2001

Recent Developments in Federal Income Taxation

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By

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William & Mary Tax Conference
December 1, 2001

I. ACCOUNTING

A. Accounting Methods

1. Final word on that other-worldly accounting method. T.D. 8929, Accounting for Long Term Contracts, 66 F.R. 2219 (1/11/01). The Treasury has promulgated final regulations [Treas. Reg. §§ 1.460-1 through 1.460-6] under § 460. [Proposed in REG-208156-91, 64 F.R. 24096 (5/5/99).] The final regulations generally follow the proposed regulations with a number of modifications. Costs are allocated to long-term contracts under a single standard linked to the Uniform Capitalization rules of § 263A. Subcontracted costs are either direct material or direct labor costs that must be allocated. The look-back rule is modified to apply first in the year in which the long-term contract is completed and accepted. Hybrid contracts involving both the manufacture of personal property and the construction of real property can electively be reported under the percentage of completion method. If the customer breaches before completion, previously reported gross income is reversed and the adjusted basis of the retained property retained equals previously deducted costs.

2. Section 446(b) denies taxpayers the “license to change freely from one characterization to another when hindsight shows that it is financially advantageous,” or as Spanky said to Alfalfa, “first thing ya say always counts.” FPL Group, Inc. v. Commissioner, 115 T.C. 554 (12/13/00). FPL, a major public utility, followed accounting and regulatory [FERC Uniform System of Accounts] rules and capitalized expenditures for the addition or replacement of “retirement unit” components, as expanded by FPL under permissible elections, of its plant and equipment. Except for using the percentage repair allowance (PRA) provided in Reg. § 1.167(a)-11(d)(2), and a reserve for storm — hurricane, like in Andrew, that is — damage, FPL characterized expenditures as capital for tax purposes using the same method it used for accounting purposes. FPL first claimed additional repair deductions in its petition in response to a deficiency notice on other issues, but never filed a Form 3115. The Commissioner argued that under § 446(e) FPL was impermissibly attempting to materially change an accounting method because FPL had not requested consent and the change was not a “mere correction.” On summary judgment, the Tax Court (Judge Ruwe) upheld the Commissioner’s position. FPL’s Schedule M-1 adjustments for the PRA and storm damage did not establish that regulatory and financial accounting treatment were not the basic accounting method it followed to determine the character of expenditures [repair vs. capital], as modified by the PRA. The IRS’s failure to object to similar changes for other years did no constitute implied consent.

3. Proposed regulations on adopting and changing taxable years. REG-106917-99, Changes in Accounting Periods, 66 F.R. 31850 (6/13/01). The Treasury has published proposed amendments to regulations under §§ 441, 442, 706, and 1378 regarding the requirement to obtain the approval of the Commissioner to adopt, change, or retain an annual accounting period. Prop Reg. §§ 1.441-1 through 1.441-4 generally are substantively the same as Temp. Reg. §§ 1.441-1T through 1.441-4T, including the general rules for the period for computing tax, numerous definitions, and the requirement that partnerships, S corporations, and PSCs generally must demonstrate a business purpose and obtain approval to adopt or retain a taxable year other than their required taxable year, but the proposed regulations are reorganized.

* This outline was prepared jointly with Martin J. McMahon, Jr., Clarence TeSelle Professor of Law, University of Florida College of Law, Gainesville, Florida.
• Prop. Reg. § 1.441-1(c) provides that a taxable year is adopted by filing the first federal income tax return using that taxable year. Filing an application for an EIN, filing an extension, or making estimated tax payments, indicating a particular taxable year would not constitute an adoption of that year. [Rev. Rul. 57-589 (1957-2 C.B. 298), and Rev. Rul. 69-563 (1969-2 C.B. 104), holding that the filing of an extension and estimated tax payments establishes a taxable year, will be superseded.]

