expense insurance reimbursements, (2) § 106 for employer provided health coverage, (3) the definition of covered employees under § 132(h)(2)(B) for purposes of certain excluded fringe benefits, (4) qualifying payments from Archer Medical Savings Accounts (§ 220(d)(2)), and (5) qualifying payments from Health Savings Accounts (§ 223(d)(2)), whether or not the custodial parent has released the claim for exemption with respect to the child under § 152(e)(2). (However, absent the filing of a release, only the custodial parent is entitled to claim a dependency exemption with respect to a child.)

a. Refining the definition of qualifying child and tightening (very modestly) eligibility for the child credit. The Fostering Connections to Success and Increasing Adoptions Act, § 501, amended the definition of a qualifying child to add requirements that a qualifying child must not have filed a joint return with a spouse (other than to claim a refund) [§ 152(c)(3)(A)] and must be younger than the claimant [§ 152(c)(1)(D)]. In addition, if the parents fail to claim their child as a dependent, another taxpayer must have a higher gross income than either of the parents in order to claim the child [§ 152(c)(4)(C)]. Finally, § 24(a) was amended to limit the child credit to taxpayers eligible to claim the child as a dependent under § 151.

2. So what's this otherwise mundane reviewed case really about? Mitchell v. Commissioner, 131 T.C. No. 15 (12/15/08) (reviewed 13-2-0). In what at first blush appears to be a mundane case, the Tax Court in a reviewed opinion by Judge Goeke held that amounts paid to the taxpayer from her former spouse's military retirement pay, pursuant to a QDRO based on community property rights, were includible in the payee spouse's gross income.

- The real issue, which the majority ducked, but on which Judge Holmes wrote a comprehensive concurring opinion (with which Judge Halpern agreed) was whether the case should have been decided on the merits, as the majority so decided it, or whether the taxpayer ought to have been collaterally estopped as argued by the Commissioner. The taxpayer had previously litigated and lost the identical issue for an earlier year in an S case. Judge Holmes's exhaustive analysis concluded that collateral estoppel principles should attach to issues previously litigated in an S case if collateral estoppel would have attached if the earlier case had been a regular case.

F. Education

1. Congress extends the [paltry] deduction for college tuition, and adds ridiculous complexity. The Emergency Economic Stabilization Act of 2008 extended through 2009 Code § 222, which allows an above-the-line deduction for up to $4,000 of qualified tuition and expenses for higher education for a taxpayer with AGI of $65,000 or less ($130,000 or less for a joint return), or up to $2,000 for a taxpayer with AGI greater than $65,000 ($130,000) but not greater than $80,000 ($160,000) through 2008. The provision, which was added in 2004, had been scheduled to expire after December 31, 2007. In addition, the Act amended § 222 to disallow the qualified tuition deduction to any taxpayer for 2008 and 2009 if in the absence of the alternative minimum tax the taxpayer would have a lower tax liability for that year if he elected the Hope or Lifetime Learning credit with respect to an eligible individual instead of the qualified tuition deduction.

- We have no idea how to explain this new limitation. We would need to plug the numbers into Turbo Tax and just believe the answer it spits out.

2. Stimulating increases in college tuition. Section 1004(a) of the 2009 ARRTA added Code § 25A(i) to increase the Hope Scholarship Credit for 2009 and 2010 to the sum of (1) 100 percent of the first $2,000 of tuition, fees and course materials, and (2) 25 percent of the next $2,000, paid during the taxable year. The maximum credit is $2,500. The temporarily increased credit has been named the “American Opportunity Tax Credit.” In addition to increasing the amount of the credit, the 2009 ARRTA extends the availability of the credit to the first four years of post-secondary education (in lieu of the prior two-year rule), and adds “course materials” to the expenses eligible for the credit (previously only tuition and fees had been eligible). Thus, for 2009 and 2010, the credit can be claimed with respect to a student with respect to whom the credit already had been claimed for two years. The revised credit can be
claimed against the alternative minimum tax. Forty percent of the allowable credit is refundable, unless the taxpayer is a child subject to the § 1(g) "kiddie tax." The American Opportunity Tax Credit is phased out for taxpayers with adjusted gross income in excess of $80,000 ($160,000 for married couples filing jointly) under the same formula as the Hope Scholarship Credit.

3. A little stimulus for Apple, HP, Dell, Microsoft, etc. Section 1005(a) of the 2009 ARRTA amended Code § 529(e)(3)(A) to include as qualified expenses, amounts paid or incurred in 2009 or 2010 for computer technology or equipment (including internet access and related services) used by the beneficiary during the time the beneficiary is enrolled at an eligible institution. Expenses for computer software designed for sports, games, or hobbies do not qualify "unless the software is predominantly educational in nature" – whatever that might mean.

G. Alternative Minimum Tax
1. Making the world safe from the AMT, one year at a time. The Tax Increase Prevention Act of 2007 provided another one-year "patch" for the AMT. The 2007 exemption amounts are $44,350 for unmarried taxpayers and $66,250 for married taxpayers filing joint returns, and $33,125 for married taxpayers filing separately. The Act also extended to 2007 the special rule in §26(a)(2) allowing the otherwise nonrefundable personal credits to offset the AMT (after taking into account the foreign tax credit).

   a. Congress, save us from the AMT! Amen, again only for a year at a time. The Emergency Economic Stabilization Act of 2008 provided yet another one-year patch for the AMT.
      - The exemption amount for 2008 is increased to $46,200 for unmarried taxpayers and to $69,950 for married taxpayers filing joint returns ($34,975 for married taxpayers filing separately). (Because of the inflation adjustments in § 59(j) the lower ceiling on the AMT kiddie tax exemption amount for 2008 will be the sum of the child’s earned income plus $6,400.)
      - The rule allowing nonrefundable credits (e.g., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, and the D.C. homebuyer’s credit) to offset the AMT also was extended to 2008.
      - The refundable credit rules also were modified. First, the refundable credit includes the § 53(f)(2) AMT credit for 2008 and 2009 of 50 percent of the aggregate amount of the interest and penalties paid by the taxpayer before October 3, 2008, as a result of failure to report AMT liability resulting from application of the § 56(b)(3) treatment of ISOS requiring taxation under § 83 for AMT purposes. Second, the $5,000 minimum allowable credit was eliminated. Third, as amended, § 53(e) provides a refundable credit amount for a tax year in an amount (not in excess of the long-term unused minimum tax credit for the tax year) equal to the greater of (1) 75% of the long-term unused minimum tax credit for the tax year (instead of 20 percent under prior law), or (2) the AMT refundable credit amount (if any) for the taxpayer’s preceding tax year (determined without regard to the increased AMT refundable credit amount allowed under § 53(f)(2)). [The change of 20% to 50% means that the long-term unused minimum tax credit can be claimed over a two-year period rather than a five-year period.] Fourth, the AGI phase-out was eliminated.
      - New §53(f)(1) abates any underpayment of tax outstanding on October 3, 2008, that is attributable to the application of the § 56(b)(3), requiring taxation of ISOS under § 83 for AMT purposes, for any taxable year ending before January 1, 2008, as well as any interest or penalty with respect to such underpayment. Any outstanding AMT liability that has been abated under § 53(f)(1) cannot be taken into account in computing the AMT credit.

2. Whittling away yet more at the original purpose of the AMT: Why not just rename it the "special tax on blue state taxpayers with kids." Code § 57(a)(5)(vi), added by § 1503(a) of the 2009 ARRTA, provides that interest on private activity bonds issued in 2009 and 2010 will not be treated as a tax preference item for AMT purposes; if the bond is issued in one of those years the interest will be tax-exempt for purposes of the AMT (as well as for regular
VI. CORPORATIONS

A. Entity and Formation

1. To check the box 75 days is extended to 3 years and 75 days. Rev. Proc. 2009-41, 2009-39 I.R.B. __ (9/3/09). Reg. § 301.7701-3(c)(1) provides that an election by 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. 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. No. 4 (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 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. The dog food corporation precedent wasn’t the people’s food corporation’s best friend. General Mills v. United States, 554 F.3d 727, 103 A.F.T.R.2d 2009-589 (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. No. 4 (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.

2. The Tax Court is bearish on Merrill Lynch. Merrill Lynch & Co. v. Commissioner, 120 T.C. 12
(1/15/03). In 1986 and 1987 Merrill Lynch structured several transactions to sell certain assets of first-tier and second-tier subsidiaries and not only eliminate any tax on the gains, but to create losses. To take advantage of the interaction of the consolidated return regulations and § 304 [before the promulgation of Reg. § 1.1502-80(b), rendering § 304 inoperative in consolidated returns], Merrill Lynch caused the subsidiaries holding the assets to drop the assets to be retained into new lower level subsidiaries [in § 351 transactions], following which the new subsidiaries were sold cross chain to other Merrill Lynch subsidiaries. The sales proceeds were then distributed to its parent by the subsidiary to be sold, and that subsidiary was then sold. The plan was that the cross-chain sale would be recharacterized as a dividend under § 304, which would result in a basis increase under Reg. §§ 1.1502-32 and -33 [as then in effect] in the stock of the subsidiaries to be sold. The IRS did not contest that § 304 applied, but responded that the “distributions” coupled with the sales of the subsidiaries outside the group were part of a firm and fixed plan by the subsidiaries that were sold outside the group to dispose of the stock of the lower tier subsidiaries that had been sold cross chain. Therefore, even after applying § 304 the distributions were treated as amounts received in a redemption under § 302(b)(3) [applying Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954)]. The Tax Court (Judge Marvel) held that under the principles of Niedermeyer v. Commissioner, 62 T.C. 280 (1974), a firm and fixed plan existed with respect to every such sale and held for the IRS.

The record establishes that on the dates of the cross-chain sales, petitioner had agreed upon, and had begun to implement, a firm and fixed plan to completely terminate the target corporations’ ownership interests in the issuing corporations (the subsidiaries whose stock was sold cross-chain). The plan was carefully structured to achieve very favorable tax basis adjustments resulting from the interplay of section 304 and the consolidated return regulations, and the steps of the plan were described in detail in written summaries prepared for meetings of Merrill Parent’s board of directors. As described in those written summaries, the cross-chain sales of the issuing corporations’ stock and the sales of the target corporations were part of the same seamless web of corporate activity intended by petitioner to culminate in the sale of the target corporations outside the consolidated group.

a. As is the Second Circuit, which affirmed the Tax Court. 386 F.3d 464 (2d Cir. 9/28/04). On appeal Merrill Lynch argued for the first time that the proceeds of the cross-chain sales should be treated as § 301 dividends, even if the actual and constructive ownership interest in the subsidiary corporation that was sold was completely terminated, because Merrill Lynch retained a constructive ownership interest in the purchased subsidiaries for purposes of § 302(b)(3). The Second Circuit remanded the case for consideration of this issue.

b. Now the Tax Court is bearish on Bank of America (as well as on Ken Gideon and Marty Ginsburg). 131 T.C. No. 19 (12/30/08). On remand, the taxpayer argued that because its ownership interest in the issuing corporations was not completely terminated within the meaning of § 302(b)(3), it properly reported sales proceeds as dividends. The taxpayer’s argument went as follows: (1) Immediately before the cross-chain sales, the acquiring corporation was a wholly owned subsidiary; (2) under the § 318 attribution rules, ownership of the issuing corporations was also attributed to it its ownership of their parent; and (3) after the sale of the subsidiaries’ former parent [the seller in the cross-chain sale], the
taxpayer continued constructively to own 100 percent of the stock of the issuing corporations through its ownership of the acquiring corporations. The Tax Court (Judge Marvel) rejected the taxpayer’s argument and agreed with the Commissioner that the rules in §§ 302 and 304 “apply only to the shareholder who, in exchange for stock, actually receives the proceeds of a cross-chain sale. The position that the section 302(b) tests may be applied to a shareholder who indirectly or constructively holds stock but has neither transferred any stock nor received the proceeds of the stock sale cannot be reconciled with the language and structure of section 304(a)(1).” The subsidiary-parent that was sold by the taxpayer was the only “person” who transferred any stock to the acquiring subsidiary corporations in the cross-chain sales, and it was the only shareholder that received property from the acquiring corporations in exchange for stock in the issuing corporations. Consequently, it was the only shareholder whose interest in the issuing corporations should be tested under section 302(b)(3). Because its interest in the issuing corporations was completely terminated upon its sale outside of the affiliated group, the redemption was a distribution in exchange for stock.

3. Every share of stock is a separate item of property and the results of (almost) every Subchapter C transaction should be determined with respect to the consideration received in regard to each share. REG-143686-07, The Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities, 74 F.R. 3509 (1/21/09). The Treasury and IRS have published proposed regulations under §§ 301, 302, 304, 351, 354, 356, 358, 368, 861, 1001, and 1016 regarding the recovery of stock basis in (1) § 301 distributions and transactions that are treated as § 301 distributions, (2) sale and exchange transactions to which § 302(a) applies (including certain aspects of reorganization exchanges. The proposed regulations also provide the method for determining gain realized under § 356 and make a number of clarifying, but nonsubstantive, modifications to the rules for determining stock basis under § 358 resulting from a reorganization. The core principal underlying the rules is that each share of stock is a separate unit of property that can be sold or exchanged and the results of a transaction should be determined with respect to the consideration received in regard to each share.

- **Section 301 distributions** — A § 301 distribution is received on a pro rata, share-by-share basis with respect to the class of stock upon which the distribution is made. Prop. Reg. § 1.301-2. A distribution that is not a dividend under §§ 301(c)(1) and 316 can result in gain with respect to some shares of a class while other shares have unrecovered basis. (This is consistent with the holding in Johnson v. United States, 435 F.2d 1257 (4th Cir. 1971).)

- **Dividend equivalent redemptions** — The same basis recovery rules that apply to §301 distributions apply to redemptions that do not qualify under § 302(a) and (b) ("dividend-equivalent redemptions") and § 304 transactions that are taxed under § 301. Prop. Reg. §§ 1.302-5(a); 1.304-2. A dividend equivalent redemption results in a pro rata, share-by-share distribution to all shares of the redeemed class held by the redeemed shareholder immediately before the redemption. The term “redeemed class” means all of the shares of that class held by the redeemed shareholder. Only the basis of shares of the redeemed class may be reduced before gain is realized. Dividend equivalent redemptions can produce gain with respect to some shares while other shares have unrecovered basis.

- Basis adjustments in dividend equivalent redemptions if less than all of the shares of a single class held by the taxpayer are redeemed — If less than all of the shares of a class of stock held by the taxpayer are redeemed, the redeemed shareholder is treated as exchanging in a tax-free reorganization all of the shares in the class owned before the redemption for the number of shares held after the redemption transaction. Prop. Reg. § 1.302-5(2). Reg. § 1.358-2 applies to preserve the basis of the shares in the shareholder’s remaining shares. Thus, a dividend equivalent redemption is generally treated in the same manner, and its results are the same as, a § 301 distribution in which no shares were cancelled.

- **Example** — A owns all 100 shares of the common stock (the only class) of X Corporation. At different times, A acquired 50 shares for $100 (block 1) and 50 shares for $200 (block 2). The corporation, which has no earnings and profits, redeems all of A’s block 2 shares for $300. Under §§ 302(d) and 301, the redemption proceeds are treated as a recovery
of basis. The distribution of property is applied on a pro rata, share-by-share basis with respect to each of the shares in the redeemed class owned by A before the redemption. Thus, A recognizes a $50 capital gain on block 1 ($150-100) under §301(c)(3) and has $50 of basis remaining in block 2 ($150-200). To reflect the actual number of shares held by A after the redemption, A's shares in the redeemed class, including the shares actually surrendered, will be treated as exchanged in a recapitalization under section 368(a)(1)(E). A's basis in the 50 recapitalized shares is determined under Reg. §1.358-2. Thus, A has 25 shares with a zero basis (attributable to block 1) and 25 shares with a basis of $50 (attributable to block 2).

- **Basis recovery in dividend equivalent redemptions in which the taxpayer surrenders all of its shares in a single class** — If all of the shares of a single class held by a shareholder are redeemed in a dividend equivalent redemption, under Prop. Reg. §1.302-5(a)(3), the unrecovered basis is treated as a deferred loss that can be used by the shareholder when (1) the conditions of §§ 302(b)(1), (2), or (3) are satisfied, or (2) when all the shares of the issuing corporation (or its successor) become worthless under §165(g). [The current rules in Reg. §1.302-2(c) that permit unrecovered basis in the redeemed shares to shift to other shares would be revoked.]

- **Dividend equivalent reorganization exchanges** — If boot is received in a reorganization that qualifies under §368, the proposed regulations provide that the overall reorganization exchange is taken into account in determining whether a particular exchange in which boot is received is dividend equivalent. For example, if a shareholder exchanges one class of stock for stock and boot and exchanges another class of stock solely for boot, the effect of the overall exchange is considered in determining whether each particular exchange is dividend equivalent. If the boot received in the exchange is a dividend equivalent, an exchange of a class of stock solely for boot is an exchange to which §302(d), and thus §301, rather than §356(a)(2), applies. However, the boot is treated as received pro rata, on a share-by-share basis, with respect to each share in the class. If both stock and boot are received with respect to a surrendered class (or classes) of stock and the boot is dividend equivalent, all of the consideration received in the exchange is treated as received pro rata (by value) with respect to all surrendered shares in the class. Prop. Reg. §§ 1.354-1(d); 1.356-1(b). However, economically reasonable designations between classes of stock or securities (as opposed to within a class) generally will be recognized.

- **Redemptions given sale or exchange treatment by §302** — The proposed regulations do not change the rule that in a §302 redemption, a shareholder who owns shares of stock with different bases can decide whether to surrender high basis shares, low basis shares or any combination thereof, as permitted by Reg. §1.1012-1(c). The acquiring corporation shall take a cost basis in the stock of the issuing corporation that it acquires under §1012. If §304 applies and the sale of issuer stock is treated as a sale or exchange, rather than as a §301 distribution, the basis and the holding period of the common stock of the acquiring corporation that is treated as redeemed will be the same as the basis and holding period of the stock of the issuing corporation actually surrendered.

- **Reorganization exchanges resulting in sale or exchange treatment** — If boot received in a reorganization is not a dividend equivalent, §302(a) applies to the extent shares are exchanged solely for boot. A shareholder can elect to surrender high basis shares, low basis shares or any combination thereof in a non-dividend equivalent redemption, a shareholder engaging in a reorganization exchange in which the boot is not dividend equivalent can designate the shares with respect to which the boot was received and the amount of boot received with respect to each share, provided that the terms of the exchange are economically reasonable. Prop. Reg. §1.354-1(d)(1). If solely boot is received with respect to a share, the shareholder will recognize gain or loss with respect to that share pursuant to §302(a), and §356(a)(1) will not apply. Nor will §356(c) deny the loss. Prop. Reg. §1.354-1(d)(2).

- **Section 351 exchanges** — Prop. Reg. §1.351-2(b) would provide that the amount of gain recognized under §351(b) as a result of the receipt of boot, is determined by allocating the fair market value of each category of consideration received by a transferor among the transferred properties in proportion to each property's relative fair market value. This is the approach of Rev. Rul. 68-55, 1968-1 C.B. 140. Prop. Reg. §1.358-2(g) provides as a general rule that in a §351 exchange, the aggregate basis of the property transferred (as adjusted
for gain and boot) is allocated among all of the shares of stock received in proportion to the fair market values of each share of stock. However, under Prop. Reg. § 1.358-2(g), if a shareholder transfers stock and other property, the separate bases will be preserved in the § 358 basis of the stock received in the exchange, provided that no liabilities are assumed in the exchange.

4. Does this case mean an "accidental" benefit conferred on a corporate shareholder is not a constructive dividend? Cox Enterprises Inc. v. Commissioner, T.C. Memo. 2009-134 (6/9/09). A member of Cox Enterprises affiliated group transferred the assets of a television station to a partnership in exchange for a majority interest in the partnership; two family partnerships, the partners of which were family members of three trusts that together held a 98 percent majority interest in Cox Enterprises contributed cash to the partnership and received minority interests. The IRS asserted that under § 311(b), the Cox Enterprises group recognized income on the constructive transfer to the trusts of a portion of the partnership interest it received in exchange for the assets because the partnership interest received by the Cox Enterprises group member that transferred the assets was worth $60.5 million less than the value of the transferred assets. The Commissioner's theory was that the Cox Enterprise group had constructively distributed a dividend of an economic portion of its partnership interest to the shareholder trusts by transferring to family partnerships 'for the benefit of' the shareholder trusts. On the taxpayer's motion for summary judgment, for purposes of the motion, the $60.5 million disparity was between the value of the assets and the value of the partnership interest it received in return was admitted. Judge Halpern found that the undisputed facts established that Cox Enterprises' primary purpose was not to provide an economic benefit to them and, derivatively, to the shareholder trusts. In summarizing the applicable case law, he quoted Gilbert v. Commissioner, 74 T.C. 60, 64 (1980): "[T]ransfers between related corporations can result in constructive dividends to their common shareholder if they were made primarily for his benefit and if he received a direct or tangible benefit.' If the benefit to the shareholder is 'indirect or derivative in nature, there is no constructive dividend.'" Applying this legal standard to his factual conclusion, there was not a constructive dividend to the shareholder trusts, even though an economic benefit was conferred on the beneficiaries of the shareholder trusts. Judge Halpern found the transfer of the television station to the partnership had a business purpose and that because a gratuitous transfer of assets would have violated the board of directors' fiduciary duty, a purpose to make a gratuitous transfer could not be assumed to exist merely due to the value disparity. Accordingly, no gain was recognized under § 311(b). Judge Halpern rejected the Commissioner's argument that to find a constructive dividend "it is only necessary to establish that appreciated assets left the corporate solution ***, for the benefit of its Shareholder Trusts, to establish that there has been a distribution with respect to [the] Shareholder Trusts' stock to which section 311 applies."

5. 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 allowance 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. Short-term beneficial treatment for charitable contributions through an S corporation teaches why you shouldn’t make future charitable contributions of appreciated property through an S corporation unless the law changes. Rev. Rul. 2008-16, 2008-11 I.R.B. 585 (3/17/08). If an S corporation made a charitable contribution of appreciated property during a taxable year beginning after 12/31/05, and before 1/1/08, the shareholder’s deduction may not exceed the sum of: (1) the shareholder’s pro rata share of the fair market value of the contributed property over the contributed property’s adjusted tax basis, and (2) the amount of the § 1366(d) loss limitation amount that is allocable to the contributed property’s adjusted basis under Reg. § 1.1366-2(a)(4). Any disallowed portion of the contribution retains its character and is carried over.
a. The Tax Technical Corrections Act of 2007 added § 1366(d)(4), which provides, in effect, that the basis limitation rule of § 1366(d)(1) does not apply to the amount of deductible appreciation in the contributed property in taxable years beginning after 12/31/05, and before 1/1/08.

b. The Pension Protection Act of 2006 amended § 1367(a)(2) to provide that the decrease in shareholder basis under § 1367(a)(2)(B) by reason of a charitable contribution of property is the amount equal to the shareholder’s pro rata share of the adjusted basis of such property in taxable years beginning after 12/31/05, and before 1/1/08.


Absent further statutory change, charitable contributions made by S corporations in subsequent taxable years are subject to the law in existence prior to these amendments [i.e., stock basis will be reduced by the full amount of the deduction]. The IRS and Treasury Department are considering issuing guidance on the treatment of charitable contributions made by S corporations in subsequent taxable years.

2. Proposed regulations restrict the use of open account debt to increase basis and deduct losses. REG-144859-04, Section 1367 Regarding Open Account Debt, 72 F.R. 18417 (4/12/07). Prop. Reg. § 1.1367-2(a), (c)(2), (d), & (e), Ex.6, would limit open account debt from an S corporation to a shareholder to debt not evidenced by written instruments for which the principal amount of aggregate advances, net of repayments, does not exceed $10,000 at the close of any day during the S corporation’s taxable year. The proposed regulations will reverse the result in Brooks v. Commissioner, T.C. Memo. 2005-204 (8/25/05), which allowed an S corporation shareholder to borrow money from a bank, advance the funds to the shareholder’s S corporation which increased basis and allowed loss deductions, receive payment of the debt in the subsequent taxable year, repay the bank, then at the end of the year again borrow funds to avoid gain on release from the low basis debt and deduct further losses. Thus the taxpayer was able to create endless deferral of gain. The preamble to the proposed regulations indicates that the purpose of the open account debt provisions is administrative simplicity. Whenever advances not evidenced by written instruments exceed $10,000, the indebtedness will be treated as a separate indebtedness for which payments and advances are separately determined for purposes of basis and gain recognition on repayment.

a. Regulations are now final, with relaxing modifications. T.D. 9428, Section 1367 Regarding Open Account Debt, 73 F.R. 62199 (10/20/08). The final regulations adopt a $25,000 aggregate principal threshold amount per shareholder for open account debt. Generally, this determination is to be made at the end of the taxable year – with exceptions for dispositions of shareholder debt and termination of a shareholder’s interest (for which the determination is to be made immediately before the event).

3. Gitlitz by analogy? “Not,” says the Tax Court. Nathel v. Commissioner, 131 T.C. No. 17 (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 the capital of 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.

- Reg. § 1.118-1 provides that "if a corporation requires additional funds for conducting its business and obtains such funds through *** payments by its shareholders *** such amounts do not constitute income." Thus, shareholder capital contributions are not treated as items of income to an S corporation under § 1366(a)(1) and are not taken into account in calculating the "net increase" under § 1367(b)(2)(B) for the purpose of restoring or increasing a shareholder's tax basis in loans a shareholder made to an S corporation. Such capital contributions are not "tax-exempt income" under § 1366(a)(1) nor under Reg. § 1.1366-1(a)(2)(viii) and do not restore or increase the bases in shareholder loans under § 1367(b)(2)(B).

4. **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 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.

5. **Suspending the built-in gains tax to goose the economy by encouraging disinvestment in business assets.** Section 1251(a) of the 2009 ARRTA amended Code § 1374 to exempt an S corporation from the built-in gains tax for taxable years beginning in 2009 and 2010 if the seventh taxable year in the recognition period preceded the 2009 and 2010 tax years. This rule applies separately for property acquired from C corporations in carryover basis transactions.

6. **Poof! A formerly unincorporated entity can move directly to S corporation status.** Rev. Rul. 2009-15, 2009-21 I.R.B. 1035 (5/7/09). When an unincorporated entity taxed as a partnership becomes a corporation for federal tax purposes, the corporation is eligible to elect to be taxed as an S corporation effective for its first taxable year as a corporation. Additionally, the corporation will not be deemed to have an intervening short
taxable year in which it was a C corporation. These results occur whether: (1) the entity is an unincorporated entity classified as a partnership that both (a) elects under Reg. § 301.7701-3(e)(1)(i) to be treated as a corporation, and (b) elects under § 1362(a) to be taxed as an S corporation, with both elections effective on the same date; or (2) the entity is an unincorporated entity classified as a partnership that both (a) converts into a corporation under a state law formless conversion statute, and (b) elects under § 1362(a) to be taxed as an S corporation, with both elections effective on the same date.

