Recent Federal Income Tax Developments

Ira B. Shepard

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RECENT FEDERAL INCOME TAX DEVELOPMENTS

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I. ACCOUNTING

A. Accounting Methods


2. * [Item of particular interest]. IRS loses in its search for inventory in its attempt to use §446(b) to place cash method businesses on an accrual method. Tax Court opinion is a useful primer for determining when cash method contractors are required to change to an accrual method. 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. Cf., manna. 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.

3. But don’t think that the Galedrige case is easy to apply by analogy. Tebarco Mechanical Corp. v. Commissioner, T.C. Memo. 1997-311 (7/3/97). A plumbing and HVAC contractor who purchased most materials for jobs on an “as-needed basis” maintained inventories and was required to use the accrual method. Taxpayer maintained a warehouse and the sale of merchandise was a material income producing factor.

4. And, the IRS is not required to change an accounting method. Morrissey v. IRS (In re EWC Inc.), 97-1 U.S.T.C. ¶50,475 (10th

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1 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.
Cir. 6/9/97). The IRS properly assessed taxes based on a return filed on the cash method, even though taxpayer was required under §448 to use the accrual method. Held, §448 does not require the IRS to place the taxpayer on the accrual method, but only prohibits the taxpayer from using the cash method.

• Taxpayer-C corporation reported income on a hybrid method that more nearly resembled the cash method in a year in which it had gross receipts in excess of $5,000,000, and thus was required by §448 to use the accrual method. The Commissioner asserted a deficiency using the cash method, and the bankruptcy trustee claimed that the Commissioner was required to use the accrual method to calculate the deficiency. The court held that even if § 448 applies to bar a particular taxpayer from reporting on the cash method, it does not require the Commissioner to calculate a deficiency under the accrual method if the taxpayer reports on the cash method. The Commissioner did not abuse her discretion in determining the deficiency under cash method because taxpayer actually reported under cash method, even though it claimed to using the accrual method, and despite being a prohibited method, the cash method did clearly reflect income.


• Applicable changes in methods of accounting include (a) advances made by a lawyer on behalf of clients, (b) claiming less than the depreciation allowable, (c) permissible to permissible method of accounting for depreciation, (d) package design costs, (e) UNICAP methods used by small resellers and reseller-producers, (f) cash or hybrid method to accrual method, (g) multi-year service warranty contracts and related multi-year insurance policies, (h) series E or EE savings bonds, (i) prepaid subscription income, (j) timing of incurring liabilities for employee compensation, (k) timing of incurring liabilities for real property taxes, under a workers' compensation act, tort, etc., and for payroll taxes, (l) cash discounts and inventories, (m) changes from LIFO method and other inventory changes, (n) bank bad debt reserves under §585 to the specific charge-off method, (o) de minimis OID, and (p) interest income on short-term obligations and stated interest on short-term loans of cash method banks in the Eighth Circuit [based upon Security Bank Minnesota v. Commissioner, 994 F.2d 432 (8th Cir. 1993) ($1281 does not require cash method bank to include in gross income stated interest on short-term loans made in the ordinary course of business as that interest accrues)].

6. Rev. Proc. 97-35, 1997-33 I.R.B. 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. See, also, Rev. Proc. 97-36 1997-33 I.R.B. (alternative LIFO method for automobile dealers); and Rev. Proc. 97-


8. 1997 Act §1211 amends Code §460 to permit an election by contractors using the percentage of completion method not to have to use the look-back method in de minimis cases (i.e., estimate is within 10% of the cumulative look-back income or loss).


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). Taxpayers’ methods of estimating inventory shrinkage at yearend is permissible because they conform to the best accounting practice and they clearly reflect income. The court refused to reconsider Dayton-Hudson Corp. v. Commissioner, 101 T.C. 462 (1993), which held that inventory shrinkage estimates were not permissible.

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. *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.

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

3. 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).

4. If you do it wrong, you’re not on LIFO long. Rev. Rul. 97-42, 1997-41 I.R.B. (9/25/97). Franchised automobile dealer that elected the LIFO inventory method violates the §472(c) or (e)(2) LIFO conformity method by providing to the credit subsidiary of its automotive 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, 1997-1.R.B. (9/25/97) (procedure that provides relief to automobile dealers for pre-10/15/97 violations of LIFO conformity).

5. 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).
   • 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.

C. Installment Method

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 "serv[ing] no economic purpose other than tax savings," following Goldstein v.
Commissioner, 364 F.2d 734 (2d Cir. 1966). Under the scheme to shelter Colgate’s $105 million 1988 capital gain, a partnership was formed in 1989; its three partners were affiliates of (a) a foreign bank (about 90%), (b) Colgate (about 9%), and (c) Merrill Lynch (about 1%). A bank note was purchased by the partnership and immediately sold for a large immediate payment and much smaller future contingent payments. Under the contingent payment sale provisions of the temporary regulations [§15a.453-1(c)] the partnership’s basis was to be allocated ratably over the several years over which contingent payments could be made, resulting in a large 1989 installment sale gain to the partnership. The lion’s share of that installment sale gain was allocated to the foreign bank (which was not taxable on U.S. source capital gain), followed by the redemption of the foreign bank’s partnership interest. This left Colgate as the 90 percent partner. In 1991, the installment sale obligation was sold by the partnership, triggering about $100 million of capital losses, which Colgate attempted to use to shelter its 1988 capital gain.

Illustration: Colgate has large capital gain in year 0. In year 1, Colgate enters into partnership. Partnership then purchases property for 100, and then sells it for contingent consideration to be paid over five years. In year 1, 100 is to be paid, with small contingent amounts to be paid in each of years 2, 3, 4, and 5. Basis is allocated ratably to each year, so there is a gain of 80 in year 1 and a loss of 20 in each year thereafter. The gain in year 1 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 triggered in year 3, so they may be carried back to the large capital gain.

D. Year of Receipt or Deduction

1. *Signet affirmed; taxpayer chose to charge for the issuance of a card, and not for the provision of card services. If you really have earned it, you really do have to accrue it. Signet Banking Corp. v. Commissioner, 97-2 U.S.T.C. §50,530 (4th Cir. 7/8/97). Affirms decision that taxpayer was properly required to report annual credit card fees in the year received because taxpayer chose to make its fees non-refundable. The Service did not abuse its discretion in
requiring the bank to report the entire amount of nonrefundable annual credit card membership fees in the year the fees were received. The fees were consideration for issuing the card and establishing a credit limit. Rev. Proc. 71-21, 1971-2 C.B. 549, did not apply because the taxpayer already had performed all of the services required to entitle it to retain all of the fees, and it could cancel the card at will and retain the fees. Compare Barnett Banks of Florida, Inc. v. Commissioner, 106 T.C. 103 (1996), applying Rev. Proc. 71-21 to permit a bank to defer inclusion of a portion of annual fees imposed with respect to credit cards that it issued, even though any services to be rendered by the bank were contingent on the customers’ actual use of the card. The fees were ratably refundable if the card was canceled within the year with respect to which the fees were imposed.

2. Didn’t think that first year property difference between a condition precedent and a condition subsequent would ever affect an income tax accounting case, did ya? Charles Schwab Corp. v. Commissioner, 107 T.C. No. 17 (11/14/96). Discount brokerage firm must accrue income on the “trade date” rather than the “settlement date” because services performed between the two dates are ministerial in nature. Taxpayer sought to distinguish itself from full service brokers (see Rev. Rul. 74-372, 1974-2 C.B. 147) by arguing that a greater percentage of services performed was performed after the trade date. The court refused to apply Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26 (1988) (seller did not have income until the passage of title and risk of loss to purchasers) because the focus is on the relationship between taxpayer and its customer, not on the relationship between the customer and the purchaser (or seller) of the securities. This case exemplifies the distinction drawn by courts, in applying the all events test, between conditions precedent, which must occur in order for the right to receive income to arise, and thus require accrual, and conditions subsequent, the occurrence of which may defeat the right to collect accrued income, but which do not prevent the accrual of the income for tax purposes.

3. Schmidt Baking Co. v. Commissioner, 107 T.C. No. 16 (11/14/96). Taxpayer entitled to deduct in 1991, amounts “paid” for vacation and severance benefits when it purchased an irrevocable standby letter of credit on March 13, 1992 because the amounts were includable in the employees’ income within 2-1/2 months after the end of 1991. Judge Tannenwald construed §§83, 162 and 404 to find that amounts includable in employees’ incomes were not deferred compensation and were “paid” to the employees. Section 404 does not require actual receipt of payment by the employee as a prerequisite for the employer’s deduction. Funding a nonqualified deferred compensation agreement so as to require inclusion by the employee prior to receipt suffices to allow a deduction to the employer.

4. Saint Claire Corp. v. Commissioner, T.C. Memo. 1997-171 (4/7/97). A corporation constructively received payment on note from a 31 percent shareholder when after the note had matured the board of director’s voted to extend its due date because the debtor-shareholder, while lacking sufficient cash to pay the note, was
credit-worthy enough to borrow sufficient funds to satisfy the obligation.

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


6. *A wise man once said that every stick crafted by the government to beat upon the taxpayer eventually will metamorphose into a serpent that will turn and bite the Commissioner on the hindquarters. Avon Products, Inc. v. United States, 97 F.3d 1435, 96-2 U.S.T.C. ¶50,525 (Fed. Cir. 10/8/96). A foreign subsidiary of the taxpayer deliberately delayed making payments of employees’ nonqualified profit sharing until after March 15 of the year following the year to which the payments related. Its reason for the delay was to invoke §404(b) to shift the deduction from the earlier to later year, in which the deduction would produce greater tax benefit for the parent corporation due to mechanics of computing foreign tax credit. Upholding the taxpayer’s argument, the court held that §404(b) can apply to defer the deduction whether the deferral is due to a formal plan, an ad hoc agreement, or an arbitrary delay in payment by the employer, as long as the delay is for more than a “reasonable period” after the close of the year to which the payment relates. Because the year in question was not governed by Temp. Reg. §1.404(b)-1T, the case was remanded for a finding of whether the payment was delayed beyond the time at which it became administratively feasible to make the payment. The court noted that for years governed by Temp. Reg. §1.404(b)-1T(b) [Q&A #2], payment on March 26 of the following year
was presumed to be an unreasonable delay because it is more than 2 and 4 months after the close of the year.


II. BUSINESS INCOME AND DEDUCTIONS
   A. Depreciation, Depletion and Credits
      1. Taxpayers owning short-lived assets attempt to avoid MACRS.
         a. Tax court: Rent-to-own companies limited to MACRS depreciation. ABC Rentals of San Antonio, Inc. v. Commissioner, T.C. Memo. 1994-601. Rent-to-own corporations improperly used the income forecast method to calculate depreciation deductions for property they rented out. The income forecast method is only available for assets such as TV and motion picture films, the useful life of which does not depend on physical wear and tear or the passage of time, and not for consumer durables that produce steady and dependable streams of income. The fact that the assets had a useful life shorter than the 5-year recovery period mandated by MACRS is not a valid argument to avoid the MACRS depreciation mandated by §168.
         b. But reversed and remanded; income forecast method may be permissible. ABC Rentals of San Antonio Inc. v. Commissioner, 97 F.3d 392, 96-2 U.S.T.C. §50,508 (10th Cir 9/27/96) (2-1). Section 168(f)(1) [all tangible property must be depreciated under MACRS unless taxpayer elects out and “the property is PROPERLY DEPRECIATED under the unit-of-production method or any method of depreciation not expressed in a term of years (emphasis in opinion). . . .”] does not preclude the use of the income forecast method to depreciate property other than movies or similar property, revenue rulings to the contrary held non-binding in the absence of any indication in legislative history that the income forecast method was so limited. The majority applied former §§167(b) and (c) [repealed in 1990] to require that in order to be excluded from MACRS: (1) the depreciation allowance during the first 2/3 of the property’s life not exceed that under the double-declining balance method, and (2) the property have a useful life of 3 years or more; the dissent would simply reverse on the ground that the exception in §168(f) applied regardless of former §§167(b) and (c), repealed as “obsolete” in 1990. The Fifth Circuit affirmed the Tax Court without opinion in El Charro TV Rentals v. Commissioner, 79 F.3d 1145, 97-1 U.S.T.C. §50,140 (2/14/96).
         c. 1996 amendments to the income forecast method of depreciation. SBJPA §1604 adds new §167(g), which makes amendments to the income forecast method of depreciation, generally effective for property placed in service after 9/13/96. Under this method, the depreciation deduction is determined by multiplying the cost of the property [minus salvage value] by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total estimated income to be derived from the property during its useful life. The amendments are: (1) all estimated income generated by the property [for the first 10 years] must be taken into account in the computation; (2) the adjusted basis
amounts to be taken into account must satisfy the §461(h) economic performance standard; and (3) taxpayers will be required to pay (or would receive) interest based on the recalculation of depreciation under a "look-back" method. Costs incurred after ten years with respect to unproductive property are deductible. If property remains productive after ten years, a new ten-year period begins.

d. *1997 Act limits the income forecast method of depreciation and prescribes the depreciation treatment for assets of rent-to-own companies.

(1) 1997 Act §1086(a) amends Code §167(g) to limit the income forecast method to copyright-type assets.

(2) 1997 Act §1086(b) amends Code §68 to provide that rent-to-own durable consumer goods have a three-year recovery period and a four-year class life. This reflects the IRS position in Rev. Proc. 95-38, 1995-34 I.R.B. 25 (optional method of accounting for rent-to-own contracts entered into by rent-to-own dealers for durable consumer goods).

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

• According to the Tax Court, Congress intended that the definition of tangible personal property under the now repealed investment tax credit be applied to determine whether a particular item is tangible personal property or real estate. (The meaning of tangible personal property for purposes of the ITC is determined under Treas. Reg. §1.48-1(c); structural components of a building, which were not eligible for the ITC, are identified under Treas. Reg. §1.48-1(e)(2).) Under this test, an item is a structural component of a building if it relates to the operation and maintenance of the building, but it is not a structural component of the building if it is machinery the sole justification for which is to meet temperature or humidity requirements essential to the operation of other machinery or processing food or materials.

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

- Query: Is there any effect on real estate investment trusts, which are required to have a high percentage of real property assets? Compare, the §465(b)(6) concept of “qualified nonrecourse financing,” which permits the holding of incidental personal property to be included in the activity of holding real property.

3. **Gas station convenience stores are 15-year property.**

SBJPA §1120 amends §168(e)(3)(E) by adding “gas station convenience stores” to “retail motor fuels outlets” already included as 15-year property. To qualify, either 50% or more of the revenues generated from the property must be derived from petroleum sales or 50% or more of the floor space in the property must be devoted to petroleum marketing sales, with motor fuels outlets of 1400 square feet or less qualifying without application of either 50% test. Effective for property placed in service on or after the date of enactment, with an election to apply the provision retroactively.

   Exclusive procedure for making election to treat motor fuels outlets placed in service before 8/20/96 as §168 15-year property for the tax year that includes 8/20/96.


4. **ITC available for “world headquarters,” but more than one headquarters location is required.**

United States v. Kjellstrom, 100 F.3d 482, 96-2 U.S.T.C. ¶50,600 (7th Cir. 11/8/96). Taxpayer was not entitled to ITC for 1989 and 1990 years for leasehold improvements, furnishing and equipment in a rented building to “serve as world headquarters of the lessee and its affiliates” under §204(a)(7) of the Tax Reform Act of 1986 -- a targeted provision for the benefit of Merrill Lynch--because taxpayer’s family-owned S corporation did not have any other “headquarters,” nor did it have affiliates. Unlike the district court, the 7th Circuit did not hold that the statute was limited to Merrill Lynch.

5. REG-209834-96, proposed regulations under §1396 on the period employers may use in calculating the empowerment zone employment credit, in which substantially all the employee’s services must be performed within an empowerment zone: either (1) each pay period or (2) the entire taxable year (pursuant to an annual election) (61 F.R. 66000, 12/16/96).

6. REG-209494-90, proposed regulations under §41 describing when computer software developed by (or for the benefit of) a taxpayer primarily for the taxpayer’s internal use can qualify for the credit for increasing research activities (62 F.R. 81, 1/2/97).
7. Proposed §197 regulations on amortization of intangible property. REG-209709-94, proposed regulations relating to the amortization of intangible property under §197 (1/9/97).

8. Proposed §197 regulations on amortization of intangible property. REG-209709-94, proposed regulations relating to the amortization of intangible property under §197 (1/9/97).

9. T.D. 8708, final regulations under §902, relating to the computation of income taxes deemed paid by a U.S. corporation that owns at least 10 percent of the voting stock of a foreign corporation (62 F.R. 923, 1/7/97). These regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity.

10. REG-208288-90, proposed regulations under §905, relating to the substantiation requirements for taxpayers claiming foreign tax credits (62 F.R. 1700, 1/13/97). Eliminates the requirement that taxpayers attach to their returns either (1) the receipt for the foreign tax payment or (2) the foreign tax return; replaces it with a provision that such evidence must be presented to the IRS upon request.

11. REG-208172-91, proposed regulations under §§108 and 1017, providing ordering rules for the reduction of bases of property by taxpayers that exclude discharge of indebtedness from gross income under §108 (62 F.R. 955, 1/7/97).

12. Everson v. United States, 108 F.3d 234, 97-1 U.S.T.C. ¶50,258 (9th Cir. 3/4/97). Trees planted on farm as windbreaks are not depreciable because they become part of land, but cost may be deducted by farmer under §175 as a soil conservation expense.

13. Norwest Corp. v. Commissioner, 108 T.C. No. 18 (4/30/97) (reviewed, 11-5). Computer software, developed by third parties and delivered on disks or tapes to taxpayer under a nonexclusive, nontransferable indefinite term license, is tangible property eligible for the investment tax credit. Judge Halpern refused to follow the test of tangibility in Comshare, Inc. v. United States, 27 F.3d 1142 (6th Cir. 1994).

14. Sprint Corp. v. Commissioner, 108 T.C. No. 19 (4/30/97) (reviewed, 10-7). Telephone switching software is held to be eligible for ITC and ACRS, in another opinion by Judge Halpern.

15. How do you establish that the fair rental value for a football stadium differs from the rent paid by the only professional football team that's a tenant in the city? Of course, you use an expert! New Orleans Louisiana Saints, Ltd. Partnership v. Commissioner, T.C. Memo 1997-246 (6/2/97). The depreciable basis of a purchased leasehold in the Louisiana SuperDome equaled the value of the premium paid attributable to rentals due under the lease being less than fair rental value of the SuperDome. Its all in the testimony of the expert witnesses!

16. 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.

17. 1997 Legislation
   a. 1997 Act §402 amends Code §56 to repeal separate AMT depreciation lives, effective for property placed in service after 12/31/98. For property placed in service after 12/31/98, AMT depreciation on tangible personal property is calculated by using the 150% declining balance method and the property’s normal §168 recovery period. AMT adjustment will still be necessary for property depreciated for regular tax purposes using a 200% declining balance method.

   b. 1997 Act §601 extends the Code §48 research credit through 6/30/98.


      (1) Notice 97-54, 1997-41 I.R.B. (9/23/97). Outlines changes made to the §51 work opportunity tax credit, as well as the provisions of the new §51A welfare-to-work credit. Notes the release of a new Form 8850 (9/97) for use in pre-screening applicants and requesting certification in connection with both credits.

   d. 1997 Act §971 amends Code §280F to exempt the incremental cost of clean-fuel vehicles from the luxury automobile depreciation limits, effective for property placed in service after 8/5/97 and before 1/1/2005. 1997 Act §906 amends Code §4001 to exempt such costs from the excise tax on luxury vehicles, effective for sales after 8/5/97.


18. Nelson-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 if 1978 as prerequisite to tax credit eligibility. Availability of the $29 nonconventional fuel source credit turns on a formal determination that a well meets the requisite standards be made under §503 of the Natural Gas Policy Act of 1978.

19. Court of Federal Claims follows District Court holding that unassembled core reactor was placed in service upon delivery. Connecticut Yankee Atomic Power Co. v. United States, 97-2 U.S.T.C. ¶50,693 (Fed. Cl. 9/17/97). Follows Northern States Power Co. v. United States, 952 F. Supp. 1346, 78 A.F.T.R.2d 5900 (D. Minn. 7/15/96) (Nuclear reactor fuel assemblies, 121 of which comprise the "reactor core," were "placed in service" upon receipt by taxpayer because there 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 acquired rather than in the year that it is actually used." It did not matter that the installation and testing process was complicated and time-consuming. 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.). The Court of Federal Claims opinion stated that

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.

