Recent Federal Income Tax Developments

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I. ACCOUNTING
   A. Accounting Methods
      1. TAM 9848001 (7/16/98). Dentist custom-ordered crowns, bridges and dentures from independent laboratories for individual patients. Therefore, he does purchase and sell merchandise inventory. The TAM stated that neither a small year-end inventory nor custom-ordering was sufficient to prevent the accrual method from being required. Nevertheless, the dentist was not required to maintain inventories because the production, purchase or sale of merchandise was not a significant income-producing factor under Reg. § 1.471-1.


   B. Inventories
      1. *Sense is injected into the issue of whether the manufacturer's base year cost of bargain inventory is acquisition cost or fair market value. La Crosse Footwear Inc. v. United States, 99-2 U.S.T.C. 50,838 (Fed. Cir. 9/14/99), rev'g and remanding unpublished opinion of the Court of Federal Claims (4/25/97). A manufacture that acquired inventory at a bargain price must use the acquisition cost for that inventory's base-year cost under the dollar-value, double-extension LIFO method of accounting. The court follows Kohler Co. v. United States, 124 F.3d 1451 (Fed. Cir. 1997), to conclude that the LIFO method can be used to compensate for inflation but cannot be used to postpone the realization of gains associated with bargain priced inventory.

         a. LaCrosse Footwear Inc. v. United States, 97 TNT 89-10 (Fed. Cl. 4/25/97) (unpublished). A new taxpayer first electing LIFO must calculate the base-year cost of bargain purchase inventory at the "fair or market" value of these items at the beginning of its first taxable year, not at the taxpayer's actual bargain cost [which was only 33% of market value and only 47% of seller's book value], because Reg. §1.472-8(e)(2) provides for actual cost only for items entering after the base date and for "current cost" for base-year items. Commissioner did not abuse her discretion under §§446 and 471 in determining that taxpayer's application of the dollar-value, double-extension LIFO inventory accounting method to its first year's inventory, as carried through to succeeding years, did not clearly reflect income. The court rejected government's contention that the purchased inventory should be treated as different "items" or placed into a different "pool."

* I would like to thank Martin J. McMahon, Jr., Clarence TeSelle Professor of Law, University of Florida College of Law, Gainesville, Florida, for his wise suggestions for revision of this outline.
C. Installment Method

1. 1997 Act §403 retroactively repeals Code §56(a)(6) to provide that the AMT preference will not apply to farmer’s installment sales of §1221(1) property, effective for dispositions made in taxable years beginning after 12/31/87 (with a special rule for years beginning in 1987).

D. Year of Receipt or Deduction

1. *Ninth Circuit holds that all events was satisfied when customers had the right to redeem “slot club” points, even though only 69% of such points were actually redeemed. Gold Coast Hotel & Casino v. United States, 98-2 U.S.T.C. ¶50,800 (9th Cir. 10/16/98). Taxpayer was permitted to deduct unredeemed “slot club” points because its liability for their redemption was fixed under the “all events” test. The points were held to be liabilities to the taxpayer, to the amount of their value; previously deducted unredeemed points are taken into income when an account is inactive for over a year. The government argued that only 69% of slot club points are actually redeemed, but the court stated that it “confuses determining the amount of [taxpayer’s] liability with determining the percentage of that liability that will be discharged by payment,” and held that what was “critical is the existence of an ABSOLUTE LIABILITY, not an ABSOLUTE CERTAINTY the liability will be discharged by payment,” citing United States v. Hughes Properties, 476 U.S. 593 (1986). The court distinguished United States v. General Dynamics Corp., 481 U.S. 239 (1987) (deductibility of year end employee medical claims not filed until the following year; filing the claim was a condition precedent to the accrual of the liability), on the ground that there was a third-party doctor involved in the employee medical expense claims, and that “a slot club member’s demand for payment (redemption of points) is a technicality.”

   * Section 461(h), relating to the “economic performance” requirement, was inapplicable to the years at issue. Reg. §1.461-4(k)(3) applies this requirement only to taxable years beginning after 12/31/91.

2. Lottery winners do not have constructive receipt if they choose an annuity over a lump-sum payment. TTREA ’98 §5301, added §451(h), which provides that a lottery winner’s “qualified prize option,” i.e., an option between a single cash payment and a prize payable over a period of at least 10 years, exercisable within 60 days, shall be disregarded in determining the taxpayer’s year of inclusion of any portion of the qualified prize.

3. REG-209619-93, proposed regulations under §468B relating to the designation of the person required to report the income earned on qualified settlement funds and certain other funds, trusts and escrow accounts (64 F.R. 4801, 2/2/99). If there is only one transferor to a qualified settlement fund, she/he/it may elect to treat the QSF as a grantor trust by attaching a statement to the first Form 1041 filed on behalf of the QSF.

   * Query whether malpractice coverage encompasses the activity of a professional as the holder of a qualified settlement fund, etc.

4. Schmidt Baking Co. v. Commissioner, 107 T.C. No. 16 (11/14/96). Taxpayer entitled to deduct in 1991, amounts “paid” for vacation and severance benefits when it purchased an irrevocable standby letter of credit on March 13, 1992 because the amounts were includable in the employees’ income within 2-1/2 months after the end of 1991. Judge Tannenwald construed §§83, 162 and 404 to find that amounts includable in employees’ incomes were not deferred compensation and were “paid” to the employees. Section 404 does not require actual receipt of payment by the employee as a prerequisite for the employer’s deduction. Funding a nonqualified deferred compensation agreement so as to require inclusion by the employee prior to receipt suffices to allow a deduction to the employer.
   a. 1998 Act §7001 amends Code §404(a)(11) to provide that for purposes of determining whether an item of compensation [e.g., vacation or severance pay] is deferred compensation, the compensation is not considered to have been paid or received until actually received by the employee. Reverses Schmidt Baking Co. v. Commissioner, 107 T.C. 271 (1996) (letter of credit furnished during
first 2-1/2 months of the year following the tax year at issue served to vest employee interests for §83 purposes, permitting employer to take the deduction in the earlier tax year). Applicable to tax years ending after 7/22/98.


c. The 50-percent solution(?). Rev. Proc. 99-26, 1999-24 I.R.B. 38 (6/1/99). This revenue procedure provides alternative 50-percent settlement options to settle cases in which taxpayers [before the effective date of the 1998 Act amendment to §411(a)(11)] accelerated deductions for accrued employee benefits by securing those benefits with a letter of credit, bond, or other similar financial instrument.

5. Well, you can’t expect the government to lose every case in which the taxpayer cites Indianapolis Power & Light, can you? Johnson v. Commissioner, 108 T.C. No. 22 (6/16/97). The taxpayer—motor vehicle dealers entered into multi-year vehicle service contracts and received a flat fee in advance for work to be performed under the contracts. If the customer canceled the contract, any refund was based on the period of time the contract had been in force and the number of miles the vehicle had been driven; the amount of repairs performed on the vehicle generally was not a factor in determining the refund. The Tax Court applied Commissioner v. Hansen, 360 U.S. 446 (1960), to require taxpayer to include in income immediately not only taxpayer’s profit, but also the amounts paid into an escrow account [to guarantee the taxpayer’s own future performance of the contract under which the amounts were received]. Amounts would be released from escrow only as the dealer fulfilled obligations under the contracts or when the period of the contract had expired. Because the only other permissible applications of the funds were to obtain services from another vendor if the taxpayer-dealer refused or was unable to provide the required services or as a refund to the customer upon cancellation of the contract pursuant to its terms, ultimately, all of the funds would be paid either to the taxpayer or for the taxpayer’s benefit. Because of the nature of the formula governing refunds, the taxpayer’s right to keep the advance payment was not dependent on the customer’s actual demand for services and thus the payments were not excludable deposits under Indianapolis Power & Light, 493 U.S. 203 (1990).

a. *On appeal, after it establishes that it’s the big dog on permissible accounting methods, the IRS grants a little relief. Johnson v. Commissioner, 183 F.3d 786, 99-2 U.S.T.C. ¶50,699, 84 A.F.T.R.2d 5306 (8th Cir. 7/21/99); affg in part and revg in part 108 T.C. 448 (1997). Affirmed in part [dealership must include in income the full purchase price of vehicle service contracts received]; reversed in part [dealership “as a matter of fairness” was entitled to deduct amounts paid to the VSC administrator and need not await the year in which services were performed]. On the income inclusion issue the Court of Appeals affirmed, tersely referring the reader to the Tax Court opinion.

• The Court of Appeals reversed on several subsidiary issues, holding (1) that the taxpayer was not required to include in gross income any investment yield on the escrow that the fund administrator was entitled to retain and (2) that any fees actually paid to the fund administrator were currently deductible, rather than deductible only as repair services were rendered as held by the Tax Court. Judge Arnold held that an immediate deduction for amounts paid to the VSC administrator is not precluded by the §461(h) economic performance requirement. Judge Arnold stated that “In so holding, we mean to establish no general rule. We hold only that what is sauce for the goose is sauce for the gander.” He concluded:

While [the fact that economic performance has not yet occurred in the year of payment to the VSC administrator] is certainly true in the abstract, the question in this case is whether the method of accounting proposed by the Commissioner clearly reflects income. To answer that question both income and deductions must be considered. If the income is to be recognized, and we have upheld the Commissioner’s decision on that point, the deduction associated directly with it should also be recognized.
b. Note that in Rev. Proc. 97-38, 1997-2 C.B. 479, the IRS using its §446(b) powers authorizes certain prescribed methods of deferring prepaid warranty contract income over the life of the contract.

II. BUSINESS INCOME AND DEDUCTIONS

A. Depreciation, Depletion and Credits

1. Research credit for internal use computer software denied. United Stationers Inc. v. United States, 97-2 U.S.T.C. ¶50,994 (N.D. Ill. 10/16/97). Office supplies wholesaler is not entitled to a §41 research tax credit for the costs incurred in developing internal-use computer software because (1) the research did not expand or refine existing computer science but merely built upon preexisting technological information; and (2) although the benefits of the product were uncertain, its ultimate development was not [so there was not “experimentation”). Further, it did not qualify under the exception in Prop. Reg. §1.41-1(e)(5) to the §41(d)(4)(E) prohibition of the credit for internal use software because – although “innovative” – its development did not involve significant economic risk.

   a. Affirmed, 99-1 U.S.T.C. ¶50,136 (7th Cir. 12/24/98). Taxpayer not entitled to §41 qualified research tax credit because the research must to discover information which is technological in nature and must involve a process of experimentation to overcome technical uncertainty.

   b. TTREA '98 §1001(a) amends §41(h)(1) to retroactively restore the research credit to 7/1/98 and extend it until 6/30/99.

   c. *Proposed §41 regulations require recordkeeping. REG-105170-97 (63 F.R. 66503, 12/2/98). Proposed regulations under §41 [as amended in 1986, 1989, 1996 and 1997] – Prop. Reg. §§1.41-0 through 1.41-8 – providing detailed rules governing the definition of qualified research expenses, computation of the credit, and the “base amount.” Under the qualified research test, expenditures must relate to research undertaken for the purpose of discovering information that is technological in nature, i.e., if (1) it is undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field of technology or science; and (2) the process of experimentation fundamentally relies on principles of physical or biological sciences, engineering, or computer science. Also required is that substantially all of the research activities are elements of a process of experimentation, which is a process that involves the evaluation of more than one alternative designed to achieve an intended result, when the means of achieving the intended result are uncertain at the outset. Extensive recordkeeping, including maintenance of research notebooks, is required.

2. REG-114664-97, proposed amendments to regulations relating to the §42 low-income housing credit (64 F.R. 1143, 1/7/99). Provides for increased compliance monitoring by the responsible housing agency.

3. An IRS foot-fault? Or a successful snooker? Maybe both. Riggs National Corp. v. Commissioner, 99-1 U.S.T.C. ¶50,185 (D.C. Cir. 1/12/99), rev'g 107 T.C. 301 (1996). Taxpayer bank received interest income on “net loans” [i.e., a loan in which the borrower pays interest to the lender and also pays the lender’s liability for local tax on that interest income] from the Brazilian Central Bank. The lender is entitled to foreign tax credits for Brazilian tax paid on its behalf by the otherwise “tax-immune” Central Bank. The Brazilian Finance Minister issued a favorable ruling to taxpayer, which Judge Silberman respected under the Act of State Doctrine. The court noted that the Commissioner should have accepted the legality of the Finance Minister’s order, but argued in the Tax Court that the payments would not be a creditable tax under §901 under U.S. tax principles.

   • Taxpayer’s treatment would have been correct had the tax been properly imposed and withheld pursuant to Brazilian law. Instead, what really happened is that taxpayer was made better off by including the amount of “tax” as extra income, and taking a §901 foreign tax credit in that same amount.

4. Rev. Rul. 98-56, 1998-47 I.R.B. 5. Section 1231 gain that is treated as long-term capital gain is not disqualified income as defined in §32(i) for purposes of the EITC.

5. Gathering pipelines depreciable over seven years. True v. United States, 97-2 U.S.T.C. ¶50,946 (D. Wyo. 11/3/97). Summary judgment granted to taxpayer, a shareholder and partner in various gathering and trunk pipeline companies, permitting 7-year MACRS depreciation on its “gathering pipelines.” Judge Johnson held that the gathering pipelines were used by petroleum producers
to produce oil [Class 13.2 asset life] because these pipelines are necessary to provide “a means for producers to get crude oil from the lease to the collecting point for further transportation.”

a. Gathering pipelines depreciable over fifteen years. Is the moral to litigate in the District of Wyoming, and not in the Tax Court? Duke Energy Natural Gas Corp. v. Commissioner, 109 T.C. No. 19 (12/16/97). Natural gas gathering systems are used to transport gas [Class 46.0] and is depreciable over 15 years. Judge Laro agreed with True, supra, that the classification of assets for depreciation purposes rests on each asset’s primary use, but did not agree that pipeline companies use gathering lines primarily to produce petroleum.

b. *Duke Energy reversed by the Tenth Circuit; seven years for gathering pipelines! Moral is to litigate in the Tenth Circuit. Duke Energy Natural Gas Corp. v. Commissioner, 173 F.3d 1253, 99-1 U.S.T.C. ¶50,449 (10th Cir. 4/13/99). Held, gathering pipelines are in (production) Asset Class 13.2 [seven-year depreciation] because the primary use of gathering systems is more closely tied to production wells than are transmission pipelines. While gathering lines may in a broad sense “transport” or “carry” gas from one place to another within the literal terms of Asset Class 46.0, “we cannot ignore their more specific inclusion as assets used in the exploration for and production of gas in Asset Class 13.2.” This applies even though taxpayer is not a “producer” of gas because there is no requirement that the pipeline user “own” the gas in the gathering pipelines. Note: The Commissioner intends to litigate this issue outside the Tenth Circuit.

- Duke owns and operates gas compression facilities and interconnected gas gathering pipelines, which were used by producers through contractual arrangements. The pipelines deliver “raw gas” to processing plants in oil and gas fields, but Duke does not own any interest in the wells that produce the gas. The court of appeals agreed with the taxpayer that the natural gas "gathering systems" are covered by asset class 13.2 and are depreciable over 7 years, because the systems are assets used in "production," not in "transportation" for MACRS purposes. The IRS claimed that pipeline systems were within asset class 46.0, “Pipeline Transportation,” see Rev. Proc. 87-56, 1987-2 C.B. 674, and were depreciable over 15 years. The court rejected the government’s argument that because taxpayer is not a “producer,” its gathering systems served a transportation rather than production function, reasoning that "used by ... producers" in the description of asset class 13.2 does not create an ownership requirement. The court noted that FERC treats gathering systems as “production related” assets rather than as transmission facilities

6. Based on expert study, Ontario Mining Tax is creditable. Texasgulf Inc. v. Commissioner, 107 T.C. 51 (9/9/96). The Ontario Mining Tax is creditable under §901 because the processing allowance in that tax meets the requirements of Reg. §1.901-2(b)(4)(i)(B) in that -- based upon an expert study of OMT tax returns that showed the aggregate amount of processing allowance was three times the aggregate amount of nonrecoverable expenses -- the OMT “permits the recovery of nonrecoverable expenses under a method that is likely to produce an amount that approximates or is greater than the amount of the nonrecoverable expenses.” Judge Colvin held that the regulations do not require that the processing allowance must be intended to compensate for nonrecoverable expenses, nor do they provide “that the processing allowance must bear a predictable relationship to the nonrecoverable expenses.”

a. *Affirmed, Texasgulf Inc. v. Commissioner, 99-1 U.S.T.C ¶50,403 (2d Cir. 4/5/99). Foreign tax can satisfy the net income requirement of Reg. §1.901-2 if it provides allowances that “effectively compensate” for nonrecovery of significant costs or expenses. Empirical evidence held relevant to the creditability issue because “quantitative empirical evidence may be just as appropriate as qualitative analytic evidence.”

- The Ontario Mining Tax is creditable under §901 because the processing allowance in that tax meets the requirements of Reg. §1.901-2(b)(4)(i)(B) in that -- based upon an expert study of OMT returns that showed the aggregate amount of processing allowance was three times the aggregate amount of nonrecoverable expenses -- the OMT “permits the recovery of nonrecoverable expenses under a method that is likely to produce an amount that approximates or is greater than the amount of the nonrecoverable expenses.” The regulations do not require that the processing allowance must be intended to compensate for nonrecoverable expenses, nor do they provide “that the processing allowance must bear a predictable relationship to the nonrecoverable expenses.” The contrary conclusion in the analysis in Rev. Rul. 85-16, 1985-1 C.B. 180, was rejected.

7. *Catch 22: In order for taxpayer to qualify for the §29 nonconventional fuel source credit, a determination that an individual gas well was tight formation must have been made
to mean a naturally occurring rock formation containing a hydrocarbon so viscous that it could not be
recovered and are typically applied in the second stage of production. Conventional recovery methods
typically the first methods used to extract crude oil from a reservoir. Secondary recovery methods involve
rely on natural energy (pressure) within the reservoir to move fluids from the rock into the well and
economically produced through a well using only primary recovery methods. Primary recovery methods
are

- Under Rev. Rul. 93-54, if a well is drilled through a seam during the period eligible for the credit, and later (without drilling any deeper) the seam is opened up for production by an eligible method, the new production is considered to be from a well drilled during the eligible period.

- Taxpayer contended and Commissioner does not deny that but for the lack of a certification under NGPA §503, the well in question would meet the qualifications for tight formation gas. Taxpayer contends that meeting the qualification by definition (in substance) should suffice and that actual certification is unnecessary.


8. *Sometimes the failure of taxpayer to secure a required certification for which it applied may be excused where the failure was because of the neglect of the certifying agency. Perdue Farms Inc. v. United States, 99-1 U.S.T.C. ¶50, 84 A.F.T.R.2d ¶99-5056 (D. Md. 6/14/99). Targeted job credits under former §51 available to employer despite state agency's failure to process 2,362 certification requests filed before the federal government ordered all certification activities ended at the expiration of the program on 12/31/94. Judge Young granted taxpayer summary judgment, holding that it had followed all of the requirements of the job credit program and that the IRS position is "contrary to the clear intent of Congress." The court further noted that, to the extend Reg. §1.51-1(d)(1) requires an employer to receive certification before the credit may be claimed, the regulation is void.

9. Tar sands oil definition is based upon the FEA definition. Shell Petroleum Inc. v. United States, 996 F. Supp. 361, 98-1 U.S.T.C. ¶50,200 (D. Del. 10/16/97). Oil produced from tar sands is defined for purposes of the §29 credit by FEA Ruling 1976-4 as oil produced from rock types containing "extremely viscous hydrocarbon which is not recoverable in its natural state by conventional oil production methods," and not (as taxpayer contended) "oil with a viscosity greater than 10,000 centipoise, measured gas-free, at original reservoir temperature." The court followed the FEA definition [from the Emergency Petroleum Allocation Act] and Texaco Inc. v. Commissioner, 101 T.C. 571 (1993).

- In the Texaco case, Judge Whitaker adopted the following definition of tight sands: "The several rock types that contain an extremely viscous hydrocarbon which is not recoverable in its natural state by conventional oil well production methods including currently used enhanced recovery techniques. The hydrocarbon-bearing rocks are variously known as bitumen-rocks, oil impregnated rocks, oil sands, and rock asphalt."

- As of April 1980, no single definition of tar sands was universally recognized, but the term "tar sands" was generally understood within the oil and gas industry to mean a naturally occurring rock formation containing a hydrocarbon so viscous that it could not be economically produced through a well using only primary recovery methods. Primary recovery methods rely on natural energy (pressure) within the reservoir to move fluids from the rock into the well and are typically the first methods used to extract crude oil from a reservoir. Secondary recovery methods involve injecting gas and/or water into wells as a means of supplying additional energy to achieve higher recoveries and are typically applied in the second stage of production. Conventional recovery methods generally include both primary and secondary recovery methods.

- In contrast to conventional recovery methods, enhanced oil recovery methods entail altering the characteristics of the fluids and/or rocks in a reservoir through the application of heat or the introduction of other substances. As of April 1980, steam flooding and cyclic
steam injection were the thermal enhanced oil recovery methods most commonly used in the production of high viscosity crude oil. Both steam flooding and cyclic steam injection were initially used in the United States in the early 1960s and involve the injection of steam into a well for purposes of heating and thinning crude oil.

- In August 1980, 4 months after enactment of section 44D [now §29], the Department of Energy's Office of Oil and Natural Gas, Resource Applications held a workshop to establish a definition of tar sands that better distinguished between tar sands and heavy oil. By letter dated December 12, 1980, the Office of Oil and Natural Gas, Resource Application distributed the following definition of tar sands to be used for that office's Alternate Fuels Program:

  Tar sand is any consolidated or unconsolidated rock (other than coal, oil shale, or gilsonite) that (1) contains a hydrocarbonaceous material with a gas-free viscosity, measured at reservoir temperature, greater than 10,000 centipoise, or (2) contains a hydrocarbonaceous material that is extracted from the mined or quarried rock.

- The Department of Energy's definition of tar sands for purposes of the Alternate Fuels Program was consistent with the oil and gas industry's definition of tar sands as of April 1980. The court, however, held that the definition did not relate back to the earlier [in 1980] enactment of the credit.

  a. *Affirmed, Shell Petroleum Inc. v. United States, 99-2 U.S.T.C. ¶50,622 (3d Cir. 6/24/99). Agreed with the district court that it would be “anomalous” should the same oil be classified both as crude oil and as tar sand oil, thus being subject to the windfall profit tax and also eligible for the nonconventional source tax credit.

10. Has the government struck another blow against smoking? Hart v. Commissioner, T.C. Memo. 1999-236 (7/21/99). No portion of the cost of a tobacco barn could be deducted under §179 because any building or a structural component of any building (other than a single purpose agricultural or horticultural structure as defined in §168(i)(13)) does not qualify as §179 property. Eligible property is defined through a cross reference to §1245(a)(3), under which the regulations define building by a cross reference to Reg. §1.48-1. Whether a property is a “building” is determined by a two part test based on “appearance,” i.e., does it look like a building in the ordinary sense, and “function,” e.g., does it provide shelter or working space? The barn in question thus was a building and since it served multiple purposes, including the provision of working space, it was not a single purpose agricultural or horticultural structure.

11. Pekar v. Commissioner, 113 T.C. No. 12 (9/1/99). Under the “last-in-time rule,” the §59(a)(2)(A) limitation of the AMT foreign tax credit to 90 percent of liability supersedes preexisting US-UK treaty rules regarding foreign tax credits or US citizen subject to UK taxation to the extent the two conflict. The limitation is not inconsistent with the US tax treaty with Germany.

12. AOD 1999-008, acquiescence in Hospital Corp. of America v. Commissioner, 109 T.C. No. 2 (1997) on the finding that the pre-1981 ITC and Reg. §1.48-1(3) tests apply for depreciation purposes, but nonacquiescence in the finding that the items were deductible as §1245 property.

  a. If you tell the building inspector that the plumbing and electrical systems aren’t part of the building, and that he doesn’t have jurisdiction, he won’t believe it. Just show the building inspector the ACRS/MACRS case law! Hospital Corp. of America v. Commissioner, 109 T.C. No. 2 (7/24/97). Citing S. Rep. 99-313 at 105 (1986), reprinted in 1986-3 C.B. (Vol 3) 105, for the proposition that §168(i)(6) incorporates the express prohibition on component depreciation in pre-1986 §168(f)(1), the Tax Court held that the “component method” of depreciating buildings, which allowed varying recovery periods for different structural parts of a single building, is proscribed under MACRS as ACRS. Nevertheless, the court went on to hold that many items ordinarily considered to be structural parts of a building for most other purposes are not structural parts of a building, and thus real estate, for tax purposes, but are tangible personal property subject to cost recovery over a shorter recovery period at an accelerated method under ACRS or MACRS.

- According to the Tax Court, Congress intended that the definition of tangible personal property under the now repealed investment tax credit be applied to determine whether a particular item is tangible personal property or real estate. (The meaning of tangible personal property for purposes of the ITC is determined under Treas. Reg. §1.48-1(c); structural components of a building, which were not eligible for the ITC, are identified under Treas. Reg. §1.48-
Under this test, an item is a structural component of a building if it relates to the operation and maintenance of the building, but it is not a structural component of the building if it is machinery the sole justification for which is to meet temperature or humidity requirements essential to the operation of other machinery or processing food or materials.

- Applying these standards, the court found the following items were not structural components of the building, and thus had a separate 5-year cost recovery period: (1) primary and secondary electrical systems attributable to electrical equipment (on a percentage basis), (2) branch electrical systems serving only equipment (except equipment that relates to the operation or maintenance of the building), (3) wiring for the telephones, (4) vinyl wall coverings, i.e., wall paper, (5) vinyl floor covering glued to the floors, kitchen water and steam piping, (6) kitchen exhaust system, (7) movable room "partitions" affixed to the walls and ceilings. Among the items found to be structural components of the building were acoustical ceilings, bathroom fixtures, and steam boilers.

- Note that Rev. Proc. 96-31, 1996-20 I.R.B. 11, grants permission for an automatic change of method of accounting for depreciation, where taxpayer has claimed less depreciation than allowable. Procedure for requesting an automatic change in method of computing depreciation or amortization where taxpayer has claimed less depreciation or amortization than allowable. Form 3115 must be submitted to IRS within 180 days of the beginning of the year and copy attached to timely filed tax return. Section 481(a) adjustment (usually negative) to be taken into account in one year, i.e., the entire amount of unclaimed depreciation is allowable as a deduction in the year of change.

13. Notice 99-51, 1999-40 I.R.B. (9/21/99). Explanation as to when successor employers may claim work opportunity credits or welfare-to-work credits for wages paid to those who worked for more than one employer in process of moving from welfare to work.

B. Expenses

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

a. *They who live by the [financial accounting] sword will die by the [tax] sword. PNC Bancorp, Inc. v. Commissioner, 110 T.C. No. 27 (6/8/98). Banks’ loan origination expenditures were incurred in the creation of loans, which were separate and distinct assets that generated revenue over a period beyond the current taxable year. Judge Ruwe held the expenditure must be capitalized. Taxpayer had argued that they were recurring expenses, so deductible. However, these costs were capitalized for financial accounting purposes, and amortized over the life of the loans, in accordance with SFAS 91 [relating to deferral of loan origination (1) “incremental direct costs” and (2) certain costs related to specified activities of the lender].

b. REG-209373-81, proposed regulations relating to §195 elections to amortize start-up expenses (63 F.R. 1933, 1/13/98). Amortization begins when business becomes active. Elections are to be effective for the year filed or any subsequent year. Expenses omitted from the initial election may be added in a later year.

(1) *No More Audit Lottery on Trying to Deduct Start-Up Expenses – The Stakes Are Now Too High. T.D. 8797, final regulations on the rules and procedures for electing to amortize start-up expenses under §195 (63 F.R. 69554, 12/17/98), 1999-5 I.R.B. 4. Promulgates Treas. Reg. §1.195-1, governing elections under §195. Although the regulation is mostly procedural it contains one very important substantive rule. The regulations require that the election specify the expenses with respect to which the election applies. The listing of expenses may be revised, but the regulations prohibit a revised election from including any expenses with respect to which the taxpayer has taken a return position treating the expenses as a currently deductible “business expansion” expenses rather than as a capitalized and amortizable start-up expense. This rule is designed to prevent taxpayers from playing audit lottery on start-up costs by aggressively claiming them as deductible expenses, confident that if they lose, the worst result is 60 month amortization. Under the regulations, if the taxpayer erroneously claims a start-up expense as a deduction, the start-up never can be amortized under §195 even though the deduction is disallowed.

c. *The magic (tragic?) moment when taxpayer has decided whether to enter into a particular acquisition. TAM 199901004 (9/28/98). Legal and accounting expenses incurred in investigating a business acquisition after the purchaser has “made up its own mind” to enter into the acquisition [e.g., by signing a letter of intent] do not qualify as §195(c)(1) start-up expenditures, but must be capitalized under §263 because they would not have been deductible had they been incurred in connection with an existing business. The TAM held that “investigatory expenditures incurred in order to
d. *Takeover target’s* costs of investigating the suitability of its own acquisition, including an allocated portion of 82 of its officer’s salaries, were required to be capitalized. A losing argument that probably shouldn’t have been made in the first place rings the second toll of the bell on the death knell for *Briarcliff Candy*, *Norwest Corp. v. Commissioner*, 112 T.C. No. 9 (3/8/99). Takeover target’s deduction for investment banking, legal and accounting fees for investigating whether to accede to the takeover were required to be capitalized because all these costs “were sufficiently related to an event that produced a significant long-term benefit,” citing *INDOPCO, Victory Markets [99 T.C. 648 (1992)] and Staley [105 T.C. 166 (1995), rev’d and remanded, 119 F.3d 482 (7th Cir. 1997)].