7. Roth IRA is not an eligible S corporation shareholder. Taproot Administrative Services, Inc. v. Commissioner, 133 T.C. No. 9 (9/29/09). The taxpayer S 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 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.)

E. Reorganizations

1. Continuity of interest is satisfied when the target corporation’s creditors get stock in the acquirer. T.D. 9434, Creditor Continuity of Interest, 73 FR 75566 (12/12/08). In 2005 the Treasury Department published proposed regulations describing the circumstances in which a corporation’s creditors will be treated as holding a proprietary interest in a target corporation immediately before a potential reorganization. REG-163314-03, Proposed Rules, Transactions Involving the Transfer of No Net Value, 70 F.R. 11903-01 (3/10/05). These regulations have been finalized with only minor modifications and clarifications, and they apply for continuity of interest purposes both within and outside of bankruptcy proceedings. The regulations adopt the holding in Helvering v. Alabama Asphalitic Limestone Co., 315 U.S. 179 (1942), that a transfer of assets pursuant to which creditors of a bankrupt concern became the controlling stockholders of a new corporation provided the requisite continuity of interest for a reorganization. The preamble notes extending the reorganization rules to reorganizations of insolvent corporations outside of bankruptcy is consistent with Congress’s intent to facilitate the rehabilitation of troubled corporations. Reg. § 1.368-1(e)(6) describes the circumstances in which creditors of a corporation generally, and which creditors in particular, will be treated as holding a proprietary interest in a target corporation immediately before a potential reorganization. In general, the regulation adopts the standard for reorganizations under § 368(a)(1)(G) recommended in the Senate Finance Committee Report to the Bankruptcy Tax Act of 1980. Claims of the most senior class of creditors that receive a proprietary interest in the issuing corporation and claims of all equal classes of creditors (the senior claims) and all junior claims represent proprietary interests in the target corporation. The value of proprietary interests in the target corporation represented by the senior claims is calculated with reference to the average treatment for all senior claims. The value of a senior claim’s proprietary interest in the target is determined by multiplying the fair market value of the creditor’s claim by a fraction, the numerator of which is the fair market value of the proprietary interests in the issuing corporation that are received in the aggregate in exchange for the senior claims, and the denominator of which is the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in the issuing corporation) received in the aggregate in exchange for such claims. The value of the proprietary interest in the target corporation
represented by a junior claim is the fair market value of the junior claim. Thus, there is 100 percent continuity of interest if each senior claim is satisfied with the same ratio of stock to nonstock consideration and no junior claim is satisfied with nonstock consideration. Where only one class of creditors receives stock, more than a de minimis amount of acquiring corporation stock must be exchanged for the creditors' proprietary interests relative to the total consideration received by the insolvent target corporation, its shareholders, and its creditors, before the stock will be counted for purposes of continuity of interest.

2. Some rules designed to trace basis in an era of paper stock certificates no longer work. Notice 2009-4, 2009-2 I.R.B. 251 (12/12/08). This notice explains the guidance that the IRS contemplates issuing regarding the determination of the transferred basis in stock that has been acquired in a §368(a)(1)(B) reorganization. Rev. Proc. 81-70, 1981-2 C.B. 729, which provided guidelines for surveying surrendering shareholders to determine the basis of Target stock and sampling and estimation procedures to address administrative burdens and shareholder nonresponsiveness is outdated because at the time Rev. Proc. 81-70 was published, most stock was registered stock, but now stock of public companies is primarily held in street name, often with several tiers of nominee owners, each subject to confidentiality.

F. Corporate Divisions

1. "Hot stock" cools off in a DSAG. T.D. 9435, Guidance Regarding the Treatment of Stock of a Controlled Corporation Under Section 355(a)(3)(B), 73 FR 75946-01 (12/25/08). The Treasury has promulgated Temp. Reg. §1.355-2T(g), dealing with the "hot stock" rule of §355(a)(3)(B) to conform to the 2006 amendments of §335(b)(3), creating the "SAG" rules, which treat a corporation's SAG [separate affiliated group] as a single corporation for purposes of determining whether the active trade or business requirements of §355 have been met. Section 355(a)(3)(B) provides that stock of a controlled corporation that has been acquired by the distributing corporation in a taxable transaction within the five year period preceding distribution to stockholders otherwise qualifying under §355 will be treated as boot taxable to the stockholders. Generally speaking, the temporary regulations provide that the hot stock of §355(a)(3)(B) rule does not apply to any acquisition of stock of controlled where controlled is a DSAG [separate affiliated group of the distributing corporation] member at any time after the acquisition (but prior to the distribution of controlled). Transfers of controlled stock owned by DSAG members immediately before and immediately after the transfer are disregarded and are not treated as acquisitions for purposes of the hot stock rule. (Prop. Reg. §1.355-3(b)(1)(ii) would apply a similar rule for purposes of the ATB requirement.) The temporary regulations also incorporate the exception of former Reg. §1.355-2(g), which provides that the hot stock rule does not apply to acquisitions of controlled stock by distributing from a member of the affiliated group (as defined in Reg. §1.355-3(b)(4)(iv)) of which distributing was a member. The regulations generally apply to distributions occurring after December 15, 2008, but there are a number of transition rules. Taxpayers also may elect to apply the regulations to distributions made after May 17, 2006.

a. REG-150670-07, Guidance Regarding the Treatment of Stock of a Controlled Corporation Under Section 355(a)(3)(B), 73 F.R. 75979 (12/15/08). The Temporary Regulations are also published as proposed regulations.

G. Affiliated Corporations and Consolidated Returns

1. The "single entity" theory of consolidated returns only goes so far when it conflicts with the actual rules. Brunswick Corp. v. United States, 102 A.F.T.R.2d 2008-7365 (N.D. Ill. 12/22/08). Brunswick acquired the stock of Bayliner Marine and Sea Ray in December 1986 and made a §338(g) election (at a time when pre-TRA 1986 §337 shielded gain recognition and §338 provided a tax-free basis step up). Brunswick claimed a refund on the ground that the §168 ACRS deductions with respect to the stepped-up basis should have been computed by applying the half-year convention to Brunswick's taxable year (a calendar year), because it was the parent of the group filing the consolidated return on which the depreciation deductions were reported. Brunswick argued that United Dominion Industries, Inc. v. United States, 532 U.S. 822 (2001) requires that all tax items be considered at the consolidated group
level, not the subsidiary level. The government took the position that the half-year convention for computing first year § 168 ACRS deductions should be determined with reference to Bayliner Marine's and Sea Ray's short taxable years, beginning the day after the election and ending on December 31th. The court agreed with the government, concluding that Reg. §§ 1.1502-11(a)(1) and 1.1502-12 provide that the separate taxable income of each member of the consolidated group, including depreciation deductions, must be computed, with certain exceptions not relevant on the facts of the case, on the subsidiary level. Looking at the subsidiary level, New Bayliner and New Sea Ray had short taxable years. This means that under § 168(f)(5), they must prorate their depreciation deductions in computing their separate taxable incomes that are included on Brunswick’s consolidated return. Thus, the short taxable years of “New Bayliner” and “New Sea Ray” were the relevant tax years, not Brunswick’s taxable year. The court also rejected, as “inconsistent with the statutory scheme” Brunswick’s argument that under § 338, it, not New Bayliner and New Sea Ray, was the purchaser of the subsidiaries assets in the deemed sale and purchase.

2. Are “new and more precise mechanics” synonymous with “ever-more complicated”? REG-107592-00, Consolidated Returns; Intercompany Obligations, 72 F.R. 55139 (9/28/07). The IRS has proposed amendments to Reg. § 1.1502-13(g) with respect to the treatment of obligations between members of a consolidated group. Reg. 1.1502-13(g) applies to three types of transactions: (1) transactions in which an obligation between a group member and a nonmember becomes an intercompany obligation – for example, the purchase by a consolidated group member of another member’s debt from a nonmember creditor or the acquisition by a consolidated group member of stock of a nonmember creditor or debtor (inbound transactions); (2) transactions in which an intercompany obligation ceases to be an intercompany obligation – for example, the sale by a creditor member of another member’s debt to a nonmember or the deconsolidation of either the debtor or creditor member (outbound transactions); and (3) transactions in which an intercompany obligation is assigned or extinguished within the consolidated group (intragroup transactions). The proposed regulations “adopt new and more precise mechanics” for the application of the deemed satisfaction-reissuance model to intragroup and outbound transactions. The following sequence of events to occur immediately before, and independently of, the actual transaction: (1) the debtor is deemed to satisfy the obligation for a cash amount equal to the obligation’s fair market value; and (2) the debtor is deemed to immediately reissue the obligation to the original creditor for that same cash amount. The parties are then treated as engaging in the actual transaction but with the new obligation. With respect to inbound transactions, the IRS and the Treasury Department have concluded that the mechanics of the deemed satisfaction-reissuance model and its application produce appropriate results and, therefore, no change has been proposed.

a. Finalized with various clarifications! T.D. 9442, Consolidated Returns; Intercompany Obligations, 72 F.R. 55139 (1/5/09). The proposed regulations have been finalized without any significant change in the basic framework of the rules. Some of the anti-abuse rules have been modified. The final regulations also clarify that the routine modification exception applies to a deemed exchange of intercompany debt for intercompany debt that occurs under Reg. § 1.1001-3 as a result of an assumption transaction. The final regulations also clarify that an exception for certain § 351 nonrecognition exchanges is available for transactions in which a debtor’s obligation is assumed. An exception also applies to exchanges to which both §§ 332 and 337(a) apply in which no amount is recognized by either the creditor or debtor member.

3. Modernizing the “controlled group” definition regulations. T.D. 9451, Guidance Necessary to Facilitate Business Election Filing; Finalization of Controlled Group Qualification Rules, 74 F.R. 25147 (5/26/09). This Treasury decision has finalized Prop. Reg. § 1.1563-1, REG-161919-05, 71 F.R. 76955 (12/22/06), with no substantive changes. Temp. Reg. § 1.1563-1T has been removed. Amendments to § 1563(a) in 2004 expanded the definition of a brother-sister controlled group to a group of corporations if five or fewer persons who are individuals, estates, or trusts own stock more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all
classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation. Prior to the 2004 amendments, the definition also required the same five or fewer taxpayers to own at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each corporation (the 80 percent requirement). The revised regulation reflects the elimination of the 80 percent requirement from the §1563(a)(2) definition of a brother-sister controlled group. The regulations also clarify an S corporation is treated as a component member of a controlled group only to the extent that a particular tax, and thus a particular tax benefit item to which §1561(a), applies. In addition, as amended, the regulations refer generically to the tax benefit items listed in §1561(a) rather than refer specifically to those items by listing and describing each one. Each component member of a controlled group must annually file a form (Form 1120, Schedule O) with its tax return indicating whether or not an apportionment plan is in effect, and any change is made to the group’s apportionment of its §1561(a) tax benefit items from the previous year. The new regulations also provide ministerial changes to facilitate e-filing.

4. A controlled corporation is not a controlled corporation, except when it is controlled. REG-13505-07, 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). 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. The proposed regulation would add §1.1563-1(a)(1)(ii) to provide that in determining whether a corporation is included as a member of a controlled group, §1563(b) would not be taken into account. The IRS indicates its belief that the provision is supported by clear statutory language.

H. Miscellaneous Corporate Issues

1. Can’t the IRS spell FANNIE MAE and FREDDIE MAC when $5 trillion is at stake? Notice 2008-76, 2008-39 I.R.B. 768 (9/7/08). Sections 1117(a) and (b) of the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 (2008), authorize the Treasury Department to purchase obligations and other securities issued by FANNIE MAE and FREDDIE MAC—described in the notice as “certain entities” to protect the names of the guilty parties. The IRS and Treasury will issue regulations under §382(m) that will provide that notwithstanding any other provision of the Code or the regulations, for purposes of §382, with respect to a corporation as to which there was such an acquisition, the term “testing date” (as defined in Reg. §1.382-2(a)(4)) will not include any date on or after the date on which the United States (or any agency or instrumentality thereof) acquires stock or an option to acquire stock in the corporation. The regulations will apply on or after 9/7/08. Thus, the bailout of FANNIE MAE and FREDDIE MAC will not trigger an ownership change invoking the §382 limitations on NOLs.

- Various media outlets attribute the substance of the provisions of the notice to Henry Paulson, who is reported to have ordered the IRS to issue the notice. See http://www.cfo.com/article.cfm/12079734/c_12079931?f=home_todayfinance

2. Who needs Congress to legislate billions of tax benefits via loss carryovers from failing banks which have undergone ownership changes? Notice 2008-83, 2008-42 I.R.B. 905 (10/1/08). Taxpayers which have acquired failing banks will not be limited by §382(h) in their deductions for losses on loans or bad debts. Under this notice, these losses
“shall not be treated as a built-in loss or a deduction that is attributable to periods before the [ownership] change date.” This notice applies whether the acquirer is a private investor (including another bank) or is the Treasury.

a. Congress tells Treasury and the IRS, “You can’t do that, but we can grandfather what you did. So there, take this.” Section 1261 of 2009 ARRTA, an uncodified provision, generally voided Notice 2008-83 for ownership changes occurring after 1/16/09. However, Notice 2008-83 will be applied to (1) any ownership change occurring on or before 1/16/09, and (2) any ownership change that occurs after 1/16/09, if the change (a) is pursuant to a written binding contract entered in to on or before 1/16/09, or (b) was described on or before that date in a public announcement or in a filing with the SEC required by reason of the ownership change.

3. Again, who needs Congress to permit continued use of loss carryovers of corporations whose toxic paper is acquired by Treasury? Notice 2008-100, 2008-44 I.R.B. 1081 (10/15/08). This notice provides guidance on the application of § 382 to loss corporations whose financial instruments are acquired by Treasury as part of the Capital Purchase Program pursuant to EESA. Under this program, Treasury will acquire preferred stock and warrants from qualifying financial institutions. This notice specifies that Treasury will not be treated as a 5 percent shareholder for this purpose.

a. Notice 2009-14, 2009-7 I.R.B. 516 (2/2/09). This Notice amplifies and supersedes Notice 2008-100, 2008-44 I.R.B. 1081, regarding the [non]application of § 382 to corporations the stock or options of which are acquired by the Treasury Department under the Troubled Asset Relief Program. This guidance is optional for taxpayer use, and is focused on treatment of debt, preferred stock, common stock, warrants, and redemption of stock held by the Treasury Department. Any capital contributions made by the Treasury pursuant to TARP programs will not be considered to have been made as part of a plan the principal purpose of which was to avoid or increase any § 382 limitation.

b. Section 1262 of the 2009 ARRTA added new Code § 382(n), which provides that the § 382 limitations on NOLs do not apply to certain ownership changes under a restructuring plan which (1) is required under a loan agreement or a commitment for a line of credit entered into with the Treasury Department under the Emergency Economic Stabilization Act of 2008, and (2) is intended to result in a rationalization of the costs, capitalization, and capacity with regard to the manufacturing workforce of, and suppliers to, the taxpayer and its subsidiaries. This waiver of § 382 does not apply, however, to an ownership change if, immediately after the ownership change, any person (other than a VEBA under § 501(c)(9)) owns either fifty percent or more of the total combined voting power or value of the stock of the old loss corporation. Related persons (as defined in §§ 267(b) or 707(b)) and persons who are members of a group acting in concert (§ 382(n)(3)(B)) are treated as a single person. The waiver of § 382 does not apply to a subsequent ownership change, unless that ownership change also is described in the preceding sentence. Section 382 is effective for ownership changes occurring after 2/17/09.

c. Notice 2009-38, 2009-18 I.R.B. 901 (4/14/09). This notice amplifies and supersedes Notice 2009-14 to provide guidance to corporate issuers with respect to Treasury’s acquisition of instruments pursuant to the following EESA programs: (I) the Capital Purchase Program for publicly-traded issuers (Public CPP); (ii) the Capital Purchase Program for private issuers (Private CPP); (iii) the Capital Purchase Program for S corporations (S Corp CPP); (iv) the Targeted Investment Program (TARP TIP); (v) the Asset Guarantee Program; (vi) the Systemically Significant Failing Institutions Program; (vii) the Automotive Industry Financing Program; and (viii) the Capital Assistance Program for publicly-traded issuers (TARP CAP).

4. Help! Stop me before I give away any more money without congressional action. Notice 2008-101, 2008-44 I.R.B. 1082 (10/15/08). This notice specifies that TARP funds received by banks for “troubled assets” will not be treated as “the provision of Federal financial assistance” within the meaning of § 597. That Code section requires that “Federal financial assistance shall be properly taken into account by the institution from which
the assets were acquired.”

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. I.R. 2008-110 (9/25/08). The IRS is considering the issue of guidance regarding technical termination of publicly traded partnerships under § 708(b) resulting in multiple taxable years of an affected partnership due to transfers of more than 50 percent of a partnership’s capital and profits interests in a 12-month period.

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

1. Partnership debt for equity swaps. Holy Asymmetry! The partners have COD income but the creditor doesn’t have a loss deduction. REG-164370-05, Section 108(e)(8) Application to Partnerships, 73. F.R. 64903 (10/31/08). As amended by the American Jobs Creation Act of 2004, § 108(e)(8) provides that for purposes of determining COD income of a partnership, if debtor partnership transfers a capital or profits interest to a creditor in satisfaction of either recourse or nonrecourse partnership debt the partnership is treated as having satisfied the debt with an amount of money equal to the fair market value of the interest. Any COD income recognized under § 108(e)(8) passes through to the partners immediately before the discharge. Prop. Reg. § 1.108-8 would provide that for purposes of § 108(e)(8), the fair market value of a partnership interest received by the creditor is the liquidation value of that debt-for-equity interest, if: (1) the debtor partnership maintains capital accounts in accordance with Reg. § 1.704-1(b)(2)(iv), (2) the creditor, debtor partnership, and its partners treat the fair market value of the debt-for-equity interest as equaling the liquidation value of the partnership interest for purposes of determining the tax consequences of the debt-for-equity exchange, (3) the debt-for-equity exchange is an arm’s-length transaction, and (4) subsequent to the exchange, neither the partnership redeems nor any person related to the partnership purchases the creditor’s partnership interest as part of a plan that has as a principal purpose the avoidance of COD income by the partnership. If these conditions are not satisfied, all of the facts and circumstances are considered in determining the fair market value of the debt-for-equity interest for purposes of applying § 108(e)(8). Prop. Reg. § 1.721-1(d) would provide nonrecognition of loss in a debt-for-partnership interest exchange in which the liquidation value of the partnership interest is less than the outstanding principal balance of the debt. The creditor’s basis in the partnership is determined under § 722. However, the proposed regulations provide that § 721 does not apply to the transfer of a partnership interest to a creditor in satisfaction of a partnership’s indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount). In addition, the proposed regulations do not supersede the gain recognition rules of § 453B regarding dispositions of installment obligations. The proposed regulations will be effective when final regulations are published in the Federal Register.

2. Rip Van Winkle awakened. After 23 years Treasury has proposed regulations under § 706(d). REG-144689-04, Determination of Distributive Share When a Partner’s Interest Changes, 74 F.R. 17119 (4/13/09). Section 706(d)(1), originally enacted in 1976 and amended in 1984, provides that in any taxable year in which there is a change in a partner’s interest, each partner’s distributive share of partnership items shall be determined under a method prescribed by regulations to take into account the partners’ varying interests during the year. Pre-1976 regulations, Reg. § 1.706-(1)(c)(2), mandated the use of the interim closing of the books method, unless the partnership elected a proration method. The proposed regulations would adopt these rules under the current statutory provision. The proposed regulation would require the partnership to split the taxable year into segments representing periods before and after a partner’s interest has changed then allocate partnership items under either method to the various segments. Although the proposed regulations would apply to a change in a partner’s interest attributable to a disposition of a partners entire interest or a partial interest, the proposed regulations would not apply to changes in allocations of partnership items among contemporaneous partners that satisfy the allocation rules of § 704(b), provided that a reallocation is not attributable to a capital contribution to the partnership or a distribution of money or property that is a return of capital. The proposed regulations would also provide safe
harbors for changes in the interests of partners in a service partnership under a reasonable method that complies with § 704(b) for taking into account varying interests during the year, and for publically traded units of a publically traded partnership that uses a semi-monthly convention. The proposed regulations would be applicable to partnership taxable years beginning after the date of publication of final regulations, but not before taxable years beginning after December 31, 2009.

C. Distributions and Transactions Between the Partnership and Partners

1. Careful capital accounts and tax accounts are necessary to avoid recognition of gain. Robertson v. Commissioner, T.C. Memo. 2009-91 (4/29/09). The taxpayers, husband and wife, were 51 and 49 percent partners in an automobile engine repair and restoration business operated as an LLC. The LLC incurred debt to finance land and building acquisitions and operating expenses. The partnership returns were prepared late by a tax return preparer who was under investigation by the IRS. The returns were filed late. The preparer died after the returns were filed and the preparer’s landlord disposed of the preparer’s records, including the records of the taxpayers’ LLC. With respect to a sale of the partnership assets, followed by distributions of money, the IRS asserted deficiencies claiming that the taxpayers had no basis in their partnership interests to offset distributions in one year, and that proceeds on the sale of partnership assets in a second year resulted in capital gain. The court (Judge Goeke) determined that the taxpayers failed to establish their partnership basis with adequate records, although the court indicated that the taxpayers’ testimony was honest.

- The court also held that reliance on the return preparer for timely filings did not relieve the taxpayers of their obligations to timely file returns and imposed late filing penalties under § 6651(a)(1). However, the court found that the taxpayers reasonably relied on the preparer to accurately report their income and rejected proposed negligence penalties under § 6662.

2. Layers within the partnership mixing bowl need comment. Notice 2009-70, 2009-34 I.R.B. 255 (8/12/09). Sections 704(c)(1)(B) and 737 require recognition of built-in pre-contribution gain with respect to property contributed to a partnership on a distribution of contributed property to a non-contributing partner, or other property to the contributing partner, within seven years of the contribution. Regulations proposed in 2007 providing that in an assets-over partnership merger, the seven-year clock begins anew with respect to built-in gain or loss with respect to property transferred from a merged partnership to the continuing partnership (the surviving partnership whose members own 50% or more of the partnership interests), but the clock dates back to the date of initial contribution with respect to pre-merger gains and losses, creating layers of old and new built-in gains and losses. The proposed regulations adopted the position of Notice 2005-15, 2005-1 C.B. 527, which was withdrawn after complaints that the Notice was inconsistent with existing regulations. Commentators raised numerous questions regarding application of the proposed regulations and the examples, including problems with respect to application of the proposed regulations to tiered partnerships. The IRS has again asked for comments on the proposed regulations, addressing, among other things, whether additional events allowing revaluation of partnership property should be included in Reg. § 1.704-1(b)(2)(iv)(f), how to provide for partnership allocation of depreciation and other items among different layers, and how to deal with specified issues in tiered partnerships. Comments are requested by 2/22/10.

D. Sales of Partnership Interests, Liquidations and Mergers

1. Too many factors, proposed regulations on disguised sale of a partnership interest are withdrawn. Ann. 2009-4, 2009-8 I.R.B. 597 (2/20/09). The IRS withdraws proposed regulations § 1.707-7 (2004). Section 707(a)(2)(B) provides that that a contribution by a partner in connection with a related distribution will under regulations be treated as a disguised sale. Regulations proposed in 2004 would have expanded that concept to provide that a transfer of money or property, including an assumption of liabilities, to a partnership by a “purchasing partner” in connection with a related distribution to a “selling partner” would be treated as a purchase and sale of a partnership interest rather than a
contribution and distribution. The latter transaction results in lower or no recognition by the selling partner. The proposed regulations would have applied a multiple factor test to identify a disguised sale of a partnership interest. The Tax Court in *Colonnade Condominium, Inc. v. Commissioner*, 91 T.C. 793 (1988), adopted a more elegant approach with an examination of whether there is an adjustment in partnership capital accounts reflecting a contribution and distribution, or whether there is simply a shift in the ownership of unchanged partnership capital. The announcement indicates only that the Treasury Department and the IRS have considered written comments regarding the proposed regulations and will continue to study the matter and may issue guidance in the future. In the meantime, determinations whether a contribution and related distribution constitute a sale of a partnership interest will be based on case law and the legislative history to § 707(a)(2)(B).

E. Inside Basis Adjustments

1. **Intervenor is not allowed to demand that an FPAA be remanded to the IRS for an explanation of its views.** *Austin Investment Fund LLC v. United States*, 103 A.F.T.R.2d 2009-607 (Fed. Cl. 1/6/09). In a refund action filed by an LLC through its tax matters partner, LLC members sought to intervene with a motion to remand the case back to the IRS for an explanation of the IRS position to support the adjustments made in the FPAA. The court denied the motion pointing out that in cases seeking readjustment of partnership items in an FPAA the court makes a *de novo* determination of all partnership items. Rewriting the FPAA to include a statement of reasons would be unnecessary. In addition, the court indicated that the intervenors cited no authority for their claim that the FPAA was required to be re-written to comply with the Administrative Procedures Act.

F. Partnership Audit Rules

1. **The wrong form letter gives these partners two-bites at litigating their Son-of-BOSS shelter.** *JT USA LP v. Commissioner*, 131 T.C. No. 7 (10/6/08). The taxpayers ("the Gregorys") sold their business producing motocross and paintball accessories for a large capital gain. The business was in a family partnership in which the taxpayer husband and wife held both direct and indirect partnership interests (interests as members of an LLC that was a member of the partnership being audited). The Gregorys were indirect partners, through both an S Corporation and a partnership, in a Son-of-Boss partnership. Just before the statute of limitations expired, The IRS issued a notice of final partnership administrative adjustment (FPAA) to the partnership and its partners without ever having provided to the partners a § 6223(a) notice that a partnership level proceeding was commencing. The IRS also sent a form letter notifying the partnership that under § 6223(e)(2) the partners could elect into the TEFRA partnership proceedings. The form letter was the wrong form letter, but the Gregorys responded and elected out as indirect partners but asked to have the "partnership items of the Direct Partner treated as partnership items." Because there was no advance notice of an audit, but the received notice before the time to challenge the adjustments proposed by the FPAA had run, the default rule of § 6223(e)(3), not § 6223(e)(2), applied, and any partner entitled to receive notice had the right to opt out and not the right to opt in. By the time the partnership engaged in the Son-of-Boss transaction to which the FPAA proposed adjustments related, the Gregorys' only interest was held as indirect partners. Thus, if the election had been valid, the Gregorys would not be subject to any deficiency proceedings because any items that become nonpartnership items under § 6223(e) are subject to the standard deficiency procedures of §§ 6211 through 6216, see § 6230(a)(2)(A)(ii), and the IRS has one year from the time a partner's partnership items become nonpartnership items to send a notice of deficiency to that partner, see §§ 6229(f)(1), and the § 6503(a) election was made more than one year before the Tax Court proceeding. The Tax Court (Judge Holmes) held that the Gregorys were allowed to make separate elections as direct and indirect partners and that their elections to opt out as indirect partners were valid. The Gregorys' elections to "opt in" in their capacity as direct partners had no effect because the default rule dictates the same result under § 6223(e)(3); a partner is bound by the TEFRA proceedings unless a proper election is made to opt out.

