Recent Developments in Federal Income Taxation

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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. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide my co-author the opportunity mock our elected representatives. The outline focuses primarily on topics of broad general interest [to the two of us, at least] — income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services. Please read this outline at your own risk my co-author and I take no responsibility for any misinformation in it, whether occasioned by our advancing ages or our increasing indifference as to whether we get any particular item right.

I. ACCOUNTING

A. Accounting Methods

1. Really kind taxpayer-favorable § 481 adjustments. Rev. Proc. 2002-19, 2002-13 I.R.B. 696 (1/02). This revenue procedure modifies Rev. Proc. 97-27, 1997-1 C.B. 680, and Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (1/22/02). It revises the revised rules for obtaining the IRS's consent to changes in accounting methods. The most significant changes to Rev. Proc. 97-27 and Rev. Proc. 2002-9 are: (1) allowing a taxpayer to change its method of accounting prospectively, without audit protection, when the method to be changed is an issue pending for a taxable year under examination or an issue under consideration by either an appeals office or a federal court; and (2) taking negative, i.e., taxpayer-favorable, § 481(a) adjustments into account entirely in the year of change. This revenue procedure was amplified and clarified by Rev. Proc. 2002-54, 2002-35 I.R.B. 432 (8/14/02).

a. And just a little more for taxpayers in the name of simplicity. REG-142605-02, Administration Simplification of Section 481(a) Adjustment Periods in Various Regulations, 68 F.R. 25310 (5/12/03). Proposed amendments to regulations under §§ 263A and 448 to allow taxpayers changing a method of accounting to take any § 481(a) adjustments into account over the same number of taxable years that is provided in the general guidance provided under Rev. Proc. 92-27, 1997-1 C.B. 680 (as modified and amplified by Rev. Proc. 2002-19, 2002-13 I.R.B.)
696, and modified by Rev. Proc. 2002-54, 2002-35 I.R.B. 432) for accounting method changes [four years for positive adjustments and one year for negative adjustments].


b. New regulations provide that a change in depreciation will generally constitute a change in accounting method. T.D. 9105, Changes in Computing Depreciation, 69 F.R. 5 (1/2/04); REG-126459-03, 69 F.R. 42 (1/2/04). These final, temporary and proposed regulations provide that changes in depreciation or amortization that are generally changes in accounting method under Reg. § 1.446-1(e). Additionally, these regulations (1) amend Reg. § 1.167(e)-1 to provide that certain changes in depreciation method for property for which depreciation is determined only under § 167 do not apply to a taxpayer's lifetime income for purposes of determining whether a change in depreciation or amortization is a change in method of accounting.

- The useful life exception to the general rule [that a change in depreciation method is a change in accounting] applies only to property for which depreciation is determined under § 167. However, a change to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Code, the regulations, or other guidance published in the Internal Revenue Bulletin is a change in method of accounting.

- Other exceptions include (1) a change in computing depreciation allowances made in the year in which the use of property changes in the hands of the same taxpayer, (2) the making of a late depreciation election or the revocation of a timely valid depreciation election, and (3) a change in the placed-in-service date of an asset.


2. Credit card issuers may recognize annual fee income ratably over the year under the Ratable Inclusion Method, whether or not the fee is refundable on a pro rata basis should the cardholder close the account during the year. Rev. Proc. 2004-11, 2004-3 I.R.B. 988. Credit card issuers described in Rev. Rul. 2004-52, i.e., those on the accrual method that charge cardholders a credit card annual fee under agreements that allow each cardholder to use a credit card to access a revolving line of credit to make purchases of goods and services (and, if so authorized, to obtain cash advances), are permitted to use the Ratable Inclusion Method for Credit Card Annual Fees. Under this method a credit card is recognized in income ratably over the period covered by the fee.

a. If not on the Ratable Inclusion Method, credit card issuers must include annual fees in income when they are due and payable. Rev. Rul. 2004-52, 2004-22 I.R.B. 973. Holds that (1) credit card annual fees are not interest for federal income tax purposes, and (2) credit card fees are includible in gross income when they become due and payable under the terms of the credit card agreements. Notwithstanding the holding of this ruling, Rev. Proc. 2004-32 allows issuers to account for annual fee income using the Ratable Inclusion Method for Credit Card Annual Fees, and that revenue procedure also provides automatic consent for a taxpayer to change its method of accounting for annual fee income.

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

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1. Even if the economic performance rules don’t get ya, the nonqualified deferred compensation rules might. Weaver v. Commissioner, 121 T.C. No. 14 (10/8/03). The taxpayer controlled two corporations, an accrual method calendar year S Corporation (CL) and a cash method July 31 fiscal year C corporation (J). J rendered services to CL and CL deducted the amounts owed to J even though it had not paid the amounts until more than two and one-half months after the close of its taxable year (i.e., by March 15) The Tax Court (Judge Laro) held that the amounts were not deductible in the year the services were rendered because the economic performance requirement of § 461(h) had not been met. Reg. § 1.461-1(a)(2)(iii)(D) and § 404(d) required deferral of the deduction amounts owed to a cash method taxpayer for services until its taxable year the last day of which is within two and one-half months of the day on which the amount is includable in the service provider’s gross income if there was a plan or arrangement for the deferral of the payment. Judge Laro emphasized the holding rested on the conclusion that there was such a plan or arrangement between the two entities.


The taxpayer-hospitals were entitled to elect the § 448 nonaccrual-experience method for years 1987 and 1988 for calculating their uncollectible amounts because they do not “sell” medical supplies to their patients, but they are furnished to patients as part of the hospitals furnishing medical services. The Sixth Circuit upheld the Tax Court’s (Judge Wells) decision that the taxpayers were required to use the amended Temp. Reg. § 1.448-2T(e)(2) to compute the excluded amount, as opposed to the original temporary regulation; under the amended temporary regulation, the “uncollectible amount” is equal to the year-end receivables multiplied by a fraction equal to (1) total bad debts sustained during the current and 5 preceding years divided by (2) total accounts receivable earned throughout the same 6-year period, not merely (1) total bad debts divided by (2) total year-end accounts receivable (which would have been the result under the traditional former §166(c) bad debt reserve computed under the Black Motor [v. Commissioner, 41 B.T.A. 300 (1940), aff’d on another issue, 125 F.2d 977 (6th Cir. 1942)] formula). Like the Tax Court, the court of appeals concluded that § 448(d)(5) was an ambiguous statute and legislative history left a gap that was properly filled by the amended temporary regulation, following Chevron U.S.A., Inc. v. National Resources Defense Council, Inc., 467 U.S. 837 (1984).

We must ... not substitute our own construction of the tax law where the regulation at issue is reasonable. ... Several permissible constructions may be reasonable, and where Congress has left gaps, agencies may fill the gaps with necessary rules that are reasonable. ... [W]e ‘should not interfere with this process,’ ... which is what would happen were we to decide whether a method is the better of two possibilities. We need only determine if the one chosen by the Treasury is reasonable. In reviewing the legislative history of the statute and the Treasury Decisions promulgating the regulation, we conclude that the Treasury did not act arbitrarily but selected a reasonable method to measure accounts that should not be accrued from experience.

* The taxpayer also argued that under United States v. Mead Corp., 533 U.S. 218 (2001), the Temporary Regulation was not entitled to Chevron deference because it was issued without following the notice and comment process that was involved in Chevron, but the court of appeals rejected this application of Mead:

The Court made clear, however, that while most of the Supreme Court cases applying Chevron involved notice-and-comment rulemaking or formal adjudication, “the want of such procedure ... does not decide the case, for we have sometimes found reasons for Chevron deference even when no such administrative formality was required and none was afforded.” 533 U.S. at 231 ...

The temporary regulations involved in this case were arrived at centrally by the Treasury Department, after careful consideration. They were issued pursuant to statutory authority to “prescribe” needful rules and regulations. See I.R.C. § 7805(a). The regulation was “interpretive” in the same sense that the regulation
in Chevron was interpretive — it gave content to ambiguous statutory terms. Congress clearly intended that the Treasury Department do so, and Chevron deference is therefore appropriate.

3. **Section 461(f) deductions for transfers related to contested liabilities.** T.D. 9095, Transfers to Provide for Satisfaction of Contested Liabilities, 68 F.R. 65634 (11/21/03); REG-136890-02, 68 F.R. 65645 (11/21/03). The Treasury has promulgated temporary regulations and published identical proposed regulations clarifying issues under § 461(f) and coordinating § 461(f) and § 461(h) [the economic performance requirement]. Temp. Reg. § 1.461-2T(c)(1) and Prop. Reg. § 1.461-2(c)(1) provide that the transfer to a trust of the transferor’s debt instrument or stock, or the stock or indebtedness of a related person or corporation, does not give rise to a deduction under § 461(f) with respect to a contested liability. Temp. Reg. § 1.461-2T(e) and Prop. Reg. § 1.461-2(e) provide that a payment to a trust to provide for satisfaction of a contested claim with respect to which the economic performance rules of § 461(h) require payment to the claimant — e.g., tort and workers compensation claims, rebates, prizes and jackpots, warranty claims, etc. — will not result in a deduction under § 461(f).

   a. Fudging around with § 461(f), especially when combined with economic performance requirements, makes for a “listed transaction.” Notice 2003-77, 2003-49 I.R.B. (11/19/03), clarified (12/1/03). Certain contested liability trusts used improperly to attempt to accelerate deductions under § 461(f) are identified as “listed transactions.” These transactions include those involving: (1) retention of powers over the trust assets by the taxpayer; (2) transfers of promissory notes to a trust under circumstances indicating the underlying liability is not genuine; (3 and 4) transfers to trusts for contested tort, workers compensation and similar, liabilities for which economic performance requires payment to the claimant, except where the trust is the person to which the liability is owed or payment to the trust discharges the taxpayer’s liability to the claimant; and (5) transfers of stock of the taxpayer, or indebtedness or stock issued by a party related to the taxpayer, that are made on or after 11/19/03 to a trust purported to be established under § 461(f).

   b. Retroactive change in accounting method by filing amended returns is the exclusive procedure for getting out of this box. Rev. Proc. 2004-31, 2004-22 I.R.B. (5/6/04). Exclusive procedures for obtaining consent to change accounting methods for transfers related to contested liabilities described in Notice 2003-77, which requires that taxpayer amend its return for the year in which the (accelerated) deduction was taken (or the earliest open year if that year is closed) and include the entire § 481(a) adjustment in income in that year.

   * While under Rev. Rul. 90-38, 1990-1 C.B. 57, a taxpayer must use an erroneous method for two or more consecutive years to adopt a method of accounting, this procedure requires taxpayers whose transactions were listed to change accounting method.

4. Prepayments for funerals are deposits because they are refundable, albeit rarely refunded. Perry Funeral Home, Inc. v. Commissioner, T.C. Memo. 2003-340 (12/16/03). Applying the principles of Indianapolis Power & Light Co. v. Commissioner, 493 U.S. 203 (1990), Judge Wherry held that refundable prepayments for funerals were excludable deposits even though refunds were rarely requested. The customers, rather than the taxpayer, controlled whether funds would be retained by taxpayer or refunded.

5. “Hello, I’m from the IRS, and I’m here to help you.” — And this time it really is true. Rev. Proc. 71-21 deferral of prepaid income rules loosened. Notice 2002-79, 2002-50 I.R.B. 964 (12/16/02). This notice is a proposed revenue procedure to modify and supersede Rev. Proc. 71-21, 1971-2 C.B. 549. The proposed revenue procedure would expand the availability of deferred reporting of advance receipts that are not accrued for financial accounting. First, certain income from other than services would be eligible: (1) sales of goods not covered by Reg. § 1.451-5(b)(1)(ii); (2) rents for the use of property in connection with the provision of services, e.g., hotel rooms, recreational facilities, cable converter boxes; (3) royalties for intellectual property; (4) warranties of services or items in the three preceding categories; (5) subscriptions not subject to §455; and (6) memberships not subject to § 456. Second, payments would be eligible even if performance might extend beyond the next succeeding year, although deferral could not extend beyond the next succeeding year. The revenue procedure will not apply to rents generally, insurance premiums, or payments with respect to financial instruments.

   a. Finalizes (with modifications) the proposed procedure first announced in Notice 2002-79. Payments for use of intellectual property are added to the list

- Qualifying advance payments include services; goods other than those utilizing §1.451-5; use of intellectual property, i.e., copyrights, patents, trademarks, service marks, trade names, and similar items; occupancy or use of property if ancillary to the provision of services; sale, lease, or license of computer software; guaranty or warranty contracts ancillary to the above items; subscriptions; memberships in an organization; and combinations of the above qualifying items.

- Non-qualifying advance payments include rents; insurance premiums; payments with respect to financial instruments (but see Rev. Proc. 2004-32 allowing deferral for credit card annual fees); payments with respect to certain service warranty contracts; payments subject to withholding; and payments in property for §83 services.

b. No deferral for advance rental receipts. REG-151043-02, Rents and Royalties, 67 F.R. 77450 (12/18/02). The Treasury Department has published a proposed amendment to Reg. §1.61-8(b) that expressly require current inclusion of advance rent receipts, regardless of the period covered or the taxpayers method of accounting, except as otherwise provided in §467 or in other published guidance.

(1) Made final, with modifications. T.D. 9135, Rents and Royalties, 69 F.R. 41192 (7/7/04). Ensures that the Commissioner, in modifying Rev. Proc. 71-21, may provide deferral rules for payments for the use of intellectual property and computer software.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. Congress might have changed one of the holdings of Gitlitz,1 but the Treasury put another one in the regulations. T.D. 9080, Reduction of Tax Attributes Due to Discharge of Indebtedness, 68 FR 42590 (7/21/03). The Treasury has promulgated Temp. Reg. §§1.108-7T and 1.1017-1T(b)(4), dealing with reduction in tax attributes under §§108(b) and 1017 when COD income is excluded from income under §108(a)(1)(A)-(C). Examples (and the preamble) indicate that the tax liability for the year of discharge first must be determined without any reduction in attributes in order to identify the amounts, if any, of the tax attributes that will be reduced. “This ordering rule affords the taxpayer the use of certain of its tax attributes described in section 108(b)(2), including any losses carried forward to the taxable year of discharge, for purposes of determining its tax for the taxable year of discharge, before subjecting those attributes to reduction.” Basis reductions under §1017 occur at the beginning of the taxable year following the year in which the discharge occurred. If a §381 transaction ends in a taxable year in which the distributing or transferor corporation excluded COD income under §108(a), the basis of the property acquired by the acquiring corporation reflects the reduction under §1017.

a. Temporary regulations are made final. T.D. 9127, Reduction of Tax Attributes Due to Discharge of Indebtedness, 69 F.R. 26038 (5/11/04). In order that the attribute reduction result in a deferral, rather than a permanent elimination, of income, the final regulations provide that the basis of stock or securities of a corporation received by the taxpayer in a §381(a) transaction is not available for reduction under §108(b)(2). Final and temporary regulations are effective 5/10/04.

2. United States v. Brown, 348 F.3d 1200, 92 A.F.T.R.2d 2003-6826 (10th Cir. 11/4/03). The Court of Appeals upheld the regulations under §468B. A receiver’s estate may be a qualified settlement fund under §468B(g) and Reg. §1.468B-1 if it is established to “resolve” claims –even if the establishment of the fund and the transfer of assets to it does not extinguish claims against the alleged tortfeasor. The creation of a qualified settlement fund is not dependent on the deductibility of amounts transferred to it. As a QSF, the receiver’s estate was liable for income taxes.

3. Section 102 of the Jobs Act of 2004 adds new §199 to provide a nine percent deduction for U.S. manufacturing income, i.e., “income attributable to domestic manufacturing.”

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1 Gitlitz v. Commissioner, 531 U.S. 206 (2001). See, Job Creation and Worker Assistance Act of 2002, which reverses the result of Gitlitz by providing that excluded cancellation of indebtedness income of S corporations does not result a §1366 adjustment to the basis of stock owned by the shareholders.
production activities.” The deduction may not exceed 50 percent of the W-2 wages of the employer for the taxable year. The deduction will be phased in over three years, beginning with 2005.

- The provision was meant to replace the ETI, which will be phased out in over a two-year period beginning in 2005

B. Deductible Expenses versus Capitalization

**INDOPCO aftermath:** "... deductions are exceptions to the norm of capitalization...” *INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992) (Blackmun, J.)*

1. Kudos from taxpayers; pans from professors. Treasury abandons the future benefits test of *INDOPCO — Long live the separate and distinct asset test.* Or, do the final regulations go beyond the separate and distinct asset test and interpret *INDOPCO* in a more efficient way? T.D. 9107, Guidance Regarding Deduction and Capitalization of Expenditures, 69 F.R. 436 (1/5/04), making final proposed regulations, REG-125638-01, 67 F.R. 77701 (12/19/02). The Treasury Department promulgated Reg. § 1.263(a)-4 and § 1.263(a)-5, which deal comprehensively with the capitalization of expenditures that relate to intangible assets and “future benefits.” These regulations are commonly referred to as the *INDOPCO* regulations, because they are intended to provide bright-line rules to make the standards based approach to capitalization articulated by the Supreme Court in *INDOPCO* more administrable. However, the regulations more aptly might be called the anti-*INDOPCO* regulations, because they reverse the principle, if not the specific holding of *INDOPCO.*

- The Supreme Court in *INDOPCO v. Commissioner, 503 U.S. 79 (1992),* unequivocally rejected the view that capitalization was not required unless the expenditure resulted in the creation or improvement of a “separate and distinct asset,” but also clearly announced that “the notion that deductions are exceptions to the norm of capitalization” is embodied in various aspects of the Code and is supported by a long line of Supreme Court precedents. The regulations turn on their head these interpretations of §§ 162, 261, and 263 by the Supreme Court.

a. Capitalization is an exception to the norm of deductibility.

Under Reg. § 1.263(a)-4(b)(1), the only expenditures that must be capitalized are those incurred (1) to acquire, create, or enhance an intangible, (2) to facilitate in the acquisition, creation, or enhancement of an intangible or (3) that are otherwise identified by the IRS in prospectively effective published guidance. The term “separate and distinct intangible” is limited by Reg. § 1.263(a)-4(b)(3) to “a property interest of ascertainable and measurable value in money’s worth that is subject to protection under applicable state or federal law and the possession and control of which is intrinsically capable of being sold, transferred, or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business.” The last phrase of this definition presumably excludes business goodwill from the definition of intangible.2 The regulations provide extensive lists of the intangibles to which they apply, including, for example, ownership interests in corporations or partnerships, debt instruments, financial interests, options, patents, copyrights, trademarks, franchises, customer lists, covenants not to compete, certain contract rights, government licenses, assembled workforce, and goodwill. See Reg. § 1.263(a)-4(c)(1) and (d). In addition, the regulations specifically provide that any fund or account that may revert to the taxpayer is a separate and distinct intangible. Reg. § 1.263(a)-4(b)(3)(i). On the other hand, expenditures to induce another person to enter into a contract are not required to be capitalized unless the expenditures are listed as expenditures that give rise to a separate and distinct intangible. Reg. § 1.263(a)-4(b)(3)(i). Thus, for example, a signing bonus to induce an employee to enter into an employment relationship is not required to be capitalized if the employee is free to leave and go to work for a competitor at any time. Reg. § 1.263(a)-4(d)(6)(vii), Ex. 8.

- In the preamble to the proposed regulations, the Treasury Department explained that “the separate and distinct asset standard has not historically yielded the same level of controversy as the significant future benefit standard,” and that “the separate and distinct asset test is a workable principle in practice.” The preambles to both the proposed and final regulations also explained that the IRS and Treasury Department might in the future identify expenditures that are not listed in the regulations, but for which capitalization is nonetheless appropriate. Capitalization of non-listed expenditures will be required, however, only if (and after)

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2 See Baker v. Commissioner, 338 F.3d 789 (7th Cir. 2003) (business goodwill cannot exist and be sold separately from business assets to which it could attach).
they have been identified in published guidance. Unless an expenditure relating to an intangible asset is listed in the regulations or in such subsequently published guidance, however, capitalization will not be required and a current deduction will be allowed. Thus, under the regulations, capitalization become an exception to the norm of deducting business expenditures

- The only expenses not related to a separate and distinct asset that must be capitalized under the proposed regulations are costs to “facilitate ... a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization.” Reg. § 1.263(a)-5 separately requires capitalization of any these expenditures, as well as any expenditures to facilitate acquisition of controlling ownership of another trade or business, regardless of whether the acquisition is an acquisition of the assets constituting the business or of the stock of the corporation conducting the business. This category includes only fact patterns analogous to the narrow fact pattern in INDOPCO and a number of cases involving similar issues that followed INDOPCO. Thus, the future benefits test of INDOPCO has been largely abandoned. See, e.g., Reg. § 1.263(a)-4(d)(4) (expenses for certification of products, services or business processes are not subject to capitalization).

- The regulations provide two very important exceptions to the rule requiring capitalization of transaction costs. First, under a “simplifying convention” that is in fact a major substantive rule, Reg. § 1.263(a)-4(e)(4)(i) provides that compensation paid to employees (including certain independent contractors who perform employee-like work) and the employer’s associated overhead are never capitalized. Reg. § 1.263(a)-5(d)(2) provides a similar rule with respect to transaction costs involving business acquisitions and restructurings. These provisions reject case law to the contrary and go far beyond the principle of those cases that in certain circumstances have allowed a current deduction for employee compensation that facilitates the acquisition of an intangible asset. Moreover, they adopt a rule for dealing with intangible assets that is diametrically opposed to the treatment of transaction costs with respect to tangible assets, which always must be capitalized under either or both of §§ 263(a) or 263A.

- Second, Reg. § 1.263(a)-4(e)(4)(ii) provides an exception that permits de minimis transaction costs — defined as costs that do not exceed $5,000 per transaction (not payee) — to be deducted currently. In applying this de minimis rule, the taxpayer may use an elective pooling method in which the transaction costs of all similar transactions are averaged and all for the costs are deductible as long as the average does not exceed $5,000. Thus for example, the taxpayer could average fifty $4,750 expenditures with fifty $5,250 expenditures and deduct them all because the average of the one hundred expenditures was only $5,000. To prevent substantial manipulation that would result in current deductions for very significant transaction costs, this pooling method must be elected prospectively, must include all similar transactions, and is available only if the taxpayer reasonably expects to include at least twenty-five transactions. Furthermore, expenditures that are reasonably expected to differ significantly from the average cannot be included. See Reg. § 1.263(a)-4(h). For example, a single $401,000 expenditure could not be averaged with 99 different $1,000 expenditures to permit a deduction of the $401,000 expenditure even though the average of the 100 expenditures is only $5,000 ((99 x $1,000) + $401,000) > 100).

b. The “whether and which” test shall too pass. Reg. § 1.263(a)-5 significantly narrowed the scope of § 195 with respect to transaction costs involving business investigation and expansion expenditures (but not start-up costs). First, the regulations replaced Rev. Rul. 99-23’s “whether and which” standard for determining the point at which expenditures are inherently capital costs of the acquisition of the business with a bright-line rule. Second, notwithstanding the provisions of § 195(a), the regulations allow a current deduction for those expenditures that are not capitalized as part of the cost of the newly acquired business. Under the regulations, expenses incurred in the process of pursuing an acquisition of a trade or business — whether the acquisition is structured as an acquisition of stock or of assets (and whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) — must be capitalized only if (1) they are “inherently facilitative” of the acquisition or (2) they relate to activities


4 Reg. § 1.263(a)-5(d)(3) provides a similar rule with respect to transaction costs involving business acquisitions and restructurings.
performed on or after the earlier of (a) the date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target, or (b) the date on which the material terms of the transaction are authorized or approved by the taxpayer's board of directors (or committee of the board of directors) or, if taxpayer is not a corporation, the date on which the material terms of the transaction are authorized or approved by the taxpayer's appropriate governing officials. Expenditures that are “inherently facilitative” include amounts expended to determine the value of the target, drafting transactional documents, or conveying property between the parties. However, a taxpayer is not required to capitalize any portion of its own employee compensation attributable to these activities, and the regulations also provide a de minimis rule similar to that applicable to intangibles generally. Reg. § 1.263(a)-5(d)(2) and (3). Under this bright-line rule, expenditures prior to the “whether and whiching hour” would either be currently deductible or subject to § 195 depending upon whether the taxpayer was already engaged in the same trade or business as the target. Of course, the actual cost of the business itself, whether structured as a stock or asset acquisition, remains a capital expense.

c. Depreciation on intangibles with unascertainable useful lives. Reg. § 1.167(a)-3(b) provides a fifteen-year “safe-harbor” amortization period for any capitalized expenses relating to a self-created intangible for which another amortization period is not prescribed by the Code or regulations and for which amortization is not proscribed.

d. The 12-month rule for prepaid expenses. Reg. § 1.263(a)-4(d)(3) requires that prepaid expenses generally be capitalized. However, Reg. § 1.263(a)-4(f) adopts the holding of the Court of Appeals in U.S. Freightways v. Commissioner, 270 F.3d 1137 (7th Cir. 2001), and provides that an expenditure to create or enhance intangible rights or benefits that do not extend for more than twelve months after the expenditure is incurred is not required to be capitalized. Furthermore, the deduction will not be deferred under the “clear reflection of income” standard of § 446(b). Amounts paid to create rights or benefits that extend beyond twelve months must be capitalized in full and deducted ratably over the period benefited. This arbitrary line produces some strange results. Suppose that in March 2004, Taxpayer A pays an insurance premium of $130,000 for the period from April 1, 2004 through April 30, 2005. Taxpayer B, on the other hand, in December 2004, pays an insurance premium of $120,000 for the period from December 1, 2004 through November 30, 2005. For 2004, Taxpayer A’s deduction is $90,000. Taxpayer B’s deduction for 2004, however, is $120,000, even though Taxpayer B’s prepayment extends further into 2005 than does Taxpayer A’s prepayment.

e. Rev Proc 2004-23, 2004-16 I.R.B. 785. Provides an exclusive administrative procedure for taxpayers to obtain automatic consent to change to a method of accounting pursuant to Reg. §§ 1.263(a)-4, 1.263(a)-5, and 1.167(a)-3(b), the final capitalization of intangible regulations.

2. Notice 2004-18, 2004-11 I.R.B. (2/19/04). Comments are sought on the treatment of transaction costs that are to be capitalized under § 263(a) with respect to issues including (1) whether the costs should be treated as giving rise to a new asset or allocated to existing assets, (2) consistent treatment for costs relating to similar taxable and tax-free transactions, and (3) consistent treatment of all capitalized costs that facilitate a transaction regardless of the type of cost.

3. Just when you thought you were safe from capitalization under § 263(a), § 263A rears its ugly head. Rev. Rul. 2004-18, 2004-8 I.R.B. (2/6/04). Costs incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of its manufacturing plant must be capitalized under § 263A and included in inventory costs. Rev. Rul. 98-25 and Rev. Rul. 94-38 are clarified by providing that the otherwise deductible amounts at issue are subject to capitalization to inventory under § 263A. See also, Rev. Rul. 2004-17, 2004-8 I.R.B. (2/6/04) (costs paid or incurred in the taxable year to remediate environmental contamination that occurred in prior taxable years do not qualify for treatment under § 1341).

• The costs would be currently deductible if they were covered by § 198.

4. IRS identifies issues to be addressed in forthcoming proposed regulations on tangible property costs. Notice 2004-6, 2004-3 I.R.B. (12/22/03). These issues

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5 A taxpayer may elect to capitalize and amortize prepaid expenses that cover a period of twelve months or less. Reg. § 1.263(a)-4(f)(7).
include [using the numbering from the Notice]: (1) What general principles of capitalization should be applied? (2) What is the appropriate “unit of property”? (3) What is the starting point for determining whether property value is increased or useful life is prolonged? (11) Should the regulations provide “repair allowance” type rules? (12) Should the regulations provide a de minimis rule? (13) When should the “plan of rehabilitation” doctrine be applied? (15) Are there circumstances where tax treatment should follow financial or regulatory accounting treatment?

5. Would you like to fly on a jet without its engines? FedEx Corporation v. United States, 91 A.F.T.R.2d 2003-1940 (W.D. Tenn. 4/7/03). The district court denied the taxpayer’s motion for summary judgment that expenditures for its off-wing engine maintenance program were deductible repairs under Reg. § 1.162-4. The court found that there was a genuine issue of fact regarding whether the appropriate unit of property for measuring whether the expenditures added value or materially prolonged life was (1) the entire aircraft, as argued by FedEx, or (2) the jet engines and auxiliary power units, as argued by the government. The court concluded that there is no ‘entire vehicle’ rule of law requiring that repairs be measured against the entire vehicle rather than against components.

a. You don’t have to, at least in Memphis. FedEx Corp. v. United States, 291 F. Supp. 2d 699, 92 A.F.T.R.2d 2003-5986, 2003-2 U.S.T.C. §50,697 (W.D. Tenn. 8/27/03). Taxpayer was permitted to deduct the costs of engine shop visits for jet aircraft engine inspection, heavy maintenance and repair because the relevant unit of property was held to be the entire aircraft, not the engine.

