Recent Developments Affecting Real Estate and Pass-Through Entities

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RECENT DEVELOPMENTS AFFECTING REAL ESTATE AND PASS-THROUGH ENTITIES

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I. LEGISLATION AND PROPOSED LEGISLATION


1. Growth Incentives for Business.

   (a) Increased Sec. 179, I.R.C. Expensing

      (1) Prior to the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA" or the "Act") on May 28, 2003, a taxpayer could elect to deduct up to $25,000 of the cost of tangible business property placed in service during the taxable year. This amount, however, was phased out for each dollar of qualifying property placed in service during the taxable year in excess of $200,000.

      (2) JGTRRA expanded considerably the tax savings available under this provision. Specifically, JGTRRA increases the amount of the maximum deduction to $100,000 and doubles the phase-out threshold to $400,000. The Act also expanded the categories of property qualifying for this election to include off-the-shelf computer software used in a trade or business. These changes are effective retroactive for tax years beginning after December 31, 2002 and will remain in effect through 2005.

   (b) Expanded First-Year Bonus Depreciation

      (1) As discussed more fully below, the Job Creation and Worker Assistance Act of 2002 introduced the concept of first-year bonus depreciation, which allowed taxpayers to deduct 30% of the adjusted basis of certain qualified property in the year the asset is placed in service in addition to the depreciation recognized under MACRS.

      (2) For property acquired after May 5, 2003 and placed in service before January 1, 2005, JGTRRA expanded the first-year bonus depreciation amount to 50% of the adjusted basis of qualified property. The placed-in-service deadline for property with a recovery period of at least 10 years is January 1, 2006. The 50% bonus depreciation is available for tax years closing after May 5, 2003.

2. Equalization of Tax Rates on Capital Gains and Dividends.

   (a) For taxable sales or exchanges on or after May 6, 2003 and before January 1, 2009, JGTRRA reduced the 10% and 20% rates on long-term capital gains to 5% (0% in 2008) and 15%, respectively. The 25% maximum rate for long-term capital gains from real estate assets, however, continues to apply to the extent of unrecaptured depreciation.

   (b) Under JGTRRA, qualified dividend income received after December 31, 2002 and before January 1, 2009 is taxed at the same rates applicable to capital gains. Thus, the maximum rate for qualified dividends is now 15%. Although dividends from most domestic corporations and qualified foreign corporations are eligible for the reduced rate, dividends from REITs do not qualify for the reduced rate, unless attributable to REIT taxable income (such as distributions from taxable REIT subsidiaries).
B. Job Creation and Worker Assistance Act of 2002.

1. Bonus Depreciation for Qualified Business Capital Investments.

(a) The Job Creation and Worker Assistance Act of 2002 added Sec. 168(k), I.R.C. to allow an additional first-year depreciation deduction equal to 30% of the adjusted basis of qualified property. The deduction is allowed for both regular and alternative minimum tax purposes for the taxable year in which the property is placed in service.

(b) The property eligible for the deduction must qualify as MACRS property that (1) has an applicable recovery period of 20 years or less, (2) is water utility property, (3) is computer software as defined in Sec. 167(f)(1)(B), I.R.C., or (4) is qualified leasehold improvement property.

(c) The taxpayer's original use of the property must commence after September 10, 2001. The taxpayer must acquire the property after September 10, 2001 and before September 11, 2004. The property must be placed in service before January 1, 2005 or for certain property with longer production periods, before January 1, 2006.

(d) Qualified leasehold improvement property is defined as any improvement to an interior portion of a building which is nonresidential real property made under a lease by either the lessee or lessor. The portion of the property must be occupied exclusively by the lessee and the improvement must be placed in service more than three years after the date the building was first placed in service. Certain improvements, such as an enlargement of the building, escalator or elevator, are not eligible.

(e) Note that a reciprocal provision is added under new Sec. 1400L(b), I.R.C. which allows a depreciation deduction equal to 30% of the adjusted basis for qualified New York Liberty Zone property. However, qualified property for purposes of Sec. 168, I.R.C. does not include qualified New York Liberty Zone leasehold improvement property as defined in Sec. 1400L(c)(2), I.R.C. Pub L No. 107-147, approved March 9, 2002.

2. Treatment of Qualified Leasehold Improvement Property. Under present law, depreciation allowances for leasehold improvements are determined under MACRS. For leasehold improvements to nonresidential real property already placed in service, the improvement is depreciated on the straight-line method over 39 years. Sec. 1400L(c), I.R.C. was added to provide that five-year property for purposes of depreciation under Sec. 168, I.R.C. includes qualified New York Liberty Zone leasehold improvement property. Qualified New York Liberty Zone leasehold improvement property is defined as an improvement placed in service after September 10, 2001 and before January 1, 2007 in the New York Liberty Zone. The applicable depreciation method for this type of property is the straight-line method and a nine-year recovery period under the alternative depreciation system of Sec. 168(g), I.R.C. will apply. Pub L No. 107-147, approved March 9, 2002.

3. Five-Year Carryback of Net Operating Losses. Under present law, a net operating loss (NOL) may be carried back two years and carried forward 20 years, generally resulting in a tax refund or a reduction of tax, respectively. There are special rules that may apply under certain circumstances, e.g., a three-year carryback is allowed for NOLs from
casualty or theft losses of individuals and no carryback is allowed for REITs. Additionally, an 
NOL carryback cannot reduce a taxpayer's alternative minimum taxable income (AMTI) by more 
than 90%. The amendments to Secs. 172 and 56, I.R.C. extend the general NOL carryback to 
five years for NOLs arising in taxable years ending in 2001 and 2002. The carryback extension 
under the amendment also applies to the extent that present law allows a three-year carryback, 
i.e., for NOLs arising from theft or casualty losses of individuals or attributable to specified 
Presidentially declared disaster areas. The amended provisions allow a taxpayer to make an 
irrevocable election to forgo the five-year carryback period. The amendment to Sec. 56, I.R.C. 
temporarily suspends the 90% limitation on NOL carryovers as applied to a taxpayer's AMTI. In 
effect, Sec. 56, I.R.C., as amended, allows an offset against 100% of a taxpayer's AMTI for an 
NOL deduction attributable to NOL carrybacks from taxable years ending in 2001 and 2002, and 
NOL carryforwards to these years. Pub L No. 107-147, approved March 9, 2002.

4. Excluded COD Income of S Corporation. The Job Creation and Worker 
Assistance Act of 2002 amends Sec. 108(d)(7)(A), I.R.C. so that cancellation of indebtedness 
income which is excluded from the gross income of an S corporation shareholder shall not result 
in an adjustment to the stock basis of such shareholder. The amendment effectively precludes 
the result that the United States Supreme Court reached in Gitlitz v. Comm'r, 531 U.S. 206 
(2001), rev'd 182 F.3d 1143 (10th Cir. 1999). The amended provision is effective for discharges 
of indebtedness which occur in taxable years ending after October 11, 2001. However, Sec. 
108(d)(7)(A), I.R.C., as amended, does not apply to any discharge of indebtedness before March 
1, 2002, which occurs pursuant to a plan of reorganization filed with a bankruptcy court on or 

5. Extension of Replacement Period for Certain Property Involuntarily 
Converted. Under present law, the replacement period for involuntarily converted property 
begins with the date of disposition and ends two years after the close of the first taxable year in 
which any part of the gain on conversion is realized. For real property held for the productive 
use in a trade or business or for investment, the replacement period is extended to three years. 
Additionally, the replacement period is four years for a principal residence converted in a 
Presidentially declared disaster. The new provision under Sec. 1400L(g), I.R.C. extends the 
replacement period to five years for a taxpayer to purchase replacement property for property 
that was involuntarily converted in the New York Liberty Zone as a result of the terrorist attacks 
on September 11, 2001. Substantially all of the use of the replacement property must be located 


Senator Kyl (R-Ariz.) and Congressman McInnis (R-Colo.) have introduced legislation in 
their respective houses of Congress (S. 169 and H.R. 139, respectively) permanently repealing 
the estate and generation-skipping transfer taxes. These bills were introduced shortly after the 

D. Additional Administration Proposals for Fiscal Year 2004

In February 2003, the Treasury Department issued its General Explanation of the 
Administration’s Fiscal Year 2004 Revenue Proposals. These include the following:
1. Modify tax on unrelated business taxable income of charitable remainder trusts
2. Provide tax credit for developers of affordable single-family housing
3. Permanently extend expensing of brownfields remediation costs
4. Exclude 50% of gains from the sale of property for conversion purposes
5. Combat abusive tax avoidance transactions
6. Limit related party interest deductions
7. Permanently extend provisions expiring in 2010
8. Temporarily extend the following expiring provisions
   (a) Extend alternative minimum tax relief for individuals
   (b) Extend the District of Columbia Enterprise Zone
   (c) Extend the waiver of the alternative minimum tax limitation on NOL use.

II. PROPOSED, TEMPORARY AND FINAL REGULATIONS

A. Sec. 61, I.R.C. (Inclusion in Gross Income of Advance Rentals).
   1. Overview – On December 18, 2002, the Service issued Proposed Regulations relating to the inclusion in gross income of advance rentals. The Proposed Regulations authorize the Commissioner to provide, through administrative guidance, rules for deferring income inclusion of advance rentals to a taxable year other than the year of receipt. Prop. Reg. § 1.61-8(b).

   2. Licenses of Intellectual Property – The proposed amendment will ensure that the IRS, in modifying Rev. Proc. 71-21, 1971-2 C.B. 549, may provide deferral unless for licenses of intellectual property.

   3. Effective Date – The Proposed Regulations are effective on the date of publication of a Treasury decision adopting these rules as final regulations.

B. Sec. 121(a), I.R.C. (Exclusion of Gain from Sale or Exchange of a Principal Residence).

   1. Overview – On December 23, 2002, the Service issued Final Regulations providing general guidance relating to the exclusion of gain from the sale or exchange of a taxpayer’s principal residence. As discussed more fully below, the Service also issued Temporary Regulations addressing grounds for a reduced maximum exclusion.
2. Exclusion of Gain from Sale or Exchange of a Principal Residence

   (a) Principal Residence (Reg. §1.121-1(b)) – The Final Regulations continue to provide that the residence that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer’s principal residence. In addition, the Final Regulations include a nonexclusive list of factors that are relevant in identifying a property as a taxpayer’s principal residence. The Final Regulations also note that the sale or exchange of vacant land is not a sale or exchange of the taxpayer’s principal residence unless the following elements are met: (1) the vacant land is adjacent to the land containing the dwelling unit of the taxpayer’s principal residence; (2) the taxpayer owned and used the vacant land as part of the taxpayer’s principal residence; and (3) the taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of Sec. 121, I.R.C. within 2 years before or 2 years after the date of the sale or exchange of the vacant land.

   (b) Ownership and Use Requirements (Reg. §1.121-1(c)) – The Final Regulations require actual occupancy of the residence to satisfy the 2-year use test. Short, temporary absences, such as for vacation or other seasonal absences (even though accompanied with rental of the residence), are permitted. If a residence is owned by a trust, then, for the period that a taxpayer is treated as the owner of the trust, under the grantor trust rules, or of the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement. This rule also applies to single owner entities (such as single member LLCs) described in Sec. 7701, I.R.C.

   (c) Property Used in Part as a Principal Residence (Reg. §1.121-1(e)) – The Final Regulations provide that Sec. 121, I.R.C. will not apply to the gain allocable to any portion of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement if the non-residential portion is separate from the dwelling unit. No allocation of gain is required if both the residential and non-residential portions of the property are within the same dwelling unit. In addition, Sec. 121, I.R.C. will not apply to the gain to the extent of any post-May 6, 1997 depreciation deductions. For purposes of determining the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate the basis and the amount realized between the residential and the non-residential portions of the property using the same method of allocation that the taxpayer used to determine depreciation adjustments, if applicable.

3. Dollar Limitations of Exclusion (Reg. §1.121-2) – The Final Regulations provide that each unmarried taxpayer who jointly owns a principal residence may be eligible to exclude from gross income up to $250,000 of gain that is attributable to such taxpayer’s interest in the property.

4. Reduced Maximum Exclusion for Taxpayers Failing to Meet Certain Requirements (Regs. §§1.121-3(a), (g)) – Although the Proposed Regulations (see below) address many substantive issues regarding the treatment of taxpayers who fail to meet the ownership and use requirements, the Final Regulations provide the reduced maximum exclusion is calculated by multiplying the maximum dollar limitation of $250,000 ($500,000 for joint filers) by the period of time that the taxpayer owned and used the property over two years.
5. **Special Rules (Reg. §1.121-4)**

(a) **Property of Deceased Spouse** – A taxpayer is treated as owning and using property as the taxpayer’s principal residence during any period that the taxpayer’s deceased spouse owned and used the property as a principal residence before death if the taxpayer’s spouse is deceased on the date of the sale or exchange of the property and the taxpayer has not remarried at the time of the sale or exchange.

(b) **Property Owned by Spouse or Former Spouse** – A taxpayer is treated as using property as the taxpayer’s principal residence for any period that the taxpayer has an ownership interest in the property and the taxpayer’s spouse or former spouse is granted use of the property under a divorce or separation instrument, provided that the spouse or former spouse uses the property as his or her principal residence.

(c) **Sales or Exchanges of Partial Interests** – A taxpayer may apply the Sec. 121, I.R.C. exclusion to gain from the sale or exchange of an interest in the taxpayer’s principal residence that is less than the taxpayer’s entire interest if the interest sold or exchanged includes an interest in the dwelling unit. All sales of partial interests in the same residence are treated as one sale.

6. **Election to Apply Regulations Retroactively** – Taxpayers who would otherwise qualify under Regs. §§1.121-1 through 1.121-4 to exclude gain from a sale or exchange of a principal residence before December 24, 2002 but on or after May 7, 1997 may elect to apply the Final Regulations for any years for which the period of limitation has not expired. Taxpayers may file an amended return to elect retroactive treatment.

7. **Effective Date** – The Final Regulations apply to sales and exchanges on or after December 24, 2002.

C. **Sec. 121(c), I.R.C. (Reduced Maximum Exclusion of Gain from Sale or Exchange of Principal Residence).**

1. **Overview** – On December 23, 2002, the Service issued Temporary Regulations providing a reduced maximum exclusion limitation for a taxpayer who has sold or exchanged property owned and used as his principal residence for less than two of the preceding five years or who has excluded gain on the sale or exchange of a principal residence before December 24, 2002 but on or after May 7, 1997 may elect to apply the Final Regulations for any years for which the period of limitation has not expired. Temp. Reg. §1.121-3T(b).

2. **Change in Place of Employment** – The Temporary Regulations provide that a sale or exchange is by reason of a change in place of employment if the taxpayer’s primary reason for the sale or exchange is a change in the location of the employment of a qualified individual (taxpayer, taxpayer’s spouse, co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer). Temp. Reg. §1.121-3T(c)(1).

(a) The Temporary Regulations adopt a safe harbor providing that the primary reason for the sale or exchange is deemed to be a change in the place of employment if
the new place of employment of a qualified individual is at least 50 miles farther from the residence sold or exchanged than was the former place of employment. Temp. Reg. §1.121-3T(c)(2).

(b) To qualify for the safe harbor, the change in place of employment must occur during the period of the taxpayer’s ownership and use of the property as his or her principal residence. A facts and circumstances test applies for taxpayers that do not satisfy the safe harbor.

3. **Sale or Exchange by Reason of Health** – The Temporary Regulations provide that a sale or exchange is by reason of health if the taxpayer’s primary reason for the sale or exchange is (1) to obtain, provide or facilitate the diagnosis, cure, mitigation or treatment of disease, illness or injury of a qualified individual; or (2) to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness or injury.

(a) A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health. Temp. Reg. §1.121-3T(d)(1).

(b) The definition of qualified person for purposes of this provision is broader than the definition that applies to the exclusions by reason of change in the place of employment and unforeseen circumstances to encompass taxpayers who sell or exchange their residence in order to care for sick family members. Temp. Reg. §1.121-3T(f)(5).

(c) The primary reason for the sale or exchange is deemed to be health if a physician (as defined in Sec. 213(d)(4), I.R.C.) recommends a change of residence for reasons of health. Temp. Reg. §1.121-3T(d)(2).

4. **Sale or Exchange by Reason of Unforeseen Circumstances** – The Temporary Regulations provide that a sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence. Temp. Reg. §1.121-3T(e)(1).

(a) The safe harbor events include the involuntary conversion of the residence, natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence.

(b) The safe harbor events also include, in the case of the qualified individual: (1) death; (2) the cessation of employment as a result of which the individual is eligible for unemployment compensation; (3) a change in employment or self-employment status that results in the taxpayer’s inability to pay housing costs and reasonable basic living expenses for the taxpayer’s household; (4) divorce or legal separation under divorce decree or separate maintenance; and (5) multiple births resulting from the same pregnancy. Temp. Reg. §1.121-3T(e)(2).

5. **Election to Apply Regulations Retroactively** – Taxpayers who would otherwise qualify under the Temporary Regulations to exclude gain from a sale or exchange that occurred before the effective date of the Regulations but on or after May 7, 1997 may elect to
apply all of the provisions of the Temporary Regulations to the sale or exchange. Taxpayers who have filed a tax return for the taxable year of the sale or exchange may elect to apply all of the provisions of these Temporary Regulations for any tax years for which the period of limitations has not expired by filing an amended return. Temp. Reg. §1.121-3T(h).

6. Effective Date – The Temporary Regulations apply to sales and exchanges on or after December 24, 2002.

D. Sec. 263(a), I.R.C. (Capitalization of Costs Incurred in Acquiring, Creating or Enhancing Intangible Assets).

1. Overview – On December 18, 2002, the Service issued Proposed Regulations under Sec. 263(a), I.R.C., on the capitalization of amounts paid to acquire, create or enhance intangible assets. The Proposed Regulations also identify specific intangible assets for which capitalization is required under this general principle of capitalization. The Proposed Regulations distinguish between intangibles acquired from another party and those created by the taxpayer. In addition, the Proposed Regulations provide rules for determining the extent to which taxpayers must capitalize transaction costs that facilitate the acquisition, creation or enhancement of intangible assets or that facilitate certain restructurings, reorganizations and transactions involving the acquisition of capital. The Proposed Regulations are designed to reduce controversy between the government and taxpayers, provide certainty, and facilitate recordkeeping.

2. General Principle of Capitalization – The Proposed Regulations require capitalization of amounts paid to acquire, create, or enhance an intangible asset. Prop. Reg. § 1.263(a)-4(b)(1). The Proposed Regulations define the term “intangible asset” to mean (i) any intangible that is acquired from another person in a purchase or similar transaction; (ii) certain rights, privileges or benefits that are created or originated by the taxpayer and identified as such in the proposed regulations; (iii) a separate and distinct intangible asset; or (iv) a future benefit that the Service and Treasury Department identify in subsequent published guidance as an intangible asset for which capitalization is required. Prop. Reg. § 1.263(a)-4(b)(2).

3. Acquired Intangibles – The Proposed Regulations require capitalization of amounts paid to another party to acquire an intangible from that party in a purchase or similar transaction. Prop. Reg. § 1.263(a)-4(c). An illustrative list of acquired intangibles that must be capitalized under this rule is provided.