- Judge Laro held that even though these costs were not incurred as “direct costs of facilitating the event that produced the long-term benefit” – which would have been required by the 7th Circuit’s *Staley* holding – “the costs were essential to the achievement of that benefit.”
  - Included among the costs capitalized was a $150,000 allocation from the salaries paid to 9 executives and 73 other officers of the target, attributable to their services on various aspects of the takeover transaction.
  - The taxpayer argued that the salaries were deductible because they would have been incurred anyway and, alternatively, that the “business expansion” doctrine was implicitly codified by the enactment of §195. Taxpayer argued that the salaries were deductible under that doctrine (an argument that was a tough row to hoe because taxpayer had conceded that under *INDOPCO* the direct costs were capital expenditures). Expanding on its earlier holding in *FMR Corp. v. Commissioner*, 110 T.C. 402 (1998), the court flatly stated that *INDOPCO* had effectively overruled the line of cases, starting with *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973), that allowed a current deduction for “business expansion” costs, in contrast to start-up costs. The court added that the enactment of §195 did not implicitly endorse the deductibility of all business expansion costs.

 e. *TAM 9825005 (3/9/98).* Capitalizes salaries paid to taxpayer’s [bank holding company] employees in investigating the acquisition of a bank. Also, such expenditures are not start-up
expenditures eligible for §195 amortization because that provision “does not apply to amounts paid or incurred as part of the acquisition cost of a trade or business.”

f. The “Dana doctrine” — Capital Expenditure versus Ordinary Expense analogue of the good old days Corn Products doctrine. Dana Corp. v. United States, 38 Fed. Cl. 356, 97-2 U.S.T.C. ¶50,566, 80 A.F.T.R.2d 5412 (Fed. Cl. 7/15/97). Taxpayer paid Wachtell, Lipton annual retainers of $100,000. Taxpayer’s motive in retaining Wachtell, Lipton was to prevent the law firm from representing any other corporation in an effort to take-over the taxpayer, but the retainer could be credited against fees for any legal services. In 1989, Wachtell, Lipton provided services in connection with taxpayer’s acquisition of another company, and billed the taxpayer $275,000, with the $100,000 retainer credited against the amount due. Taxpayer capitalized the $175,000 that it paid in addition to the retainer, but deducted the retainer. The court held that the retainer was deductible because the retainer was paid regularly and ordinarily provided no benefit beyond the year-end. The origin of the claim test applied as of the time the retainer was paid, not with hindsight as of the time it was credited to legal services.

(1) *Not so fast, Dana is reversed by the Federal Circuit; retainer fee applied to capital expenditure held not to be deductible, 174 F.ed 1344, 99-1 U.S.T.C. ¶50,411, 83 A.F.T.R.2d 1699 (Fed. Cir. 4/7/99). The lower court failed to examine the use of the retainer fees over the year. Held, the origin and character of the expense incurred governed its deductibility, which was her for services rendered for a capital purchase – not for an ordinary and necessary retainer fee to insure that the Wachtell firm would be on standby. The Federal Circuit reversed, holding that the use to which the retainer fee was applied in a particular year controlled its characterization as a deductible expense or a capital expenditure. Because of the offset clause, the payment itself was merely a deposit. Judge Michel held that it is the use of a fee in a particular year that determines the deductibility of the expense in that year, and not the pattern of other years of paying it.

- Taxpayer paid Wachtell, Lipton annual retainers of $100,000. Taxpayer’s motive in retaining Wachtell, Lipton was to prevent the law firm from representing any other corporation in an effort to take-over the taxpayer, but the retainer could be credited against fees for any legal services. In 1989, Wachtell, Lipton provided services in connection with taxpayer’s acquisition of another company, and billed the taxpayer $275,000, with the $100,000 retainer credited against the amount due. Taxpayer capitalized the $175,000 that it paid in addition to the retainer, but deducted the retainer. The Court of Claims held that the retainer was deductible because the retainer was paid regularly and ordinarily provided no benefit beyond the year-end. The origin of the claim test applied as of the time the retainer was paid, not with hindsight as of the time it was credited to legal services. The Federal Circuit reversed, holding that the use to which the retainer fee was applied in a particular year controlled its characterization as a deductible expense or a capital expenditure. Because of the offset clause, the payment itself was merely a deposit.

g. *Is Rev. Rul 94-38 all it’s cracked up to be? Dominion Resources, Inc. v. United States, 48 F. Supp. 2d 527, 99-1 U.S.T.C. ¶50,369, 83 A.F.T.R.2d 1350 (E.D. Va. 3/5/99). The taxpayer incurred environmental remediation expenses to remove asbestos and other contaminants from a site previously used as a power generating station for purpose of preparing the site of the retired power plant for use as an office building site or for sale. Rev. Rul. 94-38, 1994-1 C.B. 35, generally allows a deduction for environmental remediation costs to remedy the taxpayer’s own prior pollution. Notwithstanding the Ruling, the taxpayer was required to capitalize the expenditures because it did not merely maintain the property, but increased the appraised value of the property from approximately $1.5 million to approximately $9 million and prepared it for a new or different use. Rev. Rul. 94-38 was inapplicable because the site was no longer used as a power generating station, nor was such use in the future contemplated by taxpayer.

(1) A definitive, but less-than-comprehensive, post-Indepco revenue ruling. Rev. Rul. 94-38, 1994-25 I.R.B. 4 (6/2/94). This ruling addresses soil remediation and groundwater treatment costs attributable to pollution caused by the taxpayer, and does not apply to costs attributable to pre-ownership contamination or to costs other than soil remediation and groundwater treatment. It relies upon Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), which held that costs incurred to restore taxpayer’s property to essentially the same condition that existed prior to the contamination were deductible under §162. The ruling holds that environmental cleanup costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from its business (other than costs attributable to the construction of groundwater treatment facilities) are deductible under §162 as ordinary and necessary business expenses. The cost of construction groundwater treatment facilities must be capitalized under §§263 and 263A. This ruling applies whether
the taxpayer plans to continue its manufacturing operations that discharge the hazardous waste or to discontinue those manufacturing operations and hold the land in an idle state, but it does not apply to costs incurred in anticipation of sale of the land. This ruling supersedes TAM 9315004 (12/17/92), which required capitalization of cleanup costs for land contaminated with PCBs.

**h. *The IRS won't throw in the towel on RJR Nabisco!* AOD 1999-012 (10/4/99). The IRS indicated its nonacquiescence in RJR Nabisco. The AOD concludes that Rev. Rul. 92-80,1992-2 C.B. 57, did not concede that package design costs are advertising and, therefore, deductible, and reiterates that under Rev. Rul. 89-23, 1989-1 C.B. 85, modified in Rev. Proc. 98-39, 1999-26 I.R.B. 36, package designs have an indeterminate useful life and package design costs therefor are capital expenditures. The AOD also states that the Tax Court erred in concluding that Rev. Rul. 92-80 conceded that all advertising costs are per se deductible. The IRS continues to maintain that advertising costs must be capitalized in “the unusual circumstance” where the advertising is directed towards “obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising.”

(1) *Revenue Ruling 92-80 was binding on the Commissioner.* Forget about INDOPOCO, even the separate and distinct asset test doesn’t apply to advertising expenses to produce intangible assets. RJR Nabisco v. Commissioner, T.C. Memo. 1998-252 (7/8/98). “Graphic design” expenditures for cigarette packaging are advertising expenditures, deductible under §162. Judge Halpern followed Rev. Rul. 92-80, 1992-2 C.B. 57, to conclude that advertising expenditures should not be bifurcated between those giving short- and long-term benefit. The IRS argued that they were part of “trade dress,” which had to be capitalized in the “economic value inherent in a successful brand.” The relatively small amount of expenditures [i.e., 1.5 percent] for “package design” – the design of the physical construction of a package – were not separately addressed by the parties or the court, so were treated similarly.

- The Commissioner argued that the graphic design costs should be capitalized, distinguishing the costs of developing advertising campaigns, which should be capitalized because they produce long-term benefits, and the costs of executing those campaigns, for example, by television commercials, which the Commissioner conceded are deductible under §162. The Tax Court (Judge Halpern) rejected the Commissioner’s argument and found that neither the separate and distinct asset rule nor INDOPOCO applied. The court found as matter of fact that at the time graphic designs or advertising campaigns are introduced, no one can determine how long the graphic designs, advertising campaigns, or elements of such designs or campaigns will be used, including whether or not they will be used for more or less than a single year, although it acknowledged that many advertising designs and campaigns are used for many years. It accepted the taxpayer’s expert witness’ definition of “advertising” expenses as a unitary concept that includes “cigarette package graphic designs” qualify as advertising under that definition, and the Commissioner conceded this definition.

2. No more “reasonable compensation” figures merely picked out of the air; now the Tax Court has to explain the financial theory of its decisions, at least in the Ninth Circuit. This will make the Tax Court love valuation [and other number-determination] cases even more. Leonard Pipeline Contractors, Ltd. v. Commissioner, 142 F.3d 1133, 98-1 U.S.T.C. ¶50,356 (9th Cir. 4/24/98), rev’d and remanding T.C. Memo. 1996-316 (Jacobs, J.). The president and chief operating officer of the taxpayer corporation indirectly owned its stock. From the time the corporation was formed until 1987, the year the shareholder retired, the corporation had net income of $1,750,958. In 1987, when the shareholder retired [oh, and incidentally in the same year that he became obligated to pay his ex-wife $1,680,00 pursuant to a divorce decree] the corporation, after receiving advice from Arthur Andersen, paid him $1,777,800, a bonus of $1,680,000 (reflecting the absence of compensation in earlier years) in addition to $97,800 of salary. The IRS disallowed a deduction for all but $37,207 of the bonus. After reciting the factors of Elliots, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983), and declaring each of them in turn either “favorable” to characterization of the payment a reasonable compensation, indicating otherwise, or neutral, the Tax Court declared $700,000 to be the amount of “reasonable compensation.” The Ninth Circuit reversed and remanded, directing the Tax Court to “spell out its reasoning and to do more than enumerate the factors and leap to a figure intermediate between the [taxpayer’s] and Commissioner’s.”

- The opinion noted that the case has been pending in the Tax Court for six years, and taxpayer contended the court consulted ex parte with the experts.

reasonable compensation with mathematical precision is impossible,” proceeded to explain to the 9th Circuit how he decided that $700,000 was reasonable compensation based on the facts as found in the original opinion.

3. Dexsil Corp. v. Commissioner, 98-1 U.S.T.C. ¶50,471 (2d Cir. 6/3/98), rev’g T.C. Memo. 1995-135 (Cohen, C.J.). Reverses Tax Court holding [that shareholder-president was paid more than CEOs in similar small corporations] because the Tax Court’s failure to address the factors used to determine reasonableness of compensation from the perspective of “a hypothetical or independent investor” was erroneous as a matter of law. The Second Circuit held that the shareholder-officer’s compensation must be viewed expressly from the perspective of an independent investor, which is “a lens through which the entire analysis should be viewed” — and not merely an autonomous factor.

a. On remand, Judge Cohen explains why she got it right the first time. The Tax Court applied the Second Circuit’s “hypothetical investor” test and determined the same amounts of “reasonable compensation” as before. Dexsil Corp. v. Commissioner, T.C. Memo 1999-155 (5/5/99). Based on all relevant factors, a hypothetical investor would not have accepted the shareholder-employee’s compensation as reasonable because “the hypothetical investor standard does not look solely to the rate of return but looks to other factors as part of the entire tableau.” A hypothetical investor would not have approved pay increases of 30 and 32 percent in years in which the return on investment was declining.

Chief Judge Cohen stated that data indicated that the shareholder / president was paid more than four times the median CEO compensation, and she noted, “We do not believe the hypothetical investor would have . . . ignored the availability of other executives at less compensation.”

b. It pays to be a workaholic. Herold Marketing Associates, Inc. v. Commissioner, T.C. Memo 1999-26 (1/29/99). In a reasonable compensation case, the Tax Court allowed a deduction in full for compensation to employee sole shareholder of a computer sales firm (manufacturers’ representative) who over several year period received salary roughly equaling 92 percent of corporation’s income before deducting the salary. The amount was reasonable because he was an “exceptionally qualified” “micro-manager” “workaholic” in a “highly specialized . . . operation, occupying a unique niche in its industry.” Bonus formula, even though not determined at arms’ length, was set early in the year, and the employee shareholder had guaranteed millions of dollars of corporate loans.

c. $4.4 million dollars only served to remedy prior years of undercompensation. Alpha Medical Inc. v. Commissioner, 172 F.3d 942, 99-1 U.S.T.C. ¶50,461 (6th Cir. 4/19/99), rev’g T.C. Memo. 1997-464. Compensation in the amount of $4.4 million paid to president and sole shareholder of medical management [home healthcare] corporation was reasonable because it “did not exceed the amount needed to remedy prior years of undercompensation,” and the president was a skilled executive who had earlier forgone the opportunity to earn a salary of more than $1 million per year from an unrelated company. Judge Merritt, in reversing the Tax Court and finding the entire amount of compensation paid to be deductible, noted that the return on equity for the tax year at issue was 98.65%, “a return with which any independent investor would no doubt be satisfied.” (The IRS initially determined that $400,000 [later increased to $1.8 million] was reasonable, and the Tax Court determined that $2.3 million was reasonable.)

Note that the following year the taxpayer became an S corporation.

d. He took all the corporation’s money, and every penny of it was all reasonable compensation. Law Offices of Richard Ashare P.C. v. Commissioner, T.C. Memo 1999-282. From 1989 through 1992 the taxpayer corporation received legal fees of $12,567,623 that resulted from the $70 million settlement of a class action suit in which it represented the plaintiffs, and it paid its sole shareholder / sole professional employee compensation of $10,492,500 over those years. In 1993 it paid him $1.75 million dollars in compensation, generating an NOL of $1,857,933, which it carried back to a prior year to receive a $581,812 refund. For all of the years in question the sole case on which the corporation’s shareholder/lawyer worked was the settled class action. Prior to 1990 the corporation’s compensation plan was to pay Ashare all of the legal fees it collected, less its actual expenses, but in 1990 the corporation retained nearly $4,000,000. In subsequent years it paid Ashare substantially more than it collected in legal fees, generating NOLs. The corporation never paid any dividends. Held: the amount paid in 1993 was reasonable and was paid as compensation for past years work for which Ashare had not been fully compensated. That Ashare had lent the corporation over $900,000 to enable it to pay him in
cash. But for Ashare's efforts the corporation would not have received any of the $12,567,623 of legal fees.

e. *Payments to shareholder-employees under taxpayer corporation's “incentive compensation plan” – even if reasonable in amount – were not deductible, but were dividends in disguise. O.S.C. & Associates, Inc. v. Commissioner, 99-2 U.S.T.C. ¶50,765 (9th Cir. 8/16/99). (2-1), aff'g T.C. Memo. 1997-300. Held, “[taxpayer’s] payments to shareholders, whether or not reasonable in amount, were not intended as compensation. They were dividends in disguise.”

- The dissent characterizes the reasons for the majority decision as follows: “It cannot be doubted that the so-called “incentive compensation plan” developed by the taxpayer was nothing more than a ham-handed attempt to characterize distributions of corporate profits, which otherwise are non-deductible dividend payments, as compensation payments of the shareholder-employees.” The majority affirmed the Tax Court findings that (1) the percentages of taxpayer's net income paid to its two employee-shareholders was high [81% and 94%]; (2) taxpayer never paid or declared a dividend; (3) taxpayer's CPA manipulated the actual implementation of the plan to increase the allocations; and (4) the design of the plan itself was inconsistent with compensatory intent [applied only to shareholders and no other employees, payments calculated with reference to proportionate stock ownership, and method of calculation was not based on the value of services rendered, but was structured to distribute gross profit].

- Dissent on the ground that the Tax Court did not apportion the incentive compensation between deductible and non-deductible amounts.

4. The no-charge employee meals issue.

a. 1997 Act §970 amends Code §132(e)(2) to neutralize the treatment of no-charge employee meals (as having been provided at an amount equal to direct operating costs for the meal), for purposes of determining whether a company cafeteria meets the requirement for being a de minimis fringe benefit (i.e., the revenue derived from the facility equals or exceeds its direct operating costs). Effective for taxable years beginning after 12/31/97.

b. Clarifies the issue in Boyd Gaming Corp. v. Commissioner, 106 T.C. No. 19 (5/22/96) (on motion for partial summary judgment, held that the cost of meals provided without charge by gambling casinos to employees may be deducted in full [without reduction under §274(n)(1)] if they are within the §132(e) de minimis fringe benefit exception of §274(n)(2)(B), and whether they are within that exception is a question of fact. On the requirement that the annual revenue from the eating facility normally equals or exceeds the direct operating costs, Judge Laro noted that if §119 allows all the employees to exclude the value of the meals from gross income, the eating facility's revenues and expenses will both be zero for purposes of the test). Query: Is a full deduction available to the employer for a facility that provides only meals excludable under §119? Answer: Yes.

c. The taxpayer won the legal issue, but lost the factual issue, and thus lost the second round in the case. Boyd Gaming Corp. v. Commissioner, T.C. Memo. 1997-445 (9/30/97). The issue was whether §274(n)(1) applied to limit the employer's deduction for free meals furnished to workers in its casinos to 80% [now 50%] of the cost. In an earlier opinion, 106 T.C. 343 (1996), the Tax Court denied the Commissioner's motion for summary judgment and held that pursuant to §274(n)(2)(B), an employer could deduct 100% of free meals furnished in cafeterias on its business premises to on-duty employees if the meals were excludable by the employees as de minimis fringe benefits under §132(e). [This result is now codified in §132(e)(2).] After a trial on the merits, the court held that a majority of the employees did not receive the meals for a substantial noncompensatory business reason; because §119 thus did not apply to substantially all of the employees who received free meals, §119 did not apply to any employee's meals. Thus, the meals were not de minimis fringe benefits under, and accordingly, §274(n)(1) applied to limit the employer's deduction for the cost of meals.

d. A hand for Boyd Gaming? Taxpayer finally wins, or does it? 1998 Act §5002 amends Code §119 to provide that all meals provided to employees on the employer's business premises will be treated as furnished for the convenience of the employer [and thus excluded from gross income] if more than half of the employees furnished meals would qualify for §119 treatment. Retroactive effective date.

- Query whether the statute would help Boyd Gaming? The Tax Court found that only 41 to 49 percent of the employees furnished meals had their meals furnished for the convenience of the employer.
e. *Taxpayer was finally buoyed up by the Ninth Circuit reversal of the Tax Court. The only nexus required for full deductibility of the meals is taxpayer’s “stay-on-premises” policy. Boyd Gaming Corp. v. Commissioner, 177 F.3d 1096, 99-1 U.S.T.C. ¶50,530 (9th Cir. 5/12/99), rev’g T.C. Memo. 1997-445 (9/30/97). Held, the only nexus required for full deductibility of meals furnished to all employees is the employer’s “stay-on-premises” policy, which constituted a “substantial noncompensatory business reason” for the furnishing of meals – an argument that had been rejected by the Tax Court. (The Tax Court had required “a closer and better documented connection between the necessities of the employer’s business and the furnishing of the free meals.”). Inasmuch as the stay-on-premises policy clearly applied to more than half of the employees, taxpayer was allowed the full deduction for meals furnished pursuant to §119.

- Judge McKeown stated that taxpayer’s business judgment as to whether the meals were furnished for the “convenience of the employer” is measured by a “business-necessity” theory – particularly when that business judgment is supported by credible and uncontradicted evidence as to the security and logistics reasons for the policy – should not be second-guessed by the courts, citing Commissioner v. Kowalski, 434 U.S. 77 (1977).
- Judge McKeown warned practitioners that taxpayers are not free to simply wave a “magic wand” and say they had a policy in order to be entitled to a deduction.
- Because of the employer’s requirement that all employees remain on the business premises throughout their shifts, more than one-half of employees received their meals for substantially noncompensatory business reasons and the convenience of the employer test was met. The “stay on the premises” rule standing alone was a sufficient nexus and the taxpayer was not required to show that the meals were linked to specific duties. All of the meals were thus excludable by virtue of §119(b)(4), which is retroactively effective, and thus were de minimis fringe benefits not subject to the §274(n) limitation. The Tax Court could not substitute its judgment for the taxpayers in determining whether the requirement that the employees stay on the business premises had a business purpose.

f. See also, Announcement 98-78, 1998-34 I.R.B. 30 (IRS offer to settle hospitality industry employee meal controversies), postponed by Announcement 98-100, 1998-46 I.R.B. 42.

g. *Yes, Virginia City, there is a Santa Claus – or, at least a free lunch. The IRS throws in the towel. Announcement 99-77, 1999-32 I.R.B. 243 (7/21/99). The IRS will not seek certiorari in Boyd Gaming Corp. It will terminate the settlement initiative relating to employee meals in Ann. 98-78, 1998-34 I.R.B. 30. Pending cases involving the issue will be resolved on the basis of their particular facts in light of the Ninth Circuit’s opinion and the Service’s acquiescence. The IRS noted that the “stay on premises” policy in Boyd Gaming “is only one example of the type of business practice that could justify the employer’s providing of meals that would qualify for section 119 treatment.” The acquiescence continues, “Another example could be a practice requiring “check-out procedures for employees leaving the premises in order to address the same type of security concerns that were relevant in Boyd Gaming.” The IRS reiterated the Ninth Circuit’s warning to practitioners, that taxpayers are not free to simply wave a “magic wand” and say they “had a policy” in order to be entitled to a deduction.

5. Acceleration of date of deductibility of entire health insurance premium for self-employed. TTREA ‘98 §2002(a) amends §162(l) to accelerate the date for deductibility of 100% of self-employed’s health insurance to year 2003. For years 1999-2001, 60% of such costs are deductible, and for year 2002, 70%.

6. *Funny, nobody noticed that driving costs were going down. Rev. Proc. 98-63, 1998-52 I.R.B. Effective 1/1/99, the business mileage rate will be reduced from 32.5 cents to 31 cents.

a. Announcement 99-7, 1999-2 I.R.B. 45. The effective date for the change in the business mileage rates was delayed to 4/1/99,


7. *Professional real estate developer was denied expensing treatment available to us amateurs. Reichel v. Commissioner, 112 T.C. No. 2 (1/7/99). As was made clear by current regulations §1.263A-2(a)(3)(ii), applicable to post-1993 years, an individual real estate developer who purchased land for development must capitalize real estate taxes paid – even though he never began developing the land due to adverse economic conditions (and continues to hold the land for
development). Judge Laro held the word “produced” was to be construed broadly and that congress intended that the capitalization rules be applied to “costs incurred before as well as during the production period.” Von-Lusk v. Commissioner, 104 T.C. 207 (1995), followed.

8. *Will we ever really know what’s nondeductible commuting and what’s deductible travel from one place of business to another? Rev. Rul. 99-7, 1999-5 I.R.B. 4. The IRS now takes the position that commuting to a temporary work location within the taxpayer’s own metropolitan area (in contrast to trips outside the metropolitan area) is deductible only if the taxpayer has either one or more regular work locations away from his residence or a home office that qualifies as his principal place of business under § 280A(c)(1)(A). A temporary work location generally is any location at which the taxpayer expects to be, and actually is, employed for one year or less. Presumably this definition treats as “temporary” locations to which the taxpayer commutes intermittently over a period of years, such as a lawyer’s trips to the county courthouse, a tax practitioner’s trips to the local IRS office, and a sales representative’s regular periodic trips to visit customers. Rev. Rul. 90-23, 1990-1 C.B. 28 and Rev. Rul. 94-47, 1994-2 C.B. 18, were modified and superseded.

9. *More on what is and what isn’t commuting. Strohmaier v. Commissioner, 113 T.C. No. 5 (8/3/99). The taxpayer worked out of a home office as a minister and as an independent insurance agent. His congregation was at a snowbird mobile home park in Florida during the winter months only. His only office for both businesses was a room in his own home. He prepared all of his sermons there and also did all of his research and preparation for his insurance business in his home office. None of his client contacts, however, were in the home office. All of his sales activity was at the clients’ homes or other locations of the clients. Applying Soliman, 506 U.S. 168 (1993), the court held that the home office was not Strohmaier’s principal place of business. As a result, Rev. Rul. 94-47, 1994-2 C.B. 18 [now modified and superseded by Rev. Rul. 99-7, 1999-5 I.R.B. 4] was to deny any deduction for the expenses of the trip from his home to his first business related stop and the expenses of the trip from his last business related stop back to his home, even though the cost of his other travel during the day was deductible business travel. The court also interpreted the “sleep or rest” rule [United States v. Correll, 389 U.S. 299 (1967)], to require a rest of sufficient duration to require the securing of lodging and disqualified the taxpayer’s meal expenses. Taxpayer suffered from apnea and argued that his medical condition required him to take long rest breaks during the day, which extended his work day and thus required that he eat meals on the road.

10. *Ya gotta do it 100 percent right if ya wanna use the lease value tables to compute the fair market value of taxable fringe benefits. BMW of North America, Inc. v. United States, 39 F. Supp. 2d 445, 99-1 U.S.T.C. ¶50,255, 83 A.F.T.R.2d 787 (D. N.J. 12/22/98). BMW provided the free personal use, subject to certain restrictions on use (such as not parking on the streets of New York) of various models of BMW to more than 2000 employees as a fringe benefit. The higher ranking the employee, the more expensive model of BMW he or she was assigned. BMW valued the employees’ use of the cars using the safe harbor tables in Reg. §1.61-21(d)(2)(ii), but in determining the fair market value of the car for purposes of applying the tables to determine lease value, BMW discounted the retail price to reflect the restrictions on use, as well as the employees’ lack of choice regarding model, color, options, etc.

* The court upheld the IRS disallowance of the use of the tables and its valuation of the benefits under the general rules of Reg. §1.61-21 because Reg. §1.61-21(c)(5) limits the use of the special valuation tables to calculations that comply with all of the elements of the special valuation rules, and Reg. §1.61-2-2(d)(5) requires that the fair market value of an automobile for applying the lease valuation tables be the amount that an individual would have to pay in an arms’ length transaction, disregarding any special relationship that may exist between the employer and the employee. Since, in an arms’ length purchase, there are no restrictions on use or choice of model, color, or options, BMW’s valuation method did not comply with the regulations. The general market undesirability of the particular models or colors of the cars assigned to the employees could, however, be taken into account lease value under general valuation principles.


12. *Be careful how you word that settlement agreement! Talley Industries, Inc. v. Commissioner, T.C. Memo 1999-200 (6/18/99), on remand from 116 F.3d 382 (9th Cir. 1997), vacating
T.C. Memo. 1994-608. In its 1994 decision the Tax Court held that restitution of $1,885 paid to the United States government pursuant to a guilty plea on criminal charges under the False Claims Act of mischarging the government on a government contract was nondeductible under §162(f). On a motion for summary judgment, the Tax Court held that another $2,498,115 paid to settle claims based on similar incidents but with respect to which the taxpayer was not criminally charged was deductible. Its decision on this issue was vacated and remanded because a genuine issue of fact existed as to nature of $940,000 payment in excess of government's actual $1.56 million loss [the portion of $2.5 million settlement that exceed government's actual loss of $1.56 million]. On remand, the Tax Court held that because the settlement agreement and negotiations did not provide any evidence that the $940,000 in question was compensatory, it represented double damages under the False Claims Act and therefore was a nondeductible penalty.

13. *A lease is lease, of course, of course ...* Peaden v. Commissioner, 113 T.C. No.6 (8/9/99). Section 7701(h) prohibits the effect of a "terminal rent adjustment clause" ("TRAC") from being considered in determining whether a "qualified motor vehicle operating agreement" cast in the form of a lease is actually a lease or whether it really is a purchase and sale. Judge Wells held that in examining whether a transaction in the form of a long-term lease of customized trucks actually was a lease, §7701(h) required the IRS and courts to ignorance a clause that required the lessor to sell the vehicles at the end of the lease [which was earlier than the end of the economic useful life of the trucks] and remit to the lessee any proceeds that exceed the "base price," an amount which was determined by subtracting from the lessors acquisition cost [including the cost of customizing it for the lessee] a portion of the each rental payment. The lessee paid all registration and compliance fees and taxes on the vehicles. Some of the leases had an option to buy feature, but the lessors realized more than a *de minimis* pre-tax profit on the leases. Stripped of the rent adjustment rebate feature, the transactions were viewed as fairly standard net leases and the taxpayer-lessee was entitled to deduct that rental payments rather than depreciation, which was less than the rental payments. [The protection of §7701(h) does extend to leases of property other than motor vehicles.]

C. Losses and At Risk

1. TTREA '98 §3004(a) amends §172(f)(1)(B) to limit "specified liability losses" entitled to 10-year NOL carryback to product liability losses and to specified liability losses under certain state and federal laws (limited to: land reclamation, nuclear power plant decommissioning, drilling platform dismantlement, environmental contamination remediation, and workers compensation losses).

