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Selected Recent Federal Income Tax Developments

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SELECTED RECENT FEDERAL INCOME TAX DEVELOPMENTS

Questions to
The Honorable Mary Ann Cohen
Chief Judge, United States Tax Court

By
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i. Pages 1-2 (#A2): In Straight the Tax Court penalized the I.R.S. $5,000 because the revenue agent made changes to her report and later testified inconsistently about the matter, thereby causing the taxpayer to incur extra attorney's fees. Fees were not awarded under §7430, presumably because the taxpayer did not prevail in the case. What sanctions are available in these circumstances?

ii. Page 23 (#C2): Estate of Davis is a valuation case, and you told us in prior years that valuation cases and other factual cases are typically memorandum opinions. What was special about this one that causes you to characterize it as a published opinion? Note, also, the Eisenberg case at #C3.

iii. Page 25 (#D6): Last year we discussed Winn, which was withdrawn simultaneously with the release of the opinion in Mel T. Nelson. Can you say anything more about the change of position?

iv. Page 55 (#D2): Will the legislative solution to the unfairness of Elgart avoid the large number of cases involving motions to dismiss for lack of jurisdiction whenever a petition is filed a day or two late?

v. Page 60 (#15a): What changes can we expect to see in the Tax Court as a result of the new burden of proof shift?

vi. Page 60 (#F15d): What changes can we expect to see in the Tax Court as a result of the increase in the amount from $10,000 to $50,000 for cases to be eligible for the simplified procedure (“S”) election?

vii. Pages 61-62 (#F16): What changes can we expect to see in the Tax Court as a result of the opinion of the Sixth Circuit in Estate of Mueller?
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RECENT FEDERAL INCOME TAX DEVELOPMENTS

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I. ACCOUNTING
   A. Accounting Methods
      1. **"Inventories" were required, but the cash method was permitted! -- At least for the year in question. Usually, when inventories are required, an accrual method is also required. Golden Gate Litho v. Commissioner, T.C.Memo. 1998-184 (4/18/98). Taxpayer operated a custom printing shop and did 70 percent of its business for one customer. All printing was done to order and materials were not purchased until an order was placed; any materials remaining after completion of the order were scrap. Taxpayer did not maintain inventories and used the cash method. The Commissioner applied §446(b) to require the taxpayer to maintain inventories and was upheld on this point. The court found that since the cost of materials was a material income producing factor in the taxpayer's printing business, the materials were "merchandise" under Reg. §1.471-1. With respect to accounting methods, however, notwithstanding Reg. §1.446-1(c)(2)(i), requiring use of the accrual method if inventories are required, the Tax Court held that the IRS abused its discretion in requiring a shift from the cash method to accrual method for the year in question. The IRS inventory valuation method was generally based on value, not cost, and its accrual method was so flawed that it simply did not clearly reflect income and to require it would be an abuse of discretion. Since the record did not provide sufficient facts to determine taxpayer's income under a proper accrual method, for the year in question the cash method was permitted.
      2. *Yet, it is not always in taxpayer's interests to avoid "inventories." Deferral of "nonrefundable" customer deposits under Reg. §1.451-5 not permitted; taxpayer's S corporation did not qualify for deferral under that provision because it did not maintain any inventory. IRS penalized for not being "straight" with taxpayer. Straight v. Commissioner, T.C. Memo. 1997-569 (12/29/97). Taxpayer was the sole shareholder of Eagle Nest Homes Inc., an S corporation in the business of selling "panelized house kits." Eagle Nest reported on the accrual method. Eagle Nest received deposits that were commingled with its other funds. The deposits were nonrefundable, although as a matter of customer relations, Eagle Nest often refunded deposits or applied them to purchases beyond the contract date. Eagle Nest's engineers worked with customers to customize the designs. Eagle Nest then bought the prefabricated home kits from Timberline, another corporation that was under common control. Timberline shipped the building components directly to the end customer, and Eagle Nest never took title or possession of the building kits. Eagle Nest sought to defer the "nonrefundable" deposits until the later year(s) they were applied to the purchase of a house kit. The court upheld the Commissioner's position that the deposits were includable in the year received. Reg. §1.451-5 did not apply to defer inclusion of advance deposits because Eagle Nest did not maintain any inventory for sale to customers.

* I would like to thank Martin J. McMahon, Jr., Professor of Law, University of Florida College of Law, Gainesville, Florida, for his wise suggestions for revision of this outline.
The IRS was penalized $5,000 to cover taxpayer's additional expenses when it was revealed that the Revenue Agent made changes to his report accompanying the 30-day letter, which changes were not furnished to the taxpayer.


4. TAM 9806004 (10/21/97). Commissioner's consent to change accounting method for workers' compensation liabilities was revoked under Reg. §601.201(l)(1) because of taxpayer's failure to disclose it was under examination at the time of the request (as required by Rev. Proc. 92-20). Taxpayer contended that it was not under examination because, while it had been contacted by an examining agent and advised that "its fiscal years are open for examination," the agent did not set a specific date to meet with a representative of taxpayer. (Rev. Proc. 92-20 has since been superseded by Rev. Proc. 97-27, 1997-21 I.R.B. 10.)

5. Rankin v. Commissioner, 98-1 U.S.T.C. ¶50,254, 81 A.F.T.R.2d 1016 (9th Cir. 3/13/98), aff'g T.C. Memo. 1996-350. A bail bondsman's practice of deducting or offsetting "indemnity fund" expenses against receipts was an accounting method and requiring him to capitalize the indemnity fund expenses was a change of accounting method resulting in a §481 adjustment. Section 481(b)(2) was unavailable to the taxpayer, however, because he did not have his books and records for the prior years. Under Reg. §1.481-2(b) taxpayer must establish his income based on his books and records, and without them the taxpayer could not establish what his income for those years would have been.

6. Earliest taxable year under examination and 1-year §481(a) adjustment period? Notice 98-31, 1998-22 I.R.B. (5/15/98). Proposed revenue procedure that, when finalized [sic], will provide the procedures under §446(b) and Reg. §1.446-1(b) for changes in method of accounting initiated by the Service. Describes the discretion IRS will use as to whether an accounting method issue be resolved as an accounting method change or on a "nonaccounting-method-change basis." However, timing issues will normally be resolved as accounting method changes to be made in the earliest taxable year under examination with a §481(a) adjustment and a 1-year §481(a) adjustment period.

B. Inventories

1. Estimates of inventory shrinkage held permissible in particular cases. Wal-Mart Stores Inc. v. Commissioner, T.C. Memo. 1997-1 (1/2/97); Kroger Co. v. Commissioner, T.C. Memo. 1997-2 (1/2/97). In Dayton-Hudson Corp. v. Commissioner, 101 T.C. 462 (1993) (reviewed), the Tax Court held that inventory shrinkage estimates were not per se impermissible. These were reductions in closing inventory representing theft, etc. losses incurred between the date of taking inventory [by physical count] and year-end. In Wal-Mart and Kroger, the court held that taxpayers' methods of estimating inventory shrinkage at yearend were permissible because they conformed to the best accounting practice and they clearly reflected income.

a. ... but not for Dayton Hudson itself. Dayton Hudson Corp. v. Commissioner, T.C. Memo. 1997-260 (6/11/97), decision following refusal to grant summary judgment to government, 101 T.C. 462 (1993). Taxpayer's method of decreasing inventories for estimated "shrinkage" between the date of physical inventory and year-end did not clearly reflect income because of its failure to show a correlation between sales and shrinkage.

b. Inventory shrinkage legislation. 1997 Act §961 adds new Code §471(b) to permit estimates of inventory "shrinkages" between the date of the inventory and the end of the year. Effective for years ending after 8/5/97, with automatic consent to change methods of accounting accordingly, with a 4-year spread of the §481 adjustments.

• The Conference Committee Report contemplates Treasury's issuance of guidance, including a safe harbor applicable to retail trade "that will use a historical ratio of shrinkage to sales, multiplied by total sales between the date of the last physical inventory and year-end."
Historical ratio to be determined on a store-by-store or department-by-department basis, and must be used without adjustment.


d. *Eighth Circuit affirms Wal-Mart and reverses Dayton-Hudson, permitting inventory shrinkage for years prior to the effective date of 1997 legislation. Wal-Mart Stores Inc. v. Commissioner, 153 F.3d 650, 98-2 U.S.T.C. ¶50,645, 82 A.F.T.R.2d 5601 (8th Cir. 8/14/98), aff’g T.C. Memo. 1997-1. Taxpayer's method of estimating inventory shrinkage at year-end was permissible because it conformed to the best accounting practice and it clearly reflects income. The court distinguished Thor Power Tool [tax accounting need not follow GAAP] on the ground that there was a specific regulatory provision relating to inventory writedowns, but inventory shrinkage is not clearly covered by applicable regulations. The court made clear that inventory shrinkage estimates did not deal with future losses, but with losses that actually occurred in the stub period.

(1) In Dayton-Hudson Corp. v. Commissioner, 153 F.3d 660, 98-2 U.S.T.C. ¶50,644, 82 A.F.T.R.2d 5610 (8th Cir. 8/14/98), rev’g T.C. Memo. 1997-260. The Court of Appeals upheld the Tax Court's decision that the taxpayer's method of decreasing inventories for estimated "shrinkage" between the date of physical inventory and year-end did not clearly reflect income because of its failure to show a correlation between sales and shrinkage, but reversed because the Commissioner's method of accounting that made no allowance for shrinkage did not clearly reflect income and was therefore arbitrary.

2. Bargain purchases of inventory: Part I. TAM 9730003 (3/27/97). Inventory acquired in a §351 exchange is not required to be a separate item from otherwise identical inventory later acquired under the dollar-value LIFO inventory method. The TAM reserves the possible application of §482, clear reflection of income, and assignment of income. The TAM distinguished Hamilton Industries, Inc. v. Commissioner, 97 T.C. 120 (1991), on the ground that Hamilton Industries involved a bargain purchase of inventory (as opposed to a low carryover basis from transferor's use of LIFO).

3. Bargain purchases of inventory: Part II. Kohler Co. v. United States, 97-2 U.S.T.C. ¶50,673 (Fed. Cir. 9/17/97). Follows Hamilton Industries with respect to bargain-purchased inventory, and permits Commissioner to adjust closed year income under §481 when he changes taxpayer's accounting method (i.e., as a result of the bargain purchase in 1978 [a closed year], an adjustment in 1984 attributable to 1978 was permitted). Under Hamilton Industries, the change of method of accounting required that §481 adjustments to be made for any differences because of the method change in all years applicable to the 1954 Code [and 1986 Code] in taxpayer's earliest open year.

- The Commissioner properly applied §446(b) to prevent taxpayer from combining in a single LIFO pool low cost items acquired in a nonrecurring bargain purchase with physically fungible goods later produced or acquired by taxpayer at normal costs. To combine the items in a single pool could have resulted in prolonged deferral. Although LIFO defers income, it is not intended to defer the flow of lower costs that are not the result of inflation.

4. Bargain purchases of inventory: Part III. LaCrosse Footwear Inc. v. United States, 97-1 U.S.T.C. ¶50,439, 79 A.F.T.R.2d 1394 (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."

a. *A tax-free step up in basis without a funeral! Will this one stand up on appeal? LaCrosse Footwear, Inc. v. United States, 98-1 US.T.C. §50,435, 81 A.F.T.R.2d 2075 (Fed. Cl. 5/15/98). Under Kohler v. United States, 124 F.3d 1451 (Fed. Cir. 1997), the initial purchase of inventory at a bargain price in the taxpayer corporation's first year had to be placed in separate LIFO pool from goods subsequently manufactured or purchased at fair market value. The LaCrosse court held, however, that bargain purchased inventory is a separate "item" and [because taxpayer used the "double extension dollar value" LIFO method under Reg. §1.472-8] the base-year "cost" of the property acquired by bargain purchase was its fair market value, not its cost (which is the usual valuation rule under Reg. §1.472-2). As a result, the bargain purchased inventory obtained a tax-free step-up in basis, and the economic gain realized through the bargain purchase never will be recognized in taxable income.

5. If you do it wrong, you're not on LIFO long. Rev. Rul. 97-42, 1997-41 I.R.B. 4 (9/25/97). Franchised automobile dealer that elected the LIFO inventory method violates the §472(e) or (e)(2) LIFO conformity method by providing to the credit subsidiary of its automotivie manufacturer franchiser [for financing purposes] an income statement for the taxable year that fails to reflect the LIFO inventory method in the computation of net income. Two other situations found no violation of the conformity requirement where LIFO is reflected in either gross profit or net income.

a. See, also, Rev. Proc. 97-44, 1997-41 I.R.B. 8 (9/25/97) (procedure that provides relief to automobile dealers for pre-10/15/97 violations of LIFO conformity).

6. Judge Chiechi writes a treatise on taxpayer's impermissible use of LIFO inventory. Consolidated Manufacturing, Inc. v. Commissioner, 111 T.C. No. 1 (7/20/98). Commissioner did not abuse his discretion in terminating taxpayer's LIFO election under §§446(b) and 471. Automobile parts remanufacturer sold reconditioned automobile engines, transmissions, etc. It purchased most of the parts it used, except that it received most of the used engines, used transmissions, and used similar parts it reconditioned (taxpayer's "used core inventory") from customers in exchange for a relatively high price reduction for the trade-in. (This, of course, meant that the cost of taxpayer's used core inventory was relatively high.) Taxpayer employed a method of reporting the bulk of its goods inventory under LIFO, except that it reported its used core inventory under FIFO (and lower-of-cost-or-market). Judge Chiechi held that taxpayer's method of accounting did not clearly reflect income because it contravened §472 and the regulations thereunder, in that LIFO may be used for a "good" – but may not be used for part of a good.

- The Commissioner determined that the taxpayer's inventory method was contrary to the regulations under §472 and did not clearly reflect income and that the LIFO election should be terminated. Judge Chiechi further held that the Commissioner did not abuse his discretion under §446(b) in terminating the LIFO election even though the method might have been acceptable under GAAP. Reg. §1.472-1(c) – permitting a LIFO election to apply only to costs of all or some of raw materials incorporated into to finished goods, while other costs are taken into account under FIFO – did not authorize taxpayer's method, which purported to apply LIFO to labor and overhead and some raw materials but FIFO to other raw materials. Under taxpayer's method, LIFO did not apply to any entire good, either raw material or finished; and the regulations do not authorize taking labor and overhead into account under LIFO separately. The court determined the "purchase cost" of core parts acquired in exchange-like transactions involving the sale of remanufactured parts in exchange for cash and used core parts to be the stated credit price for the core parts. The Commissioner did not abuse her discretion in determining that the lower of cost or market for core parts was determined under Reg. §1.471-4(a) as the bid price for replacement core parts in the market in which it acquired them, not at the scrap amount at which it carried a substantial number of core parts.

C. Installment Method

1. For corporate tax shelters using the installment method regulations, see IV. I. 1. and 2., below.
D. Year of Receipt or Deduction

1. *Section 636(a) loan treatment was inapplicable where payor did not receive an economic interest in the mineral in place. Herbel v. Commissioner, 129 F.3d 788, 97-2 U.S.T.C. ¶50,986 (5th Cir. 12/8/97), aff'd 106 T.C. No. 22 (6/5/96). Taxpayers were the shareholders of Malibu Petroleum, Inc., an S corporation which purchased working interests in various gas wells that were subject to a gas purchase contract with Arkla as buyer. Arkla paid $1,850,000 to Malibu Petroleum to settle a take-or-pay dispute, but reserved the right to recoup the payment from future gas purchases under the contract. The payment was refundable if Malibu Petroleum cancelled the contract or if the property was depleted before recoupment. The $1,850,000 payment was not a §636(a) production payment [which would be treated as a loan] because Congress intended [and Reg. §1.636-3(a)(1) provided] that only production payments which constituted an economic interest in the mineral in place would so qualify. Arkla did not have an economic interest in the mineral in place because it did not look solely to mineral in place, but had refund rights under certain conditions. The validity of Reg. §1.636-3(a)(1) was upheld.*

2. *Advance §636(a) rulings require that right given to payor be an economic interest in mineral in place. Rev. Proc. 97-55, 1997-51 I.R.B. 23 (12/22/97). The Service will issue advance rulings that a right to a specified share of the production from mineral in place is a production payment if: (1) the right is an economic interest in mineral in place; (2) the right is limited by a specified dollar amount, a specified quantum of mineral, or a specified period of time; (3) it is reasonably expected, at the time the right is created, that it will terminate upon the production of not more than 90 percent of the reserves then known to exist; and (4) the present value of the production expected to remain after the right terminates is 5 percent or more of the present value of the entire burdened property (determined at the time the right is created). (A production payment is, in effect, a truncated royalty interest.)

- Section 636(a) governs the income tax treatment of mineral production payments [rights to a specific share in the production from a mineral in place], and provides that a carved-out production payment shall be treated as a loan to the payee, i.e., the person who created the carved out interest. The production payments are included in the income of the payee to the extent that such amounts would be included in gross income if the production payment had actually been a loan. The consideration received by the payee, i.e., the person who created the production payment, is not included in gross income.

3. *Fuel cost overrecoveries are not includable in income. Houston Industries Inc. v. United States, 125 F.3d 1442, 97-2 U.S.T.C. ¶50,651 (Fed. Cir. 9/11/97). Fuel cost overrecoveries and the interest accrued thereon are not includible in gross income because taxpayer is subject to an unconditional statutory obligation to refund these amounts to customers and thus did not have complete dominion over the money (but acted in a custodial role). The utility derived little or no benefit from retaining the overpayments [i.e., it was required to pay interest]. The court stated that it would follow Indianapolis Power & Light Co., 493 U.S. 203 (1990).

   a. The case below. Houston Industries, Inc. v. United States, 94-2 U.S.T.C. ¶50,526 (Fed. Cl. 10/11/94), aff'd, 125 F.3d 1442, 97-2 U.S.T.C. ¶50,651 (Fed. Cir. 9/11/97). Fuel cost overrecoveries (and interest earned thereon) received by a public utility company under a fixed fuel factor scheme instituted by the Texas PUC [for the benefit of customers, by avoiding large fluctuations in monthly bills] were not includible in gross income under the claim of right doctrine (as interpreted by Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203, 90-1 U.S.T.C. ¶50,007 (1990)) because taxpayer did not have complete dominion, but was obligated to repay (or credit) the customers directly. The Federal Circuit's Iowa Southern Utilities Co., [11 Cl. Ct. 868 (1987), aff'd, 841 F.2d 1108 (Fed. Cir. 1988)], the Fourth Circuit's Roanoke Gas Co., and the Tax Court's Southwest Energy Co. cases were distinguished on the grounds that in those cases – as opposed to this case – no effort was made to return refunds to particular customers, no interest was payable and the surcharges were incurred to benefit the utilities. The court followed the Seventh Circuit's Illinois Power Co. v. Commissioner, 792 F.2d 683 (1986).

5. Reading & Bates Corp. v. Commissioner, 98-1 U.S.T.C. ¶50,290, 81 A.F.T.R.2d 1126 (Fed. Cl. 3/2/98). Taxpayer performed services in Egypt for WEPCO under a contract that required WEPCO to indemnify taxpayer for any Egyptian taxes due. In 1981, the Egyptian government audited Reading & Bates’ tax returns for 1976 and 1977 and asserted deficiencies. WEPCO, on Reading & Bates behalf, appealed the deficiency, and after appeals paid the finally determined amounts in 1984. In a complex computation involving the foreign tax credit, Reading & Bates argued that the indemnification payments were not income until the appeal was final and the government argued that the indemnification constituted income in the years to which it related. Applying the “contested amount doctrine” of Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 (1944) (involving the accrual a deduction for contested taxes), the court held that the amounts were not properly accruable until the appeal was resolved.

6. *Is the all events test satisfied when taxpayer’s liability is conditioned upon other persons’ not-yet-filed claims? In other words, is the filing of claims an unsatisfied condition? Or is it a ministerial act? Rev. Rul. 98-39, 1998-33 I.R.B. 4 (7/10/98). An accrual method taxpayer-manufacturer properly accrues liability for cooperative advertising services performed by retailers in the year the retailer performs the advertising services, even though payment was not due until 90 days after retailer submitted a claim and proof of performance of advertising in accordance with required standards. The performance of the services satisfies both the economic performance test of §461(h) and the historic all events test, even though the retailer does not submit the claim until the next year. Submission of the claim form and proof of performance was a “mere technicality. United States v. General Dynamics Corp., 481 U.S. 239 (1987), distinguished because the filing of medical reimbursement claims [where some covered employees fail to file for various reasons] was not a “mere technicality.” Automatic change of method procedures are available.

7. *The difference between §461(f) and §1341. Chernin v. United States, 98-2 U.S.T.C. ¶50,551, 82 A.F.T.R.2d 5134 (8th Cir. 7/10/98). Taxpayer was involved in litigation with his former employer regarding the employer’s claim that he embezzled funds. The funds in question were amounts that the taxpayer had authorized be paid to himself as bonuses and that he had reported as income. A writ of garnishment against taxpayer’s bank account was issued in a state court in 1982. The taxpayer claimed a deduction for the 1982 year under §461(f), which the Commissioner disallowed because the taxpayer had not made any actual transfer or payment. The court held for the taxpayer, concluding that the garnishment satisfied the requirements of §461(f) because it transferred actual control of the garnished funds from the taxpayer to the state court. (The funds were released back to the taxpayer sometime after 1990.)

However, the court upheld the Commissioner’s position that the taxpayer could not compute the deduction under §1341. It held that the §1341(a)(2) requirement – that it be established that the taxpayer does not have an unrestricted right to the income – requires that the amount must actually be repaid to the original payor. That a deduction is allowed under §461(f) [because funds to pay a deductible expense have been put in escrow beyond the taxpayer’s control] is not sufficient for §1341 relief.

8. Section 1341 relief not available for repayment of amounts received by predecessor in interest. Estate of Smith v. Commissioner, 110 T.C. No. 2 (1/12/98). Algerine Smith, Frankie Allen and Jessamine Allen owned oil royalty interests. When Jessamine died in 1979, Algerine Smith inherited Jessamine’s interest; when Frankie died in 1989, Algerine Smith inherited a portion of Frankie’s interest. In 1988, Exxon sued Algerine (and others) to recover a portion of royalties paid to Algerine Smith, Frankie and Jessamine Allen (and others) from 1975 through 1980. After Algerine died in 1990, Algerine’s estate settled the claims against Algerine, Frankie, and Jessamine. The estate claimed the benefit of §1341 with respect to the repayment. The Tax Court held that the estate could apply §1341 only to the repayment of the claims against Algerine. Section 1341 does not apply to repayments of amounts received by and taxed to the taxpayer’s predecessor in interest. Repayments by a beneficiary of
an estate of amounts received by and taxed to the decedent and inherited by the beneficiary are not subject to §1341.

9. **Walk your checks to the bank; don't trust the Postal Service!** Walter v. United States, 98-2 U.S.T.C. ¶50,546, 82 A.F.T.R.2d 5115 (8th Cir. 7/8/98). The taxpayer received a check from a customer who purchased cattle for $77,481 in March 1986, but lost it [presumably when it was mailed to his bank] before it was deposited in his bank account. The original drawer of the check issued a new check in March 1988. The court upheld the IRS position that income was constructively received in 1986. The loss of the check was a restriction on collection resulting from the taxpayer's actions, not the drawer's actions. (The IRS was alerted to the 1986 receipt of the check by a tear-slip among the taxpayer's records).

II. BUSINESS INCOME AND DEDUCTIONS

A. **Depreciation, Depletion and Credits**

1. **Supervalu, Inc. v. United States,** 98-1 U.S.T.C. ¶50,994 (N.D. Ill. 10/16/97). For purposes of the ITC, centralized refrigeration system to cool rooms in warehouse were §38 tangible personal property under Reg. §1.48-1(c), not structural components of the building under Reg. §1.48-1(e)(2). Remember this one when you have a MACRS class life classification issue, because Hospital Corp. of America v. Commissioner, 109 T.C. 21 (1997), held that the Reg. §1.48-1 standards apply to determine if property is tangible personal property or real property for MACRS purposes.

2. **Research credit for internal use computer software denied.** United Stationers Inc. v. United States, 98-1 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.

3. *Research credit for internal use software allowed for only one of eight development activities, and that was the one that did not work. Norwest Corp. v. Commissioner, 110 T.C. No. 34 (6/29/98). Norwest developed 67 software programs for internal use in its banking business and claimed the §41 credit for increased research and experimentation costs. The case involved eight software development activities that were agreed to be representative: (1) a "strategic banking system," (2) trust account management, (3) specialized data processing management, (4) general ledger, (5) money transfer, (6) payroll management, (7) trust payments, and (8) debit card. The court held that for internal use commercial software to qualify for the §41 credit it must meet not only the four statutory tests of §41(d)(1) - (4), but also three tests set forth in the legislative history and Prop. Reg. §1.41-4(e)(5) that require a higher threshold of technological advancement and functional improvement – (1) the software must be innovative, (2) its development must involve economic risk, and (3) it must not be commercially available. Under these tests, after considering the testimony in a battle of expert witnesses, of the eight software development activities, all of which met the §174 test, only one, the strategic banking system customer module, qualified for the §41 credit.

