Recent Developments in Federal Income Taxation

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RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

By

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This recent developments outline discusses, and provides context to understand, the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide my co-author the opportunity mock our elected representatives. The outline focuses primarily on topics of broad general interest [to the two of us, at least] — income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services. Please read this outline at your own risk; my co-author and I take no responsibility for any misinformation in it, whether occasioned by our advancing ages or our increasing indifference as to whether we get any particular item right.

I. ACCOUNTING

A. Accounting Methods


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

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makes the change from the four-year to the one-year adjustment period [for negative adjustments under §
481(a)] available to those applications pending on 3/14/02 with respect to years ending before 12/31/01
to defer the year of change to the first year ending on or after 12/31/01, and allows similar relief for those
with approved applications who elect to defer the year of change on or before 12/13/02.

c.  And just a little more for taxpayers in the name of simplicity. REG-142605-02, Administration Simplification of Section 481(a) Adjustment Periods in Various Regulations, 68 F.R. 25310 (5/12/03). Proposed amendments to regulations under §§ 263A and 448 to allow taxpayers changing a method of accounting to take any § 481(a) adjustments over the same number of taxable years

3.  Taxpayer’s change in its cost recovery period is not a change of accounting method. Brookshire Brothers Holding, Inc. v. Commissioner, 320 F.3d 507, 91 A.F.T.R.2d 2003-629, 2003-1 U.S.T.C. ¶50,214 (5th Cir. 1/29/03), aff’g T.C. Memo. 2001-150 (6/22/01). The taxpayer filed amended returns changing its cost recovery period for convenience stores from 31.5 and 39 years to 15 years, as permitted by a Specialized Program Coordinated Issue Paper. The IRS asserted that the change required consent under § 446(e). The Fifth Circuit affirmed the Tax Court’s (Judge Nims) holding that Treas. Reg. § 1.446-1(e)(2)(ii)(b) [providing that a change of useful life is not an accounting method change] applied to changing the § 168 ACRS cost recovery period. Although it did not need to do so to decide the case, the Court of Appeals went a step further and reasoned that even if the switch in cost recovery periods was a change in accounting methods, for the Commissioner to have challenged the switch in cost recovery periods, he would have had to do so for the first year in which the switch had been made, before the statute of limitations had expired on that year.

4.  Another case holding that a reclassification of MACRS property is not a change of accounting method. Green Forest Manufacturing Inc. v. Commissioner, T.C. Memo. 2003-75 (3/14/03). The Tax Court (Judge Nims) followed Brookshire Brothers Holding, Inc. v. Commissioner, 320 F.3d 507, 91 A.F.T.R.2d 2003-629, 2003-1 U.S.T.C. ¶50,214 (5th Cir. 1/29/03), aff’g T.C. Memo. 2001-150 (6/22/01); in holding that reclassification of MACRS property used outside the U.S., which resulted in a changed recovery period and method, was not a change of accounting method. The court declined to follow Rev. Proc. 96-31, §2.01, 1996-1 C.B. 714, providing that a change from not allowing depreciation to allowing depreciation is a change of accounting method, because the guidance did not contain any reasoning and thus was not entitled to deference under United States v. Mead Corp., 533 U.S. 218 (2001).

- Note that the relief provided by Rev. Proc. 96-31, updated by Rev. Proc. 2002-9 and Rev. Proc. 2002-19, permits a deduction for all prior allowable depreciation that was erroneously not taken by the taxpayer with respect to an asset owned by the taxpayer. This relief is available to taxpayers who file a Form 3115 for change of accounting method with their income tax return for the year of sale, or, preferably, at an earlier date.

B.  Inventories

1.  Rev. Proc. 2003-51, 2003-29 I.R.B. 121 (6/25/03). This revenue procedure provides three basic methods for valuing inventory items acquired when a taxpayer purchases the assets of a business for a lump sum or a corporation acquires the stock of another corporation and makes a § 338 election: (1) the Replacement Cost Method, (2) the Comparative Sales Method, and (3) the Income Method. However,”[v]aluing inventory is an inherently factual determination *** [and] the three valuation methods outlined above serve only as guidelines for determining the fair market value of inventories.”

C.  Installment Method

D.  Year of Receipt or Deduction

1.  They may be losers on the diamond, but not at the Tax Court. Tampa Bay Devil Rays, Ltd. v. Commissioner, T.C. Memo. 2002-248 (9/30/02). The Tampa Bay Devil Rays collected advanced season ticket payments for the 1998 baseball season, their first “major league” season, in 1995 and 1996. In those years the Devil Rays were conducting minor league baseball activities — many sports fans think the Devil Rays still are conducting only minor league baseball activities — and deducted the expenses, but did not include the advance season ticket receipts. Judge Swift rejected the Commissioner’s argument that under Schlude v. Commissioner, 372 U.S. 128 (1963), the Devil Rays
were required to include the prepayments, and applied Artnell Co. v. Commissioner, T.C. Memo. 1970-
85, on remand from 400 F.2d 981 (7th Cir. 1968), because, since the receipts would have had to be
refunded if the Devil Rays did not play the season, the facts of the case fit within the narrow Artnell
exception to the Schluke principle.

2. **“Hello, I’m from the IRS, and I’m here to help you.” — And this time it really is true.** Rev. Proc. 71-21 deferral of prepaid income rules loosened. Notice 2002-79, 2002-50 I.R.B. 964 (12/16/02). This notice is a proposed revenue procedure to modify and supersede Rev. Proc. 71-21, 1971-2 C.B. 549. The proposed revenue procedure would expand the availability of deferred reporting of advance receipts that are not accrued for financial accounting. First, certain income from other than services would be eligible: (1) sales of goods not covered by Reg. § 1.451-5(b)(1)(ii); (2) rents for the use of property in connection with the provision of services, e.g., hotel rooms, recreational facilities, cable converter boxes; (3) royalties for intellectual property; (4) warranties of services or items in the three preceding categories; (5) subscriptions not subject to §455; and (6) memberships not subject to § 456. Second, payments would be eligible even if performance might extend beyond the next succeeding year, although deferral could not extend beyond the next succeeding year. The revenue procedure will not apply to rents generally, insurance premiums, or payments with respect to financial instruments. However, the Notice states that the Treasury Department will propose amendments to Reg. § 1.61-8(b) to permit deferral of prepaid rents under the principles of the proposed revenue procedure.

3. **But no deferral for advance rents.** REG-151043-02. Rents and Royalties, 67 F.R. 77450 (12/18/02). The Treasury Department has published a proposed amendment to Reg. § 1.61-
8(b) that expressly require current inclusion of advance rent receipts, regardless of the period covered or the taxpayers method of accounting, except as otherwise provided in § 467 or in other published guidance.

4. **Another taxpayer friendly accounting method ruling.** Rev. Rul. 2003-3, 2003-2 I.R.B. 252 (1/13/03). A state or local income or franchise tax refund resulting from NOL carrybacks is includible by an accrual method taxpayer in the earlier of the year in which the taxpayer receives payment or notice that the refund claim has been approved. Rev. Ruls. 65-190, 1965-2 C.B. 150, and 69-372, 1969-2 C.B. 104, which held that the refund is accrued in the year of the loss, are revoked. The IRS reasoned that review and approval of the refund claims by state authorities is not merely ministerial, but substantive. [This follows the holding in Doyle, Dane, Bernbach, Inc. v. Commissioner, 79 T.C. 101 (1982), nonacq., 1988-2 C.B. 1, acq., 2003-2 I.R.B. 251 (1/12/03).] Automatic change of accounting method is available.

5. **This year or next year? Only the IRS knew, and now they are telling us.** Rev. Rul. 2003-10, 2003-3 I.R.B. 288 (1/21/03). This ruling addresses the accrual under the all events test of § 451 of income from goods sold when an accrual method taxpayer’s customer disputes its liability under certain circumstances: (1) If the taxpayer overbills a customer due to a clerical mistake in an invoice and the customer discovers the error and, in the following taxable year, disputes its liability for the overbilled amount, then the taxpayer accrues gross income in the taxable year of sale for the correct amount; (2) A taxpayer does not accrue gross income in the taxable year of sale if, during the taxable year of sale, the customer disputes its liability to the taxpayer because the taxpayer shipped incorrect goods; (3) A taxpayer accrues gross income in the taxable year of sale if the taxpayer ships excess quantities of goods and in the next year the customer agrees to pay for the excess quantities of goods.

- The IRS has requested comments on the application of § 451 to a situation in which a taxpayer ships defective products to a customer that discovers the defect in the next taxable year and disputes its liability: (1) Does the taxpayer have a fixed right to income under § 451 in the taxable year of sale? (Compare Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26 (1988), with Celluloid Co. v. Commissioner, 9 B.T.A. 989 (1927), acq. VII-1 C.B. 6); (2) Does the taxable year concept require the taxpayer to accrue income in the taxable year of sale because the dispute did not arise until the next taxable year?

6. **Taxpayer got the deduction, but not § 1341 relief.** Cinergy Corp. v. United States, 55 Fed. Cl. 489, 91 A.F.T.R.2d 2003-1229 (3/10/03). The Court of Claims held that § 1341 did not apply to repayments to customers of utility charges [additional charges to cover deferred taxes] that were determined by regulatory authorities in subsequent years to have been excessive. The Court accepted the IRS’s view [see Rev. Rul. 58-226, 1958-1 CB 318; Rev. Rul. 67-48, 1967-1 CB 50] that when the taxpayer's right to an income item was absolute in the year of inclusion but was undermined by subsequently arising facts, § 1341 does not apply. Section 1341 applies only when the taxpayer had
merely an “apparent” right to the income item. Thus, although the repayments were deductible, no rate arbitrage relief was available.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. Maybe the Raiders would have won the Super Bowl if had been played in the Ninth Circuit’s courtroom. Milenbach v. Commissioner, 318 F.3d 924, 91 A.F.T.R.2d 2003-818 (9th Cir. 2/6/03), rev’g in part and aff’g in part 106 T.C. 184 (1996). The taxpayer was a partner in the Oakland/Los Angeles/Oakland Raiders. The partnership received a $6.7 million nonrecourse loan from the Los Angeles Coliseum Commission as part of a package of inducements to move the Raiders from Oakland to Los Angeles. The loan was repayable only out of net rents received by the Raiders from leases by the Raiders of luxury skyboxes in the Los Angeles Coliseum and was secured only by the suites to be constructed. At the time the loan was made, there were no such skyboxes in the Coliseum. The Raiders partnership was required by the agreement to construct the skyboxes “as soon as practicable as determined by the partnership in its reasonable discretion, having in mind considerations deemed important or significant to the partnership.” In fact, the skyboxes were never constructed, and the Tax Court found that there was no evidence that the Coliseum Commission intended to enforce the requirement that they be constructed. Reasoning that this standard for determining when the skyboxes were to be constructed “gave the Raiders great latitude in timing the construction,” which amounted to “unlimited discretion,” the Tax Court found that the obligation to construct the skyboxes to be illusory. Thus, because the Raiders’ obligation to repay the loan was conditional, the Raiders were required to include the funds in gross income upon receipt. On another related issue, the Tax Court held that $10 million received by the partnership as the first disbursement on a $115 million nonrecourse loan from the City of Irwindale, made as a part of a package to lure the Raiders to move from the Los Angeles Coliseum, was a true loan even though the loan agreement relieved the Raiders from any obligation to repay the $10 million if the City of Irwindale failed to advance the remaining funds or to perform certain other acts toward construction of a stadium as required by the loan agreement. At the time the funds were received, they were not under the Raiders’ complete dominion and control. The Raiders’ obligation to repay was not conditional on their own actions, but could be cancelled by a condition subsequent that was within the lender’s control. When the obligation was cancelled in the following year, however, the Raiders realized $10 million of discharge of indebtedness income.

   • With respect to the L.A. Coliseum Commission loan, the Ninth Circuit (Judge Tashima) reversed, finding that “the Raider’s broad discretion in the timing of the construction of the suites did not make the contract illusory. Under California law, an obligation under a contract is not illusory if the obligated party’s discretion must be exercised with reasonableness or good faith. ... Here the Raiders were required to exercise their discretion reasonably and nothing in the [agreement] indicates that construction of the suites was optional.”

   • The taxpayer’s victory might just be one of timing. The Ninth Circuit’s opinion points out that when the Los Angeles Coliseum obligation was extinguished [in 1990] the partnership realized COD income. [We wonder, did the Commissioner ask for a waiver of the statute of limitations on that year?]

   • As far as the Irwindale loan was concerned, the Ninth Circuit reversed the holding that COD was realized by the Raiders in 1988 as “clearly erroneous,” because the Tax Court had relied solely on the grounds that a state statute passed in 1988 prevented performance by the City under the plan as proposed. The court of appeals reasoned that under California law the debt might not have been discharged until a subsequent year and remanded the case for a “practical assessment of the facts and circumstances relating to the likelihood of payment.” According to the Ninth Circuit, the debt was not discharged until “when, as a practical matter, it became clear that Irwindale would not be able to fund the entire loan and that the stadium would not be built.”

   • The Commissioner did receive a consolation prize from the Ninth Circuit when the court of appeals affirmed the Tax Court’s decision that damages received by the partnership in a suit against the City of Oakland for inverse condemnation of the Raiders team were taxable as damages in lieu of lost profits; although settlement agreement stated that its purpose was to resolve a claim involving “restoration of lost franchise value,” the taxpayer’s damages study indicated that claim was based on lost profits.

interest earned thereon) received by a public utility company under a fixed fuel factor scheme instituted by state regulatory authorities [for the benefit of customers, by avoiding large fluctuations in monthly bills] were not includible in gross income under the claim of right doctrine because taxpayer did not have complete dominion, but was obligated to repay or credit the customers accounts. The court followed Houston Industries, Inc. v. United States, 125 F.3d 1442 (Fed. Cir. 1997), which also involved fuel surcharges, and distinguished Iowa Southern Utilities Co. v. United States, 841 F.2d 1108 (Fed. Cir. 1988), involving a construction surcharge, on the grounds that in that case – as opposed to this case – there was no “unequivocal contractual, statutory, or regulatory duty to repay.”

3. **Tax-free subsidies for environmentalist landowners.** Rev. Rul. 2003-59, 2003-24 I.R.B. 1014 (6/16/03). All or a portion of cost share payments received under the Conservation Reserve Program — a USDA program under which landowners receive 50 percent of the cost of establishing certain practices for soil and water conservation, wetland establishment and restoration, and reforestation — is eligible for exclusion under § 126.

4. Congress might have changed one of the holdings of Gitlitz,¹ but the Treasury put another one in the regulations. T.D. 9080, Reduction of Tax Attributes Due to Discharge of Indebtedness, 68 FR 42590 (7/21/03). The Treasury has promulgated Temp. Reg. §§ 1.108-7T and 1.1017-1T(b)(4), dealing with reduction in tax attributes under §§ 108(b) and 1017 when COD income is excluded from income under § 108(a)(1)(A)-(C). Examples (and the preamble) indicate that the tax liability for the year of discharge first must be determined without any reduction in attributes in order to identify the amounts, if any, of the tax attributes that will be reduced. “This ordering rule affords the taxpayer the use of certain of its tax attributes described in section 108(b)(2), including any losses carried forward to the taxable year of discharge, for purposes of determining its tax for the taxable year of discharge, before subjecting those attributes to reduction.” Basis reductions under § 1017 occur at the beginning of the taxable year following the year in which the discharge occurred. If a § 381 transaction ends a taxable year in which the distributing or transferor corporation excluded COD income under § 108(a), the basis of the property acquired by the acquiring corporation reflects the reduction under § 1017.

**B. Deductible Expenses versus Capitalization**

**INDOPCO aftermath:** “Deductions are exceptions to the norm of capitalization.”

(Blackmun, J.)

1. **Kudos from taxpayers; pans from professors.** Treasury abandons the future benefits test of **INDOPCO** — Long live the separate and distinct asset test. Or, do the proposed regulations go beyond the separate and distinct asset test and interpret **INDOPCO** in a more efficient way? REG-125638-01, Guidance Regarding Deduction and Capitalization of Expenditures, 67 F.R. 77701 (12/19/02). The Treasury has published the proposed **INDOPCO** regulations [Prop. Reg. § 1.263(a)-4] that will deal comprehensively with the capitalization of expenditures that relate to intangible assets and “future benefits.” They are intended to provide bright-line rules to make the standards based approach to capitalization articulated by the Supreme Court in **INDOPCO** more administrable.

a. **Capitalization is an exception to the norm of deductibility.** Under the proposed regulations, only expenditures incurred to (1) acquire, create, or enhance an intangible asset, (2) facilitate the acquisition, creation, or enhancement of an intangible asset, (3) “facilitate ... a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization,” or (4) which are otherwise identified by the IRS in prospectively effective published guidance, must be capitalized.” The term “separate and distinct intangible asset” is limited to “a property interest of ascertainable and measurable value in money’s worth that is subject to protection under applicable state or federal law and the possession and control of which is intrinsically capable of being sold, transferred, or pledged (ignoring any restrictions imposed on assignability).” The only category of expenses not related to a separate and distinct asset subject to capitalization under the proposed regulations is costs to “facilitate ... a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization.” This category includes only fact patterns analogous to the narrow fact pattern in **INDOPCO** and a number of cases involving similar issues that followed **INDOPCO**. Transaction costs incurred by a corporation to defend against a hostile takeover are not required to be

¹ Gitlitz v. Commissioner, 531 U.S. 206 (2001). See, Job Creation and Worker Assistance Act of 2002, which reverses the result of **Gitlitz** by providing that excluded cancellation of indebtedness income of S corporations does not result a § 1366 adjustment to the basis of stock owned by the shareholders.
capitalized, because they do not facilitate an acquisition. However, expenses incurred to thwart a hostile acquisition by merging with a white knight must be capitalized

* The proposed regulations provide two very important exceptions to the rule requiring capitalization of transaction costs.

First, under a “simplifying convention” that is in fact a major substantive rule, the regulations provide that compensation paid to employees and the employer’s associated overhead are never capitalized. This provision rejects the Tax Court decisions to the contrary and follows the two recent court of appeals decisions reversing the Tax Court [Norwest Corp. v. Commissioner, 112 T.C. 89 (1999), rev’d sub nom., Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000); PNC Bancorp, Inc. v. Commissioner, 110 T.C. 349 (1998), rev’d, 212 F3d 822 (3d Cir. 2000); Lychnk v. Commissioner, 116 T.C. 374 (2001)], and adopts a rule for dealing with intangible assets that is very different from the treatment of transaction costs with respect to tangible assets, which always must be capitalized under either or both of §§ 263(a) or 263A.

Second, the proposed regulations provide an exception that permits *de minimis* transaction costs — defined as costs that do not exceed $5,000 per transaction (not per payee) — to be currently deducted. Because this rule is coupled with an elective average cost pooling method, the *de minimis* rule is subject to substantial manipulation and can result in current deductions for very significant transaction costs.

* The preamble explains that the IRS and Treasury Department might in the future identify expenditures that are not listed in the regulations, but for which capitalization is nonetheless appropriate. Capitalization of non-listed expenditures will be required, however, only if (and after) they have been identified in published guidance. Unless an expenditure relating to an intangible asset is listed in the regulations or in such subsequently published guidance, capitalization will not be required and a current deduction will be allowed. Thus, under the proposed regulations, capitalization thus will become an exception to the norm of deducting expenditures.

b. The “whether and which” test shall too pass. The proposed regulations abandon the “whether and which” standard in Rev. Rul. 99-23, 1999-1 C.B. 998, for determining the line between expenditures subject to § 195 and those that are inherently capital as costs of the acquisition of the business itself. Instead, under a “bright-line rule” expenses incurred in the process of pursuing the acquisition of a trade or business (whether the acquisition is structured as an acquisition of stock or of assets and whether the taxpayer is the acquirer or the target in the acquisition) must be capitalized only if they are “inherently facilitative” of the acquisition or if they relate to activities performed after the earlier of the date a letter of intent (or similar communication) is issued or, if the taxpayer is a corporation, the date the board of directors approves the acquisition proposal. The proposed regulations specifically identify expenditures that are “inherently facilitative,” such as, amounts relating to determining the value of the target, drafting transactional documents, or conveying property between the parties. Under this bright-line rule, expenditures that do not facilitate the acquisition are not capitalized as costs of the business, and, instead, are subject to § 195.

c. Depreciation on intangibles with unascertainable useful lives. The proposed regulations would permit amortization of the basis of intangibles that do not have readily ascertainable useful lives and for which a specific amortization or depreciation period is not specified in the Code or regulations, and for which amortization or depreciation is not proscribed. [Prop. Reg. § 1.167(a)-3(b)] Unless the IRS provides a different amortization period by published guidance, the “safe-harbor” amortization period is fifteen years, using a straight-line method with no salvage value. Thus, for example, an amount paid to obtain a trade association membership of indefinite duration would be amortizable over fifteen years. The amortization rule does not apply to intangible assets acquired from another party or to self-created financial interests, but these intangibles may be amortizable under § 197 or under other provisions of the Code or regulations. Intangibles that have readily ascertainable useful lives are amortized over those lives. Capitalized costs of a corporate restructuring, reorganization or acquisition of equity capital are not amortizable.

d. The 12-month rule for prepaid expenses. The proposed regulations require that prepaid expenses be capitalized; but expenditures to create or enhance intangible rights or benefits that do not extend for more than twelve months after the expenditure is incurred are not required to be capitalized. Prepaid expenses covering a period of more than twelve months would continue to be capitalized in full and deducted ratably over the period benefited. When determining the duration of a right, renewal periods must be taken into account if the facts and circumstances indicate a reasonable expectancy of renewal. For accrual method taxpayers, however, the scope of the ability to deduct...
prepayments under the “12-month rule” in the proposed regulations is limited by the economic performance requirement of § 461(h), which under the proposed regulations trumps the “12-month rule.”

e. Not so fast, [say] Fernandez (and Keyso)! IRS officials stated on 5/14/03 that parts of the proposed INDOPCO regulations are being reconsidered [to be even more taxpayer friendly]. 2003 TNT 94-2.

2. Go ahead and deduct the cost of asbestos removal – at least as long as you don't change the building's use. Cinergy Corp. v. United States, 55 Fed. Cl. 489, 91 A.F.T.R.2d 2003-1229 (3/10/03). The Court of Federal Claims allowed a § 162 deduction for the cost of removing and encapsulating deteriorating fireproofing material that contained asbestos fibers. The fireproofing material did not create a problem for years, but as it deteriorated the danger of the asbestos circulating in the offices increased. The work prevented the asbestos from crumbling or circulating. In allowing the deduction, the court applied the test applied by the Sixth Circuit in United Dairy Farmers, Inc. v. United States, 267 F.3d 510 (6th Cir.2001), and found all of the elements to be met.

[T]hree elements must be satisfied for a valid deduction under § 162 for environmental cleanup costs: first, the taxpayer contaminated the property in its ordinary course of business; second, the taxpayer cleaned up the contamination to restore the property to its pre-contamination state; third, the cleanup did not allow the taxpayer to put the property to a new use.

The court distinguished United Dairy Farmers, Inc., in which the taxpayer acquired the property after it had been contaminated, and Dominion Resources, Inc. v. United States, 219 F.3d 359 (4th Cir. 2000), in which the environmental remediation adapted the property for a different use.

• Note, however, the possibility of deductibility of cleanup costs under § 198 if the site is certified by the state.

3. Would you like to fly on a jet without its engines? Fedex Corporation v. United States, 91 A.F.T.R.2d 2003-1940 (W.D. Tenn. 4/7/03). The district court denied the taxpayer's motion for summary judgment that expenditures for its off-wing engine maintenance program were deductible repairs under Reg. § 1.162-4. The court found that there was a genuine issue of fact regarding whether the appropriate unit of property for measuring whether the expenditures added value or materially prolonged life was (1) the entire aircraft, as argued by Fedex, or (2) the jet engines and auxiliary power units, as argued by the government. The court concluded that there is no “entire vehicle” rule of law requiring that repairs be measured against the entire vehicle rather than against components.

C. Reasonable Compensation

1. The Commissioner at least has to give it the “good old college try” if he expects to win. Devine Brothers, Inc. v. Commissioner, T.C. Memo 2003-15 (1/16/03). Judge Cohen upheld the taxpayer corporation's compensation deduction in full. The taxpayer made a prima facia case for reasonableness. The salary was within the range paid to similarly situated executives. The Commissioner provided no evidence to the contrary and failed to explain how he calculated the disallowed portion. Under either a traditional multi-factor test or the Exacto Spring [196 F.3d 833 (7th Cir. 1999)] hypothetical investor test, the result was the same.

2. Haffner's Service Stations Inc. v. Commissioner, 326 F.3d 1, 2003-1 U.S.T.C. ¶50,333 (1st Cir. 3/31/03). Corporation's payments to two officers [treasurer and assistant treasurer, who were also wife and husband] were not reasonable compensation. The corporation was founded by treasurer's parents and was run by one of their five children. Judge Boudin selected a multifactor test over the Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999), single factor independent investor test based on the facts and circumstances of this case: Return on equity, while high, was declining in recent years, and the roles played by the two officers was relatively modest.

3. An old-fashioned multi-factor reasonable comp analysis. Brewer Quality Homes, Inc. v. Commissioner, T.C. Memo 2003-200 (7/10/03). In an case appealable to the Fifth Circuit, the Tax Court (Judge Chabot) applied a traditional multi-factor analysis, based on the factors enumerated in Ownesby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315 (5th Cir. 1987), to determine the portion of bonus payments to the president of a corporation, all of the stock of which was owned by the president and his wife, that was reasonable compensation. Judge Chabot observed that the “independent investor test” is a “lens through which the entire analysis should be viewed,” citing Dexsil Corp. v. Commissioner, 147 F.3d 96, 100-101 (2d Cir.1998), and that “[d]iscerning the intent behind the payments also presents a factual question to be resolved within the bounds of the individual case.”

D. Miscellaneous Expenses

1. Only half the cost of Mint Juleps & country ham with beaten biscuits is deductible. Churchill Downs v. Commissioner, 307 F.3d 423, 90 A.F.T.R.2d 2002-6615, 2002-2 U.S.T.C. ¶ 50,691 (6th Cir. 10/8/02), affg 115 T.C. 279 (9/26/00). The Sixth Circuit (Judge Siler) upheld the Tax Court's decision (Judge Laro) that § 274(n) limited to 50% of the cost Churchill Downs' deduction for the expenses of entertainment [the Kentucky Derby sport of Kings Gala, press receptions, hospitality tents, winners parties, etc.] in connection with the Kentucky Derby, the Breeders' Cup, and other major horse races. Although Churchill Downs was in the “entertainment business” the expenses for the functions were not part of its entertainment product, which was horse racing. Nor were the costs of entertainment available to the public [§ 274(n)(2), (e)(7) exception] or sold to customers [§ 274(n)(2), (e)(8) exception] deductible because the functions were by invitation only and not open to the public. The Court of Appeals reasoned that the expenses were “entertainment” under Reg. § 1.274-2(b)(1)(ii) because:

[T]he purpose of the galas and dinners was not to make Churchill Downs' product directly available to its customers or to provide them with specific information about it, but rather to create an aura of glamor in connection with the upcoming races and generally to arouse public interest in them. In this regard, the dinners, brunches, and receptions at issue most closely resemble the example [in Reg. § 1.274-2(b)(2)(ii)] of a fashion show held for the wives of appliance retailers, and are best characterized not as a product introduction event used to conduct the taxpayer's business, but as pure advertising or public relations expenses.

- The Court of Appeals then rejected the taxpayer's argument that its business was “entertainment” generally

Although Churchill Downs argues, as any business that depends on advertising may, that it made money as a result of these publicity events, this does not change their nature as something distinct from what was actually sold. The Commissioner puts it succinctly: “taxpayers were in the horse racing business, not the business of throwing parties.” Accordingly, it is inappropriate to characterize these non-race events as Churchill Downs' “product.”


a. Subsidiary insurance company. Rev. Rul. 2002-89, 2002-52 I.R.B. 984 (12/30/02). This ruling promulgates a safe harbor and a rocky shoal for deducting insurance premiums to licensed domestic captive insurance subsidiaries. In a situation in which 90 percent of the insurance subsidiary’s premiums, on both a gross and net basis, are derived from its parent, the IRS concludes that there is no “risk shifting and risk distribution,” and thus no “insurance” or deductible insurance premiums. On the other hand, in a situation in which less that 50 percent of the insurance subsidiary’s premiums, on both a gross and net basis, are derived from its parent and the remainder are derived from unrelated insureds, and all transactions between the related taxpayer and insurance company meet an arm's length standard, the IRS concludes that there is “risk shifting and risk distribution,” and thus there is “insurance” and deductible insurance premiums.

b. Sibling insurance company. Rul. 2002-90, 2002-52 I.R.B. 985 (12/30/02). This ruling blesses the deduction of insurance premiums paid to a sibling licensed domestic insurance company, even though it insures no risks outside the group, where all parties conduct themselves in a manner consistent with insurance arrangements between unrelated parties. The ruling postulates twelve operating subsidiaries, each of which represents between five and fifteen percent of the risks insured by the insurance company member. The ruling follows Humana Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989) and Kiddie Industries, Inc. v. United States, 40 Fed. Cl. 42 (1997), and distinguishes Malone & Hyde, Inc. v. Commissioner, 62 F.3d 835 (6th Cir. 1995).
c. **Group captive.** Rev. Rul. 2002-91, 2002-52 I.R.B. 991 (12/30/02). A small group of unrelated businesses involved in a highly concentrated industry facing significant liability hazards, and required by law to maintain adequate liability insurance coverage, formed “group captive” insurance coverage that provided insurance only to its owners – its only activity. The group captive was adequately capitalized, operated separately from its owners, none of which owned more than fifteen percent or had more than fifteen percent of the vote. No owner’s individual risk insured by the group captive exceeded fifteen percent of the total insured risk insured. Premiums were actuarially determined using recognized actuarial techniques, and were based, in part, on commercial rates, and claims were investigated before payment. There was a real possibility that an insured owner would sustain losses in excess of the premiums paid, and no insured owner would be reimbursed for excess premiums paid. On these facts, the IRS ruled that the contracts issued by the group captive to its owners were insurance and the premiums were deductible under § 162. The group captive was taxed as an insurance company.

3. **Without a debt, there’s no interest.** Indeck Energy Services, Inc. v. Commissioner, T.C. Memo. 2003-101 (4/11/03). Indeck Energy Services, Inc. (“Indeck”) fired Polsky in 1990 and in January 1991 an arbitrator ordered Indeck to pay Polsky $15,030,000 to repurchase his shares of Indeck stock. Indeck appealed, and the case was settled in 1994 pursuant to the following agreement:

Indeck *** agrees to purchase *** the thirty (30) shares of *** stock *** for a price computed as follows (“Purchase Price”): (i) *** $501,000 per share, for a total of *** $15,030,000; plus (ii) an amount determined by Ten Percent (10%) per annum on the amount in (i) from January 31, 1991 through April 13, 1994 for a total of *** $4,809,600; plus (iii) an amount determined by interest on the amount in (i) at *** [the Federal funds rate] between April 14, 1994 and May 9, 1994, for a total of *** $47,321.85. The total Purchase Price of *** $19,886,921.85 shall be paid *** at the Closing.

Polsky treated the full $19,886,921.85 as the amount realized on the stock. Indeck treated $15,030,000 as the price of the stock and deducted the remaining $4,856,922 as interest. The Tax Court (Judge Gale) held that no portion of the $19,886,921 constituted interest on two alternative grounds: First, the evidence, including Indeck’s failure to issue Polsky a Form 1099 for interest, indicated that the parties intended the entire amount to be the stock purchase price. Second, until the settlement agreement was signed, there was no indebtedness within the meaning of § 163(a) on which interest could accrue – “it was not paid with respect to an existing, legally enforceable obligation for the payment of a principal sum, nor was the amount of the obligation fixed as of the date the purported interest began to accrue.” The court distinguished Halle v. Commissioner, 83 F.3d 649 (4th Cir.1996), rev’g on other grounds Kingstowne v. Commissioner, T.C. Memo.1994-630, and Dunlap v. Commissioner, 74 T.C. 1377 (1980), rev’d. on other grounds, 670 F.2d 785 (8th Cir.1982), on the ground that in both of those cases, “there was agreement between the purported debtor and creditor as to the amount of the obligation and its due date, as of the time the purported interest began to accrue.” In contrast, “Indeck’s obligation, and its due date, were disputed during the period that the bulk of the claimed interest purportedly accrued.”

4. **Every buck counts.** T.D. 9064, Substantiation of Incidental Expenses, 68 F.R. 39011 (7/1/03). Reg. § 1.274-5(i)(3) authorizes the Commissioner to permit taxpayers traveling away from home to use a specified amount for incidental expenses in lieu of substantiating (under § 274(d)) the actual cost of incidental expenses. Applicable to expenses paid or incurred after 9/30/02.

5. **Issuers of so-called “feline PRIDES” investment units may deduct interest on the debt component.** Rev. Rul. 2003-97, 2003-34 I.R.B. 380 (8/25/03). This ruling deals with whether, under very detailed facts, a corporation that issues units, each consisting of instruments in the form of a 5-year note and a 3-year forward contract to purchase a quantity of the corporation’s common stock, may deduct the "interest" accruing on the note under § 163(a), or whether the deduction is disallowed by 163(f). The ruling held that the instrument was a debt instrument, even though the components were severable when issued. The instrument was not a disqualified debt instrument under § 163(f)(2) [indebtedness of a corporation that is payable in equity of the issuer or a related party], because absent specific evidence of bad faith with respect to the debtor’s performance of its obligations the transaction was not reasonably expected to give the debtor an option to pay the notes in, or convert them into, its stock. Accordingly, the interest was deductible. The ruling will not be applied adversely to any unit issued on or before 8/22/03 if certain circumstances are met.
E. Depreciation & Amortization

1. The Job Creation and Worker Assistance Act of 2002 provides for additional first-year depreciation of 30 percent for certain property that was acquired after 9/10/01 (and before 9/11/04) and placed in service before 1/1/05. Qualifying property consists of (1) § 168 property with a recovery period of 20 years or less, (2) computer software other than computer software covered by § 197, (3) water utility property, and (4) leasehold improvement property. For passenger automobiles, the § 280F(a)(1)(A)(i) limitation is to be increased by $4,600. This provision also applies to improvements to used property.

- Depreciation claimed pursuant to this provision may be used for alternative minimum tax purposes even though the 200 percent declining balance depreciation tables are used for the basis remaining after the additional first-year depreciation is taken.
  a. Rev. Proc. 2002-33, 2002-20 I.R.B. 963 (4/29/02). This revenue procedure provides procedures for claiming the additional 30 percent first-year depreciation provided by § 168(k) [and § 1400L(B)]. It also explains how a taxpayer may elect not to deduct the additional first-year depreciation for qualified property.
  b. Fifty-percent bonus depreciation. Section 168(k)(4), added by the 2003 Act, allows a deduction of fifty percent of the adjusted basis of qualified property (in lieu of the prior 30 percent) placed in service after 5/5/03 and before 1/1/05.