B. Expenses

1. **INDOPCO aftermath:** “Deductions are exceptions to the norm of capitalization.” (Blackmun, J.).
   a. Notice 97-7, 1997-1 I.R.B. 8 (1/6/97). Proposed revenue procedure that, when final, will provide special procedures for requesting letter rulings on the tax treatment under §§162 and 263 of environmental cleanup costs that span past and future years.
   b. *Swig Investment Co. v. United States*, 98 F.3d 1359, 96-2 U.S.T.C. ¶50,540 (Fed. Cir. 10/10/96). Taxpayer was required to capitalize the $3 million cost of replacing the parapets and cornices of the Fairmont Hotel with lighter and stronger ones welded to the building because the replacement significantly improved the structural soundness of the hotel [producing significant benefits extending beyond the tax year in question]. Under the Indopco case, it was immaterial that taxpayer acted pursuant to notice of potential earthquake hazard by the City of San Francisco. The court noted, and quoted, “Deductions are exceptions to the norm of capitalization.” (Indopco, 503 U.S. at 84.)
   d. *Training costs may still be expensed*. Rev. Rul. 96-62, 1996-53 I.R.B. 6 (12/23/96). The INDOPCO decision does not affect the treatment of training costs as deductible business expenses under §162 (except under the unusual circumstance where the training is where the training is intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of a taxpayer’s trade of business).
   e. **Costs to resist successful hostile takeover must be capitalized**, but . . . . *A.E. Staley Mfg. Co. v. Commissioner*, 105 T.C. 166 (9/11/95) (reviewed, 12-5). Taxpayer incurred (among other costs) investment bankers’ fees and printing costs in response to the unsolicited and hostile (but eventually successful) tender offers to acquire its stock made by Tate & Lyle PLC. These expenditures were held—in an opinion by Judge Halpern—to be capital, for which no deduction under §162(a) was available based upon INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 92-1 U.S.T.C. ¶50,113 (1992) (involving a friendly acquisition), because the expenditures were made in connection with a change in ownership with indefinite and extended future consequences to taxpayer, and they are properly to be matched
against revenues of a taxable period longer than the taxable year during which they were incurred.

- Four judges concurred in an opinion by Judge Beghe, based upon the theory that the expenditures were nondeductible because they were for the benefit of taxpayer's shareholders by helping them obtain a higher price for their shares in the eventual takeover.

- Dissents on the grounds: (1) that court is now creating a more stringent rule that requires capitalization of all expenses relating to restructuring of stock ownership (Judge Cohen), and (2) that the hostility of the takeover indicated the lack of long-term benefits anticipated by the target in connection with the transaction (Judge Laro).

(1) *Reversed. Costs to resist hostile takeover held deductible; only that portion of investment banker costs used to facilitate takeover (including costs used to determine stock value) had to be capitalized. Moral: If you fight before you kiss and hug, it converts capital expenditures into deductible expenses. A.E. Staley Mfg. Co. v. Commissioner, 97-2 U.S.T.C. ¶50,521 (7th Cir. 7/2/97), rev'g and remanding 105 T.C. 166 (1995). The Tax Court applied INDOPCO to require capitalization of investment banking and printing fees incurred by a target corporation of a hostile corporate takeover offer that was eventually approved by the board of directors as a friendly takeover. The Court of Appeals held that the investment bankers' fees to evaluate the target's stock relative to the offer and to effect the merger—a relatively small portion of the amount in question—were capital expenditures. The fees incurred initially to resist the takeover [the vast bulk of the expenses], which were characterized as fees to defend corporate business practices, were deductible under §162. The fees relating to abandoned alternative capital transactions with prospective white knights were deductible as losses under §165.

- Fees to investment bankers directed at defeating hostile tender offer are currently deductible under §162 because they are ordinary [defending against a hostile takeover is not an unusual activity] and taxpayer did not obtain a long-term benefit from them. Only expenditures for determining the true value of taxpayer's stock, which were later used to facilitate the acquisition (and a few hours of other facilitative costs) need be capitalized under Indopco.

f. *Is the Tax Court relaxing its application of INDOPCO? Pope & Talbot Inc. v. Commissioner, T.C. Memo. 1997-116 (3/6/97). Taxpayer corporation was allowed to deduct fees paid to investment banker to review its strategies, financial position, and charter documents to allow investment banker to be able to quickly evaluate any future acquisition proposal and to recommend strategies to strengthen management's bargaining position. INDOPCO was distinguished on the grounds that the instant case produced no long term benefits because no takeover was in the offing. This decision is very difficult to reconcile with the Tax Court decision in A.E. Staley Mfg. Co. v. Commissioner, 105 T.C. 166 (1995), rev'd, 97-2 U.S.T.C. ¶50,521 (7th Cir. 1997) (Tax Court applied INDOPCO to require capitalization of investment banking and printing fees incurred by a target corporation of a hostile corporate takeover offer that was
eventually approved by the board of directors as a friendly takeover. The court reasoned that the expenditures were capital expenditures because they did nothing to contribute to production of current income."

g. *The "Dana doctrine"—a Capital Expenditure versus Ordinary Expense analogue of the good old days Corn Products doctrine. Dana Corp. v. United States, 38 Fed. Cl. 356, 97-2 U.S.T.C. §50,556, 80 A.F.T.R.2d 5412 (Fed. Cl. 7/15/97). Taxpayer paid Wachtell, Lipton annual retainers of $100,000. Taxpayer's motive in retaining Wachtell, Lipton was to prevent the law firm from representing any other corporation in an effort to take-over the taxpayer, but the retainer could be credited against fees for any legal services. In 1989, Wachtell, Lipton provided services in connection with taxpayer's acquisition of another company, and billed the taxpayer $275,000, with the $100,000 retainer credited against the amount due. Taxpayer capitalized the $175,000 that it paid in addition to the retainer, but deducted the retainer. The court held that the retainer was deductible because the retainer was paid regularly and ordinarily provided no benefit beyond the year-end. The origin of the claim test applied as of the time the retainer was paid, not with hindsight as of the time it was credited to legal services.

h. Cost of asbestos removal "was part of a general plan of rehabilitation and renovation that improved the building." Improvements that "put" the property into efficient operating condition must be capitalized—as opposed to repairs made to "keep" the property in efficient operating condition. Norwest Corp. v. Commissioner, 108 T.C. No. 15 (4/28/97). Costs of removing asbestos-containing materials, in connection with the remodeling of taxpayer's subsidiary's business building, was not currently deductible but had to be capitalized because they were part of a general plan of rehabilitation and renovation of the building. The court rejected the taxpayer's argument that asbestos removal incident to general remodeling of a building should be viewed as a separate "repair" deductible under §162, and treated the asbestos removal as an integral part of general rehabilitation of building, which was a capital expense. The court avoided analyzing the tax treatment solely of asbestos removal because it found that the asbestos would not have been removed but for the remodeling.

i. 1997 Act §941 adds new 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.

2. TAM 9715001 (10/31/96). Corporation may deduct cost of using a company-owned aircraft to transport a "control employee" [Reg. §1.61-21(g)] and his spouse to and from vacation sites only to the extent that the employee has income under that regulation's "non-commercial valuation flight rule." The TAM was based upon §274(e)(2), which provides that the §274(a) deduction disallowance will not apply to expenses for entertainment services and facilities to the extent that the expenses are treated by the employer as wages to the employee who received the entertainment.
3. **Deductible fines and penalties!** *Jenkins v. Commissioner*, T.C. Memo. 1996-539 (12/12/96). The taxpayer fertilizer manufacturer paid to the state a civil penalty with respect to nutrient deficient fertilizer. The amount of the penalty was computed with reference to financial losses incurred by purchasers that resulted from the nutrient deficiency, and if the purchasers could be identified, the penalty funds collected by the state were distributed to actual purchasers of deficient lots of fertilizer. Even though most penalty proceeds were not actually distributed to consumers, the court held that the penalty was compensatory and thus §162(f) did not apply to bar a deduction.

4. *Rothner v. Commissioner*, T.C. Memo. 1996-442 (9/26/96). Fines paid to the Chicago Mercantile Exchange by member-taxpayer for rules violations were deductible. They were “ordinary” and “necessary” because they commonly occurred and taxpayer could not continue in business without paying them. Section 162(f) does not apply to fines and similar penalties paid to private organizations, of which the taxpayer is a member, for violations of their rules.

5. *And when Dr. Geiger returned, he asked Dr. Schutt, “What do you mean the cost of surgical scrubs might not be deductible?” Bradley v. Commissioner*, T.C. Memo. 1996-461 (10/15/96). Cost of nurse’s uniforms was not deductible because taxpayer-nurse did not introduce evidence that they were not suitable for ordinary wear.

6. *The Escrow Connection, Inc. v. Commissioner*, T.C. Memo. 1997-17 (1/8/97). A formula for computing contingent “compensation” with reference to achieving a “targeted” level of corporate taxable income after deducting the compensation is evidence that the purported compensation is not really compensation for services. The shareholder-employee’s compensation of over $550,000 was unreasonable where 21 nonshareholder employees with similar day-to-day responsibilities other than management received aggregate compensation of less than $250,000.

7. **Home Offices**

   a. *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.”

   • Reverses *Soliman*, which held that the conduct of essential administrative or management activities in a home office did not result in that office being the principal place of business where activities of greater importance taking more time were performed elsewhere.

   • Legislative history states that the home office deduction will be available even though the taxpayer could have used the office outside his home to perform administrative or managerial functions, but simply chose not to do so, thus changing the result under *Miller*, below. Taxpayer remains free to perform substantial
administrative functions at a non-fixed location, e.g., in taxpayer’s car or hotel room.

- This provision is effective for taxable years beginning after 12/31/98 (i.e., 1999 and thereafter).

  (1) Commissioner v. Soliman, 113 S. Ct. 701, 93-1 U.S.T.C. ¶50,014 (U.S. 1/12/93) (8-1), rev’g 91-1 U.S.T.C. ¶50,291 (4th Cir. 1991). The principal place of business for purposes of the §280A©(1)(A) exception to the nondeductibility of home office expenses is to be determined by “the relative importance of the activities performed at each business location and the time spent at each place.” An anesthesiologist whose actual treatments were performed in hospitals, and who spent 30-35 hours per week in hospitals—as opposed to 10-15 hours per week at home—did not qualify for the exception. The Court (Kennedy) noted that “the statute does not allow for a deduction whenever a home office may be characterized as legitimate.” It held that “the point where goods and services are delivered [i.e., the focal point] must be given great weight,” but that “no one test is determinative in every case.” The Court further held that the “essentiality” of the functions performed in the home office should not have “much weight,” nor should “the availability of alternative space” have any bearing whatsoever on the “principal place of business” inquiry. Justice Stevens dissented on the ground that Congress intended to allow the deduction to “self-employed taxpayers who manage their business from a home office,” but do not meet or deal there with patients, clients or customers. Justice Stevens stated that “the principal office of a self-employed person’s business would seem to me to be the most typical example” and cited an example contained in Prop. Reg. §1.280A-2(b)(3), allowing the deduction to “the outside salesperson who has no office space except at home and spends a substantial amount of time on paperwork at home.”


IRS guidance for home office deductions in light of the Soliman decision: (1) Proposed Reg. §1.280A-2(b)(3) will be conformed to that decision, i.e., outside salesperson who spends 30 hours per week visiting customers and 12 hours per week working at his home office cannot deduct expenses for the business use of his home; (2) the IRS will not challenge 1991 or earlier home office deductions if they reasonably fell within the pre-Soliman Publication 587 (Business Use of Your Home) discussion or the example at the end of pre-Soliman proposed regulations; and (3) the IRS will waive 1992 estimated tax penalties to the extent they were attributable to the loss of home office deductions for which taxpayers would have qualified under pre-Soliman authority.

b. Miller v. Commissioner, T.C. Memo. 1996-432 (9/24/96). The taxpayer conducted a scrap metal business from a warehouse and a home office. The warehouse had no suitable office space and the taxpayer spent most of his time at his home office, where he negotiated purchases and sales over the telephone. He never met customers there, however; he generally met customers at their places of business. On these facts, under Commissioner v. Soliman, the warehouse—and not the home office—was the taxpayer’s principal place
of business, and the home office deduction was denied by §280A. (This case applies pre-1997 Act law.)

c. See Rev. Rul. 94-47, 1994-2 I.R.B. 18 [which amplified and clarified Rev. Ruls. 190 and 90-23 with respect to deductibility of costs of traveling from home to a temporary work location where there is a home office. Requires that taxpayer have a fixed business location outside the home.

8. He should have worked for Intel. Kurzet v. Commissioner, T.C. Memo. 1997-54 (1/29/97). Expenses attributable to use of taxpayer’s privately owned Lear Jet to travel to self-employed taxpayer’s secondary business location was “extravagant and not ordinary and necessary.” Deductions were limited to the equivalent of first-class airfare. Compare Noyce v. Commissioner, 97 T.C. 670 (1991), which allowed an Intel executive to deduct the costs of traveling on his Lear Jet, even though the costs exceeded a “reasonable amount”—they exceeded his income from the activity.

9. 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 (a) 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 (b) 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. A hypothetical investor would have received a return on equity of 82% for 1990 65% for 1991 and 66% for 1992.

10. TD 8792 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.

11. 1997 Legislation


b. 1997 Act §969 gradually increases the Code §274(n) deduction percentage limitation on meals away from home for persons who are subject to Federal hours of service limitations, e.g., truckers, airline pilots, railroad workers. The deduction percentage limitation increases from its current 50% to 55% in 1998 and 1999, 60% in 2000 and 2001, 65% in 2002 and 2003, 70% in 2004 and 2005, 75% in 2006 and 2007, and 80% in 2008 and thereafter.

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

(1) 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.

(2) 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.

d. 1997 Act §1204 amends Code §162(a) by removing the one-year maximum for deduction of traveling expenses for Federal employees certified by the Attorney General as traveling in temporary duty status to investigate a Federal crime. Effective for tax years ending after 8/5/97.

12. 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. *The eyes of the IRS are upon you. Sealy Corp. v. Commissioner, 107 T.C. 177 (10/21/96). Liabilities, other than products liability and tort claims, are subject to the 10 year carryback rule of §172(f) only if the deduction was deferred by the
economic performance rule of §461(h). Deductible expenses of complying with the Securities Act of 1934 with respect to a public stock offering, complying with ERISA with respect to employee benefits plans, and with respect to an audit of taxpayer’s tax return were routine expenses, not “specified liability losses” within the meaning of §172(f)(1)(B), and thus could not be carried back 10 years.


2. *Watch what I do, don’t listen to what I say. Is an unambiguous waiver of the carryback rendered ambiguous if you claim the carryback in the AMT computation? Miller v. Commissioner, 99 F.3d 1042, 96-2 U.S.T.C. ¶50,164 (11th Cir. 11/14/96), rev’g 104 T.C. 330 (1995). Taxpayers’ election on their 1985 return “to forego the net operating loss carry back period and will carryforward the net operating loss” was not an unequivocal and ambiguous waiver of the AMT NOL because it used the word “loss” (and not “losses”), so it was invalid [as taxpayer contended, following an unexpected clarification that “split” waivers were impermissible, in a Conference Report (No. 99-841, 99th Cong., 2d Sess, UU-262, 283 (1986)), issued shortly after the election was made].

- Taxpayer’s attempted election to waive regular NOL carryback period but not to waive the AMT NOL carryback period with the following language—“In accordance with the Internal Revenue Code Section 172, the Taxpayers hereby elect to forego the net operating loss carry back period and will carryforward the new operating loss”—was ambiguous because it referred to “loss” not “losses” and thus was invalid. Taxpayer could carryback NOL for both regular tax and AMT purposes. An AMT deficiency based on disallowance of the NOL carryback was not upheld. The Eleventh Circuit’s decision in Miller is questionable because it is difficult to find the ambiguity in the waiver.

3. Kahle v. Commissioner, T.C. Memo. 1997-91 (2/20/97). Taxpayer’s bankruptcy estate succeeded to pre-bankruptcy NOL because taxpayer did not make a short year election under §1398(d), and pursuant to §108(b) and (d)(8) as a result of nonrecognition of cancellation of indebtedness income arising from bankruptcy, the NOL was eliminated and thus unavailable to the taxpayer for post-bankruptcy years.

4. *Potential appreciation of new shares issued for new consideration, following the surrender of the old shares, did not vitiate the worthless stock deduction for the old shares. Delk v. Commissioner, 97-1 U.S.T.C. ¶50,407 (9th Cir. 5/7/97), rev’g T.C. Memo. 1995-265. Shareholders were entitled to a §165(g)(1) worthless stock deduction when their stock was canceled in a chapter 11 bankruptcy reorganization and they received new shares solely because they contributed new capital to the reorganized corporation. The court rejected the Tax Court’s [Tannenwald, J.] conclusion that “the cancellation of the old stock and the issuance of new stock comprised an unessential element of the plan of organization” had all the shareholders been willing to contribute their proportionate share of the capital required, by stating “it is equally true that if pigs had
wings, they could fly." Because the old shares were surrendered for no consideration and the new shares were received for new consideration, the new shares were not a continuation of old shares. The potential appreciation of new shares did not vitiate the worthlessness of old shares.

5. *MACRS cost recovery periods may not be wholly unrelated to the useful life concept. Contingent acquisition costs attributable to fully amortized assets are deductible as incurred. Meredith Corp. v. Commissioner, 108 T.C. No. 7 (2/28/97). In Meredith Corp. v. Commissioner, 102 T.C. 406 (1994), the Tax Court held that the amount of a contingent obligation related to the acquisition of property is added to the property's basis only when the debt is satisfied, and if the property is depreciable, the taxpayer may depreciate the increased basis over the remaining cost recovery period. Taxpayer took its time in satisfying the obligation and by the time it had been paid, the property's cost recovery period had expired. An ordinary loss deduction was allowed in the year the debt was satisfied; a new cost recovery period is not commenced.

6. Don't count on carrying those NOLs through bankruptcy. Firsdon v. United States, 95 F.3d 444, 96-2 U.S.T.C. ¶50,475 (6th Cir. 9/12/96) The amount of NOL carryovers to which a taxpayer succeeds from his bankruptcy estate pursuant to §1398(i) may limited because §108(b), which requires that certain tax attributes, including NOLs, be reduced by the amount of cancellation indebtedness income that was realized but not recognized by virtue of §108(a)(1), results in the reduction of the NOL carryovers. The taxpayer failed to prove that the bankruptcy estate's NOL carryover of $345,424 was the NOL remaining after reduction under §108(b) rather than the NOL carryover before reduction for approximately $1.2 million unrecognized cancellation of indebtedness income.

7. Scheiner v. Commissioner, T.C. Memo. 1996-554 (12/23/96). Taxpayer, who devoted more than 100 hours to activities on condominium-hotel management board, did not materially participate because full time employees spent more time in connection with rental activities. Taxpayer's argument that other individuals' hours of work benefiting entire complex must be prorated by number of units did not change the result because under that theory the taxpayer's work on board also would be prorated.

8. *1997 Act §1082 amends Code §172 to provide that net operating losses may be carried back 2 years and forward 20 years. 1997 Act §1083 contains a similar (but not identical) adjustment for §39 credits, with the carryback limited to 1 year and the carryforward extended to 20 years. Effective for NOLs for taxable years beginning after 8/5/97.

D. Business Income

1. *No COD income on loan discharge when original obligation is "indefinite." Preslar v. Commissioner, T.C. Memo. 1996-543 (12/17/96). Taxpayers borrowed $1 million from bank to purchase property from sellers who had been indebted to the bank, to be repaid through the assignment of lot sales contracts to the bank. Taxpayers were to receive credit equal to 95% of the stated contract price, even if the purchaser did not pay that amount at that time. The bank was
taken over by the FDIC, which demanded cash payments—the bank having received only $200,000 in cash payments previously. Taxpayers settled with the FDIC for $350,000. Held, no cancellation of indebtedness income of $450,000 because taxpayers' liability to the bank was "sufficiently indefinite in nature and amount to avoid triggering any discharge of indebtedness income.

2. 1997 Legislation
   a. *1997 Act §401 amends Code §55 to provide an exemption from the AMT for small corporations, i.e., corporations with not more than $5 million gross receipts in its first taxable year beginning in 1997 and not more than $7.5 million gross receipts in all subsequent years. Effective for taxable years beginning after 12/31/97.
   b. 1997 Act §1213 adds new Code §110 to exclude from income amounts received by lessees (of retail space for not more than a 15-year term) from lessors that are applied by the lessee to the construction of leasehold improvements that will revert to the lessor on the termination of the lease. No deduction by lessor, but the improvements will be treated at the lessor's property. Effective for leases entered into after 8/5/97.

3. Houston Industries Inc. v. United States, 97-2 U.S.T.C. ¶50,651 (Fed. Cir. 9/11/97). Ninety-eight million dollars of fuel cost overrecoveries, which taxpayer would be required to repay to its customers in the future, were not includable in income because it "received these overrecoveries contingent upon a statutory obligation of repayment," and 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).