2. **Who's the partner is not a partnership item.** *Sands v. United States*, 84
Fed. Cl. 209 (10/9/08). Robert Sands, one of four equal partners in a limited partnership, transferred partnership interests to four charitable remainder unitrusts. The partnership sold stock and claimed substantial losses. In an FPAA issued to the partnership the IRS reduced the partnership's asserted basis in the sold stock which resulted in a partnership capital gain. The IRS also sought to allocate the recognized gain to Sands by claiming that the transfers of partnership interest to the charitable remainder trusts were economic shams. The court (Judge Hewitt) held that the identity of a partner is not a partnership item subject to determination in a TEFRA partnership proceeding. The court dismissed Sands as the filing partner in the proceeding and substituted the charitable remainder trusts. Nonetheless, the court refused to refund Sand's deposit as a filing partner.

3. Whether it's a partnership is a partnership item. Petaluma FX Partners, LLC v. Commissioner, 131 T.C. No. 9 (10/23/08). Petaluma was formed to invest in foreign currency options trading. The investor partners contributed offsetting long and short foreign currency options on 10/10/00. The investor partners increased their partnership bases for the premiums of the long options, but did not offset basis to reflect a reduction of liabilities for the short options. The investors withdrew from the partnership on 12/12/00, claiming a high basis in distributed property. The property was sold for a loss on 12/26/00. In the FPAA issued to the partnerships, the IRS claimed that the partnership should be disregarded, and that even if the investors formed a partnership, the partnership had no business purpose other than tax avoidance and lacked economic substance. In granting summary judgment to the IRS, the court (Judge Geoke) held that whether a partnership exists, and whether the partnership has a business purpose or lacks economic substance, are partnership items as described in Reg. § 301.6231(a)(3)-1(a) over which the court has jurisdiction in a partnership proceeding. The court noted that because determination whether a partnership is a sham or lacks economic substance underlies all of the partnership’s purported tax items, the determination fits “squarely” within the regulations identification of partnership items.

- The court rejected the partnership’s argument that because sham treatment requires an examination of all of the facts and circumstances, including the intent of individual partners, the determination must be made at the partner level. Since the partnership indicated that it would not contest the determination on other than the jurisdictional grounds, the court issued summary judgment for the IRS that the partnership was disregarded.

- The determination of the partners’ outside basis in this case was also treated as a partnership item because, once the partnership was disregarded, no partner-level determinations were necessary. The court also held that it had jurisdiction to determine accuracy related penalties attributable to the determination that the partnership should be disregarded.

- Finally, the court rejected the taxpayer’s attempt to challenge valuation understatement penalties on the merits because of the taxpayers’ stipulations in the case, but indicated that the taxpayers could challenge the penalties in a refund action.

4. Natty Bumppo wouldn’t have signed that extension agreement. Leatherstocking 1983 Partnership v. Commissioner, 296 Fed. Appx. 171, 102 A.F.T.R.2d 2008-6695 (2d Cir. 10/20/08) (per curiam), rev’g T.C. Memo. 2006-164 (8/14/06). The Second Circuit held that – inasmuch as the IRS knew that the tax matters partner had been placed under criminal investigation – the tax matters partner was laboring under a conflict of interest and could not provide the IRS with consents that bound the underlying partners and partnership. This was so even though the IRS had not misled the partners about the extent of the criminal conduct of the tax matters partner.

5. Treasury Regulations defining defenses to penalties that may be raised in partnership proceeding are valid. New Millennium Trading, L.L.C. v. Commissioner, 131 T.C. No. 18 (12/22/08). In a TEFRA partnership proceeding, the determination of all partnership items is binding on the partners and may not be re-determined in another proceeding. Section 6221 provides for determination of penalties at the partnership level and the court may consider reasonable cause defenses of the partnership. Section 6230(c)(1)(C) provides that a partner may contest the imposition of penalties in a claim for refund, which
includes under § 6230(c)(4) the assertion of partner-level defenses to the penalties. Temp. Reg. §§ 301.6221-1T(c) and (d) provides that partner level defenses to penalties imposed at the partner level, including the reasonable cause exception of § 6664(c), can only be determined through separate refund actions. On summary judgment, the Tax Court (Judge Goeke) rejected an individual partner’s argument that the temporary regulations cannot be applied to deprive the Tax Court of jurisdiction to consider the partner’s reasonable cause defense to penalties, and upheld the validity of the regulations. The court observed that nothing in §§ 6221 or 6226(f) grants jurisdiction to consider partner-level defenses and that the partner’s remedy under § 6230(c)(4) is to assert partner-level defenses in a refund claim. The court also opined that the regulations do not misinterpret the requirement of § 6664(c)(1) that no penalty may be imposed under §§ 6662 or 6663 if it was shown that there was reasonable cause. The court reached this conclusion by applying the deference rule of Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842-843 (1984), and noting that the Court of Appeals to which the case is appealable [the D.C. Circuit] has indicated that IRS regulations are to be given Chevron deference.

a. Different judge, same result. Tigers Eye Trading, LLC v. Commissioner, T.C. Memo 2009-121 (5/27/09). In another Son-of-Boss tax shelter proceeding, the court (Judge Beghe) treated accuracy-related penalty defenses as affected items determinable only in an individual partnership proceeding and upheld the validity of temporary regulations. The court also rejected the IRS motions in limine to declare the shelter opinion of Curtis, Mallet-Prevost, Colt & Mosle LLP an opinion by a shelter promoter on which the partner could not rely for penalty protection holding that the issue was to be determined in the partnership proceeding. In addition, the court granted the IRS motion to reject the expert report of Stuart Smith on the grounds that the report consisted of legal discussion and argument.

b. In a lengthy afterword, Judge Beghe questioned the wisdom of dividing partner and partnership items into separate proceedings in these tax shelter cases and observes that the division creates complex logistical problems at great cost to judicial economy and attorney resources. Judge Beghe also notes that the IRS and Treasury have proposed regulations that would allow the IRS to convert partnership items to nonpartnership items and allow a single proceeding – but only for listed transactions.

6. William Strunk Jr. & E.B. White, The Elements of Style, help identify the statute of limitations as a partnership item. Keener v. United States, 551 F.3d 1358, 103 AFTR 2d 2009-364 (Fed. Cir. 1/8/09). The taxpayers invested in tax shelters promoted by AMCOR in the mid-1980s. In a partnership audit procedure, following issuance of an FPAA, the partnership 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. In their refund claim the taxpayer’s asserted that the statute of limitations had expired on the IRS’ assessment of tax. The Federal Circuit (Judge Prost) affirmed the finding of the Court of Federal Claims that it lacked jurisdiction to determine the refund claims because application of the statute of limitations is a partnership item as defined in § 6231(a) subject to determination in the TEFRA proceeding. Section 6231(a) defines a partnership item as “any item required to be taken into account for the partnership’s taxable year under any provision of subtitle A.” The taxpayer argued that the statute of limitations, provided for under subtitle F, is not a partnership item under this definition. Referring to the elements of style, the court concluded that the restrictive phrase “subtitle A” modifies the words that immediately precede it, “taxable year,” and not the words “partnership item.” In citing Strunk & White, the court followed Prati v. United States, 81 Fed. Cl. 422, 101 AFTR 2d 2008-1778 (2008). The court added that Reg. § 301.6631(a)(3)-1(b), which includes as a partnership item any determination of the amount, timing, and characterization of items, is a reasonable interpretation of the statutory ambiguity that is entitled to deference under Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984). The court also rejected the taxpayer’s claim for refund of additional interest penalties imposed on tax motivated transactions, holding that a determination that characterizes a partnership transaction as a sham is a partnership item.
7. **Reverse TEFRA**: Partnership items from listed transactions are to be treated as nonpartnership items. REG-138326-07, Tax Avoidance Transactions, 74 F.R. 7205 (2/13/09). The TEFRA audit rules originally were enacted to allow the IRS to address issues in the large tax shelter partnerships of the 1970s with a single partnership level proceeding rather than multiple proceedings involving the same issue against numerous partners. Many of the recent abusive tax shelter transactions are structured to provide tax benefits to a single individual through a labyrinth of partnerships and trusts. Proposed regulations §§ 301.6231(c)-3 and 301.6231-9 would permit the IRS to notify a taxpayer that a partnership item attributable to a listed transaction from an indentified partnership will be treated as a nonpartnership item, and thus not subject to the TEFRA partnership audit rules. The proposed regulations would only apply to transactions that are identified as a listed transaction under Reg. § 1.6011-4(b)(2) prior to the date the IRS notifies the taxpayer that the taxpayer’s partnership items related to the listed transaction will be treated as a nonpartnership item. The IRS would determine whether an item would be treated as a nonpartnership item on a partnership-by-partnership and partner-by-partner basis. The determination may include an item that passes through more than one partnership. In the case of an indirect partner who holds an interest in a listed transaction through a lower-tier partnership, the notification may identify only the lower-tier partnership. The determination would not apply to items from partnerships not attributable to a listed transaction, which will remain partnership items. Items attributable to listed transactions would remain partnership items unless the IRS notifies the taxpayer that the item will be treated as a nonpartnership item. Notification will apply to all partnership items from identified partnerships for all taxable years that ended before the date of the notice and all items attributable to that partnership that are related to a listed transaction. When finalized, the proposed regulations would apply to any taxable period ending on or after 2/13/09, the date of publication of the proposed regulations.

8. **River City Ranches v. Commissioner**, 103 A.F.T.R.2d 2009-1088 (9th Cir. 2/26/09), aff’g T.C. Memo. 2007-171 (7/2/07). The Ninth Circuit affirmed the tax court holding that the six year statute of limitations for fraud was applicable and that the sheep breeding partnerships at issue were sham partnerships lacking economic substance, which justified increased interest penalties under §6621(c). The Tax Court had also held that an asserted conflict of interest between the tax matters partner and the other partners did not invalidate waiver of the statute of limitations by the tax matters partner.

9. Thou shall not be allowed a jury trial to challenge an FPAA assessment. **RCL Properties, Inc. v. United States**, 103 A.F.T.R.2d 2009-1784 (D. Colo. 4/14/09). The partnership’s tax matters partner deposited an assessed deficiency as required by § 6226(e) and filed a civil action for recovery of the tax. The taxpayer filed a motion requesting a jury trial. The court (Judge Babcock) noted that under 28 U.S.C. § 2402, civil actions against the United States must be tried without a jury. An exception in 28 U.S.C. § 1346(a)(1) allows jury trials in cases for the recovery of any “internal revenue tax.” However, § 6226(e)(3) provides that a deposit for jurisdictional purposes is not treated as the payment of tax. Jurisdiction in § 6226 action is provided under 28 U.S.C. § 1346(e), and is thus not within the exception allowing jury trials of 28 U.S.C. § 1346(a)(1).

10. **Release from debt to restore negative capital account is a partnership item.** **Bassing v. United States**, 563 F.3d 1280, 103 A.F.T.R.2d 2009-1780 (Fed. Cir. 4/16/09). Affirming the Court of Federal Claims, the court (Judge Bryson) held that the release of one partner’s obligation to restore a capital account deficit is a partnership item. The taxpayer was one of two general partners and also held limited partner interests in a real estate development partnership. The partnership agreement required the taxpayer to restore his capital account deficit. The partnership entered into agreements with its principal creditor to settle outstanding liabilities and liquidate. At the same time the partnership entered into an agreement with the taxpayer, who was insolvent, to discharge the taxpayer’s deficit restoration obligation. The taxpayer reported the discharge as short-term capital gain on a deemed sale of his partnership interest. Subsequently the taxpayer filed an amended return treating the forgiveness of his deficit restoration obligation as cancellation of indebtedness income that was excluded under § 108(a)(1)(B) because of his insolvency. The court held that the taxpayer’s refund action filed
in the Court of Federal Claims was barred by § 7422(h), which prohibits refund actions attributable to partnership items as defined in § 6231(a)(3). The court reasoned that a capital account deficit is determined under the partnership capital account maintenance rules, based on partnership accounting rules. See Reg. § 301.6231(a)(3)-1(b). The release of a debt to restore a negative capital account is also a partnership item because the enforceability of the item is also determined under the partnership capital account maintenance rules so that release of the debt would be treated as cancellation of debt for the partnership. Reg. § 301.6231(a)(3)-1(a). The court rejected the taxpayer's argument that the tax treatment of the discharge of the deficit restoration obligation was an individual, non-partner issue that has no impact on the partnership or other partners. The purpose of the TEFRA audit rules is served by consistent treatment of capital account deficits for both co-general partners.

11. 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 had held in Petaluma FX Partners, LLC v. Commissioner, 131 T.C. No. 9 (10/23/08), that the determination of whether a partnership was a sham that will be disregarded for Federal tax purposes is a partnership item. 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.

12. Gateway Hotel Partners, LLC v. Commissioner, T.C. Memo. 2009-128 (6/4/09). Over the IRS objection, the taxpayer partnership was permitted to substitute as a tax matters partner a new partner who was not a partner during the years subject to TEFRA partnership audit. The court (Judge Goeke) concluded that the fact that the tax matters partner's tax liability will not be affected by the proceeding does not disqualify the substitution. The court observed that, "[t]he tax matters partner's importance derives from his role as a fiduciary serving on behalf of the other partners, and 'His personal interest, if any, is beside the point.'" (Quoting from Computer Programs Lambda, Ltd. v. Commissioner, 89 T.C. 198, 205 (1987)).

13. A Notice of Deficiency relating to partner level loss limitation rules need not wait for a FPAA. Meruelo v. Commissioner, 132 T.C. No. 18 (6/9/09). Judge Vasquez held that application to a partner of the loss limitation rules of §§ 704(d) and 465 are affected items that require a partner-level determination. A notice of deficiency to a partner based on the application of the loss limitation rules of §§ 704(d) and 465 was not issued prematurely and was valid, even though IRS had neither issued a notice of final partnership administrative adjustment for the partnership nor accepted the partnership's return as filed for the year. The Tax Court had jurisdiction over the petition.

a. But a notice of deficiency is not proper while the partnership case is still pending. Bausch & Lomb, Inc., v. Commissioner, T.C. Memo. 2009-112 (5/21/09). The court (Judge Kroupa) granted a motion by the IRS to dismiss a Notice of Deficiency for lack of jurisdiction. The IRS issued a NOD to the parent of an affiliated group disallowing losses claimed from a limited partnership investment and imposing accuracy related penalties. The
deficiencies arose from partnership items and affected items reflected in a FPAA in a partnership level proceeding that was not yet concluded. The court rejected the taxpayer’s argument that its basis in the partnership must be determined in the year of a contribution of a note to the partnership, which is not the year at issue in the FPAA, and therefore the basis is not a partnership item or affected item in the year subject to the partnership proceeding. The court concluded that the partner’s basis in contributed property is a partnership item subject to determination in the partnership proceeding.

14. The assessment of a deficiency doesn’t have to be on the computer tape if it’s manually processed. Williams v. Commissioner, T.C. Memo. 2009-158 (6/30/09). The statute of limitations under § 6229(a) for assessment of a deficiency attributable to a partnership item or an affected item is three years after the later of the date on which a partnership return is filed, the last day for filing the partnership return. If an FPAA is mailed to the tax matters partner the limitations period is suspended for the time in which a court action may be brought, or if a court action is brought, until the court action becomes final plus one year thereafter. The taxpayer asserted that assessment statute expiration dates (ASED) had expired and that the computerized account transcripts did not indicate the assessment until after the ASED. The court (Judge Cohen) concluded that testimony from IRS personnel was credible to establish that the assessments were issued manually and that the computer coding lagged the actual issue of the assessment. In addition, since the assessment was dated by August 15, within the AESD, the fact that the notice of assessment was only postmarked on August 21 (after the AESD) did not invalidate the assessment.

15. Reasonable cause defense to the gross valuation misstatement penalty is not a partnership item, and by the way, Son of Boss transactions lack economic substance as a matter of law. Clearmeadow Investments, LLC v. United States, 87 Fed. Cl. 509, 103 A.F.T.R. 2d 2009-2786 (6/17/09). Granting summary judgment to the government, the court held that the reasonable cause defense of § 6664(c)(1) to § 6662 accuracy related and substantial misstatement penalties is a partner level defense not subject to the Federal Claims Court’s jurisdiction in a TEFRA partnership proceeding. The court rejected the taxpayers’ argument that its jurisdiction to consider partnership level penalties under § 6662 empowers the court to address reasonable cause defenses asserted by a partner. Notwithstanding contrary language in Klamath Strategic Investment Fund ex rel. St. Croix Ventures v. United States, 103 A.F.T.R. 2d 2009-2220 (5th Cir. May 15, 2009), the court points out that Reg. § 301.6221-1(d) and Temp. Reg. § 301.6221-1T(c)-(d) specifically describe the reasonable cause defense as a partner level defense that may not be asserted in a partnership proceeding. The court also rejected the taxpayer’s argument that although Reg. § 1.752-6 applied retroactively to reduce basis by the amount of contingent liability in the Son-of-Boss transaction, the entity used by the taxpayers was not a partnership but a “multi-member disregarded entity.” (The taxpayers were fortunate that the court did not impose a frivolous argument penalty on this.) The court imposed a 40 percent § 6662 penalty.

• The taxpayers – whether providently or not – conceded both the retroactivity of Reg. § 1.752-6 and the lack of economic substance in their transaction.

16. The assessment of a deficiency doesn’t have to be on the computer tape if it’s manually processed. Williams v. Commissioner, T.C. Memo. 2009-158 (6/30/09). The statute of limitations under § 6229(a) for assessment of a deficiency attributable to a partnership item or an affected item is three years after the later of the date on which a partnership return is filed, the last day for filing the partnership return. If an FPAA is mailed to the tax matters partner the limitations period is suspended for the time in which a court action may be brought, or if a court action is brought, until the court action becomes final plus one year thereafter. The taxpayer asserted that assessment statute expiration dates (ASED) had expired and that the computerized account transcripts did not indicate the assessment until after the ASED. The court (Judge Cohen) concluded that testimony from IRS personnel was credible to establish that the assessments were issued manually and that the computer coding lagged the actual issue of the assessment. In addition, since the assessment was dated by August 15, within the AESD, the fact that the notice of assessment was only postmarked on August 21 (after the
AESD) did not invalidate the assessment.

17. **Salman Ranch Ltd. v. United States**, 104 A.F.T.R.2d 2009-5460 (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.

18. **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 and 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 an 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.

a. **But Judge Haines has a different view of overstated basis.** **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**, 103 A.F.T.R.2d 2009-2712 (9th Cir. 6/17/09); and **Salman Ranch Ltd. v. United States**, 104 A.F.T.R.2d 2009-5190 (Fed. Cir. 7/30/09).

b. **And the IRS loses again.** **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.

c. **The IRS gets the upper hand with temporary regulations.** T.D. 9466, Definition of Omission from Gross Income (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, “In 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).”

deficiencies. Section 6229(a) provides that the period for assessing a deficiency attributable to a partnership item shall 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).

20. 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.

21. 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.

22. 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 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. No. 9 (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.

23. 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*, 2009-2 U.S.T.C. ¶50,639, 104 A.F.T.R.2d 2009–____ (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 FPAA 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 court 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.

G. Miscellaneous

1. Publicly traded partnerships that are treated as partnerships are to include partnerships in the business of marketing carbon dioxide or transporting alternative fuels. The Emergency Economic Stabilization Act of 2008 [Division B], the Energy Improvement and Extension Act, §§ 116 and 208, amending § 7704(d)(1)(E). Publicly traded partnerships that derive income from investment, activities, real estate and natural resources are excepted from the requirement that a publicly traded partnership be taxed as an association. The definition of qualifying income is expanded to include income derived from the marketing of industrial source carbon dioxide and income derived from the transportation and storage of alternative fuels (biodiesel, alcohol, etc.).

- As promised, under pending climate control legislation there will be no tax on the inhalation of oxygen; only the exhalation of carbon dioxide will be taxed.

2. LMSB asserts that the § 118 exclusion does not apply to partnerships. LMSB-04-1007-069, 2007 TNT 202-16 (10/18/07), reaffirming LMSB-04-1106-016 (10/28/06). The § 118 exclusion from income for nonshareholder contributions to the capital of a corporation does not apply to partnerships. The directive contains the following admonition, “This Directive is not an official pronouncement of law, and cannot be used, cited, or relied upon as such.”

  a. LMSB reiterates this position in a coordinated issue paper for all industries. LMSB-04-1008-051, 2008 TNT 225-14 (11/18/08). The IRS has advised that a partnership or any other non-corporate entity cannot use § 118(a) or any common-law “contribution-to-capital” doctrine to exclude from gross income amounts received from persons other than an owner of the entity.
This is a Tier 1 issue for litigation purposes, and it arises because of the prevalence of tax increment financing by municipalities.

3. Windheim v. Commissioner, T.C. Memo. 2009-136 (6/10/09). A Canadian resident who received legal title to a partnership interest from his father (now deceased) was held not to be the beneficial owner of the partnership interest for federal tax purposes. The taxpayer was involved in disputes with his mother and sister over control of family assets. The partnership issued K-1s in the taxpayer’s name in care of his mother. A Canadian trial court had held that disbursements by Toronto Dominion Bank of partnership distributions to the taxpayer’s mother were negligent, but that decision was reversed by a higher court holding that the bank was not liable to the taxpayer. A New York court had awarded the taxpayer’s mother a constructive trust over the partnership proceeds. The Tax Court (Judge Goekte) held that the taxpayer had no economic benefit from the partnership interest and was thus not a partner subject to tax on partnership income.

VIII. TAX SHELTERS

A. Tax Shelter Cases


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

* Compound indicia of criminal tax fraud? The government believes that the Baby BOSS transactions were not being individually reported on schedule D, but instead have been buried in grantor trusts. For example, an individual taxpayer with an unrealized capital gain contributes both the appreciated assets and the baby BOSS partnership interest into a grantor trust, which sells both, and the individual reports only the net gain or loss from the grantor trust’s transactions on his return, rather than breaking out gains and losses separately, as is required [by Reg. §1.671-2]. Treasury Department officials suggest that criminal penalties might apply to this kind of reporting, which willfully conceals the facts.
Changes coming to tax shelter disclosure rules. The recently proposed corporate tax shelter disclosure rules will be changed by dropping of the requirement that a shelter be marketed to a corporation to trigger the requirement that a promoter maintain a customer list. Under the amended regulations, a customer list would have to be maintained for a shelter that is exclusively peddled to individuals, provided threshold amounts of fees and tax savings are met.

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. 3/27/07), aff’d, 515 F.3d 749 (7th Cir. 2/7/08); 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. 7/20/06), aff’d in part, vacated in part, and remanded, 2009-1 U.S.T.C. ¶50,395 (5th Cir. 5/15/09); Sala v. United States, 552 F. Supp. 2d 1167 (D. Colo. 4/22/08); Stobie Creek Investments, LLC v. United States, 82 Fed. Cl. 636 (Fed. Cl. 7/31/08); and Murfam Farms LLC v. United States, 104 A.F.T.R.2d 2009-5700 (Fed. Cl. 7/30/09).

3. Klamath. District Court upholds BLIPS tax shelter on taxpayer’s partial summary judgment motion. Klamath Strategic Investment Fund, LLC v. United States, 440 F. Supp. 2d 608 (E.D. Tex. 7/20/06). The court (Judge Ward) held that the premium portion of the loans received from the bank in connection with the funding of the instruments contributed to a partnership was a contingent obligation, and not a fixed and determined liability for purposes of § 752. The transaction was entered into prior to the release of Notice 2000-44, 2000-2 C.B. 255, which related to Son-of-BOSS transactions. Judge Ward held that a regulation to the contrary, Reg. § 1.752-6 (see T.D. 9062), was not effective retroactively, and was therefore invalid as applied to these transactions. Judge Ward held that there was clear authority existing at the time of the transaction that the premium portion of the loan did not reduce taxpayer’s basis in the partnership.

a. Klamath on the merits: It does not work because it lacks economic substance, but no penalties. The authorities discussed in the Holland & Hart and Olson Lemons opinions provide “substantial authority.” Klamath Strategic Investment Fund, LLC v. United States, 472 F. Supp. 2d 885 (E.D. Tex. 1/31/07). The transactions lacked economic substance because the loans would not be used to provide leverage for foreign currency transactions, but no penalties were applicable because taxpayers passed on a 1999 investment and they thought they were investing in foreign currencies and the tax opinions they received that relied on relevant authorities set forth in the court’s earlier opinion provided “substantial authority” for the taxpayers’ treatment of their basis in their partnerships.

b. On government motions, Judge Ward refuses to vacate partial
summary judgment decision on the retroactivity of the regulations under § 752, and he permits the deduction of operational expenses, despite his earlier finding that the transactions lacked economic substance, because the taxpayers had profit motives. Klamath Strategic Investment Fund, LLC v. United States, 99 A.F.T.R.2d 2007-2001 (E.D. Tex. 4/3/07). First, Judge Ward held that even though the loans lacked economic substance, they still existed, and thus the partial summary judgment on the non-retroactivity of the regulations under § 752 was not premised on invalid factual assumptions. Second, he held that the existence of profit motive for deduction of operational expenses was based on the purposes of Nix and Patterson – and not on the motives of Presidio, the managing partner of the partnership.

c. Affirmed in part, vacated in part, and remanded, 568 F.3d 537, 103 A.F.T.R.2d 2009-2220, 2009-1 U.S.T.C. ¶50,395 (5th Cir. 5/21/09). In ruling unfavorably on the taxpayers’ cross-appeal that the transaction lacked economic substance, the Fifth Circuit (Judge Garza) stated:

The economic substance doctrine allows courts to enforce the legislative purpose of the Code by preventing taxpayers from reaping tax benefits from transactions lacking in economic reality. See Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1353-54 (Fed. Cir. 2006). As the Supreme Court has recognized, taxpayers have the right to decrease or avoid taxes by legally permissible means. See Gregory v. Helvering, 293 U.S. 465, 469, 55 S. Ct. 266, 79 L. Ed. 596 (1935). However, “transactions[ ] which do not vary control or change the flow of economic benefits[ ] are to be dismissed from consideration.” See Higgins v. Smith, 308 U.S. 473, 476, 60 S. Ct. 355, 84 L. Ed. 406 (1940). In a more recent pronouncement, the Supreme Court held that “[w]here . . . there is a genuine multi-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.” Frank Lyon, 435 U.S. at 583-84.