4. *Unassembled core reactor was placed in service upon delivery.** Northern States Power Co. v. United States, 151 F.3d 876, 98-2 U.S.T.C. ¶50,671, 82 A.F.T.R.2d 5528 (8th Cir. 1998), affg 952 F. Supp. 1346 (D. Minn. 1996). Nuclear reactor fuel assemblies, 121 of which comprised the "reactor core," were "placed in service" upon receipt by taxpayer because they were "ready and available" to be placed in a power plant that had been operating for more than ten years. The court held the operational equipment [the assemblies] to be entitled to ITC and depreciation deductions in the year the fuel assemblies arrived at the power plant rather than in the year that it is actually used. It did not matter that the assemblies had to be inspected and installed -- no complex testing was involved. They were fundamentally ready and available for use, and therefore had been "placed in service, citing Sears

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Oil Co. v. Commissioner, 359 F.2d 191 (2d Cir. 1966). The court distinguished cases involving component parts of an uncompleted plant or facility, such as Sealy Power, Ltd. v. Commissioner, 46 F.3d 382 (5th Cir. 1995), because there component parts of a power production facility were held to be not "placed in service" until the entire system reached a condition of readiness.


If the position of the [United States] were adopted, there would be no difference between the date when the property is “ready and available” for use and the date on which it is actually used. The [statute] contemplates that the property will be “ready and available” on a date earlier than the date on which it is used.

5. *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 under a procedure no longer available. Nielsen-True Partnership v. Commissioner, 109 T.C. No. 6 (9/9/97). Section 29 requires an individual well tight formation gas determination under the procedures of §503 of the Natural Gas Policy Act of 1978 as prerequisite to tax credit eligibility. Judge Gerber held that the availability of the §29 nonconventional fuel source credit turns on whether there had been a formal determination that a well – as opposed to a determination for an entire field – met the requisite standards. He stated, “We are persuaded that Congress intended to couple the eligibility for the section 29 credit with the obtaining of well-category determinations under NGPA section 503.”

- 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.

- The case defines "tight formation" as a sedimentary layer of rock cemented together in a manner that greatly hinders the flow of any gas through the rock. Because such a formation is characterized by low permeability, wells drilled into gas-bearing formations of this kind usually produce at very low rates. To stimulate production from these formations, producers must use expensive enhanced recovery techniques.

6. *Tar sands oil definition is based upon the FEA definition. Shell Petroleum Inc. v. United States, 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 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.

7. *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.”

8. *Gathering pipelines depreciable over fifteen years. Moral: 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.

10. Spencer v. Commissioner, 110 T.C. No. 7 (2/9/98). The taxpayer claimed amortization deductions with respect to purchased intangible assets which in prior years had been amortized using too high a basis. Some of these prior years were closed by the statute of limitations. For the year in question, allowable amortization deductions were calculated by applying the straight-line percentage to a basis determined by subtracting all amortization deductions allowed in prior years, including excessive deductions claimed in closed years, from the taxpayer’s purchase price basis.

- The amortization deduction should be calculated “by apportioning the corrected amortizable bases of the property, as reduced by amortization allowed prior to taxable year 1991, over the properties’ remaining useful life.”

11. Taxpayer not permitted to follow the literal language of the regulations, says Tax Court. Exxon Corp. v. Commissioner, 102 T.C. No. 33 (6/6/94). Taxpayer was not permitted to follow the literal language of Reg. §1.613-3(a) and use “representative market or field prices” (RMFP) in determining “gross income from the property” for purposes of computing percentage depletion under §613A(b)(1)(B) ["fixed contract" exception]. Even though the regulation states that “the gross income from the property shall be assumed to be equivalent to RMFP” with respect to natural gas transported from the premises prior to sale, the purpose of that provision was to prevent integrated producers from taking depletion deductions on transportation, refining, etc. -- and not to permit taxpayer to take depletion based upon a RMFP price five times the actual sales price of the natural gas to an Exxon affiliate. The actual contract sales price was therefore reduced by royalties and transportation expenses to determine “gross income from the property.”

a. Exxon Corp. v. United States, 33 Fed. Cl. 250, 95-1 U.S.T.C. ¶50,245 (Fed. Cl. 4/11/95). On the same issue, held, that while the amount upon which depletion can be taken is not necessarily limited by actual gross income [21 cents], the RMFP calculated by Exxon [41 cents] was not a reasonable basis upon which depletion may be taken and [based upon the burden of proof] the complaint was dismissed. But reversed ....

b. Federal Circuit holds that RMFP which exceeds actual gross receipts is not precluded, nor is an “unreasonable” RMFP. Exxon Corp. v. United States, 88 F.3d 968, 96-2 U.S.T.C. ¶50,324 (Fed. Cir. 6/20/96), rev’g and remanding 33 Fed. Cl. 250, 95-1 U.S.T.C. ¶50,245 (Fed. Cl. 1995). Court finds taxpayer entitled to calculate its depletion deduction based upon an RMFP of 39 cents based upon the wellhead price that would be realized by nonintegrated producers. The court further held that the Court of Federal Claims should not have limited the price by making an independent assessment of the reasonableness of the price because the §611(a) language “reasonable allowance ... in each case” refers to the different types of depletable resource, not to individual taxpayers.

c. *On remand, the Court of Federal Claims denies government’s motion for summary judgment because percentage depletion under the §613A(b)(1)(B) fixed-contract exception is not necessarily inconsistent with the use of RMFP under Reg. §1.613-3(a). Exxon Corp. v. United States, 98-1 U.S.T.C. ¶50,142 (Fed. Cl. 1/7/98). The government contended that the regulation is a nullity with respect to post-1974 depletion allowed under the fixed contract exception. The court decided that it would hear at trial the issue of whether the regulation is inapplicable to Exxon’s computation of percentage depletion “under the facts of this case.”

12. 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.

13. Union Texas International Corp. v. Commissioner, 110 T.C. No. 25 (5/21/98). Petroleum Corp. [which was a producer of propane] owned Texgas [which was a retailer of propane]. Following a series of reorganizations, Texgas became a wholly-owned subsidiary of Products; and Products and Petroleum became lower tier subsidiaries of a common parent. Petroleum sold extracted propane to unrelated third parties through Products as its agent. Petroleum claimed percentage depletion under the independent producer exception, but the IRS argued that it sold propane through a related
retailer, Texgas. Section 613A denies percentage depletion to any oil or gas producer who sells more than $5 million of refined product at retail. Whether a taxpayer is a refiner or retailer generally is determined with respect to the activities of both the taxpayer and any related person, but a producing subsidiary of a parent retailer (or a subsidiary of a parent that owns a retailer as another subsidiary) is not a retailer if none of the producing subsidiary’s production is sold through the related retailer. Rev. Rul. 85-12, 1985-1 C.B. 181. In this case the Tax Court held that since none of Petroleum’s propane was sold to either Products or Texgas [although propane actually produced by Petroleum may have found its way to their hands because 70% of Petroleum’s propane was subject to exchange agreements], Petroleum did not sell its propane through a related retailer. Products was a real agent and did not acquire Petroleum’s propane for resale to Texgas.

14. Yuppies of the world, unite! The First Circuit finds a load-supporting rack system to be part of the structure. L.L. Bean Inc. v. Commissioner, 98-1 U.S.T.C ¶50,454 (1st Cir. 5/28/98), aff’g T.C. Memo. 1997-175. Taxpayer constructed a large storage facility [500 feet x 190 feet x 52 feet] to house its inventory in long rows of floor-to-ceiling racks. The structural support for the roof and three of the walls was the rack system itself, which saved construction costs. Held, the racks were a structural component, and structural components are excluded from the definition of tangible personal property.

- The former Ernst & Whinney would have used 900-pound gorillas for the removal process. Judge Boudin also decided that a so-called “mezzanine system” was not sufficiently removable [six to eight workers would take over a month to remove it, exclusive of time to disconnect wiring, cables, sprinkler system and ducts] to be classified as a temporary structure, comparing this system unfavorably with “removable partitions that could be packed up and carried off in a day.”

15. Rifleshot provision hits another mark. Airborne Freight Co. v. United States, 153 F.3d 967, 98-2 U.S.T.C ¶50,664 (9th Cir. 8/20/98). Taxpayer was permitted to use the Tax Reform Act of 1986 §207(a)(7) [targeted at Merrill Lynch “world headquarters” transitional provision to receive investment tax credits on its headquarters building because it qualified under both the literal words and the intent of the rifleshot statutory provision, although the legislative history could be interpreted to the contrary.

16. Norwest Corp. v. Commissioner, 111 T.C. No. 5 (1998). Furniture and fixtures in asset class 00.11 that are suitable for use in a variety of industries (7 year property) cannot be moved to an industry specific asset class with a shorter recovery period [here asset class 57.0] simply because they are used in that industry. The court also held that taxpayer may not attack its own form of structuring in order to allocate the cost of constructing an “Atrium” to the bases of adjoining properties that were held by taxpayer because the basic purpose of the Atrium was not the enhancement of the adjoining properties so as to induce sales of those properties – according to the test in Estate of Collins v. Commissioner, 31 T.C. 38 (1958).

B. Expenses

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


b. ISP Paper for the Petroleum Industry, “Replacement of Underground Storage Tanks at Retail Gasoline Stations,” 98 TNT 7-13 (1/9/98). Addresses the treatment [capitalization or current deductibility] of costs incurred to: (a) remove and replace underground storage tanks; (b) clean up soil contaminated by releases from the tanks; and (c) install monitoring systems, wells or other equipment associated with groundwater cleanup – both where the tanks are replaced with new tanks and where they are not. Costs of cleaning and disposing of the old UST are deductible; where the tanks are not replaced, the costs of removal of the UST are also deductible.
c. *An immediate deduction for the cost of a separate and distinct asset having no actual "useful life."* Rev. Rul. 98-25, 1998-19 I.R.B. 4. Taxpayer removed, emptied, cleaned, and disposed of old steel underground storage tanks containing manufacturing waste by-products and acquired, installed and filled new steel-fiberglass-reinforced plastic underground storage tanks to contain the manufacturing waste by-products for an indefinite period of time. The IRS ruled that the new storage tanks, which had no salvage value, had no useful life to the taxpayer beyond the year and thus were analogous to materials and supplies and allowed an immediate deduction for all of the costs. The IRS distinguished Rev. Rul. 94-38, 1994-1 C.B. 35, which required capitalization of a groundwater water treatment facility constructed to remedy the taxpayer's prior pollution on the basis that the groundwater treatment facility was used by the taxpayer beyond the year in question. The distinction is difficult to see; neither the underground storage tanks nor the groundwater treatment plant contributed to the taxpayer's profitability in future years, although both might have avoided future costs. Both expenditures appear to relate to past profits, not future profits, and if Rev. Rul. 98-25 and Rev. Rul. 94-38 are not distinguishable, Rev. Rul. 98-25 appears to reach the better result.

d. 1997 Act §941 added Code §198 to permit expensing of "qualified environmental remediation costs," i.e., cleanup costs of so-called "brownfields." Any otherwise nondeductible expenditures are subject to §1245 recapture on sale of the property. Effective for expenditures paid or incurred after 8/5/97.


e. TAM 9813001 (12/3/97). Commissions paid on the sales of cellular phone service must be capitalized.

f. 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."

g. *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].

h. *Has the deductible business expansion cost principle been overruled by INDOPCO? Does §195 implicitly save the day? Expenses of launching new RICs must be capitalized. FMR Corp. v. Commissioner, 110 T.C. No. 30 (6/18/98). FMR Corp. is the investment manager of the Fidelity Fund family of mutual funds. It incurred and deducted expenditures over a number of years to form and register with the SEC 82 additional RICs, which increased the number of mutual funds in the Fidelity family to approximately 140 (and which increased to 232 in subsequent years). The Commissioner asserted that the expenses were capital expenses. The RICs in question were established as separate series within a number of Massachusetts business trusts [which had perpetual existence] and the taxpayer was the sole underwriter and distributor of shares in the RICs. FMR Corp. did not own the funds or their investments – the investors did – but the taxpayer expected, and did, earn significant profits over an extended number of years from marketing and managing the RICs. It expected to manage each of the RICs throughout their duration, and in the history of the Fidelity Fund [going back to 1946] none of the RICs it managed had ever terminated its management contract. Judge Ruwe found that the "separate and distinct asset" test was not apposite and specifically applied only the INDOPCO "future benefits" analysis. Nevertheless, the court required capitalization of the expenditures under that test.
The taxpayer argued that by expanding the family of mutual funds it managed, it was preserving and expanding its existing business and that such expenses were clearly deductible under a long line of precedents, e.g., Briarcliff Candy Corp. v. Commissioner, 475 F2d 775 (2d Cir. 1973); NCNB Corp. v. United States, 684 F2d 285 (4th Cir. 1982); Colorado Springs Nat'l Bank v. United States, 505 F2d 1185 (10th Cir. 1974), allowing deductions for “business expansion” costs. The court distinguished these cases as pre-INDOPCO cases, which drew distinctions that INDOPCO was intended to resolve, and implicitly called into question their continued precedential vitality.

The Tax Court also rejected the taxpayer’s argument that in enacting §195 Congress explicitly recognized that business “expansion” costs always were currently deductible. According to the Tax Court, §195 allows amortization only of those start-up costs that would have been deductible if they were incurred by a going business, and business expansion costs are either deductible or capitalized case-by-case under a facts and circumstances test. But cf. NCNB Corp. v. United States, supra (dictum). The court also refused to allow any amortization deductions under pre-§197 rules because the future benefits were not limited to the term that the initial investors held their shares.

*Revenue Ruling 92-80 was binding on the Commissioner. Forget about INDOPCO, 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 (7/18/98). “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.

R.J. Reynolds incurred and deducted millions of dollars of expenditures for “graphic designs” developed for various components of cigarette products: cartons, packages, flags, tipping, cigarette papers foils, and soft pack closure seals. 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 INDOPCO 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. The court acknowledged the possibility of allocation between the short-and long-term benefits of advertising expenditures that would provide a basis capitalization of some advertising expenses, but cited Reg. §1.162-20(a)(2) and Rev. Rul. 92-80 for the proposition that the IRS has eschewed that approach. Although the court acknowledged that expenditures for billboards, signs, and other tangible assets associated with advertising are subject to capitalization, it refused to apply this rule to intangible assets, including trade dress, associated with advertising, even though legal rights, such as the Federal statutory and common-law trademark rights attach to such assets such as trade dress. It accepted as law the taxpayer’s expert’s opinion that the expenses in question "created intangible assets that are inseparable from brand equity and goodwill." It concluded that the long-term benefit associated with trade dress is a benefit traditionally associated with ordinary business advertising. Even though the parties stipulated that Reynolds placed copyright notices on its advertising executions, the court concluded that copyright
protection afforded to copyrightable advertising materials is merely “a traditional benefit associated with ordinary business advertising,” not the creation of a separate and distinct asset.

(1) Rev. Proc. 97-35, 1997-33 I.R.B. 11. Three permissible methods of accounting for package design costs. Two of the methods, the design-by-design capitalization method and the pool-of-costs capitalization method, permit amortization of costs over either 60 or 48 months respectively. This revenue procedure was not applied in RJR Nabisco.

(2) Rev. Proc. 98-39, 1998-26 I.R.B. 36. Rev. Proc. 97-35 is modified to make clear that capitalization under §263 (and not §263A) of the Internal Revenue Code is applicable for package design costs incurred in taxable years beginning after December 31, 1993. Rev. Proc. 97-35 is further modified to make clear that it does not apply to the costs of a package design that is an "amortizable §197 intangible" as defined in §197(c). The IRS takes the position that all package design costs are subject to capitalization without regard to whether the costs create a package design (or modification to the design) having an ascertainable useful life that extends substantially beyond the end of the tax year in which the costs are incurred.

j. *Confirmation that the INDOPCO principle is nothing new; capitalization based on future benefits acquired, citing a 1927 B.T.A. case! U.S. Bancorp v. Commissioner, 111 T.C. No. 10 (9/21/98). The taxpayer had leased a mainframe computer from an IBM credit subsidiary (ICC) for 5 years. About 18 months later, the taxpayer determined it need a more powerful computer and entered into a rollover lease arrangement under which the first lease was canceled and a new lease for a different computer was executed. In connection with the termination of the original computer lease and the execution of a new lease, which were mutually conditional, the lessor paid ICC a $2.5 million "rollover charge." The rollover charge was financed over the term of the lease, and the taxpayer was required to make monthly payments of $182,484, consisting of $128,709 rent and $53,775 rollover charge (including interest). The taxpayer, which used the accrual method, argued that the $2.5 million was currently deductible under Rev. Rul. 69-511, 1969-2 C.B. 24, which allowed an immediate §162 deduction for a lessee's payment made to obtain a release of obligations under a lease. The Tax Court held for the Commissioner. Because the cancellation of the first lease was conditioned upon the execution of the second lease, the payment was held not merely to be in consideration of the release of obligations under the first lease but also to result in the realization of future benefits over the term of the second lease. The court cited Pig & Whistle Co. v. Commissioner, 9 B.T.A. 668 (1927), which held that a lessee that had made a lump sum payment to obtain a leasehold could not deduct the unamortized payment when the lease was canceled in connection with the leasing of a different property. Accordingly, the “rollover charge” was not deductible in the year it was incurred but was capitalized and amortizable over the 5-year term of the second lease.

2. *Beginning in 1999, home offices where substantial administration and management activities are conducted will be deemed to be the principal place of business, provided that significant amounts of such administration and management activities of the business are not conducted in any other fixed location. 1997 Act §932 amends Code §280A(c) to relax the standard for home office deductions by expanding the definition of “principal place of business” to include situations where (1) the home office is used “for administrative or management activities of any trade or business of the taxpayer,” provided that (2) “there is no other fixed location of such trade or business where the taxpayer [actually] conducts substantial administrative or management activities of such trade or business.”

3. Reasonable Compensation
   a. Sunbelt Clothing Co. v. Commissioner, T.C. Memo. 1997-338 (7/28/97). Compensation of $2 million per year [for years 1990-1992] was upheld as reasonable because of (1) shareholder/employee’s superior efforts resulting in the development of a printed T-shirt business into a catalog operation with $70 million in annual sales, and (2) the fact that he was underpaid for the years 1980-1988 during which the company increased its sales from $1/2 million to $30 million. Judge Ruwe noted that a hypothetical investor would have received a return on equity of 82% for 1990 65% for 1991
and 66% for 1992. This beats the $1 million allowed in Home Interiors & Gifts v. Commissioner, 73 T.C. 1142 (1980).

b. *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’g 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.

(1) On remand, Judge Jacobs explains. Leonard Pipeline Contractors, Ltd. v. Commissioner, T.C. Memo 1998-315 (9/1/98). Judge Jacobs, after stating that “any attempt to determine 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.

c. 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.

4. TD 8729 and REG-208151-91, temporary, proposed and final regulations under §263A, relating to the capitalization of property produced in a farming business (62 FR 44542 & 44607, 8/22/97). Requires that preparatory expenditures, such as the cost of seeds and animals, must be capitalized; however, taxpayers that are not required to use an accrual method need not capitalize costs incurred for plants or animals that have a preproductive period of two years or less. Clarifies the distinction between property produced in a farming business, and property in a reselling business.

5. 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 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.

a. 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.

b. The taxpayer won the legal issue, but lost the factual issue, and thus lost 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.

c. 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 court found that only 41 to 49 percent of the employees furnished meals had their meals furnished for the convenience of the employer.

6. Premiums to related insurance company deductible. Hospital Corp. of America v. Commissioner, T.C. Memo. 1997-482 (10/27/97). Held that taxpayer had bona fide insurance from captive insurer. Follows [under the Golsen rule] the Sixth Circuit case of Humana Inc. v. Commissioner, 881 F.2d 247 (1989), permitting HCA subsidiaries [but not the parent] to deduct payments to HCA's Tennessee captive insurance subsidiary for general and professional liability insurance.

C. Losses and At Risk

1. Whitmire v. Commissioner, 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 Tax Court held 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.

2. Finish your business with the IRS first; only then should you deal with the outside world. Jeppsen v. Commissioner, 97-2 U.S.T.C. ¶50,878, 80 AFTR2d 7710 (6th Cir. 10/31/97), aff'g T.C. Memo. 1995-342. In 1987, taxpayer discovered that he had incurred a $194,000 loss in his brokerage account due to his stock broker's unauthorized trading. Taxpayer's attorney advised him that an action against the brokerage firm was risky and refused to take it on a contingency basis, instead requiring hourly fees. Suit was filed in 1988, submitted to arbitration in 1993, which resulted in a 1994 award of about $1 million and a settlement that year (with the terms subject to a confidentiality agreement). Taxpayer's claimed loss for 1987 was disallowed on the ground that he had a reasonable prospect of recovery. Although the standard is prospective as of that year, and not based on 20/20 hindsight, the Tax Court did not err in admitting evidence of the final disposition of the claim because it did not rely on the ultimate recovery to determine that there was a reasonable prospect of recovery. The standard generally is objective, but the taxpayer's subjective decision to press the claim was relevant.
3. Remember this case before you make an offshore deposit in a shaky foreign bank. Aston v. Commissioner, 109 T.C. No. 18 (12/4/97). Taxpayer deposited funds in the Isle of Mann Branch of BCCI, S.A., and in the Los Angeles agency office of BCCI, S.A. BCCI, S.A. was chartered in Luxembourg. Taxpayer lost her deposits in the infamous collapse of BCCI and claimed a loss deduction. Section 165(l) was held not to apply to allow a deduction because the foreign corporations that were not chartered or supervised under state or federal law, were not “qualified financial institutions” [as defined in §165(l)(3)]. Section 166 did not allow a deduction because for the year in issue taxpayer still had a claim pending against BCCI in its liquidation proceedings.

4. *No loss deduction for adverse zoning decision that reduced property value almost 90 percent because there was no “involuntary taking.”* Lakewood Associates v. Commissioner, 109 T.C. No. 21 (12/29/97). The taxpayer purchased a tract of land, which was zoned for agricultural use, for approximately $9,000,000, based on the expectation that the land would be rezoned for single family residences. As a result of the failure to be able to obtain the desired rezoning and tightened restrictions by the Corps of Engineers on wetlands development, the value of the land was reduced to $1,000,000. The adverse zoning decision and land use regulation actions were not “closed and completed transactions” because they are akin to market forces, and no loss was allowed. As long as the taxpayer continued to own the property, there was no closed and completed transaction. The court noted that if such events were treated as triggering loss realization, they likewise should be treated as triggering gain realization. Although the court suggested that a loss might be allowable if a land use regulation amounted to an involuntary taking, it further noted that such a result is rare, and the continued availability of the land for agricultural use precluded treating the adverse zoning and land use decisions as the equivalent of an involuntary conversion.

5. Pohoski v. Commissioner, T.C. Memo. 1998-17 (1/13/98). Taxpayer, who lived in California, owned and rented out for periods that averaged less than 7 days two condominium units in Hawaii. Although the condominium complexes were managed by management companies, taxpayer personally attended to securing tenants and major maintenance. Management company personnel provided check-in and check-out services and maid services. Taxpayer presented credible evidence, in the form of a post-event narrative summary, prepared for an IRS Appeals Officer, that he spent more than 100 hours in managing one condominium unit and that he spent more time in the activity than employees of condominium management company, including front desk staff and maid service, thus satisfying Temp. Reg. §1.469-5T(a)(3). But the taxpayer did not present credible evidence of required participation with regard to the second Hawaiian condominium unit. The court rejected the Commissioner’s argument that the availability of management company personnel to be “on call” should be taken into account and held that only “actual time spent on rental” by condominium management company personnel should be considered.

6. T.D. 8763, final regulations under §§166 and 1001, relating to the allowance of a deduction for partially worthless debts when the term of the debt are significantly modified, which (the regulations provide) constitutes a deemed charge-off (63 F.R. 4394, 1/29/98).

7. *The cookbook recipe says “If you want the deduction, abandon the building before you demolish it, not by demolishing it.”* Gates v. United States, 98-1 U.S.T.C. ¶50,353, 81 A.F.T.R.2d 1622 (M.D. Pa. 3/27/98). Section 280B applied to deny the taxpayer a loss where a building was abandoned after it was vandalized and was found to contain asbestos and was demolished three years later. The taxpayer never claimed depreciation on the building, which was purchased as a speculative investment and did not claim a loss deduction in the year of abandonment but rather in the year of demolition. The court found De Cou v. Commissioner, 103 T.C. 80 (1994), which held that §280B did not apply to disallow a loss deduction for extraordinary obsolescence of a building subsequently demolished, was not applicable. The taxpayer did not demonstrate sudden obsolescence, and if the building had become worthless by sudden obsolescence caused by the vandalism and the discovery of asbestos, the proper year for a deduction would have been the year in which those events occurred, not the subsequent year in which it was demolished. Furthermore, a unilateral decision to withdraw a building
from service alone cannot avoid the disallowance rule of §280B. The taxpayer must demonstrate either
sudden obsolescence or an affirmative act of abandonment, which the taxpayer had not done.