III. CAPITAL GAIN AND LOSS
   A. In general
      1. REG-251520-96, proposed regulations §1.861-18, classifying transactions involving the transfer of computer programs as sales, licenses, leases, or the provision of services or of know-how (61 F.R. 58152, 11/13/96).
      2. *New allocation regulations include changes required by the enactment of §197 in 1993. Relevant only where some, but not all, of the acquired intangibles are sold at a profit during the 60-month amortization period. T.D. 8711, final, temporary and proposed regulations under §§1060 and 338(b), relating to purchase price allocations in taxable asset acquisitions and deemed asset purchases to revise the treatment of intangible assets in such acquisitions to take into account the 1993 enactment of §197 (1/9/97). Class I assets are cash and equivalent; Class II, CDs, government securities, readily marketable securities; Class III continues to be the class that contains all assets not in one of the other classes (i.e., chiefly tangible assets); a new Class IV, consisting of all §197 intangibles except goodwill and going concern value; and Class V, intangibles in the nature of goodwill and going concern value.
      3. Convenience stores generated ordinary loss on sale of oil company stock, pursuant to Arkansas Best. Circle K Corp. v. United

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States, 91-1 U.S.T.C. ¶50,260 (Cl. Ct. 5/16/91), modified, 91-2 U.S.T.C. ¶¶50,382 & 50,383 (Cl. Ct. 8/2/91). Oil company stock purchased by convenience store chain company in 1980 to ensure a supply of gasoline, generated ordinary loss on sale under §1221(1) because the stock investment—under the "source of supply" principle—had a "close connection" to its business as an integral part of its "inventory-purchase system" even though any crude oil purchased would have been at the "highest economic price." The court stated that it was following Arkansas Best Corp. v. Commissioner, 88-1 U.S.T.C. ¶9210 (U.S. 1988), in this summary judgment order.

a. *Prior Claims Court orders are vacated in order to facilitate settlement. Circle K Corp. v. United States, 97-1 U.S.T.C. ¶50,338 (Fed. Cl. 11/15/96). On joint motion of the parties, the court vacates its prior orders in order to facilitate settlement. The court distinguished U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership, 115 S. Ct. 386 (1994) ("mootness by reason of settlement does not justify vacatur of a judgment under review"), on the ground that the orders here did not give rise to any judgment.

4. *The last nail in the coffin of the "source of supply" variation of the Corn Products doctrine: Ordinary loss deduction not permitted on sale of oil refining company stock. Cenex, Inc. v. United States, 97-2 U.S.T.C. ¶50,532 (Fed. Cl. 7/27/97). The taxpayer was an agricultural coop that purchased stock in an oil refining company for the purpose of securing a source of supply for petroleum products for its patrons. When it sold the stock for a loss, the taxpayer claimed an ordinary loss under the source of inventory supply variation of the Corn Products exception to the definition of capital asset. The court unequivocally rejected the taxpayer's argument that corporate stock purchased with the motive of securing the purchase of inventory from the corporation whose stock has been purchased has sufficient "business connection" to inventory to be excluded from the definition of a capital asset. Rather, the exception is limited to surrogates for inventory, and "an ownership interest in a corporation cannot fit within even a strained definition of the term 'inventory.'" In a footnote, the court specifically refused to follow the reasoning of Circle K Corp. v. United States, 23 Ct. Cl. 665 (1991), withdrawn, 78 A.F.T.R.2d 7619 (1996).

5. Estate of Israel v. Commissioner, 108 T.C. No. 13 (4/1/97) (reviewed, 14-1). Judge Swift's majority opinion held that fees paid in connection with the "cancellation" of unregulated forward contracts in interest-bearing government securities are treated as capital losses because closing a contract by "cancellation" is equivalent to closing the contract by "offset" [which constitutes a "sale or exchange"], so losses from canceled contracts should be treated as capital losses. Judge Beghe's concurring opinion noted that "true cancellations are only employed to correct mistakes, not to close out forward contracts entered into and disposed of in the ordinary course of business." The concurring opinion relies on Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962), to conclude that "formalistic distinction[s]" are "fast becoming a footnote to history." Judge Halpern's dissent was based on the ground that "cancellation, termination and relinquishment" do not fall within the
§1222 "sale or exchange" requirement for capital gain and loss (i.e., the majority approach lacks "specific statutory authority"), and he rejects the majority's extension of the "substance over form" approach [characterized by the majority as the "realities of the transaction" approach].

6. *Ordinary loss deduction allowed for losses incurred in connection with payments made with respect to transferred employees' homes. Amdahl Corp. v. Commissioner, 108 T.C. No. 24 (6/17/97). Taxpayer was entitled to an ordinary deduction for amounts it paid relocation services companies in connection with their selling homes for taxpayer's relocated employees. These amounts include losses incurred on the residence sales. Judge Gerber found that neither the taxpayer nor the relocation services company ever acquired beneficial ownership of the residences. The employees were paid the amount of the equity in their homes by the relocation sales companies, and if a greater net sales price was realized on the ultimate sale to third-party purchasers, that additional amount would go to the employee.

- This restructured version of employee relocation transactions sidesteps the holding in Azar Nut Co. v. Commissioner, 931 F.2d 314 (5th Cir.1991), aff'd 94 T.C. 455 (1990), which applied Arkansas Best Corp. to deny Corn Products ordinary loss treatment for a loss incurred on the resale of house purchased from a terminated executive pursuant to the executive's employment contract.

- **Query** whether the Amdahl employees would have income in the amount of Amdahl's loss on their houses?

7. *A stepped-up basis for property not includable in the gross estate! Did the majority in the case read §1014(b)(9)? Patten v. United States, 97-2 U.S.T.C. ¶60,279, 80 A.F.T.R.2d 5108 (4th Cir. 6/26/97). Marjorie Blaney became a joint tenant with her late husband by virtue of a gift from him in 1955. When Mr. Blaney died in 1989, 50% of the value of the property was included in his estate tax return, and when Mrs. Blaney sold the property, she claimed a stepped-up basis in a one-half interest. After Mrs. Blaney died, her administrator filed an amended return claiming that she was entitled to a basis equal to 100% of property's value on Mr. Blaney's death. The court held that stepped-up basis under §1014 applies to 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, even though under §2040(b), as amended in 1981, thereafter only ½ of the value is 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. (Gallenstein v. Commissioner, 975 F.2d 286 (6th Cir. 1992), allowed a 100% step-up where 100% of the property was included in the deceased spouses gross estate by an amended return.) A cogent dissent argued that as a result of the 1981 amendments, whether an interest is a "qualified joint interest," which results in a stepped-up basis for only 50% of the property, is determined solely with reference to the deceased spouse's date of death, not the date the interest was created.
8. *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!

a. 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, 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 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.

- Technical Corrections bill to address interaction between capital losses and capital gains, which was left unclear by the 1997 Act. Capital gains and losses under the post-technical corrections rules. Notice 97-59, 1997-45 I.R.B. (10/27/97). Summarizes the amended §1(h) rules as they would be after passage of technical
corrections legislation, including the rules for netting capital gains and losses. Net long term capital losses will offset 28% gain first, then 25% gain, and then 20% gain. Net short-term losses will offset short term gain, then 28%, 25% and 20% gain.

b. 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).

c. No applicable capital gains tax relief was provided for corporations. 1997 Act §314 amends Code §1201(a) to provide that the rate on corporate capital gain may not exceed 35 percent. Effective for taxable years ending after 12/31/97. (The House Bill had provided for a 30% top rate on corporate capital gain.)

d. 1997 Act §1001 adds new Code §1259 to provide constructive sales treatment for certain appreciated financial instruments, The prototypical transaction to which this applies is the "short sale against the box," in which taxpayer's unrealized appreciation is locked in.

- "Position" includes not only ownership of stock, debt, or partnership interest, but also a futures or forward contract, option or short sale with respect to such an interest. Generally effective for constructive sales after 6/8/97. Contains a special rule for decedents dying after 6/8/97, with pre-6/9/97 constructive sales, which provides §691 IRD treatment for the constructive sale.

- Generally speaking, a taxpayer is treated as making a constructive sale of an existing position in an appreciated financial instrument, and thus must recognize gain, when the taxpayer: (1) enters into a short sale of the same or substantially identical property, (2) enters into an offsetting notional principal contract with respect to the same or substantially identical property, or (3) enters into a futures or forward contract to deliver the same or substantially identical property.

- If a taxpayer without an existing position in an appreciated financial instrument engages in a short sale, a notional principal contract or a futures or forward contract with respect to a financial instrument, the taxpayer is treated as making a constructive sale when he acquires the same property as the underlying property for the position

e. *1997 Act §1003(a) amends Code §1234A to provide gain or loss from the cancellation, lapse, expiration or termination of any right with respect to real property [in addition to the existing rule that covers personal property] will result in capital gain and capital loss, effective to terminations more than 30 days after 8/5/97, i.e., 9/4/97.

- 1997 Act §1003(b) amends Code §1233 to provide that if taxpayer enters into a short sale of any property that becomes substantially worthless, the taxpayer will realize gain in the same manner as if the short sale were closed when the property became substantially worthless, effective after 8/5/97. Under regulations, also applicable to options, offsetting notional principal contracts,
futures and forward contracts to deliver property, and similar transactions.

IV. CORPORATIONS

A. Entity and Formation

1. **Step-down preferred to be recharacterized.** Notice 97-21, 1997-11 I.R.B. 9 (2/27/97). IRS announces it will recharacterize for tax purposes (under §7701(1)) transactions using self-amortizing investments (e.g., step-down preferred stock) in conduit financing entities which artificially allocate the conduit’s income to participants not subject to the federal income tax, the deductions to the taxpayer/sponsor owning the common stock of the conduit, and virtually all the residual to the taxpayer once the preferred is amortized in 10 years. Under the recharacterization, the holders of the preferred stock would be treated as having engaged in an “income stripping” transaction.

2. **Northern Indiana Public Service Co. v. Commissioner,** 97-1 U.S.T.C. ¶50,474 (7th Cir. 6/6/97). Netherlands Antilles finance subsidiary [which issued Euronotes guaranteed by parent] was recognized as a separate entity under Moline Properties Inc. v. Commissioner, 319 U.S. 436 (1943), and that the subsidiary was not a mere conduit and that transactions between parent and subsidiary should not be disregarded for tax purposes. The IRS contended that the parent should be treated as having paid interest directly to the Euronote holders.

3. **Liabilities for vacation pay, assumed in midstream transfer of businesses under §351, are fully deductible when incurred by transferee; amounts received to cover these liabilities are excluded from income under §1032. TAM 9716001 (6/17/96).** Following a §351 exchange, the corporation that assumed vacation pay liability [arising from transferor’s businesses] may deduct the total payments it makes to satisfy the liability in the year in which the deduction is allowed under §404(a)(5). It need not take into income, or reduce its deduction by, the amount transferred as reimbursement for the corporation’s assumption of the liability because §1032 excludes from the gross income of a corporation any money or property received in exchange for its stock. Holdcroft Transportation Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946), not followed, as the case was not followed in either Rev. Rul. 80-198, 1980-2 C.B. 113, or Rev. Rul. 95-74, 1995-46 I.R.B. 6.

4. **See, Rev. Rul. 95-74, 1995-2 C.B. 36. The §357(c)(3) exception from possible gain treatment of the transfer of liabilities that were deductible when paid, also includes liabilities that were to be capitalized when paid.**
   a. **1997 Act** §1002 amends Code §351(e) to expand the existing exception from §351 tax-free treatment for transfers to investment companies by expanding the definition of “investment company” to include a corporation more than 80% of the assets of which are securities or certain other investment assets. Effective for transfers made after 6/8/97.
   b. **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 (a) the holder has a put right, (b) the issuer or a related person is required to redeem or purchase the stock, (c) 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 (d) 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.

5. **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 reversed and held 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.

B. **Distributions and Redemptions**

   1. REG-209121-89, proposed regulations under §337(d), relating to the recognition of gain or loss [under General Utilities repeal] on a transaction where a taxable corporation transfers all or substantially all of its assets to a tax-exempt entity or converts from a taxable corporation to a tax-exempt entity (62 F.R. 2064, 1/15/97).

   2. Estate of Brown v. Commissioner, T.C. Memo. 1997-195 (4/28/97). Decedent enabled his two sons to "purchase" 33% of stock of the Cincinnati Bengals football team from his partner John Sawyer in 1993 by "selling" his 12% stock interest to Sawyer in 1983 for a promissory note. This purchase permitted Sawyer (who needed cash) to receive dividends on the 12% interest between 1983-1993, as well as on his pre-existing 21% stock interest. The transaction was accomplished
with options, promissory notes, debt forgiveness, and a limited partnership, with the result that only 1/10% of the Bengals stock was included in decedent’s estate. The government contended that the 33% stock interest should be included in gross estate because the substance of the transaction was that decedent gave Sawyer the dividends from his 12% stock interest for 10 years in return for the remainder interest of Sawyer’s 21% stock interest, resulting in a transfer by decedent of 33% of Bengals stock to his sons through Sawyer as conduit.

3. A small taxpayer victory based on “reasonable compensation” as an employment history concept. Better hope this door doesn’t swing both ways? Thoni Service Corp. United States, 97-2 U.S.T.C. ¶50,548 (11th Cir. 9/3/97) (unpublished). The Court of Appeals vacated and remanded a district court summary judgment for the government, holding that a bargain sale of property to sole shareholder/president was a dividend. Taxpayer had raised a material issue of fact, based on the affidavit of the corporate secretary (the sole shareholder’s wife) regarding whether the corporation’s intent was to compensate the shareholder/president for service in prior years for less than adequate compensation.

4. 1997 Legislation
   a. 1997 Act §1011 amends Code §1059 to provide that a corporate shareholder will recognize gain immediately with respect to any redemption treated as a dividend when the nontaxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership (or the shareholder’s total basis in all shares with respect to which any extraordinary dividend was received is rescued below zero). This provision is effective for distributions after 5/3/95 [or, under the circumstances where a distribution is not a partial liquidation, a non pro rata redemption or a redemption that is not treated as a dividend by reason of options, effective for distributions after 9/13/95]. The provision attacks transactions similar to the one in which Seagram redeemed 95% of its stock in DuPont for cash and out-of-the-money options to purchase the same number of shares redeemed, where dividend treatment was sought instead of sale treatment.

   b. 1997 Act §1013 amends §304 to provide that to the extent a §304 transaction is treated as a §301 dividend distribution, the transferor is treated as if it had transferred stock to the acquiring corporation in a §351 transaction (in return for acquiring corporation stock), followed by the acquiring corporation redeeming its newly-issued stock. The extraordinary dividend provisions of §1059 may be applied to this transaction, requiring a reduction stock in basis. This provision applies to redemptions involving related corporations (other than subsidiaries), and is effective for distributions and acquisitions after 6/8/97.

   c. 1997 Act §1015 amends Code §246©(1)(A) to modify the holding period for the [70%-80%-100%] dividends received deduction, effective generally for dividends received or accrued after 9/4/97.

C. Liquidations
1. REG-209332-80, proposed regulations under §453(h) relating to the tax treatment of installment obligations received by a shareholder from a liquidating corporation (62 F.R. 3244, 1/22/97).

D. S Corporations

1. Updates to 1996 Legislation
a. Electing small business trusts are permitted shareholders; spray and sprinkle trusts may now hold stock of S corporations. There is, however, a high price to be paid because the trust is taxed at 39.6% on its S corporation income. SBJPA §1302 amends §1361 to permit electing small business trusts to be shareholders. All beneficiaries must be eligible individuals or estates, except that charitable organizations may hold contingent remainder interests. (For years beginning after 12/31/97, the charitable organization’s interest need not be contingent.) No interests in the trust may be acquired by purchase. Each potential current beneficiary (i.e., any person who is entitled to, or may receive at the discretion of any person, a distribution from trust principal or income) is counted as a shareholder with respect to the 75 shareholder limitation. The trust is taxed at the highest individual rate on all items of income, loss or deduction, as well as on gain or loss from the sale of the S corporation stock—but these amounts are not included in DNI; in computing the trust’s income, no deduction is allowed for amounts distributed to beneficiaries.

(1) Notice 97-12, 1997-3 I.R.B. 11 (12/31/96). Guidance on making the Electing Small Business Trust §1361 election to be a shareholder of an S corporation. While all potential current beneficiaries of the ESBT are treated as shareholders for the 75-shareholder limitation, only the trustee need make the ESBT election and consent to the S corporation election.

(2) Notice 97-49, 1997-36 IRB (8/25/97). Provides guidance regarding the definitions of “beneficiary” and “potential current beneficiary” of an electing small business trust (EBST).

(3) 1997 Act §1061 amends Code §1361(c) to provide that charitable remainder trusts may not be EBSTs, effective for tax years beginning after 12/31/96.

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

(1) Announcement 97-4, 1997-3 I.R.B. (1/2/97). Informs taxpayers of procedures for obtaining IRS permission to treat a late S election as timely made and to waive the defects in an inadvertent invalid S election. Generally, a taxpayer must seek a private letter ruling.

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


c. Agreement to terminate year need not be made by "all shareholders," but only by "all affected shareholders." SBJPA §1306 amends §1377 to provide that elections to allocate items on a "closing the books" basis may be made by "all affected shareholders" (instead of "all shareholders"), but if a shareholder transferred shares to the corporation, "affected shareholders" include all persons who were shareholders during the year. Therefore, e.g., a 10 percent shareholder who continues as such for the entire year need not join in the election made when another shareholder terminates his interest by sale, and, therefore may no longer exact a price for joining in the election.

(1) T.D. 8696, final and temporary regulations under §1377, including regulations under the changes in the 1996 SBJPA with respect to the agreement to have an interim closing of the books on the termination of a shareholder’s interest in the corporation.

d. A bank makes an S election? SBJPA §1315 amends §1361 to allow a (closely held) financial institution that is not using the reserve method of accounting for bad debts to be an "eligible small business corporation" and to make an S election.

(1) Notice 97-5, 1997-2 I.R.B. 25 (12/20/96). Provides guidance on the effect of the §1361(b)(3) Qualified Subchapter S Subsidiary (QSSS) election on banks affiliated with nonbanks, in order to limit the special provisions of the Code that apply to banks only to that entity that qualifies as a bank under §581. Technical corrections may be necessary to achieve this limitation.

e. 5-year rule for reelecting subchapter S status is waived. SBJPA §1317(b) waives the Code §1362(g) 5-year waiting period for making a new S election for any corporation whose S election was terminated under Code §1362(d) in a taxable year beginning before 1/1/97.

(1) Notice 97-3, 1997-1 I.R.B. 8 (12/20/96). Guidance on waiving the limitations on a corporation’s ability to change its tax year in order to make an S election. Based upon the significant amendments to Subchapter S in the SBJPA of 1996.

(2) Notice 97-20, 1997-10 I.R.B. 52 (2/26/97). Waives restrictions on an automatic change to a calendar year effective for the short period ending 12/31/96, provided that special procedures are followed.

2. The form was sloppy, but there was enough of it to control. Bolding v. Commissioner, 117 F.3d 270, 97-2 U.S.T.C. ¶50,554 80 A.F.T.R.2d 5481 (5th Cir. 8/18/97). Taxpayer conducted a cattle ranching business through an S corporation, Three Forks Land & Cattle Co." The taxpayer arranged a line of credit from a bank, signing the note, security agreement, and UCC-1 "Dennis E. Bolding d/b/a Three Forks Land & Cattle Co. The bank disbursed the loan proceeds directly
to the corporation's bank account and the corporation made loan payments directly to the bank. When the corporation incurred losses in excess of the taxpayer's basis in his stock, he claimed losses against the amount of the loan on the theory that the bank lent him the funds and he relented them to the corporation. The corporation's return showed the loan as a loan from stockholders. The court upheld the taxpayer's contention because the transaction followed the form of a loan from the bank to the taxpayer individually, and rejected the Commissioner's argument that the loan was in substance to the corporation. Taxpayer's failure to report interest income from the corporation and interest deductions to the bank was not contrary to the taxpayer's characterization because they items washed out at the same interest rate.

3. **Basis increase on passthrough of excluded discharge of indebtedness income.** Winn v. Commissioner, T.C. Memo. 1997-286 (6/24/97). Cancellation of indebtedness income that an S corporation received as a passthrough item from a partnership was an item of income that increases shareholders' bases in their stock of the S corporation.

4. TAM 9716003 (9/30/96). C corporation, with interests in partnerships that use the LIFO method, must include in income on its conversion to an S corporation its share [passed through by the partnerships] of the §1363(d) LIFO recapture amount.

5. Broadaway v. Commissioner, 97-1 U.S.T.C. ¶50,355 (8th Cir. 4/16/97). Corporation's earnings and profits (e&p) for its last year as a C corporation must be computed on the basis of year-end estimates of the total costs of long-term contracts without later adjustment to reflect actual (higher) costs because §1371© precludes any such adjustment.