6. Judge Laro draws the line between deductible expenses and capital expenditures—in a case decided before the promulgation of the final regulations. D’Angelo v. Commissioner, T.C. Memo. 2003-295 (10/23/03). In this otherwise unremarkable case, in the context of determining whether certain legal fees were currently deductible or were capital expenditures, Judge Laro articulated the following standards for drawing the line between deductible expenses and capital expenditures:

Just because a particular expense fits within the literal language of section 162, it does not automatically become deductible. This is because other sections, such as section 261, except certain payments from the current deductibility provisions. INDOPCO, Inc. v. Commissioner, [503 U.S. 79 (1992)]. Section 261 states that “no deduction shall in any case be allowed in respect of the items specified in this part”, e.g., Part IX, Items Not Deductible. Section 263(a)(1), which is contained in Part IX, generally provides that a deduction is not allowed for “Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.”

As we recently noted in Lychuk v. Commissioner, [116 T.C. 374 (201)],[6] the Supreme Court’s mandate as to capitalization requires that an expenditure be capitalized when it (1) creates a separate and distinct asset, (2) produces a significant future benefit, or (3) is incurred “in connection with” the acquisition of a capital asset. See also Commissioner v. Idaho Power Co., 418 U.S. 1, 13 (1974); Woodward v. Commissioner, 397 U.S. 572, 575-576 (1970). If any of the three conditions is met, an expense may not be deducted and must be capitalized.

7. No INDOPCO here; no § 162(k) either. Chief Industries v. Commissioner, T.C. Memo. 2004-45 (3/2/04). The taxpayer paid its former president/shareholder over $3 million to settle various law suits that arose from his removal as president. Contemporaneously, pursuant to the settlement, the taxpayer corporation redeemed the president/shareholder’s stock for over $40 million. Judge Laro held that the $3 million settlement was an ordinary and necessary expense deductible under § 162, rather than a capital expenditure under INDOPCO, because the origin of the claim was the board of director’s decision to remove the president. Section 162(k) did not bar the deduction because the payment to settle the claims

relating to the removal of the president/shareholder were not associated with or related to the redemption.

8. A Solomon-like decision on capitalization. Putnam-Green Financial Corp. v. United States, 308 F.Supp.2d 1374, 93 A.F.T.R.2d 2004-1049, 2004-1 U.S.T.C. ¶ 50,178 (M.D. Ga. 2/6/04). The taxpayer, a bank holding company, incurred legal fees to defend against suits by minority shareholders in a subsidiary. Legal fees relating to disputes over recapitalization attempts and buy-out prices were held to be capital expenditures, but legal fees seeking damages for general mismanagement of the subsidiary and for failure to pay dividends were held to be deductible as ordinary and necessary business expenses.

9. Section 308 of the Working Families Act of 2004 extends the deduction of environmental remediation costs under § 198 for two years through 12/31/05.

C. Reasonable Compensation

D. Miscellaneous Expenses

1. Fishing trip costs deductible because taxpayer had a business purpose for them, as well as an expectation of future benefits from them. Townsend Industries Inc. v. United States, 342 F.3d 890, 92 A.F.T.R.2d 2003-6096, 2003-2 U.S.T.C. ¶ 50,666 (8th Cir. 9/15/03), rev'g 50,697 (S.D. Iowa 5/31/02). Taxpayer manufactures "T-51 printing press attachments," consisting of approximately 800 parts, that gives users the ability to print multiple color documents in a single pass through a printing press. Annually for the past 40 years, it gathers its in-house sales personnel, its outside independent contractor sales people and its engineers and factory workers for an annual two-day meeting at corporate headquarters, followed by a four-day expense-paid fishing trip. The two-day meeting was often used to introduce new products. Judge Bowman held that the costs of the fishing trip were deductible based upon taxpayer's "realistic expectation to gain concrete future benefits from the trip based on its knowledge of its own small company, its knowledge of the utility of interpersonal interactions that probably would not occur but for the trip, and its knowledge of its own past experience," and the trip qualified as a § 132(d) working condition fringe benefit for the employees who attended.

2. The IRS never seems able to catch up with the movements in the price of gasoline, and more tinkering is in store for 2004. Rev. Proc. 2003-76, 2003-43 I.R.B. 924 (10/27/03), superseding Rev. Proc. 2002-61, 2 C.B. 1610. The optional standard mileage rate for business use of automobiles will increase on 1/1/04 from 36 cents per mile to 37.5 cents per mile; the mileage rate for medical and moving will increase from 12 cents per mile to 14 cents per mile; and the mileage rate for giving services to a charitable organization will remain at 14 cents per mile. The procedure also revises the limitation on simultaneous use of multiple automobiles to allow a taxpayer using up to four vehicles simultaneously to use the standard mileage rate.

3. Change your globes -- Antigua and Barbuda are now part of North America! Rev. Rul. 2003-109, 2003-42 I.R.B. 839 (10/20/23). This revenue ruling supersedes Rev. Rul. 94-56, 1994-2 C.B. 37, and lists all of the geographical areas included in the North American area for purposes of § 274(n), which generally denies any deduction for the cost of attending a "convention, seminar, or similar meeting held outside the 'North American area.'"

4. Florida Progress Corp. v. Commissioner, 348 F.3d 954, 92 A.F.T.R.2d 2003-6583 (11th Cir. 10/21/03) (per curiam), aff'g 114 T.C. 587 (2000). Section 1341 does not apply to rate reductions by a public utility to indirectly compensate customers for prior charges that retrospectively were determined to have over-recovered costs and, therefore, to have been excessive. Section 1341 does not independently authorize a deduction, but operates only when a deduction is allowed under some other Code section. The Tax Court's finding that rate reductions were income reductions, not deductible expenses, was not erroneous.

5. Electronic employee expense reimbursement arrangement is OK, except for non-itemized hotel bills. Rev. Rul. 2003-106, 2003-44 I.R.B. 936 (11/03/03). This revenue ruling explains when an employer's expense reimbursement arrangement for deductible travel and entertainment expenses that uses electronic receipts and expense reports is an accountable plan under § 62(a)(2)(A) and (C) and the regulations thereunder. Under the plan, the credit card company provides the employer with an electronic receipt for all expenses billed to an employee's business credit card. The electronic receipt contains the date of the charge, the amount of the charge, the merchant's name, the merchant's location, and, if available, an itemization from the merchant of each expense included in the charge. Employees access the
database to create an electronic expense report to accompany the electronic receipts associated with their travel and entertainment expenses, and the employees must provide all relevant information to substantiate the deduction under § 274(d) and the regulations. Employees to submit paper expense reports and receipts for: (1) any expense over $75 where the nature of the expense is not clear on the face of the electronic receipt; (2) all lodging invoices for which the credit card company does not provide the merchant's electronic itemization of each expense; and (3) any expenses paid for by the employee without using the business credit card; paper receipts and expense reports must contain all required information.

6. **Schedule C deficiency interest is nondeductible in the Fifth Circuit.** Alfaro v. Commissioner, 349 F.3d 225, 92 A.F.T.R.2d 2003-6914, 2003-2 U.S.T.C. §50,715 (5th Cir. 11/6/03). The Fifth Circuit held that interest on taxpayers' individual income tax liability that arose from a sole proprietorship belonging to husband is nondeductible personal interest under § 163(h), joining five other circuits in this result. Judge Weiner followed Robinson v. Commissioner, 119 T.C. 4 (2002) and all of the other courts that have decided the issue, and upheld the validity of Temp. Reg. § 1.163-9T(b)(2)(i)(A), disallowing a deduction for interest on an individual income tax deficiency, as applied to interest on a deficiency arising from income attributable to a trade or business. He decided that the regulation is a reasonable interpretation of the statute, that it is consistent with the Blue Book, and that Congress has not acted to overturn it in the intervening years since it was promulgated.

7. **A taxpayer who seeks the safe harbor of a Revenue Procedure can't complain about the anchorage.** Boyd v. Commissioner, 122 T.C. No. 18 (4/27/04). The taxpayers' S corporation trucking company (Continental) paid its drivers' for services on a cents per mile basis, and in lieu of paying other expenses, Continental paid drivers a “per diem” of 9 cents per mile. Continental deducted 80 percent of the payments, but the Commissioner allowed only fifty percent of the per diem under § 274(n), treating the full amount as meal reimbursement. In order for the deduction to be allowed the per diem had to meet the deemed substantiation requirements of Rev. Proc. 94-77, 1994-2 C.B. 825; Rev. Proc. 96-28, 1996-1 C.B. 686, and Rev. Proc. 96-64, 1996-2 C.B. 427. The taxpayer claimed that under § 6.05 of the Revenue Procedures [the fourth sentence of which applies if the per diem was less than the federal M&IE rate] it could treat 40 percent of the per diem as lodging and 50 percent as meal reimbursement, thus allowing an 80 percent deduction. The Tax Court (Judge Vasquez) held that the per diem was treated under § 4.04(2) of the Revenue Procedures as being solely for meals and incidentals because it was computed on the same basis as compensation [cents per mile]. Thus, under § 274(n), only 50 percent of the per diem was deductible. The provisions in the Revenue Procedures treating the per diem as being solely for meals and incidentals because it was computed on the same basis as compensation were not in conflict with § 274(n), and the revenue procedure was not otherwise invalid. Finally, since as in Beech Trucking Co., Inc. v. Commissioner, 118 T.C. 428 (2002), the taxpayer was relying on the Revenue Procedures for deemed substantiation, in the absence of any evidence of actual substantiation, it would not be heard to challenge the conditions in the revenue procedure.

8. **This performance did not impress the Tax Court.** Fleischli v. Commissioner, 123 T.C. No. 3 (7/14/04). Judge Colvin held that the $16,000 AGI limitation in § 62(b)(1)(C) for qualified performers to take above-the-line deductions is based on total AGI from all sources, not merely on AGI from performing business. The taxpayer earned more than $16,000 as a part-time lawyer, and earned $13,435 and incurred $17,878 of expenses as a part-time actor. The statutory limitation is constitutional.

9. **"It's a bird, it's a plane ..."** Notice 2004-52, 2004-32 I.R.B. (7/19/04). The IRS has requested information on credit default swaps in connection with requests for further guidance. Possible analogues include contingent options, financial guarantees, standby letters of credit and insurance contracts. Suggestions also include sui generis classification.

10. **Section 307 of the Working Families Act of 2004 extends the above-the-line $250 deduction for K-12 teachers' supplies through 12/31/05.**

11. **Section 201 of the Jobs Act of 2004 amends § 179 to extend the $100,000 amount for expensing for small businesses through years beginning before 2008.**

12. **Section 907 of the Jobs Act of 2004 amends § 274(c) to limit the deductions for personal use by corporate officers of corporate aircraft or other corporate facilities to the amount included as compensation.** This reverses the holding to the contrary in Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197, aff'd, 255 F.3d 495 (8th Cir. 2001), applicable to expenses incurred after the date of enactment.
E. Depreciation & Amortization

1. Regulations on 50 percent bonus depreciation. T.D. 9091, Special Depreciation Allowance, 68 F.R. 52986 (9/8/03); REG-157164, Special Depreciation Allowance, 68 F.R. 53008 (9/8/03). The Treasury has promulgated Temporary Regulations [Temp. Reg. § 1.167(a)-1T (dealing with qualified intangible property); Temp. Reg. § 1.168(k)-1T (dealing with tangible property)] and published identical proposed regulations [Prop. Reg. § 1.167(a)-14; Prop. Reg. § 1.168(k)-1T] dealing with first year bonus depreciation under § 168(k).

2. Changes in use change MACRS depreciation. REG-138499-02, Changes in Use Under Section 168(i)(5), 68 F.R. 43047 (7/21/03). The Treasury has published comprehensive proposed regulations to provide rules for determining MACRS depreciation under § 168 when the taxpayer changes the use of the property. Changes in use include: (1) a conversion of personal use property to a business or income-producing use, (2) conversion from business or income-producing to personal use, or (3) a change in use that results in a different recovery period, depreciation method, or both. The regulations will be effective when finalized. Any reasonable method will be acceptable for changes after 12/31/86 and before final regulations are published. However, current Reg. § 1.167(g)-1 limits the depreciable basis of property converted from personal to business use to its fair market value at the time of the conversion.

   a. Revised proposed regulations made temporary. T.D. 9115; REG-106590-00; REG-138499-02, Changes in Use Under Section 168(i)(5), 69 F.R. 9529 & 9560 (3/1/04). The Treasury has published final, temporary and proposed regulations that render obsolete Notice 2000-4, 2000-1 C.B. 313, and withdraw Prop. Reg. §§ 1.168(a)-1 and 1.168(b)-1 (that were contained in the July 2003 proposed regulations).


3. IA 80 Group, Inc. v. United States, 92 A.F.T.R.2d 2003-6714 (8th Cir. 10/30/03). Section 168(e)(3)(E) provides a 15-year class life to “retail motor fuels outlets,” whether or not food or other items are sold there. A building of more than 1,400 square feet qualifies only if: (1) 50 percent or more of the gross revenues from the property are generated from petroleum sales, or (2) 50 percent or more of the floor space in the property is devoted to petroleum marketing sales. The court of appeals (Judge Smith) held that § 168(e)(3)(E)(iii) applies on a building-by-building basis with respect to a multi-building truck stop that consisted of fuel center buildings, and separate restaurants, stores, and other facilities. Some of the buildings, such as the restaurants, were not 15-year property, even though the gross revenue test was met with respect to the aggregate gross receipts for all the buildings, because neither the gross receipts test nor the floor space test was met with respect to those buildings.

4. T.D. 9115; REG-106590-00; REG-138499-02, Depreciation of MACRS Property That Is Acquired in a Like-Kind Exchange or as a Result of an Involuntary Conversion, 69 F.R. 9529 & 9560 (3/1/04). The Treasury has published final, temporary and proposed regulations that render obsolete Notice 2000-4, 2000-1 C.B. 313, and withdraw Prop. Reg. §§ 1.168(a)-1 and 1.168(b)-1 (that were contained in the July 2003 proposed regulations).

5. Treasury makes life a little happier for SUV salesmen. T.D. 9133, Depreciation of Vans and Light Trucks, 69 F.R. 35513 (6/25/04), making final T.D. 9069, 68 F.R. 40129 (7/7/03). Final and temporary regulations applicable to property placed in service on or after 7/7/03. Provides that a truck or van is not subject to the § 280F(a) limits if it is a qualified nonpersonal use vehicle as defined in Reg. § 1.274-51(k). Effective 6/25/04.

   a. Section 910 of the Jobs Act of 2004 amends § 179 to reduce the SUV deduction to $25,000.

6. King Kong might have been able to move them, so they’re not inherently permanent. PDV America, Inc. v. Commissioner, T.C. Memo, 2004-118 (5/12/04). Judge Marvel held that petroleum storage tanks, holding as much as 151,000 barrels and weighing as much as 1 million pounds [some of in fact had been in place 60 years] are not inherently permanent structures, because they sometimes are moved, with only minimal damage, for purposes of environmental remediation or repairs. Accordingly, the tanks were in asset class 57.0, Distributive Trades and Services, of Rev. Proc. 97-56, 1987-2 C.B. 686, and treated as 5-year property, rather than asset class 57.1, Distributive Trades and Services — Billboard, Service Station Buildings and Petroleum Marketing Land Improvements. [Pursuant to § 1245(a)(3)(E), storage facilities used in the distribution of petroleum products are § 1245 property.]

7. Section 211 of the Jobs Act of 2004 amends § 168 to provide for a 15-year recovery period for depreciation of qualified leasehold improvements and qualified
restaurant property. Generally, the improvements and property must be in buildings that are at least three years old.

8. Section 902 of the Jobs Act of 2004 amends §§ 195, 248 and 709 to provide for 15-year amortization of amounts of start-up expenditures, corporate organizational expenditures, and partnership organizational and syndication fees that exceed $5,000. The first $5,000 in each category may be deducted or amortized over 60 months, as appropriate.

F. Credits

1. A little assistance in identifying new employees that qualify for the work opportunity credit. Rev. Rul. 2003-112, 2003-45 I.R.B. 1007 (11/10/03). An individual whose family receives TANF assistance for the requisite period meets the requirements to be certified as a qualified IV-A recipient under § 51(d)(2)(A) if the individual is included on the grant and receives assistance for some portion of the specified period.

2. The final research credit regulations that weren’t. In T.D. 8930, Credit for Increasing Research Activities, 66 F.R. 280 (1/3/01), the IRS promulgated final regulations relating to the computation of the credit under § 41(c) and the definition of qualified research under § 41(d). The final regulations immediately came under withering criticism from the business sector, and, in an unusual move, in Notice 2001-19, 2001-10 I.R.B. 784 (1/31/01), the Treasury (Secretary O’Neill, himself, actually) announced that it will review the “final” regulations by reconsidering the comments submitted and requesting additional comments on the regulations to be received by 4/2/01. Any additional changes to the regulations will be made in proposed form. The regulations, including any future changes, will not be effective until the review is complete, except for the retroactive effective date [12/31/85] of the taxpayer-friendly changes to internal-use computer software rules. Taxpayers may rely on the final rules pending new regulations.

- What the suspended final regulations said. The final regulations cover the requirements to qualify for the credit, rules for computing the credit, and rules for electing and revoking the election of the alternative incremental credit, and take into account the legislative history of the Tax Relief and Extension Act of 1999.
  - The final regulations do not change the definition of gross receipts from that in the Proposed Regulations. REG-105170-97, 63 F.R. 66503 (12/2/98).
  - The final regulations retain the requirement in the proposed regulations that a taxpayer seek to discover information that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field of science or engineering. But, in response to comments regarding the discovery requirement, the final regulations make a number of changes.
    - In order to satisfy the discovery requirement, research must be undertaken for the purpose of discovering information that is beyond the knowledge that should be known to skilled professionals had they performed a reasonable investigation of the existing level of knowledge in the particular field of science or engineering [instead of technology or science], but there is no requirement that a taxpayer actually conduct such an investigation in order to claim the credit. The regulations also state, by example, that trade secrets generally are not within the common knowledge of skilled professionals (because they are not reasonably available to skilled professionals not employed, hired, or licensed by the owner of such trade secrets). Underlying principles of science or engineering used in the research need not be novel. Obtaining a patent [other than a design patent] raises a conclusive taxpayer favorable presumption.
      - The prescribed four-step process in the definition of experimentation in Prop. Reg. § 1.41-4(a)(5) has been eliminated.
      - The requirement of experimental record keeping in Prop. Reg. § 1.41-4(a)(5) has been eliminated.
      - The shrinking-back rule has been modified in response to comments. Reg. § 1.41-4(b).
The exclusion of most activities after commercial production has commenced has been retained. The *per se* exclusion list retains debugging, but not correction of flaws.

Research with respect to **internal-use software** that satisfies both the general conditions for credit eligibility and the three-part test is eligible for the credit. The final regulations retain the definition of internal-use software and the additional qualifying test in the proposed regulations, but provide a new exception (pursuant to § 41(d)(4)(E)) under which certain internal-use software used to deliver noncomputer services to customers with features that are not yet offered by a taxpayer's competitors is not subject to the additional tests. Following the Conference Report to the 1999 Act, the final regulations clarify that software that is intended to be used to provide noncomputer services to customers is internal-use software, while software that is to be used to provide computer services is not developed primarily for internal use.

The final regulations clarify (1) that the three-part test in the proposed regulations is the high threshold of innovation test, and not a separate requirement, and (2) how the three-part test high threshold of innovation test supplements the discovery requirement. Research with respect to internal-use software is credit eligible only if it is intended to exceed, expand, or refine the common knowledge of skilled professionals (as defined in Reg. § 1.41-4(a)(3)(ii)) to a degree that is substantial and economically significant.

The new research credit proposed regulations that are. REG-112991-01, new proposed regulations under § 41 that expand the definition of qualified research by eliminating the "discovery test" included in the 1/3/01 regulations, 66 F.R. 66362 (12/26/01).

- Treasury and IRS have eliminated in these proposed regulations the requirement that qualified research must be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering. Rather, Treasury and the IRS believe that the requirement that qualified research be "undertaken for the purpose of discovering information which is technological in nature" is intended to distinguish technological research, which may qualify for the research credit, from non-technological research, which does not.

- The proposed regulations repeat the requirement from Reg. § 1.174-2(a)(1) by stating that research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty, for purposes of this requirement, exists if the information available to the taxpayer does not establish the capability or method of developing or improving the business component, or the appropriate design of the business component.

- The proposed regulations revise the shrinking-back rule to conform it to the rule in the legislative history to the 1986 Act. These proposed regulations also reiterate that the shrinking-back rule may not itself be applied as a reason to exclude research activities from credit eligibility.

- No separate research credit-specific documentation requirement is included in these proposed regulations.

- The preamble notes that the Service will not generally challenge return positions that are consistent with the proposed regulations.

New final research credit regulations retain the requirement that experimentation "must be an evaluative process ... capable of evaluating more than one alternative." They validate the old joke: ""How's your wife?" "Compared with whom?"" T.D. 9104, Credit for Increasing Research Activities, 69 FR 22 (1/2/04). Final regulations generally retain the provisions of December 2001 proposed regulations. The rules for internal-use software are not included in these regulations, but are the subject of an advanced notice of proposed rulemaking.

- They require a process of experimentation directed at resolving uncertainty regarding the taxpayer's development or improvement of a business component that fundamentally relies on the principles of the physical or biological sciences, engineering, or computer science. One or more alternatives intended to eliminate that uncertainty must be identified, and a process of evaluating the alternatives must also be identified. The process may involve, e.g., modeling, simulation, or a systematic trial-and-error methodology.

ANPRM on **internal-use software**. REG-153656-03, Credit for Increasing Research Activities, 69 FR 43 (1/2/04). Advance notice of proposed rulemaking under
§ 41(d)(4)(E) seeking comments on the definition of internal-use software for research credit purposes.

d. Section 301 of the Working Families Act of 2004 extends the research credit for 18 months until 12/31/05.

G. Natural Resources Deductions & Credits


• The District Court (Judge O’Meara) held that the natural gas gathering systems were used to transport gas [Class 46.0] – not in production [Asset Class 13.2] – and thus are depreciable over 15 years rather than seven years because the taxpayer was engaged in the transportation of natural gas, not in the production or processing of natural gas. The District Court described Duke Energy Natural Gas Corp. v. Commissioner, 172 F.3d 1255 (10th Cir. 1999), as “wrongly decided.”

• The Sixth Circuit (Judge Krupansky) found the Duke Energy reasoning persuasive and reversed the District Court. The court held that the period of depreciation of natural gas gathering systems should depend upon the use to which they were being put, and not upon the producer or nonproducer status of the owner of the pipeline. Inasmuch as the pipelines in question were used to transport impure “raw” or “wet” natural gas from the field wellheads to a cleansing and processing facility, they qualify as “gathering pipelines” under Asset Class 13.2 or Rev Proc. 87-56, 1987-2 C.B. 674. Natural gas gathering systems are depreciable over seven years rather than the 15 years for pipelines used to transport gas under Asset Class 46.0.

a. Non-producer must use 15-year recovery period. Clajon Gas Co. L.P. v. Commissioner, 119 T.C. 197 (10/25/02) (reviewed, 10-5). The Tax Court in a decision by Judge Halpern upheld the government’s notices of final partnership administrative adjustment in determining that the recovery period for gathering pipeline systems owned and operated by a non-producer were transportation property with a 15-year recovery period, and not natural gas production property with a 7-year recovery period. The court adhered to its decision in Duke Energy Natural Gas Corp. v. Commissioner, 109 T.C. 416 (1997), rev’d, 172 F.3d 1255 (10th Cir. 1999), and refused to follow the Tenth Circuit’s reversal. The majority held that Clajon’s use of the pipeline system was relevant, and inasmuch as Clajon was not a producer, the pipeline system could not have been part of the production system.

• Judge Wells’ dissent was based upon the Tenth Circuit’s plain language analysis in Duke Energy of Rev. Proc. 87-56, 1987-2 C.B. 674, which only requires that the assets be “used” by natural gas producers to qualify for 7-year depreciation. The Tax Court majority requires that the asset be both owned and used by a natural gas producer. Judge Wells notes that the Tax Court held in Rauenhorst v. Commissioner, 119 T.C. 157 (10/7/02), that “the Commissioner may not choose to litigate against an official position the Commissioner has published without first revising or revoking that position.”

• Judge Foley’s dissent was based upon similar grounds, that the asset meets the regulatory requirement even though Clajon was not a producer.


2. A § 29 credit no-ruling issue. Rev. Proc. 2000-47, 2000-46 I.R.B. 482 (11/13/00). Rev. Proc. 2000-3, ¶5, 2000-1 I.R.B. 103, is amplified by adding to the list of issues on which the IRS will not issue advance rulings the question of whether a solid fuel other than coke or a fuel produced from waste coal is a qualified fuel under §29(c)(1)(C). Waste coal for this purpose is limited to waste coal fines from normal mining and crushing operations and does not include fines produced (for example, by crushing run-of-mine coal) for the purpose of claiming the credit.

which the Service will issue private letter rulings regarding whether a solid fuel produced from coal is a qualified fuel under § 29(c)(1)(C). The circumstances necessary for the Service to issue a private letter ruling include the presence of coal feedstock particles no larger than a specific size, and the performance of specific activities in processing the feedstock in order to effectuate a significant chemical change. The chief requirement is that the fuel be "synthetic." To be synthetic "a fuel must differ significantly in chemical composition, as opposed to physical composition, from the substance used to produce it." Examples of "favorable processes" set forth in the revenue procedure include "gasification [sic] and liquefaction [sic] and production of solvent refined coal that result[s] in substantial chemical changes to the entire coal feedstock rather than changes that affect only the surface of the coal."

b. Eleven days later, the Treasury did revert to pre-suspension ruling standards. Rev. Proc. 2001-34 modifies Rev. Proc. 2001-30 to expand the range of sizes of coal feedstock and to eliminate one particular activity as a necessary part of a process that results in a qualified fuel.

c. IRS looks again at coal-based synfuels — or, is it sin-fuels? Announcement 2003-46, 2003-30 I.R.B. (6/27/03). IRS suspends issuance of letter rulings related to the § 29 tax credit for the production of solid synthetic fuels produced from coal pending review of tests that purportedly show that the processes resulted in significant chemical change.

d. Someone holds the "kies" to IRS continuation of rulings in this area — at least for the time being. Announcement 2003-70, 2003-46 I.R.B. (10/29/03). In so doing, the Announcement states:

The Service has finished the review started with Announcement 2003-46. As a result of this review, the Service has determined that the test procedures and results used by taxpayers are scientifically valid if the procedures are applied in a consistent and unbiased manner. The Service believes, however, that the processes approved under its long standing ruling practice and as set forth in Rev. Proc. 2001-30 do not produce the level of chemical change required by § 29(c)(1)(C) and Rev. Rul. 86-100. Nevertheless, the Service continues to recognize that many taxpayers and their investors have relied on its longstanding ruling practice to make investments. Therefore, the Service will continue to issue rulings on significant chemical change but only under the guidelines set forth in Rev. Proc. 2001-30 as modified by Rev. Proc. 2001-34.

Although the Service will resume its ruling practice, the Service has continuing concerns regarding the sampling and data/record retention practices prevalent in the synthetic fuels industry. Accordingly, in order to receive future rulings, taxpayers will be required to (i) maintain sampling and quality control procedures that conform to ASTM or other appropriate industry guidelines at their synthetic fuel production facilities, (ii) obtain regular reports from independent laboratories that have analyzed the synthetic fuel produced in such facilities to verify that the coal used to produce the fuel undergoes a significant chemical change, consistent with prior ruling practice, and (iii) maintain records and data underlying the reports that taxpayers obtain from independent laboratories including raw FTIR data, and processed FTIR data sufficient to document the selection of absorption peaks and integration points. The Service also plans to issue guidance extending these requirements to taxpayers already holding rulings on the issue of significant chemical change. In addition to these requirements, the Service is considering whether to impose certain requirements on laboratories used by taxpayers to demonstrate significant chemical change, consistent with prior ruling practice, such as requiring that the laboratories be accredited by the NIST National Voluntary Laboratory Accreditation Program.

H. Loss Transactions, Bad Debts and NOLs

1. Graves v. Commissioner, T.C. Memo. 2001-140 (6/15/04). Judge Gerber held that a § 166 business bad debt deduction arising from employee's loan to employer to help
preserve salary income was an employee business deduction that was a miscellaneous itemized deduction subject to the 2 percent of AGI floor of § 67.

2. Maximizing the availability of post-bankruptcy NOLs. Benton v. Commissioner, 122 T.C. No. 20 (5/12/04). The taxpayer filed a chapter 11 bankruptcy petition in 1995 and the plan, which included a continuing liquidating trust, was confirmed in 1997. Judge Gerber held for the taxpayer in allowing the taxpayer to apply his pre-bankruptcy NOLs, as well as the bankruptcy estate's NOLs, to which he succeeded under § 1398(i) to 1995, 1996, and 1997. For purposes of § 1398(i), the chapter 11 bankruptcy terminated when the plan was confirmed and the debtor's discharge was granted (1997), not on the later date on which a final order was entered). Section 1398(g) barring a carryback to pre-petition years does not bar a carryback to the year the bankruptcy petition was filed or years the bankruptcy was pending. The taxpayer could apply the NOLs — subject to the period limits in § 172 based on the source years of the losses — to the year the bankruptcy was commenced and the year the bankruptcy was pending, as well as using NOLs in the year the proceeding terminated.

