Recent Developments in Federal Income Taxation

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By

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William & Mary Tax Conference
November 22, 2002

I. ACCOUNTING

A. Accounting Methods

1. Proposed regulations on adopting and changing taxable years. REG-106917-99. Changes in Accounting Periods, 66 F.R. 31850 (6/13/01). The Treasury has published proposed amendments to regulations under §§ 441, 442, 706, and 1378 regarding the requirement to obtain the approval of the Commissioner to adopt, change, or retain an annual accounting period. Prop Reg. §§ 1.441-1 through 1.441-4 generally are substantively the same as Temp Reg. §§ 1.441-1T through 1.441-4T, including the general rules for the period for computing tax, numerous definitions, and the requirement that partnerships, S corporations, and PSCs generally must demonstrate a business purpose and obtain approval to adopt or retain a taxable year other than their required taxable year, but the proposed regulations are reorganized.

- Prop. Reg. § 1.441-1(c) provides that a taxable year is adopted by filing the first federal income tax return using that taxable year. Filing an application for an EIN, filing an extension, or making estimated tax payments, indicating a particular taxable year would not constitute an adoption of that year. [Rev. Rul. 57-589 (1957-2 C.B. 298), and Rev. Rul. 69-563 (1969-2 C.B. 104), holding that the filing of an extension and estimated tax payments establishes a taxable year, will be superseded.]

- The proposed regulations under § 442 continue to require that the taxpayer demonstrate a business purpose for changing taxable years. The proposed regulations use the term ‘business purpose” rather than the “substantial business purpose” of the temporary regulations, but, according to the preamble, the Treasury does not intend the language change to change the standard. Under Prop Reg. § 1.442-1(b), Form 1128 would have to be filed by the 15th day of the third [rather than second] month of the first effective [the short] year. The automatic approval provisions have been deleted in favor of the standards of Rev. Proc. 2000-11, 2000-3 I.R.B. 309, superseded by Rev. Proc. 2002-37, 2002-22 I.R.B. 1030, infra.

- Prop. Reg. § 1.706-1 reflects the 1986 Act required taxable year rules and the least aggregate deferral standard. Generally speaking the substantive rules incorporate Temp. Reg. § 1.706-1T, but the proposed regulations elaborate the standards for determining a partner’s interests in profits and capital for purposes of applying those tests – income interests are determined with respect to taxable income, not book income, and capital interests are determined with respect to a hypothetical liquidation. Procedural rules for requesting a year other than a required year have been removed in favor of Prop Reg. § 1.442-1 procedures.

- Prop. Reg. § 1.1378-1 would not implement any substantive changes, but procedural rules for requesting a year other than a required year have been removed in favor of Prop Reg. § 1.442-1 procedures.

a. Notice 2001-34, 2001-23 I.R.B. 1302 (6/4/01). The IRS has published a proposed revenue procedure dealing with procedures under § 442 for taxpayers outside the scope of the revenue procedures providing automatic approval to adopt, change, or retain a taxable year [see, e.g.,

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procedures under proposed revenue procedure that will [superseding Rev. Proc. 87-32, 1987-2 C.B. 396] provide the procedure if they agree to certain additional terms, conditions, and adjustments designed to neutralize the do not establish a natural business year generally would be granted approval under the proposed revenue procedure. Establishing a natural business year generally will be the only circumstance under which a partnership, S corporation, electing S corporation, or PSC will be granted approval. Other taxpayers that do not establish a natural business year generally would be granted approval under the proposed revenue procedure if they agree to certain additional terms, conditions, and adjustments designed to neutralize the tax effects of substantial distortion of income resulting from the change.

-- Notice 2001-35, 2001-23 I.R.B. 1314 (6/4/01). This notice provides a proposed revenue procedure that will [superseding Rev. Proc. 87-32, 1987-2 C.B. 396] provide the procedures under § 442 for certain partnerships, S corporations, electing S corporations, and PSCs to obtain automatic approval to adopt, change, or retain their taxable years.

c. Regulations are final, with minor changes. T.D. 8996, Changes in Accounting Methods, 67 F.R. 35009 (5/3/02). The Treasury has finalized the proposed regulations [in REG-106917-99] with a number of technical and clarifying changes. The Treasury specifically rejected abandoning the general requirement of strict book conformity to adopt a year other than a required or ownership year. The final regulations remove from the proposed regulations specific time and manner requirements for filing applications; instead these are published in Rev. Proc. 2002-37 through 2002-39, discussed immediately below, to permit more flexibility. Modifications were made with respect to the 52-53-week taxable year and for closely held REITs. The final regulations are effective 5/17/02.

d. The IRS promulgates comprehensive guidance on the adoption, change, and retention of accounting periods.

(1) Automatic approval for corporations. Rev. Proc. 2002-37, 2002-22 I.R.B. 1030 (6/3/02). This revenue procedure provides the exclusive procedures for most corporations to choose a taxable year to obtain automatic approval to adopt a taxable year. Under the revenue procedure a corporation can receive automatic approval of a year based on the 25 percent of gross receipts natural business year standard notwithstanding holding an interest in a pass-through entity. An automatic change is not available (1) if the corporation’s year is under examination or in litigation or (2) if the corporation has changed its annual accounting period within 48 months prior to the last month of the requested taxable year (unless the change is to a required taxable year, to or from a 52-53 week year ending with the same calendar month, or to comply with Reg. §§ 1.1502-75(d)(3)(v) or 1.1502-76(a)(1)), or if the purpose of the change is to file consolidated financial statements with a new owner of a majority shareholder that has changed its year). The lists of ineligible corporations have been expanded. No audit protection is offered under the revenue procedure. Rev. Proc. 2000-11, 2000-1 C.B. 309 is superseded.

(2) Expanded automatic approval of natural business year taxable years for pass-through entities and PSCs. Rev. Proc. 2002-38, 2002-22 I.R.B. 1037 (6/3/02). This revenue procedure [which finalizes Notice 2001-35] provides the exclusive procedures for most partnerships, S corporations, and personal service corporations to obtain automatic approval to adopt a taxable year other than their statutorily required or permitted taxable year. Rev. Proc. 87-32, 1987-2 C.B. 396 is modified and superseded. There are quite a few significant changes from the earlier procedures. A partnership, S corporation, or PSC may change automatically to a natural business year that satisfies the 25-percent gross receipts test, regardless of whether such year results in more deferral of income than its present taxable year. Greater flexibility is available to adopt or change from a 52-53 week year. A partnership that would be required to change its taxable year because of a minor percentage change in ownership may retain its current taxable year for one year, subject to certain circumstances. Interests of certain tax-exempt entities are disregarded for purposes of determining the ownership taxable year of an S corporation, unless the S corporation is wholly owned by such tax-exempt entities. The due date for Form 1128 is the due date of the taxpayer’s return. Automatic changes are not available (1) if the entity’s year is under examination or in litigation or (2) for a change to, or retention of, a natural business year if the entity has changed its annual accounting period within 48 months prior to the last month of the requested taxable year (unless the change is to a required taxable year, to or from a 52-53 week year ending with the same calendar month, or to comply with Reg. §§ 1.1502-75(d)(3)(v) or 1.1502-76(a)(1)). If a taxpayer complies with the revenue procedure, however, audit protection for prior years generally is provided.
But sometimes you still have to ask, "Mr. Commish, may I." Rev. Proc. 2002-39, 2002-22 I.R.B. 1046 (6/3/02). This revenue procedure [which finalizes Notice 2001-34] provides the exclusive procedures for everyone to establish a business purpose to obtain non-automatic approval to adopt a taxable year other than their statutorily required or permitted taxable year. Rev. Proc. 85-16 and 74-33 are superseded. A business purpose can be established either by a natural business year or by "facts and circumstances," but the revenue procedure cautions that permission will be granted under the facts and circumstances standard "only in rare and unusual circumstances." The "natural business year" test in this revenue procedure is significantly more flexible than the natural business year for automatic approval under Rev. Proc. 2002-38. The "natural business year can be based on the "annual business cycle" or "seasonal business" tests ending "soon after" [with a one month safe harbor] the "peak" season. Alternatively, the natural business year can be established [except by tiered entities] to end with the two month period for each of the prior three years with the highest percentage of gross receipts equaling or exceeding 25 percent. Administrative and business convenience reasons described in Rev. Rul. 87-57 will not justify a taxable year; nor will hiring patterns, compensation periods, years based on annual model changes or price lists, competitors' years, or related entities' years. A taxpayer other than a partnership, S corporation or PSC [i.e., an individual] that does not establish a business purpose for the requested annual accounting period can be deemed to have established a business purpose if it provides a nontax reason for the requested annual accounting period and agrees to specified additional terms, conditions, and adjustments intended to neutralize the tax effects of any resulting substantial distortion of income. For this purpose, nontax reasons for the requested annual accounting period may include administrative and convenience business reasons that are insufficient to satisfy the business purpose requirement for a partnership, S corporation, or PSC to adopt a taxable year other than its required taxable year. "[A]n individual taxpayer that is not a sole proprietor will be able to establish a nontax reason for a fiscal year only in rare and unusual circumstances." Compliance provides audit protection for prior years.

And to top it off, the IRS explains its reasons for changes. Announcement 2002-53, 2002-22 I.R.B 1063 (6/3/02). In the notice the IRS explains the reasons for the various changes in approval procedures in Rev. Procs. 2000-37, 2002-38, and 2002-39. 2. Brookshire Brothers Holding, Inc. v. Commissioner, T.C. Memo 2001-150 (6/22/01). The taxpayer filed amended returns changing its cost recovery period for convenience stores from 31.5 and 39 years to 15 years, as permitted by a Specialized Program Coordinated Issue Paper. The IRS asserted that the change required consent under § 446(e), but the Tax Court (Judge Nims) held that Treas. Reg. § 1.446-1(e)(2)(ii)(b) [providing that a change of useful life is not an accounting method change] applied to changing the § 168 ACRS cost recovery period. 3. IRS ends the small-dollar aspect of its crusade against the cash method. a. Act I: IRS continues the crusade against "small" taxpayers with gross receipts between $1 million and $5 million. Rev. Proc. 2001-10, 2001-2 I.R.B. 272 (1/8/01), modifying and superseding 2000-22, 2000-20 I.R.B. 1008 (4/28/00). The Commissioner will exercise his discretion to except a "qualifying taxpayer," i.e., one with average annual gross receipts of $1 million or less as determined under Reg.§ 1.448-1T(0)(2)(iv) from the requirements of accounting for inventories and using an accrual method of accounting for purchases and sales of merchandise. A business that adopts the cash method under this revenue procedure will treat inventory items as materials and supplies that are not incidental under Reg. § 1.1162-3. This means that the taxpayer must capitalize the cost or actual purchases of goods or materials to be resold or incorporated into manufactured products and offset the capitalized amounts against the amount realized when the goods are resold, but the taxpayer may deduct currently all other manufacturing and handling costs (including labor, warehousing, and other direct and indirect costs that normally must be capitalized under § 263A). An automatic change in accounting method to the cash method under Rev. Proc. 2000-22 is available under Rev. Proc. 99-49, 1999-2 C.B. 725. Small businesses using an accrual method of accounting that are not required under § 471 to account for inventories may use the automatic consent provisions to change to the cash method. These procedures are effective for tax years ending after December 16, 1999.

b. Act II: The small-dollar limit for use of the cash method goes up to $10 million of gross receipts, but with significant exceptions. Notice 2001-76, 2001-52 I.R.B. 613 (12/11/01). Pursuant to the discretion granted the Commissioner under §§ 446 and 471, this notice provides a proposed revenue procedure that will allow qualifying small business taxpayers with "average annual gross receipts" of more than $1 million but less than $10 million to use the cash receipts and disbursements method of accounting as described in the proposed revenue procedure with respect to eligible trades or businesses.
Ineligible businesses include ones that derive the largest percentage of gross receipts from any of the following activities: (a) mining activities within the meaning of NAICS codes 211 and 212; (b) manufacturing within the meaning of NAICS codes 31-33; (c) wholesale trade within the meaning of NAICS code 42; (d) retail trade within the meaning of NAICS codes 44-45; and, (e) information industries within the meaning of NAICS codes 5111 and 5122. For NAICS codes, see www.census.gov/epcd/naics/naicscod.txt.

Eligible businesses include those that perform services such as janitorial, medical, veterinary, photo developing, and repairs (including auto repair), as well as restaurants, bars, hotels, and funeral homes.

c. Notice 2001-76 will be available starting in 2001. Notice 2002-14, 2002-8 I.R.B. 548 (2/1/02). The change in method permitted under Notice 2001-76 will be available for any taxable year ending on or after 12/31/01. Taxpayers must attach a Form 3115 to a timely-filed (including extensions) income tax return, file a duplicate copy with the Internal Revenue Service's National Office, and comply with the provisions of Rev. Proc. 2002-9, 2002-3 I.R.B. 327.

d. This is the revenue procedure promised in Notice 2001-76. Rev. Proc. 2002-28, 2002-18 I.R.B. 815 (4/15/02). Final guidance by which a qualifying small businesses with gross receipts of $10 million or less may obtain automatic consent to change to the cash receipts and disbursements method of accounting. Expands Notice 2001-76 to provide that taxpayers whose principal business is the provision of services [including the provision of property incident to those services] are eligible for the cash method, as are taxpayers whose principal business activity is the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications.


b. Rev. Proc. 2002-18, 2002-13 I.R.B. 678 (4/1/02). This revenue procedure provides revised rules for changes in accounting methods imposed by the IRS.

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


e. And the IRS clarifies the application of the one-year adjustment period to pending and recently-approved applications. Rev. Proc. 2002-54, 2002-35 I.R.B. (8/14/02), clarifying and modifying Rev. Proc. 2002-19, 2002-13 I.R.B. 696. Makes the change from the four-year to the one-year adjustment period [for negative adjustments under § 481(a)] available to those applications pending on 3/14/02 with respect to years ending before 12/31/01 to defer the year of change to a the first year ending on or after 12/31/01, and allows similar relief for those with approved applications who elect to defer the year of change on or before 12/13/02.

B. Inventories

2. She went to the animal fair ... the elephant sneezed ... and that was the end of her accounting method. Suzy's Zoo v. Commissioner, 273 F.3d 875, 2001-2 U.S.T.C. §50,766, 88 A.F.T.R.2d 2001-6916 (9th Cir 11/21/01), aff'g 114 T.C. 1 (1/6/00). The Court of Appeals (Judge Sneed) affirmed the Tax Court's decision that the "small reseller" exception to § 263A provided in § 263A(b)(2)(B) did not apply to greeting card business that produced cartoon characters and contracted with independent printers for production of cards and other products bearing the characters' likenesses according to taxpayer's standards. Even though the contracts provided that printers owned materials and bore risk of loss during production, taxpayer owned the images and had exclusive rights to the cards; the printers had no right to sell produced cards or cartoon characters to anyone other than taxpayer. Thus, the
taxpayer was the “producer” of the cards, not a small “reseller” to whom the § 263A(b)(2)(B) exception applied. All costs were subject to capitalization under § 263A. For purposes of the § 481 adjustment, pursuant to § 803(d) of the TRA ‘86, the year of the change was the year ending June 30, 1994, the subject year, not the year ended June 30, 1987, taxpayer’s first year after the effective date of § 263A.

C. Year of Income or Deduction

1. Tax Court again finds Reg. § 1.267(a)-3 valid, this time based upon the Chevron doctrine. Square D Company v. Commissioner, 118 T.C. No. 15 (3/27/02) (reviewed, 10-6). The Tax Court (Judge Gale) adheres to its holding in Tate & Lyle, Inc. v. Commissioner, 103 T.C. 656 (1994), rev’d. and remanded. 87 F.3d 99 (3d Cir. 1996), that Reg. § 1.267(a)-3 is a valid exercise of the regulatory authority granted in § 267(a)(3) and that a U.S. corporation wholly owned by a foreign corporation cannot deduct interest accrued until the interest is actually paid even though the interest would have been exempt from taxes under §§ 881 and 1442 under the applicable treaty. “We now hold that the regulation is valid as a permissible construction of the statutory language that authorizes it. To the extent our opinion in Tate & Lyle I is inconsistent, we will no longer follow it.”

Tate & Lyle I was decided on the matching principle. The Tax Court majority here relies on the Chevron doctrine [Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984), and Bankers Life & Cas. Co. v. United States, 142 F.3d 973 (7th Cir. 1998) (Chevron doctrine applies to tax regulations, whether legislative or interpretive]), which held that where Congressional intent was not clear, the question is whether the regulation is based on a permissible construction of the statutory language that authorizes it. To the extent our opinion in Tate & Lyle I is inconsistent, we will no longer follow it.”

In view of the refinements of the Chevron doctrine in Brown & Williamson, we believe our opinion in Tate & Lyle I may have given insufficient attention to fitting all parts of section 267(a) into “an harmonious whole”. If, as we held in Tate & Lyle I, section 267(a)(3) authorizes only regulations that address mismatches resulting from the payee’s method of accounting, then it would appear that section 267(a)(3) is redundant in relation to section 267(a)(2), as the Court of Appeals for the Third Circuit reasoned. That is because section 267(a)(2) would already reach, and implicitly authorize regulations covering, payments owed to a related foreign person with a (U.S.) method of accounting for such payments.

A close examination of the legislative history reveals that Congress intended the Secretary’s authority under section 267(a)(3) to encompass imposition of the cash method on the payor where the foreign payee does not have a U.S. method of accounting with respect to the amounts owed. Section 267(a)(3) was added to the Code because Congress felt “The application of * * * [section 267(a)(2)] is unclear when the related payee is a foreign person that does not, for many Code purposes, include in gross income foreign source income that is not effectively connected with a U.S. trade or business.” H. Rept. 99-426, at 939 (1985), 1986-3 C.B. (Vol. 2) 1, 939; S. Rept. 99-313, at 959 (1986), 1986-3 C.B. (Vol. 3) 1, 959. In this passage, Congress expressed its uncertainty as to the application of section 267(a)(2) in a situation where the foreign person has foreign source, non-effectively connected income that need not, for many Internal Revenue Code purposes, be included in U.S. gross income. A characteristic of the foregoing type of income is that the foreign recipient lacks a U.S. method of accounting for it if the income need not be included in U.S. gross income. ***

Respondent’s interpretation of the regulatory authority granted in section 267(a)(3) is reasonable in light of the legislative history and therefore is entitled to deference under Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984). As a permissible construction, the regulation is ipso facto not manifestly contrary to the statute.

2. Elective deferral rules are not available without adhering to the conditions. Bob Wondries Motors, Inc. v. Commissioner, 268 F.3d 1156, 2001-2 U.S.T.C. ¶50,733, 88 A.F.T.R.2d 2001-6489 (9th Cir. 10/23/01). The taxpayer-automobile dealers elected to report income and deductions
on extended warranty agreements under the “service warranty income” method of Rev. Proc. 92-98, 1992-2 C.B. 512, and Rev. Proc. 92-97, 1992-2 C.B. 510, which permit deferral of customer receipts in turn paid for insurance [to which is added an interest factor] over the life of the agreement [but not more than six years]. But the taxpayer deviated from Rev. Proc. 92-97 by amortizing in the first year a full year’s worth of the insurance premium expense rather than a pro-rated amount based on the actual date of the contract. The Ninth Circuit affirmed the Tax Court’s decision upholding the Commissioner’s disallowance of the deferral method. Elective deferral rules are not available without adhering to the conditions.

3. The money was simultaneously constructively received and constructively paid out for an offsetting deduction. Gale v. Commissioner, T.C. Memo. 2002-54 (2/27/02). The taxpayer’s lawyer received the proceeds from settling a lawsuit, but the proceeds were held in the attorney’s escrow account pending resolution of a fee dispute between the taxpayer and the attorney, with respect to that case and other matters. Judge Beghe held that the full amount of the proceeds were constructively received by the cash method taxpayer in the year they were paid over to the taxpayer’s lawyer by the defendant, but a deduction was allowed under § 461(f), except to the extent that the fees, if paid, would not have been deductible.

D. Installment Method

1. Beware of farmers hauling hay in their Jaguar convertibles. Thom v. United States, 283 F.3d 939, 89 A.F.T.R.2d 2002-1384, 2002-1 U.S.T.C. ¶50,293 (8th Cir. 3/19/02). The taxpayer manufactured and sold farm equipment. It reported credit sales of center pivot irrigation systems to farmers under the installment method of § 453, claiming that the § 453(l)(2)(A) exception to the general prohibition on use of the installment method by dealers for “any property used or produced in the trade or business of farming” applied. The Court of Appeals (in a 2-1 decision by Judge Magill) held that § 453(l)(2)(A) applies only to property that has been used in farming by the seller, it does not apply to sales of farm equipment by a non-farmer equipment dealer to a farmer that is “to be used” by the farmer. There is no special exception for single purpose equipment, like center pivot irrigation systems, that are used only in farming. The dissent, rather than focusing on Congressional intent and the parallelism between “produced” and “used,” discusses concepts such as “past participles,” “subordinate clauses,” and missing “relative pronouns” and verbs, which it inserted, and raised the specter of a farmer selling his Jaguar convertible on the installment method after using it once to haul hay. [We wonder whether the dissenting judge ever sold one of his cars on the used car market. We also wonder how many farmers own Jaguars, let alone use them to haul hay!]

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

INDOPCO aftermath: “Deductions are exceptions to the norm of capitalization.” (Blackmun, J.)

1. More capitalized environmental remediation costs. United Dairy Farmers, Inc. v. United States, 267 F.3d 510, 88 A.F.T.R.2d 2001-6116 (6th Cir. 10/3/01), aff’g 107 F. Supp. 2d 937, 2000-1 U.S.T.C. ¶50,538, 85 A.F.T.R.2d 2000-2235 (S.D. Ohio 5/23/00). Taxpayer incurred environmental remediation expenses to clean-up pollution caused by prior owners who operated gas stations on the site of a convenience store. Even though the taxpayer was unaware of the pollution at the time of the purchase and thus “overpaid” for the property, the expenses were required to be capitalized because they “increased the value of the property.” Rev. Rul. 94-38, 1994-1 C.B. 35 did not apply. The Sixth Circuit concluded that “when a taxpayer improves property defects that were present when the taxpayer acquired the property, the remediation of those defects are capital in nature....” When a taxpayer has improved defects that were present when the taxpayer acquired the property, [Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962)] does not apply.” Rather, Dominion Resources, Inc. v. United States, 219 F.3d 359, 2000-2 U.S.T.C. ¶50,633 (4th Cir. 7/19/00), was more apposite.

- On another issue, the court held that accounting fees paid to Ernst & Young in connection with a corporate reorganization incident to making an S election had to be capitalized.

2. Boylston Market reigns. U.S. Freightways Corp. v. Commissioner, 113 T.C. 329 (11/2/99). An accrual method trucking company was required to capitalize expenditures for licenses

1 131 F.2d 966 (1st Cir. 1942).
and insurance that had an effective period extending beyond the tax year. Judge Nims held that taxpayer’s argument – whether or not the argument is well taken – that the expenditures should be currently deductible if their benefit extends “less than 12 months into the subsequent tax period” is inapplicable to an accrual method taxpayer. Judge Nims relied, however, on § 263 and the capitalization rules, rather than on the “clear reflection of income” standard of § 446(b), which also was argued by the Commissioner.

a. Maybe? Reversed on the capitalization holding and remanded to see if the same result follows under the “clear reflection of income” standard. 270 F.3d 1137, 88 A.F.T.R.2d 2001-6703, 2001-2 U.S.T.C. ¶50,731 (7th Cir. 11/6/01). The Seventh Circuit Court of Appeals (Judge Wood) reversed the Tax Court’s decision that § 263 required that the deduction be prorated over the two taxable years. Judge Wood found the Tax Court’s distinction of how the capitalization rules applied to cash method taxpayers and accrual method, which resulted in capitalizing U.S. Freightways’ expenses when like expenses of a cash method taxpayer might not have been required to be capitalized [a point that the Tax Court did not concede but accepted arguendo for this case] to be untenable. The Court of Appeals remanded the case to the Tax Court to consider whether the deduction nevertheless should be prorated over the two taxable years under the “clear reflection of income” standard of § 446(b).

b. Kudos from taxpayers; pans from professors. Advanced Notice of Proposed Rulemaking (“ANPRM”) REG-125638-01, Guidance Regarding Deduction and Capitalization of Expenditures, 67 F.R. 3461 (1/24/02). Describes rules and standards Treasury and IRS plan to propose under § 263(a) (and not under §§ 195, 263, 263(h) or 263A) to provide a framework for addressing capitalization issues with respect to expenditures incurred in acquiring, creating, or enhancing intangible assets. Safe harbors and simplifying assumptions including a “one-year rule” under which expenditures relating to short lived intangibles need not be capitalized and “de minimis rules” under which certain types of expenditures under a specified dollar amount are not required to be capitalized.

• Specifically (A1) loan portfolios would have to be capitalized; (A2) amounts paid for § 197 intangibles would have to be capitalized; (B1) no capitalization required under the 12-month rule; (B2) prepaid items beyond 12 months would have to be capitalized; (B3) market entry payments would have to be capitalized but not costs to obtain ISO 9000 certification; (B4) amounts paid for government licenses that are valid indefinitely would have to be capitalized; (B5) amounts paid to modify contractual rights would have to be capitalized, but not those paid where the parties do not enter into a new or renegotiated agreement; (B6) amounts paid by a lessor to terminate a lease would have to be capitalized over the remaining period of the lease; *** (C) transaction costs would have to be capitalized, but this rule would not require capitalization of employee compensation, fixed overhead costs, or costs that do not exceed a specified dollar amount such as $5,000.

• Note that these proposed rules accept the Courts of Appeals decisions in Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (6th Cir. 2000), and PNC Bancorp v. Commissioner, 212 F.3d 822 (3d Cir. 2000), and turn a cold shoulder on the Commissioner’s victory in Lychuck v. Commissioner, 116 T.C. 374 (2001). These proposed regulations also reject the Tax Court’s decision in favor of the IRS in U.S. Freightways Corp. v. Commissioner, supra.

c. Meanwhile, nothing – except for the 12-month rule. Langdon & Kehoe memo for LMSB and SB/SE employees, dated 2/26/02. Contains “meanwhile” instructions pending adoption of the above ANPRM noting that the positions therein are “not Service position,” but does note that “it is likely that Treasury and this Service will ultimately adopt [a 12-month] rule in regulations.”

d. The Chief Counsel speaks. Chief Counsel Notice CC-2002-021 (3/15/02). This Notice announces a change in the Service’s litigating position regarding capitalization decisions in Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (6th Cir. 2000), and PNC Bancorp v. Commissioner, 212 F.3d 822 (3d Cir. 2000), and turn a cold shoulder on the Commissioner’s victory in Lychuck v. Commissioner, 116 T.C. 374 (2001). These proposed regulations also reject the Tax Court’s decision in favor of the IRS in U.S. Freightways Corp. v. Commissioner, supra.

e. LMSB and SB/SE follow their attorney’s advice. Langdon & Kehoe memo for LMSB and SB/SE employees dated 4/26/02, reversing their 2/26/02 memorandum by reason of Chief Counsel Notice CC-2002-021.

• The memo notes that the requirements respecting the adoption and change of accounting methods pursuant to § 446(e) continue to be applicable, i.e., that a taxpayer may not
change its method of accounting on an original tax return without first obtaining consent nor may it change a method by filing an amended return.

4. Impact fees must be capitalized. Rev. Rul. 2002-9, 2002-10 I.R.B. 614 (2/15/02). Impact fees are one-time charges that are imposed by a state or local government against new or expanded real estate developments to finance specific offsite capital improvements for general public use necessitated by the development. These fees are refundable if the new development ultimately is not constructed. These impact fees are capitalized costs allocable to the building under §§ 263(a) and 263A. The ruling also contains provisions for changing accounting methods to comply with its provisions.

5. You don’t have to capitalize and depreciate business assets that you can prove on average you use for less than one year. Prudential Overall Supply v. Commissioner, T.C. Memo. 2002-103 (4/23/02). The taxpayer was an industrial uniform rental/laundry business that derived most of its income from services related to the uniforms it rented to customers. The rental uniforms were emblazoned with customers’ logos and fitted to specific customers’ employees. The taxpayer consistently deducted the cost of the uniforms [for both tax and financial accounting purposes], but the Commissioner, under § 446(b), sought to change the taxpayer’s accounting method to capitalization and depreciation. Judge Cohen found that the taxpayer had proven that the average useful service life of the garments was less than one year, even though the physical life of the garments exceeded one year, and allowed the taxpayer to continue to expense the garments.

C.

Reasonable Compensation

1. More creeping influence of the hypothetical independent investor test. B&D Foundations, Inc. v. Commissioner. T.C. Memo 2001-262 (10/3/01). In a reasonable compensation case appealable to the Tenth Circuit, Judge Beghe applied the multi-factor test of Eberl’s Claim Service, Inc. v. Commissioner, 249 F.3d 994 (10th Cir. 2001) and Pepsi Cola Bottling Co. of Salina v. Commissioner, 528 F.2d 176 (10th Cir. 1975) [citing the Golsen rule] to uphold the Commissioner’s disallowance of a deduction for $353,911 out of $1,113,800 of compensation paid to the husband and wife employee/shareholders. Notably, Judge Beghe included an extensive discussion of the return to a hypothetical independent investor as a factor, even though that item was not a factor applied in either Eberl’s Claim Service or Pepsi Cola Bottling Co.

D.

Miscellaneous Expenses

1. The employer’s deduction was more than the includible compensation – And it was legal! Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197 (3/28/00), aff’d per curiam, 255 F.3d 495, 88 A.F.T.R.2d 2001-5026, 2001-2 U.S.T.C. ¶50,503 (8th Cir. 7/3/01). Pursuant to Reg. § 1.162-25T, an employer-corporation that provided private nonbusiness flights on a company owned airplane to employees was permitted to deduct the cost of providing the flights because the fair market value of the flights was included in the employees’ reported compensation under Reg. § 1.61-21(b). Accordingly, pursuant to § 274(e)(2), the limitations of § 274 did not apply even though the airplane otherwise could be considered to be an entertainment facility. Furthermore the employer’s deduction was not limited to the lesser amount includable by the employees under special fringe benefit valuation rules [Reg. § 1.61-21(g)].


2. The IRS never seems able to catch up with the movements in the price of gasoline. Rev. Proc. 2001-54, 2001-48 I.R.B. 530 (11/7/01), updating Rev. Proc. 2000-48, 2000-49 I.R.B. 570. The optional standard mileage rate for business use of automobiles will increase on 1/1/02 from 34.5 cents per mile to 36.5 cents per mile, the mileage rate for medical and moving will increase from 12 cents per mile to 13 cents per mile, and the mileage rate for giving services to a charitable organization will remain at 14 cents per mile.

a. And more tinkering is in store for 2003. Rev. Proc. 2002-61, 2002-39 I.R.B. (9/18/02). The rate for the business use of an automobile is 36.0 cents per mile, down from 36.5 cents per mile. The rate for the charitable use of an automobile remains at 14 cents per mile, while the rate for using an automobile for medical and moving purposes is 12 cents per mile, down from 13 cents per mile.

3. A taxpayer who seeks the safe harbor of a Revenue Procedure can’t complain about the anchorage. Beech Trucking Co., Inc. v. Commissioner, 118 T.C. No. 27 (5/23/02). The taxpayer trucking company “leased” its truck drivers from another [related] company (ATS). In addition to paying for the drivers’ services on a cents per mile basis and paying other expenses, Beech paid a “per diem” of 6.5 cents per mile. Beech deducted the full amount of the payments, but the
Commissioner disallowed fifty percent of the per diem under § 274(n). The Commissioner conceded that the per diem met the deemed substantiation requirements of Rev. Proc. 96-28, § 6.05, 1996-1 C.B. 686 [which was crucial to allowing any deduction because the taxpayer did not otherwise prove that the per diem, which was for meals and incidental expenses, not for lodging, was less that the federal M&IE rate]. The per diem was treated under Rev. Proc. 96-28 as being solely for meals and incidentals because it was computed on the same basis as compensation [cents per mile]. The Tax Court (Judge Thornton) rejected the taxpayer’s argument that because it leased the drivers from ATS, § 274(n) did not apply to its payment to ATS. On the facts [which were sparse due to the taxpayer’s failure to introduce evidence], the drivers were the taxpayer’s common law employees because it controlled their activities and had final control over who was hired and who was fired. Thus, under Rev. Proc. 96-28 and § 274(n), only 50 percent of the per diem was deductible. The provisions in Rev. Proc. 96-28 treating the per diem as being solely for meals and incidentals because it was computed on the same basis as compensation were not in conflict with Reg. § 1.62-2(d)(3)(ii), and the revenue procedure was not otherwise invalid. Finally, since the taxpayer was relying on Rev. Proc. 96-28 for deemed substantiation, in the absence of any evidence of actual substantiation, it would not be heard to challenge the conditions in the revenue procedure.

4. A deeply divided Tax Court overrules the substantive decision in Redlark, but the interpretative issue regarding the weight of the Bluebook remains opaque. Robinson v. Commissioner, 119 T.C. No. 4 (9/5/02) [appealable to the Fifth Circuit]. Temp. Reg. § 1.163-9T(b)(2)(i)(A) treats interest on any noncorporate income tax underpayment as nondeductible personal interest, even if the underlying tax liability relates to a trade or business. In Redlark v. Commissioner, 106 T.C. 31 (1996), rev’d, 141 F.3d 936 (9th Cir.1998), the Tax Court held that the Regulations were invalid to the extent they classified as nondeductible personal interest any interest paid with respect to an income tax underpayment arising from an unincorporated business. In a reviewed opinion (6-4-5) by Judge Chabot, the Tax Court overruled its prior opinion in Redlark, and upheld the validity of the regulations as applied to an underpayment attributable to the taxpayer’s law practice.

- The plurality reasoned that the words “properly allocable” in § 163(h)(2)(A), which excludes trade or business interest from the definition of non deductible personal interest, were not intended to incorporate the pre-1986 case law upon which the Tax Court had relied in Redlark: “In Redlark v. Commissioner, 106 T.C. at 34, 37, we did not deal with the fact that both the enacted TRA 1986 language (‘in connection with’) and the enacted TAMRA 1988 language (‘properly allocable to’) were different from the ‘in carrying on’ and ‘attributable to’ language interpreted in the pre-TRA 1986 opinions.” Section 163(h) itself is silent or ambiguous with respect to the question, and the regulations represent a permissible construction of § 163(h)(2)(A). The plurality noted that the five courts of appeals that have addressed the validity of the regulations all had upheld them. See Allen v. United States, 173 F.3d 533 (4th Cir.1999); McDonnell v. United States, 180 F.3d 721 (6th Cir.1999); Kikalos v. Commissioner, 190 F.3d 791 (7th Cir.1999); Miller v. United States, 65 F.3d 687 (8th Cir.1995); Redlark, supra. Unlike in its earlier Redlark opinion, the Tax Court plurality accorded some weight to the 1986 Bluebook.

