The Year in Review: A Discussion of Significant Regulations, Rulings and Cases

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THE YEAR IN REVIEW:

A Discussion of Significant Regulations, Rulings and Cases

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THE YEAR IN REVIEW: A Discussion of Significant Regulations, Rulings and Cases

I. PROPOSED LEGISLATION

A. Job Creation and Wage Enhancement Act (H.R. 9). This Bill includes many of the proposals found in the Contract with America issued January 10, 1995.

1. 50 Percent Capital Gains Deduction --

a. The Bill would allow all taxpayers (both individual and corporate) a deduction equal to 50 percent of net capital gain for the taxable year. The effective rate for an individual in the highest rate bracket would be 19.8 percent, and the effective rate for a corporation in the highest rate bracket would be 17.5 percent.

b. The Bill would repeal the provisions in the Revenue Reconciliation Act of 1993 allowing a capital gain exclusion for sales of certain small business stock.

c. The Bill would reinstate the rule which requires two dollars of long-term capital loss of an individual to offset one dollar of ordinary income.

d. These provisions generally would apply to taxable years ending after December 31, 1994.

2. Indexing of Basis of Certain Assets for Purposes of Determining Gain or Loss -- The Bill generally would provide for an inflation adjustment to the basis of certain assets for purposes of determining gain or loss upon a sale or other disposition of such assets after December 31, 1994, in taxable years ending after that date.

a. Assets which would be eligible for the inflation adjustment generally would include corporate stock and tangible property that is a capital asset or property used in a trade or business and held by the taxpayer for more than one year.

b. The inflation adjustment would not apply to stock in an S corporation, stock in a foreign corporation, preferred stock that does not participate in corporate growth to any significant extent, any mortgage or other creditor's interest in property, a lessor's interest in property subject to a net lease, property using neutral cost recovery or property sold to a related person.

c. Indexing adjustments would apply in computing the taxable income and the earnings and profits of a RIC or REIT,
but they would not apply in determining whether a corporation qualifies as a RIC or REIT.

d. With respect to installment sales, the inflation adjustment of the seller would not take into account any periods after the sale is made.

e. The inflation adjustment would be measured by increases in the Gross Domestic Product ("GDP") deflator occurring after December 31, 1994, regardless of whether the asset was acquired by the taxpayer prior to that date.

3. **Capital Loss Deduction Allowed with Respect to Sale or Exchange of Principal Residence** -- The Bill would provide that losses from the sale or exchange of a principal residence would be treated as a deductible capital loss, rather than a nondeductible personal loss. The provision would be effective for sales and exchanges after December 31, 1994, in taxable years ending after such date.

4. **Neutral Cost Recovery** -- For MACRS property placed in service after December 31, 1994, the Bill would allow a taxpayer to elect, on a property-by-property basis, to determine depreciation deductions under present law or under a new neutral cost recovery system (NCRS).

5. **Increase in Unified Estate and Gift Tax Credits** -- The bill would gradually increase the present law unified credit of $192,800 to $248,300 over a three-year period (i.e., the fully phased-in amount would effectively exempt $750,000 in taxable transfers from the Federal estate and gift tax).

   a. After 1998, the unified credit would be indexed for inflation each year by multiplying the applicable exclusion amount of $750,000 by a cost of living adjustment.

   b. The provision would apply to the estates of decedents dying, and gifts made, after December 31, 1995.

6. **Sec. 179, I.R.C. Expensing Election** -- The bill would increase the $17,500 amount allowed to be expensed under Sec. 179, I.R.C. to $25,000.

B. **Small Investors Tax Relief Act of 1995 (S. 181).** This Bill would index the basis of capital assets in a manner similar to the indexing provision contained in H.R. 9 for capital assets disposed of after December 31, 1994. The primary difference is that this Bill would use changes in the Consumer Price Index, rather than the Gross Domestic Product, as the applicable measure of inflation. This Bill would also allow an individual to take a deduction for any taxable year equal to the lesser of the individual's net capital gain for the year or $10,000.
C. The Capital Formation and Job Creation Act of 1995 (S. 182). This Bill would provide for a 50 percent deduction for capital gains, the indexation of capital assets, and a capital loss deduction on the sale or exchange of a principal residence. These provisions are identical to the provisions of H.R. 9.

II. PROPOSED AND FINAL REGULATIONS

A. Sec. 263A(f), I.R.C. (Requirement to Capitalize Interest with Respect to Production of Property).

1. Effective Date -- On December 29, 1994, the Service issued final Regulations §§1.263A-8 through -15 relating to the requirement to capitalize interest with respect to the production of property. These Regulations generally apply to interest incurred in taxable years beginning on or after January 1, 1995. Reg. §1.263A-15(a)(1). For taxable years beginning before January 1, 1995, taxpayers must take reasonable positions on their Federal income tax returns when applying Sec. 263A(f), I.R.C. A reasonable position is a position consistent with the Temporary Regulations, Revenue Rulings, Revenue Procedures, Notices and Announcements concerning Sec. 263A, I.R.C. Reg. §1.263A-15(a)(2).

2. Anti-Abuse Rule -- The interest capitalization rules must be applied by the taxpayer in a manner that is consistent with, and reasonably carries out, the purposes of Sec. 263A(f), I.R.C. The District Director may, based upon all the facts and circumstances, determine the amount of interest that must be capitalized in a manner that is consistent with, and reasonably carries out, the purposes of Sec. 263A(f), I.R.C. Reg. §1.263A-15(c).

3. Ordering Rules --

a. Interest must be capitalized under Sec. 263A(f), I.R.C. before the application of Secs. 163(d), 163(j), 266, 469 and 861, I.R.C. If, after the application of Sec. 263A(f), I.R.C., interest is deferred under any of these Sections, that interest is not subject to capitalization in any subsequent taxable year. Reg. §1.263A-9(g)(1)(i).

b. Interest that is subject to a deferral provision, including Secs. 163(e)(3), 267, 446 and 461, I.R.C., is subject to capitalization under Sec. 263A(f), I.R.C. only in the taxable year in which it would be deducted if Sec. 263A(f), I.R.C. did not apply. Thus, a deferral Section is applied prior to the application of Sec. 263A(f), I.R.C. Reg. §1.263A-9(g)(1)(ii).
4. **General Rule** -- Capitalization of interest under the avoided cost method is required with respect to the production of designated property. Reg. §1.263A-8(a)(1).

   a. **Definition of Designated Property** --

      (1) Real property; or

      (2) Tangible personal property which meets any of the following criteria:

          (a) Property with a class life of 20 years, but only if the property is not property described in Sec. 1221(1), I.R.C. in the hands of the taxpayer or a related person;

          (b) Property with an estimated production period exceeding 2 years; or

          (c) Property with an estimated production period exceeding 1 year and an estimated cost of production exceeding $1,000,000. Reg. §1.263A-8(b)(1).

   b. **De Minimis Rule** -- Designated property does not include property for which the production period does not exceed 90 days and the total production expenditures do not exceed $1,000,000 divided by the number of days in the production period. Reg. §1.263A-8(b)(4).

   c. **Definition of Real Property** -- Real property includes land, unsevered natural products of land, buildings and inherently permanent structures. Reg. §1.263A-8(c)(1).

      (1) Unsevered natural products of land includes growing crops and plants, mines, wells and other natural deposits. Growing crops and plants, however, are real property only if the preproductive period of the crop or plant exceeds 2 years. Reg. §1.263A-8(c)(2).

      (2) Inherently permanent structures include property that is affixed to real property and that would ordinarily remain affixed for an indefinite period of time. Reg. §1.263A-8(c)(3). A structure that is in the nature of machinery or is essentially an item of machinery or equipment is not an inherently permanent structure and is not real property. Reg. §1.263A-8(c)(4).

5. **The Avoided Cost Method** -- Generally, any interest that the taxpayer theoretically would have avoided if accumulated production expenditures had been used to repay or reduce the taxpayer’s outstanding debt must be capitalized. Reg. §1.263A-9(a)(1).
a. **Interest** -- Applicable interest includes all amounts that are characterized as interest expense under any Code Section, including, for example, Secs. 482, 483, 1272, 1274 and 7872, I.R.C. Reg. §1.263A-9(a)(3).

b. **Method** -- The avoided cost method requires the capitalization for each unit of designated property of --

(1) The traced debt amount and

c. **Comparison to Financial Accounting Method** -- The avoided cost method is applied without regard to any financial or regulatory accounting principles for the capitalization of interest. Reg. §1.263A-9(g)(4).

6. **Traced Debt Amount** -- Interest must be capitalized with respect to a unit of designated property in an amount equal to the total interest incurred on the traced debt during each measurement period. Reg. §1.263A-9(b)(1).

a. **Definition of Traced Debt** -- Traced debt is outstanding eligible debt that is allocated to accumulated production expenditures with respect to a unit of designated property under the rules of Temp. Reg. §1.163-8T. Reg. §1.263A-9(b)(2).

b. **Eligible Debt** -- Under Reg. §1.263A-9(a)(4), eligible debt is all debt except

(1) debt that is disallowed under a provision described in Temp. Reg. §1.163-8T(m)(7)(ii);
(2) debt, such as accounts payable and other accrued items, that bears no interest;
(3) debt that is borrowed directly or indirectly from a person related to the taxpayer and bears a rate of interest that is less than the AFR;
(4) debt bearing personal interest;
(5) debt bearing qualified residence interest;
(6) debt incurred by an organization that is exempt from income tax under Sec. 501(a), I.R.C.;
(7) reserves, deferred tax liabilities and similar items that are not treated as debt for Federal income tax purposes; and

(8) Federal, state and local income tax liabilities, deferred tax liabilities under Sec. 453A, I.R.C and hypothetical tax liabilities under the look-back method of Sec. 460(b), I.R.C. or similar provisions.

c. Election Not to Trace Debt -- Taxpayers may elect not to trace debt. If the election is made, all interest and debt fall under the rules relating to the excess expenditure amount. This election is a method of accounting. Reg. §1.263A-9(d)(1).

7. Excess Expenditure Amount -- If there are accumulated production expenditures in excess of traced debt, the taxpayer must capitalize the excess expenditure amount. Reg. §1.263A-9(c)(1).

a. Excess Expenditure Amount -- For each unit of property, this amount equals the product of --

(1) The average excess expenditures for the unit of property (which is computed by --

(a) determining the amount (if any) by which accumulated production expenditures exceed traced debt at each measurement date during the computation period; and

(b) dividing the sum of these amounts by the number of measurement dates during the computation period); and

(2) The weighted average interest rate (which is determined by dividing interest incurred on nontraced debt during the period by average nontraced debt). Reg. §1.263A-9(c)(1).

b. Interest -- With respect to an excess expenditure amount, interest incurred during the computation period is capitalized from the following sources and in the following sequence but not in excess of the excess expenditure amount for all units of designated property:

(1) Interest incurred on nontraced debt (which is all eligible debt other than traced debt);

(2) Interest relating to certain borrowings from related persons; and
(3) Guaranteed payments for the use of capital that would have been deductible by the partnership if Sec. 263A(f), I.R.C. did not apply. Reg. §1.263A-9(c)(2).

8. Selection of Computation and Measurement Periods --

a. Computation Period -- A taxpayer may (but is not required to) make the avoided cost calculation on the basis of a full taxable year. If the taxpayer uses a shorter computation period, the computation period may not include portions of more than one taxable year and, except as provided in the case of short taxable years, each computation period within a taxable year must be the same length. Reg. §1.263A-9(f)(1)(i).


   (2) The avoided cost method applies to the production of a unit of designated property on the basis of a full computation period, regardless of whether the production period for the unit of designated property begins or ends during the computation period. Reg. §1.263A-9(f)(1)(iii).

b. Measurement Period -- If a taxpayer uses the taxable year as the computation period, measurement dates must occur at quarterly or more frequent regular intervals. If the taxpayer uses computation periods that are shorter than the taxable year, measurement dates must occur at least twice during each computation period and at least four times during the taxable year.

   (1) Measurement dates must occur at equal intervals during each computation period that falls within a single taxable year.

   (2) A taxpayer is permitted to modify the frequency of measurement dates from year to year. Reg. §1.263A-9(f)(2)(i).

c. Anti-Abuse Rule -- When, in his or her opinion, more frequent measurement dates are necessary to determine capitalized interest consistent with the principles and purposes of Sec. 263A(f), I.R.C. for a particular computation period, the District Director may require the use of the same. Reg. §1.263A-9(f)(2)(iv).

d. Split Measurement Dates -- If a significant segment of the taxpayer’s production activities requires more frequent measurement dates than another significant segment, the taxpayer may request a ruling for a taxable year and all subsequent taxable years in order to segregate the two segments.

9. **Unit of Real Property** -- A unit of real property is composed of --

a. Any components of real property owned by the taxpayer or a related person that are functionally interdependent and an allocable share of any common feature owned by the taxpayer or a related person that is real property; and

   (1) **Definition of functional interdependence** -- Components are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person. Components of real property are functionally interdependent if they are customarily sold as a single unit. Reg. §1.263A-10(b)(2).

   (2) **Definition of a common feature** -- A common feature generally includes any real property that benefits real property produced by, or for, the taxpayer or a related person, and that is not separately held for the production of income. Reg. §1.263A-10(b)(3).

b. The portion of land included in a unit of real property includes

   (1) land on which real property (including a common feature) included in the unit is situated,

   (2) land subject to setback restrictions with respect to such property, and

   (3) any other contiguous portion of the tract of land other than land that the taxpayer holds for a purpose unrelated to the unit being produced. Reg. §1.263A-10(b)(1).

10. **Accumulated Production Expenditures** -- Generally, the term means the cumulative amount of direct and indirect costs that are required to be capitalized with respect to the unit of property under Sec. 263A(a), I.R.C. Reg. §1.263A-11(a).

   a. Such costs are taken into account in the computation of accumulated production expenditures at the time and to the extent they would otherwise be taken into account under the taxpayer's method of accounting. Reg. §1.263A-11(b)(1).

   b. The costs of raw materials, supplies or similar items are taken into account as accumulated production
expenditures when they are incurred and dedicated to production of a unit of property. Dedicated means the first date items are specifically associated with the production of any unit of property. Reg. §1.263A-11(b)(2).

c. The accumulated production expenditures of a common feature or land that benefits more than one unit of real property, or that benefits designated property and property other than designated property, is apportioned among the units of designated property. The apportionment of the accumulated costs of the common feature generally may be made using any method that is applied on a consistent basis and that reasonably reflects the benefits provided. Reg. §1.263A-10(b)(4).

d. There are special rules with respect to how accumulated production expenditures are counted when units of real property are constructed in phases or with common features. Reg. §1.263A-10(b)(5).

e. For property produced under a contract, the customer's accumulated production expenditures include any payments under the contract that represent part of the purchase price of the unit and any other costs incurred by the customer. For the contractor, the cumulative amount of payments made by the customer under the contract attributable to the unit of property is a reduction in the contractor's accumulated production expenditures. Reg. §1.263A-11(c).

f. Accumulated production expenditures include the adjusted bases of any equipment, facilities, or other similar assets, used in a reasonably proximate manner for the production of a unit during any measurement period in which the asset is so used. A taxpayer apportions the adjusted basis of an asset used in the production of more than one unit in a measurement period among such units using reasonable criteria. Reg. §1.263A-11(d)(1).

11. Production Period -- The production period begins on the date that production of the unit of real property begins. Reg. §1.263A-12(c)(1).

a. The production period for a unit of real property produced for self-use ends on the date that the unit is placed in service, and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. Reg. §1.263A-12(d)(1).

b. The production period for a unit of real property produced for sale ends on the date that the unit is ready to be held for sale and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. Reg. §1.263A-12(d)(1).
c. The production period of a unit of real property begins on the first date that any physical production activity is performed with respect to a unit of real property. Reg. §1.263A-12(d)(2).

(1) The production period of a unit of real property produced under a contract begins for the contractor on the date the contractor begins physical production activity on the property.

(2) The production period of a unit of real property produced under a contract begins for the customer on the date either the customer or the contractor begins physical production activity on the property.

d. The term physical production activities includes any physical activity that constitutes production within the meaning of Reg. §1.263A-8(d)(1). The following is a partial list of activities any one of which constitutes a physical production activity with respect to the production of real property:

(1) Clearing, grading or excavating raw land;

(2) Demolishing a building or gutting a standing building;

(3) Engaging in the construction of infrastructure, such as roads, sewers, sidewalks, cables and wiring;

(4) Undertaking structural, mechanical or electrical activities with respect to a building or other structure; or

(5) Engaging in landscaping activities.

Reg. §1.263A-12(e).

B. Sec. 469, I.R.C. (Definition of Activity).

1. Effective Date -- On October 4, 1994, the Service released final Regulations defining the term "activity" for purposes of applying the passive loss rules. In general, these Regulations are effective for taxable years ending after May 10, 1992. However, for taxable years in which these Regulations apply and that begin before October 4, 1994, a taxpayer may determine its tax liability in accordance with Prop. Reg. §1.469-4 (published at 1992-1 C.B. 1219). For taxable years ending on or before May 10, 1992, taxpayers must apply the rules of Temp. Reg. §1.469-4T. For the taxable year that includes May 10, 1992,
taxpayers may choose to apply the rules in Temp. Reg. §1.469-4T, rather than the rules in these Regulations. Reg. §1.469-11(b).

2. **Trade or Business Activity** -- Trade or business activities are activities other than rental activities or activities which are incidental to holding property for investment which (a) involve the conduct of a trade or business under Sec. 162, I.R.C.; (b) are conducted in anticipation of the beginning of a trade or business; or (c) involve research and development expenditures. Reg. §1.469-4(b)(1).

3. **Rental Activity** -- Rental activities are activities which fall within the meaning of Temp. Reg. §1.469-1T(e)(3).

4. **Grouping Rules** -- Activities may be grouped if the activities constitute an appropriate economic unit. Reg. §1.469-4(c).

   a. **Most Important Factors** -- The following five factors are the most important in making this facts and circumstances determination:

   (1) Similarities and differences in types of trades or businesses;

   (2) The extent of common control;

   (3) The extent of common ownership;

   (4) Geographical location; and

   (5) Interdependencies between or among the activities. Reg. §1.469-4(c)(2).

   b. **Rules Limiting Taxpayer’s Ability to Group** --

   (1) A rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit **AND**

       (a) The rental activity is insubstantial in relation to the trade or business activity;

       (b) The trade or business activity is insubstantial in relation to the rental activity; or

       (c) Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the
trade or business activity. Reg. §1.469-4(d)(1).

(2) An activity involving the rental of real property and an activity involving the rental of personal property may not be treated as a single activity. Reg. §1.469-4(d)(2).

(3) A taxpayer that owns an interest as a limited partner or a limited entrepreneur in an activity described in Sec. 465(c)(1), I.R.C. may not group that activity with any other activity. However, a taxpayer may group such an activity with another activity in the same type of business if the grouping constitutes an appropriate economic unit. Reg. §1.469-4(d)(3).

(4) A C corporation subject to Sec. 469, I.R.C., an S corporation or a partnership must group its activities under the rules of this Section. Once the entity groups its activities, a shareholder or partner may group those activities. However, a shareholder or partner may not treat activities grouped together by an entity as separate activities. Reg. §1.469-4(d)(5).

c. Rules Regarding Regrouping --

(1) Once a taxpayer has grouped activities under this Section, the taxpayer may not regroup those activities unless it is determined that a taxpayer's original grouping was clearly inappropriate or a material change has occurred that makes the original grouping clearly inappropriate. In such a situation, the taxpayer must regroup. Reg. §1.469-4(e).

(2) Note that taxpayers who grouped activities under the rules in the Temporary Regulations must regroup if their activities are not appropriate economic units under Reg. §1.469-4. Reg. §1.469-11(b)(2)(ii).

(3) The Commissioner may regroup a taxpayer's activities if any grouping does not constitute an appropriate economic unit and a principal purpose of the taxpayer's grouping was to circumvent the underlying purposes of Sec. 469, I.R.C. Reg. §1.469-4(f)(1).

d. A taxpayer may, for the taxable year in which there is a disposition of substantially all of an activity, treat the part disposed of as a separate activity, but only if the taxpayer can establish with reasonable certainty:

(1) The amount of deductions and credits carried over to that part of the activity for the taxable year and
(2) The amount of gross income and of any other deductions and credits allocable to that part of the activity for the taxable year. Reg. § 1.469-4(g).

C. Sec. 469(c)(7), I.R.C. (Rules for Rental Real Estate Activities of Taxpayers Engaged in Certain Real Property Trades or Businesses).

1. Effective Date -- On January 9, 1995, the Service issued Proposed Regulations providing rules for rental real estate activities of taxpayers engaged in certain real property trades or businesses. These rules will be effective for taxable years beginning on or after January 1, 1995. The election to treat all interests in rental real estate as one activity is made with returns filed on or after January 1, 1995. Prop. Reg. §1.469-11(a)(3).

2. Real Property Trades or Businesses -- The determination of a taxpayer's real property trades or businesses is based on all of the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services. However, once a taxpayer determines the real property trades or businesses in which personal services are provided, the taxpayer may not redetermine those real property trades or businesses in subsequent taxable years unless the original determination was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original determination clearly inappropriate. Prop. Reg. §1.469-9(d).

3. Rule for Grouping Rental Real Estate Activities -- Unless a taxpayer elects to aggregate all rental real estate interests, a taxpayer who meets the personal service requirements of Sec. 469(c)(7), I.R.C. may not group a rental real estate activity with any other activity of the taxpayer. For example if a taxpayer develops real property and owns interests in rental property, only the participation of the taxpayer with respect to the rental real estate may be used to determine if the taxpayer materially participates in the rental real estate activity. Prop. Reg. §1.469-9(e)(3).

4. Treatment of Limited Partnership Interests --
   a. If a taxpayer elects to treat all interests in rental real estate as a single rental real estate activity, and at least one interest in rental real estate is held by the taxpayer as a limited partnership interest, the combined rental real estate activity will be treated as a limited partnership interest of the taxpayer for purposes of determining material participation. Prop. Reg. §1.469-9(f)(1).
b. Thus, the taxpayer must establish material participation in a rental real estate activity under one of the three tests available to limited partners under Temp. Reg. §1.469-5T(e)(2). Prop. Reg. §1.469-9(f)(1).

c. However, if the taxpayer’s share of gross rental income from all of the taxpayer’s limited partnership interests in rental real estate is less than 10% of the taxpayer’s share of gross rental income from all of the taxpayer’s interests in rental real estate for the taxable year, this rule will not apply and the taxpayer may determine material participation under the seven tests listed in Temp. Reg. §1.469-5T(a). Prop. Reg. §1.469-9(f)(2).

5. Election to Treat all Interests in Rental Real Estate as a Single Rental Real Estate Activity -- If such an election is made, it is binding for the taxable year in which it is made and for all future years in which the taxpayer is also a qualifying taxpayer. Prop. Reg. §1.469-9(g)(1).

a. Making the Election -- A qualifying taxpayer makes the election to treat all interests in rental real estate as one activity by filing a statement with the taxpayer’s original income tax return for the taxable year. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to Sec. 469(c)(7)(A), I.R.C. Prop. Reg. §1.469-9(g)(3).

b. Revoking the Election -- A taxpayer may revoke the election if there is a material change in the taxpayer’s facts and circumstances. To revoke the election, the taxpayer must file a statement with the taxpayer’s original income tax return for that year. This statement must contain a declaration that the taxpayer is revoking the election under Sec. 469(c)(7)(A), I.R.C., and an explanation of the nature of the material change. Prop. Reg. §1.469-9(g)(3).