8. T.D. 8777, final regulations on "qualified nonrecourse financing" under the
§465(b)(6) real estate at risk provisions (63 F.R. 41420, 8/4/98).

9. *The IRS has to follow all the APA requirements when it promulgates
Regulations under a specific delegation of authority, but it did, so the taxpayer loses anyway.
Schwalbach v. Commissioner, 111 T.C. No. 9 (9/8/98). The taxpayer leased real property to a C
corporation (a professional services corporation conducting a dental practice) in which he owned one-half
of the stock and in which he materially participated. The rental activity produced significant income,
against which the taxpayer deducted passive activity losses. The Commissioner applied Reg. §1.469-
2(f)(6), which recharacterizes as “not from a passive activity” income derived from renting property to an
activity in which the taxpayer materially participates. The taxpayer argued that Reg. §1.469-4(a), which
defines activity was invalid because it was promulgated without compliance with the Administrative
Procedures Act and that since “activity” thus was not defined, Reg. §1.469-2(f)(6) was inapplicable. The
court held that becauseRegs. §§1.469-2(f)(6) and 1.469-4(a) were promulgated pursuant to a specific
grant of authority in §469(l), the IRS was required to follow the APA in promulgating them and that they
were not exempted from the notice and comment requirements of the APA. After exhaustively tracing the
history of the promulgation of these regulations, the court held that the IRS had complied with the APA
and that the regulations were valid. Even though the precise rules in the final regulations differed
substantially from those in the proposed regulations (particularly in Reg. §1.469-4(a)), no additional
notice and comment was necessary because the final rules were “in character with” and a “logical
outgrowth” of the proposed rules. Regulations are not subject to another notice and comment period
where the proposed regulations “fairly apprise interested persons of subjects and issues that maybe
addressed in the final regulations.” Commentators had “a fair opportunity to present their views on the
final plan” because this was not a case where interested persons “could not reasonably anticipate the final
rules from the proposed rules.” Even though the proposed regulations might not have contained such an
attribution rule, the potential breadth of the proposals were clear and such an attribution rule reasonably
could have been anticipated from the legislative history.

10. *An apple a day doesn't keep the tax man away! Zdun v. Commissioner, T.C.
.Memo. 1998-296 (8/17/98). Taxpayer conducted a profitable holistic dental practice and an unprofitable
organic apple orchard. He claimed that the apple orchard was part of the dental practice, not a separate
activity subject to §183, because the apples were sold to dental patients in his office. The court was
unimpressed with the taxpayer's argument and disallowed the losses from the organic apple activity
because it was not conducted for profit.

11. *Ya oughta be in movies – a §469 dodge from Tinseltown that can be filmed
and replayed elsewhere! Welch v. Commissioner, T.C. Memo. 1998-310 (8/24/98). The taxpayer was a
carpenter who was hired by various movie production companies as a construction coordinator for movie
sets. In that capacity, as an employee of the movie production company at a weekly or hourly salary, he
hired other employees and arranged for the purchase of materials. In connection with this employment,
taxpayer leased to the employers for use in construction of the movie sets, at varying rental rates, tools
and equipment purchased, owned and maintained by himself. Taxpayer reported losses from the tool and
equipment rental activity on Schedule C. The Commissioner argued that the tool and equipment rental
activity was either a passive activity under §469(j)(8) or that the expenses were employee business
expenses deductible only Schedule A, subject to the 2-percent floor of §67. The court held that because
the average rental period was for less than 30 days and taxpayer performed significant services relating to
the rental of the tools and equipment, e.g., repair, maintenance and transportation, pursuant to Temp. Reg.
§1.469-1T(e)(3)(ii), the tool rental activity was not a passive activity and that it was an activity separate
from his employment.

D. Business Income

1. *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 exceed the fair market value of his assets.

- The taxpayers 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. Query whether the moral of this tale is to go into bankruptcy.

2. T.D. 8776 and REG-110332-98, temporary and proposed regulations on the effect of euro conversion (63 F.R. 40366 & 40383, 7/29/98). The guiding IRS principle on the conversion of existing currencies into the new euro is neutrality: a realization event will not occur simply because of the conversion.

3. Florida Progress Corp. v. United States, 98-2 U.S.T.C. §50,591, 82 A.F.T.R.2d 5375 (M.D. Fla. 7/2/98). A electric utility was required to include in income amounts received from customers as "underground extension of facilities" charges. The amounts were not contributions to capital but were taxable contributions in aid of construction under §118(b). Requiring the utility to capitalize and depreciate the cost of trenching the underground utilities, for which the taxable contributions were received, did not violate any relevant "matching principle" of tax accounting.

III. CAPITAL GAIN AND LOSS
A. In general
1. Reduction in the capital gains tax rate for individuals. 1997 Act §311(a) amends Code §1(h) to provide reduced maximum capital gains rates for individuals.
   - Makes the determination of the capital gains tax rate more challenging than ever (even as compared to the post-1969 Act computation [with its factoring in of the minimum tax and the [former §1348] maximum tax on income from personal services].
   - Permanent capital gains rates of 7-1/2%, 8%, 10%, 14%, 15%, 18%, 20%, 25% and 28% are provided. Have fun determining which rate applies!
   - The lower rates apply to gains from sales of certain capital assets held for more than 18 months, termed "adjusted net capital gains." This term does not include (1) gains on "collectibles," [taxed at 28%], (2) unrecaptured §1250 gains [taxed at 25%], and (3) §1202 gain [taxed at...
14%. Gain on §1202 small business stock continues to be subject to the 50% exclusion, so it is taxed at 1/2 the usual rate, or 14% (7-1/2% for taxpayers in the 15% income tax bracket).

- Note: "Recaptured" §1250 gain is the excess depreciation taken over straight line depreciation on property placed in service before 1981, and is taxed at ordinary income rates. "Unrecaptured" §1250 gain is the rest of the depreciation allowed (including straight line depreciation), and is taxed at the 25% rate. Amounts realized in excess of original basis will be taxed at the 20% rate, as either §1231 gain or gain on the sale of a capital asset. For real estate placed in service after 1985, the entire amount of depreciation will be "unrecaptured section 1250 gain."

- For capital assets held for more than one year but not more than 18 months ("mid-term gains"), the maximum tax rate continues to be 28%. For assets held more than 18 months, the tax rate is 20% where the taxpayer is in the 28% or higher marginal income tax bracket (10% where the taxpayer is in the 15% bracket). For property held for more than five years (and acquired and sold after the year 2000 — Act §311(e) provides for a post-2000 election to deem a sale and reacquisition of such property), the 20% and 10% rates are reduced to 18% and 8%.

- The §1223(11) deemed holding period for inherited property remains at "more than one year," so it appears that, for purposes of the 20%, etc. rates, the 18-month holding period begins on decedent’s death.

- Transition rates. Long-term capital gains realized before 5/7/97 are treated as mid-term gains, and are subject to the 28% maximum rate. Special transition rule [§1(h)(8)] treats long-term capital gain with respect to property held for more than one year that is sold between 5/7/97 and 7/28/97: Such gain is "adjusted net capital gain" taxed at the 20% rate—even if the property had not been held for more than 18 months.

  a. 1998 Act §5001 amends Code §1(h) to make the 20 percent capital gains rate applicable to property held for more than one year, instead of the prior 18 months. This means that the mid-term capital gains category will apply only to tax years beginning in 1997. Effective to taxable years beginning after 12/31/97.

  b. 1998 Act §6005(d) (technical corrections) amends Code §1(h) to clean up the language in the 1997 Act §311 amendments to §1(h). Even cleaned up, §1(h) still rivals old §341(e) for complexity.

  c. 1997 Act §311(b) amends Code §55(b)(3) to provide new preferential AMT capital gains rates for individuals. New maximum rates include the 18% rate for property held for more than 5 years after 2000 (8% for gains otherwise in the 15% bracket).

2. *The effective date of an amended definition doesn't necessarily change the effective date of an earlier enacted substantive rule. Hahn v. Commissioner, 110 T.C. No. 14 (3/4/98). The Tax Court adopted an opinion by Special Trial Judge Dean following Patton v. United States, 116 F.3d 1029 (4th Cir. 1997) and Gallenstein v. Commissioner, 975 F.2d 286 (6th Cir. 1992), holding that stepped-up basis under §1014 applies to only a ½ interest only for joint tenancies between spouses created after December 31, 1976. For joint tenancies created before January 1, 1977, stepped-up basis applies to portion of joint property for which deceased spouse provided consideration because §2040(b), as amended in 1981, does not limit to ½ of the value the amount included in the decedent spouse’s gross estate. The codified 1981 amendments to §2040(b)(2) did not repeal the uncodified effective date of §2040(b)(1), enacted in 1976. Accordingly, because the joint tenancy was created before January 1, 1977 and taxpayer's husband provided 100 percent of the consideration, 100 percent of the jointly held property was properly includable in his estate (although sheltered from estate taxation by the unlimited marital deduction) and taxpayer, as a surviving joint tenant with right of survivorship, obtained a step-up in basis for 100 percent of the property.

3. Taxpayers may no longer obtain premature loss deductions on customer receivables by using mark-to-market. 1998 Act §7003 amends Code §475 to prevent the use of mark to market by dealers in nonfinancial goods and services to obtain a loss deduction that would not be
otherwise available. This was done by adding new Code §475(c)(4) to exclude from the definition of a “security” receivables from taxpayer’s [or related taxpayer’s] sale of nonfinancial goods and services.

4. Estate of Young v. Commissioner, 110 T.C. No. 24 (5/11/98). In an estate tax case, no minority discount or lack of marketability discount was allowed for a decedent’s interest in property held as joint tenants with rights of survivorship with his spouse. The principle of this holding affects the determination – positively – of a surviving spouse’s basis in jointly held property under §1014(b)(9) even if an estate tax return is not required.

5. *When the bank buys at the foreclosure sale, the bid-in price isn’t necessarily the tax price. Frazier v. Commissioner, 111 T.C. No. 11 (9/22/98). The taxpayer owned real property (which was not used in a trade or business) with a basis of $495,544 and appraised value of $375,000, which was subject to a recourse mortgage of $585,943. When the taxpayer was insolvent, at a foreclosure sale, the mortgagee bid the property in at $571,179 (including interest). The Commissioner asserted that the taxpayer realized $571,179 on the sale of the property and thus recognized a taxable gain. The taxpayer’s claimed that pursuant to Reg. §1.1002-2(a)(2), and Rev. Rul. 90-16, 1990-1 C.B. 12, the transaction should have been bifurcated; the sales price was the $375,000 fair market value of the property, which was less than its basis, resulting in a $120,544 capital loss; and that difference between the $375,000 sales price and the discharged debt resulted in $210,943 of COD income excluded under §108(a)(1)(B) because the taxpayer was insolvent. The court rejected the Commissioner’s argument that the bid-in price was the best evidence of the property’s fair market value, and distinguished Aizawa v. Commissioner, 99 T.C. 197 (1992), aff’d by order, 29 F.3d 630 (9th Cir. 1994), because in this case the taxpayer had overcome the presumption that the foreclosure sale price is the property’s fair market value. The bid-in price is only presumed to be the fair market value. It was not conclusive because it did not represent an arm’s length transaction between a willing buyer and a willing seller, etc.; instead, it was arbitrary.

IV. CORPORATIONS
A. Entity and Formation
1. *Nonqualified preferred stock to be treated as boot in transfers to corporations and in reorganizations. 1997 Act §1014 adds new Code §§351(g), 354(a)(2)(C), 355(a)(3)(D) & 356(e) to provide that “nonqualified preferred stock” will be treated as boot in contribution, reorganization and divisive transactions. Effective for transactions after 6/8/97. Nonqualified preferred stock means a preferred stock on which (1) the holder has a put right, (2) the issuer or a related person is required to redeem or purchase the stock, (3) the issuer or a related person has the right to redeem or purchase the stock and it is more likely than not that the right will be exercised (at the time of issuance), or (4) the dividend rate varies by reference to interest rates, commodities prices or similar indices. Exception for holder’s rights which may be exercised only after 20 years, holder’s rights exercised on death, disability or mental incompetence, and issuer’s rights exercised on separation from service. See IV.G., below for regulations.

2. A tax free contribution to capital from South of the Border. G.M. Trading Corp. v. Commissioner, 121 F.3d 977, 97-2 U.S.T.C. ¶50,658, 80 A.F.T.R.2d 6402 (5th Cir. 9/12/97), rev’g 103 T.C. 59 (1994). In a "debt-equity swap" a US corporation purchased for $600,000 dollar denominated debt obligations of the Mexican government in the amount of $1,200,000, which it surrendered in exchange for the transfer by the Mexican government of 1.7 billion restricted pesos to its subsidiary to establish a maquiladora plant.
   a. The Tax Court upheld the Commissioner’s position, in Rev. Rul. 87-124, 1987-2 C.B. 205, that gain was realized to the extent the dollar denominated fair market value of the pesos exceeded the amount paid for the debt.
   b. *The Court of Appeals reverses and holds for the taxpayer. Because application of the pesos was controlled by Mexican government, the portion of the restricted pesos received in exchange for the dollar denominated debt was indeterminable; thus no gain was realized on the exchange for the pesos. Any “gain” was an excludable contribution to capital under §118 made by
the Mexican government to induce investment in Mexico, even though the exact amount of the pesos that was attributable to the contribution to capital, as opposed to an exchange for the debt, was indeterminable. The Court of Appeals concluded that Rev. Rul. 87-124 is an erroneous interpretation of the relevant law. Section 118 excludes "any" contribution to capital. The provision of some services by the corporation does not taint entire transfer to it by the government if the part of the transfer is a contribution to capital.

3. *Creditworthy shareholder has basis equal to face value in unsecured promissory note the transferred to a C corporation. The note was of amount sufficient to avoid §357(c) gain on the transfer of highly leveraged property. The court held that the note gave rise to a real personal liability in the event of corporation's bankruptcy, the possibility of which was not "so remote that there is no realistic possibility it will ever occur." This doctrine is not applicable to transfers of shareholder/partner promissory notes to S corporations and partnerships because pass-through entities could funnel losses to beneficial owners in amounts inflated by unsecured promissory notes. Peracchi v. Commissioner, 98-1 U.S.T.C. ¶50,374, 1998 U.S. App. LEXIS 8174 (9th Cir. 4/29/98) (2-1). Contribution by creditworthy shareholder to his wholly-owned corporation of his unsecured $1,060,000 promissory note provides sufficient basis to avoid §357(c) gain on the simultaneous contribution of two parcels of real estate mortgaged for $566,807 more than their total basis. Judge Kozinski held that – because "bankruptcy is significant enough a contingency to confer substantial economic effect on this transaction" – the creditworthy shareholder bears the risk that corporate creditors will enforce the note against him. The court further held that taxpayer held the note at a basis of $1,060,000. Judge Kozinski disagreed with the reasoning – but not the result – of Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989) (note had no basis in shareholder's hands [Judge Kozinski said "zero basis"] and a basis equal to face value in the hands of the corporation). He noted that it "prov[ed] that two wrongs sometimes do add up to a right."

  * The court refused to follow Rev. Rul. 68-629, 1968-2 C.B. 154, because [although entitled to some deference, but not as much deference as a regulation] it "offers no rationale, let alone a reasonable one, for its holding that it costs a taxpayer nothing to write a promissory note."

4. 1998 Act §7002 amends §136(c) of the Tax Reform Act of 1984 to provide that the grandfather status accorded to stapled REITs shall not be applicable to interests in real property acquired after 3/26/98.

5. *The business purpose doctrine may be withering in some places, but it's unexpectedly flowering in §351. Estate of Kluener v. Commissioner, 98-2 U.S.T.C. ¶50,712, 82 A.F.T.R.2d 6151 (6th Cir. 9/9/98). Kluener owned all of the stock of APECO, which had over $4 million of NOLs and was in financial straits. Kluener also directly highly leveraged real estate and thoroughbred horses businesses, both of which were hemorrhaging money, and he owned over $12 million personally. To help stem his losses, he decided to sell some horses, which [on the advice of his accountants] he had transferred to APECO to shelter the gains (which were approximately $1.2 million) with APECO's NOLs. The Sixth Circuit affirmed the Tax Court's holding that Kluener himself was the true seller of the horses because the transfer to APECO lacked a business purpose. Kluener hid the transfer form APECO's directors and did not use the $2.5 million sales proceeds to alleviate APECO's financial straits but instead caused the corporation to distribute most of the funds to himself for personal use(mostly repayment of loans) shortly after the sale. Accordingly the transfer was not respected for tax purposes and the gain was taxed directly to Kluener.

B. Distributions and Redemptions

1. Corporate contribution to 100% shareholders' son's political campaign is not a constructive dividend to shareholders. Lanier v. Commissioner, T.C. Memo 1998-7 (1/7/98). A $13,000 contribution by a corporation to a political campaign committee for the shareholders' son's political campaign committee was not a constructive dividend to parent-shareholders, who owned 100%
of the stock, because the son did not directly benefit from a contribution to the incorporated campaign committee.

C. Liquidations

1. T.D. 8762, final regulations under §453(h), relating to a shareholder's use of the installment method to report gain on installment obligations distributed on the complete liquidation of a corporation (63 F.R. 4168, 1/28/98).

2. When General Utilities retired, Private Valuation changed its stripes. Discount available for corporate capital gain on hypothetical asset sale or corporate liquidation. Estate of Davis v. Commissioner, 110 T.C. No. 35 (6/30/98). The taxpayer [one of the founders of the Winn-Dixie supermarket chain] made gifts to each of two of his children of 25.77 percent of the stock of a holding company (ADDI&C) that had approximately $80 million of assets, $70 million of which was Winn-Dixie stock with a basis of $338,283. In valuing the gift of ADDI&C stock, the taxpayer claimed a blockage discount with respect to the asset value of the Winn-Dixie stock it held (which was subject to SEC Rule 144), but based on a fact finding that the taxpayer did not establish that a dribble-out sale was more likely than a private placement, this discount was not allowed.

- In addition to claiming the now-routine minority and lack of marketability discounts, much of which was allowed, taxpayer claimed an additional discount of approximately $25,000,000 for built-in capital gains taxes on the Winn-Dixie stock owned by ADDI&C. Judge Chiechi rejected the Commissioner's argument that controlling precedent proscribed the allowance of such a discount absent evidence of an impending sale or liquidation. She allowed a discount for built-in taxes because a buyer would not pay a price for the stock that did not reflect the built-in tax liability. A discount of approximately 15 percent — a discount less than the full amount of the built-in tax, for which the taxpayer argued — was allowed. Since no liquidation or asset sale was imminent, the built-in tax liability merely reduced the arm's length price a hypothetical willing buyer would pay a hypothetical willing seller. After the repeal of the General Utilities doctrine, the corporate level tax is unavoidable (except indirectly through a subchapter S election, which eliminates the shareholder gain as result of stepping-up stock basis to reflect corporate gain, and an S election was not feasible on the facts). For this reason, the built-in tax discount was treated as additional lack of marketability discount.

3. And the Tax Court was reversed by the Second Circuit in an earlier case for not having seen the light sooner. Eisenberg v. Commissioner, 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 been due if the corporation had liquidated [for 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, 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].

4. The IRS may have lost this case, but you can bet they'll find a way to cite it to their benefit in future §1060 cases. Norwalk v. Commissioner, T.C. Memo 1998-279 (7/30/98). A CPA professional services corporation dissolved and distributed its assets to its two CPA shareholders in 1992, who in turn contributed the assets a partnership that they joined in that year. The IRS asserted that in addition to the tangible assets expressly distributed, the corporation distributed customer based intangible assets, including the corporation's client base, client records and workpapers, and goodwill and going concern value, which resulted in a gain to the corporation of $588,297 and also increased the
capital gain realized by the shareholders on the liquidation. Judge Ruwe upheld the taxpayer's contention that the corporation's earnings were entirely attributable to the CPA-shareholders -- any clients would have followed the individual CPAs -- and that it owned no goodwill or customer based intangibles that could be separately sold. Clients sought the personal ability, personality, and reputation of the individual CPAs, and these assets did not belong to the corporation. The corporation's location and name had no goodwill value.

D. S Corporations


2. IRS given more discretion to waive defects in invalid elections and to validate late elections. SBPJA §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 corporation 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).

3. Johnson v. Commissioner, T.C. Memo 1997-558 (12/22/97). A taxpayer may challenge the validity of a subchapter S election based on a defect in completion of the Form 2553 even if the defect is not readily apparent from the face of the form, but might be stopped from denying that the corporation was an S Corporation. Government's motion for summary judgment on S corporation status was denied, and issue of purported forgery of a shareholder's signature was an issue to be tried.

4. Williams v. Commissioner, 110 T.C. No. 4 (1/21/98). Former C corporation made distributions in 1990 and also had losses in that year. held, the accumulated adjustments account was to be reduced by the losses first, so the shareholder/taxpayer received the distribution partially from the AAA and partially from C corporation earnings and profits. This result was confirmed by Reg. §§1.1368-1(e) and -2(a)(4), effective in 1994.
   - Taxpayer was the sole shareholder of MTI, which had in excess of $264,078 of accumulated earnings and profits at the time it made an S election. At the beginning of 1990, MTI had an AAA of $349,256. During 1990, MTI passed through to the taxpayer an ordinary loss of $217,341 and distributed $323,399 to the taxpayer. The taxpayer argued that pursuant to §1367(a) the loss should not reduce the AAA before accounting for the distribution, so that the entire distribution would be out of the AAA and none of it out of earnings and profits pursuant to §1368(c)(1).
   - The Commissioner argued that under §1368(e), the loss first reduced the AAA and that $264,078 of the distribution was taxable as a dividend under §1368(c)(2). The year in question was not controlled by Reg. §§1.1368-1(e) and 1.1368-2(a)(4), which dictate the adjustment ordering rule urged by the Commissioner, because the regulations are effective only for years after 1993. Relying on the legislative history of §§1367 and 1338, H.Rep. 97-826, at 17 (1982) and S.Rep. 97-640, at 18 (1982), the Tax Court held that §1367 does not control the order of adjustments under §1367 and that, as urged by the Commissioner, the AAA is first reduced by the corporation's losses for the year before taking distributions into account. The court noted that §1368(e) was amended in 1996 (by adding §1368(e)(1)(C)), effective for years after 1996, to provide the result urged by the taxpayer. The 1996 amendment was cited as further evidence that the Commissioner's interpretation was correct.

5. *S corporation may not deduct the suspended §469 passive activity losses it incurred when it was a closely held C corporation. St. Charles Investment Co. v. Commissioner, 110 T.C. No. 6 (2/5/98). Pursuant to §1371(b)(1), an S Corporation that prior to its S election was subject to
§469 as a closely held C corporation cannot use passive activity loss carryovers from the period it was a C corporation.

- If depreciation deductions contributed to a disallowed passive activity loss, the basis of the depreciable property is nevertheless reduced by the otherwise allowable depreciation deduction. On a subsequent sale of the property (that is not part of the complete disposition of the activity in which the property was used) the basis of the depreciable asset is not recomputed by adding back disallowed losses attributable to the suspended depreciation deductions to reduce gain recognized on the sale of the depreciable asset, citing S. Rep. No. 99-313 at 723, n.9. That the depreciation deductions have not yet produced a tax benefit – and might never produce a benefit unless the conditions for releasing them from suspension are met – is irrelevant.

- The PALs remain available for future use if the corporation terminates its S corporation status.

6. *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.”

a. Last year: Basis increase on passthrough of excluded discharge of indebtedness income, but... 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.

b. This 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. Follows Nelson, supra.

7. REG-251698-96, proposed regulations under §1361(b)(3), relating to the treatment of corporate subsidiaries of S corporations, including qualified Subchapter S subsidiaries (QSSS) and C corporations that are members of affiliated groups after the repeal of former §1362(b)(2)(A) (63 F.R. 19864, 4/22/98). Regarding QSSS, the proposed regulations deal with the manner of making the election; revoking the election; the effect of the election (constructive liquidation of subsidiary); the effect of termination of the election (constructive formation of a new corporation); and relief from inadvertent terminations. Regarding subchapter C subsidiaries, the proposed regulations deal with the treatment of intercorporate dividends.

8. REG-209446-82, 1998-36 I.R.B. 24. Proposed Regulations §1.1366-1 through -5, dealing with the pass-though of S corporation income to its shareholders (§1.1366-1), limitations on passed-through losses (§1.1366-2), treatment of family groups of shareholders (§1.1366-3), and special rules (§1.1366-5) to reflect various statutory changes since 1982 (63 F.R. 44181, 8/18/98).

9. Pahl v. Commissioner, 153 F.3d 1124, 98-2 U.S.T.C. ¶50,602, 82 AFTR2d 5418 (9th Cir. 7/29/98). The taxpayer was a member of a law firm organized as an S Corporation for 6 months,
but never paid for or received any certificates of stock. He did, however, manage the firm and its books and was responsible for hiring and firing employees. The Ninth Circuit upheld the Tax Court's decision that, under the relevant state law [which controlled the question of ownership of shares], the taxpayer was a beneficial owner of 25 percent of the stock of the corporation and accordingly was taxable on a proportionate share of the corporation's profits.