The law regarding whether a transaction should be disregarded as lacking economic reality is somewhat unsettled in the Fifth Circuit, and a split exists among other Circuits. The Fourth Circuit applies a rigid two-prong test, where a transaction will only be invalidated if it lacks economic substance and the taxpayer’s sole motive is tax avoidance. See Rice’s Toyota World, Inc. v. Comm’r, 752 F.2d 89, 91-92 (4th Cir. 1985). The majority view, however, is that a lack of economic substance is sufficient to invalidate the transaction regardless of whether the taxpayer has motives other than tax avoidance. See, e.g., Coltec, 454 F.3d at 1355; United Parcel Serv. of Am., Inc. v. Comm’r, 254 F.3d 1014, 1018 (11th Cir. 2001); ACM Partnership v. Comm’r, 157 F.3d 231, 247 (3d Cir. 1998); James v. Comm’r, 899 F.2d 905, 908-09 (10th Cir. 1990). We have previously declined to explicitly adopt either approach. See Compaq, 277 F.3d at 781-82 (finding that the transaction in question had both economic substance and a legitimate business purpose, so it would be recognized for tax purposes under either the minority or majority approach).

We conclude that the majority view more accurately interprets the Supreme Court’s prescript in Frank Lyon. The Court essentially set up a multifactor test for when a transaction must be honored as legitimate for tax purposes, with factors including whether the transaction (1) has economic substance compelled by business or regulatory realities, (2) is imbued with tax-independent considerations, and (3) is not shaped totally by tax-avoidance features. See Frank Lyon, 435 U.S. at 583-84. Importantly, these factors are phrased in the conjunctive, meaning that the absence of any one of them will render the transaction void for tax purposes. Thus, if a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be
disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations.

The evidence clearly shows that Presidio and NatWest designed the loan transactions and the investment strategy so that no reasonable possibility of profit existed and so that the funding amount would create massive tax benefits but would never actually be at risk. Regardless of Patterson and Nix's desire to make money, they entered into transactions controlled by Presidio and NatWest that were not structured or implemented to make a profit. This particular situation highlights the logic of following the majority approach to the economic substance doctrine, because the minority approach would allow tax benefits to flow from transactions totally lacking in economic substance as long as the taxpayers offered some conceivable profit motive. In cases such as the instant one, this approach would essentially reward a "head in the sand" defense where taxpayers can profess a profit motive but agree to a scheme structured and controlled by parties with the sole purpose of achieving tax benefits for them. We therefore agree with the district court that since the loan transactions lacked economic substance, they must be disregarded for tax purposes.

- In ruling unfavorably on the government's appeal of the non-imposition of penalties, the Judge Garza concluded:

  The TEFRA structure enacted by Congress does not permit a partner to raise an individual defense during a partnership-level proceeding, but when considering the determination of penalties at the partnership level the court may consider the defenses of the partnership. See New Millennium Trading, LLC v. Comm'r, 131 T.C. No. 18 (2008). Though Temp. Treas. Reg. § 301.6221-1T(d) lists the reasonable cause exception as an example of a partner-level defense, it does not indicate that reasonable cause and good faith may never be considered at the partnership level. Several courts have found that a reasonable cause and good faith defense may be considered during partnership-level proceedings if the defense is presented on behalf of the partnership. See Santa Monica Pictures v. Comm'r, T.C. Memo 2005-104, 89 T.C.M. 1157, 1229-30 (2005) (considering the reasonable cause and good faith defense asserted by the partnership to determine whether accuracy-related penalties should apply); See also Stobie Creek Investments, LLC v. United States, 82 Fed. Cl. 636, 703-04, 717-21 (2008) (considering the reasonable cause defense at the partnership level). Here, reasonable cause and good faith were asserted on behalf of Klamath and Kinabalu, by the current managing partners. Accordingly, we hold that the district court did not err in considering the defenses.

  The plaintiff bears the burden of proof on a reasonable cause defense. See Montgomery v. Comm'r, 127 T.C. 43, 66 (2006). The most important factor is the extent of the taxpayer's effort to assess his proper liability in light of all the circumstances. Treas. Reg. § 1.6664-4(b). Reliance on the advice of a professional tax adviser does not necessarily demonstrate reasonable cause and good faith; rather, the validity of this reliance turns on "the quality and objectivity of the professional advice which they obtained." Swayze v. United States, 785 F.2d 715, 719 (9th Cir. 1986). The district court found that Patterson and Nix sought legal advice from qualified accountants and tax attorneys concerning the legal implications of their investments and the resulting tax deductions. They hired attorneys to write a detailed tax opinion, providing the attorneys with access to all relevant transactional documents. This tax opinion concluded that the tax treatment at issue complied with reasonable interpretations of the tax laws. At trial, the Partnerships' tax expert concluded that the opinion complied with standards established by Treasury Circular 230, which addresses conduct of practitioners who provide tax opinions. Overall, the district court found that the
Partnerships proved by a preponderance of the evidence that they relied in good faith on the advice of qualified accountants and tax lawyers.

The Government argues only that the district court lacked jurisdiction to consider the reasonable cause and good faith defense; it has not alleged error in the substance of the district court’s finding that Patterson and Nix acted with reasonable cause and in good faith. Therefore, having concluded that the district court had jurisdiction to consider this defense, we affirm the district court’s conclusion that no penalties should apply.

- Finally, Judge Garza remanded for reconsideration the district court’s allowance of deductions for expenses and held that the district court was without jurisdiction to order a refund.

4. Sala. Interest is suspended under § 6404(g) because of the absence of fraud. Sala v. United States, 552 F. Supp. 2d 1157 (D. Colo. 5/1/07). If an individual files a timely return (including extensions) and the IRS has not sent the taxpayer a notice of additional liability (e.g., a math error notice of deficiency), including an explanation of the basis for the liability, within one year following the later of (1) the due date of the return (without regard to extension), or (2) the date on which the taxpayer filed the return, § 6404(g)(1) suspends the accrual of interest for the period beginning one year after the due date (or filing, if applicable) of the return. Interest resumes running twenty-one days after the IRS sends a notice to the taxpayer. Section 6404(g) does not apply at all if an underpayment is due to fraud. In this case, the district court held that the fraud exception to § 6404(g) does not apply to a deficiency from a tax shelter transaction ["Baby BOSS"] that lacked economic substance, unless the government shows that the taxpayer engaged in some act of concealment or misrepresentation. Even though the taxpayer entered into the transaction knowing that it was a listed transaction [Notice 2000-44], and knowing that it would not be registered with the IRS in order to conceal his participation, because taxpayer relied on a “more likely than not opinion” by R.J. Ruble that the tax results of the transaction would be upheld, the taxpayer acted in good faith and the government could not prove that the taxpayer had fraudulent intent. Summary judgment was entered for the taxpayer.

a. Was it a “qualified amended return”? Sala v. United States, 99 A.F.T.R.2d 2007-1709 (D. Colo. 5/30/07). On plaintiff’s motion for partial summary judgment, Judge Babcock held that the amended 2000 return filed by Sala on 11/18/03 was possibly not a “qualified amended return” because the date that the IRS notified KPMG that it was under a § 6700 examination was 10/17/03. The resolution of this issue depended upon the scope of the § 6700 examination at the time the amended return was filed, and an issue of fact existed that precluded summary judgment. The court refused to stay the case pending the availability of testimony from Sala’s KPMG accountant, Tracie Henderson, and from R.J. Ruble, both of whom indicated they would invoke their Fifth Amendment rights, because the delay would be substantial and would prejudice Sala.

b. Sala v. United States, 100 A.F.T.R.2d 2007-5097 (D. Colo. 7/3/07). Judge Babcock reiterated his holding that there is an issue of fact as to whether the 11/18/03 amended return was a qualified amended return.

c. 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.

d. 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.

e. 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."

5. Maguire Partners. Maguire Partners – Master Investments, LLC v. United States, __ F. Supp. 2d __, 103 A.F.T.R.2d 2009-263, 2009-1 U.S.T.C. ¶50,215 (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.

6. **Samueli.** A Twenty First Securities tax shelter bites the dust. *Samueli v. Commissioner,* 132 T.C. No. 4 (3/16/09). The taxpayer entered into a tax shelter transaction planned by Twenty First Securities (of Compaq fame), a simplified explanation of which is as follows. In October, 2001, the taxpayer purchased fixed-income securities (Freddie Mac principal strips) from a broker on a margin loan (the broker was entitled to hold the securities as collateral for the margin loan) and then “lent” the securities to the broker. The standard form agreement allowed the taxpayer to terminate the transaction and receive identical securities from the broker by giving notices on any business day, but an addendum overrode that provision and provided that the “loan” of the securities would terminate on January 15, 2003, or at the taxpayer’s election on July 1 or December 2, 2002. The taxpayer purchased the securities for $1.64 billion, but immediately “lent” the securities to the broker and received cash “collateral” of $1.64 billion, which he used to repay the margin loan. The loan contracts provided that the taxpayer was entitled to receive all interest, dividends, and other distributions attributable to the securities, but that the taxpayer was obligated to pay the broker a variable rate fee for use of the $1.64 billion cash collateral. In December, 2002, the taxpayer paid the broker $7.8 million of “interest” on the $1.64 billion cash collateral, which was relent to the taxpayer (secured by the securities, which had increased in value). The transaction terminated on January 15, 2003 and the broker was obligated to pay the taxpayer $1.69 billion to purchase the securities in lieu of transferring them to the taxpayer. The taxpayer was simultaneously obligated to pay the broker $1.68 billion, which reflected repayment of the $1.64 billion cash collateral, plus accrued but unpaid variable rate fees, but the amounts were offset and the broker paid the taxpayer $13.6 million. The taxpayer reported a $50 million long term capital gain and deducted $33 million of interest (cash collateral fees). Judge Kroupa held that the purported loan transaction did not satisfy the requirements of § 1058. To qualify as a loan of securities under § 1058, the loan agreement must (1) provide for the return to the lender of identical securities; (2) require payments to the lender equal to all interest, dividends, and other distributions on the securities during the period of the loan, and (3) not reduce the risk of loss or opportunity for gain of the security transferred. If any of these conditions is not satisfied, the purported loan will be treated as a realization event. Because the taxpayer could demand return of the securities only on three specified dates, and not at any time during the term of the loan, he could not sell the securities to realize a gain at any and all times that the possibility for a profitable sale arose. Thus, the taxpayer’s opportunity for gain with respect to the transferred securities transferred was reduced. Judge Kroupa rejected the taxpayer’s argument that because the taxpayer had not surrendered all opportunity to realize a gain with respect to the securities that the third condition prerequisite to qualifying for loan treatment under § 1058 had been satisfied. The statutory test for disqualification does not require completely elimination of the benefits of ownership, but merely a reduction. As a result, the “loan” of the securities in 2001 was treated as a sale on which no gain was realized (because the basis and amount realized were identical), and the “repayment” of the securities to the taxpayer in 2003 was treated as a repurchase followed by a resale to the broker on which a $13.5 million short term capital gain was realized. Furthermore, the taxpayer was not entitled to deduct the cash collateral fees paid as interest in connection with the purported securities lending arrangement because no debt existed. The cash transferred in 2001 represented the proceeds of the first sale and not collateral for a securities loan. Thus, no “cash collateral” was outstanding during the relevant years on which the claimed collateral fees could accrue.

a. If at first you don’t succeed, try again on procedural grounds; however, an amended return is not an administrative adjustment request. *Samueli v. Commissioner,* 132 T.C. No. 16 (5/18/09). The taxpayers were ten percent partners in a tax shelter partnership. Partnership level deductions claimed by the taxpayers were disallowed in *Samueli v. Commissioner,* 132 T.C. No. 4 (3/16/09), a partnership level determination. The taxpayers asserted that deficiencies assessed against them were not partnership items because of amended returns filed by the taxpayers for the year at issue. Section 6227 allows a partner to file
an Administrative Adjustment Request (AAR) on behalf of the partner, which allows a separate determination of an item as a non-partner item. The court (Judge Kroupa) held that the taxpayer’s amended return was not an administrative adjustment request. The request must follow the form required in Reg. § 301.6627(d)-1, which requires that a taxpayer file a partner AAR on a form prescribed – Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR) – and in accordance with the form’s instructions, which require the taxpayer to explain in detail on the form the reasons for the AAR reported on the form. The taxpayer is required to file the original form with the taxpayer’s amended income tax return and a copy of the form with the service center where the partnership files its tax return. The court rejected the taxpayer’s argument that because the amended return contained all of the information required on Form 8082 for an AAR, it constituted an AAR. The taxpayer’s claim was dismissed for lack of jurisdiction.

7. **New Phoenix. Not so heavenly BLISS. A Son of Boss transaction by any other name still stinks.** New Phoenix Sunrise Corporation v. Commissioner, 132 T.C. No. 9 (4/9/09). In this Paul Daugerdas, Jenkens & Gilchrist structured deal named BLISS (Basis Leveraged Investment Swap Spread), New Phoenix Sunrise Corporation (Phoenix) purchased two pairs of digital option contracts in a transaction designed to eliminate $10 million of capital gain realized on an asset sale by a corporate subsidiary included on the taxpayer’s consolidated return. The long portion of the options was purchased from Deutsche Bank AG for an initial payment of $10.631 million plus two additional payments of $63 million each. The short option was sold to Deutsche Bank for an initial payment of $10.369 million and two additional payments of $63.066 million. Only the $138,750 difference between the purchase and sales prices changed hands. The digital options called for offsetting payments based on the USD/JPL price with a variance in the options of only 0.00002 (2 Pips). Phoenix contributed the purchased and sold options to a general partnership for a 99% interest. The 1% partner was a dominant shareholder in Phoenix. Phoenix claimed a basis in its partnership interest in the amount of the cost of the purchased long option. Phoenix also claimed that its liability on the short position of the sold option was a contingent liability that did not reduce its basis in the partnership. Thereafter, the partnership acquired shares of Cisco stock for $149,958. After the options expired, the partnership distributed the Cisco stock to Phoenix. Phoenix claimed a basis in the Cisco stock equal to its partnership interest basis (§ 732) and a $10 million loss on its subsequent sale of the Cisco stock. In an exceedingly well written opinion, the court (Judge Goeke), rejected the claimed loss on several grounds:

- The taxpayer did not suffer a real economic loss. “The loss claimed as a result of the stepped-up basis in the Cisco stock was purely fictional.”
- The BLISS transaction had no realistic possibility of earning a profit. Deutsche Bank’s control as the calculation agent for the option contracts empowered it to assure that the market rate chosen for the closing of the options would never trigger the so-called “sweet spot” under which the investor would earn substantial profits.
- The transaction lacked economic substance. The court stated:
  Absent the benefit of the claimed tax loss, there was nothing but a cash flow that was negative for all relevant periods—the “hallmark” of an economic sham” as the Court of Appeals for the Sixth Circuit has held. Dow Chem. Co. v. United States, 435 F.3d at 602 (quoting Am. Elec. Power Co. v. United States, 326 F.3d 737, 742 (6th Cir. 2003). Such a deal lacks economic substance. Id. Because we find that the transaction at issue lacked economic substance, we do not consider Mr. Wray’s and Capital’s profit motive in entering into the transaction. Id. at 605; . . . Pursuant to the aforementioned cases, the BLISS transaction must be ignored for Federal income tax purposes. Accordingly, the overstated loss claimed as a result of the sale of the CISCO stock is disregarded, as is the flowthrough loss from Olentangy Partners.
- The court disallowed a $500,000 deduction for fees paid to Jenkins Gilchrist for the tax opinion and structuring the transaction. The fees were not incurred in
the production of any income against which a deduction is allowable.

- The court also sustained a 40 percent gross valuation penalty under § 6662(e) and (h), holding that the undervaluation penalty is applicable to overstated basis. The court also indicated that the § 6662(d) substantial understatement of tax and the § 6662(c) negligence penalties were applicable. The court rejected the taxpayer's argument that it reasonably relied on the Jenkins and Gilchrist tax shelter opinion. Since the penalties are not additive, only the gross valuation penalty was imposed.)

8. **Retroactive application of the partnership contingent liability regulation rejected again.** Murfam Farms L.L.C. v. United States, 104 A.F.T.R2d ¶ 2009-5700 (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.

9. The Second Circuit reverses a taxpayer victory in a self-liquidating partnership note transaction, in which the lion's share of income was allocated to a tax-indifferent party, on the ground that the tax-indifferent Dutch banks were not really equity partners. TIFD III-E, Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 11/1/04), rev'd, 2006-2 U.S.T.C. ¶50,442 (2d Cir. 8/3/06) (“Castle Harbour”).

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

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

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

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

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

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

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

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

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

c. A valid family partnership is found in the absence of a family. 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. 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. TIFD III-E, Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 11/1/04), rev'd, 2006-2 U.S.T.C. ¶50,442 (2d Cir. 8/3/06), on remand, ___ F. Supp. 2d ___ (D. Conn. 10/7/09). 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, it did not address the § 704(e)(1) issue. He held that the Dutch banks did satisfy the requirements of that paragraph, which reads:

(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.

* 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 he 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)

10. Government misconduct amounting to fraud does not require a showing of prejudice to justify relief. Tax shelter investors entitled to the same deal received by the taxpayers who cooperated with the government. Dixon v. Commissioner, 316 F.3d 1041 (9th Cir. 1/17/03), remanding T.C. Memo. 2000-116 and T.C. Memo. 1999-101. The Ninth Circuit reversed the Tax Court finding that misconduct by IRS attorneys during the trial of test cases [secretly allowing the deduction of attorney's fees in exchange for taxpayer cooperation] constituted harmless error. The tax shelter was one designed and administered by Honolulu businessman Henry Kersting, in which participants purchased stock with loans from entities financed by two layers of promissory notes, resulting in their being able to claim interest deductions on their individual returns. Judge Hawkins held that the taxpayers demonstrated fraud and that a demonstration of prejudice was unnecessary. The Tax Court was directed to enter judgment in favor of taxpayers on terms equivalent to the secret settlement agreements entered into with the test case taxpayers who cooperated with the government.

* Three lawyers from the Houston area represented various taxpayers. They were Henry Binder of Porter & Hedges, Michael Louis Minns, and Joe Alfred Izen, Jr.

a. Chief Counsel Notice CC-2003-008 (2/3/03). This notice reminds Chief Counsel attorneys of their obligation to adhere to the highest ethical standards in all aspects of their responsibilities, including representation of the Commissioner before the Tax Court. ABA Model Rules 3.3 [candor to tribunals], 3.4 [fairness to opposing party and counsel],
4.1 [truthfulness in statements to third persons], and 8.4 [misconduct] were discussed in the notice.

b. On remand to the Tax Court, it really hits the fan for the Commissioner — and deservedly so. The misconduct of the government lawyers involved and the Commissioner’s failure to fully disclose the misconduct to all taxpayers who had been bound by the outcome of the Kersting project test cases infested the stipulated decisions in all of the hundreds of cases settled in accordance with the outcome of the test cases. Hartman v. Commissioner, T.C. Memo. 2008-124 (5/1/08). In a 137-page opinion, the Tax Court (Judge Beghe) held that all of the hundreds of Kersting tax shelter cases in which stipulated decisions had been entered and which had became final many years ago had to be reopened and the taxpayers’ accounts had to be adjusted administratively in accordance with the settlements received by the taxpayers in the test cases.

c. The Tax Court awards attorney’s fees to Porter & Hedges under § 6673, the tests for which are different from those for attorney’s fees under § 7430. Dixon v. Commissioner, 132 T.C. No. 5 (3/23/09). In awarding fees of $1.1 million to Porter & Hedges for the services and expenses of its lawyers Henry Binder and John Irvine who represented taxpayers during the remand proceedings following the 2003 Ninth Circuit decision without charge other than the costs, expenses, and fees that the court might require the IRS to pay pursuant to § 6673(a)(2), the Tax Court (Judge Beghe) in a masterful opinion held that — unlike § 7430 fees which are limited to reimbursement of the fees paid by taxpayers plus fees which the taxpayers have incurred, i.e., for which they were personally liable — under § 6673 a party who has “multiplied the proceedings . . . unreasonably and vexatiously” has injured not only the opposing party but also the court and counsel and is liable for fees without such limitation “other than the requirement that the fees to be paid have been ‘reasonably incurred’ because of such conduct.” Judge Beghe found applicable to the § 6673 sanctioning statute the broader definition of “incurred” in Black’s Law Dictionary, which means “liabilities cast upon one by act or operation of law, as distinguished from contract.” He concluded that interest on the fee amount was applicable because “in augmenting the award of fees and expenses with interest equivalents, we do no more than mimic DeCastro’s fee arrangement with the Thompsons.” Henry Binder died of cancer on December 15, 2006. One of the authors recalls that Henry Binder was consumed by this case, even during the worst moments of his final illness.

11. Transactions underlying a tax shelter are just done for grins in the real world; you can take that to the bank, man! Hoosier homer judge grants injunctive relief to tax-indifferent party to a tax shelter contract without requiring the plaintiff to disgorge the $20 million it pocketed for entering into the tax shelter in the first place. Hoosier Energy Rural Electric Cooperative, Inc. v. John Hancock Life Insurance Co., 588 F. Supp. 2d 919 (S.D. Ind. 11/25/08). Hoosier Energy Rural Electric Cooperative ("Hoosier Energy") was the tax indifferent party in a sale-in/lease-out transaction of one of its generating plants for which it received $20 million for its participation. Professor Joseph Bankman of Stanford Law School furnished an expert opinion in affidavit form that this type of sale-in/lease-out transaction was an abusive tax shelter, leading the court to find that the “deal was an attempt to create an appearance of a sale but without any real economic substance.” Pursuant to the documentation of the arrangement, Hoosier Energy was required to maintain specified adequate security for its obligation to make future lease payments, i.e., provide a credit default swap from a party with at least an AA rating — failing which, it was required to make the agreed-upon termination payment of $120 million to a third-party which was obligated to pay the amount to John Hancock Life Insurance Co. (“John Hancock”). Hoosier Energy maintained this security in the form of a guarantee from AIG and it did timely make each of its lease payments. Upon the falling of AIG’s credit rating below the contractually-required standard, Hoosier Energy sought unsuccessfully to secure an equivalent guarantee. On Hoosier Energy’s request, Chief Judge Hamilton granted an injunction against enforcement of Hoosier Energy’s obligation to make the $120 million termination payment to the third party on the ground that the arrangement was entered into solely for tax benefits and was somehow unenforceable against Hoover.
Chief Judge Hamilton did state that Hoosier Energy might some time in the future be required to give back the $20 million, but that there was no hurry about that.

Professor Bankman's affidavit stated that the transaction was similar to that in *AWG Leasing Trust v. United States*, 592 F. Supp. 2d 953 (N.D. Ohio 5/28/08), *supra*.

a. In a later proceeding, Judge Hamilton pretends to require Hoosier Energy to give John Hancock adequate security to cover the possibility that his 11/25/08 injunction was incorrectly issued. *Hoosier Energy Rural Electric Cooperative, Inc. v. John Hancock Life Insurance Co.*, 2008 WL 5216027 (S.D. Ind. 12/11/08). Judge Hamilton, in addition to a $2 million cash bond, required Hoosier Energy “to post its own [i.e., meaningless] undertaking to pay John Hancock up to an additional $130 million in damages it might suffer from an improper injunction.”

b. Affirmed on “temporary commercial impracticability” grounds, but not because the transaction was an abusive tax shelter. ___ F.3d ___, 2009 U.S. App. LEXIS 20759 (7th Cir. 9/17/09). Judge Easterbrook held that John Hancock's taxes are a matter for it to resolve with the IRS, and that “does not affect Hoosier Energy’s contractual duties.” He further stated that “temporary commercial impracticability” becomes a pumpkin at year end. On remand, the district court increased the bond substantially (10/7/09).

12. The Supreme Court enhances the sanctity of arbitration agreements. *Arthur Andersen LLP, et al. v. Carlisle*, 129 S. Ct. 1896 (5/4/09), rev'd *Carlisle v. Curtis*, Mallet-Prevost, Colt & Mosle, LLP, 521 F.3d 597 (6th Cir. 4/9/08). The respondents in this case invested in a Son of Boss type transaction called a “leveraged option strategy.” The investors entered into an investment-management agreement with Bricolage Capital, LLC, which contained a mandatory arbitration provision. Only Bricolage Capital was a signatory to the agreement with the arbitration provision. The investors filed an action for fraud and malpractice against Arthur Andersen and Curtis, Mallet-Prevost, Colt & Mosle, LLP (who provided the tax opinion). The parties moved for a stay of the District Court action under the provisions of the arbitration agreement. The Federal Arbitration Act, 9 U.S.C. § 3, provides for a stay of any action in federal court that is “referable to arbitration under an agreement in writing.” 9 U.S.C. § 16(a)(1)(A) allows an immediate appeal from an order denying a stay. The District Court denied the stay. On appeal, the Sixth Circuit held that it had no jurisdiction to hear the appeal. The Supreme Court (Justice Scalia) reversed and remanded the case for further proceedings.

- The Court concluded that the Court of Appeals conflated questions of the applicability of 9 U.S.C. §§ 3 and 16(a) with the substantive merits of the question whether non-signatories to a written arbitration agreement possessed contract rights to arbitration under the agreement. “The jurisdictional statute here unambiguously makes the underlying merits irrelevant, for even utter frivolousness of the underlying request requires for a § 3 stay cannot turn a denial into something other than ‘an order . . . refusing a stay of any action under section 3.’”

- The Court further concluded that, in order not to award the “petitioners a remarkably hollow victory,” state law is applicable to determine whether non-signatories to the arbitration agreement may enforce the agreement and thereby obtain a stay of proceedings pursuant to the written arbitration agreement.

- The dissenting justices (Justice Souter joined by Chief Justice Roberts and Justice Stevens) argued that 9 U.S.C. § 3 offers a stay only to signatories of an arbitration agreement because “it would therefore seem strange to assume that Congress meant to grant the right to appeal a § 3 stay denial to anyone as peripheral to the core agreement as a nonsignatory, . . .”

- This opinion highlights the likelihood that the resolution of questions regarding professional responsibility in tort law of law firms, accounting firms and the banks involved in the promotion of the recent crop of abusive tax shelters will be shielded from public disclosure by confidential arbitration proceedings and only known to the parties involved.

B. Identified “tax avoidance transactions.”

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1. A safe cove (not big enough to be a harbor) for some taxpayers in the tax shelter war. Notice 2008-111, 2008-51 I.R.B. 1299 (12/1/08). This notice clarified Notice 2001-16, 2001-1 C.B. 730, and superseded Notice 2008-20, 2008-6 I.R.B. 406, regarding Intermediary Transaction Tax Shelters. A transaction is treated as an Intermediary Transaction with respect to a particular person only if that person engages in the transaction pursuant to a plan, the transaction contains the four objective components indicative of an Intermediary Transaction, and no safe harbor exception applies to that person.