6. Interests Held through Pass-through Entities -- A taxpayer’s interest in rental real estate held by a partnership or an S corporation is treated as a single interest in rental real estate if the pass-through entity grouped its rental real estate as one rental activity under Reg. §1.469-4(d)(5) unless a qualifying taxpayer holds a 50% or greater interest in the capital, income, gains, losses, deductions or credits of the pass-through entity at any time during the taxable year, in which case each interest in rental real estate held by the pass-through entity will be treated as a separate interest in rental real estate of the qualifying taxpayer, regardless of the pass-through entity’s grouping of activities. Prop. Reg. §1.469-9(h).
7. **Fresh Starts Under Consistency Rules** --

a. For the first taxable year in which a taxpayer determines its tax liability under Prop. Reg. §1.469-4, the taxpayer may regroup his or her activities without regard to the manner in which the activities were grouped in the preceding taxable year and must regroup his or her activities if his or her prior grouping was inconsistent with the Proposed Regulation. Prop. Reg. §1.469-11(b)(3)(i).

b. For the first taxable year in which a taxpayer determines his or her tax liability under Reg. §1.469-4, the taxpayer may regroup his or her activities without regard to the manner in which the activities were grouped in the preceding taxable year and must regroup his or her activities if his or her prior grouping was inconsistent with the rules of Reg. §1.469-4. Prop. Reg. §1.469-11(b)(3)(ii).

c. For the first taxable year beginning after December 31, 1993, a taxpayer may regroup his or her activities to the extent necessary or appropriate to avail himself or herself of the provisions of Sec. 469(c)(7), I.R.C. and without regard to the manner in which the activities were grouped in the preceding taxable year. Prop. Reg. §1.469-11(b)(3)(iii).

D. **Sec. 701, I.R.C. (Subchapter K Anti-abuse Rules).**

1. **Effective Date** -- On May 17, 1994, the Service promulgated Proposed Regulations relating to partnerships and the abuse of them. On January 3, 1995, final Regulations were promulgated. With the exception of the abuse of entity treatment rule of Reg. §1.701-2(e), which is effective for all transactions involving a partnership that occur on or after December 29, 1994, the Regulation is effective for all transactions involving a partnership that occur on or after May 12, 1994. Reg. §1.701-2(g).

2. **Intent of Subchapter K** -- The intent of the partnership provisions in Subchapter K is to permit taxpayers to conduct business for joint economic profit through a flexible arrangement that accurately reflects the partners’ economic agreement without incurring an entity-level tax. Implicit in this intent are the following three requirements:

a. the partnership must be **bona fide** and each partnership transaction (or series of related transactions) must be entered into for a substantial business purpose;

b. the form of each partnership transaction must be respected under substance over form principles; and
c. the tax consequences under Subchapter K to each partner must accurately reflect the partners’ economic agreement and clearly reflect the partners’ income, except to the extent that a provision of Subchapter K which is intended to promote administrative convenience or other policy objectives causes tax results that deviate from that requirement. Reg. §1.701-2(a).

3. Application of Subchapter K Rules -- If a partnership is formed or availed of in connection with a transaction or series of related transactions with a principal purpose of substantially reducing the present value of the partners' aggregate Federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Commissioner can recast the transaction even if the taxpayer complies with the literal language of one or more of the provisions of the Internal Revenue Code or the Regulations thereunder. The Commissioner can recast the transaction by (a) disregarding in whole or in part a purported partnership; (b) treating one or more of the purported partners as not a partner; (c) adjusting the methods of accounting used by the partnership or a partner; (d) reallocating a partnership’s items of income, gain, loss, deduction or credit; or (e) adjusting or otherwise modifying the claimed tax treatment. Reg. §1.701-2(b).

a. Test -- The purposes for structuring a transaction involving a partnership will be determined based on all of the facts and circumstances. Reg. §1.701-2(c). Factors which will be examined include:

(1) A comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction;

(2) Whether the present value of the partners’ aggregate Federal tax liability is substantially less than had the partners owned the partnership’s assets and conducted the partnership’s activities directly;

(3) Whether the present value of the partners’ aggregate Federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction;

(4) Whether one or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership’s activities, or have little or no participation in the profits from the partnership’s activities, other than a preferred return that is in the nature of a payment for the use of capital;
(5) Whether substantially all of the partners are related to one another;

(6) Whether partnership items are allocated in compliance with the literal language ofRegs. §§1.704-1 and 1.704-2 but with results that are inconsistent with the purpose ofSec. 704(b), I.R.C. and those Regulations;

(7) Whether the benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained by the contributing partner; or

(8) Whether the benefits and burdens of ownership of partnership property are in substantial part shifted to the distributee partner before or after the property is actually distributed to the distributee partner.

b. In contrast to the Proposed Regulations, the final Regulations give several examples of transactions consistent with the intent of Subchapter K. Following is a listing of the examples which are consistent with the intent:

(1) Avoidance of entity-level tax. Reg. §1.701-2(d), Example 1.

(2) Avoidance of Subchapter S shareholder requirements. Reg. §1.701-2(d), Example 2.

(3) Avoidance of a more restrictive foreign tax credit limitation. Reg. §1.701-2(d), Example 3.

(4) Avoidance of gain recognition under Secs. 351(e) and 357(c), I.R.C. Reg. §1.701-2(d), Example 4.

(5) Special allocations to take advantage of dividends received deductions, nonrecourse financing and low-income housing credit. Reg. §1.701-2(d), Examples 7 and 8.


(7) Basis adjustments under Sec. 732, I.R.C. Reg. §1.701-2(d), Example 12.

c. Following is a listing of the examples which are not consistent with the intent of Subchapter K:

(1) Use of both a temporary partner and a nominal partner to generate artificial losses and shelter income for a third partner. Reg. §1.701-2(d), Example 9.
(2) Through the absence of a Sec. 754, I.R.C. election, using a partnership to duplicate built-in loss present in the asset prior to contribution. Reg. §1.701-2(d), Example 10.

(3) Using basis adjustments under Sec. 732, I.R.C. to allow a person to acquire and hold land but recover a substantial portion of the purchase price. Reg. §1.701-2(d), Example 13.

4. Abuse of Entity Treatment -- The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the Regulations promulgated thereunder. Reg. §1.701-2(e). However, the Commissioner does not have that authority if:

a. A provision of the Internal Revenue Code or the Regulations promulgated thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

b. See as examples Secs. 163(e)(5) and 1059, I.R.C. Reg. §1.701-2(f).

5. Application of This Regulation -- When an issue that may be affected by this Regulation is considered on examination, any application of the Regulation must be coordinated with both the Issue Specialist on the Partnership Industry Specialization Program team and the IRS National Office. Ann. 94-87, 1994-27 I.R.B. 124.

6. Application of Regulation Solely to Income Tax -- When the Regulation originally came out in final form, the Regulation was to be applied to the operation and interpretation of any provision of the Code and the Regulations thereunder that might be relevant to a particular partnership transaction (including income, estate, gift, generation-skipping and excise tax). However, the Service has changed its mind, and the Regulation will affect only the income tax. Two examples regarding family partnerships and gift tax have been removed. Ann. 95-8, 1995-7 I.R.B. 56.

E. Sec. 704, I.R.C. (Distribution of Contributed Property).

1. Effective Date -- On January 9, 1995, the Service promulgated Proposed Regulations relating to the recognition of a partner's Sec. 704(c)(1)(B), I.R.C. gain if another partner receives a distribution of that property within five years of its
contribution to the partnership, on or after January 9, 1995. Prop. Reg. §1.704-4(g).

2. General Rule -- A partner that contributes Sec. 704(c), I.R.C. property to a partnership, which property is distributed to another partner within five years of its contribution to the partnership, must recognize gain or loss as if the distributed property had been sold to the distributee partner for fair market value. Prop. Reg. §1.704-4(a)(1).

   a. The five-year period begins on and includes the date of contribution. However, a termination under Sec. 708(b)(1)(B), I.R.C. begins a new five-year period, but only to the extent that the pre-termination built-in gain or loss, if any, on such property was not already required to be allocated to the original contributor. Prop. Reg. §1.704-4(a)(4).

   b. The character of the gain recognized under Sec. 704(c)(1)(B), I.R.C. is the same as would have resulted if the distributed property had been sold to the distributee partner by the partnership. Prop. Reg. §1.704-4(b)(1).

3. Transactions Which Are Exempted from Section -- Sec. 704(c)(1)(B), I.R.C. does not apply to the following transactions:

   a. Property contributed to the partnership on or before October 3, 1989;

   b. A distribution of an interest in the distributed property in a complete liquidation of the partnership if the contributing partner receives an interest in the property and the built-in gain or loss in the interest distributed to the contributing partner, determined immediately after the distribution, is equal to or greater than the built-in gain or loss on the property that would have been allocated to the contributing partner; and

   c. A deemed distribution of property caused by a termination of the partnership under Sec. 708(b)(1)(B), I.R.C. Prop. Reg. §1.704-4(c).

4. Anti-Abuse Rule -- The Commissioner can recast a transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of Sec. 704(c)(1)(B), I.R.C. Prop. Reg. §1.704-4(f).

F. Sec. 704(c), I.R.C. (Allocations on Contributions to Partnerships).

1. Promulgation -- On December 28, 1994, the Service promulgated final Regulations under Sec. 704(c), I.R.C., relating
to the remedial allocation method (a reasonable method of allocation with respect to property contributed by a partner to a partnership) and a special aggregation rule with respect to securities partnerships.

2. **Overview** -- In the Proposed Regulations promulgated on December 24, 1992, the Service included the deferred sale method as a reasonable allocation method. After receiving many comments, the Service determined that the results of the deferred sales method could be achieved using a less complex method. The Service also received several comments on the impracticability of making reverse Sec. 704(c) allocations on an asset-by-asset basis for securities partnerships. Because aggregation did not significantly increase the potential for abusive transactions, the Service agreed that aggregation would be allowed in such circumstances.

3. **Remedial Allocation Method** -- Reg. §1.704-3(d) sets forth the remedial allocation method for making Sec. 704(c) allocations.

   a. Remedial allocations are tax allocations of income or gain that are offset by tax allocations of loss or deduction. These tax allocations have no effect on the partnership’s book capital accounts. Reg. §1.704-3(d)(4).

   b. The first step is for the partnership to determine the amount of book items. Under Reg. §1.704-3(d)(2), the partnership determines the amount of book items in the following manner, rather than under the rules of Reg. §1.704-1(b)(2)(iv)(g)(3):

      (1) The portion of the book basis which is equal to the tax basis is recovered in the same manner as it is recovered for tax purposes.

      (2) The portion of the book basis which is in excess of the tax basis is recovered using any applicable recovery period and depreciation method available to the partnership at the time the property is contributed.

   c. The second step is determining the distributive share of these items under Sec. 704(b), I.R.C. Then the partnership makes tax allocations using the traditional method. If the ceiling rule results in a book allocation to a noncontributing partner different from the tax allocation, the partnership makes a remedial allocation of income, gain, loss or deduction to the noncontributing partner equal to the full amount of the ceiling rule limitation and a simultaneous offsetting allocation to the contributing partner. Reg. §1.704-3(d)(1).
d. The remedial allocation must have the same effect on each partner's tax liability as the tax item limited by the ceiling rule. Reg. §1.704-3(d)(3).

e. If a partnership's allocation method is not reasonable, the Service will not require the partnership to use the remedial allocation method. Reg. §1.704-3(d)(5)(ii).

f. The remedial allocation method is the only reasonable Sec. 704(c) method which creates notional tax items. Reg. §1.704-3(d)(5)(i).

4. **Special Aggregation Rule for Securities Partnerships** -- For purposes of making reverse Sec. 704(c), I.R.C. allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purpose of Sec. 704(c), I.R.C. Once a partnership adopts an aggregate approach, that partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a securities partnership. Reg. §1.704-3(e)(i).

   a. A partnership using an aggregate approach must separately account for any built-in gain or loss from contributed property. Reg. §1.704-3(e)(i).

   b. A qualified financial asset is any personal property that is actively traded. Reg. §1.704-3(e)(ii)(A).

   c. A partnership is a securities partnership if the partnership is either a management company or an investment partnership, and the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts.

   d. The Regulation details two reasonable methods for aggregating reverse Sec. 704(c), I.R.C. gains and losses: the partial netting approach and the full netting approach. Regs. §§1.704-3(e)(iv),(v).

G. **Sec. 737, I.R.C. (Recognition of Precontribution Gain).**

1. **Effective Date** -- On January 9, 1995, the Service promulgated Proposed Regulations relating to the recognition of the partner's precontribution gain if that partner receives a distribution of property (other than money) on or after January 9, 1995. Prop. Reg. §1.737-5.

   2. **General Rule** -- A partner that receives a distribution of property (other than money) must recognize gain under Sec. 737, I.R.C. in an amount equal to the lesser of (i)
the excess distribution or (ii) the partner’s net precontribution gain. Prop. Reg. §1.737-1(a)(1).

  a. **Excess Distribution** -- The amount (if any) by which the fair market value of the distributed property exceeds the distributee partner’s adjusted tax basis in the partner’s partnership interest. Prop. Reg. §1.737-1(b)(1).

  b. **Net Pre- Contribution Gain** -- The net gain, if any, that the partner would have recognized under Sec. 704(c)(1)(B), I.R.C. if, at the time of the distribution, the partnership had distributed to another partner all the Sec. 704(c), I.R.C. property contributed to the partnership by the distributee partner. Prop. Reg. §1.737-1(c)(1).

  c. **Character of Gain** -- The character of the gain recognized under Sec. 737, I.R.C. is determined by, and is proportionate to, the character of the partner’s net precontribution gain. Prop. Reg. §1.737-1(d).

  3. **Transactions Which Are Exempted from Section** -- Sec. 737, I.R.C. does not apply to the following transactions:

    a. Sec. 708(b)(1)(B), I.R.C. terminations;

    b. A transfer by a partnership of all of its assets and liabilities to a second partnership followed by a distribution of the interests in the second partnership in complete liquidation of the first partnership; and

    c. An incorporation of a partnership. Prop. Regs. §§1.737-2(a), (b) and (c).

  4. **Anti-Abuse Rule** -- The Commissioner can recast a transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of Sec. 737, I.R.C. Prop. Reg. §1.737-4(a).

H. **Sec. 1402, I.R.C. (Self-Employment Tax Treatment of Members of Certain LLCs).**

  1. **Effective Date** -- On December 29, 1994, the Service issued Proposed Regulations dealing with the self-employment status of members of certain LLCs. These Regulations will be effective beginning with the member’s first taxable year beginning on or after the date these Regulations are published as final.

  2. **General Rule** -- Except as otherwise provided in Sec. 1402(a), I.R.C., an individual’s net earnings from self-employment include the individual’s distributive share of income
or loss from any trade or business carried on by a LLC of which the individual is a member. Prop. Reg. §1.1402(a)-18(a).

3. **Treatment as a Limited Partner** -- Solely for purposes of Sec. 1402(a)(13), I.R.C., a member of an LLC will be treated as a limited partner only if:

   a. The member is not a manager of the LLC; and

   b. The entity could have been formed as a limited partnership rather than an LLC in the same jurisdiction, and the member could have qualified as a limited partner under applicable law. Prop. Reg. §1.1402(a)-18(b).

I. **Sec. 6050H, I.R.C. (Information Reporting Requirements for Recipients of Points Paid on Residential Mortgages).**

1. **Effective Date** -- On April 12, 1988, the Service released final Regulations regarding the application of Sec. 6050H, I.R.C. to amounts received as interest. On December 29, 1993, the Service issued final Regulations regarding reimbursements of interest paid in connection with a qualified mortgage. On December 8, 1994, the Service issued final Regulations regarding information reporting requirements for recipients of points paid on residential mortgages. With the exception of the Regulation dealing with points, the Regulations are effective for mortgage interest received after December 31, 1987. The reporting requirements do not apply to prepaid interest received in the form of points before January 1, 1995. Reg. §1.6050H-1(g).

2. **Reporting Requirement** -- An interest recipient that either receives at least $600 of interest on a qualified mortgage for a calendar year or makes reimbursements of interest must, with respect to that interest:

   a. File an information return with the Internal Revenue Service; and


3. **Interest Recipient** -- An interest recipient is a person engaged in a trade or business and that, in the course of the trade or business, either receives interest on a mortgage or makes a reimbursement of interest on a qualified mortgage. Reg. §1.6050H-1(c)(1).

   a. A person that, in the course of its trade or business, receives or collects interest on a mortgage on behalf of another person is the interest recipient for the mortgage unless:
(1) The initial recipient does not possess the information needed to comply with the reporting requirement; and

(2) The person for which the interest is received or collected would receive the interest in the course of its trade or business if the interest were paid directly to that person. Reg. §1.6050H-1(c)(2).

b. In the case of collection on behalf of another person, the reporting requirement does not apply to the transfer of interest from the initial recipient to the person for whom the initial recipient receives or collects the interest. Reg. §1.6050H-1(c)(2).

c. Only the lender of record or a qualified person is treated as receiving points unless a designation agreement is executed pursuant to Reg. §1.6050H-2(d), in which case only the designated party under the agreement is treated as receiving points with respect to any mortgage to which the agreement applies. Reg. §1.6050H-1(c)(3).

(1) The written designation agreement must identify the mortgage(s) and calendar year(s) for which the designated qualified person must report, and must be signed by both the designator and designee. Reg. §1.6050H-2(d)(3).

(2) A qualified person is a person who is either:

(a) A trade or business with respect to which the interest recipient is under common control, within the meaning of Reg. §1.414(c)-2; or

(b) A person who is named as the designee by the lender of record or by a qualified person, and who either was involved in the original loan transaction or is a subsequent purchaser of the loan. Reg. §1.6050H-2(d)(2).

(3) Penalties -- A designated qualified person is subject to any applicable penalties as if it were an interest recipient. Reg. §1.6050H-2(d)(4).

4. Interest -- Interest includes mortgage prepayment penalties and late charges other than late charges for a specific mortgage service. Also includes prepaid interest in the form of points. Reg. §1.6050H-1(e)(1). Note that the inclusion of points in the determination of interest applies only to transactions occurring after December 31, 1994. Reg. §1.6050H-1(g)(2).
5. **When Reported** -- Interest is reported in the later of the calendar year in which the interest is received or the calendar year in which the interest properly accrues. Points must be reported in the calendar year in which they are received. Reg. §1.6050H-1(e)(2).

6. **Points** --

   a. An amount is deemed to be points paid in respect of indebtedness incurred in connection with the purchase of the payor of record's principal residence to the extent that the amount:

      (1) Is clearly designated on the Uniform Settlement Statement prescribed under the Real Estate Settlement Procedures Act of 1974 (e.g., the Form HUD-1);

      (2) Is computed as a percentage of the stated principal amount of the indebtedness incurred by the payor of record;

      (3) Conforms to an established practice of charging points in the area in which the loan is issued and does not exceed the amount generally charged in the area;

      (4) Is in connection with the acquisition by the payor of record of a residence that is the principal residence of the payor of record and that secures the loan; and

      (5) Is paid directly by the payor of record, which occurs if payment is --

      (a) Provided by the payor of record from funds that have not been borrowed from the lender of record for this purpose as part of the overall transaction; or

      (b) Paid as points. Reg. §1.6050H-1(f)(3).

   b. Similar requirements must be met to treat amounts paid in connection with indebtedness incurred to construct a residence, or to refinance indebtedness incurred to construct a residence, as points. Reg. §1.6050H-1(f)(4).

   c. Amounts received directly or indirectly by a mortgage broker are treated as points to the same extent the amounts would be so treated if they were paid to the lender of record. Reg. §1.6050H-1(f)(5).
J.  Sec. 7701, I.R.C. (Environmental Remediation Trusts).

1. Effective Date -- On August 3, 1995, the Service issued Proposed Regulations which provide guidance on the proper classification of trusts formed to collect and disburse amounts for environmental remediation of an existing waste site. These Regulations will be applicable to trusts formed on or after the date of their publication as final. Prop. Reg. §301.7701-4(e)(5).

2. Environmental Remediation Trusts -- An organization is an "environmental remediation trust" if:
   a. The organization is organized under state law as a trust;
   b. Its primary purpose is the collection and disbursement of amounts for environmental remediation of an existing waste site in order to resolve, satisfy, mitigate, address or prevent the liability or potential liability of persons imposed by environmental laws;
   c. All contributors to the trust have potential liability or a reasonable expectation of liability under environmental laws for environmental remediation of the waste site; and

3. Environmental Remediation -- It includes the costs of assessing environmental conditions, remediating environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances and collecting amounts from persons liable or potentially liable for the costs of these activities. Prop. Reg. §301.7701-4(e)(1).

4. Treatment -- Each contributor to the trust will be treated as the owner of that portion of the trust contributed by that grantor. Prop. Reg. §301.7701-4(e)(2).

5. Trustee Responsibilities -- The trustee must furnish to each grantor a statement that shows all tax items attributable to the portion of the trust treated as owned by that grantor. In addition, the statement must provide all information necessary to take into account items under the economic performance rules of Sec. 461(h), I.R.C. Prop. Reg. §301.7701-4(e)(2).
6. **Cash-out Grantor Rules**

   a. All amounts contributed to an environmental remediation trust by a grantor who, pursuant to an agreement with the other grantors, contributes a fixed amount to the trust and is relieved of any further obligation to make contributions to the trust, but remains liable or potentially liable under the applicable environmental laws, will be considered amounts contributed for remediation. Prop. Reg. §301.7701-4(e)(3).

   b. An environmental remediation trust agreement may direct the trustee to expend amounts contributed by a cash-out grantor (and the earnings thereon) before expending amounts contributed by other grantors (and the earnings thereon). Prop. Reg. §301.7701-4(e)(3).

   c. A cash-out grantor will cease to be treated as an owner of a portion of the trust when the grantor's portion is fully expended by the trust. Prop. Reg. §301.7701-4(e)(3).

K. **Sec. 7704(b), I.R.C. (Definition of Publicly Traded Partnership).**

1. **Effective Date** -- On May 2, 1995, the Service issued Proposed Regulation §1.7704-1 relating to the definition of publicly traded partnership. These Proposed Regulations will apply for taxable years beginning on or after the date the final Regulations are published. Prop. Reg. §1.7704-1(k). Until that time, Notice 88-75, 1988-2 C.B. 386 continues to apply.