3. South Carolina has a sharply defined public policy against gambling — except, of course state sponsored gambling. Hackworth v. Commissioner, T.C. Memo. 2004-173 (7/22/04). The taxpayer operated an illegal gambling operation in South Carolina. After the local sheriff's office seized cash proceeds of the gambling operation, which were forfeited under state law, the taxpayer claimed § 165 loss deduction. The Commissioner disallowed the loss on public policy grounds, and Judge Cohen upheld the Commissioner's position because allowing the deduction would frustrate a sharply defined policy of the state of South Carolina. [The opinion fails to note that the State of South Carolina sponsors a state lottery. Perhaps the sharply defined public policy that was violated was a restraint on competition.]

I. At-Risk and Passive Activity Losses

1. Sooner or later, all amounts borrowed from your partner will not increase amount at-risk. REG-209377-89, At-Risk Limitations; Interest Other Than That of a Creditor, 68 F.R. 40583 (8/8/03). Section 465(b)(3) provides that amounts borrowed for use in an activity do not increase the borrower's amount at risk in an activity listed in §§ 465(c)(1) [(1) motion-picture films or videotapes; (2) farming; (3) leasing § 1245 property; (4) oil and gas resources and geothermal deposits] if the lender has an interest other than that of a creditor in the activity or if the lender is related to a person (other than the borrower) who has a disqualifying interest in the activity. Section 465(c)(3)(D) provides that § 465(b)(3) applies to activities to which § 465 is extended by § 453(c)(3)(A) — all other business and profit seeking activities — only to the extent provided in regulations; Alexander v. Commissioner, 95 T.C. 467 (1990), aff'd by order sub nom. Stell v. Commissioner, 999 F.2d 544 (9th Cir. 1993), held that until regulations were issued, § 465(b)(3) does not apply to activities other than those described in § 465(c)(1). Revisions to Prop. Reg. § 1.465-8 and 1.465-20 would apply § 465(b)(3) to the activities described in § 465(c)(3)(A). The regulation will be effective when finalized.

a. Proposed regulations are made final. T.D. 9124, At-Risk Limitations; Interest Other Than That of a Creditor, 69 F.R. 24078 (5/3/04). Applies to amounts borrowed after 5/3/04. There are exceptions for amounts borrowed from a related person that are "qualified nonrecourse financing," and for amounts borrowed from a related person that would have been "qualified nonrecourse financing" had the borrowing been nonrecourse.

III. INVESTMENT GAIN

A. Capital Gain and Loss

1. Welter v. Commissioner, T.C. Memo. 2003-299 (10/29/03). Grain commodity trading by the shareholder of a corporation engaged in the grain farming business were not hedging transactions under the predecessor of Reg. § 1.1221-2 because they were effected through the shareholder's personal brokerage account. The gains and losses (net losses) were capital.

   • The same result would occur under current Reg. § 1.1221-2.

2. "The purpose of narrowly construing the term capital asset under the substitute for ordinary income doctrine is to 'protect the revenue against artful devices' that undermine the Revenue Code's standard treatment of ordinary income and capital gains. [P.G. Lake, 356 U.S. [60 (1958)]. That is precisely what Maginnis has attempted
here." United States v. Maginnis, 356 F.3d 1179, 93 A.F.T.R.2d 2004-660, 2004-1 USTC ¶ 50,149, (9th Cir. 1/30/04), aff'g 2002-1 USTC ¶50,494 (D. Ore. 5/28/02). The taxpayer won $9 million in the Oregon lottery, payable over 20 years in $450,000 installments. After receiving 5 installments, he sold his remaining 15 installments for $3,950,000. After reporting the sales proceeds as ordinary income, he sought a refund based on the claim that the sales proceed were capital gain. The court (Judge Fisher) held that the right to payments was not a "capital asset" for purposes of § 1221, because (1) the taxpayer did not make any underlying capital investment and (2) there was no accretion in value over time. Judge Fisher rejected the argument that cost of the lottery ticket was an 'investment", on the grounds that the underlying transaction was a gambling transaction for tax purposes. He concluded that "Maginnis' sale of his lottery right is almost indistinguishable from the paradigmatic situation in which the substitute for ordinary income doctrine removes a right to future income from the definition of a capital asset, which occurs when a taxpayer assigns his right to future income from employment to a third party for a lump sum."

• The court also rejected the taxpayer's argument that Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988), mandates that § 1221 be read broadly, because the Court in Arkansas Best expressly held that its decision did not affect the way in which the substitute for ordinary income doctrine modifies the term capital asset.

• Finally, the court also rejected the taxpayer's argument that because he sold his entire right to the lottery payments [a "vertical slice"], instead of merely a carved-out income stream [a "horizontal slice"], the income was capital gain. "[A] transaction in which a taxpayer sells his entire interest in an underlying asset without retaining any property right does not automatically prevent application of the substitute for ordinary income doctrine."

3. The stock is still in the box. Rev. Rul. 2004-15, 2004-8 I.R.B. 515 (2/23/04). When a taxpayer who has sold stock short satisfies the obligation to the broker from the taxpayer borrowed the stock with stock borrowed from another broker, the transfer of the borrowed stock does not close the short sale under Reg. § 1.1233-1(a). Because replacing the obligation to one broker with an obligation to another does not close the short sale, the transfer does not cause the § 1259 transition rule for short sales before the close of the 30-day period beginning on August 5, 1997 to cease to apply to either the short sale or stock in the box.

4. Judge Goeke says McAllister is no longer good law. Clopton v. Commissioner, T.C. Memo ¶ 2004-95 (4/6/04). The taxpayer sold 20 of 22 remaining payments to which he was entitled as a winner of Texas lottery. Judge Goeke held that the sales proceeds were ordinary income, not capital gains, following Davis v. Commissioner, 119 T.C. 1 (2002) and United States v. Maginnis, 356 F.3d 1179 (9th Cir. 2004). He declined to follow McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946) not on the grounds that it was distinguishable because in that case the taxpayer had sold all of her rights to future payments, but on the grounds that McAllister was stripped of precedential value by the subsequent Supreme Court decision in Commissioner v. PG Lake, Inc., 356 U.S. 262 (1958), under which a substitute for future ordinary income is not a capital gain.

5. The dark side of estate tax valuation discounts. Janis v. Commissioner, T.C. Memo ¶ 2004-117 (5/12/04). The taxpayers inherited an art gallery that held in inventory a large number of paintings by famous artists [e.g., Jean Arp, Piet Modrian, Grandma Moses]. In prior administrative proceedings, the estate had succeeded in applying a blockage discount in valuing the items for estate tax purposes. In this income tax case involving determination of the cost of goods sold, Judge Cohen upheld applying a "blockage" discount to determine the § 1014 basis of the inventory. In addition to applying the blockage discount on the merits of the fair market value issue, Judge Cohen found that the taxpayers were bound by the duty of consistency because as executors of the estate they had agreed to the amount of the blockage discount in determining the estate tax value.

6. Coleman v. Commissioner, T.C. Memo. 2004-126 (5/25/04). Judge Gerber held that payments under an unexpired covenant not to compete that are payable and received after the decedent's death are IRD under § 691(a) and ineligible for a § 1041 step-up in basis. The receipts remain ordinary income to the heirs.

B. Section 1031

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

a. Temporary regulations. T.D. 9115, REG-106590-00 and REG-138499-02, Depreciation of MACRS Property That Is Acquired in a Like-Kind Exchange or as a Result of an Involuntary Conversion, 69 F.R. 9529 (2/22/04). Under these temporary and proposed regulations, generally the exchanged basis is depreciated over the remaining recovery period of, and using the depreciation method of, the relinquished MACRS property if it is the useful life of the replacement property is the same or shorter than the relinquished property. If the replacement property has a longer useful life, depreciation is computed as if the replacement property had originally been placed in service when the relinquished property was placed in service by the acquiring taxpayer. Any excess basis is treated as property placed in service in the year the acquiring taxpayer places it in service. There are specific rules for deferred exchanges and reverse exchanges, as well as for automobiles.


3. Section 839 of the Jobs Act of 2004 adds new §121(d)(10) to make the §121 exclusion of gain on the sale of a principal residence inapplicable to any property acquired in a §1031 exchange within five years of the sale.

C. Section 1041

1. A sensible ruling that favors §1041 over the assignment of income theory on the transfer of vested stock options and vested nonqualified deferred compensation incident to divorce. Rev. Rul. 2002-22, 2002-19 I.R.B. 899 (5/8/02). This ruling held that: (1) a taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer’s former spouse incident to divorce is not required to include an amount in gross income upon the transfer, and (2) the former spouse, and not the taxpayer, is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

• The ruling stated,

Similarly, applying the assignment of income doctrine in divorce cases to tax the transferor spouse when the transferee spouse ultimately receives income from the property transferred in the divorce would frustrate the purpose of §1041 with respect to divorcing spouses. That tax treatment would impose substantial burdens on marital property settlements involving such property and thwart the purpose of allowing divorcing spouses to sever their ownership interests in property with as little tax intrusion as possible. Further, there is no indication that Congress intended §1041 to alter the principle established in the pre-1041 cases such as Meisner [v. United States, 133 F.3d 654 (8th Cir. 1998)] that the application of the assignment of income doctrine generally is inappropriate in the context of divorce.

• The ruling also cited Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3d Cir. 1974), by way of analogizing §1041 to §351.
This ruling does not apply to transfers of property between spouses other than in connection with divorce. This ruling also does not apply to transfers of nonstatutory stock options, unfunded deferred compensation rights, or other future income rights to the extent such options or rights are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer. See Kochansky v. Commissioner, 92 F.3d 957 (9th Cir. 1996). [Emphasis added]

- This ruling clarified that Rev. Rul. 87-112, 1987 C.B. 207, which held that § 1041 did not apply to accrued interest on transferred U.S. savings bonds that were subsequently cashed in, was based on § 454 rather than on assignment of income principles.
- Query whether the non-employee spouse will be required to follow this ruling? Perhaps, the divorce decree or separation agreement should address this issue.
  a. Notice 2002-31, 2002-19 I.R.B. 908. Proposes that FICA/FUTA taxes on exercise of stock options and distribution of deferred compensation be imposed as if the income was that of the employee spouse.
  b. Rev. Rul. 2002-22 and Notice 2002-31 are clarified. Rev. Rul. 2004-60, 2004-24 I.R.B. (6/4/04). The options and deferred compensation remain subject to employment taxes as if the employee spouse had retained them but the employee portion of the FICA taxes is deducted from the payment to the nonemployee spouse. Income recognized by the nonemployee spouse with respect to the exercise of the nonstatutory stock options is subject to § 3402 withholding at the flat rate of 25 percent and is also to be deducted from the payments to the nonemployee spouse.
  2. Division of military retirement pay in a divorce is taxed the same as a QDRO. Pfister v. Commissioner, 359 F.3d 352, 93 A.F.T.R.2d 2004-1113, 2004-1 U.S.T.C. ¶ 50,176 (4th Cir. 2/27/04). The taxpayer was awarded one-half of her former husband's military retirement pay pursuant to a divorce decree, as permitted by the Uniformed Service's Former Spouses' Protection Act. She claimed the receipts were excludable under § 1041. The Court of Appeals (Judge Gregory) affirmed the Tax Court's holding that the receipts were gross income to the recipient former spouse; § 1041 did not apply to receipt of the payments [although it would apply to the initial division of property rights in the pension].

D. Section 1042

1. You have to get that § 1042 nonrecognition election right before the due date of the return. Estate of John W. Clause v. Commissioner, 122 T.C. No. 5 (2/9/04). The taxpayer [before he died] sold all of his shares of a corporation he controlled to the corporation's ESOP and purchased qualified replacement property [under § 1042(c)(4)] with most of the proceeds from the sale within a year of the sale. He did not report the transaction on his original return, but after an audit was commenced, he filed an amended return indicating that certain proceeds from the sale had been reinvested in qualified replacement property, but which did not contain the written statement required by § 1042(b)(3), which is a requirement to obtain nonrecognition. He subsequently filed a second amended return that to which was attached a statement that he elected nonrecognition under § 1042. Section 1042(c) provides that the election must be made on a return filed by the due date [with extensions]. Temp. Reg. § 1.1042-1T imposes a number of detailed procedural rules for form and content of the statement required under § 1042(c), none of which the taxpayer complied. Judge Haines held that Temp. Reg. Was a valid legislative regulation and that the taxpayer was not entitled to nonrecognition because he failed properly to comply with the procedural requirements of § 1042 and Temp. Reg. § 1.1042-1T. Neither the “substantial compliance” doctrine nor the fact that the taxpayer relied on his C.P.A. properly to file his return saved the day for the taxpayer.

IV. COMPENSATION ISSUES

1 Under § 402(e)(1) a former spouse who receives a distribution pursuant to a “qualified domestic relations order” (QDRO), as defined in § 414(p), is treated as an alternative beneficiary of the plan who is taxable on distributions from the qualified plan under §§ 402(a) and 72.
A. Fringe Benefits

1. You don’t need a prescription to be reimbursed by a health FSA for over-the-counter drugs. Rev. Rul. 2003-102, 2003-38 I.R.B. 559 (9/3/03). The test for reimbursement by a health FSA under § 105(b) for drugs simply requires that they be obtained for “medical care” as defined in section 213(d), and does not require that they satisfy the requirement of § 213(b) which permits an amount paid for a medicine or drug to be taken into account for purposes of the § 213 deduction “only if the medicine or drug is a prescribed drug or insulin.”

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

B. Qualified Deferred Compensation Plans

1. Cash balance plan proposed regulations provide a green light for adoptions of cash balance plans favoring younger employees, including permission to require quasi-geriatrics to spin their [retirement accrual] wheels during “wear-away” periods. REG-209500-06 and REG-164464-02, Reductions of Accruals and Allocations Because of the Attainment of any Age: Application of Nondiscrimination Cross-Testing Rules to Cash Balance Plans, 67 F.R. 76123 (12/11/02). These proposed regulations provide guidance on age discrimination requirements under §§ 411(b)(1)(H) and 411(b)(2), including the allocation of these requirements to cash balance pension plans.

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

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

   a. Courts find that Xerox and IBM cash balance plans violate ERISA. Berger v. Xerox Corporation Retirement Income Guarantee Plan, 2003 TNT 160-12 (7th Cir. 8/1/03) (plan violates ERISA because method of determining an ex-employee’s benefit if a lump sum under $25,000 is chosen on leaving before retirement); Cooper v. IBM Personal Pension Plan, 2003 TNT 149-38 (S.D. Ill. 8/1/03) (plan violates ERISA § 240(b)(1)(G) [reduction of accrued benefit solely on increases in age or service] and 240(b)(1)(H) [rate of benefit accrual decreases once a certain age is attained]).

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

regulations were withdrawn in order to give Congress the opportunity to consider the administration’s legislative proposal and to address cash balance plan issues through legislation.

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

2. The employer can pay administrative expenses allocable to current employees, while stiffing former employees. Rev. Rul. 2004-10, 2004-7 I.R.B. (1/19/04). A qualified deferred compensation plan does not fail to satisfy the requirements of § 411(a)(11) merely because it charges reasonable plan administrative expenses to the accounts of former employees and their beneficiaries on a pro rata basis, but does not charge the accounts of current employees.

3. Plan qualification after sale of a subsidiary. Rev. Rul. 2004-11, 2004-7 I.R.B. (1/19/04). Tax consequences of the sale of a subsidiary on its defined benefit pension plan and its employee profit-sharing plan with respect to the nondiscrimination requirements of § 401(a)(4) and the minimum coverage requirements of § 410(b).

4. If you roll it over, you can take it out whenever you want to. Rev. Rul. 2004-12, 2004-7 I.R.B. (1/29/04). If an eligible retirement plan separately accounts for amounts attributable to rollover contributions, distributions of amounts attributable to these rollover contributions are generally permissible at any time pursuant to the individual’s request (with spousal consent, if applicable).

5. If a plan is sweetened beyond a CODA with safe harbor matching, Dolly Parton may well smother it in her warm embrace. Rev. Rul. 2004-13, 2004-7 I.R.B. (1/25/04). A profit-sharing plan containing a cash or deferred arrangement with safe harbor matching contributions meets the requirements of § 416(g)(4)(H) and is not subject to the top-heavy rules. However, (1) adding employer-provided discretionary nonelective contributions, (2) allocation of forfeitures to participants’ accounts or (3) deferring matching contributions for newly hired nonhighly compensated employees who make elective contributions will result in the plan becoming subject to the top-heavy rules.

6. The Pension Funding Equity Act of 2004, establishes a temporary replacement for the benchmark 30-year Treasury bond interest rate for use in determining funding liabilities of pension plans.


7. They’re taking all the fun out of calculating minimum required distributions from plans and IRAs. REG-130477-00 and REG-130481-00, Required Distributions from Retirement Plans, 66 F.R. 3928 (1/17/01). Proposed regulations under § 401(a)(9), etc., substantially simplify the calculation of minimum required distributions from qualified plans, IRAs, and other related retirement savings vehicles. The changes in the proposed regulations are based on the concept of a uniform lifetime distribution period. The regulations provide a single table that any recipient can use to calculate his or her yearly MRD amount by plugging in his or her age and the prior year-end balance of his or her retirement account or IRA. The table eliminates the need to elect recalculation of life expectancy, determine a designated beneficiary by the required beginning date, or satisfy a separate incidental death benefit rule. The proposed regulations will result in reducing MRDs for the vast majority of employees and IRA holders. Although MRDs will be calculated without regard to the beneficiary’s age, the regulations continue to permit a longer payout period if the beneficiary is a spouse more than 10 years younger than the employee. Payments after the death of the employee or participant may be made over the life expectancy of the beneficiary designated by the close of the year following the participant’s death.

   a. Regulations are final, with temporary regulations also. T.D. 8987, Required Distributions From Retirement Plans, 67 F.R. 18988 (4/17/02). The final regulations retain the simplifications to the minimum distribution rules for separate accounts provided in the 2001 proposed regulations, including the calculation of the MRD during the individual’s lifetime using a uniform table (which is changed in the final regulations to reflect updated mortality calculations). The final regulations change the date for determining the designated beneficiary to September 30 of the year following the year of the employee's death (to
permit sufficient time to calculate the MRD before the end of the year). The temporary regulations provide a number of changes to the annuity rules in the proposed regulations, which merely reflected the 1987 proposed regulations. Effective for 2003 and following calendar years; for determining minimum distributions for the 2002 year, taxpayers may rely on the final regulations, the 2001 proposed regulations, or the 1987 proposed regulations.

b. Final regulations make modifications, but retain the basic rules contained in the April 2002 temporary regulations. T.D. 9130, Required Distributions From Retirement Plans, 69 F.R. 33288 (6/15/04). These regulations are effective 6/15/04, and apply for purposes of determining required minimum distributions for calendar years beginning on or after 1/1/03.

8. Think twice before you sign blank documents. Armstrong v. United States, 366 F3d 622 (8th Cir. 5/3/04). The taxpayer borrowed money from a bank to pay his children's college expenses. He intended to pledge a life insurance policy, but was in a hurry and signed blank loan documents, intending to deliver the life insurance contract later. While he was out of town, his employee delivered qualified retirement plan annuity contracts to the bank, which completed the documents based on the retirement annuity contracts. The Court (Judge Heaney) held that the collateral assignment of the qualified retirement plan annuity contracts was valid and thus constituted a distribution to the taxpayer under § 72(p)(1).

C. Nonqualified Deferred Compensation, Section 83, and Stock Options
1. Modification of a recourse note given by an employee upon the exercise of a stock option would result in compensation income, not discharge of indebtedness income. Rev. Rul. 2004-37, 2004-11 I.R.B. (2/25/04). When an employee exercises a nonstatutory stock option by using a recourse note with interest not less than the AFR on the date the note is issued, compensation income is measured by the difference between the value of the stock and the stated principal amount of the note. If, in a later year, the principal amount of the note is reduced, the amount of the reduction is treated as additional compensation income under § 83 – not as cancellation of indebtedness income under § 108, which could purportedly be excluded from gross income under § 108(e)(5) and treated as a reduction in purchase price. The rules of Reg. § 1.1001-3 are applied in determining whether a significant modification occurred.

2. Section 885 of the Jobs Act of 2004 adds new § 409A which significantly modifies the taxation of nonqualified deferred compensation plans for amounts deferred after 2004 (a) by requiring that benefits be deferred until retirement (or a similar future occasion), (b) by requiring that the deferral election be made before the beginning of the year in which the services are performed, and (c) by generally prohibiting acceleration of benefits. Subsequent deferral elections will also be subject to restrictions. Violations of these rules would make immediately taxable all amounts not subject to a substantial risk of forfeiture.

- These new rules do not apply to nonqualified stock options, incentive stock options and employee stock purchase plans, but do apply to stock appreciation rights.
- The IRS has advised employers to defer plan changes until further guidance is issued in the near future.

3. Section 251 of the Jobs Act of 2004 amends various Code sections to provide that employment taxes (including withholding) are not required with respect to exercise of incentive stock options and employee stock purchase plan stock options.

- There has been for the past several years a freeze in effect on the collection of employment taxes on the exercise of qualified options.

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates
1. Section 101 of the Working Families Act of 2004 repeals the scheduled reductions in child tax credit, marriage penalty relief, and 10 percent rate bracket. Section 102 accelerates the increase in refundability of the child tax credit. Section 103 extends the increase in AMT exemption amount for one year through 2005.

2. Dividends received are to be taxed at capital gains rates. The 2003 Act added § 1(h)(11), which provides that dividends received by taxpayers other than
corporations generally will be taxed at the same rate as long-term capital gains, i.e., 15 percent for taxpayers otherwise taxable at a rate greater than 15 percent; and five percent for taxpayers otherwise at 10 or 15 percent (with a special zero percent rate for 10- and 15-percent bracket taxpayers in 2008). This rate applies to dividends received from domestic and qualified foreign corporations for purposes of both the regular tax and the alternative minimum tax. A dividend is treated as investment income for purposes of determining the amount of deductible investment interest under §163(d) only if the taxpayer elects to treat the dividend as not eligible for the reduced rates. The provision is effective for taxable years beginning after 12/31/02, and beginning before 1/1/09.

a. Let’s pretend it has been already corrected for the Spring 2004 Filing Season. IR-2004-22 (2/19/04). The IRS announced it agreed to make the provisions of §2 of the Tax Technical Corrections Bill of 2003, related to dividends, available to taxpayers in advance of its passage. These include an increase of the 120-day period to 121 days, as well as permitting passthrough entities that received dividends in fiscal years beginning in 2002 to treat as qualifying dividends those qualifying dividends received in 2003.

0. If a shareholder does not hold a share of stock for more than [60] days during the [120]-day period beginning [60] days before the ex-dividend date (as measured under section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property. Note that the 60-day holding period cannot be satisfied by stock that is acquired one day before the ex-dividend date. This anomaly is to be retroactively corrected in the Tax Technical Corrections Bill (H.R. 3654), which was introduced by Ways & Means Committee Chair Thomas and Ranking Minority Member Rangel. 2003 TNT 236-1.

b. It is finally corrected in October. Section 402(a)(2) of the Working Families Act of 2004 does, indeed, correct that glitch.

c. Payments in lieu of dividends are not eligible for the exclusion. See sections 6042(a) and 6045(d) relating to statements required to be furnished by brokers regarding these payments. Notice 2003-67, 2003-40 I.R.B. (9/16/03). Guidance for brokers and individuals regarding payments in lieu of dividends (sometimes called “substitute payments”). Brokers are essentially given a pass for 2003 reporting as to whether a payment is a dividend [on Form 1099-DIV] or a payment in lieu of a dividend [in Box 8 of Form 1099-MISC], but must adopt proper procedures by 2004, Brokers will be permitted to treat shares as loaned first by tax-indifferent customers, then by other customers using the random lottery method provided in existing Reg. §1.6045-2(f)(2)(ii)(B).

d. Qualified foreign corporations include those “eligible for the benefits of a comprehensive income tax treaty [other than the Barbados treaty].” Notice 2003-69, 2003-42 I.R.B. 851 (10/20/23). This notice provides a list of U.S. income tax treaties meeting the requirements of §1(h)(1)(C)(ii)(II), which results in treating foreign corporations as a ‘qualified foreign corporation’ dividends from which are eligible for the 5 / 15 percent maximum rates.

e. Stock that is readily tradable on an established securities market in the United States [including stock that is traded in the form of American Depository Receipts]. Notice 2003-71, 2003-43 I.R.B. 922 (10/27/03). This notice defines what it means ‘to be readily tradable on an established securities market in the United States for purposes of determining whether dividends on stock of a foreign corporation are eligible for the 5 / 15 percent preferential rates.


B. Miscellaneous Income
1. How not to behave when dealing with an issue for which there is no precedent. Roco v. Commissioner, 121 T.C. No. 10 (9/11/03). Qui tam payments are includable in gross income, and taxpayer is penalized for not doing so – despite the absence of any precedent – in large part because the taxpayer sought a private letter ruling and withdrew his request after being advised that the Service would rule adversely.

2. Dennis Rodman is a supporting actor in what might be a far-reaching Tax Court case; only Walter Matthau and Jack Lemmon can do justice to this script. Amos v. Commissioner, T.C. Memo. 2003-329 (1/21/03). The taxpayer was a television cameraman who was kicked in the groin and injured by Dennis Rodman after Rodman ran out of bounds and tripped, landing on the taxpayer – and the kick took extra effort by Rodman. The taxpayer settled any claims he had against Rodman for $200,000. The settlement agreement expressly provided that Rodman paid the taxpayer a portion of the settlement amount at issue in return for his agreement not to: (1) defame Rodman, (2) disclose the existence or the terms of the settlement agreement, (3) publicize facts relating to the incident, or (4) assist in any criminal prosecution against Rodman with respect to the incident. The Tax Court (Judge Chietchi) characterized these provisions collectively as “the nonphysical injury provisions,” and found that $80,000 of the settlement was attributable to these provisions and that only $120,000 of the settlement was “on account of” personal physical injury and therefore excludable.

3. Home-made alimony. Dato-Nodurft v. Commissioner, T.C. Memo. 2004-119 (5/17/04). Payments under a written support agreement qualified as alimony even though the husband and wife, who were living apart, were not legally separated and the agreement was not enforceable under state law.

C. Profit-Seeking Individual Deductions

1. The alternative minimum tax (“AMT”) trap for attorneys’ fees on large recoveries.

a. Cases decided in past years by the First, Fourth, Seventh, Eighth, Ninth, Tenth and Federal Circuits sprang the AMT trap. Attorney’s fees incurred by an individual in a nonbusiness profit-seeking transaction are [§ 212] miscellaneous itemized deductions [§67] and may not be deducted for AMT purposes. To avoid this result, taxpayers in a number of cases in recent years have argued the portion of a taxable damage award retained by the taxpayer-plaintiff’s attorney as a contingent fee is excluded from the taxpayer-plaintiff’s income and treated as income earned directly by the attorney. The Tax Court and most Courts of Appeals have reached conflicting results on this question. Generally, the Tax Court holds that attorney’s fee awards paid directly to a plaintiff’s attorney [or the portion of a damage award that is the attorney’s contingent fee that is so paid] are nevertheless includable in the litigant’s gross income, and that the taxpayer then may claim a deduction, subject to any applicable limitations, including disallowance of the deduction for AMT purposes if it is a § 212 deduction. Bagley v. Commissioner, 105 T.C. 396 (1995), aff’d 121 F.3d 393 (8th Cir. 1997). Accord Baylin v. United States, 43 F.3d. 1451 (Fed. Cir. 1995), aff’d 30 Fed. Cl. 248 (1993); Alexander v. IRS, 72 F.3d 938, 96-1 U.S.T.C. ¶50,011 (1st Cir. 1995), aff’d T.C. Memo. 1995-51; Coady v. Commissioner, 213 F.3d 1187, 2000-1 U.S.T.C. ¶50,528 (9th Cir. 2000), aff’d T.C. Memo. 1998-29; Benici-Woodward v. Commissioner, 219 F.3d 941, 2000-2 U.S.T.C. ¶50,595 (9th Cir. 2000), aff’d T.C. Memo. 1998-395, cert. denied, 531 U.S. 1112 (2001); Kenesh v. Commissioner, 259 F.3d 881, 2001-2 U.S.T.C. ¶50,570, 88 A.F.T.R.2d 2001-5378 (7th Cir. 8/7/01), aff’d 114 T.C. 399 (5/24/00) (reviewed, 8-5); Young v. Commissioner, 240 F.3d 369, 2001-1 U.S.T.C. ¶50,244, 87 A.F.T.R.2d 2001-889 (4th Cir. 2/16/01), aff’d, 113 T.C. 152 (8/20/99); Hukkanen-Campbell v. Commissioner, 274 F.3d 1312, 2002-1 U.S.T.C. ¶50,351, 88 A.F.T.R.2d 2001-7983 (10th Cir. 12/19/01), aff’d T.C. Memo. 2000-180 (6/12/01), cert denied, 535 U.S. 1056 (5/13/02).

b. But the Fifth and Sixth Circuits see things differently.