• The proposed regulations under § 442 continue to require that the taxpayer demonstrate a business purpose for changing taxable years. The proposed regulations use the term "business purpose" rather than the "substantial business purpose" of the temporary regulations, but, according to the preamble, the Treasury does not intend the language change to change the standard. Under Prop. Reg. § 1.442-1(b), Form 1128 would have to be filed by the 15th day of the third [rather than second] month of the first effective [the short] year. The automatic approval provisions have been deleted in favor of the standards of Rev. Proc. 2000-11, 2000-3, I.R.B. 309.

• Prop. Reg. § 1.706-1 reflects the 1986 Act required taxable year rules and the least aggregate deferral standard. Generally speaking the substantive rules incorporate Temp. Reg. § 1.706-1T, but the proposed regulations elaborate the standards for determining a partner's interests in profits and capital for purposes of applying those tests — income interests are determined with respect to taxable income, not book income, and capital interests are determined with respect to a hypothetical liquidation. Procedural rules for requesting a year other than a required year have been removed in favor of Prop. Reg. § 1.442-1 procedures.

• Prop. Reg. § 1.1378-1 would not implement any substantive changes, but procedural rules for requesting a year other than a required year have been removed in favor of Prop. Reg. § 1.442-1 procedures.

a. Notice 2001-34, 2000-23 I.R.B. 1302 (6/4/01). The IRS has published a proposed revenue procedure dealing with procedures under § 442 for taxpayers outside the scope of the revenue procedures providing automatic approval to adopt, change, or retain a taxable year [see, e.g., Rev. Proc. 2000-11, 2000-3, I.R.B. 309; Notice 2001-35, 2001-23 I.R.B. 1314, and Rev. Proc. 66-50, 1966-2 C.B. 1260] to establish a business purpose and request approval to adopt, change, or retain a taxable year. Under the proposed revenue procedure, the IRS would no longer weigh the merit of a taxpayer's stated business purpose against the amount of distortion of income. Taxpayers generally would be granted approval to adopt, change, or retain a natural business year under the proposed revenue procedure. Establishing a natural business year generally will be the only circumstance under which a partnership, S corporation, electing S corporation, or PSC will be granted approval. Other taxpayers that do not establish a natural business year generally would be granted approval under the proposed revenue procedure if they agree to certain additional terms, conditions, and adjustments designed to neutralize the tax effects of substantial distortion of income resulting from the change.

b. Notice 2001-35, 2001-23 I.R.B.1314 (6/4/01). This notice provides a proposed revenue procedure that will [supersede Rev. Proc. 87-32, 1987-2 C.B. 396] provide the procedures under § 442 for certain partnerships, S corporations, electing S corporations, and PSCs to obtain automatic approval to adopt, change, or retain their taxable years.

4. Brookshire Brothers Holding, Inc. v. Commissioner, 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), but the Tax Court (Judge Nims) held 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.

B. Inventories

1. *This one "floors" me: now carpets are not inventory, tomorrow ... . Smith v. Commissioner, T.C. Memo 2000-353 (11/14/00). A flooring contractor who installed custom ordered, and often custom designed, flooring was not required to maintain inventories or use the accrual method. Judge Wells found that Smith Carpets was a service provider because all floor coverings were specially ordered from the manufacturer to the customer's specifications and even though the taxpayer maintained a warehouse [to store the flooring pending installation], it did not maintain a stock of goods to sell to the public merchandise within the meaning of Reg. § 1.471-1 [although it did maintain a stock of supplies, e.g., padding, glue, etc.] RACMP Enterprises, Inc. v. Commissioner, 114 T.C. 211 (3/30/00), was held to be controlling.