2. **Definition** -- A publicly traded partnership is one whose partnership interests are traded on:

   a. **An established securities market** -- Such a market includes (i) a national securities exchange registered under the Securities Exchange Act of 1934; (ii) a national securities exchange exempt from registration because of the limited volume of transactions; (iii) a foreign securities exchange; (iv) a regional or local exchange; and (v) an interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise. Prop. Reg. §1.7704-1(b).

   b. **A secondary market** -- Such a market exists where (i) interests are regularly quoted by any person making a market in the interest or (ii) any person regularly makes available to the public bid or offer quotes with respect to interests in the partnership and stands ready to effect buy or sell transactions at the quoted prices for itself or on behalf of others (firm-quote trading). Prop. Reg. §1.7704-1(c)(2).
c. The substantial equivalent of a secondary market -- Such a market exists where (i) the holder of an interest has a readily available, regular and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell or exchange interests or (ii) prospective buyers and sellers have the opportunity to buy, sell or exchange interests with the regularity and continuity that the existence of a secondary market would provide. Prop. Reg. §1.7704-1(c)(3).

3. Transfers Taken into Account -- A transfer is taken into account only if: (i) the partnership redeems the interest; (ii) the transferee is admitted as a partner; or (iii) the partnership otherwise recognizes any rights of the transferee. Prop. Reg. §1.7704-1(a)(4).

4. Transfers Disregarded (Private Transfers) --
   a. Transfers in which the basis of the partnership interest in the hands of the transferee is determined by reference to the its basis in the hands of transferor or is determined under Sec. 732, I.R.C;
   b. Transfers at death;
   c. Transfers between family members (as defined in Sec. 267(c)(4), I.R.C.;
   d. Transfers involving the issuance of interests by (or on behalf of) the partnership in exchange for cash, property or services;
   e. Transfers involving distributions from a qualified retirement plan or IRA;
   f. The transfer by a partner within a 30-day period of interests representing in the aggregate more than 2% of the total interests in capital or profits (a "block transfer");
   g. Transfers pursuant to a redemption or repurchase agreement which is exercisable only in certain limited circumstances (such as the disability or mental incompetence, or retirement or termination of services, of the partner);
   h. Transfers pursuant to a closed-end redemption plan; and
   i. Transfers by one or more partners of interests representing more than 50% of the total interests in partnership capital and profits in one transaction or series of related transactions. Prop. Reg. §1.7704-1(d)(1).
5. **Disregard of Transfers Pursuant to Redemption and Repurchase Agreements** -- Transfers pursuant to redemption or repurchase agreements not described above will be disregarded for purposes of determining the existence of a secondary market or a substantial equivalent thereof if:

   a. During the taxable year, transfers do not exceed 10% of the total interests in partnership capital or profits;

   b. Written notification is given to the partnership (or a partner or agent thereof) by the transferor partner at least 60 days before the partner intends to exercise the right; and

   c. Either the redemption or repurchase price is not established until at least 60 days after receipt of this notification or this price is established not more than four times a year. Prop. Reg. §1.7704-1(e).

6. **Disregard of Transfers Pursuant to a Qualified Matching Service** -- Transfers pursuant to a qualified matching service will be disregarded for purposes of determining the existence of a secondary market or a substantial equivalent thereof. Prop. Reg. §1.7704-1(f).

7. **Private Placements** -- Partnership interests will not be treated as readily tradeable on the substantial equivalent of a secondary market if:

   a. All interests were issued in a transaction that was not required to be registered under the Securities Act of 1933;

   b. If the partnership has more than 50 partners at any time during its taxable year, the percentage transferred (other than in private transfers) cannot exceed 10%; and

   c. Either the partnership has 500 or less partners or the initial offering price of each unit of partnership interest is at least $20,000. Prop. Reg. §1.7704-1(g).

8. **Lack of Actual Trading** -- Partnership interests will not be treated as readily tradeable on the substantial equivalent of a secondary market if the percentage transferred during a taxable year (other than in private transfers, pursuant to redemption or repurchase agreements, or pursuant to a qualified matching service) does not exceed 2%. Prop. Reg. §1.7704-1(h).
III. REVENUE PROCEDURES AND I.R.S. ANNOUNCEMENTS


The Procedure cannot be used to make the following changes:

1. For purposes of determining Sec. 471, I.R.C. costs under one of the simplified accounting methods;

2. For electing the historic absorption ratio under the simplified production method or the simplified resale method;

3. If the taxpayer is required to change accounting methods to comply with Section 263A, I.R.C. for the first time;

4. If the taxpayer is changing its method because it qualifies as a "small reseller" or no longer qualifies as a "small reseller";

5. If a request to change method was filed for a prior taxable year and the taxpayer withdrew the request, failed to sign or failed to implement the change;

6. If the taxpayer has a Sec. 263A, I.R.C. issue pending on June 28, 1994 and it is being considered by the District Director in an examination, an Appeals officer or any Federal court; or

7. If the taxpayer is the subject of a pending criminal investigation relating to tax liability.

B. Rev. Proc. 95-10 (Classification of a Domestic or Foreign LLC). In Rev. Proc. 95-10, 1995-3 I.R.B. 20, the Service specified the conditions under which it will consider a ruling request that relates to classification of a domestic or foreign LLC as a partnership for Federal income tax purposes. Rev. Proc. 89-12, 1989-1 C.B. 798, will no longer apply to LLCs.

1. This Revenue Procedure applies to all organizations that are formed as LLCs under domestic law.

   a. It also applies to all organizations formed under foreign law where the foreign law provides for, or allows, limited liability to any of their members (whether or not the foreign organization is "incorporated" under a foreign statute).
b. This Revenue Procedure does not apply to a publicly traded LLC treated as a corporation under Sec. 7704, I.R.C.

2. In submitting a request, all of the information in Rev. Proc. 94-1, 1994-1 C.B. 378, is required, as well as the following supplementary information:

   a. The name and taxpayer identification number, if any, of the LLC;

   b. The business of the LLC;

   c. The date and place of filing of the LLC’s articles of organization, or the anticipated date and place of filing;

   d. The identification of the domestic or foreign jurisdiction the law of which controls the formation and operation of the LLC;

   e. A representation that the LLC has been, and will be at all times, in conformance with the controlling laws of the domestic or foreign jurisdiction;

   f. The nature, amount and timing of capital contributions made, and to be made, by the members of the LLC;

   g. The extent of participation of the members and the managers in profits and losses of the LLC, including any possible shift in the profit and loss sharing ratios over time;

   h. A description of the relationships, direct and indirect, between the members and the managers that would suggest that the managers, individually or in the aggregate, may not at all times act independently of the members. This may also include a debtor-creditor relationship and an employer-employee relationship. These relationships definitely include:

      (1) ownership by non-manager members of 5% or more of the stock or other beneficial interests in a manager;

      (2) control by non-manager members of 5% or more of the voting power in a manager;

      (3) ownership of 5% or more of the stock or other beneficial interests in any manager and in any non-manager members by the same person or persons acting as a group; and

      (4) control of 5% or more of the voting power in any manager and in any non-manager members by the same person or persons acting as a group.
i. If it is asserted that the LLC lacks the corporate characteristic of limited liability --

(1) a description of the legal arrangements supporting the assertion that the LLC lacks limited liability;

(2) a representation of the net worth of the member or members assuming personal liability for all obligations of the LLC;

(3) a description of the assuming member’s or members’ assets and liabilities arising from transactions with the LLC or with a person related to any member or members under Sec. 267(b) or 707(b)(1), I.R.C.; and

(4) a description of all other organizations in which the member or members have an interest.

j. If the Service has issued a revenue ruling on the applicable domestic or foreign law, a discussion of how the revenue ruling applies to the taxpayer’s ruling request.

3. Under Section 4.01, the Service will consider a ruling request only if the LLC has at least two members and, to the extent applicable, the conditions of the Revenue Procedure are satisfied.

4. Section 4.02 sets forth the general rule regarding profit and loss interests in a LLC. It states that if a taxpayer requests a ruling that the LLC lacks continuity of life or free transferability of interests, the member-managers must own, pursuant to the express terms of the operating agreement, at least a 1% interest, in the aggregate, in each material item of the LLC’s income, gain, loss, deduction or credit during the entire existence of the LLC.

a. Temporary allocations, other than allocations under Sec. 704(b) or 704(c), I.R.C., will be considered a violation unless the LLC clearly establishes in the ruling request that the member-managers or the assuming members have a material interest in net profits and losses over the LLC’s anticipated life.

b. A profits interest will not be considered material unless it substantially exceeds 1% and will be in effect for a substantial period of time during which the LLC reasonably expects to generate profits.

5. The exception to this general rule is stated in Section 4.03. It states that if the LLC has total contributions exceeding $50 million, the member-managers need not meet the 1% standard in Sec. 4.02. However, the member-managers (or assuming
members), in the aggregate, must maintain an interest at all
times during the existence of the LLC in each material item of at
least 1% divided by the ratio of total contributions to $50
million, and the LLC's operating agreement must expressly
incorporate at least the computed percentage.

6. Section 4.04 contains the general rule regarding
capital account balances. It states that if a taxpayer requests
a ruling that the LLC lacks continuity of life or free
transferability of interests, the member-managers, in the
aggregate, must maintain throughout the entire existence of the
LLC a minimum capital account balance equal to the lesser of 1%
of total positive capital account balances or $500,000. If no
member has a positive capital account balance, then the member-
managers (or assuming members) in the LLC need not have a
positive capital account balance.

7. The exception to this general rule is stated in
Section 4.05. It states that if at least one member-manager has
contributed or will contribute substantial services in the
capacity as a member, apart from services for which guaranteed
payments under Sec. 707(c), I.R.C. are made, the capital account
standard in Section 4.04 does not apply to any of the member-
managers. Services that do not relate to day-to-day operations
in the LLC's primary business activity will be closely
scrutinized by the Service to determine if they are in fact
substantial services.

8. In Section 5, the Service outlines the ruling
guidelines for specific corporate characteristics, as follows:

a. **Continuity of Life** -- Unless the LLC is
continued by the consent of not less than a majority in interest
of the remaining members, the Service will generally rule that
688, defines majority in interest. If the controlling statute or
the operating agreement does not provide that death, insanity,
bankruptcy, retirement, resignation **and** expulsion of any member
dissolves the LLC, the Service will not rule that the LLC lacks
continuity of life unless the taxpayer clearly establishes that
the event or events selected provide a meaningful possibility of
dissolution.

b. **Free Transferability of Interests** -- The
Service will generally rule that the LLC lacks free
transferability of interests if each member, or those members
owning more than 20% of all interests in the LLC's capital,
income, gains, losses, deductions and credits, do not have the
power to confer upon a non-member all the attributes of the
member's interests in the LLC without the consent of not less
than a majority of the non-transferring members. The Service
will not rule that the LLC lacks free transferability of
interests unless the power to withhold consent to the transfer constitutes a meaningful restriction on the transfer of the interests.

c. Centralization of Management -- If the controlling statute or the operating agreement provides that the LLC is managed by the members exclusively in their membership capacity, the Service generally will rule that the LLC lacks centralized management. However, if the LLC is managed by member-managers, the Service will not rule that the LLC lacks centralized management unless the member-managers in the aggregate own at least 20% of the total interests in the LLC. The Service will consider all the relevant facts and circumstances, including, particularly, member control of the member-managers (whether direct or indirect), in determining whether the LLC lacks centralized management. The Service will not rule that the LLC lacks centralized management if the member-managers are subject to periodic elections by the members, or, alternatively, the non-managing members have a substantially non-restricted power to remove the member-managers.

d. Limited Liability -- The Service generally will not rule that an LLC lacks limited liability unless at least one member validly assumes personal liability for all (but not less than all) obligations of the LLC. The Service generally will not rule that an LLC lacks limited liability unless the assuming members have an aggregate net worth that, at the time of the ruling request, equals at least 10% of the total contributions to the LLC and is expected to continue to equal at least 10% of total contributions to the LLC throughout the life of the LLC.

C. Rev. Proc. 95-27 (Demolition under Sec. 280B). Rev. Proc. 95-27, 1995-23 I.R.B. 11, was issued to provide a safe harbor for certain structural modifications which will not be treated as a demolition for purposes of Sec. 280B, I.R.C.

1. A modification of a building, other than a certified historic structure, will not be treated as a demolition for purposes of Sec 280B, I.R.C. if (1) 75% or more of the existing external walls of the building are retained in place as internal or external walls, and (2) 75% or more of the existing internal structural framework of the building is retained in place.

2. A modification of a certified historic structure will not be treated as a demolition for purposes of Sec. 280B, I.R.C. if (1) the modification is part of a certified rehabilitation, (2) 75% or more of the existing external walls of the building are retained in place as internal or external walls, and (3) 75% or more of the existing internal structure framework of the building is retained in place.
3. This Revenue Procedure is effective for modifications commencing after June 5, 1995, but, at the option of the taxpayer, the Revenue Procedure may be treated as effective for any open taxable years.

IV. REVENUE RULINGS AND NOTICES

A. Rev. Rul. 94-38, 1994-1 C.B. 35. This Revenue Ruling deals with the issue of whether the costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste in the operations of its business are deductible by the taxpayer as business expenses under Sec. 162, I.R.C. or must be capitalized under Sec. 263, I.R.C.

FACTS:

X built a plant on land that it had purchased in 1970. The land was not contaminated by hazardous waste when it was purchased. X’s manufacturing operations discharge hazardous waste. In the past, X buried this waste on portions of its land. In 1993, in order to comply with presently applicable and reasonably anticipated federal, state and local environmental requirements, X decided to remediate the soil and groundwater that had been contaminated by the hazardous waste, and to establish an appropriate system for the continued monitoring of the groundwater.

X began excavating the contaminated soil, transporting it to appropriate waste disposal facilities, and backfilling the excavated areas with uncontaminated soil. X also began constructing groundwater treatment facilities which included wells, pipes, pumps, and other equipment to extract, treat and monitor contaminated groundwater. The effect of the soil remediation and groundwater treatment will be to restore X’s land to essentially the same physical condition that existed prior to the contamination. X will continue to use the land and operate the plant in the same manner as it did prior to the cleanup except that X will dispose of any hazardous waste in compliance with environmental requirements.

ANALYSIS:

The Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.

The groundwater treatment facilities constructed by X have a useful life substantially beyond the taxable year in which they are constructed and, thus, the costs of their construction are
capital expenditures under Sec. 263(a), I.R.C. The costs of these facilities are recoverable under applicable law.

X's soil remediation expenditures and ongoing groundwater treatment expenditures do not produce permanent improvements to X's land within the scope of Reg. §1.263-(a)(1) or otherwise provide significant future benefits. See Plainfield-Union Water Co. v. Comm’r, 39 T.C. 333 (1962), nonacq. on other grounds, 1964-2 C.B. 8. X's soil remediation and ongoing groundwater treatment expenditures do not result in improvements that increase the value of X's property because X has merely restored its soil and groundwater to their approximate condition before they were contaminated by X's manufacturing operations. These expenditures do not prolong the useful life of the land, nor do they adapt the land to a new or different use. Moreover, since the land is not subject to an allowance for depreciation, amortization, or depletion, the amounts expended to restore the land to its original condition are not subject to capitalization.

The soil remediation and ongoing groundwater treatment expenditures incurred by X represent ordinary and necessary business expenses within the scope of Sec. 162, I.R.C. They are appropriate and helpful in carrying on X's business and are commonly and frequently required in X's type of business.

These results are applicable whether the taxpayer plans to continue its manufacturing operations that discharge the hazardous waste or to discontinue those manufacturing operations and hold the land in an idle state.

Furthermore, Rev. Rul. 88-58, 1988-2 C.B. 36, is modified to the extent it implies that the value test applied by the Court in Plainfield-Union cannot be an appropriate test in any case other than one in which there is sudden and unanticipated damage to an asset.

B. Rev. Rul. 94-79, 1994-2 C.B. 409. This Ruling provides guidance on whether a Connecticut limited liability company will be classified as an association or a partnership.

The fact pattern illustrated an LLC with 25 members, 3 of which had been elected managers under the articles of organization. Under the Connecticut LLC Act and the LLC's operating agreement, unless there were at least two remaining members and the business of the LLC was continued by the consent of the remaining members owning a majority of the profits interests and capital interests, the LLC was dissolved upon the death, incompetency, withdrawal, removal, bankruptcy or dissolution of a member or the occurrence of any other event that terminated the continued membership of a member. Under the Connecticut LLC Act, the members and managers of an LLC are not liable for debts, obligations or liabilities of the LLC, whether
arising in contract, tort or otherwise, or for the acts or
omissions of any other member, manager, agent or employee of the
LLC. In addition, if the LLC provided professional services, the
members would not be liable for the debts of, or claims against,
the LLC, but would only have personal liability in connection
with the performance of professional services on behalf of the
LLC by themselves or by any person under their direct supervision
and control. Under the Connecticut LLC Act and the LLC’s
operating agreement, a member could assign that member’s interest
to another person who is not a member, but the assignee could not
become a member unless a majority in interest of the remaining
members approved the assignment.

Using Reg. §301.7701-2, the Service determined that this LLC
was classified as a partnership because, although it possessed
centralized management and limited liability, it lacked
continuity of life and free transferability of interests.

The Ruling noted that, because of the flexibility of the
Connecticut Limited Liability Company Act, a Connecticut LLC
could be classified as a partnership or as an association
depending upon the provisions adopted in the LLC’s articles of
organization or operating agreement.

For similar Rulings, see: Rev. Rul. 93-38, 1993-1 C.B. 233
(Delaware); Rev. Rul. 93-49, 1993-2 C.B. 308 (Illinois); Rev.
Rul. 93-81, 1993-2 C.B. 314 (Rhode Island); Rev. Rul. 93-91,
1993-2 C.B. 316 (Utah); Rev. Rul. 93-92, 1993-2 C.B. 18
(Oklahoma); Rev. Rul. 93-93, 1993-2 C.B. 321 (Arizona); Rev. Rul.
94-5, 1994-2 I.R.B. 21 (Louisiana); Rev. Rul. 94-6, 1994-3 I.R.B.
11 (Alabama); Rev. Rul. 94-30, 1994-19 I.R.B. 6 (Kansas); and

C. Rev. Rul. 95-2, 1995-1 I.R.B. 7. This Revenue Ruling
provides a list of states whose adopted versions of the RULPA
have been determined by the Service to correspond to the ULPA, as
of Jan. 3, 1995, for the purposes of Reg. §301.7701-2
(classification of the entity as an association or as a
partnership for Federal income tax purposes). No opinion is
expressed if the statute has been amended after the effective
date cited in the Ruling. The list of states includes: Alabama,
Arizona, Arkansas, California, Colorado, Connecticut, Delaware,
Florida, Georgia, Idaho, Illinois, Iowa, Kansas, Maryland,
Massachusetts, Michigan, Minnesota, Mississippi, Missouri,
Montana, Nebraska, New Jersey, Ohio, Oklahoma, Pennsylvania,
Tennessee, Texas, Utah, Virginia, Washington, West Virginia,
Wisconsin and Wyoming.

D. Rev. Rul. 95-5, 1995-2 I.R.B. 5. This Ruling analyzes
how either a partner or an S corporation stockholder who receives
a distribution in excess of basis should characterize the gain
for purposes of the passive activity loss rules of Sec. 469, I.R.C.

The Ruling holds that such gain is treated as gain from the sale or exchange of the interest and is characterized pursuant to Temp. Reg. §1.469-2T(e)(3)(ii)(A), which provides that, if a holder of an interest in a pass-through entity disposes of its interest, a ratable portion of any gain or loss from the disposition is treated as gain or loss from the disposition of an interest in each trade or business, rental activity, or investment activity in which the pass-through entity owns an interest.

E. Rev. Rul. 95-37, 1995-17 I.R.B. 10. In this Ruling, the Service issued guidance on the tax treatment of a conversion from a domestic partnership to a domestic LLC which is classified for Federal income tax purposes as a partnership. The Service ruled that such a conversion is treated as a partnership-to-partnership conversion. See Rev. Rul. 84-52, 1984-1 C.B. 157. These consequences apply whether the resulting LLC is formed in the same state or in a different state.

The partnership-to-LLC conversion does not cause a termination under Sec. 708, I.R.C. Moreover, the conversion is not a sale, exchange, or liquidation of the converting partner’s entire partnership interest for purposes of Sec. 706(c)(2)(A), I.R.C.

The conversion does not cause the taxable year of the domestic partnership to close with respect to all the partners or with respect to any partner. The resulting LLC does not need a new TIN.

The holdings contained in this Revenue Ruling apply in a similar manner if the conversion is of an interest in a domestic LLC taxed as a partnership for Federal tax purposes into an interest in a domestic partnership. Moreover, it does not matter how the conversion is achieved under the state law.

F. Rev. Rul. 95-41, 1995-23 I.R.B. 5. In this Ruling, the Service gives guidance on the interplay between Sec. 704(c), I.R.C. and the allocation of nonrecourse liabilities under Reg. §1.752-3(a).

FACTS:

A and B form a partnership and agree that each will be allocated 50% of all partnership items. A contributes depreciable property subject to a nonrecourse liability of $6,000, with an adjusted tax basis of $4,000 and a fair market value of $10,000. B contributes $4,000 cash.
ANALYSIS:

Upon A's contribution of the depreciable property, there is $6,000 of Sec 704(c), I.R.C built-in gain. A's share of the partnership's nonrecourse liabilities is determined under Reg. §1.752-3.

(1) First Tier Allocations -- Under Reg. §1.752-3(a)(1), a partner's share of the nonrecourse liabilities of a partnership includes the partner's share of partnership minimum gain. Because partnership minimum gain is computed using the contributed property's book value rather than its tax basis, allocations of nonrecourse liabilities are not affected by Sec. 704(c), I.R.C. In addition, because the book value at the time of contribution exceeds the amount of the nonrecourse liability, there is no partnership minimum gain immediately after the contribution, and, thus, neither A nor B receives an allocation of nonrecourse liabilities under Reg. §1.752-3(a)(1) immediately after the contribution.

(2) Second Tier Allocations -- Under Reg. §1.752-3(a)(2), a partner's share of the nonrecourse liabilities of the partnership includes the amount of taxable gain that would be allocated to the contributing partner under Sec. 704(c), I.R.C. If the partnership sold the contributed property in full satisfaction of the liability and for no other consideration, the partnership would recognize a taxable gain of $2,000 on the sale. All of this taxable gain would be allocated to A. The hypothetical sale also would result in a book loss of $4,000. Because this book loss would be allocated equally between A and B, B would receive a $2,000 book loss but no corresponding tax loss, creating a disparity between B's book and tax allocations.

(a) Traditional Method -- If the partnership used the traditional method of making Reg. §1.704-3(b) allocations, A would be allocated a total of $2,000 of taxable gain from the hypothetical sale of the contributed property and so would be allocated $2,000 of nonrecourse liabilities immediately after the contribution.

(b) Remedial Method -- If the partnership adopted the remedial allocation method, the partnership would be required to make a remedial allocation of $2,000 of tax loss to B in connection with the hypothetical sale to eliminate the $2,000 disparity. The partnership also would be required to make an offsetting remedial allocation of tax gain to A of $2,000. Thus, A would be allocated a total of $4,000 of tax gain and would be allocated $4,000 of nonrecourse liabilities immediately after the contribution.