(1) In Cotenam v. Commissioner, 263 F.2d 119 (5th Cir. 1959), however, the Fifth Circuit held that attorney’s fees so paid directly to a plaintiff’s attorney are not includable by the litigant. The court of appeals reasoned that under the Alabama attorney’s lien law, the ownership of the portion of the award representing attorney’s fees vested in the attorney ab initio. Subsequently, in Srinivasa v. Commissioner, 220 F.3d 353, 2000-2 U.S.T.C. ¶50,597 (5th Cir. 2000) (2-1), rev’d T.C. Memo. 1998-362, a majority decision of a Fifth Circuit panel held that Cotenam applied to attorneys’ fees under Texas law because there is no difference in the “economic reality facing the taxpayer-plaintiff” between Alabama and Texas attorney’s liens and any distinction between them does not affect the analysis required by the
anticipatory assignment of income doctrine. A dissent by Judge Dennis distinguished Cotnam on the ground that Alabama law gives the holders of attorney's liens greater power than does Texas law.

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

(3) In the Eleventh Circuit (as derived from pre-split Fifth Circuit precedents), under the Golser rule, attorney's fees are not included in the income of an Alabama taxpayer who received a large punitive damages award. Davis v. Commissioner, 210 F.3d 1346, 2000-1 U.S.T.C. ¶50,431, 85 A.F.T.R.2d 2000-1567 (4/27/00) (per curiam), aff'g T.C. Memo. 1998-248 (7/7/98). The Eleventh Circuit panel held that, with respect to Alabama taxpayers, it was bound by Cotnam.

• In Foster v. United States, 249 F.3d 1275, 1278 (11th Cir.2001), the Eleventh Circuit followed Davis in a subsequent case involving another Alabama taxpayer.

c. There is no AMT trap in Vermont! Will the Second Circuit get a chance to opine? Raymond v. United States, 247 F. Supp. 2d 548, 2003-1 U.S.T.C. ¶50,196, 91 A.F.T.R.2d 2003-535 (D. Vt. 12/17/02). The district court (Chief Judge Sessions) followed Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959), to exclude contingent attorney's fees in a wrongful discharge cases attorney's fees because under state law the plaintiff taxpayer never personally owed the contingent fee and attorney's lien gave him an equitable interest in the plaintiff's claim. He concluded that the taxpayer transferred an interest in income producing property before the income was realized, rejecting the reasoning of all of the cases to the contrary, e.g., Kenseth v. Commissioner, 259 F.3d 881 (7th Cir. 2001), aff'g 114 T.C. 399 (2000), that refused to treat state law as controlling and applying the assignment of income doctrine of Old Colony Trust Co., 279 U.S. 716 (1929). Notably, Judge Sessions also chose not to rely on Srivastava v. Commissioner, 220 F.3d 353 (5th Cir. 2000), in which the Fifth Circuit abandoned reliance on state law in holding that successful plaintiffs are not required to include and deduct contingent attorney's fees but may simply exclude them.

(1) Raymond reversed by the Second Circuit, so taxpayers in the First Circuit fall into the AMT trap. Raymond v. United States, 355 F.3d 107, 2004-1 U.S.T.C. ¶50,124, 93 A.F.T.R.2d 2004-416 (2d Cir. 12/13/04). Taxpayer-plaintiff taxed because he received "money's worth" for fee diverted to attorney; state attorney's fee lien law analyzed but not solely determinative; taxpayer had sufficient control of source of funds as to require full inclusion in gross income.

d. We discover that in the Ninth Circuit it all depends on which state's attorney's lien law controls. Banaitis v. Commissioner, 340 F.3d 1074 (9th Cir. 8/23/03), rev'g T.C. Memo. 2002-5. In a case involving attorney's fees subject to Oregon attorney's fee lien law, the Ninth Circuit (Judge Thomas) held the portion of a taxable damage award (for wrongful discharge from employment) retained by the attorney as a contingent fee was not includable in the taxpayer-plaintiff's gross income. Judge Thomas found that the nature of the attorney's fee lien was determinative. Examining relevant state law, he concluded that under Oregon law, the attorney's claim to the fee was even stronger than under Alabama law. Therefore he applied the Fifth Circuit's decision in Cotnam v. Commissioner, 263 F.2d 119 (5th Cir.1959), holding that contingent attorney's fees paid directly to an attorney were not includable in the client's gross income because Alabama attorney's fee lien law vested title in the attorney ab

9 Under Bonner v. City of Prichard, Alabama, 661 F.2d 1206 (11th Cir. 1981), Fifth Circuit decisions rendered before the Eleventh Circuit was created are binding precedent in the Eleventh Circuit.
Judge Thomas declined to apply the Ninth Circuit's precedents in Benci-Woodward v. Commissioner, 219 F.3d 941, 943 (9th Cir. 2000), cert. denied, 531 U.S. 1112 (2001), and Coady v. Commissioner, 213 F.3d 1187 (9th Cir. 2000), on the grounds that Oregon attorney's fee lien law was significantly different than that of California and Alaska, which were relevant in those cases.

In his opinion, Judge Thomas described the Fifth Circuit as having "reached a similar conclusion about the operation of Texas law" in Srivastava v. Commissioner, 220 F.3d 353 (5th Cir. 2000), and the Eleventh Circuit as "extending Cotnam's Alabama-law-based holding into the law of the entire Eleventh Circuit" in Foster v. United States, 249 F.3d 1275, 1278 (11th Cir. 2001), notwithstanding that in Srivastava the Fifth Circuit actually reached its conclusion wholly apart from the niceties of Texas attorney's lien law and in Foster the Eleventh Circuit was dealing with a case that arose in Alabama, for which there was no doubt that Cotnam was the controlling precedent. [The Eleventh Circuit has not yet decided an attorney's fees AMT trap case arising in Florida or Georgia.]

The Supreme Court will decide. A writ of certiorari was granted, 158 L. Ed. 2d 398, 124 S. Ct. 1712 (3/29/04), and this case was consolidated with Banks.

e. Now we know how to exclude California contingent attorney's fees—move to the Sixth Circuit before petitioning the Tax Court! Banks v. Commissioner, 345 F.3d 373, 92 A.F.T.R.2d 2003-6298 (6th Cir. 9/30/03). The Sixth Circuit followed the Fifth Circuit's decision in Srivastava v. Commissioner, 220 F.3d 353 (5th Cir. 2000), and reaffirmed that the Sixth Circuit's holding in Estate of Clarks v. Commissioner, 202 F.3d 854 (6th Cir. 2000), was based on a broader principle than the ground that state attorney's fee lien law determines whether the taxpayer-plaintiff can exclude attorney's fees. The taxpayer, who lived in Michigan when he filed his Tax Court petition, but who had previously been employed in California and had settled a wrongful termination suit brought in California for taxable tort damages under California law, was allowed to exclude the contingent attorney's fees, even though they were governed by California law and the Ninth Circuit would have reached a contrary conclusion under Benci-Woodward v. Commissioner, 219 F.3d 941 (9th Cir. 2000).

The Supreme Court will decide. A writ of certiorari was granted, 158 L. Ed. 2d 398, 124 S. Ct. 1713 (3/29/04), and this case was consolidated with Banaitis.

The expense of suing your former employer might be "attributable" to the trade or business of being an employee, but it's not "incurred by the employee in connection with the performance of services as an employee of the employer." Biehl v. Commissioner, 118 T.C. 467 (5/30/02). The taxpayer successfully sued his former employer for wrongful termination and, in addition to damages, pursuant to his employment contract; the employer was required to pay his attorney's fees. The taxpayer [who lived in the Ninth Circuit, which has already ruled that successful plaintiffs cannot exclude attorney's fees, see, e.g., Sinyard v. Commissioner, 268 F.3d 756 (9th Cir. 2001)] the attempted to avoid the AMT trap on miscellaneous itemized deductions by arguing that the attorney's fees were employer reimbursement of a § 162 employee business plan excludable under an accountable plan pursuant to § 62(c) and Reg. § 1.62-2(c) and (d). Judge Beghe held that that even though the expenses were § 162 employee business expenses because they were "attributable" to his trade or business of being an employee, the expenses did not meet the requirement of Reg. § 1.62-2(d) that the expenses be "paid or incurred by the employee in connection with the performance of services as an employee of the employer." This latter requirement is met only if the expenses were incurred on the employer's behalf, which clearly was not true in this case. Furthermore, it cannot be met if the expenses are incurred after the employment relationship has been terminated, which was true in this case.
And the Ninth Circuit agrees. 351 F.3d 982, 92 A.F.T.R.2d 2003-7280, 2004-1 U.S.T.C. ¶50,109 (9th Cir. 12/12/03). The Ninth Circuit (Judge Trott) affirmed following essentially the same reasoning as Judge Beghe in the Tax Court. In contrast to § 62(a)(1), which requires only that an expense be “attributable to a trade or business,” § 62(a)(2)(A) applies only to reimbursement of expenses incurred in performing duties for or on behalf of the taxpayer’s employer. The legislative history supports Treas. Reg. § 1.62-2(d).

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

E. Deductions and Credits for Personal Expenses
1. The dependency exemption may be released by the custodial parent in favor of the child’s father to whom she was never married. King v. Commissioner, 121 T.C. No. 12 (9/26/03). The support tests of § 152(e) apply to the unmarried parents of a minor child. This is because § 152(c)(1)(A)(iii) provides that § 152(e) applies to “parents . . . who live apart at all times during the last 6 months of the calendar year.” Inasmuch as the custodial parent released her claim to exemption on Form 8332 for 1987 and “future years,” Judge Goeke held that the non-custodial parent was entitled to the exemption deduction for the child.
   • Note that the current version of Form 8332 contains instructions that the form should not be used by parents who never married each other.
   a. The Service will change Form 8332 in accordance with the King decision. On 11/13/03, the IRS announced a change to the Internal Revenue Manual that Form 8332 for 2003 is being revised by deleting all references to the requirement that the custodial and non-custodial parents must be or have been married to each other before the special support tests apply.10
   2. Is the kid like a car with respect to recordkeeping? ‘He do the entries in different inks,” McCullar v. Commissioner, T.C. Memo. 2003-272 (9/17/03). If parents are divorced, §152(e) provides that custodial parent is ordinarily entitled to claim the children as dependents. In a “split-custody” case, the father proved that he had physical custody of a child for more than one-half of the year through a detailed log book — with entries written in different ink and typed in different fonts — covering the times the child was in his custody. Judge Halpern stated, “Petitioner’s log gives detailed descriptions about the time he spent with and without his daughter each day of 1998, written in different ink and typed in different fonts. Respondent argues that the log contains errors. Given the testimony of both petitioner and his ex-wife, we have determined that petitioner is a credible witness and that his log is valid and not fabricated.”
   3. Deduct some of those retirement community costs as medical expenses, but not the pool. Baker v. Commissioner, 122 T.C. No. 8 (2/19/04). If a taxpayer pays a monthly life-care fee to a retirement home, the portion of the fee that the taxpayer proves is for medical care is deductible as a medical expense for medical care. This case addressed the question of the proper method for allocating fees paid to a long-term care facility between deductible medical expenses and nondeductible personal living expenses. Relying on Rev. Rul. 67-185, 1967-1 CB 70, Rev. Rul. 75-302, 1975-2 CB 86, and Rev. Rul. 76-481, 1976-2 CB 82, Judge Goeke approved the taxpayer’s use of the “percentage method,” and declined to require the taxpayer to use the more complex “actuarial method” advocated by the Commissioner. The percentage method assumes that the medical care portion of entrance fees and monthly service fees is the same portion or percentage as the continuing care retirement community’s medical expenses to total costs because the sum of the fees over the resident’s lifetime is expected to cover the costs of care for residents in a CCRC. Based on several revenue rulings, the court held that there is “no requirement that taxpayers engage in an actuarial analysis to factor in life

10 Compare this IRS concession to the never-spoken words that immortalized “Uncle Don” Carney, who broadcast his young children’s show from the powerful 50,000 watt WOR station in New York. Carney is often remembered by the following story that never took place. The story told of Carney’s signing off one evening and thinking his microphone was off, said, “There! I guess that’ll hold the little bastards for another night.” He spent much of his career trying to undo the false story.

11 Cf., Charles Dickens, Our Mutual Friend (“He do the police in different voices.”), which was the working title of T.S. Eliot’s “The Waste Land.”
expectancy and health care level expectancy on the basis of the residency population of a CCRC to determine estimated lifetime medical care costs and total costs." The burden of proof on the issue had been shifted to the Commissioner under § 7491 because the taxpayer had presented credible evidence to support the amount claimed as a deduction and had met all of the other statutory requirements.

4. The AMT kicks New Yorkers again. Ostrow v. Commissioner, 122 T.C. No. 21 (5/21/04). Judge Calvin held that the § 56(b)(1) disallowance for AMT purposes of taxes deductible under § 164 extends to taxes on a cooperative housing corporation that are deductible by the shareholder-tenant under § 216.

5. Sections 201-208 of the Working Families Act of 2004 provides a uniform definition of "child" for head of household, dependent care credit, child tax credit, earned income tax credit, and dependent exemption purposes.

F. Education: Helping Pay College Tuition (or is it helping colleges increase tuition?)

VI. CORPORATIONS

A. Entity and Formation

1. Rev. Rul. 2004-59, 2004-24 I.R.B. (5/25/04). A partnership that converts to a corporation under a state law formless conversion statute will be deemed to contribute all its assets and liabilities to the corporation in exchange for stock in such corporation, and immediately thereafter, the partnership liquidates distributing the stock of the corporation to its partners. This is the same method provided by Reg. § 301.7701-3(g)(1)(i) when a partnership elects to be classified as an association.

- Rev. Rul. 84-111, 1984-2 C.B. 88, which permits selection among the three methods of incorporating a partnership provided that the steps described are actually undertaken, will not apply; Rev. Rul. 84-111 superseded and revoked Rev. Rul. 70-598, 1970-2 C.B. 168, which had held that partnership incorporations would be treated for tax purposes as if the partnership transferred assets to the corporation in exchange for stock.

B. Distributions and Redemptions

C. Liquidations

1. Tax treatment of the change in classification of an insolvent entity from a corporation to a disregarded entity. Rev. Rul. 2003-125, 2003-52 I.R.B. 1243 (12/29/03). This revenue ruling holds that when an election is made to change the classification of an entity from a corporation to a disregarded entity, the shareholder of such entity is allowed a worthless security deduction under § 165(g)(3) if the fair market value of the assets of the entity (including intangible assets such as goodwill and going concern value) does not exceed the entity's liabilities. In that case, the shareholder receives no distribution on its stock -- so there could not have been a liquidation under either § 331 or § 332.

D. S Corporations

1. Four-year spread for short-year income occasioned by a change in the annual accounting period to the calendar year during a transition period. Rev. Proc. 2003-79, 2003-45 I.R.B. 1036 (11/10/03). Rev. Proc. 2002-38, 2002-1 C.B. 1037, and Rev. Proc. 2002-39, 2002-1 C.B. 1046, provide procedures for a corporation to change its annual accounting period if its current taxable year no longer qualifies as a natural business year (or, for certain S corporations, an ownership taxable year). This new revenue procedure provides procedures under which a shareholder of such an S corporation may elect to take into account ratably over four taxable years the shareholder's income from the S corporation that is attributable to the short taxable year ending on or after May 10, 2002, but before June 1, 2004.

2. S corporation stock rolled over from an ESOP to and IRA does not disqualify the S election if the stock is repurchased on the same day. Rev. Proc. 2004-14, 2004-7 I.R.B. (2/13/04). The rollover distribution of S corporation stock by an ESOP to a participant's IRA will not affect the corporation's S election if the stock is immediately repurchased from the IRA by the S corporation or the ESOP.

3. Daisy-chain loans don't represent an economic outlay. Oren v. Commissioner, 357 F.3d 854, 93 A.F.T.R.2d 2004-858, 2004-1 USTC ¶50,165 (8th Cir. 2/12/04), aff'g T.C. Memo. 2002-172 (7/19/02). The taxpayer was the controlling shareholder of three S
corporations, one of which (Dart) passed-through substantial income, and the others of which (Highway Leasing and Highway Sales) passed-through losses in excess of the taxpayers basis [due to depreciation on leveraged depreciable equipment]. The taxpayer sought to utilize the losses by creating basis in Highway Leasing and Highway Sales through a series of circular loan transactions: the taxpayer borrowed money from Dart, which he lent to Highway Leasing and Highway Sales on terms identical to the terms of the loans from Dart to the taxpayer, following which Highway Leasing and Highway Sales lent the funds to Dart. In the Tax Court, Judge Ruwe held that the loans had no economic substance and that Oren had not made any "economic outlay." Thus, except to the extent of $200,000 lent from his own personal assets, Oren did not acquire basis in the promissory notes from Highway Leasing and Highway Sales against which the losses could be deducted. Furthermore, the circular loan arrangement was a "loss limiting arrangement" under § 465(b)(1) because there was no "any realistic possibility of loss" by Oren because the facts did not indicate that the circular chain of payment could be broken. Judge Ruwe rejected the possibility that the chain of payment might be broken by a tort judgment against one of the corporations in excess of its large insurance coverage.

- The court of appeals affirmed. Oren's loans to Highway Leasing and Highway Sales had no economic substance and, thus, were not real economic outlays, even though all of the formalities necessary to create legal obligations were followed. No external parties were involved and the transactions were not at arm's length. Oren was in the same position after the transactions as before. The transactions resembled offsetting book entries or loan guarantees more than substantive investments. Furthermore, Oren was not at-risk under § 465. The possibility that he would suffer at loss was remote because he was protected by the circular nature of the loan transactions. "The ‘theoretical possibility that the taxpayer will suffer economic loss is insufficient to avoid the applicability of§ 465]."

4. REG-131486-03, Adjustment To Net Unrealized Built-in Gain, 69 F.R. 35544 (6/25/04). Proposed regulations under § 1374 that provide guidance for an adjustments to net unrealized built-in gain in certain cases in which an S corporation acquires assets from a C corporation in an acquisition to which § 1374(d)(8) applies. Treasury rejected an approach that would provide for a single determination of NUBIG for all of the assets of an S corporation in favor of an approach that adjusts the NUBIG of the pool of assets that included the stock of the liquidated or acquired C corporation to reflect the extent to which the built-in gain or loss inherent in the C corporation stock is eliminated.

5. It just keeps gett'n tougher and tougher to be an S corporation shareholder when bankruptcy is in the air. Williams v. Commissioner, 123 T.C. No. 8 (7/22/04). The taxpayer owned all of the stock of two calendar year S corporations that incurred losses for the year. He filed a personal bankruptcy petition at the beginning of December and reported a pro rata share of the losses on his personal return. The Commissioner disallowed the passed through losses on the grounds that § 1377 [allocating losses on a per share per day basis] did not apply and that § 1398 allocated all of the losses to the bankruptcy estate. Judge Kroupa upheld that Commissioner's position, reasoning that under § 1398(f)(1) "a transfer of an asset from the debtor to the bankruptcy estate when the debtor files for bankruptcy is not a disposition triggering tax consequences, and the estate is treated as the debtor would be treated with respect to that asset." Thus the bankruptcy estate was treated as if it had owned all of the shares of the S corporations for the entire year and was entitled to all of the passed-through losses. [The Tax Court reached the same conclusion with respect to a bankrupt partner in a partnership passing through losses in Gully v. Commissioner, T.C. Memo. 2000-190.] Furthermore, any passed-through losses to which the bankruptcy estate succeeded, or losses that were passed through to the bankruptcy estate, and which were not used to offset income realized by the bankruptcy estate, pursuant to § 108(b)(2) were reduced by the amount of COD income that was not recognized under § 108(a) before being passed on to the taxpayer pursuant to § 1398(i) upon termination of the bankruptcy proceeding.

- Compare the situation where it is the S corporation that goes into bankruptcy. See, Mourad v. Commissioner, 121 T.C. No. 1 (7/2/03) (where an individual's wholly-owned S corporation filed for a bankruptcy chapter 11 plan of reorganization [and an independent trustee was appointed by the Bankruptcy Court] the individual remained liable for the tax on any income or gain recognized by the S corporation).

6. Rev. Rul. 2004-85, 2004-33 I.R.B. 189 (7/16/04). If an S corporation that owns a QSub engages in an "F" reorganization, the QSub election does not terminate, but if the
QSub stock is sold or transferred in a reorganization that does not qualify as an "F" reorganization, then the election terminates. An entity classification election described in Reg. §301.7701-3(b) does not terminate solely because the owner transfers all of the membership interest in the eligible entity to another person.

7. Section 231 of the Jobs Act of 2004 amends §1361 to treat members of a family as one shareholder. Shareholders with a common ancestor going back six generations are members of the same family.

- Compare this with the medieval church prohibition on marriage between persons having a common ancestor going back seven generations.

8. Section 232 of the Jobs Act of 2004 amends §1361 to increase the number of eligible shareholders from 75 to 100.

9. Section 233 of the Jobs Act of 2004 amends §1361 to permit IRAs to be shareholders of bank S corporations.

10. Section 234 of the Jobs Act of 2004 amends §1361 to disregard unexercised powers of appointment in determining potential current beneficiaries of an ESBT.

11. Section 235 of the Jobs Act of 2004 amends §1366 to permit transfers of suspended losses between spouses incident to divorce.

12. Section 236 of the Jobs Act of 2004 amends §1361 to permit use of passive activity loss and at-risk amounts by QSST beneficiaries.

13. Section 237 of the Jobs Act of 2004 amends §1362 to exclude investment securities income from the passive income test for bank S corporations.

14. Section 238 of the Jobs Act of 2004 amends §1362 to provide relief from inadvertently invalid Q-Sub elections and terminations.

15. Section 239 of the Jobs Act of 2004 amends §1361 to provide for Q-Sub treatment with respect to information returns.

16. Section 240 of the Jobs Act of 2004 amends §4975 to provide that the repayment by S corporations of loans for qualifying employer securities will not be treated as violating employment plan rules nor will they be prohibited transactions.

E. Affiliated Corporations.

1. Schizophrenic temporary regulations for consolidated group discharge of indebtedness income and reduction of attributes. T.D. 9089, Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group, 68 F.R. 52487 (9/4/03). The Treasury has promulgated temporary regulations under §1502, amending Temp. Reg. §1.1502-19T(b) and (h), Temp. Reg. §1.1502-21T(b), and Temp. Reg. §1.1502-32T and adding Temp. Reg. §1.1502-28T, governing the application of §108 when a member of a consolidated group realizes discharge of indebtedness income. The regulations provide that the amount of discharge of indebtedness income excluded from gross income in the case in which the debtor-corporation is insolvent is determined based on the assets and liabilities of only the member with discharge of indebtedness income. However, applying an interpretation of Dominion Industries, Inc. v. United States, 532 U.S. 822 (2001), the regulations provide that the group's consolidated attributes in their entirety are subject to reduction under §108(b), but the attributes attributable to the debtor member are the first attributes reduced. The regulations also adopt a look-through rule that applies if the debtor member's attribute that is reduced is the basis of stock of another group member. In this case, corresponding adjustments are made to the attributes attributable to the lower-tier member. Identical proposed regulations have been published. 68 F.R. 52542 (9/4/03).

   a. Temporary regulations are amended. T.D. 9098, Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group, 68 F.R. 69024 (12/11/03). Temp. Reg. §1.1502-28T(a)(4) provides that when a member of a consolidated group realizes COD income excluded under §108(a), after the reduction of the tax attributes attributable to the debtor member under §108(b), tax attributes attributable to other members other than the debtor member (other than asset basis) that arose in a separate return year or that arose (or are treated as arising) in a separate return limitation year to the extent that no SRLY limitation applies to the use of such attributes by the group are subject to reduction. Generally effective 8/29/03.

   b. Temporary and proposed regulations address issues related to §1245, the -13 matching rules and excess loss accounts. T.D. 9117, Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group, 69 F.R. 12069
(3/15/04); REG-167265, Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group; Computation of Taxable Income When Section 108 Applies to a Member of a Consolidated Group, 69 F.R. 12091 (3/15/04). The temporary and proposed regulations provide rules to preclude inclusion in consolidated taxable income amounts reflecting previously excluded COD income more than once, albeit as ordinary income where attributable to § 1245 property. They also provide that if the basis of an intercompany obligation held by a creditor member is reduced in respect of excluded COD income, Reg. § 1.1502-13(c)(6)(i) will not apply to exclude income of the creditor member attributable to the basis reduction. The proposed regulations include rules for the computation of that portion of an excess loss account that must be taken into income, as well as its timing.

2. T.D. 9118, Loss Limitation Rules, 69 F.R. 12799 (3/18/04); REG-153172-03, Loss Limitation Rules, 69 F.R. 12811 (3/18/04). Temporary regulation amendments relate to the deductibility of losses under the temporary regulations under § 337(d) and the antiduplication temporary consolidated returns regulations relating to the claiming of a worthless stock deduction with respect to a subsidiary's stock. The proposed regulations cross-reference the temporary regulations.


   - The Tax Court determined that taxpayer was not liable for ITC recapture because pursuant to Reg. § 1.1502-3(f)(2)(i) “a transfer of section 38 property from one member of the group to another member of such group during a consolidated return year shall not be treated as a disposition or cessation within the meaning of section 47(a)(1).” It also followed Example (5) of that regulation, which permitted the sale of all the stock of the subsidiary to a third party in a subsequent year without ITC recapture. It refused to follow Rev. Rul. 82-20, 1982-1 C.B. 6, which held the contrary where the spin-off of the subsidiary “immediately” follows the asset transfer.

   - The Sixth Circuit followed the Second and Ninth Circuits in finding that Rev. Rul. 82-20 is entitled to receive “some deference,” and under the “end-result test” variation of the step transaction doctrine, the transaction “must be treated as a single unit.” Therefore, inasmuch as taxpayer entered into the transaction to move the section 38 property out of the consolidated group, ITC recapture is appropriate.

4. Section 900 of the Jobs Act of 2004 amends § 1563 to expand the definition of controlled group of corporations for purposes of multiple use of the lower tax rates on the first $75,000 of taxable income.

F. Reorganizations

1. Notice 2004-44, 2004-28 I.R.B. (6/25/04). Requests comments on Rev. Proc. 81-70, 1981-2 C.B. 729, which sets forth guidelines on estimating the basis of stock acquired by an acquiring corporation in a B reorganization. The request is prompted by concern that changes in the marketplace since 1981, i.e., changes in the way stock is held today, may prevent access to the information necessary to determine shareholders' bases in such stock.

2. Rev. Rul. 2004-78, 2004-31 I.R.B. (7/13/04). Target merges into an acquiring corporation in an A reorganization, and in the merger target shareholders exchange their stock for common stock in the acquiring corporation and holders of target securities exchange their target debt for debt of the acquiring corporation. The debt instruments had two years remaining on their term, and were identical except for the interest rate. Held, the debt is a security, which may be exchanged tax-free under § 354.

   - Query how Reg. § 1.1001-3 applies to what would be a “significant modification” were this exchange of debt within a single corporation.

3. Rev. Rul. 2004-83, 2004-32 I.R.B. 157 (7/16/04). If, pursuant to an integrated plan, a parent corporation sells the stock of a wholly owned subsidiary for cash to another wholly owned subsidiary and the acquired subsidiary is completely liquidated into the acquiring subsidiary, the transaction is treated as a “D” reorganization. If the corporations are
members of a consolidated group, § 304 cannot apply to the stock sale nor can § 338 apply because there is no stock purchase within the meaning of § 338(h)(3)(A); if they are not members of a consolidated group, the transaction would be treated as a § 332 liquidation if the steps are not integrated and as a “D” reorganization if they are.

G. Corporate Divisions

1. Pesticides and baby food? A statement of facts that only a tax professor could have invented! Rev. Rul. 2003-110, 2003-46 I.R.B. (10/23/03). A publicly traded corporation that conducted a pesticide business spun-off its controlled subsidiary that conducted a baby food business to deal with “public perception problems” that caused potential baby food buyers from dealing with the subsidiary as long as it was affiliated with a pesticide producer. In determining whether the distribution of the stock of the controlled corporation satisfied the business purpose requirement in Reg. § 1.355-2(b), which requires that the distribution be motivated, in whole or substantial part, by one or more corporate business purposes, the fact that § 355 permits the distributing corporation to distribute the stock of a controlled corporation without recognition of gain otherwise required under § 311(b) does not present a potential for the avoidance of Federal taxes.

2. Business purpose may be satisfied even if the personal planning purposes of a shareholder are also satisfied if the shareholder purpose is so coextensive with the corporate business purpose as to preclude any distinction between them. Rev. Rul. 2004-23, 2004-11 I.R.B. (2/13/04). A distribution that is expected to cause the aggregate value of the stock of Distributing and Controlled to exceed the pre-distribution value of Distributing satisfies the corporate business purpose requirement of § 355 when the increased value is expected to serve a corporate business purpose of either or both corporations, even if it benefits the shareholders of Distributing.