E. Affiliated Corporations

1. Kohler Co. v. United States, 97-2 U.S.T.C. ¶50,673 (Fed. Cir. 9/17/97). Canadian subsidiary could not be included in the consolidated return group under §1504(d) because incorporation in Canada was not required in order for the parent to do business there. U.S. Padding Corp. v. Commissioner, 865 F.2d 750 (6th Cir. 1989), distinguished on its facts.

2. Alumax, Inc. v. Commissioner, 109 T.C. No. 8. (9/30/97). A subsidiary was not part of the parent’s affiliated group and could not be included in the parent’s group’s consolidated return because restrictions on the directors’ ability to control the subsidiary corporation resulted in parent’s stock constituting less than 80 percent of the vote and value of the stock of the subsidiary.

3. Revenue ruling followed. First Chicago NBD Corp. v. Commissioner, 98-1 U.S.T.C. ¶50,169 (7th Cir. 1/28/98). Held, that consolidated group may not take the §902(a) indirect foreign tax credit because none of the affiliated corporations owns the required 10% of the foreign corporation’s stock. Rev. Rul. 85-3, 1985-1 C.B. 222, was followed because the court deferred to the IRS’s reading of the statute on this issue. Judge Posner noted that, while Revenue Rulings are to be given less weight than Treasury Decisions, they were entitled to some weight — particularly where the aggregation issue had never before arisen — even though “there is a definite flavor of its seeking opportunistically to bolster a litigating position. . . . It would be anomalous to give weight to the Service’s interpretation only in cases against taxpayers who come AFTER the one who first decided to sail close to the wind.”

F. Section 482

1. Notice 98-10, 1998-6 I.R.B. 9 (1/22/98), Special advance pricing (APA) procedures for small business taxpayers, i.e., any U.S. taxpayer with total gross income currently less than $100 million.

G. Reorganizations and Corporate Divisions

1. *Final regulations modify continuity of interest requirements. T.D. 8760, final regulations under §368, providing that the continuity of interest (COI) requirement is satisfied if the acquiring corporation furnishes consideration which represents a proprietary interest in the affairs of the acquiring corporations, and such consideration represents a substantial part of the value of the stock or properties transferred (63 F.R. 4174, 1/28/98). The regulations further provide that dispositions of stock of the acquiring corporation by a former target shareholder are generally not to be taken into account in determining whether COI has been satisfied, except under facts and circumstances such as a purchase of the stock shortly after the reorganization by the acquiring corporation or an affiliate.

a. T.D. 8761 and REG-120882-97, temporary and proposed regulations concerning the circumstances under which a target corporation’s redemption of its stock adversely affects satisfaction of the COI requirement (63 F.R. 4183 & 4204, 1/28/98).

2. *Final regulations: Warrants are securities, instead of boot. T.D. 8752, 1998-9 I.R.B. 4. final regulations on stock rights. Reg. §§1.354-1(e) and 1.356-3(b) and (c) treat rights to acquire stock of a corporation (options and warrants) that is a party to a reorganization as securities of the corporation having no principal amount. The recipient of stock rights is not be required to recognize gain under §356 regardless of whether he surrendered stock, stock rights, or debt securities. The term "rights to acquire stock" of an issuing corporation has the same meaning as for purposes of §§305 and 317(a). Rights exercisable against persons other than the issuer of the stock are not covered by the regulations. The regulations apply only to determine gain recognized in an otherwise qualifying reorganization. They do not affect determinations of whether the continuity of shareholder interest test has been satisfied. See REG-249819-96, 1997-7 I.R.B. 50, 51. Reg. §1.355-1(c) provides similar rules for divisive reorganizations.
• Adds a new provision governing stock-for-warrant exchanges, stating that §354 is not applicable to a shareholder’s receipt of solely warrants.

3. *Nonqualified preferred stock to be treated as boot in transfers to corporations and in reorganizations. 1997 Act §1014 adds new Code §§351(g), 354(a)(2)(C), 355(a)(3)(D) & 356(e) to provide that “nonqualified preferred stock” will be treated as boot in contribution, reorganization and divisive transactions. Effective for transactions after 6/8/97. Nonqualified preferred stock means a preferred stock on which (1) the holder has a put right, (2) the issuer or a related person is required to redeem or purchase the stock, (3) the issuer or a related person has the right to redeem or purchase the stock and it is more likely than not that the right will be exercised (at the time of issuance), or (4) the dividend rate varies by reference to interest rates, commodities prices or similar indices. Exception for holder’s rights which may be exercised only after 20 years, holder’s rights exercised on death, disability or mental incompetence, and issuer’s rights exercised on separation from service.

a. T.D. 8753 and REG-121755-97, temporary and proposed regulations providing guidance on when §351(g)(2) nonqualified preferred stock will not be treated as stock or securities for purposes of §§ 354, 355 and 356 (63 F.R. 411 & 453, 1/6/98).

4. Rev. Rul. 98-10, 1998-10 I.R.B. 11 (2/23/98). Stock-for-stock acquisition that is accompanied by an exchange of securities qualifies as a “B” reorganization where a substantial proportion of the debentures are held by persons who own no stock. The exchange of securities should be disregarded for purposes of determining whether the stock-for-stock acquisition is tax-free. Effective 3/9/98.

The facts of the ruling indicate that some of debenture holders held Y Corporation stock, but a substantial portion of the debentures were held by persons who owned no Y Corporation stock. The ruling held that the stock-for-stock exchange qualified as a B reorganization. The debenture-for-debenture exchange — although not a part of the stock-for-stock exchange — was considered to be part of the reorganization, and pursuant to §354, no gain or loss was recognized to the debenture holders. Although not indicated by the facts, the ruling also noted that an exchange of options, “although separate from a §368 exchange,” may also be in pursuance of the plan of reorganization.” Accordingly, since pursuant to Reg. 1.354-1(e), effective after March 9, 1998, the options are securities without a principal amount, gain or loss also would not be recognized on such an exchange.

5. Martin Ice Cream Co. v. Commissioner, 110 T.C. No. 18 (3/17/98). Taxpayer corporation’s majority owner, rather than the corporation, sold distribution rights back to Haagen-Dazs; therefore, taxpayer is not taxable on capital gain from the sale. Judge Beghe found that the rights sold, which were based on personal relationships with supermarket chains and an oral agreement with the founder of Haagen-Dazs, belonged to the majority owner and not to the corporation. He also refused to apply Commissioner v. Court Holding Co., 324 U.S. 331 (1945), as urged by the Commissioner.

He did find taxpayer’s distribution of a newly-formed subsidiary not to be entitled to §355 nonrecognition because the subsidiary was not engaged in the active conduct of a trade or business after the distribution.

6. *Is there still a shareholder continuity of interest requirement in §355 transactions? Rev. Rul. 98-27, 1998-22 I.R.B. 4 (5/14/98). As a result of the enactment of §355(e), the IRS announced that it no longer will apply Court Holding Company principles (or any other variant of the step transaction doctrine) to determine whether for purposes of §355(a) the distributed corporation qualifies as a controlled corporation solely because of any postdistribution acquisition or restructuring of the distributed corporation, whether prearranged or not. Any implication that §355(a) restricts postdistribution acquisitions or restructurings of a controlled corporation is inconsistent with §355(e) and its legislative history. (See H.R. Rept. No. 105-220, at 529-30.) In otherwise applying the step transaction doctrine for other purposes, the IRS will continue to consider all facts and circumstances. See, e.g., Rev. Rul. 63-260, 1963-2 C.B. 147. Rev. Ruls. 96-30 and 75-406 obsoleted. Rev. Rul. 70-225 is modified to
the extent it is inconsistent with Rev. Rul. 98-27. Under §7805(b) the ruling generally applies only to distributions after April 16, 1997.

- The “obsoleted” Revenue Ruling 96-30, 1996-24 I.R.B. 4 (5/22/96). A transaction taking the form of a §355 spin-off of the stock of a wholly-owned subsidiary, followed by the acquisition of the assets of the former subsidiary in a merger, will be respected for federal income tax purposes where there had been no negotiations regarding the acquisition with the distributing corporation and the former subsidiaries voted on the merger after the distribution and were free to vote their stock for or against the merger. Section 7805(b) relief will be considered by the Service on a case-by-case basis.

7. Rev. Rul. 98-44, 1998-37 I.R.B. 4. Declares obsolete Rev. Rul. 70-225, 1970-1 C.B. 80, which held that an attempted post-distribution (B) reorganization involving the stock of the controlled subsidiary defeated nonrecognition treatment because of the control requirement of §368(a)(1)(D). Rev. Rul. 70-225 is no longer determinative in light of the changes to §355 as a result of the addition of §355(e) and (f), dealing with post-spin-off dispositions.

H. Accumulated Earnings

1. Northwestern Indiana Tel. Co. v. Commissioner, 127 F.3d 643, 97-2 U.S.T.C. ¶50,859 (7th Cir. 10/22/97). Affirms Tax Court decision that closely held corporation unreasonably accumulated earnings by using them in a cable TV company owned by the majority shareholder’s son.

I. Tax Shelters

1. 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 “serving 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 follows: 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,___, 1998 U.S. App. LEXIS 25726 (3d Cir. 10/13/98) (2-1), affg 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 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 notes.

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.

3. 1997 Act §1028 amends Code §§6111 and 6662(d)(2)(C)(iii) by requiring promoters of confidential corporate tax shelters to register and by providing penalties for failure to do so. The definition of “tax shelter” was changed from one where the avoidance or evasion of Federal income taxation was “the principal purpose” of the arrangement to one where tax avoidance or evasion is “a significant purpose.”

4. Rev. Rul. 97-48, 1997-49 I.R.B. 5, revoking Rev. Rul. 75-7, 1975-1 C.B. 244. Rev. Rul. 75-7 attributed the activities of a contract manufacturer to the controlled foreign corporation (CFC) that hired it. This would serve to convert what would otherwise be (subpart F) foreign base company sales income [taxable to the U.S. parent of the CFC] into manufacturing income [exempt from immediate U.S. taxation]. Case law held that a contract manufacturer was not a branch; the IRS announced it would follow this case law for subpart F purposes.

5. *Much ado about Notices 98-5 and 98-11
   a. Notice 98-5, 1998-3 I.R.B. 49 (12/23/97). IRS will attack abusive tax-motivated transactions with a purpose of acquiring or generating foreign tax credits that can be used to shelter low-taxed foreign-source income from residual United States tax under regulations to be issued under §§901, 901(k)(4), 904, 864(e)(7) and 7701(l). Five examples of abusive arrangements are contained in the notice. Effective for taxes paid or accrued after 12/22/97.
   b. Notice 98-11, 1998-6 I.R.B. 18 (1/16/98). The Service will issue regulations to prevent the use of hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of subpart F income. A hybrid branch is one viewed under U.S. tax principles as part of the CFC, but viewed under the law of the CFC’s (foreign) country of incorporation as an entity separate from the CFC. Two examples that involve interest payments recognized for foreign tax purposes, but ignored for U.S. tax purposes, are included.
   d. Notice 98-35, 1998-26 I.R.B. (6/19/98). IRS announces the withdrawal of Notice 98-11 and states it intends to withdraw the regulations issued under the notice. Regulations will not be final before 1/1/00, and will grandfather payments made under hybrid arrangements entered into before 6/19/98. By letter to a securities industry member, Treasury agreed to make changes in Notice 98-5.
   e. The Senate version of the IRS Restructuring Bill §3713 provides a moratorium for six months on the issuance of temporary or final regulations pursuant to Notice 98-11, and provides that it is the Sense of the Finance Committee that Treasury should withdraw Notice 98-11 and the regulations issued thereunder. The “Sense” further provides that Treasury should limit any regulations issued under Notice 98-5 to the specific transactions described therein – with an expectation that regulations would not affect transactions undertaken in the ordinary course of business and would not be retroactive [i.e., before the issuance of proposed regulations].
   f. No statutory provisions relating to Notices 98-5 and 98-11 were included in the 1998 Act.
   g. The Conference report notes that Treasury has withdrawn proposed and temporary regulations pursuant to Notice 98-11. The Conferees call upon Treasury to “take into account
the impact of any administrative guidance in this area on affected taxpayers and industries.” They expressed concern about the potentially disruptive effect of a notice which provides that future regulations would be effective as of the date of the notice. The Conferees “strongly encourage” Treasury and IRS “to limit similar types of action in the future.”

h. Query about the effect of notices. Do they merely alert taxpayers to IRS positions in advance of regulations? Or, are they attempts to stop transactions without any specific legal authority? Compare the use of rulings in the late 1970s and early 1980s in the tax shelter area.

V. EMPLOYEE COMPENSATION AND PLANS

A. In General

1. Plan Curative Programs
   a. *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.

2. *Leased workers need not be included in pension plan, even if common law employees. Bronk v. Mountain States Telephone & Telegraph Inc., 140 F.3d 1335, 98-1 U.S.T.C §50,316 (10th Cir. 4/7/98). Held, ERISA does not require that an employer include in its pension plans all employees who meet the test of common law employees. The employer may distinguish between categories of employees, but may not make such distinctions based upon age or length of service.

3. Capital Cities/ABC Inc. v. Ratcliff, 114 F.3d 1405, 1998 U.S. App. LEXIS 7565 (10th Cir. 4/17/98). Newspaper carriers are not entitled to plan benefits because of (1) their express waiver of such benefits in their agreements with the newspaper and (2) the plan terms excluded the carriers.

4. Square D Co. v. Commissioner, 109 T.C. No. 9 (10/9/97). Deductions for contributions to fund post-retirement benefits under a VEBA are currently deductible pursuant to §419A(c)(2) only if the contributions actually are added to a reserve accumulated to fund such benefits. The taxpayer was denied a deduction because, on the facts, no reserve had been created. Reg. §1.419-1T, Q&A 5(b)(1), which effectively disallows any tax deferral benefit of having a trust year end earlier than the employer’s year end, is valid.

5. Parker-Hannifin Corp. v. Commissioner, 98-1 U.S.T.C. §50,278, 81 A.F.T.R.2d 1115 (6th Cir. 3/23/98). Parker-Hannifin Corp. deposited $42,000,000 in a newly created VEBA on June 30, 1987, the day before its tax rate dropped from 46% to 34%, to fund employee health benefits. The VEBA was not required by a collective bargaining agreement and the employees were not informed of its existence. The taxpayer anticipated that this amount would fund medical benefits for current employees for 12 to 18 months. The VEBA began paying for benefits in August, 1988. By the end of 1988, taking into account employee contributions and earnings, its balance was $6,150,000. By the end of 1989, taking into account employer contributions, employee contributions, and earnings, its balance was zero. The Commissioner allowed a deduction of only $9,000,000 for incurred but unpaid medical expenses. Because no benefits were paid during 1997, under §419 the contribution was deductible only to the extent it created a qualified asset account under §419A. The contribution could have been a QAA only to the extent it funded an actuarially determined reserve for (1) incurred but unpaid claims at the close of the year (and administrative costs), and (2) a reserve for post-retirement benefits. The court held that the statute requires actual fund balances in order to qualify as a reserve and since the fund balance was entirely depleted by current expenses within two year, no reserves for post-retirement benefits had been created, and the QAA for 1987 was limited to the amount necessary to fund the reserve for incurred but unpaid claims at the close of the year and administrative costs.

- Employed geriatrics (over 70-1/2), other than 5 percent owners, need not begin receiving distributions from qualified plans until they retire. Small Business Job Protection Act of 1996, §1404. Modifies the rule that requires all participants in qualified plans to commence receiving distributions by age 70-1/2, in that for employees (other than 5 percent owners) distributions are not required to begin until the employee retires (with an actuarial adjustment to increase the benefit to take into account the period after age 70-1/2 in which the employee was not receiving benefits). (The actuarial adjustment rule does not apply to defined contribution plans.) Effective for years beginning after 12/31/96, with provisions for the optional cessation of distributions for current recipients.

7. REG-209463-82, amendments to existing proposed regulations under §401(a)(9) on required distributions from qualified plans and IRAs to make changes to the rules that apply if a trust is named as a beneficiary of the employee’s benefit under a retirement plan (12/29/97). The amendments would permit the designated beneficiary of a revocable trust to be treated as the designated beneficiary for purposes of determining the minimum distribution, provided that the trust becomes irrevocable upon the death of the employee.

8. Notice 98-2, 1998-2 I.R.B. 22 (12/16/97). Guidance on the Code §72(d) simplified method for determining the tax-free and taxable portions of annuities starting after 11/18/96, in accordance with changes made in the Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997. The simplified method is generally required for most distributions from §401(a) qualified plans, §403(a) employee annuities, and §403(b) annuity contracts. Under this method the distributee recovers his or her investment in the contract in level amounts over the expected number of monthly payments.


10. Notice this Notice. It is a good Notice. It provides needed guidance under the 1996 SBJPA amendments to sections 401(k) and (m). Notice 98-1, 1998-3 I.R.B. 42 (12/31/97). Guidance on 1996 SBJPA changes to the nondiscrimination rules under §§401(k) [cash or deferred arrangements] and 401(m) [matching and employee contributions].

11. Taming the COBRA. REG-209485-86, proposed regulations under §4980B that provide guidance on the continuation coverage requirements applicable to group health plans (63 F.R. 708 (1/7/98).

a. The IRS is here to help you, but not necessarily your employer, in plain language. Notice 98-12, 1998-5 I.R.B. 12 (1/16/98). Advice to taxpayers on whether to elect COBRA health continuation coverage after HIPAA (1996). The Notice may be modified by the employer to provide information specific to a plan and provided to covered employees and beneficiaries. Employers are not required to provide this notice, nor does it substitute for any of the notices required to be furnished under COBRA or for other information required by law to be furnished to participants or beneficiaries in group health plans.

12. Tupper v. United States, 98-1 U.S.T.C. ¶50,148 (1st Cir. 1/12/98). Neither a multiemployer pension plan trust nor an annuity plan trust that fail to meet the requirements of ERISA and §401(a) can qualify for tax exemption under §501(c)(5) (“labor organizations”).

13. *Money distributed from Keogh and IRAs must be recontributed as money into a new IRA to qualify for taxfree rollover treatment. Lemishow v. Commissioner, 110 T.C. No. 11 (2/18/98). The depositing of stock [purchased with Keogh and IRA cash distributions] into a new IRA did not qualify as a taxfree rollover. Based on the legislative history of §408(d)(3)(A)(i), H.Rep. No. 93-807 (1973), reprinted at 1974-3 CB (Supp.) 236, 374-375, the statute requires that if money is distributed, the money itself must be recontributed as prerequisite for a valid roll-over. (Taxpayer was a self-employed accountant.)
14. *Sharply divided Tax Court explores the §83(h) deduction. Employer issued neither Forms W-2 nor Forms 1099 to stock recipients, either being within a safe harbor under the subsequently-issued regulations. Venture Funding Ltd. v. Commissioner, 110 T.C. No. 19 (3/26/98) (reviewed, 10-8). In 1988, taxpayer transferred the stock of a corporation it controlled [Endotronics] to 12 of its [i.e., taxpayer's] key employees as compensation for services. It issued neither Form W-2s nor Form 1099s and none of the employees included any of this compensation in 1988 gross income. Held, no 1988 deduction because §83(h) allows as a deduction "an amount equal to the amount included under [§83(a)] ... in the gross income of the person who performed such services [in the taxable year in which such amount is included in gross income]," and no such amounts were so included in that year.

- Taxpayer argued that it was entitled to the deduction in the year the Endotronics stock was “includable” in its employees' income, and that ascertaining whether their employees “included” amounts in gross income might be difficult for employers.

- Judge Laro’s majority opinion noted that the [retroactively applicable] safe harbor provision in Reg. §1.83-6 permits the employer’s deduction if it reports the income on a timely Form W-2 or 1099. He further noted that Reg. §1.83-6(a)(3) (“Where property is substantially vested upon transfer, the deduction shall be allowed to [employer] in accordance with his method of accounting [in conformity with sections 446 and 461]”) was simply a timing rule that does not provide an independent basis for the §83(h) deduction.

- Judge Colvin concurred, noting that the safe harbor in the regulations was necessary only if the majority’s interpretation was correct.

- Judge Beghe concurred in the result, but raised questions about this fully-stipulated case. These questions included: (1) Why did the Commissioner not issue statutory notices to the employees? (2) Why did he not assess employment taxes against the employer? (3) Why did taxpayer not have income in the same amount [about $1 million] as the claimed deduction on its own receipt of the Endotronics stock as compensation? and (4) Why did taxpayer not have income in the total value of the stock it received [about $6 million] for its undertakings to provide Endotronics with management services and financing?

- Judge Ruwe dissented on the ground that Congress meant “includible” in §83(h) where it used “included.” He furnished many Code, legislative history, regulation and case law analogies to support his position. He also noted that Reg. §1.83-6(a)(3) applies to this transfer and allows the deduction in accordance with taxpayer’s accounting method “[w]here property is substantially vested upon transfer ... .” He did, however, note the questionable equity of allowing a corporate deduction for compensation to controlling shareholders and principal officers, who failed to report the same items as income.

- Judge Halpern dissented on the ground that the words of §83(h) which allow a §162 deduction in “an amount equal to the amount included under [§83(a)] ... in the gross income of the person who performed such services,” (supported by legislative history and regulations) refer to the amount the service provider is required to recognize as gross income.

15. *After you lose in the Supreme Court, it's time to start the serious planning. Ltr. Rul. 9810005 (12/3/97). HMO exempt under §501(c)(3) may fund a trust for the benefit of physicians affiliated with the exclusive provider [partnership] of medical services to the HMO. Under §83, the participants/physicians will not have income on amounts subject to a substantial risk of forfeiture, nor will the trust or partnership have income on trust earnings because the trust is the HMO’s grantor trust. Apparently, the HMO is Kaiser and the provider partnership is Permanente; see Basye v. United States, 410 U.S. 441, 73-1 U.S.T.C. 9250 (1973).

16. *Falling into Black (Sc)holes? Valuing nonstatutory stock options for gift tax purposes. Rev. Rul. 98-21, 1998-18 I.R.B. 7 (4/13/98). The transfer to a family member, for no consideration, of a nonstatutory stock option is a completed gift under §2511 on the later of (i) the transfer or (ii) the time when the donee’s right to exercise the option is no longer conditioned on the
performance of services by the transferor. See also, Rev. Proc. 98-34, 1998-18 I.R.B. 15 (4/13/98) (specific methodology for valuing compensatory stock options [granted by companies subject to FAS 123] for purposes of determining gift, estate and generation-skipping transfer taxes). The expected volatility of the underlying stock to be used is that which is disclosed in the financial statements of the publicly traded company.


18. T.D. 8738, and REG-243025-96, temporary and proposed regulations under §125, providing guidance relating to the circumstances under which a cafeteria plan participant may revoke an existing election and make a new election during a period of coverage (62 F.R. 60165, 11/7/97).

19. Notice 98-29, 1998-22 I.R.B. (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.

20. T.D. 8769, final regulations to permit an amendment to a qualified plan that eliminates plan provisions for benefit distributions before retirement but after age 70-1/2 (6/4/98).

a. Regulations under Small Business Job Protection Act of 1996, §1404. Modifies the rule that requires all participants in qualified plans to commence receiving distributions by age 70-1/2, in that for employees (other than 5 percent owners) distributions are not required to begin until the employee retires (with an actuarial adjustment to increase the benefit to take into account the period after age 70-1/2 in which the employee was not receiving benefits). (The actuarial adjustment rule does not apply to defined contribution plans.) Effective for years beginning after 12/31/96, with provisions for the optional cessation of distributions for current recipients.


22. Transportation Equity Act for the 21st Century, §9010, amends Code §132(f) to permit employees the choice between cash and a qualified transportation fringe, without having constructive receipt of the cash. It also raises the commuter bus/transit pass limit to $65 per month and the qualified parking limit to $175; effective in 1999; the commuter limit increase to $100 per month in 2002.

23. IRS Restructuring Act of 1998

a. 1998 Act §3436 adds new Code §72(t)(2)(A)(vii) to provide that the 10 percent additional tax on early withdrawals from retirement plans or IRAs will be waived when the withdrawal is made on account of an IRS levy on the plan. Effective for distributions after 12/31/99.

b. 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.

24. Lucky Stores Inc. v. Commissioner, 153 F.3d 964, 98-2 U.S.T.C. ¶50,662 (9th Cir. 8/20/98). Taxpayer may not deduct pension plan contributions made between the end of the taxable year and the date taxpayer filed its return for that year. Section 404(a)(6) holds that, for payments made after year-end, only payments relating to hours worked during the year are deductible.