(c) Curative Allocations Method -- Because any potential curative allocations cannot be determined solely from
the hypothetical sale of the contributed property, curative allocations are not taken into account in allocating nonrecourse liabilities under Reg. §1.752-3(a)(2). Thus, under this method, A would be allocated $2,000 of nonrecourse liabilities immediately after the contribution.

(3) **Third Tier Allocations** -- After the allocation pursuant to Reg. §1.752-3(a)(2), the partnership has excess nonrecourse liabilities that must be allocated pursuant to Reg. §1.752-3(a)(3). This Regulation provides several alternatives:

(a) **Partners’ Shares of Partnership Profits** -- The partnership could choose to allocate the excess nonrecourse liabilities in accordance with the partners’ shares of partnership profits. Two facts which are taken into account in making this determination are (1) the partnership agreement and (2) a partner’s share of built-in gain to the extent that the gain was not taken into account in making an allocation of nonrecourse liabilities under Reg. §1.752-3(a)(2).

(b) **Pursuant to Partnership Agreement** -- The partnership agreement may specify the partners’ interests in partnership profits for purposes of allocating excess nonrecourse liabilities, provided that the interests specified are reasonably consistent with allocations that have substantial economic effect.

(c) **In Accordance with Deductions** -- The partnership may choose to allocate the excess nonrecourse liabilities in accordance with the manner in which it is reasonably expected that the deductions attributable to the excess nonrecourse liabilities will be allocated. Because all tax depreciation will be allocated to B, if the partnership chooses this method, then all of the excess nonrecourse liabilities must be allocated to B.

**G. Notice 95-14, 1995-14 I.R.B. 7.** The Service and the Treasury issued this notice regarding the possible simplification of the classification regulations under Sec. 7701, I.R.C. for domestic unincorporated business organizations and foreign business organizations.

The existing classification regulations are based on the historical differences under local law between partnerships and corporations. However, many states recently have revised their statutes to provide that partnerships and other unincorporated organizations may possess characteristics that have traditionally been associated with corporations, thereby considerably narrowing the traditional distinctions. A consequence of this narrowing is that taxpayers can achieve partnership tax classification for a non-publicly traded organization although it is virtually indistinguishable from a corporation. Currently, taxpayers and
the Service expend considerable resources in determining the proper classification of these organizations.

1. **Domestic Unincorporated Business Organizations** -- The Service is proposing that, with respect to a domestic unincorporated business organization which has two or more associates and an objective to carry on business and divide the gains therefrom, taxpayers should be allowed to elect whether they wish to be taxed as a partnership or an association unless the organization's classification is determined under a Code section other than Secs. 7701(a)(2) and (3), I.R.C.

Because the Service and Treasury believe that these entities typically are formed to obtain partnership classification, such organizations would be classified as partnerships for Federal tax purposes unless an election were filed to be classified as an association. Under this approach, all elections would be prospective, executed by all members and binding on all future members until superseded by a subsequent election. An election to change the classification of an organization would have the same Federal tax consequences as a change in classification under current law.

2. **Foreign Business Organizations** -- The Service and Treasury are also considering simplifying the classification rules for foreign organizations. However, they are concerned because (1) there is no foreign analogue for a state-law corporation, so no foreign organization is automatically treated as a corporation for Federal tax purposes, (2) there is the possibility of inconsistent, or hybrid, entity classification, and (3) a purely elective approach could have a substantive effect on entity classification by increasing taxpayers' flexibility to achieve their desired classification of certain foreign organizations.

V. **PRIVATE LETTER RULINGS**

A. Priv. Ltr. Rul. 9431025 (May 6, 1994). The married taxpayers held a fee interest in Lots 1 and 2. Lot 1 was purchased as a home, and Lot 2 was purchased for investment or other use. A developer proposed acquiring the north half acre of Lot 1 and all of Lot 2 in a simultaneous exchange under Sec. 1031, I.R.C. for 2 town houses to be built on land acquired from the taxpayer's neighbor. With respect to Lot 2, the taxpayers had offered Lot 2 to developers from 1979 until the present, with a sign on the property. They had received numerous inquiries before making the agreement with the developer. The house, however, was not offered for sale or exchange until the developer insisted he needed more land.

The Service determined that the exchange of Lot 2 for the two townhouses to be built would qualify as an exchange of
property of a like kind held for productive use in a trade or business or for investment within the meaning of Sec. 1031(a)(1), I.R.C. However, gain or loss had to be recognized on Lot 1, which the taxpayers had not represented to be investment property.

B. Priv. Ltr. Rul. 9433003 (April 29, 1994). In this ruling, the decedent owned 94 acres of unimproved land, consisting of approximately 50% open fields and 50% woodlands. In 1985, the decedent's son and granddaughter started operating a horse boarding and riding business. On April 22, 1988, the decedent executed a revocable trust, transferring the 94 acre parcel to the trust. On September 11, 1989, the trustees of the revocable trust entered into a contract with a land development corporation, to "immediately begin the planning and engineering necessary to convert the land from its present agricultural usage into residential building lots." On February 16, 1990, an application was made for a preliminary plan of subdivision. At the time of the decedent's death on July 8, 1991, the preliminary plan of subdivision and the sewer authorization had not been approved. Since the decedent's death, the land development contract had been terminated, and no lots had been sold. The property continued to be used in the horse boarding and riding business.

In this Technical Advice Memorandum, the Service determined that the decedent's estate could elect under Sec. 2032A, I.R.C. to value the 94 acres based on its use in the horse boarding and riding business, rather than its value based on its highest and best use -- subdivided land. The Service determined that the Sec. 2032A(b)(2), I.R.C. requirement that the property be used in a trade or business was satisfied with respect to the open fields, but came to no conclusions with respect to the woodlands. The Service found that, because no physical action was taken during decedent's life which prevented the land from being used in the ongoing horse boarding and riding trade or business, the fact that the trustees intended to develop the land did not interrupt or restrict the use of the land in the business.

C. Priv. Ltr. Rul. 9439007 (June 29, 1994). The taxpayer and related persons owned undivided interests in different tracts of land. The ownership was fragmented in a complex manner. The parties planned to transfer all their interests to a qualified intermediary who would then transfer whole interests in specific tracts to the parties.

The Service determined that the taxpayer would be simultaneously exchanging real property held for productive use in a trade or business or for investment solely for other real property to be held in the same manner, so that this was a like-kind exchange under Sec. 1031(a), I.R.C. The Service cautioned the taxpayer that it doubted whether this transaction, with or
without an intermediary, would constitute a valid exchange under Sec. 1031, I.R.C. if the values of the properties being relinquished and received by each of the parties were not approximately equal. The taxpayer was also cautioned of the possible application of Sec. 1031(f), I.R.C.

D. Priv. Ltr. Rul. 9440026 (July 11, 1994). In this ruling, the taxpayer, a corporation, desired a number of rulings (1) regarding the effect of certain stock restrictions on its qualification as a REIT, (2) whether certain income was considered to be rents from real property, and (3) whether certain dividends would be deductible from REIT taxable income.

The taxpayer’s articles of incorporation provide for three transfer restrictions. First, the articles prohibit any transfer of stock that would cause the transferee to own more than a certain percent of the value of common and preferred stock. Second, the articles prohibit any transfer of stock that would cause the taxpayer to be closely held. Third, the articles prohibit any transfer of stock that would result in less than 100 persons holding the stock of the taxpayer. Each stock certificate bears a legend noting the three restrictions.

An attempted transfer of shares in violation of the restrictions is void ab initio. Such an attempt causes the shares in violation to be exchanged for "Excess Stock", which is then held by the taxpayer. The taxpayer retains an option to purchase the Excess Stock within 90 days of the later of the attempted transfer or the discovery by the taxpayer of the attempted transfer. The Excess Stock will have no voting rights and will not be entitled to any dividends or periodic distributions. The taxpayer may sell the Excess Stock to a person whose ownership will not violate the restrictions. The taxpayer received an opinion of counsel that the restrictions were enforceable under state law. It also represented that it would use its best efforts to enforce the restrictions.

The taxpayer also intends to enter into employment agreements under which it would grant employees options to purchase its stock as additional compensation. Under these agreements, if an employee terminates employment for any reason before becoming vested, the stock is deemed to be reconveyed to the taxpayer.

Sec. 856(a)(6), I.R.C. disqualifies a corporation from REIT status if it is closely held. The Service determined that, so long as the limit was valid under state law and the taxpayer used its best efforts to enforce the limit, a transfer made in violation of the limit would not result in those shares being owned by the purported transferee for Federal income tax purposes. However, the Excess Stock would be treated as treasury stock.
stock of the taxpayer. Thus, these ownership restrictions might not prevent the taxpayer from being considered closely held.

Under Secs. 857(b)(2)(B), 561 and 562(a) I.R.C., preferential dividends do not qualify as a deduction in computing a REIT’s taxable income. Because the Excess Stock is not considered to be outstanding, dividends paid on the outstanding stock would not be considered to be preferential vis-a-vis the shares of Excess Stock.

Under Sec. 856(a)(2), I.R.C., the beneficial ownership of a REIT must be freely transferable. The Service determined that the issuance of a small percentage of the stock by the taxpayer to its employees under the restrictions in the employee stock agreements would not cause the taxpayer to fail to satisfy this requirement.

The taxpayer also wanted to know whether amounts received by partnerships of which the taxpayer was a general partner, for management activities and services at residential rental properties and leasing fees related to space for vending machines and pay telephones, would be rents from real property. The Service determined that the performance by the partnerships of these services or receipt of income from these leases would not cause the income from the properties to be characterized as something other than "rents from real property" under Sec. 856(d), I.R.C.

E. Priv. Ltr. Rul. 9443018 (July 22, 1994). An entity was organized as a LLC pursuant to the Florida Limited Liability Company Act. There were two members, each of whom owned 50%. The LLC was determined to be taxable as a partnership because it lacked the corporate characteristics of continuity of life and free transferability of interests based on its Articles of Organization, which were in conformance with the Florida Act. The ruling stated that it was subject to the requirements set forth in Rev. Proc. 89-12, 1989-1 C.B. 798, but the requirements set forth in Sec. 4 of Rev. Proc. 89-12 did not apply to this ruling.

F. Priv. Ltr. Rul. 9436005 (May 26, 1994). In this Technical Advice Memorandum, the donor owned 100% of the outstanding stock of a corporation. In December, 1989, he transferred approximately 30% to each of his three children. He also transferred 5% to his spouse. With respect to each gift, the stock was valued at approximately $50 per share, representing the net asset value of the corporation less a 25% discount characterized as a discount for "minority interest and marketability".

Relying on Estate of Winkler v. Comm’r, T.C. Memo 1989-232, where the Court found that the decedent’s minority block had
special "swing vote" characteristics that enhanced its value, offsetting any minority discount otherwise available, the Service determined that each 30% gift, viewed separately, possessed the same swing vote characteristics.

The donor argued that attributing a swing vote value to each transferred block produced an arbitrary result because, if the donor had transferred the separate blocks at different times, a discount would be allowed. The Service determined this would not be true because, while the first block might be entitled to a discount, the first transferee's block would gain swing vote value upon the second transfer and would constitute an indirect gift. Likewise, the third block would have swing vote value because of the two earlier transfers. Thus, even if the three transfers were made at different times, the total value of the gifts would ultimately be the same as if the three transfers were made simultaneously.

The Service noted that all relevant factors, including swing vote potential, the minority nature of each block and any marketability concerns, should be taken into account in valuing each block.

G. Priv. Ltr. Ruls. 9437007, 9437008 (June 10, 1994). Old Partnership owned two residential projects. The partners wanted to place the projects in separate partnerships to insulate them from the liabilities of Old Partnership's commercial properties and to facilitate any future refinancing. To accomplish this, Old Partnership planned to transfer its interests in the projects to two New Partnerships and simultaneously distribute the interests in the New Partnerships to the Partners in proportion to their percentage interests in Old Partnership. One of the projects is not encumbered by an indebtedness, but the other one is. The commercial properties are encumbered. The current fair market value of each project exceeds the outstanding balance of the liabilities encumbering each of such properties. The Partners have negative tax capital accounts.

The Service determined that the transfer by Old Partnership to the New Partnerships will be treated as a contribution of property by Old Partnership to New Partnerships, with a simultaneous distribution of the interests in the New Partnerships to the Partners of Old Partnership. Under Sec. 708, I.R.C., the New Partnerships will be considered to be continuations of Old Partnership. There will be no deemed contribution or distribution of money under Sec. 752, I.R.C., and the transaction will not be considered to be a sale or exchange of Sec. 751, I.R.C. property.

H. Priv. Ltr. Rul. 9444004 (November 9, 1993). In this ruling, the taxpayer, a corporation, intended to form a
partnership with a new investor. The corporation was to contribute one of its lines of business to the partnership in return for an interest. The new investor would contribute cash. The corporation and the partnership were going to enter into a contract that would allow the corporation to continue to use certain assets that would be transferred to the partnership. The partnership planned to assume some of the business's debts; however, some debts could not be transferred because of the terms of the loan agreements between the corporation and the lenders. In addition, the corporation had made capital expenditures for property in connection with the transferred business within 30 days of receiving proceeds from loans incurred to finance the transferred business. The partnership agreement provided that, to the extent certain investor cash contributions to the partnership exceeded the liabilities transferred by the corporation, the cash would be immediately distributed to the corporation with respect to its preformation expenses.

The Service held that, for purposes of Sec. 707(a)(2)(B), I.R.C. and the disguised sale rules, qualified liabilities included only liabilities which were assumed, or taken subject to, by the partnership. Qualified liabilities did not include the liabilities which could not be transferred due to lender restrictions.

I. Priv. Ltr. Rul. 9444013 (July 30, 1994). In this ruling, the taxpayers were two general partnerships, each of which had the same six partners owning the same percentage of profits and losses in both partnerships. Two of the partners, representing 30% of the total partnership interests, were estates of deceased former partners. In the case of each deceased former partner, the partnership had stepped up the basis of the assets under Sec. 743, I.R.C., pursuant to an election under Sec. 754, I.R.C.

Each partnership owned a portion of a retail shopping center, which portions together comprised the entire shopping center. The dollar value of the assets in one partnership was greater than the dollar value of the assets in the other partnership. The assets of each partnership included certain property that was placed in service prior to January 1, 1981.

In order to achieve economies in the operation of the shopping center, the partnerships proposed to consolidate by contributing all of their respective assets, subject to all of their respective liabilities, to a newly formed general partnership. The partnerships would then liquidate by distributing their respective interests in the new partnership to the respective partners in accordance with the partners' respective capital account balances. The taxpayers needed guidance with respect to the impact of Sec. 708, I.R.C. on the effects of this transaction.
Because the members of both partnerships owned an interest of more than 50 percent in the capital and profits of the new partnership, the new partnership was considered a continuation of the partnership with the greater dollar value in assets pursuant to Reg. §1.708-1(b)(2)(i). The other partnership was considered to have contributed all of its assets and transferred all of its liabilities to the new partnership in exchange for a partnership interest, and then would be considered to terminate, with its partners considered to have received in liquidation the partnership interests in the new partnership.

As a result of the termination of one of the partnerships, the depreciation deduction under Sec. 167, I.R.C. applicable to its property transferred was determined in accordance with the rules of Sec. 381(c)(6), I.R.C. pursuant to Sec. 168(f)(5), I.R.C. The depreciation methods and periods of the pre-ACRS property that was transferred by the partnership which was considered to continue would be unaffected by the consolidation.

The Service also determined that there was no real effect on the treatment of the terminating partnership's Sec. 743(b), I.R.C. adjustment, citing Rev. Rul. 87-115, 1987-2 C.B. 163. Such adjustment would continue to be segregated and allocated to the partners to which it applied.

J. Priv. Ltr. Rul. 9444030 (August 4, 1994). In this ruling, the taxpayer was a trust established by a woman's 13 grandchildren. The trust held real property that the grandchildren had inherited from their grandmother. The grandchildren contributed their undivided fractional interests in the property to a trust so that no one of them could force a partition, and so that the property could be efficiently managed by the trustees of the trust. The property had been owned by the woman and her family for nearly 100 years. There were five houses on the property, which were used for vacation purposes by the family and friends of the grandchildren. The trust declaration specifically stated that the purposes of the trust were principally to provide for the proper and convenient management of the real property and to maintain and preserve it for the enjoyment and advantage of the blood descendants of the woman. The trustees were prohibited from conducting a trade or business. The Service determined the arrangement would be treated as a trust and not an association because it was shown, pursuant to Sec. 7701, I.R.C., that the purpose of the arrangement was to vest in the trustees responsibility for the protection and conservation of property for beneficiaries who could not share in the discharge of this responsibility and, therefore, were not associates in a joint enterprise for the conduct of business for profit.

K. Priv. Ltr. Rul. 9447028 (August 25, 1994). In this ruling, the taxpayer planned to donate land to the State to
construct a highway interchange. The taxpayer also planned to develop a planned residential community near the highway. The taxpayer represented that access to this development would be provided by existing roads and internal roads and would be sufficient to meet anticipated traffic demands without use of the highway. The taxpayer also represented that construction of the highway was not required in order for development of the community to occur. In addition, the taxpayer had agreed to donate tangible personal property, fund a portion of the cost to construct collector/distributor roads and fund part of the state’s economic feasibility shortfall. The Service found that all these amounts would qualify as charitable contributions under Sec. 170, I.R.C. because any benefit which the taxpayer would receive was incidental in comparison to the benefits to the public.

L. Priv. Ltr. Rul. 9448010 (August 29, 1994). In this ruling, the taxpayer wanted to dispose of equipment previously used in its leasing trade or business, and acquire property of a like-kind using an intermediary in a deferred like-kind exchange. The proposed form of the transaction was as follows:

The taxpayer would enter into a sales agreement to sell its property to an unrelated third party. The taxpayer would also enter into an exchange contract with an intermediary which would provide that, pursuant to an assignment agreement, the intermediary would be assigned all of the taxpayer's rights, but not its obligations, under the sales agreement. Upon receipt of the purchase price, the intermediary would deposit the cash received into an escrow account which would be placed, at the sole discretion of the taxpayer, into an interest-bearing account or non-interest bearing account. The escrow holder was expected to be a financial institution that had performed, and was expected to continue to perform, a wide range of financial services for the taxpayer and its affiliates. When cash was placed in a non-interest bearing account, the taxpayer was expecting to receive other forms of consideration approximating the value of the foregone interest, including a waiver of certain bank fees or other charges. However, the taxpayer would not be entitled to receive, pledge, borrow or otherwise obtain the benefits of the interest or other forms of consideration before the end of the exchange period.

Upon satisfaction of all the terms and conditions of the sale agreement, legal title to the taxpayer’s property would be transferred directly to the purchaser. The taxpayer then would contract to purchase replacement property from an unrelated third party who would be committed to lease the equipment once the taxpayer acquired it. To the extent that the cost of the replacement equipment exceeds the sale proceeds held by the escrow holder, the taxpayer intends either to pay such excess directly to the owner of the replacement property or deposit such
excess with the escrow holder so that payment to the seller will be made from a single source.

Based upon the information and representations presented by the taxpayer, the Service found that this would constitute a good deferred like-kind exchange under Sec. 1031, I.R.C.

M. Priv. Ltr. Rul. 9449001 (March 11, 1994). In this Technical Advice Memorandum, a donor transferred all of the stock in a wholly owned corporation by making equal gifts of stock to each of his 11 children. After the transfer, the corporate stock was owned by 11 individual shareholders, each of whom owned less than 10 percent of the outstanding stock. The National Office was requested to determine whether the value of simultaneous gifts of stock in a corporation to two or more donees is to be determined in the same manner as the bequest of stock in a corporation to two or more legatees. The Service concluded that, unlike the estate tax, where the tax is imposed on an aggregation of all the decedent's assets, the gift tax is imposed on the property passing from the donor to each donee, and it is the value of that property passing from the donor to the donee that is the basis for measuring the tax. Thus, the value of the gift to each donee is determined by considering each gift separately and not by aggregating all of the donor's holdings in the corporation immediately prior to the gift. The Service also stated that the application of any discounts for lack of control or marketability would be determined in connection with each separate gift to each donee.

N. Priv. Ltr. Rul. 9449008 (September 1, 1994). The taxpayer was a common parent of a consolidated group. One of its subsidiaries was in the business of real estate development and provided real estate consulting services. Another was in the business of development, operation and sale of resort properties, and a third was in the business of operating theme and water parks, golf course, hotel, restaurant and merchandise shops and other entertainment facilities.

The first subsidiary owned certain unimproved real property. It proposed to divide the property into two interests, an estate for years interest and a remainder interest, selling the remainder to the third subsidiary immediately and the estate for years to the second subsidiary at some later date. Both sales would be at fair market value.

The taxpayer requested guidance on how the first subsidiary should allocate basis and how its gain would be calculated and reported. The Service determined that the subsidiary would allocate its basis in the total property between the estate for years and the remainder based on the relative fair market values of the interests. The fair market value of the remainder was computed by determining its present value consistent with Sec.
7520, I.R.C. and its actuarial factors. The fair market value of the estate for years was the difference between the fair market value of the entire property and the remainder. The subsidiary's gains on sale of the two interests were determined using Sec. 1001, I.R.C.; however, because it was a member of a consolidated group, the transactions would be deferred intercompany transactions under Reg. §1.1502-13 and would not be restored until an event described in Reg. §1.1502-13(d), (e) or (f) occurred.

O. Priv. Ltr. Rul. 9450025 (September 16, 1994). The taxpayer owned real property. A state authority wrote to the taxpayer expressing its interest in acquiring the property. In its letter, the authority stated that, while it had condemnation authority and could condemn the property, it currently lacked the funds to effect a condemnation. Accordingly, it proposed that the taxpayer consider a voluntary sale. The authority also noted that, if the negotiations were unsuccessful, it would request approval of a bond measure to provide it with sufficient funds to acquire the property. The authority proposed purchasing the property immediately for a discounted cash payment. Alternatively, the authority proposed paying the entire fair market value of the property using a structured payment plan. The Service held that the taxpayer could elect to apply Sec. 1033, I.R.C. because the authority had demonstrated unequivocally its intention to acquire the real estate using its power of eminent domain if its efforts to reach a negotiated sale proved unsuccessful.

P. Priv. Ltr. Rul. 9451050 (September 22, 1994). In 1981, a limited partnership was formed; its agreement was never amended. The three general partners were a woman and her two adult daughters. Each general partner had one vote. The original partnership agreement provided for three classes of limited partnership interests -- classes A, B and C. The woman was the only class A limited partner. The class B limited partners were the adult daughters, each in her individual capacity and as trustee of a trust for her own benefit or for the benefit of her spouse and descendants. The class C limited partner interests were owned by the woman's grandchildren, either outright or as beneficiaries.

The partnership owned three parcels of realty, with the fair market value of each parcel representing, respectively, 7.22%, 7.22% and 37.7% of the current fair market value of the net total partnership assets. In this ruling, the partners planned to restructure the partnership by transferring each parcel of real estate to a new limited partnership, each of which would have 3 corporate general partners. The existing partnership would continue to hold its remaining assets. The partnership agreements of the new limited partnerships were to be
substantially identical to each other and to that of the original partnership.