E. **Affiliated Corporations**

1. Trinova Corp. v. Commissioner, 108 T.C. No. 6 (2/27/97) (reviewed, 11-6). Taxpayer's transfer of the assets of its glass division, including §38 assets on which ITCs had been claimed, to a newly-created subsidiary, followed in the same month by a transfer of the subsidiary's stock to a shareholder of taxpayer in redemption of that shareholder's stock, does not trigger ITC recapture because Rev. Rul. 82-20, 1982-1 C.B. 6, is trumped by Example 5 of Reg. §1.1502-3(f)(3). The Tax Court majority (Tannenwald, J.) followed its decision in Walt Disney Inc. v. Commissioner, 97 T.C. 221 (1991), rev'd, 4 F.3d 735 (9th Cir. 1993), stating that the regulation controlled and, that "if [Commissioner] was dissatisfied with the import of a regulation, she should use her broad powers to amend the regulation and not look to the courts to do it for her." Dissents by Judges Swift and Beghe would follow the Ninth Circuit reversal in Walt Disney Inc. and Rev. Rul. 82-20, and would distinguish Example 5 of the regulations under the substance-over-form doctrine because that example involved a transfer of the property to an existing subsidiary, followed by a separate transfer of the subsidiary's stock outside the consolidated group. (The dissent would hold that merely having a business purpose for each step of taxpayer's "reorganization plan" does not suffice to make inapplicable the step transaction doctrine.)
2. IU International Corp. v. United States, 97-1 U.S.T.C. ¶50,534 (Fed. Cir. 7/1/97). Parent corporation held not entitled to increase its basis in the stock of a second-tier subsidiary, which was spun off to it by the first-tier subsidiary by the amount of accumulated e&P allocated to the second-tier sub under §312 as a result of the §355 distribution. The court followed the consolidated returns regulations, Reg. §1.1502-32(b), and held that the only basis adjustment was for the (current) undistributed e&P actually earned by the second-tier subsidiary itself.

3. 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.

4. Alumax, Inc. v. Commissioner, 109 TC 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.

F. Section 482

1. *Government applied for certiorari in Aramco Advantage case, but Supreme Court denied certiorari.* Texaco Inc. v. Commissioner, 98 F.3d 825, 96-2 U.S.T.C. ¶50,556, (5th Cir. 10/17/96), petition for cert. filed, 65 USLW 3507 (1/10/97), cert. denied, (4/20/97). IRS could not allocate income under §482 to Texaco when Texaco had been prohibited by Saudi law from receiving it because Texaco lacked the ability to control the allocation of the income in question, so it could not have used that control to evade taxes or artificially shift its income to its foreign affiliates. The court cites Reg. §1.482-1(b)(1) (which contemplates that the controlling interest “must have ‘complete power’ to shift income among its subsidiaries”) and Commissioner v. First Security Bank, 405 U.S. 394 (1972) (restrictions of federal banking law precluded the bank holding company’s shifting income from its insurance affiliate to its bank subsidiaries).

* Section 482 could not be applied where a U.S. taxpayer sold to foreign affiliates crude oil produced in Saudi Arabia at maximum price permitted under Saudi law. Sales of crude oil to unrelated purchasers — 15 to-20 percent of total crude oil sales — were at the same price, and the taxpayer lacked any power to control the price. The court also rejected the government’s argument that Texaco ought to be taxed under Basye, and instead applied First Security Bank of Utah.


3. The teeth in §6038A bite. ASAT Inc. v. Commissioner, 108 T.C. No. 11 (3/31/97). Noncompliance penalty imposed under §6038A(e) by reason of taxpayer’s failure to be authorized as its
foreign parent’s agent was upheld. The court rejected taxpayer’s argument that it was legally impossible for it to obtain its parent’s authorization. Judge Vasquez upheld the IRS increasing taxpayer’s gross profit percentage spread in transactions with its parent from 6% to 15%, noting that the standard of proof under §6038A differs from that under §482 in that §6038A requires a taxpayer to show by “clear and convincing evidence and without reference to information to information not in [the IRS’s] possession that [the IRS’s] determination was made with an improper motive or is clearly erroneous in light of all reasonably credible interpretations or assumptions of fact.”

4. Blinded by their own brilliance—at least until the shade of §482 appeared. Kaps Warehouse, Inc. v. Commissioner, T.C. Memo. 1997-309 (7/3/97). A group of shareholders controlled a C corporation, which wholesaled auto parts, as well as a number of retail auto parts stores that were operated as S corporations. The wholesaler corporation allowed price rebates to the related retail corporations that it did not allow to unrelated retailers. As a result, the C corporation’s income was reduced and the S corporations, in which controlling shareholders had a very low or zero basis, which would have run operating losses if they paid an arm’s length price, realized small profits. The Tax Court upheld the Commissioner’s application of §482 to disallow the price rebates, thereby increasing the C corporation’s income and reducing the S corporation’s income to create operating losses.

G. Reorganizations and Corporate Divisions

1. *Proposed regulations would modify continuity of shareholder interest requirements. REG-252231-96, proposed regulations under §368, providing that the continuity of shareholder interest (COSI) 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 (61 F.R. 67512, 12/23/96). The proposed 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 COSI 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.

2. Remote continuity regulations; solving a problem for the UPREIT industry. REG-252233-96, proposed regulations under §368, providing rules that under certain circumstances transfers by the acquiring corporation of target assets or stock to controlled corporations or partnerships will not disqualify the transaction from satisfying the continuity of interest and continuity of business enterprise requirements (62 F.R. 361, 1/3/97). The proposed regulations curtail the Groman-Bashford remote continuity of interest doctrine by providing that the assets or stock can be transferred among members of a “qualified group” or the assets be transferred to a partnership (viewed as an aggregate).

3. *Warrants will be securities, instead of boot. REG-249819-96, proposed regulations under §§354, 355 and 356, to treat
rights to acquire stock (i.e., warrants) as securities of the corporation having no principal amount (61 F.R. 67508, 12/23/96).

4. 1997 Legislation
   a. *1997 Act §1012(a) adds new Code §355(e) to provide that §355 may not be used in connection with a corporate acquisition. Effective for distributions after 4/16/97, pursuant to acquisitions after that date.
      • Imposes additional restrictions on the "Morris Trust"-type transaction, where there is a change in control of the distributing or controlled corporation in connection with the distribution pursuant to a plan or arrangement. The provision requires that gain be recognized by the distributing corporation as if the stock of the controlled corporation had been sold for fair market value on the date of distribution. No basis adjustment for either stock or assets by reason of the gain recognition, but the distributee continues to receive nonrecognition treatment, and determines basis as under prior law.
      • Acquisitions occurring less than two years before or after the date of distribution are presumed [rebuttably] to have occurred pursuant to the plan or arrangement.
   b. *1997 Act §1012(b) adds new Code §§355(f) & 358(j) to provide that §355 not apply to intragroup distributions that are part of a plan of corporate acquisition, with basis adjustments pursuant to regulations. Same effective date.
   c. *1997 Act §1012(c) amends Code §351(c) to provide for a reduction in the control percentage from 80% to 50% where §351 is used in connection with a divisive transaction.

H. Accumulated Earnings
   1. Northwestern Indiana Tel. Co. v. Commissioner, 1997 U.S. App. LEXIS 29071, 97-1 U.S.T.C. ¶50, (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.

V. EMPLOYEE COMPENSATION AND PLANS
   A. In General
      1. Plan Curative Programs
         a. Administrative policy regarding self-correction. IRS Administrative Policy Regarding Self-Correction (APRSC), released 1/7/97, replaces the 1991 administrative policy regarding sanctions guidelines in the Employee Plans Examination Guidelines Handbook. Enables employers to correct operational violations in plans intended to be qualified under §§401(a) and 403(b), without adverse tax consequences.

2. Does ERISA trump community property law?
   a. Fifth circuit answer: No. Boggs v. Boggs, 82 F.3d 90 (5th Cir. 4/17/96) (2-1), cert. granted, 117 S. Ct. 379 (11/1/96). Judge Wisdom’s majority opinion held that the anti-alienation provision of ERISA did not preempt Louisiana community property law, so employee’s widow’s survivor’s annuity—to the extent it represented the community property interest belonging to employee’s first wife (who died during his employment, leaving 2/3 of her estate to the employee [her husband] in a lifetime usufruct) -- was subject to a possible accounting and award of some portion of the retirement benefits to the three sons of the first wife as owners of the naked or reversionary interest in the portion of her estate over which employee held a usufruct. Judge King dissented on the ground that the widow’s rights under ERISA—which were to have been applied uniformly nationwide—were not only “tenuously, remotely or peripherally” affected by Louisiana law, but rather, “They have been gutted.” The dissent would have followed Ablamis v. Roper, 937 F.2d 1450 (9th Cir. 1991). and DOL Advisory Opinion #90-46A (12/4/90) on this issue.
   b. Dissent from above case. Boggs v. Boggs, 89 F.3d 1169 (5th Cir. 7/16/96) (dissent from failure to grant rehearing en banc) (Weiner, J.). Disagrees with court’s refusal to reconsider opinion that ERISA does not preempt community property law. Judge Weiner and 5 other judges take the position that the court’s decision, permitting the heirs of a nonparticipant spouse to obtain a portion of the ERISA benefit from the widow of the participant, is a circumvention by indirect means of ERISA’s antialienation policy.
   c. *Supreme Court reverses: ERISA preempts community property law rights. Boggs v. Boggs, 117 S. Ct. 1754, 1997 U.S. LEXIS 3396 (U.S. 6/2/97) (5-4). Louisiana community property law is preempted by ERISA, so surviving widow’s annuity in decedent’s employer’s plan may not be burdened by claim by children of decedent’s first marriage, which was asserted based upon the bequest of decedent’s first wife’s community property interest in the plan.

3. Hopkins v. AT&T Global Information Solutions Co., 105 F.3d 153 (4th Cir. 1/24/97). Survivor benefits vest in the surviving spouse on the date her husband [the plan participant] retires, so a state court order that the participant’s former spouse be named an “alternate payee” [to enable her to collect past-due and current alimony] is not a QDRO because the surviving spouse is a “beneficiary,” and not a “plan participant,” so the order did not relate to a benefit “payable with respect to a participant” under ERISA §1056(d)(3)(B)(i)(I).

4. *Treasury must provide sample language that is also “simple language” for spousal consents and QDROs by 1996 yearend. SBJPA §1457 requires Treasury to provide sample language [that is also simple language] for inclusion in a spousal consent form and in a
qualified domestic relations order, the sample language to be developed no later than 1/1/97.


5. Excise tax on excess pension distributions suspended for distributions in 1997, 1998, and 1999; this is a gift horse whose mouth should be examined. SBPJA of 1996 §1452 also suspends the Code §4980A excise tax on excess distributions for distributions received in 1997, 1998 and 1999. See 1997 Act, below, for repeal of the tax.

a. *1997 Act §1073 repeals the Code §4980A excise tax of 15% on excess distributions from qualified retirement plans and the excise on excess retirement accumulations at death. Applies to distributions received after 12/31/96 and to estates of decedents dying after 12/31/96.

6. Date for making plan amendments.

a. Now, the date has been extended through the end of 1999, and a single "remedial amendment period" is provided. Rev. Proc. 97-41, 1997-33 I.R.B. (7/31/97). Deadlines for adopting plan amendments to comply with changes made by SBPJA, GATT and USERRA is the last day of the first plan year beginning on or after 1/1/99.

b. T.D. 8727 and REG-106043-97, final temporary and proposed regulations on amending qualification defects under §401(b) in retirement plans (during the remedial amendment period in which retroactive amendments may be made to eliminate qualification defects for the entire period).

c. 1997 Act §1541 generally provides that plan amendments for legislation between 1994 and 1997 must be completed by the end of the first year that begins in 1999.

d. Yours is not to reason why. Rev. Proc. 96-49, 1996-43 I.R.B. 74. Model amendment to amend plans to comply with the requirements of the Uniformed Services Employment and Reemployment Rights Act of 1994, P.L. 103-353, and §414(u) [added by §1704(n) of the Small Business Job Protection Act of 1996], which generally will be required to be made by the end of the 1997 [revised to 1999] plan year.

7. Medical Savings Accounts for a limited number of taxpayers. Health Insurance Portability and Accountability Act of 1996 ("HIPAA") §301 adds new §220 to provide for medical savings accounts for a 4-year pilot period 1997-2000, for up to 750,000 participants on a first-come/first-served basis, for a limited number of taxpayers. These accounts are created with employer-provided, or individual, deductible contributions [up to a maximum of 65 percent of the deductible in the case of individual coverage, or 75 percent in the case of family coverage] and are established in connection with a small employer's high deductible health plan [a deductible between $1,500 and $2,250 for individual coverage, and between $3,000 and $4,500 for family coverage] or by a similarly-insured self-employed individual. Distributions for medical expenses are excludable from income; distributions not for medical expenses are includible in
income, and are subject to an additional 15-percent tax unless made after age 65, death or disability.


8. Rev. Rul. 97-20, 1997-19 I.R.B. 4 (4/22/97). Guidance on the definition of a "high-deductible health plan" under the §220© Medical Savings Account provisions. The deductible must be stated only in family terms, without regard to which family members incur expenses. Transition period provided for plans that do not comply. Highly compensated definition modified, with election to include/exclude recipients of more than $80,000 annual compensation but are not in the top 20 percent of employees. Small Business Job Protection Act of 1996 amends §414(q) to modify the definition of "highly compensated" from prior law’s (i) 5 percent owners, (ii) recipients of more than $100,000 annual compensation, (iii) recipients of more than $66,000 annual compensation and in the top 20 percent of employees in compensation, (iv) any officer who received annual compensation in excess of $60,000, and (v) the highest paid officer, to (i) 5 percent owners, and (ii) recipients of more than $80,000 annual compensation (who are within/not within the top 20 percent of employees in compensation, based upon an annual election). Therefore, an employer can elect to treat employees with more than $80,000 in annual compensation [but not in the top 20 percent] as either highly compensated or not highly compensated on a year-by-year basis. This election would be of interest to employers [such as law firms] who have more than 20 percent of employees who are paid more than $80,000 per year.

a. Notice 97-45, 1997-33 I.R.B. 7. Guidance regarding the §414(q)(1)(B)(ii) election to exclude from the "highly compensated" group employees who earned more than $80,000 but were not in the top 20 percent.

9. *Drafting plans for companies that use workers who are leased employees or independent contractors.

a. The right way to do it; exclude workers not classified on company records as employees from plan participation. Abraham v. Exxon Corp., 85 F.3d 1126 (5th Cir. 6/10/96). On summary judgment, held that leased employees [who "report to Exxon supervisors, have Exxon business cards and play on the Exxon softball team] are not entitled to pension plan benefits even though Exxon conceded for purposes of its motion that the plaintiffs were "common law employees" of Exxon. Judge Smith refused to follow Renda v. Adam Meldrum & Anderson Co., 806 F. Supp. 1071 (W.D. N.Y. 1992) (holding that ERISA §1052(a)(1)(A) forbids employers to discriminate against leased employees when designing an ERISA plan), because ERISA §1052(a) does not prevent employers from denying participation in an ERISA plan if the employer does so on a basis other than age or length of service.

b. The wrong way to do it; include employees—however classified on company records—in the plan. But, rehearing en banc granted. Vizcaino v. Microsoft Corp., 97 F.3d 1187, 96-2 U.S.T.C. ¶50,553 (9th Cir. 10/3/96) (2-1), rehearing en banc granted, 105 F.3d 1334 (9th Cir. 2/10/97). Plaintiffs, who were classified by Microsoft
as independent contractors, sued to obtain benefits provided to regular employees. Summary judgment for Microsoft reversed on the ground that plaintiffs (aka, "Microserfs") are entitled to participate in the savings plan and the stock option plan on the same terms as regular employees.

c. Ninth Circuit en banc adheres to its earlier opinion, 97-2 U.S.T.C. ¶50,572 (9th Cir. 7/24/97) (8-3). Remanded to district court for determination with respect to the stock option plan and remanded to the plan administrator for determination with respect to the §401(k) plan.

10. *Proposed regulation would enable plans to more easily accept rollover contributions from job-shifting employees. REG-245562-96, proposed amendments to Reg. §1.401(a)(31)-1, providing guidance on the qualification of retirement plans that accept rollover contributions from employees (61 F.R. 49279). Acceptance of rollover contributions, in appropriate circumstances [e.g., where the plan administrator reasonably concludes that a distribution meets the other requirements to be an eligible rollover distribution, or is a rollover contribution from an employee within 60 days from the date of distribution from a plan, or is a rollover contribution from a conduit IRS], will not affect a plan's qualification.

a. 1997 Act §1509 mandates regulations to protect pension plans from disqualification should the administrator, acting reasonably, accept an invalid rollover contribution.

11. Tech Adv. Mem. 9647003 (6/21/96). The cost of commercial airline tickets furnished by an employer to an employee for travel from his home to a remote work site is wages for federal income tax withholding and employment taxes. They are not §132(d) working condition fringe benefits because they would not have been deductible by the employee under §§162 or 167 had employee paid for the tickets.

12. Rev. Rul. 96-41, 1996-45 I.R.B. 4 (10/22/96). Plans that provide benefits under §127 educational assistance programs will not fail to qualify merely because eligible participants include former employees, regardless of the reason for termination for termination of employment.

13. Tech. Adv. Mem. 9635002 (11/9/95). Contributions to a qualified plan [with profit-sharing features and cash or deferred arrangements] plan of an employee’s unused vacation time (converted to its equivalent in pay) are excludable under §3121(a)(5)(A) from the employee’s wages for FICA purposes. The choice made by the employee was not a cash or deferred arrangement because the employee did not have the option to receive cash or any other taxable benefit; it was simply a nonelective employer contribution to a qualified plan.


15. LTR 9712033 (12/24/96), reexamination announced, Ann. 97-45, 1997-17 I.R.B., 20 (4/15/97). Travelers Group Inc. may deduct the value of options on its own shares that it contributes to its
profit sharing plan, the valuation to be determined under a method to be determined, such as the Black-Scholes method. Travelers plans to issue options for its own stock [valued on the day before contribution, which is also the option price] to all its employees, equal to 10 percent of compensation (up to $40,000), and seeks to deduct the value of the options immediately.

- The Service subsequently announced that it was "reexamining the plan qualification and other tax issues . . . raised by a contribution of stock options to a plan and subsequent exercise of those options."

16. Inter-Model Rail Employees Ass'n v. Atchison, Topeka & Santa Fe Railway, 117 S. Ct. 1513 (U.S. 5/12/97). ERISA plan participants, who were fired allegedly to eliminate welfare benefits, may sue under to eliminate welfare benefits, may sue under ERISA §510 [unlawful to discharge employee "for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan"] even though there was no vested benefit involved.

17. Lindsay v. Thiokol Corp., 112 F.3d 1068, 1997 U.S. App. LEXIS 7904 (10th Cir. 4/18/97). ERISA does not, as a matter of law, prohibit a pension plan from setting a "normal retirement age" greater than age 65, i.e., a retirement age of 67.

18. Campbell v. Commissioner, 108 T.C. No. 5 (2/18/97). Pursuant to §72(e)(6), the taxpayer’s basis in his IRA account included not only nondeductible contributions permitted under §402(o), but also excess contributions.

19. Vorwald v. Commissioner, T.C. Memo. 1997-15 (1/8/97). Transfer of IRA proceeds to taxpayer's ex-wife pursuant to garnishment was a premature distribution, includable by the taxpayer and subject to the §72(t) penalty.

20. Lozon v. Commissioner, T.C. Memo. 1997-250 (6/4/97). Allstate Insurance Co. agents were held to be independent contractors. Nevertheless, Allstate's contributions to pension and profit sharing plans on their behalf were not taxable to them in the years made [and would not be taxable until the funds are distributed]. Section 83 did not apply because § 83(e)(2) excludes transfers to qualified pension plan trusts from the ambit of §83 and the Commissioner conceded the plan’s qualified status). Query: Could the mistaken contributions have blown the plan’s qualified status if the Commissioner chose to litigate that issue?

21. 1997 Legislation

a. A taxonomy of IRAs.

(1) Existing IRAs. 1997 Act §301 amends Code §§72 & 408 and adds new Code §408A to increase the AGI phaseout ranges for single taxpayers between $50-60,000 in year 2005 and for joint filers between $80-100,000. An individual will no longer be precluded from contributing to a deductible IRA merely because his spouse is an active participant (with phaseout at $150,000 to $160,000 income levels). The penalty-free withdrawal provisions of Code §72(t) are expanded to allow distributions for first-time homebuyer expanses ($10,000 lifetime cap) and for higher education expenses.
(2) Nonductedible [Roth] IRAs. 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.

• Technical Corrections to close the loophole that permits taxpayers to roll over existing IRAs to back-loaded "Roth" IRAs, and immediately to make a withdrawal without incurring the 10% penalty for premature withdrawals under §72(t).