- Section 168(k)(2)(F) provides that the 50 percent (and 30 percent) first year allowance is also allowable as a deduction for purposes of the alternative minimum tax.

- Bonus depreciation is extended to passenger automobiles by increasing the § 280F(a)(1)(A)(i) limit by $4,600 for passenger automobiles that are qualified property placed that are in service after 9/10/01 and before 5/6/03, and by $7,650 for passenger automobiles that are qualified property placed that are in service after 5/5/03 and before 1/1/05.

2. Increased § 179 expensing for small business – with an increased phase-out amount. The 2003 Act increased the amount deductible under §179 to $100,000 for property placed in service in taxable years beginning in 2003, 2004, and 2005. In addition, for those years, the dollar-for-dollar phase-out of the amount begins when the cost of property placed in service exceeds $400,000 (adjusted for inflation in 2004 and 2005). The 2003 Act also amended § 179(d) to treat off-the-shelf computer software placed in service in taxable years beginning in 2003 through 2005 as qualifying property.

- The 2003 Act amended § 179(c)(2) to allow elections to expense assets under § 179 with respect to taxable years beginning in 2003 through 2005 to be revoked (by an amended return) without the consent of the Commissioner.

3. The Service agrees that the rotable spare parts pool used in a maintenance service business is depreciable property, not inventory. Rev. Rul. 2003-37, 2003-15 I.R.B. 717 (3/24/03). The Service will follow Hewlett Packard, Inc. v. United States, 71 F.3d 398 (Fed. Cir. 1995), and Honeywell, Inc. v. Commissioner, T. C. Memo. 1992-453, aff'd, 27 F.3d 571 (8th Cir. 1994), and will treat rotable spare parts as depreciable assets provided they are used in the taxpayer's maintenance service business and are not held for sale. The ruling seeks comments on the maximum amount of rotable spare parts sales that should be permitted from a rotable spare parts pool that is treated as a depreciable asset.

4. The “exhaustion, wear and tear” prerequisite for depreciation is an undemanding standard. And, cost recovery periods are not accounting methods. O'Shaughnessy v. Commissioner, 332 F.3d 1125, 91 A.F.T.R.2d 2003-2559, 2003-1 U.S.T.C. ¶50,522 (8th Cir. 6/13/03), aff'g 89 A.F.T.R.2d 2002-658, 2002-1 U.S.T.C. ¶50,235 (D. Minn. 9/29/2001). The S corporation in which the taxpayer was a shareholder manufactured glass using a “float process” that involved the use of a molten tin “bath” that lost volume and purity in the manufacturing process, requiring periodic replenishment. The amount of tin added each year equaled the amount of tin consumed in glass production during the year. The corporation deducted the cost of adding tin to the bath and depreciated the cost of the original volume of tin. Applying Rev. Rul. 75-491, 1975-2 C.B. 19, which was directly on point, the IRS disallowed the depreciation. The Court of Appeals affirmed the district court's refusal to apply the revenue ruling, because it was not binding and because it predated the ACRS depreciation system, and held that the original volume of tin was depreciable because over time it would have been completely exhausted by volume and purity losses. On another issue, the Court of Appeals reversed the district court and held that reallocation of certain plant assets from one asset category to another for the purposes of MACRS depreciation did not constitute a change in accounting method, following

5. More tangible personal property that the local zoning board and building inspector think is real estate. Cost segregation studies to take advantage of this phenomenon. Rev. Rul 2003-54, 2003-23 I.R.B. (5/8/03). This ruling provides guidance on how the common gasoline pump canopies and their supporting concrete footings – used by 90 percent of gasoline stations – are to be classified for depreciation purposes. Gasoline pump canopies are not inherently permanent structures; for depreciation purposes they are classified as tangible personal property includible in asset class 57.0 of Rev. Proc. 87-56, 1987-2 C.B. 674. The supporting concrete footings are inherently permanent structures classified as land improvements includible in asset class 57.1 of Rev. Proc. 87-56.

- Note the recent trend of obtaining a “cost segregation study” to determine the amount and nature of tangible personal property in either an existing or a newly-constructed building. These studies are based on the holding in Hospital Corporation of America v. Commissioner, 109 T.C. 21 (1997), on appeal to the Sixth Circuit. This is different from component depreciation, which involved separate useful lives for different parts of the real estate. These studies determine whether there is tangible personal property that is part of the building, for purposes of depreciating this tangible personal property separately from the real estate.


- The Tax Court (Judge Ruwe) held that §197 applied to a covenant not to compete entered into when a corporation redeemed the stock of its 75-percent owner. The covenant not to compete had to be amortized over 15 years under §197, even though it was for only a 5-year term because the redemption constituted the acquisition of an interest in a trade or business. [The holding is consistent with Reg. §1.197-2(b)(9), which was not applicable because the case arose prior to its effective date.]

- The Ninth Circuit (Judge Trott) agreed with the Tax Court that taxpayer’s redemption was an indirect acquisition of an interest in a trade or business because “the substance of the transaction was to effect a change of controlling corporate stock ownership,” so taxpayer had to amortize the covenant under §197.

- Query whether the redemption of a controlling amount of stock would be required for the acquisition of an interest in a trade or business to occur?

7. Notice 2003-45, 2003-29 I.R.B. 86 (6/26/03). This notice provides for an automatic extension of time until 12/31/03 to amend returns to use the mid-year convention – as opposed to the mid-quarter convention – for property placed in service during 2001 for entities whose third and fourth quarters included 9/11/01 (as permitted by Notice 2001-70, 2001-2 C.B. 437, and Notice 2001-74, 2001-2 C.B. 551). The Treasury and IRS intend to amend the regulations under §168 to incorporate the guidance provided in this notice, which may be relied upon meanwhile.

a. Similarly, Rev. Proc. 2003-50, 2003-29 I.R.B. 119 (6/26/03), provides an extension until 12/31/03 for taxpayers to claim (or not claim) the additional 30-percent first-year depreciation under §168(k) or change their selection of §179 property for the taxable year that included 9/11/01.

8. Changes in use change MACRS depreciation. REG-138499-02, Changes in Use Under Section 168(i)(5), 68 F.R. 43047 (7/21/03). The Treasury has published comprehensive proposed regulations to provide rules for determining MACRS depreciation under §168 when the taxpayer changes the use of the property. Changes in use include: (1) a conversion of personal use property to a business or income-producing use, (2) conversion from business or income-producing to personal use, or (3) a change in use that results in a different recovery period, depreciation method, or both. The regulations will be effective when finalized. Any reasonable method will be acceptable for changes after 12/31/86 and before final regulations are published.

- However, current Reg. §1.167(g)-1 limits the depreciable basis of property converted from personal to business use to its fair market value at the time of the conversion.

F. Credits

1. Leveraging the New Markets Credit. Rev. Rul. 2003-20, 2003-7 I.R.B. 465 (2/18/03). For purposes of determining the §45D new markets tax credit (39% of the investment over seven years), the amount of the qualified equity investment made by a partnership [LLC] includes cash
from a nonrecourse loan to the partnership that the partnership invests as equity in a qualified community
development entity.

2. Big brother may be watching your mouth, but he won’t give your dentist a
tax credit for it. Fan v. Commissioner, 117 T.C. 32 (6/24/01). Dr. Fan, who had some hearing-impaired
patients, purchased an intraoral camera system [consisting of a camera and monitor, video presentations
and educational materials] for use in his dental practice [which was an eligible small business as defined
in § 44(b). The system was useful with respect to all of his patients, but because Dr. Fan considered the
system to be a more effective and efficient way to communicate with hearing-impaired patients, he
claimed the § 44 disabled access credit for the cost of the system. The Tax Court upheld the
Commissioner’s disallowance of the credit on the grounds that the system was not an “eligible access
expenditure” as defined in § 44(c). Dr. Fan was already ADA compliant; and the system was not
marketed as, acquired, or used specifically as an auxiliary aid or service to ensure effective
communication to comply with the applicable requirements of the ADA.

a. But he will give your optometrist a tax credit if he purchases an
automatic refractor to accommodate disabled patients. Hubbard v. Commissioner, T.C. Memo. 2003-
245 (8/14/03). The Tax Court allowed taxpayer a $5,000 tax credit under § 44 because his optometry
practice is an eligible small business which falls within the definition of a public accommodation and he
must make reasonable modifications to provide services to disabled individuals. The court noted that in
the year before taxpayer purchased the automatic refractor, he had to refer about 30 disabled patients to
other optometrists. Judge Swift distinguished Fan on the ground that in that case taxpayer was already in
compliance with ADA. He also noted that it was irrelevant that taxpayer used the refractor to treat
nondisabled patients.

3. Nothing in the statutory structure of the AMT warrants a de novo
7/30/03). Section 280C requires that § 162 deductions be reduced by the amount of the § 51 targeted jobs
credit [now Work Opportunity Credit] claimed in computing regular income tax. For the year in question,
the taxpayer was subject to the AMT and did not reduce the wage deduction in computing AMTI,
because the credit is not allowed against the AMT. The court (Judge Wiese) held that in computing
AMTI and tentative AMTI for purposes of § 38(c), any reduction in the amount of deductions required by
§ 280C by virtue of a credit having been claimed with respect to the otherwise deductible expenditure
must be taken into account. Judge Wiese rejected the taxpayer’s argument that the AMT was a separate
tax system, and that since the targeted jobs credit was not allowable under the AMT, the expense
deduction should not be disallowed. “Taxable income,” which is the starting point for computing AMTI
under § 55, is taxable income under the regular income tax. Nothing in the statutory structure provided
the adjustment sought by the taxpayer or warranted a de novo calculation of taxable income.

• The Tax Court reached the same decision regarding the statutory
structure in Allen v. Commissioner, 118 T.C. 1 (2002), although in that case the taxpayer was not subject to
the AMT and the issue was the application of the limitation of the general business credit in § 38(c).

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

G. Natural Resources Deductions & Credits

1. To “produce” or to “transport” gas, that is the question. Saginaw Bay

• The District Court (Judge O’Meara) held that the natural gas
gathering systems were used to transport gas [Class 46.0] – not in production [Asset Class 13.2] – and thus
are depreciable over 15 years rather than seven years because the taxpayer was engaged in the transportation
of natural gas, not in the production or processing of natural gas. The District Court described Duke Energy
Natural Gas Corp. v. Commissioner, 172 F.3d 1255 (10th Cir. 1999), as “wrongly decided.”

• The Sixth Circuit (Judge Krupansky) found the Duke Energy
reasoning persuasive and reversed the District Court. The court held that the period of depreciation of
natural gas gathering systems should depend upon the use to which they were being put, and not upon
the producer or nonproducer status of the owner of the pipeline. Inasmuch as the pipelines in question were
used to transport impure “raw” or “wet” natural gas from the field wellheads to a cleansing and processing
facility, they qualify as “gathering pipelines” under Asset Class 13.2 or Rev Proc. 87-56, 1987-2 C.B. 674.
Natural gas gathering systems are depreciable over seven years rather than the 15 years for pipelines used to transport gas under Asset Class 46.0.

a. Non-producer must use 15-year recovery period. Clajon Gas Co. L.P. v. Commissioner, 119 T.C. 197 (10/25/02) (reviewed, 10-5). The Tax Court in a decision by Judge Halpern upheld the government’s notices of final partnership administrative adjustment in determining that the recovery period for gathering pipeline systems owned and operated by a non-producer were transportation property with a 15-year recovery period, and not natural gas production property with a 7-year recovery period. The court adhered to its decision in Duke Energy Natural Gas Corp. v. Commissioner, 109 T.C. 416 (1997), rev’d, 172 F.3d 1255 (10th Cir. 1999), and refused to follow the Tenth Circuit’s reversal. The majority held that Clajon’s use of the pipeline system was relevant, and inasmuch as Clajon was not a producer, the pipeline system could not have been part of the production system.

- Judge Wells’ dissent was based upon the Tenth Circuit’s plain language analysis in Duke Energy of Rev. Proc. 87-56, 1987-2 C.B. 674, which only requires that the assets be “used” by natural gas producers to qualify for 7-year depreciation. The Tax Court majority requires that the asset be both owned and used by a natural gas producer. Judge Wells notes that the Tax Court held in Rauenhorst v. Commissioner, 119 T.C. 157 (10/7/02), that “the Commissioner may not choose to litigate against an official position the Commissioner has published without first revising or revoking that position.”
- Judge Foley’s dissent was based upon similar grounds, that the asset meets the regulatory requirement even though Clajon was not a producer.
- Query whether the Sixth Circuit’s reversal in Saginaw Bay Pipeline, supra, will affect this case, which is appealable to the Fifth Circuit?

2. The Exxon Saga: After an initial setback in the Tax Court, Exxon has been meeting with success in the Federal Circuit on the issue of taking percentage depletion on fixed contract natural gas on representative market or field prices that are greatly in excess of the actual sale price for the gas.

a. Tax Court: Taxpayer not permitted to follow the literal language of the regulations. Exxon Corp. v. Commissioner, 102 T.C. 721 (6/6/94). Taxpayer was not permitted to follow the literal language of Reg. §1.613-3(a) and use “representative market or field prices” (RMFP) in determining “gross income from the property” for purposes of computing percentage depletion under §613A(b)(1)(B) [“fixed contract” exception]. Even though the regulation states that “the gross income from the property shall be assumed to be equivalent to RMFP” with respect to natural gas transported from the premises prior to sale, the purpose of that provision was to prevent integrated producers from taking depletion deductions on transportation, refining, etc. -- and not to permit a taxpayer to take depletion based upon a RMFP price five times the actual sales price of the natural gas to an Exxon affiliate. The actual contract sales price was therefore reduced by royalties and transportation expenses to determine “gross income from the property.”

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

c. Federal Circuit holds that RMFP which exceeds actual gross receipts is not precluded, nor is it per se “unreasonable.” Exxon Corp. v. United States, 88 F.3d 968, 96-2 USTC §50,324 (Fed. Cir. 6/20/96), cert. denied (3/17/97), rev’g and remanding 33 Fed. Cl. 250, 95-1 USTC §50,245 (Fed. Cl. 1995). Court finds taxpayer entitled to calculate its depletion deduction based upon an RMFP of 39 cents based upon the wellhead price that would be realized by nonintegrated producers. The court further held that the Court of Federal Claims should not have limited the price by making an independent assessment of the reasonableness of the price because the §611(a) language “reasonable allowance ... in each case” refers to the different types of depletable resource, not to individual taxpayers.

d. And you thought you couldn’t deplete more than your gross income. Of course you can, silly boy. Exxon Corp. v. United States, 45 Fed. Cl. 581, 2000-1 U.S.T.C. §50,116, 84 A.F.T.R.2d 7235 (Fed. Cl. 12/2/99). Exxon sought a $172.6 million refund based on percentage depletion for 1975, under §613A(b)(1)(B), allowing §613 percentage depletion for natural gas sold under a fixed contract. The long-term contracts in issue were with Houston Lighting & Power Co. (HL&P) and with Southwestern Electric and Power Co. (SWEPCO), The IRS assessed a deficiency for 1975 on the grounds that Exxon was not entitled to use the RMFP under Reg. §1.613-3(a) to compute percentage.
depletion because the fixed-contract exception in §613A(b)(1)(B) did not permit use of the RMFP. Exxon filed suit, and the Court of Claims initially denied the government's motion for summary judgment, in which the government argued that Reg. §1.613-3(a) did not apply to post-1974 depletion allowed under the fixed contract exception.

- On the government's motion for summary judgment, the court (Senior Judge Gibson) held that: (1) Reg. §1.613-3(a), absent evidence that the regulation systematically causes a material distortion of the "gross income from the property," was not facially invalid as applied to percentage depletion deduction pursuant to the post-1974 fixed contract exception [even if the RMFP exceeded the actual sales price, which it can under Exxon, Corp. v. United States, 88 F.3d 968 (Fed. Cir. 1996)], and (2) evidence raised genuine issues of material fact that the regulation produced a result that was arbitrary, capricious, or manifestly contrary to the post-1974 statutory percentage depletion scheme. 40 Fed. Cl. 73 (1998).

After trial, the court held:

• First: Not all of the natural gas was eligible under Reg. §1.613A-7(c)(5) and (d). Exxon failed to prove that its contract with HL&P qualified as a "fixed contract." The HL&P excess royalty reimbursement and additional gas contract terms permitted Exxon, in part, to raise prices after Feb. 1, 1975, by amounts tied to the market price for natural gas [which would allow it to recover through price increases increased tax liabilities arising from the repeal of percentage depletion], and the sales prices did in fact increase. Exxon did not prove by "clear and convincing evidence" that the price increase did not "to any extent" permit it to recoup tax increases attributable to the repeal of percentage depletion. The contract with SWEPCO, however, was qualified. Although the contract had a price adjustment clause under which Exxon "could potentially have recovered a portion of its increased income tax liabilities," the contract qualified as a "fixed contract" because the contract price did not in fact increase after February 1, 1975.

• Second: For calculating Exxon's 1975 percentage depletion allowance, the RMFP is $0.6831 per thousand cubic feet (Mcf) of natural gas that is eligible for percentage depletion. (1) The Texas Gulf Coast/East Texas region, rather than the entire state, constituted a "market area that was geographically 'representative'" of Exxon's 1975 production from the properties at issue. (2) In determining whether that region was the relevant market area, Judge Gibson found that Exxon's 1975 "gas well gas production" - comprising 90.24 percent of the gas in issue - was comparable or superior to gas produced and sold generally through the region; only 9.76 percent [casinghead gas] was not comparable and must be excluded from the computation of Exxon's allowance. (3) After determining the appropriate RMFP transaction sample and adjusting for the pre-sale costs of compression and dehydration, the court held that the RMFP for purposes of Reg. §1.613-3(a) was $0.6831 per Mcf.

- Exxon had argued that every sale of raw gas at a delivery point anywhere on the producer's leased property was a transaction in which the sale price was untainted by transportation before the sale. The court held that Exxon failed to support that position, and that it was not feasible to cure tainted transactions by subtracting the transportation cost from the gas sale price.

e. Affirmed in part, reversed in part. Literalism triumphs in the Federal Circuit. Taxpayer celebrates a little bit more. Exxon Mobil Corp. v. United States, 244 F.3d 1341, 1001-1 U.S.T.C. §50,348, 87 A.F.T.R.2d 1508 (Fed. Cir. 4/3/01). The Federal Circuit affirmed the Court of Federal Claims holding that percentage depletion should be calculated with respect to a RMFP that exceed the taxpayer's actual sale price. Judge Michel rejected the government's argument that Reg. §1.613-3(a) here would lead to "absurd results," and would "thwart the obvious purpose" of the 1975 Act by noting that Treasury considered, but declined to fix, the "perceived anomaly." He so held because "it is not the province of this court to remedy anomalies in the tax laws that Congress and the [Treasury] have refrained from correcting." The 1975 addition of §613A "may have changed pre-1975 law by redefining what kinds of gas are eligible for percentage depletion, nothing in the regulation changes ... the method of computing the AMOUNT of percentage depletion or eligible gas." (emphasis in original)

- He also affirmed the trial court's holding that casinghead gas [gas that was dissolved in oil at reservoir conditions but becomes gaseous at atmospheric pressure at the top - or "casinghead - of an oil well] should be excluded from the computation of the RMFP because it was not comparable to its gas well gas. Finally, the court of appeals reversed the trial court's holding that the HL&P contract was not a "fixed price contract," holding as a matter of law that it was a fixed price contract, thereby entitling Exxon to percentage depletion on the gas sold pursuant to that contract. Under the contract, Exxon could not raise the price of gas unless HL&P exercised its rights under the additional gas clause.
That did not alter the fact that the price for the original quantity of gas was fixed from Exxon's perspective. HL&P controlled whether the additional gas clause, and thus the price increase, would be invoked.

f. The District Court for the Northern District of Texas permits percentage depletion, but not for the HL&P contract. Exxon Mobil Corp. v. United States, 2003-2 U.S.T.C. §50, (N.D. Tex. 2/6/03). In this refund action for the 1976 year, the court found that natural gas sold under 18 fixed price, long-term contracts was eligible for percentage depletion based upon the representative market or field price ("RMPF"). The court, however, found that two additional contracts [with HL&P and SWEPCO] were not "fixed contracts" because taxpayer failed to meet its burden of proving by clear and convincing evidence that the prices thereunder were not subject to adjustment to reflect the increase in liabilities of Exxon for federal income tax after 1974 by reason of the [1975 Act] repeal of percentage depletion.

H. Loss Transactions, Bad Debts and NOLs

1. Was he having major trouble with his car air conditioner? Wood v. United States, 2003-1 U.S.T.C. §50,193, 91 A.F.T.R.2d 2003-502 (S.D. Fla. 12/17/02). The taxpayer forfeited the proceeds from illegal smuggling of Freon into the U.S. in connection with a criminal plea bargain relating to the smuggling and the related evasion of excise taxes. The district court upheld the denial of a § 165 loss deduction, on the grounds of frustration of public policy. The forfeitures were not a payment of the excise taxes or a payment in lieu of deductible taxes.

I. At-Risk and Passive Activity Losses

1. Whose "participation" counts if the taxpayer isn't a natural person? The Mattie K. Carter Trust v. United States, 256 F. Supp. 2d 536, 2003-1 U.S.T.C. §50,418, 91 A.F.T.R.2d 2003-1946 (N.D. Tex. 4/11/03). The district court (Judge McBayde) held that in determining whether a trust "materially participated" in an activity [in this case a ranching operation] the activities of all of the trust's fiduciaries, employees, and agents should be considered, as urged by the taxpayer, and not just the activities of the trustee, as argued by the government.

2. Now no borrowing from your partner will be at-risk. REG-209377-89, At-Risk Limitations; Interest Other Than That of a Creditor, 68 F.R. 40583 (8/8/03). Section 465(b)(3) provides that amounts borrowed for use in an activity do not increase the borrower's amount at risk in an activity listed in § 465(c)(1) [(1) motion-picture films or videotapes; (2) farming; (3) leasing § 1245 property; (4) oil and gas resources and geothermal deposits] if the lender has an interest other than that of a creditor in the activity or if the lender is related to a person (other than the borrower) who has a disqualifying interest in the activity. Section 465(c)(3)(D) provides that § 465(b)(3) applies to activities to which § 465 is extended by § 453(c)(3)(A) – all other business and profit seeking activities – only to the extent provided in regulations; Alexander v. Commissioner, 95 T.C. 467 (1990), aff'd by order sub nom. Stell v. Commissioner, 999 F.2d 544 (9th Cir. 1993), held that until regulations were issued, §465(b)(3) does not apply to activities other than those described in § 465(c)(1). Revisions to Prop. Reg. § 1.465-8 and 1.465-20 would apply § 465(b)(3) to the activities described in § 465(c)(3)(A). The regulation will be effective when finalized.

III. INVESTMENT GAIN

A. Capital Gain and Loss

1. "Putting" lipstick on the telltale collar. Rev. Rul. 2002-66, 2002-45 I.R.B. 812 (10/2/02). If the grantor of a qualified covered call option holds a put option on the same underlying equity, the presence of the purchased put causes the stock and the qualified covered call option to constitute part of a larger straddle within the meaning of § 1092(c)(4)(A). In such event, under § 1092(a), the amount of losses that may be recognized is limited to the amount by which the losses exceed the unrecognized gain in any offsetting positions in that straddle.

2. This collar just plain clean works. Rev. Rul. 2003-7, 2003-5 I.R.B. 363 (1/16/03). The IRS rules that a shareholder has neither sold stock currently nor caused a constructive sale of stock under § 1259 where he (1) receives a fixed amount of cash, (2) simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date [but which does provide a "collar" on the number of shares of stock to be delivered, in effect providing a "collar" on the ultimate sale price], (3) pledges the maximum number of shares for which delivery could be required, (4) has the unrestricted right to deliver the pledged shares or to substitute cash or other shares on the delivery date, and (5) is not economically compelled to deliver the pledged shares.
There was not a sale of the pledged shares because the shareholder was not required to relinquish the pledged shares but had an unrestricted right to reacquire them by delivering cash or other shares. There was not a constructive sale under § 1259(c)(1)(C) because due to the variation in the number of shares that might be delivered, the agreement was not a contract to deliver a substantially fixed amount of property for purposes of § 1259(d)(1).

3. A little help for bears. Rev. Rul. 2003-31, 2003-13 I.R.B. 643 (3/31/03). This revenue ruling dealt with two issues regarding short sales in margin accounts. First, changes to the terms of a margin account through which a short sale was effectuated do not result in the short sale being consummated for purposes of Reg. § 1.1233-1(a)(4). Second, if a taxpayer's pre-6/9/97, appreciated financial position and short-against-the-box transactions are not taken into account for purposes of applying § 1259 of the Internal Revenue Code to post-6/8/97 transactions, as provided by the transition rule in § 1001(d)(2) of the Taxpayer Relief Act of 1997, changes to the terms of the margin account through which the short sale was effectuated will not result in transition rule ceasing to apply.

4. Capital gains rates reduced to 15 percent. Generally speaking, under the 2003 Act, gains from the sale of capital assets held for more than one year realized by taxpayers otherwise subject to income tax rates of greater than 15 percent (formerly taxed at a 20-percent rate) are taxed at a rate of 15 percent. For taxpayers otherwise subject to income tax rates of 10 or 15 percent, capital gains (formerly taxed at an 8- or 10-percent rate) are taxed at 5 percent (with a special zero percent rate capital gains rate for 10- and 15-percent bracket taxpayers in 2008).

- The 25- and 28-percent capital gains rates remain. Some or all of any capital gains realized on the sale of depreciable real estate, however, may be taxed at a maximum rate of 25 percent if realized by a taxpayer (otherwise in a tax bracket greater than 15 percent), and gains on the sale of collectibles, e.g., art work, precious gems, gold bullion, antiques, etc., are subject to a maximum rate of 28 percent.

- For taxable years that include 5/6/03, the rate on net long-term capital gains is bifurcated pursuant to § 301(c) of the 2003 Act. For gains taken into account prior to 5/6/03, net long-term capital gains are taxed under former law. Gains taken into account after 5/5/03 will be taxed at the new rates.

5. You have to transfer some other business asset before you can sell goodwill. Baker v. Commissioner, 338 F.3d 789, 92 A.F.T.R.2d 2003-5640, 2003-2 U.S.T.C. ¶50,604 (7th Cir. 8/4/03), aff'g 118 T.C. 452 (5/29/02). The taxpayer was a State Farm insurance agent, who sold policies exclusively for State Farm as an independent contractor, operating his own agency, developing clients, hiring employees, and paying expenses. Upon retirement, the taxpayer returned all of State Farm’s property to it, but transferred no identifiable assets of his own, and he received a “termination payment” - the insurance policies he had written were assigned to a successor agent. The Seventh Circuit (Judge Bauer) affirmed the Tax Court (Judge Panuthos) decision denying the taxpayer capital gain treatment with respect to the termination payment. He transferred no assets that owned; the telephone number and at-will employment relationships were not assets. He could not transfer goodwill, because he transferred nothing to which goodwill could attach because (contractually) the customer list belonged to the insurance company. The entire termination payment was ordinary income without regard to the portion of it allocable to a covenant not to compete. As the court stated:

Fundamentally, in order to have the ability to sell something, one must own it. Because Warren Baker did not own any property related to the policies, he could not sell anything.

B. Section 121

1. A man's (woman's) home is his (her) tax free castle. T.D. 9030, Exclusion of Gain From Sale or Exchange of a Principal Residence, 67 F.R. 78358 (12/24/02) [proposed in REG-105235-99, Exclusion of Gain From Sale or Exchange of a Principal Residence, 65 F.R. 60136 (10/10/00).] The Treasury Department has promulgated final regulations [Reg. §§ 1.121-1 through 1.121-4] dealing with the § 121 exclusion of up to $250,000 ($500,000 for joint returns) of gain on the sale of the taxpayer’s principal residence if the taxpayer owned and used the property as his principal residence for at least two years of the preceding five-year period.

- The final regulations follow the proposed regulations in providing that whether a property qualifies as the taxpayer’s principal residence depends upon all the facts and circumstances. Generally the property used a majority of the time during the year will ordinarily be
considered the taxpayer's principal residence. The final regulations add a nonexclusive list of factors that are relevant in identifying a property as a taxpayer's principal residence. The Treasury Department declined to follow comments suggesting that the two-year use requirement should not require actual occupancy or that the regulations provide a safe harbor definition of short temporary absences that would not affect the two-year use requirement.

- The final regulations extend the § 121 exclusion to the sale of vacant land containing the dwelling unit, owned and used as part of the taxpayer's principal residence if (1) the dwelling unit is sold within two years before or after the sale of the vacant land, (2) the land is adjacent to the dwelling unit, and (3) the sale of the vacant land otherwise satisfies the requirements of § 121. The dollar ceiling on the exclusion applies to the combined sales of the vacant land and dwelling unit. Separate sales of the dwelling unit and adjacent vacant land do not violate the § 121(b)(3) restriction allowing only one sale or exchange every two years, but both are taken into account in applying § 121(b)(3) to the sale or exchange of any other principal residence.

- The proposed regulations provided that if a residence was used partially for residential purposes and partially for business purposes only that part of the gain allocable to the residential portion would be excludable under § 121. Because the Treasury Department decided that § 121(d)(6) [excluding from the § 121 exclusion gain attributable to prior depreciation after 5/6/97] addresses the mixed use question, the final regulations do not require an allocation if both the residential and nonresidential portions of the property are within the same dwelling unit. However, an allocation is required if the non-residential portion is separate from the dwelling unit, and § 121 does not apply with respect to the gain on the nonresidential portion. Basis and the amount realized are allocated between the business and residential portions of the property using the same method the taxpayer used to allocate the basis for purposes of depreciation. The term dwelling unit has the same meaning as in § 280A(f)(1), but does not include appurtenant structures.

- The final regulations provide that if a residence is held by a trust, a taxpayer is treated as the owner and the seller of the residence during the period that the taxpayer is treated as the owner of the trust or portion of the trust that includes the residence under §§ 671 through 679. A similar rule applies to disregarded entities.

- The final regulations clarify that each unmarried taxpayer who jointly owns a principal residence is eligible to exclude from gross income up to $250,000 of gain attributable to that taxpayer's interest in the property.

- The final regulations permit a taxpayer to exclude gain from the sale of partial interests (other than interests remaining after the sale or exchange of a remainder interest) in a principal residence if the interest sold includes an interest in the dwelling unit. However, the maximum exclusion amount of $250,000 ($500,000 for joint returns) applies to the combined sales of partial interests. For purposes of the one-sale-every-two-year rule, each sale or exchange of a partial interest is disregarded with respect to other sales or exchanges of partial interests in the same principal residence, but is taken into account with respect to any other principal residence.

- The final regulations provide that a taxpayer may make or revoke an election under § 121(d)(8) [to apply the exclusion to a sale of a remainder interest] or § 121(f) [not to apply the exclusion to a sale] at any time before the expiration of the period for filing an amended return.

- The final regulations provide that the bankruptcy estate of an individual in a chapter 7 or 11 bankruptcy case may use the individual's § 121 exclusion if the individual satisfies the requirements of § 121. Although this provision is effective 12/24/02 [the date of publication of the regulations], the IRS will not challenge a position taken prior to the effective date.

- The IRS will not challenge a taxpayer's position that a sale before the effective date of the regulations qualifies for the § 121 exclusion if the taxpayer has made a reasonable, good faith effort to comply. Taxpayers may elect to apply the final regulations for any years for which the statute of limitations has not expired.

**a. Reduced exclusion ceiling on too many castle sales.** T.D. 9031, Reduced Maximum Exclusion of Gain From Sale or Exchange of Principal Residence, 67 F.R. 78367 (12/24/02). Under § 121, a reduced maximum exclusion applies to a taxpayer who sells a principal residence owned and used for less than two years or who has excluded gain on the sale or exchange of a principal residence within the preceding two years, if the primary reason for the sale is a change in place of employment, health, or unforeseen circumstances. Temp Reg. § 1.121-3T provides a list of suggestive factors that may be relevant in determining the taxpayer's primary reason. No single fact or particular
combination of facts is determinative. For each of the three grounds for claiming a reduced maximum exclusion, the temporary regulations provide a general definition and one or more safe harbors.

- The primary reason for a sale is deemed to be a change in place of employment if the new place of employment is at least fifty miles farther from the residence sold than was the former place of employment (or if the individual was unemployed, the distance between the new place of employment and the residence sold or exchanged is at least fifty miles).
- A sale is due to health if the primary reason for the sale is (1) to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury, or (2) to obtain or provide medical or personal care for disease, illness, or injury. A sale or exchange that is merely beneficial to general health or well-being is not a sale or exchange due to health. Health is defined as the health of a "qualified person," with a broad definition of qualified person that permits sale to provide care for family members of the taxpayer.
- The safe harbor events for a sale due to unforeseen circumstances include the involuntary conversion of the residence, a natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence, death, the cessation of employment as a result of which the individual is eligible for unemployment compensation, a change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household, divorce or legal separation under a decree of divorce or separate maintenance, and multiple births resulting from the same pregnancy. A taxpayer who does not qualify for a safe harbor may satisfy a facts and circumstances test.

b. Notice 2002-60, 2002-36 I.R.B. 482 (8/22/02). Provides relief under the § 121(c) reduced maximum exclusion of gain provision for taxpayers who have not owned and used their principal residence for two years prior to sale or exchange, but were affected by the 9/11/01 terrorist attacks.

2. Peripatetic taxpayers sold the wrong house. Guinan v. United States, 2003-1 U.S.T.C. ¶50,475, 91 A.F.T.R.2d 2003-2174 (D. Ariz. 4/9/03). Reg. § 1.121-1(b)(2) provides that the property used by the taxpayer for a majority of the time during the year will be treated as the taxpayer's principal residence. The taxpayers in Guinan owned three residences — a residence in Wisconsin, which they sold, a residence in Georgia, and a residence in Arizona. During the five year period prior to selling the Wisconsin residence, the taxpayers spent more time in the aggregate in the Wisconsin residence (847 days) than in either of the other two residences (563 days in the Georgia residence and 375 days in the Arizona residence), but their combined use of the Georgia and Arizona residences exceeded their use of the Wisconsin residence. The taxpayers spent the majority of their time in the Wisconsin residence only in the first year of the five-year period. The other factors listed in Treas. Reg. § 1.121-1(b)(2) did not support treating the Wisconsin residence as the taxpayers’ principal residence — at various times the taxpayers had registered to vote in Wisconsin, Georgia, and Arizona, they had Arizona and Georgia driver’s licenses, but not Wisconsin licenses, and they filed Arizona and Georgia state income tax returns, but not Wisconsin returns. Thus, the Wisconsin residence was not the taxpayers’ principal residence and the § 121 exclusion was not available.