C. Disclosure and Settlement

D. Tax Shelter Penalties, Etc.

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

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

• Judge Kaplan suggested that the constitutional violation could be rendered harmless if the defendants could successfully force KPMG to pay their legal expenses, and sua sponte instructed the clerk of the district court to open a civil docket number for an expected contract claim by the defendants against KPMG for payment of their defense costs. Judge Kaplan stated that the court would “entertain the claims pursuant to its ancillary jurisdiction over this case.” The defendants subsequently filed the anticipated complaints against KPMG.

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

b. Indictment against 13 KPMG defendants dismissed because the government interfered with their Sixth Amendment right to secure counsel which would have been available to them absent government interference. United States v. Stein, 495 F. Supp. 2d 390 (S.D.N.Y. 7/16/07). Judge Kaplan dismissed the indictment as to 13 of the 16 defendants who had been affiliated with KPMG at the time of their alleged conduct because the U.S. Attorney’s Office interfered with their ability to receive payment of their attorneys’ fees from KPMG. The government announced its intention to appeal the dismissal of the 13 defendants, and Judge Kaplan indicated his intention to proceed with the trial of the remaining five defendants in October 2007. This trial was postponed until 2008.

c. Judge Kaplan’s dismissal of the indictment against 13 former KPMG partners was affirmed by the Second Circuit. United States v. Stein, 541 F.3d 130 (2d Cir. 8/28/08). In a resounding opinion, Chief Judge Jacobs agreed with Judge Kaplan’s analysis
that the actions taken by KPMG to “condition[, cap[, and ultimately cease[ ]” to advance legal fees to defendants constituted “state action” which deprived defendants of their Sixth Amendment right to counsel because they were the result of the prosecutors’ (mis?)use of the Thompson Memorandum to overwhelmingly influence KPMG to not follow its past practice “to advance legal fees for employees facing regulatory, civil and criminal investigations without condition or cap” upon pain of a possible indictment of the firm.

d. The McNulty Memorandum is not much better than the Thompson Memorandum. The Thompson Memorandum [which was based upon the Holder Memorandum] was replaced on 12/12/06 by the McNulty Memorandum which requires threats to prosecute entities “unless” they do something [e.g., waive attorney client privilege] or “if” they do something [e.g., advance legal fees] to emanate from a higher level of the Justice Department.

- The Filip Memorandum is close, but no cigar. The McNulty Memorandum was, in turn, replaced on 8/28/08 with the Filip Memorandum, which purportedly removes the requirement that a firm must waive attorney-client privilege and work product protection in order to receive “cooperation credit.” Instead, that determination should be based on “whether the corporation has provided the facts about the events [which putatively constituted misconduct].” Also, “mere” participation in a joint defense agreement is to be permitted but such participation should not disable the firm from providing [all] relevant facts to the government. Payment of legal fees for employees is permissible unless such payment is “used in a manner that would otherwise constitute criminal obstruction of justice.”

- Eric Holder has been nominated for the post of attorney general in the Obama Administration. In the era of new politics, it is unlikely that he will receive even half as much scrutiny as did Joe the Plumber. But see, Arlen Specter & Edwin Meese III, “Even Businessmen Deserve a Lawyer,” Wall Street Journal, 1/15/09 at A11, which commented on the Holder Memorandum.

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

a. These “value ideas” did produce extraordinary results for E&Y tax partners, but not the results they expected. United States v. Coplan. Two current and two former partners of Ernst & Young, Robert Coplan, Martin Nissenbaum, Richard Shapiro, and Brian Vaughn—all members of its VIPER [Value Ideas Produce Extraordinary Results] group—were indicted on 5/30/07 in the Southern District of New York for crimes relating to tax shelters promoted by E&Y. The shelters included CDS (“Contingent Deferred Swap”); COBRA (“Currency Options Bring Reward Alternatives”); CDS Add-On; and PICO (“Personal Investment Corporation”). 2007 TNT 105-1.

b. More defendants. 2008 TNT 35-23 (2/21/08). The indictment was expanded to add David L. Smith, Private Capital Management, and Charles Bolton to the list of alleged co-conspirators. Smith is alleged to have introduced the CDS strategy to E&Y and is further alleged to have licensed the CDS transactions to Bolton and a group of Bolton companies who implemented the transactions.

c. The four indicted members of E&Y’s VIPER group were convicted by a jury following a ten-week trial in the Southern District of New York on 5/7/09. The convictions were for conspiracy relating to four tax shelters, tax evasion relating to clients who used a tax shelter transaction known as “CDS Add-On,” obstructing the IRS, and making false statements to the IRS. Department of Justice Press Release (5/7/09). 2009 TNT 88-122.

- The DOJ release further noted that Bolton pleaded guilty on 1/22/09 and Smith has not been apprehended. It further noted that Peter Cinquegrani, a former Arnold & Porter partner who provided opinion letters on E&Y tax shelters pleaded guilty to conspiracy to commit tax fraud on 9/11/08, and Bell Six, a former E&Y employee who later went to work for entities that implemented shelters for E&Y pleaded guilty to conspiracy to commit tax fraud on 6/14/07.
3. **Jerry Cohen outsmarts the government and mitigates taxpayer penalties.** Alpha I LP v. United States, 84 Fed. Cl. 622 (11/25/08), motion for reconsideration denied, 86 Fed. Cl. 126 (3/16/09). The IRS issued FPAs that adjusted the partners’ capital gains and losses based on five theories: (1) § 752; (2) Reg. § 1.752-6 (the “retroactive regulation”); (3) the transaction or entities were a sham or lacked economic substance; (4) Reg. § 1.701-2 (the partnership anti-abuse regulation); and (5) “none of the transactions of the Partnership increases the amount considered at-risk for an activity under § 465(b)(1).” The partners “conceded the adjustments on the ground that none of the transactions of the partnerships increased the amount considered at-risk for any activity under § 465(b)(1) and that the at-risk rules would disallow losses and require the partnerships and their partners to recognize gain on the transactions as set forth in the FPAs.” In addition, the IRS asserted that the § 6662 substantial valuation misstatement penalty should apply, but the taxpayers did not concede that issue. Rather, the taxpayers argued that valuation misstatement penalties were inapplicable as a matter of law because “any underpayment of tax was not ‘attributable to’ a valuation misstatement, but instead would be attributable to plaintiffs’ concession that [the IRS’s] adjustments were correct under [§ 465(b)(1)].” The court (Judge Hewitt) agreed with the taxpayers and held that where adjustments are made on grounds unrelated to valuation, valuation penalties do not apply. The court also rejected the IRS’s argument the court lacked jurisdiction to accept the taxpayer’s concession because “there are not any partnership level determinations to be made with respect to § 465.” The court found that the “concession obviate[d] the need to conduct a trial on valuation issues and therefore achieve[d] the very efficiencies and economies that the elimination of penalties sought to encourage. ... To go behind the concession and attempt to assign to it a specific ground would be to engage in an activity that the elimination of penalties is intended to prevent.” The court also refused to accept the IRS’s argument that it should consider on the merits the IRS’s alternative grounds for the adjustments that were based on valuation, i.e., basis, misstatements, solely for the purposes of determining the applicability of penalties. The court agreed with the taxpayers’ argument “that forcing a ‘trial on alternative grounds for adjustments plaintiffs have already conceded violates the purpose and policy behind the valuation misstatement penalties and is simply a waste of the Court’s and the parties’ resources.’”

   a. **Taxpayers are not precluded from asserting defenses, but they are bound by their stipulations.** Alpha I LP v. United States, 2009 U.S. Claims LEXIS 294 (Fed. Cl. 8/26/09). Taxpayers are limited to asserting defenses based on the ground under which they made their concessions to avoid valuation penalties. A trial on penalties will not encompass valuation misstatement penalties because the court has already held that valuation misstatement penalties are inapplicable. Plaintiffs are not judicially estopped from asserting defenses based on § 465.

4. **Another IRS weapon in the tax shelter war.** REG-160872-04, Section 6707 and the Failure To Furnish Information Regarding Reportable Transactions, 73 F.R. 78254 (12/22/08). Prop. Reg. § 301.6707-1 would reflect the amendments to § 6707 in The American Jobs Creation Act of 2004. A § 6707 penalty may be assessed against each material advisor required to file a return under § 6111 who fails to file a timely return as required under Reg. § 301.6111-3(e) or files a return with false or incomplete information. If more than one material advisor is responsible for filing a return under § 6111 with respect to the same reportable transaction, a separate penalty under § 6707 may be assessed against each material advisor who fails to timely file a return or files a return with false or incomplete information. Incomplete information means a Form 8918, “Material Advisor Disclosure Statement” (or successor form), filed with the IRS that does not provide the information required under Reg. § 301.6111-3(d). Failure to timely file or the submission of false or incomplete information is intentional if (1) the material advisor knew of the obligation to file a return, and knowingly did not timely file a return, or (2) filed a return knowing that it was false or incomplete. The proposed regulations provide factors that the IRS should take into account during the determination whether to rescind all or a portion of a § 6707 penalty. The list of factors generally follows Rev. Proc. 2007-21, 2007-9 I.R.B. 613. The regulations will apply to returns the due date of which is after the final
regulations are published in the Federal Register.

5. The Tax Court does have jurisdiction to determine whether partnership transactions were tax-motivated for penalty purposes. Keller v. Commissioner, 568 F.3d 710, 2009-1 U.S.T.C. ¶50,428 (9th Cir. 6/3/09), rev'g T.C. Memo 2006-166. The case concerns the outstanding tax liabilities of 16 partners who invested in cattle partnerships that were sold to investors as “The 1,000 lb Tax Shelter.” These partnerships were part of a large series of cattle- and sheep-breeding partnerships organized, promoted and operated by Walter J. Hoyt III from the 1970s through the 1990s, and which have been the subject of extensive litigation over the years. The IRS had offered a variety of settlement offers to the partners in the partnerships at issue. When the Service sent notices of intent to levy, the partners requested collection due process hearings and submitted offers in compromise to settle their outstanding tax liabilities. The IRS rejected the partners’ offers in compromise and, in collection due process hearings, imposed interest under former § 6621(c) (which imposed a higher interest rate for substantial underpayments that resulted from tax-motivated transactions). In the ensuing litigation, the Tax Court held that the IRS did not abuse its discretion in rejecting the offers in compromise. The court also held that it did not itself have jurisdiction to determine whether the partnerships’ transactions were tax-motivated for purposes of former § 6621(c).

- The Tax Court (Judge Goeke) based its jurisdiction decision on the fact that the question of whether the transactions were tax-motivated is a partnership item that must be determined in partnership-level proceedings. Here, the individual partners were the parties to the various cases being litigated, not the partnerships, so the court held that in these proceedings it did not have jurisdiction to decide the partnership-level issue. The effect of this decision was to leave the Service’s imposition of higher interest rates under former § 6621(c) in place.

- The Ninth Circuit (Judge Rymer) agreed with the Tax Court that the determination of whether transactions are tax-motivated is a partnership item to be determined at partnership-level proceedings. This rule was formulated by the Ninth Circuit in River City Ranches #1 Ltd., 401 F.3d 1136, 1144 (9th Cir. 2005). However, the partnership proceedings in this case were completed and judgment became final before the River City Ranches decision announced this rule.

- The Tax Court has jurisdiction in a collection due process proceeding to decide issues relating to liability that the taxpayer has not had an opportunity to contest (§ 6330(c)(2)(B)). Therefore, according to the Ninth Circuit, in a collection due process proceeding of a partner in a partnership, the Tax Court has jurisdiction to review the record of a partnership-level proceeding to make a determination about a partnership level issue affecting the partner’s liability that the partner did not have an opportunity to contest. In this case, the Ninth Circuit believed that the record from the partnership proceedings was sufficient to allow the Tax Court to determine whether the partnership transactions were tax-motivated. The Ninth Circuit then performed the review of the partnership proceedings itself and determined that the partnership transactions were tax-motivated.

6. Say it ain’t so, BDO. The U.S. Attorney for the Southern District of New York announced on 6/3/09 that Charles W. Bee, Jr., a former Vice-Chairman and board member at BDO Seidman, pleaded guilty to a three-count felony information charging him with conspiracy to defraud the United States in connection with tax shelter transactions involving clients of his firm and of the law firm Jenkins & Gilchrist (J&G); tax evasion in connection with a multimillion-dollar tax shelter that Bee helped sell to a client of his firm; and to giving material false deposition testimony regarding his firm’s tax shelter practice. According to the information and statements made during his guilty plea proceeding before United States Magistrate Judge Theodore Katz in Manhattan federal court:

From 1984 through October 2003, Bee, a Certified Public Accountant, was a partner and became a director and Vice-Chairman of accounting firm BDO Seidman. From 1998 through October 2000, Bee, along with the firm’s CEO as well as New York-based partner Adrian Dicker (who has previously pleaded guilty to similar tax fraud charges) was one of the leaders of the Firm’s “Tax
Solutions Group” (TSG), the activities of which were devoted to designing, marketing and implementing high-fee tax strategies, including tax shelters, for wealthy clients. Bee, together with other TSG partners, designed, marketed and implemented two different types of tax shelters with the Chicago office of the law firm Jenkens & Gilchrist and with an international bank in New York.

Bee knew that the tax shelter transactions would be allowed by the IRS only if there was a reasonable possibility of a profit. Bee also knew that, given the costs and fees to the clients, and the nature and duration of the transactions, the tax shelters had no reasonable possibility of resulting in a profit. In addition, Bee knew that the clients who purchased the tax shelter had no non-tax business reasons for entering into the transactions, and that the fees were set as a percentage of the tax loss sought by the clients. To make it appear that the tax shelter clients had the requisite business purpose and that there was a possibility of profit, Bee and his co-conspirators reviewed and approved the use of a legal opinion letter issued by J&G that contained false and fraudulent representations purportedly made by the clients about their motivations for entering into the transactions. Bee and other TSG members also developed a consulting agreement containing false and fraudulent statements to disguise the fact that the fees clients would be charged by BDO Seidman were solely for the tax shelters. Finally, Bee and his co-conspirators caused the clients to file false and fraudulent tax returns incorporating the supposed tax shelter benefits. In total, the fraudulent tax shelters implemented by Bee, BDO Seidman, J&G, and the financial institution that assisted them, caused clients to report over $1 billion in false and fraudulent tax losses, resulting in the evasion of over $200 million in taxes.***

Finally, Bee admitted that in February 2005, while under oath during a deposition in Jade Trading v. United States, a Court of Federal Claims case involving a tax shelter sold by BDO and another promoter, he knowingly made false material statements concerning BDO’s tax shelter practice.***

Co-conspirator Michael Kerekes, a principal of BDO Seidman and also a former member of BDO’s TSG and Tax Opinion Committee, pleaded guilty on February 13, 2009, to related conspiracy and tax evasion charges. Fellow co-conspirator Adrian Dicker, a former Vice-Chairman of BDO Seidman and TSG member, pleaded guilty on March 17, 2009, to conspiracy and evasion charges as well.

7. Small businesses that entered into listed transactions receive three-month delays in penalty enforcement activities to give Congress time to deal with the “unintended consequences” of §6707A. Letter from Commissioner Shulman to Rep. John Lewis, D-Ga., chairman of the Subcommittee on Oversight of the House Ways & Means Committee, 7/6/09. IRS will suspend collection enforcement activities until 9/30/09 on penalties under §6707A where the tax benefits from listed transactions were less than $100,000 for individuals or $200,000 from other taxpayers.

- This suspension is to permit time for the enactment of legislation to modify the penalty amounts so that they are more in line with the tax benefits of the transaction.

8. “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).

9. The Seventh Circuit 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, F.3d (7th Cir. 10/1/09). After the district court held taxpayer’s transaction to be invalid, but refused to uphold the Commissioner’s imposition of penalties, the government appealed the penalty issue. Judge Kanne affirmed the district court’s penalty decision, holding that taxpayer and its manager David Jump were entitled to rely on an opinion letter from Jenkens & Gilchrist where the Son of BOSS transaction was entered into as part of a restructuring to limit the liability of David Jump and his family for future tug boat accidents following a near-disaster in the St. Louis harbor.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING
A. Exempt Organizations
B. Charitable Giving
1. More computers and books for school children. The Emergency Economic Stabilization Act of 2008 extend through 2009 the application of Code § 170(c)(6), which permits a corporation to deduct an amount equal to the lesser of (1) basis plus one-half of the item’s appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis, for a contribution of computer software, equipment, and peripherals to educational institutions for use in kindergarten through twelfth grade education. The equipment must be previously unused and not more than two years old. The Act also extends § 170(e)(3)(D) which provides a similar enhanced charitable contribution deduction for contributions of book inventory by C corporations.

2. Judge Halpern writes a long opinion with pointed comments on expert testimony. Whitehouse Hotel Limited Partnership v. Commissioner, T.C. No. 10 (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 that 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.

3. Try again, but the kids’ religious school education is still not deductible even if the IRS made a deal with the Scientologists in 1993. Sklar v. Commissioner, F.3d 1252 (9th Cir. 12/12/08). The Ninth Circuit (Judge Wardlaw) followed its prior decision involving different taxable years (Sklar v. Commissioner (Sklar I), F.3d 610 (9th Cir. 2002)) and denied the taxpayers’ claimed deductions of a portion of tuition and fees paid to Orthodox Jewish Day schools for the education of their children. The taxpayers argued that deduction of a portion of their tuition payments as charitable contributions for strictly religious services is allowed under the closing agreement with the Church of Scientology. After convincing the Supreme Court that fees for training and auditing sessions provided by the Church of Scientology were paid as a quid pro quo for services rather than deductible charitable contributions (Hernandez v. Commissioner, 490 U.S. 680 (1989)), the IRS allowed the individuals involved to deduct 80 percent of the fees.

- The court held under Hernandez that tuition paid for religious education is a payment for services that is not deductible as a charitable contribution. The court pointed to statements in Hernandez that attempts to distinguish payments for religious benefits from secular services would involve the court in impermissible entanglements between church and state.
The court rejected the taxpayers' argument that 1993 amendments to §§ 170(f)(8) and 6115 (requiring reporting of the value of benefits received from quid pro quo payments to charities) overruled the Hernandez holding that a portion of payments for services are not allowable as a charitable contribution. Quoting from Sklar I, the court noted that these are procedural provisions that do not revise substantive law.

The taxpayers failed to establish that the fees and tuition payments represented dual payments that included a portion in excess of the value of the education benefit provided by the schools which represented a gift to the religious schools as charitable originations.

Finally, the court held that the Scientology closing agreement does not require the IRS to allow charitable contribution deductions for the taxpayers' tuition payments. Again quoting from Sklar I, the court expressed reservations under the Establishment Clause of the First Amendment about the impact of the closing agreement that discriminates among religions. The court also indicated concern that allowing deductions for tuition for attending religious schools would create a preference for religion that is questionable under the Establishment Clause. In addition, the court concluded that the tuition payments for the taxpayers' children were not similar to the auditing, training and other qualified religious services provided by the Church of Scientology. Thus, the taxpayers in Sklar could not assert an administrative inconsistency claim that the IRS favored Scientologists over adherents to other religions.

4. **One of Timothy McVeigh's lawyers loses again, but the consequences are not as severe this time.** Jones v. Commissioner, 129 T.C. 146 (11/1/07). Leslie Steven Jones, one of Timothy McVeigh's lawyers in the criminal proceeding stemming from the Oklahoma City Federal Building bombing, donated to the University of Texas copies of documents received by him from the government in the course of his representation of Timothy McVeigh and claimed a charitable contribution deduction for the appraised value. Judge Cohen upheld the IRS's disallowance of any deduction on the ground that under the relevant state law (Oklahoma), the materials were not attorney work product and not being attorney work product, the client, not the lawyer, was the owner of the materials in the case file. Because the taxpayer "was not the legal owner of the materials, he was not legally capable of divesting himself of the burdens and benefits of ownership or effecting a valid gift of the materials." Alternatively, even if the material in the file was attorney work product, it constituted "letters, memoranda, and similar property" prepared by the taxpayer's personal efforts, which by virtue of § 1221(a)(3)(A) was an ordinary income asset, and thus under § 170(e)(1)(A) the deduction was limited to basis, which was zero.

a. **Affirmed, but on subtly different reasoning.** Jones v. Commissioner, 560 F.3d 1196 (10th Cir. 3/27/09). The Tenth Circuit affirmed the Tax Court’s decision on the ground that the discovery material is not a capital asset, but did not address whether the taxpayer owned the discovery material under Oklahoma law. However, the rationale of the court of appeals for determining that the discovery material was not a capital asset differed from that of the Tax Court. The Tax Court held that the discovery material constituted "letters, memoranda, or similar property created by the taxpayer's own efforts" excluded from the definition of capital asset pursuant under § 1221(a)(3)(A). According to the Court of Appeals, however, the record clearly demonstrated that the discovery material for which Jones claimed a charitable contribution deduction was not created by his own personal efforts, and thus § 1221(a)(3)(A) did not apply to it. Rather, the Court of Appeals held that the discovery material, which was first compiled by the government to assist in its investigation and copies of which were made, organized, and categorized by the government and delivered to the taxpayer for the benefit of Jones and his client, was not a capital asset because it constituted letters, memoranda, or similar property "prepared or produced" for the taxpayer within the meaning of § 1221(a)(3)(B). "[T]he discovery material was provided to Taxpayer only because of his position as lead counsel for McVeigh, and it was the type of material typically produced for defense counsel in the course of a criminal trial."

The Tax Court (Judge Wells) held that the owner of a golf course was entitled to a charitable contribution deduction for its grant to the North American Land Trust of a perpetual conservation easement covering a golf course that it owned. He further rejected the asserted § 6662 accuracy-related penalty because the adjustment he made to value was “approximately 10 percent.”

6. The easement has to have some real effect to give rise to a charitable contribution deduction. Herman v. Commissioner, T.C. Memo. 2010-205 (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).

X. TAX PROCEDURE
A. Interest, Penalties and Prosecutions
1. The standard for preparer penalties is broadened to include preparers of all tax returns, and is heightened from “realistic possibility of success” to “more likely than not.” The 2007 Small Business Tax Act, § 8246, amended Code §§ 6694 and 7701 to expand the applicability of the § 6694 return preparer penalties from “income tax return preparers” to all tax return preparers. It also heightened the standards of conduct to avoid the imposition of the return preparer penalty for undisclosed positions with a requirement that there be a reasonable belief that the tax treatment of the position was “more likely than not” the proper treatment. For disclosed positions, the standard was increased from “non-frivolous” to “reasonable basis.” Penalty amounts were increased from $250 to the greater of $1,000 or 50 percent of the income to be derived by the preparer under § 6694(a) [negligent], and from $1,000 to the greater of $5,000 or 50 percent of the income to be derived by the preparer under § 6694(b) [willful or reckless]. These changes are effective for tax returns prepared after 5/25/07.

a. “God’s in His Heaven, all’s right with the world.” The Tax Extenders and Alternative Minimum Tax Relief Act of 2008, § 506, brings the standard for the § 6694 tax return preparer penalty for undisclosed positions into line with the taxpayer standard, i.e., substantial authority. It penalizes the taking of an “unreasonable position,” which is defined as a position “unless there is or was substantial authority for the position” or is a disclosed position “unless there is a reasonable basis for the position.” For tax shelters and reportable transactions, the position is an “unreasonable position ... unless it is reasonable to believe that the position would be more likely than not to be sustained on its merits.” The provision contains a reasonable-cause-and-good-faith exception. It is retroactive to 5/22/07, except that the tax shelter provision applies to returns prepared for taxable years ending after 10/3/08.


• The notice states that “substantial authority’ has the same meaning as in [Reg.] § 1.6662-4 (d) (2)” and that “[s]olely for purposes of section 6694(a), a tax return preparer nevertheless will be considered to have met the standard in section 6694(a)(2)(A) if the tax return preparer relies in good faith and without verification on the advice of another advisor, another tax return preparer, or other party.”

• For tax shelter transactions, Until further guidance is issued, solely for purposes of section 6694(a), a position with respect to a tax shelter (as defined in section 662(d)(2)(C)(ii)) will not be deemed an “unreasonable position” described in section 6694 (a) (2) (A) through (C) if there is substantial authority for the position and the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer in the event that the transaction is deemed to have a significant purpose of Federal tax
avoidance or evasion. This advice to the taxpayer must explain that, if the position has a significant purpose of tax avoidance or evasion, then there needs to be at a minimum substantial authority for the position, the taxpayer must possess a reasonable belief that the tax treatment was more likely than not the proper treatment in order to avoid a penalty under section 6662(d) as applicable, and disclosure in accordance with § 1.6662-4(f) will not protect the taxpayer from assessment of an accuracy-related penalty if section 6662(d)(2)(C) applies to the position. The tax return preparer must contemporaneously document the advice in the tax return preparer’s files.

If a nonsigning tax return preparer provides advice to another tax return preparer regarding a position with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)), the position will not be deemed an “unreasonable position” described in section 6694(a)(2)(A) through (C) if there is substantial authority for the position and the nonsigning tax return preparer provides a statement to the other tax return preparer about the penalty standards applicable to the tax return preparer under section 6694. Contemporaneously prepared documentation in the nonsigning tax return preparer’s files is sufficient to establish that the statement was given to the other tax return preparer. If a nonsigning tax return preparer and other tax return preparer are employed by the same firm, then contemporaneous documentation of advice provided by any tax return preparer in that firm to the taxpayer regarding applicable penalty standards, as described in the immediately preceding paragraph, is also sufficient to establish that the statement was given by a nonsigning tax return preparer to the other tax return preparers within the firm.

The above interim penalty compliance rules do not apply to a position described in section 6662A (a reportable transaction with a significant purpose of Federal tax avoidance or evasion or a listed transaction).

- The effective dates of this notice are as follows.

For positions other than tax shelters and reportable transaction positions, this notice is effective for all advice rendered or returns, amended returns, and claims for refund prepared after May 25, 2007. The interim guidance in this notice for tax shelters (within the meaning of section 6662(d)(2)(C)(ii)) and reportable transactions to which section 6662A applies is effective for tax shelter and reportable transaction positions on tax returns for taxable years ending after the 2008 Act’s date of enactment, October 3, 2008.

c. Despite the amended statute, IRS and Treasury still release final tax return preparer penalty regulations. T.D. 9436, Tax Return Preparer Penalties Under Sections 6694 and 6695, 73 F.R. 78430 (12/22/08). The proposed regulations were largely left intact, with provisions reserved for the changes made in 2008, i.e., the reduction of the standard for undisclosed positions to one of “substantial authority.”

- Preparer per position. The final regulations maintain a framework defining “a ‘preparer per position within a firm’” with a presumption that “the nonsigning tax return preparer within the firm with overall supervisory responsibility for the position(s) giving rise to the understatement generally will be considered the tax return preparer who is primarily responsible for the position.” If the information presented “would support a finding that either the signing tax return preparer or a nonsigning tax return preparer within a firm is primarily responsible,” then the IRS may assess the penalty against either, but not against both.