VI. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

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

2. *Exemption revoked for improper self-dealing. Anclote Psychiatric Center Inc. v. Commissioner, T.C. Memo. 1998-273 (7/27/98). Tarpon Springs (FL) organization's tax-exempt status was revoked because the sale of its hospital [to its board of directors] for $6.6 million was for almost $1.2 million less than its $7.8 fair market value, which was a "substantial amount in relation to the purchase price." Judge Wright rejected the IRS appraiser's report because is was "more characteristic of the work of a revenue agent than of an impartial, disinterested appraiser." Nevertheless, based on the entire record [including the failure to take account of adjustments between the date of appraisal and the (18-month later) date of sale], Judge Wright concluded that the price was outside "any reasonable range of fair market values." The IRS bore the burden of proof on this revocation of tax-exempt status.

3. 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).

4. *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 Gerber held that retroactive revocation of the charity's tax exemption retroactive to 6/11/84 was not an abuse of discretion.

5. Proposed regulations on "intermediate sanctions" include a broad definition of "disqualified person." REG-246256-96, proposed regulations under §4958, relating to the excise taxes on excess benefit transactions (63 F.R. 41486, 8/4/98). The provision is applicable to transactions that provide excess benefits to "disqualified persons" of public charities [public §§501(c)(3) organizations] and social welfare organizations [§501(c)(4) organizations]. The definition of "disqualified person" is broad, including any person who was in a position to exercise "substantial influence over the affairs" of the organization.

6. Fund for the Study of Economic Growth and Tax Reform v. IRS, 98-1 U.S.T.C. ¶50,251 (D. D.C. 2/24/98). 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.

7. REG-121268-97, proposed regulations under §513, clarifying when the travel and tour activities of tax exempt organizations are substantially related to the purpose for which exemption was granted (63 F.R. 20156, 4/23/98).

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

B. Charitable Giving

1. *Qualified appraisal required even if taxpayers could prove stock's fair market value. Hewitt v. Commissioner, 109 T.C. No. 12 (10/29/97). Deductibility off donation of "non-publicly traded stock" [400 shareholders and 700,000 shares] to a private foundation must be supported
by a Reg. §1.170A-13 “qualified appraisal” attached to the tax return even though there was a market for the stock and taxpayers could prove the stock’s fair market value. Bond v. Commissioner, 100 T.C. 32 (1993) (holding the requirement to be directory, rather than mandatory), was distinguished as involving a case of “substantial compliance” because in that case an appraisal was obtained and a summary rather than the appraisal itself was attached to the return.

2. Browning v. Commissioner, 109 T.C. No. 16 (11/25/97). Taxpayer’s sale to the county government for $309,000 of a conservation easement prohibiting development on his farm was held to be a bargain sale because taxpayer did not intend to receive an arm’s length price. A deduction for $209,000 was allowed, based upon the difference in appraised value of the farm before and after the sale less $309,000.

VII. INTEREST

A. In General

1. Mason v. Commissioner, T.C. Memo. 1997-352 (7/31/97). If a demand loan subject to §7872 bears no stated interest, payments during the year may not be retroactively recharacterized as interest payments, rather than principal payments.

2. Fluor Corp. v. United States, 97-2 U.S.T.C. ¶50,615 (Fed. Cir. 9/17/97). Carryback of excess foreign tax credits under §904(c) from 1984 to 1982 -- thus eliminating any deficiency for 1982 -- did not result in abatement of the §6601(a) interest due for the period between 1982 until the foreign tax credit was applied to eliminate the deficiency.

3. Uslu v. Commissioner, T.C. Memo. 1997-551 (12/16/97). The taxpayer had a bad credit history and could not obtain a home mortgage in his own name, so the taxpayer’s brother took title to a home and obtained a mortgage in his name. Taxpayer provided all of the funds for the purchase, serviced the mortgage, paid real estate taxes, and all maintenance, and lived in the home. On the facts, the court found that the taxpayer held equitable title to the residence and allowed a home mortgage interest deduction. The loan transaction was recharacterized as a back to back loan, from the mortgage lender to the brother who held legal title, and then in turn from the brother to the taxpayer.

4. Hernandez v. Commissioner, T.C. Memo. 1998-46 (2/5/98). Interest received on the redemption of tax sale certificates purchased from a county tax collector was not excludable under §103. The certificates were not issued pursuant to the state’s borrowing power; they were an assignment of the state’s rights against the landowner, who was the obligor on the debt.

5. T.D. 8746, 1998-7 I.R.B. 4. Amended Reg. §1.61-13 to require the issuer of a bond with an issue premium to take the issue premium into account under the constant interest method (the method applied under the OID rules) rather than ratably over the term of the obligation as previously required.

6. T.D. 8754, 1998-10 I.R.B. 15. Reg. §1.1275-1(j). For a private annuity, i.e., one not issued by an insurance company, to qualify for treatment as an annuity under §72, rather than as a debt instrument subject to the OID rules under the exception in §1275(a)(1)(B)(ii), the contract must both (1) provide for periodic distributions at least annually for the life of an individual (or for the joint lives of a reasonable number of individuals); and (2) contain no terms that could significantly reduce the probability that the total amount of payments will increase commensurately with the annuitant’s longevity.

7. 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 nondeductible personal interest under §163(h), is invalid as applied to interest on a deficiency arising from a Schedule C adjustment.

- The Tax Court relied on a line of pre-§163(h) decisions that treated interest on a tax deficiency arising from an unincorporated business as deductible under §162 rather than under §163, e.g., Standing v. Commissioner, 28 T.C. 789 (1957), aff'd, 259 F.2d 450 (4th Cir. 1958), even though the regulations were arguably supported by language in the accompanying committee report. The court reasoned that it would not consider the statutory change to have overturned the prior case law unless the reversal was explicit, and it did not consider the language of either the statute or the committee reports to be explicit enough. The Regulations were directly supported by language in the Staff of the Joint Committee on Taxation, General of the Tax Reform Act of 1986, but the court refused to consider the Bluebook because it was prepared by the Joint Committee Staff, and thus it was not part of the legislative history. The majority disagreed with the decision in Miller v. United States, 65 F.3d 687 (8th Cir. 1995) upheld the regulations in a case also involving interest on a sole proprietor's tax deficiency. The dissenters found the regulation to be a reasonable interpretation of an ambiguous statute.

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 Tax Court really does know how to trace interest, even though in Redlark it forgot that tracing the use of the proceeds, not the source of the transaction in which the debt originated, was the key. Seymour v. Commissioner, 109 T.C. No. 14 (11/5/97). The Tax Court held that interest on a $925,000 promissory note from a husband to a wife — given as part of the property settlement in a divorce — should be allocated, pursuant to Reg. §163-8T, governing interest tracing, among the various properties in which the wife transferred her interests to the husband as part of the property settlement. Thus, to the extent principal of the note was in exchange for the wife's interest in corporate stock transferred to the husband, the interest was deductible as investment interest, subject to the limitations in §163(d); to the extent the note was in exchange for the wife's interest in rental real estate, the interest was deductible, subject to the passive activity loss rules of §469; because the note was secured by the taxpayer's principal residence, to the extent the note was in exchange for the wife's interest in the residence, interest was deductible as qualified residence interest under §163(h)(3). See also Notice 88-74, 1988-2 C.B. 385. But to the extent that the note was in exchange for the wife's interest in personal use property, such as home furnishings, the interest was nondeductible personal interest under §163(h)(1). That the divorce instrument did not specifically allocate any amount of the note as a payment for any particular asset transferred to the husband did not affect the essential nature of the transaction. The Seymour decision did not address the issue of the deductibility of interest on an indebtedness given as a property settlement that cannot be traced to the obligee's transfer of other property to the maker of the note. The application of tracing principles in Seymour appears to be theoretically inconsistent with
the Tax Court’s decision in Redlark v. Commissioner, 106 T.C. 31 (1996), rev’d, 98-1 U.S.T.C. ¶50,322 (9th Cir. 4/10/98), (allowing a deduction for interest paid of a tax deficiency attributable to a sole proprietorship without inquiring as to the taxpayer’s use of the funds equaling the tax that were “borrowed” from the government).

The Commissioner contended that §1041 required the interest to be §163(h)(1) personal interest. Held, §1041 has no relevance to the proper characterization of interest on an indebtedness incurred incident to divorce, and the interest is to be allocated to the assets acquired in the divorce.


8. Keane v. Commissioner, T.C. Memo. 1998-116 (3/23/98). Taxpayer was a physician who received a medical school scholarship from the Department of Health and Human Services on the condition that he fulfill a post-graduation obligation to serve in National Health Service Corp for a specified period. When he failed to fulfill his NHSC agreement, in settlement of litigation with HHS, he executed a note to repay a specified amount to HHS. Interest on note was held to nondeductible personal interest, not trade or business interest, under Reg. §1.163-8T. That the failure to serve in the NHSC benefited taxpayer-physician’s private medical practice did not convert use of the “borrowed” funds from nondeductible education to business.

9. Rev. Rul. 98-34, 1998-31 I.R.B. (7/21/98). Below-market HUD mortgage loan is exempt from the §7872 below-market loan provisions because it is a loan made as part of a program of general application to the public [exempted by Reg. §1.7872-5T(b)(5)].

10. Interest netting.

a. Treasury Department report to Congress pursuant to §1208 of the Taxpayer Bill of Rights 2, “Netting of Interest on Tax Overpayments and Underpayments,” was released 4/18/97. It calls for additional legislation to achieve the policy goal of “global netting.”

b. *Global interest netting mandated. 1998 Act §3301, enacts new Code §6621(d), which eliminates the interest differential on overlapping periods of tax overpayments and underpayments by imposing a net interest rate of zero. Effective for quarters beginning after 7/22/98.

- Must make election by end of 1999. There is an election available on or before 12/31/99 to have global interest netting applied to all open years, both individual and corporate.

c. 1998 Act §3302, amends Code §6621(a)(1)(B) to increase the overpayment rate for taxpayers other than corporations from “2 percentage points over the Federal short-term rate” to the same “3 percentage points over the Federal short-term rate” applicable for underpayments. This eliminates any interest differential for such taxpayers. Interest netting will, however, also be required where [under §163] interest is not deductible. Effective for calendar quarters beginning on or after 1/1/99.

d. 1998 Act §3308 adds new Code §6631 to require notices to individual taxpayers that include “an amount of interest required to be paid” must include (1) information about the Code section pursuant to which the interest is imposed, and (2) a computation of the interest.

11. The Tax Court tells the IRS, “We got it right the first time. Same result this time.” Security State Bank v. Commissioner, 111 T.C. No. 8 (9/3/98). Section 1281(a)(1) does not apply to require a cash method bank to report OID income on short-term obligations (notes for not more than a
one-year term) held by it in the ordinary course of business as a result of making loans. The Tax Court followed Security Bank Minn v. Commissioner, 98 T.C. 33 (1992), aff'd, 994 F.2d 432 (8th Cir. 1993), in which it held that §1282(a)(2) did not require a cash method bank to accrue OID on short-term obligations. Security Bank Minn, held that §1281 applied only to short-term notes purchased by a bank notwithstanding that §1281(b)(1)(C) provides that §1281 applies to any short-term obligation held by a bank. The IRS previously had announced that it would follow Security Bank Minn. only in cases appealable to the Eighth Circuit. Rev. Proc. 97-37, 1997-33 I.R.B. 18, Appendix, §13.02(1)(b).


VIII. NONTAXABLE EXCHANGES

A. Section 1031

1. Dobrich v. Commissioner, T.C. Memo. 1997-477 (10/20/97). Husband and wife real estate investors did not identify replacement properties during the 45-day period following the exchange by telling each other which properties they would like to purchase, nor by having real estate agents prepare false letters backdated to the 45-day period. The transaction pre-dated the issuance of regulations under §1031(k).

2. Neal T. Baker Enterprises, Inc. v. Commissioner, T.C. Memo. 1998-302 (8/19/98). Taxpayer was denied §1031 like-kind exchange treatment because property was held primarily for sale, even though it might not have been held for sale "in the ordinary course of business." The exception in §1031(a)(1) is broader than the exception to capital gain treatment in §1221(1). Black v. Commissioner, 35 T.C. 90 (1960), followed. In applying §1221(1) precedents to analyze the case, which the court did, whether the property was held for sale "to customers" or "in the ordinary course of business" is not important.

B. Section 1032

1. *Zero basis no more. REG-106221-98, proposed regulations under §1032, relating to the treatment of a disposition (the acquiring corporation) of the stock of another corporation (the issuing corporation) in a taxable transaction (63 F.R. 50816, 9/23/98). Holds that if acquiring corporation receives issuing corporation stock in a §362(a) transaction and immediately transfers the stock for money or other property in a purchase-type transaction, then the transaction is treated as if the acquiring corporation had purchased the issuing corporation's stock at fmv with cash contributed by the issuing corporation immediately before the transaction. Overturns the result in International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943).

C. Sections 1034 (and 121)

1. 1997 Act §312 repeals Code § 1034 and amends Code § 121 to provide for the (permanent) exclusion of the first $250,000 of capital gain ($500,000 for joint returns, provided that both spouses satisfy the two-out-of-five-years use test) on the sale of an individual's personal [primary] residence. To qualify for the §121 exclusion, taxpayer must have owned and used the property as his principal residence for two of the five years preceding the sale; therefore, property owned by estates, trusts and bankruptcy trustees will not qualify. Taxpayers make take advantage of the exclusion with respect to only sale every two years. Any gain attributable to post-5/6/97 depreciation is not eligible for the exclusion, and is to be taxed at the 25% capital gains rate. Effective for sales and exchanges after 5/6/97, with election to apply former rules for sales and exchanges before 8/5/97.

a. *1998 Act §6005(e) amends Code §121(c)(1) to provide that when a primary residence is sold before two years because of unforeseen circumstances (such as change of employment, etc.), the percentage applicable [period of ownership and use over 2 years] is to be applied to the $250,000/$500,000 limitation - not to the amount of gain. An uncodified 1997 Act provision states that unforeseen circumstances are not required if the residence was owned on 5/7/97.
2. Oh, my! In re Popa, 98-1 U.S.T.C. ¶50,276, 81 AFTR2d 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 §1398(f) treats the bankruptcy estate as the debtor. The court refused to follow In re Barden, 105 F3d 821 (2d Cir. 1997) (reaching a contrary result regarding the pre-1997 version of §121).

3. *Home is where the heart is; not where your whole body is! Gummer v. United States, 98-1 U.S.T.C. ¶50,401, 81 A.F.T.R.2d 1740 (Fed. Cl. 4/30/98). The taxpayer resided in her home for 22 years before moving to a rental apartment. Seven months before moving, she put the house up for sale. After moving, the make the house more salable, she left a substantial amount of her furnishings in the house and allowed her daughter to live it for 1-1/2 years. She did not sell the home until 3 years after moving, and the IRS denied her claim that she could exclude $125,000 of gain under pre-1997 §121 on the grounds that she had not “used” the home as her principal residence for three of the five years prior to sale. The Court of Claims held that the meaning of principal residence is the same under former §121 as under former §1034 and that it is based on “facts and circumstances.” Actual physical occupancy is not necessarily required. Given all of the facts, including that the delayed sale was caused by local real estate market conditions despite best efforts to sell the property, the exclusion was allowed. Query: If this principle applies under new §121, is the home in which you actually live pending sale of your old principal residence not actually your principal residence until you sell the old one? What about for §163(h)(3) purposes?

D. Section 1038

1. Hovhannissian v. Commissioner, T.C. Memo. 1997-444 (9/29/97). Taxpayer sold a partially constructed store and parking garage for an installment note. Upon the buyer's subsequent default, the taxpayer reacquired the property. Section 1038 applied to deny recognition of a loss even though the reacquired property had been substantially changed by the defaulting buyer's incomplete modifications, and the taxpayer claimed that its value was less than amount of cash previously received on account of the installment sale. Section 1038 applies whether or not it is to the taxpayer’s advantage, and the taxpayer was required to recognize gain equal to amounts received that previously had been excluded on the installment sale as a recovery of basis.

E. Section 1041

1. Martin v. United States, 97-2 U.S.T.C. ¶50,731 (E.D. La. 8/22/97). 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.

2. The written instrument supporting alimony inclusion/deduction doesn't have to be worth the paper it's written on! Richardson v. Commissioner, 125 F.3d 551, 97-2 U.S.T.C. ¶50,653 (7th Cir. 9/12/97). Payments of $10,000 per month made by taxpayer to his ex-wife were held to be deductible alimony, even though the separation agreement under which the payments were made was later was ruled to be “procedurally and substantively unconscionable” because the payments provided therein were too low.

* A “designation” under §71(b)(1)(B) that alimony is not includable by the payee or deductible by the payor must be specific. Absent a designation that cash payments are not deductible by the payor and includable by the payee, they will be deductible by the payor and includable by the payee even if an examination of the basis on which the state court calculated the alimony award reveals an underlying assumption that the payor and not be payee would be taxable on the payments.
Music royalties – conveyed by former Eagles band member to his ex-wife – were taxable to her. Meisner v. United States, 98-1 U.S.T.C. ¶50,133 (8th Cir. 1/9/98). Affirms denial of “judgment as a matter of law” to ex-wife following a jury verdict on the issue of taxability to her of royalties from the Eagles band. These royalties were conveyed to her ex-husband when he left the band in 1978. In their 1981 divorce, ex-wife received 40% of that royalty interest as “her separate property.” Inasmuch as ex-husband retained no power or control of the income after the transfer [there was no reversionary interest reserved], there was evidence supporting the government’s position. Commissioner v. Sunnen, 333 U.S. 591 (1948), followed.

Burkes v. Commissioner, T.C. Memo. 1998-61 (2/12/98). Alimony was income to ex-wife in the year she constructively received the income, while her husband was entitled to claim a deduction for the alimony in the tax years that he paid it. Identical amounts of alimony income and alimony deduction in each tax year are not required.

Section 1045

1. 1997 Act §313 adds new Code §1045 to permit rollover of gain from one §1202 qualified small business stock to the purchase of another qualified small business stock, effective for sales after 8/5/97.

2. 1998 Act §6005(f) amends Code §1045 to provide that rules similar to rules in §1202(f)-(k) will apply to the “rollover” of qualified small business stock held for more than six months.


IX. PARTNERSHIPS

A. Partnership Audit Rules

1. Walthall v. United States, 97-2 U.S.T.C. ¶50,931 (9th Cir. 11/19/97). IRS was not required to notify indirect partners of the commencement of a TEFRA audit of the top-tier partnership even though it knew the identities of the taxpayers adversely affected by its action. Judge Noonan dissented, stating,

“Cornwallis surrendered to Washington to the tune of The World Turned Upside Down. The surrender ended taxation without representation. . . . [The government says] No regulations, no need to use the . . . information [about taxpayers available to it].

“Kafka could have designed such a world. I do not believe that Congress did. The whole purpose of section 6223 is to give notice to the partners affected. . . . The Secretary’s dilatoriness [in issuing regulations to §6223] prevented literal compliance [with its provision that notice is to be provided ‘in accordance with regulations prescribed by the Secretary’]. The statute should be read in the light of its evident purpose: if the Secretary is furnished with the name and address and interest of a partner, the Secretary should let him know what the Secretary is doing. As important a principle as no taxation without representation is no taxation without notice.”

2. Estate of Quick v. Commissioner, 110 T.C. No. 17 (3/16/98). While a partnership level audit proceeding is pending the statute of limitations with respect to “affected items,” for which a deficiency must be assessed against the partner following the normal deficiency process, see §6230(a)(2)(A)(I), is suspended by §6229(a) and (d). The Tax Court held that suspension of passed-through partnership losses at the individual partner level under § 469 is an affected item even though not listed in Temp. Reg. § 301.6231(a)(5)-1T. The list in the regulations is not exhaustive.

3. 1998 Act §3507 amends Code §6231(a)(7) to require notification of any change in tax management partner, effective after 7/22/98.

4. TMP under criminal investigation has no authority to extend the statute of limitations for the partnership. Transpac Drilling Venture 1982-12 v. Commissioner, 98-2 U.S.T.C ¶50,517 (2d Cir. 6/26/98). Tax matters partners lost their authority to bind the partnerships (and thereby to
extend the statute of limitations) when they became targets of a criminal tax investigation because they
"labored under a conflict of interest."

5. Greenberg Brothers Partnership #4 v. Commissioner, 111 T.C. No. 7 (8/24/98). Some partners of a TEFRA partnership entered into settlement agreements providing for (1) no change to partnership items, (2) deductibility by partners of passed-through losses only up to their at-risk amounts, and (3) treatment of their capital accounts as their at-risk amounts. Other partners sought consistent treatment with respect to partnership items pursuant to §6224(c)(2), but wanted to be free to relitigate the applicability of the at-risk rules. The Commissioner argued that under Temp. Reg. 301.6224(c)-3T(a) and (b) the consistent settlement rule did not apply because the settlements were not "self-contained," i.e. the settlement of partnership items was interrelated with the settlement of nonpartnership items [including the at-risk amounts]. The court upheld the validity and application of Temp. Reg. 301.6224(c)-3T(a) and (b).

B. Miscellaneous

1. REG-105162-97, proposed amendments to the check-the-box regulations (62 F.R. 55768, 10/28/97). Describes how some entities will be treated for federal income tax purposes once they elect to change their classification.

2. Rev. Rul. 97-38, 1997-38 I.R.B. 14 (9/22/97). When a partner is treated as having a limited deficit restoration obligation by reason of the partner's liability to the partnership's creditors, the amount of that obligation is the amount of money that the partner would be required to contribute to the partnership to satisfy partnership liabilities if all partnership property were sold for the amount of the partnership's book basis in the property.

3. Interhotel Co. v. Commissioner, T.C. Memo. 1997-449 (9/30/97). A partnership agreement that did not provide an obligation to restore negative capital accounts also failed to provide a qualified income offset as required by Reg. §1.704-1(b)(2)(ii)(d). As a result the allocations of losses under the partnership agreement were not respected and for the year in question the losses were allocated in accordance with the partners' interests in the partnership. Because the partnership agreement provided for capital accounts and required liquidating distributions only to partners with positive capital accounts, the hypothetical liquidation test of Reg. 11.704-1(b)(3)(iii) applied. Accordingly, all of the losses were allocated to the only partners with a positive capital account. On applying the this test, for purposes of adjusting the partners capital accounts, a minimum gain chargeback of lower tier partnership's was not triggered, because lower tier partnerships are not treated as hypothetically liquidating.

4. *Just think what the amortization deductions would have been if they'd won the Super Bowl in 1984, before the sale, instead of waiting until this year. (John Elway was worth $5,337,500!) The §1056 limits on transferred basis in player contracts do not apply to the purchase of an interest in a partnership that owns a professional sports franchise. The sale of a partnership interest, resulting in a §708(b) constructive termination, does not [under §§743 and 732(d), in the absence of a §754 election] affect the basis of partnership property. P.D.B. Sports, Ltd. v. Commissioner, 109 T.C. No. 20 (12/22/97). In 1984 Patrick Bowlen purchased more than 50 percent of the interests in a partnership that operated the Denver Broncos NFL franchise. Under §708(b)(1)(B), for tax purposes the old partnership dissolved and a new partnership was reconstituted. No §754 election was in effect, but Bowlen applied the automatic basis adjustment rules §732(d) to step-up the basis of player contracts. (The seller was a Canadian resident, whose tax returns were not in the record and did not testify, so there was no evidence regarding whether the seller reported any gain (including §1245 recapture) with respect to the player contracts.) The Commissioner argued that §1056 applied and that no step-up in basis of the player contracts was allowed, that a carryover basis was required. The court held that §1056 does not apply unless the contracts themselves are sold, and in this case involved the purchase of a partnership, noting that unlike §1060(d), which specifically requires the application of §1060 when applying the basis adjustment rules of §755 after the sale and purchase of a partnership interest, nothing in §1056 provides for its application upon the sale of a partnership interest. Nor, because of the aggregate theory of partnerships reflected in §§731 and 732, was the deemed liquidation and reconstitution to a new partnership under §708(b)(1)(B) a "sale or exchange" within the meaning of §1056. The step-up in basis and consequently larger amortization deductions thus were allowed.

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5. REG-209682-94, proposed regulations relating to: (1) the optional adjustments to the basis of partnership property following §743 transfers of partnership interests, (2) the calculation of gain or loss under §751(a) following the sale or exchange of a partnership interest, (3) the allocation of basis adjustments among partnership interests under §755, (4) the allocation of a partner's basis in its partnership interest to properties distributed to the partner by the partnership under §732(c), and (5) the computation of a partner's proportionate share of the adjusted basis of depreciable property under §1017 (63 F.R. 4408, 1/29/98).

- The Proposed Regulations would extensively alter the computation of optional partnership inside basis adjustments under §§734(b), 743(b), and 755. They Proposed Regulations permit offsetting positive and negative adjustments to different classes of assets under §743(b), as well as adjustments under §734(b) that increase the difference between fair market value and basis, and provide detailed rules for post-adjustment depreciation.

6. Goudas v. Commissioner, 98-1 U.S.T.C. ¶50,217 (6th Cir. 2/23/98). Court rejects attempted recharacterization of a transaction that took the form of a partnership sale of a shopping mall to another partnership, as a "part-sale/part-distribution" to the taxpayer, followed by a capital contribution to the transferee partnership.