H. Personal Holding Companies and Accumulated Earnings Tax

1. Advanced Delivery and Chemical Systems of Nevada, Inc. v. Commissioner, T.C. Memo. 2003-250 (8/20/03). The taxpayer-holding company was not liable for accumulated earnings tax. Under Reg. § 1.537-3(b), the business activities of its subsidiaries and partnerships in which it was a partner were attributed to the taxpayer. In light of the rapid growth of the affiliates’ businesses, the accumulations did not exceed the taxpayer’s reasonable needs for expansion of the affiliates, and on the particular facts [including a reorganization to reduce state taxes], even if the accumulations did exceed the taxpayer’s reasonable needs, there was not tax avoidance purpose.

I. Miscellaneous Corporate Issues

1. Contingent liabilities assumed in an asset acquisition must be capitalized. Illinois Tool Works Inc. v. Commissioner, 355 F.3d 997, 93 A.F.T.R.2d 2004-548, 2004-1 USTC ¶ 50,130 (7th Cir. 1/2/04), aff’d 117 T.C.39 (6/31/01). The taxpayer acquired the assets of another corporation [for approximately $126 million] in a taxable transaction in which the taxpayer assumed the target’s liabilities, including a contingent liability for a patent infringement claim, [Lemelson v. Champion Spark Plug Co., 975 F.2d 869 (1992)], for which it established a reserve of $350,000. Subsequently, the taxpayer, as the target’s successor was held liable for damages, interest, and court costs [totaling over $17 million], which it paid. The Tax Court (Judge Cohen) upheld the Commissioner’s treatment requiring capitalization of the payments as a cost of acquiring the assets rather than a deductible expense, even though the parties had not adjusted the purchase price to reflect the contingent liability. The liability was known, was considered in setting the price, and was expressly assumed. That the taxpayer considered it highly unlikely that it would be called upon to pay was not relevant.

• The Commissioner conceded the deductibility of the judgment in two respects: (1) pre-judgment interest accruing after the acquisition date was deductible; and (2) to the extent that the additional purchase price was allocable to assets the taxpayer had disposed of, the judgment was deductible.

• Note that in many, if not most, cases, the disposition of a portion of target’s assets will not affect the characterization of the payments because, under § 1060 and Reg. § 1.1060-1, the capitalized contingent liability will be allocated to Class VI and VII amortizable intangibles for which no loss is allowed until the complete disposition of all such intangibles acquired from the target. See § 197(f)(1). The grounds for the Commissioner’s concession were not clearly articulated in the opinion.
The Court of Appeals (Judge Kanne) affirmed. The court concluded, as did the Tax Court, "[T]hat a contingent liability, once fixed, exceeded the parties' expectations does not render it any less a part of the purchase price."

ITW knowingly assumed the Lemelson lawsuit as part of the purchase agreement for the DeVilbiss assets. Because ITW agreed to pay that contingent liability in exchange for DeVilbiss, that contingent liability formed part of the purchase price. Because the DeVilbiss acquisition was meant to benefit ITW into the future, the expenses to acquire it— including the Lemelson lawsuit, once assigned a value through the judgment— must be capitalized.

The taxpayer argued that the principles of *A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482 (7th Cir.1997) (reversing the Tax Court and holding that INDOPCO did not require capitalization of fees paid to investment bankers to unsuccessfully ward off a hostile takeover), warranted a current deduction because "... a 'pragmatic,' 'real-life' assessment of the facts demonstrates that ITW's decision, made in the ordinary course of its business, to reject Lemelson's settlement offers was the proximate cause of the amount ultimately owed to Lemelson." The court of appeals rejected this argument.

The ultimate goal of the pragmatic assessment advanced by *Staley* is to decode whether an expenditure is ordinary or capital in nature. Although ITW argues that paying $16 million more than the Lemelson lawsuit was allegedly worth could have no positive impact on the future of the company, it loses sight of the fact that what it got in exchange for its obligation to pay the judgment was the DeVilbiss assets. In this way, the Lemelson judgment was "'incurred for the purpose of changing the corporate structure for the benefit of future operations'" and must be capitalized.

**VII. PARTNERSHIPS**

A. Formation and Taxable Years

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

1. **REG-160330-02, Section 704(c), Installment Obligations and Contributed Contracts**, 68 F.R. 65864 (11/24/03). The Treasury has published proposed amendments to Reg. §1.704-3(a)(8) clarifying that if a partnership disposes of §704(c) property in exchange for an installment obligation the installment obligation is §704(c) property; likewise if a partner contributes a contract that is §704(c) property and pursuant to the contract the partnership obtains property in a transaction in which less than all of the gain or loss is recognized, the property is §704(c) property. Proposed amendments to Reg. §1.704-4(d)(1) provide that an installment obligation received by a partnership and property acquired pursuant to a contributed contract are treated as §704(c) property for purposes of §704(c)(1)(B) to the extent that the installment obligation or the acquired property is §704(c) property under Reg. §1.704-3(a)(8). Effective date: 11/24/03.

2. **These related corporations were not related for purposes of this case. IPO II v. Commissioner**, 122 T.C. No. 17 (4/23/04). Forsyth was a partner with his wholly owned S corporation (Indeck Overseas) in a partnership that borrowed money to purchase an airplane. The loan was guaranteed by Forsyth, but not by Indeck Overseas. In addition, the loan was guaranteed by Indeck Energy, an S corporation 70 percent of the stock of which was owned by Forsyth, and 30 percent of which was owned by his daughter; the loan was also guaranteed by Indeck Power, a C corporation that was 63 percent owned by Forsyth. For purposes of allocating partnership indebtedness under §752, and accordingly losses under §704(b), the partners claimed that the loan was fully recourse to both Forsyth and Indeck Overseas, They argued that Indeck Overseas was at-risk for the partnership debt because by virtue of Forsyth's common ownership of both corporations, it was related to Indeck Energy, which had guaranteed the debt, Under Reg. §§1.752-1(a)(1) and 1.752-2(c)(2) a liability is recourse if a partner or a related party bears the risk of loss. However, an exception to this related party provision in Reg. §1.752-4(b)(2)(iii) provides that persons owning directly or indirectly interests in the same partnership
are not treated as related. Judge Haines held that the relationship between the Indeck Energy, the guarantor, and Indeck Overseas was negated by Reg. § 1.752-4(b)(2)(iii) because the relationship was traced through Forsyth, who was a partner in the partnership.

3. REG-128767-04, Treatment of Disregarded Entities Under Section 752, 69 F.R. 49832 (8/12/04). Proposed regulations provide that in determining the extent to which a partner bears the economic risk of loss for a partnership liability, payment obligations of a disregarded entity are taken into account only to the extent of the net value of the disregarded entity except where the owner of the disregarded entity is otherwise required to make a payment with respect to the obligation of the disregarded entity.

C. Distributions and Transactions Between the Partnership and Partners

1. Permitting a partnership book-up when a partnership interest is granted for services and you can't make the regs work if you don't do it. REG-139796-02, Section 704(b) and Capital Account Revaluations, 68 F.R. 39498 (7/2/03). Proposed amendments to the § 704(b) regulations would expressly allow partnerships to increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property on the partnership's books in connection with the grant of an interest in the partnership (other than a de minimis interest) in consideration of services to the partnership by an existing partner acting in a partner capacity or by a new partner acting in a partner capacity or in anticipation of being a partner. The regulation will be effective when finalized.

   a. Proposed regulations are made final without change. T.D. 9126, Section 704(b) and Capital Account Revaluations, 69 F.R. 25615 (5/6/04). Effective 5/6/04.

   2. Section 833 of the Jobs Act of 2004 amends §§ 704(c), 734 and 743. Under § 704(c)(1)(C), a built-in loss on property contributed to a partnership will be taken into account only by the contributing partner and not by other partners. Section 734(b) basis adjustments will be mandatory with respect to built-in losses or adjustments that exceed $250,000. Section 743(b) basis adjustments will be mandatory for basis adjustments that exceed $250,000.

   • Adjustments under §§ 734 and 743 had been heretofore optional.

D. Sales of Partnership Interests, Liquidations and Mergers

1. Form controls partnership mergers and divisions. T.D. 8925, Partnership Mergers and Divisions, 2001-6 I.R.B. 496 (1/3/01). Final Reg. § 1.708-1(c) and amendments to § 1.752-1(f) and (g) [proposed in REG-1111199-99]. The tax consequences of mergers of partnerships depend on the form followed under the laws of the applicable jurisdiction, either the "Assets-Over Form" or the "Assets-Up Form" [even if none of the merged partnerships are treated as continuing for Federal income tax purposes]. Generally, [and if no particular form is chosen] the Assets-Over Form applies. (This approach is consistent with the treatment of partnership to corporation elective conversions under the check-the-box regulations and technical terminations under § 708(b)(1)(B)). But, if as part of the merger, the partnership titles the assets in the partners' names, the Assets-Up Form applies. If partnerships use the Interests-Over Form to accomplish the result of a merger, the partnerships will be treated as following the Assets-Over Form for Federal income tax purposes.

   • Under the Assets-Up Form, partners recognize gain under §§ 704(c)(1)(B) and 737 (and incur state or local transfer taxes) when the terminating partnership distributes the assets to the partners. However, under the Assets-Over Form, gain under §§ 704(c)(1)(B) and 737 is not triggered. See §§ 1.704-4(c)(4) and 1.737-2(b). Because the adjusted basis of the assets contributed to the resulting partnership is determined first by reference to § 732 (as a result of the liquidation) and then § 723 (by virtue of the contribution), the adjusted basis of the assets contributed may not be the same as the adjusted basis of the assets in the terminating partnership if the partners' aggregate adjusted basis of their interests in the terminating partnership does not equal the terminating partnership's adjusted basis in its assets. Under the Assets-Over Form, because the resulting partnership's adjusted basis in the assets it receives is determined solely under § 723, the adjusted basis of the assets in the resulting partnership is the same as the adjusted basis of the assets in the terminating partnership.
When two or more partnerships merge under the Assets-Over Form, increases or decreases in partnership liabilities associated with the merger are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under § 752. A partner in the terminating partnership will recognize gain on the contribution under § 731 only if the net § 752 deemed distribution exceeds that partner's adjusted basis of its interest in the resulting partnership.

If the merger agreement (or some other contemporaneous agreement) specifies that the resulting partnership is purchasing an exiting partner's interest in the terminating partnership and the amount paid for the interest, the transaction will be treated as a sale of the exiting partner's interest to the resulting partnership.

Form also will be followed, and the resulting differing tax consequences respected with regard to corporate divisions if the partnership undertakes the steps of either the Assets-Over Form or the Assets-Up Form. Gain under §§ 704(c)(1)(B) and 737 often may be triggered when § 704(c) property or substituted § 704(c) property is distributed to certain partners in the context of partnership divisions. If a partnership divides, the transfer to one new partnership can follow the Assets-Over Form while the transfer to the other follows the Assets-Up Form. All resulting partnerships are bound by the original partnership's elections.

The rules are generally effective as of 1/4/01, with an elective effective date of 1/11/00.

2. Continuing suit over the termination of a partnership means the partnership hasn't terminated. Harbor Cove Marina Partners Partnership v. Commissioner, 123 T.C. No. 4 (7/15/04). Harbor Cove Marina Partners Partnership filed a tax return indicating that its affairs had been terminated in 1998, and all of the partners but one (Collins) reported consistently. Following a TEFRA audit in which the IRS issued a Notice of Final Partnership Administrative Adjustment indicating that the "final" return was correct and that the IRS would make no changes, and the tax matters partner's [understandable] failure to petition the Tax Court for review under § 6226(a), Collins, a notice partner petitioned under § 6226(b) to readjust partnership items relating to the FPAA. Judge Laro held that the partnership did not terminate under § 708(b)(I)(A) when (1) its managing general partner purportedly wound up the affairs of the partnership's business operation using procedures apparently contrary to those stated in the partnership agreement, (2) another partner filed a lawsuit to compel the use of the procedures stated in the agreement, and (3) a resolution of that lawsuit could reasonably lead to the partnership's reporting in a subsequent year of significant income, credit, gain, loss, or deduction.

3. Section 896 of the Jobs Act of 2004 amends § 108(e)(8) to require recognition of cancellation of indebtedness income realized on the satisfaction of debt with a partnership interest.

E. Inside Basis Adjustments

1. Rev. Rul. 2004-49, 2004-21 I.R.B. 939. When a partnership revalues a § 197 intangible pursuant to Reg. § 1.704-1(b)(2)(iv)(f), the partnership may allocate amortization with respect to the intangible so as to take into account the built-in gain or loss from the revaluation provided that the intangible is amortizable in the hands of the partnership. In that event, the partnership may make remedial, but not traditional or curative allocations of amortization.

F. Partnership Audit Rules
1. Rev. Rul 2004-88, 2004-32 I.R.B. 165. A partnership that has a disregarded entity as a partner cannot qualify for the "small partnership" exclusion from the §§ 6221-6234 unified partnership and audit provisions because the disregarded entity is a pass-thru partner under § 6231(a)(9). The disregarded entity may, however, be designated the tax matters partner.

G. Miscellaneous
1. Four-year spread for short-year income occasioned by a change in the annual accounting period to the calendar year during a transition period. Rev. Proc. 2003-79, 2003-45 I.R.B. 1036 (11/10/03), Rev. Proc. 2002-38, 2002-1 C.B. 1037, and Rev. Proc. 2002-39, 2002-1 C.B. 1046, provide procedures for a partnership to change its annual accounting period if its current taxable year no longer qualifies as a natural business year. This new revenue procedure provides procedures under which a partner in such a partnership may elect to take into account ratably over four taxable years the partner's share of income from the partnership that is attributable to the short taxable year ending on or after May 10, 2002, but before June 1, 2004.

VIII. TAX SHELTERS
A. Tax Shelter Cases
1. Government's summary judgment motion denied, but on a pro-taxpayer rationale. Black & Decker Corp. v. United States, 2004-2 U.S.T.C. ¶50,539 (D. Md. 8/3/04). As the facts were stated in the opinion,

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

Citations omitted.

- The court went on to analyze and conclude:

For the purposes of its motion for summary judgment, the United States has assumed that B & D's transaction with BDHMI qualifies as a transfer to corporation controlled by transferor under 26 U.S.C. section 351. Section 351 provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for stock in such corporation and immediately after the exchange the transferor is in control of the corporation. Applying section 351 to the transaction between B & D and BDHMI, the value of the new shares that BDHMI issued to B & D would be $561 million dollars, the value of the property that B & D contributed to BDHMI in the exchange.

Section 358(d) provides, however, that when, in a section 351 exchange, the transferee assumes a liability of the transferor, such assumption shall be treated as money received by the transferor on the exchange. Applying section 358(d) to the B & D transaction, the value of the $560 million dollars worth of contingent healthcare claims assumed by BDHMI for B & D would be deducted from the original value of the stock that B & D received in the exchange (i.e., $561 million dollars - $560 million dollars = $1 million dollars).
Section 357(c)(3)(A) provides that if the contingent liabilities transferred would give rise to a deduction, then the amount of such liabilities shall be excluded in determining the amount of liabilities assumed. Because the contingent liabilities that B & D transferred to BDHMI would have been deductible as ordinary business expenses for B & D, B & D asserts that by virtue of section 357(c)(3)(A), it need not recognize the transfer of contingent liabilities to BDHMI. Accordingly, B & D argues that the value of the stock it received in the exchange is $561 million dollars, thus when it sold the stock to an investor for $1 million dollars, it incurred a substantial capital loss.

The United States contends that the contingent liabilities transferred to BDHMI are not deductible to BDHMI, but to B & D, because the healthcare expenses of B & D employees are B & D's ordinary business expenses; whereas BDHMI merely pays B & D employees' healthcare claims. In that case, B & D could double-deduct the contingent liabilities by (1) not recognizing their transfer on the 1998 exchange, and (2) deducting the amount of the contingent employee healthcare claims as they become payable.

The tax code should not be interpreted to allow taxpayers the practical equivalent of a double-deduction absent a clear declaration of intent by Congress. United States v. Skelly Oil Co., 394 U.S. 678, 684 (1969) (citing Charles Ilfeld Co. v. Hernandez, 292 U.S. 62, 68 (1934); United States v. Ludey, 274 U.S. 295 (1927)). The United States argues, therefore, that section 357(c)(3)(A) must mean that contingent liabilities assumed by a transferee in a section 351 exchange need not be recognized if the liabilities assumed would have given rise to a deduction for the transferee.

Section 357(c)(3)(A) does not explicitly state whether contingent liabilities must be deductible by the transferor or the transferee in a section 351 exchange to fall within the exception. When a statute's language is ambiguous, the court must refer to its legislative history for guidance. Holland v. Big River Minerals Corp., 181 F.3d 597, 603 (4th Cir. 1999).

The legislative history to section 357(c) lends no support to the United States' suggested interpretation. Section 357(c) was enacted as part of the Revenue Act of 1978. The Senate Report accompanying the bill explains that "for purposes of section 357(c) ... the amount of liabilities assumed or to which the property transferred is subject, the amount of a liability would be excluded ... to the extent payment thereof by the transferor would have given rise to a deduction." S. Rep. No. 95-1263, at 185 (1978) (emphasis added). The Senate Report also notes that "the provision is not intended to affect the corporate-transferees' tax accounting for the excluded liabilities." Id.; see also Joint Comm. On Taxation, 95th Cong., General Explanation Of Revenue Act Of 1978, at 219 (Comm. Print 1979). Section 357(c) was subsequently amended by the Technical Corrections Act of 1979 ("the 1979 Act"). The legislative history to the 1979 Act explains that "liabilities may be excluded under this provision only to the extent payment thereof by the transferee would have given rise to a deduction. A liability would not be excluded under this provision to the extent the liability has already been deducted by the transferor." S. Rep. No. 96-498, at 62 (1980) (emphasis added).

Moreover, the Internal Revenue Service has focused on the transferor's deductibility when applying section 357(c)(3)(A). See, e.g., Rev. Rul. 95-74, 1995-2 C.B. 36 (1995) (contingent liabilities assumed by transferee had not been
taken into account by transferor prior to transfer, thus they had not yet given rise to a deduction for the transferor and should not have been included in determining the transferor’s basis in the transferred property).

Because the Court is unable to find support for the United States’ interpretation of section 357(c)(3)(A), the United States’ motion for summary judgment must be denied.

a. Significant taxpayer victory when its summary judgment motion was granted; the contingent liability transaction was upheld despite government assertions of penalties. Black & Decker Corp. v. United States, 2004-2 U.S.T.C. ¶50, 2004 U.S. Dist. LEXIS 21201, 2004 TNT 205-1 (D. Md. 10/20/04, revised, 10/22/04). Judge Quarles held that the transaction could not be disregarded as a sham because it had economic implications for the parties to the transaction as well as to the beneficiaries of taxpayer’s health plans.

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

2. Long-Term Capital Holdings rulings on attorney-client privilege and work product. Long-Term Capital Holdings v. United States, 90 A.F.T.R.2d 2002-7446, 2003-1 U.S.T.C. ¶50,105 (D. Conn. 10/30/02), modified by, 2003-1 U.S.T.C. ¶50,304, 91 A.F.T.R.2d 2003-1139 (D. Conn. 2/14/03). In connection with a transaction, the taxpayer obtained opinions from Shearman & Sterling and King & Spalding relating to different aspects of the transaction. Without specifically disclosing the K&S opinion letter itself, the taxpayer revealed to its tax accountant that it had a “more likely than not” opinion with respect to the allowability of the deduction. The S&S opinions, in contrast, were voluntarily disclosed in the course of the audit. The magistrate held that disclosure of the existence of the K&S opinion, and that it was a more likely than not opinion with respect to allowance of the deduction, disclosed the gist of the opinion and thus was an express subject matter waiver even though the disclosure was extra-judicial. In addition, the magistrate alternatively reasoned that voluntary disclosure of the S&S opinions, while asserting privilege as to K&S opinion regarding a different aspect of the same transaction, was an attempt to use the “privileged communications as both a shield and a sword.” The magistrate found implied an waiver as to the K&S opinion. The alternative holding is confusing, however, because the magistrate also factored in the express subject matter waiver even though the disclosure was extra-judicial. In addition, the magistrate ultimately concluded that the K&S opinion could constitute work product under Second Circuit’s application of the doctrine to documents prepared “in anticipation of litigation,” in United States v. Adiman, 134 F.3d 1194 (2d Cir. 1998). Accordingly, the magistrate required submission of the documents for in camera inspection.
- On reconsideration, the magistrate found that the S&S opinion was not privileged because it was prepared for the purpose of ascertaining the basis of a partnership interest and thus was a record that had to be made available to the IRS under Reg. § 1.6001-1(a). Since the S&S opinion was not privileged to begin with, its disclosure was not a subject matter waiver. Furthermore, after considering further facts, the K&S opinion was found not to deal with the same issues as the S&S opinion, and thus the disclosure of the S&S opinion was not a waiver with respect to the K&S opinion. However, the magistrate reaffirmed that the disclosure of the existence of the K&S opinion, and that it was a more likely than not opinion with respect to allowance of the deduction, disclosed the gist of the opinion and thus was an express waiver. However, rather than being a subject matter waiver (as was originally held), the waiver was only of those portions of the opinion letter reflecting the matter actually disclosed. Finally, the magistrate held that the K&S opinion was opinion attorney work product that was not discoverable by the IRS.
a. Significant government victory in tax shelter case

Taxpayers' in-house tax counsel should have taken Nancy Reagan's advice when Don Turlington pitched him a tax planning idea. Long-Term Capital Holdings v. United States, __ F. Supp. 2d __, 2004 U.S. Dist. LEXIS 17159 (D. Conn. 8/27/04). Judge Janet Bond Arterton poured out taxpayers by holding that the tax shelter transaction [under which preferred stock with an inflated basis was contributed to a partnership in a carryover basis transaction] lacked economic substance (or, in the alternative, that the step transaction doctrine required that it be recast into a direct sale of preferred stocks to taxpayers with the result that the basis was equal to the amount they paid) and by upholding the imposition of (in the alternative) both the 40-percent gross valuation misstatement and the 20-percent substantial understatement penalties. After that introductory statement, the remainder of the 198-page opinion was all downhill for taxpayers and their lawyers.

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

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

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

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

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

Judge Arterton's official biographical information at http://air.njc.gov/servlet/tGetlnfo?iid=66 is set forth in the footnote. She has an AV rating in Martindale-Hubbell.

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

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

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

B. Identified “tax avoidance transactions.”

1. Shortly after Notice 2003-76, here's another one! Notice 2003-77, 2003-49 I.R.B. (11/19/03), clarified (12/1/03). Certain contested liability trusts used improperly to attempt to accelerate deductions under §461(f) are identified as “listed transactions.” See I.D., above, for contested liability trusts used for an attempted acceleration of deductions under §461(f).

2. And, yet one more! Notice 2003-81, 2003-51 I.R.B. (12/4/03). This transaction involve the purchase by the taxpayer of offsetting options on foreign currency (which are §1256 contracts) (the “purchased options”) and the receipt of premiums by the taxpayer for writing offsetting options on a different foreign currency that has a very high positive correlation with the first currency, but which is not traded through regulated futures contracts (which are not §1256 contracts) (the “written options”). The taxpayer assigns to a charity both (1) the purchased option that has a loss (which is marked to market when it is assigned to the charity and recognized by the taxpayer) and (2) the offsetting written option that has a gain (which is limited to the premium received for the option, and which the taxpayer does not recognize).

3. Abusive Roth IRA transactions are listed transactions. Notice 2004-8, 2004-4 I.R.B. (12/31/03). Taxpayer who owns a pre-existing business sells property from the business, such as accounts receivable, for less than fair market value to a corporation owned by taxpayer’s Roth IRA. The Notice applies to any arrangement between the Roth IRA and the taxpayer that has the effect of transferring value to the corporation owned by the Roth IRA that is comparable to a contribution to the Roth IRA that exceeds the statutory limits on such contributions contained in §408A.

4. S corporation stock owned by ESOPs that fail to provide benefits to rank-and-file employees. Rev. Rul. 2004-4, 2004-6 I.R.B. 414 (1/23/04). Ownership structures of S corporations that are designed to allow taxpayers to take advantage of the tax-exempt status of the S corporation that results from the ownership of its outstanding stock by the ESOP result in the ESOP not providing benefits to rank-and-file employees will result in the S corporation income being taxed to the person who earned it. Transactions that are the same or substantially similar to the following transaction are identified as “listed transactions.” These are transactions in which (i) at least 50 percent of the outstanding shares of an S corporation are employer securities held by an ESOP, (ii) the profits of the S corporation generated by the business activities of a specific individual are accumulated and held for the benefit of that individual in a QSub or similar entity, (iii) these profits are not paid to the individual as compensation within 2-

transactions," although President Bush's budget proposal seeks a legislative remedy for this

lessee depositing collateral in defeasance of its obligation] were not made "listed

shares of stock of the QSub or similar entity representing 50 percent or more of the fair market

value of the stock of such QSub or similar entity.

5. SILO transactions. Interestingly enough, sale-in, lease-out (SILO) deals [under which a tax-exempt or foreign entity sells property to the taxpayer and leases it back, with the lessee depositing collateral in defeasance of its obligation] were not made "listed

transactions," although President Bush's budget proposal seeks a legislative remedy for this widespread perceived abuse. 2004 TNT 19-3.

a. Section 848 of the Jobs Act of 2004 adds new § 470 to disallow losses on leases of property for tax-exempt use that were entered into after 3/12/04. The disallowed losses would be carried over to the following year much as disallowed passive activity losses are carried over. There is a safe harbor provision contained in § 470(d).

6. Removes from the list a transaction in which expected economic profit is insubstantial. Notice 2004-19, 2004-11 I.R.B. 606. Removes from the list of listed transactions those described in Notice 98-5, 1998-1 C.B. 334, which are transactions in which the expected economic profit is insubstantial in comparison to the value of the expected foreign tax credits.

7. PORC transactions also removed from the list so it's no longer considered piggy to be "PORC-y." Notice 2004-65, 2004-41 I.R.B. (9/24/04), modifying Notice 2002-70, 2002-2 C.B. 765, and Notice 2003-76, 2003-49 I.R.B. 1181. This Notice removes the producer owned reinsurance company transaction from the list of "identified tax avoidance transactions." The rationale for the removal are: (1) that examination of this type of transaction showed fewer abusive transactions than anticipated; and (2) the amendment of § 501(c)(15) [to limit the gross income of organizations exempt under that section to $600,000] by section 206 of the Pension Funding Equity Act, P.L. 108-21, as described in Notice 2004-64, 5004-41 I.R.B. (9/24/04).

8. Updated list of listed transactions minus the above two. Notice 2004-67, 2004-41 I.R.B. 600 (9/24/04), supplementing and superseding Notice 2003-76, as modified by Notice 2004-19 and Notice 2004-65. Updated list of listed transactions. Notice 2003-76, 2003-49 I.R.B. (11/7/01), supplementing and superseding Notice 2001-51, 2001-34 I.R.B. 190 (8/3/01). The IRS has identified 24 listed transactions for purposes of Reg. §§ 1.6011-4(b)(2) and 301.6111-2(b)(2). As restated and updated, the list includes: (1) Rev. Rul. 90-105, 1990-2 C.B. 69, transactions (deductions for contributions to certain pension plans attributable to future year's compensation); (2) Notice 95-34, 1995-1 C.B. 309, certain trust arrangements (purported multiple employer welfare benefit funds); (3) Transactions substantially similar to those at issue in ASA Investerings Partnership v. Commissioner, 201 F.3d 231 (3d Cir. 1999) and ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998) (contingent installment sales transactions in order to accelerate and allocate income to a tax-indifferent partner); (4) Prop. Reg. § 1.643(a)-8 transactions involving distributions from charitable remainder trusts; (5) Notice 99-59, 1999-2 C.B. 761, transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays that they have in fact recovered (the PwC so-called BOSS tax shelter); (6) Reg. § 1.7701(l)-3 fast-pay arrangements; (7) Rev. Rul. 2000-12, 2000-11 I.R.B. 744 certain transactions involving the acquisition of two debt instruments the values of which are expected to change significantly at about the same time in opposite directions; (8) Notice 2000-44, 2000-36 I.R.B. 255 transactions generating losses resulting from artificially inflating the basis of partnership interests (the KPMG so-called BLIPS tax shelter); (9) Notice 2000-60, 2000-49 I.R.B. 568, transactions involving the purchase of a parent corporation's stock by a subsidiary, a subsequent transfer of the purchased parent stock from the subsidiary to the parent's employees, and the eventual liquidation or sale of the subsidiary; (10) Notice 2000-61, 2000-49 I.R.B. 569, transactions purporting to apply § 935 to Guamanian trusts; (11) Notice 2001-16, 2001-9 I.R.B. 730, intermediary sales transactions; (12) Notice 2001-17, 2001-9 I.R.B. 730, contingent liability § 351 transfer transactions; (13) Notice 2001-45, 2001-33 I.R.B. 129 (certain redemptions of stock in transactions not subject to U.S. tax in which the basis of the redeemed stock purports to shift to a U.S. taxpayer); (14) Notice 2002-21, 2002-1 C.B. 730, transactions involving the use of a loan assumption agreement to inflate basis in assets acquired from another party in order to claim losses; (15) Notice 2002-35, 2002-1 C.B. 992, transactions involving the use of a notional principal contract to claim current deductions for periodic payments made by a taxpayer while

11 See 2003 TNT 112-12.

- Two previously-listed transactions will no longer be considered listed transactions: (1) Notice 98-5, 1998-1 C.B. 334, transactions in which the expected economic profit is insubstantial in comparison to the value of the expected foreign tax credits were removed by Notice 2004-19, 2004-11 I.R.B. 606; and (2) PORC transactions were removed by Notice 2004-65, 2004-41 I.R.B. (9/24/04), modifying Notice 2002-20, 2002-2 C.B. 765, and Notice 2003-76, 2003-49 I.R.B. 1181.