2. Turner Broadcasting System Inc. and Tracinda Corp. v. Commissioner, 111 T.C. No. 18 (12/23/98). On motions for partial summary judgment, held taxpayers were entitled to partial summary judgment. Where a corporation that is a member of a controlled group is acquired by an unrelated third party (thus terminating the controlled group relationship) and that corporation simultaneously sells an asset at a loss to a member of the former controlled group, §267(f) and its regulations do not defer or deny the loss of the selling member, nor increase the purchasing member's basis in the asset by the amount of the loss. The form selected by the taxpayers was not a fiction that failed to reflect the substance of the transaction, following Esmark [90 T.C. 171 (1988), aff'd 886 F.2d 1318 (7th Cir. 1989)], so §311 has no application to the transaction.

3. Letter Ruling 199903030 (11/24/98). Office of Chief Counsel addresses letter to the North Central District to answer question for businesses hit by the April 1997 Red River Valley flood in North Dakota and Minnesota. Businesses should not treat the cost of restoring business property to its pre-flood condition as part of the casualty loss. Instead, it should treat such costs as §263 repairs provided that they do not materially enhance the value, use, life expectancy, strength or capacity of the property (in which event they must be capitalized under §263).

4. Sealy Corp. v. Commissioner, 171 F.3d 655, 99-1 U.S.T.C. ¶40,402, 83 A.F.T.R.2d 1377 (9th Cir. 3/26/99), aff'g 107 T.C. No. 11 (1996). Liabilities, other than products liability and tort claims (and nuclear decommissioning costs), under state and federal law are subject to the 10 year carryback rule only if the deduction was deferred by the economic performance rule of §461(h). Deductible expenses of complying with the Securities Act of 1934 with respect to a public stock offering, complying with ERISA with respect to employee benefits plans, and with respect to an audit of taxpayer's tax return were routine expenses, not "specified liability losses" within the meaning of §172(f)(10)(B), and thus could not be carried back 10 years. [The Tax and Trade Relief Extension Act of 1998 amended §170(f)(1)(B) to limit the definition of "specified liability loss" to include (in addition to tort and product liability losses) only deductions for liabilities arising under federal or state law requiring: (1) land reclamation (excluding deductions for additions to a reclamation reserve under §468(a)(1)); (2) nuclear
power plant decommissioning (excluding deductions for additions to a decommissioning reserve under §468A(a)); (3) drilling platform dismantlement; (4) environmental remediation; and (5) certain workers' compensation.

5. Whitmire v. Commissioner, 178 F.3d 1050, 99-1 U.S.T.C. ¶50,563, 83 A.F.T.R.2d 2622 (9th Cir. 5/28/99), aff'd T.C. Memo. 109 T.C. 266 (10/29/97). This case involved a complex computer leasing transaction in which the taxpayer, Robert L. Whitmire, was a member of a partnership that owned the leased computer equipment. Each partner was obligated on a recourse obligation to pay a portion of the secured obligation burdening the computer subject to which the partnership acquired the computer. A corporation involved in the promotion was obligated to reimburse the partnership for any out-of-pocket payments made in connection with the investment. The Court of Appeals affirmed the Tax Court's holding that the taxpayer was protected against loss within the meaning of §465(b)(4). That the guarantor might default or be bankrupt at the time he might be called upon to indemnify the taxpayer will not be considered unless such a factor contributes to the taxpayer incurring a realistic possibility of an economic loss. Any risk to Whitmire was merely a "theoretical possibility," not an "economic reality." The court of appeals disclaimed reliance in this case on the circular transaction precedents, e.g., American Principals Leasing Corp. v. United States, 904 F.2d 477 (9th Cir. 1990), because there was a recourse note to a creditor outside the chain in this transaction.

6. "They should have hired a good appraiser. Trinity Meadows Raceway, Inc. v. Commissioner, 99-2 U.S.T.C. ¶50,754, 84 A.F.T.R.2d 5356 (6th Cir. 7/22/99). The taxpayer's racetrack and parking lot were damaged by a flood. Reg. §1.165-7(b)(2)(i) requires business casualty losses to be determined with respect to each single identifiable asset that is damaged. No loss deduction was allowed because taxpayer's calculations were based on aggregate basis and aggregate diminution in fair market value and did not reveal either basis or diminution in the fair market value of each separately identifiable asset damaged by the flood. The purpose of this rule is to prevent the "borrowing" of basis from an unharmed property to increase the loss deduction allowed with respect to a damaged property, which the taxpayer's calculations did.

7. Fransen v. United States, 1999 U.S. App. LEXIS 24362, 84 A.F.T.R.2d ¶99-5358 (5th Cir.10/1/99, as revised 10/22/99). Mr. and Mrs. Fransen each owned an interest in a building that they leased to Fransen & Hardin, a law firm organized as a "C" corporation of which Mr. Fransen was the sole shareholder. The Fransens 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 Fifth Circuit upheld the validity of Treas. 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, all of the income, including Mrs. Fransen's share was recharacterized as active and the passive activity losses were disallowed.

8. No Mulligans allowed here. Diesel Performance, Inc. v. Commissioner, T.C. Memo. 1999-302 (9/14/99). Temp. Reg. §301.9100-12T requires NOL carrybacks to be waived on a return filed before the due date (taking into regard extensions). The failure to waive the carryback on an original return due to an honest mistake could not be remedied by election on amended return filed after the due date but within the statute of limitations.

D. Business Income

1. T.D. 8787, final regulations under §§108 and 1017, relating to ordering rules for the reduction of property bases when taxpayers exclude discharge of indebtedness income from gross income under §108 (63 F.R. 56559, 10/22/98).

2. No COD income on loan discharge when original obligation is "indefinite." Preslar v. Commissioner, T.C. Memo. 1996-543 (12/17/96). Taxpayers borrowed $1 million from bank to purchase property from sellers who had been indebted to the bank, to be repaid through the assignment of lot sales contracts to the bank. Taxpayers were to receive credit equal to 95% of the stated contract price, even if the purchaser did not pay that amount at that time. The bank was taken over by the FDIC, which demanded cash payments -- the bank having received only $200,000 in cash payments previously. Taxpayers settled with the FDIC for $350,000. Held, no cancellation of indebtedness income of $450,000 because taxpayers' liability to the bank was "sufficiently indefinite in nature and amount to avoid triggering any discharge of indebtedness income."
Preslar reversed by the Tenth Circuit and Professor McMahon’s book cited by the court. Taxpayers held to have discharge of indebtedness income because the “disputed debt” [or “contested liability”] doctrine applies only if the original amount of the debt is “unliquidated.” Zarin should be kissing his lucky stars that he didn’t live in the Tenth Circuit. Preslar v. Commissioner, 167 F.3d 1323, 99-1 U.S.T.C. ¶50,258, 83 A.F.T.R.2d 851 (10th Cir. 2/16/99) (2-1). The court noted that the arrangement for 95% credit was memorialized eight months after the loan agreement; it noted that taxpayer presented no credible evidence that the property was worth only $550,000 at the time of purchase; and it held that “[a] total denial of liability is not a dispute touching upon the amount of the underlying debt.”

- Judge Briscoe noted that Bittker & McMahon’s, Federal Income Taxation of Individuals ¶4.5[3][c] (2d ed. 1995), contains a hypothetical that reached the correct result misapplied the doctrine. The hypo dealt with a debt reduction that was negotiated following a breach of warranty claim, but it indicated that the reason for the exclusion was the contested liability doctrine [instead of the purchase price adjustment rule or "infirmity exception"].
- The court went further to reject the applicability of the statutory §108(e)(5) purchase price adjustment rule on the ground that the bank was not the seller and denied the continued existence of the common law doctrine following its codification in 1980, noting that Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940) (applying the doctrine to third-party transactions), was based upon Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 (1926), which itself has been implicitly repudiated.
- The majority also noted that the "infirmity exception" did not apply because the FDIC’s refusal to abide by the repayment terms taxpayers negotiated with the bank did not relate back to the original sale.
- The essence of the reasoning in Preslar, and its cogent destruction of the erroneous reasoning of Zarin v. Commissioner, 916 F.2d (6th Cir. 1990), is captured in the following passage:

“The problem with the Third Circuit’s holding is it treats liquidated and unliquidated debts alike. The whole theory behind requiring that the amount of a debt be disputed before the contested liability exception can be triggered is that only in the context of disputed debts is the Internal Revenue Service (IRS) unaware of the exact consideration initially exchanged in a transaction. . . . The mere fact that a taxpayer challenges the enforceability of a debt in good faith does not necessarily mean he or she is shielded from discharge-of-indebtedness income upon resolution of the dispute. To implicate the contested liability doctrine, the original amount of the debt must be unliquidated. A total denial of liability is not a dispute touching upon the amount of the underlying debt.”

Since Preslar introduced no evidence that the loan obligation was linked to the repayment scheme, there was no "contest" regarding the amount owed, only on the terms for repayment of that amount.

- The court also agreed with the IRS position in Rev. Rul. 92-99, 1999-2 C.B. 35, and held that the enactment of §108(e)(5) preempted any preexisting “common law” purchase price adjustment exception. Accordingly, the taxpayer, whose obligation on a purchase money mortgage owed to a bank that financed his purchase of the property from a third party was reduced, recognized discharge of indebtedness income.
- Judge Ebel dissented, stated that the majority’s view of the contested liability doctrine is “mistakenly narrow” and that (based upon precedents) the correct view is that when “there is a legitimate dispute between a creditor and a debtor concerning THE EXISTENCE OF A LIABILITY, and a compromise between the parties is reached, no discharge of indebtedness income will arise as to the contested and unpaid portion of the original liability” (emphasis in original), for which he cited Mertens §1.19, N. Sobel, Inc., 40 B.T.A. 1263 (1939), and Zarin v. Commissioner, 916 F.2d 110 (3d Cir. 1990). His affirmance was to have been subject to the caveat that had the taxpayers aided the landing bank to commit fraud, the equitable “contested liability exception” would not have been unavailable because of taxpayers’ unclean hands.
- Judge Ebel makes a distinction between a nonrecourse debt situation [as in Tufts] and an unenforceable debt situation [as here], for which “the borrower realizes NO ECONOMIC GAIN in the settlement of disputed debt which is unenforceable for reasons relating back to the origin of the debt” (emphasis in original). He would have also applied the §108(e)(5) purchase-money debt reduction provision because the bank was for all practical purposes the seller of the property.
3. 2925 Briarpark Ltd. v. Commissioner, 163 F.3d 313, 99-1 U.S.T.C. §50,209 (5th Cir. 1/6/99) (per curiam). Income received by a partnership from the discharge of a nonrecourse loan is §61(a)(3) gain from dealings in property, and not §61(a)(12) discharge of indebtedness income, because the sale and the discharge were a single transaction in which the buyer conditioned its purchase on the mortgagee bank’s discharge of its liens [and the bank conditioned its release on the sale to the buyer].

4. Insolvency computation does not include contingent liabilities unless payment is more likely than not. Merkel v. Commissioner, 109 T.C. No. 22 (12/30/97). Partners attempted to exclude discharge of indebtedness income on account of §108(a)(1)(B) insolvency exclusion by including “contingent” liabilities in the insolvency calculation of §108(d)(3). These contingent liabilities were in the form of guarantees under a compromise settlement in which about 1/3 of the amount due to a creditor was paid. The remaining 2/3 of the obligation would become due if taxpayers or their corporation filed for bankruptcy within 400 days of the settlement. Judge Halpern held that

[A] taxpayer claiming the benefit of the insolvency exclusion must prove (1) with respect to any obligation claimed to be a liability, that, as of the calculation date, it is more probable than not that he will be called upon to pay that obligation in the amount claimed and (2) that the total liabilities so proved exceeded the fair market value of his assets.

• The taxpayer were partners who realized cancellation of indebtedness income through a partnership. They claimed that the COD income was excludable under the insolvency exception in § 108(a)(1)(B) and (d)(3), but to calculate their insolvency they included debts of a corporation in which they were shareholders [which they had guaranteed] and uncollected state sales taxes for which they might have been contingently liable as corporate officers. Neither the bank that had made the loan that they had guaranteed nor the state had yet asserted claims against the taxpayers. The Tax Court held that the taxpayer’s were not insolvent as defined in §108(d)(3). Contingent liabilities are not taken into account in determining whether the taxpayer is insolvent for purposes of §108(d)(3). The court reasoned that the analytical framework underlying the insolvency exception is based on the “freeing of assets” theory of discharge of indebtedness income. Under this analytical framework, if all of the debtor’s assets are subject to the claims of creditors after the cancellation of a debt, the taxpayer is no better off by reason of the debt cancellation and thus realizes no income. To meaningfully apply this analysis, only obligations that certainly offset assets should be taken into account. In its opinion, the court noted that the insolvency exception does not necessarily produce the same result as the bankruptcy exception.

a. Affirmed, Merkel v. Commissioner, 99-2 U.S.T.C. §50,848 (9th Cir. 9/17/99) (2-1), aff’g Tax Court. The majority holds that for the purposes of determining insolvency under §108(d)(4), a taxpayer must show by a preponderance of the evidence that he or she would be called upon to pay the contingent liability – a more-likely-than-not test.

• Judge O’Scannlain, dissenting, would allow contingent liabilities to be deducted at their fair market value, i.e., by discounting such liabilities by the probability of occurrence, following the 3d, 7th, 8th and 9th Circuits in their determinations of this issue in bankruptcy contexts. He cited Judge Easterbrook in Covey v. Commercial National Bank, 860 F.2d 657 (7th Cir. 1992), for the proposition that a taxpayer is solvent if people would be willing to pay to be put into the taxpayer’s situation (the answer to which rests upon discounting contingent liabilities).

5. TAM 199935002 (5/3/99). The fair market value of any assets exempt from a creditor’s claims under state law is included in determining a taxpayer’s insolvency under §108(d).

• The contrary conclusion reached in TAM 9130005 is revoked by the current TAM.

6. REG-1060610-98, proposed regulations on the safe harbor under §110 [added in 1997], which allows a lessee in a short-term lease or retail space to exclude from income construction allowances it uses to construct qualified long-term property (64 F.R. 50783, 9/20/99). The safe harbor defines “qualified long-term real property” as nonresidential real property which is part of the rental space and which reverts to the lessor at the termination of the lease. It defines “short-term lease” as a lease for retail space for 15 years or less. “Retail space” is defined as real property used by a lessee in its trade or business of selling tangible personal property or services to the general public.

III. CAPITAL GAIN AND LOSS

A. In general

a. Prop. Reg. §1(h)-1, dealing with rates applicable to sales of interests in entities that own property subject to different capital gains rates under §1(h) for taxable years ending after May 6, 1997.

- Pursuant to §1(h)(6)(b), any gain from the sale of an interest in a partnership, an S corporation, or a trust that has been held for more than one year (or more than 18 months for relevant periods in 1997) that is attributable to unrealized appreciation in the value of collectibles held by the entity is treated as gain from the sale or exchange of a collectible [applying rules similar to §751(a) to determine the amount of that gain]. The amount of collectibles gain equals the collectibles gain that would be allocated to the selling partner, shareholder, or beneficiary [with respect to the portion of the transferred interest that is subject to long-term capital gain] if the entity had sold all of its collectibles in a taxable transaction immediately before the transfer of the interest. If the partner, S corporation shareholder, or trust beneficiary recognizes less than all of the gain upon the sale of its interest, a proportionate part of the gain is treated as collectibles gain.

- Under §1(h)(7)(A), the amount of long-term capital gain (not otherwise treated as ordinary income under §751(a)) that would be treated as if §1250 applied to all depreciation is unrecaptured §1250 [capital] gain, subject to a maximum rate of 25 percent. The proposed regulations follow H. Rep. No. 105-356, 105th Cong. 1st Sess. (1997), at 16, fn. 11; S. Rep. No. 105-174, 105th Cong. 2d Sess. (1998), at 149, fn. 65, and provide that upon the sale of a partnership interest held for more than one year, the amount of the gain that would have been ordinary income under §751(a) if the partnership’s unrecaptured §1250 gain had been ordinary income is treated as unrecaptured §1250 gain by the selling partner. The amount of the overall gain that is unrecaptured §1250 gain equals the amount that would have been the partner’s share of unrecaptured §1250 gain if the partnership had sold all of its §1250 property in a taxable transaction immediately before the transfer of the partnership interest. If the partner recognizes less than all of the gain upon the sale of the interest, a proportionate part of the gain is treated as collectibles gain. If the partner sells the entire partnership interest, any capital gain or loss is divided between long-term and short-term capital gain or loss in the same proportions as the holding period of the interest in the partnership is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less. The portion of a partnership interest to which a holding period relates is a percentage that equals the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates divided by the fair market value of the entire partnership interest (determined immediately after that transaction). A selling partner may use the actual holding period of the portion of a partnership interest sold if the partnership is a "publicly traded partnership" [see §7704(b)], the partnership interest is divided into identifiable units with ascertainable holding periods, and the selling partner can identify the portion of the interest transferred. Otherwise, the holding periods of the transferred interest must be divided in the same ratio as the holding periods of the partner’s entire partnership interest. The preamble notes that IRS may apply judicial doctrines, e.g., substance over form or step transaction, or Reg. §1.701-2 to attack abusive transactions designed to shift gain from the portion of a partnership interest with a short-term holding period to the portion with a long-term holding period.

b. Prop. Reg. §1.1223-3, dealing with holding period of a partnership interest acquired at different times in multiple transactions. Because a partner has a single basis in a partnership interest [Rev. Rul. 84-53, 1984-1 C.B. 159], even if the partner acquired portions of the interest at different times or acquired the interest in a single transaction that gave rise to different holding periods under §1223, partnership. If a partner sells the entire partnership interest, any capital gain or loss is divided between long-term and short-term capital gain or loss in the same proportions as the holding period of the interest in the partnership is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less. The portion of a partnership interest to which a holding period relates is a percentage that equals the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates divided by the fair market value of the entire partnership interest (determined immediately after that transaction). A selling partner may use the actual holding period of the portion of a partnership interest sold if the partnership is a "publicly traded partnership" [see §7704(b)], the partnership interest is divided into identifiable units with ascertainable holding periods, and the selling partner can identify the portion of the interest transferred. Otherwise, the holding periods of the transferred interest must be divided in the same ratio as the holding periods of the partner’s entire partnership interest. The preamble notes that IRS may apply judicial doctrines, e.g., substance over form or step transaction, or Reg. §1.701-2 to attack abusive transactions designed to shift gain from the portion of a partnership interest with a short-term holding period to the portion with a long-term holding period.

2. *Front-loading the new 25 percent capital gains rate on unrecaptured §1250 gain.* Final Regulations T.D. 8836, Capital Gains, Installment Sales, Unrecaptured Section 1250 Gain,
1999-37 I.R.B. 411, 64 F.R. 45874 (8/20/99). Effective with respect to installment payments taken into account after 8/23/99. Same as the proposed regulations,

a. REG-110524-98, proposed regulations under §453, relating to the taxation of capital gains on installment sales of depreciable real property (64 F.R. 3457, 1/22/99). As payments are received, the taxpayer must take the 25 percent gain into account before the 20/10 percent gain. Some relief for payments received between the 5/7/97 effective date of the §1(h) amendments and the effective date of the final regulations.

3. The last nail in the coffin of the “source of supply” variation of the Corn Products doctrine: Ordinary loss deduction not permitted on sale of oil refining company stock. Cenex, Inc. v. United States, 98-2 U.S.T.C. ¶50,781 (Fed. Cir. 10/9/98). The court held that Arkansas Best [485 U.S. 212 (1988)] eliminated the “business motive” test under Corn Products [350 U.S. 46 (1955)], and held that inventory substitutes “must bear a close relationship to actual inventory.” The “source of supply” cases were held to have been overruled by Arkansas Best because they relied on the expansive interpretation of Corn Products.

a. Cenex, Inc. v. United States, 97-2 U.S.T.C. ¶50,523 (Fed. Cl. 7/27/97). The taxpayer was an agricultural coop that purchased stock in an oil refining company for the purpose of securing a source of supply for petroleum products for its patrons. When it sold the stock for a loss, the taxpayer claimed an ordinary loss under the source of inventory supply variation of the Corn Products exception to the definition of capital asset. The court unequivocally rejected the taxpayer’s argument that corporate stock purchased with the motive of securing the purchase of inventory from the corporation whose stock has been purchased has sufficient “business connection” to inventory to be excluded from the definition of a capital asset. Rather, the exception is limited to surrogates for inventory, and “an ownership interest in a corporation cannot fit within even a strained definition of the term ‘inventory.’” In a footnote, the court specifically refused to follow the reasoning of Circle K Corp. v. United States, 23 Cl. Ct. 659 (1991), withdrawn, 97-1 U.S.T.C. ¶50,338, 78 A.F.T.R.2d 7619 (1996).

4. Accountants did not allocate any basis a claim purchased along with other assets because it was “too speculative.” Settlement of the claim resulted in ordinary income when there was no “property” transferred to the defendant in return for the payment. Nahey v. Commissioner, 111 T.C. No. 13 (10/21/98). Taxpayer’s S corporations purchased the assets of another corporation, which included a breach of contract and misrepresentation claim against Xerox for failing to complete the installation of a computer system. In allocating values to purchased assets, no value was assigned to the Xerox claim because the accountants determined it was “too speculative.” Held, the settlement proceeds are ordinary income, not capital gain, citing Hudson v. Commissioner, 20 T.C. 734 (1953), to the effect that taxpayer’s corporations did not transfer any property to Xerox, so the claim was extinguished (or paid), and not sold or exchanged. Judge Jacobs also distinguished Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962), because in that case there were property rights [the right to produce the play Moulin Rouge] that reverted to the author, and in this case [Nahey] any property rights simply vanished.

5. Rev. Proc. 99-18, 1999-11 I.R.B.7 (3/1/99). Provides for an election to treat a substitution of publicly-traded debt instruments as a realization event for federal income tax purposes, even though it does not result in a significant modification under Reg. §1.1001-3 (and is, therefore, not an exchange). The election is made by a written agreement between the issuer and the holders of the debt instruments. Under this election, taxpayers do not recognize any realized gain or loss on the date of the substitution, but instead take the gain or loss into account over the term of the new debt instruments. Applicable to substitutions that occur between 3/1/99 and 6/30/00.

- Allows elective realization upon substitution of debt instruments if the modification or substitution does not constitute a significant modification under Reg. §1.1001-3. The issuer treats the new instrument as an OID instrument or an instrument with bond premium. The holder takes a substituted basis and treats new instrument as market discount bond if the redemption price exceeds the substituted basis.

6. Think about the tax consequences before you borrow on that life insurance policy. Atwood v. Commissioner, T.C. Memo 1999-61 (3/4/99). Taxpayer owned several whole life insurance policies against which he took out policy loans to pay for living expenses while he was unemployed. The interest that accrued on the loans was capitalized, and when the taxpayer subsequently surrendered the policies, the loans, including the capitalized interest, were offset against the cash surrender value. In computing the taxpayer’s income realized on the surrender of the policies, the amount
received included not only the actual cash proceeds, but also the discharged loans, including the capitalized interest. No offsetting interest deduction was allowed because the interest was personal interest subject to §163(h).

7. Reynolds v. Commissioner, T.C. Memo. 1999-62 (3/4/99). Held, taxpayer had no gain on the payments she received from her long-time companion because she received them in exchange for the release of her interest in property she had received as gifts from the companion, and her basis in the property interests equaled or exceeded the amount of the payments she received for the release.

8. *A district court challenges the Crane doctrine. Owen v. United States, 34 F. Supp. 2d 1071, 99-1 U.S.T.C. ¶50,159, 83 A.F.T.R.2d T555 (W.D. Tenn. 2/23/99). This case involved whether a cash method taxpayer could include in the basis of several condominiums that he sold the cost of post-acquisition improvements for which he had paid with a promissory note. The court distinguished unadjusted cost basis under §1012, which the court conceded included not only cash payments but also purchase money indebtedness, from positive adjustment to basis under §1016 attributable to subsequent improvements that were nevertheless required to be capitalized. The distinction is nonsensical, the case should not be followed, and hopefully it will be reversed on appeal.

9. *Capital gains for capital assets – the heck with the sale or exchange requirement. Gladden v. Commissioner, 112 TC No. 15 (4/15/99). The taxpayer was a partner in a partnership engaged in farming that received (indirectly) from the Department of the Interior payments in exchange for surrender of its rights to a water allotment, which were appurtenant to the land, from the Colorado River. The gain was a capital gain because the water rights were a property interest. The Commissioner’s argument that the transaction resulted in ordinary income under Commissioner v. P.G. Lake, Inc., 356 U.S. 269 (1958), was rejected because use of the water rights themselves did not directly produce ordinary income. They were simply one component of the taxpayer’s investment in its business. Even though the amounts were received in exchange for the surrender of the rights back to the Interior Department and the court referred to the payments received by the taxpayer as “relinquishment funds.” There was no discussion of fact that the rights were terminated in favor of the granting party rather than transferred to third party in which they continued and therefore there was no “sale or exchange.” However, the taxpayer, who acquired the land in 1976 and acquired the appurtenant water rights in 1983, could not allocate any portion of the basis of the land to the water rights to offset the amount realized on the disposition of the water rights in 1992.

IV. CORPORATIONS

A. Entity and Formation

1. Affiliated Foods, Inc. v. Commissioner, 98-2 U.S.T.C. ¶50,750, 82 A.F.T.R.2d 6357 (5th Cir. 9/25/98). Taxpayer was a nonexempt cooperative that was established by retail food markets to purchase in volume and which received funds from food vendors to conduct advertising promotions with respect to products purchased from vendors through the cooperative. Even though the funds, when received, were commingled with the cooperative’s operating account, the funds were not income to the cooperative. The members [rather than the cooperative] determined in which of the vendors’ various alternative promotional campaigns they would, through the cooperative, join; the advertising campaigns were conducted according to standards prescribed by the food vendors; and the taxpayer’s rights to the funds deposited by the vendors in the promotional accounts were conditional upon satisfaction of those standards. Accordingly, the taxpayer cooperative was a mere conduit. Any profits it derived from conducting the advertising campaigns were earned for performing services for the members participating in the promotions, not for the vendors.

2. *No more double-counting §357(c) gains in basis. P.L. 106-36, the Miscellaneous Trade and Technical Corrections Act of 1999 amended §357(c) and added new §357(d) to limit basis increases attributable to assumption of liabilities not to exceed the fair market value of the property transferred. Abuses had resulted where properties subject to liabilities were transferred to different corporations, with the result that both corporations increased basis by the same liabilities. Applicable to transfers made after 10/18/98.

3. A little nonrecognition on a south of the border incorporation. CMI International, Inc. v. Commissioner, 113 T.C. No. 1 (7/13/99). CMI formed a domestic subsidiary (CMI-Texas), which in turn formed a Mexican subsidiary that participated in a debt-equity-swap in which Mexican U.S.-dollar-denominated debt was exchanged for pesos. CMI-Texas purchased $2,300,000 of U.S.-dollar-denominated Mexican debt for $1,125,000, which it transferred to its Mexican subsidiary for additional
stock. Pursuant to a prearranged plan, the Mexican subsidiary then exchanged the debt to the Mexican government for Pesos worth $1,955,000. CMI reported no gain or loss from these transactions on its consolidated return, but the Commissioner determined that the CKI group recognized an $830,000 gain from the to the transaction, pursuant to §367(a), as a contribution of appreciated property to a foreign subsidiary. The court held that the fair market value of the Mexican U.S.-dollar-denominated debt contributed to the subsidiary was only $1,125,000 and that under Reg. §1.367(a)-1T(b)(3)(i) no gain was recognized because the debt was not appreciated in value.

B. Distributions and Redemptions

1. *The IRS doesn’t buy, “Now there’s a charge for what [they] used to do for free.”* Fees to loan guarantors held nondeductible because guarantors did the same thing earlier without being paid. Seminole Thriftway Inc. v. United States, 99-1 U.S.T.C. ¶50,155 (Fed. Cl. 12/21/98). Closely held corporation’s guarantor fees to shareholders were not deductible [and were treated as dividends] because they were not “necessary” in that shareholders had previously guaranteed the corporation’s obligations without being compensated. Judge Yock’s opinion is a thoughtful analysis of the existing (and somewhat confusing) authorities.

2. *The number used for §311 gain purposes may differ from the total value of the dividends received by shareholders.* Pope & Talbot Inc. v. Commissioner, 99-1 U.S.T.C. ¶50,158 (9th Cir. 1/6/99) (2-1), aff’g 104 T.C. 574 (1995). Amount realized (and gain recognized) by taxpayer corporation on the distribution to its shareholders of limited partnership interests in a tract of real property is measured by the value of the real property in its entirety. The court rejected taxpayer’s contention that aggregating the value of the limited partnership interests was the proper measure.

• Judge Noonan dissented, arguing that the total fair market value of the property [i.e., partnership interests] received by the shareholders should be equal to the amount distributed by the corporation.