- Judge Thornton (along with Gerber and Gale) concurred in the result but cautioned that:

Where there is no corroboration in the actual legislative history, we shall not hesitate to disregard the General Explanation [of the Blue Book] as far as congressional intent is concerned. *** Given the clear thrust of the conference committee report, the General Explanation [of the Blue Book] is without foundation and must fall by the wayside. To conclude otherwise would elevate it to a status and accord it a deference to which it simply is not entitled. Other opinions of this Court echo the notion that we require some direct corroboration of congressional intentions before we defer to Blue Book expressions thereof.

- Chief Judge Wells (joined by Judges Swift, Colvin, Laro and Vasquez) dissented:

The meaning of section 163(h)(2)(A) can be discerned from a plain reading of the language of that section. Moreover, prior case law defined the required nexus between an interest expense on a deficiency and a trade or business, and Congress did not indicate any intent to overturn these cases. Also, the majority placed undue emphasis and reliance

- Judge Vasquez's dissent (joined by Judges Wells, Swift, Colvin and Laro) emphasized that because the regulations in question were Temporary Regulations promulgated without either a specific delegation of authority or notice and comment, under United States v. Mead Corp., 533 U.S. 218 (2001), the regulations were not entitled to deference under the standard of Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984). He would accord "the agency's interpretation ... respect proportional to its 'power to persuade' pursuant to Skidmore v. Swift & Co., 323 U.S. 134 ... (1944). United States v. Mead Corp., supra at 234-235, 237." The dissent concluded that the plurality erred in relying on courts of appeals decisions upholding the regulations because those decisions were pre-Mead cases.

E. Depreciation & Amortization

1. "Modern" golf greens are depreciable, but costs associated with traditional greens are not. Rev. Rul. 2001-60; 2001-51 I.R.B. 587 (11/29/01). This revenue ruling provides guidance clarifying what golf course land preparation costs can be depreciated. Land preparation undertaken in the original construction or reconstruction of push-up or natural soil greens is inextricably associated with the land and, therefore, the costs attributable to that land preparation are not depreciable. However, the costs of land preparation of modern greens that are closely associated with depreciable assets, such as a network of underground drainage tiles or pipes, that the land preparation will be retired, abandoned, or replaced contemporaneously with those depreciable assets are to be capitalized and depreciated over the recovery period of the depreciable assets with which the land preparation is associated.

2. The "exhaustion, wear and tear" prerequisite for depreciation is an "undemanding" standard. O'Shaughnessy v. Commissioner, 89 A.F.T.R.2d 2002-658, 2002-1 U.S.T.C. §50,235 (D. Minn. 9/29/01). The S corporation in which the taxpayer was a shareholder manufactured glass using a "float process" that involved the use of a molten tin "bath" that lost volume and purity in the manufacturing process, requiring periodic replenishment. The amount of tin added each year equaled the amount of tin consumed in glass production during the year. The taxpayer deducted the cost of adding tin to the bath and depreciated the cost of the original volume of tin. Applying Rev. Rul. 75-491, 1975-2 C.B. 19, which was directly on point, the IRS disallowed the depreciation. The district court refused to apply the revenue ruling, because it was not binding and because it predated the ACRS depreciation system, and held that the original volume of tin was depreciable because over time it would have been exhausted by volume and purity losses.

3. The Job Creation and Worker Assistance Act of 2002 provides for additional first-year depreciation of 30 percent for certain property which was acquired after 9/10/01 and before 1/1/06. Property qualifying is (1) §168 property with a recovery period of 20 years or less, (2) computer software other than computer software covered by §197, (3) water utility property, and (4) leasehold improvement property. For passenger automobiles, the §280F(a)(1)(A)(i) limitation is to be increased by $4,600. This provision also applies to improvements to used property.

   a. Rev. Proc. 2002-33, 2002-20 I.R.B. 963 (4/29/02). Procedures for claiming the additional 30 percent first-year depreciation provided by §168(k) [and §1400L(B)]. The procedure also explains how a taxpayer may elect not to deduct the additional first-year depreciation for qualified property.

4. Proposed guidance on the now statutory "nonstatutory" depreciation method. REG-103823-99, Guidance on Cost Recovery Under the Income Forecast Method, 67 F.R. 38025 (5/31/02). The Treasury has published detailed proposed regulations under §167(g) [added in 1996] to govern depreciation under the income forecast method. The proposed regulations allow mid-recovery period recomputations where conditions necessitate it, e.g., facts indicate that the original income forecast was erroneous. "Catch-up" depreciation is allowed in a year that basis [determined under §263A] is reetermined; contingent amounts are not added until basis until the §461(h) economic performance test. Unlike under other §167 depreciation methods, but like under MACRS depreciation, salvage value is not subtracted from basis before computing depreciation. Income forecasts must be revaluated annually for accuracy. Income forecast depreciation is generally elected property-by-property, with very limited grouping available. The §461(g)(2) look-back interest rules do not apply if the basis of the property is $100,000 or less in the year the look-back would occur. In addition, the look-back rule is not applied if forecasted income (and, if applicable, revised forecasted income) for each prior year is
more than 90 percent and less than 110 of revised total forecasted income for the recomputation year. The proposed regulations will be effective upon finalization.

5. Replacing short-lived critical components inside a long-lived shell is a capital expense. Smith v. Commissioner, 300 F.3d 1023, 90 A.F.T.R.2d 2002-2, U.S.T.C. ¶50,583 (9th Cir. 8/12/02), aff'd VanAlco Inc. v. Commissioner, T.C. Memo 1999-265. The taxpayer operated an aluminum smelting plant that had 640 reduction cells [each 22 feet long, 76 inches wide, and 36 inches high]. A cell shell had a life of over 50 years and its lining had a life of approximately three years. The cost of relining a cell was 22.21 percent of the cost of a completely rehabilitated cell and was aside from the superstructure “by far the most expensive part of the cell to replace.” During each of the two years in issue, the taxpayer replaced the linings of approximately 200 cells, at a cost of over $4 million each year, which it deducted as a repair expense. The court of appeals affirmed the Tax Court’s holding that the expenses were capital. After first finding that the Tax Court’s holding that each cell — rather than all of them together — was a separate property was not clearly erroneous, the court then rejected the taxpayer’s argument that the Tax Court had misapplied Plainfield Union Water Co. v. Commissioner, 39 T.C. 333 (1962) (nonacq.). In order to determine whether the repair was merely incidental, “the significance of the part under repair to the operation of the property is a critical inquiry.” Because each cell completely lost functionality as result of the deterioration of the lining, the relining process was “integral to putting the cell back into its original functional state...[and] restoring it from a state of functional exhaustion to full functional operation.” The court concluded that “the lining is a critical component of the cell and its replacement is tantamount to reconstructing the cell itself.” Because the relining process effectively rebuilt the cell, it conferred a new life expectancy on the cell.

6. Campbell v. Commissioner, T.C. Summary Opinion 2002-117 (9/6/02) (nonprecedential pursuant to § 7463(b)). Special Trial Judge Pajek held the $8,000 expenditure for roofing work done on taxpayer’s rent house was a deductible repair, and need not be capitalized. As set forth in the opinion, “The contractors removed the existing top layers of the roof and recovered it with fiberglass sheets and hot asphalt. They made no structural changes to the roof. . . . There was no replacement or substitution of the roof. Petitioner’s only purpose in having the work done to the roof was to prevent the leakage and keep her rental house in operating condition and not to prolong the life of the property, increase its value, or make it adaptable to another use.”

F. Credits

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

- What the suspended final regulations said. The final regulations cover the requirements to qualify for the credit, rules for computing the credit, and rules for electing and revoking the election of the alternative incremental credit, and take into account the Legislative history of the Tax Relief and Extension Act of 1999.

- The final regulations do not change the definition of gross receipts from that in the Proposed Regulations. REG-105170-97, 63 F.R. 66503 (12/2/98).

- The final regulations retain the requirement in the proposed regulations that a taxpayer seek to discover information that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field of science or engineering. But, in response to comments regarding the discovery requirement, the final regulations make a number of changes.

- In order to satisfy the discovery requirement, research must be undertaken for the purpose of discovering information that is beyond the knowledge that should be known to

2 A discovery requirement was applied in United Stationers, Inc. v. United States, 163 F.3d 440 (7th Cir. 1998), cert. denied, 119 S. Ct. 2369 (1999), Norwest v. Commissioner, 110 T.C. 454 (1998), and WICOR, Inc. v. United States, 116 F. Supp. 2d 1028 (E.D. Wis. 2000), aff’d, 263 F.3d 659 (7th Cir. 2001).
skilled professionals had they performed a reasonable investigation of the existing level of knowledge in the particular field of science or engineering [instead of technology or science], but there is no requirement that a taxpayer actually conduct such an investigation in order to claim the credit. The regulations also state, by example, that trade secrets generally are not within the common knowledge of skilled professionals (because they are not reasonably available to skilled professionals not employed, hired, or licensed by the owner of such trade secrets). Underlying principles of science or engineering used in the research need not be novel. Obtaining a patent [other than a design patent] raises a conclusive taxpayer favorable presumption.

- The prescribed four-step process in the definition of experimentation in Prop. Reg. § 1.41-4(a)(5) has been eliminated.
- The requirement of experimental record keeping in Prop. Reg. § 1.41-4(a)(5) has been eliminated.
- The shrinking-back rule has been modified in response to comments. Reg. § 1.41-4(b).
- The exclusion of most activities after commercial production has commenced has been retained. The per se exclusion list retains debugging, but not correction of flaws.
- Research with respect to internal-use software that satisfies both the general conditions for credit eligibility and the three-part test is eligible for the credit. The final regulations retain the definition of internal-use software and the additional qualifying test in the proposed regulations, but provide a new exception (pursuant to § 41(d)(4)(E)) under which certain internal-use software used to deliver noncomputer services to customers with features that are not yet offered by a taxpayer’s competitors is not subject to the additional tests. Following the Conference Report to the 1999 Act, the final regulations clarify that software that is intended to be used to provide noncomputer services to customers is internal-use software, while software that is to be used to provide computer services is not developed primarily for internal use.
- The final regulations clarify (1) that the three-part test in the proposed regulations is the high threshold of innovation test, and not a separate requirement, and (2) how the three-part part high threshold of innovation test supplements the discovery requirement. Research with respect to internal-use software is credit eligible only if it is intended to exceed, expand, or refine the common knowledge of skilled professionals (as defined in Reg. § 1.41-4(a)(3)(ii)) to a degree that is substantial and economically significant.

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

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

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

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

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

  - The preamble notes that the Service will not generally challenge return positions that are consistent with the proposed regulation.
b. The court closed the barn door after the Treasury let the horse out. Tax and Accounting Software Corp. v. United States, 301 F.3d 1254, 90 A.F.T.R.2d 2002-6107 (10th Cir. 8/30/02). The Tenth Circuit (Judge Lucero), reversed the district court's grant of summary judgment to the taxpayer [and remanded the case], and held that the § 41 research credit is limited to research to "discover" new technological information that is applied toward the development of a product,3 but which is separate from the product. To meet this test, the research must expand existing knowledge. But the process of experimentation can include research in which the taxpayer tries already-known methods to achieve a result that it is not yet known can be reached by the methods being tried. On the other hand, the credit is allowable only where the feasibility of the end result is uncertain at the time the research is undertaken. On the facts, the taxpayer could not meet these standards.

- Note that the proposed regulations, REG-112991-01, Credit for Increasing Research Activities, 66 F.R. 66362 (12/26/01) impose less stringent requirements than this case, particularly with respect to the "new knowledge" requirement.

2. The AMT can bite even those who don't owe it. Allen v. Commissioner, 118 T.C. No. 1 (1/04/02). Section 38(c)(i) provides that the general business credit may not exceed the taxpayer's net income tax minus the greater of (1) AMT or (2) 25 percent of taxable income in excess of $25,000. This generally prevents the credit from offsetting AMT. This case involved a taxpayer who was not subject to AMT for the year in question, but whose tentative minimum tax would have exceeded the credit if, because the taxpayer claimed the § 51 targeted jobs credit [now Work Opportunity Credit] § 280C were applied in calculating AMTI to deny a deduction for the amount of the credit [before limitation by § 38(c)]. The Tax Court (Judge Laro) held that in computing AMTI and tentative AMT for purposes of § 38(c), any reduction in the amount of deductions required by § 280C by virtue of a credit having been claimed with respect to the otherwise deductible expenditure must be taken into account even though the taxpayer was not liable for the alternative minimum tax in that year. Judge Laro rejected the taxpayer's argument (which was accepted by the Commissioner) that the AMT was a "separate and independent tax system" that operates in parallel with the RT [regular tax] system and requires separate calculations ..." He found no support in the committee reports for treating AMTI as anything other than regular taxable income as modified by § 55(b)(2), and rejected any inference to the contrary in the 1986 Act Bluebook on the grounds that the Bluebook is "not part of the statute's legislative history" [noting that this is especially true with respect to the 1986 Act Bluebook, which was prepared by the staff of the succeeding Congress].

- Judge Laro noted that if he had accepted the argument that the AMT was a separate and independent tax system that operates in parallel with regular tax system, he would have been inclined to hold for the taxpayer.

- This case has implications beyond the Work Opportunity Credit because the same statutory structures apply to Welfare to Work Credit, Orphan Drug Credit, and Increased Research Activities Credit.

G. Natural Resources Deductions & Credits

1. To "produce" or to "transport" gas, that is the question. Saginaw Bay Pipeline Co. v. United States, 2001-2 U.S.T.C. ¶50,642, 88 A.F.T.R.2d 2001-6019 (E.D. Mich. 8/23/01). Natural gas gathering systems are used to transport gas [Class 46.0] – not in production [Asset Class 13.2] – and thus are depreciable over 15 years rather than seven years. The District Court described Duke Energy Natural Gas Corp. v. Commissioner, 173 F.3d 1253 (10th Cir. 1999), as "wrongly decided."

2. No second bite at the apple on the definition of "tar sands oil." Shell Petroleum v. United States, 50 Fed. Cl. 524, 2001-2 U.S.T.C. ¶50,724, 88 A.F.T.R.2d 2001-6448 (Fed. Cl. 10/12/01). The government was granted summary judgment that Shell did not qualify for the § 29 credit. Hydrocarbons produced by means of enhanced recovery techniques in commercial use prior to 4/2/80 are crude oil, not "tar sands oil." Oil produced from tar sands is defined by FEA Ruling 1976-4 [from the Emergency Petroleum Allocation Act], as oil produced from rock types containing "extremely viscous hydrocarbon which is not recoverable in its natural state by conventional oil well production methods including currently used enhanced recovery techniques." Shell was barred by collateral estoppel from litigating the meaning of "currently used enhanced recovery techniques" because it had been previously litigated in Shell v. United States, 182 F.3d 212 (3d Cir. 1999), which held that Shell was not entitled to the § 29 credit for oil produced using the same methods.

3 Section 41(d)(1) includes the requirement that the research must be for "the purpose of discovering information" using a "process of experimentation."
3. **Goodfellow v. Commissioner, T.C. Memo. 2002-128 (5/28/02).** Taxpayer was not entitled to depletion deductions on materials it excavated from construction sites pursuant to contracts with the general contractor because it did not have an economic interest in the materials in place. Pursuant to these contracts, taxpayer was permitted to remove materials excavated which the general contractors deemed to be unusable; taxpayer crushed these materials with equipment located at taxpayer's quarry and sold them as crushed rock. The taxpayer made no investment in the rock and had no interest in it in the ground, because whether the rock was "usable," and would be retained by the general contractor, or "unusable" was decided by the general contractor after excavation. (Taxpayer was entitled to depletion deductions on materials it extracted from its own quarry.)

4. **Enhanced oil recovery cost credit amount is alive and well for 2002.** Notice 2002-53, 2002-30 I.R.B. 187 (7/29/02). The §43 credit for domestic "enhanced oil recovery costs" equals 15 percent of qualified costs for the taxable year. The credit is subject to phase-out for any taxable year in which the reference price of crude oil (determined under §29(d)(2)(C)) for the prior year exceeds $28 (adjusted for inflation); the credit is wholly phased out if the reference price of oil equals or exceeds $34, adjusted for inflation. For taxable years beginning in 2002, the enhanced oil recovery credit is determined without regard to the phase-out for crude oil price increases.

5. **Percentage depletion rate on marginal oil or gas that is production is not enhanced for 2002.** Notice 2002-54, 2002-30 I.R.B. 189 (7/29/02). Percentage depletion [15%] remains available to independent producers and royalty owners under §613A(c). Section 613A(c)(6) increases the percentage depletion rate on oil or gas that is "marginal production," by one percentage point, to a maximum rate of 25 percent, for each dollar by which the "reference price" for crude oil B generally speaking, average wellhead price per barrel for domestic crude oil B for the preceding calendar year falls below $20. The applicable percentage for purposes of determining percentage depletion for oil and gas produced from marginal properties for 2002 is 15 percent.

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

1. **Is reporting interest income a "super factor" in debt/equity analysis?** Cerand & Co. v. Commissioner, 254 F.3d 258, 2001-2 U.S.T.C. ¶50,518, 88 A.F.T.R.2d 2001-5061 (D.C. Cir. 6/6/01). The taxpayer advanced over $1 million to three sibling corporations on "open account." When the sibling corporations went out of business, the taxpayer claimed bad debt deductions. The Tax Court upheld the Commissioner's disallowance of the deductions, finding that the evidence relating to the transfers did not warrant treating them as loans: there were no debt instruments or signed agreements, no fixed maturity date or repayment schedule, no predetermined interest rate, repayments were inconsistent and appeared dependent on financial success, and the objective likelihood of repayment was low due to thin capitalization and no historical success. The District of Columbia Circuit, applying an abuse of discretion standard, vacated and remanded, stating as follows:

The critical flaw in the tax court's analysis is its failure *** to consider Cerand's contemporaneous treatment of sums received from its sister corporations as in part the payment of "interest," taxable as income to Cerand. Over a period of several years, Cerand received $414,220 from the three corporations, of which it booked more than $175,000 as interest income. ***

Although the tax court abused its discretion by omitting from its analysis a highly significant bit of evidence, we cannot say that, had the court properly weighed this evidence, it necessarily would have reached a different conclusion, because we do not know what weight it assigned to the other evidence.

2. **On remand, the Tax Court, not surprisingly, still reaches the same result.** T.C. Memo. 2001-271 (10/9/01). On remand Judge Gerber found that the somewhat sporadic reporting of interest that was not uniform in amount or percentage, ranging from 4.7 percent to 11.3 percent, with an average far below the going rate, was inadequate evidence to support finding a true debtor-creditor relationship. Furthermore, purported principal repayments were merely book entries that were offset by larger advances. The bad debt deduction was disallowed.

2. **Intermet Corp. v. Commissioner, 117 T.C. 133 (10/2/01), on remand from 209 F.3d 901, 2001-1 U.S.T.C. ¶50,382, 88 A.F.T.R.2d 2001-1387 (6th Cir. 4/20/00).** Under the pre-1999 version of §172(f), state tax deficiencies and interest on state and federal tax deficiencies were specified
liability losses subject to a 10-year carryback. Judge Wells followed Host Marriott Corp. v. United States, 113 F.3d 790 (D.D.C. 9/8/00), aff'd by order, 267 F.3d 363, 88 A.F.T.R.2d 2001-5176, 2001-2 USTC §50,580 (4th Cir. 7/20/01), and distinguished Sealy Corp. v. Commissioner, 107 T.C. 177, aff'd, 171 F.3d 655 (9th Cir. 1999) [holding that accounting and other costs to comply with the 1934 Securities Act and ERISA were not specified liability losses].

3. **Substance over form** is a different doctrine from “economic substance,” but the taxpayer still loses. Rogers v. United States, 281 F.3d 1108, 89 A.F.T.R.2d 2002-1115, 2002-1 U.S.T.C. §50,240 (10th Cir. 2/22/02), aff'd 58 F.Supp.2d 1235 (D. Kan. 1999). The Court of Appeals (Judge Henry) affirmed the district court’s decision applying the substance over form doctrine to recharacterize a purported nonrecourse loan and foreclosure as a sale. Kaufman and Fogelman each owned 50 percent of the stock of the Kansas City Royals S corporation. When Fogelman encountered financial difficulties, on July 31, 1990, Kaufman lent the corporation $34,000,000, which the corporation treated as a loan. The Royals immediately exercised the option to purchase Fogelman’s stock on which Fogelman had an option). The option price on Fogelman’s stock was the amount due on the note. The Royals immediately exercised the option to purchase Fogelman’s stock, with the closing deferred to January 4, 1991. In the fall of 1990, J.P. Morgan & Co. conducted an attempted auction sale of the entire Royals franchise at a minimum of $80,000,000; there were no bidders and J.P. Morgan opined that Fogelman’s 50 percent interest was of only “nominal value.” On January 3, 1991 Fogelman transferred his stock of the corporation to the corporation, in lieu of foreclosure. The Royals treated the collateral as having no value and, as an S corporation passed a § 166 bad debt loss through to Kaufman. In the course of holding that the loan was not bona fide and that the transaction was in substance a purchase and sale of the stock rather than a loan, Judge Henry explained that the substance over form doctrine is different from the “economic substance” doctrine that may be applied in tax shelter-type cases. He rejected the taxpayer’s argument that the two were the same and the proper application was limited to tax shelter cases.

4. **NOLs from the grave.** Lassiter v. Commissioner, T.C. Memo. 2002-25 (1/25/02). The husband taxpayer, who had NOLs, was in chapter 11 bankruptcy in 1994 when he died [at which time the husband’s NOLs had been transferred to the bankruptcy estate pursuant to § 1398(i)]. Pursuant to Fed. R. Bankr.P. 1016, the bankruptcy proceeding was continued and concluded later in 1994, as if he had not died. The husband’s NOLs that survived the bankruptcy were deducted on a joint return for 1994. Judge Laro held that under §§ 172(b)(1) and 1398(i), the husband’s NOLs were properly deductible on the joint return. Section 1398(i) provides that the “debtor” succeeds to the bankruptcy estate’s NOLs; the “debtor” was the husband, even if he was not alive when the estate terminated, and he was entitled to use them on his final tax return.

5. **“The Northern Lights have seen strange sights.”** Kappus v. Commissioner, T.C. Memo. 2002-036 (2/8/02). The AMT § 59(a)(2) limitation to 90 percent of AMTI of a NOL incurred by a Canadian resident/US citizen taxpayer did not violate the US-Canada tax treaty elimination of “double taxation.” Section 59(a)(2) was in “harmony” with the treaty and thus the last-in-time rule did not apply to invoke a treaty override.

6. **The Job Creation and Worker Assistance Act of 2002** extends the NOL carryback period from 2 years to 5 years for NOLs in years ending in 2001 and 2002. The 90 percent limit on NOL carryovers for AMT purposes is temporarily suspended for these years.

a. **Amended returns must be filed by 10/31/02.** Rev. Proc. 2002-40, 2002-23 I.R.B. 1096 (5/22/02). This revenue procedure provides procedures that taxpayers with net operating losses incurred in 2001 or 2002 must follow to apply or elect out of the special five-year carryback period enacted in the Job Creation and Worker Assistance Act of 2002. Qualifying taxpayers who filed returns for the 2001 or 2002 tax years without taking advantage of the five-year NOL carryback, whether by using the 2-year carryback period, not claiming a carryback, or electing under § 172(b)(3) to forgo the NOL carryback period, will have until 10/31/02 to file amended returns in which they may use the five-year carryback period (including, if appropriate, the revocation of the § 172(b)(3) election). See also, REG-122564-02 and T.D. 8997, for similar relief available to acquiring consolidated groups, permitting them to waive the preacquisition portion for the five-year NOL carryback period for losses attributable to acquired members.

7. **No bad debt deduction allowed where the default is caused by the creditor’s own actions to further other business goals.** PepsiAmericas, Inc. v. United States, 52 Fed. Cl. 41, 89 A.F.T.R.2d 2002-1524, 2002-1 U.S.T.C. §50,326 (Fed. Cl. 3/20/02). The taxpayer had established an ESOP, to which it had lent substantial sums to purchase shares of its stock. To further a planned
corporate reorganization involving a spin-off of its key subsidiary – taxpayer was a holding company – it
terminated the ESOP. As a result, the ESOP was unable to repay the entire debt. Immediately prior to its
termination, the ESOP was insolvent under the balance sheet test, but was not equitably insolvent. The
Court of Federal Claims (Judge Futey) upheld the IRS’s disallowance of the taxpayer’s claimed bad debt
deduction. First, the court held that immediately before its termination, the ESOP should have been
considered to be a solvent debtor, because had it been continued, it could have continued to make
payments on the note. Second, the court treated the voluntary termination of the ESOP in furtherance of
the reorganization plan as the release of a solvent debtor from liability to further business purposes
of the creditor. Citing American Felt Co. v. Burnet, 58 F.2d 530 (D.C. Cir. 1932), the court held that no
bad debt deduction is allowed under the circumstances.

I. At-Risk and Passive Activity Losses
   a. Well, now, not for this taxpayer and not in the Fourth Circuit. What
   “plain meaning” giveth in Gitlitz, it taketh away in Hillman. Reversed, 250 F.3d 228, 2001-1
   U.S.T.C. ¶50,354; 87 A.F.T.R.2d 2001-1731 (4th Cir. 4/17/01), rehearing en banc denied, 263 F.3d 338,
   88 A.F.T.R.2d 2001-5292 (6/30/01). The Court of Appeals (Judge Hamilton) reversed, finding “nothing
   in the plain language of IRC section 469 suggests that an exception to IRC section 469(a)’s general
   prohibition against a taxpayer’s deducting passive activity losses from nonpassive activity gains exists
   where, as in the present case, the taxpayer essentially paid a management fee to himself.” The court
   reasoned that Hillman’s argument for ignoring the plain language of the statute could prevail only if one
   of “two extremely narrow exceptions to the Plain Meaning Rule” applied: (1) “when literal application of
   the statutory language at issue produces an outcome that is demonstrably at odds with clearly expressed
   congressional intent to the contrary” or (2) “when literal application of the statutory language at issue
   ‘results in an outcome that can truly be characterized as absurd, i.e., that is so gross as to shock the
general moral or common sense.’” In the eyes of the court, neither of those situations was present.

   b. On remand, 118 T.C. No. 17 (4/9/02). Judge Gerber, in denying
taxpayer relief from § 469 by reason of the Fourth Circuit’s decision, stated

Unfortunately, petitioners have been snared by the reach of section 469 in, what appears
to be, most inequitable circumstances. As we discussed in our prior opinion, section 469
was designed to limit the use of losses generated by passive activities to offset unrelated
income generated by nonpassive activities. Although section 469 was designed to stop
these practices, Congress recognized that it would be inappropriate to treat certain
transactions between related taxpayers as giving rise to passive expense and nonpassive
income.
The Secretary was charged with issuing regulations to implement section 469. Commentary contained in the legislative history suggests that self-charged items should be provided for in the regulations. In 1991, regulations were proposed that provided for self-charged interest. Although more than 15 years have passed since the enactment of section 469 and 10 years have passed since the self-charged regulation for interest was proposed, no action has been taken to relieve inequity that may be suffered with respect to self-charged items other than interest.

Although we find petitioners' plight lamentable, the Court of Appeals for the Fourth Circuit has held that the courts are incapable of providing relief in this situation.

c. "So there, Mr. Hillman!" T.D. 9013, Limitations on Passive Activity Losses and Credits--Treatment of Self-Charged Items of Income and Expense, 67 F.R. 54087 (8/21/02). Final regulations under § 469 on self-charged items of income and expense. The regulations decline to extend self-charged treatment to items beyond interest because Congress in 1993 provided relief in § 469(c)(7) to real estate professionals. (Section 469(c)(7) is applicable to years beginning after 12/31/93.) The preamble states:

Noting that Congress authorized the Secretary to identify other situations in which self-charged treatment is appropriate, several commentators suggested that self-charged treatment be extended to other transactions involving rental real estate activities, such as the payment of management fees and salaries. After publication of the proposed regulations, Congress considered the impact of section 469 on rental real estate transactions and enacted specific relief in section 469(c)(7) for certain real estate professionals for taxable years beginning after 1993. There was no indication in the legislative history of section 469(c)(7) that Congress considered additional relief for real estate transactions necessary or desirable. Moreover, there is less justification for the complexity of a self-charged rule in this area after the enactment of section 469(c)(7) because that change substantially reduced the number of real estate transactions that would benefit from a self-charged rule. Accordingly, the regulations do not extend the self-charged treatment to other transactions involving rental real estate.

2. A rule that usually helps the taxpayer has a dark side. Bailey v. Commissioner, T.C. Memo. 2001-296 (11/07/01). A real estate rental activity involving rentals under short term contracts – less than seven days – is excluded by Reg. § 1.469-1T(e)(3) from the definition of rental activities under § 469(j)(8) and Reg. § 1.469-9(b)(3). As a result, hours devoted to such an activity are not taken into account in determining the taxpayer’s participation in a real estate rental business for purposes of applying the § 469(c)(7) exception to the passive activity rules [material participation for more than 750 hours in one or more real estate businesses that constitutes more than one-half of taxpayer’s personal services hours for the year].

3. The IRS consistently wins on this issue. Krukowski v. Commissioner, 279 F.3d 547, 2002-1 U.S.T.C. §50,219, 89 A.F.T.R.2d 2002-827 (7th Cir. 2/5/02), aff'g 114 T.C. 366 (2000). Mr. and Mrs. Krukowski owned an interest in a building that they leased to Krukowski & Costello, a law firm organized as a “C” corporation of which Mr. Krukowski was a sole shareholder and from which he received all of his earned income. The Krukowski treated the rental income as passive activity income, against which they deducted passive activity losses. The Commissioner applied Reg. § 1.469-2(f)(6) to recharacterize the rental income as active income and disallowed the passive activity losses. The Seventh Circuit affirmed the Tax Court’s decision upholding the validity of Reg. § 1.469-2(f)(6) and Temp. Reg. § 1.469-5T(f)(3), which provide that participation by one spouse shall be treated as participation by the other spouse in the activity during the taxable year. Accordingly, the rental income was recharacterized as active and the passive activity losses were disallowed.1

4. Shucks, it doesn’t work! Deemed sale election will not constitute a disposition for purposes of § 469(g)(1)(A). Notice 2002-29, 2002-17 I.R.B. 797 (4/29/02). This notice

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1 Accord Fransen v. United States, 191 F.3d 599 (5th Cir. 1999); Sidell v. Commissioner, 225 F.3d 103 (1st Cir. 2000); Schwalbach v. Commissioner, 111 T.C. 215 (1998).
explains the effect under § 469 of the Internal Revenue Code of a deemed sale of property on January 1, 2001, pursuant to an election under § 311(e) of the Taxpayer Relief Act of 1997 (TRA 97). A question had arisen whether electing a deemed sale of property under § 311(e) of TRA 97 is treated as a disposition of that property under § 469(g)(1)(A). In a technical correction to § 311(e), § 414(a)(2) of the Job Creation and Worker Assistance Act of 2002 clarifies that a mark-to-market election is not a disposition for purposes of § 469(g)(1)(A). Thus, the gain included in gross income by reason of a mark-to-market election may be passive activity gross income that can be offset by passive activity deductions, but the election does not otherwise affect the determination of the passive activity loss that is disallowed under § 469.

III. INVESTMENT GAIN

A. Capital Gain and Loss

1. The 18% rate and a tax-free step-up? No way! Rev. Rul. 2001-57, 2001-46 I.R.B. 488 (11/13/01). An individual who elects under § 311(e) of the Taxpayer Relief Act of 1997 to treat his principal residence as being both sold and reacquired for an amount equal to FMV on 1/1/01 — in order to secure the 18% capital gains rate for assets acquired on or after that date and held for five years thereafter — may not exclude from gross income any of the gain recognized from the deemed sale. This result was enacted statutorily in § 414(a)(1) of the Job Creation and Worker Assistance Act of 2001.

   a. Notice 2002-58, 2002-35 I.R.B. (8/12/02). Instructions on how a noncorporate taxpayer may make the election under § 311(e) of the Taxpayer Relief Act of 1997 to treat assets held on 1/1/01 as being sold and reacquired on that date, in order to reduce the § 1(h) rates for capital gain from 20 percent to 18 percent for assets held for more than five years thereafter. Notes that taxpayers may still make this election by filing an amended return within 6 months of the due date of the original return, excluding extensions.

   2. Dad, the accommodation pledgor, escapes tax on the foreclosure, but what about sonny boy? Friedland v. Commissioner, T.C. Memo. 2001-236 (9/10/01). The taxpayer pledged to a bank appreciated stock in a closely held corporation to secure an indebtedness of his adult son to the bank. When the son defaulted on the loan, the taxpayer’s stock was transferred to the bank. Judge Vasquez held that the taxpayer had no amount realized on the transfer and thus recognized no gain. Reg. § 1.1001-2(a)(1) treats as an amount realized only the amount of the taxpayer’s own indebtedness that is discharged by the transfer of property — not the amount of indebtedness of a third party — citing Landreth v. Commissioner, 50 T.C. 803 (1968) [guarantor does not realize COD income when debtor is discharged from a debt].

   3. You have to transfer some other business asset before you can sell goodwill. Baker v. Commissioner, 118 T.C. No. 28 (5/29/02). The taxpayer was a State Farm insurance agent, who sold policies exclusively for State Farm as an independent contractor, operating his own agency, developing clients, hiring employees, and paying expenses. Upon retirement, the taxpayer returned all of State Farm’s property to it, but transferred no identifiable assets of his own, and he received a “termination payment” — the insurance policies he had written were assigned to a successor agent. (The customer list belonged to the insurance company.) The Tax Court (Judge Panuthos) denied the taxpayer capital gain treatment with respect to the termination payment. He transferred no assets that he owned; the telephone number and at-will employment relationships were not assets. He could not transfer goodwill, because he transferred nothing to which goodwill could attach. The entire termination payment was ordinary income without regard to the portion of it allocable to a covenant not to compete.