C. Disclosure and Settlement

1. June 2002 temporary and proposed regulations. T.D. 9000 and REG-110311-92, Return Filing Requirement, 67 F.R. 41324 & 41362 (6/18/02). These temporary and proposed regulations modify the disclosure, registration and list maintenance rules under §§ 6011(a), 6111(d) and 6112 with respect to tax shelters.

- The new regulations extend the requirement to disclose listed and other reportable transactions under Reg. § 1.6011-4T to individuals, trusts, partnerships, and S corporations that participate, directly or indirectly, in listed transactions. Further, they clarify indirect participation in a reportable transaction. A taxpayer indirectly participates in a reportable transaction if the taxpayer knows or has reason to know that the tax benefits claimed from the transaction are derived from a reportable transaction.

- The IRS notes that some taxpayers and promoters have applied the "substantially similar" standard in Reg. §§ 1.6011-4T and 301.6111-2T in an overly narrow manner to avoid disclosure, and the regulations to clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax benefits and that is
either factually similar or based on the same or similar tax strategy. Further, the term "substantially similar" must be broadly construed in favor of disclosure.

a. Additional guidance in October 2002. T.D. 9017 and REG-103735-00, Tax Shelter Disclosure Statements, 67 F.R. 64799 and 64840 (10/22/02). The IRS has promulgated temporary and proposed regulations to provide additional guidance needed to comply with the § 6011(a) disclosure rules. Covers transactions involving tax shelters involving income, estate, gift, employment, or exempt organizations excise taxes. Revises the categories of transactions that must be disclosed on returns: (1) listed transactions; (2) confidential transactions; (3) transactions with contractual protection; (4) loss transactions above stated thresholds; (5) transactions with a significant book-tax difference; and (6) transactions involving a less-than-45-day holding period that result in a tax credit exceeding $250,000. These temporary regulations are effective 1/1/03.

1. T.D. 9018 and REG-103736-00, Requirement to Maintain a List of Investors in Potentially Abusive Tax Shelters, 67 F.R. 64807 and 64842 (10/22/02). The IRS has promulgated conforming temporary and proposed regulations, which modify the list maintenance requirements under § 6112.

2. February 2003 final regulations. T.D. 9046, Tax Shelter Regulations, 68 F.R. 10161 (2/28/03). Modifies and makes final the rules relating to tax shelter disclosure statements to be filed with tax returns under § 6011(a), as well as the rules relating to the registration of confidential corporate tax shelters under § 6111(d) and the resulting list maintenance requirements under § 6112. Retains the six disclosure categories contained in the October 2002 temporary regulations, see a., above, with the following modifications: (2) deletes the clarification that a claim of privilege does not cause a transaction to be confidential because a privilege does not restrict the taxpayer's ability to disclose the tax treatment or tax structure of the transaction; (3) changes the focus to provide that this refers to refunds of fees to be received back from a person who stated what the tax consequences of the transaction would be, or from the person on whose behalf the statement was made; (4) a list of the loss which need not be taken into account for reporting is contained in Rev. Proc. 2003-24, 2003-1 1 I.R.B. 599 (3/17/03); (5) a list of the transactions with significant book-tax difference which need not be taken into account for reporting is contained in Rev. Proc. 2003-25, 2003-11 I.R.B. 601 (3/17/03).

Reg. § 1.6011-4(b)(3)(iii) contains a presumption relating to whether a transaction is confidential:

Presumption. Unless the facts and circumstances indicate otherwise, a transaction is not considered offered to a taxpayer under conditions of confidentiality if every person who makes or provides a statement, oral or written, to the taxpayer (or for whose benefit a statement is made or provided to the taxpayer) as to the potential tax consequences that may result from the transaction, provides express written authorization to the taxpayer in substantially the following form: "the taxpayer (and each employee, representative, or other agent of the taxpayer) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the transaction and all materials of any kind (including opinions or other tax analyses) that are provided to the taxpayer relating to such tax treatment and tax structure". Except as provided in paragraph (b)(3)(ii) of this section, this presumption is available only in cases in which each written authorization permits the taxpayer to disclose the tax treatment and tax structure of the transaction immediately upon commencement of discussions with the person providing the authorization and each written authorization is given no later than 30 days from the day the person providing the written authorization first makes or provides a statement to the taxpayer regarding the tax consequences of the transaction. A transaction that is claimed to be exclusive or proprietary to any party other than the taxpayer will not be considered a confidential transaction under this paragraph (b)(3) if written authorization to disclose is provided to the taxpayer in accordance with this paragraph (b)(3)(iii) and the transaction is not otherwise confidential.
These regulations are effective for transactions entered into on or after 2/28/03, except that taxpayers may elect to apply them for transactions entered into on or after 1/1/03.

a. Rules on disclosure of confidential transactions are clarified. T.D. 9108, Confidential Transactions, 68 F.R. 75128 (12/30/03). Reg. § 1.6011-4(b)(3) provides that certain confidential transactions are reportable transactions that are subject to the disclosure rules under § 1.6011-4 and the list maintenance rules under § 301.6112-1. Under the February 2003 regulations, a confidential transaction is a transaction that is offered under conditions of confidentiality. (The February 2003 regulations also provided that there was a presumption of non-confidentiality if the taxpayer receives written authorization to disclose the tax treatment and tax structure of the transaction.)

- Under these amended final regulations, the confidentiality filter is limited to situations in which an advisor is paid a large fee and imposes a limitation on disclosure that protects the confidentiality of the advisor's tax strategies.
- Transactions in which confidentiality is imposed by a party to the transaction acting in such capacity will no longer be reportable. Further, the exceptions and presumption language have been removed because they no longer are necessary under this narrower rule.

- Effective 12/29/03.

3. "The IRS and Treasury believe that taxpayers have improperly relied on opinions or advice issued by tax advisors to establish reasonable cause and good faith as a basis for avoiding the accuracy-related penalty." REG-126016-01, Establishing Defenses to the Imposition of the Accuracy-Related Penalty, 67 F.R. 79894 (12/31/02). The Treasury Department has published proposed amendments to the regulations under §§ 6662 and 6664 [Regs. §§ 1.6662-3; 1.6664-4] to limit the available defenses to an accuracy-related penalty when a taxpayer (1) fails to disclose a reportable transaction or (2) fails to disclose that it has taken a position on a return based upon a regulation being invalid. Under the proposed amendments, a taxpayer who takes a position that a regulation is invalid cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under § 6664(c) with respect to that position unless the position was disclosed on a return (including disclosing the position that the regulation in question is invalid). A taxpayer who engages in a reportable transaction [See Temp. Reg. § 1.6011-4T] cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under § 6664(c) with respect to the transaction unless the transaction was disclosed pursuant to the § 6011 regulations. Finally, a taxpayer who engages in a reportable transaction cannot rely on the realistic possibility standard under § 6662 to avoid the accuracy-related penalty for negligence or disregard of rules or regulations if the position regarding the reportable transaction is contrary to a revenue ruling or notice. When finalized, the amendments will apply to returns filed after 12/30/02, with respect to transactions entered into after 12/31/02.

- But be careful about over-reliance on effective dates. The preamble states:

The IRS, however, cautions taxpayers and tax practitioners that it will rigorously apply the existing facts and circumstances standard under § 1.6664-4(c) regarding a taxpayer's reasonable reliance in good faith on advice from a tax professional, as well as the other provisions of the regulations under sections 6662 and 6664, including § 1.6664-4(c) relating to special rules for the substantial understatement penalty attributable to tax shelter items of a corporation. In addition to the modifications contained in these proposed regulations, and regardless of when a transaction was entered into, the IRS, in appropriate circumstances, may consider a taxpayer's failure to disclose a reportable transaction or failure to disclose a position that a regulation is invalid as a factor in determining whether the taxpayer has satisfied the reasonable cause and good faith exception under section 6664(c) to the accuracy-related penalty.

a. Regulations are now final. T.D. 9109, Establishing Defenses to the Imposition of the Accuracy-Related Penalty, 68 F.R. 75126 (12/30/03). Under the final regulations, a taxpayer who engages in a reportable transaction must disclose the transaction in
accordance with Reg. §1.6011-4(b). See Reg. §1.6662-3(a). A taxpayer who engages in a
reportable transaction cannot rely on the realistic possibility standard under § 6662 to avoid the
accuracy-related penalty for negligence or disregard of rules or regulations if the position
regarding the reportable transaction is contrary to a revenue ruling or notice. Reg. §1.6662-3(b).
The final regulations are more generous than the proposed regulations with respect to the
availability of mitigation under § 6664(c). As under the proposed regulations, a taxpayer who
takes a position that a regulation is invalid cannot rely on an opinion or advice to satisfy the
reasonable cause and good faith exception under § 6664(c) with respect to that position unless the
position was specifically disclosed on the return. Reg. § 1.6664-4(c)(1)(iii). But the failure of a
taxpayer who engaged in a reportable transaction to disclose the transaction as required by the
§ 6011 regulations is only "a strong indication that the taxpayer did not act in good faith" in
relying on an opinion or advice to satisfy the reasonable cause and good faith exception under
section 6664(c) with respect to the transaction. Reg. § 1.6664-4(d). Under the proposed
regulations failure to disclose barred the taxpayer from raising reliance on advice as grounds for
mitigation.

b. Penalty Policy Statement issued by Commissioner Mark W. Everson goes beyond the regulations to provide that taxpayers may not rely on the advice of a "conflicted" tax advisor. Penalty Policy Statement issued by Commissioner Mark W. Everson to the LMSB and SB/SE Commissioners, 2003 TNT 249-9 (12/29/03). Advises IRS employees that taxpayers may not rely on the advice of a tax advisor who has a financial arrangement or referral agreement with a tax shelter promoter because his independent judgment is compromised. Moreover, the IRS will question the reasonableness and good faith of taxpayers who know or have reason to know that the tax advisor is not independent, and will not accept taxpayer reliance on an opinion from a non-independent tax advisor as proof of "reasonable cause and good faith." See, § 6664(c).

4. Proposed revisions to Circular 230 related to tax shelters require disclosures in tax shelter opinions of relationship between practitioner and promoter, etc. REG-122379-02, Regulations Governing Practice Before the Internal Revenue Service, 68 F.R. 75186 (12/30/03). New proposed amendments, which differ from the 1/12/01 proposed amendments in several ways: (1) § 10.33 prescribes best practices for all tax advisors; (2) § 10.35 combines and modifies the standards applicable to "marketed" and "more likely than not" tax shelter opinions from former §§ 10.33 and 10.35; (3) § 10.36 contains the revised procedures for ensuring compliance with §§ 10.33 and 10.35; and (4) new § 10.37 contains provisions relating to advisory committees to the Office of Professional Responsibility.

- Under § 10.33 "best practices" include: (1) communicating clearly with the client regarding the terms of the engagement and the form and scope of the advice or assistance to be rendered; (2) establishing the relevant facts, including evaluating the reasonableness of any assumptions or representations; (3) relating applicable law, including potentially applicable judicial doctrines, to the relevant facts; (4) arriving at a conclusion supported by the law and the facts; (5) advising the client regarding the import of the conclusions reached; and (6) acting fairly and with integrity in practice before the IRS.

- Tax shelter opinions covered by § 10.35 are more-likely-than-not and marketed tax shelter opinions; they, however, do not include preliminary advice provided pursuant to an engagement in which the practitioner is expected subsequently to provide an opinion that satisfies § 10.35. The definition of "tax shelter," tracking the one found in § 6662 which was contained in the 2001 proposed regulations, remains the same. The requirements for tax shelter opinions include: (1) identifying and considering all relevant facts and not relying on any unreasonable factual assumptions or representations; (2) relating the applicable law to the relevant facts in a reasonable manner; (3) considering all material Federal tax issues and reaching a conclusion supported by the facts and the law with respect to each issue; and (4) providing an overall conclusion as to the Federal tax treatment of each tax shelter item, and the reasons for that conclusion and providing an overall conclusion as to the Federal tax treatment of each tax shelter item and the reasons for that conclusion.

- Under § 10.35(d), a practitioner must disclose any compensation arrangement he may have with any person (other than the client for whom the opinion is prepared) with respect to the tax shelter discussed in the opinion, as well as any other referral arrangement relating thereto. The practitioner must also disclose that a marketed opinion may not be sufficient for a taxpayer to use for the purpose of avoiding penalties under § 6662(d), and must also
state that taxpayers should seek advice from their own tax advisors. A limited scope opinion must also disclose that additional issues may exist and that the opinion cannot be used for penalty-avoidance purposes.

- Under § 10.36 procedures to ensure compliance are required to be followed by tax advisors with responsibility for overseeing a firm’s practice before the IRS. These include ensuring that the firm has adequate procedures in effect for purposes of complying with § 10.35.

- Under § 10.37 the Director of the Office of Professional Responsibility is authorized to establish advisory committees to review and make recommendations regarding professional standards or best practices for tax advisors. They may also, more particularly, advise the Director whether a practitioner may have violated §§ 10.35 or 10.36.

a. Here comes Cono! Treasury and IRS announced the appointment of Caplin & Drysdale partner Cono R. Namorato as director of the IRS’s Office of Professional Responsibility on 12/29/03. 2003 TNT 249-1.

5. Making it harder for taxpayers to ‘fess up in order to avoid penalties. Notice 2004-38, 2004-21 I.R.B. (4/30/04). Treasury will issue temporary and proposed regulations that will modify the definition of “qualified amended return” in Reg. § 1.6664-2(e)(3) to provide that the period for filing is terminated when the IRS contacts a promoter, organizer or material advisor concerning a listed transaction for which the taxpayer has claimed a tax benefit (or when the taxpayer is contacted for examination concerning the activity. This will deprive a taxpayer who knows he is in the Service’s sights of the right to file a qualified amended return to avoid penalties.

- Previously, the right to file such a return ended at the earliest of a taxpayer receiving a notice of deficiency or the promoter receiving a § 6700 notice.

- The IRS is also contending that the filing of a qualified amended return retroactively revokes the interest holiday under § 6404(g)(2)(C) that begins 18 months after the filing of the original return because the interest holiday does not apply to tax shown on a return.

6. Son-of-Boss settlement terms are announced. Announcement 2004-46, 2004-21 I.R.B. (5/5/04). Settlement initiative for taxpayers to resolve “Son of Boss” transactions described in Notice 2000-44, 2000 C.B. 255, and substantially similar transactions. Taxpayers will be required to concede all claimed tax benefits and attributes, including basis adjustments with a sliding scale of penalties [none, if disclosed under Announcement 2003-2; 10 percent if this was the taxpayer’s only listed transaction; and 20 percent otherwise]. Net out-of-pocket costs and fees will be allowed as a long term capital loss (or half of these as an ordinary deduction) in the year these items were paid or accrued. The settlement initiative was open through 6/21/04.

D. Tax Shelter Penalties, etc.

1. Penalties may no longer be bargained away in Appeals. Chief Counsel Notice CC-2004-036 (9/22/04). The notice includes a memorandum from the Chief of Appeals stating, “Effective immediately we will no longer trade penalty issues in appeals. Penalties can and should still be settled, but the settlement should be based on the merits and the hazards surrounding each penalty issue standing alone.”

2. Section 811 of the Jobs Act of 2004 adds new § 6707A which provides a new penalty for any taxpayer who fails to include on his tax return any required information on a reportable transaction “of a type which the Secretary determines as having a potential for tax avoidance or evasion.” The penalty would apply regardless of whether there is an understatement of tax and would apply in addition to any accuracy related penalty. The penalty would be $10,000 for a natural person and $50,000 for other taxpayers; for a listed transaction the penalty would increase to $100,000 for a natural person and $200,000 for other taxpayers.

- The Commissioner could rescind any portion of the penalty if it did not involve a listed transaction and rescinding would promote compliance and effective tax administration. A decision not to rescind may not be reviewed in any judicial proceeding.

3. Section 812 of the Jobs Act of 2004 adds new § 6662A which would provide a modified accuracy related penalty on understatements with respect to reportable transactions. It would replace the § 6642 accuracy related penalty for tax shelters and would be in the amount of 20 percent – 30 percent if the transaction is not properly disclosed. Taxpayers could not rely on an opinion of a tax advisor to establish reasonable cause under new § 6664(d)
applicable to reportable transaction understatements] for any opinion: (a) provided by a “disqualified tax advisor” or (b) which is a “disqualified opinion.”

4. Section 813 of the Jobs Act of 2004 amends § 7525(b) to make the current exception to the federally authorized tax practitioner privilege for “corporate tax shelters” applicable to all tax shelters.

5. Section 814 of the Jobs Act of 2004 adds new § 6501(c)(10) to extend the statute of limitations for listed transactions which a taxpayer fails to disclose until one year after the transaction is disclosed by the taxpayer or by a material advisor’s satisfying the list maintenance requirement in connection with a request from Treasury.

6. Section 815 of the Jobs Act of 2004 amends §§ 6111 and 6112 to require increased disclosure on an information return for each reportable transaction by material advisors [in lieu of tax shelter registration]. “Material advisor” is defined more broadly to encompass any person who “provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction” and derives fees in excess of $50,000 for tax shelters for natural persons ($250,000 for tax shelters for other taxpayers).

7. Section 816 of the Jobs Act of 2004 amends § 670 to increase the penalty for failure to file a return under § 6111 to $50,000 — for listed transactions, the greater of $200,000 or 50 percent of the gross income derived by the person required to file the return [75 percent if the failure was intentional].

8. Section 817 of the Jobs Act of 2004 amends § 6708 to provide a penalty of $10,000 per day for failure to make available to the IRS within 20 business days any investor list required to be maintained under the provisions of § 6112.

9. Section 818 of the Jobs Act of 2004 amends § 6707 to increase the penalty on tax shelter promoters to 50 percent of the gross income to be derived from the activity on which the penalty is imposed.

10. Section 819 of the Jobs Act of 2004 amends § 6662(d) provide that a corporation’s understatement of tax in excess of $10 million is subject to the substantial understatement penalty even if it does not exceed 10 percent of the correct tax.

11. Section 820 of the Jobs Act of 2004 amends § 7408 to allow injunctions (a) against material advisors for violating reporting requirements and (b) for violating any of the Circular 230 rules.

12. Section 821 of the Jobs Act of 2004 amends 31 U.S.C. § 5321(a)(5) to provide penalties on failure to report interests in foreign financial accounts. The penalties for willful violations can reach the greater of $100,000 or 50 percent of the amount of the transaction [or 50 percent of the balance in the account at the time of the violation].

13. Section 822 of the Jobs Act of 2004 amends 31 U.S.C. § 330(b) to permit the imposition of censures or monetary penalties for Circular 230 violations. It also clarifies Treasury’s authority to impose standards applicable to written tax shelter opinions.

14. Section 838 of the Jobs Act of 2004 adds new § 163(m) [former § 163(m) is redesignated as § 163(n)] to deny interest deductions for any underpayments attributable to nondisclosed reportable transactions.

E. Individual Tax Shelters


F. Tax Shelter Discovery

1. The PwC deal. IR-2002-82 (6/27/02). The IRS announced in a news release that it cut a deal with PricewaterhouseCoopers (PwC) to resolve tax shelter registration and list maintenance issues. The IRS news release, which is similar to one issued last August regarding Merrill Lynch, says that “without admitting or denying liability, PwC has “agreed to make a ‘substantial payment’ to the IRS to resolve issues in connection with advice rendered to clients dating back to 1995.” Under the agreement, PwC will provide to the IRS certain client information in response to summonses. It will also “work with the IRS to develop processes to ensure ongoing compliance with [the shelter registration and investor list maintenance requirements].” according to the release.
a. The EY deal. IR-2003-84 (7/2/03). The IRS announced in a news release that it has settled Ernst & Young’s potential liability under the tax shelter registration and list maintenance penalty provisions for a nondeductible payment of $15 million.

b. The KPMG deal? Rumored, but not done. A criminal investigation of partners and employees was begun in the Southern District of New York.

2. Does the crime/fraud exception to the attorney client privilege defeat privilege claim? United States v. BDO Seidman, 225 F. Supp. 2d 918, 2002-2 U.S.T.C. ¶50,763, 90 A.F.T.R.2d 2002-6810 (N.D. Ill. 10/10/02). Documents for which accounting firm claimed § 7525 privilege were ordered to be produced for magistrate’s in camera review. In his opinion, Judge Shadur noted,

One last point has occurred to this Court -- something that has not been addressed by either of the parties. Suppose that some of the documents for which BDO claims privilege could otherwise fit within the standards governing the attorney-client privilege (and hence the equivalent statutory accountant-client privilege), but that they relate to the types of “abusive tax shelters” that have triggered the congressional enactment at issue here. In that event, would the utilization of such an “abusive tax shelter” by a taxpayer to whom BDO has given advice as to its use create the potential of criminal as well as civil liability on the taxpayer’s part? And if so, would that trigger the application of the crime-fraud exception to the privilege?

a. April was a pretty cruel month for tax shelter investors. John Doe I v. KPMG LLP, 93 A.F.T.R.2d 2004-1808 (N.D. Tex. 4/2/04). Investors in a KPMG-recommended “Son of Boss” tax shelter were not entitled to require KPMG to keep their identities confidential under the § 7525 tax advisor privilege because the confidentiality agreements they entered into with KPMG merely required that KPMG claim the privilege, and, since privilege does not apply to their identities and motives for participating in the tax shelter, KPMG does not breach its fiduciary duty by releasing the information. Judge Barefoot Sanders held that (1) the investors do not identify the particular “underlying communication” that would be revealed by revealing investors’ participation in the tax shelter, and (2) investors did not have a reasonable expectation that their identities or participation in the tax shelter would be protected because § 7525 does not protect “information transmitted for the purpose of preparing a tax return.” Also, §§ 6111 and 6112, requiring registration and list maintenance, prevent investors from having any reasonable expectation of confidentiality.

b. Sidley Austin Brown & Wood clients can intervene to protect their identities. United States v. Sidley Austin Brown & Wood LLP, 93 A.F.T.R.2d 2004-1849 (N.D. Ill. 4/15/04). Judge Kennelly grants a motion of 46 former anonymous Sidley Austin Brown & Wood clients to intervene in the summons enforcement action seeking their identities with respect to whether the summonses are unenforceable as unduly ambiguous. The clients include “Chamberlain Does” and “Fulbright Does.” The court noted that “[t]he issue of whether SAB&W organized or sold tax shelters within the meaning of section 6112 is a complicated question.”

c. The clients lose, but they may appeal. United States v. Sidley Austin Brown & Wood LLP, 93 A.F.T.R.2d 2004-2031 (N.D. Ill. 4/28/04). Judge Kennelly grants the government’s motion to enforce the John Doe summons that seeks to obtain the names of the former clients who had been granted permission to intervene in a limited fashion. The court holds that the mere fact that the law firm assembled the 46 names does not show the summonses to be unambiguous because “it may just show SAB&S’S desire to cooperate [in hopes of pacifying the IRS].” However, the burden on the government is to “show only that the summonses seeks...

16 Not to be confused with Shoeless Joe Jackson.
information with ‘potential relevance.’” The court answered by stating that “just because an issue is complicated does not necessarily mean that the governing regulations are ambiguous or impermissibly require SAB&W to draw legal conclusions,” and that “any marginal uncertainty that the summons leaves with SAB&W does not defeat its enforceability.”

- On 4/29/04, Judge Kennelly stayed his order of the preceding day pending appeal to the Seventh Circuit.

3. Are you practicing law or practicing tax when you write that opinion letter? United States v. KPMG LLP, 237 F. Supp. 2d 35, 2003-1 U.S.T.C. ¶50,174, 91 A.F.T.R.2d 2003-317 (D. D.C. 12/20/02). The IRS served administrative summonses on KPMG in connection with investigating KPMG’s promotion and participation in tax shelters and sought judicial enforcement when it determined that KPMG had not complied. KPMG withheld documents that would have been responsive to the summonses on grounds that the documents were privileged, and KPMG provided the IRS with a privilege log of the withheld documents. Citing United States v. Lawless, 709 F.2d 485 (7th Cir. 1983), for the principle that the attorney-client privilege does not extend to communications between a taxpayer and his attorney simply for the purpose of preparing a tax return, the court held that the § 7525 privilege does not extend to communications between a taxpayer and tax practitioner simply for the purpose of preparing a tax return. The court then went on to hold that KPMG’s tax opinion letters to its clients were not privileged because they were prepared in connection with the preparation of tax returns. Furthermore, memoranda of KPMG’s employees’ discussions with clients’ lawyers were not privileged because the communications were in connection with tax return preparation. Somewhat contradictorily, however, the court held that opinion letters prepared by law firms in connection with preparation of tax returns were privileged if the taxpayer, rather than the accounting firm, retained the lawyer.

- The court also held that § 7525 did not protect accountant work product. With respect to attorney work product, the court articulated the following standard: “The burden of showing that the materials prepared were in anticipation of litigation is on the party asserting the privilege,” and “this burden entails a showing that the documents were prepared for the purpose of assisting an attorney in preparing for litigation, and not for some other reason.” After an in camera review and comparison of a random sample of thirty allegedly privileged documents and the corresponding entries in the privilege log prepared in response to the summons, the court found that only four of the privilege log entries were completely supportable; accordingly it referred the matter to a special master to conduct an examination of the withheld documents, evaluate the asserted privileges, and submit a report and recommendation.

a. A subsequent KPMG magistrate’s opinion. United States v. KPMG LLP, 2003-2 U.S.T.C. ¶50,691, 93 A.F.T.R.2d 2003-6498 (D. D.C. 10/10/03). KPMG’s documents were reviewed by a special master, who found some of them protected by attorney-client privilege and some by § 7525.

b. The District Court rules for the government in a long omnibus memorandum. United States v. KPMG LLP, 316 F. Supp. 2d 30 (D. D.C. 5/4/04). Judge Hogan adopts the rationale of BDO Seidman, Wachovia and KMPG (N.D. Texas) to hold that the identity of KPMG clients who participated in potentially abusive tax shelters must be disclosed to the IRS. He stated,

Having reviewed the Brown & Wood “opinion letters” through the lens of the newly discovered evidence, the Court finds these opinion letters to be boilerplate templates that are almost, if not completely, identical except for date, investor name, investor advisor, and dates and amounts of investment transactions. There is little indication that these are independent opinion letters that reflect any sort of legal analysis, reasoned or otherwise. In fact, when examined as a group, the letters appear to be nothing more than an orchestrated extension of KPMG’s marketing machine. Regarding any documents that involve opinion letters from the Brown & Wood law firm, however, the Court declines at this time to broadly and definitively state that all of them are not privileged. At this point, it is only fair to shift the burden to KPMG to show that any or all of the Brown & Wood “opinion letters” are privileged by either the attorney-client privilege or the attorney work product privilege.
• He said the following regarding privilege:

Putting aside for the moment that participation in potentially abusive tax shelters is information ordinarily subject to full disclosure under the federal tax law, in order to be privileged the discussion of legal or tax advice must be based upon information communicated in confidence from the client to the lawyer or tax practitioner. See United States v. KPMG, 237 F. Supp. 2d 35, 39-40 (D. D.C. 2002) (setting forth D.C. Circuit’s concise summary of the attorney-client privilege as found in In re Sealed Case, 237 U.S. App. D.C. 312, 737 F.2d 94, 98-99 (D.C. Cir. 1984)). KPMG did not support v’th evidence, and the Special Master did not discuss, that any of these 141 documents discussing legal or tax advice is based upon or contains information communicated in confidence to the lawyers or tax practitioner by a client or a prospective client for the purpose of seeking legal or tax advice. Accordingly, these documents are not privileged and must be released to the IRS.

• Judge Hogan concluded that “KPMG is misrepresenting its unprivileged tax shelter marketing activities as privileged communications. The Court has lost confidence in KPMG’s privilege log since it has been shown to be inaccurate, incomplete, and even misleading regarding a very large percentage of the documents.” Footnote 10 reads, “The court hesitates to consider the judicial resources that have been wasted as a result of these improper claims of privilege.”

c. On the other hand, a district court in Illinois holds that outside and in-house counsel memorandums are protected by the attorney client privilege, and other documents protected by the work product doctrine. United States v. BDO Seidman, L.L.P, 2004-2 U.S.T.C. ¶50,208 (N.D. Ill. 6/28/04). Judge Holderman rules that BDO Seidman is entitled to claim privilege on 110 documents (other than six documents ordered to be produced in redacted form) prepared by the three outside law firms and in-house counsel because (1) the outside firms were not “co-promoters” of tax shelters because the government failed to submit proof other than the allegations in a civil complaint (Denney v. Jenkens & Gilchrist, 2004 WL 936843 (S.D. N.Y. 4/30/04) (ruling on defendants’ motions to compel arbitration), and communications with in-house counsel are protected to the same extent as communications with outside law firms; (2) the work product doctrine covers six documents created in anticipation of litigation; and (3) the crime-fraud exception does not apply “particularly in light of the uncertain and complex nature of the internal Revenue Code and the regulations thereunder.”


a. United States v. Jenkens & Gilchrist P.C., 93 A.F.T.R.2d 2004-2288 (N.D. Ill. 5/14/04). Senior Judge Moran provides a schedule for the production of identities and documents. Clients wishing to assert privilege claims have 21 days to do so, but are warned about sanctions for frivolous claims.