4. Created Intangibles – As a general rule, the Proposed Regulations require taxpayers to capitalize amounts paid to another party to create or enhance the following intangible assets listed in Prop. Reg. § 1.263(a)-4(d):

(a) financial interests
(b) prepaid expenses
(c) amounts paid for certain memberships and privileges
(d) amounts paid to obtain certain rights from a governmental agency
(e) amounts paid to obtain or modify certain contract rights
(f) amounts paid to terminate certain contracts
(g) amounts paid to acquire, produce or improve real property owned by another
(h) amounts paid to defend or perfect title to intangible property

To reduce the administrative and compliance costs associated with capitalizing these amounts, the Proposed Regulations adopt a “12-month rule” applicable to most created intangibles. Prop. Reg. § 1.263(a)-4(f). Under the 12-month rule, a taxpayer is not required to capitalize amounts that provide benefits of a relatively brief duration. The 12-month rule does not apply to amounts paid to create or enhance financial interests or to amounts paid to create or enhance self-created intangibles that may be amortized under Section 197.

5. Transaction Costs – The Proposed Regulations provide a two-pronged rule that requires taxpayers to capitalize transaction costs that are not de minimis (i.e., $5,000 or less). Prop. Reg. § 1.263(a)-4(e). The first prong of the rule requires capitalization of transaction costs that facilitate the taxpayer’s acquisition, creation or enhancement of an intangible asset. The second prong of the rule requires capitalization of transaction costs that facilitate the taxpayer’s restructuring or reorganization of a business entity or facilitate a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization. The Proposed Regulations provide that an amount facilitates a transaction if it is incurred in the process of pursuing the acquisition, creation or enhancement of an intangible asset or in the process of pursuing a restructuring, reorganization or transaction involving the acquisition of capital. Prop. Reg. § 1.263(a)-4(e)(1)(i).

6. Safe Harbor Amortization – The Proposed Regulations amend Reg. § 1.167(a)-3 to provide a 15-year safe harbor amortization period for certain created or enhanced intangibles that do not have readily ascertainable useful lives. The safe harbor does not apply to intangibles acquired from another party or to created financial interests.

7. Effective Date – These regulations are proposed to be applicable on the date on which the Final Regulations are published in the Federal Register.

E. Sec. 337(d), I.R.C. (Property Transfers to REITs and RICs)

1. Overview – On March 13, 2003, the Service issued Final Regulations under Sec. 337(d), I.R.C. These Regulations withdrew the prior Proposed and Temporary Regulations issued in January 2002. The new Regulations apply to transactions in which a REIT or a RIC owns property that has a basis determined by reference to a C corporation's basis in the property.

2. Effective Date – The Regulations under Reg. §1.337(d)-6 apply to conversion transactions that occur on or after June 10, 1987 (i.e., the effective date of General Utilities repeal) and before January 2, 2002. Taxpayers generally may elect to apply Reg. §1.337(d)-5 for transactions occurring on or after June 10, 1987 and before January 2, 2002,
except to the extent they are subject to Sec. 1374, I.R.C. for built-in gains and losses recognized in taxable years beginning on or after January 2, 2002. The Regulations under Reg. §1.337(d)-7 apply to transactions that occur on or after January 2, 2002.

3. **Transitional Rules** – Reg. §1.337(d)-6 sets forth transitional rules imposing tax on property owned by a C corporation that becomes property of a RIC or REIT. If property owned by a C corporation becomes the property of a RIC or REIT in a conversion transaction, then deemed sale treatment will apply unless the RIC or REIT elects to have Sec. 1374, I.R.C. treatment apply. Reg. §1.337(d)-6(a)(1).

   (a) **Net Gain or Loss on Deemed Sale** – If the C corporation recognizes net gain on the deemed sale, then the basis of the converted property in the hands of the RIC or REIT is adjusted to its fair market value immediately before the transaction. Reg. §1.337(d)-6 does not permit a C corporation to recognize a net loss on the deemed sale. If a net loss results from the deemed sale, then the C corporation recognizes no gain or loss and the C corporation's basis in the converted property carries over to the RIC or REIT. Reg. §1.337(d)-6(b).

   (b) **No Deemed Liquidation** – Reg. §1.337-6 provides that the C corporation is treated as having sold only the property actually transferred to the RIC or REIT, and there is no tax imposed at the shareholder level. (The Regulations have eliminated the deemed liquidation requirement set forth in the Proposed Regulations.)

4. **Election of Section 1374 Treatment** – According to Reg. §1.337(d)-6, a RIC or REIT that converted from a C corporation or acquired property with a carryover basis from a C corporation can make a Section 1374 election with any Federal income tax return filed by the RIC or REIT on or before September 15, 2003, provided that the RIC or REIT has reported consistently with such election for all periods. A RIC or REIT must make a separate Section 1374 election for each conversion transaction. A RIC or REIT that makes such election will be subject to tax on the net built-in gain in the converted property under the rules of Section 1374 and the applicable regulations, as if the RIC or REIT were an S corporation. Net operating loss carryforwards, capital loss carryforwards, minimum tax credits and business credit carryforwards arising in taxable years prior to the conversion are allowed as a deduction against net recognized built-in gain to the extent allowed under Section 1374. Reg. §1.337(d)-6(c)(4).

   (a) **Ten-Year Recognition Period** – In a transaction in which a C corporation qualifies as a RIC or REIT, the 10-year built-in gain recognition period begins on the first day of the RIC's or REIT's taxable year. In other conversion transactions, the 10-year recognition period begins on the day the property is acquired by the RIC or REIT. Reg. §1.337(d)-6(c)(2)(iii).

   (b) **Coordination with Subchapter M** – The recognized built-in gains and losses of a RIC or REIT are included in the computation of investment company taxable income, REIT taxable income, capital gains, gross income derived from foreign sources or a U.S. possession, and the dividends paid deduction. Reg. §1.337(d)-6(c)(3).
(c) **Section 1374 Operational Rules** – The character of recognized built-in gains and losses is preserved. The recognized built-in gains and losses of RICs and REITs are treated like other gains and losses of RICs and REITs that are not subject to tax under these Regulations. Additionally, the Regulations clarify that the earnings and profits attributable to built-in gain recognized by a RIC or REIT are Subchapter M earnings and profits.

(d) **Exception for Re-Election of RIC or REIT Status** – The Regulations provide that the recognition of gain on a conversion transaction does not apply to a C corporation that qualified to be a RIC or REIT for at least one taxable year and then failed to qualify as a RIC or REIT (i.e., was subject to tax as a C corporation) for a period not in excess of two taxable years. Reg. §1.337(d)-6(d).

5. **Rules for 2002 and Forward** – Reg. §1.337(d)-7 applies to transfers on or after January 2, 2002 and is applicable to the tax on property owned by a C corporation that becomes property of a RIC or REIT. If property owned by a C corporation becomes the property of a RIC or REIT in a conversion transaction, then Sec. 1374, I.R.C. treatment will apply unless the C corporation elects deemed sale treatment. Reg. §1.337(d)-7 modifies the applicable treatment under Sec. 1374, I.R.C. There is a special computation of the amount of a REIT's recognized built-in gain that is subject to tax under Sec. 857(b)(5), I.R.C. The exception for re-election of RIC or REIT status is also available under Reg. §1.337(d)-7(d).

(a) **Anti-Stuffing Rule** – An anti-stuffing rule requires that a C corporation must disregard converted property in computing gain or loss recognized on the conversion transaction under certain circumstances. The rule applies if

1. the converted property was acquired by the C corporation in a transaction subject to Sec. 351, I.R.C. or as a contribution to capital;

2. the converted property had an adjusted basis immediately after its acquisition by the C corporation in excess of its fair market value on the date of acquisition; and

3. the acquisition of such converted property by the C corporation was part of a plan with a principal purpose to reduce gain recognized by the C corporation in connection with the conversion transactions.

The principles of Sec. 336(d)(2), I.R.C. apply to the anti-stuffing rule.

(b) **Look-Through Rule for Partnerships** – The principles of Sec. 337(d), I.R.C. apply to property transferred by a partnership to a RIC or a REIT to the extent of any C corporation partner's proportionate share of the transferred property. Reg. §1.337(d)-7(e). For example, if a C corporation owns a 20% interest in a partnership and that partnership contributes assets to a REIT in a Sec. 351, I.R.C. transaction, then the partnership shall be treated as a C corporation with respect to 20% of the assets contributed to the REIT. If the partnership elects deemed sale treatment with respect to such transfer, the gain recognized by the partnership on the deemed sale must be specially allocated to the C corporation partner.
F. Sec. 368(a)(1)(A), I.R.C. (Statutory Mergers and Disregarded Entities).

1. Effective Date - On January 23, 2003, the Service issued Final, Temporary and Proposed Regulations, which permit certain transactions involving disregarded entities to qualify as statutory mergers or consolidations under Sec. 368(a)(1)(A), I.R.C. Although the IRS withdrew the prior proposed regulations issued in 2001, the Temporary Regulations retain the general framework of those proposed regulations. The Temporary Regulations are effective January 24, 2003.

2. Definitions - For purposes of Sec. 368(a)(1)(A), I.R.C., a disregarded entity is defined as a business entity that is disregarded as an entity separate from its owner for Federal tax purposes. The types of disregarded entities are a domestic single member limited liability company that does not elect to be classified as a corporation, a corporation that is a qualified REIT subsidiary, and a corporation that is a qualified subchapter S subsidiary. Temp. Reg. §1.368-2T(b)(1)(i)(A).

   (a) Combining Entity - A combining entity is a business entity that is a corporation (as defined in Treas. Reg. §301.7701-2(b)) that is not a disregarded entity. Temp. Reg. §1.368-2T(b)(1)(i)(A).

   (b) Combining Unit - A combining unit is a combining entity and all disregarded entities, if any, the assets of which are treated as owned by the combining entity for Federal tax purposes. Temp. Reg. §1.368-2T(b)(1)(i)(C).

   (c) Statutory Merger or Consolidation - Temp. Reg. §1.368-2T(b)(1)(i)(C) provides that, for purposes of Sec. 368(a)(1)(A), I.R.C., a statutory merger or consolidation is defined as

   (1) a transaction effectuated pursuant to the laws of the United States or a State or the District of Columbia,

   (2) in which all of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharged in the transaction) of each member of one or more combining transferor units become the assets and liabilities of one or more members of one other combining transferee unit, and

   (3) the combining entity of each transferor unit ceases its separate legal existence for all purposes; provided, however, that this requirement will be satisfied even if, pursuant to the laws of the United States or a State or the District of Columbia, after the effective time of the transaction, the combining entity of the transferor unit (or its officers, directors, or agents) may act or be acted against, or a member of the transferee unit (or its officers, directors, or agents) may act or be acted against in the name of the combining entity of the transferor unit, provided that such actions relate to assets or obligations of the combining entity of the transferor unit that arose, or relate to activities engaged in by such entity, prior to the effective time of the transaction, and such actions are not inconsistent with the “all of the assets” test.
3. **Statutory Merger or Consolidation with Disregarded Entities** – A transaction involving a disregarded entity will qualify as a statutory merger or consolidation under Sec. 368(a)(1)(A), I.R.C., provided that

(a) the transaction is effectuated pursuant to the laws of the United States or a State or the District of Columbia;

(b) any of the assets and liabilities of a combining entity of a transferor unit become assets and liabilities of one or more disregarded entities of a transferee unit; and

(c) the combining entity, the combining entity of the transferee unit, such disregarded entities other than entities that were disregarded entities of the transferor unit immediately prior to the transaction, and each business entity through which the combining entity of the transferee unit holds its interests in the disregarded entities is organized under the laws of the United States or a State or the District of Columbia. Temp. Reg. §1.368-2T(b)(1)(iii).

Consequently, the merger of a target corporation into a disregarded entity may qualify as a statutory merger or consolidation for purposes of Sec. 368(a)(1)(A), I.R.C.

4. **Certain Mergers Involving Disregarded Entities Not Permitted** -- The Temporary Regulations provide several examples of certain transactions involving disregarded entities do not qualify as statutory mergers or consolidations under Sec. 368(a)(1)(A), I.R.C. One such example concludes that the Regulations do not permit the merger of a disregarded entity into a member of transferee unit, to the extent the owner of the disregarded entity does not also merge into a member of the transferee unit. This type of transaction does not qualify because the transferor unit's assets may be divided between the transferor and transferee units, and the separate legal existence of the combining entity of the transferor unit does not terminate as a matter of law. Although this transaction does not qualify under Sec. 368(a)(1)(A), I.R.C., it may qualify for nonrecognition treatment under other Code provisions.

G. **Sec. 469, I.R.C. (Treatment of Self-Charged Items of Income and Expenses)**

1. **Effective Date** – On August 21, 2002, the Service issued Final Regulations under Section 469, I.R.C., dealing with the treatment of self-charged items of income and expense. These rules, contained in Reg. § 1.469-7, apply for taxable years ending after December 31, 1986. However, for taxable years beginning before June 4, 1991, a taxpayer is not required to apply these rules, but may, instead, use any reasonable method to offset items of interest income and interest expense from lending transactions between a passthrough entity and its owners or between identically owned passthrough entities (as defined in Reg. § 1.469-7(e)). Regs. §§ 1.469-11(a)(4) and (c)(1)(iii).

2. **General Rules.**

(a) In the case of a lending transaction (including guaranteed payments for the use of capital under Section 707, I.R.C.) between a taxpayer and a passthrough entity in which the taxpayer owns a direct or indirect interest, a percentage of certain portfolio
income and expense is recharacterized as passive activity income and expense (or self-charged items). Reg. § 1.469-7(a).

(b) The same rule applies with respect to lending transactions between passthrough entities if each owner of the borrowing entity has the same proportionate ownership interest in the lending entity. Reg. § 1.469-7(e).

3. **Election Out.** Under Reg. § 1.469-7(g), a passthrough entity can elect not to have the self-charged rules apply to it.

**H. Secs. 704, 721 and 761, I.R.C. (Taxation of Noncompensatory Options and Convertible Instruments).**

1. **Overview:** On January 21, 2003, the Service issued Proposed Regulations relating to the tax treatment of noncompensatory options (e.g., options and warrants) and convertible instruments issued by a partnership. The Proposed Regulations generally provide that the exercise of a noncompensatory option does not cause the recognition of immediate income or loss by either the issuing partnership or the option holder. The Proposed Regulations also modify the Regulations under Sec. 704(b), I.R.C. regarding the maintenance of the partners' capital accounts and the determination of the partners' distributive shares of partnership items. In addition, the Proposed Regulations characterize the holder of a noncompensatory option as a partner under certain circumstances. The Service emphasized that the guidance offered in the Proposed Regulations is limited to noncompensatory options, and that nothing in the Proposed Regulations should be construed as creating any inference regarding the proper Federal income tax treatment of compensatory options.

2. **Issuance, Exercise and Lapse of Noncompensatory Options**

   (a) **Issuance:** Generally, the Proposed Regulations do not treat the issuance of a noncompensatory option as a transaction described in Sec. 721, I.R.C. Prop. Reg. §1.721-2(b). Thus, applying general tax principles, the issuance of a noncompensatory call option or warrant is generally an open transaction for the issuer, and, in turn, is an investment in the option for the option holder.

   (b) **Exercise:** The Proposed Regulations generally provide that Sec. 721, I.R.C. applies to the holder and the partnership upon the exercise of a noncompensatory option issued by the partnership. Prop. Reg. §1.721-2(a). The Proposed Regulations, however, do not address the tax consequences of a right to convert partnership debt into an interest in the issuing partnership to the extent of any accrued but unpaid interest on the debt.

   (c) **Lapse:** The Proposed Regulations clarify that Sec. 721 does not apply to the lapse of a noncompensatory option. Prop. Reg. §1.721-2(c).

3. **Capital Account Adjustments upon Exercise**

   (a) **Partnership Revaluation:** The Proposed Regulations require the partnership to revalue its property immediately following the exercise of the noncompensatory option. Prop. Reg. §1.704-1(b)(2)(iv)(s)(1). Any revaluations during the period in which there
are outstanding noncompensatory option must take into account the fair market value, if any, of the outstanding options. Prop. Reg. §1.704-1(b)(2)(iv)(f), (h).

(b) Allocate Unrealized Income, Gain, Loss and Deduction:
Following the revaluation of partnership property, the partnership must allocate the unrealized income, gain, loss, and deduction, first, to the noncompensatory option holder (to the extent necessary to reflect the holder’s right to share in partnership capital under the partnership agreement), and, then, to the historic partners, to reflect the manner in which the unrealized income, gain, loss, and deduction in partnership property would be allocated among these partners if there were a taxable disposition. Prop. Reg. §1.704-1(b)(2)(iv)(s)(2). To the extent that unrealized appreciation or depreciation in the partnership’s assets has been allocated to the noncompensatory option holder’s capital account, the holder will recognize, under Sec. 704(c), I.R.C. principles, any income or loss attributable to that appreciation or depreciation as the underlying assets are sold, depreciated or amortized.

(c) Permissible Capital Shift: If a disparity remains between the noncompensatory option holder’s right to share in the partnership capital and the value of money and other property contributed by the partner, the partnership may reallocate partnership capital between the existing partners and the exercising partner so that the exercising partner’s capital account does reflect the exercising partner’s right to share in the partnership capital under the partnership agreement. Prop. Reg. §1.704-1(b)(2)(iv)(s)(3).

(d) Corrective Allocations: The Proposed Regulations also require additional corrective allocations in succeeding tax years until the capital shift has been fully taken into account. Prop. Reg. §1.704-1(b)(2)(iv)(s)(5).

4. Characterization Rule

(a) The Proposed Regulations state that a noncompensatory option is treated as a partnership interest if the option (and any rights associated with it) provides the holder with rights that are substantially similar to the rights afforded to a partner. Prop. Reg. §1.761-3(a). This rule applies only if, as of the date that the noncompensatory option is issued, transferred or modified, there is a strong likelihood that the failure to treat the holder of the noncompensatory option as a partner would result in a substantial reduction in the present value of the partners’ and holder’s aggregate tax liabilities. Otherwise, the noncompensatory option is not treated as entitling the holder to a fixed right to share in partnership income until the option is exercised.

(b) In determining whether a noncompensatory option provides the holder with rights that are substantially similar to the rights afforded to a partner, all facts and circumstances are considered, including whether the option is reasonably certain to be exercised (as of the time that the option is issued, transferred, or modified) and whether the option holder possesses partnership attributes. Prop. Reg. §1.761-3(c). If a noncompensatory option is reasonably certain to be exercised, the option holder ordinarily has rights that are substantially similar to the rights afforded to a partner.
5. **Effective Date:** The Proposed Regulations are proposed to apply to noncompensatory options that are issued on or after the date Final Regulations are published in the Federal Register.

I. **Sec. 705, I.R.C. (Determination of Basis of a Partner’s Interest).**

1. **Overview** – On March 18, 2003, Treasury and the Service published Final Regulations, which adopted special rules for determining the adjusted basis of a partner’s interest in a partnership under Sec. 705, I.R.C. These Regulations are, in large part, a byproduct of the development of Regulations promulgated under Sec. 705, I.R.C. that were finalized a year earlier.