(3) Education IRAs ("EIRAs"). 1997 Act §213
adds new Code §530 to permit taxpayers to contribute up to $500 per beneficiary under 18 years of age, to pay the costs of the beneficiary's higher education. Contributions are not deductible, but withdrawals to pay the cost of post-secondary school tuition, room and board are tax-free. AGI phaseout ranges are the same as for Roth IRAs. Effective in 1998 and thereafter.

(a) Notice 97-57, 1997-43 I.R.B. (10/15/97). Entities already approved to serve as nonbank trustees and custodians for regular IRAs are automatically approved to do the same for Education IRAs.


c. *1997 Act §1071 amends Code §411(a)(11) to increase the limit on mandatory distributions from $3,500 to $5,000. For accrued benefit exceeding $5,000, mandatory distributions are impermissible. Effective for plan years beginning after 8/5/97.


e. 1997 Act §1074 amends Code §4975(a) to increase the first-level tax on prohibited transactions from 10% to 15%, effective for prohibited transactions after 8/5/97.

f. 1997 Act §1075 amends Code §72(d)(1) to provide a separate table for basis recovery rules for annuities over more than one life (i.e., joint and survivor annuities).

g. *1997 Act §1084 amends Code §264, etc. to deny deductibility of premiums and limit deductibility of interest where the taxpayer (other than an individual) is directly or indirectly a beneficiary under the insurance policy. This would have an effect on corporate-owned life insurance (other than key-person insurance covering up to 20 key persons). Effective generally for interest paid or accrued after 10/13/95. Also denies benefits to S corporations and partnerships.

h. *1997 Act §1501 amends Code §402(g) to provide that matching contributions on behalf of self-employed individuals will not be treated as elective employer contributions, and therefore will not be subject to the §401(k) limit of $9,500. This provides relief for partners in firms practicing law, accountancy, etc., who
previously were required to offset the matching contribution from the $9,500 limit. Effective for years beginning after 12/31/97.

i. 1997 Act §1502 amends Code §401(a)(13) and ERISA §206(d) to provide that the prohibition of assignment or alienation does not apply to damages arising from the participant’s fiduciary violation with respect to the plan. Income includible in participant’s taxable income as of the date of offset. Effective 8/5/97.

j. 1997 Act §1503 amends ERISA §101 to eliminate the requirement that summary plan descriptions and summaries of material modification be filed with the Department of Labor, effective 8/5/97. These documents, however, must be furnished to DOL upon request.

k. 1997 Act §1504 amends Code §403(b) to adjust tax-deferred annuity contribution limits to those of qualified plans under §415, effective for years beginning after 12/31/99.

l. 1997 Act §1505 amends Code §§401(a)(5), 401(a)(26), 410(c), 401(k)(3) and 403(b)(12) to make permanent the moratorium on the requirement that government plans comply with the same nondiscrimination rules as other plans must. Effective for tax years beginning on or after 8/5/97, with retroactive relief as well.

m. 1997 Act §1506 amends Code §409(h) to permit cash distributions to be made by ESOPs holding stock of S corporations, effective for tax years beginning after 12/31/97.

n. 1997 Act §1507 amends Code §4972©(6) by adding another exception to the 10% nondeductible excise tax imposed upon nondeductible contributions to qualified plans. Contributions to defined contribution plans that exceed the “combined plan deduction limit” are no longer subject to the tax except to the extent they exceed the amount of employer matching contributions plus elective deferral contributions to a §401(k) plan (limited to 6% of compensation). Effective for tax years beginning after 12/31/97.

o. *1997 Act §1521 amends Code §412©(7) to gradually increase the full funding limit from 150% of current liability to 170% in steps of 5% every two years [beginning in 1999] through 2005. This amendment is expected to encourage smaller businesses to adopt defined benefit plans.

p. 1997 Act §1523 amends Code §512(e) repealing the application of UBIT to ESOPs holding S corporation stock, effective for tax years after 12/31/97. This makes the effective tax rate on corporate income attributable to an ESOP shareholder as zero.

q. 1997 Act §1524 amends ERISA §407(b) to encourage diversification of §401(k) investments by prohibiting employers from requiring their employees to invest more than 10% of their elective deferral contributions (including earnings on those contributions) in employer securities or employer real property. Effective for elective deferrals for plan years beginning after 12/31/98.

r. 1997 Act §1530 amends Code §664(g) to encourage transfers of stock by charitable remainder trusts to ESOPs, effective for transfers made after 8/5/97.

22. 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.

VI. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Penalty on amounts of private excess benefits (intermediate sanctions). Taxpayer Bill of Rights 2 ("T2") [see XIV., below, for full citation] §1311 adds new §4958 to provide for intermediate sanctions short of disqualification for "excess benefit transactions." There is a 25 percent excise tax on the person receiving the benefit and a 10 percent excise tax on the organization's manager, with an additional 200 percent excise tax if the excess benefit is not corrected. An excise benefit transaction includes, but is not limited to, the payment of unreasonably high compensation to a person in a position to influence the organization. Applies to §501©(3) charitable organizations other than private foundations [already covered], as well as to §501©(4) social welfare organizations. Effective to inurement occurring on or after 9/14/95, with a grandfather through the end of 1996 for written contracts binding on that date and at all times thereafter.

a. *Hospital-provided incentives to recruit physicians ruled upon. Rev. Rul. 97-21, 1997-18 I.R.B. (4/21/97). Five fact situations relating to whether hospital-provided incentives to recruit private practice physicians violates the §501©(3) requirements for exemption. Situations 1, 2, and 3 involve areas with physician shortages, and inducements are held proper. Situation 4 involves a hospital in need of diagnostic radiologists, with a guarantee of private practice income approved by the hospital's Board, where inducements are held proper. [Note: The facts of this Situation 4 involve the recruitment of radiologists, who generally do not determine the hospital to which their patients are to be admitted; the ruling does not deal with a specialty (e.g., surgery) which has the possibility of patient referrals to a particular hospital.] Situation 5 involves a hospital's physician recruiting practices that resulted in a criminal conviction, where inducements were held improper.

2. *Beware unrelated business income [in any amount] in a charitable remainder trust; it causes the trust's entire income to be taxable. Leila G. Newhall Unitrust v. Commissioner, 105 F.3d 482, 97-1 U.S.T.C. ¶50,159 (9th Cir. 1/21/97). Charitable remainder unitrust's receipt of unrelated business taxable income from three [grandfathered] publicly traded limited partnerships caused it to be taxable during the years at issue on all its income, from all sources, in accordance with §664(c) and Reg. §1.664-1(c).

3. 1997 Legislation

a. 1997 Act §965 adds new Code §513(i) to exclude "qualified sponsorship payments" from UBIT, effective for payments solicited or received after 12/31/97. Qualified sponsorship payments do not include, inter alia, advertising and contingent payments, but allocation of a single payment is permitted.
b. 1997 Act §966 amends Code §528© to provide that associations of holders of timeshare interests will qualify as homeowners associations, effective for tax years beginning after 12/31/96.

c. 1997 Act §1041 amends §512(b)(13) to provide a look-through rule for deductible [to the controlled entity] interest, annuities, royalties and rents received by the charitable organization from controlled entities, requiring the parent charity to include these amounts as UBIT. Generally effective for tax years beginning after 8/5/97.

d. *1997 Act §§1089 and 1530 amend §664(d) to require that a charitable remainder trust be subject to requirement that it pay out no more than 50% of the trust’s fair market value [there is a current requirement that the trust make minimum annual distributions of 5%] [effective for transfers in trust after 6/18/97]; and to require that the minimum actuarial value of the charitable remainder be at least 10% of the value of the trust property [effective for transfers in trust after 7/28/97, with grandfather for existing wills and for decedents under a mental disability].

4. Mississippi State University Alumni Inc. v. Commissioner, T.C. Memo. 1997-397 (8/28/97). Alumni association’s income from affinity credit cards is excludable from UBTI as royalties. The court held that the credit card company’s payments were not for services. Texas Farm Bureau v. United States, 53 F.3d 120 (5th Cir. 1995), distinguished.

5. 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).

B. Charitable Giving

1. *That the land was too remote and rugged for the appraiser’s helicopter to be able to land should have been a clue that the appraisal wasn’t reliable. Van Zelst v. Commissioner, 100 F.3d 1259, 96-2 U.S.T.C. §50,626 (7th Cir. 11/15/96), aff’g T.C. Memo. 1995-396. In 1983, taxpayer purchased a remote mining property in Alaska that was not operating, and in all likelihood could not operate or be developed for any use for $30,000. He contributed the property to the U.S. National Park Service in 1985, and claimed a $2.75 million charitable contribution deduction upon donation in 1985. A substantial valuation misstatement penalty imposed under the statutory predecessor of § 6662(g) was upheld. That taxpayer had received an appraisal — from an appraiser recommended by the National Park Service — for $2.75 million did not establish that he acted reasonably and in good faith. Taxpayer “had to have known that the . . . estimate was hooey, the sort of numbers ginned up to put one over on the revenoors.”

2. *When the assignment of income doctrine is in play, formalistic tests are out the window. Ferguson v. Commissioner, 108 T.C. No. 14 (4/28/97). The taxpayers contributed corporate stock to several charitable organizations after a tender offer for the stock had been announced and a merger agreement contingent on the success of the tender offer had been signed, but before any shareholder vote on the merger. Subsequently, the charitable donees tendered the stock.
Because more than 50 percent of the stock of the target had been tendered before the taxpayers’ contributions had been completed, the acquiring corporation was in a position to unilaterally effect the merger regardless of whether any additional stock was tendered.

- The Commissioner asserted that the donor-taxpayers were taxable on the gain realized on the sale of the stock by the charities.
- The taxpayers claimed that the tendering shareholder’s rights of withdrawal and the acquiring corporation’s right to decline the tender if less than 85 percent of shares were tendered negated the applicability of the anticipatory assignment of income doctrine.
- The court found any possibility that the transaction would not be completed to be “remote and hypothetical.” The charities had no power to vitiate the intentions of the shareholders who had tendered a majority of the stock, and the charities would have received an identical amount in consideration of the stock pursuant to the merger, which was a certainty, if they had not tendered the stock. Thus, the taxpayers were treated as the sellers of the stock and taxed on the gains.

3. *Don’t be wish’n and hope’n for something back from that charity.* T.D. 8690, 1997-5 I.R.B. 5 (61 F.R. 65946, 12/16/96). Reg. § 1.170A-1(h) and -13(f) incorporate the test of United States v. American Bar Endowment, 477 U.S. 105 (1986), for determining the extent to which payments to a charity partly in consideration for goods or services are deductible as contributions. A deduction is allowed only to the extent that the payment exceeds the fair market value of any goods or services received from the charity in the year of the contribution or in another year. No deduction is allowed unless the taxpayer intends to make a payment that exceeds the fair market value of the goods or services received. Goods or services have been received “in consideration for” the taxpayer’s payment to the charity if the taxpayer either receives or expects to receive goods or services as a result of making the payment. Reg. §1.170A-13(f)(6). Donors generally are treated as expecting to receive a quid pro quo if a contribution is in response to an express promise of a benefit or if they make contributions knowing that the charitable donee has conferred a benefit on other donors making comparable contributions. Where the facts and circumstances indicate that the donor expected that there would be a quid pro quo, even though there was no explicit promise by the charity, no deduction is allowed. But if the taxpayer expressly refuses to accept any consideration for the payment to the charity, a deduction is allowed even though a quid pro quo was available. Items of insubstantial value may be disregarded pursuant to Rev. Proc. 90-12, 1990-1 C.B. 471, amplified, Rev. Proc. 92-49, 1992-2 C.B. 987. The Regulations also ignore membership benefits received in exchange for a payment of $75 or less, if the benefits consist of either (1) rights or privileges that can be exercised frequently during the membership period, such as free admission to facilities or events, discounts at a museum shop, etc.; or (2) free admission to members-only events with a per-person cost to the charity that is no
higher than the standard for low-cost articles under § 513(h)(2), which is a very nominal amount ($6.70 for 1996). In valuing any consideration received from the charity, a taxpayer may rely on a contemporaneous written acknowledgment provided by the charity which states either that no consideration has been provided in exchange for the contribution or which values the quid pro quo, unless the taxpayer knows or has reason to know that the charity’s determination is unreasonable.

4. Fund for Anonymous Gifts v. IRS, 97-2 U.S.T.C. §50,710 (D. D.C. 1997). An organization purportedly designed to permit donors to make contributions to ultimate beneficiaries on an anonymous basis and to claim a charitable contribution failed to qualify under §503(c)(3) because contributions were invested by the fund as directed by the donor pending distribution of both original contribution and income to the ultimate charitable beneficiary.

5. 1997 Legislation
   a. 1997 Act §224 amends Code §170(e) to permit a larger deduction [basis plus 1/2 of ordinary income, had the computer been sold, but not more than twice basis] for the contribution of computer technology for elementary and secondary education, effective for tax years beginning after 12/31/97.
   b. *1997 Act §602 extends the provision allowing full fair market value deductions for contributions of appreciated stock to private foundations to 6/30/98.
   c. 1997 Act §973 amends Code §170(i) to increase the charitable mileage deduction from 12 cents to 14 cents, effective for tax years beginning after 12/31/97.

6. Qualified appraisal required even if taxpayers could prove stock’s fair market value. Hewitt v. Commissioner, 109 T.C. No. 12 (10/29/97). Donation of “non-publicly traded stock” 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 because the taxpayers in that case substantially complied with the regulation. Query: Isn’t this just a simple preparer omission?

VII. INTEREST
   A. In General
      1. Russen v. Commissioner, 107 T.C. No. 15 (11/6/96), Interest incurred by second-generation family member/funereal director employees of Russen Brothers Mortuary [a C corporation] in buying the stock that corporation from their fathers was investment interest even though the stock did not pay dividends. Judge Raum noted that, before the 1986 Act the definition was “property held for investment,” but the 1986 Act definition was “any property which produces income of a type described in section 469(e)(1) [which includes ‘interest dividends, annuities, or royalties not derived in the ordinary course of a trade or business’],” and that stock “GENERALLY” produces dividend income, following Rev. Rul. 93-68, 1993-2 C.B. 72. Dictum suggests that interest incurred to purchase the stock of an S
corporation in which the shareholder materially participates may be deductible without regard to §163(d).

2. Taxation of inflation-adjusted debt instruments.
   a. Notice 96-51, 1996-42 I.R.B. 6 (9/25/96). Describes how the inflation-indexed debt instruments that were issued by Treasury were to be treated in proposed and temporary regulations under §§1275(d) and 1286. One of two methods, the coupon bond method or the discount bond method, will apply to account for qualified stated interest and the OID that accrues on the debt instrument based on changes in the principal amount of the debt instrument and constant yield principles.
   b. T.D. 8709 and REG-242996-96, temporary and proposed regulations relating to the federal income tax treatment of inflation-indexed debt instruments, including Treasury Inflation-Indexed Securities (62 F.R. 615, 1/6/97). Methodologies to be used include the "coupon bond method" [income interest payments received are taken into income, and increases in the inflation-adjusted principal amount are treated as OID] -- provided that the bond is issued at or near par and all stated interest is "qualified stated interest"–and the "discount bond method" [current adjustments to OID accruals to account for inflation and deflation].

3. 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."

4. RHI Holdings Inc. v. United States, 97-1 U.S.T.C. §50,409 (Fed. Cl. 5/2/97). Interest on large corporate underpayments, §6621©, was applied despite the unavailability of appeals consideration.

5. Harbor Bancorp v. Commissioner, 115 F.3d 722, 97-1 U.S.T.C. §50,532 (9th Cir. 6/10/97), aff'g 105 T.C. 260 (1995) (reviewed). Interest paid on bonds issued by a county to finance the construction of multifamily housing was not tax exempt because the bonds were §148(f) arbitrage bonds. The proceeds were used to purchase guaranteed investment contracts, which secured the payments on the bonds, with excess earnings of about $3.8 million. The bonds were purportedly issued on 12/31/85 [at a closing which was one of dozens done by Matthews & Wright on that day] -- before the effective date of the arbitrage bond provisions—but the court affirmed a holding that the 12/31/85 closings were shams, that the bonds were not issued until February 1986 when payment was actually received.
   • The bonds were arbitrage bonds even though without the knowledge or approval of the issuing authority the proceeds were diverted and invested in the investment contracts that yielded the arbitrage profits that were not rebated to the government. That the disqualifying investment was unauthorized and the arbitrage profits did not inure to the issuer are irrelevant; §148 is mechanical and its application does not turn on the issuer's intent.

6. KTA-Tator, Inc. v. Commissioner, 108 T.C. No. 8 (3/11/97). Under §7872, construction loan advances to shareholders that bore no interest during the construction period and were recorded
on corporate books as advances were interest free demand shareholder loans during the construction period, even though upon completion of construction the loans were converted to interest bearing loans with an amortization schedule. The corporation was required to recognize constructive interest income at the short-term AFR and had no offsetting deduction. Although not at issue in the case, proper treatment of the shareholders would have been dividend income and interest expense capitalized under §263A.

7. 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.

8. *A distinction as gossamer as fairy wings. Michael v. Commissioner, T.C. Memo. 1996-466 (10/16/97). Interest attributable to a tax deficiency resulting from an independent contractor’s failure to pay self employment tax was nondeductible personal interest. In distinguishing Redlark v. Commissioner, 106 T.C. 31 (1996), which held that Temp. Reg. §1.163-9T(b)(2)(i)(A) was invalid to the extent it disallowed a deduction for interest on a tax deficiency attributable to a sole proprietorship, the court relied on the gossamer difference that miscalculation of trade or business income is “proximately related” to the taxpayer’s trade or business, but the misperception that the taxpayer is an employee rather than an independent contractor is not a “normal or usual incident of his business.”

9. City of Columbus, Ohio v. Commissioner, 112 F.3d 1201, 97-1 U.S.T.C. ¶50,424 (D.C. Cir. 5/13/97), vacating and remanding, 106 T.C. 325 (1996). The Tax Court held that 6% bonds, the proceeds of which would be used to retire at a 35% discount a 4.25% obligation representing funding of city’s pension obligations that were assumed by the State of Ohio, would be arbitrage bonds. Under Treas. Reg. §1.148-1(b), prepayment of the city’s own prior obligation was investment-type property and prepayment resulted in a 7.25% yield on the investment, which was materially higher than the 6% payable on the new bonds. The Court of Appeals held that pre-payment of city’s own obligation was not the acquisition of investment type property. The bonds were a “refunding” issue.

10. *$1,000,000 home mortgage should be enough to keep you warm and dry; use the extra $100,000 for a Ferrari. Pau v. Commissioner, T.C. Memo. 1997-43 (1/27/97). If the purchase money mortgage on taxpayer’s principal residence exceeds $1,000,000, only interest of $1,000,000 is deductible. Interest on an additional $100,000 is not available as home equity indebtedness because, “home equity indebtedness” deductible under §163(h)(3)© does not include acquisition cost in excess of the $1,000,000 ceiling in the §163(h)(3)(B)(ii) definition of “acquisition cost” for which the qualified home mortgage interest deduction is allowed.

11. 1997 Legislation
   a. *1997 Act §1005 amends Code §163(J) to disqualify as a debt instrument, for interest deductibility purposes, any instrument that is payable in equity of the issuer or a related party. Effective for instruments issued after 6/8/97.
b. *1997 Act §503 lowers the §6166 interest rate on the first $1,000,000 from 4% to 2%, and the interest rate on values over the first million will be 45% of the then current normal interest rate. Effective for the estates of decedents dying after 12/31/97. 1997 Act §503 also adds Code §163(k) to make interest on the deferred tax nondeductible.

VIII. NONTAXABLE EXCHANGES

A. Section 1031

1. Beeler v. Commissioner, T.C. Memo. 1997-73 (2/10/97). Taxpayer exchanged real estate on which it operated a sand mine for other real estate. The unextracted minerals exchanged with the land are not disqualified as "property held for sale," even though prior to the sale the transferor was been engaged in mining and would have sold the sand in the ordinary course of business. Follows Asjes v. Commissioner, 74 T.C. 1005 (1980), holding that trees and shrubs growing on nursery land are part of land for purposes of applying the like-kind test in §1033(g).

2. 1997 Act §1052 amends Code §1031(h) to provide that personal property within the U.S. is not like-kind property with respect to personal property outside the U.S. Applies to transfers after 6/8/97.

3. 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.

B. Section 1033

1. *Sometimes you have to consult Nostradamos to get nonrecognition. Wilson v. Commissioner, T.C. Memo. 1996-418 (9/17/96). For purposes of §1033, the two year replacement period began at the end of 1980, when the state took possession of condemned property and deposited $28,000 with the state circuit court, subject to taxpayer-property owner's unlimited right of withdrawal, notwithstanding that taxpayer appealed the amount of the condemnation award and in 1989 and 1990 received an additional $60,000. Thus the additional amount were not eligible for §1033 treatment because the replacement period had expired.