• Jenkens & Gilchrist turned over the list of names on 5/17/04. 2004 TNT 97-1.

5. Magistrate denies government’s motion to compel discovery of 63 documents, including some between taxpayer’s in-house attorneys and Deloitte & Touche. The Black & Decker Corp. v. United States, 219 F.R.D. 87, 92 A.F.T.R.2d 2003-6426 (D. Md. 9/15/03). In the course of the taxpayer’s refund suit arising from a series of transactions involving special purpose entities formed to manage employee health care benefits, the government sought discovery of numerous documents prepared by Deloitte & Touche, which taxpayer had retained to give advice regarding the transaction. First, certain communications to taxpayer’s in house counsel were not subject to attorney-client privilege under the Kovel doctrine, because the accounting firm’s advice was not necessary to facilitate communications between the taxpayer’s attorney and its non-attorney officers. This conclusion was supported by the evidence that many of the communications in question were directed to non-attorney employees of the taxpayer.
Furthermore, the documents were not "translation services" but were hybrid tax and business advice.

- Taxpayer, with the assistance of Deloitte & Touche, created special purpose entities to manage its employee and retiree health care benefits and claimed a large capital loss, as well as a total federal tax refund of about $57 million for the years 1995 through 2000. The taxpayer did provide a "short opinion" from D&T, and subsequently offered to provide a "long opinion" from D&Y on the transaction and refused to produce 63 other documents. (The production of the "long opinion" was conditioned on an agreement that the government would not assert that such disclosure does not constitute a subject matter waiver, a condition the government refused.) After reviewing the documents in camera, the magistrate held that the attorney-client privilege [in its derivative form under United States v. Kovel, 296 F.2d 918 (2d Cir. 1961)] was inapplicable because D&T was not primarily providing "translation" services to assist the in-house attorneys in rendering legal advice to the taxpayer, but was instead providing tax and business advice to the taxpayer. However, the work product doctrine was held to apply to the documents [53 of which were opinion work product and 10 of which were fact work product], and there was no waiver of this protection by the provision of the "short" opinion letter to the government.

- Nevertheless, the documents were protected under the work product doctrine. The government conceded that the documents had been prepared in anticipation of litigation, but argued that the "privilege" for work product had been waived. The court held that the work product doctrine can be waived where the party puts the work "in issue," but that the work in question had not been put in issue. That the documents may have related to an opinion letter on which the taxpayer was going to rely in an effort to avoid penalties — and with respect to which the taxpayer thus waived privilege — did not result in waiving the work product doctrine, which is "broader and more robust than the attorney-client privilege." However, the court did not explain, however how an accounting firm's work became "attorney work product." This is significant because the § 7525 privilege [which was not expressly raised in the case] does not have a "work product" variant.

- The opinion discusses four factors relevant to the applicability of the derivative privilege: (1) whether the advice was provided to the counsel or the client; (2) whether the in-house counsel also acts as a corporate officer; (3) whether the accountant is regularly employed as the client's auditor or advisor; and (4) which parties initiated or received the communications.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations
   1. Whole hospital joint ventures
      a. The whole hospital joint venture ruling. Rev. Rul. 98-15, 1998-12 I.R.B. 6 (3/4/98). Two fact patterns: Situation 1 concludes that the exempt hospital will continue to be exempt where it will receive an interest in the combined operation equal in value to the assets it contributed and the board structure gives control of the joint venture to the exempt organization's appointees. There is loss of exemption in Situation 2, where the joint venture's governing documents do not require that it serve charitable purposes, board control rests with the taxable entity, and the taxable entity may unilaterally renew the management agreement. Both conclusions depend on "facts and circumstances."
      b. Joint venture did not result in loss of tax exemption for charity hospital despite its failure to meet the criteria of Revenue Ruling 98-15. St. David's Health Care System v. United States, 2002-1 U.S.T.C. 50,452 (W.D. Tex. 6/7/02). Summary judgment was granted to community-owned, not-for-profit hospital on its tax exempt status. The hospital's entering into a limited partnership with HCA, Inc. [a for-profit health care company], in which it had general and limited partnership interests of 49.5 percent and in which the for-profit partner was the managing partner, did not result in forfeiture of hospital's § 501(c)(3) exemption. The court held that the community benefit standard did not absolutely require a community board, and that St. David's satisfied this standard even though it appointed only half the board members where the chairman's seat was reserved for a St. David's appointee. There was language in the partnership agreement requiring all the partnership's hospitals to operate in accordance with the community benefit standard outline in Rev. Rul. 69-45, 1969-2 C.B. 117, and St. David's can unilaterally dissolve the partnership if they fail to do so.
Query whether Rev. Rul. 98-15, 1998-1 C.B. 718, which provides an example of an acceptable joint venture in which the nonprofit partner has numerical control of the board, will still be considered valid. See also, Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999), aff’d per curiam, 242 F.3d 904, 2001-1 U.S.T.C. §50,271, 87 A.F.T.R.2d ¶2001-642 (9th Cir. 2001).

c. Litigation costs were ordered. St. David’s Health Care System v. United States, 2002-2 U.S.T.C. ¶50,271. 90 A.F.T.R.2d 2002-6878 (W.D. Tex. 9/20/02). The district court ordered the United States to pay $951,000 in litigation costs under § 7430 to St. David’s. Judge Nowlin held that novelty of the issues did not necessarily mean that any position that the government took was reasonable, concluding,

Finally, the United States argues that, since this case involved novel issues, it is more likely that its position was substantially justified. While it is true that some of the specific issues had a hint of novelty to them, that does not mean that any position taken on those issues is reasonable. To the extent that there were novel issues in this case, settled law clearly applied and disposed of those issues.

d. Fifth Circuit vacates the district court’s summary judgment ruling and its award of attorney’s fees, and remands for trial. Exempt organization must have control of joint venture in order for its St. David’s Health Care System v. United States, 349 F.3d 232, 2003-2 U.S.T.C. ¶50,713, 92 A.F.T.R.2d 2003-6865 (5th Cir. 11/7/03). In vacating the district court decision, Judge Garza’s opinion relied upon Rev. Rul. 98-15 and found that the central issue was not whether the partnership between St. David’s and Columbia/HCA Healthcare Corporation provided some charitable services, but rather whether the activities substantially further the profits-seeking interests of the for-profit partner. The opinion further analyzed facts that showed it was likely that St. David’s had, as a practical matter, ceded control over the partnership to HCA – particularly with respect to a noncompete provision in the partnership dissolution rights, which would have prevented either party from competing in the Austin area for two years and would have been inconvenicent for HCA but disastrous for St. David’s.

- On March 4, 2004, a jury in the Western District of Texas brought in a verdict in favor of St. David’s.

2. Joint ventures between an exempt organization and a for-profit organization. Rev. Rul. 2004-51, 2004-22 I.R.B. 974 (5/6/04). To expand its teacher training seminars, a university enters into ownership of an LLC with a for-profit company to conduct interactive video training programs. Each of the partners has a 50 percent ownership interest and equal representation on the governing board of the LLC. Holds that an ancillary activity – the university’s participation in the LLC is an insubstantial part of its activities – conducted by a partnership with a for-profit organization is attributable to the exempt organization. In the facts given, the trade or business was substantially related to the charity’s exempt purposes.

B. Charitable Giving

1. Addis v. Commissioner, 374 F.3d 881, 2004-2 U.S.T.C. ¶50,291, 94 A.F.T.R.2d 2004-5134 (9th Cir. 7/8/04). Judge Noonan holds that the substantiation rule of § 170(f)(8) bars deduction of contribution of amounts donated in 1997 and 1998 to the National Heritage Foundation to pay premiums on charitable split-dollar life insurance. The NHF gave taxpayers receipts that stated they received no consideration. Under the arrangement, the NHF was to pay $36,000 per year for twelve years (90 percent of the $40,000 annual premium) in return for 56 percent of the initial death benefit; the Addis Trust was to pay $4,000 per year in return for 44 percent of the initial death benefit plus projected increases in the death benefit. Of course, the reason NHF entered into this arrangement is the taxpayers contributed $36,000 per year to it.

- In 1999, § 170(f)(10) was added to the Code, which disallows deductions for funds transferred to charities which are used to pay premiums on life insurance with respect to the transferor, and levies a 100 percent excise tax on the premium payments to boot.

2. Section 882 of the Jobs Act of 2004 amends §§ 170(e)(1) and 6050L to restrict the amount of deductions from the contribution of intellectual property to the basis of the
contributed property. This amount may be increased to the extent that "qualified donee income" exceeds the amount deducted, which income must be reported by the donee.

3. Section 883 of the Jobs Act of 2004 amends §170(f) by adding new paragraph 11 that provides increased reporting requirements for contributions of property.

4. Section 884 of the Jobs Act of 2004 amends §170(f) by adding new paragraph 12 that requires written acknowledgment of contributions of motor vehicles, boats and airplanes that include the amount of the gross proceeds from any arm's length sale and a statement that the deduction may not exceed such amount. New § 6720 provides for penalties for furnishing fraudulent acknowledgements.

X. TAX PROCEDURE

A. Interest, Penalties and Prosecutions

1. Hot dog! No hot interest here. Med James, Inc. v. Commissioner, 121 T.C. 147 (9/9/03). Section 6621(c) increases the interest on corporate deficiencies to 5 percent above the short-term Federal rate [instead of the normal 3 percent] if the deficiency exceeds $100,000. The Tax Court (Judge Goeke) held that the increased ["hot"] interest under § 6621(c) does not apply where an NOL that arose in a year before the deficiency notice was sent is carried back to reduce the deficiency, which otherwise would have exceeded $100,000, to less than $100,000.

2. Mendes v. Commissioner, 121 TC. No. 19 (12/11/03) (reviewed, 3 dissents). In an opinion by Judge Halpern, majority held that a late return filed after a deficiency notice has been issued is not taken into account in determining whether the addition to tax for underpayment of estimated taxes is avoided under § 6654(d)(1)(B) even if the return shows that the tax due for the year was zero. The penalty can be collected pursuant to deficiency notice on underlying tax liability. Judge Foley (joined by Judges Laro and Marvel) dissented on the grounds that the literal requirements of § 6654(d)(1)(B) had been met by the late filed return, and that the proper question was whether the late filed return was indeed a valid return, i.e., was it merely an attempt to avoid the penalty without an honest and reasonable attempt to comply with the requirements for a return.

3. Bell v. United States, 355 F.3d 387, 2004-1 U.S.T.C. §50,118, 93 AFTR2d 2004-369 (6th Cir. 1/7/04). Corporate funds are not considered "encumbered" and therefore unavailable to pay over withholding and payroll taxes merely because a contractual obligation to a creditor limits the ability of the employer freely to use its assets.

4. Welcome to debtor's prison, but you do have to try to get there. United States v. Schoppert, 362 F.3d 451, 93 A.F.T.R.2d 2004-1590 (8th Cir. 4/1/04). A willful attempt to evade payment of the tax shown on the taxpayer's return was held to constitute criminal tax fraud under § 7201.

5. More Tax Court jurisdiction over interest calculations despite §§ 6512(b)(2) and 6402. Estate of Smith v. Commissioner, 123 T.C. No. 2 (7/13/04). After the Tax Court had determined the amount by which the taxpayer had "overpaid" estate tax, in making the refund the Commissioner offset asserted assessed but unpaid underpayment interest. The majority, in a reviewed opinion by Judge Ruwe, held that for purposes of determining an overpayment of tax pursuant to § 6512(b), the proper tax includes underpayment interest and that the amount of an overpayment is the amount by which payments exceed the tax, including any underpayment interest. As a matter of law, the Tax Court's prior decision that the estate overpaid its estate tax by $238,847.24 took into account underpayment interest as part of the calculation in arriving at the amount of an overpayment. Accordingly, the Tax Court had jurisdiction over the taxpayer's motion to enforce its order that the IRS refund $238,847.24. Section 6512(b)(2) does not apply to bar Tax Court jurisdiction over interest determinations where a final decision in the same case precludes the existence of the interest liabilities to which the Commissioner attempts to apply the overpayment. There were a number of overlapping concurrences and five dissents. The dissents were based on the proposition that the majority's holding exceeded the Tax Court's statutory jurisdiction because the Tax Court's prior order had merely approved Rule 155 computations that, as is customary, did not include underpayment interest owed.

B. Discovery: Summonses and FOIA

1. Hi-ho, hi-ho, it's off to redact we go. United We Stand America, Inc. v. IRS, 359 F.3d 595, 93 A.F.T.R.2d 2004-1236, 2004-1 U.S.T.C. §50,190 (D.C. Cir. 3/5/04). United We Stand America sought to obtain under FOIA a report by the IRS to the Joint
Committee on Taxation, prepared pursuant to the committee's request, dealing with an investigation by the Joint Committee of "whether the IRS's selection of tax-exempt organizations ... for audit has been politically motivated ..." The Court of Appeals (Judge Tatel: one dissent) held that the report was not subject to the FOIA exception for Congressional documents in toto and was partially discoverable under FOIA. However, the exception for Congressional documents applied to the Joint Committee's request and any portions of the IRS report that "would effectively disclose the request." The case was remanded for a determination of whether the report could be redacted sufficiently to protect the confidentiality of the Joint Committee's request.

2. A "serious" violation of procedural rules by the IRS didn't invalidate the summons. Robert v. United States, 364 F.3d 988, 93 A.F.T.R.2d 2004-2770, 2004-1 U.S.T.C. ¶ 50,233 (8th Cir. 4/29/04). The court of appeals (Judge Mello) upheld the enforcement of IRS summonses even though the issuance followed improper ex parte communications between the IRS Appeals office assigned to the case and audit personnel regarding the substance of the taxpayer's appeal. The court reasoned that under the standards of United States v. Powell, 379 U.S. 48 (1964), as long as the summons is issued for a legitimate purpose and the IRS acts in good faith, the summons will be enforced even though the IRS has failed properly to follow required internal procedures where Congress has not specifically provided a remedy.

C. Litigation Costs

1. The IRS has not taken a position until it issues a 90-day letter or Appeals has made a decision. Florida Country Clubs, Inc. v. Commissioner, 122 T.C. No. 3 (2/3/04). Even though § 7430(c)(2) provides that reasonable administrative costs include costs incurred after the IRS sends a 30-day letter, attorney's fees are not available with respect to a case in which the IRS has issued a 30-day letter but which has been settled without either an deficiency notice or Appeals decision having been issued. Although the definition of "reasonable administrative costs" includes costs incurred from the date of the 30-day letter, the government still has not "taken a position" for purposes of § 7430(c)(7) until a deficiency notice or Appeals decision has been issued, and thus the taxpayer cannot be a "prevailing party" as defined in § 7430(c)(4).

2. The Commissioner concedes the substantive issue and that a § 7430 award is proper, but the taxpayer still loses because of the fee structure. Grigoraci v. Commissioner, 122 T.C. No. 14 (3/25/04). The taxpayer prevailed in an earlier case involving the same issue [employment taxes] for an earlier year. On the basis of that decision, the Commissioner conceded the substantive issue in the instant case and that the taxpayer was entitled to recover costs. However, Judge Thornton denied the taxpayer's claim for amounts in excess of the filing fee on two grounds: (1) the taxpayer's obligation to pay any fees that had been billed to him was contingent on receiving a fee award, and § 7430 does not authorize an award of contingent fees; and (2) the fees related to the first Tax Court case involving the taxpayer, § 7430 does not authorize awarding fees that relate to an earlier case involving the taxpayer, even if the earlier case involved the same issue for a different year.

D. Statutory Notice

1. "Clear and concise" notification of a change of address. Hunter v. Commissioner, T.C. Memo. 2004-81 (3/23/04). Judge Holmes held that it is not necessary to file a Form 8822 to give the IRS "clear and concise" notification of the taxpayer's new address. The taxpayer filed a Form 2848, Power of Attorney, showing his new address as the address to which all originals were to be sent with a copy to his attorney. That was "clear and concise" notification to IRS of taxpayer's new address. "[T]he IRS is chargeable with knowing the information it has readily available when it sends notices to taxpayers."

E. Statute of Limitations

1. Martin v. Commissioner, T.C. Memo. 2003-288 (10/8/03). An unauthorized Tax Court petition filed by the taxpayer's former wife's attorney with respect to a statutory notice relating to a year for which they filed a joint return, and which was dismissed with respect to the taxpayer on his motion, nevertheless [pursuant to § 6503(a)(1)] suspended the statute of limitations on assessment.

2. The statute of limitations remains suspended until the IRS acknowledges the withdrawal of an offer in compromise. United States v. Donovan, 348 F.3d
509, 92 A.F.T.R.2d 2003-6762 (6th Cir. 10/31/03). Form 656, on which an offer in compromise is submitted provides that the statute of limitations is suspended “while the offer is pending (see (m) above) ... and for one additional year beyond each of the time periods identified in this paragraph.” Paragraph (m) provides: “The offer is pending starting with the date an authorized IRS official signs this form and accepts my/our waiver of the statutory periods of limitation. The offer remains pending until an authorized IRS official accepts, rejects or acknowledges withdrawal of the offer in writing.” The court of appeals (Judge Boggs) held that when the taxpayer withdrew his offer on April 18, 2000, the statute of limitations continued to be suspended until the IRS acknowledged the withdrawal on April 28, 2000. As a result, the statute of limitations expired the day after the suit for collection was filed, not nine days earlier.

3. The statute of limitations when taxpayers litigate identity privilege issues in lawsuits against their tax advisers. John Doe 1 v. KPMG LLP, 2004-1 U.S.T.C. §50,270, 93 A.F.T.R.2d 2004-1808 (N.D. Tex. 4/2/04). Judge Barefoot Sanders denied the government's motion to require the John Doe taxpayers to sign consents to extend the statute of limitations, but found instead that the statute was suspended.

[16] In the instant case, Plaintiffs choose not to intervene in the judicial enforcement proceeding instituted by the IRS against KPMG in the District Court of the District of Columbia. (See Pl.'s Br. at 3-5.) Such intervention would have suspended the running of the statute of limitations. Instead, Plaintiffs chose to institute this action and subsequently asked the Court to enter an Agreed Order preventing KPMG from disclosing "to the Government of the United States (including the Internal Revenue Service), the identities of the John Doe Plaintiffs, or any documents or other information relating to the John Doe Plaintiffs or relating to their transactions that are the subject of this action, until this Court enters final judgment on the merits of the privilege issues raised by the John Doe Plaintiffs." (Agreed Order, entered September 11, 2003 (emphasis added).) In light of this language, Plaintiffs' assertion that the United States could have prevented the statute of limitations from running by filing for judicial enforcement of the summons is, at best, implausible. The United States could have reasonably assumed from reading the Agreed Order that filing for judicial enforcement of the summons, or taking any of the actions Plaintiffs suggest in their brief, would have been useless until a final order is entered by this court. It appears to the Court that the United States's assertion that Plaintiffs are trying to "run out the clock" is correct./3/

/3/Plaintiffs instituted this suit on September 8, 2003, and filed the Agreed Order on September 11, 2003. In their Joint Status Report, the parties estimated that five months would be needed for discovery. (See Joint Status Report, filed October 3, 2003.) Based on this information, the Court entered a Scheduling Order setting the discovery deadline as February 17, 2004, and the deadline for filing dispositive motions as February 24, 2004. (See Scheduling Order, entered October 9, 2003.) As of December 1, 2003, the parties had not started any discovery. (See Joint Report, filed December 1, 2003.) On February 17, 2004, the parties filed an agreed request to extend the time to conduct discovery and to file dispositive motions. (See Motion to Extend Time, filed February 17, 2004.) However, it appears that little discovery actually took place; the parties have stipulated to all the facts on which they are relying in their motions for summary judgment, and the facts appear to be information that must have been known at the time the lawsuit was filed in September. It is puzzling, therefore, why the parties would have needed an extension of time to complete discovery, unless it was for the purpose of "running out the clock."
The Court concludes that it is appropriate to apply equitable principles to suspend the running of the statute of limitations in the instant case. "As a general rule, equitable tolling operates only in rare and exceptional circumstances where it is necessary to preserve a plaintiff's claims when strict application of the statute of limitations would be inequitable." Fierro v. Cockrell, 294 F.3d 674, 682 (5th Cir. 2002) (citations omitted). "Equitable tolling thus applies principally where the plaintiff is actively misled by the defendant about the cause of action or is prevented in some extraordinary way from asserting his rights." Id. The Court concludes that the application of the three year statute of limitations pursuant to section 6501 of the I.R.C. would be inequitable to the United States as a plaintiff in a tax assessment action against these Plaintiffs. The United States was prevented from asserting its rights to assess the John Doe Plaintiffs additional taxes for the year 2000 by Plaintiffs filing this suit and by the entry of the Agreed Order on September 11, 2003. Cf. United States v. Henderson, 133 F.R.D. 26, 32 (M.D.N.C. 1990).

In United States v. Henderson, Magistrate Judge Eliason reasoned that it would be inequitable to allow the statute of limitations to run as to taxpayers who had purposely not intervened in the action against their attorney to enforce a third-party summons. If the taxpayers had intervened, the statute of limitations would have been tolled, thus protecting the IRS while allowing the taxpayers to assert their rights. Magistrate Judge Eliason would not allow the taxpayers to "have their cake and eat it too." Although Magistrate Judge Eliason's solution was to deny the attorney standing to assert the taxpayers' rights, the Court finds the underlying concerns of the Henderson case and the instant case analogous.

The Court concludes that suspending the running of the statute of limitations allows Plaintiffs to assert their confidentiality privilege without prejudicing the rights of the United States. The Court further concludes that the time period provided in I.R.C. section 6503(a)(1) is an appropriate time period to use in the instant case. See I.R.C. section 6503(a)(1) (establishing the time period for suspension of the statute of limitations when a taxpayer files an action in Tax Court). Therefore, the Court SUSPENDS the running of the statute of limitations in section 6501(a) as to the John Doe Plaintiffs' year 2000 returns until this Court issues a final judgment on the merits and for a period of 60 days thereafter.


The clients lose, but they may appeal. United States v. Sidley Austin Brown & Wood LLP, 93 A.F.T.R.2d 2004-2031 (N.D. Ill. 4/28/04). Judge Kennelly grants the government’s motion to enforce the John Doe summons that seeks to obtain the names of the former clients who had been granted permission to intervene in a limited fashion.

On 4/29/04, Judge Kennelly stayed his order of the preceding day pending appeal to the Seventh Circuit.

Another tax procedure song from the Supremes. United States v. Galletti, 124 S. Ct. 1548, 93 A.F.T.R.2d 2004-1425, 2004-1 U.S.T.C. ¶ 50,204 (3/23/04). A unanimous Supreme Court, in an opinion by Justice Thomas, held that a valid assessment of an employment tax deficiency against a partnership extends the 10-year statute of limitation on judicially collecting the tax against the general partners individually, even thought here had been no individual assessments against the partners within three years.

No refund of paid but unassessed taxes. Williams-Russell & Johnson, Inc. v. United States, 371 F.3d 1350, 93 A.F.T.R.2d 2004-2543, 2004-1 U.S.T.C. ¶ 50,266 (11th Cir. 6/7/04). The court of appeals, Judge Edenfield, held that the statute of limitation on refunds [on employment taxes in this case] under § 6511 runs from the later of payment or the due date of return even if IRS fails to make a timely assessment of taxes. A payment due, owning, and made is not an “overpayment” under § 6401(a) merely because the IRS failed to formally assess the tax after it was paid.

Why did the IRS contest this one; the statutory language is clear. Zarky v. Commissioner, 123 T.C. No. 7 (7/20/04). The taxpayer failed to file a return, received a deficiency notice, and filed a Tax Court petition within three years after the return due date. The Tax Court determined that the taxpayer had overpaid his taxes by the amount that had been withheld [§270]. Normally, under § 6511(b)(2) and § 6512(b) where a refund claim has not been filed within three years of filing a return, the refund is limited to amounts paid within two years prior to filing the claim. The second paragraph of flush language of § 6512(b)(2), added in 1997 provides a special limitation if a taxpayer who fails to file a return receives a deficiency notice and files a Tax Court petition within three years after the due date of the return; in this case the taxpayer may obtain a refund of an overpayment for the year of the asserted deficiency if the overpayment was made within three years prior to the date of the deficiency notice. In this case, Judge Laro applied the special rules to order refund of overpaid withholding taxes for the year of the asserted deficiency because the withholding was deemed paid on April 15, which was within three years prior to the date of the deficiency notice.

F. Liens and Collections

1. Procedures for submitting an offer in compromise. Rev. Proc. 2003-71, 2003-36 I.R.B. 517 (9/8/03). This revenue procedure explains the procedures for submitting an offer in compromise, and the procedures followed by the IRS in processing the offer. It is effective as of 8/21/03, except the fee provisions, which are effective 11/1/03.

2. Rev. Rul. 2003-108, 2003-44 I.R.B. 963 (11/3/03). For purposes of § 6323(a), a purchaser, holder of a security interest, mechanic’s lienor or judgment lien creditor is protected against a statutory tax lien for which a notice of federal tax lien has not been filed notwithstanding actual knowledge of the statutory tax lien.

3. Montgomery v. Commissioner, 122 T.C. No. 1 (1/22/04). Because no deficiency notice is issued when the IRS attempts to collect unpaid taxes shown as due on the return filed by the taxpayer, at a § 6330 collection due process hearing the taxpayer may challenge the existence or amount of the tax liability reported on the original tax return. The taxpayer did not have any other opportunity to “contest” the liability.

4. You don’t actually have to receive the notice that Appeals has not granted relief in a due process hearing for the clock to start ticking on the time to appeal to the Tax Court. Weber II v. Commissioner, 122 T.C. No. 12 (3/22/04). Section 6330(a)(2) requires an IRS written notice to the taxpayer of its intent to levy on any of the taxpayer’s property be delivered in person, left at the taxpayer’s home or usual place of business, or sent by certified or registered mail to his last known address at least thirty days before the date of the levy. Although the statute does not specify the manner in which the Appeals Office must inform the taxpayer of its determination following a due process hearing, the Tax Court has held that notice sent by certified or registered mail to the taxpayer’s last known address — the method specifically authorized for sending deficiency notices in § 6212(a) and (b) — suffices. [The court also observed that notice might be sufficient if it is given in person or left at the taxpayer’s
jurisdiction to redetermine interest in reviewing due process hearings, even though it generally disallowed in an offer in compromise computation of ability to pay.

pews. Unless it is a requirement of ministerial employment, tithes to the church are determination.

evidence is presented to the court is to ask for a remand of the case to Appeals for a supplemental (9/1/04). Deborah Butler provides guidance to Chief Counsel attorneys as to how to handle were three dissents.

concurring opinions was supported additional nine judges, in some of which the five "majority" judges joined, and one of which breach the offer in compromise and that the Appeals Officer abused his discretion in declaring the copy was delivered to Appeals. Nevertheless, the court held that the taxpayer did not materially accountant used a private meter and the return was not received, until several years later when the mailed. Although the testimony was admitted, it did not prove timely mailing because the mail the return, and other evidence not in the administrative record indicating that the return was not new issues). The court held that the Administrative Procedures Act review provisions do not hold that it may consider evidence presented at trial that was not in the administrative record (but not new issues). The court held that the Administrative Procedures Act review provisions do not apply to § 6330(d) proceedings, and admitted taxpayer’s testimony that he signed and delivered the taxpayer signed it, and the accountant mailed it using a private postage meter [Uh-oh]. The taxpayer had entered into an offer in compromise (based on doubts as to collectibility) relating to years prior to 1992, which required that he file timely returns for 1995 through 1999. The returns for 1995 through 1997 were timely filed, but the 1998 return was never received. The taxpayer and his accountant claimed that on the day the 1998 return was due, his accountant prepared it, the taxpayer signed it, and the accountant mailed it using a private postage meter [Uh-oh]. The IRS declared the compromise in default. After a due process hearing in which the taxpayer claimed good faith compliance and offered alternative proof of mailing, including a copy of the 1998 return, the Appeals Officer issued a notice of determination to proceed with collection, because the Appeals Officer would accept only a certified or registered mail receipt as proof of mailing. Even though the Tax Court’s review of collection due process hearings is not

Tax Court review of collection due process hearings is not perfunctory. Fowler v. Commissioner, T.C. Memo. 2004-163 (7/13/04). In reviewing the IRS’s rejection of the taxpayer’s offer in compromise in a collection due process hearing, Judge Gerber held that the rejection was an abuse of discretion because in considering whether the taxpayer could make installment payments the Appeals Officer relied solely on national average statistics to determine living expenses rather than taking taxpayer’s actual expenses into account.