2. **Coordination of Secs. 705 and 1032, I.R.C.**

   (a) **Scope** – The Final Regulations apply to situations in which (i) a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation; (ii) the partnership distributes money or other property to another partner and that partner recognizes gain or loss on the distribution or the basis of the property distributed to that partner is adjusted during a year in which the partnership does not have an election under Sec. 754, I.R.C. in effect; and (iii) the partnership subsequently sells or exchanges the stock. Reg. § 1.705-2(b)(2).

   (b) **Basis Adjustments**

      (1) **Single Partnerships** – The increase or decrease in the corporation’s adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain or loss that that corporate partner would have recognized absent the application of Sec. 1032, I.R.C. (a corporation shall not recognize any net gain or loss on the receipt of money or other property in exchange for its stock) if, for the year in which the partnership made the distribution, a Sec. 754 election had been in place. Reg. § 1.705-2(b)(2).

      (2) **Tiered Partnerships** – The Final Regulations add a sentence to the end of Reg. § 1.705-2(c)(1) clarifying that the tiered partnership rule applies to these types of partnership distributions as well.

3. **Effective Date** – The Final Regulations apply to sales or exchanges of stock occurring on or after March 18, 2003.

J. **Sec. 706, I.R.C. (Taxable Year End of Partnerships with Foreign Partners).**

1. **Effective Date** -- On July 23, 2002, Treasury and the Service issued Final Regulations concerning the taxable year end of a partnership with foreign partners. Reg. §1.706-4 provides that a foreign partner is disregarded in determining the taxable year end of a partnership if the foreign partner is not subject to U.S. taxation on income earned through the partnership.

2. **Partnership Taxable Year End** -- The taxable year end of a partnership is determined by the taxable year end of the partner who or which owns a majority interest in the
partnership. The taxable year end of the principal partners will govern if the taxable year end cannot be determined by the majority interest. The least aggregate deferral method applies to the extent that the partnership taxable year end cannot be determined by the taxable year of the majority interest or principal partners.

3. Treatment of Foreign Partners -- The Regulations change the prior rule, which took into account the taxable year end of foreign partners in determining a partnership's taxable year end under Sec. 706(b), I.R.C. Reg. §1.706-4 corrects the inconsistency that may result when the taxable year end of a foreign partner is taken into account under Sec. 706, I.R.C. If the taxable year of a foreign partner governs under the majority interest test, deferral may result with respect to the U.S. partners who earn income through the partnership, without affecting the foreign partners who are not subject to U.S. tax on such income.

K. Sec. 752, I.R.C. (Assumption of Partner Liabilities).

1. Overview – On June 23, 2003, Treasury issued Temporary and Proposed Regulations relating to the assumption of partner liabilities under Sec. 752, I.R.C. Briefly stated, these Regulations are designed to crack down on the abusive “Son of BOSS” (bond and options sales strategy) tax shelter strategy identified in Notice 2000-44, 2000-2 C.B. 255.

2. Temporary Regulation

(a) General Rule – For transactions occurring after October 18, 1999, and before June 24, 2003, if a partnership assumes a liability of a partner (other than a liability to which Sec. 752(a) and (b), I.R.C. apply) in a transaction described in Sec. 721(a), I.R.C., then, after application of Sec. 752(a) and (b), the partner’s basis in the partnership is reduced (but not below the adjusted value of such interest) by the amount (determined as of the date of the exchange) of the liability. Reg. § 1.752-6T(a).

(b) Exceptions – A reduction in the partner’s basis is not required after a partnership’s assumption of that partner’s liability if:

(1) the trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange; or

(2) substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange. Reg. § 1.752-6T(b).

3. Proposed Regulations

(a) Broadly stated, Prop. Reg. § 1.752-7 provides rules regarding a partnership’s assumption of certain fixed and contingent obligations (i.e., “§ 1.752-7 liability”). The Proposed Regulations define a “Sec. 1.752-7 liability” as an obligation to which Sec. 752 does not apply. More specifically, Prop. Reg. § 1.752-1(a)(1)(i) defines “liability”, for purposes of Sec. 752 and the Regulations thereunder, to include an obligation if and to the extent that incurring the obligation:
(1) creates or increases the basis of any of the obligor’s assets (including cash);

(2) gives rise to an immediate deduction to the obligor; or

(3) gives rise to an expense that is not deductible in computing the obligor’s taxable income and is not properly chargeable to capital. Prop. Reg. § 1.752-1(a)(1)(i).

(b) General Rules

(1) Any Sec. 1.752-7 liability of a partner assumed by a partnership in a Sec. 721(a) transaction is treated under Sec. 704(c), I.R.C. principles as having a built-in loss equal to the amount of the Sec. 1.752-7 liability as of the date of the partnership’s assumption of the Sec. 1.752-7 liability. Prop. Reg. § 1.752-7(c)(1). Thus, items of deduction or loss with respect to the Sec. 1.752-7 liability, if any, must be allocated, first, to the Sec. 1.752-7 liability partner to the extent of the built-in loss. Deductions or losses with respect to the Sec. 1.752-7 liability that exceed the built-in loss are shared among the partners in accordance with Sec. 704(b) and the Regulations thereunder.

(2) If the Sec. 1.752-7 liability partner sells exchanges all or part of the partnership, immediately before the sale or exchange the partner’s basis in the partnership interest is reduced by the Sec. 1.752-7 liability reduction, which is the lesser of (i) the excess of the Sec. 1.752-7 liability partner’s basis in the partner’s partnership interest over the adjusted value of that interest; or (ii) the remaining built-in loss associated with the Sec. 1.752-7 liability. Prop. Reg. § 1.752-7(e)(1). However, in nonrecognition transactions where the transferee’s basis in the partnership interest is determined in whole or in part by reference to the transferor’s basis in the partnership interest, the Sec. 1.752-7 liability reduction does not apply. Prop. Reg. § 1.752-7(e)(3).

(3) Liquidation of Sec. 1.752-7 liability partner’s interest also triggers a reduction in that partner’s basis. Prop. Reg. § 1.752-7(f)(1).

(4) When another partner assumes part or all of a partner’s Sec. 1.752-7 liability, the partnership must reduce the basis of the partnership assets by the remaining built-in loss associated with the Sec. 1.752-7 liability. The reduction in the basis of partnership assets must be allocated among partnership assets as if that adjustment were a basis adjustment under Sec. 734(b). Prop. Reg. § 1.752-7(g)(3). As for the assuming partner, no deduction or capital expense is allowed to an assuming partner (other than the Sec. 1.752-7 liability partner) on the economic performance of a Sec. 1.752-7 liability assumed from a partnership to the extent of the remaining built-in loss associated with the Sec. 1.752-7 liability. Upon economic performance of the Sec. 1.752-7 liability, the assuming partner must adjust the basis of the partnership interest, any assets (other than cash, accounts receivable, or inventory) distributed by the partnership to the partner, or gain or loss on the disposition of the partnership interest. Prop. Reg. § 1.752-7(g)(4). Nevertheless, if the Sec. 1.752-7 liability partner is a partner in the partnership at the time another partner assumes the Sec. 1.752-7 liability and remains such, the
Sec. 1.752-7 liability partner must reduce its basis in its partnership interest by the Sec. 1.752-7 liability reduction.

(c) Exceptions – The rules regarding the subsequent sale/exchange or liquidation of a Sec. 1.752-7 liability partner’s interest and the rules applicable when another partner assumes the Sec. 1.752-7 liability from the partnership do not apply if:

(1) the partnership assumes the Sec. 1.752-7 liability as part of a contribution to the partnership of the trade or business with which the liability is associated, and the partnership continues to carry on that trade or business after the contribution;

(2) immediately before the testing date, the amount of the remaining built-in loss with respect to all Sec. 1.752-7 liabilities assumed by the partnership in one or more transactions governed by Sec. 721(a) is less than the lesser of (i) 10% of the gross value of partnership assets or (ii) $1 million. Prop. Reg. § 1.752-7(d)(2).

(d) The Proposed Regulations also provide rules under Sec. 358(h), I.R.C. for assumptions of liabilities by corporations from partners and partnerships. Prop. Reg. § 1.358-7. Specifically, if a corporation assumes a Sec. 358(h)(3) liability from a partnership in an exchange to which Sec. 358(a) applies, then, for purposes of applying Sec. 705 and Reg. § 1.704-1(b), any reduction, under Sec. 358(h)(1), in the partnership’s basis in corporate stock received in the transaction is treated as an expenditure of the partnership described in Sec. 705(a)(2)(B). Prop. Reg. § 1.358-7(b). This expenditure is allocated among the partners in accordance with Sec. 704(b) and (c) and Prop. Reg. § 1.752-7(c).

(e) Effective Date – The Proposed Regulations apply to transactions occurring on or after June 24, 2003.


1. Overview – On June 9, 2003, Treasury published Final Regulations in the Federal Register relating to the allocation of optional basis adjustments among partnership assets under Sec. 755, I.R.C. These Regulations were necessary to implement Sec. 1060(d), which applies the residual method to certain partnership transactions.

2. Prior Allocation Method –

(a) Under the prior regulations, optional basis adjustments under Secs. 734(b) and 743(b), I.R.C., were allocated as follows. First, the adjustment was allocated between ordinary income property and capital gain property. The amount of the basis adjustment allocated to the class of ordinary income property was the total amount of income, gain, or loss that would be allocated to the transferee from the sale of all ordinary income property at fair market value. Whereas, the amount of the basis adjustment allocable to the capital gain property was the difference between the total basis adjustment and the amount allocated to the ordinary income property. Next, the basis adjustment was allocated to the individual assets in each class.
b) The prior regulations with Reg. § 1.755-2T to determine the fair market value of partnership property used in a trade or business. In the case of a basis adjustment under Sec. 743(b), I.R.C. (relating to certain transfers of interests in a partnership) or Sec. 732(d) (relating to certain partnership distributions), Reg. § 1.755-2T provided that the fair market values of all assets other than goodwill or going concern value were determined on the basis of all the facts and circumstances, and the fair market value of goodwill and going concern was determined using the residual method. Reg. § 1.755-2T was published prior to the enactment of Sec. 1060(d), I.R.C., which applied the residual method for purposes of determining the value of Sec. 197, I.R.C. intangibles for purposes of applying Sec. 755.

3. **New Allocation Methodology** – The Final Regulations replace Reg. § 1.755-2T and utilize the residual method to value all Sec. 197, I.R.C. intangibles, not just goodwill or going concern value. Under the Final Regulations, a partnership is required to assign values to its assets as follows:

   a) Determine the value of each partnership asset (other than Sec. 197, I.R.C. intangibles) based on all the facts and circumstances, which takes into account Sec. 7701(g), I.R.C. (treating the fair market value of an asset as not less than the amount of nonrecourse debt to which it is subject). Reg. § 1.755-1(a)(3).

   b) Determine the gross value of all partnership assets. Reg. § 1.755-1(a)(4).

   1) Sec. 743(b) adjustments generally -- Partnership gross value equals the amount that, if assigned to all partnership property, would result in a liquidating distribution equal to the transferee’s basis in the transferred partnership interest immediately following the relevant transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities).

   2) Sec. 743(b) adjustments resulting from substituted basis transactions and Sec. 734(b) adjustments – Partnership gross value equals the value of the entire partnership as a going concern, increased by the amount of the partnership liabilities. For Sec. 734(b) adjustments, the value of the entire partnership as a going concern is determined immediately after the distribution causing the adjustment.

   c) Use the residual method to assign values to the partnership’s Sec. 197 intangibles. Reg. § 1.755-1(a)(5). For purposes of these regulations, Sec. 197 intangibles include all Sec. 197 intangibles, as defined in Sec. 197, as well as any goodwill or going concern value that would not qualify as a Sec. 197 intangible under Sec. 197. Reg. § 1.755-1(a)(2).

   1) If the aggregate value of partnership property other than Sec. 197 intangibles is equal to or greater than partnership gross value, then all Sec. 197 intangibles are deemed to have a value of zero for purpose of this regulation. In all other cases, the aggregate value of the partnership’s Sec. 197 intangibles (the residual Sec. 197 intangibles value) is deemed to equal the excess of partnership gross value over the aggregate value of partnership property other than Sec. 197 intangibles. This amount then is allocated between (i)
Sec. 197 intangibles other than goodwill and going concern value and (ii) goodwill and going concern value. Reg. § 1.755-1(a)(5)(i).

(2) The fair market value assigned to a Sec. 197 intangible other than goodwill or going concern shall not exceed the actual fair market value of that asset on the date of the relevant transfer. The Regulations also provide a mechanism to allocate the adjustment among this class of Sec. 197 intangibles. Reg. § 1.755-1(a)(5)(ii).

(3) The fair market value of goodwill and going concern value is the amount, if any, by which the residual Sec. 197 intangibles value exceeds the aggregate value of the partnership’s Sec. 197 intangibles other than goodwill and going concern value.

4. Clarifying Changes – The final Regulations add the following two clarifying rules for allocating basis adjustments under Sec. 743(b) among a partnership’s assets in the case of a transaction that is not a substituted basis transaction:

(a) assets in which the transferee partner has not interest in income, gain, losses, or deductions are not taken into account in allocating basis adjustments to capital assets; and

(b) in no event may the amount of any decrease in basis allocated to an item of capital gain property exceed the partnership’s adjusted basis in that item. Reg. § 1.755-1(b)(3)(iii).

5. Effective – The final Regulations apply to transfers of partnership interests and distributions of property from partnerships that occur on or after June 9, 2002.

III. ANNOUNCEMENTS

A. Treasury 2003-2004 Priority Guidance Plan. On July 24, 2003, the Department of the Treasury and the Internal Revenue Service issued the 2003-2004 Priority Guidance Plan. Among the items of particular interest are the following:

1. Corporations and Their Shareholders –

(a) Final regulations regarding the effect of reorganizations on attribute reduction in respect of cancellation of indebtedness.

(b) Guidance regarding redemptions of corporate stock.

(c) Guidance regarding transactions involving the transfer or receipt of no net equity value.

(d) Guidance regarding the business purpose requirement, the active trade or business requirement, and predecessor and successor organizations under Sec. 355, I.R.C.
(e) Guidance regarding the assumption of liabilities in certain transfers of property.

(f) Guidance under Sec. 382, I.R.C.

(g) Guidance under Sec. 1374, I.R.C. regarding liquidations of C corporations.

2. Exempt Organizations –

(a) Guidance on joint ventures between exempt organizations and for-profit companies.

(b) Guidance on low-income housing partnerships and Sec. 501(c)(3) participation.

3. Financial Institutions and Products –

(a) Proposed regulations regarding accruals on sales of REMIC regular interests between payment dates.

(b) Final regulations under Sec. 263(g), I.R.C.

(c) Revenue ruling under Sec. 856, I.R.C. on customary services performed by REITs.

(d) Advance notice of proposed rulemaking on interest-only REMIC interests.

(e) Final regulations on REMIC residual interests.

(f) Guidance under Sec. 7872, I.R.C.

4. General Tax Issues –

(a) Guidance under Sec. 42, I.R.C. (low-income housing credit).

(b) Final regulations under Reg. §§ 1.42-6 and 1.42-14 to conform to statutory changes.

(c) Final regulations under Sec. 121(c), I.R.C. regarding the reduced maximum exclusion for gain on the sale of a principal residence.

(d) Revenue ruling under Sec. 121 and Sec. 1031, I.R.C. regarding the like-kind exchange of a principal residence.

(e) Final regulations under Sec. 167, I.R.C. regarding the income forecast method.
(f) Proposed and temporary regulations under Sec. 168, I.R.C. relating to like-kind exchanges.

(g) Final regulations under Sec. 168, I.R.C. regarding depreciation of property for which the use changes.

(h) Proposed and temporary regulations under Sec. 168 and 1400L, I.R.C. regarding special depreciation allowance.

(i) Guidance under Sec. 168, I.R.C. regarding asset and activity classes under Rev. Proc. 87-56 and changes in property classifications.

(j) Guidance under Sec. 172, I.R.C. regarding specified liability losses.

(k) Guidance under Sec. 179, I.R.C. on elections.

(l) Guidance under Sec. 1031, I.R.C. regarding reverse like-kind exchanges of property.

(m) Revenue ruling under Sec. 1241, I.R.C. on cancellation of lease or distributor agreements.

5. Partnerships –

(a) Guidance regarding partnership transactions under Sec. 337(d), I.R.C.

(b) Final regulations under Sec. 704(b), I.R.C. regarding capital account book-up and the allocation of foreign tax credits.

(c) Guidance under Sec. 704(c), I.R.C.

(d) Guidance under Sec. 707, I.R.C. regarding disguised sales.

(e) Proposed regulations under Sec. 721, I.R.C. regarding partnership interests issued for services and the treatment of compensatory partnership options.

(f) Update the Sec. 751, I.R.C. regulations.

(g) Final regulations under Sec. 752, I.R.C. regarding the assumption of partnership liabilities.

(h) Guidance under Sec. 752, I.R.C. where a general partner is a disregarded entity.
(i) Guidance on the application of Sec. 1045, I.R.C. to certain partnership transactions.

(j) Guidance under Sec. 7701, I.R.C. regarding disregarded entities and collection issues.

6. Subchapter S

(a) Revenue ruling under Sec. 1361, I.R.C. regarding QSub elections.

(b) Guidance on the treatment of LIFO recapture under Sec. 1363(d).

(c) Guidance under Sec. 7701, I.R.C. on deemed corporation entity elections for electing S corporations.

7. Tax Accounting

(a) Final regulations under Sec. 162 and Sec. 263, I.R.C. regarding the deduction and capitalization of expenditures for intangible assets.

(b) Regulations under Sec. 162 and Sec. 263, I.R.C. regarding the deduction and capitalization of expenditures for tangible assets.

(c) Guidance under Sec. 162 and Sec. 263, I.R.C. regarding the deduction and capitalization of costs incurred to fertilize established timber stands.

(d) Guidance under Sec. 165, I.R.C. regarding the treatment of preproduction costs of creative property.

(e) Regulations under Sec. 263A, I.R.C. regarding the simplified service cost and simplified production methods, “negative” additional Sec. 263A costs, and adjustments under Sec. 481(a), I.R.C. for certain changes in accounting methods.

(f) Regulations under Sec. 381, I.R.C. regarding changes in accounting methods.

8. Tax Administration

(a) Revenue ruling regarding the classification of items and the statute of limitations under the TEFRA partnership provisions.

(b) Revenue ruling under Sec. 6231, I.R.C. regarding the application of certain TEFRA partnership provisions to disregarded entities.