4. The IRS has got you coming and going. Year-end straddle coverage of short sales results in gains in earlier year and losses in later year. Rev. Rul. 2002-44, 2002-28 I.R.B. 84 (7/15/02). If stock to close an existing short position, e.g., from a short sale, is purchased with a trade date in one year and a settlement date the following year, e.g., a December 31 trade date and a January 5 settlement date, pursuant to § 1259 any gain realized with respect to the short position — because the stock has fallen in value — is recognized in the year of the trade date on which the stock to cover is acquired, not the later year the short sale is closed. But if the short sale is closed at a loss — because the stock has risen in value — § 1259 does not apply and pursuant to Reg. § 1.1233-1(a)(1) and Rev. Rul. 93-84, 1993-2 the loss is realized in the year of the closing.

5. Arkansas Best didn’t ring the death knell for all judicial exceptions to the statutory definition of “capital asset.” Davis v. Commissioner, 119 T.C. No. 1 (7/03/02). The taxpayer won the California lottery and received the right to 20 annual payments of $679,000. Subsequently, the taxpayer sold a portion of his right to eleven of the fourteen remaining payments for approximately $1,000,000 and reported the gain as long-term capital gain. Judge Chiechi rejected the taxpayer’s
argument that the Supreme Court's decision in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 overruled the line of cases, including *Hort v. Commissioner*, 313 U.S. 28 (1941); *Commissioner v. P.G. Lake*, Inc., 356 U.S. 260 (1958); *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130 (1960); and *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965), citing footnote 5 of the *Arkansas Best* opinion. In holding that the taxpayer realized ordinary income, not capital gain, on the sale, the Tax Court specifically held that the "right to receive future annual lottery payments does not constitute a capital asset within the meaning of section 1221," without placing much, if any emphasis on the temporal division. [Compare *McAllister v. Commissioner*, 157 F2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947).] In this regard, footnote 9 of the Davis opinion states:

It is well established that the purpose for capital-gains treatment is to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year. **Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134, 80 S.Ct. 1497, 4 L.Ed.2d 1617 (1960) (citing *Burnet v. Harmel*, 287 U.S. 103, 106, 53 S.Ct. 74, 77 L.Ed. 199 (1932)).]

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A. United States v. Maginnis, 2002-1 U.S.T.C. 50,494 (D. Ore. 5/29/02). Summary judgment was entered in the government's favor, holding that gain recognized on the assignment of lottery winnings to a third party for a lump-sum cash payment was not capital gain, but was ordinary income.

B. Interest

C. Section 1031

1. The erosion of the Glass-Steagall Act changes the face of like kind exchanges. REG-107175-00, Definition of Disqualified Person, 66 F.R. 3924 (1/17/01). Proposed Amendments to Reg. § 1.1031(k)-1(k)(4) would generally provide that a bank that is a member of a controlled group that includes an investment banking or brokerage firm as a member will not be a disqualified person [with respect to deferred like-kind exchanges through an intermediary] merely because the investment banking or brokerage firm has provided services to an exchange customer within a two-year period ending on the date of the transfer of the relinquished property by that customer. Proposed effective date: 1/17/01.

A. Now final. T.D. 8982, Definition of Disqualified Person, amendments to Reg. § 1.1031(k)-1, 67 F.R. 4907 (2/1/02). Applicable to transfers of property made on or after 1/17/01.

2. Ruling guidelines for UFIs in real estate are very taxpayer-friendly. Rev. Proc. 2002-22, 2002-14 I.R.B. 733 (4/8/02), superseding Rev. Proc. 2000-46, 2002-2 C.B. 438. The Service has announced the conditions under which it will consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity. Section 6 of the Procedure imposes 15 conditions for obtaining a ruling, with a facts-and-circumstances alternative where all 15 conditions are not satisfied.

Footnote 5 states:

Petitioner mistakenly relies on cases in which this Court, in narrowly applying the general definition of capital asset, has "construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income," even though these items are property in the broad sense of the word. *Midland Ross*. See, e.g., *Gillette Motor Corp.* ("capital asset" does not include compensation awarded taxpayer that represented fair rental value of its facilities); *P. G. Lake* ("capital asset" does not include proceeds from sale of oil payment rights); *Hort* ("capital asset" does not include payment to lessor for cancellation of unexpired portion of a lease). This line of cases, based on the premise that § 1221 "property" does not include claims or rights to ordinary income, has no application in the present context. Petitioner sold capital stock, not a claim to ordinary income. (citations abbreviated)

The conditions under which the IRS will consider issuing a ruling that an undivided fractional interest in rental real property is not an interest in a business entity, i.e., a partnership interest, are limited; among the requirements are: (1) the co-owners must hold title as tenants in common under local law; (2) not more than 35 co-owners; (3) co-owners must act and hold themselves out as co-owners and not as partners; (4) co-owners must retain the right to manage the property, any sale, lease, blanket encumbrance, hiring of a manager or management contract must be unanimously approved, but as to other matters the owners may agree to be bound by a majority vote, (5) each co-owner must have
Under § 1.761-1(a) and §§ 301.7701-1 through 301.7701-3, a federal tax partnership does not include mere co-ownership of property where the owners' activities are limited to keeping the property maintained, in repair, rented or leased. ... Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created. Furthermore, where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes. [citations omitted]

D. Section 1033

1. Fire, wind, and pestilence bring tax benefits. Willamette Industries Inc. v. Commissioner, 118 T.C. No. 7 (2/12/02). Taxpayer was forced to harvest some of its trees before maturity by reason of various casualties [wind, ice storm, wildfires, insect damage], and it processed those trees into its usual products. Taxpayer sought to defer under § 1033 [presumably because the cost of qualified replacement property exceeded the value of the downed timber, but the opinion does not describe the replacement property] the portion of its gain on the sale of the resulting inventory equal to the excess of the value of the trees over basis immediately after the casualty and before salvaging and processing. The Tax Court (Judge Gerber) held that the deferral was permitted under the holding and reasoning of Rev. Rul. 80-175, 1980-2 C.B. 230 [in which timber downed by a hurricane was sold for cash without any further processing]. He reasoned that in both the ruling and the instant case, the taxpayers were "prematurely forced to salvage (sell or use) the damaged trees," and stressed that Rev. Rul. 80-175 rejected imposing a requirement that the conversion must be directly into cash without a voluntary sale. Judge Gerber stated that the possibility that the partial damage to the trees might have been "relatively small or resulted in a nominal amount of reduction in gain is not a reason to deny relief." He further stated that if taxpayer’s "salvage efforts were more successful than [those of] other taxpayers[,] that is not a reason for denial of relief."

E. Section 1041

1. Is it property or is it income? Yankwich v. Commissioner, T.C. Memo. 2002-037 (2/8/02). Pursuant to the taxpayer’s divorce, her husband was obligated to remit to her, as received, amounts equal to the interest and principal payments received on a promissory note from a third party owned by her husband. [The facts indicated that the note was actually owned by the husband’s controlled corporation, but the parties and the court analyzed the issues as if the husband owned the note.] Because there was no transfer of beneficial ownership in the note itself to the taxpayer-wife, § 453B(g) did not apply to treat the note as transferred to the wife in a § 1041 transaction, and thus she did not take a carryover basis in the note. The payments received from the husband were excludable by the wife under § 1041 to the extent they represented principal on the underlying note; to the extent the payments represented interest on the underlying note, § 1041 did not apply. In essence, the court treated the husband as having transferred to the wife a note with a principal amount, interest rate, and payment schedule identical to the underlying note.

2. A sensible ruling that favors § 1041 over the assignment of income theory on the transfer of vested stock options and vested nonqualified deferred compensation incident to the right to transfer, partition, or encumber his undivided interest, (6) if the property is sold, net sales proceeds must be distributed to the co-owners, (7) all revenues must be shared and expenses borne in proportion to the co-owners’ undivided interests in the property, (8) all co-owners must share in any blanket indebtedness encumbering the property in proportion to their undivided interests in the property, (9) the co-owners’ activities, including the activities of their agents, must be limited to those customarily performed in connection with the repair and maintenance of rental property, (10) management and brokerage agreements with respect to the property must be subject to renewal no less often than annually, (11) all leases on the property must be bona fide, (12) any lender with respect to the property of the undivided interests must be unrelated to all owners, lessees, managers, and sponsors of the syndication, and (13) any payments for acquisition of the interest must reflect the fair market value of the co-ownership interest (or services rendered) and may not depend on the profits derived from the property by any person; the owners may enter into a co-ownership agreement providing cross rights of first refusal at fair market value and co-owners may issue call options on their undivided interests at their fair market values; for this purpose, fair market value of an undivided interest is the fair market value of the property as a whole multiplied by the co-owner's fractional interest.
This ruling held that: (1) a taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer, and (2) the former spouse, and not the taxpayer, is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

The ruling stated, "Similarly, applying the assignment of income doctrine in divorce cases to tax the transferor spouse when the transferee spouse ultimately receives income from the property transferred in the divorce would frustrate the purpose of § 1041 with respect to divorcing spouses. That tax treatment would impose substantial burdens on marital property settlements involving such property and thwart the purpose of allowing divorcing spouses to sever their ownership interests in property with as little tax intrusion as possible. Further, there is no indication that Congress intended § 1041 to alter the principle established in the pre-1041 cases such as Meisner [v. United States, 133 F.3d 654 (8th Cir. 1998)] that the application of the assignment of income doctrine generally is inappropriate in the context of divorce." The ruling also cited Hempt Bros., Inc. v. United States, 490 F.2d 172 (3d Cir. 1974), by way of analogizing § 1041 to § 351.

This ruling does not apply to transfers of property between spouses other than in connection with divorce. This ruling also does not apply to transfers of nonstatutory stock options, unfunded deferred compensation rights, or other future income rights to the extent such options or rights are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer. See Kochansky v. Commissioner, 92 F.3d 957 (9th Cir. 1996). [Emphasis added]

This ruling clarified that Rev. Rul. 87-112, 1987 C.B. 207, which held that § 1041 did not apply to accrued interest on transferred U.S. savings bonds that were subsequently cashed in, was based on § 454 rather than on assignment of income principles.

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. T.D. 8878, Tax Treatment of Cafeteria Plans, 65 F.R. 15548 (3/23/00). Final Reg. § 1.125-4 permits a mid-year cafeteria plan election with respect to medical and group term life insurance by an employee who has a change of status, such as change in marital status or number of dependents, employment, work site, etc., during the year. [Employees generally are permitted to make elections between cash or qualified tax free benefits only at the beginning of the plan year.]
   a. REG-117162-99, Notice of Proposed Rulemaking, Tax Treatment of Cafeteria Plans, 65 F.R. 15587 (3/23/00). Proposed amendments to various subsections of Regs. §§ 1.125-1, -2, and -4 would extend to dependent care assistance and adoption assistance the availability of mid-year cafeteria plan elections based on a change of status, under the same terms that apply to mid-year elections with respect to medical and group term life insurance under Reg. § 1.125-4.
   b. T.D. 8921, 66 F.R. 1837 (1/10/01). The final cafeteria plan regulations under § 125 on midyear election changes modify the March 2000 final regulations to permit employees to elect to increase or decrease group-term life insurance or disability coverage in response to a change-of-status event, including birth, adoption, or death.
   c. T.D. 8966, Additions to Final Cafeteria Plan Regulations Under § 125, 66 F.R. 52675, 10/17/01). The Treasury has finalized regulations relating to cafeteria plans that reflect changes made by the Family and Medical Leave Act of 1993 in Q&A form.

2. Fundamental changes in the treatment of split-dollar life insurance. Notice 2001-10, 2001-5 I.R.B. 459 (1/9/01). This notice provides interim guidance on split-dollar life insurance contracts. It notes that the P.S. 58 rates no longer reflect the current fair market value of insurance protection. The Notice requires that employer payments be consistently treated as: (1) interest-free loans under § 7872, (2) investments by the employer in the contract, or (3) payments of compensation. The Service had long rejected interest-free loan treatment of the employer investment in the cash value of split dollar life insurance, but the enactment of § 7872 in 1984 enables interest-free loan treatment to be used as a valid model. The alternative is to have the true cost of insurance protection reflected in the employee's income; insurance companies will be required to provide rates at which comparable term
policies will be available to the general public (instead of the low-ball rates that had been provided in the past). This notice revokes Rev. Rul. 55-747, 1995-2 C.B. 228, and provides that, after 2001, P.S. 58 rates may not be used.

a. IRS revokes Notice 2001-10 and will for future arrangements require taxation under one of two mutually exclusive regimes. Notice 2002-8, 2002-4 I.R.B. 398 (1/3/02), revoking Notice 2001-10, 2001-5 I.R.B. 459. When the Treasury and Service publish proposed regulations providing comprehensive guidance regarding the tax treatment of split-dollar life insurance arrangements, those regulations will provide in employment-related arrangements:

* If the employer is formally designated as owner of the life insurance contract, then the employee will be treated as providing current life insurance protection and other economic benefits to the employee. A transfer of the life insurance contract to the employee would be taxed under § 83, but an employer would not be treated as having made a transfer of the cash surrender value for purposes of § 83 “soley because the interest or other earnings credited to the cash surrender value of the contract cause the cash surrender value to exceed the portion thereof payable to the employer.” This has the effect of leaving that issue unresolved, and would change the position in Notice 2001-10 that the employee would be taxed under § 83 on the transfer of a beneficial interest in the cash surrender value.

* If the employee is formally designated as owner, the premiums paid by the employer would be treated as a series of loans by the employer to the employee — if the employee is required to repay the employer out of insurance proceeds or otherwise. The loans are subject to taxation under the §§ 1271-1275 OID provisions and the § 7872 compensation-related below-market loan provision. If the employee is not required to repay the employer, then the premiums paid are treated as compensation income to the employee when paid.

  * Effective for arrangements entered into after the date of publication of final regulations. Provisions for valuing current life insurance protection entered into before 1/28/02 (P.S. 58 is OK) and for arrangements entered into before the date of publication of final regulations.

b. Notice 2002-8 is carried into proposed regulations. REG-164754-01, proposed regulations that provide guidance on the income, employment and gift taxation of split-dollar life insurance arrangements, 67 F.R. 45414 (7/9/02). Carries out the concepts of Notice 2002-8. To be effective for split-dollar life insurance arrangements entered after the date of publication of final regulations in the Federal Register.

c. Crackdown on split-dollar life insurance arrangements that are designed to understate the value of benefits for income or gift tax purposes. Notice 2002-59, 2002-36 I.R.B. (8/19/02). The IRS held that neither the premium rates in Table 2001 nor the insurer’s lower published premium rates may be relied on to value the insured’s current life insurance protection for the purpose of establishing the value of policy benefits to which another party may be entitled.” Under reverse split-dollar arrangements, one party with a right to current life insurance protection may use various techniques to confer policy benefits other than current life insurance protection on another party, but using such techniques to understate the value of other policy benefits “distorts the income, employment, or gift tax consequences of the arrangement.”

  * According to Tax Notes, 2002 TNT 161-4, this notice was issued after Treasury officials read a 7/28/02 story in the New York Times, which stated that Jonathan Blattmachr had developed this technique based upon a 1996 private letter ruling [identified as LTR 9636033].

3. Employers may structure cafeteria plans to force-feed insurance and make cash the optional choice. Rev. Rul. 2002-27, 2002-20 IRB 925 (5/20/02). A § 125 cafeteria plan may provide for automatic enrollment in employee-only group health insurance coverage with a commensurate salary reduction, subject to an opt-out provision whereby the employee may decline the health insurance and receive full salary. Such a plan may also include family insurance coverage as a non-automatic option. The plan also may prohibit an employee from electing out of employee-only health insurance unless he proves that he has other medical insurance.

  * The ruling also contains a model amendment that a sponsor may use if it permits an employee to elect cash in lieu of group health coverage only if the employee is able to certify that he or she has other health coverage.

4. Pass the cafeteria tray. Rev. Rul. 2002-32, 2002-23 I.R.B. 1069 (6/10/02). Following an asset purchase and sale of a portion of a seller’s business, the seller’s transferred employees who had elected to participate in uninsured health care expense flexible spending arrangements under the seller’s may continue to exclude salary reduction amounts and medical reimbursements from gross income under either the seller’s plan, for a limited period of time, as agreed upon, or under the buyer’s §
125 cafeteria plan, at the same level of coverage without interruption, after becoming employees of the buyer.

5. Health reimbursement arrangements.
   a. Excludable “health reimbursement arrangements” with carryovers of unused amounts. Notice 2002-45, 2002-28 I.R.B. 93 (7/15/02). This notice describes the tax treatment of employer-provided medical care expense reimbursements under a “health reimbursement arrangement” (HRA). An HRA is a plan that: (1) is paid for solely by the employer and not provided pursuant to salary reduction election or otherwise under a § 125 cafeteria plan, (2) the only benefit from which is reimbursement to employees [or certain former employees] for medical expenses incurred by the employee, and the employee’s spouse and dependents, and (3) provides reimbursements up to a maximum dollar amount for a coverage period and any unused portion of the maximum dollar amount at the end of a coverage period is carried forward to increase the maximum reimbursement amount in subsequent coverage periods. An HRA that meets these conditions is an employer-provided accident or health plan, and coverage and reimbursements are excluded from the employee’s gross income under §§ 106 and 105. An HRA may allow a participant to carry forward unused reimbursement allowances to later coverage periods because the requirements for flexible spending arrangements (FSAs) under §125 are generally not applicable to HRAs. To retain exemption from the §125 FSA requirements, the HRA must be solely employer-funded and cannot be directly or indirectly paid for pursuant to salary reduction election.

b. And here’s a qualifying HRA. Rev. Rul. 2002-41 2002-28 I.R.B. 75 (7/15/02). Sections105 and 106 apply to exclude employer financed medical expenses reimbursements, not dependent on salary reduction, available to cover deductibles for employees and retired employees, and their spouses and dependents, under medical insurance provided pursuant to a § 125 cafeteria plan, even though amounts unused in earlier years carry-over and are available in future years [which is not permitted under a § 125 salary reduction plan].


B. Qualified Deferred Compensation Plans
   1. The 2001 Act made extensive technical changes in the rules governing qualified pension plans. The unindexed benefits limit for defined contribution plans has been increased from $90,000 to $160,000. The unindexed contributions limit for defined benefit plans has been increased from $30,000 to $40,000.

   • Special rules in new § 414(v) allow increased elective contributions to defined contribution plans by employees age 50 or older. Employees age 50 and older may make “catch up” additional elective deferrals of $1,000 for 2002, increasing in $1,000 annual increments to $5,000 in 2006 (and indexed for inflation thereafter).

     (1) Guidance on § 415 changes. Rev. Rul. 2001-51, 2001-45 I.R.B. 427 (10/16/01), modifying Rev. Rul 98-1. Provides guidance in Q&A form relating to the increases in the limitations of § 415 enacted as part of the 2001 Act. Specifically, this revenue ruling provides questions and answers on: (1) Benefit increases that may be provided as a result of the increased § 415 limitations; (2) Plan amendments that may be adopted to take into account the increased § 415 limitations; (3) The effect of the increased § 415 limitations on other qualification requirements; and (4) How the “sunset” provision of EGTRRA is taken into account for purposes of §§ 412 and 404.

     (2) How to apply the “ketchup” at the 2001 Act picnic. REG-142499-01, Proposed Regulations on Catch-up Contributions, 66 F.R. 53555 (10/23/01). These proposed regulations would implement new section 414(v) by providing that an employer plan is not treated as violating any provision of the Code solely because the plan permits individuals age 50 or older to make catch-up contributions. Catch-up contributions generally are elective deferrals made by a catch-up eligible participant that exceed an otherwise applicable limit and that are treated as catch-up contributions under the plan, but only to the extent they do not exceed the maximum amount of catch-up contributions permitted for the taxable year. See also, Announcement 2001-93, 2001-44 I.R.B. 416, for information on how to report participants’ elective pension deferrals on Form W-2, Box 12, and in the totals reported for codes D through H and S.

401(a)(17) [and related sections], increasing the compensation limit [to $200,000] – effective for plan years beginning on or after 1/1/02, even if the plan uses annual compensation for a period beginning before 1/1/02; (2) § 416, regarding determination of top-heavy status – effective for plan years beginning after 12/31/00, even if the determination date is before 1/1/02, and (3) revisions to the regulations relating to hardship distributions under § 401(k)(2)(B)(i)(IV), as mandated by § 636(a) of EGTRRA – regulations to effective for calendar years beginning after 12/31/01.


4. Prolong the GUST-o. Rev. Proc. 2001-55, 2001-49 I.R.B. 552 (11/14/01). The Service has extended the GUST remedial amendment period under § 401(b) of the code for qualified retirement plans to 2/28/02. For plans affected by the September 11th terrorist attack, the extension is to 6/30/02, with a possible further extension to 12/31/02.


5. Flynn v. Commissioner, 269 F.3d 1064, 2001-2 U.S.T.C. ¶50,737, 88 A.F.T.R.2d 6586 (D.C. Cir. 10/30/01), aff'd T.C. Memo. 2000-223. The Court of Appeals affirmed the Tax Court’s decision upholding Reg. § 1.7476-1(b)’s “interested parties” rule, which excludes former employees from the group entitled to bring an action under § 7476 seeking a declaratory judgment regarding the status of a qualified plan [except in cases involving plan terminations]. Accordingly, the taxpayer lacked standing to challenge the IRS’s favorable determination following a plan amendment, even though he may have been adversely affected.

6. Flaherty's Arden Bowl Inc. v. Commissioner, 271 F.3d 763, 2001-2 U.S.T.C. ¶50,770, 88 A.F.T.R.2d 6580 (8th Cir. 11/16/01) (per curiam). Participant's plan made loans to taxpayer/corporation [57% owned by participant]. Even though ERISA § 404(c) excepted participants who direct their own accounts from the definition of fiduciary, § 4975 does not contain any parallel provision and the corporation was a disqualified person under the § 4975 excise tax provisions. But penalties were not upheld, because participant followed the advice of an attorney who advised him that the loans would not violate ERISA or cause liability under § 4975.

- Rev. Proc. 2002-21, 2002-19 I.R.B. 911 (4/24/02). Describes steps that may be taken to ensure the qualified status of defined contribution retirement plans maintained by employee leasing organizations (also called professional employer organizations or PEOs) for the benefit of “Worksite Employees,” where there may be uncertainty as to whether the employer is the PEO or the client organization. The PEO retirement plan may either be converted into a “multiple employer plan” or be terminated by various dates in 2003.


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

1. Regulations are final. T.D. 8987, final and temporary regulations under § 401(a)(9), 67 F.R. 18988 (4/17/02). The final regulations retain the simplifications to the minimum distribution rules for separate accounts provided in the 2001 proposed regulations, including the calculation of the MRD during the individual's lifetime using a uniform table (which is changed in the final regulations to reflect updated mortality calculations). The final regulations change the date for determining the designated beneficiary to September 30 of the year following the year of the employee's death (to permit sufficient time to calculate the MRD before the end of the year). The temporary regulations provide a number of changes to the annuity rules in the proposed regulations, which merely reflected the 1987 proposed regulations. Effective for 2003 and following calendar years; for determining minimum distributions for the 2002 year, taxpayers may rely on the final regulations, the 2001 proposed regulations, or the 1987 proposed regulations.

b. Just "snap on" these model plan amendments to comply with the new MRD regulations. Rev. Proc. 2002-29, 2002-24 I.R.B. 1176 (5/28/02). This revenue procedure provides model plan amendments for plans to comply with the final and temporary regulations under the § 401(a)(9) minimum distribution rules. Generally, plans must be amended by the end of the first year beginning on or after 1/1/03.


This revenue procedure updates the comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements of § 401(a), § 403(a), § 403(b), or § 408(k), but that have not met these requirements for a period of time. This system, the Employee Plans Compliance Resolution System ("EPCRS"), permits plan sponsors to correct these failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis. The components of EPCRS are the Self-Correction Program ("SCP"), the Voluntary Correction Program ("VCP"), and the Audit Closing Agreement Program ("Audit CAP").

It goes on to state that, "Sponsors and other administrators of eligible plans should be encouraged to establish administrative practices and procedures that ensure that these plans are operated properly in accordance with the applicable requirements of the Code."

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

1. Although the exercise of a statutory stock option does not result in taxable income, it does result in wages for FICA / FUTA purposes— but not until 2003. REG-142686-01, Application of the Federal Insurance Contributions Act, Federal Unemployment Compensation Act, and Collection of Income Tax at the Source to Statutory Stock Options, 66 F.R. 57023 (11/14/01), issued as provided in Notice 2001-14, 2001-6 I.R.B. 546. Prop._regs. §§ 31.3121(a)-1(k), 31.3306(b)-1(j), and 31.3401(a)-1(b)(9) would provide that the holder of a statutory stock option [§ 422 ISO or §423 ESPP] receives wages for FICA and FUTA purposes upon exercise of the option, but no withholding is required because no gross income has been received. The amount of the wages received is the excess of the fair market value of the stock over the amount paid. The IRS will develop "rules of administrative convenience" permitting employers to deem the wages to have been paid on a specific date or over a specific period of time.

a. Notice 2001-73, 2001-49 I.R.B. 549 (12/3/01). The IRS announced and requested comments on proposed "rules of administrative convenience" permitting employers to deem the wages to have been paid on a specific date for FICA and FUTA purposes. FICA and FUTA wages could be treated as paid on a pay period, quarterly, semi-annual, annual, or other basis.

b. Notice 2001-72, 2001-49 I.R.B. 548 (12/3/01). The IRS announced and requested comments on proposed rules regarding the employer's income tax withholding and reporting obligations on the sale by an employee of stock received pursuant to exercise of a statutory stock option. The employer is not required to withhold, but is required to report if the amount is at least $600, unless the employer has made reasonable efforts to determine if reporting is necessary and has been unable to do so.

c. IRS extends moratorium on assessment of employment taxes on stock options for two more years. Notice 2002-47, 2002-28 I.R.B. 97 (6/25/02). Pending the
completion of its review and the issuance of further guidance, the IRS will not assess FICA or FUTA taxes (nor will it seek federal income tax withholding) upon the exercise of a statutory stock option or disposition of stock acquired by an employee pursuant to the exercise of a statutory stock option. The Notice further provides that it is contemplated that any final guidance that would apply employment purposes of the parachute purposes. Rev. Proc. 2002-13, 2002-8 I.R.B. 549 (2/19/02). Guidance for valuing stock time the option was exercised.

The option was exercised. The taxpayer argued that during 1994 the stock was subject to risk of stock option based on the difference between the option price and the price the stock was selling for on acquisition, he would be subject to sec. 16(b) of the Securities Exchange Act of 1934. On 6/9/93, the taxpayer received a nonstatutory employee stock option from C; on 9/7/94, he exercised this stock option. He pledged some of this stock as collateral for a loan, and the stock was subsequently sold by the lender. The Commissioner determined that the taxpayer realized income in 1994 from the exercise of the stock option based on the difference between the option price and the price the stock was selling for on the date the option was exercised. The taxpayer argued that during 1994 the stock was subject to risk of forfeiture under § 83(c)(3) as a result of the lock-up agreement.

- Judge Vasquez held that § 83(c)(3) was inapplicable because the 6-month restricted period under § 16(b) of the Securities Exchange Act of 1934 commenced on the date of grant of the option and had expired on the date of exercise. Furthermore, for purposes of § 83(c)(3) the six-month period in § 16(b) cannot be extended by agreement. Accordingly, the taxpayer realized income at the time the option was exercised.


- See also, the valuation of stock options for gift tax purposes in retroactive taxes are

4. The employee-COO’s behaviour vis-à-vis the shareholders was as unripe as the refund claim. Robinson v. United States, 52 Fed. Cl. 725, 90 A.F.T.R.2d. 2002-5003 (6/24/02). The Court of Federal Claims followed Venture Funding, Ltd. v. Commissioner, 110 T.C. 236 (1998), aff’d per curiam, 198 F.3d 248 (6th Cir. 1999), cert. denied, 530 U.S. 1205 (2000), to hold that §83(h) allows a deduction for the value of a compensatory transfer of restricted stock to an employee only when the amount of the discount is actually “included” by the employee, not when the amount is “includable” but not reported as income by the employee. Since the employee was appealing from an unfavorable audit with respect to the income item attributable to the year of the transfer [in which the employee-COO had made a § 83(b) election and reported the bargain element as zero, giving notice to himself as a representative of the corporation, even though the taxpayers owned all of the remaining stock of the S corporation – an overwhelming majority], the fact of inclusion was not yet established and the refund claim was not ripe. Taxpayers claimed that employee received restricted stock worth $28 million for $2 million and made the § 83(b) zero election without advising them or anyone else at the corporation at the time; taxpayers did not find out about the § 83(b) election until negotiating the COO’s termination three years later (when they sent the COO an amended Form W-2).

- Query: should taxpayers have dealt with this possibility by contract at the time of transfer?

D. Individual Retirement Accounts

1. Retroactive taxes are OK. Kitt v. United States, 277 F.3d 1330, 2002-1 U.S.T.C. ¶50,167, 89 A.F.T.R.2d 2002-497 (Fed. Cir. 1/10/02), adhered to rehearing, 288 F.3d 1355, 2002-2 U.S.T.C. ¶50,466, 89 A.F.T.R.2d 2002-2212 (Fed. Cir. 5/1/02). The retroactive amendment of § 408 on July 22, 1998, providing that distributions from Roth IRAs made within five years of a rollover that are allocable to the funds rolled over are subject to the ten percent additional tax under § 72(f), was not unconstitutional because Congress was correcting a mistake in the 1997 Taxpayer Relief Act. United States v. Carlton, 512 U.S. 26 (1994), followed. The 10 percent additional tax applied to the 44-year old taxpayer’s premature March 6, 1998 withdrawal from a Roth IRA into which his regular IRA had been rolled-over.
2. He was just a conduit for his IRA. Ancira v. Commissioner, 119 T.C. No. 6 (9/24/02). The taxpayer had a self-directed IRA and asked the custodian to purchase common stock of a corporation that was not publicly traded. Although the investment was not prohibited, the custodian, as a matter of policy, refused to purchase the stock because it was not publicly traded. The taxpayer's desires were accommodated by the custodian issuing a check drawn on the IRA account to the issuing corporation, which was sent to the taxpayer, who forwarded it to the corporation. To effectuate the transaction, the custodian required the taxpayer to complete a "Distribution Request Form," which stated that "(Use of this form will result in a distribution reportable to the IRS [Internal Revenue Service] on Form 1099-R [Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.]."

The corporation issued the stock in the name of the taxpayer's IRA. The taxpayer received the stock and delivered it to the custodian. The Tax Court rejected the Commissioner's argument that these had been a distribution from the IRA to the taxpayer. The taxpayer was a conduit. The court distinguished Lemishow v. Commissioner, 110 T.C. 110 (1998), because in this case, the taxpayer did not receive cash, and the IRA, not the taxpayer, at all times was the owner of the shares even though the IRA might not have been in physical possession of the stock certificate.

V. PERSONAL INCOME AND DEDUCTIONS

A. Miscellaneous Income

1. Making the [tax] world safer for frequent flyers. Announcement 2002-18, 2002-10 IR.B. 621 (2/20/02). As a matter of administrative policy, the Service has announced, "Consistent with prior practice, the IRS will not assert that any taxpayer has understated his federal tax liability by reason of the receipt or personal use of frequent flyer miles or other in-kind promotional benefits attributable to the taxpayer's business or official travel," and that any future guidance on the taxability of these benefits will be applied prospectively.

- The safe harbor is inapplicable to benefits that are converted to cash, to compensation paid in the form of benefits, or where these benefits 'are used for tax avoidance purposes.'

2. The Clergy Housing Allowance Clarification Act of 2002 amends § 107(2) to limit the amount "ministers of the gospel" may exclude from gross income as housing allowances to "the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities." The legislation applies to tax years beginning after 12/31/01 and "to any taxable year beginning before January 1, 2002, for which the taxpayer -- (A) on a return filed before April 17, 2002, limited the exclusion under [IRC § 107] as provided in [this legislation], or (B) filed a return after April 16, 2002.


If a parsonage allowance is paid to a minister, under § 107(2) it is excludable up to the amount of eligible expenses actually paid out of the allowance, even though the amount of the allowance exceeds the "fair rental value" of the parsonage, which can occur when the allowance covers mortgage payments in full, as well as real estate taxes, maintenance, utilities, and furnishings for a home owned by the minister. The court rejected the Commissioner’s argument that the exclusion under § 107(2) was limited to the $58,000 rental value of the minister's home where between $76,000 and $80,000 of total compensation of $77,000 to $99,000 designated as an annual parsonage allowance over three taxable years was expended on qualifying expenditures. The excess of the designated allowance over actual housing expenditures was taxable.

b. In Warren v. Commissioner, 282 F.3d 1119 (9th Cir. 3/5/02), in a 2-1 decision, the Ninth Circuit ordered briefing on the constitutionality of § 107(2). Judge Reinhardt, for the majority, also appointed Professor Erwin Chemerinsky of the University of Southern California Law School to serve as amicus curiae.

- Judge Tallman, in his dissent, stated:

Because the constitutional issue was not raised in the Tax Court, nor briefed or argued by the parties on appeal, and because it is unnecessarily and improvidently raised by my colleagues sua sponte, I respectfully dissent from the order directing supplemental and court-appointed amicus briefing. This case can easily be decided without reaching the constitutionality of the statutory exclusion.

- The appointed amicus's report concluded that § 107(2) was unconstitutional under the Establishment Clause [pursuant to Texas Monthly, Inc. v. Bullock, 489 U.S. 1
most of the year away from his wife's residence. However, he did "visit" his wife's house for more than 

filing a joint return, whose base amount is $32,000, and (2) married persons who file separate returns but 
of Social Security receipts if the sum of "modified adjusted gross income" plus one half of the Social 
 discontinuance filed by all "correct" parties.

LEXIS 17647 (9th Cir. 8/26/02). Denies motion of amicus to intervene in light of the stipulation of 
plaintiff in the case, despite a stipulation of dismissal agreed to by the IRS and the taxpayer. 
[110x320]

however, the Fifth Circuit held that attorney's fees so paid directly to a plaintiffs attorney are not 

results on this question. Generally, the Tax Court holds that attorney's fee awards paid directly to a 
attorney as a contingent fee is excluded from the taxpayer-plaintiff's income and treated as income 
earned directly by the attorney. The Tax Court and most Courts of Appeals have reached conflicting 

attorney's fee statutory lien law in 

Subsequently, in Srivastava v. Commissioner, 220 F.3d 353, 2000-2 U.S.T.C. ¶50,597 (5th Cir. 2000) (2- 
1), rev'g, T.C. Memo. 1995-51, Coady v. Commissioner, 213 F.3d 1187, 2000-1 U.S.T.C. ¶50,528 (9th Cir. 2000); Benci-Woodward v. Commissioner, 219 F.3d 941, 2000-2 U.S.T.C. ¶50,595 (9th Cir. 7/18/00).