Tax Court makes it easier to find abuse of discretion in collection due process hearings. Robinette v. Commissioner, 123 T.C. No. 5 (7/20/04). In 1995, the taxpayer had entered into an offer in compromise (based on doubts as to collectibility) relating to years prior to 1992, which required that he file timely returns for 1995 through 1999. The returns for 1995 through 1997 were timely filed, but the 1998 return was never received. The taxpayer and his accountant claimed that on the day the 1998 return was due, his accountant prepared it, the taxpayer signed it, and the accountant mailed it using a private postage meter [Uh-oh]. The IRS declared the compromise in default. After a due process hearing in which the taxpayer claimed good faith compliance and offered alternative proof of mailing, including a copy of the 1998 return, the Appeals Officer issued a notice of determination to proceed with collection, because the Appeals Officer would accept only a certified or registered mail receipt as proof of mailing. Even though the Tax Court’s review of collection due process hearings is for abuse of discretion, in a reviewed opinion by Judge Vasquez (in which 5 judges joined), the Tax Court held that it may consider evidence presented at trial that was not in the administrative record (but not new issues). The court held that the Administrative Procedures Act review provisions do not apply to § 6330(d) proceedings, and admitted taxpayer’s testimony that he signed and delivered the return to his accountant for mailing, the accountant’s testimony regarding the procedures used to mail the return, and other evidence not in the administrative record indicating that the return was mailed. Although the testimony was admitted, it did not prove timely mailing because the accountant used a private meter and the return was not received, until several years later when the copy was delivered to Appeals. Nevertheless, the court held that the taxpayer did not materially breach the offer in compromise and that the Appeals Officer abused his discretion in declaring the compromise in default. There were an indescribable number of overlapping concurrences by an additional nine judges, in some of which the five “majority” judges joined, and one of which concurring opinions was supported by more judges than supported the “majority” opinion; there were three dissents.

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

Tithes are allowed for people in the pulpit, but not for those in the pews. Unless it is a requirement of ministerial employment, tithes to the church are disallowed in an offer in compromise computation of ability to pay. Pixley v. Commissioner, 123 T.C. No. 15 (9/15/04). Ordained Baptist minister was not entitled to claim tithes to the
church as expenses on an offer in compromise in Appeals where he was not currently employed as a minister and such tithes were therefore not required as "a condition to employment."

G. Innocent Spouse

1. Zoglman v. Commissioner, T.C. Memo. 2003-268 (9/12/03). The Tax Court denied § 6015(c) apportioned innocent spouse relief with respect to an understatement attributable to the taxpayer's spouse's omitted social security benefits because the taxpayer had actual knowledge of the amount of spouse's social security benefits.

2. Principal purpose of separation was to transfer assets under the guise of state family law. Ohrman v. Commissioner, T.C. Memo. 2003-301 (10/29/03). Section 6015(c)(4) provides that an allocated liability election under § 6015(c) is ineffective to the extent of the value of property transferred from the spouse to whom an erroneous item is attributable to the spouse making the election, if the principal purpose of the transfer was tax avoidance. Any transfer occurring after the date one year before the taxpayer receives a thirty-day letter proposing a deficiency is presumed to have the proscribed purpose regardless of its actual motivation, unless the transfer was pursuant to a divorce or separation and the taxpayer proves that it did not have the proscribed purpose. Judge Cohen held that a transfer of assets pursuant to legal separation within one year before taxpayers received a thirty-day letter, after which the spouses continued to reside together, was subject to the § 6015(c)(4) exception to apportioned liability because the principal purpose for the legal separation was to transfer assets under the guise of state family law.

3. Election not made within two years of first collection activity. Campbell v. Commissioner, 121 T.C. 290 (11/24/03). Pursuant to §§ 6015(b)(1)(E) and (c)(3)(B) [and Rev. Proc. 2000-15, § 5, 2001-1 C.B. 447], an innocent spouse election must be made within two years of the IRS's first collection activity against the individual making the election. In this case, Judge Foley held that an offset of an overpayment for one year as credit against an unpaid tax liability for another year, pursuant to § 6402(a), is a collection activity. As a result, the taxpayer's election was not timely.

4. Ewing v. Commissioner, 122 T.C. No. 2 (1/28/04). In a reviewed opinion by Judge , the Tax Court held that even though the standard for reviewing the Commissioner's failure to grant equitable relief under § 6015(f) is abuse of discretion, the Tax Court's review is not necessarily limited to the facts that were in the administrative record. Judges Halpem, Holmes, Chiechi, and Foley dissented.

5. They're literally dying to try to get § 6015(c) relief. Estate of Jonson v. Commissioner, 118 T.C. 106 (2/8/02). In an innocent spouse case involving tax shelter deductions that was appealable to the Tenth Circuit, the Tax Court applied the Ninth Circuit's liberal standard from Price v. Commissioner, 887 F.2d 959 (9th Cir. 1989), requiring only that a spouse seeking relief "establish that she did not know and had no reason to know that the deduction would give rise to a substantial understatement," on the basis of a favorable citation to Price in an unpublished Tenth Circuit opinion. However, the Tax Court denied § 6015(b) relief because the spouse was well educated, active in her husband's financial affairs, had full knowledge of the facts of the investment, and benefited from the understatement. The deceased wife's personal representative [her husband] made a § 6015(c) apportioned liability election more than 12 months after her death [and the Commissioner did not challenge the representative's procedural right to make the election], but § 6015(c) relief was denied. The personal representative "stepped into the shoes" of the deceased spouse, and she did not qualify for § 6015(c) relief because at the time of her death she and her husband were not divorced or separated and were members of the same household. Although H. Rept. No. 105-559 at page 252, n.16 states that a taxpayer is no longer married if he or she is widowed, Congress did not intend § 6015(c) to apply to the estate of a spouse who was "happily married" at the time of death. Equitable relief under § 6015(f) also was denied.

a. Affirmed, but possibly on different grounds. 353 F.3d 1181, 93 A.F.T.R.2d 2004-323, 2004-1 U.S.T.C. ¶50,122 (10th Cir. 12/30/03). The Tenth Circuit (Judge Hartz) affirmed, although the reasoning might [or might not be] slightly different. The court of appeals concluded that, although the estate could perform the act of filing request for relief, it could not satisfy the condition that the "individual" seeking relief was "no longer married to" or "not a member of the same household as" the other the spouse. Only an "individual" can meet that condition and an "individual" is a living being, not a decedent's estate. Thus, there was no individual eligible for relief.
6. Did a procedural detail slip through the statutory cracks? Maier v. Commissioner, 119 T.C. 267 (11/20/02). When one spouse requests innocent spouse relief from the IRS, § 6015(h)(2) assures the other spouse a right to participate in the process [although it does not guarantee a personal appearance]. If a requesting spouse seeks Tax Court review of a denial of innocent spouse relief in a proceeding to which the other spouse is not already a party, § 6015(e)(4) provides the nonrequesting spouse the right to intervene. But if the IRS administratively grants the requesting spouse innocent spouse relief, according to the Tax Court [Judge Panuthos], the nonrequesting spouse has no independent right to petition the Tax Court to review the administrative grant of relief to the requesting spouse.

a. Yes, answers the Second Circuit. Affirmed, Maier v. Commissioner, 360 F.3d 361, 2004-1 U.S.T.C. ¶50,179, 93 A.F.T.R.2d 2004-1139 (2d Cir. 2/26/04). Judge Walker affirms by reason of lack of Tax Court jurisdiction over petitions for review from non-electing spouses after innocent spouse relief has been administratively granted, and cites [Shepard & McMahon], 6 Fla. Tax Rev. 81, 177 (2003), in support of his conclusion that a legislative remedy would be needed in order for judicial relief to be granted in such situations.

7. Accepted offer in compromise bars subsequent innocent spouse relief. Dutton v. Commissioner, 122 T.C. No. 7 (2/11/04). The taxpayer's offer in compromise (based on doubt as to collectibility) was accepted by the IRS. The taxpayer mistakenly thought that because an IRS agent informed him that § 6015(c) apportioned liability would be considered, he would obtain a refund of amounts paid under the compromise. Judge Goeke held that once a taxpayer has entered into a valid compromise of his tax liability pursuant to § 7122, he cannot seek innocent spouse relief under § 6015 with respect to the liability.

8. Tax liens against possibly innocent spouses are OK. Beery v. Commissioner, 122 T.C. No. 9 (3/1/04). After election has been made, § 6015(e)(1)(B)(i) generally bars the IRS from levying or collecting the tax until the later of the expiration of the ninety-day period for petitioning the Tax Court or, if a petition has been filed, the date the Tax Court order becomes final. However, Judge Panuthos held that § 6015(e)(1)(B)(i) does not bar the IRS from filing a lien after an innocent spouse election has been filed and during the pendency of a petition for innocent spouse relief.

9. Well, the former spouses weren't totally antagonistic. He supported her innocent spouse claim. Van Arsdalen v. Commissioner, 123 T.C. No. 7 (7/22/04). The taxpayer filed a stand-alone Tax Court petition seeking review of the Commissioner's denial of innocent spouse relief under § 6015(f). The IRS issued her former husband a notice of filing petition and right to intervene that stated that his right to intervene was limited to intervening solely for the purpose of challenging the taxpayer's right to innocent spouse relief. Her former husband intervened to support her claim. Judge Panuthos held that neither § 6015 nor Tax Court Rule 325 precludes a nonelecting spouse from intervening for the purpose of supporting the electing spouse's claim for relief.

H. Miscellaneous

1. Burton Kanter in trouble again. Investment Research Associates, Ltd. v. Commissioner, T.C. Memo. 1999-407 (12/15/99). In a 600-page opinion Burton Kanter was held liable for the §6653 fraud penalty by reason of his being "the architect who planned and executed the elaborate scheme with respect to the kickback income payments . . . . In our view, what we have here, purely and simply, is a concerted effort by an experienced tax lawyer [Kanter] and two corporate executives [Claude Ballard and Robert Lisle] to defeat and evade the payments of taxes and to cover up their illegal acts so that the corporations [employing the two corporate executives] and the Federal Government would be unable to discover them."

a. So far, he is unable to wriggle out, the way he did 25 years ago when he was acquitted by a jury. The taxpayers subsequently moved to have access to the special trial judge’s "reports, draft opinions, or similar documents" prepared under Tax Court Rule 183(b). They based their motion on conversations with two unnamed Tax Court judges.

His partner (and son-in-law) was convicted and imprisoned. See United States v. Baskes, 649 F.2d 471 (7th Cir. 1980), cert. denied, 450 U.S. 1000 (1981).

Kanter’s attorney revealed the names of the two judges when asked at oral argument to the Seventh Circuit as Tax Court Judge Julian Jacobs and Chief Special Trial Judge Peter J. Panuthos. See the text at footnote 1 of Judge Cudahy’s dissent in the Seventh Circuit Kanter Estate opinion, below.
that the original draft opinion from the special trial judge was changed by Judge Dawson before he adopted it. They were turned down because the Tax Court held that the documents were related to its internal deliberative processes. See, Tax Court Order denying motion, 2001 TNT 23-31 (4/26/00) and (on reconsideration) 2001 TNT 23-30 (8/30/00). Taxpayers sought mandamus from the Fifth, Seventh and Eleventh Circuits, but were unsuccessful.

b. And the Tax Court's procedures are vindicated and taxpayer Ballard loses on appeal on the fraud issue in the Eleventh Circuit. Ballard v. Commissioner, 321 F.3d 1037, 2003-1 U.S.T.C. ¶50,246, 91 A.F.T.R.2d 2003-928 (11th Cir. 2/13/03), affg T.C. Memo. 1999-407. The Eleventh Circuit affirmed the Tax Court decision and rejected the taxpayers' argument that changes allegedly made by the Tax Court Special Trial Judge were improper. Judge Fay stated:

Even assuming Dick's [taxpayers' lawyer's] affidavit to be true and affording Petitioners-Appellants all reasonable inferences, the process utilized in this case does not give rise to due process concern. While the procedures used in the Tax Court may be unique to that court, there is nothing unusual about judges conferring with one another about cases assigned to them. These conferences are an essential part of the judicial process when, by statute, more than one judge is charged with the responsibility of deciding the case. And, as a result of such conferences, judges sometimes change their original position or thoughts. Whether Special Trial Judge Couvillion prepared drafts of his report or subsequently changed his opinion entirely is without import insofar as our analysis of the alleged due process violation pertaining to the application of [Tax Court] Rule 183 is concerned. Despite the invitation, this court will simply not interfere with another court's deliberative process. The record reveals, and we accept as true, that the underlying report adopted by the Tax Court is Special Trial Judge Couvillion's. Petitioners-Appellants have not demonstrated that the Order of August 30, 2000 is inaccurate or suspect in any manner. Therefore, we conclude that the application of Rule 183 in this case did not violate Petitioners-Appellants' due process rights. Accordingly, we deny the request for relief and save for another day the more troubling question of what would have occurred had Special Trial Judge Couvillion not indicated that the report adopted by the Tax Court accurately reflected his findings and opinion.

(1) Cert. granted. A writ of certiorari was granted on 4/26/04, 72 U.S.L.W. 3672, 124 S. Ct. 2066, and the case was consolidated with Estate of Kanter.

c. And the Tax Court's procedures are vindicated and taxpayer Kanter's Estate19 loses on appeal on the fraud issue in the Eleventh Circuit Estate of Kanter v. Commissioner, 337 F.3d 833, 2003 U.S.T.C. ¶50,605, 92 A.F.T.R.2d 2003-5459 (7th Cir. 7/24/03) (per curiam) (2-1), affg in part and rev'g in part T.C. Memo. 1999-407. The court finds the nondisclosure of the special trial judge's original report to be proper, following the Eleventh Circuit's Ballard opinion. It affirms the findings on deficiencies, fraud and penalties, but reverses on the issue of the deductibility of Kanter's expenses for his involvement in the aborted sale of a purported John Trumball painting of George Washington because "Kanter has shown a distinct proclivity to seek income and profit through activities similar to the failed sale of the painting."

(1) The Supremes will sing over Kanter's grave. A writ of certiorari was granted on 4/26/04, 72 U.S.L.W. 3672, 124 S. Ct. 2066, and the case was consolidated with Ballard.

d. And the Tax Court's procedures are vindicated but taxpayer Lisle's Estate wins on appeal on the fraud issue in the Fifth Circuit. Estate of Lisle v. Commissioner, 341 F.3d 364, 2003 U.S.T.C. ¶50,606, 92 A.F.T.R.2d 2003-5566 (5th Cir. 7/30/03), affg in part and rev'g in part T.C. Memo. 1999-407. The Fifth Circuit (Judge Higginbotham) followed the Eleventh and Seventh Circuits on the nondisclosure of the special trial judge's original report by the Tax Court. It affirms the findings of deficiencies, except for the

deficiency in a closed year because the government’s proof of Lisle’s fraud did not rise to the level of “clear and convincing evidence.”

2. When does a taxpayer become subject to the “duty of consistency” rule? Banks v. Commissioner, 345 F.3d 373, 92 A.F.T.R.2d 2003-6298 (6th Cir. 9/30/03), rev’d T.C. Memo. 2001-48. The Sixth Circuit held that the duty of consistency rule does not apply when the taxpayer merely makes a mistake of law that the Commissioner does not challenge (a “mutual mistake of law”), rather than an affirmative misrepresentation; in such a case the taxpayer subsequently may claim the deduction in the proper year, even though the year of the erroneous deduction is closed. The taxpayer originally claimed an alimony deduction in 1993, when an amount escrowed with the state court was paid to his ex-wife; in a subsequent Tax Court proceeding with respect to 1990, the taxpayer claimed the deduction properly should have been allowed under § 461(f) in 1990 when the amount was paid over to the state court. The case was remanded for a finding on whether the taxpayer made a misrepresentation or there was merely a mutual mistake of law [and whether the payment actually was alimony].

3. Sometimes the Tax Court has jurisdiction to redetermine interest due on overpayments for years not covered by the deficiency notice. Sunoco, Inc. v. Commissioner, 122 T.C. No. 4 (2/14/04). Once the Tax Court’s jurisdiction has been properly invoked, it has jurisdiction under § 6512(b) to determine that there was an overpayment. This jurisdiction extends to overpayments of interest as well. Estate of Baumgardner v. Commissioner, 85 T.C. 445 (1985). Judge Whalen held that both underpayment and overpayment interest are calculated with respect to the cumulative balance of the taxpayer’s account with the IRS, the Tax Court’s jurisdiction also extends to determination that IRS had not properly credited taxpayer with overpayment interest attributable to other years.

4. Factor NOLs into your qualified settlement offer up front or forfeit the right to raise the issue. Johnson v. Commissioner, 112 T.C. No. 6 (2/11/04). The taxpayer made a qualified settlement offer under § 7430(g) that was accepted by the IRS. Subsequently the taxpayer attempted to reduce the amount through carried-backs that were not in dispute at the time the offer was made. Judge Nims held that under Temp. Reg. § 301.7430-7T, the IRS’s acceptance of the qualified offer “fully resolved the issue” of the taxpayer’s liabilities for the years in question, and he was “not now allowed to add additional terms to the agreement by applying NOLs from other years to reduce the agreed-upon amounts,” where the offer did not expressly provide that the offered amount was subject to adjustment for net operating loss carrybacks. He noted that the final regulations provide that whether the qualified offer can be reduced by NOLs depends on contract principles, but that those regulations did not apply because the taxpayer’s offer was made before that date.

5. Eighth Circuit to Tax Court: “Who will you believe, us or your own lying eyes and ears?” Just how detailed a finding on the burden of proof issue does the Eighth Circuit want the Tax Court to make? Griffin v. Commissioner, 315 F.3d 1017, 2003-1 U.S.T.C. §50,186, 91 A.F.T.R.2d 2003-486 (8th Cir. 1/14/03), rev’g T.C. Memo. 2002-6 (1/8/02), on remand, T.C. Memo. 2004-64 (3/11/04). Reversing the Tax Court, the Eighth Circuit, in a per curiam opinion, held that the taxpayer had introduced credible evidence that payments of real estate taxes on property owned by an S corporation in which he was a shareholder were made in his capacity as a proprietor of a business, not in his capacity as a shareholder. (If the payments had been made in his capacity as a proprietor they could have been deductible.) The court accepted the Commissioner’s definition of “credible evidence”: “the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness)”, and found this standard satisfied by the testimony of the taxpayer and his accountant. The Commissioner had cross examined the taxpayer’s witnesses, but had not introduced any evidence. The case was remanded to the Tax Court for further proceedings to determine if the Commissioner met the burden of proof, even though the Tax Court opinion, in a footnote, stated that its decision would have been the same if the Commissioner had borne the burden of proof. Perhaps tipping its hand that it wanted the taxpayer to win, the Court of Appeals admonished the Tax Court that “[i]f the same conclusion is reached by the tax court without a new hearing, an explanation is warranted as to how the existing record justifies the conclusion that the Commissioner has met his burden of proof.”

According to the Tax Court, the taxpayers did “not contend that the real property taxes in question were imposed upon them, that they owned the real property
against which the taxes were assessed, or that they owned any equitable or beneficial interest in the real property that might entitle them to a deduction under section 164. ... The only evidence regarding the nature of [taxpayers'] business activities consists of [one taxpayer's] summary and uncorroborated testimony. He testified, with little elaboration, that he has been a building contractor and land developer for about 30 years, during which time he has developed about one project a year. On cross-examination, he testified that his construction and real-estate development businesses are not separate businesses, but are all tied together. They're all any business I have is if I - if they are - oftentimes I incorporate, because of the liability aspect. They are Subchapter S if they are.' ... [T]here is no credible evidence that the tax payments were made with respect to such activities. To the contrary, [taxpayer's] accountant testified that the tax payments were reported on Schedule E because they were attributable to [his] S corporations. ... [Taxpayers] failed to introduce credible evidence to establish that [taxpayer's] failure to make the tax payments would have caused direct and proximate adverse consequences to any businesses conducted in [taxpayers'] individual capacities. [One taxpayer] testified that he made the tax payments 'in order to preserve my integrity and my standing with the bank, and my good name, my goodwill.' There is no evidence to indicate, however, to what extent [the taxpayer's] failure to make the tax payments would have resulted in any damage to his reputation or creditworthiness. [Taxpayers] have introduced no credible evidence to show that petitioner made the tax payments to protect the reputation of any business operation conducted in [their] individual capacities. On the basis of [taxpayer's] testimony, we are unable to conclude that the tax payments would have represented ordinary expenses to advance any business carried on in [taxpayers'] individual capacities, as opposed to capital outlays to establish or purchase goodwill or business standing....'

a. Tax Court responds, "If you tell us to believe taxpayer's rooster-and-gentleman-cow story, we will be forced to." Section 7491 has real teeth, and the burden of proof is shifted. On remand, T.C. Memo. 2004-64 (3/11/04). Neither party accepted the Tax Court's offer to introduce further evidence, but both parties submitted briefs on the issue of the burden of proof. Judge Thornton found himself bound by the Eighth Circuit's holding that taxpayer had produced sufficient "credible evidence" to shift the burden of proof to the government, even though he found to the contrary in his initial decision. Moreover, he felt himself bound to change his earlier conclusion that, had the burden of proof been shifted to the government, it had satisfied that burden. Footnote 7 states

In our original opinion, we noted: "Even if the burden of proof were placed on respondent, we would decide the issue [as to the deductibility of the tax payments] in his favor based on the preponderance of the evidence." T.C. Memo. 2002-6 n. 4. This statement reflected this Court's conclusion that Mr. Griffin's testimony was not only insufficient to support petitioners' claim to ordinary and necessary business deductions but indeed undermined their claim, insofar as Mr. Griffin's testimony convinced us that his relevant business activities were conducted entirely through S corporations. In light of the Court of Appeals' conclusion that Mr. Griffin's testimony was sufficient to support the claimed deductions, the preponderance of the evidence, thus evaluated, is no longer in respondent's favor.

• Query whether the caveat in footnote 6 is sufficient to prevent game-playing taxpayers from taking advantage of § 7491?

... We do not construe the opinion of the Court of Appeals as standing for the proposition that, in assessing the credibility of evidence for purposes of deciding the placement of the burden of proof pursuant to see. 7491(a)(1), the trial court is required to accept at face value self-serving testimony which it finds unworthy of belief. See, e.g., Day v. Commissioner, 975 F.2d 534, 538 (8th Cir. 1992) (stating that "The Tax Court is not required to give credence to the self-serving testimony of interested parties."), affg. in part, revg. in part and remanding T.C. Memo. 1991-140. As stated in the relevant legislative history of see. 7491: "The introduction of evidence will not meet this standard [of credible evidence] if the court is not convinced that it is worthy of belief." H. Conf. Rept. 105-599, at 241(1998), 1998-3 C.B. 747, 995; cf. Kincade v. Mikles, 144 F.2d 784, 787 (8th
As to the contention that the evidence is unworthy of belief, it need only be said that it was the function of the trial court to pass upon the credibility of the witnesses and the weight to be given their testimony.

6. An example of post-divorce cooperation between former spouses. Threat to ex-husband that she would write the IRS and get them to audit his returns results in IRS employee losing her job for committing a "deadly sin." James v. Tablerion, 363 F.3d 1352, 93 A.F.T.R.2d 1814 (Fed. Cir. 4/13/04). The Federal Circuit (Judge Clevinger) reverses an arbitrator's decision ordering restatement of a Revenue Agent in Tempe after she was dismissed by the Commissioner pursuant to the provisions of §1203 of The IRS Reform and Restructuring Act of 1998 for "threatening to audit a taxpayer for the purpose of extracting personal gain or benefit." Mrs. Tablerion told her ex-husband that if he did not sign Forms 8332 relinquishing his claim for a tax exemption for one of their two children (after she had signed such forms with respect to their other child), saying "If you don't... I will write the IRS and, and, uh inform them to audit your returns." Her ex-husband eventually (but not immediately) reported the statement to the Treasury Inspector General for Tax Administration (TIGTA).

7. The roaster got roasted, but just once. Siddiqui v. United States, 359 F.3d 1200, 93 A.F.T.R.2d 2004-1305, 2004-1 U.S.T.C. ¶50,193 (9th Cir. 3/9/04). An IRS special agent made a negligent disclosure of a criminal investigation of the taxpayer at a retirement dinner that included numerous guests, many of whom were not IRS CID personnel. In the absence of proof of any actual damages, the taxpayer was awarded the $1,000 minimum damages award under §7431. The court of appeals (Judge Alarcon) held that the $1,000 minimum is based on each separate event of unauthorized disclosure, not how many people heard the unauthorized disclosure. Furthermore, punitive damages were denied because the statutory language precludes an award of punitive damages in absence of actual damages.

8. To the IRS, he was never a window. Payne v. United States, 2004-2 U.S.T.C. ¶ 50, (5th Cir. 9/8/04) (unpublished per curiam opinion), aff'g 290 F. Supp. 2d 742 (S.D. Tex. 2003). Affirms district court denial of damages for alleged unlawful disclosure of confidential tax return information during an IRS criminal investigation because the disclosures resulted from the IRS agent's good faith, but erroneous, interpretation of the Internal Revenue Code.

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

10. Section 842 of the Jobs Act of 2004 adds new § 6603 to codify the treatment of deposits made to suspend the running of interest on potential underpayments. These deposits were formerly governed by Rev. Proc. 94-58, 1984-2 C.B. 501.

11. Section 881 of the Jobs Act of 2004 adds new §§ 6306 and 7433A to permit "qualified tax collection contracts" to be entered into with persons who are not IRS employees, and to provide damages for certain unauthorized collection actions by such persons.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes
B. Self-employment
C. Excise Taxes

A.F.T.R.2d 2004-463 (11th Cir. 1/20/04). Horton purchased vehicles, known as "toters," to transport manufactured homes. The IRS asserted the 12-percent excise tax levied in § 4051 because it contended that the toters were "[t]ractors of the kind chiefly used ... in combination with a trailer or semitrailer." The statute had not changed since 1938, but in 1983, temporary regulations that expanded the definition of "tractor" to include "a highway vehicle primarily designed to tow a vehicle, such as a trailer or semitrailer," and further provided that a vehicle" equipped with air brakes and/or towing package will be presumed to be primarily designed as a tractor." The court held that the regulation could not change the clear statutory language, and decided for Horton.

a. Rev. Rul. 2004-80, 2004-32 I.R.B. 164 (7/28/04). A chassis cab with a gross vehicle weight rating of 23,000 and a gross combination weight rating of 43,000 pounds [when it is towing a 20,000 pound trailer], with hydraulic disc brakes with a four-wheel automatic braking system, a 300 horsepower engine, and a six-speed automatic transmission [as well as a removable ball gooseneck hitch, a fifth wheel hitch, and a heavy duty trailer receiver hitch – all of which maximize towing capacity at the expense of carrying capacity. Held that pursuant to the 1983 temporary regulations referred to in Horton Homes, the vehicle is a tractor for purposes of § 4051.

2. TAM 200425048 (2/17/04). This TAM concludes that monthly management fees and variable rate fees paid to an aircraft management company by aircraft owners participating in a joint ownership program are subject to the § 4261 excise tax on amount paid for taxable transportation. This arrangement is comparable to payments under a "wet lease" that are subject to tax as payments for air transportation, as opposed to payments under a "dry lease" that are treated as rental payments.

XII. TAX LEGISLATION

A. Enacted

1. The Military Family Tax Relief Act of 2003, Pub. L. 108-121, was signed by President Bush on 11/10/03.


3. The Pension Funding Equity Act of 2004, P.L. 108-218, was signed by President Bush on 4/10/04.


5. Fire your lobbyist if you didn’t get relief in this act. The American Jobs Creation Act of 2004 ("Jobs Act of 2004") H.R. 4520, was signed by President Bush on 10/22/04.

- Title I of the Act repeals the extraterritorial income regime and substitutes a 9-percent deduction for income attributable to U.S. production activities.
- Title II extends the increase in § 179 expensing for two more years, improve depreciation deductions, relax several Subchapter S requirements, expand the AMT exemption for small corporations, and exclude ISOs and ESOPP stock from wages.
- Title III relates to agriculture (including timber) and provides relief for small manufacturers.
- Title IV relates to foreign businesses and foreign income of U.S. businesses, and would provide for a 5.25 percent tax rate on foreign earnings repatriated in 2004 or 2005.
- Title V permits deduction of state and local general sales taxes as an alternative to deducting state income taxes.
- Title VI relates to tobacco road.
- Title VII contains other provisions including exclusion from UBTI of gain or loss from sale or exchange of brownfield sites, and provides relief from the AMT Trap for recoveries in civil rights-type cases.
- Title VIII contains revenue provisions, including those related to tax shelters and deferred compensation. Also included are provisions to permit private sector debt collection companies to collect tax debts, to modify charitable contribution rules for donations of patents and other intellectual property, to require increased reporting for noncash
charitable contributions, to limit deduction of charitable contributions of vehicles and to modify the deduction for personal use of company aircraft and other entertainment expenses.