C. Section 1031

1. The nonrecognition canteen turned out to be dry. Wiechens v. United States, 228 F. Supp. 2d 1080, 90 A.F.T.R.2d 2002-6705, 2002-2 U.S.T.C. ¶50,708 (D. Ariz. 9/16/02). The taxpayer [through a partnership] exchanged Colorado River water rights, which under state law were real property, for a fee simple interest in land. The water rights were for a limited quantity of water for a duration of 50 years. On summary judgment, the court (Judge McNamee) held that the exchange did not qualify for nonrecognition under § 1031 because the water rights and a fee simple interest in land were not "like-kind," even under the broad standard of Reg. § 1.1031(a)-1(b). The court rejected the taxpayer's argument that the 50-year water rights were analogous to the 30-year lease that qualified as like-kind with a fee simple in real estate under Reg. § 1.1031(a)-1(c). Because the water rights were not perpetual, they were not like-kind with a fee simple based on Rev. Rul. 55-749, 1955-2 C.B. 295 (dealing with perpetual water rights).

2. Nonrecognition denied – Caught by a targeted anti-abuse rule. Rev. Rul. 2002-83, 2002-49 I.R.B. 927 (12/9/02). Individual A owned highly appreciated real property held for investment (Property 1) and individual B, related to individual A within the meaning in § 267(b), owned real property (Property 2), which was not appreciated. In a multiparty like-kind exchange A and B each transferred their properties to a qualified intermediary. C, an unrelated purchaser of Property 1, transferred cash to the qualified intermediary, who transferred Property 2 to A, Property 1 to C, and the
cash to B. The IRS ruled that pursuant to § 1031(f), a taxpayer – A – who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under § 1031(a) if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property. Based on the legislative history [H.R. Rep. No. 101-247 at 1340 (1989)], the IRS reasoned that the purpose of §1031(f) is to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. Accordingly, the IRS applied § 1031(f)(4) because the multi-party exchange was “part of a transaction (or a series of transactions) structured to avoid the purposes of § 1031(f)(1).”


D. Section 1035

1. Rev. Rul. 2003-76, 2003-33 I.R.B. 355 (8/18/03). An exchange of a portion of an annuity contract into a new annuity contract effected by the owner assigning a portion of the cash surrender value (60 percent) to a different insurance company was a tax-free exchange under § 1035. The investment in the contract and basis are allocated according to the cash value immediately prior to the exchange using the rules of §§ 72 and 1031. Thus, the basis in the new contract equals 60 percent of the basis in the contract immediately before the exchange. After the transaction, the basis in the old contract equals 40 percent its original basis.

E. Section 1041

1. A welcome regulation is made final! Subchapter C principles govern which spouse will be taxed on stock redemptions incident to a divorce – at least unless the spouses mutually elect otherwise. T.D. 9035, Constructive Transfers and Transfers of Property to a Third Party on Behalf of a Spouse, 68 F.R. 1534 (1/13/03). Because of the inconsistent standards applied by the courts in dealing with redemptions of stock incident to a divorce, in REG-107151-00, Constructive Transfers and Transfers of Property to a Third Party on Behalf of a Spouse, 66 F.R. 40659 (8/3/01), the Treasury proposed regulations [Prop. Reg. § 1.1041-2] to provide greater certainty in determining which spouse will be taxed on stock redemptions occurring during marriage or incident to divorce. Reg. § 1.1041-2 has been finalized and Reg. § 1.1041-1T(c) Q&A-9 no longer controls redemptions of stock incident to a divorce. Reg. § 1.1041-2 applies only where the nonredeemed spouse owns stock of the redeeming corporation either immediately before or immediately after the stock redemption. If a corporation redeems stock of one spouse, and that redemption is treated as a constructive distribution to the other spouse under Subchapter C principles – the primary and unconditional obligation standard [Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Sullivan v. United States, 363 F.2d 724 (8th Cir. 1966)] – the redemption is treated as a distribution to the spouse who continues as a shareholder. Section 1041 applies to the deemed transfer of the stock by the redeemed spouse to the continuing shareholder spouse. Section 1041 does not apply to the deemed transfer of stock from the nontransferor spouse to the redeeming corporation. Any property actually received by the redeemed spouse from corporation is treated as flowing through the continuing shareholder-spouse, and § 1041 applies to that transfer. In all other cases, the form of the stock redemption will be respected; the redeemed spouse will be taxed on the redemption and the continuing spouse has not tax consequences. The preamble to the proposed regulations specifically state:

[If] the rules of the proposed regulations had applied in the Arnes case,1 because the husband did not have a primary and unconditional obligation to purchase the wife’s stock, the redemption would have been taxed in accordance with its form with the result that the wife would have incurred the tax consequences of the redemption.

- A special rule applies if an effective divorce or separation instrument, or a written agreement between the spouses [executed before the due dates of their returns], requires the spouses to file their federal income tax returns in a consistent manner that treats the stock as

1 Arnes v. United States, 981 F.2d 456 (9th Cir. 1992), not applied by Tax Court, Arnes v. Commissioner, 102 T.C. 522 (1994) (reviewed, 7 judges dissenting).
being redeemed from the continuing shareholder spouse rather than from the spouse from whom it was actually redeemed. In such a case spouses and former spouses will treat a redemption that otherwise would be taxed according to its form as a redemption from the continuing shareholder spouse involving (1) a deemed § 1041 transfer of the stock by the redeemed spouse to the continuing shareholder spouse, and (2) a deemed § 1041 transfer by the continuing shareholder spouse to the redeemed spouse of the redemption proceeds.

- The final regulations add a provision dealing with situations in which the redemption results in a constructive dividend distribution to the nontransferor spouse under Subchapter C principles, but the spouses nevertheless would like to agree that the redemption will be treated as a redemption distribution to the transferor spouse. Reg. § 1.1041-2(c) allows the spouses to agree in the divorce or separation instrument, or other valid written agreement, that the redemption will be taxable to the transferor spouse notwithstanding that the redemption might otherwise result in a constructive dividend distribution to the nontransferor spouse. Example 2 in § 1.1041-2(d) illustrates the application of this special rule.

Under the final regulations, the spouses can elect the special rule by expressly providing, in a divorce or separation instrument or other valid written agreement, that expressly supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption, their mutual intent concerning which spouse should receive redemption treatment.

These regulations are applicable to redemptions of stock on or after January 13, 2003 that are pursuant to instruments in effect after January 13, 2003. These regulations are also applicable to redemptions before January 13, 2003 or that are pursuant to instruments in effect before January 13, 2003 if the spouses or former spouses execute a written agreement on or after August 3, 2001, that satisfies the requirements of § 1.1041-2(c)(1) or (2).

IV. COMPENSATION ISSUES

A. Fringe Benefits

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

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

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

   - The above rules will be effective for arrangements entered into after the date of publication of final regulations. P.S. 58 rates may be used for provisions valuing current life insurance protection entered into before 1/28/02 and for arrangements entered into before the date of publication of final regulations.

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

b. Crackdown on split-dollar life insurance arrangements that are designed to understate the value of benefits for income or gift tax purposes. Notice 2002-59, 2002-36 I.R.B. 481 (8/16/02). The IRS held that neither the premium rates in Table 2001 nor the insurer's lower published premium rates may be relied on to value the insured's current life insurance protection for the “purpose of establishing the value of policy benefits to which another party may be entitled.” Under reverse split-dollar arrangements, one party with a right to current life insurance protection may use various techniques to confer policy benefits other than current life insurance protection on another party, but by using such techniques to understate the value of other policy benefits “distorts the income, employment, or gift tax consequences of the arrangement.”

According to Tax Notes Today, 2002 TNT 161-4 (8/20/02), this notice was issued after Treasury officials read a 7/28/02 story in the New York Times, which stated that Jonathan Blattmachr had developed this technique based upon a 1996 private letter ruling [identified as LTR 9636033].

c. Equity split-dollar proposed regulations. REG-164754-01, Split-Dollar Life Insurance Arrangements, 68 F.R. 24898 (5/8/03). Supplement the 2002 proposed regulations to provide guidance on the valuation of economic benefits under an equity split-dollar life insurance arrangement. Under an equity split-dollar arrangement, the payments by the owner of the policy establish a pool of assets in which the non-owner has rights of withdrawal, borrowing, surrender, assignment or the like; in addition, this pool of assets may be also placed beyond the reach of the owner’s creditors. The proposed regulations provide that the non-owner “has current access to any portion of the policy cash that is directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner’s general creditors.” “Access” is thus to be broadly construed.

Thus, the non-owner is to be taxed on the value of current term life insurance protection plus the amount of policy cash value to which he has “current access.” There is also a third component, “the value of any economic benefits provided to the non-owner.”

d. Final split-dollar regulations are effective on 9/17/03. T.D. 9092, Split-Dollar Life Insurance Arrangements, 68 F.R. 54336 (9/11/03). Comprehensive final regulations under §§ 1.61-22, 1.83-3(e), 1.83-6(a)(5), 1.301-1(g), and Reg. § 1.7872-15, regarding the federal income, gift, and employment taxation of split-dollar life insurance arrangements (as defined in § 1.61-22(b)(1) or (2)). They adopt the proposed regulations with only minor changes. The effective date of the final regulations is 9/17/03, the date of publication in the Federal Register, i.e., the regulations apply to any split-dollar life insurance arrangement that is entered into after 9/17/03 and to any split-dollar life insurance arrangement entered into on or before that date that is materially modified after that date.

(1) Rev. Rul. 2003-105, 2003-40 I.R.B. (9/12/03). Makes prior guidance in this area obsolete. In the case of any split-dollar life insurance arrangement entered into on or before 9/17/03, taxpayers may continue to rely on these revenue rulings to the extent described in Notice 2002-8, but only if the arrangement is not materially modified after that date.

2. Well, duh! Rev. Rul. 2002-58, 2002-38 I.R.B. 541 (9/23/02). Amounts reimbursed under a self-insured medical expense reimbursement plan for medical expenses incurred by an employee prior to the establishment of the plan are not excludable from the employee's gross income under §105(b).

3. It's not a reimbursed medical expense if the employee is paid in any event and the amount is retrospectively characterized if and when medical expenses are incurred. Rev. Rul. 2002-80, 2002-49 I.R.B. 925 (12/9/02). An employer provided employee medical insurance under a salary reduction program, but paid employees approximately the same amount as they would have received if there had been no salary reduction. The amount equal to the salary reduction was labeled “advance reimbursement” of the uninsured medical expenses. To the extent an employee submitted claims for uninsured medical expenses during the year, the employer characterized the “advance reimbursement” as excludable income under § 105(b), and did not withhold income tax or treat the amount as wages for FICA; excess amounts were treated compensation includible in the employee's gross income. The IRS ruled that no part of the “advance reimbursements” qualified for exclusion under § 105(b).

4. Another Tax Court loss for an airline pilot. Tuka v. Commissioner, 120 T.C. 1 (1/06/03). The taxpayer claimed that disability payments, based on age, years of service, and salary, received from an employer sponsored plan were tax exempt under § 104(a)(3). Judge Ruwe held that the
exclusion of disability benefits under § 104(a)(3) is available only if the contributions to the accident and health plan were includible in the employee’s gross income. Even if the plan had been funded by wage savings to the employer resulting from collective bargaining with the union it would not have been an employee contribution plan.

5. **Amounts received from employer may be excluded as § 139 qualified disaster relief; amounts received from a state agency are excluded as gifts.** Rev. Rul. 2003-12, 2003-3 I.R.B. 283 (1/21/03). Amounts received by an individual from an employer to reimburse the individual for necessary medical, temporary housing, or transportation expenses incurred as a result of a flood are not excludable as a gift under § 102, but are excluded from gross income as qualified disaster relief under § 139 if the flood was a Presidentially declared disaster. Similar amounts received from a state agency are excludable under the administrative general welfare exclusion; and similar amounts received from a charity are excluded under §102.

6. **Health FSAs and HRAs with point of service electronic payment.** Rev. Rul. 2003-43, 2003-21 I.R.B. 935 (5/27/03). An employer-sponsored health FSA [§ 125] or HRA [Notice 2002-45, 2002-28 I.R.B. 93] qualifies under § 105 where the plan provides electronic reimbursement of medical expenses through the use of a debit card or stored-value card, or payment by a credit card, issued to the employee and charged to the employer’s account if: (1) use of the card is limited to the maximum dollar amount of coverage available in the cardholder’s health FSA or HRA, (2) the card is effective only at authorized physicians, pharmacies, dentists, vision care offices, hospitals, and other medical care providers, (3) the employee certifies that any expense paid with the card has not been reimbursed and that the employee will not seek reimbursement under any other plan, (4) the employee agrees to acquire and retain sufficient documentation, including invoices and receipts, for expenses paid with the card, and (5) the employer maintains comprehensive procedures for substantiating claimed medical expenses after the use of the card. But where the employer does not comprehensively substantiate that the expenses paid with the card qualify as medical expenses — for example, only statistically samples expenditures to verify that the expenditure was not for cosmetic procedures — the plan does not qualify.

B. **Qualified Deferred Compensation Plans**


2. **Cash balance plan proposed regulations provide a green light for adoptions of cash balance plans favoring younger employees, including permission to require quasi-geriatries to spin their [retirement accrual] wheels during “wear-away” periods.** REG-209500-86 and REG-164464-02, Reductions of Accruals and Allocations Because of the Attainment of any Age; Application of Nondiscrimination Cross-Testing Rules to Cash Balance Plans, 67 F.R. 76123 (12/11/02). These proposed regulations provide guidance on age discrimination requirements under §§ 411(b)(1)(H) and 411(b)(2), including the allocation of these requirements to cash balance pension plans.

- A cash balance plan is a defined benefit plan under which an employee has a hypothetical individual account that provides a benefit upon retirement based upon pay credits and interest credits — a concept that closely resembles a defined contribution plan. Section 411(b)(1)(H) provides that a defined benefit plan fails to comply with the age discrimination rules of § 411(b) if benefit accrual is ceased or reduced on the attainment of any age, and § 411(b)(2) provides that a defined contribution plan similarly fails to comply unless the rate at which amounts are allocated to an employee’s account is not similarly ceased or reduced because of age.

- A cash balance qualifies, *inter alia*, only if “the participant accrues the right to future interest credits (without regard to future service) at a reasonable rate of interest that does not decrease because of the attainment of any age.”

- The rules for conversion of traditional defined benefit plans to cash balance plans require that either (1) the converted plan defines the benefit as the sum of the benefits under the traditional defined benefit plan and the cash balance account, or (2) the converted plan must establish each participant’s opening account balance as an amount not less than the actuarial present value of the participant’s prior accrued benefit. The second alternative would permit a “wear-away” period during which the participant will not accrue net benefits for some period after the conversion.

a. **Treasury and IRS withdraw the proposed cash-balance plan nondiscrimination regulations.** Announcement 2003-22, 2003-17 I.R.B. 846 (4/7/03). The proposed nondiscrimination regulations under § 401(a)(4) that would have required a modified form of cross-testing, which were proposed at the same time as the proposed cash balance regulations, are withdrawn.
because (as proposed) they would make it difficult “for plan sponsors converting long-standing traditional pension plans to cash balance plans to provide different types of transitional relief to plan participants.” The withdrawn proposed regulations will be re-proposed.

b. Courts find that Xerox and IBM cash balance plans violate ERISA. Berger v. Xerox Corporation Retirement Income Guarantee Plan, 2003 TNT 160-12 (7th Cir. 8/1/03) (plan violates ERISA because method of determining an ex-employee’s benefit if a lump sum under $25,000 is chosen on leaving before retirement); Cooper v. IBM Personal Pension Plan, 2003 TNT 149-38 (S.D. Ill. 8/1/03) (plan violates ERISA § 240(b)(1)(G) [reduction of accrued benefit solely on increases in age or service] and 240(b)(1)(H) [rate of benefit accrual decreases once a certain age is attained]).

3. Here’s how to deduct a redemption. Boise Cascade Corp. v. United States, 329 F.3d 751, 91 A.F.T.R.2d 2003-2280, 2003-1 U.S.T.C. ¶50,472 (9th Cir. 4/10/03). Boise Cascade’s ESOP held over 6.7 million shares of Boise Cascade convertible preferred stock. To fund distributions to employees who had terminated their employment when they had vested account balances, Boise Cascade redeemed a relatively small number of shares of the convertible preferred stock held by its ESOP. The Court of Appeals upheld Boise Cascade’s claim that the redemption failed all of the tests of § 302(b), and thus was a dividend under § 301, and, as such, was deductible pursuant to § 404(k). Furthermore, § 162(k) did not apply to bar the deduction. Responding to what appears to have been a groundless argument by the government, the court held that § 318 did not treat the plan beneficiaries as owners [because the ESOP was a § 401(a) trust]. The court held that the ESOP was not a grantor trust of which the beneficiaries were the owners.

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

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

   a. Reversed and Reg. § 1.83-6(a) invalidated. “Included” means included under law, not included in fact. Robinson v. United States, 92 A.F.T.R.2d 2003-5349 (Fed. Cir. 7/15/03). The Federal Circuit (Judge Bryson) reversed. The court reasoned that since a deduction under § 162 for compensation paid is allowed whether or not the employee actually includes the amount in income, the word “included” in § 83(h) refers only to whether the amount was properly includable by the employee under § 61. In support of this proposition, the court quoted the legislative history of § 83(h): “The allowable deduction is the amount which the employee is required to recognize as income. The deduction is to be allowed in the employer's accounting period which includes the close of the taxable year in which the employee recognizes the income.” S. Rep. No. 91-522, 91st Cong., 1st Sess. 123 (1969) [emphasis added], focusing on the italicized language. The court also cited the Bluebook for support.

   • Furthermore, the court refused to apply Reg. § 1.83-6(a), as revised in 1995, which was the controlling regulation and which supported the Commissioner’s position, because, the court reasoned, the regulation was contrary to the plain meaning of the statute [even though that plain meaning was not apparent to the Tax Court or the Sixth Circuit in Venture Funding, Ltd. v. Commissioner, with which the Federal Circuit noted it disagreed] and flunked the first half of the Chevron analysis.

2. Rev. Rul. 2003-98, 2003-34 I.R.B. 378 (7/25/03). This revenue ruling deals with the corporation entitled to claim the deduction under § 83(h) when a nonstatutory stock option with no ascertifiable value granted to an employee of T is exercised or settled after T has been acquired by P. In three situations, after the acquisition of the T stock, T survives as a subsidiary [for which there was no §
338 election made]. In all three cases, T was entitled to the deduction without regard to whether the employee received cash from T to settle the option or the employee exchanged the T option for a P option that was later exercised. In the fourth situation, T merged into P and the employee exchanged the T option for a P option that was later exercised; in that case P was entitled to the deduction.

D. Individual Retirement Accounts

1. Bear market relief for pre-geriatrics. Rev. Rul. 2002-62, 2002-43 I.R.B. 710 (10/3/02). The IRS will allow a one-time change, without penalty, in IRA and retirement plan periodic payment schedules for an individual receiving fixed IRA or retirement plan payments. This ruling modifies the provisions of Q&A-12 of Notice 89-25, 1989-1 C.B. 662. This will help a taxpayer who suffers an unexpected drop in the value of his or her retirement savings, who will be able to reduce the amount of those fixed periodic payments without becoming subject to the § 72(t) penalty on withdrawals before reaching the age of 59-1/2.

2. Guidance for waivers of the 60-day rollover period. Rev. Proc. 2003-16, 2003-4 I.R.B. 359 (1/8/03). The IRS has provided guidance in applying for a waiver of the 60-day rollover period for IRAs and pension plan distributions, including when automatic waivers will be granted.

3. T.D. 9056, Earnings Calculation for Returned or Recharacterized IRA Contributions, 68 F.R. 23586 (5/5/03). Final regulations provide a new method to be used for calculating the net income attributable to IRA contributions that are distributed as a returned contribution under § 408(d)(4) or recharacterized under § 408A(d)(6). Applicable to IRA contributions made on or after 1/1/04

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. Dividends received are to be taxed at capital gains rates. The 2003 Act added § 1(h)(11), which provides that dividends received by taxpayers other than corporations generally will be taxed at the same rate as long-term capital gains, i.e., 15 percent for taxpayers otherwise taxable at a rate greater than 15 percent; and five percent for taxpayers otherwise at 10 or 15 percent (with a special zero percent rate for 10- and 15-percent bracket taxpayers in 2008). This rate applies to dividends received from domestic and qualified foreign corporations for purposes of both the regular tax and the alternative minimum tax. A dividend is treated as investment income for purposes of determining the amount of deductible investment interest under § 163(d) only if the taxpayer elects to treat the dividend as not eligible for the reduced rates. The provision is effective for taxable years beginning after 12/31/02, and beginning before 1/1/09.

   Note that § 1(h)(11) treats dividends as “adjusted net capital gain” under § 1(h)(3), even though the dividend itself (in contrast to the stock) is not a capital asset as defined in § 1221, and dividends are not taken into account in the calculation of “net capital gain” under § 1222. The principal effect of this statutory construction is to extend the 5-percent and 15-percent maximum rates under § 1(h) to dividends received by taxpayers, without permitting capital losses to be deducted against dividend income (except to the extent allowed by §§ 1211 and 1212).

   a. Which dividends are taxed at capital gains rates? The 2003 Act added § 1(h)(11), which provides that dividends received by taxpayers other than corporations generally will be taxed at the same rate as long-term capital gains, i.e., 15 percent for taxpayers otherwise taxable at a rate greater than 15 percent; and five percent for taxpayers otherwise at 10 or 15 percent (with a special zero percent rate for 10- and 15-percent bracket taxpayers in 2008). The Conference Report states:

Under [§ 1(h) (11)], dividends received by an individual shareholder from domestic [and qualified foreign’] corporations are taxed at the same rates that apply to net capital gain.

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2 Qualified foreign corporations include those “eligible for the benefits of a comprehensive income tax treaty [other than the Barbados treaty]” and those paid “with respect to stock that is readily tradable on an established securities market in the United States [including those whose stock is traded in the form of American Depository Receipts].”
This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, under the provision, dividends will be taxed at rates of five and 15 percent.\(^3\)

If a shareholder does not hold a share of stock for more than [60] days during the [120]-day period beginning [60] days before the ex-dividend date (as measured under section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

If an individual receives an extraordinary dividend (within the meaning of section 1059(c)) eligible for the reduced rates with respect to any share of stock, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the dividend.

b. Investment income § 163(d) limitations may lead to a taxpayer election to have dividends taxed at regular rates. The existence of a preferential rate for dividends gives rise to tax arbitrage possibilities similar to those that arise when an interest deduction is allowed with respect investments that produce only tax-favored capital gains, for which § 163(d) historically has limited interest deductions. Accordingly, the 2003 Act amended § 163(d)(4) to exclude from the definition of net investment income any dividends that are taxed at preferential rates under § 1(h). However, §§ 1(h)(1)(D)(i) and 163(d)(4)(B) allow taxpayers to elect to forgo the preferential rates for dividends and to treat the dividends as investment income for purposes of § 163(d). If a taxpayer does not have other investment income against which investment interest may be deducted under § 163(d), it may be to the taxpayer’s advantage to elect not to have the preferential rates under § 1(h) apply to an amount of dividend income equal to the amount of investment interest that otherwise would be nondeductible by virtue of §163(d).

2. Income tax rate reductions accelerated. In the 2003 Act, Congress accelerated the rate reduction by putting the 25 percent, 28 percent, 33 percent, and 35 percent brackets previously scheduled to take effect in 2006 into effect for all years after 2002.

3. Marriage penalty relief for the upper limit of the 15-percent bracket accelerated. The 15-percent bracket rate was not reduced, but the 2003 Act increased the size of the upper limit of the 15-percent regular income tax rate bracket for married taxpayers filing joint returns to twice the width of the 15-percent regular income tax rate bracket for single returns for taxable years beginning in 2003 and 2004.

• For taxable years beginning after 2004, the upper limit of the 15 percent rate bracket for married taxpayers filing joint returns reverts to the amount provided in § 1(a) and (f).

4. Increased width of the 10-percent rate bracket. The 2003 Act also temporarily accelerated an increase in the taxable income ceiling of the 10-percent rate bracket from $6,000 to $7,000, and for married taxpayers filing joint returns from $12,000 to $14,000 (index for inflation in 2004), previously scheduled to take effect in 2008, to be effective in 2003 and 2004.

• Starting in 2005, the taxable income ceiling for the 10-percent rate bracket reverts to the levels provided under the 2001 Act (which are not adjusted for inflation). See § 1(f).

5. Increased AMT exemption amount. The 2001 Act and the 2003 Act combined to increase the alternative minimum tax exemption amount for 2001 and 2002 to $35,750 for single taxpayers and $49,000 for married taxpayers filing joint returns, and for 2003 and 2004 to $40,250 for unmarried taxpayers and to $58,000 for married taxpayers filing joint returns.

B. Miscellaneous Income

1. You have to prove that the damages were received for a physical personal injury. Prasil v. Commissioner, T.C. Memo. 2003-100 (4/9/03). The taxpayer received $7,650 to settle a sex discrimination claim against her employer. The court held that § 104(a)(2) did not exclude the

\(^3\)Payments in lieu of dividends are not eligible for the exclusion. See sections 6042(a) and 6045(d) relating to statements required to be furnished by brokers regarding these payments.

\(^4\)In the case of preferred stock, the periods are doubled.
payment. The record was devoid of any evidence to corroborate the taxpayer’s “own self-serving testimony *** that [the employer’s] sex discrimination caused a physical injury to or the physical sickness of Mrs. Prasil.” Furthermore, the settlement agreement referred only to the sex discrimination claim and “did not specifically carve out any portion of the settlement payment as a settlement on account of personal physical injury or physical sickness, let alone make reference to a physical injury or a physical sickness . . . .”

2. Forste v. Commissioner, T.C. Memo. 2003-103 (4/16/03). When Deloitte, Haskins & Sells informed the taxpayer that he was being terminated because of his refusal to fly to meetings, he negotiated a settlement for retirement payments and “other amounts.” In negotiating the settlement, the taxpayer asserted numerous tort and contract causes of action. The settlement agreement described $25,130 of the payments as “[i]n settlement of all claims for Workmen’s Compensation arising from my employment or termination with DH & S, and without DH & S admitting any liability, and expressly denying any liability for any and all claims which may be or are claimed to result from my employment or termination with DH & S . . . .” Additional amounts, equal to the difference between $25,130 and the taxpayer’s salary, were described as paid to settle other claims. Nevertheless, the taxpayer excluded the full payments [which DH&S reported on W-2s], claiming that § 104(a)(2) [as in effect before 11/13/95] applied. The Tax Court (Judge Ruwe) held that the taxpayer produced credible evidence that $25,130 of the $45,615 received by the taxpayer was paid and received on account of tort or tort type personal injuries, that under § 7491 the burden of proof shifted to the Commissioner with respect to that amount of $25,130, and that the Commissioner had failed to satisfy the burden. The court concluded that the workers’ compensation language was based on advice from the taxpayer’s accountant and was intended to indicate that the payment was to settle tort-type claims, for which workers’ compensation is a substitute. Thus, $25,130 was excludable. The taxpayer, who bore the burden of proof regarding the amount in excess of $25,130, failed to prove that the excess was excludable; as it was paid to settle the contract claims.

3. A fraudulently obtained annulment leaves you married for filing status purposes. Rinehart v. Commissioner, T.C. Memo. 2003-109 (4/18/03). Judge Vasquez held that the taxpayers proper filing status was as married, as asserted by the Commissioner, notwithstanding that they had their marriage judicially annulled, because, on the unusual facts, the Tax Court found that annulment had been obtained by a fraud on the Texas court.

C. Profit-Seeking Individual Deductions

1. The alternative minimum tax (“AMT”) trap for attorneys’ fees on large recoveries.

a. Cases decided in past years by the First, Fourth, Seventh, Eighth, Ninth, Tenth and Federal Circuits sprang the AMT trap. Attorney’s fees incurred by an individual in a nonbusiness profit-seeking transaction are [§ 212] miscellaneous itemized deductions [§67] and may not be deducted for AMT purposes. To avoid this result, taxpayers in a number of cases in recent years have argued the portion of a taxable damage award retained by the taxpayer-plaintiff’s attorney as a contingent fee is excluded from the taxpayer-plaintiff’s income and treated as income earned directly by the attorney. The Tax Court and most Courts of Appeals have reached conflicting results on this question. Generally, the Tax Court holds that attorney’s fee awards paid directly to a plaintiff’s attorney [or the portion of a damage award that is the attorney’s contingent fee that is so paid] are nevertheless includable in the litigant’s gross income, and that the taxpayer then may claim a deduction, subject to any applicable limitations, including disallowance of the deduction for AMT purposes if it is a § 212 deduction. Bagley v. Commissioner, 105 T.C. 396 (1995), aff’d 121 F.3d 393 (8th Cir. 1997); Accord: Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995), aff’d 30 Fed. Cl. 248 (1993); Alexander v. IRS, 72 F.3d 938, 96-1 U.S.T.C. ¶50,011 (1st Cir. 1995), aff’d T.C. Memo 1995-51; Coady v. Commissioner, 213 F.3d 1187, 2000-1 U.S.T.C. ¶50,528 (9th Cir. 2000), aff’d 212 F.3d 1451, 2000-2 U.S.T.C. ¶50,595 (9th Cir. 2000), aff’d T.C. Memo. 1998-29; Benci-Woodward v. Commissioner, 219 F.3d 941, 2000-2 U.S.T.C. ¶50,595 (9th Cir. 2000), aff’d T.C. Memo. 1998-395, cert. denied, 531 U.S. 1112 (2001); Kenseth v. Commissioner, 259 F.3d 881, 2001-2 U.S.T.C. ¶50,570, 88 A.F.T.R.2d 2001-5378 (7th Cir. 8/7/01), aff’d 113 T.C. 399 (5/24/00) (reviewed, 8-5); Young v. Commissioner, 240 F.3d 369, 2001-1 U.S.T.C. ¶50,244, 87 A.F.T.R.2d 2001-889 (4th Cir. 2/16/01), aff’d, 113 T.C. 152 (8/20/99); Hukkanen-Campbell v. Commissioner, 274 F.3d 1312, 2002-1 U.S.T.C. ¶50,351, 88 A.F.T.R.2d 2001-7983 (10th Cir. 12/19/01), aff’d 219 F.3d 941, 2000-2 U.S.T.C. ¶50,595 (9th Cir. 2000), aff’d T.C. Memo. 2000-180 (6/12/01), cert. denied, 535 U.S. 1056 (5/13/02).

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

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5 See TAM 200041022 (7/17/00) for some indication as to what the IRS might consider a physical injury.
In Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959), however, the Fifth Circuit held that attorney's fees so paid directly to a plaintiff's attorney are not includable by the litigant. The court of appeals reasoned that under the Alabama attorney's lien law, the ownership of the portion of the award representing attorney's fees vested in the attorney ab initio. Subsequently, in Srivastava v. Commissioner, 220 F.3d 353, 2000-2 U.S.T.C. ¶50,597 (5th Cir. 2000) (2-1), rev'g T.C. Memo. 1998-362, a majority decision of a Fifth Circuit panel held that Cotnam applied to attorneys' fees under Texas law because there is no difference in the "economic reality facing the taxpayer-plaintiff" between Alabama and Texas attorney's liens and any distinction between them does not affect the analysis required by the anticipatory assignment of income doctrine. A dissent by Judge Dennis distinguished Cotnam on the ground that Alabama law gives the holders of attorney's liens greater power than does Texas law.

In the Eleventh Circuit (as derived from pre-split Fifth Circuit precedents), under the Golsen rule, attorney's fees are not included in the income of an Alabama taxpayer who received a large punitive damages award. Davis v. Commissioner, 210 F.3d 1346, 2000-1 U.S.T.C. ¶50,431, 85 A.F.T.R.2d 2000-1567 (4/27/00) (per curiam), aff'g T.C. Memo. 1998-248 (7/7/98). The Eleventh Circuit panel held that, with respect to Alabama taxpayers, it was bound by Cotnam.

In Foster v. United States, 249 F.3d 1275, 1278 (11th Cir.2001), the Eleventh Circuit followed Davis in a subsequent case involving another Alabama taxpayer.

And there is no AMT trap in Vermont! Will the Second Circuit get a chance to opine? Raymond v. United States, 247 F. Supp. 2d 548, 2003-1 U.S.T.C. ¶50,196, 91 A.F.T.R.2d 2003-535 (D. Vt. 12/17/02). The district court (Chief Judge Sessions) followed Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959), to exclude contingent attorney's fees in a wrongful discharge cases attorney's fees because under state law the plaintiff taxpayer never personally owed the contingent fee and attorney's lien gave him an equitable interest in the plaintiff's claim. He concluded that the taxpayer transferred an interest in income producing property before the income was realized, rejecting the reasoning of all of the cases to the contrary, e.g., Kenseth v. Commissioner, 259 F.3d 881 (7th Cir. 2001), aff'g 114 T.C. 399 (2000), that refused to treat state law as controlling and applying the assignment of income doctrine of Old Colony Trust Co., 279 U.S. 716 (1929). Notably, Judge Sessions also chose not to rely on Srivastava v. Commissioner, 220 F.3d 353 (5th Cir. 2000), in which the Fifth Circuit abandoned reliance on state law in holding that successful plaintiffs are not required to include and deduct contingent attorney's fees but may simply exclude them.

Now we discover that in the Ninth Circuit it all depends on which state's attorney's lien law controls. Banaitis v. Commissioner, F.3d ___, 2003 WL 22016822, 2003 U.S. App. LEXIS 17913 (9th Cir. 8/27/03), rev'g T.C. Memo. 2002-5. In a case involving attorney's fees subject to Oregon attorney's fee lien law, the Ninth Circuit (Judge Thomas) held the portion of a taxable damage award (for wrongful discharge from employment) retained by the attorney as a contingent fee was not includable in the taxpayer-plaintiff's gross income. Judge Thomas found that the nature of the attorney's fee lien was determinative. Examining relevant state law, he concluded that under Oregon law, the attorney's claim to the fee was even stronger than under Alabama law. Therefore he applied the Fifth Circuit's decision in Cotnam v. Commissioner, 263 F.2d 119 (5th Cir.1959), holding that contingent attorney's fees paid directly to an attorney were not includable in the client's gross income because Alabama attorney's fee lien law vested title in the attorney ab initio. Judge Thomas declined to apply the Ninth Circuit's precedents in Benci-Woodward v. Commissioner, 219 F.3d 941, 943 (9th Cir.2000), cert.

* Under Bonner v. City of Prichard, Alabama, 661 F.2d 1206 (11th Cir. 1981), Fifth Circuit decisions rendered before the Eleventh Circuit was created are binding precedent in the Eleventh Circuit.
denied, 531 U.S. 1112 (2001), and Coady v. Commissioner, 213 F.3d 1187 (9th Cir.2000), on the grounds that Oregon attorney’s fee lien law was significantly different than that of California and Alaska, which were relevant in those cases.