The original partnership agreement restricted transfers of partnership interests, provided options to purchase such interests, provided for the succession of general partners and provided for the dissolution or continuance of the partnership upon the withdrawal, death or legal insolvency of any partner. Under the proposed transaction, before any of the steps needed to effectuate the transaction were taken, all of the partners of the original partnership, all of the partners of the new partnerships and all of the shareholders of the new corporations intended to execute an agreement which would apply the buy-sell restrictions of the original partnership agreement to the shares of each shareholder in each new corporation, as well as to the partnership interests of each partner in the original partnership and the new limited partnerships. The taxpayers requested a ruling that the proposed transaction would not be subject to Sec. 2701, 2703 or 2704, I.R.C.

The Service determined that Sec. 2701, I.R.C would not apply to the transaction because, after the proposed transaction, each limited and general partner in the original partnership would have substantially the same interest, rights and limitations in the assets of the new entities and the remaining original partnership as they had before the proposed transaction. Under these circumstances, the retained interests held by each person in the original partnership were not "applicable retained interests" under Reg. §25.2701-1(c)(3) because the rights attendant to the retained interests were identical to the rights in the transferred interest, except for non-lapsing differences with respect to limitations on liability.

Sec. 2703, I.R.C. applies to an agreement, option, right or restriction entered into or granted after October 8, 1990. The Section also applies to any agreement, option, right or restriction that was entered into, or granted, on or prior to October 8, 1990, and substantially modified after October 8, 1990. Sec. 2704, I.R.C. applies to restrictions or rights (or limitations on rights) created after October 8, 1990. The Service determined that neither Section applied to the proposed transaction. Because the proposed transaction effectuated a continuation of the terms of the original partnership agreement and any options, rights to acquire property and other restrictions and rights in that agreement, it was determined that the proposed transaction would not result in a substantial modification of the agreement so as to fall under the purview of Sec. 2703, I.R.C. Similarly, Sec. 2704, I.R.C. did not apply because the transaction did not involve the creation of any new restrictions or rights (or limitations on rights) after October 8, 1990.
Q. Priv. Ltr. Rul. 9501001 (November 19, 1993). In this Technical Advice Memorandum, two individuals each owned a 50% interest in a S corporation that had no accumulated earnings and profits. During 1988, this S corporation conducted several activities (as defined in Temp. Reg. §1.469-4T). In 1988, the S corporation distributed money to both stockholders. These distributions constituted distributions of property to which, but for Sec. 1368(a), I.R.C. (which states that distributions from S corporations with no accumulated earnings and profits will be treated as gain from the sale or exchange of property to the extent such distributions are in excess of the stock’s basis), Sec. 301(c), I.R.C. would apply. Because of losses sustained by the S corporation, both stockholders had a zero basis in their stock at all times during 1988.

Because Sec. 1368(b)(2), I.R.C. treats the S corporation’s distributions in excess of the stockholder’s bases as gain from the sale or exchange of properties, the Service determined that Temp. Reg. §1.469-2T(e)(3) determines how the gain treated for purposes of Sec. 469, I.R.C. is allocated. Pursuant to Temp. Reg. §1.469-2T(e)(3)(iv)(A) (because the distribution occurred in the 1988 calendar taxable year, a year which began prior to February 19, 1988), gain recognized from the distributions is allocated among the S corporation’s activities under any reasonable method selected by the S corporation. The Service noted that one reasonable method the S corporation could select would be the method prescribed by Temp. Reg. §1.469-2T(e)(3)(ii). Once the gain is allocated, the activity’s character determines whether the gain is passive or active.

R. Priv. Ltr. Rul. 9502037 (October 19, 1995). The taxpayer was a corporation which intended to elect to be a REIT. It held no real estate assets directly, but it had a partnership interest in Ops which held real property directly and indirectly through partnerships. With respect to all of the real estate properties, Ops planned to perform management and leasing services. Ops planned to perform the same management and leasing services for two partnerships in which neither Ops nor the REIT owned any partnership interest. With respect to shopping centers, Ops planned to provide: (i) ordinary, necessary and customary common area services; (ii) all necessary services relating to HVAC, electrical and plumbing systems; (iii) usual and customary utility services; and (iv) parking areas on an unreserved, no-charge basis. With respect to office buildings, Ops planned to provide ordinary and necessary maintenance services, as well as access to a parking garage which would be managed by an independent contractor. One office building was connected to a hotel that was going to be leased to a limited partnership and operated by an independent contractor. Ops also planned on owning all of the non-voting preferred stock of a company which was engaged in the construction business and would provide real estate development, engineering, architectural and
construction services to Ops in connection with its existing properties and properties that it might acquire in the future.

The Service determined that the performance by Ops of the planned services would not cause the income from the properties to be characterized as something other than "rents from real property". Such services would not be disqualified services, pursuant to Reg. §1.512(b)-1(c)(5) (nonqualifying services are those rendered to the occupant primarily for the occupant's convenience and are other than usually or customarily rendered in connection with the rental of space for occupancy only), Rev. Rul. 69-176, 1969-1 C.B. 158 (utilities and janitorial services are qualified services for purposes of Sec. 512(b)(3), I.R.C.), and Rev. Rul. 80-297, 1980-2 C.B. 158 (the proceeds from the leasing of tennis facilities to a 3rd party for a fixed fee without services is rent).

The Service also determined that, since Ops would be allocating fees to its partners based on each partner's capital interest, a significant amount allocated to the REIT would be in effect for services provided to its own properties. To this extent, pursuant to Reg. §1.856-3(g), the amounts would be disregarded for purposes of applying the gross income tests under Sec. 856(c)(2), I.R.C. (95% test) and Sec. 856(c)(3), I.R.C. (75% test). However, to the extent that the taxpayer was deemed to receive amounts for services that were provided to third parties, these amounts would be treated as "other than rents from real property."

S. Priv. Ltr. Rul. 9503025 (October 27, 1994). In 1949, the grantor of a trust and his spouse purchased a vacation home that was situated on a lot on the east side of an avenue. In 1964, two lots on the opposite side of the avenue were purchased. These two lots were contiguous to a bay and together were the same size as the single lot on which the house was situated. The two lots provided a view and access to the bay. The grantor and his spouse requested a ruling that the two lots were not in excess of that which was reasonably appropriate for residential purposes within the meaning of Reg. §25.2702-5(c).

Under Reg. §25.2702-5(c)(2)(ii), a personal residence may include adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location). The Service concluded that distinct parcels can, in appropriate circumstances, constitute adjacent land. The Service concluded this was such a case because the two lots had been used as a part of the vacation residence for 30 years and the grantor and his spouse intended to continue using the lots in the same manner.

T. Priv. Ltr. Rul. 9504019 (October 28, 1994). The taxpayer was an S corporation which owned part of another
corporation. The taxpayer intended to merge with the other corporation. After the merger, the taxpayer would conduct the combined rental operations of both corporations. In this rental operation, the officers were involved in each major decision affecting operations. The taxpayer advertised its properties. It had employees who handled all lease negotiation and administrative work. On short-term leases, it was responsible for maintenance. It incurred significant expenses for salaries, payroll taxes, employee benefits, maintenance, insurance and legal expenses.

Under all the facts and circumstances, the Service determined that the rental income received was not passive investment income for purposes of Sec. 1362(d)(3)(D)(i), I.R.C.

U. Priv. Ltr. Rul. 9505002 (September 20, 1994). In this Technical Advice Memorandum, the taxpayers owned an interest in a condominium in a beach resort area. The ownership gave the taxpayers the right to use the property for a certain number of weeks a year. The property was an ocean-front resort-type condominium that offered various amenities, such as an off-site pool, tennis and golf memberships. The taxpayers paid for the use of the amenities through association dues. The taxpayers rented the condominium to third parties for an average period of less than 7 days. Significant services were not provided by the taxpayers or on their behalf. The taxpayers did not materially participate in the condominium activity during the tax years in question, but it was represented that they did actively participate in the activity during those years.

The Service determined that, pursuant to Temp. Reg. §1.469-1T(e)(3)(ii)(A), the taxpayers' activity of providing a condominium for use by customers was a trade or business activity that was not a rental activity for purposes of Sec. 469, I.R.C. Therefore, the taxpayers were not eligible for the $25,000 offset for rental real estate activities under Sec. 469(i), I.R.C. with respect to that activity.

V. Priv. Ltr. Rul. 9505011 (November 4, 1994). In 1990, the taxpayer, a corporation, entered into a stock redemption agreement with certain of its shareholders. Pursuant to the agreement, one of the shareholders sold certain of its shares for cash and a 15-year promissory note. The shareholder did not elect out of the installment sale method under Sec. 453(d), I.R.C. and, therefore, was reporting gain under the installment method of accounting. The corporation believed it would soon be experiencing cash flow problems. The corporation had a subordination agreement with its bank which provided that it could not make principal payments on the promissory note unless it delivered a "no default certificate" to the bank. The bank, believing that it would be likely that the corporation would not be able to make the scheduled principal payments on the
promissory note, suggested that the corporation consider restructuring the promissory note.

Absent a restructuring, the principal would have been paid in equal installments from 1996-2005. The corporation proposed making principal payments from 1996-2015, with smaller amounts being paid in the earlier years. The terms of the note in all other respects would remain unchanged.

Citing Rev. Rul. 68-419, 1968-2 C.B. 196, and Rhombar Co. v. Comm'rx, 47 TC 75 (1966), affd., 1967-2 C.B. 3, as support, the Service determined that this modification would not constitute a disposition or satisfaction of the note within the meaning of Sec. 453B, I.R.C., so that the stockholder should continue to report the gain as the remaining note payments are received.

W. Priv. Ltr. Rul. 9506046 (November 17, 1994). The taxpayer was an organization exempt from Federal income tax under Sec. 501(c)(6), I.R.C. It supported a junior golf program, conducted tournaments and provided services such as handicapping to member clubs. It owned land which it intended to develop into a public golf course. No debt was associated with the land, but the organization intended to borrow funds in the future to provide capital to complete the construction of the golf course improvements and to purchase related equipment.

The taxpayer stated that, in order to eliminate the economic, personal and property liability risks associated with construction of the golf course, and because the construction and operation of the golf course were not in keeping with its exempt purpose, it had formed a wholly owned for-profit subsidiary. This subsidiary was to be the development company and was going to be the initial lessee of the property. In addition, the subsidiary was to provide ongoing maintenance and improvement services both before and after the golf course opened. Because the subsidiary did not have the unique expertise necessary for management of a golf course, the subsidiary contemplated forming a wholly owned for-profit subsidiary (second-tier) which would possess the special expertise necessary to manage and operate the golf course. This second-tier subsidiary would purchase and own all furniture and fixtures. In addition, it would assume the lease of the golf course from the subsidiary and pay the taxpayer rent.

The taxpayer represented that both subsidiaries had economic and operational lives separate from itself and that both subsidiaries had a business purpose of earning a profit. All parties were to deal on an arms-length basis with each other.

Under Sec. 512(b)(13), I.R.C., rents derived from a controlled organization are unrelated business taxable income. This is an exception to the general rule excluding rents from

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real property under Sec. 512(b)(3), I.R.C. Control means ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes.

The Service determined that the rent received from the second-tier subsidiary would not constitute unrelated business taxable income because the taxpayer would not own or "control" the second-tier subsidiary. The second-tier subsidiary was not a sham organization nor was it the taxpayer's instrumentality. It had definite business purposes and activities. In addition, the taxpayer also was not so involved in, or in control of, the day-to-day operations of the second-tier subsidiary that the relationship between it and the taxpayer assumed the relationship of principal and agent.

X. Priv. Ltr. Rul. 9507023 (November 18, 1994). The subject of this ruling is the proper allocation of partnership nonrecourse liabilities among cross-collateralized properties under Sec. 752, I.R.C. The taxpayer proposed forming a partnership which would hold existing real estate. Some of this real estate was financed with the proceeds of tax-exempt bond indebtedness. This bond debt is secured by a first deed of trust on a particular property and is nonrecourse in nature. This debt is also secured by a "direct-pay" letter of credit issued by a bank, whereby the bond trustee collects principal and interest payments from the bank, which is reimbursed for these amounts by the owner of the real estate. Any reimbursement obligations to the bank are secured by a nonrecourse second deed of trust obligation on the same property that secures the bond debt.

After the formation of this new partnership, it plans to restructure the tax-exempt indebtedness. Rather than restructuring the bond debt, the partnership will restructure the bank’s secured obligations. Each new obligation will be secured by specific properties, some of which are currently collateral and others of which are not. Thus, some bond debt may be secured by property other than the property that secures the corresponding reimbursement obligation. Each new obligation held by the bank will specify a fixed dollar amount that the bank can recover upon a foreclosure of any particular collateral property.

The Service determined that, for purposes of Sec. 752, I.R.C., the bond debt may be allocated among the properties serving as security based on the relative specified dollar amounts that the bank can recover from each property upon a foreclosure, subject to the reimbursement obligation.

Y. Priv. Ltr. Rul. 9508019 (November 23, 1994). The taxpayer was a REIT which owned, either directly or through partnerships, shopping malls. As was usual and customary in the geographic areas in which the shopping centers were located,
merchants' associations were used for promoting and marketing the shopping center as a whole to the public. Expenses of market programs were paid out of fees collected by the merchants' association or amounts contributed to marketing funds. The merchants' associations were separate legal entities, generally corporations, that were owned and operated by the tenants occupying a shopping center. The taxpayer proposed undertaking some or all of the administrative activities of the merchants' associations which were currently being performed by an independent manager. Such proposed activities included: (i) the implementation of marketing and promotional activities, including entering into contracts on behalf of the merchants' associations; (ii) the collection of fees from members of the merchants' association; (iii) the hire of vendors of advertising media; and (iv) the payment of all expenses of the merchants' associations.

The Service determined that the performance by the REIT of these management activities and services through the merchants' association would not cause the income from the shopping centers to be characterized as something other than "rents from real property". Such services would not be disqualified services because such services would be excluded from UBTI under Sec. 512(b)(3), I.R.C. if received by a Sec. 511(a)(2), I.R.C. organization. See Reg. §1.512(b)-1(c)(5) (nonqualifying services are those rendered to the occupant primarily for the occupant's convenience and are other than usually or customarily rendered in connection with the rental of space for occupancy only); Rev. Rul. 69-176, 1969-1 C.B. 158 (utilities and janitorial services are qualified services for purposes of Sec. 512(b)(3), I.R.C.); and Rev. Rul. 80-297, 1980-2 C.B. 158 (leasing of tennis facilities to a 3rd party for a fixed fee without services is rent).

The Service also determined that any income received by the REIT from partnerships in which it held an interest for services that benefit third parties would be treated as "other than rents from real property".

Z. Priv. Ltr. Rul. 9508031 (November 29, 1994). The taxpayer, a private foundation, was an irrevocable charitable trust exempt under Sec. 501(c)(3), I.R.C. In 1994, a court had modified the trust such that the only charitable beneficiaries were schools. In addition to some cash, the taxpayer's principal asset consisted of an undivided one-quarter interest in a historical movie theater and adjacent retail space. About a year earlier, the retail space was destroyed by a fire which also caused minor damage to the theater. The taxpayer and other owners planned to rebuild. Under the plan, a government agency planned to provide money for refurbishing the theater, including two additional theaters in the basement. This money would be structured as a loan secured by the property, but would be forgiven if the theater was used continuously as a theater for
twenty years. In addition, the agency planned to loan the owners money to rebuild and expand the retail space. Other rehabilitation funds were expected to come from a commercial loan secured by a first deed of trust on the property.

The owners of the property had not formed, nor had they ever intended to form, a partnership. Instead, they owned undivided interests in the property as tenants-in-common.

The taxpayer determined to terminate its private foundation status so that the debt incurred to rehabilitate the theater would not be considered acquisition indebtedness causing rental income to be UBTI. The Service approved the same.

The Service also determined that the debt taken on for rehabilitation of the theater did not constitute acquisition indebtedness because pursuant to Sec. 514(c)(9)(A), I.R.C. the indebtedness of a "qualified organization" is not "acquisition indebtedness" if incurred in acquiring or improving real property. The trust would be a "qualified organization" because of its status as a supporting organization under Sec. 509(a)(3), I.R.C., and the trust would have incurred the debt to improve real property.

AA. Priv. Ltr. Rul. 9510030 (December 9, 1994). The taxpayer was a corporation that intended to elect REIT status. It intended to conduct its business through an operating partnership which would own real estate either directly or through lower-tier partnerships. The REIT intended to perform certain services through a corporation. The operating partnership would own all of the nonvoting preferred stock, but none of the voting common of this corporation. All of the voting common would be owned by a company owned by certain officers of the REIT. This corporation would be engaged in providing the following services:

Construction Management -- The property partnerships normally provide an allowance for certain improvements in the lease space at no charge to the tenant. Such build-out would be performed by independent contractors. The REIT represented that it was usual and customary for construction build-out work to be provided to tenants free of charge by owners of rental properties of the same class and located in the same geographic area. It also provided an opinion letter from a national commercial property management company that indicated that such practice was customary.

Space Design -- The REIT, through the corporation, intended to provide space design services at no charge. The REIT represented that it was usual and customary for space design services to be provided to tenants free of charge. It provided independent verification of this fact.
Parking -- The REIT represented, and independently verified, that it was usual and customary to provide tenants with reserved parking free of charge.

Health Club, Teleconference Center, Board Room, Art and Food Service -- With respect to one property, several services and amenities were made available to tenants and non-tenants. These included (i) a health club leased to an unrelated party; (ii) a teleconference center available for rent to both tenants and non-tenants; (iii) a board room available for rent to tenants; (iv) art located in a lobby open to all building visitors; and (v) an executive dining room and self-service cafeteria available to tenants and non-tenants and operated by an unrelated corporation. However, a related corporation did receive income or loss from this operation.

Gymnasiums -- Many of the office buildings had gyms to which tenant employees had access by paying a nominal annual charge.

The Service determined that the provision to tenants of construction services, space design services, reserved parking spaces, the health club facility, the teleconference center, the board room, the art, the food services and the gymnasiums would not cause the income from the properties to be characterized as something other than "rents from real property". Such services would not be disqualified services because they would be excluded from UBTI under Sec. 512(b)(3), I.R.C. if received by a Sec. 511(a)(2), I.R.C. organization. See Reg. §1.512(b)-1(c)(5); Rev. Rul. 69-176, 1969-1 C.B. 158; and Rev. Rul. 80-297, 1980-2 C.B. 158.

However, the REIT's distributive share of any fees or charges associated with the gymnasiums would not constitute qualifying income under Sec. 856(c)(2) and (3), I.R.C.

AB. Priv. Ltr. Rul. 9512014 (December 23, 1994). An S corporation owned and operated real estate, either directly or through partnerships. This real estate consisted of office buildings, apartments, shopping centers, mini-storage areas and a congregate care facility. The taxpayer hired a related management corporation at a market rate to provide on-site management, leasing and contract maintenance, landscaping, security and other various services depending on the type of property. The taxpayer provided administrative services as owner of the real estate.

The Service determined that the rental income received was not passive investment income for purposes of Sec. 1362(d)(3)(D)(i), I.R.C.

AC. Priv. Ltr. Rul. 9513001 (November 28, 1994). In this Technical Advice Memorandum, the decedent died in 1991 at age 84.
He was survived by three children. In 1982, the decedent entered into separate contracts with each of his children to sell specific parcels of real property. Each contract specified a purchase price. However, under the terms of each contract, payments were to be made by each child in amounts and at times suitable to that particular child. No minimum payment or schedule of payments was set forth, and no interest was to be charged. The decedent was to receive all the income from the property and pay all the taxes and other expenses on the property until final payment was made. No deed was to be issued until the final payment was made. During 1982 through 1986, the decedent forgave $50,000 of the contract price due from each child’s contract. However, there was no contemporary written evidence regarding such forgiveness. During those years, the decedent operated the various properties as farms, receiving income and paying expenses. In 1990, after having a stroke, the decedent executed deeds conveying the parcels subject to the 1982 contracts to the children.

On that same day, he also entered into three separate private annuity agreements, whereby he transferred other real property in return for an initial payment of $10,000 and an annual annuity payment payable for his lifetime. The present value of the annuity payments was calculated to equal the fair market value of the real property. The initial $10,000 payment was immediately forgiven by the decedent, and there was no indication that any child made the next annual annuity payment, which was due one month before the decedent died in 1991.

The National Office determined that the decedent’s transfer in 1990 of the various parcels of real estate was a taxable gift, treated as an adjusted taxable gift, for purposes of determining estate tax liability. The Service determined that a gift did not occur in 1982 when the contracts were executed because under local law such contracts were not instruments of conveyance and because the decedent did not relinquish dominion and control over the property until 1990. The Service determined that a gift was made in 1990 and that the value of the gift was the difference between the fair market value of the property and the consideration actually paid. It did not take into account the amounts forgiven because (1) there was no written evidence of such "forgiveness"; (2) the sales contracts were not revised to account for any adjustment to the purchase price; and (3) based on the provisions of the sales contracts, it appeared there was not a forgiveness of any specific payments under the contract.

The Service also determined that the private annuities did not constitute adequate consideration in money or money’s worth for the other parcels of real estate. In order to show that there was adequate consideration, the estate had to demonstrate a real expectation of repayment and an intent to enforce collection of the indebtedness. The Service found that the facts supported
that there was no expectation of repayment and no intention to enforce collection of the annuity. Instead, the actions of the decedent indicated he was systematically entering into transactions for the sole purpose of transferring substantial property while avoiding Federal estate and gift tax. Thus, the decedent made gifts in 1990 of the fair market value of the property transferred to each of his children.

AD. Priv. Ltr. Rul. 9514005 (December 23, 1994). An S corporation received rental income from farm land, buildings and equipment. For a certain period of time, the farm was rented on a cropshare basis. Under the cropshare lease, the corporation was not responsible for any of the growing expenses. However, because its stockholders knew the land better than the tenant, they were actively involved in the tenant’s farming operations as advisors, unofficial managers and even laborers. More specifically, the stockholders (1) acted as consultants; (2) taught the tenant how to use the equipment and storage; (3) planted and harvested crops; (4) maintained all the farm roads, tile systems, ditch systems and buildings; and (5) maintained all equipment. After the cropshare lease ended, the corporation rented the farm to a new tenant for cash. However, because the new tenant could not afford the farm help necessary to operate successfully, two of the stockholders performed the same type of duties which they had performed during the cropshare lease.

Under all the facts and circumstances, the Service determined that the rental income the taxpayer received from the farm land, buildings and equipment was not passive investment income for purposes of Sec. 1362(d)(3)(D)(i), I.R.C.

AE. Priv. Ltr. Rul. 9514006 (December 30, 1994). This ruling concerned the consequences of a loan made by a REIT to its operating partnership. At the same time that the REIT contributed properties and cash to the operating partnership in exchange for a general partner interest, it also loaned the partnership the net proceeds from its debenture offering. These debentures bore interest payable semiannually until the maturity date and were unsecured by any interest in real property.