X. PERSONAL AND INDIVIDUAL INCOME AND DEDUCTIONS

A. Deductions and Credits

1. *The AMT trap for attorneys' fees on large recoveries. Dye v. United States, 97-2 U.S.T.C. ¶50,592 (10th Cir. 8/8/97). Taxpayer's stockbroker mismanaged her investment account. Taxpayer sued the broker under §10(b) of the Securities Act of 1933 and in a settlement received damages partly attributable to recovery of previously deducted interest on her margin account and lost dividend and interest income, and partly attributable to recovery of lost investment in capital assets. She paid her lawyers a contingent fee. Taxpayer (on her 1989 return) reported the recovery as capital gain and the legal fees as capital expenses. As a result, she claimed capital loss carryovers and avoided disallowance of a deduction for §212 expenses in computing AMT liability. Held, her recovery was ordinary income to the extent it compensated taxpayer for previously-deducted interest, and lawyers' fees attributable to ordinary income were miscellaneous itemized deductions [subject to the AMT trap]; the lawyers' fees attributable to capital gain were capital expenses.

2. *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 $151,000 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.1995).

- 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 plaintiffs 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.

3. AMT applies to individual with gross income under $50,000. Holly v. Commissioner, T.C. Memo. 1998-55 (2/10/98). Taxpayer with gross income under $50,000 was subject to the AMT despite his argument that the AMT was created to apply only to higher income taxpayers.
4. Another case of gross income taxation. Purdey v. United States, 97-2 U.S.T.C. ¶50,894 (Fed. Cl. 10/31/97). If an activity is subject to §183 because the taxpayer does not have a profit seeking motive, any deductions that are allowed under §183(b) are miscellaneous itemized deductions. Thus, they may not be taken into account in computing AGI or in calculating the alternative minimum taxable income.

5. *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. Klaasen 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 AMTI], a taxpayer with none of the preference items listed in §67 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.

   a. 1997 Act §302 adds new Code §408A to allow individuals to contribute to a specially-designated "backloaded" IRA. Contributions are not deductible, but qualified distributions are tax-free. Two limitations: (a) total IRA contributions may not exceed $2,000 per year for each spouse, and (b) AGI phaseout ranges for single taxpayers are $95,000-110,000 and for joint filers, $150,000-160,000.

- Taxpayers are permitted to "roll over" existing IRAs in years where AGI does not exceed $100,000. The converted amount is includable in income, but is not included for purposes of the $100,000 limitation.


   c. 1998 Act §7004 amends Code §408A(c)(3)(C)(i) to provide that the AGI in the $100,000 limitation on taxable conversions from existing IRAs to Roth IRAs is to be computed without regard to the income from minimum required distributions (in addition to not including the amount converted in AGI). Effective to tax years beginning after 12/31/04. The 4-year spread of income from conversion is no longer mandatory.

- Therefore, while AGI for the $100,000 test includes contributions to an existing IRA, it does not include either the "converted amount" or (after 2004) "mandatory distributions."

   d. 1998 Act also includes an election to undo the IRA conversion by the due date (including extensions) of the tax return for the year of conversion. This would permit a look-back at the investment markets.

   e. 1998 Act §6005(b) (technical corrections) amends Code §408A to provide that the §72(t) penalty provisions would be applicable to withdrawals from Roth IRAs during their first 5 years of existence. The penalty even applies to taxpayers over 59-1/2 if the Roth IRA fails to meet the 5-year test. This closes the loophole that permitted taxpayers to roll over existing IRAs to backloaded "Roth" IRAs, and then immediately make a withdrawal. Before the 1998 Act, this would have permitted withdrawals from IRAs without incurring the §72(t) ten percent penalty for premature withdrawals.
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.

7. Sengpiehl v. Commissioner, T.C. Memo. 1998-23 (1/20/98). Taxpayer was a lawyer who worked exclusively from his home. He carried the burden of proof that his living room was used exclusively as a conference room for his legal practice, even though it contained a piano, because taxpayer’s testimony that he and his wife “usually did not entertain at home,” their children “never had guests,” and they used only the bedrooms, kitchen, bathroom, hallway, and occasionally the dining room for personal purposes was credible. No deduction was allowed for the dining room, however, because although it was used exclusively for legal practice during working hours, it was occasionally used for family meals after working hours.

8. Lenn v. Commissioner, T.C. Memo. 1998-85 (2/26/98). Taxpayer incurred attorney’s fees in an unsuccessful suit against a school board under the Individuals with Disabilities Education Act to attempt to compel the school district to pay expenses for taxpayer’s learning disabled son to attend a private residential school for the learning disabled. The court denied a medical expense deduction for the attorney’s fees, even though the cost of the school itself was a deductible medical expense. The legal fees were not proximately related to medical care received at the school because the expenses were not incurred to legitimate treatment but to attempt to avoid the financial burden of bearing the expense.

9. *As the original astronauts used to ask each other, “Are you a turtle?”* Henderson v. Commissioner, 143 F.3d 497, 98-1 U.S.T.C. ¶50,375 (9th Cir. 4/29/98) (2-1). Taxpayer was a stage hand for a travelling show [Walt Disney’s World of Ice] for about 9 to 10 months of the year, spending about two to three months at his parents’ home in Boise (where he maintained all his residence-type personal contacts, i.e., dog, bank account, voter registration, etc.). His employment was on a tour by tour basis at locations outside Boise; he looked for employment in Boise, but was employed for only one night as a stage hand for a ZZ Top concert. Held, taxpayer has no tax home [for §162(a)(2) traveling expense purposes] if he continuously travels and does not maintain a permanent home for some business reason, following Hantzis v. Commissioner, 638 F.2d 248 (1st Cir. 1981) (law student with summer job in New York had no business reason to maintain a home in Boston, where taxpayer lived with her husband), and James v. United States, 308 F.2d 204 (9th Cir. 1962) (lack of continuing expenses while taxpayer was on the road). The majority opinion did reject as unnecessary James’s emphasis on lack of duplication of expenses.

- Query whether the majority is retaining the duplication of expenses test.
- Judge Kozinski dissented, noting that taxpayer was not on the road 365 days per year and did have a permanent home, and – unlike James – was not a “tax turtle.” He distinguished Hantzis because Henderson’s job had no fixed location and he – unlike Hantzis – could not have avoided the travel expenses by moving closer to his work. Judge Kozinski further noted, “That his home happens to be owned by his parents makes it no less his home,” and concluded, “In the name of family values, I respectfully dissent.”

10. Smith v. Commissioner, T.C. Memo. 1998-166 (5/6/98). Taxpayer not entitled to alimony deduction for payment of ex-wife’s attorney’s fees because the debt would survive the ex-wife’s death, i.e., would not be extinguished on her death. Taxpayer contended that the question is whether the payment was for a “period after the death of the payee spouse.”

11. Is the EITC welfare or is it a tax refund? It matters in bankruptcy. In re Montgomery, 98-1 U.S.T.C. ¶50,389, 81 A.F.T.R.2d 1649 (B.A.P. 10th Cir. 4/21/98). As result of the advance availability of the EIC under §3507, even if a taxpayer does not claim advance credits under that provision, a refund attributable to the taxpayer’s EIC upon filing a tax return can become part of the taxpayer’s bankruptcy estate for the portion of the year to which the EIC relates that was prior to the date the taxpayer filed for bankruptcy.
Some courts, however, have held that the taxpayer’s EIC is exempted from the bankruptcy estate by state law “support” payment exclusions incorporated into the Bankruptcy Code by 11 U.S.C. §522(b)(2)(A) in “opt-out” states, see, e.g., In re Brown, 81 A.F.T.R.2d 1978 (Bankr. W.D. Ky. 1995), while others have found no such exclusion, see, e.g., In re Goertz, 81 A.F.T.R.2d 1873 (Bankr. W.D. Mo. 1996).

12. 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.”

B. Miscellaneous Income

1. Goeden v. Commissioner, T.C. Memo. 1998-18 (1/14/98). Taxpayer was fired from his position as the president of a credit union, with Board of Directors charging him with mismanagement. Taxpayer threatened to sue for defamation and age discrimination, and received a severance settlement. He originally reported that 25 percent of the payments were taxable and 75 percent were excluded under §104(a)(2) [as in effect before limited to physical injury]. He later filed amended returns, claiming that the full amount was excludable. The Commissioner took the position that the full amount was includable. Taxpayer presented testimony of members of the Board of Directors of his former employer (and taxpayer’s attorney) about the negotiation of the employment severance package; the Commissioner relied entirely on a burden of proof argument.

- The court held that 40 percent of settlement was includable as received for potential age discrimination claims and 60 percent was excludable under §104(a)(2), as received for potential defamation and other personal injury claims.
- The Commissioner’s attempt to apply negligence and substantial underpayment penalties was rejected because the taxpayer had substantial authority for his position when the returns were filed (before Schleier was decided) and he reasonably relied on KPMG Peat- Marwick in characterizing the receipts on his returns.

2. Section 104(a)(2) litigation will never cease, no matter how many clarifying amendments Congress enacts. Rozpad v. Commissioner, 154 F.3d 1, 98-2 U.S.T.C. ¶50,692, 82 A.F.T.R.2d 5840 (1st Cir. 8/25/98). Taxpayer was awarded a judgment for $963,250 in a medical malpractice action. The judgment consisted of compensatory damages of $650,000 and prejudgment interest of $250,250. Pending appeal, the suit was settled for an unapportioned sum of $800,000. (Another taxpayer's joined case involved similar facts). Neither taxpayer reported any income, and the Commissioner asserted that the settlements in part represented taxable prejudgment interest. The court applied its earlier holding in Delaney v. Commissioner, 99 F.3d 20 (1996), to hold that since the claim had been reduced to a judgment including interest, even though it was not a final judgment, there was a reasonable guideline for allocating the judgment (proportionately) between compensatory damages and prejudgment interest. The court then held that since under the relevant state law prejudgment interest was awarded in all cases, not just personal injury cases, the prejudgment interest was not “damages” and was not awarded “on account of personal injury” and thus was not excludable under §104(a)(2).

3. Waterman v. Commissioner, 110 T.C. No. 9 (2/9/98). Severance pay received by 14-year Navy enlisted man who was, at the time of receipt, in a combat zone was not excludable from gross income under §112. The Commissioner conceded that severance pay was excludable to the extent of
an apportioned amount based on the time taxpayer served in a combat zone over his total time served. Judge Gerber disagreed, holding that the severance pay did not relate to earlier service, but instead was compensation for taxpayer's agreeing to early separation from the Navy.

4. **Godfrey v. Commissioner,** T.C. Memo. 1998-51 (2/9/98). Former newspaper delivery boy whose college tuition was paid by the newspaper was not entitled to a §74(b) exclusion from gross income for a prize that is transferred to a charitable institution. Congress did not intend to characterize tuition payments as transfers to a charitable institution. It wasn't a §74(b) award either.

5. **Even the good must render unto Caesar.** Adams v. Commissioner, 110 T.C. No. 13 (3/3/98). The taxpayer was a devout Quaker, whose religious convictions dictated that she not participate directly or indirectly in military activities. On the basis of her religious beliefs, she claimed that the Religious Freedom Restoration Act exempted her from the obligation to pay federal income taxes because federal income taxes fund the military and her religious tenets therefore prohibited the payment of income taxes. The Tax Court found United States v. Lee, 455 U.S. 252 (1982) (requiring the Amish to pay social security taxes) to be controlling notwithstanding the subsequent enactment of the Religious Freedom Restoration Act and sustained the deficiency and penalties for failure to file and failure to pay estimated taxes assessed by the Commissioner.

6. **Wallace v. United States,** 98-1 U.S.T.C. ¶50,513 (7th Cir. 4/6/98). Affirms summary judgment, holding that NFL football player's receipt of injury compensation under collective bargaining agreement was not eligible for exclusion under §104(a)(1) (amounts received under workmen's compensation acts as compensation for personal injuries or sickness).

7. **Stanley v. United States,** 98-1 U.S.T.C. ¶50,325 (10th Cir. 4/9/98). Reverses summary judgment, holding that there is a fact issue as to whether firefighters' and police officers' disability statutory provisions are in the nature of workmen's compensation [in that they are limited to work-related injuries].

8. **Payne v. Commissioner,** T.C. Memo. 1998-227 (6/19/98). When a guarantor is released from liability, the guarantor does not realize discharge of indebtedness income because the guarantor has not received any previously untaxed accretion to wealth that otherwise would go untaxed.

**XI. PROCEDURE, PENALTIES AND PROSECUTIONS**

A. **Penalties and Prosecutions**

1. **Finley v. United States,** 97-2 U.S.T.C. ¶50,613 (10th Cir. 8/20/97). Reverses district court grant of judgment to the government, notwithstanding a verdict in favor of Mr. Johnson on §6672 liability for unpaid withholding taxes. The Tenth Circuit held that the jury should have the opportunity to decide whether §6672 “willful” conduct can be negated by showing that “the responsible person had reasonable cause for failing to pay withholding taxes held in trust for the government.” The government contended that Mr. Johnson was liable because when he learned that the withholding taxes had not been paid, he directed Mr. Finley to pay them (which he subsequently learned [when it was too late] was not done). Also involved was the corporation's bank's offsetting about $100,000 of collected funds delivered to it with directions to pay the withholding tax liability.

2. **Carlson v. United States,** 97-2-U.S.T.C. ¶50,702 (7th Cir. 9/23/97). Having schizophrenic child does not excuse failure of Chicago attorney and his wife from penalties for their failure to pay $154,000 of income taxes for three years.

3. **United States v. Tenzer,** 97-2 U.S.T.C. ¶50,689 (2d Cir. 9/19/97). Dismissal of failure-to-file indictment of an experienced Long Island tax attorney was reversed. Judge Miner held that defendant was not entitled to the benefit of the IRS “voluntary disclosure” policy because he had not paid his taxes or made “bona fide arrangements to pay.” Moral: don’t be too cute because that can adversely impact a voluntary disclosure; that policy requires taxpayer to be currently compliant and to have made a reasonable offer as to past unsatisfied taxes.

4. **Legal fees awarded on penalty issue because of prior IRS leeway to cash method contractors.** Galedridge Construction Co. v. Commissioner, T.C. Memo. 1997-485 (10/28/97). Attorney’s fees were awarded to the taxpayer with respect to litigation of the substantial understatement.
penalty asserted by the IRS, but not with respect to substantive issue; the Commissioner position on the substantive issue was not unreasonable, but taxpayer had substantial authority to support its return position. IRS not substantially justified in determining a former §6661 penalty because the IRS permitted contractors to account for construction materials as supplies until the early 1990s.

a. Galedrige Construction Inc. v. Commissioner, T.C. Memo. 1997-240 (5/22/97). Paving contractor not required to change to the accrual method because, under all the facts and circumstances, it had no “merchandise” for sale that would require it to account for inventory on the accrual method. The circumstances of emulsified asphalt are that it remained in a usable softened state for no more than five hours, so that it had to be discarded at the end of each day. The court distinguished several other cases where taxpayers had no year-end inventory because of their ability to return items to the seller for credit. Taxpayer was not required to show that income as reported on cash method was substantially identical to income that would have been reported on the accrual method.

5. *The Fifth Circuit extends its penalty-free zone from “lunchpails” to heiresses. Streber v. Commissioner, 138 F.3d 216, 98-1 U.S.T.C. ¶50,333 (5th Cir. 4/15/98) (2-1). The majority held that negligence and substantial understatement penalties should not be applied against two young women who were beneficiaries of an interest in undeveloped real property held by their father. The father arranged a sale, taking back notes payable to the daughters. The daughters ultimately had to sue to collect the notes. Upon collection of $1.7 million each, the daughters sought tax advice from Lake Charles (Louisiana) lawyer Edwin Hunter as to the proper reporting of the transaction. Hunter allegedly advised the daughters that they had two tax alternatives -- (1) pay tax on the gain or (2) not report and pay tax on the gain at all [by treating the transactions as a sale by the father and a gift by him of the net proceeds], a notion that would require the father to pay income tax and a gift tax. The attorney may not have ranked these alternatives. The second alternative, of course, from a net revenue perspective, was far more tax costly -- at least to the father. The daughters chose the latter, without making any return disclosure. Apparently, sometime after filing, the daughters, assisted by their attorney, reported to the IRS that the father had failed to pay the resulting taxes, apparently motivated by spite toward their father and the hope of the IRS's financial reward. The IRS audited the father and the daughters and set up protective positions against the father on the one hand and the daughters on the other. The issue on appeal was whether the daughters were subject to the negligence and the substantial understatement penalties, as the Tax Court had held in connection with its holding that the daughters were required to report and pay tax on the gain.

• Judge Edith Jones, writing for the majority, rejected the Tax Court's suspicions as to the daughters' credibility as to what they had been advised by the attorney, finding that the daughters' uncontradicted testimony was that they had been so advised. Judge Jones then held that, if a tax advisor discusses alternative tax strategies and does not discount or rank the alternatives, the taxpayer may rely upon either alternative without liability for a penalty. As to the substantial understatement penalty, the court found that the alternative upon which they relied was supported by substantial authority, although Judge Jones did not cite any authority, stating instead that the case turned upon a factual issue as to when the gift was made. The majority held, in effect, that so long as there is some evidence going both ways on a factual issue, substantial authority exists, meaning that the IRS abused its discretion in failing to waive the penalty. Attorneys therefore are given some license in the Fifth Circuit to sell penalty insurance as part of their legal services. The case follows Heasley v. Commissioner, 902 F.2d 380 (5th Cir. 1990), which held that “due care does not require moderate-income investors . . . to independently investigate their investments. They may rely on the expertise of their financial advisors and accountants [i.e., the tax shelter salesman and the accountant he recommended]." Apparently the Heasley court intended to limit that type of relief to truly unsophisticated taxpayers. It is unclear whether the daughters in this case fell to the low level of sophistication of the Heasleys.

• Judge King dissented strongly, noting that there was no evidence that the daughters had disclosed to their attorney all the facts underlying the issue of when their father made the gift to them, and further noting that the tax attorney [although present at the trial] did not testify
and that the daughters were suing the tax attorney for malpractice based upon his advice that they were not liable for tax on their gain. She noted that "substantial authority" related to legal authority, and not factual authority.

- In a federal court civil suit against Edwin Hunter, a jury in Austin (Texas) awarded the daughters $18 million in June 1998. The jury award was $2 million in actual damages and $16 million in punitive damages. The daughters contended that Hunter should have advised them to just pay the taxes on the gain.

6. **Multiple indicia of estate tax fraud.** Estate of Trompeter v. Commissioner, T.C. Memo. 1998-35 (1/27/98). Notable coin collector's estate held liable for the §6663(a) fraud penalty where it failed to report certain assets and undervalued other assets accompanied by the following indicia of fraud: (1) the estate's reporting preferred stock at less than one percent of determined value; (2) the estate's reporting gold coins at about 43 percent of determined value by a co-executor keeping secret from the estate tax return preparer a higher appraisal; (3) the co-executors' [decedent's two daughters] keeping secret from the preparer a safe deposit box; (4) the estate's reporting no value for $4.5 million of assets including decedent's gun collection, music collection and various diamonds and other gems; and (5) the co-executors fabricating (and deducting) a $1.4 million claim by the decedent's ex-wife [their mother]. Judge Laro found further indicia of fraud in a co-executor's implausible and inconsistent explanations of her behavior, in the presence of large amounts of unreported assets, and in the failure of the estate to cooperate with the estate tax audit.

   a. "A vigorous, but unsuccessful, attack on a tax fraud penalty usually pays off only for the taxpayer's representatives; for estate tax fraud penalties, it now pays off for the taxpayer as well. Estate of Trompeter v. Commissioner, 111 T.C. No. 2 (7/22/98) (reviewed, 2 judges dissenting). In the Rule 155 computation, estate's fraud penalty underpayment amount is reduced by trustee's fees, attorney's fees and deficiency interest that were incurred after the estate tax return was filed. Judge Laro's majority opinion was based upon the §6663(a) language "any underpayment of tax required to be shown on a return," which was the value of the taxable estate reduced by allowable expenses. In determining the amount of an underpayment of estate tax subject to the fraud penalty, deductions that could have been claimed on the return, using 20/20 hindsight, but which were not claimed, nevertheless should be taken into account to reduce the underpayment. This principle should apply to income tax returns subject to the fraud penalty as well. Judge Laro rejected the line of cases holding that a NOL carryback cannot reduce the amount of an underpayment in the carryback year for penalty purposes because the estate tax is a "one-time charge" computed on the value of the estate, less deductions [some of which are not determined until after the return is filed]."

7. **Second Circuit holds that skimming cash [$400,000] from a closely-held corporation that has no earnings and profits is not criminal tax evasion.** United States v. D'Agostino, 98-1 U.S.T.C ¶50,380 (2d Cir. 4/30/98). Defendants [husband and wife] diverted about $400,000 from amounts collected in commercial laundromats owned by two of their wholly-owned corporations. This was done by exchanging between $2,000 and $4,000 per week for large bills, which were kept in their home. Convictions of tax evasion were reversed because diverted funds did not represent taxable income. Held, that the diverted funds are taxable to recipients only to the extent the corporations had earnings and profits (which they did not, because the amount diverted did not exceed the balance of their opening loan accounts [$560,000] and their capital accounts [$282,000] with the corporations).

   - Query whether the government's stipulation that the corporations had no accumulated earnings and profits was well-advised; was it not possible that, without the skimming, there would have been current earnings and profits?

8. **Notice 98-30, 1998-22 I.R.B. 9 (6/1/98).** Period during which penalty will not be imposed on taxpayers who were first required to make federal tax deposits electronically on or after 7/1/97 is further extended through 12/31/98.

9. **Lemishow v. Commissioner, 110 T.C. No. 26 (6/2/98).** On Rule 155 computation of the negligence payment, the Commissioner properly calculated the total underpayment, then calculated
the underpayment excluding the “negligent” income, and imposed the penalty on the difference. (Taxpayer had calculated the underpayment by adding the “negligent” income to the reported income.) Reg. § 1.6664-3 was upheld as a reasonable construction of the statutory provision applying the penalty to the portion of the underpayment attributable to negligence. See V., above, for the original case Lemishow v. Commissioner, 110 T.C. No. 11 (2/18/98). (The depositing of stock [purchased with Keogh and IRA cash distributions] into a new IRA did not qualify as a taxfree rollover.)

10. United States v. Minneman, 98-1 U.S.T.C. §50,347, 81 A.F.T.R.2d 1544 (7th Cir. 4/17/98). The taxpayer and his lawyer were convicted under 18 U.S.C. §371 of conspiracy to commit tax fraud. Because of the conviction under Title 18 of the United States Code, under the Victim and Witness Protection Act (which does not apply to offences under the IRC), the court ordered restitution, i.e., payment of the taxes fraudulently evaded (under 18 USC §§3663, 3664, which were applicable by virtue of 18 USC 2248), as part of the sentence. The IRS qualifies as a “victim” under the VWPA.

11. And she didn’t even know either Linda Tripp or Monica Lewinsky! United States v. Romer, 82 A.F.T.F.2d 5123, 1998 U.S. App. LEXIS 13468 (4th Cir. 6/24/98). The defendant was a real estate speculator who was convicted of violating the Sherman Antitrust Act, bank fraud, and conspiracy to commit tax fraud in connection with a scheme to rig bids at public real estate foreclosure auctions. One of her co-conspirators, who turned government informant, was wired during some of the coconspirators’ meetings. The defendant said on tape at one of those meetings, “You can’t report it on your taxes ... we don’t want any check writing between us ... if we get caught by the IRS, we’ll be dead.” Her conviction for tax fraud was upheld because the tape provided sufficient evidence of a conspiracy to evade taxes.

12. *If he had said that he was investigating to determine whether she had concealed a contraband Cuban cigar on her person, that evidence might have been suppressed. United States v. Nolan-Cooper, 98-2 U.S.T.C. §50 __, 1998 U.S. App. LEXIS 21403 (3d Cir. 9/2/98). Undercover [sic] IRS agent, posing as a wealthy Louisiana drug dealer, had sexual intercourse on one occasion with the target of his investigation, a Philadelphia lawyer who "laundered" money for him. Held, this single encounter -- occurring as it did one month before the end of a 13-month investigation, when the evidence against the target had been largely gathered -- did not constitute "outrageous government misconduct." The court concluded that the single instance of sexual conduct did not serve any investigatory purpose and that it was unrelated to any evidence-gathering, but noted that the result might have been different had the sexual intercourse been part of the evidence-gathering process.