2. IRS ends the small-dollar aspect of its crusade against the cash method, but continues the crusade against "small" taxpayers with gross receipts between $1 million and $5
The Commissioner's method did not clearly reflect income. Nor did the court accept the taxpayer's which it acquired a majority of its cores, however, the Court of Appeals reversed, on the grounds that replacement core parts in the market in which it acquired them [i.e., the price it paid its customers, from materials but FFO to other raw materials. Under taxpayer's method, LIFO did not apply to any entire account under LIFO separately. The court determined the "purchase cost" of core parts acquired in determining that under Reg. § 1.472-1(c) — permitting a LIFO election to apply only to costs of all or some of raw materials incorporated into to finished goods, while other costs are taken into account under FIFO — did not authorize taxpayer's method, which purported to apply LIFO to labor and overhead and some raw materials but FIFO to other raw materials. Under taxpayer's method, LIFO did not apply to any entire good, either raw material or finished; and the regulations do not authorize taking labor and overhead into account under LIFO separately. The court determined the "purchase cost" of core parts acquired in exchange-like transactions involving the sale of remanufactured parts in exchange for cash and used core parts to be the stated credit price for the core parts. The Commissioner did not abuse her discretion in determining that the lower of cost or market for core parts was determined under Reg. § 1.471-4(a) as the bid price for replacement core parts in the market in which it acquired them, not at the scrap amount at which it carried a substantial number of core parts.

a. And the Tenth Circuit says she got it right for the most part. Affirmed in part, rev'd in part. 249 F.3d 1231, 87 A.F.T.R.2d 2111 (10th Cir. 5/8/01). The Court of Appeals agreed that Reg. § 1.472-1(a) did not permit the mixed LIFO / FIFO method employed by the taxpayer and that the Commissioner did not abuse her discretion by terminating the taxpayer's LIFO election. With respect to the Tax Court's holding that the Commissioner did not abuse her discretion in determining that under Reg. § 1.471-4(a), the lower of cost or market for core parts was the bid price for replacement core parts in the market in which it acquired them [i.e., the price it paid its customers, from which it acquired a majority of its cores], however, the Court of Appeals reversed, on the grounds that the Commissioner's method did not clearly reflect income. Nor did the court accept the taxpayer's argument that the "market" was the salvage yard market, since the taxpayer did not purchase cores in that...
market. [On appeal the taxpayer conceded that its original method of valuing a substantial number of core parts at scrap value did not clearly reflect income.] Although the taxpayer’s customer price reflected "price," as far as "market" was concerned, the proper market was the professional supplier market (as adjusted for certain differences such as transportation and guarantees), because that was the only "open market" in which the taxpayer acquired any cores. The case was remanded for market valuation, and comparison with price, under this standard.

C. Installment Method

1. Tax Relief Extension Act of 1999 amended § 453 by adding new § 453(a)(2) denying accrual method taxpayers the privilege of installment reporting on any sales of property whatsoever. Even though the taxpayer uses the accrual method, however, § 453(a)(2) does not disallow the installment reporting under § 453(l) for dispositions of property used or produced in the trade or business of farming or dispositions of residential lots or time-share condominium units.

   a. The Installment Tax Correction Act of 2000, signed December 28, 2000, retroactively repealed the 1999 addition of § 453(a)(2) and restored the availability of § 453 installment reporting to accrual method taxpayers on the same basis that it was available before the 1999 legislation.

   b. Automatic consent to revoke elections out of installment method. Notice 2001-22, 2001-12 I.R.B. 911 (3/19/01). An accrual method taxpayer that entered into an installment sale on or after December 17, 1999, and filed a federal income tax return by April 16, 2001, reporting the sale on the accrual method may revoke its election out of § 453. The taxpayer must file, within the applicable period of limitations, amended federal income tax returns for the taxable year in which the installment sale occurred, and for any other affected taxable year, reporting the gain on the installment method.

2. The Tax Relief Extension Act of 1999 also amended § 453A(d) to apply the "pledge as recognition" rule whenever a taxpayer holding an installment obligation has the right to satisfy all or any portion of his own debt to any creditor by transferring the installment obligation.

   a. This provision was not repealed in 2000.