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

(1) In Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959), however, the Fifth Circuit held that attorney's fees so paid directly to a plaintiff's attorney are not includable in the litigant's gross income, and that the taxpayer then may claim a

deduction, subject to any applicable limitations, including disallowance of the deduction for AMT purposes if it is a §212 deduction. Bagley v. Commissioner, 105 T.C. 396 (1995), aff'd 121 F.3d 393 (9th Cir. 1997). Accord Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995); Alexander v. IRS, 72 F.3d 938, 96-1 U.S.T.C. ¶50,011 (1st Cir. 1995), aff'g T.C. Memo 1995-51; Coady v. Commissioner, 213 F.3d 1187, 2000-1 U.S.T.C. ¶50,528 (9th Cir. 2000); Benci-Woodward v. Commissioner, 219 F.3d 941, 2000-2 U.S.T.C. ¶50,595 (9th Cir. 7/18/00).

(2) Estate of Clarks v. Commissioner, 202 F.3d 854, 2000-1 U.S.T.C. ¶50,158, 85 A.F.T.R.2d 2000-405 (6th Cir. 2000). The Sixth Circuit held that the taxpayer was not required to include the portion of the taxable interest attached to a damage award excluded under §104(a)(2) that was paid directly to the taxpayer's attorney. The court discussed the particularities of the attorney's fee statutory lien law in Cotnam, found the Michigan attorney's fees common law lien law to be similar to the Alabama law involved in Cotnam, and stated that it was following Cotnam. But the court also provided a broader explanation for its decision, concluding that the opinions representing the weight of authority, e.g., Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995), inappropriately relied on the assignment of income doctrine cases, e.g., Lucas v. Earl, 281 U.S. 111 (1930) and Helvering v. Horst, 311 U.S. 112 (1940), which, while relevant in family transactions, were not relevant in a arm's length transaction.
(3) In the Eleventh Circuit (as derived from pre-split Fifth Circuit precedents6), under the Golsen rule Attorney’s fees are not included in the income of Alabama taxpayer who received a large punitive damages award. Davis v. Commissioner, 210 F.3d 1346, 2000-1 U.S.T.C. ¶50,431, 85 A.F.T.R.2d 2000-1567 (2000) (per curiam), aff’g T.C. Memo. 1998-248 (7/7/98). The Eleventh Circuit panel held that with respect to Alabama taxpayers, it was bound by Cotnam.

c. In 2001, the Fourth, Seventh, and Tenth Circuits join the parade.

(1) Wisconsin attorney’s fees subject to the AMT trap because of assignment of income doctrine. Tax Court majority holds that it was Congress’s doing; dissent states that courts can cure the problem, Kenseth v. Commissioner, 259 F.3d 881, 2001-2 U.S.T.C. ¶50,570, 88 A.F.T.R.2d 2001-5376 (7th Cir. 8/7/01), aff’g 114 T.C. 399 (5/24/00) (reviewed, 8-5). The Tax Court adhered to its prior decisions that contingent attorney’s fees paid in an age discrimination settlement are includible in taxpayer’s gross income. The Seventh Circuit affirmed the Tax Court’s decision.

[Kenseth] concedes as he must that had he paid the law firm on an hourly basis, the fee would have been an expense. It would have been a deduction from, not a reduction of, his gross income ***. We cannot see what difference it makes that the expense happened to be contingent rather than fixed. If a firm pays a salesman on a commission basis, the sales income he generates is income to the firm and his commissions are a deductible expense, even though they were contingent on his making sales. Of course there is a sense in which contingent compensation constitutes the recipient a kind of joint venturer of the payor. But the plaintiff concedes, as again he must, that Wisconsin law does not make the contingent-fee lawyer a joint owner of his client’s claim in the legal sense any more than the commission salesman is a joint owner of his employer’s accounts receivable. ***

There is nothing exotic about this analysis—nothing, indeed, that depends on the particular contractual setting, that of a contingent-fee contract with a lawyer, out of which this case arises. The settlement of Kenseth’s age-discrimination suit against his former employer presumably replaced lost income, which would have been taxable; and many of the expenses of producing that income, such as the cost of commuting, would not have been deductible. So incomplete deductibility here is not surprising or anomalous or inappropriate. We mentioned the commissioned salesman; consider now the operation of a construction business. All receipts are counted as gross income, and outlays to subcontractors and materialmen are deductible, even though these subcontractors have liens on the work and even though the general contractor could say that he just “assigns” a part of the job to the sub. ***

Enough; for in any event it is not a feasible judicial undertaking to achieve global equity in taxation *** especially when the means suggested for eliminating one inequity (that which Kenseth argues is created by the alternative minimum income tax) consists of creating another inequity (differential treatment for purposes of that tax of fixed and contingent legal fees). And if it were a feasible judicial undertaking, it still would not be a proper one, equity in taxation being a political rather than a jural concept. Indeed the cases that reject the Tax Court’s position seem based on little more than sympathy for taxpayers. *** [The Cotnam] rationale badly flunks the test of neutral principles. It is often the case that to obtain income from an asset one must hire a skilled agent and pay there and the inherent conflict with Estate of Clarks was ignored.).

(2) The Fourth Circuit rejects Cotnam too. Young v. Commissioner, 240 F.3d 369, 2001-1 U.S.T.C. ¶50,244, 87 A.F.T.R.2d 2001-889 (4th Cir. 2/16/01), aff’g, 113 T.C. 152 (8/20/99). A former husband defaulted on a $1.5 million promissory note given his former wife in a divorce settlement in 1989 and satisfied a judgment on the note by transferring real

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6 Under Bonner v. City of Prichard, Alabama, 661 F.2d 1206 (11th Cir. 1981), Fifth Circuit decisions rendered before the Eleventh Circuit was created are binding precedent in the Eleventh Circuit.
estate, which he had received in the original divorce, to his former wife in 1992. The value of the real estate equaled the sum of the principal of the note, accrued but unpaid interest, the wife's attorney's fees, and certain costs. The Tax Court held that under Old Colony Trust Co., 279 U.S. 716 (1929), the wife recognized gross income equal to the value the property attributable to her attorney's fees and costs. In affirming the Tax Court's decision, the Court of Appeals for the Fourth Circuit rejected Mrs. Young's argument that it should follow the reasoning of Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959), to exclude the amount, noting that only the Sixth Circuit in Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000), has followed Cotnam and expressly joined the circuits that have rejected Cotnam.


Attorneys' fees in pre-1991 Title VII sex discrimination are includable in plaintiff's income in computing AMT.

d. The AMT trap snaps shut on attorney's fees that aren't even part of the plaintiff-taxpayer's award. Sinyard v. Commissioner, 268 F.3d 756, 2001-2 U.S.T.C. ¶50,645, 88 A.F.T.R.2d 2001-6034 (9th Cir. 9/25/01) (2-1), aff'g T.C. Memo. 1998-364. The taxpayer was required to include in gross income the portion of the settlement of an ADEA suit that was paid directly to the attorneys as their fee pursuant to the settlement agreement, even though the suit went to trial and the taxpayer won, under the ADEA the defendant would have been statutorily liable for the taxpayer-plaintiff's attorneys' fees in addition to compensatory damages to the plaintiff. Judge McKeown, who wrote the Ninth Circuit's opinion in Benci-Woodward v. Commissioner, 219 F.3d 941 (9th Cir. 2000), held that contingent attorneys' fees are included in the successful plaintiff's gross income, and that the expense of suing your former employer might be "attributable" to the trade or business of being an employee, but it's not "incurred by the employee in connection with the performance of services as an employee of the employer." Biehl v. Commissioner, 118 T.C. No. 29 (5/30/02). The taxpayer successfully sued his former employer for wrongful termination and, in addition to damages, pursuant to his employment contract; the employer was required to pay his attorney's fees. The taxpayer [who lived in the Ninth Circuit, which has already ruled that successful plaintiff's cannot exclude attorney's fees, see, e.g., Sinyard v. Commissioner, 268 F.3d 756 (9th Cir. 2001)] attempted to avoid the AMT trap on miscellaneous itemized deductions by arguing that the payment was employer reimbursement of a § 162 employee business plan excludable under an accountable plan pursuant to § 62(c) and Reg. § 1.62-2(c) and (d). Judge Beghe held that even though the expenses were § 162 employee business expenses because they were "attributable" to his trade or business of being an employee, the expenses did not meet the requirement of Reg. § 1.62-2(d) that the expenses be "paid or incurred by the employee in connection with the performance of services as an employee of the employer." This latter requirement is met only if the expenses were incurred on the employer's behalf, which clearly was not true in this case. Furthermore, it cannot be met if the expenses are incurred after the employment relationship has been terminated, which was true in this case.

2. Schoolteachers should keep receipts. The Job Creation and Worker Assistance Act of 2002 provides for an above-the-line § 162 deduction of up to $250 for K-12 school teachers' purchase of books, supplies, equipment, etc. used in the classroom. Effective for taxable years beginning after 12/31/01.

3. Auditing the auditors. Reynolds v. Commissioner, 296 F.3d 607, 90 A.F.T.R.2d 2002-5294, 2002-2 USTC ¶50,525 (7th Cir. 2002). The taxpayer was an IRS revenue agent who was a licensed attorney and to whom the IRS had granted permission to practice law part-time during off duty hours. In connection with an IRS investigation that he conducted his law practice during IRS working hours, the taxpayer incurred substantial legal fees, which he deducted on Schedule C as expenses of his law practice, and which resulted in the law practice operating at a substantial loss for the years in question. The court upheld the IRS determination that the legal fees were employee business expenses, deductible only as itemized deductions, subject to § 67. The origin of the legal fees was an effort to preserve the taxpayer's IRS employment, not to further his independent law practice.
C. Hobby Losses and § 280A Home Office and Vacation Homes

1. Dancing at the Rascal Fair. Bush v. Commissioner, T.C. Memo. 2002-33 (1/30/02). The taxpayer's sole proprietorship talent agency, the only client of which was his teenage daughter who was enrolled as full-time student studying ballet in a school for arts, was not a business conducted for profit. Expenses for school supplies, pointe shoes, clothing, and dance tuition were inherently personal under § 262 and completely nondeductible. Expenses that otherwise would be business expenses were deductible under § 183 to the extent they did not exceed the talent agency's income from the activity (reduced by any expenses allowable without regard to profit motive).

D. Deductions and Credits for Personal Expenses

1. You don't have to rush to establish your MSA. The deadline for establishing a Medical Savings Account has been extended to 2002. Section 62(a)(18) was added by the 2001 Act to allow a deduction for contributions to an MSA by a taxpayer who does not itemize deductions. See, Announcement 2001-99, 2001-42 I.R.B. 340 (10/15/01).

   a. The Job Creation and Worker Assistance Act of 2002 extended the MSA deadline through 2003.

2. The IRS just might be listening to the AMA: Obesity is a disease and weight loss program costs are deductible medical expenses. Rev. Rul. 2002-19, 2002-16 I.R.B. 778 (4/22/02). Uncompensated expenses paid by individuals for participation in a weight-loss program [meetings where they develop a diet plan, receive diet menus and literature, and discuss problems encountered in dieting] as treatment for a specific disease or diseases, including obesity and hypertension (even if the taxpayer is not obese) diagnosed by a physician are deductible as medical expenses under § 213 if they have been directed by a physician to lose weight as treatment. The cost of purchasing diet food items, however, is not deductible. Rev. Rul. 79-151 and Rev. Rul. 55-261 are distinguished.

   * Those trial lawyers who missed out on the big tobacco settlement are looking at manufacturers of fattening foods.

3. How a dead client may incur attorney's fees. Berry v. Commissioner, 2002-1 U.S.T.C. ¶50, (10th Cir. 6/7/02) (nonprecedential order). Former husband's payment of former wife's attorney's fees in the divorce was not deductible alimony under § 71(b)(1)(D) because [under Oklahoma law] he would have been obligated to pay those fees after her death.

4. Spell it out in the divorce instrument, don't rely on state law to fill in the gaps. Lovejoy v. Commissioner, 293 F.3d 1208, 89 A.F.T.R.2d 2002-2989, 2002-2 U.S.T.C. ¶50,473 (10th Cir. 6/18/02), aff'd T.C. Memo. 1999-273. An unallocated family support allowance that does not terminate upon the payee's death (under either the terms of the agreement or state law) cannot qualify as alimony by reason of § 71(b)(1)(D). In this case, neither the divorce instrument nor state law provided that a temporary unallocated family support allowance pendente lite terminated upon wife's death. Even though her death would have abated the divorce, state law [Colorado] provided that child support orders were not terminated by custodial spouse's death. State law was at best unclear, and because the taxpayer had the burden, the payments were not deductible by the husband and not includable by the wife.

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

1. Notice 2001-55, 2001-39 I.R.B. 299 (9/24/01). This notice provides guidance to qualified tuition programs described in § 529 and participants in § 529 programs regarding the restriction on investment direction described in § 529(b)(5), and sets forth a special rule under which a program may permit investments in a § 529 account to be changed annually and upon a change in the designated beneficiary of the account.


3. T.D. 8992, final and temporary regulations relating to the information reporting requirements under § 6050S for payments of interest on qualified education loans, 67 F.R. 20901 (4/29/02).

4. REG-161424-01, proposed regulations relating to information reporting requirements under § 6050S for qualified tuition and related expenses to assist taxpayers and the IRS in determining any of educational tax credits allowable under § 25A (as well as any other tax benefits for higher education expenses), 67 F.R. 20923 (4/29/02).

VI. CORPORATIONS

A. Entity and Formation
B. Distributions and Redemptions

1. Recourse debts are "assumed" only if they really are. T.D. 8924, Liabilities Assumed in Certain Corporate Transactions, 66 F.R. 723 (1/3/01). Temp. Reg. § 1.301-1T(g) applies rules similar to those of § 357(d) [for determining when a liability is assumed] for purposes of determining when the amount of a distribution will be reduced under § 301(b). [Identical proposed regulations in REG-106791-00 (1/3/01.)] A recourse debt has been assumed only if, based on all the facts and circumstances, the transferee has agreed to pay the debt regardless of whether or not the transferor has been relieved of liability vis-à-vis the creditor. A transferee is treated as assuming any nonrecourse debt encumbering property it receives, but the amount of the debt assumed is reduced by the lesser of: (1) the amount of the debt secured by assets not transferred that another person or corporation has agreed (and is expected to) satisfy, or (2) the fair market value of the other assets secured by the debt.

a. Final regulations. T.D. 8964, Liabilities Assumed in Certain Corporate Transactions, 66 F.R. 49278 (9/27/01). Temp. Reg. § 1.301-1T(g) has been replaced by final Reg. § 1.301-1(g), which is identical to the temporary regulations.

2. The mark of the devil? Reallocation of $666,000 from covenant not to compete to goodwill produces a double tax. Bemidji Distributing Co. v. Commissioner, T.C. Memo. 2001-260 (10/1/01). In a [pre-§ 197] sale of the corporation's assets, no amount was allocated to intangible assets, including goodwill or going concern value, but $1,000,000 was allocated to the shareholder's covenant not to compete and $200,000 to a two-year consulting contract [compared to $817,461 for the assets]. Based on all the facts and circumstances, e.g., the seller's ability to compete and expert witnesses's valuation testimony, the Tax Court (Judge Parr) found that the value of the covenant was only $334,000 and that $666,000 allocated to the covenant by the taxpayer was really the price of goodwill. Thus, the corporation realized an additional $666,000 of gain on the sale if its [zero basis] intangible assets, and the shareholders who received the payments recognized constructive dividends.

3. Rogers v. United States, 281 F.3d 1108, 89 A.F.T.R.2d 2002-1115, 2002-1 U.S.T.C. ¶50,240 (10th Cir. 2/22/02), aff'g 58 F. Supp.2d 1235 (D. Kan. 1999). Purported loan was a stock redemption by the Kansas City Royals baseball team S corporation, so related expenses are nondeductible under § 162(k). See also, II.H., above.

4. Didn't Judge Swift ever see The Godfather? Capital Video Corporation v. Commissioner, T.C. Memo 2002-040 (2/11/02). Capital Video Corporation paid "tribute" to Richichi, a capo in the Gambino crime family. In connection with these payments, Guarino, the sole shareholder of Capital Video, was indicted, inter alia, for conspiracy to obstruct the IRS in collecting Richichi's taxes, and Capital Video paid Guarino's attorney's fees to defend the criminal charges. Judge Swift held that the payment of Guarino's attorney's fees was not deductible by Capital Video because the payments were disguised shareholder distributions.

There is no evidence herein that indicates that Richichi would not have provided the protection to Capital Video if Guarino had not participated in the conspiracy relating to Richichi's taxes and if Capital Video had not paid Guarino's legal fees. ...

Apart from whether the tribute payments made by Capital Video to Richichi were made to protect the business of Capital Video, petitioners have not established that Guarino's participation in the conspiracy to avoid Richichi's income taxes and Capital Video's payment of the legal fees in dispute had a sufficient business relationship with the protection or promotion of Capital Video's business.

5. After the taxpayer's crack dealer customers found that he kept books, his tax problems were probably the least of his worries. Zhadanov v. Commissioner, T.C. Memo. 2002-104 (4/25/02). Zhadanov's wholly owned corporation was found to have fraudulently underreported nearly $750,000 of income from its business of manufacturing plastic bottles for sale to crack cocaine dealers. Among the badges of fraud were that the cash receipts were not deposited in the corporation's bank account, but were diverted to a safe in the sole shareholder's home. Nevertheless, Judge Marvel found that the diversion of possession of the cash to the sole shareholder was not a constructive dividend because, although he had physical control of the cash, he never used any of it for personal purposes, and it was still in the safe when it was seized by DEA agents. That none of the diverted cash was used for personal purposes was supported by the taxpayer's cash receipts journal – a second set of books, (the real books?) – that accounted for the cash.
C. Liquidations

1. More check-the-box fallout. REG-110659-00, Proposed Regulations, Amendment, Check the Box Regulations, 66 F.R. 3959 (1/16/01). Prop. Reg. § 301.7701-3(g)(2)(ii) would provide that if an unincorporated entity that previously had elected to be taxed as a corporation elects to convert to a partnership, it is treated as distributing all of its assets to its shareholders in a taxable liquidation, followed by the contribution of all the assets to a newly formed partnership. If the entity elects to convert from a corporation to a disregarded entity, it is deemed to have distributed its assets to its owner. Sections 332 and 337 can apply if the owner is a corporation. To facilitate application of § 332, the proposed regulations provide that a plan of liquidation is deemed to have been adopted immediately before the deemed liquidation resulting from the election to change entity classification, unless a formal plan of liquidation that contemplates the filing of the elective change was adopted at an earlier date.

a. T.D. 8970, 66 F.R. 64911 (12/17/01). The final regulations relating to elective changes in entity classification adopt the proposed regulations without modification. Applicable to elections filed on or after 12/17/01, with retroactivity permissible to elections filed on or after 11/29/99 if the parties take consistent positions.

D. S Corporations

1. Normal operating income of a timber, coal or iron-ore mining company is not §1374 built-in gain. Rev. Rul. 2001-50, 2001-43 I.R.B. 343 (10/10/01). The §1374 built-in gains tax does not apply when a former C corporation (or S corporation that acquired the property from a C corporation) cuts and sells timber during the 10-year recognition period and recognizes gain under §631(a), (b), or (c) with respect to a timber cutting contract or disposal of timber, coal or iron ore with a retained economic interest. The IRS applied by analogy Reg. § 1.1374-4(a)(3), Ex. (1), which provides that the extraction and oil from a working interest held on the conversion date is not subject to §1374. Section 631 was intended to provide a tax benefit for operating income and there is not indication that the deemed capital gain treatment was intended to result in application of §1374.

2. If they had followed a different form, maybe they could have gotten some additional basis. Estate of Alton Bean v. Commissioner, 268 F.3d 553, 2001-2 U.S.T.C. ¶50,669, 88 A.F.T.R.2d 2001-6111 (8th Cir. 1/10/01). The Eighth Circuit (Judge Hansen) affirmed the Tax Court’s holding that the shareholders of an S corporation acquired no additional basis in their stock of corporation by virtue of the transfer of assets, subject to liabilities, from a partnership they controlled, to the S corporation, in a transaction originally treated as a sale [on which neither gain nor loss was realized]. Even if there was equity in the party in the partnership’s assets, it was the partnership’s equity, not the shareholder / partner’s equity.

The partnership was an entity distinct from its partners, and the partner’s cannot bootstrap their bases in the corporation by transfers made by the partnership. The fact that the partnership was dissolved following the sale in 1992 does not change the form of the transaction that the taxpayers chose to utilize-selling the assets from the partnership to the corporation. Once chosen, the taxpayers are bound by the consequences of the transaction as structured, even if hindsight reveals a more favorable tax treatment.

3. The technical result in Gitlitz sleeps the big sleep, but the method of statutory analysis might have everlasting life. The Job Creation and Worker Assistance Act of 2002 reverses the result of Gitlitz v. Commissioner, 121 S. Ct. 701 (1/19/01), by amending § 108(d)(7)(A) to provide that excluded cancellation of indebtedness income of S corporations is not to result in an adjustment to the basis of stock in the hands of shareholders. The statutory rule is applicable to discharges of indebtedness after 10/11/01 (but not to discharges of indebtedness before 3/1/02 pursuant to a plan of reorganization filed with a bankruptcy court on or before 10/11/01).

4. ESBT Regulations are now final. T.D. 8994, Electing Small Business Trusts, 67 F.R. 34388 (5/13/02). The Treasury has promulgated final regulations regarding the qualification and treatment of electing small business trusts (ESBTs) which reflect amendments in the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997 and section 316 of the Community Renewal Tax Relief Act of 2000. Treas. Reg. § 1.641(c)-1 and amendments to Reg. § 1.1361-1 implement § 1361(f), permitting ESBTs to be permitted S corporation shareholders. Under the final regulations, temporary waivers of powers of appointment do not eliminate a beneficiary, but a permanent release will be effective. “Negligible” future interests are disregarded. If a grantor trust makes an ESBT election, the
trust consists of a grantor portion and a non-S portion, subject to normal rules, and an S portion, subject to § 641(c). When a trust consists of an S-portion and a non-S portion, the source of distributions controls their taxation to beneficiaries. A QSST may convert to an ESBT; an ESBT can convert to a QSST if it qualifies. The final regulations [Reg. § 1.444-4] provide that an ESBT, or a trust described in § 401(a) or 501(c)(3) that is tax-exempt under § 501(a) of the Code, is not treated as a deferral entity for purposes of Reg. § 1.444-27.

S. What happens when Subchapter S and Subchapter K collide?

a. In the Tax Court, the aggregate theory of partnership taxation was applied. Coggin Automotive Corp. v. Commissioner, 115 T.C. 349 (10/18/00). Taxpayer originally was a holding company that had a number of controlled subsidiaries engaged in the retail sale of motor vehicles. The subsidiaries maintained their inventories under the LIFO method, and all of the corporations filed a consolidated return. In 1993, the taxpayer restructured to make an S election. Six new S corporations were formed to become the general partners in six limited partnerships. Each subsidiary contributed its dealership assets to a limited partnership in exchange for a limited partnership interest, following which the subsidiaries were liquidated and the taxpayer became the limited partner in each. The Commissioner asserted that the taxpayer’s conversion to an S corporation triggered the inclusion of the affiliated group’s pre-S-election LIFO reserves (approximately $5 million) under § 1363(d). The Commissioner argued alternatively (1) that the restructuring should be disregarded because it had no purpose independent of tax consequences, and (2) that under the aggregate approach to partnerships, a pro rata share of the pre-S-election LIFO reserves (approximately $4.8 million) was attributable to the taxpayer as a partner. The Tax Court (Judge Jacobs) rejected the Commissioner’s first argument, holding that the restructuring was a genuine multiple-party transaction with economic substance, compelled by business realities and imbued with tax-independent considerations. But Judge Jacobs accepted the Commissioner’s second argument, holding that application of the aggregate approach [rather than the entity approach] to partnership taxation furthered the purpose of §1363(d).

b. But the Eleventh Circuit sees things differently, and reverses the Tax Court. “Plain language” requires application of the entity theory. 392 F.3d 1326, 89 A.F.T.R.2d 2002-2826, 2002-1 U.S.T.C. ¶50,448 (11th Cir. 6/6/02). Expressly applying the Gillett “plain language” principle, the Eleventh Circuit (Judge Hill) reversed the Tax Court. The Court of Appeals held that § 1363(d) LIFO recapture is triggered only if the corporation electing S status itself directly owned the LIFO inventory. Since the result turned on “plain language” rather than the purpose of the statutory pattern, Judge Hill was spared the need to write a lengthy opinion.

E. Affiliated Corporations.

1. The Federal Circuit doesn’t appear to buy into the single entity theory of consolidated returns. Regulation § 1.1502-20, which prohibited recognition of loss in the transactions involving, inter alia, “duplicated losses,” was held to be “manifestly contrary to the statute.” A.F.T.R.2d 2001-5058 (Fed. Cir. 6/6/01), rev’d 46 Fed. Cl. 500, 2000-1 U.S.T.C. ¶50,429, 85 A.F.T.R.2d 2000-1439 (Fed. Cl. 4/21/00). Rite Aid sold a subsidiary (Encore) and realized a taxable loss of $33 million and an “economic loss” of $22 million, which it claimed should be deductible. Reg. § 1.1502-20, subject to certain exceptions, disallows any loss realized by a member of a consolidated group upon the disposition
of the stock of a subsidiary. Under Reg. § 1.1502-20, the amount of loss that is disallowed is limited to the sum of (1) income or gain resulting from “extraordinary gains dispositions,” which are defined as dispositions of capital assets, depreciable property used in the trade or business, certain bulk asset dispositions, and discharge of indebtedness income, (2) positive investment adjustments (other than those attributable to extraordinary gain dispositions), and (3) “duplicated loss,” which is the aggregate of the subsidiary’s asset bases and loss carryovers over the value of the subsidiary’s assets. Any losses in excess of these amounts are deductible. Reg. § 1.1502-20 is designed to prevent “duplicated losses” — the deduction by both the parent and subsidiary of the same economic loss. The Court of Federal Claims upheld the validity of Reg. § 1.1502-20 and because Encore’s built-in loss of $28 million [as calculated by Rite-Aid] exceeded Rite-Aids’ economic loss, no loss deduction was allowed. The court pointed out that Rite Aid could have avoided Reg. § 1.1502-20 by finding a buyer who would agree to a § 338(h)(10) election.

The Federal Circuit (Judge Meyer) reversed, declaring the “duplicated loss factor” in Reg. § 1.1502-20 invalid because it disallows a loss that is otherwise allowed by § 165 and is “manifestly contrary to the statute.” Because “realization of the loss [on the stock sale] does not stem from the filing of a consolidated return, ... the denial of the deduction imposes a tax on income that otherwise would not be taxed,” something that § 1502 does not authorize the Treasury to do. The Federal Circuit summarily rejected the government’s argument that Reg. § 1.1502-20 is necessary to prevent a double deduction, stating that the subsidiary’s future deductions were not created by the consolidated return rules because the same duplication occurs outside the consolidated return context, and Congress has addressed the problem by the enactment of §§ 382 and 383. Judge Mayer concluded that “the duplicated loss factor distorts rather than reflects the tax liability of consolidated groups and contravenes Congress’ otherwise uniform treatment of limiting deductions from the subsidiary’s losses.”

B. John Williams of Shearman & Sterling — the new IRS Chief Counsel — represented the taxpayer.

a. At first the IRS decided to keep on fighting. In Chief Counsel Notice CC-2001-042 (8/30/01), the Service has advised chief counsel attorneys that it does not agree with the Federal Circuit decision in Rite Aid Corp. v. United States and that it has filed a petition for rehearing en banc with the Federal Circuit.

b. But six months later, the IRS caved and announced that it will change the regulations instead. Notice 2002-11, 2002-7 I.R.B. 526 (2/1/02). The Notice reads:

In Rite Aid, the Federal Circuit held that the duplicated loss component of § 1.1502-20 of the Income Tax Regulations, which disallows certain losses on sales of stock of a member of a consolidated group, was an invalid exercise of regulatory authority. The Internal Revenue Service believes that the court’s analysis and holding were incorrect.

Nevertheless, the Service has decided that the interests of sound tax administration will not be served by continuing to litigate the validity of the loss duplication factor of § 1.1502-20. Moreover, because of the interrelationship in the operation of all of the loss disallowance factors, the Service has decided that new rules governing loss disallowance on sales of stock of a member of a consolidated group should be implemented.

Accordingly, the Service intends to promulgate interim regulations that, prospectively from the date of their issuance, will require consolidated groups to determine the allowable loss on a sale or disposition of subsidiary stock under an amended § 1.337(d)-2 instead of under § 1.1502-20. For transactions (including those for which a return has been filed) completed before the date of issuance of interim regulations, or for which there is a binding contract before that date, groups will be allowed certain choices with respect to a disposition of subsidiary stock, including a choice to apply § 1.337(d)-2 as amended. The Service and Treasury are undertaking a broader study of the regulatory provisions necessary to implement § 337(d) of the Internal Revenue Code in the context of affiliated groups filing consolidated returns and will request comments in conjunction with the issuance of the interim regulations.
It is the Service's position that the Rite Aid opinion implicates only the loss duplication aspect of the loss disallowance regulation and that the authority to prescribe consolidated return regulations conferred on the Secretary is limited only by the requirement that the Secretary, in his discretion, has determined such rules necessary clearly to reflect consolidated tax liability.

e. Notice 2002-18, 2002-12 I.R.B. 644 (3/11/02). The Service announced that it and the Treasury "intend to issue regulations that will prevent a consolidated group from obtaining a tax benefit from both the utilization of a loss from the disposition of stock (or another asset that reflects the basis of stock) and the utilization of a loss or deduction with respect to another asset that reflects the same economic loss. For example, where a member of a group contributes built-in loss assets to another member of the group in exchange for stock of such member in a transaction in which the basis of such stock is determined, directly or indirectly, in whole or in part, by reference to the basis of such assets and the transferor member sells such stock without causing the deconsolidation of the transferee, the group may benefit from the built-in loss in the contributed assets more than once. It is expected that the regulations will defer or otherwise limit utilization of the loss on the stock in such transactions and other transactions that facilitate the group's utilization of a single loss more than once."

d. **The new regulations are here.** T.D. 8984, Loss Limitation Rules, 67 F.R. 11034 (3/7/02), and REG-102740-02, Loss Limitation Rules, 67 F.R. 11070 (3/7/02). The IRS has published final, temporary and proposed regulations under §§ 337(d) and 1502. New Temp. Reg. § 1.337(d)-2T governs the amount of loss allowed. The regulations disallow deductions for any losses on the sale of the stock of a subsidiary by a member of a consolidated group except to the extent that the taxpayer can prove that the loss is not attributable to the recognition of built-in gain on the disposition of any asset, including stock and securities. Gain recognized on the disposition of any asset is "built-in gain" to the extent that the gain is attributable to any excess of value over basis that is reflected in the basis of the stock. Thus, the new rule focuses only on losses attributable to basis adjustments to the subsidiary's stock attributable to gains recognized by the subsidiary. The new regulations also require that on deconsolidation of a subsidiary, the basis of stock of the subsidiary held by members of a consolidated group must be reduced to an amount not exceeding the stock's value, except to the extent that the taxpayer can show that the required basis reduction is not attributable to recognition of built-in gain. The new rules do not deal with the duplicated losses formerly disallowed by Reg. § 1.1502-20(c)(1)(iii). The new regulations are applicable to dispositions after 3/6/02. For dispositions prior to 3/7/02 (or pursuant to a binding contract entered into prior to 3/7/02) the taxpayer may elect to apply Reg. § 1.1502-20.

e. **A glitch is fixed — in the taxpayer's favor.** T.D. 8998, Loss Limitation Rules, 67 F.R. 37998 (5/31/02); REG-102305-2, Loss Limitation Rules, 67 F.R. 38040 (5/31/02). New Reg. § 1.337(d)-2T(a)(4) provides a netting rule [similar to that in former Reg. § 1.1502-20(a)(4)], pursuant to which gain and loss may be netted with respect to the disposition of stock of a subsidiary, to the extent that, as a consequence of the same plan or arrangement, gain is taken into account by members with respect to stock of the same subsidiary having the same material terms. New Reg. § 1.337(d)-2T(b)(4) provides a similar netting rule for basis reductions on deconsolidations of subsidiary stock. The temporary regulations are also issued as proposed regulations.

2. **Deferred intercompany transaction timing rules are a method of accounting.** REG-125161-01, Conforming Amendments to Section 446, 66 F.R. 56262 (11/7/01). These proposed regulations would conform Reg. § 1.446-1(c)(2)(iii) to Reg. § 1.1502-13(a)(3), promulgated in 1995, which provides that the deferred intercompany transaction rules are a method of accounting, which members are required to apply in addition to their usual methods of accounting.

3. **The IRS acts to eliminate an anomaly that would hurt corporate taxpayers in consolidated returns.** REG-137519-01, Consolidated Returns: Applicability of Other Provisions of Law: Nonapplicability of Section 357(c), 66 F.R. 57021 (11/14/01). A proposed amendment to Reg. § 1.1502-80(d) would clarify that liabilities described in § 357(c)(3) are not taken into account as a basis reduction with respect to § 351 transfers to which § 357(c) is inapplicable.

4. **Corporate remarriage OK if you talk sweetly to the IRS!** Rev. Proc. 2002-32, 2002-20 I.R.B 959 (5/20/02). This revenue procedure permits qualifying corporations to obtain a waiver of
the § 1504(a)(3)(4) bar from joining in a consolidated return with a group of which it had ceased to be a member within the preceding sixty months.