For purposes of the applicable income restriction tests of Sec. 856(c), I.R.C., the Service determined that, pursuant to Reg. §1.856-3(g), (1) the amount of the debentures, including interest, which was proportionate to the capital interest of the REIT in the partnership would be disregarded; (2) the amount of the debentures which was proportionate to the capital interest of the other partners would be considered a non-real estate asset; and (3) the amount of interest payments proportionate to the capital interests of the other partners would be interest from an obligation not secured by any interest in real property.
AF. Priv. Ltr. Rul. 9515005 (December 7, 1994). The taxpayer intended to elect to be treated as a REIT. This REIT, simultaneous with an IPO, contributed its leasing service company assets and cash to Operating Partnership in exchange for partnership units as its sole general partner. Operating Partnership owned, directly and through partnerships, manufacturers outlet shopping centers. In addition, Operating Partnership owned all of the nonvoting stock and some percentage of the voting stock of a Service Corporation. Service Corporation provided development, leasing, marketing and management services to certain properties owned in part by Operating Partnership. Operating Partnership had begun to perform similar management services for the outlet shopping centers it owned directly. In addition, Operating Partnership, along with Service Corporation, planned to provide certain services to the properties owned by the partnerships. For these services, Operating Partnership and Service Corporation charged management fees. Alternatively, in certain cases, the partners of each of the partnerships would be charged their allocable share of management fees.

The Service determined that, so long as the partnerships qualified as entities properly treated as partnerships for Federal income tax purposes, the activities undertaken by Operating Partnership and Service Corporation for the partnerships would not cause the REIT's share of otherwise qualifying rental income from the partnerships to be excluded from "rents from real property" as defined in Sec. 856(d), I.R.C. because they would not be disqualified services pursuant to Reg. §1.512(b)-1(c)(5); Rev. Rul. 69-178, 1969-1 C.B. 158; Rev. Rul. 80-297, 1980-2 C.B. 196; and Rev. Rul. 80-298, 1980-2 C.B. 197.

However, the portions of the development, leasing, marketing and management fees that were apportioned to the capital interests of the partnerships' other partners would be considered non-qualifying income for purposes of Sec. 856, I.R.C.

AG. Priv. Ltr. Rul. 9517005 (January 18, 1995). As of 1989, certain real estate assets were held directly or indirectly by a Foundation, a Marital Trust (one-quarter of which was owned by the sons of the grantor, with the other three-quarters ownership being disputed), and the sons of the Marital Trust grantor in varying proportions. From 1989 until 1993, the Foundation and the sons were engaged in litigation with respect to the disputed ownership of the Marital Trust.

In December 1993, the parties entered into a settlement agreement whereby the common ownership of the properties would be eliminated. To achieve this result, the parties proposed engaging in several like-kind exchanges. The Marital Trust disclosed that, after the like-kind exchanges were effectuated, the Marital Trust and the Estate would be distributing the
properties within a short period of time to the Foundation, the
sons and other parties as provided in the settlement agreement.
Such transfers, coupled with some other residuary transfers,
would terminate the Marital Trust and the Estate for Federal
income tax purposes.

The Service determined that the Marital Trust would
simultaneously exchange real property held for investment solely
for other real property to be held for investment, and thus
qualify for non-recognition under Sec. 1031(a), I.R.C. Citing
Rev. Rul. 57-244, 1957-1 C.B. 247, the Service approved the
proposed circular structure of some of the exchanges. The
Service also noted that Sec. 1031(d), I.R.C. could apply because
of mortgages which would be assumed or transferred in these
exchanges. The Service noted that, because the settlement
agreement gave substantial assurances that none of the parties
would make a subsequent disposition within two years, it was
unlikely that the related party rules of Sec. 1031(f) would come
into play.

AH. Priv. Ltr. Rul. 9517006 (January 18, 1995). At the
time of his death, the decedent owned 100% of the stock of a
corporation which was in the business of owning and leasing real
estate. The main assets of the corporation were two properties.
One property consisted of office bays leased to unrelated users
on an arms'-length basis, except for one bay which was occupied
by the corporation for management purposes. The other property
consisted of four two-story buildings leased to two users on an
arms'-length basis.

Prior to his death, the decedent exercised total management
responsibility with respect to the business of the corporation.
His responsibilities included advertising for and screening
tenants; negotiating leases; collecting rental payments; and
contracting for, and directly supervising, the work of
maintenance people. In addition, he personally performed day-to-
day repairs and maintenance of the properties. He had the sole
authority to (1) execute all leases and other documents in
relation to the management of the real estate; (2) execute all
sales contracts, mortgages, deed of trust and other documents in
relation to the real estate; (3) open checking accounts and
savings accounts and deal with all other related financial
operations of the corporation; (4) pay dividends and divide
profits; (5) carry out all the purposes of the corporation
described in its articles of incorporation; and (6) execute all
documents necessary for the corporation's dissolution.

The estate requested that the Service determine that the
decedent’s interest constitute an interest in a closely held
business for purposes of Sec. 6166(a), I.R.C. Under Sec.
6166(b)(9), I.R.C., the value of any interest in a closely held
business does not include the value of that portion of the
interest that is attributable to passive assets held by the business. Citing Rev. Rul. 75-365, 1975-2 C.B. 471, and Rev. Rul. 75-367, 1975-2 C.B. 472, for the proposition that the level of activity is the distinguishing factor in determining the conduct of an active business from the mere passive ownership of assets, the Service determined that the scale of management activity in the corporation was significantly greater than that described in the Revenue Rulings, and so the decedent’s interest qualified as an interest in a closely held business.

AI. Priv. Ltr. Rul. 9519015 (February 7, 1995). When the decedent died in 1987, an election was made under Sec. 2032A, I.R.C. to value specially the qualified real property. The taxpayer’s heir wished to convey this property to a revocable trust of which he would be the beneficiary, and of which, his spouse and he would be the trustees. The Service determined that this transfer would not be considered a disposition of the property for purposes of the imposition of the additional estate tax pursuant to Sec. 2032A(c), I.R.C. as long as (1) the taxpayer and spouse (as trustees) and the taxpayer (as beneficiary) entered into an agreement to be fully liable for any additional estate tax and (2) the trust continued to use the property in its qualified use. The Service also noted that, should the taxpayer die during the 10-year recapture period, the transfer of the property on the taxpayer’s death would not be considered a taxable disposition provided the property remained in the wholly revocable trust or was distributed to the taxpayer before his death.

AJ. Priv. Ltr. Rul. 9522006 (February 15, 1995). The taxpayer and related persons owned undivided interests in different tracts of land. The parties agreed that the ownership arrangement was impractical because it impeded the pursuit of separate objectives and hindered plans for the eventual settlement of their family affairs. In order to rectify this situation, the parties entered into an exchange agreement with an intermediary whereby they transferred all their interests to the intermediary and the intermediary transferred whole interests for eight separate portions to the parties by a single special warranty deed. Appraisals of the exchange properties show that the total value of the replacement properties nearly equalled that of the relinquished properties.

The Service determined that, based on the facts and the taxpayer’s representations, the taxpayer simultaneously exchanged real property held for productive use in the trade or business or for investment solely for other real property held for productive use in a trade or business or for investment, thereby engaging in a qualified like-kind exchange. However, the Service cautioned the taxpayer stating that (1) because related persons were involved, the taxpayer needed to be aware of the possible application of Sec. 1031(f), I.R.C., and (2) the Service did not
believe the transaction could be successfully executed either with or without an intermediary if the values of the properties being relinquished and received by each of the parties were not approximately equal.

AK. Priv. Ltr. Rul. 9522040 (March 6, 1995). A husband and wife held a residential investment income property jointly with the wife's brother as tenants in common. They mutually agreed to dispose of the property with the brother investing his share separately. The husband and wife intended to do a like-kind exchange of 50% of the proceeds. The replacement property was a unit in a condominium development. However, the ruling stated that it might be necessary to choose a different unit within the complex prior to the end of the identification period. The taxpayers requested that the Service determine that the transfer would constitute an exchange eligible for nonrecognition under Sec. 1031, I.R.C. The Service determined that it could not rule on the factual questions of whether the currently held property or the replacement condominium unit constituted property held for productive use or investment. However, it stated that, if these factual questions were affirmative and all requirements of Reg. §1.1031(k)-1 were met, the transfer would constitute an exchange eligible for nonrecognition of gain under Sec. 1031, I.R.C.

AL. Priv. Ltr. Rul. 9523014 (March 10, 1995). The taxpayer is a corporation which proposes to elect S status as of January 1, 1995. It is in the business of operating and renting low-income, low-rental residential and commercial real estate. None of the properties was rented on a net lease basis. The taxpayer employs a professional property management company for daily operational decisions with respect to its residential properties; however, all decisions are subject to taxpayer's management's approval. Moreover, the taxpayer's management is actively involved on a day-to-day basis with the management of the commercial properties.

Under all the facts and circumstances, the Service determined that the rental income received from the properties was not passive investment income for purposes of Sec. 1362(d)(3)(D)(i), I.R.C. See also Priv. Ltr. Rul. 9523016 (March 10, 1995).

AM. Priv. Ltr. Rul. 9523017 (March 10, 1995). The taxpayer is an S corporation which leases out and manages properties both directly and through partnerships. One of the stockholders is president, responsible for overseeing the accounting and property management functions for all the buildings. The taxpayer directly manages five industrial/commercial buildings, a condominium and a certain number of duplexes. The taxpayer and the stockholder also own general and limited partnership interests in a partnership which owns a golf
resort consisting of an 18-hole golf course, a full-service hotel, a restaurant and bar (operated by an affiliated corporation) and swimming facilities. All management decisions are made by the stockholder and one other general partner, and many decisions are implemented by taxpayer staff. The taxpayer also owns a general partnership interest in an apartment building that includes swimming pools, a tennis court, a volleyball court, a basketball court and a clubhouse. Both the stockholder and the taxpayer are actively involved in the apartment's management.

The taxpayer also owns a property rented on a net lease basis, as well as two other properties which do not generate rental income. None of these is covered by this ruling.

Under all the facts and circumstances, the Service determined that the rental income received from the properties was not passive investment income for purposes of Sec. 1362(d)(3)(D)(i), I.R.C.

AN. Priv. Ltr. Rul. 9524001 (October 11, 1994). In this Technical Advice Memorandum, the National Office determined whether the taxpayer was required, pursuant to Sec. 471, I.R.C., to use inventories for the construction materials and supplies it provided customers under its construction contracts, and thus was required to change from the cash method to the accrual method. The taxpayer was a general contractor for both residential and light commercial construction projects, which included both new construction and the remodeling/renovation of existing structures. Taxpayer did not construct any houses or commercial buildings for speculative purposes. The taxpayer did not maintain any inventories of construction materials, but rather purchased the exact amount of materials needed for each job, usually having the materials delivered directly to the job site.

The taxpayer argued that it was not required to use inventories for these materials because (1) all of the materials were specified by the architect; (2) most of the materials were provided either by the client or by the various subcontractors; and (3) none of the bills presented to clients separately stated the cost of those materials. The taxpayer also argued that Reg. §1.471-1 does not require inventories when the materials are used for the production of a finished custom product.

The Service was not persuaded by the taxpayer's arguments and determined that it must use inventories to reflect income clearly. Citing J.P. Sheahan Associates, Inc. v. Comm'r, TC Memo. 1992-239, and Independent Contracts, Inc. v. United States, 94-1 U.S.T.C. ¶50,135 (N.D. Ala. 1994), the Service stated that the courts have found that construction contractors must use inventories for construction materials and supplies. Citing Reg. §1.446-1(c)(2) as the authority allowing the Service to require the taxpayer to change its accounting method, the
Service also stated that the taxpayer was required to use an accrual method because the use of the cash method did not produce results that were substantially identical to the results produced under an accrual method.

AO. Priv. Ltr. Rul. 9525002 (February 23, 1995). The taxpayers entered into an oral agreement with a corporation wherein they agreed to exchange standing timber owned by them for three tracts of timberland. The corporation began cutting all hardwood and pine timber on 60 acres of land owned by the taxpayers. Ten days later, the corporation conveyed to the taxpayers by deed the three tracts of timberland. A week later, the cutting and removal of all trees was completed, and the taxpayers conveyed by timber deed "all hardwood and pine timber now standing or lying on the said land". The deed also stated that all timber had to be cut or removed within two years of the deed or it would become the property of the taxpayers.

The National Office in this Technical Advice Memorandum was asked to determine whether the timber interest conveyed by the taxpayers and the land conveyed to them were like-kind properties for purposes of Sec. 1031, I.R.C. The Service determined they were not like-kind, citing Fleming v. Comm'r, 24 T.C. 818 (1955). In effect, the taxpayers sold the timber existing on their property during the contract period. The contract period amounted to a de facto restriction on the number of trees that could be removed. Therefore, the corporation's interest was similar to the limited "carve-out" royalty in Fleming. In effect, the taxpayers sold trees and bought land; the corporation sold land and bought trees.

AP. Priv. Ltr. Rul. 9526001 (September 30, 1994). In this Technical Advice Memorandum, the taxpayers owned interests (directly and indirectly) in various partnerships. A number of the partnerships in which the taxpayers were investors lent money to a number of other partnerships in which the taxpayers also invested. These borrowing partnerships in turn paid interest to the lending partnerships. After the issuance of a new Proposed Regulation, modifying former Temp. Reg. §1.469-11T(a)(2)(iii), the taxpayers amended their 1989, 1990 and 1991 returns. In these amended returns, they treated their distributive shares of the lending partnerships' interest income as self-charged interest and offset such income with passive activity losses attributable to their shares of the interest deductions of the borrowing partnerships on the same loans.

The Proposed Regulation provided that, for taxable years beginning before June 4, 1991, a taxpayer was not required to apply the rules in Reg. §1.469-7, but instead could use any reasonable method of offsetting items of interest income and interest expense from lending transactions between the pass-through entity and its owners. The taxpayers argued that the
Proposed Regulation allowed the application of any method which prevented them from being taxed on transactions in which they essentially loaned money to themselves. The National Office concluded, however, that to read this rule as providing relief via a "reasonable method" standard to entity-to-entity loans expanded the Proposed Regulation to transactions it was not intended to cover.

The taxpayer also argued that relief was available under the authority of Sec. 469(1), I.R.C. regardless of the existence of Regulations. The Service determined that the self-charged rules were not self-executing, so that, in the absence of Regulations, self-charged treatment was not available for items of interest income or other items.

AQ. Priv. Ltr. Rul. 9527020 (April 6, 1995). The taxpayer REIT intended to acquire all of the assets of a target corporation through a statutory merger. The target had been a "qualified REIT subsidiary" from the date of its incorporation until it conducted a private offering of its shares to persons other than its parent. The target intended to elect REIT status for the short taxable year beginning on the day such status was lost and all subsequent tax years. The target owned several subsidiaries which were indirect qualified subsidiaries and would be direct qualified subsidiaries when the target elected REIT status.

If the subsidiaries did not qualify as "qualified REIT subsidiaries" following the merger, the taxpayer REIT would be unable to satisfy the asset tests of Sec. 856(c)(5), I.R.C. and the subsidiaries would have to be liquidated at the time of the merger.

In order to effectuate Congress' purpose in allowing "qualified REIT subsidiaries", the Service determined that, at the time of the merger, the subsidiaries would qualify as REIT subsidiaries of the target. Immediately after the merger, the taxpayer would be treated as having contributed the assets and liabilities of the subsidiaries to newly organized corporations in exchange for 100% of their stock. Accordingly, the new subsidiaries would be "qualified REIT subsidiaries" following the merger, and, inasmuch as the taxpayer would have owned 100% of the stock of at all times during the period that the new subsidiaries were in existence, they would continue to be "qualified REIT subsidiaries" so long as 100% of the shares were owned by the taxpayer REIT.

AR. Priv. Ltr. Rul. 9529035 (April 27, 1995). The taxpayer owned property which consisted of a residence on four parcels of land which were listed as one tax lot. The taxpayer represented that the property was not a farm and had been used as one residence for over 20 years and that the structures were
integral to the use of the property as a residence. Because the parcels were shown as one tax lot, the Service determined that the property constituted a residence and adjacent land not in excess of that which was reasonably appropriate for residential purposes for purposes of Reg. §25.2702-5(c).

AS. Priv. Ltr. Rul. 9530020 (April 28, 1995). An individual owned and used a single-family home as his principal residence. He disappeared and has since been missing. However, he had not been determined to be deceased under state law because he had not been missing the requisite seven-year period. The missing individual's administrator sold his house to unrelated parties. The administrator wanted to elect the $125,000 exclusion pursuant to Sec. 121, I.R.C. The administrator argued that, because the missing individual met the age and use requirements, he, as a fiduciary, should be able to "step into the shoes" of the missing person under Reg. §1.121-4 and Rev. Rul. 82-1, 1982-1 C.B. 26.

However, the Service determined that the administrator could not make the election. It stated that the authority cited by the administrator stands only for the proposition that a fiduciary may make an election when there is some evidence that the affected taxpayer intended to sell the home. This rationale was buttressed by G.C.M. 37673 (December 30, 1980), which noted, in the context of Sec. 1033, I.R.C., that, if a taxpayer had not taken reasonable steps towards replacement of the condemned property before dying, nonrecognition treatment would not be applicable to a fiduciary's acquisition of replacement property. Thus, because there was no evidence that the missing person intended to sell his home prior to disappearing, the election could not be made.

VI. CASES

A. Adams v. Comm'r, 69 TCM 2297 (1995). On June 29, 1987, the taxpayer purchased real property for use as a personal residence. The purchase price was $124,000. Over the next two years, he made improvements totaling $15,908. Sometime in 1988, the taxpayer became unemployed. As a result, in June 1989 he moved out and leased the property for a lease term ending December 31, 1989, thereby converting his personal residence into rental property.

In September 1988, petitioner entered into an agreement with a realtor listing the residence for sale at a price of $145,000. He received no offers at this price. In October 1989, the property sold for $130,000, subject to the remaining lease period. On his 1989 income tax return, the taxpayer took a $12,905 loss on the sale of the property. In addition, he
claimed various deductions with respect to the property for the period January 1 through October 23, 1989.

Pursuant to Reg. §1.1001-1, for purposes of determining loss, the fair market value of the property at the time of conversion was fundamental to the question of whether the loss was allowable. The Service argued that the fair market value of the rental property was $130,000 at the time of conversion. The taxpayer argued that the value was $145,000.

The Court stated that, although generally the purchase price of property changing hands between two unrelated parties is highly reflective of fair market value, in this case the taxpayer was unemployed, was 2 years in arrears in property taxes and behind on his mortgage payments. Based on these circumstances, the Court held that the taxpayer was compelled to enter into the sales transaction. Because the buyers knew the taxpayer's circumstances, they were in a position to negotiate a price below market value. The Court found that the buyers taking the property subject to a lease provided further evidence that the purchase price was not reflective of the property's fair market value. The court concluded that the fair market value of the property was $135,000 at the time the property was converted, thus allowing a $5,000 loss.

The Court also held that expenses incurred by the taxpayer prior to the date of conversion could not be deducted, but that the expenses incurred after conversion were deductible under Sec. 162(a), I.R.C.

B. Adler v. Comm'r, F.3d ___, 95-1 USTC ¶50,098 (Cl. Ct. 1995). In 1987 and 1988, the taxpayer reported significant passive activity losses. These losses were partially deductible for regular tax purposes. However, the taxpayer was subject to the alternative minimum tax ("AMT"), under which no losses were deductible. Thus, no tax savings were achieved in 1987 and 1988. The taxpayer took the losses sustained in 1987 and 1988 that were unused in her regular tax net operating loss deduction and carried these amounts back to reduce her 1984 and 1985 regular and AMT net operating loss deductions. Looking to the purposes for enactment of Sec. 469, I.R.C. and the statutory language thereof, the Court found that the taxpayer was not allowed to have these losses enter into a computation of net operating losses in 1987 and 1988, and thus could not carry them back to the earlier years.

C. Belden v. Comm'r, 70 TCM 274 (1995). On December 19, 1988, the taxpayers entered into a contract for the purchase of a residence and took possession within 2 weeks. The purchase contract committed taxpayers to paying $500,000; $20,000 was paid to the seller as an earnest money deposit, $80,000 was to be in the form of a promissory note to the seller and $400,000 was to
be permanent financing. The purchase contract was subject to the condition subsequent that the seller obtain suitable financing for the $400,000 under terms acceptable to the taxpayers.

On January 16, 1989, the taxpayers entered into an occupancy agreement providing the taxpayers with immediate rights of occupancy. Until permanent financing was arranged, the occupancy agreement required the taxpayers to pay the seller $3,500 a month. This $3,500 was equal to the interest being paid by the seller on his outstanding construction loan. It was the parties' understanding that the taxpayers would bear the $3,500 construction mortgage interest charge as long as they possessed the house and until permanent financing could be obtained. All utilities were to be placed in taxpayers' names, and taxpayers agreed to obtain liability and contents insurance. Following a 2-month transition period, the taxpayers were responsible for the costs of repairs to plumbing, heating, cooling, electrical equipment and appliances. The taxpayers paid in excess of $13,000 to repair, maintain or improve the property during 1989. If the sale ultimately was unsuccessful, the taxpayers were liable for any damage that they caused to the property.

The taxpayers did not close on the purchase contract. The taxpayers ultimately purchased the house from a foreclosing bank. After commencement of the foreclosure proceeding, and prior to taxpayers' purchase, the taxpayers paid the $3,500 monthly payments directly to the bank.

On their 1989 and 1990 Federal income tax returns, taxpayers claimed the $3,500 monthly payments as deductible interest payments. The Service argued that the payments were rent and not interest.

Noting that this was a unique set of circumstances, the Court held that the taxpayers were entitled to qualified residence interest deductions. Pursuant to Sec. 163(h)(3), I.R.C., the Court determined that (1) the interest was paid on acquisition indebtedness because the payments were designated as interest in the occupancy agreement and were paid to the bank, either directly or indirectly, (2) the loan was incurred to build a qualified residence, and (3) the property secured such loan, with the taxpayers ultimately receiving title from the bank.

Under Reg. §1.163-1(b) and Baird v. Comm'r, 68 T.C. 115 (1977), interest is deductible where the taxpayer is the legal or equitable owner of the property even if the taxpayer is not directly liable on the debt. Thus, the Court had to determine whether the benefits and burdens of ownership had been transferred to the taxpayers prior to 1991. The Court found that such benefits and burdens had shifted once the taxpayers took possession because, under applicable Oklahoma law, they had an
equitable ownership interest and they had assumed many of the burdens of ownership based on the occupancy agreement.

Brown Cayman, a controlled foreign corporation ("CFC"), owned a 88% interest in a Cayman Island partnership, Brinco. The partnership acted as the Brazilian purchasing agent for Brown Cayman and its affiliates. It was paid a 10% commission. At issue was whether Brown Cayman's share of partnership income from Brinco was foreign base company sales income, includable as Subpart F income, in the consolidated income tax return of the group. The taxpayer argued that it was not Subpart F income because Brinco's income was not derived in connection with the purchase of personal property from any person on behalf of a related person. Brinco was not a related person to Brown Cayman or its affiliates under Sec. 954(d)(3), I.R.C.