(c) Revisions to Circular 230 regarding practice before the IRS.
IV. REVENUE PROCEDURES AND REVENUE RULINGS

A. **Rev. Proc. 2002-22, 2002-14 I.R.B. 733.** This Revenue Procedure supersedes Rev. Proc. 2000-46, 2002-2 C.B. 438. Rev. Proc. 2002-22 specifies the conditions under which the Service will consider a request for a ruling that an undivided fractional interest in rental real property (other than mineral property) is not an interest in a business entity. Nonrecognition treatment under the like-kind exchange rules does not apply to the exchange of an interest in a business entity. Accordingly, Rev. Proc. 2002-22 applies to the co-ownership of rental real property (other than mineral interests) in an arrangement classified under local law as a tenancy-in-common. The Service will treat multiple parcels of property as a single property to the extent that (1) the parcels are owned by co-owners, (2) the parcels are leased to a single tenant pursuant to a single lease agreement, and (3) any debt of one or more co-owners is secured by all of the parcels. The Service will not consider a ruling request in such case unless (1) each co-owner's percentage interest in each parcel is identical to that co-owner's percentage interest in every other parcel, (2) each co-owner's percentage interests in the parcels cannot be separated and traded independently, and (3) the parcels of property are properly viewed as a single business unit. Contiguous parcels will be treated as a single business unit.

The Service will not consider a request for a ruling under Rev. Proc. 2002-22 unless the stated conditions are satisfied. For tenancy in common ownership, each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant in common under local law. The title to the property as a whole may not be held by an entity recognized under local law. The number of co-owners must be limited to no more than 35 persons. A husband and a wife are treated as a single person. The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders or members of a business entity, or otherwise hold itself out as a form of business entity. The Service will not issue a ruling if the co-owners held interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership. The co-owners may enter into a limited co-ownership agreement that may run with the land. The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of property, any lease(s) of a portion or all of the property, or the creation or modification of a blanket lien. Each co-owner must have the rights to transfer, partition and encumber the co-owner's undivided interest in the property without the agreement or approval of any person. Note that restrictions on the right to transfer, partition or encumber interests in the property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. If the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners. The Revenue Procedure also specifies conditions concerning the proportionate sharing of profits and losses, proportionate sharing of debt, options, business activities, management and brokerage agreements, leasing agreements and loan agreements.

The Service is expected to release guidance shortly on whether a Delaware business trust qualifies for nonrecognition of gain under Sec. 1031, I.R.C.

B. **Rev. Proc. 2002-69, 2002-45 I.R.B. 831.** This Revenue Procedure provides guidance on the Federal tax classification of a business entity that is not treated as a corporation under Reg. § 301.7701-2 and is wholly owned by a husband and wife as community property
under the laws of a state, foreign country or possession of the United States. If the business
entity and the husband and wife treat the entity as either a disregarded entity or a partnership for
Federal tax purposes, the Service will accept such classification. A change in the reporting
position will be treated for Federal tax purposes as a conversion of the entity. Revenue
Procedure 2002-69 was effective November 4, 2002.

harbors with respect to programs involving ongoing exchanges of tangible personal property
using a single intermediary, referred to as an “LKE Program”. An LKE Program is defined as an
ongoing program involving multiple exchanges of 100 or more properties. Despite variations
among LKE Program, an LKE Program must have all of the following characteristics:

1. The taxpayer regularly and routinely enters into agreements to sell
tangible personal property, as well as agreements to buy tangible personal property.

2. The taxpayer uses a single, unrelated intermediary to accomplish the
exchanges in the LKE Program.

3. The taxpayer and the intermediary enter into a written agreement ("master
exchange agreement").

4. The master exchange agreement expressly limits the taxpayer's right to
receive, pledge, borrow or otherwise obtain the benefits of money or other property held by the
intermediary as provided in Reg. §1.1031(k)-1(g)(6).

5. In the master exchange agreement, the taxpayer assigns to the
intermediary the taxpayer's rights (but not necessarily its obligations) in some or all of its
existing and future agreements to sell relinquished property and/or to purchase replacement
property.

6. The taxpayer provides written notice of the assignment to the other party
to each existing and future agreement to sell relinquished property and/or to purchase
replacement property.

7. The taxpayer:

(a) implements a process that identifies potential replacement property
or properties before the end of the identification period for the
relinquished property or group of relinquished properties of which
it is disposing in each exchange,

(b) complies with the identification requirement by receiving
replacement property or properties before the end of the 45-day
identification period, or

(c) satisfies the identification requirements by a combination of the
approaches in (a) and (b).
8. The taxpayer implements a process for collecting, holding and disbursing funds (which may include the use of joint taxpayer and intermediary bank accounts, or accounts in the name of a third party for the benefit of both the taxpayer and the intermediary) that ensures that the intermediary controls the receipt, holding, and disbursement of all funds to which the intermediary is entitled (i.e., proceeds from the sale of relinquished properties).

9. Relinquished properties that are transferred are matched with replacement properties that are received in order to determine the gain, if any, recognized on the disposition of the relinquished property and to determine the basis of the replacement property.

10. The taxpayer recognizes gain or loss on the disposition of relinquished properties that are not matched with replacement properties, and the taxpayer takes a cost basis in replacement properties that are received but not matched with relinquished properties.

The IRS announced three distinct safe harbors for LKE Programs having these requisite characteristics. The IRS provided that exchanges of property pursuant to LKE Programs may qualify for nonrecognition treatment under Section 1031 even though they fall outside the specified safe harbors.

Section 4 of the Revenue Procedure provides a safe harbor for exchanges of relinquished property and replacement property. In the case of a LKE Program, the taxpayer's transfer of each relinquished property or group of relinquished properties and the taxpayer's corresponding receipt of each matching replacement property or group of replacement properties is treated as a separate and distinct exchange for purposes of Section 1031. The failure of one property exchange within a group to qualify for Section 1031 treatment will not affect the application of Section 1031 to any other exchange pursuant to the LKE Program.

Section 5 of the Revenue Procedure provides a safe harbor for actual or constructive receipt of money or other property. A taxpayer will not be deemed to be in actual or constructive receipt of money or other property as a result of any of the following, in each case provided that certain requirements are satisfied:

(a) processing a check or other negotiable instrument made payable to a person other than the taxpayer, subject to certain restrictions set forth in Reg. § 1.1031(k)-1(k);

(b) depositing proceeds from the sale of relinquished property into a joint bank, trust, escrow or similar account in the name of the taxpayer and the qualified intermediary, or in an account in the name of a third party (other than a disqualified person) for the benefit of both the taxpayer and the qualified intermediary;

(c) netting funds against sales or purchase price;

(d) lending money to a buyer; or
application by the buyer-lessee of its lease security deposit to the purchase price of the relinquished property.

Section 6 of the Revenue Procedure provides a qualified intermediary safe harbor. A taxpayer's assignment of rights to an exchange program intermediary in a master exchange agreement, provided certain requirements are met, will satisfy the assignment safe harbor and notice requirement of Reg. §1.1031(k)-1(g)(4)(v).

D. Rev. Proc. 2003-65, 2003-32 I.R.B. 336. This Revenue Procedure sets forth a safe harbor under which (i) a loan from a REIT secured by an interest in a partnership or by the sole member interest in a disregarded entity will be treated as real estate for purposes of Secs. 856(c)(4)(A) and (5)(B), I.R.C., and (ii) interest on the loan will be treated as interest on an obligation secured by a mortgage on real property for purposes of Sec. 856(c)(3)(B), I.R.C. Under the Revenue Procedure, (i) if the borrower is either a partner in a partnership or the sole member of a disregarded entity; (ii) the loan is nonrecourse, secured only by the partner’s or the member’s interest; (iii) the lender has a first priority security interest in the pledged interest; (iv) upon default and foreclosure, the lender will replace the borrower as partner or member; (v) on the date the commitment by the lender to make the loan becomes binding, the partnership or disregarded entity holds real property for purposes of Sec. 856, I.R.C.; (vi) on each testing date, the value of the real property held by the partnership or disregarded entity equals at least 85% of the value of all of the assets held by such partnership or disregarded entity; (vii) the loan value of the real property owned by the partnership or disregarded entity equals or exceeds the amount of the loan; and (viii) interest on the loan meets the requirements of Reg. §1.856-5(a) and (b), then the loan will be treated as a real estate asset for purposes of Secs. 856(c)(4)(A) and (5)(B), I.R.C., and the interest on the loan will be treated as interest on an obligation secured by real property for purposes of Secs. 856(c)(3)(B), I.R.C.

E. Rev. Proc. 2003-66, 2003-33 I.R.B. 1. In this Revenue Procedure, the IRS describes the conditions under which rental payments to a REIT from a joint venture between a taxable REIT subsidiary ("TRS") and an unrelated third party for space at property owned by the REIT are treated as rents from real property under Sec. 856(d), I.R.C. The Revenue Procedure applies to a REIT that leases space to a joint venture between a TRS and a third party that is unrelated to either the TRS or the REIT and is treated as a partnership for Federal income tax purposes, if the REIT would be treated under Sec. 856(d)(2), I.R.C. as having an interest of 10% or more in the assets or net profits of the joint venture. The Revenue Procedure provides that the IRS will treat rents from a joint venture described above as rents from real property if amounts paid to the REIT by the joint venture as rents from real property are substantially comparable to such rents paid by the other tenants of the REIT's property for comparable space and at least 90% of the leased space of the REIT's property is rented to persons other than (1) TRSs of the REIT and (2) related parties described in Sec. 856(d)(2)(B), I.R.C. Rev. Proc. 2003-66 is effective for leases in effect or entered into on or after January 1, 2001.

F. Rev. Rul. 2002-9, 2002-10 I.R.B. 614. In this Ruling, the taxpayer was in the business of developing, owning and leasing residential rental property. The taxpayer planned to construct a new residential rental building and purchased unimproved land. The county in which
the land was located imposed "impact fees" on new and expanded development. The impact fees are one-time charges imposed to finance specific offsite capital improvements for general public use necessitated by new or expanded development. The impact fees are refundable in full or in part if the new or expanded development is not constructed as planned. The taxpayer paid the fees for schools, law enforcement and fire protection facilities. The fees were calculated based on the taxpayer's estimate of the size of the building and the number of rental units in the building. The Service determined that the impact fees incurred by the taxpayer resulted in a permanent improvement or betterment to the development project and therefore should be capitalized to the property produced under Sec. 263(a), I.R.C. The impact fees were considered indirect costs under Sec. 263A, I.R.C. because they directly benefited and were incurred by reason of the taxpayer's production activity. The taxpayer was required to capitalize the impact fees under Sec. 263A, I.R.C. as indirect costs allocable to the new residential rental building.

G. Rev. Rul. 2002-38, 2002-26 I.R.B. 1. This is the first published guidance in which the Service addresses treatment of non-customary services provided by a Taxable REIT Subsidiary ("TRS").

In Situation 1, the parent REIT owns residential apartment buildings. Its wholly-owned TRS provides housekeeping services to tenants of the REIT's apartment buildings. The housekeeping services do not qualify as customary services under Reg. §1.856-4(b)(1). TRS employees perform all of the housekeeping services received by the tenants of the REIT. TRS also rents space in the REIT's apartment buildings in accordance with Sec. 856(d)(8)(A), I.R.C. and makes only rental payments for the space to the REIT. The annual value of the housekeeping services provided at each property exceeds 1% of the total annual amount received by the REIT from the property. Charges to the tenants for the housekeeping services are not separately stated from the rents that the tenants pay to the REIT. TRS does not enter into contracts with the tenants for the performance of housekeeping services. The REIT compensates TRS for providing the housekeeping services by paying TRS an amount that is 160% of TRS' direct cost of providing the services. TRS reports the full amount of the REIT's payment as gross income on its Federal income tax return.

In Situation 2, the facts are the same as Situation 1 except that the REIT compensates TRS for providing the services by paying TRS less than the arms'-length charge under Section 482 for providing the services—an amount that is 125% of TRS' direct cost of providing the housekeeping services.

The housekeeping services, if considered rendered by TRS, are not treated as rendered by its REIT by reason of Sec. 856(d)(7)(C)(i), I.R.C., and thus would not give rise to impermissible tenant service income under Sec. 856(d)(7)(A), I.R.C. Hence, the primary question is whether the REIT or TRS is the service provider. In determining the provider of the housekeeping services, all relevant facts and circumstances are considered.

Even though no service charges are separately stated from the tenants' rent payments, the Service concluded that the housekeeping services should be treated as rendered by TRS for the following reasons: (i) Congress, as evidenced by the structure of the 100% tax on redetermined rents under Sec. 857(b)(7)(E), I.R.C., did not intend that the lack of a separately stated service charge, alone, would cause services to be treated as rendered by a REIT; (ii) TRS' employees
perform all of the housekeeping services; (iii) TRS pays all costs of providing the services; and
(vi) TRS rents space to carry out its housekeeping operations and makes no payment to the REIT
other than its rental payments for the space.

Since TRS is considered the provider of the housekeeping services in both Situation 1
and Situation 2, the services do not give rise to impermissible tenant service income and do not
cause any portion of the rents received by the REIT to fail to qualify as “rents from real
property” under Sec. 856(d), I.R.C. However, different results are obtained with respect to the
treatment of the rents as redetermined rents subject to the 100% tax under Sec. 857(b)(7)(A),
I.R.C.

In Situation 1, the rents fall within the safe harbor protection of Sec. 857(b)(7)(B)(vi),
I.R.C., pursuant to which the definition of redetermined rents does not include any service
rendered by a TRS to a REIT tenant if the TRS’ gross income from the service is at least 150%
of its direct cost in rendering the service. The Service is careful to point out that this safe harbor
protection from the 100% tax on redetermined rents does not prevent an allocation under
Section 482, if the amounts paid by the REIT to TRS represent less than an arms’-length charge.
In such cases, income allocated under Sec. 482, I.R.C. would be deductible by the REIT under
Section 162, thereby reducing taxable income, but would not reduce gross income. An
allocation under Section 482, in any event, would not cause any portion of the rents received by
the REIT to fail to qualify as “rents from real property” under Sec. 856(c), I.R.C.

In Situation 2, no safe harbor protects the REIT from imposition of the 100% tax on
redetermined rents, and the service compensation paid to TRS is less than the arms’-length
charge under Sec. 482, I.R.C. Sec. 857(b)(7)(A), I.R.C. imposes a tax on the REIT equal to the
amount by which the Section 482 arms’-length charge for providing the services exceeds the
payment from the REIT to TRS. Pursuant to Sec. 857(b)(7)(E), I.R.C., imposition of the 100%
tax is in lieu of allocating that amount from the REIT to TRS under Sec. 482, I.R.C.

Rev. Rul. 99-14, 1999-1 C.B. 835, that a taxpayer may not deduct, under Secs. 162 and 163,
I.R.C., rent or interest paid or incurred in connection with a lease-in/lease-out transaction ("LILO
transaction). In a LILO transaction, a taxpayer leases property and then immediately subleases it
back to the lessor. The lease requires the taxpayer to make a large rental payment in year one
and a smaller payment at the end of the lease period. The sublease, however, requires the
original lessor to make fixed, annual rental payments over the term of the sublease, which is
shorter than the duration of the lease. Thus, this transaction is structured to generate sizeable,
up-front rental deductions for the taxpayer with minimal recognition of rental income from the
sublease. The Service disregards the transfer and retransfer of the right to possess the property
as offsetting obligations, and so treats the large payment from the taxpayer to the lessor as a loan
which the lessor repaid in the form of rents payable monthly under the sublease.

In Rev. Rul. 99-14, the Service denied the deduction on the basis that LILO transactions
lacked economic substance. When the Service re-examined this issue in Rev. Rul. 2002-69, it
again denied the rent and interest deductions, but this time on the grounds that the LILO
transaction conferred merely a future interest in property for which no rental deduction is
available. (Therefore, Rev. Rul. 99-14 is modified and superseded in Rev. Rul. 2002-69.) The
Service left open the possibility that it may also challenge LILO transactions on the basis that there is a lack of profit potential or business purpose.

I. Rev. Rul. 2002-83, 2002-49 I.R.B. 927. The Service concluded that a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under Sec. 1031(a) because the related parties used the qualified intermediary to circumvent the Sec. 1031(f)(1) limitation.

In this Ruling, two individual taxpayers, which are related persons within the meaning of Sec. 267(b), I.R.C., held separate parcels of investment real property with the same fair market value. Taxpayer #1 owned appreciated real property with a low basis. Taxpayer #2's basis in his property equaled its fair market value. Taxpayer #3, an unrelated taxpayer, sought to purchase the property owned by Taxpayer #1. Seeking to defer the immediate recognition of gain on the sale of his property, Taxpayer #1 attempted to use a qualified intermediary to structure a like-kind exchange. Pursuant to an agreement, Taxpayer #1 transferred his property to the qualified intermediary, who then sold the property to Taxpayer #3 for fair market value. Following this sale, the qualified intermediary used the sales proceeds from the sale of Taxpayer #1's property to acquire Taxpayer #2's property. The qualified intermediary then transferred this property to Taxpayer #1.

Although taxpayers may use a qualified intermediary to facilitate a like-kind exchange, a taxpayer exchanging like-kind property with a related person cannot use the nonrecognition provisions of Sec. 1031, I.R.C. if, within two years of the date of the last transfer, either the related person disposes of the relinquished property or the taxpayer disposes of the replacement property. This limitation is intended to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. Moreover, nonrecognition is not available for a transaction or series of transactions designed to avoid this limitation. In this scenario, because Taxpayer #1 employed a qualified intermediary to circumvent this limitation, the nonrecognition provisions of Sec. 1031, I.R.C. do not apply to the exchange between Taxpayer #1 and the qualified intermediary. Thus, Taxpayer #1 must recognize a gain on this exchange.

J. Rev. Rul. 2003-56, 2003-23 I.R.B. 985. This Ruling addressed the question of whether liabilities are netted for purposes of Sec. 752, I.R.C. when a partnership enters into a deferred like-kind exchange under Sec. 1031, I.R.C. straddling two taxable years. In Situation 1 of the Ruling, a partnership started a deferred like-kind exchange in year 1 by disposing of relinquished property with a value of $300x and subject to a liability of $100x. In year 2, the partnership (within the applicable time requirements) acquired replacement property with a value of $260x and subject to a liability of $60x. In Situation 2 of the Ruling, the same facts applied except that the replacement property had a value of $340x and was subject to a liability of $140x. The Service applied the liability offsetting rule in regulations under Sec. 1031, I.R.C. in determining whether any deemed distributions occurred for Sec. 752, I.R.C. purposes. In both situations, consequently, the partners of the partnership were entitled to net the liability on the replacement property against the liability on the relinquished property in determining their consequences under Sec. 752, I.R.C. As a result, although the partners of the partnership experienced a deemed distribution under Sec. 752, I.R.C. in Situation 1 ($100x liability on
relinquished property offset only to the extent of the $60x liability on the replacement property), they received no deemed distribution and, therefore, recognized no income or gain under Situation 2 ($100x liability on relinquished property fully offset by $140x liability on the replacement property). The Service also stated that a similar analysis would apply in determining reductions of partnership minimum gain.

K. Rev. Rul. 2003-86, 2003-32 I.R.B. 1. This Ruling holds that a joint venture between a taxable REIT subsidiary ("TRS") of a REIT and a corporation that qualifies as an independent contractor of the REIT under Sec. 856(d)(3)(B), I.R.C. may provide noncustomary services to tenants of the REIT without causing tenant rents to fail to qualify as "rents from real property" under Sec. 856(d), I.R.C.