D. Year of Receipt or Deduction

1. *Taxes now, cash received later – the worst of all possible worlds. Keith v. Commissioner, 115 T.C. 605 (12/29/00). The taxpayer [through a partnership] sold residential real property through contracts for deed, under which the buyers obtained possession, assumed responsibility for taxes, insurance, and maintenance, and agreed to make monthly payments, with interest, of the purchase price. A warranty deed would be delivered to the buyers only upon full payment; any default by the buyers voided the contracts; the seller could retain, as liquidated damages, all amounts previously received, and the buyer was not liable for the remaining balance. The partnership, whose return indicated was on the accrual method, did not report any gain attributable to the contracts until the year in which full payment was received and title transferred. Interest payments were included over the term of the contracts. The partnership also depreciated the subject properties during the term of each contract. In a reviewed decision (13-2-0), the Tax Court held that because under state law the benefits and burdens of ownership passed to the buyers, there was a completed sale for tax purposes in the year the contracts were executed. Because the sales were dealer dispositions to which the buyers voided the contracts; the seller could retain, as liquidated damages, all amounts previously received, and the buyer was not liable for the remaining balance. The partnership, whose return indicated was on the accrual method, did not report any gain attributable to the contracts until the year in which full payment was received and title transferred. Interest payments were included over the term of the contracts. The partnership also depreciated the subject properties during the term of each contract. In a reviewed decision (13-2-0), the Tax Court held that because under state law the benefits and burdens of ownership passed to the buyers, there was a completed sale for tax purposes in the year the contracts were executed. Because the sales were dealer dispositions to which the buyer's obligation precluded passage of the benefits and burdens of ownership.

2. T.D. 8917, Section 467 Rental Agreements Involving Payments of $2,000,000 or Less, 66 F.R. 1038 (1/5/01). Reg. § 1.467-3(b)(1)(iii) provided that if a lease did not require more than $2 million of rent and other consideration and all payments are due in the year in which the rent relates or the preceding or succeeding year, the effect of § 467 was limited to requiring both the lessor and the lessee to take the rent into account in the year to which it relates rather than in the year in which it is paid, thus exempting such leases from the rent-leveling rules. The $2 million safe harbor has been eliminated from the regulations effective for leases entered into on or after July 19, 1999.

3. Credit card fees are not payments for "services" under Rev. Proc. 71-21. American Express Co. v. United States, 47 Fed. Cl. 127, 2000-1 U.S.T.C. §50,575, 86 A.F.T.R.2d 5217 (6/20/00). Before 1987, taxpayer included annual credit card fees in income when the fees were billed. In 1987 taxpayer changed its method of accounting on the basis of FASB 91 to include the fees ratably over the 12-month period for which they were billed and sought the Commissioner's approval for the change
in accordance with Rev. Proc. 71-21, 1971-2 C.B. 549. The court held the Commissioner’s denial of the request to be within his discretion on the ground that Rev. Proc. 71-21 and G.C.M. 39434 (10/25/85) provide an adequate basis for the determination that the fees were not for services. The G.C.M. viewed card fees as payments for credit, not as payments for “contingent services.”

- The Court of Federal Claims held that Barnett Banks of Florida v. Commissioner, 106 T.C. 103 (1996) (allowing ratable inclusion of refundable credit card fees) was decided on its own facts [which are, in fact, difficult to distinguish] and did not as a matter of law require overturning the Commissioner’s discretion in this case. The court further noted that the Barnett Banks court did not “fully address [] the question of whether there was an adequate basis for the Commissioner’s exercise of discretion under Rev. Proc. 71-21” and that the Court of Federal Claims will not make close factual judgments where there is no abuse of discretion.

  a. Affirmed. IRS interpretation of its own regulations is entitled to substantial deference, even if Chevron deference was not earned. 2001-2 U.S.T.C. ¶50,596 (Fed. Cir. 8/23/01). The Federal Circuit (Judge Dyk) affirmed, describing the sole issue as “whether the IRS properly interpreted its own Revenue Procedure by treating “services” as not including fees for the acquisition of credit. Even though under the standards of United States v. Mead Corp., 121 S.Ct. 2164, 2171 (2001), “[t]he interpretation of Rev. Proc. 71-21 contained in the General Counsel Memorandum and the IRS decision under the Revenue Procedure is not reflected in a regulation adopted after notice and comment and probably would not be entitled to Chevron deference,” “[t]he Supreme Court has firmly established that agency interpretations of their own regulations are entitled to substantial deference.” The court distinguished Hewlett-Packard Co. v. United States, 71 F.3d 398 (Fed.Cir.1995) (rejecting the Commissioner’s determination that a taxpayer’s pool of rotatable spare parts used to repair computers it had sold was inventory rather than a §1231 asset) as involving a fact determination, not an interpretation of a regulations. The court rejected the Tax Court’s holding in Barnett Banks of Florida v. Commissioner, 106 T.C. 103 (1996) that the annual fee payments received by a credit card company qualified as “services” under Rev. Proc. 71-21.