3. *Watch how you word that shareholders’ buy / sell agreement!* Or else you convert a return of magical §1014 basis into taxable IRD. Estate of Cartwright v. Commissioner, 84 A.F.T.R.2d 5218, 99-2 U.S.T.C. ¶50,666 (9th Cir. 7/12/99), aff’g in part and remanding in part, T.C. Memo. 1996-286. Cartwright owned 71.43 percent of the stock of a law professional services corporation (CSB). CSB paid no dividends, but paid each associate and shareholder a salary and distributed its profits as bonuses. Bonuses were based on each attorney’s contribution to the firm. A shareholders’ agreement provided that CSB would purchase a deceased shareholder’s interest, paying to the shareholder’s surviving spouse or estate the following amounts: (1) the shareholder’s actual purchase price for his CSB stock; (2) any earned but unpaid profits prior to death; (3) any earned but unpaid salary prior to death; (4) incurred but unreimbursed expenses or loans; (5) 25 percent of the net amount received after death for cases that the shareholder brought to CSB; (6) ten percent of the net amount received for cases pending at the date of death that came to the firm due to the firm name or the efforts of an associate; (7) 25 percent of the net amount received during the three years following the shareholder’s death from cases for clients that the shareholder brought to the firm who provide continuing legal business; and (8) for shareholders other than Cartwright one-half of any life insurance proceeds from policies on the shareholder’s life, to be applied toward the previous obligations. With respect to Cartwright, CSB purchased two $5 million life insurance policies, of which CSB was the beneficiary and the proceeds of which it would use exclusively to purchase "all of Mr. Cartwright's stock in the Corporation together with any claim to any cases or work in process that may otherwise be made on behalf of Robert E. Cartwright.... The value of said stock and claim in said cases and work in process is hereby fixed as the amount of proceeds of said life insurance policies. Any amounts owed to Mr. Cartwright for unpaid salary or expenses will be additionally paid or reimbursed to his Estate ...."

• Cartwright’s Estate treated the entire $5,062,000 payment as the redemption price of the stock [which, of course, had a date-of-death value basis under §1014], but the corporation issued a Form 1099-Misc treating approximately $4,080,000 as non-employee compensation, a position adopted by the IRS because as such it was IRD [not entitled to a §1014 basis step-up].

• The Tax Court substantially agreed with the IRS, holding that the value of Cartwright’s stock was approximately $1,060,000 and that approximately $3,956,000 was taxable to the estate as IRD.

• The Ninth Circuit affirmed, holding “the plain language” of the agreement “explicitly provides, CSB’s distribution of the insurance proceeds to Cartwright’s estate
constituted payment for both Mr. Cartwright's stock together with any claim to any cases or work in process." This reflected the shareholders' understanding that a shareholder would or might have "an interest in the firm's cases or work in process that the firm agreed to buy out." That the primary component of Cartwright's compensation was a bonus, paid at the end of each year based on his contribution to the firm, created a "reasonable expectation that he again would be voted a bonus for the cases that he had brought into the firm or had worked on himself."

- But the Ninth Circuit remanded on the stock valuation issue, holding that the Tax Court erred in not including in CSB's assets (1) advanced client costs, which should have been treated as loans made, and (2) CSB's work in process on contingent fee cases. The Tax Court correctly excluded the life insurance proceeds as an asset of CSB. The insurance proceeds would not affect the price a willing buyer would pay for the stock because of their dedicated use.

- Judge Thomas, dissenting, would have valued the stock at the amount of the full payment because, although Cartwright's efforts contributed mightily to the firm's success, at the time of his death he had no right apart from his shareholder's interest to CSB's work in process.

4. *Checks issued to corporation were diverted by sole shareholder. Result: income to the corporation and dividend income to shareholder. Ajf Transportation Consultants, Inc. v. Commissioner, T.C. Memo 1999-16 (1/28/99). Ajf operated a furniture delivery business. Its sole shareholder/president diverted to his own account checks issued by customers to Ajf. None of the diverted funds were reported as income on either the corporation's or the shareholder's return. The court held that the amounts were taxable to both the corporation, as business income, and the shareholder as constructive dividends. Because the corporation was on the cash method, there was no reduction in its earnings and profits for taxes payable, but not paid, on its income.

- Because the Commissioner was relying on the fraud exception to the statute of limitations on assessment, the Commissioner bore the burden of proof, but the burden of proving previously unreported deductible expenditures allegedly paid in cash, which would partially offset the unreported gross income, remained on the taxpayer and was not met.

5. *Nunc pro tunc increases in claimed shareholder-employee compensation don't work to cancel out additional income reported on an amended return. Simco Automotive Pump Co. v. Commissioner, T.C. Memo 1999-235 (7/21/99). Simco was owned equally by two brothers, John and Neal. Unbeknownst to Neal, John sold on his own behalf for approximately $150,000 scrap metal that belonged to Simco and retained the proceeds. Upon discovery, Neal caused the Simco to file an amended return reflecting increased gross income and offsetting increased deductions for compensation. John also filed amended returns reflecting the additional income, classified by him as "additional income." The corporation was denied the compensation deduction because there was no contemporaneous intent to compensate John at the time he actually received the funds. [Query, might the corporation have been better off claiming a theft deduction? Of course, that might have caused even more of a rift between John and Neal.]

C. Liquidations

1. *The Tax Court was reversed by the Second Circuit in a pre-Davis case for not having seen the light sooner. Eisenberg v. Commissioner, 155 F.3d 50, 98-2 U.S.T.C. ¶50,322, 82 AFTR2d 5757 (2d Cir. 8/18/98), vacating T.C. Memo. 1998-483. In filing gift tax returns the taxpayer reduced the value of shares of a closely held corporation by the proportionate amount of the hypothetical corporate-level gains tax [from the hypothetical sale of its sole asset, a highly appreciated commercial building] that would have due if the corporation had liquidated [or sold its asset]. The Tax Court disallowed any reduction in value by reason of the built-in corporate gain tax because any liquidation or sale that would trigger the tax was speculative. The Court of Appeals reversed, citing Estate of Davis v. Commissioner, 110 T.C. 530 (6/30/98), and remanded the case to the Tax Court to determine the proper discount. The Second Circuit reasoned that a buyer would consider the potential tax liability to be of material and significant concern in determining the stock's purchase price, even though immediate liquidation was not contemplated, and, therefore, it should be taken into account for gift tax valuation. The court held no "imminent liquidation" requirement exists as a prerequisite to take the corporate gain tax into account for valuation purposes. The court was not moved by the possibility that the corporate tax could be postponed [by continuing to operate the building in the corporation] or avoided [by making an S election and retaining the asset for 10 years].
2. REG-209121-89, proposed regulations under §337(d), relating to the recognition of gain or loss [under General Utilities repeal] on a transaction where a taxable corporation transfers all or substantially all of its assets to a tax-exempt entity or converts from a taxable corporation to a tax-exempt entity (62 F.R. 2064, 1/15/97).

   a. T.D. 8802, final regulations under §338(d), relating to a taxable corporation that transfers all or substantially all of its assets to a tax-exempt entity (pursuant to the repeal of the General Utilities doctrine) (63 F.R. 71591, 12/23/98).

3. REG-107069-97, Notice of Proposed Rulemaking, Purchase Price Allocations in Deemed Actual Asset Acquisitions, 1999-36 I.R.B. 346, 64 F.R. 43461 (8/10/99). Under the proposed regulations, there will be a total of VII classes of assets possible in an acquisition.

   • Proposed regulations §1.338-1 through -10, §1.338(h)(10)-(1) and §1.1060-1 are intended to clarify the treatment of, and provide consistent rules (where possible) for, both deemed and actual asset acquisitions under sections 338 and 1060. The IRS identified three major deficiencies in the current regulations: (1) their statement of tax accounting rules and their relationship to tax accounting rules for asset purchases outside of §338; (2) the effects of the allocation rules; and (3) their lack of a complete model for the deemed asset sale (and, in the case of §338(h)(10) elections, the deemed liquidation) from which tax consequences not specifically set forth in the regulations can be determined. The proposed also take into account amendments to the Code enacted since the different portions of the current regulations were promulgated.

   • The proposed regulations have four major aspects: (1) reorganization of the regulations; (2) clarification and modification of the accounting rules applicable to deemed and actual asset acquisitions; (3) modifications to the residual method mandated for allocating consideration and basis, increasing the number of classes to seven; and (4) miscellaneous revisions to the current regulations. Old target and new target (and any other affected parties, for example, when a §338(h)(10) election is made) must determine their tax consequences as if they actually had engaged in the sale and purchase transactions deemed to have occurred under §338. The consistency rules are unchanged.

   • The seven classes are: Class I – cash and cash equivalents; Class II – CDs, securities, foreign currency; Class III – accounts receivable, mortgages, credit card receivables; Class IV – inventory; Class V – all assets not included in the other classes; Class VI – section 197 assets other than goodwill and going concern value; Class VII – section 197 goodwill and going concern value. The change relates to the addition of two new classes of “fast pay” assets, which must receive basis up to fair market value before there is any basis allocated to tangible property.

D. S Corporations

1. IRS given more discretion to waive defects in invalid elections and to validate late elections. SBJPA §1305 amends §1362(f) to allow the Service discretion to waive the effect of an invalid election (caused by inadvertent failure to qualify as an S corporation or to obtain the required shareholder consents) and to validate late elections as timely [retroactive for taxable years beginning after 12/31/82].

   a. Rev. Proc. 97-40, 1997-33 I.R.B. 50 (7/30/97). Provides guidance under §1362(b)(5) for requesting “corrective action” relief for [with reasonable cause] late S corporations elections that are filed within 6 months of the due date. Under this procedure corporations need not apply for a private letter ruling (or pay the user fee normally required).


   • This revenue procedure provides guidance regarding eligibility and procedures for taxpayers requesting relief for late-filed S corporation elections and certain other
untimely elections (Q-Sub, ESBT, QSST) required to be filed by or with respect to an S corporation. The Rev. Proc. has a user-friendly flowchart and specifies procedural requirements for automatic relief [reflecting the post '98-Act kinder and gentler IRS?].

2. *The awesome power of the Bankruptcy Trustee to retain a subchapter S election against your will: The shareholders pay the tax while the corporation's creditors take the proceeds. In re Bakersfield Westar, Inc., 123 F.3d 1243 (B.A.P. 9th Cir. 10/16/98). Bakersfield Westar, Inc., which was wholly owned by Mr. and Mrs. Saunders and had a valid S election in effect, filed an immediately effective revocation of its S election, together with the required shareholders' consents on 2/1/94. The Saunders filed for bankruptcy on 2/14/94 [How romantic!], and the trustee in Saunders' bankruptcy case soon thereafter filed a voluntary Chapter 7 petition on behalf of Bakersfield Westar. The trustee in the Bakersfield Westar proceeding sought to avoid the revocation of the S election under §§544(b) and 548 of the Bankruptcy Code as a fraudulent transfer, on the grounds that the Saunders caused the corporation to revoke its S election “with the intent to shift to the debtor the significant capital gains tax burden that would arise from the future sale or other disposition of the debtor's assets” and “with the actual intent to hinder, delay, and defraud creditors.” The Saunders and IRS argued that regulations under §1362 provide the exclusive rules for rescinding a revocation of an S election. The trustee argued that the revocation was a fraudulent transfer under Bankruptcy Code §548(a)(1) because (1) the corporation's right to make or revoke its S election was “property,” and (2) the revocation of the S election was a “transfer” within the meaning of Bankruptcy Code §548, and sought an order directing IRS to disregard the revocation and to retroactively reinstate the S election. Reversing the bankruptcy court, which held for the Sanders and the IRS, the Court of Appeals upheld the bankruptcy trustee's position, concluding that: (1) the corporation's prepetition right to make or revoke an S election was "property" or "an interest in the debtor's property" within the meaning of the Bankruptcy Code [citing In re Russell, 927 F.2d 413 (8th Cir. 1991), holding that NOL carryovers are "property" for purposes of the Bankruptcy Act and that the trustee could avoid an irrevocable election to waive the NOL carryback]; (2) the corporation's prepetition revocation of its S election constituted a "transfer" of "the ability not to pay taxes" that may be avoided by a trustee under §548(a) of the Bankruptcy Code; and (3) the Internal Revenue Code provisions governing Subchapter S elections do not limit a bankruptcy trustee's avoidance powers under §548(a) of the Bankruptcy Code. "Avoidance" under the Bankruptcy Code is different than "revocation" of an election under the Internal Revenue Code outside of bankruptcy.

3. The story of what happens when §108 meets §1367. “[W]e must read the Internal Revenue Code as a whole.” Two years ago: Basis increase on passthrough of excluded discharge of indebtedness income. Winn v. Commissioner, T.C. Memo. 1997-286 (6/24/97). Cancellation of indebtedness income that an S corporation received as a passthrough item from a partnership was an item of income that increases shareholders' bases in their stock of the S corporation. Query whether the issue was properly presented to the court.

a. ...But last year: Reverses earlier opinion and holds that shareholder bases are not increased by discharge of indebtedness income of an insolvent S corporation. Winn v. Commissioner, T.C. Memo. 1998-71 (2/19/98), withdrawing T.C. Memo. 1997-286. The Tax Court followed its reviewed decision in Nelson v. Commissioner, 110 T.C. No. 114 (1998), aff'd, 84 A.F.T.R.2d 5067 (10th Cir. 7/6/99), which held that a shareholder of an insolvent S corporation may not increase his stock basis under §§1367(a)(1)(A) and 1366(a)(1)(A) by the amount of his pro rata share of the corporation's[excluded under §108(a)] discharge of indebtedness income on the theory that the COD income was passed-through exempt income. The Tax Court agreed with the IRS that §108(d)(7)(A) requires that the exclusion of income applies at the S corporation level, so that the reduction of tax attributes applied by §108(b) also applies at the corporate level and the discharge of indebtedness income never passes through to the shareholder. Section 108, through the attribute reduction rules, is generally intended to defer the recognition of income, not to exempt it totally from income.

b. Last Year: No shareholder stock basis increase on passthrough of discharge of indebtedness income of an insolvent S corporation. Nelson v. Commissioner, 110 T.C. No. 12 (2/19/98) (reviewed, 12-0-7). Taxpayer/shareholder of an insolvent S corporation may not increase his stock basis under §§1367(a)(1)(A) and 1366(a)(1)(A) by the amount of his pro rata share of the corporation's[excluded under §108(a)] discharge of indebtedness income on the theory that the COD income was passed-through exempt income. Judge Hamblen agreed with the IRS that §108(d)(7)(A) requires that the exclusion of income applies at the S corporation level, so that the reduction of tax attributes applied by §108(b) also applies at the corporate level and the discharge of indebtedness income never passes through to the shareholder. Section 108, through the attribute reduction rules, is generally intended to defer the recognition of income, not to exempt it totally from income.
• Judge Foley (joined by 4 other judges) concurred in the result, stating that – after the §108(b) reduction of tax attributes – there are no “items of income,” tax-exempt or otherwise, to which §1366(a) may apply. Judge Beghe (joined by Judge Halpern) concurred, agreeing with Judge Foley’s opinion, except they thought that the opinion was a concurrence, not a “concurrence in result only.”

c. *This year: Nelson and Winn affirmed by Tenth Circuit. “The Internal Revenue Code ‘should not be interpreted to allow [taxpayers] the practical equivalent of [a] double deduction...’” Gitlitz v. Commissioner, 99-2 U.S.T.C. ¶ 50,645, 84 A.F.T.R.2d 5059 (10th Cir. 7/6/99), aff’g Winn v. Commissioner, T.C. Memo. 1998-71, withdrawing T.C. Memo. 1997-286. Gitlitz and Winn each owned 50 percent of the stock of an S corporation that realized $2,021,096 of COD income. At that time the corporation was insolvent to the extent of $2,181,748. Thus all of the COD income was excluded under §108(a)(1)(B). Both shareholders had carried losses that had been suspended under §1366(d)(1) as well as operating losses that would be further suspended unless the excluded COD income nevertheless increased their basis in their stock under §1367(a)(1).

• The Tenth Circuit rejected the taxpayer’s argument that the excluded COD income was “tax exempt income” under §1366(a)(1)(A). The basis increase for tax exempt income is designed to preserve the tax exemption on distribution. But to allow a basis increase for the COD income would (1) allow an exclusion as well as an increased capital loss on the subsequent sale of their stock, and (2) allow the shareholders to claim the corporation’s net operating losses without reducing them by the excluded debt [contrary to the pattern in §108(b)]. The court agreed with the Commissioner and the Tax Court that that §108(d)(7)(A) requires that the exclusion of income applies at the S corporation level, so that the reduction of tax attributes applied by §108(b) also applies at the corporate level and the discharge of indebtedness income never passes through to the shareholder. The court further concluded that §108(d)(4)(A) merely requires that attribute reduction is the last step in the calculations, it does not necessarily defer the attribute reduction until the year following the year in which the excluded COD income is realized. Thus, there was no corporate level income to pass through to the shareholders and to increase their basis. Furthermore, the reduction in tax attributes under §108(b) absorbed the shareholders losses carried over from prior years under §1366(d)(1).

d. Ibid. Nelson v. Commissioner, 182 F.3d 1152, 99-2 U.S.T.C. ¶50,646, 84 A.F.T.R.2d 5067 (10th Cir. 7/6/99), aff’g 110 T.C. 12 (1998) (reviewed decision, 12-0-7). Taxpayer was the sole shareholder of an S corporation that realized cancellation of indebtedness (COD) income while it was insolvent. Under §108(a), the corporation properly excluded the COD income. Upon the subsequent disposition of the stock (in the same year), the taxpayer-shareholder nevertheless claimed an increase in the basis of his stock in the corporation pursuant to §§1367(a)(1)(A) and 1366(a)(1)(A), on the theory that the COD income was passed-through “exempt” income and reported a long-term capital loss on his 1991 Federal income tax return. The Commissioner disallowed a portion of the claimed long-term capital loss on the premise that §108(d)(7)(A), which provides that for purposes of subchapter S the COD income exclusion is applied at the corporate level. The Tax Court upheld the Commissioner’s position and denied the basis increase. Section 108, through the attribute reduction rules, is generally intended to defer the recognition of income, not to totally exempt it from taxation. The Court of Appeals affirmed on the basis of its decision in Gitlitz.

4. Not close enough to Selfe. Sleiman v. Commissioner, 99-1 U.S.T.C. ¶50,828 (11th Cir. 9/10/99). Shareholders’ personal guarantees of S corporations’ debt does not serve to increase their stock bases. Judge Kravitch upheld the Tax Court’s finding that the situation here [the lender looked primarily to the corporations for repayment of the loans] was distinguishable from the facts of Selfe v. United States, 778 F.2d 769 (11th Cir. 1985), because the facts here were not in substance a loan to the shareholders followed by capital contributions to the S corporations.

E. Affiliated Corporations

1. *Losses suffered by a profitable corporation were not part of a group’s consolidated net operating loss. Internet Corp. v. Commissioner, 111 T.C. No. 16 (12/8/98). For 1992, the taxpayer’s consolidated group reported a consolidated net operating loss of nearly $26 million. Three of the members of the group reported positive taxable income but reported deductions of $1,226,000 that arguably were specified liability loss deduction items within the meaning of §172(f)(1). [The items were state and local taxes and interest on federal taxes relating to a year more than three years before 1992.] Judge Wells held that under Reg. §§1.1502-12 and 1.1502-21A, the group’s specified liability losses did not include the deductions in question because members of the group that reported positive separate taxable income did not contribute to the group’s consolidated NOL. Accordingly, the 10-year carryback
period of §172(b)(1)(C) did not apply with respect to a portion of the consolidated NOL equal to the items in question. [The court did not reach the question of whether the items were specified liability losses under §172(f)(1), as in effect for 1992, in the first place.]

a. TTREA '98 §3004(a) amends §172(f)(1)(B) to limit “specified liability losses” entitled to 10-year NOL carryback to product liability losses and to specified liability losses under certain state and federal laws (limited to: land reclamation, nuclear power plant decommissioning, drilling platform dismantlement, environmental contamination remediation, and workers compensation losses).

2. Interlake Corp. v. Commissioner, 112 T.C. No. 10 (3/18/99). In the absence of a contractual provision to the contrary in the documents reflecting the change of ownership, the corporation that was the common parent when the NOLs were generated (the “new CP”) is entitled to the refund when those NOLs were carried back to a year during which another corporation no longer a member of the consolidated group (the “former CP”) was the common parent. Tentative refunds paid to the former CP — which itself suffered NOLs — did not constitute rebates to the new CP because the former CP’s authority to act for the group terminated when its affiliation with the group terminated.

- The issue in this case was whether a former common parent of a consolidated group that became a subsidiary member of the group as a result of a reorganization and which was subsequently spun-off was an authorized taxpayer to receive a tentative refund attributable to a carryback of post-spin-off NOL. ILC was the common parent of a consolidated group. In 1996, pursuant to a reorganization, ILC became the common parent and ILC became a subsidiary. Later that year, ILC was spun-off and ILL and ILC were no longer related. ILL incurred an NOL for its short 1996 taxable year and received a tentative refund from a carryback against its former group’s taxable income for 1981, 1984, and 1985. Subsequently, the IRS redetermined ILL’s NOL and reduced the refund. Because the refund had been credited to the tax account of group now headed by ILC, the IRS sought to recover the refund from ILC. If ILL was authorized to receive the refund under Reg. §1.1502-78(b)(1), then the refund was a “rebate” refund (a refund based on a recalculation of the taxpayer’s liability), and the excessive refund could be collected from ILC through the deficiency procedure. If ILL was not authorized to receive the refund, it was not a “rebate” refund and it could not be recovered from ILC through a deficiency proceeding. The court held that because ILL ceased to remain a member of the group after it ceased to be the common parent, only ILC was authorized under Reg. §502-78(b)(1) to receive a carryback refund against the group’s prior tax liability. The refund was not a rebate and could not be recovered through a deficiency proceeding.

3. REG-106219-98, proposed regulations amending Reg. §1.1502-76 on consolidated group acquisition of 80 percent or more of an S corporation’s stock (63 F.R. 69581, 12/17/98). The regulations provide that the S corporation becomes a member of the group at the beginning of the day of its acquisition and its tax year ends at the end of the previous day.

4. REG-105964-98, proposed regulations amending Reg. §1.1502-13 that clarify the treatment of the transfer or extinguishment of rights under an intercompany obligation (63 F.R. 70354, 12/21/98). The deemed satisfaction proceeds, rather than the obligation, are treated as transferred by the initial creditor in the actual transaction and then advanced by the transferee to the debtor in the deemed reissuance of the obligation.

5. Alumax Inc. v. Commissioner, 99-1 U.S.T.C §50,210 (11th Cir. 1/21/99). Taxpayer corporation and its subsidiaries were not part of an affiliated group because, although the stock held by the group gave it 80 percent of the board, it did not give the group control because the board lacked “the actual power to run the corporation” over the objection of the minority shareholders.

- This case interpreted the 80 percent voting control requirement of §1502(a)(2) in the face of a complicated voting arrangement. Alumax had two classes of stock outstanding. The class C stock, which was owned by an affiliated group claiming control, was entitled to elect four of six voting members of the Alumax Board. The class B stock was entitled to elect two of six voting members. The class B and class C directors, in the aggregate and not voting by class, elected one of two special nonvoting directors. By agreement between the two class stockholders, the class B directors were permitted to name this special director. The other special nonvoting director was the CEO of Alumax. Each of the two class B directors had one vote. Each of the four class C directors had two votes. However, on a number of corporate matters, a majority of the directors of each of the two classes was required to approve the action. Likewise, with respect to shareholder votes, each share of class C stock had four votes while each share of class B stock had one vote. With respect to a number of restricted stockholder matters, a majority vote of each class of stock was required. The court rejected the
taxpayer's assertion that a mechanical application of these voting formulae represented 80 percent voting
control. The court held that the impact of various restrictions on the actions of elected directors must be
taken into account in assessing the existence of voting control under §1502(a)(2). Accordingly, the
court held that the impact of various restrictions on the actions of elected directors must be
taken into account in assessing the existence of voting control under §1502(a)(2). Accordingly, the
control test was not met and Alumax was not part of the affiliated group.

6. *GM-GMAC group's change in treatment of item for consolidated returns purposes was not a change in accounting method. Also, interest rate support payments made by GM to GMAC were not intercompany transactions because the payments were passed through to independent third parties. General Motors Corp. v. Commissioner, 112 T.C. No. 19 (5/25/99). GM subsidized car loans by GMAC, a member of the GM consolidated group, to reduce the rate that purchasers of GM cars paid to an amount lower than the market rate. To do this GM paid GMAC, which normally borrows at rates lower than the rates charged to consumers on car loans, lump sum interest rate subsidies. GM originally had deferred its deduction for the interest rate subsidy payments under the deferred intercompany transaction rules of a former [1966 to 1995] version of Reg. §1.1502-13, but in 1985 it stopped reporting those items as intercompany transactions and began deducting them currently, apparently on the theory that they ran to the benefit of the ultimate consumers. The IRS argued unsuccessfully that this switch in reporting these subsidies on its consolidated return was a change in its method of accounting, requiring the Commissioner's consent, was not obtained. The Tax Court (Judge Vasquez) held that the consolidated return rules are a method of reporting — not a method of accounting — and that GM did not need the Commissioner's consent for the change. The court rejected the Service's argument that the matching rule contained in former Reg. §1.1502-13(b)(2) was an accounting method. Judge Vasquez reasoned that § 446(e) and the consolidated return regulations do not treat consolidated reporting as an accounting method. See Reg. §1.1502-17 ("The method of accounting to be used by each member of the group shall be determined in accordance with the provisions of section 446 as if such member filed a separate return.") Judge Vasquez also rejected the Service's alternate argument that under Reg. §1.1502-13(b)(2) GM should have deferred the deductions for the subsidy payments until GMAC took into account. GMAC's income earned from customers. The court found GMAC's interest income was not a "corresponding item of income" because it did not flow directly from the lump sum interest subsidy. In any event, the transactions involved outside parties and a net cost to the consolidated group. The subsidy payments were passed on to independent GM dealers who made the initial low-interest loans to the customer and sold the receivables at their lower fair market to GMAC. The subsidy payments, therefore, could not be characterized as intercompany transactions, which are subject to a matching rule to prevent "paper deductions." [Note that current Reg. §1.1502-13(a)(3) (1995) states 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.]

- Commentators have contended that §1502 gives the Commissioner discretion to prescribe the method of computation of tax liability of the consolidated group "in such manner as clearly to reflect the income tax liability... and in order to prevent avoidance of such tax liability." This statutory provision does not give the Commissioner discretion as to individual taxpayers, see RLC Industries Co. v. Commissioner, 58 F.3d 413, 95-2 U.S.T.C. ¶50,328 (9th Cir. 6/19/95), aff'g 98 T.C. 457 (1992) (Reg. §1.611-3(d)(5), which gives Commissioner the discretionary "power to readjust taxpayer's timberland blocks to reach a reasonable depletion allowance," was held invalid as going beyond the rulemaking authority granted in the statute (§611(a)), which -- the court found -- provided only that depletion was to be determined under regulations to be prescribed by the Secretary, and did not give Commissioner the authority to make adjustments in individual cases).

7. Application of §382 in short taxable years and with respect to controlled groups. T.D. 8825, 1999-28 I.R.B. 19 (6/25/99). Amendments to various sections of the §382 regulations to require appropriate adjustments to the value of a loss corporation that is a member of a controlled group of corporations so that the same value is not counted twice in determining the §382 limits for the component members of the group. Adjustments generally are required only when corporations are members of the same controlled group both (1) when a pre-change loss arises and (2) on the date of the ownership change.

8. SRLY no more -- sometimes. Consolidated returns' limitations on the use of certain losses and deductions, T.D. 8823, 1999-29 I.R.B. 34 (7/02/99). Final regulations so complex it takes six pages to list the affected sections of consolidated return regulations. Generally speaking, the SRLY rule is eliminated with respect to carryovers of NOLs from SRLY years, Reg. §1.1502-21, but is retained for built-in losses, Reg. §1.1502-15.

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9. When §382 met the consolidated return rules – forty-six pages the MDP firms will love. Regulations Under Section 1502 of the Internal Revenue Code of 1986; Limitations on Net Operating Loss Carryforwards and Certain Built-in Losses and Credits Following an Ownership Change of a Consolidated Group, T.D. 8824, 1999-29 I.R.B. 62 (7/02/99). Regs. §§1.1502-91 through 1.1502-93 provide for the treatment of NOLs that arise in (and unrealized built-in losses with respect to) years that are not separate return limitation years (SRLY) with respect to a consolidated group, i.e., a taxable year of a subsidiary for which the subsidiary was not a member of the group. Generally speaking, these regulations adopt a single entity approach to determine ownership changes and apply the §382 limitations with respect to such losses. The final regulations also extend the single entity approach to loss subgroups within consolidated groups. A loss subgroup generally consists of two or more corporations that continue to be affiliated with each other after leaving one group and joining another where at least one of the corporations carries over losses from the first group to the second group. The single entity approach can apply, for example, to a consolidated group's acquisition of another consolidated group or of a chain of subsidiaries from another group.

- Reg. §§1.1502-94 and 1.1502-95, apply to tax attributes other than those arising in a consolidated return year of corporations that join or leave a consolidated group. In general, §382 is applied separately with respect to those attributes because the attributes cannot be used by other members.

- Reg. §1.1502-98 provides that the rules in Reg. §§1.1502-91 through 1.1502-96 also apply for purposes of §383, with adjustments to reflect that §383 applies to credits and net capital losses.