The REIT, which owns and operates rental apartment in several metropolitan areas, formed a corporation to provide tenant services. The REIT and the corporation filed a joint election on Form 8875 to treat the corporation as a TRS. The TRS provides services to tenants that are not customarily provided to tenants of rental apartment properties in the metropolitan areas where the properties are located. An independent contractor under Sec. 856(d)(3)(B), I.R.C. also provides various tenant services that are noncustomary and are primarily for the convenience of the tenants of the REIT. The independent contractor and the TRS form a partnership for Federal income tax purposes to provide the noncustomary services that formerly were provided to the tenants separately either by the independent contractor or the TRS.

The IRS held that the partnership services are treated as provided by the TRS to the extent of the TRS' interest in the partnership. Since the REIT's only interest in the partnership is through the TRS, the REIT will not be treated as providing impermissible tenant services to the tenants, so that the rents paid by the tenants to the REIT will still qualify as "rents from real property" under Sec. 856(d), I.R.C.

V. LETTER RULINGS

A. Priv. Ltr. Rul. 200222026 (May 31, 2002). The Service analyzed whether an LLC treated as partnership for Federal tax purposes must recognize cancellation of indebtedness income under Sec. 61(a)(12), I.R.C., upon a technical termination when its assets and liabilities are deemed distributed to its remaining member, a foreign banking corporation. In this case, the foreign member had loaned money to the LLC. The Service treated these loans as cancelled when they were distributed to the foreign entity. Because the fair market value of the assets distributed to the foreign entity exceeded the amount of the liabilities, the Service concluded that the LLC is treated as paying the full issue price of the cancelled debt. Accordingly, neither the LLC nor the foreign entity realized any cancellation of indebtedness income.

B. Priv. Ltr. Rul. 200223036 (June 7, 2002). An LLC treated as a partnership for tax purposes is owned by a brother, sister and trusts for their benefit and their mother's benefit. The LLC's assets include marketable securities. To avoid family dissension and give the individual members greater influence in managing certain assets, the partners plan to divide the LLC into two. The original LLC will transfer half of its assets and liabilities to a new LLC and then
distribute the interests in the LLC to the brother and his trusts in exchange for their interests in the original LLC and to the mother's trusts in exchange for 1% of her interest in the original LLC. After the division, both LLCs will be continuing partnerships.

The amount of a distribution of marketable securities treated as a distribution of money is reduced under Sec. 731(c)(3)(B), I.R.C. by a distributee partner's share of the built-in gain in the securities "held by the partnership". The original LLC is concerned that the "partnership" referred to in determining the reduction may include both continuing partnerships, thereby eliminating most of the anticipated limitation on gain resulting from the division.

C. Priv. Ltr. Rul. 200225033 (June 21, 2002). The Service provided the following two rulings to a Mortgage REIT holding direct investments in various loans and mortgage-backed securities: (1) the interest held by the Mortgage REIT in a loan, described as "the Additional Loan", secured by partnership interests qualifies as a "real estate asset" under Sec. 856(c)(4)(A), I.R.C.; and (2) the interest earned thereon qualifies as "interest on obligations secured by mortgages on real property or on interests in real property" under Sec. 856(c)(3)(B), I.R.C.

The Mortgage REIT held the following investment: (a) a "First Mortgage Loan" with a Partnership, as borrower, consisting of mortgage-backed security ("MBS") representing the securitized first mortgage loan on an underlying complex or a participation interest in a first mortgage loan on a particular complex; (b) the Additional Loan to the Majority Partner of the borrower Partnership to provide additional funds for the financing of the complex; and (c) a "Subordinated Promissory Note", with a subordinated mortgage on the property, which provided a participation interest in the cash flow from and appreciation of the complex conveyed to the REIT.

The insurer ("Insurer") of the First Mortgage Loan permitted third-party loans of additional funds over and above the First Mortgage Loan, such as the Additional Loan, only if such obligations are secured in conformance with specific requirements set forth in a Memorandum. The Memorandum provided that such obligations could not be secured by the first mortgage insured by Insurer or by a second mortgage, but instead could be collateralized by security agreements pledging the partners' partnership interests and/or the partners' rights to cash and the net proceeds resulting from any payment event.

As a consequence, the Additional Loan was secured by a pledge of the interests in the Partnership, which was the borrower under the First Mortgage Loan. Pursuant to the Additional Loan Agreement and the Pledge and Security Agreements, the following terms and restrictions applied to the pledged partnership interests: (1) all of the partners granted a first priority security interest in their partnership interests and the proceeds therefrom; (2) the pledging parties agreed not to cause a disposition of the underlying real estate assets of the borrower Partnership outside of the ordinary course of business or cause a change in the voting rights that would cause a disposition of or a granting of a security interest in their partnership interests; (3) the borrower Partnership was prohibited from conveying the general partner interest and from conveying, transferring or encumbering the property that is the subject of the First Mortgage Loan; and (4) additional restrictions applied with respect to incurring liabilities, engaging in other business, placing additional mortgages or liens on the property, etc.
The Service concluded that, to the extent the fair value of the pledged partnership interests’ share of the real property was at least equal to the total aggregate amount of all loans secured by the property, the loan qualified as a real estate asset under Sec. 856(c)(4)(A), I.R.C. In addition, the Service concluded that the interest income qualified under Sec. 856(c)(3)(B), I.R.C. to the extent the pledged partnership interests’ share of the loan value of the property was at least equal to the amount of all loans secured by the property, provided that the amount of the income did not depend on the income or profits of any person, except as provided in Sec. 856(f), I.R.C.

D. Priv. Ltr. Rul. 200225034 (June 21, 2002). The Service issued favorable “real estate asset” rulings similar to the first ruling in Priv. Ltr. Rul. 200225033, above, with respect to differing circumstances. The rulings were requested by a REIT whose shares are publicly traded on the NYSE and which operates as an UPREIT. The operating partnership (“Limited Partnership”) invests in commercial office properties, either directly or indirectly through affiliated partnerships and limited liability companies in substantially all of which affiliated entities Limited Partnership holds controlling interests.

Limited Partnership, directly or indirectly through its affiliated entities, makes loans to the entities that own the commercial office properties or to the owners of such entities. In the first proposed transaction, the commercial property (“Property 1”) is owned by a single-member limited liability company (“SME-LLC”), 100% of which interests are held by another limited liability company (“LLC2”). The SME-LLC is treated as a disregarded entity for Federal income tax purposes. Instead of making a loan to SME-LLC, Limited Partnership proposes to make a loan (“Mezzanine Loan”) to LLC2 secured by LLC2’s 100% interest in SME-LLC.

In the second transaction, another limited partnership (“LP3”) owns 100% of the commercial office property (“Property 2”) and no other significant assets. Limited Partnership will make a loan (“Partnership Interest Loan”) to one of the partners of LP3, an upper tier partnership (“LLC4”). The Partnership Interest Loan will be secured by LLC4’s partnership interest in LP3. The Partnership Interest Loan will be a nonrecourse loan with the only security being the pledged partnership interest in which the Limited Partnership will have a first priority security interest.

With respect to the two transactions, the Service concluded that the Mezzanine Loan and the Partnership Interest Loan, as of the initial loan date and on the date of any additional borrowings, each qualified as a “real estate asset” under Section 856(cc)(4)(A), subject to the following caveats applicable both to the date of the initial loan and on the date of any additional borrowings: (1) the net value of Property 1 equals or exceeds the principal amount of the Mezzanine Loan; and (2) the net value of the pledged partnership interests’ share of the real property held by LP3 equals or exceeds the principal amount of the Partnership Interest Loan. See also Priv. Ltr. Rul. 200226013 (June 28, 2002).

E. Priv. Ltr. Rul. 200226031 (June 28, 2002). The taxpayer created a trust, which was a grantor trust, and funded the trust with all of the stock of an S corporation. The taxpayer was the trustee of the trust. Upon the taxpayer’s death, the trust was to distribute the stock to
three individuals. On taxpayer's death, the executors of taxpayer's estate elected under Section 6166 to extend the time for payment of the estate tax.

The Service, citing Rev. Rul. 76-23, 1976-1 C.B. 264, ruled that, so long as the trust did not otherwise become ineligible, it would continue to be an eligible S corporation shareholder under Section 1361(b), unless the provisions of Section 6166 were no longer complied with. The Service further ruled that the trust did not need to distribute the S corporation stock during the period of the Section 6166 election, and that the period of administration of the estate would not be considered "unduly prolonged", under Section 641(a)(1), because of the trust holding onto the shares for purposes of the Section 6166 election.

F. Priv. Ltr. Rul. 200226032 (June 28, 2002). X corporation's shareholders will form Y, a general partnership, which will elect under Reg. §301.7701-3 to be treated as an S corporation. After such election, all outstanding stock in X will be contributed to Y, which will elect to treat X as a qualified Subchapter S subsidiary under Section 1361(b)(3). Y will next form Z, a limited liability company, which will be a disregarded entity under Reg. §301.7701-3. Y will then transfer 1% of X's stock to Z, and X will then convert under state law from a corporation to a limited partnership. After such conversion, Z will hold a 1% general partner interest and Y will hold a 99% limited partner interest in X.

The Service ruled that Y would be eligible to be treated as an S corporation, where the partnership agreement created voting interests (with full voting rights) and nonvoting interests (with limited voting rights as set forth in the partnership agreement) and all interests in the partnership had identical rights to distribution and liquidation proceeds. See Regs. §§1.1361-1(I)(2) and -1(I)(2)(iii)(A).

G. Priv. Ltr. Rul. 200226039 (June 28, 2002). Taxpayer sold his interest in a corporation in exchange for unregistered stock in a new company. Because the unregistered stock could not be sold on the public market, the taxpayer intended to use the installment method for reporting the gain on the sale. In addition, due to a temporary default, the taxpayer received promissory notes, which he was advised were demand notes. After selling the stock, the taxpayer reported the gain using the installment method for the stock, but not for the notes. Subsequently, taxpayer was advised by two separate attorneys that the notes were not payable on demand. Taxpayer sought to amend his original reporting to revoke his election out of the installment method. Generally, an election out of Section 453 is irrevocable. However, here the taxpayer originally intended to use the installment method; the request to use the installment method was frustrated by inadvertent errors of third persons; the taxpayer acted diligently in requesting a revocation; and the requested revocation did not prejudice the interests of the government. Therefore, the Service concluded that the installment method of reporting was not precluded for the notes, and the taxpayer was allowed to amend his original reporting.

H. Priv. Ltr. Rul. 200232029 (August 9, 2002). A cooperative leasing corporation owns an apartment building which is currently being used for commercial purposes. The co-op proposes to convert the commercial units to cooperative ownership, and is planning to issue common stock attributable to the commercial units. The co-op intends to sell the shares, and the purchaser will have a proprietary lease for a unit.
The Service reviewed the facts and focused on Section 216 and the Regulations thereunder. In addition, the Service cited Rev. Rul. 74-241, 1974-1 C.B. 68, and Rev. Rul. 90-35, 1990-1 C.B. 48. Based on the same, the Service concluded that (1) provided that the co-op satisfies the requirements of Sections 216(b)(1)(A), (C) and (D), neither the issuance of stock by the co-op to be allocated to the commercial units, nor the possible non-residential use of the commercial units would prevent the co-op from in fact qualifying as a “cooperative housing corporation” within the meaning of Section 216(b)(1); and (2) a person who purchases stock of the co-op attributable to one of the commercial units for use of such unit as a store will qualify as a “tenant-stockholder” for purposes of Section 216(b)(2), so long as the stock is fully paid up and in an amount which bears a reasonable relationship to the portion of the total value of the co-op’s equity in the building and land attributable to the unit which the purchaser is to occupy.

I. Priv. Ltr. Rul. 200234054 (August 23, 2002). This ruling deals with a number of questions relating to taxable REIT subsidiaries (“TRS”) under Section 856(l), three of which are set forth below.

First, a TRS will enter into a joint venture with a third party service provider (“Provider”). The joint venture will likely be a limited liability company or general partnership, but in any event will be treated as a partnership for Federal tax purposes. The Provider will qualify as an independent contractor with respect to the REIT under Section 856(d)(3). The Provider will provide non-customary services to tenants (such as specialized cleaning services or customized business conference centers), for which fees will be paid the joint venture and, net of expenses of the joint venture, will be shared between the TRS and the Provider. The Service concludes that, while the joint venture is not eligible to make a TRS election, the TRS can receive its proportionate share of the income of the joint venture without tainting the REIT. See Section 856(d)(7)(C).

Second, a TRS, through a wholly owned TRS, operates health clubs at several buildings owned by the REIT. The health club space at any particular property generally is space that is unmarketable for traditional office use and is unique space within the particular building. Within that building, there thus may not be similar space rented to unrelated third parties; however, the health club space is rented for an amount comparable to similar spaces in other properties leased to unrelated third parties in the same geographic area. The Service concludes that amounts paid by the health club TRS for space at a property of the REIT with respect to which there is no comparable space will not fail to qualify for the limited rental exception of Section 856(d)(8)(A) so long as the rent paid by the TRS is substantially comparable to rents paid by unrelated tenants for comparable space in the same geographic area.

Third, Section 856(l) provides that a REIT and a corporation may elect to have the corporation treated as a TRS of the REIT if the REIT directly or indirectly owns stock in such corporation. The REIT proposes to own less than 5% of the common stock of another corporation (“Parent 2”), which will in turn own stock in a national executive office suites business (“Operator 2”). Parent 2 will not be directly engaged in providing any services to any tenants at any of the properties owned by REIT. Parent 2 will not elect to be treated as a TRS. However, Operator 2 will lease space at certain properties owned by REIT to operate its business there, and Operator 2 intends to elect TRS status with respect to the REITs. This Service notes that there is no requirement that Parent 2 be a TRS for Operator 2 to be treated as a TRS. Under
Section 856(1), Operator 2 will be treated as a TRS of the REIT so long as the REIT indirectly owns stock in Operator 2 by virtue of a direct stock ownership in Parent 2, even if Parent 2 does not elect to be treated as a TRS with respect to the REIT.

J. Priv. Ltr. Rul. 200239012 (September 27, 2002). In this ruling, the taxpayers possessed certain property rights in a facility, namely the right to the non-exclusive use and enjoyment of a facility and the right of first refusal and a purchase-option upon any proposed sale or disposition of the facility. The owner of this facility sold it to an unrelated party. The taxpayers brought suit in state court for fraudulent conveyance. The state court found in favor of the taxpayers and awarded money damages. The Service concluded that the fraudulent conveyance constituted an involuntary conversion of property for purposes of Section 1033, which allowed the taxpayers to defer any gain resulting from this conversion of their property rights into money damages provided that they acquire appropriate replacement property within the replacement period.

K. Priv. Ltr. Rul. 200241002 (October 11, 2002). In this ruling, the Service ruled that rents received by an S corporation that owns, leases and manages commercial real estate are not passive investment income as defined under Section 1362(d)(3)(C)(i). Passive investment income includes gross receipts derived from rents unless the rents arise in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Based upon the facts submitted, the Service concluded that the rents received by the taxpayer are not passive investment income. This ruling is particularly important because an S corporation election terminates if passive investment income accounts for more than 25% of the corporation’s gross receipts for three consecutive taxable years.

L. Priv. Ltr. Rul. 200241016 (October 11, 2002). The taxpayer requesting the ruling is in the business of leasing equipment to customers of various independent dealers who sell equipment manufactured by the parent of the taxpayer’s consolidated group. In this case, the taxpayer sought to initiate an exchange program through which it disposed of equipment coming off a lease (upon which gain was realized by the taxpayer) and acquired replacement property with the proceeds from the disposition of the relinquished equipment. The taxpayer represented that the properties will be like-kind because each piece of equipment exchanged will be in the same product class as listed in the Standard Industrial Classification manual. Accordingly, the issue here was not whether the property was of like-kind, but whether the taxpayer actually or constructively received money or other property before it actually receives the replacement property.

To meet the requirements of Section 1031, the taxpayer entered into a master exchange agreement with a qualified intermediary. Pursuant to an escrow agreement, the taxpayer established a qualified escrow account with a third party to effect the proposed exchanges in order to avoid being deemed in actual or constructive receipt of the proceeds from the sales of relinquished equipment.

The Service concluded that each equipment transfer entered in accordance with the master exchange agreement qualifies as a like-kind exchange. Thus, the Service ruled that,
assuming the taxpayer’s representations are correct and that the relevant parties adhere to the requirements of the master exchange agreement and escrow agreement, the taxpayer will not be deemed in constructive receipt of any money or other property held by the qualified intermediary or escrow holder unless such items are actually payable to and deposited by the taxpayer.

M. Priv. Ltr. Rul. 200242041 (October 18, 2002). The taxpayer, a tax-exempt, nonprofit corporation that operated a religious school to promote, maintain and sustain a resident monastic community, and to promote religious education, life and values, sought to sell approximately fifteen acres of real property that it acquired by bequest. The taxpayer decided to sell the property after it determined that it was not suitable for constructing additional campus facilities.

As an exempt organization, any unrelated business taxable income is subject to taxation. All gains or losses from the sale, exchange or other disposition of property other than property held primarily for sale to customers in the ordinary course of the trade or business are excluded from the computation of unrelated business taxable income. In concluding that the taxpayer’s surplus real estate qualified for this exception, the Service listed several facts that distinguished this situation from that of a taxpayer which held property for sale to customers in the ordinary course of a trade or business. Specifically, the Service noted (1) the taxpayer received the property by bequest and held the property for 15 years, (2) the small number of lots and acreage to be sold, (3) the fact the town where the land was located mandated certain improvements, and (4) the taxpayer’s lack of marketing efforts. Thus, the Service ruled that any gain realized on the sale of the property was not subject to the unrelated business income tax under Section 511(a).

N. Priv. Ltr. Rul. 200248014 (November 29, 2002). In this ruling, the Service held that payments from real estate developers to a regulated public utility for placing underground existing overhead electric distribution lines are nonshareholder contributions to the capital of the utility under Section 118(a) and not taxable contributions in aid of construction under Section 118(b).

In reaching its conclusion, the Service noted that the undergrounding of the overhead lines on the developers’ properties was a condition of site plan approval imposed by the local county. Moreover, the local county ordinance mandated undergrounding of overhead power lines for purposes of community aesthetics and the general benefit of the public. The Service also concluded that the payments to the utility from the developers satisfied the five characteristics of nonshareholder contributions to capital stated in United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973), providing that a payment is a nonshareholder capital contribution if (1) the payment becomes a permanent part of the transferee’s working capital structure; (2) the payment is not compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee; (3) the payment is part of a bargained-for exchange; (4) the asset transferred foreseeably must benefit the transferee in an amount commensurate with its value; and (5) the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

O. Priv. Ltr. Rul. 200249014 (December 6, 2002). The Service concluded that the construction, ownership and leasing of a student housing project for a specific, historically black
college would neither adversely affect the tax-exempt status of the taxpayer, a charitable community development corporation created to promote economic and community development around this particular university, nor constitute an unrelated trade or business.

In this case, the taxpayer intended to develop, own and operate the housing project through a single member limited liability company, which was disregarded for Federal tax purposes. The taxpayer’s primary purpose in undertaking this project was to stimulate economic development and create jobs in the economically depressed area in and around the college. Both taxable and tax-exempt bonds would be used to finance the project, with any excess revenue donated to the college on an annual basis. Once the bonds are paid off, the taxpayer will donate the housing to the college. The Service found that that developing and operating student housing facilities for the exclusive use of this particular college’s students advanced the taxpayer’s charitable purposes.