2. M.I.C. Ltd. v. Commissioner, T.C. Memo. 1997-96 (2/24/97). Because a condemnation award was approximately equal to the fair market value of condemned building in which a pornographic movie theater was operated, no portion of the proceeds was attributable to business goodwill or going concern value even though settlement agreement between taxpayer and city provided that payment was in discharge of all claims, including the value of business goodwill and going concern value. Thus, §1033 deferral was available with respect to the entire condemnation payment.

3. Shipes v. Commissioner, T.C. Memo. 1997-304 (7/1/97). Section 1033 was unavailable for additional condemnation proceeds received after the expiration of the two year replacement period started by receipt of the original amount of condemnation award.
Section 1033 does not permit two replacement periods for one involuntary conversion.

4. **1997 Act** §913 amends Code §1033(e) to provide §1033 nonrecognition treatment for amounts received on sale of livestock because of flood or other weather related conditions (in addition to drought). Applies to sales and exchanges after 12/31/96.

5. **1997 Act** §1087 amends Code §1033(i) to provide that nonrecognition does not apply where the taxpayer obtains the replacement property from a related person [and the gain realized on the involuntarily converted property exceeds $100,000]. Applies to involuntary conversions occurring after 6/8/97.

C. **Sections 1034 (and 121)**

1. **Snowa v. Commissioner,** 97-2 U.S.T.C. ¶50,614 (4th Cir. 8/19/97), rev'g T.C. Memo. 1995-336. Reverses Tax Court, and holds that a taxpayer need not be married to the same spouse [as of the time of sale of the old home] to take advantage of §1034(g), which allows a married taxpayer to include in her own cost the portion of the purchase price paid by her spouse when calculating the cost of the new home for tax purposes because that provision treats spouses as having a "single pocketbook." Reg. §1.1034-1(f)(1), which provided to the contrary, was held to be in conflict with the statute. Taxpayer was entitled to include in her cost of the new home that part of the purchase price paid by her new spouse. The IRS had conceded that Mrs. Snowa could have avoided gain recognition had she structured the transaction differently.

2. *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.

   • New §121(c)(3)(B) provides that if property is acquired from a spouse or former spouse in a transaction to which §1041 applies, the transferee spouse gets to tack the transferor spouse's ownership period.

   • New §121(c)(3)(B) treats the use of a residence by a former spouse pursuant to a divorce or separation instrument as use by the other former spouse during any period in which that spouse retains an ownership interest.

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. Gibbs v. Commissioner, T.C. Memo. 1997-196 (4/29/97). The interest portion of annual payments taxpayer received from her ex-husband in exchange for her property interest in a convenience store was not excludable under §1041 as a transfer incident to divorce. The court noted that this result differed from the hypothetical result where a taxpayer received [§483] “unstated” interest, but saw the problem as “one of proof rather than principle.”

2. 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.

3. 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.

G. Section 1042

1. 1997 Act §968 would have added new §1042(g) to permit nonrecognition of gain on sale or stock in agricultural refiners and processors to an eligible farmer’s cooperative, effective for sales after 12/31/97. This provision was line-item vetoed by President Clinton.

G. 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.

IX. PARTNERSHIPS

A. Partnership Audit Rules

1. T.D. 8698, final regulations under §6231, providing guidance necessary for the designation or selection of a tax matters partner for partnerships including LLCs classified as partnerships (61 F.R. 67458, 12/23/96).

2. *Brookes v. Commissioner, 108 T.C. 1 (1/2/97). Tax Court lacks jurisdiction in an “affected items” proceeding to redetermine partnership adjustments that were resolved by decision entered based upon an agreement between the IRS and the tax matters partner [of Barrister Equipment Associates Series 122] despite taxpayer/partner’s lack of notice from the TMP of the settlement with the IRS because they could have moved to vacate the decision in the partnership proceeding upon receiving notice of the decision.

3. 1997 Legislation
   a. 1997 Act §§1221 adds new Code §§771-777 to provide simplified flow-through rules for electing large partnerships (100 or more partners).
   b. 1997 Act §§1222 adds new Code §§6240-6255 to provide new simplified audit procedures for electing large partnerships.
   c. 1997 Act §§1231-1243 amend the Code §§6621-6631 TEFRA partnership rules, as well as add a new Code §6234 to provide a new declaratory judgment procedure in the Tax Court for non-partnership items in an oversheltered tax return Effective for partnership years ending after 8/5/97.

B. Miscellaneous

1. *Check-the-box regulations are now final, as of the beginning of 1997. T.D. 8697, final entity classification (check-the-box) regulations under §7701 (61 F.R. 66584, 12/18/96).
   a. 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. *REG-209762-95, proposed regulations under §704, relating to the allocation of §1245 depreciation recapture among partners in a partnership (61 F.R. 65371, 12/12/96).

3. T.D. 8707, final regulations providing rules for partnership distributions of marketable securities under §731© and for determining when those distributions are taxable to the distributee partner (61 F.R. 67936, 12/26/96).

4. Remember this if you win the lottery . . . but don’t count on it. *Estate of Winkler v. Commissioner, T.C. Memo. 1997-4 (1/2/97). Holds that woman who purchased winning ($6.5 million) lottery ticket did so on behalf of a family partnership, which partnership agreement was subsequently reduced to writing.

5. *Treatment of members of LLCs as limited partners for self-employment tax purposes. REG-209824-96, proposed amendments to limited partner self-employment tax regulations under §1402(a)(13),
relating to which partners of a limited partnership (or LLC) are not subject to self-employment tax (62 F.R. 1702, 1/13/97). The earlier proposed regulations, EE-45-94 (59 F.R. 67253, 12/29/94), which contained a (non-) management test and a limited partner equivalence test, are withdrawn. Instead, an individual will be treated as a limited partner unless the individual (1) has personal liability for partnership debts by reason of being a partner, (2) has authority to contract on behalf of the partnership under state law, or (3) participates in the partnership’s trade or business for more than 500 hours during the taxable year; however, service partners in service partnerships [substantially all of the activities of which involve performance of services in health, law, engineering, architecture, accounting, actuarial science, or consulting] may not be limited partners under this provision. (The professions listed are the same as those in §448(d)(2)(A), except for the omission of “performing arts.”) Limited bifurcation to eliminate from tax income from a limited partnership interest, provided that other limited partners hold identical interests.

a. *1997 Act §935 provides a moratorium through 6/30/98 on final or temporary regulations under Code §1402(a)(13), relating to the definition of a limited partner.

6. Proposed regulations (PS-5-96) under §708(b)(1)(B), relating to the termination of a partnership on the sale or exchange of 50 percent or more of the total interest in partnership capital or profits (61 F.R. 21985, 5/13/96). The proposed regulations would change the current rule that the partnership is deemed to have distributed its property to the purchaser and the remaining partners, who are deemed immediately thereafter to have contributed the properties to a new partnership. The rule under the proposed regulations would be that a termination under §708(b)(1)(B) would no longer result in a deemed distribution of the terminated partnership’s assets, but, instead, the partnership would be deemed to have transferred all of its assets and liabilities to a new partnership with the terminated partnership distributing interests in the new partnership to the purchasing partner and the other remaining partners in liquidation of the terminated partnership. Therefore, the federal income tax consequences of a deemed distribution of assets would no longer occur, including the possibility of §731(a) gain, a change of partnership’s basis in property, and the commencement of a new five-year period for purposes of §§704(c)(1)(B) and 737.


7. 1997 Legislation

a. 1997 Act §964 adds Code §7704(g) to provide an election for pre-1987 Act publicly traded partnerships ("electing 1987 partnerships") to continue their exclusion from taxation as corporations. A 3.5% tax on gross income is provided, with gross income of upper-tiered partnerships defined as including distributive shares of gross income of lower-tiered partnerships from the active conduct of trades and businesses. Effective for tax years beginning after 12/31/97.
b. *1997 Act §1061 amends Code §732 to provide that the basis of distributed property, for purposes of basis allocation among properties distributed by a partnership, shall be made by relative fair market values of distributed properties (as opposed to the former rule of relative basis of the distributed properties). An allocation is first to be made to unrealized receivables and inventory (to the extent of the partnership's basis in these items). Effective for distributions after 8/5/97.

c. *1997 Act §1062 amends §751(a)(2) to provide that any inventory item held by a partnership—not merely an item which has appreciated substantially in value—is a "hot asset." For disproportionate distributions of property governed by §751(b), the substantial appreciation requirement remains intact. Effective for sales, exchanges and distributions after 8/5/97, with binding contract exception.

d. *1997 Act §1063 extends the periods under Code §§704(c)(1)(B) and 737(b)(1) during which precontribution gain may be required to be recognized from 5 years to 7 years. Applicable to property contributed to a partnership after 6/8/97.

e. *1997 Act §1236 amends Code §706(c)(2) to provide that the partnership taxable year closes with respect to any partner "whose entire interest in the partnership terminates (whether by reason of death, liquidation or otherwise)." Effective for partnership tax years ending after 12/31/97. Does not change prior law with respect to the effect of a partner's bankruptcy. Query: What are the pro's and con's of this provision? Are there planning possibilities? Does this add an additional accounting burden, requiring that partnerships close the books each time a partner dies?

8. Rev. Rul. 97-38, 1997-38 I.R.B. (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.

9. 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 Treas. 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 Treas. 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.
X. PERSONAL AND INDIVIDUAL INCOME AND DEDUCTIONS
A. Miscellaneous Deductions and Credits
1. 1996 Legislation
   a. Long-term care provisions. HIPAA §321 adds §7702B to treat long-term care insurance as accident and health insurance and HIPAA §322 amends §213(d) to treat qualified long-term care services as medical care (applicable to benefits paid after 12/31/96). HIPAA §323 adds §6050Q to require an information return to be filed by the payor of benefits.


   b. New adoption credit and exclusion. SBJPA §1807 adds new §23 (credit for qualified adoption expenses up to $5,000, $6,000 if adopt a special needs child) and adds new §137 (excluding from gross income employer-provided adoption assistance), effective for taxable years beginning after 12/31/96.


   c. Earned income tax credit provisions tightened. HIPPA of 1996 §910 amends the §32 earned income tax credit by (1) denying the earned income credit to individuals not authorized to be employed in the United States [i.e., those without valid taxpayer identification numbers]; (2) changing the disqualified income test and (3) modifying the definition of adjusted gross income used for phasing out the credit. Generally effective for tax years beginning after 12/31/95.

   (1) 1997 Act §1085 amends Code §32 to provide that the EITC will be unavailable to taxpayers who fraudulently claim the credit (10 years), to taxpayers who recklessly or intentionally disregard rules and regulations (2 years), and to taxpayers who made improper prior claims (until requested information is furnished to IRS). Effective for tax years beginning after 12/31/96.

2. Day v. Commissioner, 108 T.C. No. 2 (1/9/97). Tax preference deductions normally disallowed by §57 in computing AMTI, but which would not have reduced regular tax liability for the year, because of the availability of nonrefundable credits, which cannot be claimed against AMT liability, against regular tax liability, are not automatically allowable in computing AMTI by virtue of §59(g). Section 59(g) provides that the IRS may promulgate regulations under which items treated differently under the AMT than under the regular income tax will be adjusted if the tax treatment giving rise to the items did not reduce the taxpayer’s regular tax for the year the item was incurred or for any other year. Because this statutory provision permits the promulgation of regulations, but does not direct that they be promulgated, it is not self-executing, and no relief is available under §59(g) because no regulations have been promulgated.

3. 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 could claim capital loss carryovers and avoid disallowance of a deduction for §212 expenses in computing AMT liability.

- The IRS treated the entire recovery as ordinary income and the legal fees as §212 expenses disallowed in computing AMT.

- The district court awarded summary judgment for the government, and the court of appeals reversed. The recovery was ordinary income to the extent it compensated taxpayer for previously deducted interest on margin account and lost dividend and interest income, and a recovery of capital, hence capital gain (due to prior loss deductions) to the extent attributable to recovery of her lost investment.

- Attorney’s fees attributable to recovery of ordinary income were deductible (and disallowed under AMT), and attorney’s fees to recover lost investment were capital expenditures. The court did not address the method of apportionment. It noted, however, the different approaches of other courts. Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995), attributed all of the contingent attorney’s fees in an appeal of a condemnation award that resulted in a compensatory award of $10,625,850, plus interest of $6,358,418 to the disposition of the land, and thus the entire attorney’s fee was a capital expense. The Baylin court emphasized that the relative portion of the award labeled interest did not approximate the legal fees attributable to its recovery; there was no evidence that the attorney devoted any effort to increasing the interest portion of the award independently of the compensatory portion of the award. In Leonard v. Commissioner, 94 F.3d 523 (9th Cir. 1996), the taxpayers received interest on a condemnation award with respect to their personal residence. Only the interest portion of the award was includable in gross income. The taxpayers paid their lawyers both an hourly fee and a 25% contingency fee. They were allowed to deduct the hourly fees directly attributable to the interest award plus a portion of the contingency fee equal to 25% of the interest award.

4. The cost of marijuana used for medical purposes is not a deductible §213 medical expense. Rev. Rul. 97-9, 1997-9 I.R.B. 4 (2/13/97). An amount paid to obtain marijuana (or any other controlled substance) for medical purposes, in violation of federal law, is not a deductible medical expense under §213 because Reg. §1.213-1(e)(2) includes in “medicine or drugs” only those items that are “legally procured” “This holding applies even if the state law requires a prescription of a physician to obtain and use the controlled substance and the taxpayer obtains a prescription.”

5. Notice 97-24, 1997-16 I.R.B. 6 (4/3/97). IRS alerts taxpayers about “abusive trust arrangements,” including (1) the business trust, (2) the equipment or service trust, (3) the family residence trust, (4) the charitable trust, and (5) the final trust.
6. Ribera v. Commissioner, T.C. Memo. 1997-38 (1/22/97). Ex-husband’s payment of ex-wife’s legal fees through wage garnishment was not deductible as alimony under §215 because his obligation to pay her legal fees was fixed by divorce decree as an absolute obligation that would not terminate upon her death as required by §71 to qualify as alimony.

7. 1997 Legislation
   a. *The new $500 per child credit was enacted by 1997 Act §101, which added new Code §24. Effective in 1998, but for only $400 in that year. Phases out at 5% for AGI in excess of $110,000 (joint) or $75,000 (single).
      • Complicated provisions to determine the amount of credit for lower-income taxpayers, pursuant to Code §26 (Limitation Based on Tax Liability; Definition of Tax Liability). The credit will be considered before the calculation of the earned income credit. New §32(m) is added by the 1997 Act to provide, for low income families with three or more children, an additional refundable supplemental child credit.
   b. *Educational tax incentives.
      (1) The so-called Hope Scholarship Credit and the Lifetime Learning Credit were enacted by 1997 Act §201, which added new §25A. The HOPE Scholarship Credit is limited to $1,500 per year for up to two years for tuition paid in 1998 and thereafter; the Lifetime Learning Credit is limited to $1,000 per year for tuition paid on or after 7/1/98 ($2,000 per year beginning in 2003). Both credits are phased out between $40,000 and $50,000 of modified AGI [AGI plus amounts excluded under §§911, 931 and 933] for single individuals (double those amounts for married couples). The Hope Scholarship Credit will be denied to any student convicted of a Federal or State drug felony unless the student can demonstrate by clear and convincing evidence that he or she did not inhale. The maximum HOPE credit amount, as well as the income phase-out amounts, will be indexed for inflation from 2000, beginning in 2002. New Code §6050S requires educational institutions to file information returns relating to this credit.
      (a) Notice 97-53, 1997-40 I.R.B. (9/16/97). Guidance on the effective date of §203 of the 1997 Act (which provides that the additional §72(t) ten-percent tax on amounts withdrawn from IRAs does not apply to certain distributions for educational expenses after 1997). IRA funds may be used for the January 1998 semester if the IRA distribution is made after 12/31/97 and the expenses are paid after that date.
      (2) Section 202 of the 1997 Act adds new section 221, which allows an above-the-line deduction for interest on "qualified education loans" paid in the first 60 months in which interest payments were required. Deduction effective in 1998; dollar limit of $1,000 in 1998, $1,500 in 1999, $2,000 in 2000, and $2,500 in

2 He grew up in Hot Springs.
2001 and thereafter. Phases out between $40,000 and $60,000 of modified AGI [AGI plus amounts excluded by §§135, 137, 221, 911, and 933, but after application of §§86, 219 and 469; however for purposes of §§83, 135, 137, 219 and 469, AGI is to be determined without regard to the new §221 deduction] for single individuals (between $60,000 and $75,000 for married couples).

(3) 1997 Act §203 amends Code §72(t) [by adding new §72(t)(2)(E)] to permit penalty-free withdrawals from qualified retirement plans for higher education expenses, beginning in 1998.

(4) 1997 Act §211 amends Code §529 to, inter alia, expand the definition of "qualified higher education expenses" to include minimal room and board expenses, effective as if included in the Small Business Job Protection Act of 1996 (enacted 8/20/96). Other amendments to §529, including expanding the definitions of "eligible educational institution," and "member of family," are effective in 1998. Also clarifies that qualified State tuition programs may not allow directed investments.

(5) 1997 Act §221 extends the §127 exclusion for employer-paid educational assistance from 7/1/97 through 6/30/00.

(6) 1997 Act §225 amends Code §108(f) to expand the tax-free treatment of student loan forgiveness, effective for discharges of indebtedness after 8/5/97.

c. *1997 Act §975 amends Code §62(a)(2) to permit above-the-line deductions by state officials who are reimbursed for their expenses, effective for expenses paid or incurred in tax years beginning after 12/31/86 [sic]. This ratifies and expands the result in the Beatty case.

(1) A sympathetic court rescues an employee required to make large business expenditures. Beatty v. Commissioner, 106 T.C. 268 (4/17/96). Taxpayer was a county sheriff, who was paid a salary of $30,566. He was required to provide meals to all prisoners in the county jail and received per diem per prisoner meal allowances of $109,952; if he was able to provide meals for less than the per diem, he was permitted to keep the difference. The taxpayer reported that he provided the meals as an independent contractor and reported the meal allowances and the cost of the prisoner's meals on Schedule C, but the Commissioner argued that the meal allowances were additional compensation and the cost of the prisoners' meals was an employee business expense, deductible only after taking into account all of the limitation, and not deductible at all in computing alternative minimum tax. Held: It was irrelevant whether the sheriff provided the meals as an independent contractor or as an employee because the cost of the prisoner's meals was a cost of goods sold—not a §162 employee business expense. Thus this cost was not subject to any of the limitations governing employee business expenses [$67 floor of 2% of AGI and nondeductibility for AMT purposes]. Only the profit from providing the meals was included in taxpayer's gross income. Compare Alexander v. IRS, 72 F.3d 938, 96-1 U.S.T.C. §50,011 (1st Cir. 12/22/95) (legal fees paid in settling employment contract dispute were deductible only as a $67 miscellaneous itemized deduction, and not as an offset to the settlement proceeds, and, therefore, were not deductible for AMT purposes).
d. 1997 Act §1203(a) adds new Code §162(o) to do much the same for rural mail carriers, effective for tax years beginning after 12/31/97.

e. 1997 Act §1201 amends Code §63©(5) to increase the standard deduction for children who are dependents of other taxpayers to the greater of $500 [indexed for inflation] or the dependent’s earned income plus $250 [also indexed], effective for tax years beginning after 12/31/97.

B. Miscellaneous Income

1. Damage awards


b. Payments from former employers not personal injury claim settlements, but . . . LeFleur v. Commissioner, T.C. Memo. 1997-312 (7/7/97); Morabito v. Commissioner, T.C. Memo. 1997-315 (7/7/97); Brennan v. Commissioner, T.C. Memo. 1997-317 (7/7/97). Cases all held that payments from former employers to discharged employees were not paid to settle personal injury claims, and were therefore not excludable under §104(a)(2).

c. . . . payments to taxpayer/farmers from their dairy's bank lenders were excludable personal injury damages, not payments for milk. Knevelbaard v. Commissioner, T.C. Memo. 1997-330 (7/21/97). Payments to taxpayer/farmers from their dairy’s bank lenders were excludable personal injury damages, not payments for milk. Farmers contended that the banks misled them about the dairy's solvency, so they suffered from [the banks’ negligent infliction of] emotional distress. Even though damages were allocated roughly in proportion to amounts due from the dairy, the farmers’ claims were separate and apart from their contractual claims against the dairy.

2. Punitive damages

a. Tenth Circuit: Punitive damages in physical injury (wrongful death) action not excluded from gross income under §104(a)(2); certiorari granted. O’Gilvie v. United States, 66 F.3d 1550, 95-2 U.S.T.C. §50,508 (10th Cir. 9/19/95), cert granted. The Tenth Circuit joins the Fourth, Fifth, Ninth and Federal Circuits in finding that punitive damages are not excludable from gross income under §104(a)(2) because “exclusions from income are narrowly construed.” This case—unlike the cases in those circuits—involved physical injury, i.e., a products liability wrongful death action based upon the death of taxpayers’ wife and mother from toxic shock syndrome.