13. IRS Restructuring Act of 1998
   a. 1998 Act §3303 adds new Code §6651(h) to mitigate for individual taxpayers the “failure to pay” penalty [from 0.5 percent to 0.25 percent per month] during periods during which an installment agreement under §6159 is in effect for the payment of such tax. The installment agreement may not be an informal oral agreement. Effective in 2000, i.e., for months beginning after 12/31/99.
   b. 1998 Act §3304 amends Code §6656 to mitigate the penalty for “failure to deposit” [2 percent to 15 percent, depending on how late the deposit is made] by permitting designation of the period to which a deposit of tax is to be applied, effective for deposits required to be made after 12/31/01. The IRS had tended to apply deposits to the earliest underpayment period, thus triggering penalties for the most recent period. Also, expands the exemption for first-time deposits, effective after 180 days after 7/22/98.
   c. 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.
d. 1998 Act §3306 adds new Code §6751 that requires the written personal approval of the supervisor of the individual making the penalty determination in order for a penalty [including an addition to tax or an additional amount] to be assessed. Inapplicable to §6651 failure to file or failure to pay penalties, §§6654 and 6655 underpayment penalties, and penalties “automatically calculated through electronic means.”

e. IRS prohibited from badmouthing tax protesters. 1998 Act §3707 prohibits the IRS in using the designation “illegal tax protester,” but use of the designation “nonfiler” is allowable. If a nonfiler is compliant for two years, the IRS must remove the designation. Effective on 7/22/98.

14. A district court reacts to §6672 precedent. Unger v. United States, 94-1 U.S.T.C. ¶50,176 (S.D.N.Y. 2/9/94). Section 6672 penalty of more than $1 million was upheld against the then-twenty-eight-year-old chief financial officer of 200-person advertising agency who paid other creditors instead of paying withholding taxes because the coked-up advertising agency CEO, who had hired him seven years earlier as a $10,000 assistant to the controller, so directed him. The court held the result was required by Hochstein v. United States, 900 F.2d 543, 90-1 U.S.T.C. ¶50,205 (2d Cir. 1990), although it agreed that "personal liability for such a sum is a very harsh penalty for a person who essentially acted as a cabin boy on a sinking ship." Hochstein had held that it was sufficient for liability that the individual have significant control over the disbursement of funds, and that his belief that he lacked authority to sign checks to the government without the CEO's consent was irrelevant. Judge Knapp lamented his inability to adopt the dissent in Hochstein and stated, "[s]o far as we can determine, the only course open to [Unger] is to migrate to some more civilized country and try to start life over again."

a. On review by Second Circuit. United States v. Landau, 98-2 U.S.T.C. ¶50,667 (2d Cir. 8/25/98). Robert Landau was president, CEO, and sole owner of Robert Landau Associates Inc. (RLA). He controlled every aspect of RLA's activities. Nathan Unger was RLA's senior vice president and CFO. Unger was hired fresh from college in 1978; he became RLA's controller in late 1983 and resigned at the end of 1989. Unger signed checks, hired and fired employees, and executed agreements on RLA's behalf, but only as directed by Landau. RLA failed to pay its withholding taxes during 1984, and the IRS assessed §6672 penalties against both men. The district court granted the government summary judgment but later suggested that Unger file a motion to reconsider in light of United States v. Rem, 38 F.3d 634 (2d Cir. 1994). A jury then found in favor of the government, but the district court granted Unger's motion to have the verdict set aside. The court found that Unger honestly and reasonably believed that Landau's orders limited his authority; thus, he had technical authority but no actual authority. On appeal, Judge Parker noted that there was no dispute that Unger acted willfully in failing to pay the taxes because, by his own admission, he knew that the taxes were not being paid and that other creditors were being preferred. Therefore, the only question was responsibility. Judge Parker compared this case with Rem, in which Rem also asserted that he had only "technical authority." There, the Second Circuit concluded that the factual issue as to whether Rem had actual control over the company's finances was to be left to the jury. The jury did decide that question and concluded that Unger possessed actual authority. The appeals court ruled that the district court erred in setting that verdict aside, because the lower court failed to consider the evidence in the light most favorable to the government. Judge Parker pointed to testimonial evidence that Unger did in fact make decisions regarding whether to pay certain bills. From evidence like that, the appeals court held, "the jury could reasonably have drawn an inference . . . that Unger did in fact exercise significant control over [RLA's] finances." . The Second Circuit remanded for a ruling on Unger's motion for a new trial.

- Landau, who was president of a corporation that failed to pay over employment taxes and employee withholding, claimed that his failure was not willful because it was caused by a debilitating cocaine addiction. The jury returned a verdict in his favor but the trial court set aside the verdict and entered judgment as a matter of law for the government. The Court of Appeals affirmed, holding that voluntary intoxication though addictive drug use is not a defense to §6672 liability.
The court reasoned that §6672 does not require specific intent and voluntary intoxication does not preclude a finding that nonpayment was "willful."

15. **Estate of Kluener v. Commissioner,** 98-2 U.S.T.C. ¶50,712, 82 A.F.T.R.2d 6151 (6th Cir. 9/9/98). The trial court's decision regarding the application of a substantial underpayment penalty under §6662 is subject to *de novo* review regarding whether or not there was substantial authority for the taxpayer's position. Where the case turns on factual issues -- i.e., in this case whether the transfer of property to a controlled corporation in a putative §351 transaction had a valid business purpose -- there is substantial authority for the taxpayer's position if there is "considerable factual evidence ... substantial in relation to the contrary evidence" that supports the taxpayer's characterization of the transaction.

B. **Discovery: Summonses and FOIA**

1. **Tax Preparation Software**
   a. *Copyright protection does not trump the IRS summons power.* **United States v. Norwest Corp.**, 97-2 U.S.T.C. ¶50,510 (8th Cir. 6/26/97). The court enforced an IRS summons seeking production by taxpayer of Arthur Anderson's "Tax Director" software program, which was used by the taxpayer, under license, to prepare its tax return that was under audit. The court rejected taxpayer's argument that the program was not "books, records, paper, or other data," which are the subject of summons under §7602. Arthur Anderson's copyright did not protect software from summons; the Copyright Act does not "trump" the Internal Revenue Code. The opinion also noted that the district court provided limitations to protect Arthur Andersen's proprietary interest in Tax Director.
   b. *Retention of, and IRS access to, taxpayer records maintained in automatic data processing (i.e., computer) systems.** **Rev. Proc. 98-25,** 1998-11 I.R.B. 17 (2/26/98). Specifies the basic §6001 requirements that the IRS considers essential where taxpayers maintain records within Automatic Data Processing systems, i.e., on computers. Includes a requirement that taxpayer must provide such of its ADP resources to the IRS during examination as are necessary to process the taxpayer's machine-sensible books and records, including any computer programs [which may not be subject to any contract that would limit or restrict IRS access to the computer program, including hardware, etc.]. Also contains record retention provisions.
   c. **United States v. Caltex Petroleum Corp.**, 81 A.F.T.R.2d 1798 (N.D. Tex. 4/16/98). Taxpayer used the ITMS/FTMS computer program designed by Price Waterhouse (and later sold to CLR) to calculate its foreign tax credits. The IRS issued a summons to the taxpayer for an executable copy of the software and issued a summons to Price Waterhouse and CLR for the "source code." IRS reports indicated that if it found "bugs" in the program, all taxpayers using the program might be audited. None of the summonses were honored and the IRS sought enforcement. The district court held that the computer program and the source code were "other data" specific to the taxpayer's tax return and thereby subject to summons. But, on the taxpayer's motion to quash, the summons was not enforced because the IRS issued it for improper purpose. The evidence indicated that IRS did not need source code to audit Caltex -- it had its own software for calculating the foreign tax credit, licensed to the IRS by CLR but which it refused to use -- but was using the summons as a test case in an effort to establish its right of access to all tax return preparation software source codes.
   d. *More on hiding the ball from the IRS: Protection of software trade secrets.* **1998 Act** §3413 adds new Code §7612 to prohibit the IRS from requiring that any tax-related computer software source code be produced or analyzed. Inapplicable to software not produced for commercial distribution or to communications between the owner of the software and the taxpayer. The IRS may obtain particular portions of computer software source code if: (1) it determines the impossibility of ascertaining otherwise the correctness of any item on the return, (2) it identifies with specificity the portion of source code needed to ascertain the correctness of such item, and (3) it determines that the need for such portion of source code outweighs the risks of unauthorized disclosure of trade secrets. Alternatively, the first two requirements are met if (a) it is not feasible to determine the correctness of an item without the computer software executable code and associated data, (b) the IRS makes a request for such executable code, and (c) the executable code and associated data is not provided within 180 days of the formal IRS request.
New Code §7612(c) provides that any software provided to the IRS is to be treated as tax return information to ensure protection of trade secrets and other confidential information.

Software needed for §6111 registration requirements for corporate confidential tax shelters must be provided without regard to new Code §7612.

Rev. Proc. 98-25 [relating to required records] will have to be modified in light of this provision.

2. TAX NOTES continues to give you access to more information that you ever can possibly process. Tax Analysts v. IRS, 97-2 U.S.T.C. ¶50,529, 80 A.F.T.R.2d 5152 (D.C. Cir. 7/8/97), aff'g and remanding 96-1 U.S.T.C. ¶50,205 (D. D.C. 1996). Affirms district order that no blanket exemption under §6103 applies to IRS field service advice memorandums. Under §552(a) of FOIA, field service advice memoranda (FSAs) issued by the Office of Chief Counsel are subject to disclosure after information that might identify the taxpayer with respect to whom the FSA was issued has been redacted. FOIA provides no blanket exemption for FSAs. The court analogized the FSAs to GCMs and Technical Advice Memoranda, and held that the attorney client privilege did not apply because the FSAs were statements of policy and interpretation adopted by an agency. The Court of Appeals agreed with the district court that and that the FSAs must be released after true return information was redacted, but remanded for consideration of a number of subsidiary issues.

a. If you think there's an “information deficit” of Revenue Rulings, blame Tax Analysts. It has made certain that the IRS is kept busy redacting FSAs. Tax Analysts v. IRS, 81 A.F.T.R.2d 1784 (D. D.C. 5/1/98), on remand from 117 F.3d 607 (D.C. Cir. 1997). The district court dealt with a number of subsidiary issues that remained after the Court of Appeals upheld its holding that FSAs were subject to disclosure after return information had been redacted. First, the standards for determining return information to be redacted from FSAs is the same as the standard for determining return information to be redacted from TAMs. Second, the IRS need not add explanations to make FSAs more understandable in light of redactions. Third, FSAs relating to docketed cases are not exempt in their totality and must be released after redacting return information and “true ... attorney work product.” (FSAs [or portions of FSAs] that related to the scope, direction, or emphasis of audit activity, however, are exempt from disclosure under the attorney-client privilege.) Finally, the 1300FSAs at issue in the case were “reading room material” under §5552(a)(2)(B) of FOIA.

b. 1998 Act §3509 amends Code §6110 to require public disclosure of any Chief Counsel advice in the same manner as private letter rulings and technical advice memorandums.

3. No privilege for cash payor and identity of client. Lefcourt v. United States, 97-2 U.S.T.C. ¶50,648 (2d Cir. 9/10/97). Absent special circumstances, the attorney-client privilege does not excuse the penalty for omitting from the Form 8300 [filed under §60501] the exact amount received and the identity of the payer and the client.

4. Conditional summons enforcement? No way! United States v. Jose, 97-2 U.S.T.C. ¶50,119 (9th Cir. 12/19/97) (en banc). The district court may not conditionally enforce summonses, following United States v. Barrett, 837 F.2d 1341 (5th Cir. 1988) (en banc). The IRS issued the summons for a proper purpose, and could not be restricted from transferring the summoned documents to the Criminal Investigation Division.

Held that, in an administrative summons enforcement proceeding, the district court is limited to enforcing or denying enforcement of the IRS summons. The district court has no power to order conditional enforcement, limiting the use by the IRS of information and documents obtained pursuant to the summons. Here, the district court had improperly required the IRS to give the taxpayer five days notice before transferring the summoned documents to any division, including CID, other than civil examination.

5. Testimonial Privilege

a. Attorney-client privilege does not apply to accounting firm’s tax planning memorandum supplied both to corporation’s VP for taxes [an attorney] and to other
corporate officers. United States v. Adlman, 68 F.3d 1495, 95-2 U.S.T.C. ¶50,579 (2d Cir. 10/26/95, amended 11/1/95). The attorney-client privilege does not apply to a 53-page Arthur Andersen memorandum prepared for Sequa Corporation, which memorandum advised on the form a proposed plan of restructuring should take. The memorandum was written to Sequa’s VP for Taxes [who was a lawyer], but who was “not expert in the highly complex corporate reorganization provisions [of the tax code].”

- The district court found the attorney-client privilege inapplicable to advice from accountants. Sequa contended that Arthur Andersen’s advice came within the privilege under United States v. Kovel, 296 F.2d 918 (2d Cir. 1961), because the advice was rendered to Adlman to assist him in giving legal advice to his client Sequa. However, there were also direct communications between Arthur Andersen and non-lawyer officers of Sequa.

- Further, there was no separate engagement letter for the work embodied in this memorandum, but it was billed together with other work -- clearly unprivileged -- performed by the accounting firm during the same period. The Second Circuit stated that a separate engagement letter was not a requirement, but that the absence of contemporaneous documentation of the Kovel contention supported the district court’s finding.

- The case was remanded for findings as to whether work product doctrine applies, which the district court had held inapplicable because the events giving rise to the anticipated litigation -- i.e., the proposed merger -- had not yet occurred. Judge Leval’s Second Circuit opinion stated that, although the non-occurrence of events giving rise to the anticipated litigation is a factor arguing against applicability of the doctrine [when the expected litigation is “merely a vague abstract possibility without precise form”], the work product doctrine does apply although the events have not yet occurred if the expected litigation is being “immediately contemplated” [when the expected litigation is “quite concrete”].

b. Attorney-client privilege was waived by disclosure to another government agency. United States v. Massachusetts Institute of Technology, 129 F.3d 681, 97-2 U.S.T.C ¶50,955 (1st Cir. 11/25/97). University waived its attorney-client privilege for documents previously disclosed to the Defense Contract Audit Agency pursuant to contracts between MIT and the Defense Department.

c. Attorney-client privilege was waived by placing in issue the character of settled claims. Cleveland Indians Baseball Co. v. United States, 98-1 U.S.T.C. ¶50,197 (N.D. Ohio 1/28/98). Club was required to produce documents in an employment tax refund case [based on whether settlement payments made to free agents were subject to FICA/FUTA taxation], including the “club’s reasons for settling the free agent arbitration,” over claims of (possibly waived) attorney-client privilege and work-product doctrine. Taxpayer had placed at issue “the character of the settled claims” and has waived privilege as to that issue.

d. *On privilege: CPAs got everything they said they wanted to protect taxpayer confidences, except for what they really wanted to protect themselves. IRS Restructuring Act of 1998, §3411, adds new Code §7525 to establish a new limited privilege with respect to “tax advice” for taxpayer communications with a “federally-authorized tax practitioner” (a CPA or enrolled agent or enrolled actuary, “if such practice is subject to Federal regulation under [31 U.S.C. §330]”). The privilege applies only “to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.” The new privilege does not apply to communications regarding corporate tax shelters.

- The limitations on the privilege is that it may only be asserted in a noncriminal tax matter before the IRS and a “noncriminal tax proceeding in Federal court brought by or against the United States.”

- Tax advice is defined as “advice given by an individual with respect to a matter which is within the scope of the individual’s authority to practice as described in [the definition of a ‘federally authorized tax practitioner’].”
Code §7525(b) states that the new privilege is inapplicable to "any written communication between a federally authorized practitioner and a director, shareholder, officer, or employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any [corporate] tax shelter (as defined in section 6662(d)(2)(C)(iii))." [1997 Act §1028 amended Code §§6111 and 6662(d)(2)(C)(iii) by requiring promoters of confidential corporate tax shelters to register and by providing penalties for failure to do so. The definition of "tax shelter" was changed from one where the avoidance or evasion of Federal income taxation was "the principal purpose" of the arrangement to one where tax avoidance or evasion is "a significant purpose." See the discussion of software protection in relationship to confidential corporate tax shelters at XI.B.1., above.]

Section 7525(b) does not in any way affect the existing privilege applicable between lawyers and clients.

6. *Work-product doctrine applies to a document prepared because of anticipated litigation, that is also used to assist in making a business decision and which would not have been prepared in similar form but for the prospect of that litigation. United States v. Adlman, 134 F.3d 1194, 98-1 U.S.T.C. ¶50,230 (2d Cir. 2/13/98) (2-1). On this appeal from the district court's rejection of taxpayer's claim of work-product doctrine, reversed and remanded. Judge Leval, speaking for the majority, held,

[A] document created because of anticipated litigation, which tends to reveal mental impressions, conclusions, opinions or theories concerning the litigation, does not lose work-product protection merely because it is intended to assist in the making of a business decision influenced by the likely outcome of the anticipated litigation, and would not have been prepared in substantially similar form but for the prospect of that litigation, it falls within [Fed. R. Civ. P.] Rule 26(b)(3) [the work-product exception to discovery].

In interpreting Hickman v. Taylor, 329 U.S. 495 (1947), and Rule 26(b)(3) ["in anticipation of litigation"], Judge Leval rejected the requirement that the document be "prepared primarily or exclusively to assist in litigation," in favor of a test that would ask whether the documents were prepared "because of existing or expected litigation." He refused to follow United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982), which applied the "primarily . . . to assist in litigation" test to deny protection to tax reserve work papers.

* Judge Kearse, in dissent, argued that the work-product privilege should not be extended "to afford protection to documents not prepared in anticipation of litigation but instead prepared in order topermit the client to determine whether to undertake a business transaction, where there will be no anticipation of litigation unless the transaction is undertaken."

7. IRS Restructuring Act of 1998
   a. 1998 Act §3412 adds new Code §7602(d), which forbids financial status or economic reality examination techniques to determine the existence of unreported income unless the IRS "has a reasonable indication that there is a likelihood of such unreported income."
   b. 1998 Act §3415 amends Code §7609(a), allowing taxpayer motions to quash all third-party summons.
   c. 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.

C. Litigation Costs
   1. Cozean v. Commissioner, 109 T.C. No. 10 (10/15/97). "Tax expertise" alone is not a special factor warranting attorney's in excess of the statutory hourly cap under §7430. Nor is "limited availability" of tax attorneys a factor unless the particular attorney possessed an additional
special skill with respect to which there was limited availability. Hourly fees for a CPA who is authorized
to represent taxpayers before the IRS and assisted in representation and presentation of the taxpayer’s
case are likewise subject to the statutory ceiling even though the taxpayer also is represented by counsel.

2. Attorney’s fees awarded to two taxicab companies that claimed relief under §530 of the Revenue Act of 1978 against the IRS claim that their drivers were employees. Howard’s Yellow Cabs Inc. v. United States, 98-1 U.S.T.C. ¶50,303 (W.D. N.C 3/19/98); J&J Cab Service Inc. v. United States, 98-1 U.S.T.C. ¶50,360 (W.D. N.C. 3/30/98). The taxicab companies had not filed Forms 1099, but offered to do so in the future. They took the position that they did not make payments to their
drivers. The IRS refusal of the taxicab companies’ offer “lends credence to plaintiff’s allegation that the
IRS targeted it, as a small business, to use as a ‘guinea pig’ to further its own agenda, in spite of the
enactment of Section 530 as a remedy to [or, in J&J Cab, bulwark against] such action.”

3. 1998 Act §3101 amends Code §7430 to increase attorney’s fees from $110 to
$125 per hour, to impose administrative costs from the date of the 30-day letter, to provide fees to CPAs
and enrolled agents, and to provide fees to taxpayer or his employer for pro bono services rendered to
taxpayer.

D. Statutory Notice
1. How do you terminate an unlimited waiver of the statute of limitations that – until it issues the deficiency notice – the IRS claims it never received? Fredericks v. Commissioner, 97-2 U.S.T.C. ¶50,692, 80 A.F.T.R.2d 6412 (3d Cir. 9/11/97). In 1980, taxpayer signed and filed an
unlimited waiver of the statute of limitations for 1977 pursuant to a form 872-A. Subsequently, at the
request of the IRS taxpayer signed a number of Form 872s that extended the limitations period to June 30,
1984. The IRS continually denied having received an unlimited waiver on a Form 872-A, and when the
waiver was discovered, the IRS did not inform the taxpayer. The government was estopped to assert
taxpayer’s unlimited waiver of the statute of limitations pursuant to the form 872-A because the
government capitalized on the taxpayer’s failure to file a Form 872-T, which due to the government’s
action the taxpayer did not realize was necessary to terminate the waiver. Thus, an assessment made in
1992 for 1977 was not timely.

2. Counting to 90 on your fingers is no longer necessary. 1998 Act §3463 amends Code §6213 to require the statutory notice to specify the deadlines for filing a Tax Court petition,
and provides that any petition filed within the deadline specified will be timely. Applicable to notices
mailed after 12/31/98. Cures the problem in Elgart where the IRS gave taxpayer’s attorney the wrong
90th-day date.

a. What is the moral of this case that received a great deal of attention? It is that Tax Court jurisdiction is statutory. Elgart v. Commissioner, T.C. Memo. 1996-379
(8/15/96). Taxpayers mailed their Tax Court petition by certified mail in an envelope bearing a U.S.
postmark date of March 14, 1996. The court dismissed their petition for lack of jurisdiction, rejecting
taxpayers’ argument that their attorney was advised by several IRS employees that the due date for a
petition filed in response to a statutory notice dated December 14, 1995 was March 14, 1996. In fact, the
90-day period expired on March 13th, and that date is jurisdictional so the Commissioner cannot waive it
and jurisdiction cannot be established by estoppel. Taxpayers were relegated to a suit for refund after
payment of the tax.

E. Statute of Limitations
1. Bachner v. Commissioner, 109 T.C. No. 7 (9/24/97). Individual’s refund claim
must be reduced by the amount of his correct tax liability, including penalties, even though the assessment
of the tax and penalties is barred by the statute of limitations.

2. *You can keep pennies from heaven in the Fourth Circuit, but not in the
10/20/97) (2-1). The IRS erroneously refunded over $60,000 to the taxpayer due to an interpretive error
by the IRS. After the period of limitations for filing a suit to recover an erroneous refund under §7405(b),
the IRS issued a supplemental assessment without first issuing a deficiency notice. To prevent property
from levy the taxpayer paid the assessment and sought a refund based on the Commissioner’s failure first
to issue a deficiency notice. The district court held that the payment constituted a waiver of any procedural defect, but the court of appeals held that the repayment of an erroneous refund based on a supplemental assessment by IRS without issuance of a prior deficiency notice does not constitute a waiver of the deficiency procedure and the taxpayer can recover the repayment of the erroneous refund attributable to an IRS error. The opposite result was reached in Rendel v. United States, 80 A.F.T.R.2d 7647 (9th Cir. 1997), aff'g by order 79 A.F.T.R.2d 499 (N.D. Cal. 1996).

3. *Facts so “convoluted” and law so “arcane” that “only a tax lawyer could love.”* Stanley v. United States, 98-1 U.S.T.C ¶50,304, 81 A.F.T.R.2d 1307 (Fed. Cir. 4/2/98), aff’d by order 79 A.F.T.R.2d 499 (N.D. Cal. 1996). A taxpayer who remitted a $630,250 “bond” to stop the payment of interest and penalties when the IRS sought repayment of an erroneous refund of $637,004 based on an IRS assessment without issuance of a deficiency notice has not waived the defective procedure. The court held that the taxpayer did not knowingly voluntarily “repay” the erroneous refund. Thus, the taxpayer could recover the bond payment that was an amount equal to the erroneous refund, even though the amount rightfully belonged to the Treasury, became the IRS did not follow proper procedures in seeking repayment. The Federal Circuit’s holding is consistent with the doctrine that an erroneous refund does not revive an extinguished assessment. See, e.g., Bilzerian v. United States, 86 F.3d 1067 (11th Cir. 1996). The court observed that “despite the convoluted factual history, and the arcane rules regarding reassessments, demands, collections, and so, on that only a tax lawyer could love, the case boils down to a simple proposition: Has the Government proceeded to recover what rightfully belongs to it in a manner authorized by law? The court answered its question: “Our decision awards Stanley a windfall of some $600,000. Though this may seem offensive to many other taxpayers who mostly give but do not receive, that is not a sufficient reason to deny Stanley’s claim.” The taxpayer was not permitted, however, to recover interest, because he had not made any “payment” on which interest runs.

4. IRS Restructuring Act of 1998

a. *Statute of limitations for filing refund claims is suspended during the period an individual taxpayer is “financially disabled.”* 1998 Act §3202 adds new Code §6511(h) to suspend the statute of limitations for filing refund claims during periods of disability, i.e., for taxpayers who are “financially disabled.” An individual is not disabled where a spouse or other person is authorized to act on his behalf. Retroactive effectiveness, but this provision will not revive any claim barred as of 7/22/98.

To qualify, the individual must be “unable to manage his financial affairs by reason of a medically determinable physical or mental impairment of the individual which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.”

This legislatively changes the result of United States v. Brockamp, 117 S. Ct. 849, 97-1 U.S.T.C. ¶50,216 (2/18/97), which held that the statute of limitations is not suspended during periods of disability.

b. 1998 Act §3461(b) amends Code §6501(c)(4) to require notice to taxpayer of right to refuse or limit extensions of the statute of limitations. Effective after 12/31/99.