F. Section 482


G. Section 269

1. Fear not §269! Plains Petroleum Co. v. Commissioner, T.C. Memo 1999-241 (7/23/99). In 1986, before the effective date of current §382, Plains, an oil and gas producer, acquired the stock of TriPower, another oil and gas producer, and TriPower’s $84 million NOL, for $10.5 million. The closing was conditioned on Plains receiving a favorable opinion from both its tax advisor and TriPower’s tax counsel regarding the accuracy of the NOL calculation, but was not conditioned on any favorable opinion regarding TriPower’s reserves. Following the acquisition, Plains dropped it’s own producing properties down into TriPower [thereby avoiding the then applicable SRLY rules of former Reg. §1.1502-21A(c)]. TriPower’s total proved, developed, and producing reserves were less than the net reserves of several single wells already owned by Plains, but the TriPower wells production did replace 50 percent of Plains production for the year of the acquisition. The Commissioner tried to disallow Plains use of TriPower’s NOL under §269, arguing that the acquisition and drop down were primarily tax motivated. But based on all the facts and circumstances, the Tax Court held that the acquisition and the drop-down both were motivated by business considerations, notwithstanding the similarity of the transaction to Reg. §1.269-3(b)(1) and (c)(2), not principally by tax avoidance.

H. Reorganizations and Corporate Divisions

1. *What, a little theoretical consistency across types of reorganizations – What will they think of next? The Solely for Voting Stock Requirement in Certain Corporate Reorganizations, REG-115086-98, 1999-26 I.R.B. 6 (64 F.R. 31770, 6/14/99). Prop. Reg. §1.368-2(d)(4)(i) - (iii) would vitiate the application of the Bausch & Lomb doctrine in §368(a)(1)(C) stock-for-asset reorganizations. [The new rules will be effective upon publication of final regulations, subject to the usual grandfathering of transactions pursuant to a binding agreement at that time.]

- Bausch & Lomb Optical Co. v. Commissioner, 30 T.C. 602 (1958), aff’d, 267 F.2d 75 (2d Cir.), cert. denied, 361 U.S. 835 (1959), upheld the IRS’s position in Rev. Rul. 54-396,1954-2 C.B. 147, that the acquisition of assets of a partially controlled subsidiary cannot qualify as a tax-free reorganization under §368(a)(1)(C). The rationale of the Bausch & Lomb doctrine is that the acquisition violates the solely for voting stock requirement, because the parent corporation acquires only part of the subsidiary’s assets in exchange for its voting stock, with the remaining portion of the subsidiary’s assets being acquired in a liquidating distribution in exchange for previously held stock of the subsidiary.
The Bausch & Lomb doctrine has been criticized because (1) a transaction in which a parent corporation converts an indirect ownership interest in a subsidiary’s assets to a direct interest does not resemble a sale, and (2) the taxable treatment of the "upstream" type (C) reorganization under the Bausch & Lomb doctrine inconsistent with the tax-free treatment of the "upstream" type (A) reorganization.

Under the proposed regulations, preexisting ownership of a portion of a target corporation's stock by an acquiring corporation generally will not negate satisfaction of the sole for voting stock requirement in a (C) reorganization. If in connection with a potential (C) reorganization the acquiring corporation acquires any target corporation's stock for consideration other than its own voting stock (or its parent's voting stock if the parent's stock is used in attempted (C) reorganization), whether from a shareholder of the target corporation or from the target corporation itself, such consideration will be treated as money or other property exchanged by the acquiring corporation for the target corporation's assets for purposes of applying the boot limitation in §368(a)(2)(B). Whether there has been an acquisition in connection with a potential (C) reorganization of a target corporation's stock for consideration other than voting stock will be made on the basis of all of the facts and circumstances.

2. REG-106004-98, proposed regulations under §355(d), relating to gain recognition on certain “disqualified distributions” of stock or securities of the controlled corporation where the transaction is used to achieve a sale-like result (64 F.R. 23554, 5/3/99). Provides that a distribution is not a “disqualified distribution” if it and any related transaction do not violate the purposes of §355(d).

3. *Complexity, thy name is proposed §355(e) regulations, as shown by the plan to increase fees for tax professionals advising on corporate separation transactions. REG-116733-98, proposed regulations under §355(e), relating to the anti-Morris Trust provision that requires recognition of General Utilities-type gain by the distributing corporation in what would otherwise be a tax-free corporate separation (64 F.R. 46155, 8/24/99).


I. 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). 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). 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 1988 capital gain.

* Illustration: Colgate has large capital gain in year 1. In year 2, Colgate enters into partnership. Partnership then purchases property for 100, and then sells it for contingent consideration ("LIBOR notes") to be paid over five years. In year 2, 100 is to be paid, with small contingent amounts to be paid in each of years 3, 4, 5, and 6. Basis is allocated ratably to each year, so there is a gain of 80 in year 2 and a loss of 20 in each year thereafter. The gain in year 2 is allocated as 90% to the foreign bank [not taxed in U.S.] and 9% to Colgate. The foreign bank then withdraws from the partnership. The losses of 80 over the next years are allocated 90% to Colgate. The remaining losses are accelerated, or triggered, in year 4 by disposing of the LIBOR notes, so the losses may be carried back 3 years to offset the large capital gain.
a. ACM affirmed by Third Circuit, except for determination that out-of-pocket amounts are deductible. ACM Partnership v. Commissioner, 98-2 U.S.T.C. ¶50,790 (3d Cir. 10/13/98) (2-1), aff'g and rev'g T.C. Memo.1997-115. Affirms Tax Court on its application of the "economic substance" doctrine, which eliminated the capital gains and losses attributable to ACM's application of the contingent installment sale provisions and the ratable basis recovery rule.

- Dissent on the ground that if the Commissioner is displeased by the result taxpayer sought, he should seek to change the Code or change the regulations.
- The Third Circuit reversed the Tax Court's disallowance of deductions arising from actual economic losses associated with the partnership's ownership of installment ("LIBOR") notes. In doing so, the court distinguished United States v. Wexler, 31 F.3d 117, 94-2 U.S.T.C. ¶50,361 (3d Cir. 1994) (holding actual economic losses to be nondeductible). The court used the Wexler test, i.e., whether the losses associated with the LIBOR notes were "both economically substantive and separable from the sham aspects of the underlying transaction."

2. 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, AlliedSignal, 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.


4. Step-down preferred to be recharacterized. REG-104072-97, proposed regulations that recharacterize for tax purposes, financing arrangements involving fast-pay stock (64 F.R. 805, 1/6/99). Economically, fast-pay stock is self-amortizing because distributions are in part a return on investment and in part a return of the investment, which understates the taxable income on the benefited stock during the initial period. Follows Notice 97-21, except that a different model is used that treats the benefited shareholders as first issuing the financing instruments in exchange for cash equal to the fast-pay stock’s fair market value, and then as contributing the cash to the corporation (which increases their basis in the benefited stock). Grandfather that limits taxable income to that provided in Notice 97-21 until these regulations become final.

a. Notice 97-21, 1997-11 I.R.B. 9 (2/27/97). IRS announces it will recharacterize for tax purposes [under §7701(l)] transactions using self-amortizing investments (e.g., step-down preferred stock) in conduit financing entities which artificially allocate the conduit’s income to participants not subject to the federal income tax, the deductions to the taxpayer/sponsor owning the common stock of the conduit, and virtually all the residual to the taxpayer once the preferred is amortized in 10 years. Under the recharacterization, the holders of the preferred stock would be treated as having engaged in an "income stripping" transaction.

5. *Lease-in, lease-out ("LILO") transactions lack economic substance, so rent and interest paid or incurred are not deductible. Rev. Rul. 99-14, 1999-13 I.R.B. 3 (3/11/99). Taxpayer may not deduct, under §§162 and 163, rent and interest paid or incurred in connection with a LILO transaction under which a foreign municipality (e.g., Belgrade(?) leases property with a remaining useful life of 50 years and a fair market value of $100 million to taxpayer under a head lease with a 34 year term, and immediately leases it back for a 20 year term and a "put renewal" term of 10 years. Taxpayer is required to make a rental prepayment of $89 million and a huge postpayment [having a discounted present value of $8 million] at the end of the lease. The $60 million of the prepayment is borrowed by taxpayer from unrelated banks, which require the foreign municipality to collateralize the borrowings with $60 million from the first rental payment. The municipality's annual rent payments to the taxpayer are sufficient to cover taxpayer's interest payments to the banks, and these payments are funded from the earnings from the collateral. Taxpayer also requires the municipality to invest $15 million of the head lease prepayment in safe debt securities that will mature in an amount sufficient to cover its option to buy out the head lease (which would also obviate taxpayer's need to make the postpayment). Taxpayer has the right to require a renewal of the sublease, which will operate as a collar on the value of the head lease residual [and will as a matter of practicality cause the municipality to exercise its buyout option]. Having defeased all its obligations, the municipality keeps the remaining $14 million of the first lease payment for its expenses and as its return on the deal.
Taxpayer invokes the proposed §467 regulations to spread its deduction of the $89 million prepayment and the huge postpayment as rent over six and 28 years, respectively. This results in a pre-tax return to taxpayer "that is insignificant compared to its net after-tax return by accounting for each element of the deal separately." Held, this transaction does not have sufficient economic substance to be respected for tax purposes because it "lacks the potential for significant economic consequences other than the creation of tax benefits," citing Knetsch v. United States, 364 U.S. 361 (1960) and ACM Partnership v. Commissioner, 157 F.3d 231 (1998).

a. Lease stripping transaction is a sham. FSA 199914001 (10/27/98). Complex transaction was essentially a circle of leases that created a mismatch of income and deductions, so the sham transaction doctrine was applied when looking at the transaction as a whole and at the individual transactions. Contains lists of information and documents the National Office recommends that the District Counsel obtain.

b. See also, Notice 94-48, 1994-19 I.R.B. 10, which attacks so-called reverse MIPS, in which the partnership is the issuer of the debt and a domestic corporation would issue preferred equity to the partnership to secure the debt. The Notice would treat the partnership as nonexistent and would treat the domestic corporation as the direct issuer of equity.

c. *Back to the drawing board, with delayed applicability and grandfathering. T.D. 8827 and REG-113909-98, withdrawal of 1998 guidance on hybrid branch transactions [T.D. 8757 and REG-10453-97] and issuance of new, more limited, proposed regulations (64 F.R. 37677, 7/13/99). Provides that these proposed regulations will not be finalized before 7/1/00 and that they would be effective for payments made no earlier than years beginning after five years after the date of finalization; further provides for grandfathering of arrangements entered into before 6/19/98.

8. *The $67,000,000 deficiency, with more years in the pipeline for the same transaction with bigger amounts. Here a home-grown tax-saving plan was found to be a sham. United Parcel Service v. Commissioner, T.C. Memo 1999-268 (8/09/99). UPS generally limits its liability for damages to goods in transit to $100, but customers may pay and it collects "excess value charges" (EVCs) to insure the packages for greater amounts [even though UPS is not licensed as an insurance company]. Prior to 1984, UPS retained all of the EVCs, paid claims, and reported the income and deduction items on its return. Beginning in 1984 UPS restructured the manner in which it dealt with and
reported EVCs. Although it did not change its practices for dealing with customers in handling receipts and claims, beginning in 1984 UPS remitted net [of claims paid] EVCs collected from customers and other shippers to an unrelated insurance company (NUF), which in turn, after deducting certain fees, remitted the net EVCs as a reinsurance premium to OPL OPL was a Bermuda insurance company that was formed by UPS and 97.33 % owned by UPS's 14,000 shareholders (who received OPL stock as a dividend in a taxable spin-off). The OPL stock was subject to restrictions on transfer. After this arrangement was established, for 1984 UPS did not report as income the $99,794,790 of EVCs collected and remitted to NUF. However, UPS performed the same EVC functions and activities that it had performed before 1984 [when it had included the EVCs in income], and it remained responsible for bad debts or uncollectible items because neither NUF nor OPL had any control over the customers' premium payments.

**The Tax Court (Judge Ruwe) upheld the IRS determination that UPS was taxable on the $99,794,790 of EVCs under the assignment of income doctrine regardless of the separate existence of OPL, which was accepted arguendo.** Rather, the court found that the entire 1984 arrangement lacked business purpose and economic substance. The court rejected UPS's proffered business purpose — that its continued receipt of EVCs was potentially illegal under various state insurance laws, because no state insurance regulator ever questioned the prior practice. UPS never sought legal advice on the issue, federal common carrier law probably preempted state law in any event, and if federal law did not preempt state law the 1984 practice was probably as violative of state law as the pre-1984 practice. Judge Ruwe also was not convinced that the arrangement was designed to facilitate UPS rate increases. Nor was he impressed by UPS claim that a business purpose was to leverage the excess value profits into a new reinsurance company; he noted that "any investment of money into [the subsidiary reinsurer] could accomplish this purpose." After examining UPS's pre-1984 reinsurance practices [only of claims over $25,000] and the fairly consistent 70 percent ratio of net EVCs [over claims paid] retained to total EVCs collected Judge Ruwe did not accept the UPS claim that the NUF/OPL arrangement sufficiently reduced the risk to UPS core transportation activity assets to have economic substance. Finally, Judge Ruwe found that there was contemporaneous documentation that the transaction was tax motivated and concluded that the arrangement was "done for the purpose of avoiding taxes" and "had no economic substance or business purpose." To top it off, because the EVC restructuring was a sham transaction, the court denied UPS's deduction for approximately $1 million retained by NUF. And for the inevitable icing on the IRS's cake negligence and substantial understatement penalties, plus increased interest for tax-motivated transactions, were sustained.

**On a minor [in a relative sense], Judge Ruwe allowed UPS to deduct $11.2 million paid to Liberty Mutual Insurance Group for workers' compensation insurance premiums for 1984 over the IRS claim that although the Liberty Mutual policy was valid, "in practice [UPS] and Liberty Mutual disregarded the transactional documents in subsequent years and allowed [UPS's subsidiary reinsurer], through Liberty Mutual, to collect an increased premium when losses increased in subsequent years," a claim that was not supported by the evidence.**

**More to come -- The New York Times and Wall Street Journal report that UPS says it has received notices of deficiency based on a similar analysis for the tax years 1985 through 1990. UPS reserved more than one billion dollars by reason of this decision.**

**9. New Rule in the Tax Court: No More Mr. Nice Guy! (Ms. Nice Gal?) Royal Dutch Shell ADR arbitrage transaction peddled by investment banking firm lacked economic substance.** Compaq Computer Corp. v. Commissioner, 113 T.C. No. 17 (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. 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. Chief 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.

**Important to Judge Cohen’s decision was that Compaq did not perform a cash flow analysis, nor did it investigate the investment. She noted that Compaq shredded the spreadsheet provided by the promoter and "has chosen not to disclose any communications" indicating any reliance on the advice of its tax department or counsel.**
Judge Cohen quotes ACM Partnership to the effect that the business purpose requirement of the economic substance is only satisfied when “the transaction [is] rationally related to a useful nontax purpose that is plausible in light on the taxpayer’s conduct and * * * economic situation.” She continues, “This inquiry takes into account whether the taxpayer conducts itself in a realistic and legitimate business fashion, thoroughly considering and analyzing the ramifications of a questionable transaction, before proceeding with the transaction,” citing the UPS case.

"The ADR transaction was market to petitioner by Twenty-First for the purpose of partially shielding a capital gain previously realized . . . . {Its} evaluation of the proposed transaction was less than businesslike with [the Assistant Treasurer] committing {Compaq} to this multimillion-dollar transaction based on one meeting with Twenty-First and on his call to a Twenty-First reference. . . . We conclude that [Compaq] was motivated by the expected tax benefits of the ADR transaction, and no other business purpose existed.”

10. Another tax shelter that does not work. The Limited, Inc. v. Commissioner, 113 T.C. No. 13 (9/7/99). This one involved the exclusion from the income of a foreign depositor of interest from a purported bank’s certificates of deposits.

11. *Tax Court denies “pre-amendment” benefits “retroactively.” The Tax Court determined that pre-1996 HIPAA leveraged corporate-owned life insurance program lacked economic substance and business purpose, and thus was a sham for tax purposes. Deductions for interest on policy loans were denied. Winn-Dixie Stores Inc. v. Commissioner, 113 T.C. No.21 (10/19/99). In 1993, taxpayer entered into a broad-based leveraged corporate-owned life insurance (“COLI”) group plan covering approximately 36,000 of its employees. The decision to shift from its existing “key-person” COLI program of individual policies [covering 615 managers] was made pursuant to a proposal that emphasized the “tax arbitrage created when deductible policy loan interest is paid to finance non-taxable policy gains.” The proposal indicated that taxpayer would have pre-tax loss totaling $755 million for its 1993-2052 years, but would have total after-tax earnings of more than $2.2 billion for the same period (as the result of total projected income tax savings of more than $3 billion). The COLI policies were terminated in 1997, following 1996 legislation that impacted the plan. Judge Ruwe held that the COLI program lacked substance and business purpose, and thus was a sham.

- Judge Ruwe rejected taxpayer’s argument that the policies could conceivably produce pre-tax benefits is some catastrophe were to occur that would produce large, unexpected death benefits. “We are convinced that this was so improbable as to be unrealistic and therefore had no economic significance.”

- The court further found that the possible use of projected after-tax earnings to fund employee benefit plans would not cause the COLI plan to have economic substance, noting that, if so, “every sham tax-shelter device might succeed.”

- In light of the $3,000 per year premium paid to insure each employee or former employee, it was irrelevant that there was a relatively small death benefit of $5,000 paid with respect to each dead employee or former employee.

- Judge Ruwe rejected taxpayer’s position that the §264 safe-harbor test protected its interest deductions. He noted that the right to an interest deduction is governed by §163 [and not §264], citing Knetsch v. United States, 364 U.S. 361 (1960). He further quoted, “But we do not agree with [taxpayer’s] assertion that the legislative history should be turned into an open-ended license applicable without regard to the substance of the transaction . . . . Knetsch . . . involved transactions without substance. Congress in enacting section 264(a)(3), struck at transactions with substance. It is a reductio ad absurdum to reason, as [taxpayer] does, that Congress simultaneously struck down a warm body and breathed life into [taxpayer’s] cadaver.”

b. The Tax and Trade Relief Extension Act of 1998 §4003(i) further amended §264 to expand the definition of “unborrowed [insurance] policy cash value” to include “inside buildup,” for purposes of the COLI pro rata interest disallowance rules.

V. EMPLOYEE COMPENSATION AND PLANS

A. In General
1. **Plan Curative Programs.** Employee Plans Compliance Resolution System provides a uniform set of correction issues, covering APRSC, VCR, Walk-in CAP and Audit CAP. Rev. Proc. 98-22, 1998-12 I.R.B. 11 (3/11/98). Features of this new system include: (a) self-correction of “insignificant operational failures” without paying any fee or sanction; (2) self-correction within a two-year period of “significant operational failures” where the plan has a favorable IRS determination letter; (3) voluntary correction with IRS approval; and (4) for correction on audit, sanctions imposed will bear a reasonable relation to the “nature, extent and severity of the failure.” The Tax Sheltered Annuity Voluntary Correction Program is not yet covered by this procedure.


   b. On 2/19/99, the IRS issued a statement of “Best Practices under the Closing Agreement and Determination Letter Programs.” Provides that “[i]n order to encourage voluntary and timely correction of the qualification program, EP SPECIALISTS SHOULD NOT REQUEST COPIES OF A PLAN SPONSOR’S COMPLIANCE AUDIT REPORT” (emphasis in original).

2. Notice 98-29, 1998-22 I.R.B. 8 (5/14/98). IRS intends to propose regulations under §411(d)(6)(B) to provide exceptions to the §411(d)(6) general rule that precludes qualified plan amendments that have the effect of eliminating optional forms of benefit.

   a. REG-101363-98, proposed regulations re same (9/4/98).

   b. T.D. 8806, final regulations under §411(d)(6) providing changes to the rule prohibiting reduction of plan benefits (64 F.R. 1125) (1/8/99).

3. *The fifth annual payment is only four years after the first payment; pre-59 1/2 taxpayers must wait an additional year before making modifications in order to avoid the applicability of the §72(t) 10-percent penalty. Arnold v. Commissioner, 111 T.C. No. 12 (1998). Section 72(t)(2)(iv) excepts from the 10 percent penalty tax IRA distributions received before the taxpayer attains age 59 1/2 that are received as part of a series of substantially equal payments made not less frequently that annually for the life of the taxpayer (or the joint lives of the taxpayer and a designated beneficiary). However, if any change in the amount of the payments (other to reflect a cost-of-living adjustment) is made during the five year period commencing with the date of the first payment, §72(t)(4) imposes the 10 percent penalty on all payments received before age 59 1/2. In December 1989, before he attained age 59 1/2, the taxpayer began receiving equal annual distributions of $44,000 from an IRA. Thereafter distributions were received in January. In November, 1993, after five annual payments had been received and after the taxpayer had attained age 59 1/2, but before five years had elapsed since the first distribution, the taxpayer received an additional distribution of $6776. Imposition of the §72(t) penalty with respect to all $220,000 received before taxpayer attained age 59 1/2 was upheld. The November 1993 distribution impermissibly modified the series of substantially equal periodic payments within the 5 year period beginning with the first distribution. Therefore the 10 percent recapture tax under §72(t)(4) applied to all distributions he received prior to attaining age 59 1/2. The measure is five years -- and not receipt of five equal distributions -- before a disqualifying modification. The November 1993 distribution did not represent a cost-of-living adjustment because taxpayer received it due to financial need.

4. Notice 98-52, 1998-46 I.R.B. 16 (10/29/98). Guidance on the design-based alternative or “safe harbor” methods in §§401(k)(12) and 401(m)(11) in satisfying the nondiscrimination tests of those subsections. Treats whether a §401(k) plan satisfies the actual deferral percentage (“ADP”) test of §401(k) or the actual contribution percentage (“ACP”) test of §401(m) with respect to matching contributions.

5. Morrissey v. Commissioner, T.C. Memo. 1998-443 (12/16/98). Taxpayer borrowed money from the pension plans of his wholly owned corporation, and repaid the debt by transferring the one of the plans his 50-percent interest in two parcels of unencumbered real estate. Judge Laro held that the transfer was a §4975 “sale or exchange,” and, hence, a prohibited transaction. The second-tier tax also applied because the prohibited transaction was never “corrected.” Commissioner v. Keystone Consol. Indus., Inc., 508 U.S. 152 (1993), followed. Judge Laro distinguished the “self-correcting” holding of Zabolotny v. Commissioner, 7 F.3d 774 (8th Cir. 1993), aff’g in part and rev’g in part 97 T.C. 385 (1991), and found that the plans in this case were not in the “exceptional financial condition” as was the plan in Zabolotny.
6. T.D. 8795, final regulations under ERISA §204(h), requiring the plan administrator to give notice to participants of plan amendments which provide for a significant reduction in the rate of future benefit accrual (63 F.R. 68678, 12/14/98).

7. T.D. 8794 and REG-113694-98, temporary and proposed regulations under §§411 and 417 providing guidance on the increase from $3,500 to $5,000 of the limit on distributions from qualified retirement plans that can be made without participant consent [increased cash-out limit] (63 F.R. 70356, 12/21/98).

8. Hughes Aircraft Co. v. Jacobson, 119 S. Ct. 755 (U.S. 1/25/99) (9-0). Employer who amends an overfunded defined benefit plan and uses its surplus to fund an early retirement program and a new noncontributory plan does not violate its "fiduciary duty" because that term relates to the administration of plan assets -- not to amending a plan, following the doctrine of Lockheed Corp. v. Spink, 517 U.S. 882 (1996). Had the contributory defined benefit plan been terminated, the participants would have had rights to a portion of the plan surplus. After holding that the overfunded defined benefit plan had not been terminated, Justice Thomas further held that participants in a defined benefit plan generally "have no entitlement to share in a plan's surplus."


10. Notice 99-44, 1999-35 I.R.B. (8/16/99). Guidance in Q&A format on the repeal of the §415(e) combined limitation on defined benefit and defined contribution plans, as well as on the amendment to the §415(c)(3) definition of contribution. The Small Business Job Protection Act of 1996 repealed the §415(e) combined limitation on defined benefit plans and defined contribution plans, effective for plan years beginning on or after 1/1/98.

11. The actuarial tables reflect recent mortality experience. T.D. 8819, temporary and proposed regulations revising actuarial tables under §7520, etc. for valuing annuities, interests for life or terms of years, and remainder or reversionary interests (64 F.R. 23187, 4/30/99). The actuarial tables were updated to reflect the most recent mortality experience available, that we are living longer.

12. The cost of group term life insurance drops. T.D. 8821, Group Term Insurance; Uniform Premiums. For insurance provided after June 30, 1999, amended Reg. §1.71-3(d) increases the number of age brackets from ten to eleven and provides lower Table I rates than previously in effect.

13. Courts will not scrutinize whether an ERISA plan is tax-qualified. Traina v. Sewell (In re Sewell), No. 99-30109 (5th Cir. 7/27/99). For purposes of the Bankruptcy Code §541(c)(2) exclusion of ERISA plans from the property of the estate, it is irrelevant whether the ERISA plan is tax-qualified. The Trustee had argued that the plan lost its qualification because of a compliance failure by the employer. Judge Weiner concluded that otherwise the debtor's beneficial interest in her ERISA employee pension benefit plan could lose its protection by the failure of another -- beyond debtor's control -- to maintain tax qualification of the plan. Follows Baker v. LaSalle, 114 F.3d 636 (7th Cir. 1997).

This contention was also made concerning the proper person to tax after a distribution is made with respect to the recipient of an alleged QDRO.

VI. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. REG-246250-96, proposed regulations relating to the §6104(e) public disclosure requirements [to make its application for tax exemptions and annual information return available for public inspection] of tax-exempt organizations (62 F.R. 50533, 9/25/97).

a. Final regulations are out. T.D. 8818, final regulations under §6104(d), relating to the public disclosure requirements for tax-exempt organizations other than private foundations (64 F.R. 17279, 4/9/99).
2. *Professional fundraiser held to be an “insider.”* United Cancer Council Inc. v. Commissioner, 109 T.C. No. 17 (12/2/97). On declaratory judgment, a professional fundraiser [Watson and Hughey Co.] was held to be an “insider” for purposes of the private inurement provisions of §§501(c)(3) and 170(c)(2)(C) because an “insider’s” control consists of a meaningful opportunity to influence any portion of the organization’s activities that could readily be manipulated to the benefit of the insider.

The professional fundraiser received the lion’s share of amounts it raised for the charity. Judge Chabot held that retroactive revocation of the charity’s tax exemption retroactive to 6/11/84 was not an abuse of discretion.

a. *Reversed; there was no reason why any insider would want to benefit the professional fundraiser, and the arms-length contract did not make the fundraiser an insider.* United Cancer Council Inc. v. Commissioner, 165 F.3d 1173, 99-1 U.S.T.C. 50,248 (7th Cir. 2/10/99). The court reversed, finding no private inurement because there was no relationship whatsoever between the UCC board and the fundraiser and the UCC board was desperate, not disloyal. Judge Posner rejected the IRS argument that the exclusive 5-year contract would have left UCC at the mercy of the fundraiser, stating that the argument “merely demonstrated the Service’s ignorance of contract law. When a firm is granted an exclusive contract, the law reads into it an obligation that the firm use its best efforts to promote the contract’s objectives [citing Wood v. Duff-Gordon, 118 N.E. 214 (N.Y. 1917)].”

The case was remanded to determine the result of the IRS’s alternative basis for revocation, that UCC was not really operated exclusively for charitable purposes, but rather for the private benefit of the professional fundraiser as well; Judge Posner went on to note that the usual private benefit case was one in which the charity has dual public and private goals.

3. Fund for the Study of Economic Growth and Tax Reform v. IRS, 98-1 U.S.T.C. ¶50,251 (D. D.C. 2/12/98). Organization established to fund the Kemp Commission study on reforming the Code was not exempt because it “clearly supported a one-sided political agenda” and did not operate exclusively for exempt purposes. Further, the fund was a Reg. §1.501(c)(3)-1(c)(3) “action organization” in that its primary objective could be achieved only through legislative reform.

a. **Affirmed.** Fund for the Study of Economic Growth and Tax Reform v. IRS, 161 F.3d 755, 98-2 U.S.T.C. ¶50,908 (D.C. Cir. 12/8/98). The Kemp Commission to reform the tax code was not exempt because it “clearly supported a one-sided political agenda” and did not operate exclusively for exempt purposes. Further, the fund was a Reg. §1.501(c)(3)-1(c)(3) “action organization” in that its primary objective could be achieved only through legislative reform.

4. Unreleased TAM dated 12/1/98, 1999 TNT 24-25, holds that the Progress & Freedom Foundation, involved with Newt Gingrich’s college course, qualified under §501(c)(3). It did not serve the private interests of, nor did it allow its earnings to inure to the benefit of, Newt Gingrich. Further held, it was not an “action” organization.

5. REG-106177-97, proposed regulations under §529, relating to qualified state tuition programs (63 F.R. 45019, 8/24/98).

6. American Society of Account Executives v. United States, 23 F. Supp. 2d 64, 98-2 U.S.T.C. ¶50,885, 82 A.F.T.R.2d 7173 (D. D.C. 10/29/98). The “proxy tax” under §6033(e)(2) imposed on exempt organizations that conduct lobbying activities is constitutional. The proxy tax is imposed on an organization which does not shift the burden of the §162(e) disallowance of lobbying deductions to its members, but instead reports as income the estimated amount of nondeductible dues.