(1) *Supreme Court affirms: Even before the effective date of the 1996 amendments to §104(a)(2), punitive damages received in a suit for personal injury were not excludable. O’Gilvie v. United States, 117 S. Ct. 452, 96-2 U.S.T.C. §50,664 (U.S. 12/10/96) (6-3). Punitive damages were not received “on account of” personal injuries, so the §104(a)(2) exclusion does not apply and the damages are taxable. Breyer’s majority opinion holds that punitive damages were received “on account of” a defendant’s reprehensible
conduct. Scalia’s dissent rests on the fact that “the statutory text unambiguously covers punitive damages that are awarded on account of personal injuries . . . .”

3. Allocation of damage awards
a. *In characterizing damages received under a settlement, the courts “should neither engage in speculation nor blind themselves to the settlement’s realities.” Bagley v. Commissioner, 97-2 U.S.T.C. ¶50,586 (8th Cir. 8/6/97). A jury awarded taxpayer $1,000,000 compensatory damages for libel, $150,000 for tortious interference with present employment, $100,000 for tortious interference with future employment, $250,000 for invasion of privacy, and $7,500,000 punitive damages. Pending a new trial—after certain portions of the award were vacated on appeal—taxpayer settled for $1,500,000.

- The settlement agreement provided that the amount was in settlement of claims for “personal injuries including alleged damages for invasion of privacy, injury to personal reputation, including defamation, emotional distress, and pain and suffering,” without any mention of punitive damages.
- The court of appeals held that the Tax Court properly allocated $500,000 to punitive damages. The reality of the settlement negotiations was that even if the defendant won all of the issues to be retried, it still would have had to pay $250,000 of punitive damages, and it faced a significant risk of having to pay another $1,500,000 of punitive damages.
  - Even if a settlement agreement allocates nothing to a particular class of damages, if the defendant almost certainly would have been liable for an amount of a particular type of damages absent the settlement, apportionment of some portion of the settlement to that class of damages may be proper. This is particularly true with respect to punitive damages, because it is almost always to the defendant’s advantage for nontax purposes to avoid characterizing any portion of the settlement as attributable to punitive damages (which might not be covered by insurance and lead to greater adverse publicity) and to the plaintiff’s advantage to avoid such a characterization because of tax consequences. Thus the parties to the settlement agreement lack adverse interests in bargaining over such a provision.

4. Interest on damage awards
a. *Interpreting §104(a)(2) continues to keep tax lawyers busy. Delaney v. Commissioner, 99 F3d 20, 96-2 U.S.T.C. ¶50,576 (1st Cir. 11/1/96), aff’g T.C. Memo. 1995-378. Settlement of physical personal injury tort action for $250,000 “without interest,” where the jury found damages of $175,000 to which $112,000 of statutory interest was added by the court clerk, was allocated 61 percent to §104(a)(2) damages and 39 percent to taxable interest.
  - The Tax Court held that a portion of the settlement should be allocated to taxable prejudgment interest even though settlement agreement specifically provided that no portion was interest, because the agreement was not bargained at arm’s length; amount of interest was same percentage of settlement as interest
component of jury verdict was of total jury verdict. On appeal, the 1st Circuit held that the Tax Court properly examined the settlement agreement and the extrinsic evidence probative of the true nature of the settlement. On different facts it might have been possible to conclude that a settlement agreement did not provide for any interest even if state law otherwise provided for prejudgment interest. In dictum the court said that if under state law prejudgment interest is an element of damages on account of personal injury, interest might be excluded under §104(a)(2), but under the relevant state law it was not. Section 104(a)(2) does not exclude prejudgment interest that is not an element of damages for personal injury under state law.

5. Notice 96-60, 1996-49 I.R.B. 7 (11/13/96). Interim guidance concerning the due date of §877 ruling requests, §6039F information statements and §6048(a) information statements for expatriates who renounce citizenship after 2/5/95; no submissions will be required before a date no earlier than 60 days after the issuance of detailed guidance to be issued “before the end of 1996.”

6. Doing work for yourself through your employer creates income. Kelly v. Commissioner, T.C. Memo. 1996-529 (12/2/96). Commissions received by a stockbroker from his employer-brokerage firm on transactions executed for the broker’s own account were includable as income and added to his basis in the securities.

Guidance for individuals who expatriate in order to avoid tax, and the reporting requirements for those individuals under §6039F.

7. Pergament v. United States (In re Barden), 105 F.3d 821, 97-1 U.S.T.C. §50,244 (2d Cir. 1/29/97) (per curiam), aff’g (E.D. N.Y. 4/13/97). Bankruptcy trustee is not entitled to make an election under §121 to exclude gain on the sale of a residence of a debtor because §1398(g), which provides that the estate succeeds to the tax attributes of the debtor, does not include eligibility to make an election under §121.

XI. PROCEDURE, PENALTIES AND PROSECUTIONS

A. Penalties and Prosecutions

1. T.D. 8703, final regulations under §6081, relating to procedures for an individual to obtain an automatic extension of time to file an individual income tax return (61 F.R. 69027, 12/31/96). The requirement to “properly estimate” the tax is retained, but there is no longer any requirement of payment of the amount of unpaid tax nor is demonstration of inability to pay a condition for obtaining the automatic extension. Removes the requirement that Forms 4868 be signed.

2. IA-42-95, proposed regulations defining “reasonable basis” under the $6662 accuracy-related penalty (61 F.R. 58020, 11/12/96). The final regulations already provide that the reasonable basis standard is “significantly higher than the not frivolous standard applicable to preparers under section 6694.” The proposed regulations provide for a standard “significantly higher than not frivolous or not patently improper,” and note that it is not satisfied “by a return position that is merely arguable or that is merely a colorable claim.” They further provide that a return position that
does not satisfy the Reg. §1.6662-4(d)(2) "substantial authority" standard may satisfy the reasonable basis standard if it "is reasonably based upon one or more of the authorities set forth in section 1.6662-4(d)(3)(iii).”

3. **McMahan v. Commissioner**, 97-1 U.S.T.C. ¶50,443 (2d Cir. 5/23/97). Taxpayer penalized for failure to file a timely return because reliance on his attorney to file an extension request does not establish reasonable cause for failure to file a timely return.

4. **Tax professionals who are tax protestors better have $25,000 to spare.** **Heun v. Commissioner**, T.C. Memo. 1997-265 (6/12/97). A $25,000 penalty under §6673 was assessed *sua sponte* against a CPA who claimed that his wages were not taxable income because he was a nonresident alien.

5. **The sad story of how a tax lawyer ended up with a fraud penalty.** **Peterson v. Commissioner**, T.C. Memo. 1997-321 (7/10/97). First, he entered into a C corporation business with a former client (50/50); then he entered into a buy-sell agreement with the client (funded by the client’s life insurance policy); then when the client died and the insurance company successfully denied coverage, he did not attempt to renegotiate the buy-sell agreement, but used corporate funds to buy the client’s stock from his estate (characterizing those funds inconsistently as a bonus to the estate [while they were actually used to satisfy his obligation to buy the stock from the estate]); then he continued the tangled web; then he was indicted. . . .After his acquittal, Judge Beghe imposed the fraud penalty.

6. **Even nice guys who fess up in advance pay the §6672 penalty.** **Buffalow v. United States**, 109 F.3d 570, 97-1 U.S.T.C. ¶50,290 (1st Cir. 3/20/97). The president/sole shareholder of a corporation who paid other creditors in a “good faith” effort to “rescue” the insolvent corporation and realize greatest value on orderly liquidation of assets was liable for §6672 penalty despite having informed IRS in advance of his plan. The IRS was not estopped by advance notice that taxpayer would favor other creditors.

7. **What you find out can hurt you.** **United States v. Kim**, 111 F.3d 1351, 97-1 U.S.T.C. ¶50,370 (7th Cir. 4/21/97). If a responsible person who was unaware that withholding taxes were not paid in past quarters (in which he also was a responsible person) becomes aware of the nonpayment, he is under a duty (in order to avoid the §6672 penalty) to apply all unencumbered funds then available or acquired in the future to make the required payments. Unencumbered funds are funds other than those legally required to be applied to another use.

8. **Little v. Commissioner**, 106 F.3d 1445, 97-1 U.S.T.C. ¶50,207 (9th Cir. 2/11/97). For purposes of the §6662(b)(2) substantial understatement penalty, reporting numerous real property sales transactions individually on Schedule D was not adequate disclosure of a potential controversy regarding whether gains properly should have been ordinary income.

9. **1997 Legislation**
   a. **1997 Act §1085** adds new Code §6695(g) to provide a $100 preparer penalty for each return on which a preparer
erroneously claims an earned income tax credit without exercising due diligence in determining the taxpayer’s eligibility and the proper amount of the credit.

b. **1997 Act** §1091 amends Code §6654, to jigger the applicable percentage of last year’s tax, for the penalty on failure to pay estimated tax, for individuals with adjusted gross income exceeding $150,000. The percentage of preceding year’s tax due is 105% [for preceding taxable years beginning in 1998, 1999, and 2000], 112% [for preceding taxable years beginning in 2001] and 110% [for years beginning in 2002 or thereafter]. Not applicable to a preceding taxable year beginning in 1997.

c. **1997 Act** §1281 extends the reasonable cause exception to penalties under §§6652(g) (failure to report deductible employee contributions to a retirement savings plan), 6652(k) (failure to report section 1202 small business stock), 6683 (failure to report personal holding companies by foreign corporations), and 7519 (failure to make required penalties for entities that elect to use other than their required tax year). Effective for tax years beginning after 8/5/97.

d. The **Taxpayer Browsing Protection Act** §2 adds new Code §7213A and amends Code §7213 to provide criminal penalties for unauthorized inspections of tax returns or return information by federal employees or IRS contractors (and others with authority to receive such information), effective for violations occurring after 8/5/97.

10. **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.

11. **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.

12. **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.”

B. **Summons**

1. **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.

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
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.

3. Discovery provided to enable church to challenge
revocation of its exemption for political activities. Branch
Ministries Inc. v. Richardson, 970 F. Supp. 11, 80 A.F.T.R.2d 5300 (D.
D.C. 7/3/97). Holds that the corporation which operates the Church at
Pierce Creek was entitled to limited discovery from the IRS, both of
its own tax return information and IRS data relevant to the issue of
the church’s being discriminatorily singled out for selective
prosecution. (The church’s tax exemption was revoked in 1995
[retroactive to 1/1/92] for participating in the 1992 presidential
political campaign. The church took out open letter advertisements in
the Washington Times and USA Today that challenged Clinton’s positions
on abortion, homosexuality and condom distribution. The open letter
concluded, “How then can we vote for Bill Clinton?”)

4. Lefcourt v. United States, 97-2 U.S.T.C. ¶50, (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 §6050I] the exact amount received and the identity of the
payer and the client.

C. Litigation Costs
1. Sometimes it doesn’t pay to have a rich spouse -- or
at least the government doesn’t pay if you do. Thompson v.
Commissioner, T.C. Memo. 1996-468 (10/17/96). Wife could not recover
attorneys fees because husband, who was ineligible to receive
attorney’s fees, award actually incurred the entire expense. Wife had
no funds with which to pay attorney’s fees.

   a. 1997 Act §1453 amends Code §7430 to apply the net
worth limitation separately to each joint filer, as well as separately
to estates and trusts. Effective for proceedings commenced after 8/5/97.

2. *Eifert v. Commissioner*, T.C. Memo. 1997-214 (5/7/97). Litigation costs awarded where IRS relied solely on three identical Forms 1099-G furnished by the FDIC, each in the amount of $600,000, despite the debt having been discharged in bankruptcy. IRS assertion that taxpayer failed to exhaust administrative remedies was rejected by the court, which noted that the taxpayer never received the 30-day letter because the IRS mailed it to the wrong address.

3. *You may be able to argue in the inconsistent alternative to win your state law case, but you may give up the chance at collecting attorney’s fees in your tax case if you do. Maggie Management Co. v. Commissioner*, 108 T.C. No. 21 (6/11/97). In a motion for attorney’s fees under §7430, the taxpayer was estopped from arguing that the government’s position was unreasonable because in a prior suit in state court the taxpayer had previously characterized the transactions in question in the same manner as the IRS did in the tax proceeding.

4. *Attorneys’ fees do not belong to the taxpayer, but belong to the attorneys.* Agritech Enterprises, Inc. v. United States, 117 F.3d 297, 97-1 U.S.T.C. ¶50,573 (5th Cir. 7/22/97). While the government may offset damages awarded under §7431 to a tax shelter promoter and his corporation with outstanding assessments against them, it could not similarly offset §7430 attorneys’ fees awarded to the promoter. Judge Garwood held that, although §7430 provides that attorneys’ fees are to be awarded to “the prevailing party,” the fees here are to be paid in addition to the damage award and therefore belong solely to the promoter’s lawyers [Urquhart & Hassell] -- as opposed to fees to be paid out of a damage award, which belong to the client.

   • Taxpayer’s attorneys are the real parties in interest to a §7430 attorney’s fee award, so the government has no right to set off against the award unpaid taxes and penalties assessed against the taxpayer.

5. *Steffen v. United States*, 952 F. Supp. 779, 97-1 U.S.T.C. ¶50,224 (M.D. Fla. 1997). Damages may be awarded under §7432 if IRS fails to release a lien when the relevant IRS agent “should have known” that the assessment had been fully satisfied; taxpayer must prove that IRS should have released lien in addition to proving that IRS knowingly failed to release the lien.

6. *1997 Act §1285(b) amends Code §7430 to limit the period for applying to the IRS for administrative costs to 90 days from the mailing of the final IRS decision, effective for civil actions and proceedings commenced after 8/5/97.*

7. *Cozean v. Commissioner*, 109 T.C. No. 10 (10/15/97). Section 7430(c)(3) fees claimed by accountants and other nonlawyers who are authorized to practice before the IRS are subject to the same dollar per hour limitations applicable to attorney’s fees.

contractors to account for construction materials as supplies until the early 1990s.

D. Statutory Notice

1. Did you know that a stat notice isn’t always necessary? Goldston v. United States, 104 F.3d 1198, 97-1 U.S.T.C. ¶50,149 (10th Cir. 1/6/97). Prior assessment of tax is not a prerequisite to existence of tax liability and recovery through claim filed in taxpayer’s bankruptcy proceeding.

2. Brookes v. Commissioner, 108 T.C. No. 1 (1/2/97). No deficiency notice is required for a computational adjustment to a partner’s return following a redetermination of the partner’s distributive share of partnership income in a partnership level audit proceeding.

E. Statute of Limitations

1. Not a durable power! Extension given by representative pursuant to power of attorney is ineffective because taxpayer had previously become incapacitated (which revoked the power of attorney). Halper v. Commissioner, T.C. Memo. 1997-58 (2/3/97). On motion for partial summary judgment, held that Form 872 consents were ineffective to extend the statute of limitations because they were signed by taxpayer’s purported representative after taxpayer was incapacitated (and the IRS had actual notice of the incapacity), which revoked the representative’s authority.

2. Bugge v. United States, 99 F.3d 740, 96-2 U.S.T.C. ¶50,629 (5th Cir. 11/15/96). An erroneous abatement processed by an IRS Service Center without proper approval by a collections manager was not effective, and taxpayer’s liability was not extinguished by the subsequent running of the statute of limitations.

3. Equitable tolling

a. “Gift taxes” paid by thieves to cover up their thefts are not recoverable by victim kept isolated by thieves because she did not regain her freedom until after the statute of limitations had run for claiming a refund of gift taxes. Webb v. United States, 66 F.3d 691, 95-2 U.S.T.C. ¶50,531 (4th Cir. 10/2/95) (2-1), cert. denied, 65 USLW 3584 (2/24/97). The §6511 statute of limitations applicable in tax refund suits was not subject to equitable tolling, and taxpayer’s administrator’s claim for recovery of about $4 million of gift taxes paid while taxpayer was cruelly abused and defrauded [kept drugged up and isolated] by her physician and attorney was time barred. The majority refused to apply the decision in Irwin v. Department of Veterans Affairs, 498 U.S. 89 (1990) (statutory time limits for suits against the United States were subject to equitable tolling) to tax refund suits. The court stated that “taxes are the life blood of government.”

b. Equitable tolling may be allowed (on proper showing) for incapacitated geriatric who mistakenly sent IRS a large check; certiorari granted. Brockamp v. United States, 67 F.3d 260, 95-2 U.S.T.C. ¶50,551 (9th Cir. 10/5/95) (2-1), cert. granted, 6/3/96. Taxpayer’s administrator will be permitted to show that 93-year-old taxpayer lacked mental capacity when he mistakenly sent a $7,000 check with an application for automatic extension of time and did not take further action because of his senility. Dissent on the ground that
Congress intended to create a "tesselated scheme" to assure that the
government can, after a time, be assured that its receipts can be
counted upon.

c. Supreme Court reverses Brockamp, unanimously holding that courts cannot toll, for nonstatutory equitable reasons, the §6511 statutory time limits for filing tax refund claims. United States v. Brockamp, 117 S. Ct. 849, 97-1 U.S.T.C. ¶50,216 (2/18/97). The unusually emphatic language of the Internal Revenue Code's §6511 limitations provisions rebut the plausibility of their containing an implied "equitable tolling" exception.

4. AOD-CC-1997-006. Nonacquiescence in Risman v. Commissioner, 100 T.C. 191 (1993), which held a remittance filed with an extension request to be a deposit in the nature of a cash bond. The IRS will continue to litigate this issue in all circuits, arguing that a remittance sent with a Form 4868 is a payment of tax as a matter of law.

5. *1997 Act §1282 amends Code §6512(b)(3) to provide a three-year period for refunds of amounts paid where no return was filed. This provision overturns the result in the Lundy case, immediately below. Effective for claims for refund for tax years ending after 8/5/97.

a. Overwithheld nonfiler has only 2 years within which to claim refund. Commissioner v. Lundy, 116 S. Ct. 647, 96-1 U.S.T.C. ¶50,035 (U.S. 1/17/96) (7-2), rev'd 45 F.3d 856 (4th Cir. 1995). Taxpayers not entitled to recover amounts withheld in excess of federal income taxes actually owed for the 1987 year when they did not file a return for that year until after the IRS mailed a notice of deficiency 2-1/2 years after the return was due. Held, §6512(b)(3)(B) provides for only a 2-year "look-back" period, not the 3-year period applicable where a return is filed before the IRS mails its notice of deficiency. Dissent on the ground that IRS policy [Rev. Rul. 76-511, 1976-2 C.B. 428, construing 6511(a)] is to allow a 3-year look-back period where suit is filed in the district court, instead of in the Tax Court where taxpayers filed.

6. 1997 Act §1284 amends Code §6501(a) to codify the Bufferd [93-1 U.S.T.C ¶50,038 (U.S 1993)] case, to provide that the filing of an information return from a payor or passthrough entity does not cause the three-year statute of limitations to begin to run, applicable to tax years beginning after 8/5/97. It is only the taxpayer's own return that can start the running of the statute.

7. 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.

8. 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.

F. Miscellaneous

1. Innocent Spouse

   a. Wilson v. Commissioner, T.C. Memo. 1996-520 (11/25/96). Lawyer’s wife entitled to innocent spouse treatment with respect to omitted income from the law practice, but was not entitled to innocent spouse treatment with respect to overstated deductions because they were not grossly erroneous.

   b. Lawyer-wife’s knowledge that large deductions were taken does not defeat her innocent spouse claim. Fifth Circuit holds the test should be whether spouse knew or had reason to know that the deductions would give rise to a substantial understatement. Reser v. Commissioner, 97-1 U.S.T.C. ¶50,416 (5th Cir. 5/12/97), rev’g T.C. Memo. 1995-572. Personal injury defense lawyer-wife held to be an innocent spouse with respect to her husband’s deduction of S corporation real estate losses despite his having insufficient basis in the corporation because bank loans were made directly to the corporation. Reser was the sole earner in the family during the years in question and much of her income went into the S corporation. Judge Wiener, writing for the court, stated “Significantly, we hold that henceforth in erroneous deduction cases in this circuit, the proper inquiry concerning a spouse’s knowledge is whether the spouse seeking relief knew or had reason to know that the DEDUCTIONS in question would give rise to a substantial understatement, not whether he knew or had reason to know of the existence of the underlying transaction. Whether the spouse has a duty to inquire regarding deductions depends on the magnitude of deductions in question relative to investment in activity generating the deductions.

   c. *Tax Court doesn’t understand ’86 amendments to §6103(e) says the Sixth Circuit. Silverman v. Commissioner, 97-2 U.S.T.C. ¶50,499, 79 A.F.T.R.2d 3052 (6th Cir. 6/18/97), rev’g T.C. Memo. 1996-6. That an otherwise innocent spouse financially benefited from the understatement of tax liability should not in and of itself result in a determination that innocent spouse relief should not be granted. Such a benefit is merely a factor to be taken into account in determining whether it would be inequitable to hold the spouse liable.