5. Ott v. United States, 141 F.3d 1306, 98-1 U.S.T.C. ¶50,331, 81 A.F.T.R.2d 1536 (9th Cir. 4/15/98). Taxpayer filed a Form 4868, request for automatic extension of time to file, for his 1986 return on April 9, 1987 and remitted $25,000. The taxpayer failed to file a return within the four month extension period; he filed a return in 1991, requesting refund of $10,100, which the IRS denied as an untimely request for a refund. The court held that the $25,000 payment accompanying the Form 4868 was a tax “payment” as a matter of law. The two year statute of limitations on claiming a refund of the amount began running on April 15th, 1988, not the date on which the return was filed. Gabelman v. Commissioner, 86 F.3d 609 (6th Cir. 1996), followed and Risman v. Commissioner, 100 T.C. 191 (1993) (non-acq.), rejected. Marco v. United States, 98-1 U.S.T.C. ¶50,337, 81 A.F.T.R.2d 1540 (D. Conn.
3/31/98), in contrast, applied the Risman facts and circumstances test and determined that a remittance with a Form 4868 was a payment as a matter of fact, not law.

6. **Union Texas International Corp. v. Commissioner, 110 T.C. No. 25 (5/21/98).** Taxpayer corporation was the successor to the original taxpayer corporation, which had been merged into it during the period of an audit of prior years excise tax (Windfall Profit Tax) returns. After the merger and dissolution of the original taxpayer, Forms 872 [extending the statute of limitations] were executed by and through the merged corporation's former officers, who no longer had actual authority to execute extensions of the statute of limitations. Taxpayer's course of conduct with IRS during audit, including over 25 items of correspondence sent and received in the course of the audit, indicated that the original corporate taxpayer continued in existence, and the IRS acted to its detrimental reliance by not seeking execution of Forms 872 from proper officers. The IRS had no knowledge of the merger and the existence or nonexistence of the old corporation was a question of fact, not law. The taxpayer was equitably estopped from questioning the former officers' authority to extend the statute.

7. **Bresson v. Commissioner, 111 T.C. No. 6 (8/19/98).** Under §6901(c)(1), the statute of limitations on an assessment based on a fraudulent transfer against a transferee of a taxpayer against whom the underlying deficiency was assessed is one year after the three year statute of limitations on the deficiency itself has run. Under the doctrine of United States v. Summerlin, 310 U.S. 414 (1940), state statutes of limitations cannot bar claims by the federal government. Thus, the expiration of a state law statute of limitations under a state fraudulent conveyance law does not bar the government from assessing and recovering taxes from a transferee if the statute of limitations under §6901(c) has not yet run. The majority held that §6901(c) takes precedence over state law statute of limitations regardless of whether state law statute of limitations is procedural or a substantive element of the cause of action. Judge Halperin, in a dissent joined by three other judges, would have held that because under the relevant state fraudulent transfer act (California) failure to make a timely extinguished the substantive right and did not merely bar enforcement that Summerlin did not apply. Both the majority and dissent assumed that the government had to rely on state law to establish that the transfer was fraudulent, see Commissioner v. Stern, 357 U.S. 39 (1958), and ignored the possible application of the Federal Debt Collection Procedures Act, 28 U.S.C. §3001, et. seq.

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. Apportionment of 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.”

2. *The source of an overpayment determines the character of the refund; source was husband’s sole management community property, so he is entitled to the refund. Ragan v. Commissioner, 98-1 U.S.T.C. ¶ 50,209 (5th Cir. 2/17/98). Texas wife was not entitled to one-half of a refund paid to her husband’s bankruptcy estate. The refund was attributable to her husband’s earnings. The court held that “the source of an overpayment of income tax determines the character of the refund,” and that “personal earnings, while community property, are subject to the sole management and control of the spouse who earned them.”

3. T.D. 8723, final regulations relating to the deposit of Federal taxes by electronic funds transfer (“EFT”) (7/14/97). Delays 1/1/97 start-up date to 7/1/97.
   a. Notice 97-43, 1997-30 I.R.B. 9 (7/11/97). The Service will waive the § 6656 failure to deposit by EFT penalty to deposit concluding obligations incurred on or before 12/31/97 by taxpayers first required to make deposits by EFT on or after 7/1/97.
   b. 1997 Act § 931 waives the penalty on small businesses failing to make § 6302(h) electronic transfers of taxes, effective for failures occurring before 7/1/98.

4. New York Life Insurance Co. v. United States, 97-2 U.S.T.C. ¶ 50,569, 80 A.F.T.R.2d 5117 (Fed. Cir. 7/3/97). Filing an administrative refund claim is not a prerequisite for a suit to recover a “deposit” that was not a “payment” of taxes.

5. “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, on Form 1099-B 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.)

• Query whether lawyer is required, in turn, to issue Forms 1099 to his clients? Suppose the client may exclude the recovery under § 104(a)?
   a. FSA 1998-78 (8/25/92). Field Service Advice concluded that I.R.C. section 6041 does not require a creditor to file a Form 1099 reporting cancellation of indebtedness income accruing to debtors with past-due accounts. It is unclear that any blanket solution can be applied prospectively to prevent abuse [sic] filing of Forms 1099 by creditors.” Note, however, § 6050P (reporting requirements for cancellation of indebtedness in the year of discharge) (added in 1996) and § 7434 (civil damages for fraudulent filing of information returns) (also added in 1996).

6. *Consider these regulations before calling your malpractice carrier? Probably not, but . . . T.D. 8742, final regulations §§ 301.9100-1 through -3, providing the procedures
for requesting a retroactive extension of time to make elections (62 F.R. 68167, 12/31/97). These regulations provide for automatic extensions of time to make a wide variety of elections under the Code, as well as standards that will be applied by the Commissioner in granting discretionary extensions of time to make other elections. Reg. §301.9100-2 provides for automatic extensions of up to 12 or 6 months. Reg. §301.9100-3 provides for extensions for a longer period where taxpayer has acted reasonably and in good faith, with six examples. Examples 1 [taxpayer discovers own error], 2 [reliance on qualified professional], and 4 [election not requiring §481(a) adjustment] are favorable to the taxpayer; however, Example 3 [accuracy-related penalty] is unfavorable; and, Examples 5 [election requiring §481(a) adjustment] and 6 [under examination by IRS] are questionable.

7. REG-251502-96, proposed regulations under §7433 relating to civil actions for damages caused by IRS employees, to reflect amendments made by the 1996 Taxpayer Bill of Rights 2 (62 F.R. 68242, 12/31/97).

8. REG-100841-97, proposed regulations under §6159 relating to terminations of installment agreements for payments of tax liabilities (62 F.R. 68241, 12/31/97). Provides a procedure for requesting independent administrative review of an alteration, modification, or termination of an installment agreement.

9. REG-209276-87, proposed regulations under §6404 relating to the abatement of interest attributable to unreasonable errors or delays by an IRS employee in performing a ministerial or managerial act (63 F.R. 1086, 1/8/98). To reflect changes made by the Tax Reform Act of 1986 and TBOR 2. Twelve examples are provided.

10. Bouerkis v. Commissioner, 110 T.C. No. 3 (1/13/98). Section 6404(g) does not confer jurisdiction on the Tax Court to determine interest as part of a deficiency proceeding. Relief under §6404(g) is available only after the Commissioner has issued a notice of a final determination not to abate interest. A deficiency notice, even though the taxpayer has been notified of the amount of interest due, is not a notice of a final determination not to abate interest.

11. Freytag v. Commissioner, 110 T.C. No. 5 (2/5/98). When the bankruptcy automatic stay provision [11 U.S.C. §362(a)] is invoked, the Tax Court is not ousted from jurisdiction; its proceedings are merely stayed while the case is processed by the bankruptcy court, and the period of limitations for assessing the tax is similarly stayed. If, however, the taxpayer’s liability for tax is adjudicated in the bankruptcy proceeding, res judicata bars relitigation in the Tax Court once the stay is lifted.

12. Taxpayer entitled to rely on published ruling. Estate of McLendon v. Commissioner, 98-1 U.S.T.C. ¶60,303 (5th Cir. 3/9/98). Gordon McLendon transferred assets in return for a private annuity at a time he was close to death. Held, the estate could rely on Rev. Rul. 80-80, 1980-1 C.B. 194, which provided that the gift tax actuarial tables should be used “unless the individual is known to have been afflicted, at the time of transfer, with an incurable physical condition that is in such an advanced stage that death is clearly imminent. . . . For example, death is not clearly imminent if the individual may survive for a year or more and if such a possibility is not so remote as to be negligible.” The court stated that the Commissioner consistently defined the phrase “not so remote as to be negligible” to mean “less than 5 percent” in other areas of estate tax. There was evidence that McLendon had a 10 percent chance of surviving for a least a year.

- Holds that under Reg. §601.601(E), taxpayer may rely on published rulings, following Silco, Inc. v. United States, 779 F.2d 282 (5th Cir. 1986), because McLendon “went to great lengths to structure his transaction to comply with applicable law” and relied on Rev. Rul. 80-80.

13. Notice 98-34, 1998-27 I.R.B. 30 (6/18/98), modifying Notice 97-19, 1997-1 C.B. 394. Modified guidance on expatriate tax advance ruling practice, by reason of the difficulty of making an advance determination. Where a substantive ruling is not received, the submission of a ruling request will not subject individuals to the tax avoidance presumption of §§877(a)(2), but will not preclude the IRS from making a later determination based upon the individual’s tax return.
14. United States v. Estate of Romani, 118 S. Ct. 1478, 81 A.F.T.R.2d 1729 (U.S. 4/29/98). A judgment creditor’s perfected lien against property held by a decedent’s estate is superior to a subsequently filed tax lien. The judgement creditor is entitled to be paid out of proceeds from the property ahead of the government, notwithstanding the provisions of 31 USC §3713(a), which generally requires that estates pay debts due to the United States before paying other debts. The Federal Tax Lien Act, which codified §6323, takes precedence over the priority claim statute.

15. IRS Restructuring Act of 1998

a. *Burden of proof shift. 1998 Act §3001 adds new Code §7491, which shifts the burden of proof to the IRS when taxpayer produces in any court “credible evidence with respect to any factual issue.” In order for the burden to be shifted to the IRS, the taxpayer (1) must have complied with substantiation requirements; (2) must have maintained all required records and “[have] cooperated with reasonable requests by [the IRS] for witnesses, information, documents, meetings and interviews”; and (3) if an entity, must fall within the net worth limitations under §7430 (relating to the award of attorney’s fees).

- The Service will have the burden of proof concerning any item of income reconstructed from statistical information on unrelated taxpayers, e.g., the use of BLS statistics to determine a taxpayer’s income. The IRS also has the burden of proof on the imposition of most (non-automatic) penalties.

- Effective for examinations commencing after 7/22/98, or (if there is no examination) to court proceedings arising in connection with taxable periods or events beginning or accruing after 7/22/98.

b. 1998 Act §1001(a)(4) requires the IRS to implement a plan that prohibits “ex parte conversations between appeals officers and other [IRS] employees to the extent that such communications appear to compromise the independence of the appeals officers.”

c. 1998 Act §3102 amends Code §7433 to provide for civil damages of up to $100,000 for negligent unauthorized collection actions, in addition to the existing damages provision of up to $1 million for reckless or intentional collection actions.

d. 1998 Act §3103, amends Code §7463 to increase the dollar limit for the Tax Court small case calendar from $10,000 to $50,000.

e. 1998 Act §3104, amends Code §7422 to give district courts and the Court of Federal Claims jurisdiction over refund claims from estates that have elected installment payments under §6166 and are current in their payments, even though the full tax liability has not been paid.

f. 1998 Act §3105 requires the IRS to amend its administrative procedures to provide an administrative appeal of an adverse determination of the tax-exempt status of a bond issue. Bond issuers had wanted a post-issuance court remedy.

g. Taxpayers will be given a sporting chance to hide their assets. 1998 Act §3401(a) adds new Code §6320, which provides that after a lien is filed, notice must be given to the taxpayer within 5 business days. Act §3401(b) adds new Code §6320, which provides for 30-days notice and opportunity for hearing before a levy may be made [unless a finding is made that collection of tax is in jeopardy]; following an adverse determination at the hearing, there is provision for judicial review by the Tax Court or district court. Effective 180 days after 7/22/98.

h. 1998 Act §3421 contains procedures relating to the approval process for liens, levies and seizures. Effective on 7/22/98.

i. 1998 Act §3432 adds new Code §6343(e) to provide for release of levies on salaries or wages when it is agreed that the underlying tax is uncollectible. This prevents the continuation of the levy when an offer-in-compromise has wiped out the obligation. (Effective for levies made after 12/31/99).

j. 1998 Act §3433 adds new Code §6331(i) to prohibit levies during pendency of refund proceedings or during periods an offer-in-compromise is effective.
k. 1998 Act §3434 amends Code §7429(a)(1) to provide for higher-level IRS approval for jeopardy and termination assessments and jeopardy levies. Written notice to taxpayer of the information upon which IRS relied in making the levy or assessment within 5 days. Effective after 7/22/98.

l. 1998 Act §3445 amends Code §6334 to provide new procedures for seizure of residences and businesses. Approval of a federal judge or magistrate will be needed for seizure of principal residences; personal approval in writing of the district director or the assistant district director for seizure of business assets.

m. 1998 Act §3462(a) adds new Code §7122(c) to require the IRS to provide guidelines for determining whether an offer-in-compromise is adequate. These include schedules of “national and local allowances designed to provide that taxpayers entering into a compromise have an adequate means to provide for basic living expenses.” That provision also mandates that no financial statements may be required where the offer-in-compromise is requested only for reasons of liability. Effective on 7/22/98.

n. 1998 Act §3462(c) adds new Code §7122(d) to provide for administrative review of rejections.

o. 1998 Act §3462(b) adds new Code §6331(k), providing that no levy be made during the period an offer-in-compromise or an installment agreement is pending or in effect. This provision will be effective only after 12/31/99.

p. 1998 Act §3465 adds new Code §7123 to provide alternative dispute resolution procedures, i.e., mediation and arbitration, for taxpayer appeals of examination and collection disputes.

q. 1998 Act §3466 adds new Code §6304 to provide fair tax collection practices, including the prohibition of harassment and abuse. Effective on 7/22/98.

r. 1998 Act §§3501 through 3509 require explanations to taxpayers of various procedures.

s. 1998 Act §3601 adds new Code §7526 to provide funding for low income taxpayer clinics.

t. 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.

u. How recipients of correspondence may get an IRS employee’s number. 1998 Act §3405 provides for designation of a single employee [by name, telephone number, and unique identifying number] for taxpayer to contact at the IRS in dealing with correspondence and notices sent by the IRS.

v. 1998 Act §3711 adds new Code §6402(e) to provide that federal overpayments may be reduced by the amount of past-due, legally enforceable State income tax obligations. Applies to all taxpayers (including corporations), but “only if the address shown on the Federal return ... is an address within the state seeking the offset.” Applicable for funds payable after 12/31/99.

16. *Sixth Circuit holds that Tax Court is not the King's Chancellor because it lacks jurisdiction to apply the doctrine of equitable recoupment. Estate of Mueller v. Commissioner, 153 F.3d 302, 98-2 U.S.T.C. ¶60,325 (6th Cir. 8/20/98). The court held that §6214(b) [prohibition against determining whether taxes in other years or quarters have been overpaid or underpaid – although it may consider facts in relationship with those years or calendar quarters to correctly redetermine the amount of deficiency] and §6512(b) [jurisdiction to determine overpayment of income tax for the same taxable year, of gift tax for the same calendar year or quarter, or of estate tax in respect of the same decedent], taken together, limit the Tax Court’s jurisdiction. The court held that Commissioner v. Gooch Milling &
Elevator Co., 320 U.S. 418 (1943), applies to estate tax cases as well as income tax cases. The Tax Court, had held in Mueller, 101 T.C. 551 (1993), that it had jurisdiction to consider the equitable recoupment claim, but in a later opinion held that the estate could not recover the time barred income tax overpayment because there was no estate tax deficiency. 107 T.C. 189 (1996). If the Sixth Circuit decision in Estate of Mueller is followed, it also would appear to overrule, sub silentio, the Tax Court's decision in Estate of Bartels v. Commissioner, 106 T.C. 430 (1996), which held that equitable recoupment can be applied to offset time-barred overpayment of estate taxes against estate's income tax deficiency because §6214(b) precludes only the redetermination of income taxes for prior years.

* While the Sixth Circuit decision was an affirmation, it was based on the Tax Court's lack of jurisdiction, reversing 101 T.C. 551. The Tax Court subsequently held, 107 T.C. No. 13, that the facts did not support taxpayer's claim for equitable recoupment.

a. It is bull to say that the Tax Court doesn't have equitable recoupment jurisdiction. Estate of Mueller v. Commissioner, 101 T.C. 551 (12/13/93) (reviewed, 13-5). The Tax Court is authorized to apply the doctrine of equitable recoupment, in order "to allow the bar of the expired statutory limitation period to be overcome in limited circumstances in order to prevent inequitable windfalls to either taxpayers or the Government that would otherwise result from inconsistent tax treatment of a single transaction, item, or event affecting the same taxpayer or a significantly related taxpayer," but "equitable recoupment 'operates [as an affirmative defense] only to reduce a taxpayer's timely claim for a refund or to reduce the government's timely claim of deficiency.'" See Bull v. United States, 295 U.S. 247, 35-1 U.S.T.C. ¶9346 (1935). Neither the absence of an express statutory grant of jurisdiction under §7442 nor §§6214(b) or 6512(b) bars the Tax Court from considering the doctrine because it comes within its jurisdiction to redetermine deficiencies. This decision applied to a claim made by taxpayer when, in T.C. Memo. 1992-284, the Tax Court raised the valuation of stock previously sold by the estate on which gain had been reported based upon the lower valuation set forth in the estate tax return.

b. ... but recoupment not allowed when there was no estate tax liability to be offset by the overpayment of income tax on gain from sale of asset whose value was increased by the Tax Court. Estate of Mueller v. Commissioner, 107 T.C. No. 13 (11/5/96) (reviewed, 12-5). Judge Ruwe's majority opinion held that where no additional tax was due from the estate, "there is no liability against which equitable recoupment can be used to defend." Judge Beghe's dissent concluded that a taxpayer's overpayment status is no obstacle to recoupment.

* Note that both the Fifth and Ninth Circuits have held that the Tax Court has equitable powers within its limited jurisdiction. Buchine v. Commissioner, 20 F.3d 173, 94-1 U.S.T.C. ¶50,221 (5th Cir. 5/9/94), affg T.C. Memo. 1992-36. Tax Court did not improperly expand its limited jurisdiction by reforming a Form 872-A consent form to extend the limitation period for assessment of taxes because it was not exercising "general equitable powers" to take jurisdiction over a matter not provided for by statute, but merely applying "equitable principles" to a case over which it had jurisdiction. The Fifth Circuit further held that the Tax Court did not clearly err in finding that a written agreement to extend the limitation period existed between each of the taxpayers and the IRS. See, also, Kelley v. Commissioner, 95-1 U.S.T.C. ¶50,062 (9th Cir. 1/23/95), affg T.C. Memo. 1990-158.

17. *Dueling decisions in the Circuits. Is this issue set up for certiorari? Leggett v. United States, 120 F3d 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 Comparato v. United States, 22 F.3d 455 (2d Cir. 1994), on whether state or federal law controls.

18. Notice 97-47, 1997-37 I.R.B. 8. Modifies Notice 97-26, 1997-1 C.B. 413, to "update," without change the list of private delivery services qualify under §7502(f) for the timely mailed, timely filed rule that applies to documents mailed by U.S. mail. The list includes only certain specified Airborne Express, DHL Worldwide Express, Federal Express, and UPS services with 2-day or sooner delivery as qualifying. Services not specifically listed, even if offered by an approved service provider, do not qualify.

XII. TAX SHELTERS
A. In General
1. LDL Research & Development II Ltd v. Commissioner, 97-2 U.S.T.C. ¶50,643 (10th Cir. 9/8/97). Partnership’s payments made to third parties to engage in R&D were not deductible because partnership was not actively engaged in the R&D business, nor was it realistically likely to be so engaged.
2. Bus shelter (tax shelter(?)) program using an IRA established by promoter’s salesman runs afoul of the rule that an individual cannot serve as an IRA trustee; transfers to the purported IRA are not qualified §408 IRA rollovers. Schoof v. Commissioner, 110 T.C. 1 (1/12/98).

XIII. WITHHOLDING AND EXCISE TAXES
A. Employee/Independent Contractor
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 6002 (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.
2. Rev. Proc. 98-16, 1998-5 I.R.B. 19. New standards for the §3121(b)(10) FICA tax exemption for student workers for colleges and universities. The exemption is available to half-time (or more) students who are not career employees. The exemption is for services performed for the institution as an incident to, and for the purpose of, pursuing a course of study. The exemption does not apply to postdoctoral students and medical residents or interns. An anti-abuse rule is included. These standards replace the former 12/20 rule, which had been rigidly enforced.
3. Notice 98-21, 1998-15 I.R.B. 14. The Service is extending the Classification Settlement Program indefinitely. The CSP is an optional settlement program that allows a business to have a worker classification case resolved quickly, with a standard closing agreement and proper relief under §530 of the Revenue Act of 1978.

4. American Airlines Inc. v. United States, 98-1 U.S.T.C. ¶50,323 (Fed. Cl. 4/2/98). Employer liable for withholding and FICA taxes on per diem payments provided to employees under collective bargaining agreements and exclusion was limited to $14 per day (as allowed by Reg. §1.274-5) because the per diem payments were not excludable as working condition fringe benefits as amounts reasonably expected to be incurred on an overnight trip. Credit card vouchers [of $100 per employee] did not constitute de minimis fringe benefits because the employer could have easily accounted for them, a result confirmed by the subsequently-issued Reg. §1.132-6T(c).

5. Like professional gamblers, street hustlers are engaged in a trade or business. Basada v. Commissioner, T.C. Memo. 1998-144 (4/20/98). Income from street hustling, pimping, panhandling and gambling were §1402 self-employment income because these activities are part of taxpayer's trade or business of street-hustling.

6. *When do farming related payments become rents? Wuebker v. Commissioner, 110 T.C. No. 31 (1998). Payments received by a farmer for enrolling land in the Conservation Reserve Program under the Food Security Act of 1995, removing the land from production and establishing a vegetative cover were rents from real estate – even though related to farming activities – and pursuant to Reg. §1.1402(a)-4(d) were not subject to self employment tax.

7. Employment Tax Notice 98-43, 1998-33 I.R.B. 13. New Procedures for Processing Employment Tax Cases Involving Worker Classification and Section 530 of the Revenue Act of 1978 under Code §7436. With respect to taxpayers whose workers are the subject of an employment tax determination, the Notice of Determination addressed to a taxpayer will constitute the "determination" that is a prerequisite to invoking the Tax Courts jurisdiction under §7436. Proceedings may be filed as small cases under §7363. Section 7436 does not confer jurisdiction on the Tax Court to determine the amount of employment tax or penalty. Only the person for whom the services are performed, not the worker, can seek Tax Court review.

8. Marlar Inc. v. United States, 151 F.3d 962, 98-2 U.S.T.C. ¶50,619 (10th Cir 8/5/98). Nightclub entitled to safe harbor of §530 of the Revenue Act of 1978 because it did not have an employment relationship with its dancers because it received "rent" from them. Therefore, it did not fail to file required Forms 1099, so it met the requirements of §530

B. Excise Tax

1. United States Shoe Corp. v. United States, 97-1 U.S.T.C. ¶70,078, 79 A.F.T.R.2d 2813 (Fed. Cir. 6/3/97). Section 4461 harbor maintenance tax as applied to exports violates the Export Clause of the Constitution because the tax is a tax on exports, and not a user fee. IBM v. United States, followed.

a. Affirmed, 118 S. Ct. 1290 (U.S. 3/31/98). The harbor maintenance is not a user fee because Congress called it a tax; it is determined entirely on an ad valorem basis [at 0.125 percent of cargo's value]; and the value of export cargo does not correlate reliably with the federal harbor services used or usable by the exporter. These last depend on size and tonnage of a vessel, how much time it spends in port and the services it requires.


XIV. TAX LEGISLATION

A. Pending

1. S. 1301, Consumer Bankruptcy Reform Bill of 1998 was passed by the Senate on 9/23/98; this bill did not contain tax provisions. The House passed H.R. 3150, another version of bankruptcy reform legislation, on 6/10/98. The conference agreement included the House tax provisions.
B. Enacted

1. P.L. 105-34, the Taxpayer Relief Act of 1997 ("1997 Act") was signed by President Clinton on 8/5/97. Three items in the Act were deleted by line item veto. (The Line Item Veto Act was held unconstitutional in City of New York v. Clinton, 985 F. Supp. 168, 98-1 U.S.T.C. ¶50,193 (D. D.C. 2/12/98), aff'd, 118 S. Ct. 2091, 98-2 U.S.T.C. ¶50,504 (U.S. 6/25/98).)

2. P.L. 105-178, Transportation Equity Act for the 21st Century ("ISTEA") was signed by President Clinton in June 1998.

3. H.R. 2676, Internal Revenue Restructuring and Reform Act of 1998 (including Technical Corrections Act of 1998) was signed by President Clinton on 7/22/98.