5. T.D. 9002, Agent for Consolidated Group, 67 F.R. 43538 6/27/02). Reg §§1.1502-77 and -78 [proposed in REG-103805-99, Agent for Consolidated Group, 65 F.R. 57755 (9/25/00)] clarify and supplement the rules concerning the agent for a consolidated group and the designation of a new agent for the group. The final regulations are substantially the same as the proposed regulations, with clarifying changes. Under the regulations the common parent remains the agent as long as it continues to exist as a corporation, even if it ceases to be the common parent. The common parent is the agent also for any corporation improperly included in the consolidated return. The regulations continue the current rule that if the common parent ceases to exist it may designate another member of the group as its successor agent. If no such designation is made, the IRS may designate the successor agent, except in case where the parent has a single domestic successor, that successor becomes the agent, by default, upon notification to the Commissioner. The prior rule permitting the remaining members to designate the successor agent will be removed. The regulations deal with the Interlake Corp. v. Commissioner, 112 T.C. 103 (1999), problem by providing that a refund resulting from a carryback of a NOL under §172 should be paid to the common parent or agent for the carryback year. The revised regulations generally are effective with respect to taxable years beginning on or after 6/28/02.

F. Reorganizations and Corporate Divisions

1. The wrath of General Utilities repeal rewritten. REG-107566-00, Notice of Proposed Regulations, Guidance Under Section 355(e): Recognition of Gain on Certain Distributions of Stock or Securities in Connection with an Acquisition, 66 F.R. 66 (1/2/01). The Treasury revised Prop. Reg. § 355-7 and withdrew proposed regulations (66 F.R. 76) issued in REG-116733-98 (64 F.R. 46155, 8/24/99). The proposed regulations provided that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. They included nonexclusive lists of facts and circumstances to be considered in making the determination and six safe harbors.

   • If an acquisition follows a distribution, the distribution and acquisition are considered part of a plan if the distributing corporation (D), the controlled corporation (C), or any of their controlling shareholders intended on the date of the distribution that the acquisition or a similar acquisition occur in connection with the distribution. If an acquisition precedes a distribution, the distribution and acquisition are considered part of a plan if D, C, or any of their controlling shareholders intended on the date of the acquisition that a distribution occur in connection with the acquisition. All acquisitions of stock of a corporation that are pursuant to a plan are aggregated to determine whether the 50 percent threshold of § 355(e)(2)(A)(ii) is met.

   • **Facts and Circumstances** — There are two nonexclusive lists of factors to consider, one list tends to demonstrate that a distribution and an acquisition are part of a plan and the other list tends to demonstrate that a distribution and an acquisition are not part of a plan. The weight of the factors varies and the determination does not depend on merely counting factors.

   • **Factors indicating a plan:** Six factors [3 with respect to pre-acquisition distributions and 3 with respect to post-acquisition distributions] focus on whether D, C, or their respective controlling shareholders discussed the second transaction of the pair with outside parties before the first transaction occurred. The seventh factor considers whether the distribution was motivated by a purpose to facilitate the acquisition or a similar acquisition of D or C; evidence of such a purpose exists if there was a reasonable certainty that within 6 months after the distribution an acquisition would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding an acquisition. Elaborate "operating rules" describe the impact of numerous scenarios. The eighth factor considers whether an acquisition and a distribution occurred within 6 months of each other, or whether there was an agreement, understanding, arrangement, or substantial negotiations regarding the second transaction (or, if an acquisition is the second transaction, a similar acquisition) within 6 months after the first transaction. The ninth factor considers whether the debt allocation between D and C made an acquisition of D or C likely in order to service the debt.

   • **Factors indicating the absence of a plan:** Five factors [3 with respect to pre-acquisition distributions and 2 with respect to post-acquisition distributions] focus on the absence of any discussions between D, C, or their respective controlling shareholders, with outside parties regarding the second transaction of the pair before the first transaction occurred. One of the factors in each category is that there was an identifiable, unexpected change in market or business conditions after the first transactions that resulted in the second, unexpected transaction. The sixth nonplan factor is the existence of a real and substantial corporate business purpose, other than a purpose to facilitate the acquisition or a
similar acquisition, for the distribution [using principles similar Reg. § 1.355-2(b)(1)]. The seventh factor is that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a previously proposed similar acquisition.

- **Safe harbors:** A distribution and an acquisition are not part of a plan if they are described in one of the safe harbors.

  1. An acquisition more than 6 months after a distribution if there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution and the distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate an acquisition is not part of a plan. This safe harbor applies if the distribution was motivated in whole or substantial part by a nonacquisition business purpose.

  2. An acquisition more than 6 months after a distribution for which there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution is not part of a plan. This safe harbor applies where the distribution was motivated in whole or substantial part by a business purpose to facilitate an acquisition of no more than 33% of the stock of either D or C, and no more than 20 percent of the stock of the corporation whose stock was acquired in the acquisition that motivated the distribution was either acquired or the subject of an agreement, understanding, arrangement, or substantial negotiations before a date that is 6 months after the distribution.

  3. An acquisition more than 2 years after a distribution if there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter is not part of a plan.

  4. An acquisition more than 2 years before a distribution if there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within 6 months thereafter is not part of a plan.

  5. If D or C is listed on an established market, an acquisition if the stock is transferred between shareholders of D or C who are not 5% shareholders is not part of a plan. This safe harbor is subject to certain exceptions.

  6. An acquisition of stock by an employee or director in connection with the performance of services, including an acquisition resulting from the exercise of certain compensatory stock options, is not part of a plan.

- For all purposes, depending on all relevant facts and circumstances, parties can have an agreement, understanding, or arrangement even though they have not reached agreement on all terms. Under certain circumstances, such as in public offerings or auctions of D or C stock, an agreement, understanding, arrangement, or substantial negotiations can exist regarding an acquisition even if the acquirer has not been specifically identified. Special rules deal with options.

a. **And apparently the government thinks it did a better job on the regulations the second – or is this the third? – time around.** T.D. 8960, Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection With An Acquisition, 66 F.R. 40590 (8/3/01). The Treasury has promulgated temporary regulations identical to the Proposed Regulations, except that the temporary regulations reserve §1.355-7(e)(6) (suspending the running of any time period during which there is a substantial diminution of risk of loss under the principles of §355(d)(6)(B)) and Example 7 of the Proposed Regulations (interpreting the term “similar acquisition” in the context of a situation involving multiple acquisitions).

b. **The third (fourth?) time’s the charm.** T.D. 8988, temporary regulations. 67 F.R. 20632 (4/26/02), and REG-163892-01, proposed regulations, 67 F.R. 20711 (4/26/02). These regulations amend Temp. Reg. § 1.355-7T and identical Prop. Reg. § 1.355-7, and set forth new guidelines in the anti-Morris Trust regulations. The 2002 temporary and proposed regulations disregard the presumption of §355(e)(2)(B) and provide that “whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances.” However, Temp. Reg. §1.355-7T(b)(2) provides a “super-safe harbor” for an acquisition not involving a public offering that occurs within two years following the date of a distribution — the distribution and acquisition “will be treated as part of a plan only if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the 2-year period ending on the date of the distribution.” [italics added].

Under the facts and circumstances test, the existence of an agreement, understanding, arrangement, or substantial negotiations during the two-year period tends to show that the distribution and acquisition are part of a plan, but such an understanding etc., is merely a factor among the facts and
circumstances to be evaluated. If an acquisition precedes the distribution, discussions regarding a distribution with the acquirer by either the controlled or distributing corporation within the two year period preceding the acquisition indicate the existence of a plan. The absence of discussions regarding a distribution during the two year period preceding the acquisition indicates that the acquisition and distribution were not part of a plan. Discussions with an investment banker during the two year period preceding an acquisition by public offering are a factor indicating the existence of a plan. A corporate business purpose [as defined in Reg. § 1.355-2(b)], other than a business purpose to facilitate the acquisition, is a factor indicating the absence of a plan. That the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition indicates the absence of a plan.

A distribution and an acquisition are not part of a plan if they are described in one of the following seven safe harbors:

1. An acquisition occurs more than six months after a distribution, there was no agreement, understanding, arrangement, or substantial negotiations regarding the acquisition from one year before the distribution to six months after the distribution, and the distribution was motivated in whole or substantial part by a corporate business purpose other than to facilitate an acquisition.

2. An acquisition occurs more than six months after a distribution and there was no agreement, understanding, arrangement, or substantial negotiations regarding the acquisition from one year before the distribution to six months after the distribution, the distribution was not motivated by a business purpose to facilitate an acquisition of either the distributing or controlled corporations, and no more than twenty-five percent of the stock of the corporation whose stock was acquired in the acquisition was either acquired or the subject of an agreement, understanding, arrangement, or substantial negotiations during a period from one year before the distribution to six months following the distribution.

3. An acquisition occurs after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within one year thereof. This provision eliminates the statutory two-year post-distribution presumption and replaces it with a one-year safe harbor.

4. A distribution occurs more than two years after an acquisition and there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within six months thereafter.

5. An acquisition of stock of the distributing or controlled corporation listed on an established market occurs as a result of transfers between shareholders of distributing or controlled who are not controlling shareholders [five percent shareholders who participate in management] or ten percent shareholders. This safe harbor does not apply if the transferor or transferee of the stock is controlled by the acquired corporation, is a member of a controlled group that includes the acquired corporation, or is an underwriter with respect to the acquisition.

6. An acquisition of stock by an employee, director, or independent contractor [other than controlling shareholders] in connection with the performance of services.

7. An acquisition by a qualified pension or retirement plan.


P acquired T by merging P's shell subsidiary S into T in a reverse triangular merger in which the T shareholder's received 70 percent P voting stock and 30 percent cash (the Acquisition Merger). Following the acquisition, "as part of the plan," T merged into P (the Upstream Merger). The ruling assumes that (1) "absent some prohibition against the application of the step transaction doctrine, the step transaction doctrine would apply to treat the Acquisition Merger and the Upstream Merger as a single integrated acquisition by [P] of all the assets of T," and (2) "the single integrated transaction would satisfy the nonstatutory requirements of a reorganization under §368(a). The ruling holds that Acquisition Merger is not a qualified stock purchase under § 338 followed by a § 332 liquidation, but instead that the integrated transaction is a statutory merger of T into P under § 368(a)(1)(A). No § 338 election is available. The ruling reaches the same result - type (A) merger if the T shareholders receive solely P voting stock [instead of a §368(a)(1)(E) reverse triangular merger followed by a § 332 liquidation].

- The IRS applied Rev. Rul. 67-274, 1967-2 C.B. 141, holding that if P acquires the stock of T in exchange for P voting stock and thereafter liquidates T into P, the transaction is a type (C) reorganization rather than a type (B) reorganization. It distinguished Rev. Rul. 90-95, 1990-2 C.B. 67 (Situation 2), holding that the cash merger of a newly formed wholly owned S into T followed by
the merger of T into P will be treated as a qualified stock purchase of T followed by a § 332 liquidation of T.

- Pursuant to § 7805(b) the IRS will not apply the ruling to challenge a taxpayer's contrary position with respect to an acquisition before 9/25/01, or acquisition of stock of the target corporation meeting the requirements of § 1504(a)(2) by the purchasing corporation pursuant to a written agreement binding on 9/24/01 if: (1) a timely § 338(g) or (h)(10) or § 338(g) has been filed and (2) the taxpayer does not take an inconsistent position.

- The IRS is considering whether to issue regulations that reflect the principles of the ruling, but nevertheless allow § 338(h)(10) elections pursuant to a written agreement that requires or permits the § 338(h)(10) election.

3. **Treasury does an “about-face” on mergers into disregarded entities.** REG-126485-01, Statutory Mergers and Consolidations, 66 F.R. 57400 (11/15/01). The Treasury has withdrawn proposed regulations [REG-106186-98, 65 FR 31115 (5/16/00)], which would have provided that neither the merger of a disregarded entity into a corporation nor the merger of a target corporation into a disregarded entity was a statutory merger qualifying as a reorganization under § 368(a)(1)(A), and has proposed new more liberal regulations [Prop. Reg. § 1.368-2(b)(1)]. Under the new proposed regulations, a merger of a corporation into a disregarded entity that is wholly owned by another corporation could qualify as a type (A) merger. As the IRS is wont to do these days, the new proposed regulations introduce more definitional jargon. The term “disregarded entity” means a business entity (as defined in § 301.7701-2(a)) that is disregarded as an entity separate from its owner for Federal tax purposes, including single member corporate-owned LLCs, qualified REIT subsidiaries, and Q-Subs. “Combining entity” means a business entity that is a corporation [as defined in Reg. § 301.7701-2(b)] that is not a disregarded entity. “Combining unit” means a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for Federal tax purposes. Under the proposed regulations, a statutory merger or consolidation under § 368(a)(1)(A) must be effected pursuant to the laws of the United States or a State or the District of Columbia. [Foreign statutory mergers still do not qualify, but the domestic statute no longer needs to be a “corporate” law.] All of the following events must occur simultaneously: (1) 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 units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and (2) the combining entity of each transferor unit ceases its separate legal existence for all purposes. The examples provide all the details in the rules: (Ex. 1) Divisive mergers [see Rev. Rul. 2000-5, 2000-1 C.B. 436] cannot qualify; (Ex. 2&3) Forward triangular mergers (into a disregarded entity owned by S) are allowed; (Ex. 4) The owner of the disregarded entity must be a corporation; (Ex. 5) Mergers of disregarded entities into corporations do not qualify; and (Ex. 6) None of the consideration received by the T shareholders may be interests in the disregarded entity.

4. **Backing into control within 5 years of the spin-off backed them right out of § 355.** McLaughlin v. Commissioner, 276 F.3d 1269, 2002-1 U.S.T.C. ¶50,156, 88 A.F.T.R.2d 2001-7324 (11th Cir. 12/21/01), aff'g 115 T.C. 255 (9/20/00). The taxpayers were shareholders of RPI, an S corporation. Until 1993, RPI owned 50 percent of the stock of Sunbelt (a C corporation); the other 50 percent was owned by Hutto. In 1993, after protracted negotiations regarding whether RPI should purchase Hutto's stock in Sunbelt or Hutto should purchase RPI's Sunbelt stock, Sunbelt redeemed all of Hutto's stock for cash [$828,943], which was borrowed from RPI, and property [$101,000], leaving RPI as Sunbelt's sole shareholder. Later on the same day as the redemption, RPI distributed all of the stock of Sunbelt to RPI's three equal shareholders — the taxpayers — in a transaction intended to qualify as a tax-free spinoff under § 355. The stated purposes of the distribution were to relieve RPI from any potential liabilities arising from Sunbelt's operations, to prepare Sunbelt to go public, and to preserve RPI's S election [the controlling version of § 1361(b) for the year in question prohibited the parent of an affiliated group from being an S corporation].

- The Tax Court (Judge Halpern) held that because RPI's distribution of the stock of Sunbelt occurred less than 5 years after RPI acquired control of Sunbelt in a transaction in which gain or loss was recognized [i.e., the redemption of Hutto's stock], the distribution failed to satisfy the active business requirement of § 355(a)(1)(C) and (b)(2)(D)(ii). Judge Halpern rejected the taxpayer's 'blanket assertion' that a redemption of stock of the other shareholder's stock, thereby backing the parent into control of the subsidiary, never could be treated as the acquisition of control within 5...
years in a taxable transaction. He likewise declined to follow the Commissioner's argument directly to apply Rev. Rul. 57-144, 1957-1 C.B. 123, which would treat any instance in which a redemption resulted in the acquisition of control within 5 years as a disqualifying acquisition. Rather, he emphasized the negotiations leading up to the transaction and the fact that the cash for the redemption came from RPI to conclude that in this case there was no difference between the transaction as it occurred and a direct purchase by RPI.

- Accordingly, § 335(c)(1) did not apply to provide nonrecognition at the corporate level; under § 311(b), RPI recognized gain on the distribution of the Sunbelt stock, and the gain passed through to the RPI shareholders under § 1366(a). [The court did not address the Commissioner's argument that the shareholders failed to prove that the distribution was designed to achieve a corporate business purpose as required by Reg. § 1.355-2(b)].
- The Court of Appeals affirmed the Tax Court's decision with minimal discussion.

The tax court found that the facts of Rev. Rul. 57-144 were not distinguishable from the present case in any significant way. We agree. ....

We need make no distinction between indirect control of Sunbelt by Ridge at 50% ownership and direct control of Sunbelt by Ridge at 100% ownership. Under the plain meaning of the statute, Ridge acquired control on January 15th, the moment the taxable Hutto redemption occurred. This event resets the five- year clock and renders Ridge's distribution of the Sunbelt stock taxable, albeit stock that it had held for more than twelve years.

As the tax court said, this is not the mere conversion of indirect control to direct control. It is the 'acquisition of control where none had existed previously."

5. Post-spin-off stock options and restricted stock taxation determined with reference to the policy of § 1032. Rev. Rul. 2002-1, 2002-2 I.R.B. 268 (1/14/02). This ruling answers several questions with respect to transactions involving restricted stock and stock options held by employees of both corporations following a § 355 spin-off of a controlled corporation (C) by a distributing corporation (D). The distributions of C stock and warrants were in an amount and on terms designed to exactly preserve the employees' pre-spin-off economic rights. First, the ruling holds that D does not recognize any gain or loss when restrictions lapse on C stock that was received by D employees in the spin-off with respect to their restricted D stock. Likewise, D does not recognize gain or loss as a result of the exercise by D employees of options on C stock that were received in the spin-off with respect to options on D stock that they held. Second, C does not recognize gain or loss when restrictions lapse on D stock held by C employees that was received before the spin-off. Likewise, C does not recognize gain or loss as a result of the exercise by C employees of options on D stock that were received in the spin-off with respect to options on D stock that they held before the spin-off. Third, D is entitled to deductions for amounts includible in D employees' income as a result of the lapse of restrictions on D and C stock and the exercise of options to acquire D and C stock.

6. Just a simple earnings bailout scheme. South Tulsa Pathology Laboratory, Inc. v. Commissioner, 118 T.C. No. 5 (1/28/02). The Tax Court (Judge Marvel) held that a pre-§355(e) pro rata spin-off followed by a prearranged sale of the controlled corporation's stock was a "device" precluding tax-free treatment under § 355. There was no business purpose for the distribution of the controlled business to the shareholders prior to its sale even if there was a business purpose of the sale of the business. That the distributing corporation's earnings and profits were only $253,000, compared with the $5,530,000 sale price did not negate that the transaction was a device to bailout earnings and profits because the earnings and profits that were being bailed out were the profits from the sale of the controlled corporation's business. The distributing corporation's recognized gain was computed with reference to the selling price of the stock – not the appraised fair market value of the assets transferred by the distributing corporation to the controlled corporation – because the contemporaneous arm's length sales price was the best evidence of the fair market value of the stock, Pope & Talbot, Inc. v.
identifying the distributed asset; in the instant case the distributed asset clearly was the stock of the partnership units was treated as distributing the land), was distinguished as involving a question of D's shareholders. The IRS applied Rev. Rul. 92-17, 1992-1 C.B. 147, to find disregarded entity. On the first day of year 6, the LLC distributed forty percent of the rental properties to management. After two years, the LLC, along with the officers of another 20 percent owner (none of the other owners participated in the acquisition as a pooling for financial accounting.) The Commissioner argued that Penrod v. Commissioner, 88 T.C. 1415 (1987), should control to treat the 1991 acquisition as a reorganization with a transferred basis. The court (Judge Horn) denied cross motions for summary judgment, holding that a genuine issue of fact existed as to whether the RSC shareholders intended, at the time of the reorganization on August 9, 1991, to dispose of the NovaCare stock received in the reorganization or to hold it.

- The court noted that for reorganizations occurring after 1/28/98, under Reg. § 1.368-1(e), post-reorganization dispositions are irrelevant with respect to continuity of interest, but gave no weight to the promulgation of the regulation to solve the McDonald's/Penrod problem.

7. When IRS use a word ... it means just what IRS choose it to mean. Rev. Rul. 2002-49, 2002-32 I.R.B. 288 (8/12/02). This revenue ruling deals with whether the 5-year active conduct of a trade or business requirement of § 355(b) is satisfied when, during the 5-year period prior to a transaction that otherwise meets the requirements of § 355, a corporation holding a membership interest in a member-managed limited liability company purchases the remaining interests in that limited liability company, contributes a portion of the business to a newly formed subsidiary, and then distributes the stock of the controlled subsidiary to its shareholders.

- In Situation 1, D Corporation's sole asset was 20 percent of the LLC, which operated numerous rental properties and its officers actively participated in the management of the LLC, along with the officers of another 20 percent owner (none of the other owners participating in management). After two years, D purchased the other 80 percent of the interests, and the LLC became a disregarded entity. On the first day of year 6, the LLC distributed forty percent of the rental properties to D, which contributed the properties to C in exchange for all of C's stock, following which C was spun-off to D's shareholders. The IRS applied Rev. Rul. 92-17, 1992-1 C.B. 147, to find D was engaged in the active conduct of the leasing business [within the meaning of § 355(b)] for the first two years. Notwithstanding Rev. Rul. 99-6, 1999-1 C.B. 432 [holding that the sale and purchase of all of the remaining interests in an LLC is treated as the distribution of assets to the selling members and the purchase of assets by the continuing members], the purchase of the 80 percent interest in the LLC within five years did not violate § 355(b)(2)(C), even though gain or loss was recognized in the transaction, because the transaction was not the acquisition of new or different business under Reg. § 1.355-3(b)(3)(i).

- Situation 2, is the same as Situation 1, except that D obtained the 20 percent interest in the LLC on the first day of year 2, in exchange for appreciated securities in a § 721 transaction, before the spin-off in year 6. This situation does not qualify because D is treated as having acquired the LLC's business in a transaction in which gain or loss was recognized within the 5-year pre-distribution period [§ 355(b)(2)(C)]. Although no gain or loss was recognized [§ 721(a)] on D's acquisition of the LLC interest in year 2, if D had directly acquired the LLC's business in exchange for the property D contributed to the LLC, the exchange would have been a transaction in which gain or loss was recognized. For purposes of § 355(b), therefore, D is treated as acquiring the LLC's business in year 2 in a transaction in which gain or loss was recognized. Huh!

G. Personal Holding Companies and Accumulated Earnings Tax

1. "Accrued" tax liabilities are different from tax liabilities "imposed." Metro Leasing & Development Corp. v. Commissioner, 119 T.C. No. 2 (7/11/02) (reviewed). In an earlier
proceeding [T.C. Memo. 2001-119], the Tax Court held that the taxpayer was liable for the accumulated earnings tax under §§ 531-537. In this supplemental opinion, the Tax Court, in a reviewed opinion by Judge Gerber rejected the taxpayer’s arguments that the amount of the unreasonably accumulated earnings should be adjusted under §§ 535(b)(1) and 535(b)(6)(A) in three respects.

1. First, the court held that no adjustment for unpaid “accrued” taxes should be made with respect to taxes that would become due in future years with respect to a closed transaction that was being reported on the § 453 installment method; since the gain to be recognized in future years had not been included in the accumulated income, it was not appropriate to reduce the accumulated income by the taxes attributable to that gain.

2. Second, no adjustment should be made with respect to any tax deficiency, including the accumulated earnings tax, that the taxpayer continued to contest. Since the taxpayer continued to contest an underlying deficiency, even though payment had been tendered, no adjustment was allowed. The Tax Court specifically declined to follow J.H. Rutter Rex Manufacturing Co. v. Commissioner, 853 F.2d 1275 (5th Cir. 1988), rev’g T.C. Memo 1987-296, in which the Fifth Circuit held to the contrary. The Tax Court found no basis for treating a taxpayer who pays the contested deficiency differently from the taxpayer who does not pay the contested deficiency.

3. Third, the court held that the decrease in the downward adjustment for capital gains under § 535(b)(6)(A) be the taxes “attributable,” i.e. “imposed” under the statute, to those capital gains is not limited to the to the combined income tax liability on capital gains and ordinary income or loss shown on the taxpayer’s return, but takes into account the taxes due after the determination of a deficiency. Accordingly, because the taxpayer’s tax liability exceeded $100,000 after the determination of the deficiency, the taxpayer, who reported $35,884 of net capital gain, but only $17,825 of taxable income due to net operating losses, was required to reduce the negative adjustment by $15,738 of taxes “attributable” to the capital gain, not merely the $2,674 of taxes shown as due on the return. The court found no conflict between its second and third holdings because a tax is “imposed” if it has been paid and is being contested, even though it is not “accrued” under those circumstances.

H. Miscellaneous Corporate Issues

1. Could they have obtained a better result if their advisor had read Zenz before structuring the deal? Or would §311(b) taken a big tax bite? Steel v. Commissioner, T.C. Memo. 2002-113 (5/6/02). The taxpayer was a partner in a partnership that owned the stock of a corporation. At the time of the sale of the stock of the corporation, the corporation had a claim pending for lost profits under a business interruption insurance policy. As permitted by the purchase and sale contract, the claim was assigned to the partnership, but nothing in the purchase and sale agreement indicated that the pricing was in any way related to the assignment. Subsequently, the partnership received cash in settlement of the claim, which the partners reported as additional capital gain on the sale of the stock. Judge Ruwe upheld the Commissioner’s determination that the receipt of the insurance claim proceeds was unrelated to the sale of the stock. That the assignment would not have occurred “but for” the stock sale, was not enough to integrate them. Since there was no sale or exchange on receipt of the proceeds, the amount realized was ordinary income.

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. No more “inappropriate” increases or decreases in the adjusted basis of a corporate partner’s interest in a partnership. T.D. 8986, Determination of Basis of Partner’s Interest; Special Rules, 67 F.R. 15112 (3/29/02). The Treasury has finalized Reg. § 1.705-2 [proposed in REG-106702-00, Determination of Basis of Partner’s Interest; Special Rules, 66 F.R. 315 (1/3/01)] which is intended to prevent what the IRS has determined to be “inappropriate” increases or decreases in the adjusted basis of a corporate partner’s interest in a partnership [consistent with Notice 99-57,1999-2 C.B. 692] resulting from the partnership’s disposition of the corporate partner’s stock [under the general principles of Rev. Rul. 99-57, 1999-2 C.B. 678], when: (1) a corporation acquires an interest in a partnership that holds stock in the corporation, (2) the partnership does not have a § 754 election in effect for the year in which the corporation acquires the interest, and (3) the partnership later sells or exchanges the stock, then 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 the corporate partner would have recognized (absent the application of § 1032) if, for the tax year in which the

8 Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954).
corporation acquired the interest, a § 754 election had been in effect. The final regulations require appropriate adjustments to the basis of tiered partnerships to prevent evasion of their purpose where a corporation acquires an indirect interest in its own stock through a chain of partnerships and gain or loss from the sale of stock is subsequently allocated to the corporation. The regulation is effective retroactively to gain or loss allocated on sales or exchanges of stock occurring after 12/06/99.

a. Proposed amendments before the ink is dry. REG-167648-01, Amendments to Rules for Determination of Basis of Partner’s Interest; Special Rules, 67 F.R. 15132 (3/29/02). The Treasury has proposed amendments to Reg. 1.705-2, which was finalized on the same day the proposed amendments were published, “to address remaining issues that [were] considered during the development of the final regulations. The proposed amendments would extend the rules of Reg. § 1.705-2 to situations in which a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes gain on the distribution during a year in which the partnership does not have a § 754 election in effect, and the partnership subsequently sells or exchanges the stock. The proposed amendments also clarify that “stock” of a corporate partner includes any position with respect to stock of a corporate partner. The proposed amendments would be effective retroactively to gain or loss allocated on sales or exchanges of stock occurring after 3/29/02.

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

1. The gestalt theory of partnership allocations. Estate of Ballantyne v. Commissioner, T.C. Memo. 2002-160 (6/24/02). The decedent taxpayer and his brother for many years operated a partnership that engaged in the oil and gas business, run by the decedent, and the farming business, run by the decedent’s brother. The partnership was an oral partnership, and the brothers consistently reported as equal partners, even though the decedent consistently withdrew the profits from the oil and gas business and decedent’s brother consistently withdrew the profits from the farming business. After the decedent’s death, the estate took the position that all of the income from the farming activity was reportable as the decedent’s brother’s distributive share. Because the partnership did not maintain capital accounts, the allocation lacked economic substance, and the partners’ interests in the partnership were determined under the facts and circumstances test of Reg. § 1.704-1(b)(3). Based on the evidence, the estate could not overcome the presumption that the partners were equal partners. There was no record of capital contributions; the amount of profits of each activity varied from year to year, as did withdrawals but the partners’ economic interests and interests in cash flow could not be determined because the partnership books and records were inadequate. However, the “facts” — mostly the witnesses’ “beliefs” that the brothers were 50/50 partners — indicated that they were to share liquidating distributions equally. That factor, combined with the brothers long-time consistent reporting as equal partners and the absence of any evidence that the brothers’ reporting position involved tax avoidance, was sufficient to convince Judge Ruwe that they were equal partners.

C. Distributions and Transactions Between the Partnership and Partners

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

1. Final Unified Partnership Audit Regulations. T.D. 8965, Unified Partnership Audit Rules, 66 F.R. 50541 (10/3/01). The final partnership audit regulations, Reg. 301.6221-1 through 301.6223-1, inclusive, are substantially similar to the previously proposed and temporary regulations. Numerous clarifying changes have been made to reflect subsequent statutory changes impacting partnership level determinations and judicial interpretations of the Temporary Regulations.

   • Partnerships with a nonresident alien partner cannot qualify for the small partnership exemption of §6231(a)(1)(B)(i).

   • The passive activity loss rules of § 469 are an affected item [Reg. §301.62331(a)(5)-1] that will be directly assessed with respect to individual partners following the partnership level proceeding.

   • If the IRS fails to provide a partner with timely notice of the beginning of an administrative proceeding (NBAP) as required by §6223, the partner may, under § 301.6223(e)-2(c)(2), elect to have either the FPAA, a court decision, a consistent settlement agreement, or conversion to nonpartnership items apply to that partner’s partnership items.
The final regulations clarify that the election must be mailed within 45 days after the mailing of the FPAA, not the NBAP.

The final regulations conform to changes in the 1997 Act providing that partnership-level proceedings include the determination of applicable penalties at the partnership level, and that partners could raise any partner-level defenses to the imposition of penalties only in a subsequent refund action.

Reg. § 301.6224(c)-1 clarifies that a settlement agreement between the tax matters partner and the IRS with respect to penalties, like a settlement agreement with respect to partnership items, binds partners other than notice partners and members of a notice group.

Reg. § 301.6226(e)-1 clarifies that in the case of a petition filed by a 5-percent group or pass-thru partner, the members of the group or the indirect partners holding an interest in the partnership through the pass-thru partner must deposit the aggregate amount by which their tax liabilities would be increased if the treatment of partnership items on the partners' returns were made consistent with the treatment of partnership items on the partnership return (effective for civil actions beginning on or after 4/2/02).

The final regulations also incorporate the holding of Callaway v. Commissioner, 231 F.3d 106 (2d Cir. 9/15/00), holding that a wife was not bound by the outcome of a unified partnership proceeding where her husband's partnership items converted to nonpartnership items during the proceeding.

2. Phillips v. Commissioner, 272 F.3d 1172, 2002-1 U.S.T.C. ¶50,103, 88 A.F.T.R.2d 2001-7092 (9th Cir. 12/4/01). An IRS criminal investigation of Tax Matters Partner Hoyt did not disqualify him from consenting to an extension of the statute of limitations. Taxpayer argued that Transpac Drilling Venture 1982-12 v. Commissioner, 147 F.3d 221 (2d Cir. 1998), which held that a TMP under IRS criminal investigation had a disabling conflict of interest because his fiduciary duty to his partners conflicted with his desire to ingratiate himself with the IRS. Judge Noonan stated:

Two circumstances differentiate this case. The IRS made no attempt to get waivers from limited partners. The partnerships for which Hoyt was being investigated have not been shown to be the partnerships involved in this case. It is not intuitively obvious that Hoyt did what is a routine accommodation — signing a waiver in order to avoid immediate assessment by the IRS — in order to ingratiate himself in the investigation of his partnerships. Phillips has speculated that Hoyt so acted; he has not proved it.

3. Are conflicts are worse than criminality? Madison Recycling Associates v. Commissioner, 295 F.3d 280, 90 A.F.T.R.2d 2002-5132, 2002-2 U.S.T.C. ¶50,515 (2d Cir. 7/9/02). The Ninth Circuit held that a consent to extend the statute of limitations executed by an otherwise properly designated agent of the TMP was not invalid merely because the TMP was under criminal tax investigation at the time the consent was signed. Because the TMP was unaware of the criminal investigation at the time the consents were signed, he had no conflict of interest. On that basis the court distinguished its holding in Transpac Drilling Venture 1982-12 v. Commissioner, 147 F.3d 221 (2d Cir. 1998).

4. Partnerships shouldn't bother applying for § 7841(c) interest redeterminations. ASA Investerings Partnership v. Commissioner, 118 T.C. No. 26 (5/22/02). The decision in the tax shelter case, ASA Investerings Partnership v. Commissioner, T.C. Memo. 1998-305, aff'd, 201 F.3d 505 (D.C. Cir. 2000) was entered pursuant to a partnership level proceeding filed in the Tax Court under §6226(a), rather than § 6215(a). Accordingly, the substantive proceeding was not a redetermination of a deficiency, and Judge Ruwe held that the Tax Court lacked jurisdiction under §7481(c) to review the Commissioner's determination of interest, even though all of the other conditions for §7481(c) review had been met. A petition for redetermination of the deficiency under §6215(a) is an express statutory prerequisite for §7481(c) review of an interest determination.

5. Gustin v. Commissioner, T.C. Memo. 2002-64 (3/7/02). A deficiency notice disallowing a portion of a partner's distributive share of losses from a TEFRA partnership under § 704(d), on the ground that the losses exceeded the partner's basis in his partnership interest, was valid even though there had been no FPAA and partnership-level proceeding. A partner's basis in the partnership is not a partnership item.