P. Priv. Ltr. Rul. 200251008 (December 20, 2002). The Service ruled that an S corporation will not recognize gain or loss in a like-kind exchange of real property using the qualified exchange accommodation arrangement (QEAA) with an exchange accommodation titleholder (EAT). This transaction is sometimes referred to as a “parking” transaction. Rev. Rul. 2000-37, 2000-40 I.R.B. 308, set forth a safe harbor for acquiring replacement property through this type of transaction.

Here, the proposed parking transaction involved related parties. The taxpayer, an S corporation, sought to relocate its business, through a like-kind exchange, to a parcel of unimproved land currently leased by another related S corporation. To this end, the taxpayer proposed to enter into the QEAA with EAT, and to enter an exchange agreement with a qualified intermediary (QI). As part of the overall transaction, the second S corporation would sublease the real property for fair market rental to a limited liability company (LLC) wholly owned by EAT. The taxpayer then would lend funds to LLC to construct improvements necessary for the relocation of the taxpayer’s business. In addition, the taxpayer would assign its rights and interests in the real property where its business was currently located to QI, which would use the proceeds from the sale of the taxpayer’s property to pay EAT for all of its interests in LLC. The EAT will use these proceeds from QI to pay LLC, which is managing the construction of the premises for the taxpayer’s new business location, and to repay the loan from the taxpayer. Finally, QI will direct EAT to transfer its interest in LLC, which holds title to the real property where the taxpayer’s new business will be located, directly to the taxpayer.

The Service ruled that the proposed transaction conformed with the requirements of the safe harbor rules for QIs and QEAAAs. Because the QI and EAT employed in this transaction were not considered the taxpayer’s agents, the taxpayer was not in actual or constructive receipt of money or other property prior to receiving the replacement property. Accordingly, the taxpayer did not recognize any gain or loss on the exchange. However, if the planned improvements on the subleased property are not completed within the exchange period, then, as pointed out by the Service, the taxpayer will recognize gain to the extent of any boot received in the exchange.

Q. Priv. Ltr. Rul. 200301004 (January 3, 2003). The Service concluded that the exercise of an option to invest in a partnership, followed shortly thereafter by a cash distribution
from the partnership to an original partner, constituted a disguised sale of a partnership interest. In this case, the exercise price was based on a formula designed to treat the option holder as though it had been a partner since the formation of the partnership though the option holder would exercise the option subsequent to the partnership’s formation. After the new partner made its contribution, the partnership made a related distribution to the original partner. The Service held that the related contribution and distribution yielded a result that was economically indistinguishable from a sale.

R. Priv. Ltr. Rul. 200303023 (January 17, 2003). The Service concluded that the partition of jointly owned property does not constitute a sale or exchange under Section 1001. In this situation, four related individuals owned a contiguous tract of real estate as tenants-in-common. The taxpayers proposed to partition the tract into separate parcels. Appraisals indicated that each proposed parcel was equal approximately to the value of the taxpayer’s respective undivided interest in the jointly owned tract immediately prior to the partition. Accordingly, partitioning the property in this manner would not benefit disproportionately a particular taxpayer. As part of its analysis, the Service concluded that Rev. Rul. 56-437, 1956-2 C.B. 507, which held that a partition of jointly owned property was not a sale or disposition of property, applied here.

S. Priv. Ltr. Rul. 200304011 (January 27, 2003). The Service granted a corporate taxpayer’s request for an extension of time to make an election under Section 856(1) to treat a subsidiary as a taxable REIT subsidiary. A taxpayer makes this election on Form 8875, Taxable REIT Subsidiary Election. The effective date of the election cannot be more than two months and 15 days prior to the date of filing the election. In this case, the taxpayer sought to treat its subsidiary as a taxable REIT as of a particular date. The taxpayer’s chief financial officer, however, failed to file Form 8875 in time.

Reg. §301.9100-1(c) provides that the Commissioner has discretion to grant a reasonable extension of time to make a regulatory election if the taxpayer acted reasonably and in good faith and granting the requested relief does not prejudice the government (i.e., granting the relief does not result in the taxpayer having a lower tax liability). The Service ruled that the taxpayer satisfied the requirements for granting a reasonable extension of time to make this election.

T. Priv. Ltr. Rul. 200320013 (February 4, 2003). This letter ruling involves an S corporation (“Oldco”), owned by an individual, which holds assets used in two businesses and a percentage of stock in a subsidiary (“Old Sub”). Because the state in which Oldco is located imposes requirements on one business that restrict the growth of the other business, Oldco seeks to separate the two businesses into separate state law entities.

Oldco proposes to transfer the assets of one business and the stock of Old Sub to a newly formed subsidiary (“Newco”). Newco will form a merger subsidiary that will merge into Oldco, with Oldco surviving. All of the merger subsidiary stock held by Newco will be converted into stock of Oldco, and all of the Oldco stock held by the individual will be converted into Newco stock. Also, concurrently with the merger, Newco will form a new subsidiary (“Newco2”) and transfer the assets of the other business to Newco2. Newco will file an election to be treated as an S corporation, effective as of the merger date. Newco will also file qualified subchapter S subsidiary (“QSub”) elections for Oldco and Newco2, with both elections effective as of the
merger date. As a result of these steps, referred to as the “Transaction”, the individual will own all the stock of Newco, an S corporation, solely by reason of the individual’s prior ownership of Oldco stock, and Newco will operate the two businesses in Oldco and Newco2, each treated as a separate QSub.

Notwithstanding the no-ruling position in Section 3.01(29) of Rev. Proc. 2003-3, 2003-1 I.R.B. 133, 115, the IRS ruled that the Transaction will qualify as a reorganization under Section 368(a)(1)(F) because the case involved significant issues related to S status and the effect of the Transaction on Section 1374 assets currently held by Oldco. The IRS issued additional rulings, most notably the following: (1) that the assets transferred from Oldco to Newco and from Newco to Newco2 would not be subject to the built-in gain provisions of Section 1374, except to the extent those assets were subject to the built-in gain provisions in the hands of Oldco; and (2) that the taxable year of Oldco will not close on the date of the reorganization, but will continue in the name of Newco.

U. Priv. Ltr. Rul. 200307063 (February 18, 2003). The Service granted a partnership, which failed to include a properly executed election under Section 754, an extension of time to make this election. In this case, the partnership prepared its return as though the election had been made and even included a Section 754 election with its return. The Service concluded that the taxpayer acted reasonably and in good faith, and that granting relief would not prejudice the interests of the government.

V. Priv. Ltr. Rul. 200310014 (March 7, 2003). In this case, a corporation that had elected to be treated as a REIT owns direct and indirect interests in partnerships and companies seeking to qualify as taxable REIT subsidiaries (“TRS”). Section 856(c) provides that, for a corporation to qualify as REIT for any taxable year, at least 95% of its gross income must be derived from certain specified sources, including rents from real property, and at least 75% of its gross income must be derived from real property interests. Reg. §1.856-3(g) provides that a REIT that is a partner in a partnership will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. In this situation, the Service concluded that Reg. §1.856-3(g) applies to a tiered partnership arrangement.

The Service ruled that, for purposes of the gross income and asset tests under Section 856(c), a REIT’s share of the gross income and assets from its indirect interests in a Tier 2 entity will be based on the product of (i) the REIT’s capital interest in a Tier 1 partnership, expressed as a percentage, multiplied by (ii) the Tier 1 partnership’s interest in the Tier 2 entity, expressed as a percentage. To determine the respective capital interests, divide the relevant capital account by the sum of all partner capital accounts for the particular partnership.

The REIT’s Managing Partnership is a Tier 2 entity. Managing Partnership provides services relating to property management, leasing, development, acquisition and other administrative services to the REIT and the Operating Partnership. In addition, Managing Partnership’s employees may be used to perform services for unrelated third parties or tenants that the TRSs contracted to perform. In such situations, the TRS enters a cost-sharing arrangement whereby the TRS reimburses Managing Partnership for a portion of its costs incurred in this capacity. The Service ruled that the amounts paid by a TRS to Managing
Partnership as reimbursement for personnel costs and other shared expenses will not be considered gross income to Managing Partnership to the extent Managing Partnership does not perform the same services for third parties as those for which the TRS reimburses it. Thus, because the reimbursements are not taxable to Managing Partnership under this arrangement, it may not deduct these otherwise deductible expenses. Ruling otherwise would provide Managing Partnership with a double benefit.

W. Priv. Ltr. Rul. 200317005 (April 25, 2003). The Service analyzed whether the transfer of certain land and the proceeds of certain bonds from a local government to a corporation qualified as a nonshareholder contribution to capital excludible from income under Sec. 118(a) I.R.C. To locate its new facility in a particular area, the taxpayer received certain incentives from local government authorities, including the transfer of land and proceeds from a bond offering. Because the local government authorities transferred the land and the proceeds of the bonds to induce the taxpayer to build and operate its business within its jurisdictional area, the Service determined that the transfers were instituted by a desire to benefit the general community, and that the local government contributor did not anticipate any direct benefit from the contributions. Therefore, the Service concluded that the transfers were eligible for nonshareholder capital contribution treatment under Sec. 118(a) I.R.C.

X. Priv. Ltr. Rul. 200320023 (May 16, 2003). This ruling was sought by a REIT that owns an interest in a partnership (the "Partnership") and serves as the Partnership's managing general partner. The Partnership owns and operates office buildings in City A and several other major metropolitan areas (the "Properties") through separate limited liability companies or partnerships (the "Property-Owning Entities"). Under the terms of the leases of office space in the Properties, certain interior cleaning services must be performed. These services include basic routine dusting, emptying of wastepaper baskets, cleaning of floors and floor coverings (e.g., vacuuming), cleaning of lavatories, washing of windows and certain other janitorial services (collectively, the "Services"). The REIT represented that the Services are customarily rendered, furnished or arranged for by landlords of Class A office buildings in City A and the other major metropolitan areas where the Properties are located. The Services are part of the total package offered to tenants and are an integral part of the rental of the office space. The Services are currently performed for each Property-Owning Entity by independent contractors from which the REIT does not derive or receive any income or through a taxable REIT subsidiary of the REIT, as provided in Sec. 856(d)(7)(C)(i), I.R.C. For business reasons, the REIT now desires to have the Services performed directly by employees of the Property-Owning Entities. The IRS ruled that the Services will not cause income from tenants at the Properties in which the Services are provided by the REIT through the Property-Owning Entities to be treated as other than "rents from real property" under Sec. 856(d), I.R.C.

Y. Priv. Ltr. Rul. 200326014 (June 27, 2003). Taxpayer, a corporation (with accumulated subchapter C earnings and profits) that intends to make an S election, was formed to own and operate commercial and residential real estate. Taxpayer's business activities are all conducted through its full-time office employees and its full-time residential apartment managers. Taxpayer, through its employees, negotiates and signs leases, approves all purchases, schedules, oversees and inspects all repairs and capital improvements, negotiates financing, settles tenant disputes, makes personnel decisions, markets its units to potential tenants, performs all bookkeeping tasks and maintains the properties. The IRS ruled that Taxpayer's rental income
from its commercial and residential real estate and undeveloped lots does not constitute "passive investment income" under Sec. 1362(d)(3)(C)(i), I.R.C.

Z. **Priv. Ltr. Rul. 200326018 (June 27, 2003).** In this ruling, the Service held that rents received by an S corporation that owns, leases and manages commercial real estate are not "passive investment income", as defined under Sec. 1362(d)(3)(C)(i), I.R.C. Passive investment income includes gross receipts derived from rents unless the rents arise in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Based upon the facts in this ruling, the Service concluded that the rents received by the taxpayers are not passive investment income. This ruling is particularly important because an S corporation election terminates if passive investment income accounts for more than 25% of the corporation's gross receipts for three consecutive years.

AA. **Priv. Ltr. Rul. 200326032 (June 27, 2003).** In this ruling, the Service ruled that a recapitalization involving United State real property interests will be tax-free. Based on the facts of this ruling, two foreign corporations ("Corp A" and "Corp B") are the shareholders of a subsidiary ("Sub 1"). Corp A, Corp B and Sub 1 are the shareholders of a fourth corporation ("Sub 2") which is a United States real property holding corporation.

For valid business reasons, the parties will engage in a two-step transaction. In the first step, Corp A and Corp B will amend the charter of Sub 2 to alter the voting power of the Sub 2 stock owned by Corp A and Corp B. In the second step, Corp A and Corp B will each contribute those shares of Sub 2 stock for which the voting power was decreased to Sub 1 in exchange, on a share-for-share basis, for shares of stock of Sub 1. Sub 2 is a United States real property holding corporation within the meaning of Sec. 897(c)(2), I.R.C. and the shares of Sub 2 stock contributed by Corp A and Corp B are United States real property interests (USRPIs) within the meaning of Sec. 897(c)(1), I.R.C.

The Service explained that, under Temp. Reg. §1.897-6T(a), a "nonrecognition provision" applies to a transfer by a foreign person of a USRPI only to the extent that it is exchanged for another USRPI that would be subject to U.S. tax on its disposition. A Sec. 368(a)(1)(E), I.R.C. recapitalization is a nonrecognition provision as defined in Temp. Reg. §1.897-6T(a)(2). In order to obtain nonrecognition treatment for the transfers, therefore, Corp A and Corp B must meet the requirements of Temp. Reg. §1.897-6T(b).

The Service ruled that Corp A and Corp B will not recognize gain with respect to the amendment of the charter of Sub 2 under Sec. 897(e), I.R.C. In addition, the Service ruled that Corp A and Corp B will not recognize gain on the exchange of Sub 2 stock for Sub 1 stock under Sec. 897(e), I.R.C.

BB. **Priv. Ltr. Rul. 200329021 (July 18, 2003).** In this ruling, the Service concluded that the taxpayer's proposed exchange of property held for productive use through a qualified intermediary and an exchange accommodation titleholder conformed with the requirements of the qualified intermediary and qualified exchange accommodation arrangement (QEAA) safe harbor rules provided by Rev. Proc. 200-37.
Here, Taxpayer, a wholly owned subsidiary of Parent, proposed to create a QEAA by entering into an agreement with Company, which would serve as both a qualified intermediary and an exchange accommodation titleholder in this transaction. Pursuant to the QEAA Agreement, LLC, a single-member LLC wholly owned by Company and disregarded for Federal income tax purposes, accepted an assignment from Parent of a leasehold interest in Site Y (Leasehold Interest) on Date 1. Under the laws of the state where Site Y is located, the Leasehold Interest is considered a real property interest. On the same date of the assignment, Taxpayer also entered an Exchange Agreement with Company even though it did not own the Leasehold Interest. LLC will construct and own a building (Improvements) on Site Y pursuant to Parent’s design. LLC is expected to complete the construction project by Date 2 (a date within 180 days after the earlier of the transfer of Leasehold Interest to LLC or the date LLC acquires title to the Leasehold Interest).

Under the Exchange Agreement, Taxpayer will identify within the 45-day period set forth in Sec. 1031(a)(3), I.R.C., in a written instrument delivered to the Qualified Intermediary (Company), the legal description of the Leasehold Interest and a general description of the Improvements to be constructed on the Leasehold Interests. The Qualified Intermediary will not take title to either the Relinquished Property or the Replacement Property.

Under the QEAA Agreement, Taxpayer will identify, within the 45-day period beginning on Date 1, the Relinquished Property disposed of under the Exchange Agreement as the real property being exchanged for the Replacement Property held under the QEAA Agreement.

Within 180 days after the earlier to occur of (i) the conveyance of the Relinquished Property and (ii) LLC’s acquisition of the Replacement Property in the form of the Leasehold Interest and Improvements, Taxpayer will, under the Exchange Agreement and the QEAA Agreement, acquire the Leasehold Interest and the Improvements to complete the exchange.

In holding that this proposed transaction qualifies for like-kind treatment, the Service observed that, if the planned improvements are not completed within the exchange period, Taxpayer will recognize gain to the extent of any boot received in the exchange. Also, to the extent that the estimated cost of the Improvements is less than the qualified funds held by Qualified Intermediary, if Taxpayer does not timely identify and acquire additional like-kind replacement property, Taxpayer will receive the remaining funds as boot.

VI. FIELD SERVICE ADVICE AND INTERNAL LEGAL MEMORANDA

A. Field Service Advice 200216005 (April 19, 2002). In this Field Service Advice, the Service concluded that a limited partnership formed under the Revised Uniform Limited Partnership Act cannot elect out of Subchapter K because the partners are not co-owners of the partnership property and cannot take their shares of property at will. A limited partnership was formed to finance a new aircraft. The limited partnership agreement specifically stated that the partners intended that the partnership be an investing partnership, as defined in Reg. §1.761-2(a)(2). On audit, the question was whether the partnership was eligible to make a Section 761(a) election to be excluded from Subchapter K. Despite the stated intent in the agreement
and the terms of the agreement, the election was denied to the partnership on the basis that the partners of a limited partnership "generally" do not have the right to take separately or dispose of their shares of the partnership property, and so are not co-owners of the property in the limited partnership. Therefore, the limited partnership did not meet the requirements of Reg. §1.761-2(a)(2)(i).

B. Field Service Advice 200217001 (April 26, 2002). Taxpayer claimed that cash received in settlement of a claim for tortious interference with contract relations was an involuntary conversion eligible for deferral under Section 1033(a)(2).

Citing Rev. Rul. 73-477, 1973-2 C.B. 302 (dealing with proceeds received under a use and occupancy insurance policy), the Service found, however, that the funds were received in lieu of expected ordinary income, were taxable as such ordinary income and thus were ineligible for Section 1033 nonrecognition treatment. See Reg. §1.1033(a)-2(c)(8).

The Service noted that "Congress did not contemplate nonrecognition relief for dispositions resulting from tortious actions - short of theft or destruction - or business expediency (actionable or not) such as what occurred here; rather, it intended relief for taxpayers faced with the actual or threatened loss of their property to the government and/or a loss by casualty or theft".

C. Field Service Advice 200219008 (May 10, 2002). The Service concluded that partners cannot use the Subchapter K rules to shift appreciation on real estate to interests in lower-tier partnerships without recognizing gain. In this case, a partnership was formed to own and operate real estate. The interests in this partnership were held by two upper-tier partnerships. The upper-tier partnerships liquidated and distributed their interests in the real estate partnership to their partners. Following the liquidation, the real estate partnership borrowed money and purchased short-term debt instruments that it contributed to two newly formed subsidiary lower-tier partnerships. The real estate partnership then distributed its interests in the lower-tier partnerships to its partners.

The Service found that upper-tier partnerships’ distributions of interests in the real estate partnership resulted in a termination of the real estate partnership under Section 708(b)(2)(B). The Service further found that such a termination resulted in a deemed contribution of the real estate partnership’s assets to a new partnership in exchange for new partnership interests and a distribution of the new partnership interests to the partners in liquidation of the old partnership. Under Section 732(b), this resulted in each partner’s basis in the real estate partnership being the same as its basis in the upper-tier partnership prior to liquidation. The Service also concluded that the distribution by the real estate partnership of its interests in the lower-tier partnerships should be treated as a distribution of money under Section 731(c), subjecting the partners to gain recognition under Section 731(a).