- In his opinion, Judge Thomas described the Fifth Circuit as having “reached a similar conclusion about the operation of Texas law” in Srivastava v. Commissioner, 220 F.3d 353 (5th Cir.2000), and the Eleventh Circuit as “extending Cotnam’s Alabama-law-based holding into the law of the entire Eleventh Circuit” in Foster v. United States, 249 F.3d 1275, 1278 (11th Cir.2001), notwithstanding that in Srivastava the Fifth Circuit actually reached its conclusion wholly apart from the niceties of Texas attorney’s lien law and in Foster the Eleventh Circuit was dealing with a case that arose in Alabama, for which there was no doubt that Cotnam was the controlling precedent. [The Eleventh Circuit has not yet decided an attorney’s fees AMT trap case arising in Florida or Georgia.]

2. A non deductible estate administration expense. Schwan v. United States, 2003-1 U.S.T.C. §50,362, 91 A.F.T.R.2d 2003-1658 (D. S.D. 3/16/03). Interest, required by a statute, on a specific legacy payable from an estate to the legatee when the legacy is not paid within a statutorily specified period, is not deductible under either § 163 or § 212.

D. Hobby Losses and § 280A Home Office and Vacation Homes

E. Deductions and Credits for Personal Expenses

1. Another court imposes second-class citizen status on a trust’s § 212 deductions for investment advisory fees. The Fourth Circuit follows the Federal Circuit’s Mellon case, but not the Sixth Circuit’s O’Neill case, in deciding that a trust’s investment advisor fees are subject to the § 67(a) two-percent floor for miscellaneous itemized deductions. Scott v. United States, 328 F.3d 132, 2003-1 U.S.T.C. §50,428, 91 A.F.T.R.2d 2003-2100 (4th Cir. 5/1/03), aff’g 186 F. Supp. 2d 664, 2002-1 U.S. T.C. §50,364, 89 A.F.T.R.2d 1314 (E.D. Va. 2/28/02). The court used dictionary definitions to affirm the District Court’s grant of summary judgment to the government, and rejected the taxpayers’ contention that the fees were fully deductible under § 67(e) (which allows full deduction if the fees “would not have been incurred if the property were not held in trust”). The court concluded that the requirement of the second clause of § 67(e)(1), excepting from the floor costs that would not have been incurred if the property were not held by a trust or estate did not apply because “investment-advice fees are commonly incurred outside the context of trust administration.” That “the investment advisory fees were necessary to the continued growth of the Trust and were caused by the fiduciary duties of the co-trustees” was irrelevant. “The second requirement of § 67(e)(1) does not ask whether costs are commonly incurred in the administration of trusts. Instead, it asks whether costs are commonly incurred outside the administration of trusts.”

2. The Fourth Circuit did not reach the Virginia state law issue on which the District Court decided the case.

3. Boltinghouse v. Commissioner, T.C. Memo. 2003-134 (5/13/03). A declaration that the custodial spouse will not claim the child as a dependent is valid pursuant to § 152(e)(2) even though it was executed prior to the divorce decree and was not incorporated into the divorce decree.

3. Grandma’s big teeth may not be whitened with tax-deductible dollars, but the costs of breast reconstruction surgery and vision correction surgery are deductible. Rev. Rul. 2003-57, 2003-22 I.R.B. 959 (5/16/03). Costs to whiten teeth discolored as a result of age are not deductible, though it was executed prior to the divorce decree and was not incorporated into the divorce decree.

4. Sometimes you need a prescription, sometime you don’t. Rev. Rul. 2003-58, 2003-22 I.R.B. 959 (6/2/03). Amounts paid by an individual for medicines that may be purchased without a prescription of a physician, e.g., aspirin, are not deductible under § 213 of the Code, even when the taxpayer’s physician instructs the taxpayer to take the medication to alleviate a medical problem. Amounts paid by an individual for equipment, supplies [e.g., crutches for a taxpayer with a broken leg] or diagnostic devices [e.g., a blood sugar monitoring kit for a taxpayer with diabetes] that may be purchased without a physician’s prescription may be deductible under § 213.

5. Marriage penalty relief for the standard deduction amount. The combined effect of the 2001 Act and the 2003 Act has been to double of the basic standard deduction amount for
married taxpayers filing a joint return to twice the basic standard deduction amount for single individuals on a temporary basis for 2003 and 2004.

- For 2005 the basic standard deduction amount married taxpayers filing a joint return is 174 percent of the basic standard deduction for single individuals, increasing in steps over the following four years, with the result that in 2009 and thereafter the amount of the basic standard deduction for married taxpayers filing a joint return again will be twice the basic standard deduction for single individuals. However, these changes sunset on 12/31/10.

6. Acceleration of increase in the § 24 child credit. In the 2001 Act, the amount of the § 24 child credit was increased to $600 for taxable years 2001 and 2002. The 2003 Act increases the amount to $1,000 for 2003 and 2004.

- In 2005, the credit is reduced to $700, but then increases to $1,000 for 2010. See § 24(a)(2). However, these changes sunset on 12/31/10. Thus, absent further congressional action the amount of the credit reverts to $500 in 2011.

7. Advance refund of the increased amount of 2003 child credit. The 2003 Act adds new § 6429, which provides an advance cash refund of $400 per child who was allowed a § 24 credit for the 2002 year and who has not attained the age 17 (as of 12/31/03). The cash refund is to be made before 10/1/03. The amount of the cash refund will reduce the 2003 child credit, but not below zero.

- This provision may be expanded to include more children of lower-income (non)taxpayers.

8. “Happy birthday to you, happy birthday to you. ... How old are you now?” Rev. Rul. 2003-72, 2003-33 I.R.B. 346 (8/18/03). A child attains an age on his or her birthday for purposes of §§ 21 (child and dependent care credit), 23 (adoption credit), 24 (child tax credit), 32 (earned income credit), 129 (excludable dependent care benefits), 131 (excludable foster care benefits), 137 (excludable adoption assistance benefits), and 151 (dependency exemptions).

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

1. Is there any HOPE that the educational credit rules ever will be understandable to anyone in the income range eligible to use them – like the earned income tax credit rules? T.D. 9034, Education Tax Credit, 67 F.R. 78687 (12/26/02). The Treasury Department has promulgated final regulations regarding the Hope Scholarship Credit and the Lifetime Learning Credit under § 25A.


VI. CORPORATIONS

A. Entity and Formation

1. Relief for late initial classification elections. Rev. Proc. 2002-59, 2002-39 I.R.B. 615 (9/30/02), modifying and superseding Rev. Proc. 2002-15, 2002-6 I.R.B. 490 (2/11/02). This notice provides guidance for seeking relief from a late filed initial classification election under the § 7701 check-the-box regulations by a newly formed entity. Relief is available only if Form 8832 was not filed, the due date for the return for the desired classification has not passed, and the entity shows reasonable cause.

2. The “emerging equitable interpretation of § 357(c)” argument wasn’t a winner. Seggerman Farms v. Commissioner, 308 F.3d 803, 90 A.F.T.R.2d 2002-6981, 2002-2 U.S.T.C. ¶50,728 (7th Cir. 10/24/02), aff’g T.C. Memo. 2001-99 (4/25/01). Shareholders who transferred a family farm to a corporation in a § 351 transaction were required under § 357(c) to recognize gain on the transfer to the extent the liabilities to which the transferred property was subject exceeded the adjusted basis of the property. The shareholders argued that because they had personally guaranteed the debt, they were not relieved of their obligations on the transferred property, and, thus, no gain should be recognized on the transfer. The court (Judge Bauer) held that § 357(c) requires gain recognition even if the transferor remains liable as a guarantor. Judge Bauer rejected the taxpayers’ argument that under “‘the emerging equitable interpretation of § 357(c)”’ their guarantees should be treated in the same manner as the shareholders’ promissory notes to the corporations in Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989) and Peracchi v. Commissioner, 143 F.3d 487 (9th Cir. 1998), because the a guarantee, standing alone, does not constitute an “economic outlay.”
• Although the case arose prior to the 1999 amendments to § 357(c) and (d), the Tax Court noted in its opinion that the result would not be different under the current statute.

3. **Back to back § 351 transfers are OK.** Rev. Rul. 2003-51, 2003-21 I.R.B. 938 (5/5/03). W Corporation and X Corporation (unrelated to W) both engaged in the same line of business. W's business was worth $40x; X's business, conducted through its subsidiary, Y Corporation, was worth $30x. Pursuant to a prearranged binding agreement W and X consolidated their business operations in a new corporation with a holding company structure. W formed Z Corporation by transferring the business assets to Z in exchange for all of Z's stock. W immediately contributed the Z stock to Y in exchange for Y stock of Y and X simultaneously contributed $30x to Y (to meet the capital needs of the business) in exchange for additional stock of Y. W and X owned 40 percent and 60 percent, respectively, of the Y stock. Y, in turn, transferred all of its assets to Z. Viewed separately, each of the first transfer, the combined second and third transfers, and fourth transfer qualifies as a transfer described in § 351. The IRS ruled that the second transfer — W's transfer of its Z stock to Y — did not cause the first transfer — W's transfer of assets to Z — to fail the control requirement of § 351, event though both transfers were undertaken pursuant to a prearranged binding agreement. Citing Rev. Rul. 84-111, 1984-2 C.B. 88 (Situation 1), the IRS concluded that treating a transfer of property that is followed by a nontaxable disposition of the stock received as a § 351 transaction is "not necessarily inconsistent with the purposes of § 351." The IRS distinguished Rev. Rul. 70-140, 1970-1 C.B. 73, in which a transfer of assets of a proprietorship to a controlled corporation, followed by an exchange of the subsidiary's stock for stock of an unrelated, widely held corporation was treated as a direct transfer of assets to the other corporation in a taxable transaction. In Rev. Rul. 70-140 no alternative form of transaction could have qualified for nonrecognition. In the instance case, however, W's transfer of the business assets to Z was not necessary for W and X to combine their businesses in a holding company structure that would have qualified under § 351. If in exchange for Y stock, W had transferred the assets to Y and X had transferred $30x to Y, and Y had transferred the business to Z in exchange for all of the Z stock, the transfers would have would have qualified under § 351. [See Rev. Rul. 83-34; Rev. Rul. 77-449.]

4. **An ANPRM announcing that the Treasury intends to amend the Code via regulations — and this time it might actually have the statutory authority to do so.** REG-100818-01, Liabilities Assumed in Certain Transactions, 68 F.R. 23931 (5/6/03). The IRS and Treasury are concerned that §§ 357(d) and 362(d) [providing rules for determining the amount of liability treated as assumed for purposes of §§ 357, 358(d), 358(h), 362(d), 368(a)(1)(C), and 368(a)(2)(B)], enacted as part of the Miscellaneous Trade and Technical Corrections Act of 1999, Public Law 106-36, do not always produce appropriate results and that it might be desirable to modify certain rules by regulation, as permitted by § 357(d)(3). This notice explains the issues and the rules the IRS and Treasury are considering proposing. The major proposals are as follows:

- (1) Modify § 357(d)(1)(B) to provide that if the transferor and the transferee have no agreement regarding the satisfaction of a nonrecourse liability, the transferee will not be treated as assuming the entire amount of the nonrecourse liability; if one or more of the assets that secure a nonrecourse liability are transferred to a transferee, the transferee would be treated as assuming a pro rata amount of the nonrecourse liability, based on relative fair market values of the transferred assets securing the liability and the fair market value of all of the assets securing the liability that are retained by the transferor.

- (2) Treating a transferee's express assumption of a nonrecourse debt of the transferor as a debt assumption even if no assets secured by the debt have been transferred if the transferee is expected to satisfy the nonrecourse liability.

- (3) Modifying § 357(d)(2) to reduce the amount of the nonrecourse liability a transferee is treated as assuming to reflect the amount another person has agreed, and is expected, to satisfy, even if such amount is in excess of the fair market value of the assets subject to such liability that the other person owns after the transfer.

- (4) Applying standards similar to those used to determine whether a transferee has assumed a recourse liability to determine whether a transferee has assumed a nonrecourse liability, if the transferee agrees to satisfy all or a portion of the liability. In such a case should the amount of liability assumed by a subsequent transferee be determined with reference to the rules pertaining to assumptions of nonrecourse liabilities or with reference to the rules pertaining to assumptions of recourse liabilities.

- (5) Whether to respect an agreement that the transferee will satisfy only a portion of a nonrecourse debt secured by transferred property with a value greater than the agree
upon portion where the transferor does not agree to indemnify the transferee against a loss in excess of the agreed upon debt assumption.

- (6) Providing that if a transferee has agreed to satisfy an amount of a liability that is greater than the amount that it is expected to satisfy, the transferee will be treated as having agreed to satisfy only the amount of the liability that it is expected to satisfy [only if the transferor, the transferee, and each person related to the transferor and transferee within the meaning of §§ 267(b) and 707(b) treat the transferee as having agreed to satisfy the amount of the liability that it is expected to satisfy].

- (7) A debt assumed by a transferee will no longer be treated as a debt of the transferor for any purposes, including a subsequent application of § 357(d).

- (8) Extending the rules of § 357 to §§ 304 and 336.

B. Distributions and Redemptions

1. Basis can live long after the stock is “redeemed.” Who’d a thunk it? REG-150313-01, Redemptions Taxable as Dividends, 67 F.R. 64331 (10/18/02). The IRS has proposed replacing the “proper adjustment” to the basis of remaining stock rule of Reg. § 1.302-2(c), which takes into account the unused basis of redeemed stock when the redemption is treated as a § 301 distribution. Prop. Reg. § 1.302-5 would provide that the redeemed shareholder [who is taxed under § 301] would retain the basis of the redeemed stock as a basis item separate from any remaining shares, whether or not the shareholder continues to actually own the stock of the redeeming corporation, and take it into account as a loss deduction at some future date. The loss subsequently can be claimed under either the “final inclusion date” rule or the “accelerated loss inclusion date” rule. The “final inclusion date” rule allows the loss deduction on the date on which the redeemed shareholder would have qualified under §302(b)(1), (2) or (3) if the facts on that date had been the facts immediately after the redemption, or alternatively, when an individual shareholder dies or a corporate shareholder is liquidated in a transaction to which § 331 applies. The “accelerated loss inclusion date” rule allows the redeemed shareholder to claim a loss attributable to the unutilized basis when the shareholder subsequently recognizes a gain on stock of the redeeming corporation, but the loss may be claimed only to the extent of the gain recognized. Because the loss attributable to the basis of the redeemed stock is treated as recognized on the redemption date, the attributes (e.g., character and source) of the loss are fixed on the redemption date, even if such loss is not taken into account until after the redemption date. These rules apply to § 304(a)(1) transactions taxed under § 301 by treating the unutilized basis in the redeemed corporation stock as basis in the stock of the acquiring corporation. Special rules apply to partnerships, in consolidated returns [Prop. Reg. § 1.1502-19(b)(5)], and to foreign corporations. These rules do not apply to redemptions of § 306 stock, but they do generally apply even in the case of a corporation wholly owned by a single shareholder, whether a corporation or an individual.

- These regulations are a reaction, in part, to basis shifting transactions, such as that described in Notice 2001-45, 2001-33 I.R.B. 129 [the so-called Bank of America transaction].

- It has been noted that if nuclear disaster ever overcomes the Earth, only the cockroach and basis would survive.

2. The Tax Court is bearish on Merrill Lynch. Merrill Lynch & Co., Inc. v. Commissioner, 120 T.C. 12 (1/15/03). In 1986 and 1987 Merrill Lynch structured several transactions to sell certain assets of first-tier and second-tier subsidiaries and not only eliminate any tax on the gains, but to create losses. To take advantage of the interaction of the consolidate return regulations and § 304 [before the promulgation of Reg. § 1.1502-80(b), rendering § 304 inoperative in consolidated returns], Merrill Lynch caused the subsidiaries holding the assets to drop the assets to be retained into new lower level subsidiaries [in § 351 transactions], following which the new subsidiaries were sold cross chain to other Merrill Lynch subsidiaries. The sales proceeds were then distributed to its parent by the subsidiary to be sold, and as that subsidiary was then sold. The plan was that the cross chain sale would be recharacterized as a dividend under § 304, which would result in a basis increase under Reg. §§ 1.1502-32 and -33 [as then in effect] in the stock of the subsidiaries to be sold. The IRS did not contest that § 304 applied, but responded that the “distributions” coupled with the sales of the subsidiaries outside the group were part of a firm and fixed plan by the subsidiaries that were sold outside the group to dispose of the stock of the lower tier subsidiaries that had been sold cross chain. Therefore, even after applying § 304 the distributions were treated as amounts received in a redemption under §302(b)(3) [applying Zenz v. Quinlivan, 213 F.2d 913 (6th Cir. 1954)]. The Tax Court (Judge Marvel) held that under the principles
of Niedermeyer v. Commissioner, 62 T.C. 280 (1974), a firm and fixed plan existed with respect to every such sale and held for the IRS.

The record establishes that on the dates of the cross-chain sales, petitioner had agreed upon, and had begun to implement, a firm and fixed plan to completely terminate the target corporations' ownership interests in the issuing corporations (the subsidiaries whose stock was sold cross-chain). The plan was carefully structured to achieve very favorable tax basis adjustments resulting from the interplay of section 304 and the consolidated return regulations, and the steps of the plan were described in detail in written summaries prepared for meetings of Merrill Parent's board of directors. As described in those written summaries, the cross-chain sales of the issuing corporations' stock and the sales of the target corporations were part of the same seamless web of corporate activity intended by petitioner to culminate in the sale of the target corporations outside the consolidated group.

3. **Nothing succeeds like the sweet smell of success.** Delta Plastics, Inc. v. Commissioner, T.C. Memo. 2003-54 (2/28/03). Shareholder loans to a start-up corporation were respected as such, and an interest deduction allowed, even thought the corporation's debt-equity ratio was 26:1. The corporation was capitalized with $183,500. It incurred $2,322,838 of secured startup loans - $2,169,013 from three unrelated creditors and $153,825 from a 47 percent shareholder. The corporation borrowed another $1,337,500 from a group of individuals consisting of six of its seven shareholders and the father of the one shareholder who did not make a loan to the corporation. The shareholder loans were roughly proportional to stock holdings, but they had all of the formal indicia of debt. They were evidenced by debenture notes, bore reasonable interest, and had a 10-year repayment schedule. Payments were not dependent upon profits or losses. Although the notes were unsecured and subordinated to secured creditors, and the debenture holders could enforce payment on the debenture notes only if the holders of more than 50 percent of the value of all the outstanding debenture notes joined in a proceeding to enforce payment, the corporation made all scheduled payments due. In just over 3 years, as a result of successful operations, the taxpayer's debt-equity ratio (treating the notes as debt and not as equity) was reduced from approximately 26:1 to approximately 4:1. However, the corporation paid no dividends. After examining those debt-equity analysis factors that it found relevant, the court concluded, “credible trial testimony was offered that a debtor-creditor relationship was intended between petitioner and the debenture holders with regard to the debenture funds.”

4. **Which dividends are taxed at capital gains rates?** See V.A.1.a., above.

C. **Liquidations**

D. **S Corporations**

1. **Excusing late elections is now simpler.** Rev. Proc. 2003-43, 2003-23 I.R.B. 998 (5/9/03). Provides a simplified method for taxpayers to request relief for late S corporation elections, ESBT elections, QSST elections and Qsub elections. Generally, relief is provided if the request for relief is filed within 24 months of the due date of the election.

2. **When your S corporation goes into bankruptcy, watch out!** Mourad v. Commissioner, 121 T.C. No. 1 (7/2/03). The filing of a bankruptcy petition by taxpayer's wholly-owned S corporation for a chapter 11 plan of reorganization (in which an independent trustee was appointed by the Bankruptcy Court) neither terminates an S election nor creates a separate taxable entity. Judge Ruwe held that the taxpayer is liable for the tax on the sale by the S corporation of its principal assets.

* Query: How could taxpayer have planned this better?

3. **Stacking qualified subpart E or testamentary trust status and a QSST or ESBT election.** T.D. 9078, Qualified Subchapter S Trust Election for Testamentary Trusts, 68 F.R. 42251 (7/17/03). Amendments to Reg. § 1.1361-1 relating to the two-year period for which former qualified subpart E trusts and testamentary trusts continue as qualified shareholders of S corporations and QSST elections for testamentary trusts at the termination of that period. The final regulations provide that a testamentary trust includes a trust that receives S corporation stock from a § 645 electing trust. The regulations also clarify that an ESBT election may be made for a former qualified subpart E trust or a testamentary trust that qualifies as an ESBT. Subject to certain exceptions, the regulations are effective 7/18/03.

4. **T.D. 9081; REG-129709-03, ESOP Qualifications, 58 F.R. 42970 (7/21/03).** Temporary and proposed regulations under § 409(p) concerning requirements for ESOPs holding stock of
S corporations, which prohibits allocations or accruals to the ESOP for any year that "meaningful benefits" are not provided to rank-and-file employees. The temporary and proposed regulations provide rules defining terms, such as "synthetic equity" and "disqualified persons."

E. Affiliated Corporations.

1. 

Suspended loss rules to be promulgated. Notice 2002-18, 2002-12 I.R.B. 644 (3/9/02). The Service announced that it and the Treasury intend to issue regulations that will prevent a consolidated group from obtaining a tax benefit from both the utilization of a loss from the disposition of stock (or another asset that reflects the basis of stock) and the utilization of a loss or deduction with respect to another asset that reflects the same economic loss. For example, where a member of a group contributes built-in loss assets to another member of the group in exchange for stock of such member in a transaction in which the basis of such stock is determined, directly or indirectly, in whole or in part, by reference to the basis of such assets and the transferor member sells such stock without causing the deconsolidation of the transferee, the group may benefit from the built-in loss in the contributed assets more than once. It is expected that the regulations will defer or otherwise limit utilization of the loss on the stock in such transactions and other transactions that facilitate the group's utilization of a single loss more than once.

a. The proposed suspended loss regulations are here. REG-131478-02, Guidance Under Section 1502; Suspension of Losses on Certain Stock Dispositions, 67 F.R. 65060 (10/23/02). Temp. Reg. §1.337(d)-2T (3/7/02), which generally allows a loss on the disposition of subsidiary member stock only to the extent that a taxpayer can establish that the stock loss is not attributable to the recognition of built-in gain, does not disallow stock loss that reflects loss carryforwards, deferred deductions, or built-in asset losses of the subsidiary member.

b. Final regulations on suspended losses. T.D. 9048, Guidance Under Section 1502; Suspension of Losses on Certain Stock Dispositions, 68 F.R. 12287 (3/14/03); Reg-131478-02, 68 F.R. 12324 (3/14/03).7 The Treasury Department has promulgated Temp. §1.1502-35T, amended various provisions, and published identical proposed regulations that: (1) require a consolidated group to redetermine the basis in subsidiary stock it owns immediately before certain transactions involving the subsidiary; and (2) suspend certain losses that the group recognizes on the disposition of subsidiary stock. These regulations implement Notice 2002-18, 2002-12 I.R.B. 644.

Basis Redetermination: If a group member transfers subsidiary stock with a basis exceeding its value ("loss shares") but the subsidiary remains a member of the group, the basis of the subsidiary's stock held by members of the group immediately before the transfer must be redetermined as follows: (1) all members of the group aggregate their bases in all shares of the subsidiary; and (2) that basis is allocated, (a) first to the shares of the subsidiary's preferred stock owned by the members of the group in proportion to, but not in excess of, their value on the date of the transfer, then (b) second, among all common shares of the subsidiary held by members of the group in proportion to their value on the date of the transfer.

If a group member owns loss shares in a subsidiary before the subsidiary deconsolidates the basis of the subsidiary's stock held by members of the group immediately before the deconsolidation must be redetermined as follows: (1) the group's basis in subsidiary loss shares is reduced by the "reallocable basis amount;" and (2) the "reallocable basis amount" is allocated (a) to increase the basis of all preferred shares of the subsidiary held by members of the group after the transfer to increase the basis of each share to its value immediately before the transfer, and then (b) to increase the group's basis in common shares in the subsidiary so that to the extent possible each share has the same ratio of basis to value. The "reallocable basis amount" is the lesser of (1) the aggregate loss in the group's subsidiary loss shares immediately before the deconsolidation, or (2) the subsidiary's items of deduction and loss that the group took into account in computing its basis adjustments for any subsidiary shares that were not loss shares. The basis redetermination rule does not apply if, among other things, the group disposes of all of its subsidiary stock to nonmembers in a single taxable year in one or more fully taxable transactions, or is

7 We are indebted to Prof. Don Leatherman, University of Tennessee College of Law for assistance with this description. Any errors that remain are our own.
allowed a worthless stock deduction with respect to all of its subsidiary stock (other than any transferred stock).

- **Suspended Losses:** If, after applying the basis redetermination rule, a member of the consolidated group recognizes a loss on the disposition of stock of a subsidiary that remains a member of the group, the loss is suspended to the extent of the "duplicated loss" with respect to that stock. The aggregate amount of duplicated loss for a subsidiary is the excess of (1) the sum of (a) the aggregate basis of the subsidiary's assets (excluding stock in other subsidiaries), (b) the subsidiary's losses that are carried to its first taxable year after the disposition, and (c) the subsidiary's deductions that have been recognized but deferred under another provision, over (2) the sum of (a) the value of stock of the subsidiary and (b) the subsidiary's liabilities that have been taken into account for tax purposes. The group must allocate that aggregate amount among all subsidiary shares, including the transferred shares. The suspended loss is limited to the duplicated loss for the transferred shares. The suspended loss is thereafter reduced, i.e., disallowed, as the subsidiary's deductions and losses are taken into account (i.e., absorbed) in determining the group's consolidated taxable income (or loss). But the loss reduction loss is limited to the excess of (1) the amount of the subsidiary's losses and deductions, over (2) the amount of those items the group takes into account in basis adjustments under the investment adjustment rules. An item of income or deduction is not taken into account to the extent the group can establish that the item was not reflected in the computation of the subsidiary's duplicated loss. Any suspended stock loss remaining at the time the subsidiary leaves the group is allowed (to the extent otherwise allowable). The regulations also provide that the loss suspension rule will not to be applied in a manner that permanently disallows an otherwise allowable deduction for an economic loss.

- **Worthlessness, Etc.:** If a member treats subsidiary stock as worthless under §165(g) and §1.1502-80(c) or if a member disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, e.g., a liquidation or worthless stock deduction, the unabsorbed losses of the subsidiary are treated as expired at the beginning of the group's next consolidated return year. However, the deemed expiration does not result in a negative basis adjustment to any member's stock under Reg. §1.1502-32,

- All of the rules are subject to various exceptions and tiering rules.

The regulations are generally effective after March 7, 2002, but only if the return is due after March 14, 2003.

2. **So just when will this suspended loss be allowed?** Textron, Inc. v. Commissioner, 115 T.C. 104 (8/7/00). In 1967, when AVCO acquired Paul Revere (PR) and PR became part of the AVCO group, PR owned 4 million shares of AVCO. In 1977, AVCO redeemed its shares owned by PR, and pursuant to former Reg. §1.1502-14(b)(1), PR did not recognize its loss, but pursuant to former Reg. §1.1502-31(b)(2)(ii) PR's basis in the stock was reallocated to the note. In 1987, after AVCO had been acquired by Textron, AVCO redeemed the note held by PR, on which PR realized a $15,000,000 loss, following which PR was liquidated into AVCO in a §332 liquidation. Judge Laro agreed with the Commissioner that former Reg. §1.1504-14(d)(4)(i) "deferred" PR's loss in 1987 [because the note was received in exchange for property, i.e., AVCO stock, in an exchanged basis transaction and the note was never held by a nonmember]. Judge Laro held that the determination of whether a note has been held by a nonmember under former Reg. §1.1502-14(d)(4)(i)(c) looks to whether the holder of the note is a nonmember at the time of the redemption, not to whether the holder of a note was a nonmember when the note was received when the holder becomes a member before the redemption. Finally, under former Reg. §1.1502-14(d)(4)(ii) and (e)(2), the liquidation of PR in a §332 liquidation did free up the suspended loss because AVCO inherited PR's tax characteristics.

- The analytical methodology of the Textron opinion is at odds with Tax Court Judge Wells's opinions in CSI Hydrostatic Testers v. Commissioner, 103 T.C. 398 (1994) and Internet Corp. v. Commissioner, 111 T.C. 294 (12/8/98), rev'd, 209 F.3d 901(6th Cir. 4/20/00). Those cases strictly construed the consolidated return regulations even though the results were difficult to support theoretically. In contrast, in Textron, Judge Laro interpreted Reg. §1.1502-14(d)(4)(i) in a manner that is difficult to justify under the literal language, but which reached a sensible theoretical result [under the single-entity theory of consolidated returns. He concluded that Reg. §1.1502-14(d)(4)(i) required PR to defer its loss on the redemption of the obligation it received for its AVCO stock even though one of the conditions for that section to apply is that the obligation "never have been held by a nonmember." Since PR

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8 We are indebted to Prof. Don Leatherman, University of Tennessee College of Law, for insightful suggestions regarding the analysis of the Textron case.
acquired the obligation before it became a member of the Textron group that redeemed the obligation, Judge Laro's conclusion that membership status was determined at the time that the obligation was redeemed effectively read out of the rule the word. He could have more effectively reached the same result by looking to former Reg. §1.1502-13(f)(2) to note that the AVCO group was a predecessor group to the Textron, so that Paul Revere should not have been considered ever to have been a nonmember.

- Note that if the redemption by AVCO of its stock held by PR had occurred after July 12, 1995, the loss would have been permanently disallowed under Reg. §1.1502-13(f)(6), which disallows any loss to a member on the sale or exchange of stock of the common parent corporation of a consolidated group. Under current regulations, if AVCO and PR both had been subsidiary members of the same consolidated group and the redemption was described in §302(a) – which would be unlikely – Reg. §1.1502-20(a) would disallow the loss, although a portion of it might be allowed under Reg. §1.1502-20(c). Section 267(f) would not defer the loss because Reg. §1.267(f)-1(c)(1) adopts the acceleration rule of Reg. §1.1502-13(d). The loss might, however, be subject to the anti-avoidance rules of both Reg. §1.267(f)-1(h) and §1.1502-13(h).

a. Exactly when the taxpayer wanted to, says the court of appeals. “Plain meaning” carries the day. Reversed. Textron v. United States, 92 A.F.T.R.2d 2003-5373 (1st Cir. 7/16/03). The Court of Appeals (Judge Porfilio) applied Gitliz style “plain meaning” analysis to interpreting the regulations and allowed the loss deduction. Since former Reg. §1.1504-14(d)(4)(i)(e) required that the note never have been held by a nonmember, and PR was a nonmember when it acquired the note, the condition in the regulation for deferring the loss had not been satisfied.

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

- In General Motors Corp. v. Commissioner, 112 T.C. 270 (1999), the Tax Court held that the timing rule of former [pre-1995] Reg. §1.1502-13(b)(2) was not a method of accounting for purposes of §446(e). The proposed regulations confirm the IRS’ position that the timing rules of current §1.1502-13 are a method of accounting.

a. Finalized. T.D. 9025, Intercompany Transactions: Conforming Amendments to Section 446, 67 F.R. 76985 (12/16/02). The proposed regulations were adopted without change, and are effective 11/7/01.

4. T.D. 9084, Consolidated Return Computation, 68 F.R. 44616 (7/30/03). Final regulations providing that certain events will not trigger recapture of a dual consolidated loss or payment of the associated interest charge.

F. Reorganizations

1. “Expessio unis est exclusio alterius”? Nope, not the way the IRS thinks. Rev. Rul. 2002-85, 2002-52 I.R.B. 986 (12/8/02). An acquiring corporation's transfer of the target corporation's assets to a subsidiary controlled by the acquiring corporation as part of a plan of reorganization will not disqualify a transaction that otherwise qualifies as a §368(a)(1)(D) reorganization – i.e., the original transferee acquires substantially all of the target’s assets, the COSI and COBE requirements are met, and the remote continuity principle of Groman and Bashford does not apply – and which would not have qualified as a type (C) reorganization [due to excessive boot]. The IRS reasoned, as it did in Rev. Rul. 2001-24, 2001-1 C.B. 1290, that §368(a)(2)(C) is permissive and not restrictive; thus the lack of a reference to §368(a)(2)(C) in §368(a)(2)(C) does not indicate that such a transfer following a transaction that otherwise qualifies as a reorganization under §368(a)(1)(D) will prevent the transaction from qualifying. In addition, the IRS treated the parenthetical exception in §368(a)(2)(A), dealing with the overlap of (C) and (D) reorganizations – “other than for purposes of §§368(a)(2)(C),” – as “in the same spirit as §368(a)(2)(C), i.e., to resolve doubts about the qualification of transactions as reorganizations, and *** not [to] indicate that the transfer of assets to a controlled subsidiary necessarily prevents a transaction from qualifying as a reorganization under §368(a)(1)(D).”

2. Merging tax somethings into tax nothings is OK, but not the opposite! T.D. 9038, Statutory Mergers and Consolidations, 68 F.R. 3384 (1/24/03), and REG-126485-01, Statutory Mergers and Consolidations, 68 F.R. 3477 (1/24/03). In REG-126485-01, Statutory Mergers and Consolidations, 66 F.R. 57400 (11/15/01), the Treasury withdrew the proposed regulations [REG-106186-98, Certain Corporate Reorganizations Involving Disregarded Entities, 65 FR 31115 (5/16/00)].
that would have provided that neither the merger of a disregarded entity into a corporation nor the merger of a target corporation into a disregarded entity was a statutory merger qualifying as a reorganization under § 368(a)(1)(A), and proposed more liberal regulations [Prop. Reg. § 1.368-2(b)(1)]. Under the 2001 proposed regulations, a merger of a corporation into a disregarded entity that is wholly owned by another corporation could qualify as a type (A) merger. The Treasury Department has now promulgated the 2001 proposed regulations, with some modifications, as Temp. Reg. § 1.368-2T(b) and simultaneously published new identical proposed regulations.

- The main point of the regulations is that the merger of a target corporation into an LLC wholly owned by another corporation (thereby rendering the LLC a disregarded entity) can qualify as a type (A) reorganization [and under more complex structures as a triangular reorganization; that the merger of a corporation into a Q-Sub [also a disregarded entity] can qualify as a type (A) reorganization; and that a merger into a qualified REIT subsidiary can qualify as a type (A) reorganization.

- Nevertheless, the new regulations introduce significant definitional jargon. The term "disregarded entity" means a business entity (as defined in Reg. § 301.7701-2(a)) that is disregarded as an entity separate from its owner for federal tax purposes, including single member corporate-owned LLCs, qualified REIT subsidiaries, and Q-Subs. "Combining entity" means a corporation [as defined in Reg. § 301.7701-2(b)] that is not a disregarded entity. "Combining unit" means a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for federal tax purposes. Under the proposed regulations, a statutory merger or consolidation under § 368(a)(1)(A) must be effected pursuant to the laws of the United States, a state or the District of Columbia. [Foreign statutory mergers still do not qualify, but the domestic statute no longer needs to be a "corporate" law.] All of the following events must occur simultaneously: (1) all of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharged in the transaction) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and (2) the combining entity of each transferor unit ceases its separate legal existence [although its formal existence can continue under state law for certain limited purposes that are not inconsistent with the "all of the assets" requirement.]. The examples provide all of the details of the rules: Divisive mergers [see Rev. Rul. 2000-5, 2000-1 C.B. 436] cannot qualify (Ex. 1); forward triangular mergers (into a disregarded entity owned by a subsidiary) are allowed (Ex. 2 & 4); the merger of a target S corporation that owns a Q-Sub into a disregarded entity owned by a C corporation qualifies as to both the target S corporation and its Q-sub (Ex. 3); the owner of the disregarded entity must be a corporation (Ex. 5); mergers of disregarded entities into corporations do not qualify (Ex. 6); none of the consideration received by the target shareholders may be interests in the disregarded entity (Ex. 7); and the target can be tailored by selling assets and distributing proceeds, as long as all of the remaining assets are transferred to the disregarded entity in the merger (Ex. 8).