G. Miscellaneous
VIII. TAX SHELTERS

A. Corporate Tax Shelters

1. Tax shelter benefits from § 453 contingent sale partnership tax shelter not allowed because the tax shelter is a sham and "serves no economic purpose other than tax savings." Merrill Lynch's persistence overcomes initial doubts of tax department. ACM Partnership v. Commissioner. T.C. Memo. 1997-115 (3/5/97) aff'd, 157 F.3d 231, 98-2 U.S.T.C. ¶50,790, 82 A.F.T.R.2d 98-6682 (3d Cir. 10/13/98) (2-1), cert. denied, 526 U.S. 1017 (1999). Judge Laro found a § 453 contingent sale partnership tax shelter to be a prearranged sham, "tax-driven and devoid of economic purpose," and "serv[ing] no economic purpose other than tax savings," following Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967). Under the scheme to shelter Colgate's $105 million 1988 capital gain, a partnership was formed in 1989; its three partners were affiliates of (a) a foreign bank (about 90%), (b) Colgate (about 9%), and (c) Merrill Lynch (about 1%). A bank note was purchased by the partnership and immediately sold for a large immediate payment and much smaller future contingent payments. Under the contingent payment sale provisions of the temporary regulations [§ 15a.453-1(c)] the partnership's basis was to be allocated ratably over the several years over which contingent payments could be made, resulting in a large 1989 installment sale gain to the partnership. The lion's share of that installment sale gain was allocated to the foreign bank (which was not taxable on U.S. source capital gain), followed by the redemption of the foreign bank's partnership interest. This left Colgate as the 90-percent partner. In 1991, the installment sale obligation was sold by the partnership, triggering about $100 million of capital losses, which Colgate attempted to use to shelter its 1998 capital gain.

- The Third Circuit affirmed the Tax Court's application of the "economic substance" doctrine, which eliminated the capital gains and losses attributable to ACM's application of the ratable basis recovery rule of the contingent installment sale provisions. The Third Circuit held, however, that out-of-pocket amounts were deductible.

a. Judge Foley finds another Merrill Lynch §453 partnership plan does not work because, under the facts, there was no partnership. ASA Investerings Partnership v. Commissioner. T.C. Memo. 1998-305 (8/20/98). In another Merrill Lynch §453 partnership plan to create capital losses to shelter earlier capital gains, AlliedSigna, lost when Judge Foley held that the parties to the partnership agreement did not join together for a common purpose of investing in interest-bearing instruments, and they did not share profits and losses.

(1) Affirmed, ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 2000-1 U.S.T.C. ¶50,185, 85 A.F.T.R.2d 2000-675 (D.C. Cir. 2/1/00). The D.C. Circuit's opinion noted that it disagreed with the Tax Court's statements that persons with "divergent business goals" are precluded from having the requisite intent to form a partnership; however, this view was not essential to the Tax Court's conclusion that the parties did not intend to join together as partners to conduct business activity for a purpose other than tax avoidance. The court held that there was a single business purpose rule.

b. Saba Partnership v. Commissioner. T.C. Memo. 1999-359 (10/27/99). Brunswick's transactions identical to ACM's were found to lack economic substance. Judge Nims held that the transactions lacked nontax business purposes and that Congress did not intend to favor such transactions "regardless of their economic substance." He held that fees paid for the organization of the partnership were deductible subject to the limitations of §709(b) [60-month amortization], but that the fees paid with respect to the sham transactions were not deductible.

(1) D.C. Circuit remands Saba for reconsideration in light of its opinion in ASA Investerings. Saba Partnership v. Commissioner, 273 F.3d 1135, 2002-1 U.S.T.C. ¶50,145, 88 A.F.T.R.2d 2001-7318 (D.C. Cir. 12/21/01), remanding for reconsideration in light of ASA Investerings T.C. Memo. 1999-359 (10/27/99). The court felt this case to be indistinguishable from ASA Investerings, which was decided on a sham partnership theory, as opposed to Judge Nims' decision in the Tax Court, which was grounded on a sham transaction theory. The court of appeals refused to simply affirm the Tax Court's decision on the alternative ground that the partnerships were shams. Even the government conceded that the sham transaction and sham partnership approaches yield different results; the adjustments under the sham partnership theory would be different than under the sham transaction theory although the government apparently conceded at oral argument that under either approach, Brunswick could deduct actual losses from the transactions]. The government argued that the court of appeals should apply ASA Investerings to hold that the partnerships were shams, and remand the case to the Tax Court for the limited purpose of determining the amount of any necessary adjustments. But the
court of appeals accepted the taxpayer’s argument that the “question of whether ‘an entity should be regarded as a partnership for federal tax purposes is inherently factual,’” and remanded to allow the taxpayer to address the question to the trial court, even though it doubted that the Tax Court’s “findings are inadequate because of ‘significant differences’” alleged by the taxpayer “between the actions of [the taxpayer] in this case and those of [the taxpayer] in ASA.” Indeed, the court of appeals opinion said: “As far as we can tell, the only difference between this case and ASA is that Brunswick and ABN did not meet in Bermuda.” In remanding, Judge Tatel foreshadowed what he expected to be the result on remand:

In any case, ASA makes clear that “the absence of a nontax business purpose is fatal” to the argument that the Commissioner should respect an entity for federal tax purposes. *** Here, the Tax Court specifically found “overwhelming evidence in the record that Saba and Otrabanda were organized solely to generate tax benefits for Brunswick.” *** Arguably, this broader finding subsumes any factual differences that might exist between this case and ASA.

*** Although the present record might strongly suggest that Saba and Otrabanda were sham partnerships organized for the sole purpose of generating paper tax losses for Brunswick, fairness dictates that we ought not affirm on this ground. In particular, in presenting its case in the Tax Court, Brunswick may have acted on the mistaken belief that the Supreme Court’s decision in Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 87 L. Ed. 1499, 63 S. Ct. 1132 (1943), established a two-part test under which Saba and Otrabanda must be respected simply because they engaged in some business activity, an interpretation that ASA squarely rejected ***.

- Query the effect of this opinion on the Boca Investerings case, noted below?

c. Merrill Lynch pays for the contingent installment sale tax shelter.

Did they pay too soon? News Release IR-2001-74 (8/28/01). IRS announced that Merrill Lynch agreed to settle a penalty case the IRS had brought against it under §§ 6700 [promoting abusive tax shelters, etc.], 6701 [aiding and abetting understatement of tax liability], 6707 [failure to furnish information regarding tax shelters by persons subject to the requirement to register a tax shelter under § 6111] and 6708 failure to maintain lists of investors in potentially abusive tax shelters] for the 1989-1990 promotion of the contingent installment sale shelter in ACM Partnership v. Commissioner, 157 F.3d 231 (8th Cir. 1998), cert. denied, 526 U.S. 1017 (1999), and other cases.

d. Same arrangement as earlier failed shelters, different trial court judge – it’s a business deal, not a shelter. Boca Investerings Partnership v. United States, 167 F. Supp. 2d 298, 2001-2 U.S.T.C. §50,690, 88 A.F.T.R.2d 2001-6252 (D. D.C. 10/5/01). American Home Products [now Wyeth] entered into a Merrill Lynch marketed tax shelter virtually identical to those in ACM Partnership v. Commissioner, 157 F.3d 231, 98-2 U.S.T.C. §50,790 (3d Cir. 10/13/98), aff’g T.C. Memo. 1997-115 (3/5/97), cert. denied, 526 U.S. 1017 (1999), ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 2000-1 U.S.T.C. §50,185 (D.C. Cir. 2/1/00), aff’g T.C. Memo. 1998-305 (8/20/98), and Saba Partnership v. Commissioner, T.C. Memo. 1999-359 (10/27/99). The losses from the transaction sheltered the gain on the sale of a corporate subsidiary. Judge Friedman held that a valid partnership existed and that the losses were allowable because he found that the taxpayer had both a business purpose and an objective profit potential in entering into the transaction. He applied the test used by the District of Columbia Circuit in Horn v. Commissioner, 968 F.2d 1229 (D.C. Cir. 1992), [a commodities straddle case], which stated the test as: “To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists.” Judge Friedman found, as matters of fact, that “while potential tax benefits were considered by AHP, it was understood that AHP was not committing to engage in all of the transactions necessary under the Merrill Lynch presentation in order to give rise to a tax loss.” Judge Friedman excluded much of the evidence offered by the IRS, including [under the attorney client privilege] the tax analysis portions of AHP’s in-house lawyer’s planning memorandum, but not the business planning portions of the memorandum, other internal memos, including one that summarized the installment sale shelter and described the timetable for the bank’s exit from the partnership; and the testimony of a former
Merrill Lynch banker who participated in the deal. Judge Friedman did not credit the testimony of the former Merrill Lynch banker because he was both impeachable and impeached.

2. Identified “tax avoidance transactions.”


b. Loan assumption agreement used to claim an inflated basis in assets. Notice 2002-21, 2002-14 I.R.B. 730 (3/18/02). This notice adds to the list of “listed transactions” one where the taxpayer uses a loan assumption agreement to claim an inflated basis in assets acquired from a tax-indifferent party, and thus generate a loss equal to the excess of the stated principal amount of the loan over the fair market value of the acquired assets. The tax-indifferent party borrows money on a long-term basis and uses the proceeds to purchase assets, which serve as collateral for the loan. A portion of the assets are transferred to the taxpayer, who becomes a co-obligor on the loan; the fair market value of the assets transferred equals the present value of the loan’s principal payment at maturity. Taxpayer then disposes of the assets for their fair market value, and claims a loss for federal income tax purposes.

c. Accrual over the term of the notional principal contract of the noncontingent component of the nonperiodic payment to be received at the end of the term is required. Rev. Rul. 2002-30, 2002-21 I.R.B. 971 (5/6/02). When a notional principal contract provides for payment comprised of noncontingent and contingent components, the appropriate method for the inclusion into income or deduction of a the noncontingent component of the nonperiodic payment is over the term of the NPC. Interest must also be accounted for in a manner consistent with Reg. §§ 1.446-3(f)(2) (ii) or (iii), and 1.446-3(g)(4).

- Taxpayer agrees to make quarterly payments to counterparty based on the three-month LIBOR multiplied by a notional principal amount of $100,000,000. In return, at the end of 18 months, the counterparty will pay taxpayer 6 percent per year multiplied by a notional principal amount of $92,000,000 [or, $8,280,000], and, in addition, the counterparty will either pay taxpayer $8 million times the percentage increase in the stock index, or taxpayer will pay the counterparty $8 million times the percentage decrease in the stock index. The ruling holds that, to offset the taxpayer’s deductible principal amount of $92,000,000 [or, $8,280,000], and, in addition, the counterparty will either pay taxpayer $8 million times the percentage decrease in the stock index. In return, the counterparty is required to make a single payment at the end of the term of the NPC that consists of a noncontingent component and a contingent

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component. The noncontingent component, which is relatively large in comparison the contingent component, may be based upon a fixed or floating interest rate; the contingent component may reflect changes in the value of a stock index or currency.

- This transaction may be entered into without any initial cash investment by the taxpayer. The counterparty may lend the money to the taxpayer, who pays it back in installments as purportedly deductible payments. The taxpayer may engage in other transactions, such as interest rate collars, for purposes of limiting risk with respect to the NPC transaction.

- Taxpayer seeks to deduct the ratable daily portion of each periodic payment to which that portion relates, but taxpayer does not accrue income with respect the the nonperiodic payment until the year the payment is received.

- The proper treatment of the payments is as set forth in Rev. Rul. 2002-30, that the nonperiodic payment to be received by the taxpayer at the end of the term of the NPC must be accrued ratably over the term of the NPC.

- Transactions that are the same as, or substantially similar to, the transaction described are identified as “listed transactions” for purposes of Temp. Reg. §§ 1.6011-4T(b)(2) and 301.6011-2T(b)(2).

d. The noncontingent bond method applies to a convertible debt instrument that also provides for one or more contingent cash payments. Rev. Rul. 2002-31, 2002-22 I.R.B. 1023 (5/6/02). The noncontingent bond method described in Reg. § 1.1275-4(b) applies to a debt instrument that is convertible into stock of the issuer and that also provides for one or more contingent cash payments. The comparable yield is to be determined as that yield at which the issuer would issue a fixed rate nonconvertible debt instrument, which is to be used to determine the accruals of interest on the instrument.


3. IRS announces a tax shelter disclosure initiative through 4/23/02 for penalty waivers. Announcement 2002-2, 2002-2 I.R.B. 304 (12/21/01). The initiative would result in waiver of any of the § 6662 accuracy-related penalties if disclosure is made before the earlier of 4/23/02 or the date an issue about the disclosed item is raised during an examination. The disclosure statement must contain, inter alia (1) the material facts of the item; (2) the taxpayer’s tax treatment of the item; (3) the taxable years affected by the item; (5) the names and addresses of the promoters, solicitors, and recommenders of the item and (if known) the parties who advised the promoter, solicitor or recommender; and (6) an agreement to provide [if requested] all transactional documents, internal memoranda, and materials that provide a legal analysis of the item.

- Exceptions for transactions that: (1) did not in fact occur; (2) involved fraudulent concealment of the amount or source of any item of gross income; (3) involved concealment of an interest over a foreign financial account; (4) involved the concealment of a distribution from a transfer of assets to, or that taxpayer was a grantor of a foreign trust; or (5) involved the treatment of personal, household, or living expenses as deductible trade or business expenses.

a. Larry Langdon memorandum, dated 12/20/01, for LMSB personnel provides guidelines for applying the about-to-be-issued Announcement 2002-2, 2001 TNT 247-8 (12/21/01). The IRS will not assert that a disclosure made under the tax shelter initiative constitutes a waiver of the attorney-client privilege.

b. According to a June 11 IRS “Tax Talk Today” webcast, the IRS stated that the tax shelter initiative resulted in 1,633 disclosures from 1,180 taxpayers. The disclosures covered 1,506 tax returns and involved more than $30 billion in claimed losses or deductions. 2002 TNT 113-5.

c. IR-2002-99 (9/16/02). The IRS announced that, as of the end of August 2002, the IRS Office of Tax Shelter Analysis has “recorded 1,664 disclosures from 1,206 taxpayers who disclosed their questionable transactions.”

d. In a 6/27/02 news release, the IRS announced that it has cut a deal with PricewaterhouseCoopers (PwC) to resolve tax shelter registration and list maintenance issues. The IRS news release, which is similar to one issued last August regarding Merrill Lynch, says that without admitting or denying liability, PwC has agreed to make a “substantial payment” to the IRS to resolve issues in connection with advice rendered to clients dating back to 1995. Under the agreement, PwC will provide to the IRS certain client information in response to summonses. It will also work with the IRS to
develop processes to ensure ongoing compliance with the shelter registration and investor list maintenance requirements, according to the release.

e. Warm-up the photocopier for those tax accrual workpapers. Announcement 2002-63, 2002-27 I.R.B. 72 (7/8/02). In auditing returns filed after 7/1/02 that claim any tax benefits from a “listed transaction,” see Notice 2001-51, 2001-34 I.R.B. 190, the IRS may request tax accrual workpapers. Listed transactions will be determined “at the time of the request.” Neither the attorney client privilege nor the § 7525 tax practitioner privilege protects the confidentiality of the workpapers.

f. No third-party identification without Associate Chief Counsel review. Chief Counsel Notice CC-2002-028 (7/22/02). Requirements for review of privilege logs or similar documents that identify third parties, and for coordination of the disclosure of these documents with the Associate Chief Counsel (Procedure & Administration).

4. Fifth Circuit and Eighth Circuit agree that American Depository Receipts (ADR) arbitrage transactions do not lack economic substance.

a. New Rule in the Tax Court: No More Mr. Nice Guy! (Ms. Nice Gal?). Royal Dutch Shell ADRs peddled by an investment banking firm lacked economic substance. Compaq Computer Corp. v. Commissioner. 113 T.C. 214 (9/21/99). Compaq recognized a $232 million long-term capital gain in 1992. Shortly afterwards, an investment firm [Twenty-First Securities Corp.] contacted the Compaq Treasury Department with the suggestion that it take advantage of an ADR arbitrage transaction. (American Depository Receipts are transferable units in a trust that represent ownership of foreign stock.) This involved purchases of $888 million of Royal Dutch Shell ADRs cum dividend, followed by sales of those ADRs ex dividend within the hour for $868 million. Compaq then carried back $20 million of loss against the previously recognized gain. It also claimed a $3.4 million foreign tax credit for taxes withheld from the $22.5 million dividend received. Judge Cohen held that the transaction lacked economic substance because the net cash flow from the transaction without regard to tax consequences was a $1.5 million loss. The foreign tax credit was denied and a negligence penalty was imposed.

b. But the Eighth Circuit looks at different ADR deals peddled by the same investment banker and concludes that they did have economic substance. Was the difference that taxpayer satisfied the new “two-meeting rule,” or was it that taxpayer sought outside advice on securities law and tax law, or was it that foreign withholding taxes did not reduce the amount of dividend income received (so taxpayer had a pre-tax profit)? Risk minimization was seen as “prudence,” as opposed to “sham.” IES Industries v. United States. 253 F.3d 350, 2001-2 U.S.T.C. §50,471, 87 A.F.T.R.2d 2001-2492 (8th Cir. 6/14/01), rev’g 84 A.F.T.R.2d 99-6445, 2001-2 U.S.T.C. §50,470 (N.D. Iowa 9/22/99). Taxpayer purchased the ADRs from tax-exempt organizations, which paid no U.S. taxes, but were subject to foreign withholding on the dividends. The ADR arbitrage transaction created foreign tax credits (as in the Compaq case). On a motion for summary judgment by the government, Judge McManus held that the ADR transactions “did not change IES’s economic position except for the transactions having resulted in the transfer of the claim to the foreign tax credit to IES.” The court also did not permit deduction of taxpayer’s out-of-pocket costs.
The Eighth Circuit reversed, finding a business purpose and distinguishing Compaq. First, the court rejected the government's argument that "the tax benefits that were the sole reason for the transactions, [because] each series of ADR trade pairs resulted, as pre-planned, in an economic loss." It rejected the government's view that "IES purchased only the right to the net dividend— not the gross dividend"—a view which if accepted would result in IES realizing an economic benefit only if it received the foreign tax credit. Rather, the court concluded that the profitability of the transaction should be analyzed by considering the gross income realized by IES, not the cash flow. It concluded that "the economic benefit to IES was the amount of the gross dividend, before the foreign taxes were paid. ... The fact that the taxes were withheld, and then paid, by the foreign corporation that issued the stock represented by the ADRs, so that IES received only 85% of the dividend in cash, is of no consequence to IES's liability for the tax. ... Because the entire amount of the ADR dividends was income to IES, the ADR transactions resulted in a profit, an economic benefit to IES."

Second, the Eighth Circuit concluded that the proper inquiry when applying the business purpose test is "whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved." The court described the business purpose test as "a subjective economic substance test," and invoked Gregory [293 U.S. 465, 469 (1935)] for the proposition that "the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted," concluding that a "taxpayer's subjective intent to avoid taxes thus will not by itself determine whether there was a business purpose to a transaction."

The court rejected the government's argument that the transactions were shams because there was no risk of loss, focusing on the legal, as opposed to economic, risk of nonpayment of the dividends, and distinguishing Compaq by stating: "The risk may have been minimal, but that was in part because IES did its homework before engaging in the transactions. Company officials met twice with Twenty-First representatives and studied the materials provided. After that, IES consulted its outside accountants and its securities counsel for reassurances about the legality of the transactions and their tax consequences." The court noted that IES did its own investigation and rejected some of the ADR trades that Twenty-First proposed. That IES structured the transactions [e.g., making some trades when the U.S. markets were closed, in order to avoid the risk of fluctuations in market price of the ADRs between the purchase and sale and to prevent a third party from attempting to break up the trades] to avoid "any more risk than necessary," was characterized as "good business judgment consistent with a subjective intent to treat the ADR trades as money-making transactions." The court was "not prepared to say that a transaction should be tagged a sham for tax purposes merely because it does not involve excessive risk." Finally, the court emphasized that all of the parties involved were unrelated to IES and engaged in "legitimate business, and the transactions were at arms' length."

In a footnote, the court noted that in 1997, Congress amended § 901(k) to increase to at least sixteen days the amount of time an ADR must be held within a thirty-day period that includes the dividend record date in order for the foreign taxes paid on the dividend to qualify for the foreign tax credit. But it attached no importance to that change either way.

Lease-strip transaction by pseudo-black box intermediary fails in the Tax Court. Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (12/28/01). The taxpayer corporation's stock was sold to an intermediary [which then merged downstream], following which its assets were sold to the prearranged ultimate purchaser. To offset the gains realized on the asset sale, the taxpayer acquired by a § 351 transaction interests in certain equipment leaseback transactions [secured by trusts that resulted in a circular cash flow] that had no foreseeable value, which it immediately transferred to a Dutch bank, the sole consideration for which was assumption of taxpayer's obligations [of which there were in reality none]. Taxpayer claimed a $22 million ordinary business expense deduction as a result of the transfer of the leaseback interests. The deduction was denied because the transactions lacked business purpose and...
economic substance under "any version" of the tests. Judge Swift held that the transaction lacked business purpose and economic substance even as measured against the Eleventh Circuit's broad articulation of the test in *UPS* that "a transaction has a 'business purpose' when we are talking about a going concern . . . , as long as it figures in a bona fide, profit-seeking business."


Norwest, through its equipment leasing subsidiary, engaged in a complex [seven PowerPoint slides worth] purchase and leaseback tax shelter transaction involving 40 IBM mainframe computers already under lease to end-users. The promoter [Comdisco] sold the computers for cash and notes to an LCC owned by two nonresident aliens, which leased them back to the promoter, who retained all responsibilities to the end-users; the LLC sold the stream of rental payment to be received for net present value, thereby accelerating income realization, and applied the proceeds to the balance due on the note. Less than three months later, one of the nonresident aliens [indirectly] transferred his 2 percent LLC interest to a trust established by promoter, and Norwest, thorough a subsidiary, acquired the remaining 98 percent interest in the LLC [thereby closing the taxable year in which the income had been realized] for an amount roughly equal to one half of one percent of the approximately $122 million basis of the computers. Norwest subsequently reported its distributive share of depreciation deductions, but was allocated no income. After three years, the computers were reconveyed to the promoter, pursuant to an "early termination option," which the court found the "economics of the transaction . . . mandate[d]," and the LLC was liquidated.

- Judge Jacobs struck down the shelter. He concluded that neither the original LLC, with the foreign partners, nor the subsequent LLC of which Norwest's subsidiary was a member, was a valid partnership to be recognized for Federal tax purposes; in neither case did the purported partners intend to join together as partners for the purpose of carrying on a business, i.e., they did not join together to share in the profits or losses from an equipment leasing activity. Alternatively, Judge Jacobs would have disregarded the participation of the foreign LLC members in the transactions under the step transaction doctrine [applying either the end result or mutual interdependence test]. Furthermore, the LLC's sale-leaseback transaction with the promoter was a sham because it (1) was not a true multiple-party transaction, (2) lacked economic substance, (3) was not compelled or encouraged by business realities, and (4) was shaped solely by tax-avoidance features. As far as Norwest and its subsidiary were concerned, the transaction was not respected because it lacked both business purpose and economic substance. The LLC, and Norwest's subsidiary, had no reasonable possibility of making an economic profit, but the tax benefits were more than sufficient to cover any potential losses. Norwest subsidiary never acquired the benefits and burdens of ownership of the depreciable equipment, and thus was not entitled to depreciation deductions. In addition, the LLC's debts were not *bona fide* and no interest deductions were allowable.

- Finally, Judge Jacobs concluded by looking back to early Supreme Court jurisprudence:

In *Higgins v. Smith*, 308 U.S. [473] at 476-477 [1940], the Supreme Court stated:

> There is no illusion about the payment of a tax exaction. Each tax, according to a legislative plan, raises funds to carry on government. The purpose here is to tax earnings and profits less expenses and losses. If one or the other factor in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire tax-paying group. * * *

The sale-leaseback transaction was designed by Comdisco to create just such a distortion.

It is axiomatic that taxpayers may structure transactions to take advantage of tax benefits. But "After a certain point, * * *, the transaction ceases to have any economic substance and becomes no more than a sale of tax profits." *Hines v. United States* 912 F.2d 736, 741 (4th Cir.1990). Here, the evidence in the record clearly indicates that the investment
scheme devised and orchestrated by Comdisco "reached the point where the tax tail began to wag the dog." Id.

7. A tax shelter that doesn't work in the Tax Court. The Limited, Inc. v. Commissioner, 113 T.C. No. 13 (9/7/99). This one involved the exclusion from the income of a foreign corporation of the amount of a related bank’s certificates of deposits. Judge Halpem held that the CDs were §956 assets and were not excludible as “deposits with [a] person carrying on the banking business.”

a. Does work in the Sixth Circuit: Another taxpayer victory on appeal. The Limited, Inc. v. Commissioner, 286 F.3d 324, 2002-1 U.S.T.C. ¶50,353, 89 A.F.T.R.2d 2002-1924 (6th Cir. 4/11/02). CDs purchased by a foreign subsidiary of taxpayer from a taxpayer subsidiary in the banking business were not investments in U.S. property for purposes of § 956, but were “deposits with persons carrying on the banking business.” There is no related party prohibition in the portion of § 956 applicable to this transaction.

8. Third Circuit comes down hard on COLI, with lots of language the government will love. Internal Revenue Service v. CM Holdings Inc. (In re CM Holdings Inc.), 301 F.3d 96, 90 A.F.T.R.2d 2002-5850, 2002-2 U.S.T.C. ¶50,596 (3d Cir. 8/16/02), aff’g 254 B.R. 578, 2000-2 U.S.T.C. ¶50,791, 86 A.F.T.R.2d 6470 (D. Del. 10/16/00). In CMI’s bankruptcy, the IRS filed proofs of claim for taxes based on the disallowance of interest deductions that CMI claimed for its COLI plan (involving policies on 1400 employees).

- The district court held no interest deduction was allowable under §163(a) because the entire transaction was a “sham in substance” that lacked subjective business purpose. Apart from tax savings from the interest deduction, CMI could not reasonably expect a positive cash flow from the COLI plan in any year and could not expect to benefit from the inside cash value build-up [which continuously remained at zero throughout the plan] or profit from the death benefits on covered employees. Interest deductions were disallowed and §6662 substantial understatement penalties were imposed because the transaction lacked economic substance. The transaction was entered into without a reasonable expectation of profit – in the absence of the interest deductions – over the life of the 40-year transaction from either the inside build-up or mortality components of the plan.

- The Third Circuit Court of Appeals (Judge Ambro) affirmed on the ground that the “COLI policies lacked economic substance and therefore were economic shams.” [The court did not reach the issue of whether the transactions were factual shams.] The court dismissed out of hand the need to examine the “intersection of ... statutory details.”

[P]ursuant to Gregory v. Helvering, 293 U.S. 465 (1935), and Knetsch v. United States, 364 U.S. 361 (1960), courts have looked beyond taxpayers’ formal compliance with the Code and analyzed the fundamental substance of transactions. Economic substance is a prerequisite to the application of any Code provision allowing deductions. ... It is the Government’s trump card; even if a transaction complies precisely with all requirements for obtaining a deduction, if it lacks economic substance it “simply is not recognized for federal taxation purposes, for better or for worse.”

In holding for the government, the court rejected the taxpayer’s argument that [based on Gregory, Knetsch, ACM Partnership and other cases] the application of the application of the economic shams doctrine properly hinges on the “fleeting and inconsequential” nature of the transaction under scrutiny. Rather, the court concluded that “Duration alone cannot sanctify a transaction that lacks economic substance. The appropriate examination is of the net financial effect to the taxpayer, be it short or long term. The point of our analysis in ACM Partnership is that the transactions ‘offset one another with no net effect on ACM’s financial position.’” In any event, the court found the COLI transactions bore “striking similarities” to Knetsch. The court further rejected the argument that for analytical purposes the pre-tax profit should have been “grossed-up” by the anticipated tax benefits because,

[the point of the analysis is to remove from consideration the challenged tax deduction, and evaluate the transaction on its merits, to see if it makes sense economically or is mere tax arbitrage. Courts use “pre-tax” as shorthand for this, but they do not imply that the court must imagine a world without taxes, and evaluate the transaction accordingly. Instead they focus on the abuse of the deductions claimed: “[w]here a transaction has no substance other than to create deductions, the transaction is disregarded for tax
purposes.” [citation omitted] Choosing a tax-favored investment vehicle is fine, but engaging in an empty transaction that shuffles payments for the sole purpose of generating a deduction is not.

- Finally, the court rejected the taxpayer’s argument that because “the transaction had objective non-tax economic effects ... the Court must not look further,” and that the district court improperly applied a subjective analysis. Rather, the Court of Appeals read Gregory to permit an inquiry into motive. “If Congress intends to encourage an activity, and to use taxpayers’ desire to avoid taxes as a means to do it, then a subjective motive of tax avoidance is permissible. But to engage in an activity solely for the purpose of avoiding taxes where that is not the statute’s goal is to conduct a sham transaction.” Because the court found that nothing in statute to indicate that Congress intended to encourage leveraged COLI investments, the inquiry into motive was proper. In this regard, it was significant that “the plan was marketed as a tax-driven investment.” Because the COLI “plan had no net effect on Camelot’s economic position, ... it fails the objective prong of the economic sham analysis.” Because there was no “legitimate business purpose behind the plan, ... it fails the subjective prong as well.” Penalties were also upheld.

B. Individual Tax Shelters

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

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

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

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Intermediate sanctions regulations are out; break out the supply of 1099s. REG-246256-96; T.D. 8920, proposed and temporary regulations under § 4958, which permits the IRS to impose excise taxes against disqualified persons who participate in excess benefit transactions with section 501(c)(3) and 501(c)(4) organizations (66 F.R. 2144 & 2173, 1/10/01). These rules reflect the spirit under which § 4958 was enacted, which was to tax “excess” benefits provided by charities to insiders (including board members); these “excess” benefits also include benefits provided to insiders that are not reported as compensation.

a. Regulations made final. The Treasury has promulgated final regulations relating to the excise taxes on excess benefit transactions under § 4958. T.D. 8978, 67 F.R. 3076 (1/23/02).

2. Notice 2001-78, 2001-50 I.R.B. 576 (12/10/01). Provides interim guidance to charities regarding payments made by reason of the death, injury or wounding of an individual incurred as a result of the September 11, 2001 terrorist attacks. The Service will treat such payments made by a charity to individuals and their families as related to the charity’s exempt purpose provided that the payments are made in good faith using objective standards. The notice is effective until the earlier of final legislation or 12/31/02.

a. The Victims of Terrorism Tax Relief Act clarifies that payments made by charities are for an exempt purpose even if made without demonstration of financial need if made in good faith under an objective formula consistently applied.

3. Joint venture did not result in loss of tax exemption for charity hospital despite its failure to meet the criteria of Revenue Ruling 98-15. St. David’s Health Care System v. United States, 2002-1 U.S.T.C. ¶50,452 (W.D. Tex. 6/7/02). Summary judgment granted to community-
owned, not-for-profit hospital on its tax exempt status. The hospital’s entering into a limited partnership with HCA, Inc. [a for-profit health care company], in which it had general and limited partnership interests of 45.9 percent and in which the for-profit partner was the managing partner, did not result in forfeiture of hospital’s § 501(c)(3) exemption. The court held that the community benefit standard did not absolutely require a community board, and that St. David’s satisfied this standard even though it appointed only half the board members where the chairman’s seat was reserved for a St. David’s appointee. There was language in the partnership agreement requiring all the partnership’s hospitals to operate in accordance with the community benefit standard outlined in Rev. Rul. 69-45, 1969-2 C.B. 117, and St. David’s can unilaterally dissolve the partnership if they fail to do so.

- Query whether Rev. Rul. 98-15, 1998-1 C.B. 718, which provides an example of an acceptable joint venture in which the nonprofit partner has numerical control of the board, will still be considered valid. See also, Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999), aff’d per curiam, 242 F.3d 904, 2001-1 U.S.T.C. ¶50,271, 87 AFTR2d ¶2001-642 (9th Cir. 2001).

**B. Charitable Giving**

1. **Is the cost of religious instruction in day schools deductible?** Field Service Advice 2000-1 (7/11/97). Tuition payments to Jewish day schools were not deductible as charitable contributions to the extent [55 percent] that their children’s education consisted of religious instruction. The Service followed Hernandez v. Commissioner, 490 U.S. 680 (1989) (substantial benefit received in return for payments), and no mention was made of the 1993 Church of Scientology settlement nor of §170(f)(8). In the 1993 closing agreement the IRS agreed “not to contest the deductibility of Church of Scientology fixed donations in connection with qualified religious services.”

   a. **Taxpayers should have sued IRS officials like the Scientologists did.** Sklar v. Commissioner, T.C. Memo. 2000-118 (4/5/00). The court, in an opinion by Special Trial Judge Nameoff, relied on Hernandez and found that the Church of Scientology settlement was irrelevant because the “auditing” involved there was “not identical [to the general, including religious, education involved in the case at hand] in their organization, structure or purpose.”

   b. **Affirmed, 279 F.3d 697, 2002-1 U.S.T.C. ¶50,210 (9th Cir. 1/29/02), withdrawn and reissued as amended, 882 F.3d 610, 89 A.F.T.R.2d 2002-808 (2/27/02).** The Ninth Circuit affirmed the Tax Court in an opinion by Judge Reinhardt, with a concurrence by Judge Silverman. The majority opinion explored the apparent conflict between the Hernandez case and the settlement with the Church of Scientology and concluded that (1) the IRS improperly refused to disclose the terms of its Scientology closing agreement, (2) the closing agreement unconstitutionally discriminates among religions, but that (3) the Sklars are not entitled to relief because there was no “administrative inconsistency” in the treatment of their tuition payments and the payments to the Church of Scientology because taxpayers failed to show that their payments for tuition were “dual payments” in that they exceeded the tuition charged by other private schools, citing United States v. American Bar Endowment, 477 U.S. 105 (1986).

   * Judge Silverman’s concurrence was based upon the conclusion that the proper course of action is a lawsuit to stop the preferential policy towards the Church of Scientology, “not to require the IRS to let others claim the improper deduction, too.”

2. **Price guesstimates aren’t market quotations.** Todd v. Commissioner, 118 T.C. No. 19 (4/19/02). The fair market value, rather than the basis, is the deduction for a contribution of appreciated stock to a private foundation under § 170(c)(5) only if actual market quotations are readily available. Judge Halpern held that an estimate of price by the broker who executed trades in the stock, which sporadically traded over the counter, but for which market quotations were not readily available, did not qualify as a market quotation. The stock did not meet the standard for market quotations under Reg. § 1.170A-13(c)(xi)(A), and the deduction was limited to the taxpayer’s basis in the stock.