2. United States v. Ruff, 99 F.3d 1559, 97-1 U.S.T.C. ¶50,130 (11th Cir. 11/21/96). Under §6332(d)(1), a bankruptcy trustee was personally liable for failure to honor levy on amounts due to broker-taxpayer who rendered services to the bankruptcy estate because amount owed was fixed and determinable on the date of levy even though payment still had to be approved by the bankruptcy court.

3. Withholding credit need not be apportioned equally; prenuptual agreement may be used. United States v. Elam, 97-1 U.S.T.C. ¶50,399 (9th Cir. 5/2/97). IRS was to be permitted to use taxpayer’s
California prenuptial agreement (which provided that each spouse's property—whether acquired before or during marriage—was separate property) to show that overpayment credit [tax refund] could be apportioned entirely to taxpayer’s ex-husband.

4. Improper Disclosure of §6103 Tax Return Information
   Circular letter to 386 patients of a plastic surgeon that requested information and informed them that the surgeon was being criminally investigated improperly disclosed tax return information because it was not necessary for the letters to say that the investigation was criminal. The court found that the letters were not sent in good faith because the requirements of the Internal Revenue Manual were not followed, particularly the requirement that the Chief of the CID approve the content of all circular letters; however, approved letters under the relevant IRM provision would have contained "Special Agent" and "Criminal Investigation Division" in the signature block. Also found pertinent was the fact that letters were sent to patients in three years not under investigation, as well as patients in the two years that were.

   (1) On remand, only statutory damages for disclosure of tax return information—no punitive damages because only a technical violation. Barrett v. United States, 917 F. Supp. 493, 96-1 U.S.T.C. §50,082 (S.D. Tex. 12/6/95). Disclosures to plastic surgeon’s patients in circular letters that he was under criminal tax investigation gave rise to only $260,000 in statutory damages. Punitive damages were inappropriate because IRS agent’s conduct in stating that Dr. Barrett was under criminal tax investigation was not willful or grossly negligent because the Internal Revenue Manual form letter has the words "Criminal Investigation Division" in the signature block, and also §7431(c) precludes the award of punitive damages in the absence of actual damages.

   (2) *Fifth Circuit affirms, limiting damages to statutory damages and rejecting claims for actual and punitive damages. Barrett v. United States, 100 F.3d 35, 96-2 U.S.T.C. §50,656 (5th Cir. 11/27/96). The court reinterprets its language in its earlier opinion, and holds that damages were left up to the district court. The court further notes that patients’ concerns about breach of privacy are not relevant to damages here, because it was only the content of the letters (i.e., that Barrett was a “tax cheat”) that Barrett is entitled to recover for—not the mere fact of sending the letters (which caused most of the damage).

   b. *No liability for agent’s good faith, but erroneous, interpretation of §6103 tax return information confidentiality. Jones v. United States, 97 F.3d 1121, 96-2 U.S.T.C. §50,537 (8th Cir. 10/11/96). District court held [in a §7431 suit for damages based upon disclosure of return information by an IRS agent to a confidential informant] that the agent’s conduct violated §6103, but because the agent made a good faith, but erroneous interpretation of the statute, the government was not liable. Affirmed in part [disclosure violated §6103], reversed in part and remanded by the 9th
Circuit on the ground that the burden of proof for the §7431(b) good faith exception is on the government, not (as the district court ruled) on the complaining party. The court did not adopt the Fifth Circuit's de facto "bad faith" rule set forth in Barrett v. United States, 51 F.3d 475 (1995) (adopting a rule that an IRS agent "can be expected to know statutory provisions governing disclosure, as interpreted and reflected in IRS regulations and manuals"), but noted that "an agent's failure to consult the statutory language as interpreted and reflected in IRS regulations and manuals prior to an improper disclosure of return information is strong evidence that the interpretation of the statute was not in good faith."

c. Federal Tort Claims Act multimillion dollar judgment for IRS post-conviction press release affirmed, but en banc rehearing ordered. Johnson v. Sawyer, 980 F.2d 1490, 93-1 U.S.T.C. ¶50,065 (5th Cir. 12/29/92) (2-1), aff’g, modifying, rendering and remanding 760 F. Supp. 1216, 91-2 U.S.T.C. ¶50,302 (S.D. Tex. 1991). IRS press release following Johnson's guilty plea to tax evasion violated §6103 and constituted negligence per se under Texas law, so recovery of damages against the United States under Federal Tort Claims Act (FTCA) was proper. The action was not preempted by former §7217, nor by the tax assessment and collection exception to the FTCA. The §6103 violations resulted in the guilty plea becoming a matter of public knowledge by adding to the information in the court record such additional information as Johnson's middle initial, his age, his home address and his official job title. Remanded for recomputation of the $10 million plus damages. Dissent on the ground that IRS violations of §6103 did not give rise to a cause of action under FTCA and did not in any event cause Johnson's damage. Neither majority nor dissent relied upon an agreement that the U.S. Attorney's office would not issue a press release on the conviction. Note Supplemental and amending panel decision, 4 F.3d 369, 93-2 U.S.T.C. ¶50,582 (5th Cir. 10/14/93) (majority holds for Johnson on his invasion of privacy cause of action, stating that while §6103 did not create a duty, it did establish a standard of conduct to the duty not to improperly publicize embarrassing or damaging private facts about another person. The dissent notes that Johnson’s recovery is based on federal, not Texas, law contrary to the Federal Tort Claims Act, and that no material damage proximately resulting from the §6103 violation was shown). On 10/28/93, en banc rehearing was granted by the Fifth Circuit.

(1) Judgment reversed on rehearing en banc. Reversed and remanded with directions to dismiss Federal Tort Claims Act claim, 47 F.3d 716, 95-1 U.S.T.C. ¶50,159 (5th Cir. 3/16/95) (en banc, 2 judges dissenting). Plaintiff failed to establish the elements of either the Texas tort of invasion of privacy [because no embarrassing private facts were disclosed in the press release] or the Texas negligence per se doctrine [no Texas court has ever found a duty in a statute [here, I.R.C. §6103(a)] which provides another comprehensive and express private cause of action].

individually IRS employees (who participated in the issuance of press releases) under §6103(a) [and former §7217] results in a verdict of $6 million of compensatory damages and a total of $3 million of punitive damages. Judge Hoyt held that Judge Singleton’s findings of fact in the Federal Tort Claims action [with respect to what the individual defendants did] had not been overturned by the Fifth Circuit, and castigated the U.S. Attorney from the Department of Justice for “insist[ing], in an unprofessional and disingenuous way, that the opposite was true.”

(3) *Judgment against individual defendants is reversed because of erroneous instruction, and case to be reassigned to another judge on remand. Johnson v. Sawyer, 97-2 U.S.T.C. ¶50,616 (5th Cir. 8/21/97). The court found that major portions of the 1981 press releases [such as the charge on which Johnson was convicted and the effect of the conviction] were not violative of §6103, and that Judge Hoyt’s instruction to the contrary was erroneous. Judge Hoyt was disqualified because of his appearing to lack impartiality, particularly because statements Judge Hoyt made during trial were predicated on Johnson’s claims of innocence of the tax evasion crime for which he was convicted. The court noted that it had earlier rejected the plaintiff’s contention that Johnson’s criminal conviction was open to attack.

- The court concluded that tax return information disclosed in open court does not lose its confidentiality, and subsequent publication by an IRS employee violates §6103 where the source of the information is the confidential tax return information, as opposed to the public court proceedings.
- Elvis Johnson appeared on the CBS program “60 Minutes” on 9/21/97.

d. IRS press releases based upon attendance at the criminal trial and sentencing hearing by the IRS public affairs specialist did not disclose §6103 tax return information. Rice v. United States, 97-1 U.S.T.C. ¶50,812, 80 A.F.T.R.2d 5795 (D. N.M. 7/2/97). Taxpayer was criminally convicted on two felony counts of filing false claims for federal tax refunds and on three felony counts of making and subscribing false federal tax returns. On his suit for §7431 and Federal Tort Claims Act damages, summary judgment was granted to defendants. (It may have helped defendants that plaintiff appeared pro se.

e. *Add this one to the list of things not to say to an Internal Revenue Agent. Ward v. United States, 97-2 U.S.T.C. ¶50,504, (D. Colo. 6/2/97). Taxpayer action under §7431 for unauthorized disclosure of her tax return information by IRS agents on a radio talk show, in a fact sheet sent to “Inside Edition,” and in a letter to the editor printed in a local Colorado Springs newspaper. The court held that only four acts of disclosure had occurred, but awarded damages of $75,000 for emotional distress. The letter to the editor, written by a Revenue Officer and containing information he had obtained on the job, was the basis for the punitive damage award of $250,000.

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The revenue officer who wrote the letter did not seek prior advice regarding whether the disclosure would be authorized. The other disclosures resulted in only statutory damages. The disclosures were unauthorized even though the taxpayer had previously disclosed information on the program because the taxpayer's consent to release did not conform to requirements of Treas. Reg. §301.6601©-1, but the agents were not grossly negligent because they relied on erroneous advice that disclosure was authorized.

- The IRS originally issued a jeopardy assessment in the amount of $324,889, which was eventually reduced to $3,480.

- According to the 7/14/97 National Review magazine, the taxpayer had reportedly said to an IRS auditor: "Honey, from what I can see of your accounting skills the country would be better served if you were dishing up chicken fried steak on some Interstate in West Texas, with all the clunky jewelry and big hair."

- Carol Ward appeared on the CBS program "60 Minutes" on 9/21/97.

5. Professional responsibility

a. Tax Court judge need not recuse himself. Nobles v. Commissioner, 97-1 U.S.T.C. ¶50,144 (9th Cir. 1/13/97). There is no requirement that Tax Court Judge Joel Gerber recuse himself in a tax shelter case pending in the Tax Court since 1983. Before his appointment to the court in 1984, Judge Gerber had been IRS Deputy Chief Counsel and then Acting Chief Counsel. After taxpayers moved to recuse Judge Gerber pursuant to 28 U.S.C. §455 on the ground that he had been responsible for the initial litigation involving their case by virtue of his IRS position, Tax Court Chief Judge Hamblen reviewed the motion and interviewed Judge Gerber, who said he had no knowledge of or involvement in the case while at the IRS. The Ninth Circuit opinion holds that because the recusal provision applies only to lifetime-appointed judges, Tax Court judges [who serve only a 15-year term] do not fall within it. [Former Tax Court judge] Cynthia Hall's opinion further notes that the Tax Court has "chosen to adhere" to the Code of Conduct for United States Judges [Canons 3C(1) and 3C(1)(e) of which contain provisions substantially similar to 28 U.S.C. §455], but has not formally adopted the Code of Conduct; therefore, it provides no authority to order a judge to disqualify himself on a motion from a party.

6. Updates to 1996 Legislation

a. Interest abatement. T2 §§301 and 302 amend §6404 (1) to expand the Service's authority to abate interest in situations where managerial acts results in unreasonable error or delay in resolving a taxpayer dispute [effective for interest accruing with respect to deficiencies for tax years beginning after the date of enactment], and (2) to give the Tax Court jurisdiction to review denials of requests for interest abatement [effective for requests after the date of enactment].

(1) The Tax Court adopted interim Rules 280-284 to govern litigation under the provision of T2 that permits judicial review of IRS decisions not to abate interest (9/30/96). The prerequisites for jurisdiction are that the Commissioner has mailed a
notice of final determination not to abate interest under Code Section 6404 and that the taxpayer has filed a timely "Petition for Review of Failure to Abate Interest under Code Section 6404."

b. Designated private delivery services may provide "postmark" to prove date of mailing; high standards established for designation. T2 §1204 adds new §7502(f) to permit taxpayers to prove date of mailing by use of electronic records of receipt by public-available delivery services. One requirement for designation is that the delivery service must be "at least as timely and reliable on a regular basis as the United States mail."


(2) Is it time for tax professionals to invest in private delivery services? Notice 97-26, 1997-17 I.R.B. 6 (4/10/97). Section 7502(f), enacted in 1996, authorizes the Commissioner to designate private delivery services that qualify for the timely mailed, timely filed rule that applies to documents mailed by U.S. mail. To qualify a private delivery service must be available to the general public, be at least as timely and reliable as the U.S. mail, and maintain adequate records. The Commissioner has designated certain 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. Sets forth rules that are effective for the interim period specified in Rev. Proc. 97-19 (which ends on the date the IRS issues guidance superseding that procedure).

7. United States v. Decker, 78 A.F.T.R.2d 7367 (9th Cir. Bankr. 10/28/96) (unpublished). A debtor in possession under Chapter 11 of the Bankruptcy Act cannot avoid an unrecorded tax lien by claiming hypothetical purchaser for value status pursuant to 11 USC §544(a)(3) and §545(2). The standard for defining a "purchaser" under §6323(h)(6) is higher than under the Bankruptcy Act

8. Chateauguay v. LTV Steel Co., Inc., 94 F.3d 772, 96-2 U.S.T.C. ¶50,458 (2d Cir. 1996). When a taxpayer is in bankruptcy, the government's right under §6402(a) to set off refunds due to the taxpayer against taxes owed is qualified by limitations in the Bankruptcy Code regarding creditor's setoff rights.

9. Manchester Group v. Commissioner, 97-1 U.S.T.C. ¶50,434 (9th Cir. 5/19/97), rev'g T.C. Memo. 1994-604. The §7502 "timely mailing is timely filing" rule applies to motions for "leave to file motion to vacate final [Tax Court] decisions."

10. Dorchester Industries Inc. v. Commissioner, 108 T.C. No. 16 (4/29/97) (reviewed, 16-1). The court refused to permit one of the parties to a settlement agreement to repudiate the agreement, even though the settlement agreement had not been filed as a stipulation in the court.

11. 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.

12. 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.

13. 1997 Legislation
   a. *1997 Act §505 adds new Code §7479 to authorize a declaratory judgment Tax Court action to determine initial qualification and continued eligibility for §6166 deferral, effective for decedents dying after 8/5/97.
   b. *1997 Act §506 adds Code §7477 to authorize a Tax Court declaratory judgment action to resolve valuation controversies, effective for gifts made after 8/5/97.
   c. 1997 Act §463 amends Code §6621(c) to eliminate from application the increased interest rate for large corporate underpayments any deficiency (or proposed deficiency) of not more than $100,000. Effective for determining interest for periods after 12/31/94.
   d. 1997 Act §1604 amends Code §6621(a) to reduce the interest rate on overpayments in excess of $10,000 by 1-1/2 percentage points. Effective for periods after 12/31/97.
   e. 1997 Act §911 adds new Code §7508A to give the IRS authority (under regulations to be prescribed) to postpone tax-related deadlines for taxpayers affected a Presidentially declared disaster. Effective for any period that has not expired before 8/5/97. 1997 Act §915 would permit the IRS to abate interest during such extensions, effective for disasters declared after 12/31/96.
   f. **"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© 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.)
   g. 1997 Act §1027 adds new Code §6034A(c) to require beneficiaries to file returns consistent with the estate or trust return, or to notify the IRS identifying the inconsistency. Effective for beneficiary returns filed after 8/5/97.
   h. *1997 Act §1205 amends Code §6311 to permit payment of taxes by "commercially acceptable means," including by credit card. Effective 9 months after enactment, 5/5/98.
   i. 1997 Act §1452 amends Code §7481(c) to provide that Tax Court jurisdiction over redeterminations of interest involved in a Tax Court proceeding by filing a petition with the court within 1
year after the date the Tax Court decision becomes final. Effective on 8/5/97.

(1) BankAmerica Corp. v. Commissioner, 109 T.C. No. 1 (7/15/97). Section 7481(c) confers jurisdiction on the Tax Court to determine if there has been an overpayment of interest resulting from a simultaneous underassessment but overcharge of interest due to the Commissioner's failure to allow credit carryovers to offset the interest. Applying the "use of money" principle to determine if interest was due, the court allowed the taxpayer's claim that a carryback of ITC that was freed-up by a subsequent NOL carryback to year the ITC was originally claimed offset the interest due on a deficiency for the year to which the ITC was carried.

14. Bachner v. Commissioner, 109 T.C. No. 7 (9/24/97). In applying Tax Court's refund jurisdiction under §6512, the amount of any refundable "overpayment" is limited to payments, such as withholding and estimated tax payments, that exceed the taxpayer's "correct" tax liability, even though a deficiency assessment is barred by the statute of limitations.

XII. TAX SHELTERS

A. In General

1. Bergstrom v. United States, 97-1 U.S.T.C. ¶50,143 (Fed. Cl. 12/30/96). Nonrecourse debt exceeding property's value is disregarded entirely for tax purposes, following Estate of Franklin v. Commissioner, 544 F.2d 1045, 76-2 U.S.T.C. ¶9773 (9th Cir. 1976), and rejecting the approach of Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263, 88-2 U.S.T.C. ¶9601 (3d Cir. 1988) of recognizing the debt to the extent it does not exceed the property's value.

2. Tax shelter investors did not reasonably rely on NYU tax professor's opinion. Sann v. Commissioner, T.C. Memo. 1997-259 (6/10/97). Three lawyers who invested in a plastics recycling program were subject to penalties on their 1981 and 1982 tax shelter investments because they did not reasonably rely on NYU tax professor Guy Maxfield's opinion. This was because Maxfield disclaimed expertise about anything except tax law and acted merely as a "conveyor of information" and stressed that the decision to invest rested with each individual investor. The court noted that, reflecting on his own decision to invest, Maxfield testified: "[I]f I would have asked the right questions, I wouldn't have made the investment." The price of the machine was more than $1.1 million, but comparable plastics recycling machines were priced between $20,000 and $200,000.

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. LDL Research & Development II Ltd v. Commissioner, 97-1 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.

5. *Whitmore v. Commissioner*, 109 T.C. No. 13 (10/29/97). Limited partner was not at risk under §465 with regard to a recourse third-party bank loan to the partnership in a computer leasing transaction because the loan was guaranteed by the grandparent of the corporation that sold the computer to the partnership.

XIII. WITHHOLDING AND EXCISE TAXES

A. Employee/Independent Contractor

1. Classification of workers as lessees upheld by district court. *Marlar, Inc. v. United States*, 934 F. Supp. 1204, 96-2 U.S.T.C. ¶50,463 (W.D. Wash. 8/2/96). Summary judgment granted to owner of a club which features nude and semi-nude dancers in that classification of the relationship between the club and its dancers as lessor/lessees was in accordance with industry practice and within the safe haven of §530 of the Revenue Act of 1978. The failure to issue Forms 1099 to the dancers is immaterial because no such form is required in a lessor/lessee relationship.

2. Tech. Adv. Mem. 9639001 (1/20/96). Law school student hired by lawyer as a part-time law clerk to perform legal research and assist with litigation support was an employee because the worker had no substantial capital investment nor risk of loss, and the firm supplied worker with computer, office equipment, secretarial services, and law books, and paid parking expenses as well.

3. Country club golf and tennis professionals. TAM 9717001 (4/3/96). Country club golf and tennis professionals are employees, both while teaching lessons to club members and while operating the pro shops because they did not have any investment in a business related to the services they performed, etc. so the control test was met. Rev. Rul. 68-126, 1968-2 C.B. 466, followed, and Rev. Rul. 68-125, 1968-2 C.B. 465, distinguished.

4. TAM 9718001 (12/10/96). Referral fees paid to retired attorneys on conclusion of matters, with respect to pre-retirement referrals, are subject to FICA taxation.

5. *Alford v. United States*, 97-1 U.S.T.C. ¶50,502, (8th Cir. 6/20/97). Ordained minister of the Assemblies of God Church is an independent contractor for deduction purposes, and was not subject to the 67 2% floor on miscellaneous itemized deductions.

6. *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.

B. Excise Tax

1. Notice 97-18, 1997-10 I.R.B. 35 (2/24/97). Guidance with respect to transfers of property to foreign corporations, partnerships, trusts, or estates, as described in §1491, together with guidance concerning the §1494(c) penalty for failure to file a return reporting a §1491 transfer, as amended by the SBJPA of 1996.
2. 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.

XIV. TAX LEGISLATION

A. 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.
      • Adds considerable complexity to the Code.
      • Generally effective on 1/1/98.
      • 1997 Act §§1600-1604 contain technical corrections to earlier tax acts and to the current budget act, H.R. 2015.
   2. H.R. 1226, Taxpayer Browsing Protection Act, was signed by President Clinton on 8/5/97. Adds new §7213A to make criminal the unauthorized inspection of a tax return or of tax return information. See XI.A., above.

B. Pending