The Service noted its concern that, in this case, the partners were seeking to use Subchapter K to defer gain by shifting their appreciation in the property to the interests in the lower-tier partnerships without recognizing gain. Wishing to apply the anti-abuse rule of Reg. §1.701-2, but recognizing the litigating hazards in doing so, the Service decided first to assert the anti-abuse rule under the Section 731 regulations. In addition, the Service noted that
“it might be appropriate to question the validity of the [lower-tier partnerships] on the grounds that they lack any apparent business purpose and, therefore, economic substance”, citing ACM Partnership v. Comm’r, 73 T.C.M. (CCH) 2189 (1997), aff’d in part, rev’d and rem’d in part 157 F.3d 231 (3d Cir. 1998).

D. Internal Legal Mem. 200250013 (December 13, 2002). In this Legal Memorandum, a partner received partnership assets upon withdrawal from a partnership, and at the same time agreed to assume the partnership’s only liability. The Service concluded that the distribution of all of a partnership’s operating assets to a withdrawing partner should be treated as a distribution of that partner’s share of partnership assets under Sec. 731(b), I.R.C. in complete redemption of that partner’s interest, followed by a disguised sale of the remaining operating assets of the partnership to the redeemed partner in return for the assumption of the partnership’s liabilities. Because the distribution of the partnership’s assets in redemption of the withdrawing partner was, in substance, equivalent to a distribution of marketable securities to the remaining partners, the transaction should be recast under Reg. §1.731-2(h) as a distribution of marketable securities to the remaining partners.

VII. CASES

A. Abrams v. Comm’r, T.C. Summary Opinion 2002-155. The taxpayers rented a house, which was previously their personal residence, for approximately 18 months before selling the property to the lessee. The taxpayers claimed a deductible loss on the sale of the property.

The loss allowed upon the sale of residential property converted to rental property is the excess of the adjusted basis over the amount realized from the sale. The adjusted basis is the lesser of the following amounts at the time of conversion, reduced for depreciation for the period after conversion: (1) the fair market value, or (2) the adjusted cost basis. The taxpayers claimed that the fair market value of the house at the time of conversion was $480,000, which was less than the adjusted cost basis of the property. The taxpayers, however, did not obtain an appraisal at the time of conversion or provide any information regarding comparable sales. After evaluating the record, the Tax Court concluded that the fair market value of the property at the time of conversion was $435,000. The Court pointed to the fact that the property languished on the market with an asking price of $435,000 for more than a year before the lessor bought it for that amount. Thus, because the taxpayers’ basis in the property equaled the amount realized, the taxpayers did not sustain a deductible loss on the sale of their former home.

B. Estate of Adams v. Comm’r, 83 T.C.M. (CCH) 1421 (2002). In determining the value of shares of an S corporation, the Tax Court held that the net cashflow and the capitalization rate used to compute the fair market value of the stock should have the same character (i.e., before or after corporate tax). See also Gross v. Comm’r, 272 F.3d 333 (6th Cir. 2001). Here, the Court concluded that it was appropriate to use a zero corporate tax rate to estimate net cashflow when the stock being valued is stock of an S corporation. Accordingly, there should be no adjustments to reflect the lack of any corporate level income tax on the S corporation’s earnings.
C. **Estate of Bailey v. Comm’r**, 83 T.C.M. (CCH) 1862 (2002). Decedent and his spouse each owned one-half of the 300 shares in C&L Bailey, a company that owned two motels. Decedent’s spouse predeceased decedent and left her shares in the company in a trust, which elected QTIP status as to 50 of the 150 shares. At his death, decedent owned 50 shares and the QTIP trust owned 50 shares, with then-remaining outstanding 100 shares in the non-QTIP trust of decedent’s spouse.

The Service allowed a combined 50% discount (for lack of marketability, minority interest, built-in gains and “stock sale costs”) on the shares decedent owned outright and on those held in the QTIP trust. The Service effectively acknowledged that such shares would not be combined, and the Court concurred. See **Estate of Mellinger v. Comm’r**, 112 T.C. 26 (1999).

After reviewing the parties’ respective positions and listening to their expert, the Court accepted the 50% discount, noting that the Service, in its notice of deficiency, “accepted this 50% combined discount rate and has not shown that a lower discount rate is appropriate.”

D. **Estate of Ballantyne v. Comm’r**, 83 T.C.M. (CCH) 1896 (2002), aff’d __ F.3d __ (8th Cir. 2003). The decedent and his brother formed a partnership, Ballantyne Brothers Partnership (“BBP”). No written partnership agreement was executed. The partnership was involved in two separate business operations. Decedent and his sons conducted oil and gas explorations. Decedent’s brother and his sons engaged in a farming activity.

Each brother paid the expenses for his activity, and each withdrew from the partnership the profits attributable to his activity. Each brother reported 50% of the partnership’s income and loss on his individual return. Partnership capital accounts were not maintained.

After decedent died, his widow sued his brother, claiming that he had embezzled from the partnership. The suit was settled, and, as part of the settlement, the parties agreed that decedent’s brother would retroactively be allocated all farming income. The Service sought deficiencies against decedent’s estate and decedent’s brother in order not to be whipsawed.

Because BBP was an oral partnership, the Tax Court considered all facts and circumstances relating to the brother’s economic arrangements, including the four factors listed in Treas. Reg. §1.704-1(b)(3)(ii) and the testimony of the tax return preparer, to determine that each partner had a 50% interest in the partnership. Accordingly, the farming income had to be allocated equally between them.

E. **Dunn v. Comm’r**, 301 F.3d 339 (5th Cir. 2002), rev’g and rem’g 79 T.C.M. (CCH) 1337 (2000). In an opinion that was highly critical of the Tax Court, the Fifth Circuit reversed and remanded the Tax Court’s decision regarding the proper valuation of the decedent’s 62.96% interest in a closely held, family-operated corporation. The Tax Court calculated the corporation’s “earnings based value” at $1,321,740 and its net “asset-based value” at $7,922,892, as of the valuation date. To reach the fair market value of the decedent’s interest, the Tax Court assigned a weight of 35% to the earnings-based value and 65% to the asset-based value, which the Court calculated by reducing the value of the corporation’s assets by 5% for built-in gains tax liability.
On appeal, the decedent’s estate challenged the Tax Court’s determination of the asset-based valuation and the Tax Court’s allocation of weight between the earnings-based and asset-based valuations. The estate did not challenge the Tax Court’s earnings-based valuation or the Tax Court’s discounts for lack of marketability or lack of super-majority control.

The Fifth Circuit significantly modified the Tax Court’s determination of the decedent’s interest in the corporation. Specifically, the Fifth Circuit ordered the Tax Court to reduce the previously determined market value of the corporation’s assets by the amount of the tax on the corporation’s built-in gains. The Fifth Circuit also reallocated the assignment of relative weights to the results of the two principal valuation approaches. In large part because the corporation was an operating company, the Fifth Circuit assigned a weight of 15% to the revised asset-based value and 85% to the earnings-based value.

F. Estate of Fontana v. Comm’r, 118 T.C. 318 (2002). Decedent and his spouse owned all of the outstanding voting and nonvoting common shares of Fontana Ledyard Co., Inc. (“Ledyard”). Decedent’s spouse died in 1993, leaving her shares in two trusts. Decedent was trustee of both trusts, and had a testamentary general power of appointment over the first trust. Decedent died in 1996, at which time he owned outright 50% of the Ledyard Stock and the first trust owned another 44.069%.

The Service contended that the two blocks had to be aggregated, and as such were valued at decedent’s date of death at $4,850,000. The Service agreed that, if the blocks were not aggregated, decedent’s shares were valued at $2,043,500 and the trust’s shares were valued at $1,747,500, for an aggregate value of only $3,791,000.

The Court agreed with the Service, distinguishing Estate of Mellinger v. Comm’r, 112 T.C. 26 (1999). There, the second portion of the property was in a QTIP trust, under which the decedent had no power to control the ultimate disposition. Here, the taxpayer, pursuant to the general power of appointment, “at the moment of death (i.e., the critical moment for estate tax valuation purposes), had control and power of disposition over the property.”

G. Fowler v. Comm’r, 84 T.C.M. (CCH) 281 (2002). Taxpayers claimed that rental real estate losses were not subject to the passive activity loss limitations under Section 469, because Mr. Fowler qualified as a real estate professional under Section 469(c)(7). Taxpayers did not elect to aggregate their real property rental activities for purposes of Section 469.

The Court noted that, under Section 469(c)(7)(B), a taxpayer qualifies as a real estate professional (and, thus, is not engaged in a passive activity under Section 469(c)(2)) if (i) more than one-half of the personal services performed in trades or businesses by the taxpayer (or his spouse) during a taxable year are performed in real property trades or businesses in which the taxpayer (or his spouse) materially participates and (ii) more than 750 hours of services are so performed.

Taxpayer kept electronic calendars of his activities, in which he entered in advance the dates and times of each activity, including the beginning and ending times based on estimates. He did not go back and correct these entries to reflect actual time spent. In addition to these
entries, taxpayer computed an estimate of the hours spent traveling to and from his various rental properties.

Temp. Reg. § 1.469-5T(f)(4) provides that the “extent of an individual’s participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.”

The Court found that the taxpayer’s calendar entries did “not reliably or reasonably reflect the hours that [taxpayer] actually devoted … to his rental real estate activities”. Although in preparation for trial the taxpayer made “notations on his calendars based on his recollection of the activities occurring” 6 and 7 years earlier, the Court pointed out that the cited Temporary Regulation does not “allow a postevent ‘ballpark guesstimate’”. Finally, finding that the taxpayers’ “reconstruction and assertions of time spent are not credible in the context of the types of properties, the amount of rent received, and the services allegedly performed”, the Court held against the taxpayers.

H. Godley v. Comm’r, 286 F.3d 210 (4th Cir. 2002), aff’d 80 T.C.M. (CCH) 158 (2000). At the time of his death, decedent Godley owned a 50% interest in five general partnerships. The decedent’s son, Godley, Jr., was the managing partner and the owner of the remaining interests in the partnerships. Godley, Jr. could not, however, make any “major decisions” without the affirmative vote of 75% of the partnership shares. “Major decisions” included buying or selling land or partnership property, securing financing, spending in excess of $2,500, entering into major contracts, or taking any other action “which materially affects the Partnership or the assets or operations thereof.”

Each partnership agreement contained a provision granting Godley, Jr. an option to purchase his father’s interest in that partnership for $10,000, upon his father’s death. Godley, Jr. exercised these options and purchased his father’s interest in the five partnerships for an aggregate price of $50,000. On Godley’s Federal estate tax return, his interests in the partnerships were reported at a fair market value of $10,000 each (i.e., the option price).

The Tax Court disregarded the option price, and instead determined the value of Godley’s 50% interest by looking at the value of the partnership’s assets and the income generated by them. The Tax Court applied a 20% lack of marketability discount, but not for the alleged lack of control.

In affirming the Tax Court’s ruling, the Fourth Circuit held that a minority discount for lack of control was inappropriate in this case because (1) Godley’s right to approve “major decisions” ensured that his concurrence was required if Godley, Jr. decided to establish reserves that resulted in distribution reductions and (2) the partnerships’ contracts with the Department of Housing and Urban Development provided a long-term, steady income stream that was largely unaffected by the efforts of Godley, Jr. Accordingly, no discount for lack of management control was warranted in this case.
I. **Gulig v. Comm’r**, 293 F.3d 279 (5th Cir. 2002), aff’g in part, rev’g in part **Strangi v. Comm’r**, 115 T.C. 478 (2000). In 1994, the decedent formed a family limited partnership with a corporate general partner under Texas law. The decedent transferred assets valued at approximately $10 million to the partnership, in exchange for a 99% limited partnership interest and a 1% general partnership interest. In addition, the decedent purchased 47% of the partnership’s corporate general partner. His children purchased the remaining 53% of the corporation. The decedent died about two months after the formation of these entities. The decedent’s estate valued his interest in the entities on the date of his death at a little more than $6.5 million, even though the market value of the assets held by the partnership had increased in value to more than $11.1 million. The estate’s valuation reflected a 33% discount from the value at the time of transfer to the partnerships for lack of marketability and lack of control.

The Fifth Circuit upheld the Tax Court’s decision that the partnership had sufficient economic substance to be recognized for Federal estate tax purposes, and affirmed the Tax Court’s conclusion that the decedent’s transfer of property to the partnership was not a taxable gift. The Fifth Circuit, however, reversed the Tax Court’s denial of the Commissioner’s request for leave to amend its pleadings to add a claim that the decedent’s taxable estate included the value of the decedent’s assets transferred to the partnership. In reaching its holding, the Fifth Circuit emphasized that the Commissioner filed the motion to amend more than two months before trial, which it believed was unlikely to cause delay or prejudice. The Fifth Circuit also noted the absence of bad faith on the Commissioner’s part. Accordingly, the Fifth Circuit remanded the case to the Tax Court for full consideration of the Commissioner’s claim under Sec. 2036, I.R.C.

J. **Hackl v. Comm’r**, 335 F.3d 664 (7th Cir. 2003), aff’g 118 T.C. 279 (2002) The taxpayers created a limited liability company (“LLC”) to own and operate tree farming properties. In 1995 and 1996, the taxpayers made gifts of interests in the LLC to their children and grandchildren. On their 1995 and 1996 gift tax returns, the taxpayers elected to treat the gifts as made one-half by each and as qualifying for the gift tax annual exclusion. The IRS disallowed the annual exclusion treatment.

The taxpayers contended that the interests transferred qualified for the annual exclusion because they were properly characterized as present interests. The taxpayers stated that they made direct, outright transfers of the LLC interests, each of which had a substantial and stipulated value. The taxpayers did not place any restrictions on the donees’ LLC interests, so that the donees received rights that were identical to those of the taxpayers.

The Service disagreed with the taxpayers, stating that, because of the restrictions in the operating agreement of the LLC, the donees did not receive a present possessory interest in the LLC interests. It asserted that the inability of the donees freely to transfer the interests or compel distributions from the LLC prevented the donees from receiving a present interest.

The Seventh Circuit rejected the taxpayers’ contention that, when a gift is in the form of an outright transfer, it is automatically considered a present interest. In doing so, the Seventh Circuit stated that “the phrase ‘present interest’ connotes the right to substantial present economic benefit” and the Court concluded that LLC’s operating agreement “clearly foreclosed
the donee’s ability to realize any substantial present economic benefit”. In this case, the operating agreement provided as follows: (1) no member could withdraw his or her capital contribution without manager consent; (2) no one member alone could effect a dissolution of the LLC; (3) a member could not transfer his or her interest in the LLC to a third party without the manager’s consent, which consent could be given or withheld, in the manager’s sole discretion; and (4) distributions of LLC income and other property were to be made only in the manager’s discretion.

Accordingly, the Seventh Circuit held that the transfer of the LLC’s shares did not confer upon the donees a substantial present economic benefit and thus the Hackls’ gifts were not gifts of present interests. Hence, the transfers did not qualify for the annual exclusion.

K. Estate of Harper v. Comm’r, 83 T.C.M. (CCH) 1641 (2002). In 1994, the decedent created a family limited partnership, to which he contributed the majority of his assets, consisting primarily of marketable securities and a promissory note. The decedent’s two children were named as the general partners, with a combined 1% interest in the partnership, and the decedent’s revocable trust was named as the limited partner, with a 99% interest in the partnership. Shortly after the formation of the partnership, the decedent transferred 60% of the trust’s limited partnership interest to his children. The interests transferred to the decedent’s children became Class B interests, and the decedent’s remaining limited partnership interest became a Class A interest.

The decedent passed away in February 1995. On the estate tax return, the decedent’s estate included a 39% limited partner interest in the partnership. The decedent’s estate also filed a gift tax return reporting the gifts of the 60% limited partner interest to the decedent’s children. The Service issued a notice of deficiency stating that the full fair market value of the partnership assets should be included in the decedent’s estate. It argued that either the partnership lacked economic substance and should be disregarded or that Sec. 2036(a), I.R.C. applied due to the decedent’s retention of the economic benefit of the assets.

Sec. 2036(a), I.R.C. requires that an asset be included in the decedent’s estate if the decedent retained, either expressly or impliedly, the possession, control or enjoyment of or the right to income from such asset. Here, the Service contended that the decedent had an implicit agreement to retain control or enjoyment of the assets he transferred to the partnership.

The Court compared this situation to Estate of Reichardt v. Comm’r, 114 T.C. 144 (2000), and Estate of Schauerhamer v. Comm’r, 73 T.C.M. (CCH) 2855 (1997), in which the Tax Court held that Section 2036 applied to include all of the partnership assets in the decedent’s estate. In Estate of Reichardt, the decedent transferred his residence and all of his other property, other than his car, personal effects and a small amount of cash, to a family limited partnership. The decedent deposited all partnership income into his personal account, used the partnership checking account as his personal account and lived in his residence without paying rent to the partnership. In Estate of Schauerhamer, the decedent transferred business assets, including real estate, partnership interests and notes receivable, to a family limited partnership. The decedent deposited partnership income into her personal account and wrote checks from her personal account for both personal and partnership expenses. The decedent continued to manage the assets in the same manner as she did before the transfer.
In this case, the decedent commingled the partnership funds with his own funds for more than 3 months after the partnership was formed. In addition, the decedent did not actually transfer the marketable securities and note to the partnership until months after its formation and the transfer of the limited partner interests to his children. Finally, the partnership funds were distributed disproportionately, heavily weighted in favor of the decedent. Accordingly, the Court held that Sec. 2036(a), I.R.C. applied and included the full value of all of the partnership assets in the decedent's estate.

The Court reviewed whether the decedent's transfer of the assets to the partnership was for consideration, so that Sec. 2036(a), I.R.C. would not apply. Citing Estate of Reichardt and Estate of Schauerhamer, the Court found that, because of the commingling of the funds and late transfer, the decedent merely changed the form in which he held his beneficial interest in the assets, rather than receiving actual consideration for the contribution.

L. Kerr v. Comm'r, 292 F.3d 490 (5th Cir. 2002), affg 113 T.C. 449 (1999). In 1993, the taxpayers and their children formed two family limited partnerships under Texas law. Each partnership agreement provided that the partnership would dissolve and liquidate upon the earliest to occur of December 31, 2043, the agreement of all of the partners or the happening of certain specified events. In addition, each partnership agreement provided that no limited partner could withdraw from the partnership prior to its dissolution and liquidation.

In June 1994, the taxpayers contributed Class A limited partnership interests in both partnerships to the University of Texas. In 1994 and 1995, the taxpayers gave Class B partnership interests in one of the partnerships to their children. At the same time, the taxpayers created grantor retained annuity trusts ("GRATs"), to which each taxpayer transferred a Class B limited partnership interest in one of the partnerships. On their 1994 gift tax return, the taxpayers reported the value of the interests transferred to their children and the GRATs applying marketability discounts. The Service asserted that the values were understated because the restrictions in the partnership agreements constituted applicable restrictions under Section 2704(b). On summary judgment, the Tax Court held in favor of the taxpayers, stating that the partnership agreement restrictions were not applicable restrictions for purposes of 2704(b). The Service appealed the decision to the Fifth Circuit.