3. **The high cost of knowingly inaccurate substantiation of claimed charitable contributions.** Addis v. Commissioner, 118 T.C. No. 32 (6/10/02). The taxpayers entered into a charitable split-dollar life insurance scheme with the National Heritage Foundation, a § 501(c)(3) organization [prior to the enactment of § 170(f)(10), which would impose a 100 percent excise tax on charitable split-dollar life insurance payments]. The Addises paid approximately $36,000 to NHF in each of 1997 and 1998 and claimed charitable contribution deductions for the payments. NHF used the amounts as premiums on a charitable split-dollar life insurance policy on Mrs. Addis’ life. NHF was entitled to 56 percent of the death benefit and the taxpayers’ family trust was entitled to the remainder. NHF was not required to pay the premiums, but the Addises reasonably expected it to do so. NHF provided the taxpayers with receipts for their payments which stated that NHF did not provide any goods
or services to them in return for the payments. Taxpayers claimed charitable contribution deductions for the entire amount of their payments to NHF. Judge Colvin upheld the Commissioner’s disallowance of any charitable contribution deduction. The taxpayers did not meet the substantiation requirements of § 170(f)(8) and Reg. § 1.170A-13(b)(7) because NHF failed to make a good faith estimate of the value of the benefits provided to the taxpayers through their family trust’s share of the death benefits. Reg. §§ 1.170-1(h)(4)(ii) and 1.170-13(f)(6) were interpreted to deny completely a charitable contribution deduction under the circumstances.

X. TAX PROCEDURE

A. Penalties and Prosecutions

1. Eight commonly used tax scams. IR-2001-19 (2/12/01). The Service warns taxpayers not to fall victim to eight commonly used tax scams. They include (1) No taxes being withheld from your wages; (2) “I don’t pay taxes”; (3) African-Americans get a special tax refund; (4) “Pay the tax, then get the prize”; (5) “Untax yourself for $49.95”; (6) Social Security tax scheme; (7) “I can get you a big refund . . . for a fee!”, and (8) IRS “Agent” comes to your house to collect. To drop a dime, call 1-800-829-0433, except for #1 (1-800-829-1040) and #8 (1-800-366-4484).

a. Now there are a “Dirty Dozen.” IR-2002-12 (1/31/02) The common tax schemes include (1) no taxes being withheld from wages; (2) the concept that “I don’t pay taxes—why should you?”; (3) an African American special tax refund; (4) paying the tax and getting a prize; (5) untaxing yourself for $49.95; (6) a social security scheme; (7) the concept that “I can get you a big refund for a fee”; (8) sharing/borrowing earned income tax credit dependents; (9) the concept of “Put Your Money in a Trust And Never Pay Taxes Again”; (10) improper home-based business; (11) a disabled access credit for pay phones; and (12) an IRS agent coming to your house to collect your taxes.

2. Plead it’s wrong or be ready to pay. Swain v. Commissioner, 118 T.C. No. 22 (5/3/02). Section 7491(c) provides that the Commissioner bears the burden of production with respect to penalties in all cases. The taxpayer, in her petition to the Tax Court, failed to assign error to the Commissioner’s determination that § 6662 accuracy related penalties were due. Judge Halpern held that pursuant to Tax Court Rule 34(b)(4), the taxpayer conceded the penalties issue, and that notwithstanding § 7491(c), the Commissioner was not required to produce any evidence that the penalty was appropriate. The penalty was upheld.

3. These guys better hope that the UMWA rank and file doesn’t read tax advance sheets. Lyon v. United States, 2002-2 U.S.T.C. §50511, 90 A.F.T.R.2d 2002-5069 (W.D. Va. 6/4/02). The president and sole shareholder of corporation was not a responsible party for purposes of the § 6672 penalty because he was merely a “front-man,” holding title to stock on behalf of and taking orders from the true parties in interest who owned and managed the unionized corporation anonymously to evade union contract limitations [because they owned and managed other nonunionized companies].

4. DeGuerin v. United States, 2002-2 U.S.T.C. §50, (S.D. Tex. 8/5/02). Summary judgment denied to both parties in this action relating to penalties under § 6721(e), which provides for enhanced penalties of between $25,000 and $100,000 for intentional disregard of the obligation to include the names of the payors of cash exceeding $10,000 on Forms 8300 pursuant to the requirements of § 60501 and the regulations thereunder. Plaintiff attorneys contended that the names of the payors on Forms 8300 filed during the year were privileged under the attorney-client privilege. Judge Lake held that if that were so, penalties would not be imposed. Plaintiffs are to be given the opportunity at trial to demonstrate factually that the names of the payors were privileged.

B. Discovery: Summonses and FOIA

1. Seawright v. Commissioner, 117 T.C. 294 (12/18/01). Judge Thornton held that § 7602(c), which generally requires the IRS to notify the taxpayer before contacting a third person in connection with examinations and collections, does not apply to contacts by IRS trial counsel with potential witnesses in the course of litigation. This result is consistent with Prop. Reg. § 301.7602-2(f)(7).

2. Hambarian v. Commissioner, 118 T.C. No. 35 (5/13/02). In the course of a state criminal proceeding arising from the same transactions that gave rise to the Tax Court deficiency proceeding, the taxpayer’s criminal defense lawyer selected 100,000 pages of documents from a much larger amount in the possession of the prosecuting attorney and converted the documents into computer searchable media. In the Tax Court proceeding, the IRS sought production of the documents and computer searchable media, but the taxpayer resisted on the grounds that the criminal defense lawyer’s selection of the particular documents reflected his mental impressions and was therefore protected work.
product. Judge Gerber held that since over 100,000 pages of otherwise discoverable documents were involved, it was highly unlikely that attorney's mental impressions would be discernable and the mere selection of particular documents by the taxpayer's lawyer did not automatically transmute the documents into work product. Because the taxpayer failed to otherwise demonstrate how disclosure of the selected documents would reveal the defense attorney's mental impressions of the case, the requested documents and computerized electronic media were not protected by the work product doctrine.

3. The "I relied on advice of counsel, but I won't let him tell you what we discussed" defense to tax fraud doesn't cut it. Johnson v. Commissioner, 119 T.C. No. 3 (8/8/02). In a deficiency proceeding in which the Commissioner sought to enforce assessment of civil tax fraud penalties, the taxpayer asserted the affirmative defense of reliance on "qualified experts" in preparing the tax returns in question. The Commissioner moved for an order in advance of trial denying the taxpayer the right to assert attorney-client privilege to prevent his former attorney from testifying about or producing notes made by the lawyer regarding a particular meeting between the taxpayer and another person regarding the transactions giving rise to the asserted deficiency and penalties. The Commissioner argued that the taxpayer had waived the privilege by claiming reliance on counsel's advice to avoid the penalties. The Tax Court (Judge Nims) first held that the question of whether attorney client privilege had been waived was one of federal law, not state law. Next, the court held that there was a three part test for finding an implied waiver: "(1) assertion of the privilege was a result of some affirmative act, such as filing suit, by the asserting party; (2) through this affirmative act, the asserting party put the protected information at issue by making it relevant to the case; and (3) application of the privilege would have denied the opposing party access to information vital to his defense." With respect to the first prong, on the various pleadings the court rejected the taxpayer's argument that his defense of reliance on "qualified experts" referred to an accountant, not his lawyer; and the court found that the affirmative defense referred to his former lawyer, who had provided him tax advice during the years in question. The second prong of the test was easily satisfied: "to the extent that ...[the taxpayer] claims that its tax position is reasonable because it was based on advice of counsel, ... [the taxpayer] puts at issue the tax advice it received." Finally, because the Commissioner bears the burden of proving fraud (§ 7454(a)), the third prong was met: "To 'defend' against this defense [of reliance on counsel], respondent must show that such reliance either was unreasonable or did not in fact occur. Respondent can do so only through knowledge of what tax advice Mr. Johnston received, and such would include communications from [his lawyer]." Having invoked reliance on experts, the taxpayer could not selectively withhold communications from particular experts who provided tax advice, while allowing disclosure of communications from other experts.

C. Litigation Costs

1. How not to represent a client. Carpentier v. Commissioner, T.C. Memo. 2002-43 (2/12/02). Judge Gerber imposed a $15,000 penalty on the taxpayer who was represented by counsel under § 9973(a) for a 5-year delay marked by "incorrigible" "spurious attacks on the authority and/or integrity" of IRS counsel and Tax Court judges and failure to comply with requests for stipulations.

2. The high price of zealous foot-dragging in representing a client. Johnson v. Commissioner, 289 F.3d 452, 89 A.F.T.R.2d 2002-2338, 2002-1 U.S.T.C. ¶50,402 (7th Cir. 5/3/02), aff'g 116 T.C. 111 (2/27/01). In a case involving defense of a sham trust arrangement, the Tax Court (Judge Cohen) imposed sanctions and costs under § 6673 in the amount of $8,587.50 of IRS counsel expenses [at $150 per hour] and $807.06 of expenses against taxpayer's counsel [Joe Alfred Izen, Jr.]. Izen was described, with citations to prior cases, as "having a long history of involvement with sham trusts" for multiplying the proceedings "unreasonably and vexatiously" by "pursu[ing] claims that have been rejected so frequently that they are 'entirely without colorable pretext or basis and are taken for reasons of harassment or delay or for other improper purposes'" and by "chronic failure to comply with discovery orders."

- The Court of Appeals for the Seventh Circuit (Judge Posner) upheld the imposition of the government's costs on Izen. Judge Posner found that for costs to be imposed on the taxpayer's attorney under §6673, the attorney must have acted in "bad faith," and that "reckless" or 'extremely negligent' conduct satisfies that standard. "Izen's repeated flouting of discovery orders even after being threatened with sanctions and promising to comply established his bad faith all by itself." The Tax Court properly took into account Izen's behavior in prior cases. "[D]rugged good faith persistence in bad conduct becomes sanctionable once an attorney learns or should have learned that it is sanctionable."

D. Statutory Notice
partnership and not merely the gross income of the upper tier partnership.

Outside date for filing a petition. Judges Foley and Colvin would have found that the deficiency notice was valid, but that there was no consequence of noncompliance with § 6213(a) [providing that a petition filed by the date indicated on the deficiency notice as the last date is timely] does not result in unlimited time to file a petition if no due date is specified. The taxpayer was not confused, misled, or prejudiced by the notice or the absence of a specified petition filing date.

- Judge Chabot (joined by Gale and Marvel) dissented, basically on the grounds that “shall” means “shall” and “each” means “each” and that failure to do what the IRS is directed to do must have consequences, specifically, rendering the deficiency notice invalid. Judge Swift would have found the notice valid but would have allowed a “reasonable extension” of time to file as the consequence of noncompliance with § 3463(a) of the 1998 Act and would have found the petition timely. Judges Foley and Colvin would have found that the deficiency notice was valid, but that there was no outside date for filing a petition.

a. Affirmed by the usually taxpayer-friendly Fifth Circuit. 293 F.3d 740, 89 A.F.T.R.2d 2002-2787, 2002-1 U.S.T.C. §50,447 (5th Cir. 6/4/02). The Fifth Circuit affirmed the Tax Court in a one paragraph per curiam opinion endorsing Judge Vasquez’s majority opinion. The panel obviously did not find the issue as controversial as did the Tax Court.

E. Statute of Limitations

1. Just where on the return do you find “gross income”? Harlan v. Commissioner, 116 T.C. 31 (1/17/01). This case involved the calculation of gross income for purposes of determining whether the six-year statute of limitations in § 6501(e)(1)(A) applied. The Tax Court (Judge Chabot), in a matter of first impression, held that pursuant to § 702(c) the gross income of a partner in a partnership (the upper tier partnership) that holds an interest in another partnership (the lower tier partnership) includes the upper tier partnership’s distributive share of the gross income of the lower tier partnership and not merely the gross income of the upper tier partnership.

a. CC-2002-03 (3/14/02). Acquiescence in Harlan.

2. Robinson v. Commissioner, 117 T.C. 308 (12/19/01). Under § 6501(a), the period of limitations for assessing tax attributable to a constructive dividend is determined with respect to the shareholder’s return, not with respect to the corporation’s return.

3. A “not so simple” application of the refund statute of limitations. Wertz v. United States, 51 Fed. Cl. 443, 2002-1 U.S.T.C. §50,192, 89 A.F.T.R.2d 2002-491 (1/9/02). The taxpayer failed to file a tax return, but filed an informal refund claim [for withheld taxes] more than two years after the return’s due date but less than three years after the due date; he filed a tax return claiming the refund more than three years after the due date. The court held that the claim was untimely under § 6511. The late-filed tax return did not relate back in time to the date of an untimely informal claim, so as to permit the three year look back rule of § 6511(b)(2)(A) to permit a refund otherwise barred by the two year look-back rule of § 6511(a).

4. Maybe the IRS should have accepted the check for taxes and let the interest and penalty go. Hoffman v. Commissioner, 119 T.C. No. 7 (9/24/02). The taxpayers were partners in two partnerships in which they did not materially participate. They filed a timely return for 1990 based on information returns from the partnerships. In 1998, after the three year statute of limitations had expired, and two days before the six year statute of limitations expired, they filed an amended return reporting additional income for which the partnership and paid the additional tax. The Commissioner proceeded to assess penalties and interest in addition to the tax. In a § 6330 due process hearing, the taxpayers raised the statute of limitations as a bar on lien and levy, and sought a refund of the tax paid, but the Commissioner determined that the six-year statute of limitations applied. The Tax Court (Judge Laro) applied the special definition of gross income of a trade or business in § 6501(e)(1)(A)(i), which provides that for a trade or business “gross income” includes the total of the amounts received or accrued from the sale of goods or services before diminution by the cost of those sales or services. Judge Laro saw no reason to limit the previously established application of this principle to partnerships to cases in which the partners had materially participated. Thus, because the Commissioner failed to introduce any evidence regarding the partnerships’ gross income, the “gross income stated in the return” was
determined by reference to the partnerships' information returns, and the six-year period of limitations was inapplicable. The assessment was untimely.

5. **Even the government said the taxpayer was right.** Omohundro v. United States, 300 F.3d 1065, 90 A.F.T.R.2d 2002-5860, 2002-2 U.S.T.C. ¶ 50,590 (9th Cir. 8/19/02). The Ninth Circuit followed Rev. Rul. 76-511, 1976-2 C.B. 428, holding that under § 6511(a) a refund claim is timely if it is filed within three years from the date the income tax return is filed, regardless of when the return is filed, and overruled its prior decision to the contrary in Miller v. United States, 38 F.3d 473 (9th Cir. 1974). [Note, however, that the amount of the refund continues to be limited by the three-year look-back rule in § 6511(b)(2).]

F. **Liens and Collections**

1. **Foreign postmarks now determine date of filing.** Rev. Rul. 2002-23, 2002-18 IRB 811 (5/6/02). The Service will accept as timely filed any document required or permitted to be filed with the Service, based upon a timely mailing as evidenced by an official postmark in a foreign country, as well as by timely delivery to a designated international delivery service.

   a. **But, too late for Mr. Sarrell.** Sarrell v. Commissioner, 117 T.C. No. 11 (9/25/01). Neither the timely mailed/timely filed rule of § 7502(a) that generally applies to Tax Court petitions nor the extended filing period under § 6213(a) for petitions from taxpayers receiving a notice addressed outside the United States applies to petitions under § 6330(d). The petition was dismissed for lack of jurisdiction.

   - The Tax Court opinion stated that "section 7502(b) provides that the rule 'shall apply in the case of postmarks not made by the United States Postal Service only if and to the extent provided by regulations prescribed by the Secretary.' It is well settled that the timely mailing/timely filing rule of section 7502(a) does not apply to foreign postmarks. See Pekar v. Commissioner, 113 T.C. 158, 168 (1999), and cases cited therein; see also sec. 301.7502-1(c)(1)(ii), Proced. & Admin. Regs., stating: 'Section 7502 does not apply to any document which is deposited with the mail service of any other country.'"

2. **When a “hearing” isn’t a hearing, but just a letter from the IRS.**
   a. **Lunsford v. Commissioner.** 117 T.C. 159 (11/30/01) (reviewed, 8-3-5). In deciding the validity of a notice of determination for purposes of ascertaining whether the Tax Court has jurisdiction to review the IRS determination in a § 6330 [due process before levy] proceeding, Judge Ruwe held that the court will not look behind the face of the notice of determination to inquire as to whether the taxpayer was afforded a proper hearing. **Meyer v. Commissioner,** 115 TC 417 (2000), is overruled to the extent it is to the contrary.

   b. **Lunsford v. Commissioner.** 117 TC 183 (11/30/01) (reviewed, 7-2-7). A notice of determination to levy under § 6330 can be valid even though the taxpayer was not afforded a face-to-face hearing but instead was provided a documentary response by mail to his inquiry regarding the propriety of the levy. The taxpayer questioned whether there was a valid summary record of assessment and the Appeals officer responded by sending the taxpayer a Form 4340, Certificate of Assessments and Payments. The majority noted that other cases might arise where the nature of the question requires an actual hearing. Seven dissenting judges would have required an actual hearing as a prerequisite to upholding the notice of determination.

   c. **Johnson v. Commissioner.** 117 T.C. 204 (11/30/01) (reviewed, 9-7).

   Section 6330(d) does not confer on the Tax Court jurisdiction to review an Appeals decision not to stay a levy pursuant to an assessed § 6702 frivolous return penalty. Section 6330(d) does not expand the Tax Court’s jurisdiction to types of taxes over which the Tax Court does not ordinarily have jurisdiction. Van Es v. Commissioner, 115 T.C. 324 (10/13/00), followed. If subject matter jurisdiction is lacking, the Tax Court will no longer look behind a the face of the notice of determination to inquire as to whether the taxpayer was afforded a proper hearing as required by § 6330(b). **Meyer v. Commissioner,** 115 TC 417 (2000), is overruled to the extent it is to the contrary. Commissioner’s motion to dismiss granted.

3. **Aguire v. Commissioner.** 117 T.C. 324 (12/28/01). A taxpayer who consents to immediate assessment [by signing Form 4589, Income Tax Examination Changes] has waived the right to a § 6330 per-levy administrative hearing. That the Form 4589 was executed prior to the effective date of § 6330 is not relevant.

4. **More due process.** Downing v. Commissioner, 118 T.C. No. 2 (1/7/02). The Tax Court has jurisdiction under § 6330(d) to review the Commissioner’s determination to levy to satisfy an addition to tax under § 6651(a)(2) for failure to pay the tax shown as due on the return. Making an inadequate offer in compromise along with the tax return was not reasonable cause for failure to pay.
5. T.D. 8979 & 8980, final regulations on the right to a collection due process hearing following lien filing under §6320 and on the right to a similar hearing before levy under §6330, 67 F.R. 2558 & 2549 (1/18/02).

6. Have due process hearings become the playground of frivolity? Nestor v. Commissioner, 118 T.C. No. 10 (2/19/02) (8-6-2). Judge Colvin, writing for the majority, held the taxpayer [who was described in a concurring opinion as a "flagrant tax protestor"] was not improperly precluded from challenging his underlying tax liability — on the grounds that the deficiency notices he received were invalid because they were not prepared or issued by the Secretary and because the Director of the Service Center who prepared and issued them did not give petitioner a copy of the delegation order — in a §6330 hearing. Section 6330(c)(2)(B) barred the taxpayer from contesting liability at the hearing because he [concededly] received the deficiency notices. The court further held that §6203 (second sentence), which requires that a copy of the record of assessment be delivered upon demand, did not entitle the taxpayer to receive or be shown all of the documentation relating to the assessment at the hearing, and the taxpayer was not prejudiced by the fact that he received a copy of the Forms 4330 after the §6330 hearing. The taxpayer's other arguments were "frivolous."

- Judge Swift's concurring opinion noted that the majority opinion should not be construed to permit the Commissioner to withhold computerized transcripts of account or Forms 4340. In response to Judge Foley's dissent (infra), he would have held that "tax protester issues[] need not be considered by Appeals officers in collection hearings under section 6330(b) and that tax protestor issues may and should be summarily dismissed by the courts."

- Judge Halpem's concurring opinion focused on the "rule of prejudicial error" — that in reviewing administrative action the court should disregard procedural errors, even statutorily required prerequisites, unless the complaining party was prejudiced by the error. Any errors of the Appeals Officer in the conduct of the hearing were harmless error.

- Judge Beghe's concurrence stated that it should be standard practice for the Appeals Officer to provide the taxpayer a Form 4340 at or before the due process hearing, but in this case the failure was harmless error.

- Judge Laro (joined by Judges Vasquez and Gale) concurred in the result, but was of the opinion that §6330(c)(1) requires the Appeals Officer to verify that all statutory, regulatory, and administrative requirements for assessment and collection have been met, and that providing a Form 4330 is not always alone sufficient, although on the facts of this case it was.

- Judge Foley's dissenting opinion concluded that the failure to have a record of assessment at the hearing or to provide the taxpayer with a Form 4330 at the hearing constituted a failure to comply with the requirement of §6330(c)(1) that the Appeals Officer verify compliance with applicable laws and regulations. He would have afforded the taxpayer a new hearing.

7. A major pronouncement by the Supreme Court: the existence of "property rights" now is a matter of federal, not state, law. United States v. Craft. 122 S. Ct. 1414, 2002-1 U.S.T.C. ¶50,361, 89 A.F.T.R.2d 2002-2005 (4/17/02). Mrs. Craft's husband owed delinquent income taxes, but Mrs. Craft did not. The IRS filed a tax lien against property held by them as tenants by the entirety. Under state [Michigan] law, the spouses had no individual right to sever or convey their interests in the property and his creditors could not levy on the property under state law. Subsequently, Mr. Craft quit claimed the property to Mrs. Craft. When she sold the property, the IRS released the lien on the condition that one-half of the proceeds be escrowed, following which Mrs. Craft brought a quiet title action seeking the escrowed proceeds. The Sixth Circuit held for Mrs. Craft, but the Supreme Court, in an opinion by Justice O'Connor, held (6-3) that the husband, as tenant by the entirety, possessed "property" or "rights to property" to which federal tax lien could attach.

... "[W]e look initially to state law to determine what rights the taxpayer has in the property the Government seeks to reach, then to federal law to determine whether the taxpayer's state-delineated rights qualify as 'property' or 'rights to property' within the compass of the federal tax lien legislation." Drye v. United States, 528 U.S. 49, 58, 120 S.Ct. 474, 145 L.Ed.2d 466 (1999).

A common idiom describes property as a "bundle of sticks" — a collection of individual rights which, in certain combinations, constitute property. ... State law
property.” And it pointed out that in unilaterally alienate it would, moreover, exempt a rather large amount of what is commonly thought of as excluding property from a federal tax lien simply because the taxpayer does not have the power to proceed from its sale (with the consent of his wife), and to bar his wife from selling it constituted excluding property to receive one half of the income from the property and one half of the proceeds from its sale (with the consent of his wife), and to bar his wife from selling it constituted “property” or “rights to property” for purposes of the federal tax lien statute. “[I]f the conclusion were otherwise, the entirety property would belong to no one for the purposes of § 6321.” The court noted that “[e]xcluding property from a federal tax lien simply because the taxpayer does not have the power to unilaterally alienate it would, moreover, exempt a rather large amount of what is commonly thought of as property.” And it pointed out that in United States v. Rodgers, 461 U.S. 677 (1983), it had already held that property that could not be unilaterally alienated [Texas homestead] nevertheless could be subject to a federal tax lien.

- NOTE that in the Rodgers case, the Supreme Court upheld not just the validity of the lien, but the power of the District Court to order a forced sale of the entire property, subject to an equitable accounting for the value of the nontaxpayer spouse’s interest.
- Justices Scalia, Thomas and Stevens dissented. They would have respected the state law characterization of Mrs. Craft’s rights to the property to which a creditor’s lien could attach.

8. A rare opportunity to run away from Tax Court jurisdiction once it’s established. Wagner v. Commissioner, 118 T.C. No. 18 (4/15/02). The Tax Court held that a taxpayer may voluntarily withdraw his appeal of the Appeals Officer’s decision in a § 6320 pre-lien due process hearing. Estate of Ming v. Commissioner, 62 T.C. 519 (1974), holding that taxpayer may not voluntarily withdraw without prejudice a petition in a deficiency case, was distinguished. In a deficiency case, § 7459(d) treats an order dismissing the petition for any reason other than lack of jurisdiction as sustaining the deficiency; but § 7459(d) does not apply to review of § 6320 or § 6330 hearings.

9. It can be expensive to seek judicial review of a §§ 6320/6330 due process hearing primarily for purposes of delay. Roberts v. Commissioner, 118 T.C. No. 23 (5/3/02). In reviewing the Appeals Officers decision in a §§ 6320/6330 due process hearing that collection of a tax shown on the return but not paid was warranted, Judge Chiuchi held that a computer generated record of assessment on Form RACS 006 complied with the requirements of Reg. § 301.6203-1; a signed Assessment Certificate, Form 23C, is not required. A $10,000 penalty under § 6673(a)(1) was imposed on the taxpayer for petitioning for review of the §§ 6320/6330 due process hearing primarily for purposes of delay.

10. The Supreme Court appears to be infatuated with tax procedure cases: Equitable tolling keeps the claim for taxes alive through successive bankruptcy proceedings. Young v. United States, 122 S. Ct. 1036, 89 A.F.T.R.2d 2002-1258, 2002-1 U.S.T.C. ¶50,257 (3/4/02). Under § 507(a)(8)(A)(i) of the Bankruptcy Code, claims for taxes for which a return was due within three years before an individual taxpayer files a bankruptcy petition are not dischargeable. The taxpayers had not paid the taxes shown on a return due and filed within three years prior to filing a Chapter 13 bankruptcy petition in 1996. In March 1997, the taxpayers filed a Chapter 7 petition, and their Chapter 13 petition was dismissed; they were subsequently discharged of their debts. When the IRS sought payment of the taxes, the taxpayers claimed that the taxes were discharged because they were due more than three years before their Chapter 7 filing. The Court, in an opinion by Justice Scalia, held that the look-back period is subject to equitable tolling. Because the Chapter 13 petition resulted in an automatic stay that prevented the IRS from collecting the unpaid taxes, when the Chapter 7 petition was filed, the three-year look-back period excluded time during which their Chapter 13 petition was pending. Thus, the tax debt was not discharged. Tolling was appropriate regardless of whether the Chapter 13 petition was filed in good faith or solely to run down the look-back period.

11. Behling v. Commissioner, 118 T.C. No. 36 (6/17/02). If a taxpayer’s consideration of the underlying liability in a collection due process hearing is barred by § 6330(c)(2)(B)

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[because the taxpayer received a deficiency notice], the Tax Court will not review the underlying liability, even though IRS Appeals officer reconsidered it and addressed it the notice of determination.

G.  Innocent Spouse

1. When the legislative history is ambiguous, read the statute. Tax Court majority holds that the test for knowledge under the § 6015(c)(3)(C) separate liability election is the same as that under former § 6013(e)(1)(C), which is that knowledge of an item of omitted income is sufficient to deny relief even if the spouse has no reason to believe that the way the item was reported on the return was correct. Cheshire v. Commissioner, 115 T.C. 183 (8/30/00) (reviewed, 11-4). A spouse who has actual knowledge of the transaction giving rise to omitted income has “reason to know” of the understatement and is not entitled to innocent spouse relief under § 6015(b). The taxpayer’s proposed standard based on a prudent taxpayer being expected to know of the understatement was rejected as providing too broad an escape hatch from liability. More importantly, the Tax Court (Judge Price) held that for the spouse to be denied apportioned liability relief, § 6015(c)(3)(C) does not require actual knowledge of whether the entry on the return is or is not correct. The applicable knowledge standard under § 6015(c)(3)(C) is “an actual and clear awareness (as opposed to reason to know) of the existence of an item which gives rise to the deficiency (or portion thereof).” Thus because when the spouse seeking apportioned liability in Cheshire signed the joint return, she was aware of the amount, the source, and the date of receipt of a retirement distribution received by her then husband, she was denied apportioned liability, even though at that time she misunderstood how much of the retirement distribution properly was taxable and thus did not know that the amount of income was understated. The court declined to follow a statement in H. Conf. Rept. 105-599, at 253 (1998) that “if the IRS proves that the electing spouse had actual knowledge that an item on a return is incorrect, the election will not apply to the extent any deficiency is attributable to such item.” The court did, however, find that the Commissioner abused his discretion in failing to grant equitable relief from penalties under § 6015(f), even though the failure to grant equitable relief on the underlying deficiency was not an abuse of discretion. The taxpayer relied on her husband’s description of the tax consequences of the transaction and his representations that he had been advised by a CPA and had no reason to doubt him.

- Judge Jacobs writing for the majority held that the wife was properly denied innocent spouse treatment under § 6015(c)(3)(C) where she had knowledge that her husband had received a distribution from his retirement plan. The wife was told by her husband that their accountant had advised him that amounts used to pay off the mortgage could be excluded from income the same way that the portion of the distribution that was “rolled over” was treated. The majority held that the wife does not need to have knowledge of the tax consequences of the item or that the entry on the return is incorrect. The court relied on former § 6013 cases, such as Wiksell v. Commissioner, 215 F.3d 1033 (9th Cir. 2000), aff’d without published opinion T.C. Memo. 1999-32, and Bokum v. Commissioner, 94 T.C. 126 (1990), aff’d, 992 F.2d 1132 (11th Cir. 1993), to the effect that knowledge of the legal consequences of an item may be presumed if the spouse has knowledge of the item.

- The dissenting opinions (Judges Parr, Colvin, Marvel, and Gale), based on the legislative history, would limit denial of relief under § 6015(c)(3)(C) to cases in which the spouse actually knew of the understatement of the item. Judge Colvin’s dissent is based upon the conclusion that § 6015(c) was enacted to make clear that the spouse must have had “actual knowledge that the treatment of the item on the tax return was incorrect” in order to be denied innocent spouse treatment.

a. Affirmed by “plain meaning” interpretation. 282 F.3d 326, 89 A.F.T.R.2d 2002-900, 2002-1 U.S.T.C. §50,222 (5th Cir. 2/8/02). On appeal, Mrs. Cheshire argued that the case was a mistaken deduction case to which the knowledge-of-the-incorrect-deduction standard was applicable; the IRS argued that the case was an omitted income case and that the knowledge-of-the-transaction test was applicable. The Court of Appeals (Judge King) held that Mrs. Cheshire “knew or had reason to know” of the understatement under both the omitted income standard and the Price 887 F.2d 959 (9th Cir. 1989) erroneous deduction standard. Thus, § 6015(b)(1)(C) barred innocent spouse relief. Section 6015(e) apportioned liability relief was denied because “the term ['item'] refers to an actual item of income, deduction, or credit, rather than the incorrect reporting of such an item.” Mrs. Cheshire’s argument that § 6015(c)(30)(C) precludes relief only if the spouse has knowledge of incorrect tax reporting was inconsistent with the general rule that “ignorance of the tax laws is not a defense to a tax deficiency.” The Court declined to interpret the legislative history as compelling a different result for two reasons.
First, when interpreting a statute, this court "must presume that a legislature says in a statute what it means and means in a statute what it says there." [citations omitted.] Unless the text of a statute is ambiguous on its face, this court adheres to that statute's plain meaning. ... Section 6015(c)(3)(C) is not facially ambiguous.

Second, the legislative history of § 6015(c)(3)(C) is ambiguous. Some portions of the history appear to support the Commissioner's position. [citations omitted] Other parts of the history, however, suggest that the § 6015(c)(3)(C) exception is intended to cover spouses with knowledge of the transaction giving rise to the deficiency in addition to spouses with knowledge that the tax return is incorrect. [citations omitted] We decline to allow inconclusive legislative history to affect our interpretation of the plain meaning of § 6015(c)(3)(C).

The Court of Appeals noted that subsequent to deciding Cheshire, in King v. Commissioner, 116 T.C. 198 (2001), the Tax Court interpreted the applicable knowledge standard in erroneous deduction cases to be "actual knowledge of the factual circumstances which made the item unallowable as a deduction." Even under this standard, however, the Court of Appeals concluded that Mrs. Cheshire was not entitled to relief because her "actual and clear awareness" of Mr. Cheshire's retirement distribution satisfied the § 6015(c)(3)(C) knowledge standard for omitted income cases.

2. A little retroactive equity. Flores v. United States, 51 Fed. Cl. 49, 2002-1 U.S.T.C. §50,108, 88 A.F.T.R.2d 2001-7020 (11/28/01). If a portion of the a tax liability that arose before the effective date of § 6015 has been paid and a portion remained unpaid, § 6015(f) equitable innocent spouse relief is available with respect to the entire liability if the facts warrant relief.

3. Only limited apportioned liability relief granted to wife whose husband's erroneous deductions exceeded his income. Mora v. Commissioner, 117 T.C. 279 (12/17/01). Mrs. Mora was denied innocent spouse relief under § 6015(b) because she had "reason to know" of an understatement attributable to her husband's erroneous tax shelter deductions that offset over two-thirds of the spouse's combined salary income (of less than $40,000). However, because the tax shelter investment was solely her husband's and she had no involvement with it or, under the standard of King v. Commissioner, 116 T.C. 198 (2001), "factual basis for the denial of the deductions," Judge Beghe held that Mrs. Mora was entitled to § 6015(c) apportioned liability relief. This principle applies to the spouse requesting apportioned liability even if the spouse who owned the limited partnership interest -- and thus could not qualify for apportioned liability with respect to the item -- had no "factual basis for the denial of the deductions. Nevertheless, Mrs. Mora received only partial relief because the disallowed deductions exceeded her husband's income and she received a tax benefit from the excess deductions. To the extent she benefited from the deductions, § 6015(d)(3)(B) denies relief.

4. They're literally dying to try to get § 6015(c) relief. Jonson's Estate v. Commissioner, 118 T.C. No. 6 (1/28/02). In an innocent spouse case involving tax shelter deductions that was appealable to the Tenth Circuit, the Tax Court applied the Ninth Circuit's liberal standard from Price v. Commissioner, 887 F.2d 959 (9th Cir. 1989), requiring only that a spouse seeking relief "establish that she did not know and had no reason to know that the deduction would give rise to a substantial understatement, on the basis of a favorable citation to Price in an unpublished Tenth Circuit opinion. However, the Tax Court denied § 6015(b) relief because the spouse was well educated, active in her husband's financial affairs, had full knowledge of the facts of the investment, and benefited from the understatement. The deceased wife's personal representative [her husband] made a § 6015(c) apportioned liability election more than 12 months after her death [and the Commissioner did not challenge the representative's procedural right to make the election], but § 6015(c) relief was denied. The personal representative "stepped into the shoes" of the deceased spouse, and she did not qualify for § 6015(c) relief because at the time of her death she and her husband were not divorced or separated and were members of the same household. Although H.Rept. No. 105-559 at page 252, n.16 states that a taxpayer is no longer married if he or she is widowed, Congress did not intend § 6015(c) to apply to the estate of a spouse who was "happily married" at the time of death. Equitable relief under § 6015(f) also was denied.