- These regulations became effective on January 24, 2003.

3. CALIGULA XXI had COBE. Payne v. Commissioner, T.C. Memo. 2003-90 (3/27/03). The transfer from one corporation to another corporation wholly owned by the same shareholder of the substantially all assets associated with operation of a Houston strip club [CALIGULA XXI] in a transaction that met all of the statutory requirements of § 368(a)(1)(D) was a tax-free reorganization, even though at the time of the transfer the shareholder contemplated selling strip club and three months later the transferee corporation did sell all of its assets. Judge Halpern held that the continuity of business enterprise requirement of Reg. § 1.368-1(d) was met:

> [T]here is no direct evidence that JKP's actual sale of its assets was part of an overall plan existing at the time of the transfer of the club's operation from 2618 to JKP; and we do not infer the existence of such a plan by reason of the proximity in time of the two transactions. The mere fact that petitioner may have contemplated selling the club at the time of its transfer from 2618 to JKP does not require a finding that such transfer lacked COBE.

> [In Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1984, the taxpayer's] plan contemplated that the new company would carry on the * * * business, and this was done. Although petitioners' intention was to dispose of the * * * [business] eventually, the fact that a going business
was transferred and operated left the new company and petitioners, its shareholders, in a position where they stood to gain or lose from operations just as before the transfer; if business conditions warranted it, the business could have been continued indefinitely.

We hold that the reasoning of the First Circuit Court of Appeals in Lewis v. Commissioner, supra, applies to this case and that the transfer of the club from 2618 to JKP possessed COBE.

4. Rev. Proc. 2003-33, 2002-16 I.R.B. 803 (4/21/03). This procedure provides guidance to taxpayers in obtaining an extension of time under Reg. § 301.9100-3 to file § 338 elections [Form 8023].


- Situation 1 involved the conversion of a mutual insurance company to a stock insurance company. The mutual amended its articles of incorporation to authorize the issuance of stock and changed its name. Members of the mutual exchanged their interests for all the stock company's voting common stock, but persons holding mutual membership interests under contracts covered by § 403(b) or § 408(b) received policy credits in exchange for those interests. The IRS ruled that the conversion was either a § 368(a)(1)(E) recapitalization or a § 368(a)(1)(F) reorganization.
- Situation 2 involved the conversion of a mutual insurance company to a stock insurance company and the creation of a holding company structure. Mutual incorporated a Mutual Holding Company, which incorporated a Stock Holding Company. Mutual amended its articles of incorporation to authorize the issuance of stock and changed its name. Mutual's members received Mutual Holding Company membership interests in exchange for their mutual membership interests. Stock Company issued all of its stock directly to Mutual Holding Company; and Mutual Holding Company transferred all of its Stock Company stock to Stock Holding Company in exchange for voting stock of Stock Holding Company. The IRS ruled that the conversion was a reorganization under either § 368(a)(1)(E) or § 368(a)(1)(F). Furthermore, the result was not altered by the subsequent change in the direct ownership of the converted company, citing Reg. § 1.368-1(e)(1); Rev. Rul. 96-29, 1996-1 C.B. 50; and Rev. Rul. 77-415, 1977-2 C.B. 311. In addition, the acquisition by Stock Holding Company of Stock Company qualified as reorganization under § 368(a)(1)(B), as well as a § 351 transfer.
- In Situation 3 Mutual Holding Company owned all of the stock of Stock Holding Company, which owned all of the stock of Stock Company 2, a stock insurance company. Mutual Company amended its articles to authorize the issuance of stock and changed its name to Stock Company 2; Mutual Company's members received Mutual Holding Company interests in exchange for their Mutual Company interests; Stock Company 2 issued all of its stock directly to Mutual Holding Company; and Mutual Holding Company transferred all of its Stock Company 2 stock to Stock Holding Company in exchange for voting stock of Stock Holding Company. The conversion from Mutual Company to Stock Company 2 qualified as a reorganization under both § 368(a)(1)(E) and § 368(a)(1)(F). In addition, Mutual Holding Company's acquisition of either an interest equivalent to the stock of Stock Company 2 or the actual stock of Stock Company 2 qualified as a § 368(a)(1)(B) reorganization. Mutual Holding Company's transfer of its Stock Company 2 stock to Stock Holding Company qualified as both a § 368(a)(1)(B) reorganization and as a § 351 transfer.

6. **Mutual-to-Stock F reorganization followed by a second reorganization is OK (Part II).** Rev. Rul. 2003-48, 2003-19 I.R.B. 863 (4/22/03). The revenue ruling applied the principles developed in Rev. Rul. 2003-19, 2003-7 I.R.B. 468 (2/18/03), to the conversion of mutual savings banks to stock banks, as well as the adoption of holding company structures. The initial conversion and creation of a holding company qualified under § 351 and under § 368(a)(1)(E) and (F).

- But in Situation 1, which involved a reverse triangular merger of the stock bank, into which the mutual bank had been converted, into a transitory subsidiary of the Mutual Holding Company [to invert the parent-subsidiary relationship of the converted mutual and the Mutual Holding Company] followed by a prearranged drop of the stock savings bank to a Stock Holding Company [more than 50 percent, but less than 80 percent of the stock of which was owned by the Mutual Holding Company], the merger was not a reorganization under § 368(a)(1)(B) or § 368(a)(2)(E) because mutual holding did not control stock holding. However, because pursuant to the integrated plan the Stock Holding Company had issued more than 20 percent but less than 50 percent of its common stock to the public in a
qualified underwriting transaction [as defined in Reg. § 1.351-1(a)(3)], the merger transfer was entitled to nonrecognition under § 351.

- In Situation 2, not more than 20 percent of the stock of Stock Holding Company was issued to the public. In that situation, the merger qualified under both § 368(a)(1)(B) and § 368(a)(2)(E).

7. Turning off the step transaction doctrine when the acquirer so chooses. T.D. 9071, Effect of Elections in Certain Multi-step Transactions, 68 F.R. 40766 (6/10/03). Temp. Reg. § 1.338(h)(10)-1OT(c)(2) provides that the step transaction doctrine will not be applied if a taxpayer makes a valid § 338(h)(10) election with respect to a stock acquisition that, standing alone, is a qualified stock purchase, even if the transaction is part of a multi-step transaction that would otherwise qualify as a reorganization. The effective date of these temporary regulations is 7/9/03. See also, REG-143679-02, for proposed regulations that mirror the temporary regulations.


G. Corporate Divisions

1. Does this ruling apply when the Geo dealer buys a Mercedes dealership? Rev. Rul. 2003-18, 2003-7 I.R.B. 467 (1/22/03). This ruling held that the taxable acquisition of a franchise to sell and service brand Y automobiles and the assets to operate the franchise by a corporation that had a five-year history of being a dealer of brand X automobiles constituted an expansion of the brand X business rather than the acquisition of a new or different business under Reg. §1.355-3(b)(3)(ii). The facts of the ruling state that the brand X and brand Y dealership businesses were conducted on adjacent leaseholds, but the analysis does not pursue this fact. The analysis states:

[B]ecause (i) the product of the brand X automobile dealership is similar to the product of the brand Y automobile dealership, (ii) the business activities associated with the operation of the brand X automobile dealership (i.e., sales and service) are the same as the business activities associated with the operation of the brand Y automobile dealership, and (iii) the operation of the brand Y automobile dealership involves the use of the experience and know-how that D developed in the operation of the brand X automobile dealership, the brand Y automobile dealership is in the same line of business as the brand X dealership and its acquisition does not constitute the acquisition of a new or different business ....

- Rev. Rul. 57-190, 1957-1 C.B. 121 was obsoleted.
- Although the quoted language might be read as a factual conclusion that the specific cars involved were similar, e.g., Toyotas and Hondas, IRS Chief Counsel's Office views it as a conclusion of law, e.g., Geos are the same as Mercedes.

2. Bricks to clicks business expansion passes the SMOAKE test. Rev. Rul. 2003-38, 2003-17 I.R.B. 811 (4/4/03). Corporation D operated a retail shoe store business in shopping malls and other locations, under the name "D" for more than five years. D's business enjoyed favorable name recognition, customer loyalty, and goodwill in the retail shoe market. D created an Internet web site and began selling shoes at retail through the Internet. To take advantage of D's name recognition, customer loyalty, and established goodwill, and to enhance the web site's chances for success, the web site was named "D.com." To a significant extent, the operation of the web site drew upon D's experience and know-how. Two years later, D transferred the web site based business's assets and liabilities to C, a newly formed controlled subsidiary, and spun-off C pro rata. The IRS ruled that under Reg. § 1.355-3(b)(3)(ii), the Internet sales operation was an expansion of the retail store business, not a new business. Thus, each of D and C was engaged in the active conduct of a five-year trade or business. See Rev. Rul. 2003-18 and § 1.355-3(c), Examples (7) and (8). The products and the principal business activities of the retail shoe store business and the internet-based business were the same. Although selling shoes on the Internet required some know-how different from operating a retail store (different marketing approaches, distribution chains, and technical operations issues), the web site's operation drew significantly on D's existing experience and know-how, and its success would depend largely on D's pre-existing goodwill.

- The analytical model used by the Revenue Ruling to determine that the clicks business was an expansion of the bricks business was based on analyzing the extent that the

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9 Shared (1) subject matter; (2) operational activities; and (3) knowledge and experience.
two shared (1) subject matter; (2) operational activities; and (3) knowledge and experience. [The SMOAKE test?] The first two were met and the third was not, but the deficiency was cured by the overlapping goodwill.

3. **Beef for the boy and grass for the girl equals business purpose.** Rev. Rul. 2003-52, 2003-22 I.R.B. 960 (5/12/03). The IRS ruled that the business purpose requirement of Reg. § 1.355-2(b) was satisfied in the following circumstances. X Corporation was engaged in the farming business, consisting of breeding and raising livestock and growing grain, for more than five years. The stock of X was owned equally by Father, age 68, Mother, age 67, Son, and Daughter. Father and Mother participated in some major management decisions, but Son and Daughter performed most of the management. Son and Daughter generally cooperated and operated the farm without disruption, but they disagreed about the appropriate future direction of the farming business. Son wanted to expand the livestock business, while Daughter wanted to sell the livestock business and concentrate on the grain business. The disagreement prevented them from developing, as they saw fit, the business in which each of them was most interested. Father and Mother were neutral regarding the disagreement, but because of the disagreement, they wanted to bequeath separate interests in the farm business to the children. For reasons unrelated to the farm, Son and Daughter's husband dislike each other. Although this did not impair the farm's operation, Father and Mother believed that requiring Son and Daughter to run a single business together was eventually likely to cause family discord. To enable Son and Daughter each to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested, to further the estate planning goals of Father and Mother, and to promote family harmony, X transfers the livestock business to a newly formed wholly owned subsidiary, Y Corporation, and X distributed 50 percent of the Y stock to Son in exchange for all of his X stock. The remaining Y stock was distributed equally to Father and Mother in exchange for half of their X stock. Thereafter, Father and Mother (who each owned 25 percent of the outstanding stock of X and Y) continued to participate in some major management decisions related to the business of each corporation. Daughter, who had no interest in the livestock corporation, managed and operated X, and Son managed and operated Y and had no interest in X. Father and Mother amended their wills to devise their Y stock to Son and their X stock to Daughter. The IRS reasoned that the distribution eliminated a disagreement that prevented the development of the business and "allowed each sibling to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested, with the expectation that each business would benefit. Therefore, although the distribution is intended, in part, to further the personal estate planning of Father and Mother and to promote family harmony, it is motivated in substantial part by a real and substantial non-Federal tax purpose that is germane to the business of X."

4. **You only have to be pure of mind at the time of the distribution.** Rev. Rul. 2003-55, 2003-22 I.R.B. 961 (5/12/03). The IRS ruled that the business purpose requirement of Reg. § 1.355-2(b) is satisfied if the distribution of the stock of a controlled corporation is, at the time of the distribution, motivated, in whole or substantial part, by a corporate business purpose, but that purpose cannot be achieved as the result of an unexpected change in circumstances following the distribution. "The regulations do not require that the corporation in fact succeed in meeting its corporate business purpose, as long as, at the time of the distribution, such a purpose exists and motivates, in whole or substantial part, the distribution." The specific facts were as follows. D, a publicly traded corporation conducted two businesses directly and a third business through its wholly owned subsidiary, C. To invest in plant and equipment and to make acquisitions, C had to raise a substantial amount of capital. D's investment banker advised D that the best way to raise this capital was by a public offering of C stock after C was separated from D. D distributed the C stock to its shareholders, and C prepared to offer its stock to the public, with a target date approximately six months after the distribution. Following the distribution and before the offering could be undertaken, market conditions unexpectedly deteriorated to such an extent that the public offering was postponed. One year after the distribution, conditions still had not improved sufficiently to permit the offering to go forward and C funded its capital needs through the sale of debentures.

5. **Management focus is a business purpose.** Rev. Rul. 2003-74, 2003-29 I.R.B. 77 (6/24/03). Distributing is a publicly traded corporation that conducts a software technology business. Controlled is a wholly-owned subsidiary of Distributing and conducts a paper products business. Management of each corporation would prefer to concentrate its efforts solely on the business conducted by that corporation, but the ownership of Controlled by Distributing prevents Distributing's management from concentrating solely on the software business. Held, the distribution of the stock of a controlled
corporation by a distributing corporation to enable the management of each corporation to concentrate on its own business satisfies the business purpose requirement of Reg. § 1.355-2(b).

6. Competing for investors and lenders is a business purpose. Rev. Rul. 2003-75, 2003-29 I.R.B. 79 (6/24/03). Distributing is a publicly traded corporation that conducts a pharmaceuticals business. Controlled is a wholly-owned subsidiary of Distributing and conducts a cosmetics business. These businesses compete for capital from borrowing and internal cash flows. The distribution of the stock of a controlled corporation to resolve a capital allocation problem between the two corporations satisfies the business purpose requirement of Reg. § 1.355-2(b).

7. Private letter rulings under § 355 will be harder to come by after August 8th. Rev. Proc. 2003-48; 2003-29 I.R.B. 86 (6/24/03). This revenue procedure notes that in the past the IRS has not adhered to its policy of not giving “comfort rulings” in the § 355 area. It sets up a one-year pilot program for rulings postmarked after 8/8/03 of not ruling on three issues with respect to corporate divisions. The National Office will not determine (1) whether a proposed or completed distribution of the stock of a controlled corporation is being carried out for one or more corporate business purposes, (2) whether the transaction is used principally as a device, or (3) whether the distribution and an acquisition are part of a plan under § 355(e).

8. “Nephew of Morris Trust” transaction is blessed. Rev. Rul. 2003-79, 2003-29 I.R.B. 80 (7/1/03). A spin-off or one of two business of equal size by means of a transfer of the assets of one of the businesses to a controlled corporation, followed by the acquisition of substantially all the assets of the controlled corporation by an unrelated corporation in the same business, meets all the requirements of §§ 368(a)(1)(D), 355(a), and 368(a)(1)(C) – even though an acquisition of the same properties from the distributing corporation would have failed this requirement if the transfer of those properties had not been made to the controlled corporation.

H. Personal Holding Companies and Accumulated Earnings Tax

1. Personal holding company tax rate reduced to 15 percent. Because the 2003 Act reduced the maximum tax rate on dividends to 15 percent, § 541 was amended to reduce the personal holding company tax rate to 15 percent.

2. Accumulated earnings tax rate reduced to 15 percent. Because the 2003 Act reduced the maximum tax rate on dividends to 15 percent, § 531 was amended to reduce the accumulated earnings tax rate to 15 percent.

3. Debt aversion avoids AET. Otto Candies, LLC v. United States, 91 A.F.T.R.2d 2003-2520, 2003-1 U.S.T.C. ¶50,516 (E.D. La. 5/28/03). The taxpayer [an LLC taxed as an S corporation that was a successor to a C corporation], a family corporation with three shareholders that was “one of the leading providers of marine transportation in the Gulf of Mexico,” was held not to be liable for the § 531 accumulated earnings tax. The corporation, which had accumulated reserves of between $15 and $21 million during the years in question, was engaged in a volatile business and the dominant shareholder was conservative and avoided debt. Accumulations were required to fund necessary periodic fleet replacement, including newer vessels with modern technology meeting customer demands, new ventures into related businesses, and to internally fund future redemptions [under a contract] upon the death of a shareholder.

I. Miscellaneous Corporate Issues

1. Telling the IRS about your corporate/shareholder transactions. T.D. 9022, Information Reporting Relating to Taxable Stock Transactions, 67 F.R. 69468 (11/18/02). Temp. Reg. § 1.6043-4T imposes information reporting requirements [Form 8806] on corporations that have undergone a change in control or a substantial change in capital structure, e.g., a recapitalization, redemption, merger, transfer of substantially all its assets or an (F) reorganization. However, transactions in which the amount of cash and the fair market value of property (including stock) provided to the shareholders is less than $100,000,000 are exempt, as are transactions within an affiliated group.

2. Repeal of collapsible corporation rules. With dividends and long-term capital gains taxed at the same rate, the tax avoidance issues at which § 341 was directed no longer exist. Accordingly, § 341 was repealed in the 2003 Act.

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. Husbands and wives are co-owners of a disregarded entity or partners [their choice], if the business is community property; if the business is not community property, then they are partners. Rev. Proc. 2002-69, 2002-45 I.R.B. 831 (10/9/02). This revenue procedure deals
with the classification of business entities (other than corporations), i.e., partnerships and LLCs, that are wholly owned by a husband and wife as community property. If the husband and wife treat the entity as a disregarded entity for federal tax purposes, the IRS will accept the position that the entity is a disregarded entity for federal tax purposes. On the other hand, if the entity, and the husband and wife, treat the entity as a partnership for federal tax purposes and file appropriate partnership returns, the IRS will accept the position that the entity is a partnership for federal tax purposes. A change in reporting position will be treated for federal tax purposes as a conversion of the entity.

- Nothing in the revenue procedure allows husbands and wives who wholly own an LLC or partnership in a common law property state to avoid entity characterization.

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

1. No more "inappropriate" increases or decreases in the adjusted basis of a corporate partner’s interest in a partnership. T.D. 8986, Determination of Basis of Partner’s Interest; Special Rules, 67 F.R. 15112 (3/29/02). The Treasury has finalized Reg. § 1.705-2 [proposed in REG-106702-00, Determination of Basis of Partner’s Interest; Special Rules, 66 F.R. 315 (1/3/01)] which is intended to prevent what the IRS has determined to be “inappropriate” increases or decreases in the adjusted basis of a corporate partner’s interest in a partnership [consistent with Notice 99-57, 1999-2 C.B. 692] resulting from the partnership’s disposition of the corporate partner’s stock [under the general principles of Rev. Rul. 99-57, 1999-2 C.B. 678], when: (1) a corporation acquires an interest in a partnership that holds stock in the corporation, (2) the partnership does not have a § 754 election in effect for the year in which the corporation acquires the interest, and (3) the partnership later sells or exchanges the stock. The increase or decrease in the corporation’s adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain or loss that the corporate partner would have recognized (absent the application of § 1032) if, for the tax year in which the corporation acquired the interest, a § 754 election had been in effect. The final regulations require appropriate adjustments to the basis of tiered partnerships to prevent evasion of their purpose where a corporation acquires an indirect interest in its own stock through a chain of partnerships and gain or loss from the sale of stock is subsequently allocated to the corporation. The regulation is effective retroactively to gain or loss allocated on sales or exchanges of stock occurring after 12/6/99.

   a. **Proposed amendments before the ink is dry.** REG-167648-01, Amendments to Rules for Determination of Basis of Partner’s Interest; Special Rules, 67 F.R. 15132 (3/29/02). The Treasury has proposed amendments to Reg. § 1.705-2, which was finalized on the same day the proposed amendments were published, “to address remaining issues that [were] considered during the development of the final regulations. The proposed amendments would extend the rules of Reg. § 1.705-2 to situations in which a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes gain on the distribution during a year in which the corporation does not have a § 754 election in effect, and the partnership subsequently sells or exchanges the stock. The proposed amendments also clarify that “stock” of a corporate partner includes any position with respect to stock of a corporate partner. The proposed amendments would be effective retroactively to gain or loss allocated on sales or exchanges of stock occurring after 12/6/99.

   b. **Finalized.** T.D. 9049, Amendments to Rules for Determination of Basis of Partner’s Interest; Special Rules, 68 F.R. 12815 (3/18/03). The proposed amendments to Reg. § 1.705-2 have been finalized with a generally effective date of after 12/6/99. The final regulations extend the rules of the proposed regulations to situations in which a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes loss on the distribution or the basis of the property distributed to that partner is adjusted during a year in which the partnership does not have an election under § 754 in effect, and the partnership subsequently sells or exchanges the stock.

2. **What happens when § 752 meets a deferred like-kind exchange that straddles year-end?** Rev. Rul. 2003-56, 2003-23 I.R.B. 985 (5/9/03). The ruling deals with the treatment of partnership liabilities under § 752 when a partnership enters into a deferred § 1031 like kind exchange in which property subject to a liability is transferred in one taxable year and replacement property subject to a liability is received in the following taxable year. The IRS ruled that the liabilities are netted for purposes of § 752. A net decrease in a partner’s share of partnership liability is treated as a distribution under § 752(b) in the year the surrendered property was transferred; and under Reg. § 1.731-1(a)(1)(ii) and Rev. Rul. 94-4, 1994-1 C.B. 196, it is treated as an advance or draw of money to the extent of each partner’s distributive share of income for that year, with the result that basis increases for partnership
income for the year are taken into account for the deemed distribution. The gain recognized under § 1031 attributable to the boot that results from net debt relief is treated as recognized in the year in which the relinquished property has been transferred; thus the gain from the § 1031 transaction is taken into account in determining whether the § 752(b) deemed distribution exceeds the partner's basis in the partnership interest under § 731. [If the relinquished liability and the replacement liability are nonrecourse, under Reg. § 1.704-2(d), the partnership minimum gain on the last day of the first taxable year of the partnership is computed by using the replacement property and its tax basis as determined under § 1031(d) and the replacement nonrecourse liability (but only to the extent of the relinquished nonrecourse liability).] A net increase in a partner's share of partnership liability is taken into account under § 752(a) in the year in which the partnership receives the replacement property.

3. **Fighting duplication and acceleration of losses through partnerships before June 24, 2003.** T.D. 9062, Assumption of Partner Liabilities, 68 F.R. 37414 (6/24/03). Temp. Reg. § 1.752-6T provides rules, similar to the rules applicable to corporations in § 358(h), to prevent the duplication and acceleration of loss through the assumption by a partnership of a liability of a partner in a nonrecognition transaction. Under the temporary regulations, if a partnership assumes a liability, as defined in § 358(h)(3), of a partner (other than a liability to which § 752(a) and (b) apply) in a § 721 transaction, after application of §§ 752(a) and (b), the partner's basis in the partnership is reduced (but not below the adjusted value of such interest) by the amount of the liability. For this purpose, the term "liability" includes any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for Federal tax purposes. Reduction of a partner's basis generally is not required if: (1) the trade or business with which the liability is associated is transferred to the partnership, or (2) substantially all of the assets with which the liability is associated are contributed to the partnership. However, the exception for contributions of substantially all of the assets does not apply to a transaction described in Notice 2000-44, 2000-2 C.B. 255 (or a substantially similar transaction).

The temporary regulations are effective for transactions occurring after 10/18/99 and before 6/24/03.

4. **Defining the term "liability" in § 752 and fighting duplication and acceleration of losses through partnerships after June 24, 2003.** REG-106736-00, Assumption of Partner Liabilities, 68 F.R. 37434 (6/24/03). The Treasury has proposed extraordinarily complex, verging on incomprehensible, regulations: (1) defining liabilities under § 752; (2) dealing with a partnership's assumption of certain fixed and contingent obligations in exchange for a partnership interest [Prop. Reg. § 1.752-7]; and (3) providing rules under § 358(h) for assumptions of liabilities by corporations from partners and partnerships [Prop. Reg. § 1.358-7]. Reg. § 1.752-1(a)(1)(i) would be amended to include the principles of Rev. Rul. 88-77, 1988-2 C.B. 128; an obligation is a liability to the extent that incurring the obligation: (1) creates or increases the basis of any of the obligor's assets (including cash); (2) gives rise to an immediate deduction; or (3) gives rise to an expense that is not deductible in computing taxable income and is not properly chargeable to capital. Prop. Reg. § 1.752-7 deals with the assumption by a partnership of a partner's fixed or contingent obligation to make payment that is not one of the three types described in Reg. § 1.752-1(a)(1)(i) [including accrual method liabilities the deduction for which was deferred under § 453(h)]. Unlike Temp. Reg. § 1.752-6T, the proposed regulations do not reduce the partner's outside basis when the partnership assumes a § 1.752-7 liability. If the partnership satisfies the liability while the partner remains in the partnership, the deduction with respect to the built-in loss associated with the § 1.752-7 liability is allocated to the partner, reducing that partner's outside basis. Alternatively, if one of three events occurs that separate the partner from the, then the partner's outside basis is reduced immediately before the occurrence of the event. The events are: (1) a disposition (or partial disposition) of the partnership interest by the partner, (2) a liquidation of the partnership's partnership interest, and (3) the assumption (or partial assumption) of the liability by another partner. The basis reduction generally is the lesser of (1) the excess of the partner's basis in the partnership interest over the adjusted value of the interest, or (2) the remaining built-in loss associated with the liability. (In the event of a partial disposition, the reduction is pro rated.) Thereafter, to the extent of the remaining built-in loss associated with the liability, the partnership (or the assuming partner) is not entitled to any deduction or capital expense upon satisfaction (or economic performance) of the liability, but if the partnership notifies the partner, the partner is entitled to a loss or deduction. If another partner assumed the liability, the partnership must immediately reduce the basis of its assets by the built-in loss, and upon satisfaction, the assuming partner must make certain basis adjustments to his partnership interest. There are exceptions for (1) transfer of the trade or business with which the liability is associated is transferred to the partnership, and (2) de minimis transactions (liabilities less than 10 percent of the partnership's assets...
or $1,000,000). Unlike under the Temporary regulations, there is no exception for transactions in which substantially all of the assets with which the liability is associated are contributed to the partnership. When finalized, the regulations will be effective for transactions occurring after 6/24/03.

5. “[O]ne brother got the ... income without paying all of the tax, while the other brother paid the tax without getting any of the income.” Estate of Ballantyne v. Commissioner, 92 A.F.T.R.25-5694 (8th Cir. 8/7/03), aff'g T.C. Memo. 2002-160 (6/24/02). The decedent taxpayer (Melvin) and his brother (Russell) for many years operated a partnership that engaged in the oil and gas business, run by the decedent, and the farming business, run by the decedent’s brother. The partnership was an oral partnership, and the brothers consistently reported as equal partners, even though the decedent consistently withdrew the profits from the oil and gas business and decedent’s brother consistently withdrew the profits from the farming business. After the decedent’s death, the estate took the position that all of the income from the farming activity was reportable as the decedent’s brother’s distributive share. Because the partnership did not maintain capital accounts, the allocation lacked economic substance, and the partners’ interests in the partnership were determined under the facts and circumstances test of Reg. § 1.704-1(b)(3). Based on the evidence, the estate could not overcome the presumption that the partners were equal partners. There was no record of capital contributions; the amount of profits of each activity varied from year to year, as did withdrawals but the partners’ economic interests and interests in cash flow could not be determined because the partnership books and records were inadequate. However, the “facts” — mostly the witnesses’ “beliefs” that the brothers were 50/50 partners indicated that they were to share liquidating distributions equally. That factor, combined with the brothers long-time consistent reporting as equal partners and the absence of any evidence that the brothers’ reporting position involved tax avoidance, was sufficient to convince Judge Ruwe that they were equal partners.

- The Court of Appeals (Judge Beam) affirmed. First, the claimed allocation did not have economic effect because the partnership failed to comply with the capital account rules in the § 704(b) regulations. Second, the Tax Court correctly applied the regulations to determine the partners’ distributive shares based upon their interests in the partnership based on all the facts and circumstances. The court rejected the estate’s argument it was clear that the brothers had agreed that Russell would get farming profits and Melvin the oil profits, because it was also “clear that the brothers had evenly split some of the burdens, i.e., the tax consequences of the combined profits and losses.” Finally, the brothers’ interests in cash flow and liquidating distributions supported the Tax Court’s conclusion. Actual operating distributions were not based on the clear-cut delineation claimed by the taxpayer — to some extent the brothers shared the profits form the two businesses.

C. Distributions and Transactions Between the Partnership and Partners

1. Partnership capital shifts resulting from option exercises won’t be taxable. REG-103580-02, Noncompensatory Partnership Options, 68 F.R. 2930 (1/22/03). The Treasury Department has published proposed regulations dealing with noncompensatory partnership options, including convertible debt and convertible equity interests. The proposed regulations do not address compensatory options, and the preamble states that no inferences regarding the treatment of compensatory options should be drawn. Under the proposed regulations, neither the grant nor the exercise of an option generally results in the recognition of gain or loss to either the partnership or the option holder. Prop. Reg. § 1.721-2. The issuance of an option is not governed by § 721, but rather (under general tax principles) is an open transaction for the issuer and an investment (capital expenditure) by the holder. If the holder uses appreciated or depreciated property to acquire the option, the holder recognizes gain or loss.

- Upon exercise, the option holder is treated as contributing property in the form of the premium, the exercise price, and the option privilege to the partnership in exchange for the partnership interest, and § 721 applies, even if the conversion results in a shift of capital from the old partners to the option holder. The conversion right in convertible debt or convertible equity is taken into account for tax purposes as part of the underlying instrument. (The proposed regulations do not deal with the consequences of a right to convert partnership debt into an interest in the issuing partnership to the extent of any accrued but unpaid interest on the debt.) An amendment to Reg. § 1.1271-1(e) would treat partnership interests as stock for purposes of the special OID rules for convertible debt instruments. Section 721 does not apply to the lapse of an option; the lapse of an option results in recognition of income by the partnership and the recognition of loss by the former option holder.

- The proposed regulations amend the §704 regulations to deal with the fact that the option holder generally receives a partnership interest with a value that is greater or less
than the sum of the option premium and exercise price, i.e., there is a capital shift. The option holder’s initial capital account equals the consideration paid to the partnership for the option plus the fair market value of any property (other than the option itself) contributed to the partnership upon exercise. To meet the substantial economic effect test of Reg. § 1.704-1(b), the partnership must revalue its property following the exercise of the option, and must allocate the unrealized income, gain, loss, and deduction from the revaluation, first, to the option holder to reflect the holder’s right to partnership capital, and, then, to the historic partners. To the extent that unrealized appreciation or depreciation in the partnership’s assets has been allocated to the option holder’s capital account, under § 704(c) principles the holder will recognize any income or loss attributable to that appreciation or depreciation as the underlying assets are sold, depreciated, or amortized. If after all of the unrealized appreciation or depreciation in the partnership’s assets has been allocated to the option holder, the option holder’s capital account still does not equal the amount of partnership capital to which the option holder is entitled, the partnership must adjust the capital accounts of the historic partners by the amounts necessary to provide the option holder with a capital account equal to the holder’s rights to partnership capital under the agreement. Starting with the year the option is exercised, the partnership must make corrective allocations of tax items — that differ from the partnership’s allocations of book items — of gross income or loss to the partners to reflect any shift in the partners’ capital accounts occurring as a result of the exercise of an option.

- The proposed regulations also provide rules for revaluing the partners’ capital accounts under Reg. § 1.704-1(b)(2)(iv)(f) while an option is outstanding. The aggregate value of partnership property is reduced by the amount by which the value of the option exceeds its price or is increased by the amount by which price of the option exceeds its value.

- An option holder will be recharacterized as a partner if (1) under facts and circumstances test, the option holder’s rights are substantially similar to the rights afforded to a partner and (2) as of the date that the noncompensatory option is issued, transferred, or modified, there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners’ and the option holder’s aggregate tax liabilities. Prop. Reg. § 1.761-3. If an option is reasonably certain to be exercised, the first half of this test is generally met. If the option holder is treated as a partner under the proposed regulations, then the holder's distributive share of the partnership's income, gain, loss, deduction, or credit must be determined in accordance with such partner's interest in the partnership under Reg. § 1.704-1(b)(3). For this purpose, the option holder’s share of partnership items should reflect the lesser amount of capital investment if appropriate; the option holder’s distributive share of partnership losses and deductions may be limited by §§ 704(b) and (d) to the amount paid for the option.

- The proposed regulations do not apply to options issued by single member LLCs.

- The regulations will apply to noncompensatory options issued on or after the date final regulations are published.

2. Permitting a partnership book-up when you can’t make the regs work if you don’t do it. REG-139796-02, Section 704(b) and Capital Account Revaluations, 68 F.R. 39498 (7/2/03). Proposed amendments to the § 704(b) regulations would expressly allow partnerships to increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property on the partnership’s books in connection with the grant of an interest in the partnership (other than a de minimis interest) in consideration of services to the partnership by an existing partner acting in a partner capacity or by a new partner acting in a partner capacity or in anticipation of being a partner. The regulation will be effective when finalized.

3. If you want § 707(a) treatment, document the transaction as such. Bitker v. Commissioner, T.C. Memo 2003-209 7/15/03). The taxpayers owned farmland that they allowed a family partnership engaged in the farming business to use in that business without any express rental agreement. The partnership made payments of principal and interest on the taxpayer’s mortgage debt secured by the land, and the taxpayers claimed that the payments should be deductible by the partnership as rental expenses and includable by them as passive activity rental income. Although this type of transaction could be so characterized under § 707(a), the taxpayer’s offered no evidence that partnership actually made the payments as rent for such use or the payments represented fair rental value. Accordingly, the taxpayers’ shares of partnership income were not be reduced for rent, their income from their rental real estate activity was not be increased for such rent, and the payments were treated as partnership distributions (which, on the facts, were not in excess of basis).