- May rely on taxpayer’s legal conclusions. The rule that a tax return preparer may not rely on legal conclusions regarding Federal tax issues furnished by taxpayers was removed from the final regulations with the caveat that tax return preparers nevertheless have to meet the diligence standards otherwise imposed.

- Estimates. The final regulations will not include any general rule regarding the use of estimates.

- Opportunity for disclosure. Nonsigning preparers must
advise clients of the opportunity to avoid penalties for positions for which there is a reasonable basis but not substantial authority by making appropriate disclosure.

- **Anti-abuse exception to 5-percent rule.** The final regulations contain an anti-abuse rule which provides that if a tax professional is abusing the 5-percent rule to avoid tax return preparer status by deliberately performing all the return preparation work before the transaction takes place, then the rule is inapplicable.

  a. **Rev. Proc. 2009-11, 2009-3 I.R.B. 313 (12/15/08).** This revenue procedure identifies the returns which are subject to the § 6694(a) penalty. It is effective 1/1/09 and renders obsolete Notice 2008-12 and Notice 2008-46 and modifies and supersedes the list of forms in Notice 2008-13.

2. **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. **Watch out for this one when not filing partnership tax returns for years beginning in 2008:** The revenue offset to a tax reduction. P.L. 110-141, “An Act to exclude from gross income payments from the Hokie Spirit Memorial Fund to the victims of the tragic event at Virginia Polytechnic Institute & State University” was signed by President Bush on 12/17/08. Section 2 of that Act is an off-Code provision that adds $1 to the § 6698(b)(1) “Failure to File a Partnership Return” penalty. The $1 addition does not apply to S Corporation returns. The $1 increase only applies to a taxable year beginning in 2008.

  b. **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.

4. It is not criminal tax fraud if you intended to cheat but after the fact discover a rationale that might disprove the existence of any deficiency. Justice Souter emphasizes that transactions should be treated in accordance with their substance, regardless of the intent of their participants. **Boulware v. United States, 128 S. Ct. 1168, 2008-1 U.S.T.C. ¶50,206 (3/3/08) (9-0).** Michael Boulware was convicted on nine counts of tax evasion and filing a false income tax return, stemming from his diversion of funds from Hawaiian Isles Enterprises (HIE), a closely held corporation of which he was the president, founder, and controlling (though not sole) shareholder. The Supreme Court emphasized the necessity of a tax deficiency as an essential element of tax evasion under § 7201 in reversing the taxpayer’s conviction. Boulware involved a shareholder of a closely held corporation who failed to report millions of dollars from the corporation. “[H]e siphoned off this money primarily by writing checks to employees and friends and having them return the cash to him, by diverting payments by HIE customers, by submitting fraudulent invoices to HIE, and by laundering HIE money through companies in the Kingdom of Tonga and Hong Kong.” The funds were used to support his “lavish lifestyle,” and were treated as distributions of property to him from the corporation. Boulware sought to introduce evidence that HIE had no earnings and profits in the relevant taxable years and because the amount diverted did not exceed his basis for his stock, there was no dividend under §§ 301(c)(1) and 316, and the entire amount was a return-of-capital treatment under § 301(b)(2). Boulware’s argument was that because the return of capital was nontaxable, the Government could not establish the tax deficiency required as an element of criminal tax fraud. The trial court refused to admit the proffered evidence, and the Ninth Circuit affirmed, reasoning that the return of capital theory could be advanced only if at the time the occurred the corporation intended it to be a return of capital, following its prior decision in United States v. Miller, 545 F.2d 1204 (9th Cir. 1976). The Supreme Court (Justice Souter) vacated the conviction. The Court concluded:

There is no criminal tax evasion without a tax deficiency, ... and there is no deficiency owing to a distribution (received with respect to a corporation’s stock)
if a corporation has no earnings and profits and the value distributed does not exceed the taxpayer-shareholder’s basis for his stock.

- With respect to the intent question the Court reasoned as follows:

Miller’s view that a criminal defendant may not treat a distribution as a return of capital without evidence of a corresponding contemporaneous intent sits uncomfortably not only with the tax law’s economic realism, but with the particular wording of §§ 301 and 316(a), as well. As those sections are written, the tax consequences of a “distribution by a corporation with respect to its stock” depend, not on anyone’s purpose to return capital or to get it back, but on facts wholly independent of intent: whether the corporation had earnings and profits, and the amount of the taxpayer’s basis for his stock.

- The Court stated the test to be “that economic substance remains the right touchstone for characterizing funds received when a shareholder diverts them before they can be recorded on the corporation’s books,” and that they “may be seen as dividends or capital distributions for purposes of §§ 301 and 316(a).” He analyzed the treatment of distributions received with respect to a corporation’s stock under § 301(a) and concluded that an exception for criminal cases was improper, and concluded

The implausibility of a statutory reading that either creates a tax limbo or forces resort to an atextual stopgap is all the clearer from the Ninth Circuit’s discussion in this case of its own understanding of the consequences of Miller’s rule: the court openly acknowledged that “imposing an intent requirement creates a disconnect between civil and criminal liability,” 470 F.3d at 934. In construing distribution rules that draw no distinction in terms of criminal or civil consequences, the disparity of treatment assumed by the Court of Appeals counts heavily against its contemporaneous intent construction (quite apart from the Circuit’s understanding that its interpretation entails criminal liability for evasion without any showing of a tax deficiency).

- In footnote 7 to the opinion the Court cited Isenbergh, “Review: Musings on Form and Substance in Taxation,” 49 U. Chi. L. Rev. 859 (1982), for the proposition that the tax consequences of a transaction should depend on what was actually done, and not on whether alternative routes would have offered better or worse tax consequences.

- The court declined to address the government’s alternative argument that diversion was an unlawful act akin to embezzlement, rather than a distribution with respect to the corporation’s stock, which would result in §§ 301 and 316 being irrelevant and give rise to deficiency for failure to report the proceeds of a theft, because that question had not been considered by the court of appeals.

a. Boulware on remand. It was a Pyrrhic victory before the Supreme Court. He’s still going to get room and board from the federal government for a few years. The Ninth Circuit still refuses to permit the use of the “return of capital” theory. United States v. Boulware, 558 F.3d 971, 103 A.F.T.R.2d 2009-1259 (9th Cir. 3/9/09). In ruling to affirm Boulware’s conviction, the court (Judge Thomas) held that the proffer of expert testimony to establish the theory that corporate distributions were legally non-taxable when the corporation had no earnings and profits was properly rejected because the expert testimony constituted a legal opinion and it was within the discretion of the trial judge to exclude it. Judge Thomas went on to hold that in order to be non-taxable the distribution had to be made with respect to the corporation’s stock and there was no affirmative evidence “that any nexus existed between the distribution and Boulware’s stock ownership.” “[A]t the very least a taxpayer must tender some evidence of nexus between the corporate distribution and stock ownership, or show that there were no other alternate explanations, in order to proceed with a return of capital theory at trial.” Boulware did neither, and thus the district court did not err in declining to allow him to present his theory to the jury.

- He further held there was no evidence that Boulware’s stock
basis equaled or exceeded the $10 million of corporate distributions to Boulware.

b. And on the merits in the tax case, Boulware’s corporations lose deductions. HIE Holdings, Inc. v. Commissioner, T.C. Memo. 2009-130 (6/8/09). Based on a voluminous trial record, the Tax Court (Judge Laro) denied losses and deductions to corporations controlled by Boulware and owned in part by his former secretary/mistress in trust for one of their children. The court denied net operating losses arising from NOL carryovers, disallowed claimed bad debt deductions, denied deductions for claimed professional fees (related to Boulware’s criminal defense and civil proceedings by the former mistress), and upheld constructive dividend treatment for distributions to Boulware because professional fees were paid by his constructive withdrawals from the corporations. The court found that the professional fees treated as constructive dividends did not exceed the E&P available for the year.

5. Apparently it’s OK to lie on irrelevant attachments to an amended return. United States v. Adams, 314 Fed. Appx. 633, 103 A.F.T.R.2d 2009-889 (5th Cir. 2/17/09). The taxpayer was convicted under § 7206(1) on two counts of filing a false return. One count was based on the theory that in signing a Form 1040X amended return, by virtue of the jurat the taxpayer falsely swore to truth of an attached copy of his original Schedule C, which contained income omissions. (The government did not seek an indictment for making false statements on the original Form 1040, because the applicable statute of limitations had run.) The court of appeals reversed the conviction on this count. The jurat on the Form 1040X states that the taxpayer has “examined this amended return, including accompanying schedules and statements, and to the best of my knowledge and belief, this amended return is true, correct, and complete.” By specifying that the signer’s examination extends to the amended return and all attachments while limiting the signer’s assurance of truth, correctness, and completeness to just the amended return, the jurat’s language makes a clear distinction between that which the taxpayer examined and that which he swore was true. In the case of an original return, this distinction is insignificant because accompanying schedules and statements are generally considered integral parts of the return to which the jurat applies. In this case, however, the court concluded that the original Schedule C, which constituted an integral part of his 1999 Form 1040, was not an integral part of the Form 1040X. The purpose of the amended return was to report additional gross income from the sale of the business, not the operation of the business and the IRS Form 1040X instructs taxpayers to “[a]ttach only the supporting forms and schedules for the items changed.”

6. It’s no defense to a criminal failure to pay charge that you squandered the money and couldn’t have paid it you wanted to. United States v. Easterday, 539 F.3d 1176 (9th Cir. 8/22/08). The defendant was convicted under § 7202 for willful failure to pay over withheld employee payroll and income taxes. He had requested “an ‘ability to pay instruction’ in order to contend to the jury that his failure to pay over the taxes he owed was not ‘willful,’ because he had spent the money on other business expenses and therefore could not pay it to the government when it was due,” but the district court refused to give the instruction. The Ninth Circuit affirmed, overruling its prior decision to the contrary in United States v. Poll, 521 F.2d 329 (9th Cir. 1975), on the ground that the subsequent Supreme Court decision in United States v. Pomponio, 429 U.S. 10 (1976), by implication repudiated any requirement of proving ability to pay as an element of the crime of willful failure to pay. Possession of sufficient funds to pay the tax is not an element of the crime of under § 7202 (or § 7203). A conviction will be sustained without any showing of the taxpayer’s ability to pay and a taxpayer is not entitled to a jury instruction that to support a conviction the government must prove that the taxpayer could have paid the tax.

a. Petition for rehearing en banc denied. United States v. Easterday, 564 F.3d 1004, 103 A.F.T.R.2d 2009-1916 (9th Cir. 4/27/09). In denying the taxpayer’s petition for a rehearing en banc (2-1), Judge Schroeder amended the original opinion, but reached the same conclusion. In the amended option, the court rejected the taxpayer’s argument that as long as United States v. Poll, 521 F.2d 329 (9th Cir. 1975), a panel opinion had not been overruled by an en banc panel of the court, a panel of the Ninth Circuit was bound to follow Poll as law of the circuit. The dissent by Judge Smith would have upheld the taxpayer’s
argument that one panel of the Ninth Circuit cannot overrule a decision of an earlier panel, even though Judge Smith agreed that Poll was wrongly decided.

7. Steven N.S. Cheung, Inc. v. United States, 545 F.3d 695 (9th Cir. 9/23/08). The flush language of § 6621(a)(1) provides for a one and a half point reduction in the overpayment rate, from 2 points above the Federal short term rate to ½ point above the Federal short term rate, if an overpayment of tax by a corporation exceeds $10,000. The Ninth Circuit held that the flush language of § 6621(a)(1) applies to interest payable by the government to a corporate taxpayer pursuant to a wrongful levy judgment.

8. Williams v. Commissioner, 131 T.C. No. 6 (10/2/08). Because § 6404(e) authorizes the Commissioner to “abate the assessment” of interest, § 6404(e) operates only after there has been an assessment of interest; Thus, Tax Court has no jurisdiction under § 6404(h) to review the IRS’s decision not to abate interest until interest has been assessed and the IRS has mailed a “final determination not to abate such interest.” Nor does the Tax Court have jurisdiction to review the assessment of foreign bank account reporting (FBAR) penalties imposed under 31 U.S.C. § 5321(a) (and assessed under 31 U.S.C.) for violations of the reporting requirements in 31 U.S.C. Under the statute, FBAR penalties are assessed without a deficiency notice – a deficiency notice is neither authorized under § 6212(a) nor required by § 6213(a) before the assessment may be made.

9. He was convicted of criminal tax fraud, but in the civil case, the IRS couldn’t prove that any of the over $200,000 deficiency was due to fraud, so Judge Holmes “estimates” $500 of the deficiency due to fraud in order to avoid inconsistency. Barrow v. Commissioner, T.C. Memo. 2008-264 (11/25/08). Because the IRS issued the deficiency notice more than three years after the return filing date, the deficiency notice was timely only if the understatement of tax was fraudulent. The taxpayer had been convicted of criminal tax fraud with respect to taxable years 1985, 1987, and 1988. In the criminal trial, the government’s primary theory was that Barrow had cheated on his taxes by not reporting on his individual returns fees that two health care organizations paid to him as the chairman of the board and a trustee. In the civil action, however, the government’s theory was that Barrow’s unreported income was income diverted from the incorporated accounting firm that he headed (because the government also was seeking a deficiency against the accounting firm). The government argued that Barrow was collaterally estopped from arguing that the understatement was not fraudulent. The Tax Court (Judge Holmes) upheld that the taxpayer’s argument that because the government’s theory with respect to the unreported fees was different in the civil action from in the criminal action, the issues in that regard were not identical — a requirement for collateral estoppel to apply — with respect to the two actions, but that Barrow nevertheless was collaterally estopped from arguing that the understatement was not fraudulent because they were “relatively minor items of unreported income or incorrect expenses whose consequences for Barrow’s tax liability are unaffected by the switch in government theories between the cases.” Because in the criminal trial, the government established willful tax evasion beyond a reasonable doubt, but the jury was not required to return a verdict detailing which items of income had not reported or which claimed expenses had not been paid, collateral estoppel applied with respect to the entire claimed deficiency. However, on the merits, Judge Holmes found that even though in the criminal case the government proved beyond a reasonable doubt that some part of Barrow’s underpayments for 1987 and 1988 were due to fraud, in the civil case the Commissioner failed to prove that any particular underpayments were actually due to fraud. Recognizing that “it would be inconsistent to hold no part of the underpayment due to fraud,” Judge Holmes “estimate[d] that $500 in 1987 and 1988 was due to fraud for purposes of applying the fraud penalty. But because no part of any underpayments for 1984 or 1986 (the accounting firm’s 1988 and 1989 deficiencies) was due to fraud, the Commissioner’s determination for those years was not sustained.

10. Hip, hip, hypocrisy! Treasury Press Release on the swearing-in of a new Secretary of the Treasury, http://www.ustreas.gov/news/index1.html (1/26/09). This appointment requires IRS employees to feel ashamed — but undeterred — when they propose penalties or criminal prosecutions with respect to an amount of tax owed that does not exceed $48,268. See,
a. H.R. 735, the Rangel Rule Bill of 2009, was introduced on 1/28/09 by Representative John Carter (R-TX). It would permit taxpayers to immunize themselves from penalties and interest when they file a return to pay back taxes.

11. Joe Garza won't want to post this opinion on his web site. Estate of Hurford v. Commissioner, T.C. Memo. 2008-278 (12/11/08). The Tax Court (Judge Holmes) began its opinion in the case dealing with the estate of the widow of the president of Hunt Oil Company as follows:

It is a truth universally acknowledged, that a recently widowed woman in possession of a good fortune must be in want of an estate planner. Thelma Hurford had devoted her life to family and friends, leaving the management of the finances to her husband Gary. When he died suddenly, she had to learn what they owned and decide what to do with it. While she struggled with this burden, she was herself stricken with cancer and so had to arrange the accelerated planning of her own estate. Two attorneys vied for her attention and she chose Joe B. Garza.

She lost her life to the cancer. We must now decide how much of her estate will be lost to taxes.

- Judge Holmes first found that the property that was sought to be transferred out of Thelma Hurford’s estate using three family limited partnerships and a private annuity was includible in her estate because the private annuity agreement was not bona fide, but was a disguised gift and was an exercise by decedent of a right to designate the persons who should possess or enjoy the property under §§ 2036(a)(2) and 2038(a)(1). The FLP interests placed in the annuity were undervalued and were held by decedent’s children in the same form as before the transfer. The annuity payments were simply transfers of the property in its original form back to the decedent. The FLPs lacked a business purpose because there was neither asset protection nor any advantage in consolidated management. Penalties were not applied because the executor could not have reasonably known that the estate plan was not within the realm of legitimate estate-planning practices because it resembled some of Sandy Bisignano’s suggestions implemented sloppily. Judge Holmes sums this up as follows:

There are many other problems with the Marital Trust’s assets independent of the FLP and private-annuity transactions. For example, though Gary’s will passed all of the property in his estate -- except for the Family Trust’s assets, his home, and his personal effects -- into the Marital Trust, only a small portion of it ended up in the Marital Trust account with Chase or was otherwise titled in the Trust’s name. And Gary’s estate took a QTIP election for approximately $6,500,000. Were we to try to construct an alternate holding for this part of Thelma’s estate, as the Commissioner urges, we would quickly run into tricky questions of whether Thelma’s handling of that property was a conversion and disposition of the QTIP property under sections 2511 and 2519. We’ll leave those questions for another case, and hold instead that all the property that Garza moved from Thelma and the Trusts into the FLPs and the private annuity is included without discount in her gross estate under section 2031(a)’s broad language including in an estate “all property, real or personal, tangible or intangible, wherever situated. (footnote omitted)

- He concluded:

We consider it well established that a taxpayer has the right to minimize his tax liability, and it was reasonable for Michael to have relied on professionals in the arcane and complex field of estate-tax law. That his and his family’s choice of

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Cf., “It is a truth universally acknowledged, that a single man in possession of a good fortune, must be in want of a wife.” Jane Austen, Pride and Prejudice.

The other attorney was Sandy Bisignano.
advisers proved so unsuitable has led them to their present situation -- unable to enjoy fully the estate built up by old Mr. Hurford, and seeking relief at court instead. But we do find that Michael’s reliance on the professionals he chose, however unsuitable they turned out to be, was nevertheless under the circumstances done reasonably and in good faith. We therefore impose no penalty for negligence or disregard of the Code.

12. Small businesses that underpay estimated taxes are the backbone of the American economy. Section 1212 of the 2009 ARRTA amended §6654(d) to reduce the 100 percent of the prior year’s taxes safe-harbor to 90 percent of the prior year’s taxes for an individual whose adjusted gross income for the prior year was less than $500,000, if more than 50 percent of the gross income on the prior year’s tax return was from a small business (generally defined as a business with fewer than 500 employees).

13. IRS announces an amnesty for offshore credit-card abusers who clear up their tax liabilities by April 15th 2003. IRS News Release IR-2003-05, 2003 TNT 10-11 (1/14/03). An Offshore Voluntary Compliance Initiative provides 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, 2003-4 I.R.B. 311 (1/14/03). This revenue procedure contains 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 is 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.

(1) 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].

(2) 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.

e. 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.

  (1) 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.

14. **Sentence was unreasonably lenient, said Third Circuit.** United States v. Tomko, 498 F.3d 157, 100 A.F.T.R.2d 2007-5621 (3d Cir. 8/21/07). A sentence of one year of home confinement, “the very mansion built through the tax evasion scheme at issue,” a $250,000 fine, three years probation, and 250 hours of community service for evading taxes of $228,557, was vacated as unreasonably lenient. The case was remanded for resentencing.

a. **However, the court en banc affirmed the district court’s sentence.** United States v. Tomko, 562 F.3d 558 (3d Cir. 4/17/09) (8-5). The majority opinion (Judge Smith) held that the district court’s variation from the [18 U.S.C. § 3553(a)] U.S. Sentencing Guidelines’ recommendations [which included between twelve and eighteen months’ imprisonment] after consideration of all relevant factors was entitled to “due deference” despite the fact that some judges in the majority would have imposed prison time on a plumbing contractor who directed numerous subcontractors who were building his multimillion dollar home to falsify information on billing invoices so the invoices would show work done at one of his corporation’s many job sites instead of at his home, resulting in a tax deficiency of $228,557. Defendant’s work for Habitat For Humanity’s Pittsburgh affiliate and his willingness to work for its New Orleans affiliate post-Katrina – despite its beginning after his indictment – appears to have influenced the district court’s downward departure.

b. Judge Fisher’s dissent focused on the greater apparent pervasiveness of defendant’s scheme, including his repeated statements that his vacation home in Maryland was “a gift from Uncle Sam,” and found that the district court “exceeded the lower outer limit of the range of appropriate choices it had the discretion to make, and in doing so abused that discretion” because virtually all other “typical tax evader[s]” possessed the same type of mitigating factors relied upon by the district court.

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 these 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 \textit{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.

\textbf{a. This split decision has been taken to the banc.} \textit{United States v. Textron Inc.}, 507 F. Supp. 2d 138 (D. R.I. 8/28/07), \textit{affirmed in part, vacated in part and remanded}, 553 F.3d 87 (1st Cir. 1/21/09) (2-1), \textit{taxpayer's petition for rehearing denied}, (3/24/09), \textit{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 are 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 \textit{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 so that the district court could 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.

- Note that the government's petition for rehearing en banc was granted.

\textbf{b. The First follows the Fifth to \textit{El Paso}. Reversed by a divided First Circuit in an en banc rehearing.} \textit{United States v. Textron Inc.}, 2009-2 U.S.T.C. ¶50,574 (1st Cir. 8/13/09) (3-2). 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 \textit{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)

2. The work product privilege claim didn’t work, but the § 7525 privilege claim did. Valero Energy Corp. v. United States, 100 A.F.T.R.2d 2007-6473 (N.D. Ill. 8/23/07). Valero sought to quash summonses issued by the IRS to Valero’s tax advisor, Arthur Andersen, relating to certain branch transactions, foreign currency transactions, dual consolidated losses, overall foreign losses, and hedge positions in connection with fluctuation risks. The court (Judge Kennelly) rejected Valero’s claim that the documents were protected by the work product doctrine. He found that the documents were “best categorized as having been prepared during the ordinary course of business, with the possibility of future litigation being secondary at most.” He concluded that “Valero confuse[d] the possibility of litigation with the requirement that to be protected, a document must have been prepared because of anticipated litigation. The fact that Valero hired Arthur Andersen with an eye toward the complex nature of the transaction, and the possibility that the IRS might investigate, does not support a contention that Arthur Andersen prepared its materials because Valero or Andersen anticipated actual litigation.” [Under Seventh Circuit precedent, the work product doctrine applies only when “the document can fairly be said to have been prepared or obtained because of the prospect of litigation.” *Logan v. Commercial Union Ins. Co.*, 96 F.3d 971, 976–77 (7th Cir. 1996) (emphasis in original).] However, the documents were protected under the § 7525 tax practitioner’s privilege as ‘confidential tax advice.’ Even though it had the effect of avoiding federal income taxes, the tax shelter exception in § 7525(b) did not apply for two reasons. First, “the transactions in question did not involve the promotion of tax shelters”; nothing in the record indicated that Arthur Andersen had anything to do with ‘promotion’ of participation in a tax shelter. Second, the tax shelter exception only applies to a transaction in which tax avoidance is a “significant purpose,” and not where tax avoidance is merely “one of the purposes” of the transaction. Nothing in the record indicated the purpose of the transactions. [Under Seventh Circuit precedent, *United States v. BDO Seidman, LLP*, 492 F.3d 806 (7th Cir. 6/11/07), “the burden rests on the opponent of the privilege to prove preliminary facts that would support a finding that the claimed privilege falls within an exception.”]

a. Valero Energy Corp. v. United States, 102 A.F.T.R.2d 2008-5916 (N.D. Ill. 8/1/08), on reconsideration, 102 A.F.T.R.2d 2008-5929 (N.D. Ill. 8/26/08). On the government’s motion for entry of a further order of an IRS summons issued to Valero’s tax advisors, Arthur Andersen, LLP, and after an in camera inspection of the requested documents, Judge Kennelly held that the government “met its burden of showing a foundation in fact that the transactions involved a tax shelter” so the lion’s share of the documents are not privileged. The court refused to construe the word “promotion” in § 7252(b) narrowly, and held that “promotion” includes participation in the organization or sale of a tax shelter.

b. Affirmed. “Nothing ... limits tax shelters to cookie-cutter products peddled by shady practitioners or distinguishes tax shelters from individualized
tax advice.” Valero Energy Corp. v. United States, 102 A.F.T.R.2d 2008-5916 (N.D. Ill. 8/1/08), on reconsideration, 102 A.F.T.R.2d 2008-5929 (N.D. Ill. 8/26/08), aff’d, 569 F.3d 626 (7th Cir. 6/17/09). The Seventh Circuit, in an opinion by Judge Evans, affirmed the district court’s order enforcing the summons, noting that “our review of the district court’s ruling is deferential, and we will reverse only if it is clearly erroneous. Findings regarding privilege are fact-intensive, case-specific questions that fall within the district court’s expertise, and, under these circumstances, ‘a light appellate touch is best.’” First, the court of appeals described many of the documents as “the type of information generally gathered to facilitate the filing of a tax return,” which is “accounting advice ... not covered by the privilege, ...whether or not the information made it on the tax returns.” Other documents dealt with “inventory methods, compensation packages, or general structure, and analyzed how they affect tax computations.” The court concluded that the documents were discoverable, even though they “contain[ed] some legal analysis,” because it comes part and parcel with accounting advice, and is therefore also open to the government.” Finally, the court held that “[n]othing in [the § 6662(d)(2)(C)(ii) definition of a ‘tax shelter’] limits tax shelters to cookie-cutter products peddled by shady practitioners or distinguishes tax shelters from individualized tax advice. Instead, the language is broad and encompasses any plan or arrangement whose significant purpose is to avoid or evade federal taxes.”

3. The IRS now permanently can rat out terrorists. The Emergency Economic Stabilization Act of 2008 made permanent the § 6103(i)(3) exception for terrorists to the return confidentiality rules.

4. You can’t quash a summons on a tax advisor just because he’s the one who has been referred to the Justice Department for criminal prosecution. Khan v. United States, 548 F.3d 549 (7th Cir. 11/20/08). The court upheld the validity of Reg. § 301.7602-1(c)(1), which limits the application of the § 7602(d)(1) bar on the IRS summons only when there is a Justice Department referral of the person whose tax liability is at issue. Section 7602(d) does not authorize quashing a summons on a third party tax advisor in connection with an investigation of taxpayer’s liability even if there has been a Justice Department referral with respect to the tax advisor.


[E]nforcement of the tax laws, a largely self-policing obligation, depends heavily on the personal probity of taxpayers and the deterrent effect of severe and certain sanctions. And, as a slew of high profile cases have recently demonstrated, compliance will often be delayed until enforcement (or unfavorable exposure) is imminent. ...