7. T.D. 8818, final regulations under §6104(d), providing guidance for exempt organizations, other than private foundations, that must disclose their exemption application and the three most recent annual information returns to the public (64 F.R. 17279, 4/9/99).

8. Fund for Anonymous Gifts v. IRS, 83 A.F.T.R.2d 1796 (D.C. Cir. 4/12/99), vacating and remanding 79 A.F.T.R.2d 2520 (D. D.C. 1997). An organization designed to permit donors to make contributions to ultimate beneficiaries on an anonymous basis and to claim a charitable contribution may qualify under §503(c)(3). Because contributions were invested by the fund as directed by the donor
pending distribution of both original contribution and income to the ultimate charitable beneficiary, the district court properly denied the exemption, but after the governing instruments were retroactively amended to preclude any such control, allowance of the exemption was ordered. The IRS agreed that “the anonymity aspect of the fund does not disturb the government.”

9. *The IRS strikes out in yet another royalty UBIT case! No All-Star batting average in this game. Common Cause v. Commissioner, 112 T.C. No. 23 (6/22/99). Common Cause, a §501(c)(4) exempt organization received payments from renting its mailing list. In each transaction, the mailer's rent payment, which was remitted through a list broker / manager, compensated CC for the mailer's use of its list. The list broker/manager retained a portion of the payment that was its compensation as well as amounts to pay the computer house that maintained CC’s list for its participation in the transaction. (in some instances an additional list broker was involved) CC treated the payments as royalty income not subject to UBIT under §512(b)(2). The IRS treated the list broker, list manager, and computer house as CC's agents in carrying on a business and the payments as UBIT. The court (Judge Wells) sided with Common Cause. Although the list brokerage activities were not royalty-related activities, the list brokers and the list manager, in its capacity as a list broker, were not acting as CC's agents. Consequently, the list brokerage activities and any compensation received by the list brokers or the list manager, in its capacity as list broker, were not attributable to CC. Except for those amounts, the mailer's list rental payment in each list rental transaction was a royalty excluded from UBIT by §512(b)(2).

   a. The opinion in Planned Parenthood Federation of America, Inc. v. Commissioner, T.C. Memo 1999-206 (6/22/99) basically appears to be the result of copying the Common Cause opinion to a new word-processing file and running a few universal search & replace functions.

10. *Not-for-Profits have to pick their partners carefully, and pay attention to the governing structure of the partnership. Redlands Surgical Services v. Commissioner, 113 T.C. No. 3 (7/19/99). Redlands Surgical Services (RSS) was a nonprofit corporation that was affiliated with a nonprofit Hospital. RSS sole activity was participating as co-general partner with a for-profit corporation in a limited partnership that was general partner of an operating partnership that owned and operated an ambulatory surgery center. Nothing in the partnership agreements or any of the other agreements related to operation of the surgery center, established any obligation that charitable purposes be put ahead of economic objectives in the surgery center's operations, and the profits of both partnerships were distributable to for-profit partners as well as RSS. After an exhaustive review of the terms of the partnership agreements, relevant contracts, and the actual management practices, on the facts RSS was found to have ceded effective control over the operations of the partnerships and thus the surgery center to for-profit parties. RSS had surrendered the ability to cause the surgery center to respond to community needs and nothing required the surgery center management to be guided by any charitable or community benefit, goal, policy, or objective. An impermissible private benefit was conferred. The Tax Court (Judge Thornton) reasoned:

   "It is no answer to say that none of petitioner's income from this activity was applied to private interests, for the activity is indivisible, and no discrete part of the Operating Partnership's income Producing activities is severable from those activities that produce income to be applied to the other partners' profit. ... Clearly, there is something in common between the structure of petitioner's sole activity and the nature of petitioner's purposes in engaging in it."

   "To the extent that petitioner cedes control over its sole activity to for-profit parties having an independent economic interest in the same activity and having no obligation to put charitable purposes ahead of profit-making objectives, petitioner cannot be assured that the partnerships will in fact be operated in furtherance of charitable purposes. In such a circumstance, we are led to the conclusion that petitioner is not operated exclusively for charitable purposes."

The court also declined to find that RSS qualified for exemption as an integral part of the affiliated not-for-profit Redlands Hospital. The surgery centers patient population did not overlap substantially with that of Redlands Hospital and prior cases in which the integral part doctrine was applied were categorized as not involving any private benefit or control, unlike the instant case. RSS therefore was not operated
exclusively for exempt purposes within the meaning of §501(c)(3) and its petition for a declaratory judgment of its tax exempt status was denied.

- The reasoning of the whole hospital joint venture ruling was applied. Rev. Rul. 98-15, 1998-12 I.R.B. 6 (3/4/98) (Two fact patterns: Situation 1 concludes that the exempt hospital will continue to be exempt where it will receive an interest in the combined operation equal in value to the assets it contributed and the board structure gives control of the joint venture to the exempt organization’s appointees. There is loss of exemption in Situation 2, where the joint venture’s governing documents do not require that it serve charitable purposes, board control rests with the taxable entity, and the taxable entity may unilaterally renew the management agreement. Both conclusions depend on “facts and circumstances.”)

B. Charitable Giving

1. TTREA '98 §1004(a)(1) amends §170(e)(5)(D) to restore the full fair market value deduction for contributions of qualified appreciated stock to private foundations back to 7/1/98 and to make the full fmv deduction permanent.

2. T.D. 8791, final regulations relating to charitable remainder trusts under §664 and to special valuation rules for transfers of interests in trusts under §2702 (63 F.R. 68188, 12/10/98). The final regulations expand the availability of the flip unitrust. A CRUT’s governing instrument may provide for a one-time conversion from an income-exception method to the fixed-percent method for calculating the unitrust amount, i.e., a flip unitrust.

3. *Assignment of income doctrine applied to charitable contributions of stock that was about to be sold. Ferguson v. Commissioner, 99-1 U.S.T.C. ¶50,412 (9th Cir. 4/7/99), aff’g 108 T.C. 244 (1997). Individuals who donated corporate stock to charitable organizations immediately before the corporation merged pursuant to a cash tender offer are taxable on the stock’s gain under the “anticipatory assignment of income” doctrine because the stock had earlier “ripened from an interest in a viable corporation into a fixed right to receive .to receive cash [when more than 50 percent of the stock had been tendered] . . . .” The donations were made at a later date, by which time 95 percent of the stock had been tendered or submitted for exchange in the pending merger. The merger had been negotiated and planned by one of the donors. Judge Choy stated:

Therefore, we will not go out of our way to make this dangerous business any easier for taxpayers who knowingly assume its risks. Moreover, from the perspective of judging such cases, there is no special reason that we should curtail the application of [the anticipatory assignment of income] doctrine simply because it requires “engaging in an exercise in line drawing, a difficult task which nevertheless is part of the daily grist of judicial life.”

a. *Query whether the gift could have been made earlier had there been constructive delivery under state law? Tenth Circuit holds that Reg. §25.2511-2(h) (which appears to require delivery of stock certificates and stock powers for a completed gift) is “not the only manner in which a gift of stock may be delivered.” Estate of Davenport v. Commissioner, 184 F.3d 1176, 99-1 U.S.T.C. ¶60___, 84 A.F.T.R.2d 5144 (10th Cir. 7/13/99, as corrected 9/20&21/99). Gift of stock for gift tax purposes was completed under Oklahoma law when shareholder who did not have legal title to the stock executed and delivered a deed of gift (which constituted constructive delivery of the stock).

4. *The IRS goes after charitable split-dollar life insurance arrangements with all guns blazing. Notice 99-36, 1999-26 I.R.B. 3 (6/28/99). The IRS “advises” taxpayers and §170(c) organizations (including §501(c)(3) charities) that certain charitable split-dollar insurance transactions that purport to produce charitable contribution deductions under §§170 or 2522 will not produce the tax benefits advertised by their promoters and may lead to penalties. The targeted transactions generally involve transfers of funds to a charity, with the understanding that the charity will use the funds to pay premiums on a cash value life insurance policy that benefits both the charity and the taxpayer’s family. In a related transaction, the charity enters into a split-dollar agreement (usually with a trust) that specifies the portion of the insurance policy premiums to be paid by parties related to the donor and the portion to be paid by the charity and the extent to which each party can exercise standard policyholder rights. Commonly the noncharitable beneficiaries enjoy disproportionately high percentages of the cash-surrender value and death benefits relative to the percentage of premiums paid. Although there is no express obligation that the taxpayer will transfer funds to the charity to cover premium payments, or
requiring the charity to use funds transferred by the taxpayer for that purpose, both parties understand that this will occur.

- The IRS will apply the substance-over-form doctrine based on the mutual understanding between the taxpayer, the related party, and the charity, and will treat the transaction as one in which the taxpayer obtains an insurance policy, pays premiums with respect to that policy, and transfers some of the rights under that policy to the trust and the remaining rights to charity.

- Regardless of whether or not Reg. §1.170A-1(h) and United States v. American Bar Endowment, 477 U.S. 105 (1986), apply, no deduction is allowed.

- Under §§170(f)(3) and 2522(c)(2), which disallow charitable deductions for transfers of partial interests, no charitable contribution deduction is permitted when a taxpayer assigns a partial interest in an insurance policy to a charity. [Rev. Rul. 76-143, 1976-1 C.B. 63, held that an irrevocable assignment of the cash surrender value of a life insurance policy to a charity, with a retained right to designate the beneficiary and assign the balance of the policy was a transfer of a nondeductible partial interest under §170(f)(3).] The transaction is not within the "transfer-of-an-entire-interest" exception to the partial-interest rule of §170(f)(3)(B)(ii) and Reg. §1.170A-7(a)(2)(i).

- The IRS also may challenge, on the basis of private inurement or impermissible private benefit, the tax-exempt status of a charity that participates in charitable split-dollar insurance transactions.

- The IRS may assess the following penalties: (1) taxes on excess-benefit transactions under §4958, or self-dealing under §4941, against any disqualified person who benefits from the charitable split-dollar insurance transaction and the charity's managers; (2) taxes on taxable expenditures under §4945 against any private foundation that participates in such transactions and against certain of the foundation's managers; (3) penalties under §6701 for aiding and abetting the understatement of tax liability against a charity that provides written substantiation of a charitable contribution in connection with a charitable split-dollar insurance transaction; (4) accuracy-related penalty, §6662; (5) return-preparer penalty, §6694; (6) promoter penalty, §6700; and (7) the §6701 penalty for aiding and abetting the understatement of tax liability.

5. **"Toto, I've a feeling we're not in Kansas anymore."** Greene v. United States, 185 F.3d 67, 99-2 U.S.T.C. ¶50,701, 84 A.F.T.R.2d 5415 (2d Cir. 7/23/99). The taxpayers donated the long term capital gain portion of appreciated futures contracts to a tax exempt private foundation that they had established. The futures contracts were subject to §1256, which requires that gain accruing on certain futures contracts and options be recognized as if the property had been sold on the last business day of the taxable year, with the gain treated as 40 percent short-term capital gain and 60 percent long-term capital gain. The taxpayer retained the short-term capital gain portion of the contracts that was not available for deduction as a charitable contribution.

- The Court of Appeals noted that contrary to the taxpayer's argument, §1256 puts cash method taxpayers on the accrual method with respect to mark-to-market gain on futures contracts. That the taxpayer never received the accrued gain does not change the fact that it was treated as realized. Section 1256(a)(2) only requires a negative adjustment in the mark-to-market gain upon the contribution equal to the amount necessary to prevent any double taxation attributable to mark-to-market gain recognized in previous years by the transferor: "The amount of taxable gain or deductible loss recognized by the transferor at the time of the charitable transfer will therefore equal the difference between the fair market value of the futures contracts at the time of such transfer ... and the transferor's tax basis in the futures contracts, as adjusted under §1256(a)(2) to account for gains and losses already recognized in prior tax years under the mark-to-market rules." Section 1256, the court explained, harmonizes the tax treatment of commodity futures contracts with the economic reality of the marketplace.

  a. Greene v. United States, 79 F.3d 1348 (2d Cir. 1996), held that §1256 required that the long-term capital gains portion of futures contracts donated to charity be marked-to-market at the time of contribution. Under the court's reasoning, this result is unique to long-term capital gain property subject to the special rules of §1256.

  b. **On remand,** 975 F. Supp. 273 (S.D. N.Y. 1997), the district court rejected the taxpayer's argument that §1256(a)(2) requires a negative adjustment to amount deemed to be realized by taxpayer-donor equal to the full amount of the mark-to-market gain because the amount ultimately realized on the futures contract actually was received by the charitable donee)
VII. INTEREST

A. In General

1. Interest on federal income tax deficiencies arising from Schedule C errors was properly allocable to business indebtedness. Temp. Reg. §1.163-9T(b)(2)(i)(A) — providing that personal interest includes interest paid on underpayments of individual federal income taxes — was held to be invalid as it was here applied. Redlark v. Commissioner, 106 T.C. No. 2 (1/11/96) (reviewed, 11-7). The 1986 Act provision for nondeductibility of personal interest [§163(h)] did not make any substantive change in earlier case law [e.g., Standing v. Commissioner, 28 T.C. 789 (1957), aff’d, 259 F.2d 450, 58-2 U.S.T.C. ¶9835 (4th Cir. 1958)] holding that interest on a federal income tax deficiency resulting in part from improper reporting of income from a sole proprietorship was deductible as a business expense. Therefore, Temp. Reg. §1.163-9T(b)(2)(i)(A), which provided that interest on deficiencies in individual federal income tax is non-deductible personal interest under §163(h), is invalid as applied to interest on a deficiency arising from a Schedule C adjustment.

a. Redlark reversed by Ninth Circuit. Redlark v. Commissioner, 98-1 U.S.T.C. ¶50,322 (9th Cir. 4/10/98). The court followed Miller v. United States, 65 F.3d 687, 95-2 U.S.T.C. ¶50,485 (8th Cir. 9/7/95), holding that the temporary regulation is a permissible interpretation of §163(h). The court held it would defer to the Commissioner’s “reasonable interpretation” of a statutory provision in interpretive regulations.

b. *The temporary regulation is valid. The Fourth Circuit follows the Ninth (and Eighth) in finding the temporary regulation to be valid. Allen v. United States, 99-1 U.S.T.C. ¶50,470, 83 A.F.T.R.2d 2114 ¶99-736 (4th Cir. 4/20/99). The change in statutory law casts doubt upon the Standing line of cases, the statute is ambiguous and the temporary regulation is a permissible interpretation (i.e., a reasonable interpretation) of the statute. The statute, of course, is the Tax Reform Act of 1986, which “fundamentally altered the tax character of personal interest, creating the presumption that such interest is non-deductible. This sweeping change in the tax law casts doubt upon the contemporary relevance of the Standing line of cases.”


d. *More nondeductible personal interest attributable to income tax liability. Carlson v. Commissioner, 112 T.C. No. 17 (4/30/99). Interest to the IRS under §453(l)(3) paid by an S corporation shareholder with respect to sales of timeshare units by the corporation reported on the installment method was nondeductible personal interest. Whether or not the interest ever could be deemed to be “attributable to a trade or business,” the trade or business would be that of the corporation and not the taxpayer. At the corporate level, no indebtedness was allocated to its trade or business. The court’s reasoning expressly ducked the issue how any such interest paid by a sole proprietor would be treated, because the court declined to rule (on the grounds of mootness in light of its reasoning) on validity of Reg. §1.163-8T(b)(2)(i)(B), which treats all interest under §453(l)(3) as personal interest. But under the Tax Court’s reasoning in Redlark v. Commissioner, 106 T.C. 31 (1996), rev’d, 141 F.3d 936 (9th Cir. 1998), the interest presumably would be deductible by a sole proprietor.

2. Intel Corporation v. Commissioner, 111 T.C. 90 (7/30/98) (reviewed, 13-0). Interest accrues on deficiencies later eliminated by foreign tax credit carrybacks. Fluor Corp. v. United States, 126 F.3d 1397 (Fed. Cir. 1997), followed. Further held, for post-1981 deficiencies, that interest accrued to the due date for the tax return for the year the credits arose.

a. Hallmark Cards Inc. v. Commissioner, 111 T.C. 266 (10/30/98). In 1997 the Tax Court entered a final decision that there were overpayments for 1987 and 1988. The overpayment for 1987 was due to a foreign tax carryback from 1989 that exceeded the amount of the deficiency computed without taking the foreign tax carryback into effect. Taxpayer paid the unreduced deficiency and the interest, and the Commissioner refunded the 1987 overpayment resulting from the carryback, a portion of overpayment interest thereon, and a portion of previously assessed deficiency interest. The motion to redetermine interest alleged that the Commissioner erred by computing interest on the portion of the previously existing deficiency that was satisfied by the application of the foreign tax carryback. Subsequently, taxpayer filed a proper motion for redetermination of interest under §7481(c), but then filed a motion for leave to withdraw motion to redetermine interest on deficiency. Taxpayer’s concern
was that the Tax Court would follow Intel Corp v. Commissioner, 111 T.C. 90 (1998), and hold for the Commissioner. First, the Judge Tannenwald denied the motion for leave to withdraw the motion to redetermine interest. If a motion is properly filed pursuant to §7481(c), the taxpayer may not voluntarily withdraw the petition. The substantive issue being the same as that in Intel, the court held for the Commissioner.

3. TTREA '98 §4003(i) amends §264(f) to expand the definition of “unborrowed [insurance] policy cash value” to include “inside buildup,” for purposes of the COLI pro rata interest disallowance rules.

4. TAM 199901005 (9/29/98). Interest deductions denied on corporate owned life insurance (COLI) contracts because the arrangement was a Knetsch-type sham that fell afoul of the §264(c)(1) four-out-of seven rule, 364 U.S. 361 (1960).

5. *This time it would have paid to sign the Form 870 agreeing to the deficiency. Exxon Corp. v. Commissioner, T.C. Memo. 1999-247 (7/28/99) (Swift, J.). Under the “all events test,” interest on an income tax deficiency could not be accrued until the audit was completed and Form 870 executed without further protest or litigation by the taxpayer corporation, even though 85 percent of the adjustments had been agreed upon. All of the details of the settlement and the required documentation had not yet been agreed upon.

VIII. NONTAXABLE EXCHANGES

A. Section 1031

1. Step transaction doctrine applied to deny basis-shifting in purported §1031 exchange. True v. United States, 99-1 U.S.T.C. ¶50, 1999 U.S. App. LEXIS 21604 (10th Cir. 9/9/99), aff'g in part, rev'g in part and remanding [on another issue] summary judgment order of the District Court for the District of Wyoming. Taxpayers purchased five new ranch properties to add to the ranching operations of their Ranching Partnership, each purchase taking place through the same series of steps. First, taxpayers' Oil S Corporation [in the oil business] purchased the parcels of real property. Then the parcels were transferred to taxpayers' Oil Partnership in exchange for selected productive oil and gas leases, purportedly under §1031. After the transfer, the Oil Partnership distributed the newly-acquired ranchlands to the individual family members, who then contributed them to the Ranching Partnership. The effect of these transfers was that the Oil S Corporation received cost-depletable oil and gas leases with the same cost basis it had in the non-depreciable ranchland it had transferred in the exchange with taxpayers' Oil Partnership. The ranching partnership acquired the non-depreciable ranchland at a zero basis.

- Held, the step transaction doctrine – in either its “end result test” or its “interdependence test” – was applicable and the court stated that “objective realities of the multi-step transactions [must be examined] to determine their tax status.” The overwhelming evidence of the Trues’ intent to achieve a particular end result make summary judgment appropriate on this issue. The ranchland transactions were treated as direct purchases by the Ranching Partnership.
- The court noted that the existence of a business purpose and economic effect is not directly relevant a step transaction doctrine, but rather relates more closely to a sham transaction doctrine analysis – even though both doctrines “are corollaries of the basic substance over form principle.”
- Summary judgment on another issue was remanded for a fact determination.

B. Sections 1034 (and 121)

1. Oy veh! In re Mehr, 93-1 U.S.T.C. ¶50,091 (Bankr. D. N.J. 1/28/93). The bankruptcy estate of individual debtors at least 55 years old could not (under §121) exclude $125,000 of gain from the sale of their personal residence owned by the estate. The estate's succession under §1398(g) to the tax attributes of the debtors, including basis, holding period and character of assets (§1398(g)(6)), was not meant to entitle the estate to take the §121 election on behalf of the debtors.

a. Oh, my! In re Popa, 98-1 U.S.T.C. ¶50,276, 81 A.F.T.R.2d 1282 (Bankr. ND Ill. 3/10/98). The court held that the $250,000 exclusion under § 121 is available to an individual’s bankruptcy estate. Because under § 1398(g)(6) an individual’s bankruptcy estate succeeds to the holding period and “character” of the property in the individual’s hands, the use of a property as the bankrupt’s
primary residence for two out of five years defines its “character” as a primary residence in the hands of the bankruptcy trustee and the exclusion is available because §121 excludes the bankruptcy estate as the debtor. The court refused to follow In re Barden, 105 F.3d 821 (2d Cir. 1997) (reaching a contrary result regarding the pre-1997 version of §121, which contained an age 55 requirement and a limitation to a single use of the provision).


c. IRS victory: But not in my house! In re Winch, 226 B.R. 591 (Bankr. S.D. Ohio 9/3/98). The exclusion under §121 is limited to individual taxpayers and is not available to an individual’s bankruptcy estate. The court declined to follow Popa, finding that the policy reasons for the §121 exclusion – to eliminate “lock-in” to large homes for individuals, to increase homeowners’ mobility and to free resources for their support, as well as the reduction of burdensome record-keeping – were continued (and expanded) when the scope of the exclusion was expanded in 1997; thus, pre-1997 cases limiting the exclusion to individuals retained their vitality. Furthermore, §1398 does not confer a “principal residence” attribute on the bankruptcy trustee.

d. IRS gives up the battle and acquiesces in Bradley, 1.b., above. AOD 1999-009.

2. Only the big guys can hedge; the little people have personal losses. Taylor v. Commissioner, T.C. Memo 1998-351 (10/5/98). Taxpayers owned a 5 acre parcel of land in Thousand Palms, CA that included a single family home, a 20 x 40 work shed used in the taxpayers’ construction business, and a mobile home. For purposes of income tax reporting, 25 percent of the property was treated as business property. To facilitate moving to Missouri and buying a combined residence / campground, the taxpayers entered into a sale/exchange agreement pursuant to which they sold the Thousand Palms property to a third party from who they purchased for an identical price a single family residence in Palm Springs, CA. As result of the sale / exchange transaction, taxpayers obtained sufficient cash to purchase the Missouri property to which they moved. Five months later, never having occupied the Palm Springs property as residence, they sold it for a $133,592 loss, which they claimed as a capital loss. The Tax Court upheld the Commissioner’s contention that no loss was allowable because the Palm Springs property was not purchased with sufficient profit-seeking intent. Instead, the court found that the taxpayers purchased the property for a personal purpose of facilitating their move to Missouri, believing the Palm Springs home to be more marketable than the Thousand Palms property, which the purchasers would not have bought without the reciprocal transaction involving the Palm Springs property. The court concluded that the loss was in substance a nondeductible loss on the sale of the taxpayers personal residence.

C. Section 1041

1. Martin v. United States, 97-2 U.S.T.C. ¶50,731 (E.D. La. 8/22/97) aff’d, 159 F.3d 932, 82 A.F.T.R.2d 7038 (5th Cir. 11/12/98). Amount of $5.7 million received by ex-wife of bankruptcy debtor on the sale of her community property claims in the bankruptcy is held taxable gain, and not excludable under §§1398 or 1041 because she did not receive any property from either the bankruptcy estate or from her ex-husband (nor did she transfer any marital property). The desired asset of her husband’s was a take-or-pay gas purchase contract with Tenneco. The $5.7 million she received from Tenneco was held not to be an estate asset by the bankruptcy court.

a. Affirmed. Martin v. United States, 98-2 U.S.T.C. ¶50,889 (5th Cir. 11/12/98). Taxpayer wife, a Louisiana resident, was held taxable [on ordinary income] on the $5.7 million she received from Tenneco in exchange for her claim against her husband’s bankruptcy estate. Wife alleged that her husband’s bankruptcy estate held a valuable gas purchase contract between one of his corporations and a Tenneco subsidiary, and that she had a community property interest in that valuable gas purchase contract. Held, that had wife waited to receive a distribution from her husband’s estate, “she might have been entitled to treat such distribution as a nontaxable payment incident to divorce, pursuant to [§1041],” but that the actual transaction between taxpayer and Tenneco “can be characterized as nothing other than a garden variety sale on which [she] recognized substantial and immediate gain.”

Judge Wiener noted that the “origin of the claim” doctrine, in which courts have held that proceeds received “in lieu of” otherwise tax-exempt funds were themselves
nontaxable, e.g., Lyeth v. Hoey, 305 U.S. 188 (1938), was inapplicable because taxpayer did not receive proceeds “from an adverse party in settlement of an underlying, disputed claim.”

2. **Ingham v. United States**, 99-1 U.S.T.C. ¶50,249 (9th Cir. 2/11/99). Former wife’s sale of property to a third person in order to generate funds to pay off an outstanding debt to her former husband is not tax-free under §1041 because the sale was not made “on behalf” of the former husband. The court distinguished *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992), because, unlike *Arnes*, the former wife’s transaction did not satisfy “some legal obligation or liability owed BY her former husband.” (emphasis in original).

- The court further held that disclosure of former wife’s return information to former husband was made in good faith pursuant to IRM (22)63(3), which authorizes limited disclosure in whipsaw situations.

3. **The nuances of §§301 and 302 elude yet another court when §1041 is pulled over the judge’s eyes. Craven v. United States**, 99-1 U.S.T.C. ¶50,336, 83 A.F.T.R.2d 1268 (N.D. Ga. 2/18/99). The court followed the Ninth Circuit’s decision in *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992), to apply §1041 to provide nonrecognition on redemption pursuant to divorce decree of wife’s 47 percent of stock of a corporation controlled by husband. The court reasoned that the purpose of the redemption was to effect a division of marital property and thus §1041 applied to the wife. The opinion states that the proper treatment of the husband, i.e., whether the husband had a constructive dividend by reason of the redemption, was not before the court and, in any event, was not relevant to the proper treatment of the wife’s redemption. The court did get right that §1041 did apply to the OID component of the promissory note that the wife received in exchange for the redeemed stock.

4. **Young v. Commissioner**, 113 T.C. No. 11 (8/20/99). A former husband defaulted on promissory note given his former wife in a divorce settlement in 1989 and satisfied a judgement on the note by transferring real 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 (Judge Foley) held that the husband’s transfer of the real estate was “incident to the divorce.” Accordingly, under §1041, the husband recognized no gain on the transfer. The court also 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. The opinion does not explain how the portion of the property transferred in satisfaction of accrued but unpaid interest was treated, but under Notice 88-74, 1988-2 C.B. 385, *Seymour v. Commissioner*, 109 T.C. 279 (1997), and *Gibbs v. Commissioner*, T.C. Memo 1997-196, the portion of the transaction attributable to interest on the note should not have been subject to §1041.

IX. **PARTNERSHIPS**

A. **Partnership Audit Rules**

1. T.D. 8808 and REG-106564-98, temporary and proposed regulations on unified partnership audit procedures (64 F.R. 3837 & 3886, 1/26/99).

2. **Crop Associates v. Commissioner**, 113 T.C. No. 15 (9/14/99). In a partnership level audit deficiency proceeding, the tax matters partner is not entitled to raise the affirmative defense of equitable recoupment. Equitable recoupment is not a partnership item.

B. **Miscellaneous**

1. *What happens when a tax nonentity entity becomes a tax entity? Rev. Rul. 99-5, 1999-6 I.R.B. 8 (1/14/99).* Tax results on the conversion of a single-member LLC to a partnership by either a purchase from the member [purchaser and seller are both treated as contributing their respective asset interests – treated as held directly – to the partnership in exchange for ownership interests in the partnership] or from the LLC [the single member is treated as contributing all of the LLC’s assets to the partnership and the purchaser is treated a making a contribution to the partnership, both in exchange for ownership interests in the partnership].

2. Rev. Rul. 99-6, 1999-6 I.R.B. 6 (1/14/99). Tax consequences arising when one related or unrelated person buys all the ownership interests in an LLC, causing the partnership status to terminate. If a related person, the partnership terminates under §708 and is deemed to make a liquidating distribution of all of its assets, following which the purchaser is treated as acquiring the other partner’s assets. If an unrelated person, the partnership is deemed to make a liquidating distribution of its assets, following which the purchaser is deemed to acquire all these assets by purchase.
3. CGF Industries, Inc. v. Commissioner, T.C. Memo 1999-45 (2/12/99). In 1988, the taxpayer-closely held family corporations formed partnerships with the shareholder family members, in which the corporations acquired limited partnership interests that would terminate in either 10 or 20 years. This would leave the individual shareholders as the sole partners. The partnerships invested the contributed capital in financial assets. The corporate limited partners claimed deductions for amortization of the basis of their partnership interests as term interests. After acknowledging that “partnership interests ... generally [are] considered to be nonamortizable,” the Tax Court proceeded to apply the “common law” precedents that recast the simultaneous purchase of a term interest and a remainder interest by related parties as a purchase by one taxpayer [in this case the corporations] followed by a transfer of a partial interest to the other taxpayer [in this case the shareholders]. The amortization deductions were disallowed. Although the issue was not before the court, this analysis also infers that the shareholders received constructive dividends.