D. Sales of Partnership Interests, Liquidations and Mergers
E. Inside Basis Adjustments

1. Partnership inside basis adjustments fully coordinated with §§ 197 and 1060. T.D. 9059, Coordination of Sections 755 and 1060; Allocation of Basis Among Partnership Assets and Application of the Residual Method to Certain Partnership Transactions, 68 F.R. 34293 (6/9/03). The Treasury has promulgated final regulations [proposed in REG-107872-99, 65 F.R. 17829 (4/5/00) to replace Temp. Reg. § 1.755-2T] relating to the allocation of basis adjustments among partnership assets under § 755 to implement § 1060(d) [which applies the residual method to partnership transactions in connection with determining the value of § 197 intangibles].

* The new rules are amendments to Reg. § 1.755-1. As amended, Reg. § 1.775-1 applies the residual method to all allocations for § 743(b) and § 734(d) inside basis adjustments under § 755. Reg. § 1.755-1(a) uses the residual method to value all § 197 intangibles [not just goodwill and going concern value, as would have been the rule under the proposed regulations]. Values are assigned to assets as follows. First, the partnership determines the values of its assets other than § 197 intangibles [taking into account § 7701(g)]. Second, the partnership determines the “partnership gross value.” Third, the partnership determines the value of its § 197 intangibles under the residual method [partnership gross value minus value of assets other than § 197 intangibles]. If the aggregate value of partnership property other than § 197 intangibles is equal to or greater than the partnership gross value, all § 197 intangibles are treated as having zero value. If there is any value assigned to the § 197 intangibles, that value is allocated among § 197 intangibles other than goodwill and going concern value before any value is assigned to goodwill and going concern value. In allocating values [and basis to § 197 intangibles, value is assigned first to those § 197 intangibles (other than goodwill and going concern value) that would produce § 751(c) flush language unrealized receivables [i.e., previously amortized or depreciated] to the extent of basis and the unrealized receivable amount; then among all § 197 intangibles (other than goodwill and going concern value) relative to fair market value. For most § 743(b) basis adjustments, the benchmark for determining the gross partnership value is the amount paid for a transferred partnership interest. Partnership gross value is the amount that, if assigned to all partnership property, would result in a liquidating distribution to the transferee partner equal to that partner’s basis (reduced by the amount, if any, of such basis that is attributable to partnership liabilities) in the transferred partnership interest immediately following the relevant transfer. In cases involving § 734(b) basis adjustments [and § 743(b) basis adjustments resulting from substituted basis transactions], partnership gross value is the value of the entire partnership as a going concern, increased by the amount of partnership liabilities.

F. Partnership Audit Rules

1. Even the IRS doesn’t know when it has to have a partnership level audit in order to send a valid deficiency notice to a partner. Katz v. Commissioner, 92 A.F.T.R.2d 2003-5153 (10th Cir. 7/7/03), rev’d 116 T.C. 5 (2001). The Commissioner disallowed the taxpayer’s losses claimed as a distributive share of partnership income in 1990, the year he filed a bankruptcy petition, on the grounds that the distributive share for the entire partnership taxable year was reportable by bankruptcy estate.

* The Tax Court (Judge Vasquez) denied the taxpayer’s motion to dismiss for lack of jurisdiction, in which the taxpayer argued that the deficiency notice was invalid because there had not been any FPAA under the partnership audit provisions. Judge Vasquez held that the allocation of the distributive share of partnership loses between the bankrupt partner and his bankruptcy estate was not a partnership item that would require a partnership-level proceeding, because the bankrupt partner and his bankruptcy estate were a single partner as far as the partnership-level audit rules were concerned. On the merits, he held that the entire distributive share of partnership losses was properly reportable by the bankruptcy estate.

* The Court of Appeals (Judge Hartz) reversed. First, the court held that Reg. § 301.6231(c)-7T(a), which converts items that otherwise would be partnership items into nonpartnership items if they arose in a taxable year “ending on or before the last day of the latest taxable year of the partner with respect to which the United States could file a claim for income tax due in the bankruptcy proceeding,” was not controlling because 1989 was the latest taxable year for which the United States could file a claim in the bankruptcy proceeding. Second, the court held that the partner’s share of partnership losses was a partnership item that could not be determined without a partnership-level proceeding even though the allocation of the distributive share of losses between the bankrupt partner and his bankruptcy estate did not affect other partners. The holding was grounded on the idea that regardless of whether the items were properly the bankrupt partner’s or the bankruptcy estate’s, the partnership return was required to show the allocation and the allocation is a partnership item that can be challenged only in a
partnership-level proceeding, even if there might be “sound policy reasons for not requiring a full-blown partnership-level proceeding when an alleged error in one partner’s return affects only one other taxpayer rather than all the partners.”

G. Miscellaneous

VIII. TAX SHELTERS

A. Tax Shelter Cases

1. Tax shelter benefits from § 453 contingent sale partnership tax shelter not allowed because the tax shelter is a sham and “serves no economic purpose other than tax savings.” Merrill Lynch’s persistence overcomes initial doubts of tax department. ACM Partnership v. Commissioner, T.C. Memo. 1997-115 (3/5/97) aff’d in part, rev’d in part, 157 F.3d 231, 98-2 U.S.T.C. §50,790, 82 A.F.T.R.2d 98-6682 (3d Cir. 10/13/98) (2-1), cert. denied, 526 U.S. 1017 (3/2/99). Judge Laro found a § 453 contingent sale partnership tax shelter to be a prearranged sham, “tax-driven and devoid of economic purpose,” and “serving no economic purpose other than tax savings,” following Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967). Under the scheme to shelter Colgate’s $105 million 1988 capital gain, a partnership was formed in 1989; its three partners were affiliates of (a) a foreign bank (about 90%), (b) Colgate (about 9%), and (c) Merrill Lynch (about 1%). A bank note was purchased by the partnership and immediately sold for a large immediate payment and much smaller future contingent payments. Under the contingent payment sale provisions of the temporary regulations [§ 15a.453-1(c)] the partnership’s basis was to be allocated ratably over the several years in which contingent payments could be made, resulting in a large 1989 installment sale gain to the partnership. The lion’s share of that installment sale gain was allocated to the foreign bank (which was not taxable on U.S. source capital gain), followed by the redemption of the foreign bank’s partnership interest. This left Colgate as the 90 percent partner. In 1991, the installment sale obligation was sold by the partnership, triggering about $100 million of capital losses, which Colgate attempted to use to shelter its 1988 capital gain.

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

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

a. Affirmed. ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 2000-1 U.S.T.C. §50,185, 85 A.F.T.R.2d 2000-675 (D.C. Cir. 2/1/00), cert. denied, 531 U.S. 871 (10/2/00). The D.C. Circuit’s opinion noted that it disagreed with the Tax Court’s statements that persons with “divergent business goals” are precluded from having the requisite intent to form a partnership; however, this view was not essential to the Tax Court’s conclusion that the parties did not intend to join together as partners to conduct business activities for a purpose other than tax avoidance. The court held that there was a single business purpose rule.

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

a. D.C. Circuit remands Saba for reconsideration in light of its opinion in ASA Investerings. Saba Partnership v. Commissioner, 273 F.3d 1135, 2002-1 U.S.T.C. §50,145, 88 A.F.T.R.2d 2001-7318 (D.C. Cir. 12/21/01), remanding for reconsideration in light of ASA Investerings T.C. Memo. 1999-359 (10/27/99), on remand to T.C. Memo. 2003-31 (2/11/03). The court felt this case was indistinguishable from ASA Investerings, which was decided on a sham partnership theory, as opposed to Judge Nims’ decision in the Tax Court, which was grounded on a sham transaction theory. The court of appeals refused to simply affirm the Tax Court’s decision on the alternative ground that the partnerships were shams. Even the government conceded that the sham transaction and sham partnership...
approaches yield different results; the adjustments under the sham transaction theory would be different from those under the sham partnership theory [although the government apparently conceded at oral argument that under either approach, Brunswick could deduct actual losses from the transactions]. The government argued that the court of appeals should apply ASA Investerings to hold that the partnerships were shams, and remand the case to the Tax Court for the limited purpose of determining the amount of any necessary adjustments. But the court of appeals accepted the taxpayer’s argument that the “question of whether ‘an entity should be regarded as a partnership for federal tax purposes is inherently factual,’” and remanded to allow the taxpayer to address the question to the trial court, even though it doubted that the Tax Court’s “findings are inadequate because of ‘significant differences’” alleged by the taxpayer “between the actions of Brunswick in this case and those of [the taxpayer] in ASA.” Indeed, the court of appeals opinion said: “As far as we can tell, the only difference between this case and ASA is that Brunswick and ABN did not meet in Bermuda.” In remanding, Judge Tatel foreshadowed what he expected to be the result on remand:

In any case, ASA makes clear that “the absence of a nontax business purpose is fatal” to the argument that the Commissioner should respect an entity for federal tax purposes.

*** Here, the Tax Court specifically found “overwhelming evidence in the record that Saba and Otrabanda were organized solely to generate tax benefits for Brunswick.” *** Arguably, this broader finding subsumes any factual differences that might exist between this case and ASA. [citations omitted].

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

b. On remand, the same result, following the Court of Appeals’ instructions. T.C. Memo 2003-31 (2/11/03). On remand Judge Nims again denied the deductions. He found the case indistinguishable from ASA Investerings. The partnerships were not recognized for tax purposes because they had no business purpose other than tax avoidance. The minimal business activity of the partnership with respect to commercial paper did not amount to a nontax purpose.


a. Reversed: ASA Investerings is followed. Boca Investerings Partnership v. United States, 314 F.3d 625, 2003-1 U.S.T.C. ¶50,181 (1/10/03). The D.C. Circuit held that the district court “erred as a matter of law when it did not properly apply the holding of ASA Investerings, requiring that a legitimate non-tax business necessity exist for the creation of the otherwise sham entity inserted into the partnership for tax avoidance reasons in order to meet the intent test of Commissioner v. Culbertson, 337 U.S. 733 (1949), as applied to this type of partnership transaction.” Judge Sentelle quoted ASA to make clear that “the absence of a nontax business purpose” is fatal to an argument that the Commissioner should respect an entity for federal tax purposes.
5. **Lease-strip transaction by pseudo-black box intermediary fails in the Tax Court; affirmed by Second Circuit.** Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (12/28/01), aff'd by summary order, 320 F.3d 282, 2003-1 U.S.T.C. ¶50,137; 90 A.F.T.R.2d 2002-7702 (2d Cir. 12/13/02) (per curiam), publication status changed by the court from unpublished to published, (2d Cir. 2/24/03). The taxpayer corporation’s stock was sold to an intermediary [which then merged downstream], following which its assets were sold to the prearranged ultimate purchaser. To offset the gains realized on the asset sale, the taxpayer acquired by a § 351 transaction interests in certain equipment leaseback transactions [secured by trusts that resulted in a circular cash flow] that had no foreseeable value, which it immediately transferred to a Dutch bank, the sole consideration for which was assumption of taxpayer’s obligations [of which there were in reality none]. Taxpayer claimed a $22 million ordinary business expense deduction as a result of the transfer of the leaseback interests. The deduction was denied because the transactions lacked business purpose and economic substance under “any version” of the tests. Judge Swift held that the transaction lacked business purpose and economic substance even as measured against the Eleventh Circuit’s broad articulation of the test in *UPS of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001), that “a transaction has a ‘business purpose’ when we are talking about a going concern …, as long as it figures in a bona fide, profit-seeking business.”

6. **The Tax Court hammers another shelter, and in the process tells us the “purpose” of the legislative plan.** Andantech L.L.C. v. Commissioner, T.C. Memo. 2002-97 (4/9/02), aff’d and remanded, 331 F.3d 972, 91 A.F.T.R.2d 2003-2063, 2003-1 U.S.T.C. ¶50,530 (D.C. Cir. 6/17/03). Norwest, through its equipment-leasing subsidiary, engaged in a complex [seven PowerPoint slides worth] purchase and leaseback tax shelter transaction involving 40 IBM mainframe computers already under lease to end-users. The promoter [Comdisco] sold the computers for cash and notes to an LLC owned by two nonresident aliens, which leased them back to the promoter, who retained all responsibilities to the end-users; the LLC sold the stream of rental payment to be received for net present value, thereby accelerating income realization, and applied the proceeds to the balance due on the note. Less than three months later, one of the nonresident aliens [indirectly] transferred his 2 percent LLC interest to a trust established by promoter, and Norwest, through a subsidiary, acquired the remaining 98 percent interest in the LLC [thereby closing the taxable year in which the income had been realized] for an amount roughly equal to one half of one percent of the approximately $122 million basis of the computers. Norwest subsequently reported its distributive share of depreciation deductions, but was allocated no income. After three years, the computers were reconveyed to the promoter, pursuant to an “early termination option,” which the court found the “economics of the transaction … mandate[d],” and the LLC was liquidated.

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

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

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

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

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

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

a. The Sixth Circuit (Judge Sentelle) concluded that the partnership should be disregarded and remanded to the Tax Court for a determination as to how the reported income and losses should be allocated. The court followed ASA Investerings and determined that the purported partners "did not intend to join together in order to share any profit or loss from the business activity of Andantech [partnership], namely the sale and leaseback of computer equipment," and "the absence of a nontax business purpose" is fatal to the validity of a partnership.

7. Third Circuit comes down hard on COLI, with lots of language the government will love. Internal Revenue Service v. CM Holdings Inc. (In re CM Holdings Inc.), 301 F.3d 96, 90 A.F.T.R2d 2002-5850, 2002-2 U.S.T.C. ¶50,596 (3d Cir. 8/16/02), aff'd 254 B.R. 578, 2000-2 U.S.T.C. ¶50,791, 86 A.F.T.R.2d 2000-6470 (D. Del. 10/16/00). In CMI's bankruptcy, the IRS filed proofs of claim for taxes based on the disallowance of interest deductions that CMI claimed for its COLI plan (involving policies on 1400 employees).

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

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

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

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

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

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

  a. But a District Court finds for the taxpayer in an incredible opinion. Dow Chemical Co. v. United States, 250 F. Supp. 2d 748, 2003-1 U.S.T.C. ¶50,346, 91 A.F.T.R.2d 2003-1489 (E.D. Mich. 3/31/03). In a carefully-detailed opinion Judge Lawson finds that Dow did correctly almost everything that Camelot and AEP did incorrectly. The interest rate on policy loans was not unreasonably high, and a positive pre-tax cash flow was expected. The court found that there was a business purpose for the COLI arrangements, i.e., to provide retiree benefits. The premiums for the first three years were payable with policy loans and the premiums for years four through seven were payable 90% with partial [cash] withdrawals (from policies whose cash value had been previously borrowed) and 10% with cash from the taxpayer. Judge Lawson found that the partial withdrawals were “shams in fact” because there was no cash value left in the policies to borrow, but that the § 264(c)(1) test was met because of the payments of 10% of the premiums by taxpayer with its own cash in years four through seven. The court found that the § 264(c)(1) test was met because of the payments of 10% of the premiums by taxpayer with its own cash in years four through seven. The government’s argument relating to the logical consequences of this earlier finding, i.e., that taxpayer did not meet the four-out-of-seven test required level premiums.

  b. There's no harm in asking? Not from asking Judge Lawson! Dow Chemical Co. v. United States, 2003 U.S. Dist. LEXIS 14784 (E.D. Mich. 8/12/03). The government’s motion to amend the court’s judgment was granted in part and denied in part, but the same judgment and basic result. Ironically, since the motion opened up all findings of fact, Judge Lawson reversed his earlier finding that the partial withdrawals in years four through seven were “shams in fact,” thus making moot the government’s argument relating to the logical consequences of this earlier finding, i.e., that taxpayer did not meet the four-out-of-seven test because it did not pay the entire premium in each of years four through seven from its own funds.

  c. The circuit to which Dow is appealable (Sixth Circuit) holds for the government in a COLI case. American Electric Power Co. v. United States, 326 F.3d 737, 91 A.F.T.R.2d 2003-2060, 2003-1 U.S.T.C. ¶50,416 (6th Cir. 4/28/03). The Sixth Circuit Court of Appeals affirmed the District Court finding that taxpayer’s COLI plan was an economic sham because it would lose a substantial amount of money absent the policy-loan interest deductions. The court declined to
decide whether the dividends in years 4-7, generated by circular cashless netting transactions, were factual shams.

B. Identified “tax avoidance transactions.”

1. Some of these are still being peddled to your clients. Notice 2001-51, 2001-34 I.R.B. 190 (8/3/01), superseding Notice 2000-15, 2000-1 C.B. 826. The IRS has identified sixteen listed transactions for purposes of Temp. Reg. §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2). The listed transactions include: (1) Rev. Rul. 90-105, 1990-2 C.B. 69, transactions (deductions for contributions to certain pension plans attributable to future year’s compensation); (2) Notice 95-34, 1995-1 C.B. 309, certain trust arrangements (purported multiple employer welfare benefit funds); (3) Notice 95-53, 1995-2 C.B. 334, “lease strips”; (4) Notice 98-5, 1998-1 C.B. 334, transactions in which the expected economic profit is insubstantial in comparison to the value of the expected FTCs; (5) ASA Invesiterings-type and ACM-type transactions; (6) Prop. Reg. § 1.643(a)-8 transactions involving distributions from charitable remainder trusts; (7) Rev. Rul. 99-14, 1999-1 C.B. 835, lease-in/lease-out [LILO] transactions; (8) Notice 99-59, 1999-2 C.B. 761, transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays that they have in fact recovered (the PwC so-called BOSS tax shelter); (9) Treas. Reg. § 1.7701(1)-3 fast-pay arrangements; (10) Rev. Rul. 2000-12, 2000-11 I.R.B. 744 certain transactions involving the acquisition of two debt instruments the values of which are expected to change significantly at about the same time in opposite directions; (11) Notice 2000-44, 2000-36 I.R.B. 255 transactions generating losses resulting from artificially inflating the basis of partnership interests (the KPMG so-called BLIPS14 tax shelter); (12) Notice 2000-60, 2000-49 I.R.B. 568, transactions involving the purchase of a parent corporation’s stock by a subsidiary, a subsequent transfer of the purchased parent stock from the subsidiary to the parent's employees, and the eventual liquidation or sale of the subsidiary; (13) Notice 2000-61, 2000-49 I.R.B. 569, transactions purporting to apply § 935 to Guamanian trusts; (14) Notice 2001-16, 2001-9 I.R.B. 730, intermediary sales transactions; (15) Notice 2001-17, 2001-9 I.R.B. 730, contingent liability § 351 transfer transactions; and (16) Notice 2001-45, 2001-33 I.R.B. 129 (certain redemptions of stock in transactions not subject to U.S. tax in which the basis of the redeemed stock purports to shift to a U.S. taxpayer.

2. Rev. Rul. 2002-71, 2002-44 I.R.B. 763 (10/17/02). A taxpayer should take into account gain or loss on the termination of a notional principal contract that hedges a portion of the term of a debt instrument issued by the taxpayer over the period to which the hedge relates. This is because of the matching requirement of Reg. § 1.446-4(b), which requires that this be done in order to clearly reflect income.

3. Notice 2003-22, 2003-18 I.R.B. 851 (4/4/03). This notice addresses an abusive arrangement designed to evade income and employment taxes on compensation income through the use of unrelated conduit domestic and foreign employee leasing companies. The arrangements are “listed transactions.” See VII.D., below for a more complete description.

4. Temporary and proposed Son-of-Boss regulations. T.D. 9062, Assumption of Partner Liabilities, 68 F.R. 37414 (6/24/03); REG-106736-00, Assumption of Partner Liabilities, 68 F.R. 37434 (6/24/03). Temporary and proposed regulations regarding a partnership’s assumption of a partner’s liabilities in a transaction substantially similar to the Son-of-Boss transactions described in Notice 2000-44. These regulations prevent taxpayers from relying on the exceptions in § 358(h)(2)(B) [for transfers of the trade or business with which the liability is associated is, or substantially all of the assets with which the liability is associated are, transferred to the partnership assuming the liability], which were intended to exclude ordinary business transactions from the application of § 358(h), and were not intended to allow taxpayers to engage in transactions that create noneconomic tax losses.

5. Lease strips are made a listed transaction. Notice 2003-55, 2003-34 I.R.B. (7/21/03), superseding Notice 95-53, 1995-2 C.B. 354. The IRS has concluded – based upon its victories in Andantech L.L.C. v. Commissioner, 331 F.3d 972 (D.C. Cir. 2003), and Nicole Rose v. Commissioner, 320 F.3d 282 (2d Cir. 2002) – that lease strips improperly separate income from related deductions. The notice also states that the IRS may challenge lease strips on other grounds, including (1) assignments or accelerations of future payments as financings, (2) lack of a valid partnership, and (3) judicial doctrines such as lack of business purpose, step transaction, sham, etc.

a. But not on § 482 grounds. Rev. Rul. 2003-96, 2003-34 I.R.B. (7/21/03). The IRS has concluded the inapplicability of the § 482 rationale of Notice 95-53 because an agreement between unrelated parties to arbitrarily shift income or deductions “does not by itself evidence the type of control necessary to satisfy [§ 482].”

10 See 2003 TNT 112-12.
6. See VII.D., below, for additional “listed transactions” aimed at individuals.

C. Disclosure and Settlement

1. June 2002 temporary and proposed regulations. T.D. 9000 and REG-110311-92, Return Filing Requirement, 67 F.R. 41324 & 41362 (6/18/02). These temporary and proposed regulations modify the disclosure, registration and list maintenance rules under §§ 6011(a), 6111(d) and 6112 with respect to tax shelters.

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

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

   a. Additional guidance in October 2002. T.D. 9017 and REG-103735-00, Tax Shelter Disclosure Statements, 67 F.R. 64799 and 64840 (10/22/02). The IRS has promulgated temporary and proposed regulations to provide additional guidance needed to comply with the § 6011(a) disclosure rules. Covers transactions involving tax shelters involving income, estate, gift, employment, or exempt organizations excise taxes. Revises the categories of transactions that must be disclosed on returns: (1) listed transactions; (2) confidential transactions; (3) transactions with contractual protection; (4) loss transactions above stated thresholds; (5) transactions with a significant book-tax difference; and (6) transactions involving a less-than-45-day holding period that result in a tax credit exceeding $250,000. These temporary regulations are effective 1/1/03.

   b. February 2003 final regulations. T.D. 9046, Tax Shelter Regulations, 68 F.R. 10161 (2/28/03). Modifies and makes final the rules relating to tax shelter disclosure statements to be filed with tax returns under § 6011(a), as well as the rules relating to the registration of confidential corporate tax shelters under § 6111(d) and the resulting list maintenance requirements under § 6112. Retains the six disclosure categories contained in the October 2002 temporary regulations, see a., above, with the following modifications: (2) deletes the clarification that a claim of privilege does not cause a transaction to be confidential because a privilege does not restrict the taxpayer’s ability to disclose the tax treatment or tax structure of the transaction; (3) changes the focus to provide that this refers to refunds of fees to be received back from a person who stated what the tax consequences of the transaction would be, or from the person on whose behalf the statement was made; (4) a list of the loss which need not be taken into account for reporting is contained in Rev. Proc. 2003-24, 2003-11 I.R.B. 599 (3/17/03); (5) a list of the transactions with significant book-tax difference which need not be taken into account for reporting is contained in Rev. Proc. 2003-25, 2003-11 I.R.B. 601 (3/17/03). In addition, the provision for retention of documents contains the following added sentence:

   A taxpayer is not required to retain earlier drafts of a document if the taxpayer retains a copy of the final document (or, if there is no final document, the most recent draft of the document) and the final document (or most recent draft) contains all the information in the earlier drafts of the document that is material to an understanding of the purported tax treatment or tax structure of the transaction.

   • Reg. § 1.6011-4(b)(3)(iii) contains a presumption relating to whether a transaction is confidential:

      Presumption. Unless the facts and circumstances indicate otherwise, a transaction is not considered offered to a taxpayer under conditions of confidentiality if every person who
makes or provides a statement, oral or written, to the taxpayer (or for whose benefit a statement is made or provided to the taxpayer) as to the potential tax consequences that may result from the transaction, provides express written authorization to the taxpayer in substantially the following form: "the taxpayer (and each employee, representative, or other agent of the taxpayer) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the transaction and all materials of any kind (including opinions or other tax analyses) that are provided to the taxpayer relating to such tax treatment and tax structure". Except as provided in paragraph (b)(3)(ii) of this section, this presumption is available only in cases in which each written authorization permits the taxpayer to disclose the tax treatment and tax structure of the transaction immediately upon commencement of discussions with the person providing the authorization and each written authorization is given no later than 30 days from the day the person providing the written authorization first makes or provides a statement to the taxpayer regarding the tax consequences of the transaction. A transaction that is claimed to be exclusive or proprietary to any party other than the taxpayer will not be considered a confidential transaction under this paragraph (b)(3) if written authorization to disclose is provided to the taxpayer in accordance with this paragraph (b)(3)(iii) and the transaction is not otherwise confidential.

- These regulations are effective for transactions entered into on or after 2/28/03, except that taxpayers may elect to apply them for transactions entered into on or after 1/1/03.

2. Warm-up the photocopher for those tax accrual workpapers. Announcement 2002-26, 2002-27 I.R.B. 72 (7/8/02). In auditing returns filed after 7/1/02 that claim any tax benefits from a "listed transaction," see Notice 2001-51, 2001-34 I.R.B. 190, the IRS may request tax accrual workpapers. Listed transactions will be determined "at the time of the request." Neither the attorney client privilege nor the § 7525 tax practitioner privilege protects the confidentiality of the workpapers.

a. Specific procedures regarding requests for tax accrual workpapers. Chief Counsel Notice CC-2003-012 (4/9/03). Procedures to be used regarding requests for tax accrual and other financial audit workpapers.

3. IRS News Release IR-2002-105 (10/4/02). The IRS announced it will for a limited time offer settlements to taxpayers involved in three types of tax shelters.

a. Rev. Proc. 2002-67, 2002-43 I.R.B. 733 (10/5/02), as revised (10/17/02). Procedures to settle cases involving Contingent Liability Transactions (§ 351 contingent liability tax shelters), similar to the ones described in Notice 2001-17, 2001-1 C.B. 730, are provided.

b. Announcement 2002-97, 2002-43 I.R.B. 757 (10/11/02). This announcement provides procedures to settle cases involving the § 302/318 basis shifting tax shelter transactions that are the same or similar to those described in Notice 2001-45, 2001-2 C.B. 129. Notification of the IRS must be made on or before 12/3/02.

c. Announcement 2002-96, 2002-43 I.R.B. 756 (10/11/02). This announcement terminates the appeals settlement initiative to settle corporate-owned life insurance (COLI) transaction tax shelters, subject to a 45-day window within which taxpayers will be permitted to enter into the "current settlement arrangement."

4. "The IRS and Treasury believe that taxpayers have improperly relied on opinions or advice issued by tax advisors to establish reasonable cause and good faith as a basis for avoiding the accuracy-related penalty." REG-126016-01, Establishing Defenses to the Imposition of the Accuracy-Related Penalty, 67 F.R. 79894 (12/31/02). The Treasury Department has published proposed amendments to the regulations under §§ 6662 and 6664 [Regs. §§ 1.6662-3; 1.6664-4] to limit the available defenses to an accuracy-related penalty when a taxpayer (1) fails to disclose a reportable transaction or (2) fails to disclose that it has taken a position on a return based upon a regulation being invalid. Under the proposed amendments, a taxpayer who takes a position that a regulation is invalid cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under § 6664(c) with respect to that position unless the position was disclosed on a return (including disclosing the position that the regulation in question is invalid). A taxpayer who engages in a reportable transaction [See Temp. Reg. § 1.6011-4T] cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under § 6664(c) with respect to the transaction unless the transaction was disclosed pursuant to the § 6011 regulations. Finally, a taxpayer who engages in a reportable transaction cannot rely on the realistic possibility standard under § 6662 to avoid the accuracy-related penalty for negligence or disregard of rules or regulations if the position regarding the reportable transaction is contrary to a
revenue ruling or notice. When finalized, the amendments will apply to returns filed after 12/30/02, with respect to transactions entered into after 12/31/02.

- But be careful about over-reliance on effective dates. The preamble states:

The IRS, however, cautions taxpayers and tax practitioners that it will rigorously apply the existing facts and circumstances standard under § 1.6664-4(c) regarding a taxpayer’s reasonable reliance in good faith on advice from a tax professional, as well as the other provisions of the regulations under sections 6662 and 6664, including § 1.6664-4(c) relating to special rules for the substantial understatement penalty attributable to tax shelter items of a corporation. In addition to the modifications contained in these proposed regulations, and regardless of when a transaction was entered into, the IRS, in appropriate circumstances, may consider a taxpayer's failure to disclose a reportable transaction or failure to disclose a position that a regulation is invalid as a factor in determining whether the taxpayer has satisfied the reasonable cause and good faith exception under section 6664(c) to the accuracy-related penalty.

D. Individual Tax Shelters
1. Another listed tax shelter – this time an individual tax shelter. Notice 2002-65, 2002-41 I.R.B. 690 (10/15/02). This notice adds to the list of “listed transactions” a tax shelter involving a straddle entered into by an S corporation or partnership, with one or more transitory shareholders or partners. The entity closes the gain leg, and passes through the gain, redeems some shareholders or partners, with the redeemed members claiming losses, closes the books for allocating gain or loss, and then closes the loss leg of the straddle, which is passed through to the remaining shareholders or partners.

2. Government misconduct amounting to fraud does not require a showing of prejudice to justify relief. Tax shelter investors entitled to the same deal received by the taxpayers who cooperated with the government. Dixon v. Commissioner, 316 F.3d 1044, 2003-1 U.S.T.C. ¶50,194 (9th Cir. 1/17/03), remanding T.C. Memo. 2000-116 and T.C. Memo. 1999-101. The Ninth Circuit reverses the Tax Court finding that misconduct by IRS attorneys during the trial of test cases [secretly allowing the deduction of attorney’s fees in exchange for taxpayer cooperation] constituted harmless error. The tax shelter was one designed and administered by Honolulu businessman Henry Kersting, in which participants purchased stock with loans from entities financed by two layers of promissory notes, resulting in their being enable to claim interest deductions on their individual returns. Judge Hawkins held that the taxpayers demonstrated fraud and that a demonstration of prejudice was unnecessary. The Tax Court was directed to enter judgment in favor of taxpayers on terms equivalent to the secret settlement agreements entered into with the test case taxpayers who cooperated with the government.

- Three lawyers from the Houston area represented various taxpayers. They are Henry Binder of Porter & Hedges, Michael Louis Minns, and Joe Alfred Izen, Jr.

a. Chief Counsel Notice CC-2003-008 (2/3/03). This notice reminds Chief Counsel attorneys of their obligation to adhere to the highest ethical standards in all aspects of their responsibilities, including representation of the Commissioner before the Tax Court. ABA Model Rules 3.3 [candor to tribunals], 3.4 [fairness to opposing party and counsel], 4.1 [truthfulness in statements to third persons], and 8.4 [misconduct] were discussed in the notice.

3. Faux foreign. Notice 2003-22, 2003-18 I.R.B. 851 (4/4/03). This notice addresses an abusive arrangement designed to evade income and employment taxes on compensation income through the use of unrelated conduit domestic and foreign employee leasing companies. The taxpayer purports to terminate his employment relationship with his employer, to enter unto an employment relationship with a foreign employee leasing corporation, which leases the employee to a domestic employee leasing corporation, which it turn leases the employee to his original employer. Domestic leasing pays taxpayer substantially less than the original employer and remits the balance (less a fee) to the foreign company, which (1) claims treaty benefits resulting in no US tax because it has no effectively connected income, and (2) effectively sets-aside the funds for the taxpayer’s benefit. The IRS will challenge these (and similar) arrangements on a variety of theories, and will impose penalties. The arrangements are “listed transactions.”
4. Sale of nonqualified stock option to related person is a listed transaction. Arrangements heavily promoted to executives to defer the tax on the option gain by selling the option to a related person for a long-term unsecured note, and claiming that the option gain is not taxable until payments are made on the note. The IRS attacks the E&Y, *inter alia*, nonstatutory stock option deferral shelter, Act I. Notice 2003-47, 2003-30 I.R.B. 132 (7/1/03). Transactions involving the transfer of nonstatutory stock options to a related person in exchange for a long-term, unsecured deferred payment obligation are not arm's length transactions for purposes of Reg. § 1.83-7. The receipt of the deferred payment obligation will not result in a deferral of the recognition of income arising from the transfer. "[T]he IRS will argue that the option recipient recognizes income to the extent that the amount of the deferred payment obligation transferred to the option recipient, plus any cash or other property received by the individual, exceeds the amount, if any, the option recipient paid for the option." The transactions (and any substantially similar transactions) are "listed transactions" for purposes of Reg. §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2).

a. Act II: The IRS hammers the nonstatutory stock option deferral shelter. T.D. 9067, Transfers of Compensatory Options, 68 F.R. 39453 (7/2/03). Temp. Reg. § 1.83-7T provides that a sale or other disposition of a nonstatutory stock option to a related person will not be treated as a transaction that closes the application of § 83 with respect to the option. A person is related to the service provider if: (1) the person and the service provider bear a relationship to each other that is specified in § 267(b) or § 707(b)(1), modified to replace "50 percent" with "20 percent" and to treat the spouse of any family member as a family member for purposes of constructive stock ownership under § 267(c)(4), or (2) the service provider and the person are engaged in trades or businesses under common control (as defined in § 52(a) and (b)), excepting the service recipient with respect to the option or the grantor of the option. The effective date is 7/2/03.

**IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING**

A. Exempt Organizations

1. HMOs are not tax exempt. IHC Health Plans, Inc. v. Commissioner, 325 F.3d 1188, 2003-1 U.S.T.C. ¶50,368, 91 A.F.T.R.2d 2003-1767 (10th Cir. 4/9/03), aff'd T.C. Memo. 2001-246. The Commissioner denied HMOs' requests for tax exemption under § 501(c)(3), and this decision was affirmed by the Tax Court and by the Tenth Circuit on appeal. Judge Tacha held that the HMOs did not operate primarily for the purpose of promoting health for the benefit of the community – even though they covered fifty percent of Utah's total Medicaid population and twenty percent of Utah's total population – because providing health care services to all in the community in exchange for a fee is not sufficient for charitable tax exemption. The organization must provide some additional "plus," such as (1) providing free or below-cost services, (2) maintaining an emergency room open to all regardless of ability to pay, or (3) devoting surpluses to research, education and medical training. In the absence of any "positive externalities," or "public goods," or "additional community or public benefits" – however this "plus" is denominated – the HMOs do not provide a community benefit in order to be charitable organizations exempt from taxation under § 501(c)(3).

   * Additionally, the HMOs do not qualify for exemption as an "integral part" of IHC Health Services, Inc., a related § 501(c)(3) organization that operates hospitals and provides charitable care, because "separately incorporated entities must qualify for tax exemption on their own merits," following and quoting *Geisinger Health Plan v. Commissioner*, 30 F.3d 494, 498 (3d Cir. 1994).