The Tax Court first filed an opinion in this case on April 12, 1994, **Brown Group, Inc. v. Comm'r**, 102 T.C. 616 (1994). The Court found there that the income received from Brinco was not Subpart F income. Its rationale was that Brinco was not a CFC, and so its income could only be Subpart F income to Brown Cayman if its existence as an entity was ignored and Brown Cayman was treated as if it engaged in the activities of Brinco. The Court found that Brinco should be respected as an entity and that characterization of income was to be made at the partnership level. That opinion was subsequently withdrawn, and this reviewed decision was issued.

In this decision, the Court held that the income was Subpart F income. The Court based its opinion on a close reading of the Regulations under Subpart F, a consideration of the structure and language of Subchapter K, Congress' purpose in enacting Subpart F, and certain language of Sec. 954(d)(1), I.R.C. Based on Reg. §1.952-2(c)(1), which lays out a scheme under which the U.S. shareholder of a CFC must determine the foreign base company sales income of the CFC under most of the rules applicable to a domestic corporation determining its tax liability under Sec. 11, I.R.C., the Court concluded the rules of Subchapter K should be applicable to this situation.

Under Subchapter K, Brinco is required separately to state its commission income in order to give effect to Sec. 702(a)(7), I.R.C. and Reg. §1.702-1(a)(8)(ii). To do otherwise, the Court held would frustrate Congress' purpose in enacting Subpart F. The court also stated that, to accomplish Congress' purposes for enacting Subpart F, the aggregate or conduit nature of Brinco as a partnership rather than as an entity must be emphasized. The Court found that, although the cases required an entity level determination of income, once that determination was made, the partnership was ignored and the individual partners took into account the income as if they had earned it directly. The Court
and other courts had attributed to a partner the activities and even the property of a partnership to determine whether the partner had a particular status important for determining some aspect of the partners' Federal income tax status. Thus, Brown Cayman should be put into the shoes of Brinco for determining whether Brown Cayman was earning commission income on sales by third parties to its affiliate.

The Court (with three concurring opinions and one dissenting opinion) found such a relationship existed. It held that Brown Cayman was a CFC whose distributive share of partnership profits was, by design and reality, connected to and dependent on purchases made on behalf of a party related to Brown Cayman.

E. Estate of Cervin v. Comm'r, 68 TCM 1115 (1994). On December 3, 1988, the date of his death, the decedent owned an undivided 50% interest in approximately 657.3 acres of farm real estate and an undivided 50% interest in a homestead, both located in Texas. His children owned, in equal shares, the remaining 50% interests in these properties. The fair market value of the farm at the date of decedent's death was $650,000. The fair market value of the homestead at the date of decedent's death was $625,000. In the estate tax return, the undivided one-half interest in the farm was valued at $243,750 and the undivided one-half interest in the homestead was valued at $234,375. The Service initially disallowed any discounts for the decedent's fractional interests. At trial, it conceded that some discount was appropriate but maintained that the fractional interest discounts should be 6.54% with respect to the farm and 8.20% with respect to the homestead. The taxpayer contended that a fractional interest discount of 25% was appropriate for both properties.

The make-up of the farm's 634.76 acres was that 40% was suitable for farming, 30% was suitable for ranching and the rest was floodplain. Any partition would result in an amount of land well below the minimum amount of acreage necessary for profitable operation. Both parties' experts agreed that some discount was appropriate with respect to the farm because partition would be difficult. The taxpayer's expert concluded that a 25% discount was appropriate because of the following factors: (1) partition was not feasible because of the farm's varied soil type and configuration, its limited access to a paved road and the uneconomical amount of acreage suitable for farming that would remain; (2) the lack of control associated with a minority interest in property; (3) the lack of marketability of a fractional property interest; and (4) the difficulty of obtaining mortgage financing for the purchase of a fractional interest. The Service's expert felt the farm was easily partitioned and that the discount should be 6.54%, representing a fractional discount and the costs of partition. The Court held that the farm could be partitioned on the basis of value but this would
involve substantial legal costs, appraisal fees and delay so that a 20% discount was appropriate.

With respect to the homestead, both experts agreed that the homestead was not capable of partition and therefore would be subject to a forced sale. The taxpayer’s expert decided that a 25% discount was appropriate based on the fact that any potential purchase of decedent’s fractional interest would require a substantial discount to offset the legal costs and appraisal fees associated with bringing about a forced sale of the homestead. In addition, he argued that, because the home was in need of substantial repair, any potential purchaser of decedent’s fractional interest would require a discount for repair costs as well as for a fractional interest. The Service’s expert testified that the homestead would sell quickly in a forced sale because of its lot size and desirable location. The Court concluded that a 20% discount was appropriate. The taxpayer’s expert’s reliance on the poor condition of the homestead was misplaced because that condition was already considered in determining the agreed fair market value of the homestead.

F. DeMauro v. Comm’r, 68 TCM 721 (1994). The taxpayer sold his residence on December 14, 1989. The gain on the sale of the residence was $88,004. He did not report any gain on the sale of the property on his 1989 Federal income tax return. At all relevant times, taxpayer maintained his personal residence within the United States and did not roll over the gain. In a letter dated November 29, 1989, the taxpayer requested that the proceeds from the sale be held on deposit until after January 12, 1990. However, neither the contract nor the settlement provided for any type of escrow arrangement. The settlement took place on December 14, 1989, and provided for cash in the amount of $133,429.74, after adjustments, to be paid to seller.

The Service issued a notice of deficiency with respect to the 1989 year because of the taxpayer’s failure to report the gain. The taxpayer made the following three arguments: (1) he was unable to meet the Sec. 1034, I.R.C. requirements because a lien was placed on his bank account by the Service relating to the 1985 year; (2) he intended to relocate to England; and (3) he reported the gain in 1990 because the proceeds were not distributed from an escrow until 1990. The Court found none of these arguments to be acceptable because (1) decisions consistently hold that the time limits of Sec. 1034, I.R.C. are uniformly applicable, and the courts are without authority to weigh the merits of the events causing delay; (2) the taxpayer never moved to England; and (3) the taxpayer did not prove the existence of a valid escrow.

acquired the property as tenants in common. The purchase price was $149,900. The taxpayer and his parents each paid approximately $20,000 cash and obtained a 30-year loan of $111,750. From July 1985 until August 1988, they rented the property. In August 1988, the taxpayer sold his primary residence for $225,000. His selling expenses were $11,000 and his adjusted basis was $102,000 at the time of the sale. When he filed his 1988 Federal income tax return, he stated he was deferring the recognition of gain because he intended to buy a new residence within the prescribed replacement period. On August 30, 1988, the taxpayer moved into the rental property under an oral agreement (between his parents and him) that he would pay all of the property’s expenses as rent. On February 21, 1990, he gave his interest in the property to his parents. On July 31, 1990, the taxpayer agreed to repurchase the property from his parents for its then fair market value of $215,000.

The taxpayer argued that he should be allowed to include the original mortgage liability in his cost of purchasing the new residence from his parents because the property was subject to the liability at the time he purchased it. The Court held that the taxpayer could not include such amount because the debt had been incurred outside the replacement period. The Court stated that the taxpayer was ignoring the language of Reg. §1.1034-1(c)(4)(ii), which sets the time frame for incurring acquisition costs with respect to a replacement residence.

H. *Eastwood Mall Inc. v. United States*, ___ F. Supp. __, 95-1 USTC ¶50,236 (N.D. Ohio 1995). In 1982, the taxpayer, as a member of a partnership, purchased a piece of property which was being developed into a mall. The property consisted of 100 acres of mountainous terrain with sharply contrasting elevations. In order to develop the property as a shopping mall, the land had to be leveled. This leveling was done by reshaping the mountains and valleys into a flat earthen plateau. The costs for clearing, blasting, filling and grading totalled $9,674,743. In 1985 and 1986, the partnership included these costs as part of the total depreciable cost of the mall building, depreciating the building using a 15-year life.

Citing *Aurora Village Shopping Center, Inc. v. Comm’r*, 29 TCM 126 (1970), and Rev. Rul. 80-93, 1980-1 C.B. 50, the Court held that these costs were incurred for permanent improvements inextricably associated with the land, and thus were non-depreciable. The Court pointed out that these costs would not be reincurred if the mall building was rebuilt or replaced, and so the plateau was not subject to exhaustion, wear and tear or obsolescence. The Court contrasted the treatment of these costs with the costs incurred in digging spaces and trenches in the top of the plateau for the mall building’s foundations and utilities, which the government had not disputed were part of the mall building’s depreciable cost basis.
I. Gehl v. Comm'r, ___ F.3d ___, 95-1 USTC ¶50,191 (CA8 1995). In this case, a creditor held a recourse note from the taxpayers with a balance due of $152,260. Pursuant to a restructuring agreement on December 30, 1988, the taxpayers transferred to the creditor 60 acres of farm land having a fair market value of $39,000 and a basis of $14,384. On January 4, 1989, an additional 141 acres, having a fair market value of $77,725 and a basis of $32,080, were transferred, $6,123 was paid in cash and any remaining debt was forgiven. The taxpayers were insolvent both before and after the transfers and the discharge of indebtedness.

The taxpayers argued that the entire set of transactions should be considered together and treated as income from the discharge of indebtedness. The Tax Court found in favor of the Commissioner. In doing so, it "bifurcated" its analysis of the transaction, considering the transfers of land and the discharge of the remaining debt separately.

Affirming the Tax Court, the Eighth Circuit, in a decision which was designated as being not for publication, held that the taxpayers' transfers by deeds in lieu of foreclosure of their land in partial satisfaction of the recourse debt were properly considered sales or exchanges for purposes of Sec. 1001, I.R.C. The Eighth Circuit cited Reg. §1.1001-2, Ex. (8), Estate of Delman v. Comm'r, 73 TC 15 (1979), and Danenberg v. Comm'r, 73 T.C. 370 (1979).

J. Guenther v. Comm'r, 69 TCM 2980 (1995). Metropolitan was an S corporation engaged in the business of renting and managing apartments and condominiums. Its shareholders were the taxpayer and his daughters. For purposes of Sec. 453(g), I.R.C., Metropolitan and the taxpayer were related taxpayers. On January 18, 1988, the taxpayer sold two parcels of real property containing condominiums to Metropolitan for $1,038,026, which was made up entirely of mortgage assumption. At the time of the transfer, an officer of the bank holding a second mortgage on the properties approved the taxpayer’s transfer, but did not require or suggest that the transfer be made. For purposes of Sec. 453(g), I.R.C., the properties were depreciable property. The taxpayer reported the gain from the sale of the properties on the installment method from 1988 to 1992. In each year, the taxpayer said the property was not sold to a related person.

The rule of Sec. 453(g)(1), I.R.C. states that installment sale reporting is not allowed on a sale of depreciable property between related parties if tax avoidance was a principal purpose of the transfer. The taxpayer argued that tax avoidance was not a principal purpose because he transferred the properties to avoid foreclosure by the bank. However, the Court did not find this explanation convincing. Instead, it looked at the depreciation benefit to Metropolitan arising from the stepped-up
basis and the tax benefits which the taxpayer received from the transfer and concluded that the transfer was engaged in for the principal purpose of tax avoidance. The Court found the taxpayer to have received the following tax benefits: (1) the deferral of gain over several years while keeping some control over the property and (2) the ability to offset suspended passive losses through the passive characterization of the gain. Additional support for this holding came from the failure to identify the sale as a related party sale.

K. Higgins v. Comm'r, 69 TCM 2281 (1995). In 1984, the taxpayers purchased a house for $325,000. As of May 26, 1989, the taxpayers had an adjusted cost basis for the house of $381,998. They used the house as their personal residence from the date of purchase until May 1989. On May 26, 1989, the taxpayers entered into a contract to lease the home, with the tenant having an option to buy. The tenant paid taxpayers $20,000 for the option. Additionally, the lease/option provided that $1,000 of each $3,055.79 monthly lease payment would be applied against the agreed prospective purchase price of $295,000, if the option were exercised by January 31, 1990. The option was in fact exercised.

On their 1990 tax return, the taxpayers took a loss, pursuant to Sec. 165(c), I.R.C., on the difference between their determination of fair market value at the date of conversion of the home from personal to business use, $350,000, and the sales price of $295,000. Under Reg. §1.165-9(b)(2), the Service disallowed this loss, stating that the fair market value of the property was not its adjusted basis, but rather the selling price of $295,000. Finding that the fair market value was $295,000, the Court held that the taxpayers had no deductible loss, because on the date of conversion the taxpayers knew they could not sell the property for any greater amount.

L. Holmes v. United States, 868 F. Supp. 42 (W.D. NY 1994). The taxpayers, a mother and her son, formed a partnership to purchase shares of a cooperative apartment in Brooklyn Heights, N.Y. Because the son was living there, they had the opportunity to buy at a discounted price. While the partnership's initial costs exceeded its income, the partners understood that the apartment potentially represented a very profitable investment. The son continued to live in the apartment after the purchase and during 1985 and 1986.

For these two years, the taxpayers' tax returns reflected the partnership's income and losses generated by the apartment. Upon audit, the Service disallowed most of the losses on the asserted grounds that the rent charged to the son was not a fair rent, and that the partnership itself was not engaged in an activity for profit. The taxpayers paid and filed claims for refund upon which they partially prevailed. They then instituted
a refund suit for the remaining amounts. The jury found that the partnership was engaged in an activity for profit and had charged a fair rent. The government, in this case, was asking for that judgment to be overturned as a matter of law. Its argument was based on whether Sec. 280A, I.R.C. applies to the shares of a cooperative apartment.

The Court held that, based on the statute’s language, its legislative history, the limited scope of Sec. 216, I.R.C. and the case law prior to the enactment of that provision, Sec. 280A, I.R.C. does not apply to the ownership of shares of a cooperative corporation. The shares of a cooperative corporation do not constitute "a dwelling unit" as defined by Sec. 280(f)(1)(A), I.R.C. Although the government argued that substance over form required that the taxpayers be treated as if they took deductions with respect to a dwelling unit, the Court found no citation of authority for such a proposition. The Court noted that Sec. 216, I.R.C. did not redefine the meaning of real property to include cooperative apartments, but instead extended certain deductions to certain tenant-stockholders while retaining the distinction between owners of stock and owners of real property. Thus, the Court held that the jury verdict would stand.

M. Estate of Hudgins v. Comm’r, 57 F.3d 1393 (CA5 1995). The decedent was a Texas rancher who died testate in 1987. In his will, he left several tracts of ranch property to various combinations of five grandsons. On the estate tax return, the "Yes" box was checked on the question asking whether the estate intended to elect special use valuation on any of its property. A "Notice of Election" was attached, but it contained only nine of the fourteen items required by the instructions and the Regulations. Only three of the five grandsons signed the election, with the explanation that one was not available and the other was in the military. The notice stated that it would remedy this lack of signatures, but no steps were taken until the Service audited the estate return and notified the estate that its special use valuation election was defective. Within 90 days after receiving that notice, the estate submitted all previously missing information, documentation and signatures. The Tax Court held that the estate was entitled to the special use valuation because the estate’s initial election substantially complied with the election requirements, entitling it to perfect its election within the statutory period following notice of the defects.

The Ninth Circuit reversed the Tax Court’s decision, holding that the estate had not substantially complied with the election requirements. The three requirements of election under Sec. 2032A, I.R.C. are (1) checking the appropriate box and completing Schedule N, thereby evidencing the intention to make such an election, (2) completing and attaching to the return a Notice of Election containing the information specified and (3) attaching a Recapture Agreement that has been signed by all parties with
interests in the property to be specially valued, expressly consenting to the imposition of the additional tax and to be personally liable to pay it in the event of a premature disposition of the property or cessation of its qualified use. Citing the legislative history of Sec. 2032A, the Court noted that Congress had stated that, in order to be eligible for perfection after the fact, both a notice of election and a recapture agreement valid under state law and signed by all parties must be included with the estate tax return. In this case, the estate did not meet this standard. The Court noted that the decisions in McDonald v. Comm'r, 853 F.2d 1494 (CA9 1988), McAlpine v. Comm'r, 968 F.2d 459 (CA5 1992), and Prussner v. United States, 896 F.2d 218 (CA7 1990) were consistent with its decision.

N. Hustead v. Comm'r, 68 TCM 342 (1994). The taxpayers purchased three contiguous lots which were zoned for one residential dwelling per acre. In 1989 and 1990, the taxpayers expended $26,000 and $22,000, respectively, on challenging the constitutionality of the zoning ordinance. They deducted these expenses, and the Service disallowed the deduction on the theory that the costs should have been capitalized under Sec. 263A, I.R.C.

The Court found the expenses were capitalizable, but under Sec. 263, I.R.C., rather than Sec. 263A, I.R.C. Sec. 263A, I.R.C. was held to be inapplicable because (1) the zoning challenge did not cause the property to be "produced", and so it did not qualify under Sec. 263A(b)(1), I.R.C., and (2) the property did not qualify as property acquired for resale under Sec. 263A(b)(2), I.R.C. because the taxpayers did not hold the property for sale to customers in the ordinary course of business. The expenses were found to be capitalizable under Sec. 263, I.R.C. because the increased fair market value attributable to the zoning challenge constituted a benefit which extended beyond the taxable years in which incurred.

O. Johnston v. Comm'r, 69 TCM 1749 (1995). In 1980, the taxpayers purchased a residential duplex home for $70,000. At the time of the purchase, one half of the duplex was rented. The petitioners continued to rent that half of the duplex until May of 1987, when they decided to renovate the property. The taxpayers resided in the other half of the duplex. In May, the taxpayers started the renovation of the duplex and spent $102,820 in renovation expenses for 1987. Renovation continued through August 1988, and they spent an additional $16,313 in renovation expenses. The duplex retained 95% of its original walls after the renovation, and it was stipulated that the building was substantially rehabilitated within the meaning of Sec. 48(g)(1)(C), I.R.C. The building was originally constructed in about 1914 but, it was not listed in the National Register of
Historic Places, was not located in a registered historic district and was not a "certified historic structure".

The taxpayers argued they were entitled to a 10% investment tax credit under Sec. 48, I.R.C. for the rehabilitation of their qualified residential rental property. The Service argued that the taxpayers were not entitled to an investment tax credit because the duplex did not constitute "section 38 property", as the duplex was used predominantly for lodging within the meaning of Sec. 48(a)(3), I.R.C.

The taxpayers claimed that the lodging exclusion provided in Sec. 48(a)(3), I.R.C. applied only to personal property used in the quarters of a hotel, motel, inn, dormitory or any other facility where sleeping accommodations are provided, and did not apply to the building itself.

The Court held that the taxpayers were not eligible for the credit based on the statute, the legislative history and case law, all of which demonstrated that the investment tax credit pertaining to qualified rehabilitation expenditures for a qualified rehabilitated building was unavailable if the property was a noncertified historic structure used predominantly for or in connection with the furnishing of lodging within the meaning of Sec. 48(a)(3), I.R.C.

P. Johnston v. Comm'r, 69 TCM 2283 (1995). Sometime in the summer of 1982, a limited partnership promoter approached the taxpayer to ascertain whether he would be interested in participating in the organization of a real estate limited partnership that was to acquire, own and operate a shopping center in the Detroit area. The taxpayer agreed to participate in the formation of the partnership and to serve as its general partner. In September 1982, the limited partnership was formed under the laws of Michigan. Its initial capital was $100, $90 of which was paid by the taxpayer in return for a 90% general partner interest and $10 of which was paid by another individual in return for a 10% limited partner interest. This limited partner was to withdraw upon the admission of investors who agreed to purchase the limited partner interests. Forty units were offered for sale at $200,000 per unit. According to the private placement memorandum, the taxpayer was to serve as the general partner, making no capital contribution but owning a 1% capital interest. It noted that "this compensation will be received despite no capital contribution . . . [and] . . . He will also receive a one-time organization fee of $30,000." All of the contributions received by the investors were held in escrow until the partnership purchased the shopping center, which occurred in December 1982. The Service determined in its notice of deficiency that the 1% capital interest had a fair market value of $80,808, which was includible in the taxpayer's gross income upon receipt.
The taxpayer made two arguments regarding the Service’s evaluation. The taxpayer argued that either (1) he received his partnership interest for a capital contribution of $90, and not in return for services or, alternatively, (2) he received his interest in return for services, but in September 1982, so that the fair market value of such interest must be determined as of that date, and not as of late December 1982.

The Tax Court determined that the taxpayer’s arguments ignored Reg. §1.721-1(b)(1), which specifically states that a shift in capital from one partner to a service partner can occur subsequent to the formation of a partnership. Citing Mark IV Pictures, Inc. v. Comm’r, 969 F.2d 669 (CA8 1992), the Court noted that, in order to determine whether such a capital shift occurred, it was necessary to examine the effect on the taxpayer of a hypothetical liquidation of the partnership occurring immediately after the partners received their partnership interests. Because the limited partners did not receive their interests until late December 1982, the Court held that was the appropriate time at which to determine whether the limited partners shifted part of their capital to the taxpayer in return for services. If the partnership had been liquidated as of that time, the taxpayer would have been entitled to 1%, or a total of $80,808 in cash and negotiable installment notes. Thus, each limited partner shifted capital to the taxpayer.

The Court found this holding to be bolstered by the statements in the private placement memorandum that (1) a dilution of the limited partners’ investment would occur as a result of their giving the taxpayer a 1% interest in the capital and (2) the reason this shift occurred was to compensate the taxpayer. The record also established that the taxpayer did perform certain services for the partnership.

The Court then looked to see whether the transfer of the capital interest was conditioned on the completion of future services by the taxpayers because, if it was, the fair market value of that interest would have to be determined at the time such services were rendered. The Court held that, although the taxpayer was obligated to perform some minimal future services after the capital shift, the record did not establish that the transfer was conditioned on the performance of future services. Thus, the Court held the taxpayer should include $80,808 in income in 1982.

Finally, the taxpayer argued that the valuation of the interest was less than this amount because the interest was an unlimited liability general partnership interest and some of the value was based on installment notes which were uncollectible. The taxpayer, however, failed to offer any evidence that would have provided the Court with an informed, reasoned basis on which to find that the fair market value was less.

In the summer of 1984, the sole shareholder (Halle) of a corporate land developer learned about the existence of a land tract suitable for residential development located in Fairfax County, Virginia. The owners of the tract had submitted an application to rezone for increased development rights. In February 1985, Halle reached an agreement with the shareholders of the tract owner to purchase all of the stock. He then formed the taxpayer, a partnership, for purposes of acquiring the stock.

On March 8, 1985, the taxpayer and the stockholders entered into a stock purchase agreement whereby the partnership would pay $29 million for the stock of the tract owner. A $3 million downpayment, consisting of $2 million in cash and $1 million in a non-interest bearing promissory note, was paid on that date. The purchase agreement entitled the taxpayer to defer settlement, which was scheduled to occur on April 26, 1985, on a monthly basis until October 1, 1985, provided that the taxpayer did not default under the purchase agreement and it paid in advance $225,000 per month. The $225,000 monthly payment approximated a return on the unpaid purchase price of 10%. The agreement stated that, should the taxpayer fail either to settle or to pay the $225,000, then any monthly installment paid would be forfeited as liquidated damages and the parties would have no further rights or liabilities to each other.