4. **Partnership §179 passthrough is limited to the taxable income of the partnership.** Hayden v. Commissioner, 112 T.C. No. 11 (3/19/99). The Tax Court upheld the validity of Reg. §1.179-2(c)(2), which limits the §179 deduction passed through to partners to the taxable income of the partnership. The court found that the result was dictated by §§179(b)(3)(A) and 179(d)(8) themselves.

5. Rev. Rul. 99-43, 1999-42 I.R.B. (10/18/99). "Partnership special allocations lack substantiality when the partners amend the partnership agreement to specially allocate COD income and book items from a related revaluation after the events creating such items have occurred if the overall economic effect of the special allocations on the partners' capital accounts does not differ substantially from the economic effect of the original allocations in the partnership agreement." The amendment was to allocate the COD income to the insolvent partner, and the book loss from revaluation to the solvent partner.

X. **PERSONAL AND INDIVIDUAL INCOME AND DEDUCTIONS**

A. **Deductions and Credits**

1. **The alternative minimum tax (“AMT”) trap for attorneys’ fees on large recoveries.** See Alexander v. Commissioner, 72 F.3d 938; 96-1 U.S. T.C. ¶50,011 (1st Cir. 1995), aff'g T.C. Memo 1995-51. Attorney’s fees are miscellaneous itemized deductions, and may not be deducted for AMT purposes. Recovery of $250,000, with $245,000 attorney’s fees attributable thereto, must be included in gross income, with the attorney’s fees as a miscellaneous itemized deduction.

   a. **Attorney’s fees not included in the income of taxpayer who received a large punitive damages award, at least in the Fifth and Eleventh Circuits (as derived from pre-split Fifth Circuit precedents), under the Golsen rule.** Davis v. Commissioner, T.C. Memo 1998-248 (7/7/98). Willa Mae Davis recovered $152,000 of compensatory damages and $6 million of punitive damages against two companies that made loans to homeowners in Alabama. Her share of the recovery after legal fees and expenses was $3,039,191. Generally, the Tax Court holds that attorney’s fee awards paid directly to a plaintiff’s attorney [or the portion of a damage award that is the attorney’s contingent fee that is so paid] are nevertheless includable in the litigant’s gross income, and that the taxpayer then may claim a deduction, subject to any applicable limitations, including disallowance of the deduction for AMT purposes if it is a §212 deduction. Bagley v. Commissioner, 105 T.C. 396 (1995), aff’d 121 F.3d 393 (8th Cir. 1997). Accord Baylin v. United States, 43 F.3d. 1451 (Fed. Cir. 1999).

   - 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 by the litigant. In Davis, which was appealable to the Eleventh Circuit, the Tax Court followed Cotnam under the Golsen rule because 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.

   b. **But, not so fast... Cases involving attorneys fees paid under Texas and Arizona common law are not bound by Cotnam, which involved Alabama law which by statute gives attorneys a substantive right to fees based on their lien. Srivastava v. Commissioner, T.C. Memo. 1998-362 (10/6/98). Taxpayers not entitled to excluded the 40 percent of their settlement proceeds from a personal injury lawsuit that they assigned to their attorneys. Under the Texas common law on attorneys’ liens, no ownership interest was transferred to the attorneys. Judge Parr held that Cotnam v. Commissioner, supra, was inapplicable to this case under the Golsen rule because the Texas common law [giving no ownership rights to the attorneys] differed from the Alabama statutory law [“the
same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or
may have for the amount due thereon to them.

- The attorneys' fees are deductible for regular income tax only as a miscellaneous itemized deduction governed by §67, and not deductible at all for alternative minimum tax ("AMT") purposes.
- On the issue of allocating the settlement that was entered into after the damage award by the trial court, the Commissioner proposed a method of allocation, suggesting that "it is presumed that actual damages would be paid before prejudgment interest, postjudgment interest, or punitive damages, and that prejudgment interest would be paid before punitive damages." To the same effect under Arizona common law attorneys' liens is Sinyard v. Commissioner, T.C. Memo. 1998-364 (10/7/98) (Swift, J.).
- Whether an profit-seeking expense is deductible under §162 or, on the other hand, under §212, and thereby subject to the myriad of more restrictive ancillary rules, turns on the "origin and character of the claim for which the expense was incurred and whether the claim bears a sufficient nexus to the taxpayer's business." Guill v. Commissioner, 112 T.C. No. 22 (6/18/99). Taxpayer was a sole proprietor / independent contractor insurance agent who after having been fired by an insurance company sued the insurance company and collected compensatory damages for breach of contract and conversion of business profits, together with punitive damages. The taxpayer deducted his legal fees on Schedule C, but the IRS took the position that the taxpayer's attorney's fees were deductible under §212 as itemized deductions [subject to the myriad of limitations on deductibility of miscellaneous itemized deduction], but the Tax Court (Judge Laro), in what was described as a case of first impression held that the attorney's fees were deductible above the line under §162. One wonders how this was a case of first impression since in Srivastava v. Commissioner, T.C. Memo. 1998-362 (10/6/98), the Tax Court held that plaintiffs' attorney's fees incurred in a defamation suit were §212 expenses, not §162 expenses even though the defamation related to the taxpayer's conduct of his medical practice, obviously a trade or business. The court reasoned that whether the defamatory attack was on the personal reputation or the professional reputation, the defamation is personal in nature even though it may have derivative consequences for the business, relying on Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983) and Threlkeld v. Commissioner, 87 T.C. 305 (1986). But, in Fabry v. Commissioner, 111 T.C. 305 (1998), the Tax Court held that "injury to business reputation" [which in that case resulted from the effect on the taxpayer's products of defective products purchased from a supplier] is not as a matter of law a "personal injury." One further wonders how this aspect of Srivastava can be reconciled with Guill and Fabry other than as an idiosyncratic anomaly attributable to the torturous history of the interpretation of §104(a)(2).

- Is the AMT a birth control reverse tax expenditure? It's certainly anti-family! This decision is sure to be news both to Congress and to God. Klaassen v. Commissioner, T.C. Memo. 1998-241 (7/2/98). AMT applies to a couple with ten children and AGI of $83,056. Special Trial Judge Armen held that Congress intended it that way. The court also held that the free exercise of religion [i.e., the first commandment in Genesis, to "be fruitful and multiply"] is not thereby inhibited.

  Because the §151 personal and dependency deductions for computing regular tax liability are added back to taxable income [and a lump sum exemption that is not increased to reflect the number of dependents of a taxpayer is substituted in computing AMT], a taxpayer with none of the preference items listed in §57 and few, if any, of the §56 adjustments, may be subject to the AMT. Indeed, AMT liability can result solely from the combination of a large number of children claimed as dependents, and relatively, modest amounts of itemized deductions that are disallowed for AMT purposes. The taxpayers in this case were married filing jointly, had $83,056 of gross income, $10,996 of medical expenses, $3,264 of state and local taxes, and 12 personal exemptions; they had a $1,085 AMT liability in addition to their $5,111 regular income tax liability.


  "[T]he statute's plain language unequivocally reaches the Klaassens, and our inquiry is therefore complete. While the law may result in some unintended consequences, in the absence of any ambiguity, it must be applied as written. It is therefore from Congress that the Klaassens should seek relief."
Concurring opinion notes that the legislative history to the AMT indicates that Congress never intended this result.

e. Bay v. Commissioner, T.C. Memo. 1998-411 (11/16/98). Administrative expenses of a grantor trust taxed to the grantor under §671 are miscellaneous itemized deductions subject to the 2% floor under §67 [as well as the AMT trap, which was not in issue in this case] even though the expenses would not have been incurred but for the trust arrangement. Section 67(e) does not apply to grantor trusts.

2. *IRS limits reconversions: these involve a conversion from a traditional IRA to a Roth IRA, back to a traditional IRA, followed by “reconversion” to a Roth IRA. The limit is once in November/December 1998 and once in 1999. Notice 98-50, 1998-44 I.R.B. 10 (10/20/98). Interim rules, effective 1/1/98 as to successive “reconversions” from a traditional IRA, following an earlier conversion to a Roth IRA and a transfer back to a traditional IRA. Allows only one “reconversion” for November/December 1998 and one reconversion for 1999.

a. REG-115393-98, proposed regulations under §408A relating to the establishment of Roth IRAs (63 F.R. 46937, 9/3/98).

b. T.D. 8816, final regulations relating to §408A Roth IRAs (64 F.R. 5597, 2/4/99).

c. Announcement 99-5, 1999-3 I.R.B. 16 (12/23/98). Provides that reasonable alternative methods of reporting 1998 and 1999 recharacterizations of IRA contributions and 1998 and 1999 reconversions will be acceptable provided that the trustee provides appropriate instructions to the IRA owner on how to properly report the recharacterizations and reconversions for federal income tax purposes.

3. 1998 Act §6004 provides technical corrections in child credit stacking rules, amends HOPE and lifetime learning credit amendments, and amends education IRA and cancellation of student loans provisions.

a. REG-116826-97, proposed regulations relating to the §221 student loan interest deduction (64 F.R. 3257, 1/21/99).

b. REG-106388-98, proposed regulations relating to the §25A HOPE scholarship credit and the lifetime learning credit (64 F.R. 794, 1/6/99).

4. Being surly and smellin’ like horse sweat pays off in hobby loss case. Morely v. Commissioner, T.C. Memo. 1998-312 (8/24/98). The taxpayer was a dentist who engaged in Arabian horse breeding and sales. In finding that the activity was engaged in for profit, the Tax Court cited a litany of factors indicating the business-like manner in which the activity was conducted. In addition, it noted that: “Mr. Morley’s work on the farm was difficult, and it often precluded him from spending time with his family. Mrs. Morley credibly testified that she and her children missed her husband and that she would have preferred it if Mr. Morley had been at home instead of working on the horse-breeding activity. Mr. Morley arrived home after dark, very tired, in a bad mood, and dirty with a ‘certain aroma’ from his work on the farm. It appeared to the Court that Mrs. Morley resented the amount of time Mr. Morley spent on the horse-breeding activity and that she was unhappy that her husband came home every night dirty and smelly. We are not convinced that Mr. Morley would subject himself to such rigors solely for recreation or pleasure.”

5. *As long as you have some records, it’s OK if they’re “amateurish” in the Sixth Circuit. Holmes v. Commissioner, 99-2 U.S.T.C. ¶50,642, 83 A.F.T.R.2d 2987 (6th Cir. 7/1/99). The Court of Appeals reversed the Tax Court holding that under §183 the taxpayers’ farming activities on land adjacent to their home was not conducted for profit because the Tax Court had “erred by focusing on the [taxpayer’s] amateurish record keeping practices and the relatively minor potential personal benefits which may have realized from their agricultural pursuits, and by unreasonably discounting the overwhelming weight of the supporting evidence of the taxpayer’s economic productivity motivations.”

6. TTREA ’98 §2001 amends §26(a) to allow nonrefundable personal credits fully against regular tax liability during 1998, and amends §24(d)(2) to provide that the additional [$400] child tax credit is not reduced by AMT during 1998.

7. TTREA ’98 §4004(b) amends §67(b) to provide that nonbusiness casualty and theft losses deductible under §165(c)(2) [arising from transactions entered into for profit] will not be treated as
miscellaneous itemized deductions. Prior law provided that personal casualty losses deductible under §165(c)(3) were not so treated.

8. *Another example of the ubiquitous second class nature of §212 deductions. Wang v. Commissioner, T.C. Memo. 1998-389 (11/2/98). During 1987 and 1988, taxpayer, who was a securities analyst for Morgan Stanley, sold inside information regarding securities in violation of §§10(b) and 14(e) of the Securities Exchange Act of 1934, receiving approximately $150,000 in 1987 and $50,000 in 1988. In 1988, pursuant to action by the SEC seeking disgorgement (and a criminal conviction), taxpayer disgorged approximately $125,000 that he still had. Upholding the Commissioner, the Tax Court held first that the deduction for disgorgement of profits under §§10(b) and 14(e) of the ‘34 Act was a §212 expense, not a §162 expense, because the sales of inside information were sporadic, and the net loss for 1988 could not be carried back under §172 to offset the 1987 income from selling inside information. Second, the court held that §1341 relief was not available with respect to the disgorgement payment deduction because taxpayer’s activities were illegal in every respect and he did not have a claim of right or appearance of on unrestricted right to the proceeds received because they were subject to disgorgement.

9. *His employment may have required him to secure a hotel room for an inebriated female lounge customer, but it did not require him to tuck her in bed afterwards. If a homeowner’s insurance policy covers part of the expenses, that’s evidence that remaining unreimbursed expenses weren't business expenses. Kelly v. Commissioner, T.C. Memo. 1999-69 (3/8/99). Taxpayer was a hotel executive against whom criminal sexual assault charges were brought as a result of an incident involving an inebriated hotel lounge customer for whom the taxpayer obtained a complementary room pursuant to hotel policy designed to avoid patrons driving home drunk. Taxpayer’s claim that his legal expenses to defend the criminal charges were deductible as a business expense was rejected. While it might have been part of his job to secure the room for the customer, returning to the room after the customer had been checked in was not part of his job. Furthermore, his homeowner’s insurance policy, which excluded work related claims, had covered his legal fees and the damage award in the civil suit arising from the incident.

10. *Don’t forget, even though they may file a joint return, husband and wife are separate taxpayers, and, unless the Code provides otherwise, transactions between them are given effect, even if it whipsaws the Treasury. Coordinated Issue, All Industries, Health Insurance Deductibility For Self-employed Individuals, UIL 162.35-02, LEXIS, TAXANA. 1999 TNT 77-12 (4/21/99). Applying Rev. Rul. 71-588, 1971-2 C.B. 91, a self employed individual who employs his or her spouse and provides employer-paid medical insurance to the spouse as an employee fringe benefit (excluded under §106) may deduct the cost of the medical insurance as a business expense under §162(a), even if the employing taxpayer also is covered under a family policy. This result occurs only if the employee-spouse is a "bona fide employee of the business under the common law rules or otherwise provides services to the business for which the accident and health coverage is reasonable compensation." If the “employee-spouse” does not meet this standard, the accident and health coverage is a non-deductible personal expense under §262(a). But if the accident and health insurance policy is purchased in the name of the employer-spouse the limitations of §162(l) apply, notwithstanding that the policy provides coverage for the employee-spouse as well as for the employer-spouse (and their dependents). Similar principles apply to self-insured medical expenses reimbursement plans. However, marital property or community property laws that give a spouse an ownership interest in a business operated by a self-employed individual may be relevant, but not necessarily conclusive, for determining whether the spouse is also self-employed in the business.

11. *It's just business – nothing personal (even though he also went to burlesque shows just to listen to the band). At least Gladstone did not try to deduct expenses incurred in his quest to save prostitutes. Vitale v. Commissioner, T.C. Memo 1999-131(4/21/99). A Treasury department budget analyst engaged in a part-time activity writing a book about legalized prostitution, titled “Searchlight Nevada,” which was published and marketed and in researching and writing a sequel entitled “Nevada Nights, San Joaquin Dawn.” Judge Fay found that taxpayer was engaged in the activity for profit and that he was allowed to deduct most of his expenses (including expenses in excess of income from the activity), even though not all were documented; the Cohan rule was applied. Amounts paid to prostitutes for “interviews,” however, were nondeductible as inherently personal expenses, even to the extent documented by a journal and credit card receipts.

have slept through 1963 – the IRS has finally recognized that nicotine is a powerful addictive drug and that a strong causal link exists between smoking and several diseases. Accordingly, expenses incurred to participate in a smoking cessation program and to purchase prescription drugs to alleviate the effects of nicotine withdrawal are deductible medical expenses even though the taxpayer had not been diagnosed as having any specific disease and even though participation in the program had not been suggested by a physician. The cost of nonprescription drugs purchased in connection with the program, however, was not a deductible medical expense. Rev. Rul. 79-162, 1979-1 C.B. 116, holding to the contrary with respect to stop-smoking program expenses is revoked.

13. Furlow v. United States, 84 A.F.T.R.2d 5246 (D. Md. 6/6/99). Section 151(e) requires that a taxpayer provide a dependent’s social security (or TIN) number on the tax return as a condition of claiming a dependency exemption. This requirement cannot be avoided by providing an affidavit under Reg. §301.6109-1(c) stating that the dependent’s social security number is unknown to the taxpayer, was requested, and was not provided. The taxpayer’s claimed dependent in this case did not have a social security number.

B. Miscellaneous Income

1. Fabry v. Commissioner, 111 T.C. No. 17 (12/16/98). Taxpayers received $3.8 million from du Pont in settlement or a Benlate fungicide claim. As part of the settlement stipulation $500,000 of the payment was allocable to business reputation damages, which taxpayers excluded under §104(a)(2). Judge Halpern cited Threlkeld v. Commissioner, 87 T.C. 1294 (1986), for the proposition that there was not a per se rule that damages received on account of injury to an individual’s business reputation are excludable under §104(a)(2), but that this determination presented a question of fact. Held, taxpayers failed to prove that the payment was received as personal injury damages because there were no specific personal injury damages alleged in the lawsuit.

2. Gerbec v. United States, 164 F.3d 1015, 99-1 U.S.T.C. ¶50,194 (1/15/99) (2-1). Portion of settlement proceeds paid in class action against employer for violating ERISA was excludable under §104(a)(2) as received on account of personal injuries. The settlement occurred before the decision in Mertens v. Hewitt Associates, 508 U.S. 248 (1993), which limited damages for such ERISA violations to equitable remedies.

3. Picard v. Commissioner, 165 F.3d 744, 99-1 U.S.T.C. ¶50,218, 83 A.F.T.R.2d 616 (9th Cir. 1/26/99). A pension received by a policeman who went on a 75 percent of pay disability retirement pension after six years and had pension reduced to 50 percent after another 19 years, matching what would have been his pension if he continued to work for those 19 years continued to be exempt under §104(a)(1) because the taxpayer was not actually shifted to the retirement pension program.

4. Preferential treatment for post-doc Docs? Shame on you IRS! Streiff v. Commissioner, T.C. Memo. 1999-84 (3/23/99). After the 1986 amendment to §117, there is no longer even a colorable argument that §117 allows the exclusion of stipends to support postgraduate medical studies. This fact apparently is not a complete deterrent to young physicians pathologically addicted to tax avoidance from claiming the exclusion anyway. In 1993 Dr. Streiff received a postgraduate stipend to pay living expenses while training to receive a board certification in hematology, which he claimed was excludable under §117. The court quickly dismissed all of his claims — including that it was good public policy to allow him an exemption — in upholding the deficiency. Amazingly, it appears that the IRS did not seek to impose any penalties on Dr. Streiff. Given the severity with which the IRS often treats errors involving complex interpretations of law by relatively uneducated taxpayers, the kid glove treatment apparently accorded Dr. Streiff warrants a big Bronx cheer for the IRS.

5. *The Tax Court says you can’t trust the KGB to live up to its promises, Ames v. Commissioner, 112 T.C. No. 20 (5/28/99). Aldrich Ames was required to include amounts received from the Soviet Union in 1989 through 1992 in consideration of his espionage activities on its behalf. Imposition of the civil negligence [what about fraud, since Ames — thinking it would help his case — argued that he fraudulently failed to report the amount in 1985?] penalty in addition to imprisonment for criminal tax fraud — not to mention a life sentence for espionage — did not violate the double jeopardy clause of the Constitution. Ames did not constructively receive the amounts in 1985 when, according to the KGB, $2 million was set aside for him in a special account in the Soviet Union because the Soviets retained control of the funds and “if the KGB had questioned [Ames’] loyalty at any time before payment, there is no assurance that [Ames] would have continued to receive cash deliveries or payments.” [Anyway, since the amount was fraudulently not reported in 1985 either, the statute of limitations wasn’t running in any event.]
XI. PROCEDURE, PENALTIES AND PROSECUTIONS

A. Penalties and Prosecutions

1. 1998 Act §3305 amends Code §6404 to abate interest and most penalties if a timely-filing taxpayer is not provided with a statutory notice within the 1-year period, beginning on the later of the date on which the return was filed or the due date of the return without extensions. Effective for taxable years ending after 7/22/98. For taxable years beginning before 1/1/04, the period for providing the notice is 18 months. The suspension period is to last from the day after the close of the 1-year period until a date that is 21 days after the statutory notice is provided by the IRS. This provision is inapplicable to criminal penalties, fraud penalties, penalties for tax liabilities shown on the return, and penalties under §6651 for failure to file tax return or failure to pay tax.

   a. T.D. 8789, final regulations under §6404 relating to interest abatements attributable to unreasonable errors or delays by an IRS officer or employee performing a ministerial or managerial act (63 F.R. 70012, 12/19/98).

   b. Lee v. Commissioner, 113 T.C. No. 10 (9/15/99) The Commissioner did not abuse his discretion in refusing to abate interest under §6404(e). Suspension of taxpayer's civil audit pending resolution of criminal tax fraud case based on the same items was not a "ministerial act."

2. Harrison v. Commissioner, T.C. Memo. 1998-417 (11/18/98). Although taxpayers' applications for extension of the filing date for the 1988 and 1989 years were invalid [because their tax liabilities were not properly estimated], they were not liable for late-filing penalties because the filings and estimations of tax liability were the result of professional advice, i.e., there was reasonable cause for the untimely filings. Judge Whalen distinguished United States v. Boyle, 469 U.S. 241 (1985), in that it was reasonable here for taxpayers to rely on the substantive advice of their accountants (from whom they withheld no information).

3. T.D. 8790, final regulations under §6662 on the accuracy-related penalty (63 F.R. 66433, 12/2/98). Defines "reasonable basis" and clarifies the reasonable basis standard. This standard will be satisfied if it is reasonably based upon one or more specified authorities. If the return does not satisfy the reasonable basis standard, a reasonable cause and good faith exception may still apply. Also, no reasonable basis for tax treatment of an item attributable to a multi-party financing transaction entered into after 8/5/97, if the treatment does not clearly reflect the income of the corporation.

4. *Imposition of 40% penalty. DHL Corp. v. Commissioner, T.C. Memo. 1998-461 (12/30/98). Section 482 was applied to the sale of more than half of the DHL network located outside the United States to related foreign corporations. The court imposed the 40% penalty for gross valuation misstatements with respect to income related to the DHL trademark.

5. Penalties imposed on UPS. United Parcel Service v. Commissioner, T.C. Memo 1999-268 (8/09/99). In this sham transaction, discussed at IV.I., above, negligence and substantial understatement penalties were sustained (plus increased interest for tax-motivated transactions).

6. Fran Corp. v. United States, 99-1 U.S.T.C. ¶50,208, 83 A.F.T.R.2d 621 (2d Cir. 1/21/99). The taxpayer corporation failed to pay its employment taxes and failed to pay over the withheld employees' share of employment taxes during a period in which it was encountering financial difficulties. It also filed late quarterly returns. The IRS assessed penalties under §§6651(a)(1) (failure to file), 6651(a)(2) (failure to pay), and 6656(a) (failure to deposit). Taxpayer paid the penalties and sought a refund on the grounds that its failure was due to reasonable cause and not due to willful neglect.

   • The Second Circuit held that under Reg. §1.6651-1(c)(1) - (2) and §1.6161-1(b), a taxpayer's strained financial circumstances leading it to pay other creditors may constitute reasonable cause for its failure to pay both its own taxes and trust fund taxes (disagreeing with the Sixth Circuit's decision in Brewery, Inc. v. United States, 33 F.3d 589 (6th Cir. 1994), which held that use of funds to pay other creditors as a matter of law never could constitute "reasonable cause"). Nevertheless, the penalties were upheld because the taxpayer failed to exercise reasonable care and prudence, and thus did not show reasonable cause. During the period it failed to pay: (1) it continued to make cash rental payments to its president for office space notwithstanding the existence of an outstanding loan to him that could have been set off, (2) it continued to support numerous auto leases, including one on a Porsche; and (3) it incurred substantial entertainment expenses.

the taxpayer, an executive of the target corporation, sold stock options that did not have a readily ascertainable value, but for which he had attempted to make a §83(b) election in 1982, and reported the profits as long-term capital gains without flagging that the reporting was contrary to Treas. Reg. §1.83-7(b)(2), which would have treated the profits as ordinary income. On the substantive issue, the taxpayer was bound by stipulation to the result in Cramer v. Commissioner, 64 F.3d 1406 (4th Cir. 1995), rejecting a challenge to the regulations. Henry sought to avoid the §6662 penalty by arguing that he did not personally know of the regulation and relied on his accountant’s advice. The Court of Appeals held, that he could avoid the “intentional disregard” branch of the §6662 penalty because he demonstrated that he had neither actual knowledge nor any reason to have knowledge of the regulation, and because he reasonably relied on the advice of a competent tax professional, the negligence aspect of the §6662 penalty did not apply (even though it appeared that his accountant did have reason to suspect that gain was ordinary but did not so inform Henry).

8. *He should of known better! Grossman v. Commissioner, 83 A.F.T.R.2d 99-2999 (11th Cir. 6/28/99). Grossman was a tax attorney with an LL.M. from NYU and over twenty years experience, including a stint as a senior trial attorney in the IRS Chief Counsel’s Office. He and his then-wife filed a joint return and didn’t report constructive dividends from corporations owned by his wife but which were operated by Grossman. Most of the constructive dividends were in the form of family vacation expenses paid with credit cards issued to one of the corporations, the bills for which were paid with checks signed by Grossman. Not surprisingly, the civil fraud penalty was upheld. The court did not place much stock in the taxpayer’s contention that he justifiably relied on his accountant to prepare the returns. His innocent spouse claim, even under the revised statute, didn’t go far either. Duh!

9. *So should he! Sadler v. Commissioner, 113 T.C. No. 4 (7/29/99). Texas tax attorney, who was president and sole shareholder of six corporations, prepared his own Forms W-2 for each of the corporations. These forms listed large amounts of federal income tax as having been withheld, although the corporations neither withheld nor deposited the taxes that were listed. Judge Vasquez held that taxpayer had an underpayment of tax for the years involved arising from his overstatement of the credit for withholding, Reg. § 1.6664-2(g), Ex. (3), and was liable for the fraud penalty because he was a tax attorney who engaged in a fraudulent refund scheme in order to generate money for his financially strapped businesses. In view of the fraudulent returns, the limitations defense failed.

10. Schachter v. Commissioner, 113 T.C. No. 14 (9/1/99). The taxpayer was not entitled to credit of a fine paid as a result of his conviction of criminal tax fraud against a subsequently assessed civil tax fraud penalty.

B. Discovery: Summonses and FOIA

1. *No attorney-client privilege applies when a corporate tax lawyer conferred with an investment banker about a transaction the corporation eventually entered into with another investment banking firm. United States v. Ackert, 99-1 U.S.T.C. ¶50,298 (2d Cir. 2/26/99), rev’g district court. IRS permitted to question Goldman Sachs investment banker about his conversations with the tax counsel for Paramount Communications Inc., the taxpayer, concerning a conversation about an investment proposal to generate significant capital losses to offset earlier capital gains. (Paramount subsequently entered into the proposed investment with a different investment banker.) Held, The conversations are not privileged because the privilege does not cover communications between an attorney and a third party. The United States v. Kovel [296 F.2d 918 (2d Cir. 1961)] exception does not apply because the investment banker was not translating or interpreting information given to the tax counsel by his client, but was merely “sought out for information Paramount did not have about the proposed transaction and its tax consequences.” Note: Goldman Sachs was paid $1.5 million by Paramount even though Paramount entered into the Merrill Lynch deal (and not the Goldman Sachs deal).

   a. *Documents created by a lawyer-accountant while preparing his client’s returns are not protected by the attorney-client privilege, nor are they protected by the work product doctrine United States v. Frederick, 99-1 U.S.T.C. ¶50,465 (7th Cir. 4/15/99), amended 5/18/99 (Posner, J). The court stated that the privilege was not intended to provide a taxpayer with the means, “by hiring a lawyer to do the work that an accountant, or other tax preparer, or the taxpayer himself, normally would do, to obtain greater protection from government investigators than a taxpayer who did not use a lawyer as a tax preparer.” Judge Posner’s original opinion also provided that there is no privilege where a lawyer represents a taxpayer on an IRS audit because this is also work typically done by accountants. (This was amended later, see below.) Judge Posner notes in dictum that §7525 would not give accountants greater privilege than taxpayer’s lawyer had in this case, i.e., none. Therefore no §7525 privilege for accountants’ return preparation activities or their representation of a client on audit.
The opinion was amended on 5/18/99 to provide an attorney-client privilege with respect to legal issues in the IRS audit, but not where the lawyer merely number-crunches. Presumably, [under §7525] an accountant's work on legal issues in the course of an IRS audit would also be privileged.

2. 1998 Act §3417 adds new Code §7602(c) to require IRS to give taxpayer "reasonable notice in advance to the taxpayer that contacts with persons other than the taxpayer may be made," and to require that the IRS provide a record of such contacts periodically or on request.

a. *The IRS can mess up if it makes third-party contacts without notifying taxpayers in advance; it can also mess up when it sends a prophylactic letter to an unnecessarily large number of taxpayers about possible third-party contacts. IR-1999-19 (3/2/99). The Service will revise a letter for taxpayers to "more clearly spell out the circumstances surrounding third-party contacts about liability." Beginning 1/18/99, letters began going out to taxpayers stating that the IRS "may need to contact third parties [which] may include, but are not limited to, neighbors, employers, employees and banks." Commissioner Rossotti stated that the letter "mistakenly raised taxpayer concerns about privacy issues."