B. Charitable Giving

1. Do you have Kelly's Blue Book on your desk? Rev. Rul. 2002-67, 2002-47 I.R.B. 873 (11/8/02). The IRS has ruled that an automobile donated to charity may be valued by reference to an established used car pricing guide if, and only if, the guide lists the sales price for a car that is the same make, model, and year, sold in the same area, and in the same condition as the donated car. The ruling also provides that the substantiation requirements of § 170(f)(8) can be met through an authorized (for-profit) agent of the charity who solicits donations on the charity's behalf, in this case an entity that solicited and accepted the donations of used cars, sold the cars, and remitted the proceeds to the charity.

   2. Professor donates his patent to the university, but... Contributions of partial interests in patents aren't deductible. Rev. Rul. 2003-28, 2003-11 I.R.B. 594 (2/26/03). No deduction is allowed under § 170 for a charitable contribution of (1) a license to use a patent, if the taxpayer retains any substantial right in the patent [e.g., a right to license to others], or (2) a patent subject to a conditional reversion [e.g., a contribution of a patent to a university subject to a reversion if a
particular faculty member ceases to be a member of the faculty within 15 years], unless the likelihood of the reversion is so remote as to be negligible. Both of these transfers are transfers of partial interests, a deduction for which is disallowed by § 170(f)(3). A § 170 deduction is allowable for a charitable contribution of a patent subject to a license or transfer restriction generally [e.g., a restriction of transfer or licensing for 3 years], but the restriction reduces what would otherwise be the value of the patent.

X. TAX PROCEDURE

A. Penalties and Prosecutions

1. If you abuse the bankruptcy process to delay your Tax Court case, you might acquire a new debt – a fine for criminal contempt. *Williams v. Commissioner*, 119 T.C. 276 (12/12/02). After filing a Tax Court petition, the taxpayer repeatedly filed and withdrew bankruptcy petitions to invoke the automatic stay rule [11 U.S.C. § 362(a)(8)], to delay proceeding in the Tax Court, and on one occasion he filed a forged bankruptcy petition with the Tax Court. In addition to imposing a $25,000 penalty under § 6673 for delay, Judge Gerber imposed a $5,000 criminal contempt sanction.

2. This false W-2 resulted in a felony rather than a misdemeanor. *United States v. Gambone*, 314 F.3d 163, 2003-1 U.S.T.C. 50,162, 91 A.F.T.R.2d 2003-330 (3d Cir. 1/3/03). An employer who files fraudulent W-2s for the purpose of evading employment taxes and income tax withholding, and who encourages employees to file fraudulent returns consistent with the W-2s, can be convicted of a felony under § 7206(2). The exclusivity of § 7204, which makes filing a false or fraudulent W-2 a misdemeanor in lieu of any other crime is limited to instances in which the only action taken is “merely furnishing false W-2s.” Conduct involving the furnishing of false W-2s, but not limited to filing false W-2s, such as encouraging employees to file false returns, can be prosecuted under § 7206(2).

3. IRS announces an amnesty for offshore credit-card abusers who clear up their tax liabilities by April 15th 2003. IRS News Release IR-2003-5, 2003 TNT 10-11 (1/14/03). An Offshore Voluntary Compliance Initiative provides that “eligible taxpayers,” who used offshore payment cards or other offshore financial arrangements to hide their income, may avoid civil fraud and information return penalties [but not failure to pay tax or accuracy-related penalties] if they come forward and pay up by 4/15/03 and provide full details on those who promoted or solicited the offshore scheme. Promoters and solicitors are not eligible. The information release contains the following example:

For example, a taxpayer who understated his income to avoid $100,000 in taxes in 1999 would wind up paying $149,319 to the government. This includes the tax liability plus $29,319 in interest and an additional accuracy-related penalty of $20,000.

   a. Rev. Proc. 2003-11, 2003-4 I.R.B. 311 (1/14/03). This revenue procedure contains detailed procedures for the Offshore Voluntary Compliance Initiative, including as an exhibit the “specific matters closing agreement” to be executed by the taxpayer.

4. Rev. Rul. 2003-23, 2003-8 I.R.B. 511 (2/24/03). An individual who files a late return for the preceding taxable year and pays as required the installments properly based upon the tax shown on that return, will not be liable for the § 6654(a) addition to tax for an underpayment of estimated tax for the current taxable year. The § 6654(d)(1)(B)(ii) safe harbor does not require a timely return.

5. The IRS foot-faulted on preparing a tax protestor's substitute return and lost the failure to pay penalty, but salvages a frivolous position penalty. *Cabirac v. Commissioner*, 120 T.C. 163 (4/22/03). The taxpayer filed income tax return forms with zeros on the relevant lines for computing tax liability. The IRS prepared unsubscribed substitute returns showing zeros, and sent a deficiency notice based on a calculation of taxable income and tax shown in a revenue agent’s report, which had not been attached to the substitute returns. The Tax Court (Judge Ruwe) held that the taxpayer was liable for the § 6651(a)(1) failure to file penalty, but not for the § 6651(a)(2) failure to pay penalty. The unsubscribed substitute returns showing zero taxes did not meet the requirements for a § 6020(b) return, and the subsequently prepared notice of proposed adjustments and the revenue agent's report, which were not attached to the unsubscribed substitutes for return, whether viewed separately or in conjunction with the substitute return, were not an adequate § 6020(b) return. However, a $2,000 § 6673(a)(1) frivolous position penalty was assessed.

the entire underpayment relating to a joint return, the § 6662 accuracy related penalty cannot be assessed against the other spouse with respect to any part of the understatement.

B. Discovery: Summons and FOIA

1. The PwC deal. IR-2002-82 (6/27/02). The IRS announced in a news release that it cut a deal with PricewaterhouseCoopers (PwC) "to resolve tax shelter registration and list maintenance issues. The IRS news release, which is similar to one issued last August regarding Merrill Lynch, says that without admitting or denying liability, PwC has agreed to make a 'substantial payment' to the IRS to resolve issues in connection with advice rendered to clients dating back to 1995. Under the agreement, PwC will provide to the IRS certain client information in response to summonses. It will also work with the IRS to develop processes to ensure ongoing compliance with the shelter registration and investor list maintenance requirements, according to the release."

   a. The EY deal. IR-2003-84 (7/2/03). The IRS announced in a news release that it has settled Ernst & Young's potential liability under the tax shelter registration and list maintenance penalty provisions for a nondeductible payment of $15 million.

2. Does the crime/fraud exception to the attorney client privilege defeat privilege claim? United States v. BDO Seidman, 225 F. Supp. 2d 918, 2002-2 U.S.T.C. ¶50,763, 90 A.F.T.R.2d 2002-6810 (N.D. Ill. 10/10/02). Documents for which accounting firm claimed § 7525 privilege were ordered to be produced for magistrate's in camera review. In his opinion, Judge Shadur noted,

One last point has occurred to this Court -- something that has not been addressed by either of the parties. Suppose that some of the documents for which BDO claims privilege could otherwise fit within the standards governing the attorney-client privilege (and hence the equivalent statutory accountant-client privilege), but that they relate to the types of "abusive tax shelters" that have triggered the congressional enactment at issue here. In that event, would the utilization of such an "abusive tax shelter" by a taxpayer to whom BDO has given advice as to its use create the potential of criminal as well as civil liability on the taxpayer's part? And if so, would that trigger the application of the crime-fraud exception to the privilege?

   a. Decision on whether proposed intervenors could claim "identity" privilege under § 7525. United States v. BDO Seidman, 2003-1 U.S.T.C. ¶50,255 (N.D. Ill. 2/4/03). Judge Holderman decides that there are four criteria as to whether client identity is privileged on a document-by-document basis: (1) Was the purpose of the representation to provide tax advice? [must be "yes" to be privileged]; (2) whether revealing identity would reveal client's motives for seeking tax advice [must be "yes"]; (3) whether the IRS could determine that clients participated in the transactions without obtaining their names from BDO [must be "no"]; and (4) whether the document was generated for the purpose of preparing tax returns [must be "no"]. Findings for each in camera document followed.

   b. Affirmed. Seventh Circuit say tax shelter disclosure rules virtually preclude assertions of identity privilege by tax shelter investors. United States v. BDO Seidman, 92 A.F.T.R.2d 2003-5443 (7th Cir. 7/23/03). The Court of Appeals (Judge Ripple) affirmed the district court's determination that the investors failed to establish that a confidential communication would be disclosed if their identities were revealed. Disclosure of their identities would disclose to the IRS only that they had participated in one of the tax shelters described in the summonses, but no confidential communication could be inferred from that information alone. The court distinguished In re Grand Jury Proceeding (Cherney), 898 F.2d 565 (7th Cir.1990); Tillotson v. Boughner, 350 F.2d 663 (7th Cir.1965), as cases in which "the Government already knew much about the substance of the communications between the attorney and his unidentified client," from this case, where "the IRS knows relatively little about the interactions between BDO and the [the investors], the nature of their relationship, or the substance of their conversations." Furthermore none of the summonsed documents were not subject to any other independent claim of privilege beyond identity. Then, in sweeping language, the court concluded that the tax shelter disclosure rules virtually preclude assertions of identity privilege by tax shelter investors.

More fundamentally, the Does' participation in potentially abusive tax shelters is information ordinarily subject to full disclosure under the federal tax law. ... Congress has determined that tax shelters are subject to special scrutiny, and anyone who
organizes or sells an interest in tax shelters is required, pursuant to I.R.C. § 6112, to maintain a list identifying each person to whom such an interest was sold. This list-keeping provision precludes the Does from establishing an expectation of confidentiality in their communications with BDO, an essential element of the attorney-client privilege and, by extension, the § 7525 privilege. ... At the time that the Does communicated their interest in participating in tax shelters that BDO organized or sold, the Does should have known that BDO was obligated to disclose the identity of clients engaging in such financial transactions. Because the Does cannot credibly argue that they expected that their participation in such transactions would not be disclosed, they cannot now establish that the documents responsive to the summonses, which do not contain any tax advice, reveal a confidential communication. ....

BDO's affirmative duty to disclose its clients' participation in potentially abusive tax shelters renders the Does' situation easily distinguishable from the limited circumstances in which we have determined that a client's identity was information subject to the attorney-client privilege. ...

c. **You don't have to be a criminal to claim identity privilege in Chicago.** United States v. Arthur Andersen, LLP, 92 A.F.T.R.2d 2003-5207 (N.D. Ill. 6/30/03). Investors in tax shelters promoted by Arthur Andersen successfully intervened anonymously and asserted identity privilege under § 7525 when the IRS sought to enforce an administrative summons to obtain the lists of investors. The court (Judge Castillo) rejected the government's argument [based on In re Grand Jury Proceeding (Cherney), 898 F.2d 565 (7th Cir.1990); Tillotson v. Boughner, 350 F.2d 663 (7th Cir.1965)] that identity privilege can exist only where the client has engaged in past criminal conduct, and applied the four part test of United States v. BDO Seidman, 91 A.F.T.R.2d 2003-1016, 20031 U.S.T.C. §50,255 (N.D. Ill. 2/4/03). (N.D. Ill. 2003) [United States v. BDO Seidman, 92 A.F.T.R.2d 2003-5443 (7th Cir. 7/2/03)]. Judge Castillo concluded that "revealing the clients' identities would reveal their motives for seeking tax advice [because] [t]he IRS is seeking information, including the identities ... in an effort to determine whether or not Andersen was complying with the IRS regulations governing potentially abusive tax shelters. ... Under these circumstances, it is difficult to see how revealing the identities of the Poes and the Does could amount to anything less than a revelation of their motivations in seeking Andersen's tax advice-to invest in potentially abusive tax shelters. This motivation, the "very substantive reason that the client sought ... advice in the first place," is confidential and therefore privileged under § 7525. Judge Castillo held further that Reg. § 301.6112-IT Q & A-17(b) provides that the § 7525 privilege trumps the requirements of § 6112. Finally, he rejected the government's argument that the crime-fraud exception to privilege applied because there was no prima facia showing of a crime.

- It would appear that the Seventh Circuit's subsequent opinion in BDO Seidman, see above, overrules Judge Castillo's opinion in Arthur Andersen, LLP.

d. **And indeed it does!** United States v. Arthur Andersen LLP, 2003-2 U.S.T.C. §50,624, 92 A.F.T.R.2d 2003-5800 (N.D. Ill. 8/15/03). Judge Castillo characterizes BDO as providing that "it appears that the Seventh Circuit intended in BDO to pronounce a generally applicable prohibition on the assertion of the identity privilege in IRS summons enforcement actions that does not seem altered by differing factual scenarios," and reluctantly holds that the intervenors may not assert a § 7525 privilege in their identities.

3. **Now here's a legitimate case of identity privilege.** United States v. Braun, 92 A.F.T.R.2d 2003-5406 (N.D. Cal. 6/17/03). The IRS was investigating the civil tax liability of W, W and C were under investigation by a local police force for grand theft. C was charged by the U.S. government with structuring transactions to avoid reporting under 31 U.S.C. § 5324(a)(3). C was represented in the criminal matter by attorney A. C waived attorney client privilege and the IRS obtained documents from attorney A that identified attorney B as the source of payments of C's legal fees. The district court refused to enforce an IRS summons against attorney B seeking the identity of his client who had sought legal representation for C, because, based on information in the attorney's sealed affidavit, the court found that the client had disclosed confidential information to the attorney that would necessarily be revealed if the client's identity were known.

KPMG's promotion and participation in tax shelters and sought judicial enforcement when it determined that KPMG had not complied. KPMG withheld documents that would have been responsive to the summonses on grounds that the documents were privileged, and KPMG provided the IRS with a privilege log of the withheld documents. Citing United States v. Lawless, 709 F.2d 485 (7th Cir. 1983), for the principle that the attorney-client privilege does not extend to communications between a taxpayer and his attorney simply for the purpose of preparing a tax return, the court held that the § 7525 privilege does not extend to communications between a taxpayer and tax practitioner simply for the purpose of preparing a tax return. The court then went on to hold that KPMG's tax opinion letters to its clients were not privileged because they were prepared in connection with the preparation of tax returns. Furthermore, memoranda of KPMG's employees' discussions with clients' lawyers were not privileged because the communications were in connection with tax return preparation. Somewhat contradictorily, however, the court held that opinion letters prepared by law firms in connection with preparation of tax returns were privileged if the taxpayer, rather than the accounting firm, retained the lawyer.

- The court also held that § 7525 did not protect accountant work product. With respect to attorney work product, the court articulated the following standard: "The burden of showing that the materials prepared were in anticipation of litigation is on the party asserting the privilege," and "this burden entails a showing that the documents were prepared for the purpose of assisting an attorney in preparing for litigation, and not for some other reason." After an in camera review and comparison of a random sample of thirty allegedly privileged documents and the corresponding entries in the privilege log prepared in response to the summons, the court found that only four of the privilege log entries were completely supportable; accordingly it referred the matter to a special master to conduct an examination of the withheld documents, evaluate the asserted privileges, and submit a report and recommendation.

5. District court finds subject-matter waiver of privilege in all communications between two corporations and their outside tax counsel by reason of the assertion of a "reasonable cause" defense. In re: G-I Holdings Inc., 2003-2 U.S.T.C. ¶50, (D. N.J. 7/18/03). The court (Judge Bassler) refused to bifurcate discovery and trial on the issue of penalties pending resolution of the substantive tax issues because the debtors waived any attorney-client privilege with respect to their outside tax counsel [Bill McKee and Will Nelson] by asserting a "reasonable cause" defense that placed attorney-client communications at issue. The court further finds that the debtors' communications with Michael Baldasaro [an accountant then with Arthur Andersen] are not privileged under United States v. Kovel, 296 F.2d 918 (2d Cir. 1961), because he was hired as a consultant – his expertise in partnership taxation was too great to consider him as a "translator or facilitator."

6. Long-Term Capital Holdings rulings. Long-Term Capital Holdings v. United States, 90 A.F.T.R.2d 2002-7446, 2003-1 U.S.T.C. ¶50,105 (D. Conn. 10/30/02), modified by, 2003-1 U.S.T.C. ¶50,304, 91 A.F.T.R.2d 2003-1139 (D. Conn. 2/14/03). In connection with a transaction, the taxpayer obtained opinions from Sherman & Sterling and from King & Spalding relating to different aspects of the transaction. Without specifically disclosing the K&S opinion letter itself, the taxpayer revealed to its tax accountant that it had a "more likely than not" opinion with respect to the allowability of the deduction. The S&S opinions, in contrast, were voluntarily disclosed in the course of the audit. The magistrate held that disclosure of existence of the K&S opinion and that it was a more likely than not opinion with respect to allowance of deduction disclosed gist of opinion and thus was an express subject matter waiver even though disclosure was extra-judicial. In addition, the magistrate alternatively reasoned that voluntary disclosure of the S&S opinions, while asserting privilege as to K&S opinion regarding a different aspect of the same transaction, was attempt to use the "privileged communications as both a shield and a sword." The magistrate found implied waiver as to the K&S opinion. The alternative holding is confusing, however, because the magistrate also factored in the express waiver resulting from the disclosure of the existence of the K&S to its tax accountant. Nevertheless, the Magistrate ultimately concluded that the K&S opinion could constitute work product under Second Circuit's application of the doctrine to documents prepared "in anticipation of litigation," in United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998). Accordingly, the magistrate required submission of documents for in camera inspection.

- On reconsideration, the magistrate found that the S&S opinion was not privileged because it was prepared for the purpose of ascertaining the basis of a partnership interest and thus was a record that had to be made available to the IRS under Reg. § 1.6001-1(a). Since the S&S opinion was not privileged to begin with, its disclosure was not a subject matter waiver. Furthermore, after considering further facts the K&S opinion was found not to deal with the same issues as the S&S opinion, and thus the disclosure of the S&S opinion was not a waiver with respect to the K&S opinion. However, the
magistrate reaffirmed that the disclosure of existence of the K&S opinion and that it was a more likely than not opinion with respect to allowance of deduction disclosed gist of opinion and thus was an express waiver, but rather than being a subject matter waiver – as originally held – the waiver was only of those portions of the opinion letter reflecting the matter actually disclosed. Finally, the magistrate held that the K&S opinion was opinion attorney work product that was not discoverable by the IRS.

7. Attorney-client privilege and work product doctrine can shield documents from the IRS, but you've got to have a privilege log. Toler v. United States, 2003-1 U.S.T.C. ¶50,476, 91 A.F.T.R.2d 2003-2262 (S.D. Ohio 4/29/03). In connection with a criminal investigation [prior to a referral to the Justice Department], the IRS issued a summons seeking the taxpayer's documents, including all records used or resulting from preparation of the taxpayer's tax returns, to Kiesling, an accountant-attorney, who had advised the taxpayer on various tax matters in his capacity as an attorney. Kiesling represented the taxpayer in the criminal matter until August 2000, when the taxpayer retained another law firm, "SZD," which in turn retained Kiesling. Because prior to August 2000, Kiesling did not possess any of the documents in question, the summons was quashed in that regard. However, if Kiesling possessed any documents or obtained any information described in the summons that were created or obtained after the taxpayer retained SZD — a fact that was not admitted — the documents and information were protected by the attorney-client privilege to the extent that they "serve[d] to disclose confidential legal communications between [taxpayer] and SZD," since Kiesling was SZD's agent. Furthermore, to the extent any relevant documents were prepared or created to assist in defending against the possible criminal charges, they were protected by the work product doctrine, regardless of whether Kiesling was acting as an attorney or accountant after being retained by SZD. However, because the taxpayer failed to provide a privilege log, the motion to quash was denied, without prejudice to renew following preparation of a disclosure log. Finally, the pre-existing documents that were gathered after August 2000 were not protected by the Fifth Amendment because the "fact that the contents of such documents, to the extent they exist, may be incriminating does not render the production of those documents incriminating.

8. A lawyer's description and opinion regarding a prepackaged tax shelter transaction is not privileged. Doe #1 v. Wachovia Corporation, 92 A.F.T.R.2d 2003-5125 (W.D. N.C. 6/24/03). The IRS served an administrative summons on Wachovia seeking investor lists, documents, and other information relating to potentially abusive tax shelters under Reg. § 301.6112-1T. Investors argued that disclosure of their names would "be tantamount to disclosure of privileged information" provided by them to KPMG [§ 7525 privilege] and to Jenkins & Gilchrist [attorney-client privilege], and that other confidential privileged information would be disclosed by compliance with the summons. The court found that there was no attorney-client relationship between the investors and Jenkins & Gilchrist. Rather, Jenkins & Gilchrist "appear[ed] to have merely sold a package to them which contained a description of the transaction and a memorandum as to the potential tax consequences stemming from the transaction." There was no evidence that any investor "ever had so much as a conversation with an attorney at J & G," and there was nothing uniquely tied to the individual investors' financial situation. The package contained no confidential information, was sent to all investors without any individual tailoring, and was delivered by Wachovia, not Jenkins & Gilchrist.

In this case there is no evidence that J & G was (1) retained by the client, as opposed to by Wachovia; (2) contacted by the client, except through Wachovia; (3) providing legal advice based on individual financial information, as opposed to selling a tax advantaged structure; and (4) by the terms of its own agreement, acting as an attorney for the “client.”

- Similarly, the § 7525 privilege did not apply with respect to KPMG. First, the privilege only applies in cases by or against the government and before the IRS. This was a suit by investors seeking an injunction against Wachovia, not a proceeding in which the United States appeared, and the issuance of an administrative summons to a bank is not a “tax proceeding” before the IRS. Second, the privilege does not apply "to any written communication between a federally authorized tax practitioner and a director, shareholder, officer, or employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter," which exactly described this cases. Third, KPMG did not provide any advice other than in the context of return preparation, which is not privileged.

- On 6/26/03, the investors filed a notice of intent to appeal.
9. There's no client identity privilege when it's the lawyer's tax return being audited. Najar v. United States, 2003-1 U.S.T.C. ¶50,470, 91 A.F.T.R.2d 2003-2166 (S.D. Ind. 4/11/03). The IRS issued a summons to the taxpayer-lawyer's bank seeking documents relating to the taxpayer's account designated as an Interest on Lawyers' Trust Account (IOLTA). The court rejected the taxpayer's argument that the requested documents were protected by attorney-client-privilege. Banking transactions are not confidential communications between an attorney and client; they are commercial transactions that disclose the identity of the parties to the transaction to the third party banking institution. The requested documents were relevant because "the clients themselves may be instrumental in identifying and verifying non-income and income items in the attorney's trust account."

10. A § 7602 summons solely for a criminal investigation is OK! Scotty's Contracting and Stone, Inc. v. United States, 326 F.3d 785, 2003-1 U.S.T.C. ¶50,413, 91 A.F.T.R.2d 2003-2047 (6th Cir. 4/24/03). The IRS issued summonses to accountants for Scotty's Contracting and its owner, Scott, "to determine whether *** has unreported federal income tax liabilities ***, and whether *** Scott has committed any offense under the internal revenue laws." The Court of Appeals (Judge Gibbons) rejected the government's argument that Scotty's Contracting lacked standing to challenge the summonses because they were held that under § 7602, as amended in 1982, the IRS may validly issue a summons pursuant for the sole purpose of a criminal investigation of Scott, not Scotty's. However, the court held that under § 7602, as amended in 1982, the IRS may validly issue a summons pursuant for the sole purpose of a criminal investigation, as long as the case has not yet been referred to the Justice Department. Accord: United States v. Millman, 822 F.2d 305, 308 (2d Cir.1987); Pickel v. United States, 746 F.2d 176, 183-84 (3d Cir.1984); United States v. G & G Adver. Co., 762 F.2d 632; United States v. Schmidt, 816 F.2d 1477 (10th Cir.1987); La Mura v. United States, 765 F.2d 974 (11th Cir.1985).

11. Chief Counsel sets forth the rules for playing hardball by keeping secret certain Chief Counsel Advice. Chief Counsel Notice CC-2003-022, 2003 TNT 129-3 (7/1/03), modifying and supplementing Chief Counsel Notice CC-2002-026 (5/16/02). This notice apprises Chief Counsel employees of the procedures for processing taxpayer specific Chief Counsel Advice when it is determined that no portion of a particular CCA need be disclosed to the public under the provision of § 6110.

C. Litigation Costs
1. Frivolous arguments are painful to lawyers' pocketbooks. Takaba v. Commissioner, 119 T.C. 285 (12/16/02). Judge Halpern sua sponte awarded the government excess attorneys costs of $10,500, payable by taxpayer's counsel, under § 6673(a)(2), where counsel continued to press a frivolous "§ 861 argument" [that only income earned from possessions, corporations, or the Federal government is subject to tax] originally advanced by the taxpayer acting pro se.

2. It will warm your heart to know that the sword to push the IRS to settle has a keen edge. Gladden v. Commissioner, 120 T.C. No. 16 (6/27/03). The taxpayer made a "qualified offer" under § 7430(c)(4)(E), and after a judicial decision relating to issues pertinent to the substantive tax adjustment the parties finally settled the substantive tax adjustment for less than the offer. Temp. Reg. § 1.7430-7T(a) provides that "[t]he provisions of the qualified offer rule do not apply if the taxpayer's liability under the judgment * * * is determined exclusively pursuant to a settlement ...." Because legal arguments and issues relating to the substantive issues were litigated and decided by a court, the judgment was not regarded as merely pursuant to a settlement. Thus the taxpayer's qualified offer was not limited by the settlement limitation on qualified offers in section § 7430(c)(4)(E)(ii)(I). Accordingly, the taxpayers qualified as a prevailing party under § 7430(c)(4) by reason of section 7430(c)(4)(E).

D. Statutory Notice
1. The IRS does not have to comply with at least one section of the IRS Restructuring and Reform Act of 1998. Eilings v. Commissioner, 324 F.3d 1110, 2003-1 U.S.T.C. ¶50,357, 91 A.F.T.R.2d 2003-1648 (9th Cir. 4/8/03). The Ninth Circuit held that the failure to comply with § 3463(a)(2) of the IRS Restructuring and Reform Act of 1998, an uncodified provision, stating that the IRS "shall include on each notice of deficiency ... the date determined by [the IRS] as the last day on which the taxpayer may file a petition in the Tax Court," does not invalidate the deficiency notice. Accord Rochelle v. Commissioner, 116 T.C. 356 (2001), aff'd, 293 F.3d 740 (5th Cir. 2002); Smith v. Commissioner, 275 F.3d 912 (10th Cir. 2001).

2. The IRS relies on Postal Service Forms. Clough v. Commissioner, 119 T.C. 183 (10/18/02). The taxpayer's petition was dismissed as untimely. Where the existence of the notice of deficiency is not disputed, Postal Service Form 3877, Acceptance of Registered, Insured, C.O.D., and
Certified Mail, or its equivalent – a certified mail list – is direct documentary evidence of the date and fact of mailing. Exact compliance raises a presumption of official regularity in the Commissioner's favor.

E. Statute of Limitations

1. The Eighth Circuit rejects a thirty-year-old Revenue Ruling. Kaffenberger v. United States, 314 F.3d 944, 2003-1 U.S.T.C. ¶50,164, 91 A.F.T.R.2d 2003-374 (8th Cir. 1/3/03). Section 6532(a) allows the IRS to agree to an extension of time [beyond the normal two year period of limitations] for filing a refund suit. In Rev. Rul. 71-57, 1971-1 C.B. 405, the IRS ruled that such an agreement was valid only if the agreement is executed before the statutory time expired. The court of appeals held that Rev. Rul. 71-57 misconstrues § 6532(a)(2), and that an agreement to extend the statute of limitations executed by the IRS after it had expired was valid. The court reasoned that § 6501, the provision limiting the period for the IRS's to assess taxes allows the period to be extended "by subsequent agreements in writing made before the expiration of the period previously agreed upon," but that § 6532(a)(2) contains no such language; and the inference therefore is that the agreement need not be entered into before the period expires, because to "do so renders the above quoted portion of § 6501 'insignificant, if not wholly superfluous.'"

2. Brosi v. Commissioner, 120 T.C. 5 (1/13/03). Tolling of the statute of limitation under § 6511(h) is not available to a taxpayer who serves as a "care-giver" to a relative; it applies only in the case of a serious mental or physical disability of the individual taxpayer seeking relief.

3. The government end-runs the statute of limitations via a setoff. Pacific Gas & Electric Co. v. United States, 55 Fed. Cl. 271, 91 AFTR2d 2003-1035, 2003-1 U.S.T.C. ¶50,267 (2/20/03). Without any particular statutory authority, the government may setoff an erroneous refund against other refunds due to the taxpayer. If the other refund relates to the same taxpayer, tax, and tax year, the government can setoff the prior erroneous refund even if the statute of limitations on bringing suit for the erroneous refund has expired. In this case, an erroneous overpayment of interest on income tax was setoff against a subsequent refund claim. The IRS did allow the taxpayer a deduction for the amount of the setoff in the year of the setoff.

4. Counting the days on the calendar. Rev. Rul. 2003-41, 2003-17 I.R.B. 814 (4/28/03). If pursuant to § 7503 [providing that, if the last day for filing a return falls on a Saturday, Sunday, or legal holiday, the return will be considered timely if filed on the next succeeding day that is not a Saturday, Sunday, or legal holiday], a taxpayer files a timely return after April 15, e.g., on April 17, then § 6511statute of limitations for filing a refund claim expires three years after the extended filing date, e.g. April 17. But if the taxpayer had filed a timely return before April 15, when the due date was extended by § 7503 to a later date, a refund claim filed after April 15 three years later, because §6513(b)(1) treats wage withholding as paid on April 15, and § 7503 does not affect § 6513(b)(1).

5. Regulations on the statute of limitations suspension when enforcement is sought with respect to a designated summons issued to a corporation. REG-208199-91, Suspension of Limitations Period, 68 F.R. 44905 (7/31/03). Proposed regulations under § 6503(j), relating to the suspension of the statute of limitations when a case is brought with respect to a "designated" or "related" summons issued to a corporation.

6. No Mulligan for the Tax Court and the IRS. Carroll v. United States, 339 F.3d 61, 92 A.F.T.R.2d 2003-5650, 2003-2 U.S.T.C. ¶50,608 (2d Cir. 8/5/03). For purposes of suspending the statute of limitations for deficiencies pending a Tax Court order in a docketed case, the order is entered under § 7459 when it is signed, docketed, and served, even if the document itself is undated due to a clerical error. The Tax Court's order vacating its earlier undated order and reentering the original order did not restart the statute of limitations – either because the Tax Court had no jurisdiction to vacate its first order or because the second order was a "non-substantive housekeeping document," and the assessment was untimely.

F. Liens and Collections

1. You'll soon have to pay the IRS for the privilege of proving that you can't pay the IRS. REG-103777-02, User Fees for Processing Offers to Compromise, 67 F.R. 67573 (11/06/02). The proposed regulations [31 C.F.R. § 300.3] impose a $150.00 user fee for processing offers in compromise [pursuant to the Independent Offices Appropriations Act, 31 U.S.C. § 7901]. The proposed user fee would not apply to offers based on doubt as to liability, offers made by low income taxpayers, offers accepted to promote effective tax administration, and offers accepted based on doubt as to collectibility where there has been a determination that, although an amount greater than the amount offered could be collected, collection of more than the amount offered would create economic hardship within the meaning of Reg. § 301.6343-1.
1. "Decision letter," "determination letter." What's the difference? Craig v. Commissioner, 119 T.C. 252 (1/14/02). After the IRS sent the taxpayer a final notice of intent to levy, the taxpayer filed a timely request for a § 6330 hearing. The taxpayer was accorded an "equivalent hearing" [under Reg. § 301.6330-1(i)], at which the taxpayer was erroneously told that he was not entitled to a hearing, and after which a decision letter upholding the levy was issued, stating that the taxpayer was not entitled to judicial review of the decision because the request for a hearing was untimely. The taxpayer appealed and Judge Laro held that the Tax Court had jurisdiction to review the IRS's decision even though the IRS never issued the taxpayer a notice of determination with respect to a § 6330 hearing. The Commissioner conceded that the taxpayer was entitled to and should have been given a hearing, and Judge Laro accepted the Commissioner's argument that the Tax Court had jurisdiction on the grounds that the taxpayer had received an "equivalent hearing" and a decision letter. Since there was a timely request for a hearing, an equivalent hearing, and decision letter, the 'decision' reflected in the decision letter issued to petitioner is a 'determination' for purposes of section 6630(d)(1)." The court proceeded to grant summary judgment for the Commissioner, rejecting the taxpayer's tax protestor arguments and imposing a $2,500 § 6673(a)(1) penalty.

a. But timeliness counts. Herrick v. Commissioner, T.C. Memo. 2003-167 (6/9/03). Special Trial Judge Armen held that where the taxpayer fails to file a timely request for a collection due process hearing, the Tax Court lacks jurisdiction to review a the IRS's decision in a "decision letter" following an "equivalent hearing." It was irrelevant that the IRS had erroneously advised the taxpayer that he had been granted an extension of time to request the due process hearing, because Kennedy v. Commissioner, 116 T.C. 255 (2001), held that the Commissioner is not authorized to waive the time period requirements in § 6330.

3. T.D. 9027, Levy Restrictions During Installment Agreements, 67 F.R. 77416 (12/18/02). The Treasury Department has promulgated regulations [Reg. § 301.6331-4] under § 6331 relating to restrictions on levy during the period that an installment agreement is proposed or in effect.

4. Due process in jeopardy assessments and levies. Dorn v. Commissioner, 119 T.C. 356 (12/30/02). Section 6330(f) denies taxpayers the right to a pre-levy hearing in the case of jeopardy assessments, but § 6330(b) accords the taxpayer a right to an administrative due process hearing within a reasonable time after the levy. Judge Colvin held that under § 6330(d), the taxpayer is entitled to Tax Court review of an administrative decision in a § 6330(b) hearing that finds a jeopardy levy was proper.

5. The taxpayer won the procedural battle but lost the substantive war. Washington v. Commissioner, 120 T.C. 114 (3/6/03). In a reviewed opinion by Judge Chiechi, the Tax Court held (majority of 8, with 7 judges concurring) that in a § 6330 due process hearing, the Tax Court has jurisdiction to determine whether the U.S. Bankruptcy Court previously had discharged the taxpayers from unpaid income tax liabilities for the years in question. [The bankruptcy court order simply provided "the Debtor is released from all dischargeable debts."]. PS - the taxpayer lost on the merits.

6. It can be expensive to seek judicial review of a §§ 6320/6330 due process hearing primarily for purposes of delay. Roberts v. Commissioner, 329 F.3d 1224, 2003-1 U.S.T.C. §50,359, 91 A.F.T.R.2d 2003-1675 (11th Cir. 3/13/03), aff'g 118 T.C. 365 (5/3/02). In reviewing the Appeals Officer's decision in a §§ 6320/6330 due process hearing that collection of a tax shown on the return but not paid was warranted, Judge Chiechi held that a computer generated record of assessment on Form RACS 006 complied with the requirements of Reg. § 301.6203-1; a signed Assessment Certificate, Form 23C, is not required. A $10,000 penalty under § 6673(a)(1) was imposed on the taxpayer for petitioning for review of the §§ 6320/6330 due process hearing primarily for purposes of delay. The Court of Appeals affirmed, finding the taxpayer's due process claims without merit and that the Tax Court did not abuse its discretion in imposing sanctions.