In addition, the purchase agreement obligated the taxpayer to pay all rezoning costs incurred after March 15, 1985. However, the tract owner was obligated to continue to operate the land tract in the normal and usual manner and to pursue the land tract rezoning until settlement.

The taxpayer extended the settlement date by paying four payments of $225,000. Settlement finally occurred on August 23, 1985. The taxpayer treated these payments as nonemployee compensation sending Forms 1099-MISC to each of the tract owner’s stockholders. The sellers objected to the issuance of the forms by the partnership and treated the fees as additional sales proceeds paid for their stock. On its tax return, the taxpayer treated the payments as deductible interest.

The Court held that the payments were additional purchase price, not deductible interest, finding the taxpayer’s arguments unpersuasive.

First, the taxpayer argued that it had an unconditional and legally binding contractual obligation to pay the balance of the purchase price; therefore, the payments represented interest because they compensated the sellers for the delay in their receipt of the unpaid purchase price balance. The Service countered that the taxpayer merely had an option to purchase. The Court held that, although there might be circumstances where
an executory contract creates an unconditional obligation supporting an interest deduction, this contract did not create such an obligation. Instead, the Court found these circumstances to be similar to Midkiff v. Comm’r, 96 T.C. 724 (1991), and Kaempfer v. Comm’r, TC Memo 1992-19.

The taxpayer’s second argument was that substantially all of the benefits and burdens of ownership of the land tract were transferred as of the original settlement date, April 26, 1985, so that the payments were interest on debt arising under an executed contract of sale. The Court held that the taxpayer failed to demonstrate that it was the beneficial owner of the tract prior to the date of final settlement. The Court noted that, although the partnership was responsible for reimbursing the sellers for any rezoning costs incurred after March 1985, the sellers retained primary liability for such costs as well as for any mortgage debt which constituted a significant burden of ownership.

R. Koppen v. Comm’r, 70 TCM 72 (1995). On April 23, 1980, the taxpayer sold his entire leasehold interest in property located in Honolulu, Hawaii. Pursuant to the terms of that sale, the buyer was to make a downpayment at the time the sales contract was signed, monthly interest payments thereafter, and payment of the balance of the purchase price no later than April 23, 1983. On his 1983 tax return, the taxpayer elected to exclude his gain of $11,360 based on Sec. 121, I.R.C. In June 1987, the taxpayer purchased a leasehold interest in property in Kailua, Hawaii and began to use it as his principal residence. On January 5, 1988, he purchased the underlying land. In August 1990, he sold his entire interest. On his 1990 income tax return, he excluded $125,000 of gain pursuant to Sec. 121, I.R.C. from his return.

The taxpayer argued that, under Hawaiian law, he sold his interest in the Honolulu property in 1980, and not in 1983, and that he was not 55 years of age when that sale occurred. Thus, the 1983 election was invalid and no election was made in 1980. The Service argued that the taxpayer was not entitled to elect in 1990 because he was estopped under the duty of consistency from denying his previous election.

The Court agreed with the Service. The duty of consistency is an equitable doctrine that prevents a taxpayer from adopting a position for a particular year and, after the period of limitations has expired for that year, adopting a contrary position that affects his or her tax liability for an open year. The Court further noted that (1) the duty of consistency can apply to a taxpayer receiving a double tax benefit as a result of transactions which are not the same or related and (2) the mitigation provisions did not provide an adequate remedy for the Service.
S. Lawler v. Comm'r, 69 TCM 1699 (1995). This case had many issues, only one of which is related to real estate. In 1976, creditors of the taxpayer commenced an involuntary bankruptcy proceeding against him. In this proceeding, the Service asserted claims against the taxpayer for income tax liabilities for his taxable years from 1967 through 1978. In 1980, the taxpayer settled the tax issues with the Service by executing a tax settlement agreement, which was approved by the bankruptcy court and became effective on December 20, 1983. The agreement provided that all liabilities of the taxpayer and of his related entities for income taxes, interest and additions to tax for the 1969-1978 taxable years would be satisfied by the taxpayer's payment of $3 million in taxes, $2 million in interest, and additional interest of 11% on the unpaid balance of the $3 million tax liability. The taxpayer made a $1 million cash payment in 1984, and executed and delivered a $4 million note for the remaining principal and $2 million in interest. This note was secured by a deed of trust on the Lawler Farm. The taxpayer resided in a house built on a 39.8-acre parcel of the farm and used the remaining acreage in his farming business.

The taxpayer did not timely pay the Service under the agreement. The Department of Justice attempted to collect on the note beginning in 1988. The taxpayer paid $2 million on the principal of the note in June 1989, and paid interest of $3,020,740 in December 1989. The taxpayer reported his payment of the interest on his 1989 Schedule C as an ordinary and necessary business expense. In amended returns, the taxpayer asserted that the interest was deductible because it was qualified residence interest under Sec. 163(h), I.R.C., and that he was making a protective selection of the Lawler Farm as the "one other residence" defined in Sec. 163(h)(4)(A)(i)(II), I.R.C.

The Service argued that this interest was personal interest, and so was only 20% deductible in 1989. The Service further argued that this interest could not be qualified residence interest because the taxpayer designated the farm as his "one other residence" at, or after, the time that he petitioned the Court. The Court held that the timing of the taxpayer's selection did not defeat or otherwise lessen the validity of the selection. In addition, the note was secured by the residence from its making until its payment in full. Thus, the Court held that the taxpayer could deduct the interest as qualified residence interest.

T. Marcaccio v. Comm'r, 69 TCM 2420 (1995). In February 1984, the taxpayer and 11 other individuals formed a partnership for the purpose of developing a parcel of real property in Texas. The taxpayer was a general partner. The partnership borrowed $2,980,000 from a bank. The bank secured the property with a deed of trust and a security agreement. As additional
collateral, the bank required each partner personally to guarantee payment of a portion of the note principal. The taxpayer executed a guaranty in the amount of $336,000 in August 1984. In January 1986, the partnership borrowed an additional $300,000 from the bank. Again the bank required each partner personally to guarantee payment of a portion of the principal amount. The taxpayer executed a guaranty in the amount of $33,750.

The partnership was unable to develop the property and fell into default on the notes. In November 1986, the property was sold to the bank at public auction for $2,441,000. At the time of the foreclosure sale, the partnership owed the bank $3,280,000, the sum of the principal amount of each of the two promissory notes. Therefore, after the sale there remained a deficiency in the amount of $839,000. The partnership reported a long-term capital loss associated with the foreclosure in the amount of $471,499, of which the taxpayer was allocated $35,362. The return also allocated recourse liabilities to the taxpayer in the amount of $62,925, which represented his portion of the $839,000 deficiency.

In June 1987, the bank's attorneys sent a letter to the partnership stating that, unless payment was made of the $839,000 deficiency plus accumulated interest, a suit for collection would be filed. Suit was filed in early 1988 against the partnership and the partners. In March 1988, the taxpayer and the bank agreed to settle, with the taxpayer paying the bank a total sum of $31,250. In July 1988, the court dismissed the taxpayer from the suit. The taxpayer did not report any income from the discharge of indebtedness on his 1988 return.

The Service determined that the taxpayer had income from discharge of indebtedness in the amount of $31,675 -- the difference between his share of the deficiency ($62,925) and the amount paid ($31,250). The taxpayer was unable to prove satisfactorily that (a) the foreclosed property had a fair market value in excess of the debt outstanding; (b) the settlement constituted the compromise of a disputed debt; or (c) that the second guaranty was intended to replace the first guaranty.

U. **Moore v. Comm'r**, 68 TCM 660 (1994). On September 2, 1987, the taxpayer sold his interests in various partnerships to Porter, who already owned an interest in each of the entities sold, for $80,000 plus Porter's assumption of the taxpayer's obligation with regard to one of the partnership's debts. In connection with the sale, the other co-guarantors of the partnership's debt signed a waiver of contribution in favor of the taxpayer. At the time of sale, the taxpayer had a $420,066 negative capital account balance in the partnership with the debt. In November of 1987 and January of 1988, the partnership's creditor and the partnership entered into modification agreements
regarding the partnership debt. The taxpayer neither signed the agreements nor transferred any property to the creditor. On the taxpayer's return, he reported the negative capital account balances as long-term capital gain, but he characterized the income as income from discharge of indebtedness and offset the reported capital gain by claiming an exclusion from income pursuant to Sec. 108, I.R.C. According to the taxpayer, his share of partnership debt was not assumed by Porter, because Arizona law does not allow the debts of a partner to be assumed by a third party without the consent of the lender. Instead, it was discharged by the creditor after the September 1987 sale, when the creditor entered into the modification agreements which the taxpayer did not sign, thus terminating his obligation. The Court disagreed with the taxpayer, stating that he had misread Weiss v. Comm'r, 956 F.2d 2452 (CA11 1992) and Barker v. Comm'r, T.C. Memo 1983-643. The court found there was no discharge of indebtedness.

V. Moores v. Comm'r, 69 TCM 1797 (1995). On September 1, 1986, the taxpayer entered into a contract to purchase an office building located in Casper, Wyoming. As of this date, the building was subject to a lease which obligated the lessee to pay a rent which exceeded market rent until April 30, 1989. The purchase price for the property was $2,210,644. The various documents memorializing the sale did not purport to allocate the purchase price among the building, land, personal property or the lease.

The taxpayers allocated $932,715 of the total purchase price to the building and reported depreciation deductions computed under the straight line method over 19 years. At the same time, the taxpayers allocated $1 million to the premium value of the lease as a separate, depreciable asset, and began amortizing it over the 32-month remaining rental period. The Service disallowed the amortization deductions for the taxable years 1986 through 1989.

The Court noted that its position with respect to treating a lease as a separate depreciable asset was uniformly to reject the proposition that the premium value of a lease could be the subject of an amortization deduction under the circumstances presented. It noted that this position had been upheld by the Fourth Circuit in Schubert v. Comm'r, 286 F.2d 573 (CA4 1961). It did note that such position had been reversed in Comm'r v. Moore, 207 F.2d 265 (CA9 1953), but that appeal in this case would not lie in that Circuit. The Court held that the value of the lease (whether favorable or unfavorable) is reflected in the value of the property which it encumbers.

During 1988 and 1989, the taxpayer worked as an employee for some hospitals and medical clinics and as an independent contractor for others. He typically worked at one hospital or clinic one day and at a different hospital or clinic the next, working 8-hour shifts at each location. Because none of the hospitals or medical clinics provided taxpayer with an office, taxpayer set up an office in his apartment. He spent approximately 70% of his work time at the various hospitals and clinics and the other 30% of his work time in his home office. The time the taxpayer spent in this office was devoted primarily to reading medical publications, watching and listening to medical video and audio tapes, and maintaining the books and records relating to his medical practice.

After Soliman was decided, the Service stated, in Notice 93-12, 1993-1 C.B. 298, that home office deductions taken for years prior to 1992 would not be challenged if the taxpayer’s situation reasonably fell within either the example set forth in Prop. Reg. §1.280A-2(b)(3) or the example in Publication 587. The taxpayer argued that the example provided in Publication 587, involving an outside salesperson whose only office was in his home, was similar to his situation and should be controlling. The Court held, however, that the example relied on the fact that the salesperson spent a substantial amount of time in the office maintaining business records and making appointments. This was different from the taxpayer, inasmuch as he spent little time in his office maintaining the records relating to his medical practice. Thus, the taxpayer was not entitled to the deductions.

The decedent and her husband owned several properties, some jointly and some individually, which they began to transfer to their four children in equal shares, beginning in the late 1970s. The Service made adjustments to the estate tax return with respect to certain of these properties.

Prior to 1982, decedent and her husband owned a one-half interest in a shopping center, with the other one-half interest owned by two unrelated persons. Because of business disputes, these unrelated parties sought to liquidate their interest by sale to a corporation formed by decedent’s children to manage and operate properties. In September 1981, the unrelated parties sold their one-half interest to the corporation for a purchase price of $272,500. In February 1982, decedent and her husband transferred their one-half interest in the shopping center to their four children as tenants in common.

The Service determined that the market value of the interest transferred by decedent and her husband was $386,000 on the date of transfer so that decedent was determined to have made a
taxable gift to her children of $153,000 (50% less four annual $10,000 exclusions), which was treated as an adjusted taxable gift in calculating the taxpayer's estate tax. The taxpayer argued that the decedent's interest was worth $136,250 on the date of the transfer, because the other one-half interest in the shopping center was sold in an arms'-length transfer less than 5 months earlier for $272,500.

The Court held that the value of the decedent's interest was $136,250. In addition to noting certain problems with the Service's appraisal of the property, it determined that the third-party sale was valid evidence of fair market value because the unrelated parties were not under any compulsion to sell.

Fitch and Osgood Groves

In March 1985, the decedent executed quitclaim deeds for the transfer of two groves to her two daughters. However, these deeds were never delivered or recorded. Sometime after these deeds were executed, the decedent's two sons heard about the deeds. Believing they were entitled to the groves, the sons had deeds to the properties prepared. In June, shortly after the decedent's hospitalization for dizziness and fatigue, the sons took the deeds to their mother's home where they were executed. These deeds then were recorded.

In early 1986, when one of the daughters did not receive a real estate tax bill with respect to these groves, she discovered the existence of her brothers' deeds and informed her mother. In March 1986, a demand letter was sent to the sons from their mother stating that it had not been her intention to transfer the groves to her sons. The sons refused to reconvey the groves and her lawyer told her she would have to bring suit to recover the properties. In September 1986, the decedent was adjudicated incompetent. A bank was appointed guardian of the decedent's property, whereupon it retained an attorney to conduct an investigation into the circumstances surrounding the grove deeds. As part of this investigation, the groves were appraised at a fair market value as of April 28, 1987 for $3,265,000. The decedent died on May 31, 1987. In October 1987, the daughters, in their capacity as the estate's personal representatives, brought suit against their brothers for cancellation and rescission of the deeds on the grounds of undue influence, fraud and misrepresentation. In January 1988, the court held that the deeds were procured by undue influence and misrepresentation and that the deeds were void.

These groves were not reported on the estate tax return. Instead, a claim for recovery of real estate and for ancillary damages was reported with a date-of-death value of $1,226,522. This value was intended to represent a discount from the 1987 bank appraisal to account for the risk of an unsuccessful outcome.
in the litigation necessary to enforce decedent's claims and for the delays associated with such litigation. The risk discount taken was 50%. The Service determined that the fair market value of the decedent's interest at death was $3,265,000 and that the allowable discount on the property did not exceed $98,531, the total amount of attorney's fees and litigation costs incurred in resolving the dispute.

The Service's position was that, because decedent's transfer was judicially set aside, her estate must include the full value of the groves less costs to resolve the title dispute. The estate argued that, because of the circumstances surrounding the transfer, at the time of her death decedent only owned a cause of action for the recovery of the groves which must be discounted substantially.

The Court determined that decedent's interest in the groves at her death was worth something less than the full value of the groves and that the argument over what sort of interest she possessed was essentially academic. The Court held that an appropriate discount was 25%, rather than 50%, because the taxpayer's experts failed to consider how the facts affected the risks of litigation. The Court noted that it was troubled at how the decedent managed to reduce the value of the groves by making an invalid "gift", but believed these facts to be unusual. It characterized the use of this case as a basis for estate planning as extremely hazardous.

Y. Tollis v. Comm'r, __ F.3d __, 95-1 USTC ¶50,076 (CA6 1995). In 1958, the taxpayer purchased approximately 69 acres of land in Ohio. After subdividing the parcel and building a road through it, he built condominium and apartment complexes on parts of it. In 1979, the taxpayer decided to retire. When his son expressed no interest in developing the land, he sought buyers for the remaining undeveloped property. In January 1980, he negotiated an option contract to sell the remaining land. In 1983, after purchasing three of the nine parcels, the buyer cancelled the option contract. The taxpayer reacquired the three parcels and began seeking new buyers for the undeveloped land. He also developed some of these parcels. The Tax Court held that the taxpayer realized ordinary income from the sale of this property in various years because the property was held primarily for sale to customers in the ordinary course of business.

The taxpayer appealed, arguing that, while he was a real estate developer, he had never sold undeveloped land before. Thus, the sales could not be in the ordinary course of his business. The Sixth Circuit found this reasoning to be unpersuasive and affirmed the Tax Court in an opinion designated as not for publication. The Court stated that use of the taxpayer's reasoning, in many circumstances, would give a business a "free pass" to capital asset status the first time it
did something new. In this case, the taxpayer purchased the land intending to develop it and developed portions of it over the course of two decades. Absent objective contemporaneous facts showing a change of intent, the Sixth Circuit concluded that the property was not a capital asset.

Z. Von-Lusk, A California Limited Partnership v. Comm'r, 104 T.C. 207 (1995). The taxpayer, a partnership, was formed for the purpose of managing, holding and developing 278 acres of raw land. During 1988, 1989 and 1990, the years at issue, no physical activities with respect to the land occurred because the taxpayer was contesting (1) the county's development fee and (2) a number of conditions which had been imposed in 1989 at the time of tentative plat approval. During these years, the taxpayer engaged independent contractors to meet with government officials, obtain building permits and zoning variances, negotiate permit fees, perform engineering and feasibility studies and draft architectural plans. However, the land was used for agricultural purposes by tenant farmers. The Service's Final Partnership Administrative Adjustment disallowed interest expense, taxes and other administrative deductions based on the argument that the taxpayer was "producing property" under Sec. 263A, I.R.C., and so the expenses should be capitalized. After the initial pleadings were filed, the Commissioner conceded the interest disallowance.

The Court held that the expenses had to be capitalized under Sec. 263A, I.R.C. because the activities associated with the costs represented the first steps of development. In looking to the legislative history, the Court found that Congress (1) expected a single set of comprehensive rules to apply to the capitalization question and (2) needed "produce" to be defined broadly in order to give full effect to the capitalization provision. The Court stated that Congress meant to include as capitalized costs the preliminary, nonphysical steps of development.

One of the arguments that the taxpayer brought up was that property could not be "produced" causing the capitalization of direct and indirect expenses until its "production period" (the time at which interest begins to be capitalized) began. Under the interest capitalization rules, the production period begins when there is physical change to the land. The Court held that the interest capitalization rules of Sec. 263A(f), I.R.C. should be read narrowly, rather than expansively. The Court also found to be without merit the taxpayer's arguments that (1) "production" should be read consistently with Sec. 312(n)(1), I.R.C. (the adjustment to earnings and profits for construction period carrying charges) and (2) certain of the expenses at issue were specifically excluded from capitalization under Reg. §1.263A-1T(b)(2)(v)(A) and thus were deductible.
AA. *Walgreen Co. v. Comm’r*, 103 T.C. 582 (1994). The taxpayer operated retail drugstores throughout 30 states. The dispute pertained to depreciation deductions claimed by taxpayer with respect to certain real property leasehold improvements (Sec. 1250, I.R.C. leasehold improvements) made by the taxpayer between September 1, 1980 and August 31, 1984. The leasehold improvements in dispute consisted of (1) interior partitions made up of drywall, glass and metal; (2) miscellaneous millwork, carpentry, lumber, metals, steel and paint; (3) acoustic, drywall and plaster ceilings; (4) restroom accessories; (5) electric lighting fixtures; (6) interior floor finishings, including carpet, vinyl, rubber tile, ceramic tile, quarry tile and terrazzo tile; and (7) decor finishes, including wood trim, decorative steel work and simulated structures.

With respect to the leasehold improvements placed in service before January 1, 1981, the taxpayer claimed depreciation deductions under Sec. 167, I.R.C. under the ADR class life system, using a seven-year useful life for the property. For the property placed in service on or after January 1, 1981, the taxpayer took ACRS depreciation under Sec. 168, I.R.C. using a useful life of 10 years. The taxpayer calculated the useful lives based on its belief that the improvements were classified under ADR Class 57.0. For the years in question, ADR Class 57.0 included assets used in wholesale and retail trade, and personal and professional services.

The taxpayer argued that ADR Class 57.0 included certain items of Sec. 1250, I.R.C. property that did not constitute the structural shell of a building or an integral part thereof and that the leasehold improvements at issue met this criterion. The Service argued that the legislative intent behind the applicable depreciation Sections prevented Sec. 1250, I.R.C. property from being included in any ADR class unless such class explicitly contained Sec. 1250, I.R.C. property.

After examining the history of the ADR class system and the legislative changes made to the depreciation deduction during this time period, the Court held that Congress intended that the class life for categories of Sec. 1250, I.R.C. property had to be explicitly prescribed, and not merely by inference, particularly in light of Treasury’s difficulties in establishing workable class lives. Thus, the leasehold improvements were defined as 15-year real property because they did not have a class life. This determination was buttressed by the fact that if these improvements were classified as land improvements, they would still have been considered 15-year property.

AB. *Wiseman v. Comm’r*, 69 TCM 2564 (1995). The taxpayer reported on her 1989 income tax return a passive loss distributed to her from her 25% interest in Man O’War limited partnership (LP), and passive income distributed to her from her 25% interest
in the Richmond Road/Man O'War Joint Venture (JV). She aggregated the loss and the income. In 1982, JV had acquired an undeveloped tract of land (Land) which was leased to Man O'War general partnership (GP), whereupon GP constructed improvements and leased those improvements to third parties. (LP was a general partner in GP, owning 85% of the interests therein.) In 1989, more than 85% of the total unadjusted basis of the Land and the improvements owned by GP consisted of real property; and more than 30% of the total unadjusted basis of the Land and the improvements owned by GP consisted of depreciable property. Less than 30% of the unadjusted basis of property owned by JV with respect to its ownership of the Land consisted of depreciable property. The passive income claimed on the taxpayer's return reflected her distributive share of ground rents received by JV for the lease of the Land to GP. The passive losses reflected her distributive share (from LP, via its interest in GP) of the net loss incurred by GP from its leasing of the improvements to third parties.

The Service disallowed the aggregation of the income and the loss and recharacterized the income from JV as nonpassive income pursuant to Temp. Reg. §1.469-2T(f)(3). Pursuant to this Temporary Regulation, if less than 30% of the unadjusted basis of the property used or held for use by customers in a rental activity is subject to the allowance for depreciation, an amount of gross income from the activity equal to the taxpayer's net passive income from the activity shall be treated as not from a passive activity. The taxpayer argued that she could aggregate because the partnerships' undertakings were one activity inasmuch as they constituted an appropriate economic unit.

The Court held that the taxpayer could not aggregate her income and loss. They determined that the application of the passive loss rules hinges on a determination of a taxpayer's "undertakings" and "activities". Because the operations of JV, GP and LP were not owned directly by the same person, nor was the taxpayer a direct owner of any of these undertakings, each partnership was a separate undertaking pursuant to Temp. Reg. §1.469-4T(c)(2)(v). Thus, each undertaking was a separate activity unless such undertakings could be aggregated. The Court held that the undertakings could not be aggregated as rental activities under Temp. Reg. §1.469-4T(k)(2)(i). This was because Temp. Reg. §1.469-4T(k)(6) states that rental activities where less than 30% of the basis of rented property is subject to depreciation cannot be aggregated with other rental activities. Since JV was such an activity, it could not be aggregated with GP.