5. No "plain language" limitation of the Tax Court's jurisdiction in this case. Ewing v. Commissioner, 118 T.C. No. 31 (5/31/02). The taxpayer and her husband filed a joint return but did not pay all of the tax shown on the return. Subsequently, before the IRS asserted any deficiency, the taxpayer requested equitable relief from joint and several liability under § 6015(f). The IRS denied relief.
and mailed a notice of determination that was not mailed to the taxpayer’s last known address, but was actually received by the 88th day after it was mailed. The taxpayer’s petition for review was postmarked 92 days after the mailing of the notice, and was received and filed seven days later. The Commissioner moved to dismiss on the ground that the petition was not timely filed. The Tax Court sua sponte raised the issue of whether it had jurisdiction under § 6015(e) to review the IRS’s denial of § 6015(f) relief where no deficiency had been asserted. [Section 6015(e), granting the Tax Court jurisdiction to review denials of § 6015 relief, as amended by the Consolidated Appropriations Act of 2001, begins, “In the case of an individual against whom a deficiency has been asserted and who elects to have subsection (b) or (c) apply...”] In a reviewed opinion by Judge Ruwe, the majority (9-4) held that the Tax Court has jurisdiction to review an denial of § 6015(f) relief in a stand alone petition where the taxpayer is seeking relief from liability of tax shown on the return, without a deficiency having been asserted. The court further held that the petition was timely because it was filed more than 6 months after the date she submitted her request for relief [see. § 6015(e)(1)(A), the IRS failed to mail the notice of determination to taxpayer’s last known address, and the misaddressed notice prejudiced the taxpayer’s ability to file her petition within 90 days after the mailing of the notice. The court concluded that:

The language “against whom a deficiency has been asserted” was inserted into section 6015(e) to *** to prevent taxpayers from submitting premature requests to the Commissioner for relief from potential deficiencies before the Commissioner had asserted that additional taxes were owed. *** Congress was concerned with the proper timing of a request for relief for underreported tax and intended that taxpayers not be allowed to submit a request to the Commissioner regarding underreported tax until after the issue was raised by the IRS.

There is nothing in the legislative history indicating that the amendment of section 6015(e) *** was intended to eliminate our jurisdiction regarding claims for equitable relief under section 6015(f) over which we previously had jurisdiction. The stated purpose for inserting the language “against whom a deficiency has been asserted” into section 6015(e) was to clarify the proper time for a taxpayer to submit a request to the Commissioner for relief under section 6015 regarding underreported taxes. We conclude that the amendment of section 6015(e) does not preclude our jurisdiction to review the denial of equitable relief under section 6015(f) where a deficiency has not been asserted. In the instant case, petitioner filed a claim for relief from joint and several liability for an amount of tax correctly shown on the return but not paid with the return. Because respondent has not challenged the tax reported on the return, no deficiency has been asserted. In this situation, petitioner may be entitled to relief under section 6015(f) because subsection (f) applies where “it is inequitable to hold the individual liable for any unpaid tax or any deficiency.”

Judge Laro’s dissent argued that the Tax Court lacked jurisdiction to review the denial of § 6015 relief in the absence of a deficiency, because he considered § 6015(e)(1) to be a “clear statutory mandate from Congress” limiting the Tax Court’s jurisdiction to review denials of § 6015 relief to deficiency cases. 6. It’s not “inequitable to collect taxes from widows on their husband’s unreported income. Mitchell v. Commissioner, 292 F.3d 800, 2002-2 50, U.S.T.C. ¶50,475, 89 A.F.T.R.2d 2002-2961 (D.C. Cir. 6/14/02). In a case involving receipt of a unrolled-over lump-sum distribution from the taxpayer’s late husband’s pension plan that was not reported on the [final] joint return, the Court of Appeals held the denial of any § 6015 relief. The wife knew of the receipt and disposition of the distribution and thus had the requisite “knowledge” even if she did not know of the tax consequences of the transactions. A spouse who has actual knowledge of the transaction giving rise to omitted income has “reason to know” of the understatement — “ignorance of tax law is not a defense to liability.” The taxpayer’s proposed standard based on whether a prudent taxpayer would be expected to know of the understatement was rejected; the court expressly refused to apply the more relaxed standard applied to erroneous deduction cases under Price v. Commissioner, 887 F.2d 959 (9th Cir. 1989). Section 6015(c) apportioned liability relief was denied on the same grounds. In denying relief under § 6015(f), the court rejected the appeal that it would be inequitable to hold her liable due to her bereavement: “The
loss of spouse is not only not the sort of circumstance that makes it inequitable to collect tax, it is a normal condition of many of the taxpayers covered by the provisions of the innocent spouse rule.

7. Proposed § 6015 regulations. REG-106446-98, Relief From Joint and Several Liability, 66 F.R. 3888 (1/17/01). The Treasury has published proposed regulations under § 6015 to reflect changes in the law made by the IRS Restructuring and Reform Act of 1998, where § 6013(e) was replaced with § 6015. They clarify that case law interpreting the language under former § 6013(e) will be used to interpret that same language under § 6015. Also, “knowledge or reason to know” of an understatement exists only when either the requesting spouse actually knew of the erroneous item giving rise to the understatement, or a reasonable person in similar circumstances would have known of the item. Knowledge of an item under the proposed regulations would be knowledge of the receipt or expenditure. The proposed regulations would further amend Reg. § 1 6013-4 to clarify that if a spouse asserts and establishes that he or she signed a joint return under duress, then the return is not a joint return, and he or she is not jointly and severely liable. Relief must be requested within two years from the first collection activity, but not before the taxpayer receives a notification of an audit or notice that there might be outstanding liability. Finally, the proposed regulations would provide that the nonrequesting spouse must be given notice that the requesting spouse has filed a claim for relief and be given an opportunity to participate in the proceedings. At the request of one spouse, the IRS would omit from shared documents information that would reasonably identify that spouse’s location.

- With respect to the “knowledge” standard applicable to erroneous deductions, the final regulations provide that “knowledge of the item means knowledge of the facts that made the item not allowable as a deduction” [following King v. Commissioner, 116 T.C. 198 (2001)]. The final regulations also negate application of the actual knowledge limitation on relief in certain cases involving domestic abuse without specific duress.

8. Proposed § 66 regulations for married individuals in community property states who do not file joint returns. REG-115054-01, Treatment of Community Income for Certain Individuals Not Filing Joint Returns, 67 F.R. 2841 (1/22/02). The IRS has published proposed regulations under § 66, relating to the treatment of married individuals in community property states who do not file joint income tax returns. The proposed regulations deal primarily with issues under § 66(c) [relief from community property rules].

II. Miscellaneous

1. The quality of equity is not strained. Estate of Branson v. Commissioner, 264 F.3d 904, 2001-2 U.S.T.C. §50,622, 88 A.F.T.R.2d 2001-5726 (9th Cir. 9/5/01), cert. denied, 122 S. Ct. 1298 (3/18/02). The Ninth Circuit held that Commissioner v. Gooch Milling & Elevator Co., 320 US 418, 420 (1943), in which the Supreme Court has held that [under the predecessor of § 6214(b)] the Tax Court lacks jurisdiction to apply equitable recoupment in income tax cases, does not bar equitable recoupment of an income tax overpayment for same year as estate tax deficiency. (The Sixth Circuit has held to the contrary in Estate of Mueller v. Commissioner, 153 F.3d 302 (6th Cir. 1998).) The estate’s estate tax overpayment [resulting from an undervaluation of an asset] and the beneficiary’s income tax overpayment [resulting form the consequent lower-than-appropriate §1014 basis] were a single transaction to which equitable recoupment applied.

2. 9-11 relief
   a. Notice 2001-61, 2001-40 I.R.B. 305 (9/21/01). Provides tax relief under sections 6081, 6161, and 7508A for taxpayers affected by the September 11, 2001, Terrorist Attack. Taxpayers who have difficulty in meeting their federal tax obligations because of disruption in the transportation and delivery of documents by mail or private delivery services resulting from the terrorist attack, and who do not otherwise qualify for relief, will have until 11/15/01 to file returns and make payments required to be made from 9/11/01, through 10/31/01.
   b. Notice 2001-63, 2001-40 I.R.B. 308 (9/17/01). Postpones the due date for all federal tax obligations falling between 9/10/01 and 9/24/01 until 9/24/01. This postponement of time covers the filing of returns and claims for refund, the payment of tax (including estimated tax payments), making elections, and filing any other federal tax documents.
   c. Notice 2001-68, 2001-47 I.R.B. 504 (11/5/01). Expands and clarifies the definition of an affected taxpayer to include missing persons and lists additional acts for which a
postponement is granted. Notice 2001-68 also clarifies relief available to S corporations and beneficiaries of trusts who are not themselves affected by the disaster. Further, it extends relief for affected partnerships that fail to file returns by magnetic media. The notice postpones IRS deadlines only if the last day for performing the act involved would otherwise be on or after November 2, 2001. Also contains postponements with respect to §1031 exchanges where the last date for performing an act would fall between 9/11/01 and 11/30/01.

1. Announcement 2001-117, 2001-49 I.R.B. 567 (11/13/01). The IRS grants relief to partners, shareholders, or beneficiaries that had income tax returns due between 9/11/01 and 11/2/01, but did not file the returns because the taxpayer believed that the IRS had granted a 120 day postponement solely by virtue of the taxpayer’s interest in the affected entity. The IRS will waive any failure to file penalty if the taxpayer files his return by 12/15/01. Similar relief is provided for any failure to pay penalty.

2. Announcement 2001-124, 2001-52 I.R.B. 630 (12/10/01). Modifies and expands the relief granted in Announcement 2001-117. Partners, shareholders, and beneficiaries of an affected taxpayer are eligible for all the relief granted by Notice 2001-61 and Notice 2001-68. Thus, for example, a partner that is an individual income taxpayer with an extended due date of October 15, 2001, for the 2000 return will have until February 12, 2002, to file the return.

   • If a partner, shareholder, or beneficiary of an affected taxpayer qualifies for relief under this notice because an original due date fell within the specified period, and such partner, shareholder, or beneficiary has already obtained an extension of time to file, the IRS will supplement such extension with the relief granted by Notice 2001-61 and/or Notice 2001-68. Thus, for example, a corporate partner with an original due date during the specified period that has obtained the automatic six-month extension of time to file will be granted a six-month extension of time to pay and an additional 120 day postponement of time to file and time to pay.


d. Notice 2001-69, 2001-46 I.R.B. 491 (10/24/01). The Service will not assert that payments made by an employer to an organization described in §170(c), in exchange for vacation, sick, or personal leave that the employee elects to forgo, constitute gross income or wages of an employee, provided that the payments are made to such organizations before 1/1/03. Similarly, the Service will not assert that the opportunity to make such an election results in constructive receipt of gross income or wages for employees.

e. Notice 2001-70, 2001-45 I.R.B. 437 (10/18/01). Treasury and the IRS intend to issue regulations permitting taxpayers to elect not to apply the mid-quarter convention rules contained in §168(d)(3) to property placed in service in the taxable year that includes 9/11/01 in its third quarter.

   • Section 168(d)(3) generally provides that, except as provided in regulations, if the aggregate basis of property placed in service during the last three months of the taxable year exceeds 40 percent of the aggregate basis of property (other than property described in §168(d)(3)(B)) placed in service during the taxable year, the applicable depreciation convention for all property (other than property described in §168(d)(2)) to which §168 applies placed in service during the taxable year is the mid-quarter convention.

1. Notice 2001-74, 2001-49 I.R.B. 551 (11/12/01). Expands Notice 2001-70 to also include taxpayers for whom September 11th falls in the fourth quarter. This would cover taxpayers who purchase substantial amounts of property to replace property destroyed on September 11th.

g. Rev. Proc. 2001-53, 2001-47 I.R.B. 506 (11/2/01). Lists certain acts, the time for which is postponed by reason of service in a combat zone or a Presidentially declared disaster.

h. Congress passed the Victims of Terrorism Tax Relief Act on 12/20/01. Pub. L. 107-134 provides tax relief for those who died or were injured in the terrorist attacks on 9/11/01, the Oklahoma City bombing in 1995, and bioterrorism involving anthrax on or after 9/11/01 and before 1/1/02. It also clarifies that the Secretary has the authority to disregard for up to one year some Code
provisions by reason of presidentially declared disaster or terrorist or military actions. It also broadens § 6103 to permit Treasury to share return information with federal law enforcement and intelligence agencies engaged in terrorist investigations.

j. Notice 2002-7, 2002-6 I.R.B. 489 (1/24/02). The due date for satisfying the § 412 minimum funding requirements (and the comparable requirements of § 302 of ERISA) for those directly affected by the Terrorist Attack on 9/11/01 for making contributions originally required to have been made between 9/11/01 and 9/23/01 is postponed to 9/24/02, and the date for applying for waivers originally due between 3/15/01 and 2/28/02 is postponed to 3/1/02.

k. Relief from contemporaneous written acknowledgment deadlines. Notice 2002-25, 2002-15 I.R.B. (3/27/02). Relief from the § 170(f)(8) "contemporaneous written acknowledgment" requirement for donors who made charitable contributions of $250 or more between 9/11/01 and 12/31/01 provided they either obtain the required acknowledgment from the donee organization by 10/05/02 or have evidence of a good faith effort to obtain it. A copy of a letter or e-mail requesting the acknowledgment sent to the donee organization is evidence of a good faith effort.

l. Notice 2002-60, 2002-36 I.R.B. (8/22/02). Provides relief under the § 121(c) reduced maximum exclusion of gain provision for taxpayers who have not owned and used their principal residence for two years prior to sale or exchange, but were affected by the 9/11/01 terrorist attacks.

m. Notice 2001-62, 2001-40 I.R.B. 307 (10/1/01). The IRS has published an updated list of designated private delivery services that qualify for the timely mailing is timely filing or payment rule of § 7502. UPS Worldwide Express Plus and UPS Worldwide Express have been added to the list.

n. Uihlein v. United States, 272 F.3d 577, 2001-2 U.S.T.C. ¶50,786, 88 A.F.T.R.2d 2001-6976 (8th Cir. 11/27/01). Taxpayers were estopped to obtain a refund of taxes to which they agreed — in a settlement on Form 870-AD — where the statute of limitations had run on the IRS for the years covered by the settlement agreement.

o. T.D. 8969, Payment by Credit Card and Debit Card, 66 F.R. 64740 (12/14/01). The IRS has promulgated final regulations under § 6311.

p. Can you believe it? The taxpayer complained that the IRS didn’t hound her enough for payment! Smith v. Commissioner, T.C. Memo. 2002-001 (1/02/02). Judge Thornton refused to abate interest on the taxpayer’s deficiency even though the taxpayer offered the novel argument that the reason that she did not pay the deficiency in a timely manner was that the IRS failed to “hound her enough.”

q. The Commissioner gets a second bite at the apple. Hambrick v. Commissioner, 18 T.C. No. 20 (4/22/02). The Commissioner had filed uncontested proofs of claim for nondischargable income tax liabilities in the taxpayer’s chapter 11 bankruptcy reorganization; the bankruptcy court confirmed the plan of reorganization without deciding the merits of the tax liabilities. Subsequently the Commissioner issued deficiency notices for additional tax liabilities. Judge Gerber held that res judicata did not apply because the merits of the claim were not litigated in the bankruptcy court. Collateral estoppel did not apply because the deficiency was a different issue. The Commissioner was not estopped from determining the additional deficiencies.

r. The taxpayer gets a mulligan on premature filing of a refund suit. Tobin v. Troutman, 89 A.F.T.R.2d 2002-2271, 2002-1 U.S.T.C. ¶50,392 (W.D. Ky. 4/19/02). The taxpayer filed a refund suit contemporaneously with the filing of an administrative claim for refund. The IRS rejected her claim within six months, and the taxpayer filed “a pleading styled ‘First Amended and Supplemental Complaint,’” which the court characterized as a motion under Fed. R. Civ. P. 15(d), less than two weeks later. The government moved to dismiss the taxpayer refund suit on the grounds that under § 7422(a) it had been filed prematurely. The court held that the filing of the amended complaint after the IRS denied the administrative claim satisfactorily remedied the original failure to exhaust administrative remedies. The “duty of consistency” makes you stick to your story even when you don't want to. Blonien v. Commissioner, 118 T.C. No. 34 (6/12/02). A former Finley Kumble partner claimed, in an “affected items” petition, following a partnership level proceeding, that he was not a partner to whom a distributive share of the partnership’s COD income passed-through. Judge Beghe held that partnership status is a partnership proceeding level issue when it affects the other partners’ distributive shares. Furthermore, the duty of consistency barred the taxpayer from arguing that he was merely an employee, not a partner, of Finley Kumble in the year the partnership realized COD income, when in prior closed years in which he had received cash draws from the partnership in excess of his reported distributive share of partnership income, he had reported the excess as a reduction in the basis of

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his partnership interest, rather than as employee compensation. Finally, for the year in question, he had failed to file a Form 8082 notifying the Commissioner that he was taking a position inconsistent with the Schedule K-1.


11. Let's mediate, not litigate. Rev. Proc. 2002-44, 2002-26 I.R.B. 10 (6/10/02). The IRS has formally established the voluntary nonbinding Appeals mediation procedures. The revenue procedure significantly expands the availability of mediation. There is no dollar amount of controversy floor. Legal issues are subject to mediation, as are unsuccessful attempts to enter into closing agreements. Or should we arbitrate. Announcement. 2002-60, 2002-26 IRB 28 (6/7/02). The pilot arbitration program in Rev. Proc. 2000-4 has been modified and extended though June 30, 2003.

12. REG-126024-01, Reporting of Gross Proceeds Payments to Attorneys, 67 F.R. 35064 (5/17/02). IRS and Treasury amended and reproposed regulations under §§ 6041 and 6045(f), which, inter alia, eliminates the delivery rule [check delivered to non-payee attorney does not constitute making a payment to him]; rejects the suggestion that the § 6041 “payor” definition be used for § 6045(f) purposes because under the § 6041 “middleman” rules neither the tort claim defendant nor the insurer are required to report the payment to the attorney; rejects the suggestion that no report is required under § 6045(f) if any other person is required to report the payment under §§ 6041 or 6051; and adopts a $600 reporting threshold.

13. Modifications of Circular 230 are proposed, including the standards for providing advice regarding tax shelters; firms will be required to have procedures to ensure compliance. REG-111855-99, proposed Circular 230 regulations, 66 F.R. 3276 (1/12/01). Changes proposed to Circular 230 include:

- § 10.21 would require practitioners to advise a client who had not complied with revenue laws of the manner in which the error or omission may be corrected and the possible consequences of not taking such corrective action.
- § 10.24 would limit the dissociation from a disbarred or suspended person only to matters constituting practice before the IRS.
- New § 10.35 would prescribe new standards for tax shelter opinions at the more-likely-than-not (or higher) level of confidence. These would include a requirement to make inquiry as to all relevant facts, and be satisfied that the material facts are accurately and completely described in the opinion. The regulations under §§ 6662 and 6664 will be modified to provide that only opinions that satisfy the standards of Circular 230 may be relied upon.
- § 10.33 would apply to all tax shelter opinions not governed by new § 10.35, and would also provide a series of requirements for compliance.
- § 10.36 would require that a practitioner who is a member of, associated with, or employed by a firm must take reasonable steps, consistent with his or her authority and responsibility for the firm’s practice advising clients regarding matters arising under the Federal tax laws, to make certain that the firm has adequate procedures in effect for purposes of ensuring compliance with §§ 10.33, 10.34, and 10.35.

a. T.D. 9011, final regulations governing practice before the IRS (with respect only to non-tax shelter related provisions), 67 F.R. 48760 (7/26/02).
- Under § 10.20, a practitioner’s duty to provide information regarding the identity of persons having possession or control of requested documents is “limited only to making reasonable inquiry of the practitioner’s client.”
- Under § 10.21, the duty to advise as to the consequences of a failure to take corrective action is limited only to the consequences “provided under the Code and regulations of such noncompliance, error, or omission.”
- Under § 10.22(b), the standard for due diligence with respect to reliance on the work product of another person will be based on “common sense and experience,” and the standard with respect to the engagement of an outside specialist “will be more focused on the reasonable care taken in the engagement of the specialist.”
Under § 10.28, the requirement to return client's records upon request, regardless of a fee dispute, is restricted to those records necessary for compliance with Federal tax obligations.

Under § 10.29, the conflict of interest rules in close conformance with the recently revised ABA Model Rule 1.7 (which requires written consent).

Under § 10.30, solicitation rules follow relevant state bar rules, and also "expands the prohibition of deceptive and other improper solicitation practices to cover private, as well as public, solicitations."

14. T.D. 9014, Furnishing Identifying Number of Income Tax Return Preparer, 67 F.R. 52862 (8/14/02). The IRS has made final as Reg. § 1.6109-2 earlier proposed and temporary regulations, which provide for alternative identification numbers for tax preparers to use on returns and refund claims in lieu of social security numbers. Procedures under the temporary regulations [file Form W-7P, Application for Preparer Tax Identification Number] had been in place since 1999.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. How will this affect service in Cocco Pazzo? Same interpretation as Federal and Eleventh Circuits. 330 West Hubbard Restaurant Corp. v United States, 203 F.3d 990, 2000-1 U.S.T.C. §50,225, 85 A.F.T.R.2d 2000-869 (7th Cir. 2/15/00). Under §§ 3111(a) & (b) and 3121(q), the IRS could validly assess the employer's share of FICA with respect to restaurant employees' unreported tips on the basis of an aggregate computation, without determining individual employees' shares. Following both the Federal and Eleventh Circuits, the Seventh Circuit held that the IRS is authorized to collect an employer's FICA taxes without first assessing individual employees and crediting their Social Security earnings records. Judge Coffey also deferred to the IRS interpretation of § 3121(q).

2. But that same interpretation isn't reasonable on the West Coast. Let's see how it plays in Washington, DC, now that certiorari has been granted. Fior D'Italia, Inc. v. United States, 242 F.3d 844, 2001-1 U.S.T.C. §50,261, 87 A.F.T.R.2d 2001-1118 (9th Cir. 3/7/01) (2-1), cert. granted, 122 S. Ct. 865 (1/11/02), aff'g 21 F. Supp. 2d 1097 (N.D. Calif. 9/18/98) (The IRS lacks authority to assess the employee's share of FICA without determining the tip income of individual employees). The IRS assessment of FICA taxes on unreported tip income, which was determined by applying the average tip rate on credit card receipts, applying that rate to the employer's gross receipts, and then subtracting reported employee tip income was invalid. Judge Kozinski held that the IRS lacks authority to assess employer FICA taxes on an estimated aggregate basis because the IRS method does not account for tips that might be outside the "wage band" [which excludes tips of less than $20 per month or above the social security wage base] from FICA tax. The IRS method does not account for the fact that cash tips are usually less than credit card tips, that tip sharing with busboys, dishwashers, etc. may result in employees receiving less than $20 per month, or "for an upscale restaurant like Fior D'Italia" how many employees' tips exceeded the social security wage base. Section 446 authority is unavailing to the IRS because it does not apply to FICA taxes, and the negative implication of § 446 not applying to FICA taxes is that the IRS has no authority to rely on estimates in assessing FICA taxes. Nor does § 3121(q) provide any such authority. Although the IRS can assess the employer's share of FICA taxes without assessing a deficiency against the employees, it may not do so without auditing the employees' records to determine tip income on an employee-by-employee basis.

3. Supreme Court reverses Seventh Circuit and upholds the IRS. United States v. Fior D'Italia, Inc., 122 S. Ct. 2117, 2002-2 U.S.T.C. §50,459, 89 A.F.T.R. 2d 2002-2883 (6/17/02) (6-3). The Court held that the IRS has broad power under § 6201(a) to determine the method it uses to make assessments, and that its use of the "aggregate estimation method" to determine the total amount of tip income upon which to base an assessment of FICA taxes on an employer is reasonable in light of the employer's stipulation of the accuracy of the calculation. The method used was an amount based upon a
percentage of total restaurant checks (extrapolated from the percentage of tips on restaurant checks paid with credit cards) minus the tip income reported by each employee to the restaurant owner.

- Justice Breyer, writing for the majority, held that an employee-by-employee determination was unnecessary. He further held that certain features of an aggregate estimate—that it includes tips that should not count in calculating FICA tax [e.g., tips amounting less than $20 per month] or that a calculation based on credit slips can overstate the aggregate amount [e.g., cash-paying customers tend to leave a lower percentage tip]—do not show that the method is so unreasonable as to violate the law. The employer is free to present evidence that an assessment is inaccurate in a particular case.

- Justice Souter (joined by Justices Scalia and Thomas) in dissent notes that the statute and regulations expressly excuse employers from the obligation to keep tips information on an employee-by-employee basis beyond the tip amounts actually reported by each employee.

4. S corporation shareholders can't take unreasonably low compensation to avoid employment taxes. Veterinary Surgical Consultants P.C. v. Commissioner, 117 T.C. 141 (10/15/01). The taxpayer was an S corporation with a single shareholder, who was the only individual who provided any services on behalf of the corporation. All of the taxpayer-corporation's income was earned by virtue of services provided to a third party by the shareholder. The corporation paid the sole shareholder no salary, and he reported all of its income under § 1366; the income was distributed to him [subject to §1368]. The corporation paid no employment taxes. Judge Jacobs held that the shareholder was an employee of the corporation and upheld the recharacterization of the amounts paid to him as salary. Section 530 relief was not available because the corporation had no reasonable basis for not treating the shareholder as an employee. Accordingly the wage tax deficiency was upheld. That the shareholder personally had paid the maximum employee FICA for the year by virtue of employment by another corporation was not relevant to the employer's wage tax.

a. Same scam, same answer. Yeagle Drywall Co. v. Commissioner, T.C. Memo 2001-284 (10/15/01). Veterinary Surgical Consultants P.C. v. Commissioner, 117 T.C. 141 (10/15/01), was followed with respect to a 99 percent shareholder/office in case involving a drywall contracting business that treated all of its workers as independent contractors.

b. Tax planner loses on same scam as his client, with his client's case decided a year earlier cited as authority. Joseph M. Grey Public Accountant, P.C. v. Commissioner, 119 T.C. No. 5 (9/16/02). The taxpayer was an S corporation with a single shareholder, who was the only individual who provided any services on behalf of the corporation. All of the taxpayer-corporation's income was earned by virtue of services provided to third parties by the shareholder. The corporation paid the sole shareholder some fees as an "independent contractor," but no salary, and he reported all of the taxpayer's remaining income under § 1366; the income was distributed to him [subject to §1368]. The corporation paid no employment taxes. Judge Halpern applied Veterinary Surgical Consultants P.C. v. Commissioner, 117 T.C. 141 (10/15/01) [which Judge Halpern noted involved a client of the taxpayer to which the taxpayer had suggested the same arrangement be used to avoid employment taxes], to hold that the shareholder was an employee of the corporation and upheld the recharacterization of the amounts paid to him as salary. Under § 3121(d)(1), as its president, the shareholder was a statutory employee of the corporation and performed all of his services as such. Section 530 relief was not available because (1) the corporation had no reasonable basis for not treating the shareholder as an employee, and (2) relief under section 530 is not available with respect to statutory employees. Accordingly the wage tax deficiency was upheld.

5. "Expense reimbursements" under an unaccountable plan are "wages." Shotgun Delivery, Inc. v. United States, 269 F.3d 969, 2001-2 U.S.T.C. ¶50,700, 88 A.F.T.R.2d 2001-6391 (9th Cir. 10/16/01). "Mileage reimbursements" paid by an employer-messenger service to its employee drivers were wages because they were not paid under an accountable plan [Reg. §1.62-2]. Drivers were invariably paid a total amount, for wages and mileage, equal to 40 percent of delivery charges, with an amount equal to minimum wage denominated "wages" and the remainder denominated "mileage," without any regard to even approximating actual mileage.

6. Full service employment tax litigation in the Tax Court. Ewens and Miller Inc. v. Commissioner, 117 T.C. 263 (12/11/01). Bakery's workers were employees, and the bakery was not entitled to relief under § 530 of the Revenue Act of 1978 [because it had before 1992 treated such workers as employees]. Judge Vasquez found that the workers who produced and marketed the product were common law employees under the seven-factor test [(1) degree of control by principal, (2) who made the investment, (3) profit or loss opportunity, (4) whether the worker can be discharged, (5) whether part of principal's regular business, (6) permanency of the relationship, and (7) the relationship
the parties believed they were creating) of Weber v. Commissioner, 103 T.C. 378 (1994), aff'd per curiam, 60 F.3d 1104 (4th Cir. 1995), and that the route drivers were statutory employees under the § 3121(d)(3)(A) agent-driver/commission driver provision.

• Judge Vasquez further held that the Tax Court's jurisdiction over worker classification gave it the jurisdiction to decide the correct amounts of employment taxes, as well as to decide the proper additions to tax and penalties. Section 7436, which grants the Tax Court jurisdiction to determine employment status and employment tax deficiencies in connection with such a determination, does not expressly provide jurisdiction to determine § 6656 penalties for underpayment of employment taxes. Nevertheless, jurisdiction to determine such penalties is founded on § 6665(a)(2) [providing that any reference in Title 26 to a tax imposed by Title 26 shall be deemed also to refer to the additions to tax, additional amounts, and penalties provided by chapter 68 of subtitle F] because § 6656 penalty is in chapter 68 of subtitle F and it applies to taxes imposed by Title 26, and § 7436(e) does not exclude additions to tax or penalties from the definition of employment tax.

B. Self-employment
C. Excise Taxes

XII. TAX LEGISLATION

A. Vetoed
B. Enacted

1. The Victims of Terrorism Tax Relief Act, Pub. L. 107-134, was signed by President Bush on 1/23/02. Pub. L. 107-134 provides tax relief for those who died or were injured in the terrorist attacks on 9/11/01, the Oklahoma City bombing in 1995, and bioterrorism involving anthrax on or after 9/11/01 and before 1/1/02.

• Waives income taxes for the year of death and the prior year and provides a minimum benefit of $10,000 to each victim. Shields the first $8.5 million in assets from federal estate tax. Provides tax-free treatment of death benefits paid by an employer.

• Clarifies that payments made by charities are for an exempt purpose even if made without demonstration of financial need if made in good faith under an objective formula consistently applied.

• Imposes 40 percent excise tax on persons who acquire structured settlements for a lump sum unless the transaction is approved by a court as being in the victim’s best interest.

• Exempts from gross income disaster relief payments received from airlines and certain other “qualified payments” received by individuals in a “qualified disaster.”

• It also clarifies that the Secretary has the authority to disregard for up to one year some Code provisions by reason of presidentially declared disaster or terrorist or military actions.

It also broadens § 6103 to permit Treasury to share return information with federal law enforcement and intelligence agencies engaged in terrorist investigations.


3. P.L. 107-181, the Clergy Housing Allowance Clarification Act of 2002 was signed by President Bush on 5/20/02. See V.A., above.

4. The Sarbanes-Oxley Act, Pub. L. 107-204, formerly known as the Public Company Accounting Reform and Investor Protection Act of 2002, was signed by President Bush on 7/30/02. One provision in the Act is a “sense of the Senate” that corporate Federal income tax returns be signed by the CEO. See also, Act § 307 for lawyer whistleblowing requirements.

C. Pending

1. H.R. 4069, the Social Security Benefit Enhancements for Women Bill of 2002, was passed by the House on 5/14/02 by a unanimous vote. Contains several taxpayer protection provisions.

2. H.R. 4737, the Personal Responsibility, Work, and Family Promotion Bill of 2002, was passed by the House on 5/16/02 by a 229-197 vote. The bill contains several taxpayer protection provisions.
3. H.R. 4626, the Encouraging Work and Supporting Marriage Bill of 2002 was passed by the House on 5/21/02 by a 409-1 vote. Would accelerate the increase in the standard deduction for married couples filing jointly, as well as modify the work opportunity and welfare-to-work tax credits.

4. S. 2119, the Reversing the Expatriation of Profits Offshore Act, and H.R. 3884, the Corporate Patriot Enforcement Bill of 2002, would both legislate against so-called “corporate inversions.”
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SELECTED RECENT FEDERAL INCOME TAX DEVELOPMENTS

Questions to The Honorable Mary Ann Cohen, Judge, United States Tax Court, asked by Professor Ira B. Shepard at the William & Mary Tax Conference, November 22, 2002

A. At I.C.1. on page 5, the Square D case deals with whether the Tax Court will defer to IRS/Treasury interpretations under the Chevron doctrine. This doctrine is also mentioned by one of the dissents in the Robinson case (at pages 9-10). Could you comment on this.

B. At II.D.4. on pages 9-10, the Robinson case overrules it prior decision in Redlark. Could you please discuss the procedure the Tax Court uses when it overrules one of its earlier cases, as well as discuss the Robinson case generally.

C. At II.E.6., on page 11, the Campbell case is a Summary Opinion. Could you please discuss the Tax Court’s treatment of Summary Opinions.

D. At II.I.1, on pages 16-17, the first Tax Court opinion in the Hillman case turned, in part, on a proposed regulation. In Eller v. Commissioner, 77 T.C. 934 (1981), the Tax Court found a proposed regulation irrelevant. Could you please discuss the weight given to proposed regulations by the Tax Court.

E. At V.A.2.a., on pages 27-28, the Warren case was decided by the Tax Court without attention to the constitutionality of the parsonage allowance provision, § 107(2). Could you please discuss why the Tax Court does not usually address constitutional issues in its opinions.

F. At X.D.1., on page 58, the Rochelle case was affirmed by the Fifth Circuit. Please discuss whether the IRS be permitted to operate in disregard of a statutory requirement without suffering any adverse consequences.

G. At X.F.2. and X.F.6., on pages 59-60, the Lunsford, Johnson and Nestor cases were reviewed decisions in pre-lien and pre-levy hearing area. Please discuss to what extent the Tax Court is able to deal with this area.

H. In Magana v. Commissioner, 118 T.C. No. 30 (5/31/02), the Tax Court refused to consider a new objection to the Commissioner’s lien filings, raised by for the first time in his Tax Court petition. The opinion stated, “Accordingly, in our review for an abuse of discretion under section 6330(d)(1) of respondent’s determination, generally we consider only arguments, issues, and other matter that were raised at the collection hearing or otherwise brought to the attention of the Appeals Office.” Please discuss the impact of this decision on issues to be raised in IRS hearings.

I. Please discuss the consideration that the Tax Court should give to the new § 7491 burden of proof provision.