On appeal, the Fifth Circuit affirmed the Tax Court's decision. The Court stated that there are three defining features of an applicable restriction. These are (1) the restriction limits the ability of the partnership to liquidate, (2) the restriction either lapses or can be removed by family members after the transfer, and (3) the restriction is more restrictive than applicable state law.

The Service argued that restrictions in the partnership agreement were removable by the family because the University of Texas likely would not oppose such removal. The Court disagreed with the Service, citing Sec. 2704(b)(2)(B)(ii), I.R.C., which states that, for a restriction to be removable by the family, "the transferor or any member of the transferor's family, either alone or collectively," must have the right to remove the restriction. The Code does not provide any possibility of disregarding non-family partners. The Court continued that the "probable consent" by the University of Texas does not fulfill the requirement that the family
may remove the restriction. Because the removal feature did not exist, the Court did not review
the other features, as they were not applicable.

M. KRP, Inc. v. Comm'r, 83 T.C.M. (CCH) 1709 (2002). KRP, Inc. was formed in
1985 as a C corporation and elected owned S corporation status beginning in tax year 1992. At
the time of the S election, KRP, Inc. owned two gas stations. In 1995, KRP, Inc. sold the gas
stations and reported $500,000 in gain on the sale. After entering into three consents to extend
the time for assessment, the Service audited the 1995 return and sent a final S corporation
administrative adjustment (FSAA) to the corporation on April 24, 2000. The FSAA determined
that the corporation was liable for built-in gains tax of $136,107 under Sec. 1374, I.R.C. for 1995
as a Subchapter S item. The primary issue before the Court was whether the FSAA properly
characterized the built-in gains tax as a Subchapter S item. The taxpayer argued that the built-in
gains tax was not a Subchapter S item, that the Service should have issued a statutory notice of
deficiency as opposed to an FSAA. The Court—citing N.Y. Football Giants, Inc. v. Comm'r,
117 T.C. 152 (2001)—held that the built-in gains tax is a Subchapter S item and that the TEFRA
audit and litigation procedures apply. The taxpayer further argued that the Court was without
jurisdiction to enter a decision against KRP, Inc. because the TEFRA procedures and the FSAA
are directed to the stockholders of an S corporation and not the corporation itself. The Court,
however, held that liability for built-in gains tax is imposed under Subtitle A and also is a
Subchapter S item. The Court further held that KRP, Inc. was a proper party to the proceeding
as its S corporation income tax liability under Subtitle A is determined by taking into account the
built-in gains tax.

N. Krukowski v. Comm'r, 279 F.3d 547 (7th Cir. 2002), aff'g 114 T.C. 366 (2000).
Taxpayer was the president and sole shareholder of two C corporations. The first operated a
health club, and the second operated a law firm. Taxpayer actively worked for the law firm.

Taxpayer and his wife owned two buildings, one of which was rented to the health club
and the other of which was rented to the law firm. For the tax year 1994, taxpayer reported (1) a
loss on the rental of the building to the health club, (2) income on the rental of the building to the
law firm, (3) the two rentals were separate passive activities under Section 469, and (4) an offset
of the rental loss against the rental income. The Service, in turn, held that, because taxpayer
materially participated in the law firm’s business activity, the rental income from the building
leased to the law firm was recharacterized as nonpassive income under Treas. Reg. §1.469-
2(f)(6). The Seventh Circuit affirmed the Tax Court, holding that the taxpayer could not offset
his rental loss from the building leased to the health club against the rental income from the
building leased to the law firm.

The Court found that the Regulation is in furtherance of Congress’s goal of eliminating
tax shelters. The Court further noted that this type of regulation was anticipated by Congress,
citing H.R. Rep. No. 99-841, at 147(1986), which stated that “Examples of where the exercise of
such authority [that is, to prevent the sheltering of positive income sources through the use of tax
losses derived from passive business activities] may...be appropriate include... (2) related
property leases or sub-leases, with respect to property used in a business activity, that have the
effect of reducing active business income and creating passive income...”
See also Sidell v. Comm’r, 225 F.3d 103 (1st Cir. 2000), and Fransen v. U.S., 191 F.3d 599 (5th Cir. 1999).

O. McFadden v. Comm’r, 84 T.C.M. (CCH) 6 (2002). The taxpayer, through his profit-sharing plan, made a loan to his daughter to enable her to purchase and renovate a house. The loan was secured by a second deed of trust on the house. The first deed of trust secured a loan made by a bank to enable the daughter to purchase the house. On audit of the profit-sharing plan, the Service determined that the loan to the taxpayer’s daughter was a prohibited transaction, which resulted in a deemed distribution to the taxpayer. In 1995, the taxpayer agreed to the deemed distribution and assigned the note issued to the plan by his daughter, together with the second deed of trust, to himself. The taxpayer’s daughter was having financial difficulties and notified the taxpayer that she could no longer make payments on the note. In August of 1995, when the house had a fair market value of $207,500 and the two loans on the house were $168,957 (first deed of trust) and $170,371 (second deed of trust), the taxpayer accepted a deed in lieu of foreclosure, subject to the first deed of trust. The taxpayer made payments on the first deed of trust until he sold the house in December 1995. On his 1995 income tax return, the taxpayer reported the early distribution from his profit-sharing plan and a $136,331 short-term capital loss from the sale of the house. The taxpayer calculated a $336,331 basis in the house, constituting $170,371 (the amount owed under the second deed when he took the deed in lieu of foreclosure) and $168,957 (the amount outstanding under the first deed of trust), less an unexplained discrepancy of $2,997. The Court held that the taxpayer’s basis in the house was its fair market value as of the date of the voluntary conveyance, which was $207,500, not $336,331. The Court further held that the unpaid balance of the loan to his daughter could be deducted under Section 166 if and to the extent the taxpayer established worthlessness. Since the taxpayer was able to prove that the debt was a bona fide debt and that the debt was worthless given his daughter’s financial circumstances in 1995, the taxpayer was allowed to deduct the unsatisfied portion of the debt under Section 166.

P. McGrath v. Comm’r, 84 T.C.M. (CCH) 238 (2002). The taxpayers leased retail space in a shopping center to operate a bakery. When the taxpayers entered into the lease, the leased space was nothing more than a dirt floor enclosed by temporary walls. The lease agreement obligated the taxpayers to make substantial improvements to the leased space at their own expense. Other than trade fixtures, the permanent improvements that the taxpayers made to the premises became the property of the lessor upon installation. The taxpayers deducted the cost of these improvements as repairs and maintenance in the year of expenditure. In addition, they did not make a timely Section 179 election on their tax returns for the relevant tax years at issue. The taxpayers argued that, under Sec. 162(a)(3), I.R.C., they were allowed to deduct the cost of the improvements because they (1) were required to pay for and make the improvements, and (2) did not acquire either title to, or an equity interest in, the improvements. The Tax Court rejected the taxpayers’ argument and held the taxpayers’ expenditures for the permanent improvements constitute capital expenditures that are not currently deductible. Also, because the period for making a Section 179 election had expired, the taxpayers’ only means of cost recovery was through depreciation deductions.
Q. Mitchell v. Comm'r, 83 T.C.M. (CCH) 1524 (2002). This case was before the Tax Court on remand from the Ninth Circuit, which directed the Tax Court to explain how it valued the stock included in the decedent's estate. Specifically, the Ninth Circuit stated that it was unclear whether a 35% combined discount for lack of control and lack of marketability falls within a range that is supported in the record. The Ninth Circuit also directed the Tax Court to shift the burden of proof to the IRS. The Tax Court responded with a detailed explanation of how it ascertained the fair market value of the decedent's minority interest in a closely-held corporation.

R. Saunders v. Comm'r, 83 T.C.M. (CCH) 1795 (2002). The Court held that the taxpayer had not converted his personal residence to "property held for the production of income" merely because the taxpayer rented the residence on a temporary basis for several years while he was trying to sell the residence. The Court identified five factors which are important for purposes of determining if a personal residence has been converted in the hands of the same taxpayer into investment property: (1) the length of time the house was occupied as a personal residence by the taxpayer before placing it on the market for sale, (2) whether the taxpayer permanently abandoned all further use of the house, (3) the character of the property (recreational or otherwise), (4) offers for rent and (5) offers for sale.

S. Shepherd v. Comm'r, 283 F.3d 1258 (11th Cir. 2002), aff'd 115 T.C. 376 (2000). The taxpayer owned more than 9,000 acres of land subject to a long-term timber lease, which he deeded to his family partnership. The taxpayer was the managing partner and 50% owner of the partnership. His two sons each owned 25% of the partnership. The Eleventh Circuit affirmed the Tax Court's holding that the taxpayer's contribution of the land to the partnership constituted an indirect gift to his sons of an undivided 25% interest in the land, rather than a direct gift of a partnership interest. In reaching its holding, the Court noted that the taxpayer's sons already held their partnership interests when their father's deed of land became effective. Thus, whatever interests the sons acquired in the land were the result of their status as partners.

The Eleventh Circuit also held that only, the characteristics of the gift of land, and not the donee's method of receiving the gift or the stipulated partnership interest discount, were relevant to discounting the value of the gift of land. In this case, the taxpayer presented evidence of a stipulation providing an automatic 33.5% minority interest discount for a 25% interest in the family partnership. Because the taxpayer's gift was not a property interest, the stipulated minority discount was not applicable in determining the value of the taxpayer's gift.

T. Smith v. Comm'r, 300 F.3d 1023 (9th Cir. 2002), aff'd 78 T.C.M. (CCH) 251 (1999). Vanalco operated an aluminum smelting facility, and deducted its expenses for relining cells (steel shells used to produce aluminum) and replacing portions of the brick floors of the cell rooms with cement.

The Service disallowed such deductions, arguing that the costs should be treated as capital expenditures and depreciated under Sec. 263, I.R.C. The Tax Court, holding for the Service, found that the cell lining's function is vital to the smelting and that the lining has a shorter life than that of the cell unit. The Tax Court concluded that, because the cell must be taken out of service when the lining fails, the cell's productive cycle ends when the lining's does, so that replacing the lining rebuilds the cell and gives it a new three-year life expectancy. The
Tax Court also held that replacing brick floors in the cell rooms with cement was more than incidental repair and added value.

The Ninth Circuit affirmed the Tax Court. In doing so as to the cell linings, it considered and rejected *Plainfield-Union Water Co. v. Comm'r*, 39 T.C. 333 (1962), on the basis that here the relining prolonged the life expectancy of the cell. Instead, the Circuit Court found that the case was on all fours with *Buffalo Union Furnace Co. v. Helvering*, 72 F.2d 399 (2d Cir. 1934), involving the relining of blast furnaces. Of course, in its holding, the Circuit Court likewise found it appropriate to cite *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992).

U. **Stewart v. Comm'r**, 84 T.C.M. (CCH) 292 (2002). Taxpayer operated a real estate business as a sole proprietorship, and thereafter formed a C corporation, of which taxpayer was the sole shareholder and director. The corporation was formed to engage in real estate development, real property management services (through a third party property manager), a screen printing sign business and the operation of a computer company.

Taxpayer, on behalf of his sole proprietorship, and the corporation entered into a management agreement, providing for an annual retainer to be paid the corporation, not to exceed 70% of the proprietorship's net profit before taxes. In the two taxable years in issue, the corporation was paid $120,000 and $100,000, respectively, thereby enabling the corporation to absorb losses claimed on its returns for such years. The taxpayer received no compensation or draws from the corporation in either such year.

The Service claimed that the payments were not ordinary and business expenses of the proprietorship (or taxpayer), but rather were capital contributions to the corporation. The Court, noting that the "agreement was not the product of arm's-length negotiations" and that "transactions among related taxpayers are subject to close scrutiny", found that the taxpayer had "not shown that the corporation rendered any general management services to the sole proprietorship". The Court thus held that the payments made to the corporation as compensation for services were not deductible business expenses.

V. **Tampa Bay Devil Rays, Ltd. v. Comm'r**, 84 T.C.M. (CCH) 394 (2002). The taxpayer, a limited partnership formed under the laws of Florida, was formed to acquire, own, manage and operate a major league baseball team in St. Petersburg, Florida. In 1995, the taxpayer and major league baseball entered an agreement under which the partnership would become a full participating member of major league baseball upon the satisfaction of certain conditions by late 1997.

During 1995 and 1996, the taxpayer received deposits on advance season tickets (representing 25% of the total stated season ticket price), on reservations for private suites and a sponsor fee for games to be played in 1998, the Devil Rays' first season in the major leagues. On its Federal partnership tax returns for 1995 and 1996, the taxpayer did not include these deposits in income. Instead, the taxpayer recognized the deposits as income in 1998 when the Devil Rays began playing baseball games. For book purposes, the taxpayer treated the deposits received in 1995 and 1996 as deferred revenue.
Citing Artnell v. Commissioner, 400 F.2d 981 (7th Cir. 1968), the Court held that the taxpayer’s deferral of reporting the deposits in income until 1998 more clearly matches the partnership’s related expenses that were incurred and deducted in 1998. Accordingly, the taxpayer may defer until 1998 reporting as income the deposits received in 1995 and 1996 on the advance season tickets and on the private suite reservations.

W. Toberman v. Comm’r, 294 F.3d 985 (8th Cir. 2002), aff’d in part, rev’d in part 80 T.C.M. (CCH) 81 (2000). The taxpayer was the sole owner of two S corporations from which the taxpayer had received loans in excess of $2 million. In 1990, the S corporations filed for relief under Chapter 11 of the Bankruptcy Code and the case was later dismissed. While the facts are unclear, the taxpayer took the position that the S corporations ceased operations in 1993. In 1993, the taxpayer filed a Collection Information Statement for Individuals (CIS), which reported net worth of $389,650, and which failed to include several asset and liability items of the taxpayer. On the taxpayer’s 1993 income tax return, he reported $3.9 million of net operating loss (NOL) carryovers from 1986 to 1991 relating to the two S corporations and did not report any income for discharge of indebtedness relating to the $2 million in loans which were made to him by the S corporations. The Service determined that, for the 1993 tax year, (a) the taxpayer had over $2 million in income from discharge of indebtedness and, based on the CIS and the evidence offered by the taxpayer, the taxpayer failed to establish that he was insolvent for purposes of qualifying for the insolvency exception with respect to discharge of indebtedness income; and (b) the taxpayer failed to carry the burden of establishing his entitlement to the NOL deduction since he was unable to explain the loss of the original books and records of the two S corporations and did not produce sufficient other evidence. On appeal, the 8th Circuit held that the Tax Court’s determination that the taxpayer was not insolvent at the time of the discharge of indebtedness was in error, as the taxpayer had produced sufficient evidence to show that he owed millions of dollars under judgments which had been entered against him. The 8th Circuit affirmed the Tax Court’s holding with respect to the NOL deduction.

X. Tsakopoulos v. Comm’r, 83 T.C.M. (CCH) 1064 (2002). The taxpayer owned a partial interest in a gasoline and diesel dispensing facility. In 1995, due to health problems, financial problems and fear of potential lawsuits regarding the toxic contamination of this facility, the taxpayer deeded his entire interest in the property to his brother, who also owned an interest in the property. The taxpayer claimed a deduction for an abandonment loss in regard to this transfer. The Tax Court concluded that the taxpayer did not abandon the property, in large part because the abandonment cannot occur if the transferor intends for a particular person to be the transferee, which was the case here. Consequently, the Court held that the taxpayer was not entitled to an abandonment loss deduction.

The taxpayer also owned shopping centers. The taxpayer deducted expenses incurred for work performed on the roofs of his shopping centers. After considering the testimony of the person who supervised the roof work, the Court concluded that the taxpayer replaced the roof. The new roof was expected to last 10 years. Accordingly, the Court denied the taxpayer’s immediate deduction on the grounds that the expenditures were of a substantial nature and thus capital under Sec. 263(a), I.R.C.
In addition, the Court required the taxpayer to capitalize real estate taxes paid on property held for subsequent development. Under Sec. 263A, I.R.C., real estate taxes qualify as indirect costs that must be capitalized if the property is held for future production. In reaching this holding, the Court concluded that it was the taxpayer's intention to develop the property when he paid the real estate taxes.

Y. Turner v. Comm'r, T.C. Summary Opinion 2002-60. The taxpayers purchased a house that they used as their principal residence for almost eleven years. The taxpayers listed the property for sale with a real estate agent in February 1994. After moving out of the house in May 1994, the taxpayers upgraded and refurbished the house in order to make it easier to sell. Specifically, the taxpayers replaced carpets throughout the house, added a tile floor to the entryway, installed new kitchen counter tops, removed wallpaper throughout the house, installed new vinyl flooring, repaired drywall, and painted the interior and exterior of the house.

Even though the taxpayers never placed a "For Rent" sign in front of the house or ran an ad in any newspaper listing it for rent, the taxpayers claimed a business loss deduction on the sale of their house. The Tax Court concluded that the taxpayers failed to establish that they converted their former residence to income-producing purposes. Accordingly, the loss on the sale was not deductible under Sec. 165, I.R.C.

Z. Weiner v. Comm'r, 83 T.C.M. (CCH) 1874 (2002). Taxpayer contributed $93,000 to National Heritage Foundation ("NHF") in each of 1997 and 1998. NHF used the funds to acquire life insurance on the lives of taxpayer's daughter and son-in-law, under charitable split-dollar life insurance contracts. Under these contracts, NHF was to receive 48% to 98% of the initial death benefits, with taxpayer's family trusts to receive from 8% to 52% of these benefits.

The Service determined that the taxpayer was not entitled to deduct his payments to NHF as charitable contributions. The Court agreed with the Service. The Court focused on the failure of NHF to make a good faith estimate (as required in Sec. 170(f)(8)(B)(iii), I.R.C.) of the value of the benefits received back by taxpayer, noting that, when taxpayer made the contributions, he expected NHF to use the dollars to pay the life insurance premiums, with the family trusts to receive a substantial part of the death benefits under the policies. See also Addis v. Comm'r, 118 T.C. 528 (2002).

AA. Willamette Indus. Inc. v. Comm'r, 118 T.C. 126 (2002). The taxpayer operated a vertically integrated forest products manufacturing business with its principal office in Portland, Oregon. The business included the ownership and processing of trees at manufacturing plants including lumber mills, plywood plants and paper mills. The taxpayer owned 1,253,000 acres of timberland. The taxpayer's trees provided the raw materials used in the manufacturing process. In the years 1992 to 1995, the taxpayer's standing timberland was damaged by wind, ice storms, wildfires and insects. The taxpayer salvaged the trees and processed them in its own manufacturing plants. The taxpayer attempted to defer gain under Sec. 1033, I.R.C. attributable to the difference between its basis and the fair market value at the time the trees were salvaged before they were used in the manufacturing process. The taxpayer's gain resulted from the sale of the finished products. The Court applied Rev. Rul. 80-175, 1980-2 C.B. 230, which permitted the deferral of gain from the sale of trees damaged by hurricane. In Willamette, the taxpayer was
forced to salvage its damaged trees prior to the time it had intended to harvest them or otherwise suffer a complete loss. The Court held that the taxpayer was entitled to defer the gain from the damaged trees which was reinvested in like kind property.