7. Administrative levy on property held as tenants by the entirely for one spouse's tax liability is OK. Hatchett v. United States, 330 F.3d 875, 91 A.F.T.R.2d 2003-2457, 2003-1 U.S.T.C. § 50,504 (6th Cir. 6/4/03). The Sixth Circuit held that pursuant to Craft v. United States, 535 U.S. 274 (2002) [holding that under § 6321 a tax lien for one spouse's tax liability attached to that spouse's interest in real property held with his wife as tenants by the entirely], the IRS had to power under § 6331 to levy on the taxpayer-husband's interest in real property held as tenants by the entirely by seizing and selling the entire property and accounting to the wife for her interest.

8. You have a right to make an oral recording of the frivolous arguments you make in a due process hearing, even if you can't do so in an ordinary Appeals conference. Keene v. Commissioner, 121 T.C. No.2 (7/8/03). In a reviewed opinion (Judge Dawson) adopting the opinion of Special Trial Judge Armen, the Tax Court held that § 7521(a)(1) provides taxpayers the right to audio
record a § 6330 due process hearing. Several concurrences pointed out that the holding did not invalidate any other IRS procedures or regulations regarding the ordinary Appeals process.

- Judge Chiechi (joined by Judge Cohen and Swift) dissented on the grounds that § 7521 was intended to apply only to the in-person audit interviews and the in-person collection interviews that existed in 1988, when § 7521 was enacted, and did not intend the provision to apply to voluntary conferences initiated by taxpayers “conducted in an informal setting in order to review and consider actions taken by the examination division or the collection division of the IRS and to discuss the facts and the law relating to such actions for the purpose of settling or resolving those matters without resort to litigation.”

- Judge Swift dissented on the grounds that the taxpayer had raised only frivolous argument and should not be permitted to complain about procedural questions to further delay the proceedings.

9. Sometimes it's a return, sometimes it isn't. Swanson v. Commissioner, 121 T.C. No. 7 (8/28/03). A substitute for a return prepared by the IRS pursuant to § 6020 is not a return for purposes of § 523(a)(1)(B) of the Bankruptcy Act. Because the taxpayer had not files any returns for the year in issue, he was not discharged from his income tax liabilities by the discharge in bankruptcy.

10. A QDRO creates an interest in a pension fund that trumps a later federal tax lien. United States v. Taylor, 338 F.2d 947, 92 A.F.T.R.2d 2003-5606 (8th Cir. 1/14/03). When the IRS attempted to levy on a delinquent taxpayer's pension fund, his ex-wife, who had an interest in the fund under a valid QDRO intervened. The court (Judge Riley) held that as a result of the QDRO, the ex-wife was a “judgment lien creditor” with a perfected interest, regardless of whether she had satisfied state law perfection requirements. Furthermore, a modification of the QDRO related back to the date of the original QDRO. Accordingly, her claim had priority over a subsequent federal tax lien.

G. Innocent Spouse

1. Innocent spouse relief applies only to joint returns. Raymond v. Commissioner, 119 T.C. 191 (10/22/02). The filing of a joint return is a statutory prerequisite for relief under § 6015(b) and (c), but the statute is silent as to § 6015(f) relief. The Tax Court (Judge Vasquez) held that a taxpayer who did not file a joint return is not entitled to relief under the equitable relief provisions of § 6015(f) because the Conference Report states that relief is to be granted where “it is inequitable to hold an individual liable for all or part of any unpaid tax or deficiency arising from a joint return.” Relief was unavailable to the taxpayer, who claimed that the income reported on her “married filing separately return” was not hers and that she had not filled it out, but had signed a blank return.

2. Did a procedural detail slip through the statutory cracks? Maier v. Commissioner, 119 T.C. 267 (11/20/02). When one spouse requests innocent spouse relief from the IRS, § 6015(h)(2) assures the other spouse a right to participate in the process [although it does not guarantee a personal appearance]. If a requesting spouse seeks Tax Court review of a denial of innocent spouse relief in a proceeding to which the other spouse is not already a party, § 6015(e)(4) provides the nonrequesting spouse the right to intervene. But if the IRS administratively grants the requesting spouse innocent spouse relief, according to the Tax Court [Judge Panuthos], the nonrequesting spouse has no independent right to petition the Tax Court to review the administrative grant of relief to the requesting spouse.

3. A limitation on claiming the assessment is barred by the statute of limitations. Block v. Commissioner, 120 T.C. 62 (1/23/03). Judge Ruwe held that he Tax Court's jurisdiction under § 6015(e) to review the Commissioner's denial of innocent spouse relief pursuant to a stand alone petition does not permit the taxpayer seeking innocent spouse relief to raise other substantive or procedural claims (e.g., the statute of limitations on assessments).

4. Appeal rights for taxpayers seeking relief under § 66. Rev. Proc. 2003-19, 2003-5 I.R.B. 371 (2/3/03). This revenue procedure provides guidance regarding administrative appeal rights of a taxpayer seeking relief from tax liability under § 66(c). [Section 66(c) provides relief for a spouse who does not file a joint return, and does not know of or include in income certain items of community income attributable to the other spouse, if it would be “inequitable” to include the items in the innocent spouse's gross income.]

5. Sorry Kathryn, the Tax Court is indeed a court of limited jurisdiction. Bernal v. Commissioner, 120 T.C. 102 (2/20/03). The taxpayer, a resident of a community property state, sought relief under § 66(c) from tax liability for community income earned by her spouse, from whom she lived apart and was in the process of divorcing and with whom she did not file a joint return. The Commissioner denied the relief and the taxpayer filed a stand alone petition for review of the
Commissioner's decision. The Tax Court dismissed the petition because § 66(c) does not contain a provision parallel to § 6015(e) providing for review by the Tax Court of the Commissioner's decision not to grant innocent spouse relief: "There is nothing in the statute or legislative history from which we could conclude that Congress intended to provide independent ('stand alone') review by the Tax Court of the denial of a claim for relief under section 66."

6. Innocent spouse relief for the dead. Rev. Rul. 2003-36, 2003-18 I.R.B. 849 (5/5/03). An executor may pursue an existing § 6015 request for innocent spouse relief made during decedent's lifetime, and he has authority under § 6903 to file a request for innocent spouse relief under § 6015 "as long as the decedent had satisfied any applicable requirements while alive."

7. "Since refunds are included in the relief provided under section 6015, ... a request for relief under section 6015 encompasses a request for a refund of tax to the extent permitted under section 6015." Washington v. Commissioner, 120 T.C. 137 (4/21/03). The taxpayer and her then husband filed a joint return for 1989, reflecting her salary income and his self-employment income, that showed tax owed, but did not pay the tax, beyond the wage withholding on the taxpayer's salary. The IRS garnished the taxpayer's wages and applied overpayments of her tax from 1992 and 1994-98 to the unpaid 1989 tax liability. The IRS denied the taxpayer's request for § 6015 equitable relief. Judge Jacobs held that the IRS had abused its discretion because it had not taken into account the extent of the economic hardship that the taxpayer would suffer if relief were not granted and the facts established that the unpaid tax was attributable to the taxpayer's former husband's income and she had no knowledge of reason to believe at the time the returns was signed that he would not pay it. No factors in Rev. Proc. 2000-15, 2000-1 C.B. 447 or Reg. § 301.6343-1 weighed against granting relief. The court also reject the IRS's argument that even if the taxpayer was entitled to relief under § 6015(f), the provision did not apply to the portion of the tax liability that was paid on or before July 22, 1998 [the date of enactment of Internal Revenue Service Restructuring and Reform Act of 1998], for which she was seeking a refund. Section 6015 applies to the full amount of any preexisting tax liability for a particular taxable year, if any of that liability remained unpaid as of July 28, 1998, and not just to the portion of tax liability that remained unpaid thereafter [following Flores v. United States, 51 Fed. Cl. 49 (2001), followed]. However, pursuant to sec. 6015(g)(1) the taxpayer's right to a refund was limited to amounts for which claims were filed within the period in § 6511 – in this case amounts paid within two years prior to filing the refund claim. Taxpayer's letters to a revenue officer seeking to have her account placed on "uncollectible status" and requesting abatement of interest and penalties on the grounds that her husband owned the taxes constituted a sufficient informal refund request.

8. The Tax Court is the Chancellor under § 6015(f). Wiest v. Commissioner, T.C. Memo 2003-91 (3/27/03). The Commissioner's denial of § 6015(f) equitable innocent spouse relief was arbitrary where only $900 of a $4,162 underpayment (after wage withholding) was attributable to the requesting spouse's income, and the nonrequesting spouse had handled the preparation and filing of the return. In light of the nonrequesting spouse's "pattern of deception," the taxpayer had no reason to know that she would not pay the tax shown on the return, and the IRS erred in treating signing the return as knowledge or reason to know that the tax would not be paid. Furthermore, the IRS's calculation of the taxpayer's share of the unpaid tax was arbitrary.

9. You might be able to wriggle out of a closing agreement under the power of § 6015. Hopkins v. Commissioner, 120 T.C. No. 17 (6/30/03). The taxpayer-wife (Yvonne) filed a request for innocent spouse relief under § 6015 with respect to 1982 and 1983. The taxpayers had reported losses from a partnership for those years; in 1988 they signed a closing agreement under § 7121 with respect to adjustments relating to the deductions. In a subsequent bankruptcy the taxpayer-wife sought innocent spouse relief under former § 6013(e), but the bankruptcy court, in a decision that was affirmed [In re Hopkins, 146 F.3d 729 (9th Cir.1998)], held that the closing agreement precluded innocent spouse relief. In the instant case the Commissioner argued that the closing agreement precluded a claim for relief under § 6015, and also argued that res judicata and collateral estoppel precluded the taxpayer's claim. Judge Ruwe held that a closing agreement entered into prior to the effective date of § 6015 does not preclude the taxpayer from seeking § 6015 innocent spouse relief, which may be available for any tax that remained unpaid as of 6/22/98. Nor did res judicata or collateral estoppel preclude the claim.

10. When they both have income and erroneous deductions, how do you apportion liability? Hopkins v. Commissioner, 121 T.C. No. 5 (7/29/03). Mr. and Mrs. Hopkins filed a joint return on which he claimed erroneous deductions passed-through from a partnership and she claimed erroneous NOL deductions. Mrs. Hopkins (Marianne) was denied innocent spouse relief under § 6015(b), but was granted some apportioned liability relief under § 6015(c). She was granted relief from
tax liability attributable to Mr. Hopkins erroneous partnership deductions except for the portion, if any, that offset her income. She was liable for any deficiencies attributable to her erroneous NOL deductions to the extent they offset her income, but she was relieved of liability for any remaining portion of the deficiencies attributable to the NOL that offsets his income. Decision was entered under Rule 155.

11. But you can't wriggle out of a prior judgment in a stand alone innocent spouse petition. Just one bite at the innocent spouse apple. Thurner v. Commissioner, 121 T.C. No. 3 (7/11/03). Judge Cohen held that a taxpayer who had failed to raise a innocent spouse claim in a prior district court proceeding instituted by the IRS to reduce an assessment to judgment was barred by res judicata from raising the claim in a stand alone petition if the taxpayer participated meaningfully in the prior action. Because the Mr. Thurner had meaningfully participated, his claim was barred; whether Mrs. Thurner had materially participated could not be determined on a motion for summary judgment. On another issue, the court held that § 6015 relief is not available for tax liabilities that had been paid prior to 6/22/98.

12. Community property income on separate returns. T.D. 9074, Treatment of Community Income for Certain Individuals Not Filing Joint Returns, 68 F.R. 41067 (7/10/03). The Treasury has promulgated final regulations under § 66, relating to the treatment of married individuals in community property states who do not file joint income tax returns. The regulations deal primarily with issues under § 66(c) [relief from community property rules]. The regulations apply only to community income, and provide that whether income is community property is determined by the law of the state in which the taxpayer is domiciled. The regulations apply an item-by-item approach to § 66(c) relief, and provide that knowledge of the source of community income or the income-producing activity, without knowledge of the specific amount of income, is sufficient knowledge to preclude relief.


H. Miscellaneous

1. Miller v. Commissioner, 310 F.3d 640, 2002-2 U.S.T.C. ¶50,759, 90 A.F.T.R.2d 2002-7159 (9th Cir. 11/8/02). Reg. § 301.6404-2(a)(1) properly restricts the IRS’s authority to abate interest to income, estate, gift generation skipping, and certain excise taxes. The abatement of interest provisions do not apply to employment taxes.

2. December 2002 proposed amendments to Circular 230. REG-122380-02, Regulations Governing Practice Before the Internal Revenue Service, 67 F.R. 77724 (12/19/02). The proposed regulations include a proposal to rename the Director of Practice as the Director of the Office of Professional Responsibility, together with a list of proposed procedural changes.


4. Published guidance will be followed by the courts. Rauenhorst v. Commissioner, 119 T.C. 157 (10/7/02). Taxpayers transferred warrants to four charities, which the charities sold shortly thereafter. At the time of the transfer, the taxpayers knew of a contemplated acquisition of the corporation. Judge Ruwe held that the taxpayers were not subject to tax on the charities’ sale of warrants, under the anticipatory assignment of income doctrine, because Rev. Rul. 78-197, 1978-1 C.B. 83, holds that the anticipatory assignment of income doctrine is inapplicable to donated property where the charitable donees are not legally obligated, nor can they be compelled, to sell the contributed property.

   a. Chief Counsel reminds IRS lawyers. Chief Counsel Notice CC-2002-043 (10/17/02). The IRS reminds Chief Counsel attorneys of the requirement to follow published guidance in papers filed in the Tax Court or in defense or suit letters sent to the Department of Justice.

   b. And again, this time with more specificity. Chief Counsel Notice CC-2003-014 (5/8/03). Clarifies the guidance of CC-2002-043 to provide specific rules regarding the requirement to follow published guidance.

   • Rule 1: Chief Counsel attorneys may not argue contrary to final guidance; they should generally follow final or temporary regulations in force even if the Service has subsequently issued proposed regulations which might yield a different result;
reputation or creditworthiness. [Taxpayers] have introduced no credible evidence to show that petitioner
what extent [the taxpayer’s] failure to make the tax payments would have resulted in any damage to his
standing with the bank, and my good name, my goodwill.’ There is no evidence to indicate, however, to
cause direct and proximate adverse consequences to any businesses conducted in [taxpayers’] individual
introduce credible evidence to establish that [taxpayer’s] failure to make the tax payments would have
were reported on Schedule E because they were attributable to [his] S corporations.... [Taxpayers] failed to
made with respect to such activities. To the contrary, [taxpayer’s] accountant testified that the tax payments
are Subchapter S if they are.’
They’re all
construction and real-estate development businesses are not separate businesses, but are ‘all tied together.
[taxpayers’] business activities consists of [one taxpayer’s] summary and uncorroborated testimony. He
might entitle them to a deduction under section 164.
(1/2/01).
regulations generally follow the proposed regulations, REG-104906-99, Third Party Contacts, 66 F.R. 77
(1/2/01).
5. T.D. 9023, Taxpayer Identification Number Rule Where Taxpayer Claims Treaty Rate and Is Entitled to an Unexpected Payment, 67 F.R.70310 (11/22/02). The Treasury has promulgated regulations [Reg. §§ 1.1441-6(g); 301.6109-1] governing withholding agents obtaining individual TINs on an expedited basis when foreign individuals who claim reduced withholding rates under a treaty receive an unexpected payment from the withholding agent and do not have a TIN.
6. T.D. 9028, Third Party Contacts, 67 F.R. 77419 (12/18/02). The Treasury Department has promulgated final regulations under § 7602(c) [requiring reasonable advance notice to the taxpayer] regarding third party contacts made by the IRS in audits and collections. The final regulations generally follow the proposed regulations, REG-104906-99, Third Party Contacts, 66 F.R. 77 (1/2/01).
7. Just how detailed a finding on the burden of proof issue does the Eighth Circuit want the Tax Court to make? Griffin v. Commissioner, 315 F.3d 1017, 2003-1 U.S.T.C. ¶50,186, 91 A.F.T.R.2d 2003-486 (8th Cir. 1/14/03), rev’g T.C. Memo. 2002-6 (1/8/02). Reversing the Tax Court, the Eighth Circuit, in a per curiam opinion, held that the taxpayer had introduced credible evidence that payments of real estate taxes on property owned by an S corporation in which he was a shareholder were made in his capacity as a proprietor of a business, not in his capacity as a shareholder. (If the payments had been made in his capacity as a proprietor they could have been deductible.) The court accepted the Commissioner’s definition of “credible evidence”: “‘the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness)’”, and found this standard satisfied by the testimony of the taxpayer and his accountant. The Commissioner had cross examined the taxpayer’s witnesses, but had not introduced any evidence. The case was remanded to the Tax Court for further proceedings to determine if the Commissioner met the burden of proof, even though the Tax Court opinion, in a footnote, stated that its decision would have been the same if the Commissioner had borne the burden of proof. Perhaps tipping its hand that it wanted the taxpayer to win, the Court of Appeals admonished the Tax Court that “[i]f the same conclusion is reached by the tax court without a new hearing, an explanation is warranted as to how the existing record justifies the conclusion that the Commissioner has met his burden of proof.”
* Rule 2: proposed regulations have no legal effect unless and until they are adopted; proposed regulations should not be the subject of PLRs and TAMs;
* Rule 3: if there are no final or temporary regulations, Chief Counsel attorneys may not take a position that is inconsistent with proposed regulations;
* Rule 4: perceived conflict between proposed regulations and final guidance (or between two or more pieces of nonregulatory final guidance) should be coordinated;
* Rule 5: case law invalidating or disagreeing with the Service’s published guidance does not alter rule 1 or 3; and
* Rule 6: The government’s authority to resolve cases through settlement or other dispute resolution mechanisms remains unchanged, so long as the rules set forth above are not violated.

According to the Tax Court, the taxpayers did “not contend that the real property taxes in question were imposed upon them, that they owned the real property against which the taxes were assessed, or that they owned any equitable or beneficial interest in the real property that might entitle them to a deduction under section 164. ... The only evidence regarding the nature of [taxpayers’] business activities consists of [one taxpayer’s] summary and uncorroborated testimony. He testified, with little elaboration, that he has been a building contractor and land developer for about 30 years, during which time he has developed about one project a year. On cross-examination, he testified that his construction and real-estate development businesses are not separate businesses, but are ‘all tied together. They’re all — any business I have is — if I — if they are — oftentimes I incorporate, because of the liability aspect. They are Subchapter S if they are.’ ... [T]here is no credible evidence that the tax payments were made with respect to such activities. To the contrary, [taxpayer’s] accountant testified that the tax payments were reported on Schedule E because they were attributable to [his] S corporations. ... [Taxpayers] failed to introduce credible evidence to establish that [taxpayer’s] failure to make the tax payments would have caused direct and proximate adverse consequences to any businesses conducted in [taxpayers’] individual capacities. [One taxpayer] testified that he made the tax payments ‘in order to preserve my integrity and my standing with the bank, and my good name, my goodwill.’ There is no evidence to indicate, however, to what extent [the taxpayer’s] failure to make the tax payments would have resulted in any damage to his reputation or creditworthiness. [Taxpayers] have introduced no credible evidence to show that petitioner
made the tax payments to protect the reputation of any business operation conducted in [their] individual
capacities. On the basis of [taxpayer's] testimony, we are unable to conclude that the tax payments would
have represented ordinary expenses to advance any business carried on in [taxpayers'] individual capacities,
as opposed to capital outlays to establish or purchase goodwill or business standing....

8. Burton Kanter in trouble again. Investment Research Associates, Ltd. v. Commissioner, T.C. Memo. 1999-407 (12/15/99). In a 600-page opinion Burton Kanter was held liable for the §6653 fraud penalty by reason of his being "the architect who planned and executed the elaborate scheme with respect to the kickback income payments . . . . In our view, what we have here, purely and simply, is a concerted effort by an experienced tax lawyer [Kanter] and two corporate executives [Claude Ballard and Robert Lisle] to defeat and evade the payments of taxes and to cover up their illegal acts so that the corporations [employing the two corporate executives] and the Federal Government would be unable to discover them."

a. So far, he is unable to wriggle out, the way he did 25 years ago when he was acquitted by a jury.¹¹ The taxpayers subsequently moved to have access to the special trial judge's "reports, draft opinions, or similar documents" prepared under Tax Court Rule 183(b). They based their motion on conversations with two unnamed¹² Tax Court judges that the original draft opinion from the special trial judge was changed by Judge Dawson before he adopted it. They were turned down because the Tax Court held that the documents were related to its internal deliberative processes. See, Tax Court Order denying motion, 2001 TNT 23-31 (4/26/00) and (on reconsideration) 2001 TNT 23-30 (8/30/00). Taxpayers sought mandamus from the Fifth, Seventh and Eleventh Circuits, but were unsuccessful.

b. And the Tax Court's procedures are vindicated and taxpayer Ballard loses on appeal on the fraud issue in the Eleventh Circuit. Ballard v. Commissioner v. Commissioner, 321 F.3d 1037, 2003-1 U.S.T.C. §50,246, 91 A.F.T.R.2d 2003-928 (11th Cir. 2/13/03), aff'g T.C. Memo 1999-407. The Eleventh Circuit affirmed the Tax Court decision and rejected the taxpayers' argument that changes allegedly made by the Tax Court Special Trial Judge were improper. Judge Fay stated:

> Even assuming Dick's [taxpayers' lawyer's] affidavit to be true and affording Petitioners-Appellants all reasonable inferences, the process utilized in this case does not give rise to due process concern. While the procedures used in the Tax Court may be unique to that court, there is nothing unusual about judges conferring with one another about cases assigned to them. These conferences are an essential part of the judicial process when, by statute, more than one judge is charged with the responsibility of deciding the case. And, as a result of such conferences, judges sometimes change their original position or thoughts. Whether Special Trial Judge Couvillion prepared drafts of his report or subsequently changed his opinion entirely is without import insofar as our analysis of the alleged due process violation pertaining to the application of [Tax Court] Rule 183 is concerned. Despite the invitation, this court will simply not interfere with another court's deliberative process.

The record reveals, and we accept as true, that the underlying report adopted by the Tax Court is Special Trial Judge Couvillion's. Petitioners-Appellants have not demonstrated that the Order of August 30, 2000 is inaccurate or suspect in any manner. Therefore, we conclude that the application of Rule 183 in this case did not violate Petitioners-Appellants' due process rights. Accordingly, we deny the request for relief and save for another day the more troubling question of what would have occurred had Special Trial Judge Couvillion not indicated that the report adopted by the Tax Court accurately reflected his findings and opinion.

¹¹ His partner (and son-in-law) was convicted and imprisoned. See United States v. Baskes, 649 F.2d 471 (7th Cir. 1980), cert. denied, 450 U.S. 1000 (1981).

¹² Kanter's attorney revealed the names of the two judges when asked at oral argument to the Seventh Circuit as Tax Court Judge Julian Jacobs and Chief Special Trial Judge Peter J. Panuthos. See the text at footnote 1 of Judge Cudahy's dissent in the Seventh Circuit Kanter Estate opinion, below.
c. And the Tax Court's procedures are vindicated and taxpayer Kanter's Estate loses on appeal on the fraud issue in the Eleventh Circuit. *Estate of Kanter v. Commissioner*, 337 F.3d 833, 2003 U.S.T.C. ¶50,605, 92 A.F.T.R.2d 2003-5459 (7th Cir. 7/24/03) (per curiam) (2-1), aff'g in part and rev'g in part *T.C. Memo* 1999-407. The court finds the nondisclosure of the special trial judge's original report to be proper, following the Eleventh Circuit's *Ballard* opinion. It affirms the findings on deficiencies, fraud and penalties, but reverses on the issue of the deductibility of Kanter's expenses for his involvement in the aborted sale of a purported John Trumball painting of George Washington because "Kanter has shown a distinct proclivity to seek income and profit through activities similar to the failed sale of the painting."

d. And the Tax Court's procedures are vindicated but taxpayer Lisle's Estate wins on appeal on the fraud issue in the Fifth Circuit. *Estate of Lisle v. Commissioner*, _F.3d_, 2003 U.S.T.C. ¶50,606, 92 A.F.T.R.2d 2003-5566 (5th Cir. 7/30/03), aff'g in part and rev'g in part *T.C. Memo* 1999-407. The Fifth Circuit (Judge Higginbotham) followed the Eleventh and Seventh Circuits on the nondisclosure of the special trial judge's original report by the Tax Court. It affirms the findings of deficiencies, except for the deficiency in a closed year because the government's proof of Lisle's fraud did not rise to the level of "clear and convincing evidence."

9. Alleged settlement based upon Appeals Officer's mistake in computation is unenforceable. *Estate of Halder v. Commissioner*, *T.C. Memo* 2003-84 (3/25/03). The Tax Court (Judge Vasquez) declined to enter decision on a settlement that was reached after an appeals officer faxed the estate's accountant a valuation that mistakenly listed the proposed value of a partnership interest as $1 million [its 1987 value], as opposed to $1,124,410 [its value as of the 1997 date of death]. The Tax Court ruled that the appeals officer's offer was based upon a mistake, so that there was no meeting of the minds between the parties. In a footnote, Judge Vasquez also noted:

> Even if we held there was a meeting of the minds, we would deny the estate's motion because the "settlement" was never signed or approved by, or even submitted to, any IRS official authorized to approve it. *Gardner v. Commissioner*, 75 T.C. 475, 479 (1980).

- The accountant advised the estate's lawyers and beneficiary of the mistake and was advised by them not to inform the Appeals Officer, but instead to accept the $1 million offer.

10. The regulations say I have to file this document at an IRS office that no longer exists. Notice 2003-19, 2003-14 I.R.B. 703 (3/19/03). Guidance on the proper locations for filing elections, statements and the like following the IRS reorganization. The notice provides that, pending issuance of revised regulations, if a taxpayer files a document as directed in existing regulations, the Service will forward it to its proper filing location.

11. *Strong v. Commissioner*, *T.C. Memo* 2003-87 (3/25/03). In response to an IRS reconstruction of the taxpayer's income using the bank deposit method, the taxpayer claimed that he had held a $165,000 cash hoard at the beginning of the period under examination, even though he had asserted in a bankruptcy petition that he had no such cash at that time. The Commissioner moved for summary judgment on the issue of the existence of the cash hoard on the grounds that the taxpayer was estopped from claiming its existence, but the court (Judge Panuthos) denied summary judgment on the grounds that there were genuine material issues of fact regarding the reason for the omission of the cash hoard from the bankruptcy petition that might affect the application of estoppel.

12. The TEFRA notice wasn't an unauthorized disclosure even if some of the recipients turned out not to be partners. *Abelein v. United States*, 323 F.3d 1210, 2003-1 U.S.T.C. ¶50,331, 91 A.F.T.R.2d 2003-1476 (9th Cir. 3/7/03). The taxpayer, an investor in a tax shelter partnership of which the IRS was conducting a TEFRA audit, claimed the mailing of final partnership administrative adjustment (FPAA) forms to all persons who the IRS believed might have been partners entitled to notice improperly disclosed confidential tax return information because some notices went to people who were not partners. There was no doubt that return information had been disclosed, but the IRS argued that the § 6103(h)(4) exception for disclosure in administrative proceedings applied. The Court of Appeals (Judge Fernandez) held that the administrative proceeding exception applied because (1) the taxpayers were parties to the administrative proceeding, and (2) under § 6231 the IRS must notify all persons who the IRS believes to be partners in the partnership undergoing the TEFRA audit.

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13. **Sign the Form 870 and sue for a refund.** *Smith v. United States*, 328 F.3d 760, 2003-1 U.S.T.C. ¶50,396, 91 A.F.T.R.2d 2003-1919 (5th Cir. 4/16/03), rev’d 2002-1 U.S.T.C. ¶50,409 (S.D. Tex. 4/1/02), corrected by 2003-1 U.S.T.C. ¶50,176 (S.D. Tex. 11/22/02). The taxpayer, whose deficiency was determined in a partnership level proceeding, could seek refund of penalties after executing Form 870 with phrase “Settlement Position” at top. Although the taxpayer clearly waived right to file a Tax Court petition, neither Form 870, nor accompanying “penalty report,” which taxpayer also signed, clearly indicated that the taxpayer was his waiving right to contest the penalties through a refund claim.

14. **The ACLU unsuccessfully tries to protect Irwin Schiff’s right to pander fraudulent tax-scams.** *United States v. Schiff*, 92 A.F.T.R.2d 2003-5047 (D. Nev. 6/16/03). The United States obtained an injunction against Irwin Schiff, an infamous fraudulent tax-scam promoter. Schiff falsely stated that income earned by individuals is not subject to federal income taxes, advised customers to file zero-income tax returns, assisted them in submitting false W-4 forms to stop withholding taxes fraudulently, etc. The taxpayers signed, clearly indicated that the taxpayer was his waiving right to contest the penalties through a refund claim.

15. **You have a choice of forum for review of the Commissioner’s refusal to abate interest.** *Beall v. United States*, 92 A.F.T.R.2d 2003-5001 (5th Cir. 6/27/03). The Fifth Circuit (Judge Garwood) held that a district court has jurisdiction in a refund suit to review for abuse of discretion the Commissioner’s refusal to abate interest. Judge Garwood reasoned that the grant of jurisdiction to the Tax Court in § 6404(h) was not exclusive.

**XI. WITHHOLDING AND EXCISE TAXES**

**A. Employment Taxes**

1. **Is there a Circular 230 issue lurking here?** *Veterinary Surgical Consultants, P.C. v. Commissioner*, T.C. Memo. 2003-48 (2/26/03). An S corporation failed to treat its sole shareholder/president/sole employee as an employee for employment tax purposes. The Tax Court (Judge Cohen) denied § 530 relief because the corporation had no reasonable basis for disregarding the explicit rules of § 3112(d)(1) and Reg. §§ 31.3121(d)-1(b) and 31.3306(i)-1(e), treating corporate officers as employees. For the same result for earlier years, see *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 141 (2001).

   - The taxpayer was a client of Joseph M Grey, a tax practitioner who suffered a similar fate with respect to his own S Corporation in *Joseph M. Grey Public Accountant, P.C. v. Commissioner*, 119 T.C. 121 (2002).


2. **“Nothing in the language or legislative history of section 530 leads us to the conclusion that denial of section 530 relief was meant to be an additional penalty for the failure to timely file information returns . . . .”** *Medical Emergency Care Associates, S.C. v. Commissioner*, 120 T.C. No. 15 (5/19/03). The taxpayer provided hospitals with emergency room physicians and treated those physicians as independent contractors. The taxpayer did not treat the physicians as employees for any period, filed all tax returns treating the physicians as independent contractors, and had no reasonable basis for not treating the physicians as employees. For the year in question however, the taxpayer filed the information returns after the due date (but before the audit). The Commissioner denied § 530 relief because the taxpayer failed to timely file Forms 1096 and 1099. Rev. Proc. 85-18, 1985-1 C.B. 518 states that the IRS will not grant § 530 relief unless all Forms 1099 have been timely filed. Judge Nims refused to follow Rev. Proc. 85-18 and granted relief, holding that the late filing of information returns did not preclude the taxpayer from obtaining relief. “Nothing in the language or legislative history of section 530 leads us to the conclusion that denial of section 530 relief was meant to be an additional penalty for the
failure to timely file information returns, particularly under the circumstances in this case.” Because the court was “unable to ascertain the thoroughness of the agency's consideration or the validity of its reasoning’ it would not “defer to its requirement of timely filing as a prerequisite to section 530 relief...”

3. Both the taxpayer and the Commissioner argued against Tax Court jurisdiction, but they were both wrong. Charlotte’s Office Boutique v. Commissioner, 121 T.C. No. 6 (8/4/03). The Commissioner asserted a deficiency for unreported employment taxes and additions to tax for 1995 through 1998, and the taxpayer petitioned the Tax Court under § 7436(a) for a determination of employment status. Thereafter, the taxpayer conceded that the person whose status was in question for 1996 through 1998 was an employee, and the parties agreed that the Tax Court lacked jurisdiction over those years because the taxpayer did not dispute the employment status during those years. The Commissioner argued that the Tax Court’s jurisdiction under § 7436(a) extends only to cases in which a taxpayer asserts that an individual performing services for the taxpayer is a nonemployee and the Commissioner has determined that the individual is an employee. The Tax Court (Judge Laro) held that the agreement of the parties as to jurisdiction is not dispositive. Section 7436(a) confers not only jurisdiction to determine whether an individual providing services is an employee, but also whether an employer, is entitled to relief under § 530 of the Revenue Act of 1978, and the correct amounts of employment taxes. The court went on to find that purported royalties were wages, that § 530 relief was not available, and that penalties were warranted.

B. Self-employment
C. Excise Taxes

XII. TAX LEGISLATION

A. Enacted


- The 2003 Act accelerated the effective dates of a number of the income tax provisions enacted in the Economic Growth and Tax Reconciliation Act of 2001 (the “2001 Act”), most significantly, the reduction of the upper level income tax rates. The 2003 Act also decreased corporate and other business taxes through preferential depreciation deductions, and significantly reduced the tax rate on long-term capital gains. Finally, and most dramatically, the 2003 Act significantly reduced the tax rate on dividends received on corporate stock, taxing such dividends at the same preferential low rates that apply to long-term capital gains. Many of the changes in the 2003 Act are scheduled to sunset after three or four years, and those that are not scheduled for an earlier sunset, will sunset on 12/31/10, like all of the changes in the 2001 Act.
RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

By

Ira B. Shepard

William & Mary Tax Conference
November 21, 2003

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SELECTED RECENT FEDERAL INCOME TAX DEVELOPMENTS

Questions to The Honorable Mary Ann Cohen, Judge, United States Tax Court, asked by Professor Ira B. Shepard at the William & Mary Tax Conference, November 21, 2003

A. II.A.1. at page 4 (Milenbach): In light of the difference between the Tax Court and the Ninth Circuit in interpreting California law, could you comment on how federal courts determine state law.

B. III.E.1. at pages 19-20 and footnote: Could you comment about the Tax Court’s decision in the second Ames case that resulted in the government being whipsawed.

C. VI.D.2. at page 32: Don’t you think it was inequitable that the S corporation’s creditors got the benefit of selling assets at a gain while sticking Mr. Mourad [the sole shareholder] with the tax on the gain?

D. VIII.D.2. at page 54 (Dixon): Could you please comment on the different approaches taken by the Tax Court and the Ninth Circuit?

E. X.C.1. at page 61 (Takaba): Could you comment on the practice of imposing costs on attorneys who make arguments that seem frivolous to the Tax Court Judge.

F. X.C.2. at page 61 (Gladden): Could you comment on the Tax Court’s practice under the § 7430(c) “qualified offer” provisions.

G. X.H.7. at pages 67-68 (Griffin): Could you comment on what happens procedurally on the remand of the Eighth Circuit’s decision to the Tax Court. This case dealt with the shift of the burden of proof under § 7491. Do you think the Eighth Circuit has opened the door for taxpayers to give uncontradicted self-serving testimony and prevail unless the Commissioner puts on affirmative evidence?