C. Litigation Costs

D. Statutory Notice

1. Andrews v. Commissioner, T.C. Memo 1998-342 (9/23/98). Taxpayers gave the IRS inconsistent notices of a change of address, using a new address on some letters but on a power of attorney filed in the course of the audit they used the same address as was used on their most recently filed tax return that contained an address [the most recently filed return did not contain any address]. Taxpayers failed to complete and return a Form 8822 (Change of Address) sent to them by the IRS in response. Held, a deficiency notice mailed to the address shown on the tax return was properly mailed to taxpayers' last known address.


3. *1939 Code cases, 1954 Code Regulations. – Guess which controls. Elliot v. Commissioner, 113 T.C. No. 7 (8/10/99). Elliot's tax return was filed by his attorney, acting under oral agency, on October 17, 1991. A power of attorney [Form 2848] was not filed until July 12, 1993, and the IRS issued a deficiency notice on October 12, 1995. The deficiency notice was held to be timely because the return filed on October 17, 1991 was not valid. Reg. §1.6012-1(a)(5) requires that return signed by an agent be accompanied by a written power of attorney (the original or a copy of which must be attached to the return). The court refused to follow cases that arose under the 1939 Code [Miller v. Commissioner, 237 F.2d 830 (5th Cir. 1956); Booher v. Commissioner, 28 T.C. 817 (1957)] that held a purported return met the statutory requirements if the taxpayer's name was signed by a person with actual authority to do so, even if there was not written delegation, finding that they had been superseded by the Commissioners authority under §6061 to prescribe the requirements of a return, which was exercised in part by the promulgation of Reg. 1.6012-1(a)(5), which was a valid legislative regulation.

E. Statute of Limitations


2. Crisp v. United States, 99-1 U.S.T.C. ¶50,330, 83 A.F.T.R.2d 1125 (E.D. Cal 2/18/99). In an action to quiet title under 28 U.S.C. §2410, to remove a tax lien, the district court does not have jurisdiction to entertain taxpayer's claim that the assessment was barred by the statute of limitations on the grounds that the 3-year period rather than the six year period provided by §6051(e)(1) controlled. Determining whether 3-year or 6-period controls limitations inherently involves determination of proper tax liability, for which court lacks jurisdiction under 28 U.S.C. §2410.

3. *An election under §183(e) to extend period of limitations for deficiency assessment based on the determination of whether an activity is conducted for a profit-motive results in a coterminous extension of the period for obtaining a refund in a Tax Court proceeding pursuant to §§6511(e)(4) and 6512(b)(3)(B). Waldow v. Commissioner, 112 T.C. No. 18 (5/11/99)
The taxpayer filed a §183(e)(1) election to invoke the presumption under §183(d), and the extended statute of limitations under §183(e)(4), with respect to the determination of whether his horse boarding and training activities were conducted for profit. The Commissioner subsequently assessed deficiencies, but in the Tax Court conceded that the taxpayer had overpaid for the relevant years. Accordingly, a refund would be allowable if the conditions of §6512(b) were met. Section 6512(b)(3)(B) allows a refund if the statute of limitations for seeking a refund on the grounds found by the Tax Court was open on the date of the deficiency notice under §6511(b)(2), (c), or (d). In this case the normal statute of limitations on seeking a refund had passed. But in a reviewed opinion the Tax Court held that the §183(e)(4) election supersedes and is the equivalent of an agreement to extend the statute of limitations under §6511(c) and that it extends the statute of limitations on refunds as well as deficiencies. Accordingly, the refund was allowed. Nine dissenters would have held that under a literal reading of the Tax Court was open on the date of the deficiency notice under §6511(b)(2), (c), or (d). In this case the normal statute of limitations on seeking a refund had passed. But in a reviewed opinion the Tax Court held that the §183(e)(4) election supersedes and is the equivalent of an agreement to extend the statute of limitations under §6511(c) and that it extends the statute of limitations on refunds as well as deficiencies. Accordingly, the refund was allowed. Nine dissenters would have held that under a literal reading of

F. Miscellaneous

1. Relief for "innocent" spouses. 1998 Act §3201, adds new Code §6015 to replace Code §6013(e) to provide relief from joint and several liability on joint returns.

• An election is available under §6015(b) within two years after collection activity has begun against the innocent spouse for understatements attributable to the other spouse. The innocent spouse must establish that in signing the joint return (s)he did not know (and had no reason to know) that there was an understatement and that it is inequitable to hold her liable for the deficiency in light of all the facts and circumstances. Partial relief is provided even if (s)he knew of the understatement but did not know (and had no reason to know) the extent of the understatement.

• A second election of separate liability, or "apportioned," innocent spouse relief is available within the same time limitation under §6015(c) to spouses who are divorced, separated or living apart for at least 12 months. The relief would limit any liability of the electing spouse to that portion of the deficiency allocable to the electing spouse's own income [as determined under §6015(d)]. Relief under this provision will not be available if the IRS is able to establish (1) that assets were transferred between spouses as part of a joint fraudulent scheme to evade taxes; or (2) that the electing spouse had actual knowledge of the item (or portion of the item) giving rise to the deficiency at the time of signing the return; or (3) that assets were transferred to the electing spouse for tax avoidance purposes [but only to the extent of the assets so transferred]. With respect to (3), there is a presumption that any asset transfer made later than 1 year before the issuance of a 30-day letter is for the proscribed purpose, with the exception of a transfer pursuant to a divorce or separation.

• The IRS was given broad power in new Code §6015(f) to provide equitable relief to taxpayers to whom neither an innocent spouse election nor a separate liability election is available if it nevertheless would be inequitable to hold the taxpayer liable for any unpaid tax or deficiency after taking into account all of the facts and circumstances.

• Code §6015(e) provides for Tax Court review to determine the appropriate relief available under §6015(b) or 6015(c) elections. Note that the 90-day period for petitioning for review begins on the day of the notice of an adverse IRS decision, not the day after [as is the case of a deficiency notice]. Effective for tax liabilities not paid before 7/22/98.

• 1998 Act §3501 requires IRS to give notice to married taxpayers under audit as to how they might limit their liability under Code §6015.

• 1998 Act §3201(b) amends Code §66(c) to provide that appropriate relief from liability should be provided with respect to an item of community income of spouses filing separate returns. Relief is to be provided under procedures to be prescribed by the IRS, based upon "all the facts and circumstances," where it is "inequitable to hold the [spouse] liable."

a. *No refunds under separate liability elections. TTREA '98 §4002(c)(2) amends §6015(c) to provide that the joint return separate liability election cannot be used to obtain a credit or refund.

b. *The IRS as King's Chancellor dispensing equitable relief from joint and several tax liability. Notice 98-61, 1998-51 I.R.B. 13. Interim guidance for taxpayers seeking equitable relief from federal tax liability under the innocent spouse provisions of §6015(f) or §66(c) ["taking into account all the facts and circumstances, it is inequitable to hold a taxpayer liable . . . "].
the employment tax classification settlement program, collection procedures and the individual liable for the unpaid liability or deficiency. The factors weighing in favor of relief include:

- (1) the taxpayer filed a joint return for the taxable year in question; (2) relief is not available under §6015(b) or §6015(c); (3) the taxpayer applies for relief no later than two years after the date of the IRS's first collection activity (after July 22, 1998) with respect to the taxpayer; (4) the liability remains unpaid; (5) no assets were transferred between the taxpayers filing the joint return as part of a fraudulent scheme; (6) no disqualified assets (as defined in '6015(c)(4)(B) were transferred to the individual by the other spouse [if there were disqualified assets transferred to the individual by the other spouse, relief will be available only to the extent that the liability exceeds the value of such disqualified assets]; and (7) the taxpayer did not have fraudulent intent when the return was filed. Even if these qualifying conditions have been met, §6015(f) equitable relief ordinarily will be granted only under the following circumstances: (1) the liability reported on the joint return year was unpaid when the return was filed; (2) at the time relief is requested, the taxpayer is no longer married to, or is legally separated from, the spouse with whom the joint return was filed (or at no time during the 12-month period ending on the date relief is requested has been a member of the same household as the spouse with whom the joint return was filed); (3) at the time the return was filed, the taxpayer did not know, and had no reason to know, that the tax would not be paid If a taxpayer otherwise would qualify for relief except for the fact that he did not know, and had no reason to know, of only a portion of the unpaid liability, the taxpayer may be granted relief attributable to that portion of the liability. The taxpayer seeking relief must establish that it was reasonable to have believed that the other spouse would pay the reported liability; and (4) the taxpayer would suffer undue hardship (as defined in Reg. §1.6161-1(b)) if relief from the liability were not granted. [If the tax due on the return has been adjusted to reflect an understatement, relief is available only to the extent of the liability shown on the return prior to the adjustment.] If these preliminary requirements for §6015(f) relief have been met, §6015(f) relief is available if, taking into account all the facts and circumstances, it is inequitable to hold the individual liable for the unpaid liability or deficiency. The factors weighing in favor of relief include:

- (1) that the taxpayer requesting relief is separated (whether legally separated or living apart) or divorced from the other spouse; (2) the taxpayer requesting relief will suffer hardship if the relief is not granted (even though it does not constitute "undue hardship" for purposes of Reg. §1.6161-1(b); (3) the taxpayer requesting relief was abused by his or her spouse; and (4) the other spouse has a legal obligation pursuant to a divorce decree or agreement to pay the liability. The following factors weigh against relief: (1) that any unpaid liability or item giving rise to the deficiency was attributable to the individual requesting relief: (2) that the taxpayer had knowledge or reason to know of an unpaid liability or deficiency (if the other factors supporting equitable relief are unusually strong, relief may be granted even if the taxpayer knew or had reason to know of an unpaid liability); and (3) the taxpayer has significantly benefited (beyond normal support) from the unpaid liability or items giving rise to the deficiency; (4) the taxpayer requesting relief has a legal obligation pursuant to a divorce decree or agreement to pay the liability attributable to the other spouse’s income. Section 66(c) relief is dependent on these factors, without regard to the threshold qualifiers and disqualifiers that apply to §6015(f).

2. Expedited appeals. Rev. Proc. 99-28, 1999-29 I.R.B. 109 (7/19/99). Section 7123(a) directs the IRS to provide procedures under which taxpayers may request an early referral of an unresolved issue to the Office of Appeals from the Examination or Collection Division. The IRS has provided procedures for early referrals from examinations, IRS instituted changes of accounting methods, the employment tax classification settlement program, collection procedures and EP/EO issues. An early referral requires that (1) an early referral can be expected to result in quicker resolution of the entire case, (2) agreement of both the taxpayer and the District, (3) full development of the issue, and (4) the remaining issues in the case are not expected to be resolved before Appeals can resolve the referred issue.


   a. T.D. 8809 and REG-117620-98, temporary and proposed regulations under §6331, relating to the notification of taxpayers of their right to a hearing both (1) before a levy is made and (2) after a levy is made (64 F.R. 3405 & 3462, 1/22/99). In Q&A form.
b. T.D. 8810 and REG-11684-98, temporary and proposed regulations under §6321, relating to the notification required to be made to any taxpayer named in a notice of lien (64 F.R. 3461 & 3398, 1/22/99).

4. 1998 Act §3703 provides that the IRS shall establish procedures to allow payment of taxes by check or money order made payable to the United States Treasury.

5. 1997 Act §1205 amends Code §6311 to permit payment of taxes by "commercially acceptable means," including by credit card. Effective 9 months after enactment, 5/5/98.

a. T.D. 8793 and REG-111435-98, temporary and proposed regulations under §6311 add approved debit and credit cards to the list of acceptable methods of payment (63 F.R. 68995 & 69031, 12/15/98). The date of payment is deemed to be when the card issuer authorizes the credit or debit transaction, provided that the Treasury actually receives (and keeps) the payment in the ordinary course of business. The debit or credit card issuer may impose a fee on holders who use their cards to pay their tax bills. Also, payments by check or money order are to be made to the order of "United States Treasury."

6. *Dueling decisions in the Circuits sets this issue up for certiorari. Leggett v. United States, 120 F.3d 592, 97-2 U.S.T.C. ¶50,635 (5th Cir. 9/4/97). Continuing tax lien under §6321 did not attach to right to bequest that was validly disclaimed under Texas law because under state law a right to accept a bequest was not a property interest. "State law determines whether a taxpayer has a property interest to which a federal tax lien may attach." Leggett is consistent with Mapes v. United States, 15 F.3d 138 (9th Cir. 1994), on whether state or federal law controls.

a. Drye Family 1995 Trust v. United States, 152 F.3d 892, 98-2 U.S.T.C. ¶50,651, 82 A.F.T.R.2d 5821 (8th Cir. 8/17/98). Continuing tax lien under §6321 did attach to right to bequest that was validly disclaimed under Arkansas law notwithstanding that under state law the disclaimer "related back." The right to accept a bequest is property to which a tax lien attaches. "[S]tate law determines whether a given set of circumstances creates a right or interest: federal law then dictates whether that right or interest constitutes 'property or a right to property' under section 6321." Drye Family Trust is consistent with United States v. Comparato, 22 F.3d 455 (2d Cir. 1994), on whether state or federal law controls.

b. A writ of certiorari to the Eighth Circuit was granted. 119 S. Ct. 1453 (4/21/99).

7. TTREA '98 § 3003(a) amends §6213(g)(2) to expand the mathematical error procedures to cover inconsistent information revealed through taxpayer identification numbers and affecting the dependent care tax credit, the child tax credit, and the earned income tax credit.

8. IR-1999-04, announcement the gross income threshold is raised from $150,000 to $1 million for the special $500 user fee for private letter rulings.

9. IRS press releases based upon attendance at the criminal trial and sentencing hearing by the IRS public affairs specialist did not disclose §6103 tax return information. Rice v. United States, 97-1 U.S.T.C. ¶50,833, 80 A.F.T.R.2d 5795 (D. N.M. 7/2/97). Taxpayer was criminally convicted on two felony counts of filing false claims for federal tax refunds and on three felony counts of making and subscribing false federal tax returns. On his suit for §7431 and Federal Tort Claims Act damages for unauthorized disclosure of tax return information, summary judgment was granted to defendants because the IRS press release was based upon court proceedings that the writer of the press release attended.

a. Affirmed, Rice v. United States, 166 F.3d 1088, 99-1 U.S.T.C. ¶50,224 (10th Cir. 1/28/99). Taxpayer "failed to present more than a scintilla of evidence that the public affairs officer obtained the information for the IRS press release from an impermissible source. Like it or not, a trial is a public event. . . . While those proceedings may have revealed 'return information,' that revelation was proper under the exception to section 6103 allowing such disclosure in federal court where the taxpayer is a party to the proceedings. 26 U.S.C. section 6103(h)(4)(A)."

* Information is not "return information," however, if the source of the information for the person making the disclosure was public records, such as a court opinion or testimony at a trial, even if the source of the information in the public record was the taxpayer's tax return. Thus, information from the taxpayer's tax return that was disclosed at a trial for criminal tax fraud
and which was included in an IRS press release about his conviction was not return information because taxpayer did not prove that the source of the information for the press release was his return itself rather than the testimony and evidence introduced at the trial.

10. Savage v. Commissioner, 112 T.C. 46 (2/16/99). The taxpayer overpaid his reported liability on his 1993 return, and pursuant to §6402(a) the Commissioner credited the overpayment against outstanding tax liabilities (including interest and penalties) for 1990 and 1991. Subsequently, the Commissioner determined a deficiency with respect to 1993. The taxpayer conceded the deficiency, but in a Tax Court petition grounded on the 1993 deficiency claimed that the Commissioner improperly calculated the 1990 and 1991 tax liabilities, interest, and penalties and that some portion of the 1993 payment that had been credited against those liabilities remained available to offset in part the 1993 deficiency. The court held that under §6512(b)(4), it did not have jurisdiction to review the Commissioner’s method of crediting the 1993 payment against the 1990 and 1991 taxes.

11. Nixon v. Commissioner, 167 F.3d 920, 83 A.F.T.R.2d 930 (5th Cir. 2/26/99). The dismissal or disposition of some issues, or years, in a single petition is not an appealable final order unless the Tax Court enters a separate Rule 54(b)-type order indicating that there is not just reason for delaying appellate review of the partially resolved petition. This was a case of first impression for the Fifth Circuit, which followed the generally prevailing rule in other circuits.

12. Allied/Royal Parking L.P. v. United States, 166 F.3d 1000, 83 A.F.T.R.2d 806 (9th Cir. 2/1/99). Damages are not available under §7433 to a taxpayer whose claim is that IRS wrongfully levied on funds of another person in taxpayer’s possession even if taxpayer suffers harm as a result of such a wrongful levy.

13. *Fourth Circuit requires IRS to issue a refund despite the anti-injunction provision and despite Lewis v. Reynolds. Estate of Michael v. Lullo, 173 F.3d 503, 99-1 U.S.T.C. §60,339 (4th Cir. 4/2/99) (2-1), reversing district court. On the application of an estate seeking to receive an agreed foreign death tax credit (which would have offset an assessment previously made by the IRS), a writ of mandamus requiring the IRS to issue the credit was ordered by the Fourth Circuit. The IRS had discovered a computational error after the assessment period expired and attempted (under Rev. Proc. 85-13, §4, reopening is permitted [as here applicable] when “other circumstances exist that indicate failure to reopen would be a serious administrative omission”) to offset the new liability against the agreed credit. Judge King distinguished Lewis v. Reynolds, 284 U.S. 281 (1932) (the IRS may offset a time-barred underpayment in a refund suit) as being inapplicable where an additional amount of taxes is sought in violation of §6501(a), as opposed to the time-barred underpayment being used merely as a shield. The majority further held that requiring the estate to pay the tax and sue for refund was not sufficiently expedient so as to require the application of the §7421 Anti-Injunction Act.

   Dissenting Judge Luttig stated that the relief granted was foreclosed by the anti-injunction provision, §7121, noting, "Whether one sympathizes or not with the majority’s frontier instincts in this case . . . the IRS, no less than any other litigant, is entitled to the protection of the law."

14. “I’m a lawyer; why can’t I be trusted?” 1997 Act §1021 adds new Code §6045(f) to require information reporting of payments to attorneys [in connection with legal services, whether or not the services were performed for the taxpayer], effective for payments made after 12/31/97. The reporting requirement would be applied to amounts paid, even if the payment is a gross amount and it is not known what portion is the attorney’s fee. The Reg. §1.6041-3(c) exception for payments to corporations is inapplicable to payments made to attorneys. (The provision is not applicable to reporting payments of salaries or profits to members of a law partnership, because of Form K-1 reporting.) The House Report stated, “It is anticipated that gross proceeds reporting would be required on Form 1099-B (currently used by brokers to report gross proceeds).”

   Query whether lawyer is required, in turn, to issue Forms 1099 to his clients? Suppose the client may not exclude the recovery under §104(a)? Answer: Example 2 of Prop. Reg. §1.6045-5(f), infra, indicates that the attorney has no further reporting requirement because it is the payor who has the reporting requirement on Form 1099MISC or Form W-2 as to amounts received by the client [and if this amount is uncertain, as to the gross amount]. However, the attorney may have a reporting requirement under some provision other than §6045(f), which is unlikely in the usual situation (because the attorney is not normally the payor).

   a. *More on §6045(f) reporting, REG-105312-98, proposed regulations under §6045 relating to the reporting of payments of gross proceeds to attorneys (64 F.R. 27730, 5/21/99). The
$6045(f) reporting requirement does not relieve the payor from any other reporting requirement. Information is to be reported on Form 1099-MISC, not Form 1099-B. Payments are reportable under §6045(f) even if the check is made payable to the client only.

15. *The “10 deadly sins.”* Notice 99-27, 1999-21 I.R.B. (5/5/99). Interpretation of §1203 of the IRS Restructuring and Reform Act of 1998, which requires the termination of IRS employees who, in the performance of official duties, violate any of the ten specific rules listed in 1998 Act §§1203(b)(1) – (10) (1. Willful failure to obtain required approval signatures on documents authorizing seizure of home, personal belongings or business assets; 2. False statement under oath regarding material matter involving taxpayer or representative; 3. Violating constitutional rights or antidiscrimination statutes; 4. Falsifying or destroying documents to conceal mistakes; 5. Assault or battery on taxpayer, representative or another IRS employee; 6. Retaliating or harassing taxpayer, representative or another IRS employee by ignoring law, rules and regulations, or IRS policies; 7. Willful misuse of §6103 to conceal information from a congressional inquiry; 8. Willful failure to file tax return without reasonable cause; 9. Willful understatement of federal tax liability without reasonable cause; and 10. Threatening to audit a taxpayer for the purpose of extracting personal gain.)

- The Commissioner’s determination to terminate an IRS employee pursuant to this provision is not appealable.
- Generally, an independent determination in a civil or criminal case [in which the IRS employee is a party] is required.
- The NTEU continues to exert influence on termination procedures.

16. *Tax Court thumbs its nose at the Sixth Circuit in a case appealable to the Ninth.* Estate of Branson v. Commissioner, 113 T.C. No. 2 (7/13/99) (reviewed, 3 judges dissenting). For estate tax purposes, the estate reported the date-of-death fair market values of the certain corporate stock at amount substantially below the values finally determined in a Tax Court proceeding (Estate of Branson v. Commissioner, T.C. Memo. 1999-231) after audit. The estate had sold some of the stock and distributed the proceeds to the residuary legatee, who properly reported the gain [computed on the originally claimed date-of-death-value basis] and paid the income tax thereon. The estate asserted that it was entitled to equitable recoupment of the residuary legatee’s income tax overpayment, the refund of which was barred by the statute of limitations. In a reviewed opinion (with only 3 dissents), the Tax Court held that it has the power to apply equitable recoupment to allow the estate a credit for the residuary legatee’s income tax overpayment. The Tax Court followed its opinion in Estate of Mueller v. Commissioner, 101 T.C. 551 (1993), and since the instant case was appealable to the Ninth Circuit, declined to follow the Sixth Circuit’s opinion in Mueller, 153 F.3d 302 (6th Cir. 1998).

17. *Has it truly become a “voluntary income tax”?* Offer in compromise temporary and proposed regulations. T.D. 8829 and REG-116991-98, 1999-32 I.R.B. 242, temporary and proposed amendments to Reg. §301.7122-1 to provide additional guidance regarding the compromise of internal revenue taxes [implementing the amendments to §7122 in the Internal Revenue Service Restructuring and Reform Act of 1998] (64 F.R. 39020 & 39106, 7/21/99). Most of the changes are procedural, but some highlights are:

- All rejected offers in compromise may be appealed to the IRS Office of Appeals, except those submitted solely to delay collection and those where taxpayer failed to provide required information.
- The new regulations delete the limitation on the compromise of criminal liabilities to cases involving a regulatory provision without intent to defraud. As revised, the regulations specifically note that unless expressly done, compromise of a civil liability does not remit a criminal liability and compromise of a criminal liability does not remit a civil liability.
- The regulations eliminate a former limitation that prohibited compromise of a tax liability that had been reduced to judgment unless there was a doubt as to collectibility.
- In addition to providing for the use of compromises in cases involving doubt as to either “liability” or “collectibility,” the regulations now provide rules for compromises “to promote effective tax administration” when (a) collection “will create an economic hardship,” (b) regardless of the taxpayer’s financial circumstances “will be detrimental to voluntary
compliance by taxpayers,” or (c) a compromise will not undermine compliance by taxpayers with the tax laws.

18. *In re Orr*, 84 A.F.T.R.2d 5390 (5th Cir. 6/12/99). A tax lien against bankrupt taxpayer’s equitable interest in a spendthrift trust [which was valid under Texas law] was a valid lien. It survived taxpayer’s bankruptcy in which his personal liability for tax debts was discharged, and the lien applied to distributions payable to the taxpayer after the bankruptcy.

19. *Do you have your alternative PTIN? IR-1999-72 (8/14/99).* IRS will begin issuing alternative identification numbers for tax preparers to use on returns and refund claims prepared after 1999, in lieu of the social security numbers they are now required to use. Preparers may not write “PTIN applied for” in lieu of supplying their social security numbers.

20. *Ex parte communications between Exam and Appeals? Notice 99-50, 1999-40 I.R.B. 444 (9/17/99).* Provides a proposed revenue procedure that, when “finalized,” will provide guidance on the prohibition of ex parte communications between IRS Appeals Officers and other IRS employees pursuant to the directive in the Internal Revenue Service Restructuring and Reform Act of 1998 to develop a plan to prohibit such communications that appear to compromise the independence of Appeals Officers. Appeals Officers may speak to lawyers in Office of Chief Counsel, but the Appeals Officers are to “remain responsible for independent evaluation of the strengths and weaknesses of specific issues or positions in the case, or of the case as a whole, and for making independent judgments concerning the hazards of litigation.” The prohibition will have no impact on the procedures relating to the Appeals process for cases docketed in the Tax Court.

- Section 1001(a)(4) of the 1998 Act requires that the plan to reorganize the Internal Revenue Service ensures an independent Appeals function within the Internal Revenue Service. The notice contains proposed revenue procedure to provide guidance regarding ex parte communications between Appeals Officers and IRS employees that compromise or appear to compromise the “independence” of Appeals officers. It is in the form of a series of questions and answers, that address situations frequently encountered by Appeals Officers during the course of an administrative appeal. The Service invites comments [to be submitted] by December 3, 1999 to aid in the development of this revenue procedure. The prohibition on ex parte communications will not take effect until the revenue procedure is issued in final form. In the interim, existing procedures relating to communications in the course of Appeals consideration of disputes remain in effect.

21. Rev. Rul. 99-40, 1999-40 I.R.B. 443 (10/4/99), modifying and superseding Rev. Rul. 84-58, 1984-1 C.B. 254, and Rev. Rul. 88-98, 1989-2 C.B. 356. When a taxpayer reports an overpayment on its income tax return, interest will be assessed on that portion of a subsequently determined deficiency for the overpayment return year that is less than or equal to the overpayment as of: (1) the date on which the Service refunds the overpayment without interest; or (2) the date on which the overpayment is applied to the succeeding year’s estimated taxes. Interest will be assessed on any remaining portion of the deficiency from the original due date of the tax for the overpayment return year. *May Department Stores Co. v. United States*, 36 Fed. Cl. 680 (1996) (Acq.), followed.

XII. TAX SHELTERS

A. In General

1. For corporate tax shelters, see IV.I., above.

XIII. WITHHOLDING AND EXCISE TAXES

A. Employee/Independent Contractor and Employment Tax

1. *Court defers to reasonable IRS interpretation.* *Morrison Restaurants, Inc. v. United States*, 97-2 U.S.T.C. ¶50,598, 80 A.F.T.R.2d 5999 (11th Cir. 8/12/97). Under §3111(a) & (b) and §3121(q), IRS could validly assess employer’s share of FICA with respect to restaurant employees’ unreported tips on the basis of an aggregate computation, without determining individual employees’ shares.

   a. *Fior D’Italia Inc. v. United States*, 98-2 U.S.T.C. ¶50.840 (N.D. Calif. 9/18/98) holds that the IRS lacks authority to assess employer’s share of FICA without determining the tip income of individual employees.

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b. Bubble Room Inc. v. United States, 98-2 U.S.T.C ¶50,799 (Fed. Cir. 10/16/98). IRS has statutory authority to assess FICA taxes against an employer without determining the tip income of individual employees and awarding wage credits to the employees.

c. *Is the Northern District of Florida still in the Eleventh Circuit?* Quietwater Entertainment, Inc. v. United States, 84 A.F.T.R.2d 5007 (N.D. Fla. 6/28/99). The IRS determined a deficiency in the employer’s share of FICA taxes for tips to employees in its restaurant. In doing so, the IRS used a modified McQuatters formula [T.C. Memo, 1973-240], on an aggregate basis, a methodology approved by the Eleventh Circuit in Morrison Restaurants v. United States, 118 F.3d 1526 (11th Cir.1997), and presumed a 12 percent tip rate for cash bills and a 16 percent rate for credit card bills. District Court Judge Vinson held that the 11th Circuit got it wrong in Morrison and that §6053(c), which requires withholding by the employer of the employee’s share of FICA based on a presumed 8 percent tip rate implicitly caps the assessment of the employer’s share at 8 percent as well and prescribes the only available allocation methods, implicitly proscribing aggregate assessments of the employer’s share.

2. Notice 99-6, 1999-3 I.R.B. 12 (1/5/99). Two temporary methods owners of disregarded entities may use to report and pay employment taxes for employees of the disregarded entity. The first method permits the entity’s owner to do this under the owner’s TIN; the second method permits the entity to do this under its own TIN.

3. T.D. 8814, final regulations under §3121(v) to provide guidance as to when amounts deferred under or paid from a nonqualified deferred compensation plan are taken into account as wages for FICA purposes (64 F.R. 4542, 1/29/99).

B. **Excise Tax**

**XIV. TAX LEGISLATION**

A. **Vetoed**


B. **Enacted**


3. P.L. 106-36, the Miscellaneous Trade and Technical Corrections Act of 1999 was signed by President Clinton on 6/25/99.