[C]ompanies using LILO schemes would love to have information about the IRS’s objectives of settlement, assessment of litigation hazards, and acceptable ranges for settlement. Why? Because this information would inform their cost-benefit analysis about the advantages of evading the law. Constructing a phony tax shelter may only be worthwhile if the IRS’s acceptable settlement range is below 80% of the tax liability. Once armed with (hypothetical) information that the IRS’s acceptable settlements are between 60% and 75%, a questionable tax scheme becomes viable. Even a failure may be a win. And, once also armed with information about which cases the IRS does not like to litigate, the illegal tax shelter can be designed to minimize the chances of litigation or the likelihood of sanctions.
6. The IRS has the burden of showing that the exception to the FATP privilege for corporate tax shelter promotion communications applies. 

*Countryside Limited Partnership v. Commissioner*, 132 T.C. No. 17 (6/8/09). When the IRS moved to compel production of certain meeting notes prepared by one of the taxpayer's accountant-advisors, the taxpayer claimed that the documents were protected from disclosure by the attorney client privilege and the § 7525 federally authorized tax practitioner [FATP] privilege. The meeting notes “constitute[d] a cumulative chronicle of communications, in part confidential, from clients, including Countryside Limited Partnership ... , to their attorneys for legal advice or to Timothy Egan ... , whom [the court] found to be an FATP, for tax advice, or from those individuals back to their clients.” The Tax Court (Judge Halpern) held that the taxpayer has the burden of proving the preliminary facts necessary to establish the § 7525 privilege. The Commissioner can negate the privilege claim by proving that the requested documents are written communications in connection with the promotion of corporate tax shelters and that the exception in § 7525(b) thus applies. On the facts, Judge Halpern found that because the meeting notes in question were not themselves communicated to anyone but were merely written summaries of oral communications, they were not a written communication that could satisfy that element of the § 7525(b) exception. The documents in question also were not within the § 7525(b) exception because the Commissioner failed to show that the accountant had “promoted” a corporate tax shelter. Section 7525 does not define “promotion,” but the legislative history quoted in the opinion provides, “[t]he Conferences do not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client. Accordingly, the Conferences do not anticipate that the tax shelter limitation will adversely affect such routine relationships.” H. Conf. Rept. 105-599, at 269 (1998), 1998-3 C.B. 747, 1023. Judge Halpern found Eagan's relationship to the taxpayer to be a “routine” relationship that did not involve promotion of a tax shelter.

Mr. Egan has had a long, close relationship with the Winn organization, preparing returns, assisting with tax planning when asked, answering questions when asked, and responding to notices and inquiries from Federal and State tax officials. His advice with respect to the partnership redemptions and associated transactions under review in these cases was furnished (as was similar advice with respect to similar transactions) as part of a long-standing, ongoing, and, hence, routine relationship with the Winn organization. Mr. Egan provided tax advice to the Winn organization when requested to do so, and his advice here followed the same regular course of procedure as did his other tax advice, including tax advice related to partnership redemptions. His employer, PWC, had no stake in the outcome of the transactions under review in this case other than in the continued retention of the Winn organization as a client. It did not receive a fixed fee or a fee based on a percentage of some claimed tax saving. It was paid by the hour pursuant to a rate schedule for Mr. Egan's time in rendering his advice, just as it was for the other services outside of return preparation that he rendered to the Winn organization.

C. Litigation Costs

1. A contingent attorney’s fee has been incurred even if it’s not owed. 

*Morrison v. Commissioner*, 565 F.3d 658, 103 A.F.T.R.2d 2009-2096 (9th Cir. 5/13/09). The Ninth Circuit reversed a Tax Court decision, T.C. Memo 2006-103, which held that a taxpayer had not “incurred” attorney’s fees reimbursable under § 7430 when the fees were advanced by a corporation owned by the taxpayer under an agreement providing that the taxpayer would reimburse the corporation if he was able to recover them under § 7430. It should be self evident that when a third person, e.g., a corporation of which the taxpayer is a shareholder, who has no direct interest in the litigation pays attorney’s fees on behalf of a taxpayer, the taxpayer has “incurred” the fees as long as the taxpayer has an absolute obligation to repay the third person, regardless of whether he successfully moves for an attorney’s fees award under § 7430. Going a step further, the Ninth Circuit held that when such a third person pays attorney’s fees on behalf...
of a taxpayer, the taxpayer has "incurred" the fees if he has only a contingent obligation to pay the fees in the event that he is able to recover them under § 7430. Because the nature of the agreement between the taxpayer and the corporation that advanced the attorney's fees was unclear from the record, the Ninth Circuit remanded the case to the Tax Court to apply the definition it adopted of "incurred," after determining the precise nature of the fee agreement, if any, between the taxpayer and the corporation.

D. Statutory Notice of Deficiency

E. Statute of Limitations

1. You have to raise the statute of limitations the first time you get the chance or forever hold your peace. Golden v. Commissioner, 548 F.3d 487 (6th Cir. 11/26/08). Settlement of all claims in an earlier tax court proceeding barred the taxpayer from raising a claim in a subsequent CDP proceeding that the original deficiency notice was outside the three-year statute of limitations. Principles of res judicata apply to bar consideration of issues, including the statute of limitations, that could have been raised in a prior judicial proceeding.

2. You can't rely on an unclarified informal refund claim to beat the statute of limitations. Greene-Thapedi v. United States, 549 F.3d 530 (7th Cir. 12/3/08). To satisfy the jurisdictional requirements of § 7422(a) authorizing district court review of the IRS's denial of a refund, the taxpayer's timely informal refund claim must be followed by a subsequent formal refund claim. "The informal claim doctrine is predicated on the expectation that any formal deficiency will at some point be corrected. ... To hold otherwise would eliminate, as a practical matter, the formal claim requirement."

3. The taxpayer might have been confused by inconsistent letters from the IRS, but that's no excuse. Leonard v. United States, 85 Fed. Cl. 435, 103 A.F.T.R.2d 2009-679 (1/30/09). A letter sent to the taxpayer on Feb. 29, stating that a formal disallowance of a refund claim that will start the statute of limitations on filing a refund suit would be issued in the following week, did not toll the period of limitations that had been commenced by a letter sent on Feb. 6, stating that the refund claim had been disallowed and that a suit for refund could be commenced within two years of the date of the Feb. 6 letter.

4. Home Concrete & Supply LLC v. United States, 599 F. Supp. 2d 678, 103 A.F.T.R.2d 2009-465 (E.D. N.C. 11/21/08). On the government's motion for partial summary judgment, the district court (Judge Flanagan) 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 Grapevine Imports, Ltd v. United States, 77 Fed. Cl. 505 (2007), and Bakersfield Energy Partners, LP v. Commissioner, 128 T.C. 207 (2007), both of which held that understated gain attributable to overstated basis was not an omission of "gross income" that would invoke the 6-year statute of limitations. The district court concluded that those cases were erroneously decided because they had applied Colony, Inc. v. Commissioner, 357 U.S. 28 (1958), which had so construed the statutory predecessor of § 6501(e) in the 1939 Code, without taking into account statutory changes in 1954. The court reasoned as follows:

[G]ross income" as related to dealings in property is defined with reference to the property's adjusted basis. Any overstatement in basis will necessarily decrease the amount of gross income that a taxpayer states on his return. In other words, by overstating basis in the gross income calculation, the taxpayer "leave[s] out" or fails to "include" "an amount properly includible therein." Therefore, where a taxpayer incorrectly states an overestimated basis in property, the taxpayer "omits" gross income by leaving the amount out of gross income stated on the taxpayer's return.

5. Benson v. Commissioner, 560 F.3d 1133 (9th Cir. 3/31/09), aff'g T.C. Memo. 2006-55 (3/27/06). Items on the tax returns of brother-sister corporations reflecting payments between them, which on the facts were found to be constructive dividends to their common shareholder, did not constitute adequate disclosure with respect to the shareholder's return to prevent the § 6501(e)(1)(A) six-year statute from being applicable.
F. Liens and Collections

1. **Timely request a CDP hearing or forever hold your peace.** Wilson v. Commissioner, 131 T.C. No. 5 (9/10/08). The taxpayer failed to timely request a CDP hearing with Appeals with respect to a proposed levy. Following a late request, Appeals held an equivalent hearing and issued a form letter “NOTICE OF DETERMINATION CONCERNING COLLECTION ACTION(S) UNDER SECTION 6320 and/or 6330.” The Tax Court dismissed the taxpayer’s petition for review for lack of jurisdiction. The Court held that because the taxpayer did not timely request a hearing, Appeals did not make a § 6330 determination pursuant to the equivalent hearing, and thus the letter to the taxpayer was not a valid notice of determination under § 6330 that the taxpayer was entitled to appeal pursuant.

2. **Present all your claims at the CDP hearing or lose your right of Tax Court review.** Brecht v. Commissioner, T.C. Memo. 2008-213 (9/15/08). When reviewing a CDP determination, the Tax Court will not consider an issue regarding abatement of interest under § 6404(e) if it was not properly raised at the CDP hearing and/or considered in the notice of determination.

3. **Hoyle v. Commissioner,** 131 T.C. No. 13 (12/3/08). Judge Wells held that whether the Appeals officer verified as required by § 6330(c)(1) that all procedural requirements, including that a deficiency notice had been properly mailed to the taxpayer, will be considered on Tax Court review without regard to whether the issue was raised by the taxpayer at the Appeals CDP hearing. [Giamelli v. Commissioner, 129 T.C. 107 (2007), held that in reviewing an Appeals officer’s CDP determination the Tax Court does not consider issues that are not a part of that determination.] Because the court was unable to ascertain the basis for the Appeals officer’s verification that the requirements of § 6330(c)(1) were met, the case was remanded to Appeals to clarify the record.

4. **Live by your OIC or pay up.** Trout v. Commissioner, 131 T.C. No. 16 (12/16/08). The taxpayer entered into a compromise of tax liability pursuant to § 7122(a), pursuant to which he agreed to file his tax returns, and pay any tax due, on time for the next five years. He failed to file returns for two of the required years, and the IRS declared him in default and sought to levy on his assets. On review of a CDP hearing sustaining the levy, the Tax Court, in a reviewed opinion by Judge Holmes, held that the IRS did not abuse its discretion in declaring the OIC in default and seeking to levy on taxpayer’s assets. An accepted offer in compromise is a contract and if the taxpayer fails to satisfy the condition that the taxpayer file his tax returns and pay any tax due on time for a specified period of subsequent years, the IRS may void the compromise and collect the original tax liability in full. In interpreting the compromise agreement to determine whether its terms have been satisfied or breached, the federal common law of contracts, not any particular state law, applies. Judge Holmes held that the breach was not immaterial.

5. **The government’s rights as a lien-holder under the Code trump conflicting state law.** Russell v. United States, 551 F.3d 1174, 102 A.F.T.R.2d 2008-7337 (10th Cir. 12/19/08) Section 7425(b) provides for the discharge of a junior federal tax lien by a nonjudicial sale by a senior lien holder, if proper notice is provided to the government. The Tenth Circuit reversed a district court opinion that vacated the tax lien because the government did not redeem or purchase the property from the senior lien holder within the period after the sale of the property as provided by state [Colorado] law, even though the government did not receive notice of the sale. The Tenth Circuit held that § 7425(b) preempts state law and leaves federal tax liens undisturbed where the government did not receive notice of a nonjudicial sale.

6. **Regardless of whether or not she’s a Blues fan, Judge Marvel says the Queen of the Blues has a legal obligation to honestly report and pay her income tax liability each year.** Taylor v. Commissioner, T.C. Memo. 2009-27 (2/5/09). The taxpayer, Koko Taylor – the "Queen of the Blues," failed to pay estimated taxes or remit full payment with her tax returns for several years. The IRS rejected her subsequent offer in compromise, which she grounded on “economic hardship”, because it found no hardship or reasonable cause for failure to pay, and following a collection dues process hearing issued a determination that a levy should proceed. The Queen of the Blues appealed to the Tax Court, but Judge Marvel upheld the IRS’s
determination.

Both petitioner and respondent repeatedly commented on petitioner's stature as a beloved and well-known professional singer as support for their respective positions in these consolidated cases. We disagree with both parties insofar as they contend that a taxpayer's celebrity status is somehow relevant to what this Court must do in deciding whether the Commissioner's collection action may proceed. Every taxpayer, no matter how famous or notorious, has a legal obligation to honestly report and pay his or her income tax liability each year and is entitled to fair enforcement of Federal tax laws. A taxpayer like petitioner whose business income is generated by performances must carefully comply with estimated tax requirements. The record establishes that petitioner had outstanding tax liabilities for 1998, 2000, and 2001 because she did not make required estimated tax payments when due and that respondent did not abuse his discretion in determining that the filing of an NFTL was appropriate and that respondent may proceed to collect petitioner's outstanding tax liabilities by levy. Respondent gave petitioner ample opportunity to rectify her failure to pay estimated tax when due and considered petitioner's collection alternatives in accordance with applicable administrative and legal requirements.

7. Pennoni v. United States, 79 Fed. Cl. 552 (12/4/07). After the taxpayer failed to file a federal income tax return for tax year 1998, the IRS sent him a Proposed Individual Income Tax Assessment, claiming that he owed $17,764. Although the IRS eventually agreed that the taxpayer was owed a refund in the amount of $2,801, it sent him a refund check in the amount of $80,166. The IRS recognized its mistake after the taxpayer cashed the check, and it sent the taxpayer a Notice of Balance Due and ultimately placed a levy on his bank account and garnished his wages. The taxpayer sued the Government, seeking an order requiring it to repay amounts it took from his bank account and wages, plus costs, and the Government filed a motion to dismiss the action, claiming that the court lacked jurisdiction because the taxpayer did not file an administrative claim for a refund before he filed suit. The court found that the taxpayer did not have to file an administrative claim before he filed suit because he was not seeking a tax refund. Instead, he was suing the Government for illegal exaction, and the suit was timely under the six-year statute of limitations pertaining to lawsuits filed under the Tucker Act, so the Government's motion to dismiss was denied.

a. The IRS might not have to follow administrative procedures to "reassess" liability for an erroneous refund, but the taxpayer has to follow administrative procedures before filing suit to recover money to which he was never entitled. Pennoni v. United States, 86 Fed. Cl. 351, 103 A.F.T.R.2d 2009-1057 (2/26/09). The Court of Federal Claims (Judge Firestone) applied the principles of United States v. Clintwood Elkhorn Mining, 128 S. Ct. 1511 (2008), which held that the requirements of § 7422 are to be strictly construed, to hold that § 7422(a) requires that administrative remedies be pursued before a taxpayer files suit seeking recovery of amounts that the IRS has collected by administrative levy, without following deficiency or assessment procedures, to recoup an erroneous refund. The court concluded that "even if the plaintiff is correct in its characterization that the IRS improperly used its levy powers to collect a non-tax debt created by the erroneous refund, rather than to collect an unpaid tax liability, this case nonetheless clearly falls within the 'any sum' language of section 7422(a). By its terms, section 7422(a) extends beyond suits for 'the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected,' to suits for the recovery of 'any sum alleged to have been excessive or in any manner wrongfully collected.'"

b. Strategic Housing Finance Corporation of Travis County v. United States, 86 Fed. Cl. 518, 103 A.F.T.R.2d 2009-1097 (2/27/09). Judge Scott interpreted the requirements of § 7422(a) in the same manner as Judge Firestone did in Pennoni and denied a nonprofit housing finance corporation/tax-exempt bond issuer's refund claim, for which there
had no administrative claim filed, seeking to recover an IRS-accelerated arbitrage rebate overpayment made under protest. The plaintiff characterized the suit as one for an "illegal exaction" or "illegal taking."

8. Mason v. Commissioner, 132 T.C. No. 14 (5/6/09). The taxpayer sought review of a CDP hearing with respect to § 6672 penalties assessed against her as a responsible person for failure to collect and pay over withholding taxes of a corporation. She had not been permitted to contest liability at the CDP hearing, even though prior to the CDP hearing the taxpayer had not received a notice of the IRS's intent to assess § 6672 penalties. The Tax Court (Judge Gerber) held that because the taxpayer had not received a notice of intent to assess a trust fund recovery penalty, she had not had an opportunity to dispute that tax liability under § 6330(c)(2)(B). Because the taxpayer did not have an opportunity to dispute the underlying tax liability at any time during the administrative proceedings and raised the issue at the CDP hearing, the Tax Court reviewed the liability de novo. However, a notice of intent to assess § 6672 penalties is valid for purposes of assessing the penalties, even though the taxpayer has not received the notice. Thus, the penalties were validly assessed. On the facts, the taxpayer was a "responsible person" who willfully failed to pay over withholding taxes and was liable for the trust fund penalties. The IRS's determination to uphold the lien filing was not an abuse of discretion.

9. Even the certainly dead face the certainty of taxation. Estate of Brandon v. Commissioner, 133 T.C. No. 4 (8/27/09). Judge Foley held that a tax lien that is filed after the taxpayer's death with respect to taxes assessed prior to the taxpayer's death is valid, even though at the time the lien was filed ownership of the property had passed to the taxpayer's estate. Under § 6321 a tax lien arises when the assessment is made and under § 6322 continues to be enforceable until it is satisfied or it becomes unenforceable by a lapse of time, and the IRS complied with the lien notice and filing requirements.

G. Innocent Spouse

1. The Tax Court sticks to its position that it has broad discretion in reviewing denial of innocent spouse relief. Porter v. Commissioner, 130 T.C. No. 10 (5/15/08) (reviewed, 2 judges dissenting). Judge Haines held that the Tax Court continues to follow its holding in Ewing v. Commissioner, 122 T.C. 32 (2004), vacated on unrelated jurisdictional grounds, 439 F.3d 1009 (9th Cir. 2006), that (1) its determination whether the IRS abused its discretion in denying innocent spouse relief under § 6015(f) is made in a trial de novo, and (2) it may consider evidence introduced at trial which was not included in the administrative record. He rejected the IRS's argument that pursuant to the Eighth Circuit's decision in Robinette v. Commissioner, 439 F.3d 455 (8th Cir. 2006), rev'g 123 T.C. 85 (2004), the Tax Court's review is limited to the administrative record. Judge Haines distinguished Robinette as involving review of a § 6330 CDP determination: "Whereas section 6015 provides that we 'determine' whether the taxpayer is entitled to relief, section 6330(d) provides for judicial review of the Commissioner's determination by allowing the taxpayer to 'appeal such determination to the Tax Court' and vesting the Tax Court with 'jurisdiction with respect to such matter'. As discussed above, the use of the word 'determine' suggests that we conduct a trial de novo.'"

a. Porter v. Commissioner, 132 T.C. No. 11 (4/23/09). This opinion dealt with issues not addressed in Porter v. Commissioner, 130 T.C. No. 10 (5/15/08), which held that in determining whether the IRS abused its discretion in denying innocent spouse relief under § 6015(f) the Tax Court conducts a trial de novo, and may consider evidence introduced at trial which was not included in the administrative record. In this reviewed opinion by Judge Haines, in which eight other judges joined, supported by a concurring opinion of two other judges, the Tax Court held that it applies de novo standard of review as well as de novo scope of review. Jonson v. Commissioner, 118 T.C. 106 (2002), aff'd, 353 F3d 1181 (10th Cir. 2003), and Butler v. Commissioner, 114 T.C. 276 (2000), which applied an abuse of discretion standard of review are no longer controlling. Applying this standard of review, equitable relief was granted on the facts. Six judges dissented from the opinion with respect to the standard of review and two judges who concurred with respect to the standard of review dissented on the merits.
b. And the Eleventh Circuit agrees with the Tax Court that it's more powerful than the IRS's administrative record. Commissioner v. Neal, 557 F.3d 1262, 103 A.F.T.R.2d 2009-801 (11th Cir. 2/10/09) (2-1). In an opinion by Judge Wilson, the Eleventh Circuit held that the Tax Court properly considered facts that were not in the administrative record in determining in a trial de novo that the IRS abused its discretion in denying innocent spouse relief under § 6015(f). He concluded that Commissioner had not shown that the Tax Court’s reasoning to that effect in Ewing v. Commissioner, 122 T.C. 32 (2004), vacated on other grounds, 439 F.3d 1009 (9th Cir. 2/28/06), and Porter v. Commissioner, 130 T.C. No. 10 (5/15/08) was in error, and he rejected the Commissioner’s argument that the Administrative Procedure Act required that the Tax Court’s review be limited to the administrative record. Section 6015(e), providing for Tax Court jurisdiction to review the IRS’s denial of innocent spouse relief in a stand alone petition cannot be read in isolation from the remainder of rules governing Tax court review of deficiency “determinations,” which differ from “appeals” from the IRS’s decision.

[Section] 6015 is “part and parcel” of the statutory framework for Tax Court review of IRS deficiency determinations. ... It is from this framework that the “[Tax Court’s] de novo review procedures emanate.” ... Accordingly, when Congress chose to use the same statutory language in § 6015 as it used in establishing the longstanding trial de novo procedure for deficiency actions, “it did so in full awareness of [the Tax Court’s] long history of de novo review,” and did not intend to impose a different procedure. Thus, per § 559, “the APA does not disturb or supersede [the Tax] Court’s longstanding de novo judicial review procedures for cases involving spousal relief under section 6015.” ...

- The Court noted that the legislative history of the APA confirms it does not supersede the Tax Court’s adjudication procedures, quoting the relevant language from the House report.
- Finally, the decision regarding the scope of review was not a Pyrrhic victory: the taxpayer won on the merits.
- Judge Tjoflat [dis? disrespectfully dissents. Judge Tjoflat wrote a lengthy dissent concluding that the Administrative Procedures Act did apply to limit the Tax Court’s review to the administrative record. He caustically concluded as follows:

Today, the court has given the Tax Court the authority to second-guess the Commissioner at its whim, superimposed upon the farce that the Commissioner’s determination is given discretionary weight. Under such a scheme, why should the Commissioner conduct his hearings in a careful and diligent manner? Why bother when the Commissioner knows that his review of the facts and law will be ignored? For that matter, why should taxpayers be required to fund and use the IRS appeals process since any conclusions made by those federal officials will dissipate in the Tax Court like whispers in the wind? I have found no satisfactory answers to these questions. Therefore, I respectfully dissent from the court’s judgment.

2. Kollar v. Commissioner, 131 T.C. No. 12 (11/25/08). Judge Marvel held that the Tax Court’s jurisdiction under § 6015(e)(1) to review the denial by the IRS of § 6015(f) equitable relief extends to relief solely from liability for interest on a tax deficiency where relief from the principal deficiency is not in issue. Sections 6601(e)(1) and 6665(a) provide that “‘tax’ for purposes of the Code included interest and penalties, except in certain cases not relevant to [the question of § 6015(e)(1) jurisdiction].”

3. Taxpayer is screwed out of substantive rights by Congress’s failure to adequately deal with procedural issues. Pollock v. Commissioner, 132 T.C. No. 3 (2/12/09). The taxpayer sought § 6015(f) nondeficiency stand alone innocent spouse relief. In April 2007, the IRS denied the relief before § 6015(e) was amended to confer jurisdiction on the Tax Court to review denial of such relief. The taxpayer did not seek judicial review of the IRS determination. Subsequently, Congress amended § 6015 to confer jurisdiction on the Tax Court
to hear § 6015(f) nondeficiency stand-alone cases, effective for tax liabilities "arising or remaining unpaid on or after [December 20, 2006]." When the IRS sought to collect the taxes in a lien-enforcement action, the district court invoked the doctrine of equitable tolling to give the taxpayer 30 days to file a petition with the Tax Court to review the denial of innocent spouse relief. The taxpayer filed her petition within the time limit set by the district court's order. The Tax Court (judge Holes), although showing sympathy for the taxpayer’s plight granted the Commissioner’s motion to dismiss for lack of jurisdiction because the taxpayer filed her petition more than 90 days after the IRS had mailed the notice of determination to her. The § 6015(e)(1)(A) 90-day limit for filing a Tax Court petition for review of the IRS’s denial of innocent spouse relief is jurisdictional and therefore does not allow for equitable tolling. Thus, even though the taxes remained unpaid on December 20, 2006, the Tax Court lacked jurisdiction because the petition for review had not been timely filed. The timely filing requirement applied even though on the last day for filing a petition, the Tax Court lacked jurisdiction to review the denial of innocent spouse relief.

4. 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 sounds of [congressional] silence." Lantz v. Commissioner, 132 T.C. No. 8 (4/7/09). 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 Goekke, joined by eleven judges, with four dissents, the Tax Court held Reg. § 1.6015-5(b)(1) to be invalid as applied to § 6015(f) relief. [Following the Golsen rule, the Tax Court applied Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984), because the Seventh Circuit held in Bankers Life & Cas. Co. v. United States, 142 F.3d 973, 979 (7th Cir. 1998), that regulations issued under general or specific authority of the IRS to promulgate necessary rules are entitled to Chevron deference; Reg. § 1.6015-5 was issued under both a general grant of authority under § 7805 and a specific grant of authority in § 6015(h).] The court focused on the explicit inclusion of a two-year deadline in both § 6015(b) and § 6015(c), in contrast to the absence of any deadline in § 6015(f), to find that the regulation was not a reasonable interpretation of the statute under the Chevron standard.

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

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

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

a. 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 or inform her of the notice. 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 relief within two years from the IRS’s first collection action is invalid as applied to § 6015(f) relief.

H. Miscellaneous

1. The Court of Federal Claims refused to exclude most of Stuart Smith’s report, but the language Judge Damich used was “unprintable.” Murfam Farms LLC v. United States, 102 A.F.T.R.2d 2008-6319, 83 Fed. Cl. 635 [sic] (9/19/08). Judge Damich permitted Stuart Smith to opine on whether the Proskauer Rose opinions were of a quality that the taxpayers could reasonably rely on them, but not on whether the Proskauer Rose opinions were correct.

The Government first asserts that Mr. Smith’s analysis is unreliable because the only standard by which to properly gauge a reasonable cause defense to accuracy-related penalties is I.R.C. section 6664(c) and the Treasury Regulations promulgated under that section. In response, Plaintiffs assert that Mr. Smith’s report does not state that Treasury Circular 230 is the correct standard by which to consider a reasonable cause defense. Instead, Plaintiffs assert, “Mr. Smith references the Circular 230 standards only in his evaluation of the quality of the tax opinions to demonstrate that such opinions were ‘objectively reasonable.’”

The Government also argues that Mr. Smith’s report simply presents an argument on an issue of law to be decided by the Court. As Plaintiffs point out, however, Mr. Smith’s report does not opine that the Proskauer Rose opinions were legally correct. Rather, Mr. Smith’s report simply opines that the Proskauer Rose opinions appear to have been prepared based on a certain standard of care, and are of a threshold quality such that taxpayers such as the Plaintiffs could reasonably rely on them.

The Court finds that only certain portions of Mr. Smith’s report constitute improper testimony on a legal issue. While discussing the characteristics of the Proskauer Rose opinions in a section titled “(2) Relate Law to Facts”, Mr. Smith’s report also analyzes the Internal Revenue Service’s legal position on the COBRA transactions at issue, finding it to “lack an objective appearance of

5 The Editor’s Note in Westlaw reads, “The opinion of the United States Court of Federal Claims, in Murfam Farms, LLC ex rel. Murphy v. U.S., published in the advance sheet at this citation, 83 Fed.Cl. 635, was withdrawn from the bound volume because it was not intended for print publication. For electronic version, see 2008 WL 4725468.”
reasonableness." Despite Mr. Smith’s attempt to disguise his legal discussion as an objective analysis of the quality of the Proskauer Rose opinions, this section of Mr. Smith’s report appears to be little more than a legal argument that Plaintiffs’ analysis of the transactions is correct while the Government’s analysis is not. There is a difference between opining that a legal analysis is thorough-enough to be reasonably relied upon and opining that the legal analysis is correct while another is incorrect. The former opinion can be helpful to the court, while the latter is not. In addition, the merit of the Internal Revenue Service’s subsequent legal position on the COBRA transactions at issue would play no part in a determination of whether the Proskauer Rose opinions could reasonably have been relied upon prior to execution of the transactions. Similarly, Mr. Smith provides a discussion of the Eastern District of Texas’s decision in Klamath Strategic Investment Fund v. United States, which was issued well after the Proskauer Rose opinions were written (citing Klamath, 472 F. Supp. 2d 885 (E.D. Tex. 2007)). Mr. Smith attempts to use the Klamath opinion as subsequent corroboration that the analysis contained in the Proskauer Rose opinions was correct. Neither of these discussions is helpful to the Court.

a. And a criminal sentence for obstructing and impeding the administration of federal tax laws was vacated because a CPA’s two “very good” defense counsel failed to retain an expert witness in tax law to determine the proper amount of tax loss. Baxter v. United States, ___ F. Supp. 2d ___, 104 A.F.T.R.2d 2009-5090 (N.D. Ill. 6/25/09). After plea negotiations, a CPA pleaded guilty to one count of violating § 7212(a) (obstructing and impeding the administration of federal tax laws) and in the plea agreement stated that “the offense involved a tax loss of more than $550,000 [i.e., $576,000]” but the government asserted that she was accountable for a tax loss of $5.1 million for sentencing purposes. The court rejected the $5.1 million amount after a 2005 hearing, but did not understand that the $576,000 amount was included in the rejected $5.1 million tax loss. In this 28 U.S.C. § 2255 proceeding to “vacate, set aside or correct sentence,” Judge Holderman held that her two [“very good”] criminal defense lawyers provided constitutionally ineffective counsel “because they had failed to retain a tax expert to ascertain the correct amount of tax loss attributable to Baxter’s criminal conduct and had failed to evaluate the correct tax ramifications of Baxter’s criminal conduct for sentencing purposes.”

2. Beware of showing the “real books” to the guy who claims he wants to buy your business. The Emergency Economic Stabilization Act of 2008 made permanent the IRS’s Code § 7608(c) authority to engage in undercover operations.

3. 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, No. 08-964 (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.

4. A tie goes to the taxpayer, otherwise § 7491 doesn’t count. Knudsen v. Commissioner, 131 T.C. No. 11 (11/12/08). Section 7491 does not require the trial court to decide whether the burden of proof has been shifted to the Government in all cases where the issue of a burden shift is raised. Where parties have satisfied their burden of production by offering some evidence, the Tax Court (Judge Marvel) holds that the party supported by the weight of the evidence prevails “regardless of which party bore the burden of persuasion, proof or preponderance.” "A" shift in the burden of preponderance has real significance only in the
rare event of an evidentiary tie."

5. Politics as usual; but different politics now. A union suit no longer means underwear but whether it suits a union (such as the NTEU). IR-2009-19 (3/5/09): After conducting an extensive review of the private debt collection program, including the cost effectiveness of the effort, the IRS will not renew its contracts with two private debt collection agencies, the agency announced today. The IRS determined that the work is best done by IRS employees who have more flexibility handling cases, which is particularly important with many taxpayers currently facing economic hardship.

6. The government gets a chance to establish a greater deficiency when the civil suit follows the criminal prosecution. McHan v. Commissioner, 558 F.3d 326, 103 A.F.T.R.2d 2009-1076 (4th Cir. 2/27/09). The IRS is not barred by collateral estoppel from asserting a deficiency in a civil proceeding that is based on the determination of a greater understatement of income than was determined to have been the amount of unreported income in a prior criminal proceeding against the taxpayer. Collateral estoppel does not apply "where the party against whom the doctrine is invoked had a heavier burden of persuasion on that issue in the first action than he does in the second."

7. The taxpayer has no legal remedy to restrain backup withholding. Zigmont v. Commissioner, T.C. Memo. 2009-48 (3/5/09). Special Trial Judge Armend held that the Tax Court lacks jurisdiction to enjoin the IRS (under § 6213(a)) from collecting amounts through § 3406 backup withholding. Backup withholding is not a deficiency. Nor is it a proposed lien or levy subject to CDP procedures that the tax Court has jurisdiction to review under § 6330(e)(1).

8. Two stop shopping to find out if the redetermined deficiency was discharged in a prior bankruptcy. Ferguson v. Commissioner, 568 F.3d 498, 103 A.F.T.R. 2d 2009-2170 (5th Cir. 5/12/09), aff'g, T.C. Memo 2006-32 (2006). If subsequent to the taxpayer's discharge in bankruptcy the IRS issues a deficiency notice for a year prior to the discharge and the taxpayer properly invokes the Tax Court's jurisdiction for a redetermination of the deficiency, the Tax Court lacks jurisdiction to determine whether the taxpayer's liability was discharged in bankruptcy.

9. When they called, should he have said, "I gave at the office"? Commissioner of Internal Revenue Mark Everson announced his resignation to become head of the American Red Cross. 2007 TNT 76-1 (4/19/07). In his message to IRS employees, he said, "Together, we have rebalanced the organization, bringing to life the equation: Service + Enforcement = Compliance."

a. Now, we can all look forward to seeing the IRS getting stiffed. Brown's successor as Acting Commissioner will be Deputy Commissioner for Operations Support Linda Stiff, who will assume the position of Deputy Commissioner for Services and Enforcement and, on Brown's departure, Acting Commissioner. 2007 TNT 146-2 (7/30/07).

b. Apparently someone at the Red Cross under Mark Everson was also getting stiffed. It appears that Everson was really "giving at the office." Mark Everson resigned his Red Cross presidency on November 27, 2007 because the Red Cross Board learned that he "engaged in a personal relationship with a subordinate employee." All in all, it is a sad commentary on the IRS that Everson could not find anyone there with whom to have a "personal relationship."

c. Is this a come-down? Mark Everson has joined Alliantgroup as vice chair. 2009 TNT 148-3 (8/5/09). "I couldn't be more pleased that Mark Everson has decided to join us," said Alliantgroup CEO Dhaval Jadav. "His service with the IRS and with the OMB gives him unmatched insight into building positive bridges between taxpayers, CPA firms, and the IRS."

10. 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 Goeke held that neither res judicata and 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.

11. 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 judicata, 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 judicata 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.

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 is granted by the District Court holding 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 2008-5573 (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 exemption 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, 103 A.F.T.R.2d 2009-1044 (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, 103 A.F.T.R.2d 2009-1409 (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 for the Mayo Clinic. Mayo Foundation for Medical Education and Research v. United States, 568 F.3d 675, 2009-1 U.S.T.C. ¶50,432 (8th Cir. 6/12/09). For purposes of the student exclusion from FICA taxes under § 3121(b)(10), Reg. § 31.3121(b)(10)-2(c), (d), limits 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.

2. Truck drivers are employees but relief was granted under § 530 of the Revenue Act of 1978. Peno Trucking, Inc. v. Commissioner, 296 Fed. Appx. 449 (6th Cir. 10/3/08). The taxpayer leased tractor-trailer combinations to another company and supplied the drivers. The drivers entered into agreements with the taxpayer that they were independent contractors and the taxpayer reported the drivers' incomes on Form 1099. The court affirmed the Tax Court's holding that the drivers were employees relying on the Tax Court's conclusions that (1) the taxpayer oversaw the drivers' responsibilities, determined the days they could work, and controlled the loads they would haul; (2) made a substantial investment to acquire and maintain the trucks; (3) the drivers did not assume a risk of loss; (4) the taxpayer had the right to discharge its drivers; (5) the drivers performed a service that was essential to the taxpayer's operations; (6) the drivers worked in the course of the taxpayer's business rather than having a transitory relationship with the taxpayer; and (7) although the taxpayer and its drivers entered into written agreements which expressly provided that the drivers were independent contractors, the facts indicated otherwise. The appellate court reversed the Tax Court's holding that the
taxpayer was not entitled to relief under § 530 of the Revenue Act of 1978, which protects employers from employment tax if there was a reasonable basis for treating workers as independent contractors. The court noted that the taxpayer had consistently treated drivers as independent contractors and that the taxpayer reasonably relied on state workers' compensation decisions as a basis for that status.

3. Section 403(b) salary reduction agreements defined. T.D. 9367, Payments Made by Reason of a Salary Reduction Agreement, 72 F.R. 64939 (11/19/07). Treasury has finalized regulations, § 31.3121(a)(5)-2, defining contributions to § 403(b) plans under a salary reduction agreement that are subject to employment taxes. Employer contributions to a § 403(b) plan that are not made pursuant to a salary reduction agreement are not subject to employment taxes. A salary reduction agreement exists if the employee elects to reduce compensation pursuant to a cash or deferred election, the employee elects to reduce compensation under a one-time irrevocable election made at or before the time of initial eligibility to participate in the plan, or the employee agrees as a condition of employment (whether imposed by statute or otherwise) to make a contribution that reduces compensation.

a. The Seventh Circuit agrees with the IRS position on involuntary plans, with penalties. University of Chicago v. United States, 547 F.3d 773 (7th Cir. 10/29/08). Upholding the District Court (100 A.F.T.R.2d 2007-6261 (N.D. Ill. 8/22/07)), the appellate court held that contributions to employee § 403(b) plans were subject to FICA withholding. The University of Chicago required employees to make payments into a § 403(b) plan and referred to the employee contributions as being withheld from salaries. Employees were required to sign a “salary reduction agreement.” The University also contributed to the plan on behalf of employees. Section 3121(a)(5)(D) excludes from wages subject to employment taxes any payment under a § 403(b) annuity contract, “other than a payment for the purchase of such a contract which is made by reason of a salary reduction agreement.” The University argued that FICA taxes are payable only with respect to contributions only if the employee voluntarily agrees to receive a lower stated salary plus payments to the plan in lieu of cash. The court reasoned that § 3121(a)(5)(D) applies to salary supplement arrangements rather than plans that provide for a reduction in employee compensation to fund contributions.

   b. In addition, the court affirmed penalties in the amount of the employee withholding that the University failed to collect and failure to deposit and failure to pay penalties. The court found that the University’s failure to make the deposits was not due to reasonable cause. The University asserted under the “divisible tax doctrine” that its payment of a portion of the tax in order to bring the refund action absolved it of the penalty. The court indicated that the divisible tax doctrine is jurisdictional and does not absolve the taxpayer from applicable penalties.

4. Temporary and Proposed Regulations simplify filing for small employers. T.D. 9440, Employer’s Annual Federal Tax Return and Modifications to the Deposit Rules, 73 F.R. 79354 (12/29/08); REG-148568-04, Employer’s Annual Federal Tax Return and Modifications to the Deposit Rules, 73 F.R. 79423 (12/29/08); Rev.Proc. 2009-13, 2009-3 I.R.B. 323 (12/29/08). Temp. Reg. § 31.6011(a)-1T(a)(5) provides for annual filing of employment tax returns for employers notified by the IRS to file annual returns on Form 944 (instead of quarterly filings on Form 941), generally applicable to employers with less than $1,000 of annual employment tax liability (Social Security, Medicare, and wage withholding). The temporary regulations were revised to make the use of Form 944 optional for taxpayers who notify the IRS that they will file the quarterly Form 941 and permit taxpayers to change their filing method from year-to-year. Temp. Reg. §§ 31.6011(a)-1T(a)(5) and 31.6011(a)-4T(a)(4) allow taxpayers who estimate that their employment tax liability will be $1,000 or less to contact the IRS to express a desire to file Form 944 instead of Form 941, following which the IRS will send a notice to the taxpayer directing the taxpayer to file the Form 944 annually. Taxpayer in receipt of this notice must continue to file the Form 944 until they contact the IRS to change the filing requirement and receive confirmation from the IRS that their filing requirement has been changed. Rev. Proc. 2009-13 contains procedures for changing the filing status. The temporary regulations also modify the “look-back” rules for determining whether Form 941 filers with less
than $2,500 of employment tax liability in a quarter can file quarterly rather than monthly or semi-weekly deposits.

5. Ten ways to be a contractor – estate rebuffed in its attempt to collect damages and indemnification on its claim that decedent was an employee of multiple employers rather than an independent contractor. Estate of Suskovich v. Anthem Health Plans of Virginia, Inc. 553 F.3d 559, 103 A.F.T.R.2d 2009-573 (7th Cir. 1/22/09). The decedent worked as a computer programmer for Wellpoint, a health insurance company and Trasys, an information technology company. The decedent’s estate claimed damages from the companies for failure to treat the decedent as an employee and provide certain employee benefits, and claimed indemnification for employment taxes paid directly by the decedent. The court upheld the District Court’s finding that the decedent was an independent contractor based on the District Court’s application of the ten factor test for employment status of the Restatement (Second) of Agency. The court concluded, “[i]n fact, overwhelming evidence suggests that he considered himself an independent contractor, filed his tax returns as an independent contractor, and was compensated like an independent contractor. Accordingly, the district court properly awarded summary judgment to WellPoint and Trasys on this issue.”

6. The Tax Court follows the 6th and 2d 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), the Tax Court (Judge Cohen), held that the check-a-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.”

7. “Check-the-Box.” OK! Medical Practice Solutions, LLC v. Commissioner, 132 T.C. No. 7 (3/31/09). This case involved review of a CDP determination that collection of unpaid employment taxes of a single member LLC that was a disregarded entity should proceed against the sole member of the LLC. The only issue before the court (Judge Cohen) was whether “check-the-box” regulations, § 301.7701-3(b), in effect for the periods in issue, were invalid in allowing collection of employment taxes against the sole member of a limited liability company. Citing 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 court upheld the validity of the “check-the-box” regulations in the first Tax Court case to challenge their validity.

- The LLC performed “medical practice consulting,” and was not in the specialty of gynecology.

8. Rev. Rul. 2009-11, 2009-18 I.R.B. 896 (4/16/09). Under § 3401(h), added by the Heroes Earnings Assistance and Relief Tax Act of 2008, differential wages paid to an employee on active duty in the military are treated as wages for purposes of income tax withholding. This revenue ruling explains that these are supplemental wages that are to be added to the employee’s regular wages for the period for purposes of calculating wage withholding. However, differential wages paid to a person providing service to the military for an extended period of time are not wages subject to FICA and FUTA tax. See Rev. Rul. 69-136, 169-1 C.B. 252.
9. **Hi-Q Personnel, Inc. v. Commissioner, 132 T.C. No. 13 (5/4/09).** The taxpayer corporation provided temporary workers for clients for fees related to the work performed. The taxpayer offered the workers a choice between being paid in cash or by check. The taxpayer reported workers paid by check as employees and paid applicable employment taxes. The taxpayer failed to pay employment taxes for workers paid in cash. The taxpayer’s president, Luan Nguyen, plead guilty to Federal criminal charges for failing to pay employment taxes on $14,845,019 of wages paid to temporary workers. The court (Judge Halpern) agreed with the IRS that because of its president’s plea agreement in the criminal matter, the taxpayer could not contest its liability for employment taxes or fraud penalties under the doctrine of issue preclusion or collateral estoppel. The court concluded that the plea agreement was a judgment on the merits with respect to identical issues, and that the corporation’s president and sole shareholder was in privity with it with respect to the obligation to pay employment taxes. The court also concluded Mr. Nguyen’s guilty plea imputed his fraudulent intent to the corporation for purposes of fraud penalties.

10. **Both back pay and front pay are subject to withholding, Josifovich v. Secure Computing Corp., 104 A.F.T.R. 2d 2009-5807 (D. N.J. 7/31/09).** Josifovich entered into a settlement agreement with her former employer for unpaid commission income, violations of the New Jersey Conscientious Employee Protection Act and the New Jersey Law Against Discrimination. The settlement included back pay for prior work and front pay for compensation she would have received after the settlement date. The parties could not agree on whether the payments were subject to wage withholding and sought to resolve the issue in the District Court. The court recognized that payments for back wages were subject to wage withholding. The court also concluded that the front pay was based on contract and quasi-contract claims under the New Jersey statutes for wages that are thus subject to withholding. The court, which is in the Third Circuit, did not cite the Eighth Circuit opinion in Newhouse v. McCormick & Co., 157 F.3d 582 (8th Cir. 1998), which held that front pay is not subject to wage withholding or FICA. The court also rejected Ms. Josifovich’s claim that the damage award in the settlement should be grossed up to account for the withholding taxes.

11. **Zhang v. United States, 104 A.F.T.R. 2d 2009-5396 (Fed. Cl. 9/22/09).** Nonresident aliens, Chinese nationals who were temporary contract workers in the Commonwealth of the Northern Mariana Islands, are 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 notes 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.

### B. Self-employment Taxes
1. The **Emergency Economic Stabilization Act of 2008, Division C, § 504(c),** provides that amounts received by a taxpayer engaged in the fishing business from the settlement of Exxon Valdez litigation are not treated as self-employment income.

### C. Excise Taxes
1. **Ahoy mates! The Emergency Economic Stabilization Act of 2008, Act§ 306, retroactively extends the $13.50 per gallon payment of excise tax to Puerto Rico (up from $10.50) for imported rum.**

2. **Benefits for Robin Hood's children hunting pork. The Emergency Economic Stabilization Act of 2008, Act § 503(a), amends § 4161(b)(2)(B) to exempt from excise tax all-natural arrow shafts measuring 5/16 of an inch that are not suited for use with bows drawing more than 30 pounds.**

3. **The Emergency Economic Stabilization Act of 2008 [Division B], the Energy Improvement and Extension Act, § 113, extends the temporary increase in the coal excise tax of § 4121, funding the Black Lung Disability Trust, to 12/31/18.**
   a. Section 202 extends the gasoline excise tax credit of § 6426 for biodiesel and renewable diesel fuels to fuels produced before January 1, 2010, and increases the biofuel credit from 50 cents to $1 per gallon.
b. Section 206 amends § 4053 by adding an exclusion from the heavy truck excise tax of § 4051 for truck heating and cooling devices that do not require operation of the main engine while the vehicle is parked.

4. **Refund claims for telephone excise taxes are subject to the three year statute of limitations of § 6511(a).** RadioShack Corp. v. United States, 566 F.3d 1358, 103 A.F.T.R.2d 2009-2360 (Fed. Cir. 5/26/09). RadioShack filed a refund action for erroneously collected telephone excise taxes in 1996. The IRS stopped collecting the tax in May 2006 and announced in Notice 2006-50, 2006-1 C.B. 1141, that it would accept claims for refund of taxes billed between February 28, 2003, and August 1, 2006, pursuant to claims for refund filed in accord with the Notice. The Court of Appeals affirmed the holding of the Federal Claims Court that the refund action is subject to the three year statute of limitations of § 6511(a) and the court lacked jurisdiction to consider the refund claims. Claims for taxes paid in 2002 are still pending.

5. **Northstar Trekking LLC v. United States,** 103 A.F.T.R. 2d 2009-2616 (D. Ak. 5/4/09). The Alaska District Court (Judge Sedwick) held that a helicopter glacier tour company that operated Alaska glacier tours mostly for tour ship customers did not operate on a regular line and was thus exempt from the Air Transportation Excise Tax.

6. **Telephone excise tax trouble for the government ahead.** Cohen v. United States, _ F.3d __, 104 A.F.T.R.2d 2009-5841 (D.C. Cir. 8/7/09) (2-1). In this telephone excise case, Judge Janice Rogers Brown’s majority opinion held that the telephone excise tax challenge litigation violated neither (1) the Anti-Injunction Act, 26 U.S.C. § 7421(a) [“no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed”] nor (2) the Declaratory Judgment Act, 28 U.S.C. § 2201(a) [which allows for declaratory relief but specifically excludes federal taxes from its reach] because (1) this standalone Administrative Procedure Act [5 U.S.C. § 702] claim is “the anomalous case where the wrongful assessment is not disputed and the litigants do not seek a refund,” and (2) the Declaratory Judgment Act is coextensive with the Anti-Injunction Act [citing circuit precedent]. Judge Brown began her opinion:

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

We conclude the notice bound the Service, tax collectors, and taxpayers. Accordingly, we reverse the district court’s dismissal of Appellants’ claims made under the Administrative Procedures Act (“APA”).

- Judge Brown further stated:

The IRS insists taxpayers do not need to follow the notice in order to exercise their right to file suit under section 7422. It claims, “Nothing in [the notice] prohibits taxpayers from submitting otherwise valid claims for refund under the usual statutory procedures for claiming a refund of tax, nor does it in any way sanction taxpayers who elect to use the statutory procedure.” Appellee’s Br. 58. That’s just mean. To go the “statutory” route, as the IRS suggests, places taxpayers in a virtual house of mirrors. Section 7422 requires taxpayers to file a refund claim “with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.” 26 U.S.C. section 7422. Regulation, 26 CFR section 301.6402-2, enunciates the
process for filing a refund claim. Of primary importance here, it dictates the appropriate form for the taxpayer to use. Id. section 302.6402-2(c). It states, in relevant part, that "all claims by taxpayers for the refunding of taxes, interest, penalties, and additions to tax shall be made on Form 843." Id. Form 843, however, does not permit this type of refund claim. At the top of the form, it reads, "Do not use Form 843 if your claim is for ... [a]n overpayment of excise taxes reported on Form(s) 11-c, 720, 730, or 2290." Form 720 is the Quarterly Federal Excise Tax Return on which communications excise taxes, including the excise tax at issue here, are reported by the service providers (who collect and remit the taxes). Therefore, taxpayers cannot use Form 843 to file their refund claim. The instructions for Form 843, however, suggest that taxpayers fill out Form 8849 "to claim a refund of excise taxes other than those resulting from adjustments to [their] reported liabilities" and refers them to IRS Publication 510, Excise Taxes, "for the appropriate forms to use to claim excise tax refunds." IRS Publication 510 states, "Do not use Form 8849, Form 720, or Form 843 to make claims for nontaxable service; the IRS will not process these claims." Even if the taxpayer ignored the reference to the IRS publication, Form 8849 itself cautions "Do not use Form 8849 ... to claim any amounts that were or will be claimed on Schedule C (Form 720), Claims ... ." While this language sounds slightly more flexible, taxpayers have no way of knowing whether their service provider has or will claim the nontaxable funds at issue.

Counsel for the IRS took the enigmatic position at oral argument that if the taxpayers had used either Form 843 or Form 8849 to file their refund claims, then IRS's acceptance would have been mandatory and the claims would have sufficed to meet section 7422's jurisdictional exhaustion requirements. Tr. of Oral Arg. at 29-31. But these assertions directly conflict with the cautionary instructions printed in bold typeface on the front of both forms and the explicit directions given in IRS Publication 510. Furthermore, the IRS provided absolutely no authority supporting its position. In reality, unless taxpayers follow the dictates of Notice 2006-50, they run into nothing but dead ends. The "usual statutory procedures for claiming a refund of tax," Appellee's Br. 58, provide no avenue by which individual taxpayers can fulfill their obligations in order to seek judicial review. ***

Despite the obvious infirmities of these options, the IRS still has the chutzpah to chide taxpayers for failing to intuit that neither the agency's express instructions nor the warning on its forms should be taken seriously. According to the IRS, taxpayers should have realized all the options the Service said were closed to them -- using forms that proclaim their inapplicability in bold letter or filing informal claims that could not be perfected -- were nonetheless sufficient to fulfill their administrative refund obligations and to serve as a prerequisite to judicial review. Not hardly. Taxpayers bear a heavy burden when pursuing refund claims, but we have yet to demand clairvoyance. ***

In sum, the IRS unlawfully expropriated billions of dollars from taxpayers, conceded the illegitimacy of its actions, and developed a mandatory process as the sole avenue by which the agency would consider refunding its ill-gotten gains. It cannot avoid judicial review of that process by simply designating it a policy statement. Notice 2006-50 constituted a final agency action that aggrieved taxpayers by hindering their access to court. Accordingly, we reverse the district court and remand Appellants' APA claims for further consideration.

- Judge Brown did conclude that "[a]ppellant Neiland Cohen filed his refund claim prematurely and, thus, affirm the district court's dismissal of his refund claim." The case was remanded to the district court for its consideration of the merits.
- Judge Kavanaugh dissented, stating that the appellant could
simply have followed the procedures of Notice 2006-50.

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

7. The telephone excise tax may involve only one-way communication. IRS v. WorldCom, Inc., 2009-2 U.S.T.C. ¶70,290, 5881 (S.D. N.Y. 8/7/09). WorldCom purchased central office based remote access (COBRA) services from local exchange carriers in order to receive information across analog dial-up connections and route the communication to its computer servers. Reversing the Bankruptcy Court’s allowance of a refund of the telecommunications excise tax and remanding for further findings, the District Court overruled the Bankruptcy Court’s interpretation of § 4252(a) as requiring capacity for two-way communication in order to impose the telecommunications excise tax. Section 4252(a) defines telephone service as “access to a local telephone system, and the privilege of telephonic quality communication with substantially all persons having telephone or radio telephone stations . . .” Distinguishing § 4252(b)(2), the court held that the phrase “communication with” does not require communication to and from telephone stations. Thus, the essential in-bound nature of communication into the COBRA system may fall within the definition of § 4252(a).

XII. TAX LEGISLATION

A. Enacted
1. The Emergency Economic Stabilization Act of 2008 [Division A], the Energy Improvement and Extension Act of 2008 [Division B], and the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 [Division C], P.L. 110-343 was signed by President Bush on 10/3/08.

• The provisions of these Acts authorize the Secretary of the Treasury to establish a Troubled Assets Relief Program to purchase troubled assets from financial institutions; provide Alternative Minimum Tax relief; extend expiring tax provisions and establish energy tax incentives; and temporarily increase Federal Deposit Insurance limits.

2. The Fostering Connections to Success and Increasing Adoptions Act of 2008, P.L. 110-351 was signed by President Bush on 10/7/08.

3. A tax reduction provision that included a revenue offset. P.L. 110-141, “An Act to exclude from gross income payments from the Hokie Spirit Memorial Fund to the victims of the tragic event at Virginia Polytechnic Institute & State University” was signed by President Bush on 12/19/08. Section 2 of that Act is an off-Code provision that adds $1 to the § 6698(b)(1) “Failure to File a Partnership Return” penalty.