  4. Wicor, Inc. v. United States, 88 A.F.T.R.2d 5474 (7th Cir. 8/14/01), aff’g 116 F. Supp. 2d 1028 (E.D. Wis. 2000). Section 1341 does not apply to the restoration to a utility of prior years’ overcharges through reduced rates in future years. There was no payment in the later year to which to apply § 1341; the taxpayer merely realized less gross income than it otherwise would have.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. Rev. Rul. 2001-20, 2001 IR.B. (4/10/01). The “purpose” requirement under Reg. § 1.110-1(b)(3) does not require a lease agreement to provide that the entire construction allowance is for the purpose of constructing or improving qualified long-term real property. However, only the portion of the construction allowance actually so expended may qualify.

2. A self-inflicted tax wound. Catalano v. Commissioner, 240 F.3d 842, 2001-1 U.S.T.C. ¶50,233, 87 A.F.T.R.2d 2001-874 (9th Cir. 2/15/01) (per curiam). The taxpayer, an attorney, leased three yachts to his wholly owned S corporation, which in turn used the yachts for entertaining clients. Not surprisingly, the S corporation’s deduction for rental payments was disallowed as for prohibited “entertainment facilities” under § 274(a)(1)(B). Also, not surprisingly, the taxpayer nevertheless was required to include the rental receipts in gross income.

3. GAAP, Schmap! WestPac Pacific Foods v. Commissioner, T.C. Memo 2001-175 (7/16/01). The taxpayer was required to include in gross income cash payments received from various manufacturers as “advance trade discounts” upon agreeing to use the manufacturer as its primary or exclusive supplier for various products to be sold in its retail stores. The Tax Court (Judge Vasquez) held that Reg. § 1.471-3(b), providing that only net invoice price be taken into account in inventory costs did not justify an exclusion of amounts received that are not related to the purchase of specific goods. That the taxpayer’s accounting method followed GAAP did not save the day.

4. Money now, taxes, later. Nice result, if you can get. Smartheath, Inc. v. Commissioner, T.C. Memo 2001-145 (6/20/01). Customer overpayments that were commingled with the taxpayer’s other receipts and routinely applied against the customers’ future orders were not includable under the claim of right doctrine because the taxpayer would have been willing to refund the overpayments if requested.

5. Apportioning basis to an expectancy. Gladden v. Commissioner, F.3d ___, 2001-2 U.S.T.C. ¶50,597, 88 A.F.T.R.2d 5543 (9th Cir. 8/20/01), rev’g and remanding 112 T.C. 209 (4/15/99). The taxpayer was a partner in a partnership engaged in farming that received (indirectly) from
the Department of the Interior payments in exchange for surrender of its rights to a water allotment, which were appurtenant to the land, from the Colorado River. The gain was a capital gain because the water rights were a property interest. The Commissioner's argument that the transaction resulted in ordinary income under Commissioner v. P.G. Lake, Inc., 356 U.S. 269 (1958) was rejected because use of the water rights themselves did not directly produce ordinary income. They were simply one component of the taxpayer's investment in its business. Even though the amounts were received in exchange for the surrender of the rights back to the Interior Department and the court referred to the payments received by the taxpayer as "relinquishment funds," there was no discussion of fact that the rights were terminated in favor of the granting party rather than transferred to third party in which they continued and therefore arguably there was no "sale or exchange." (Under the 1997 amendments to §1234A, the surrender of an interest in property would be deemed a "sale or exchange.") The Tax Court held, however, the taxpayer, who acquired the land in 1976 and acquired the appurtenant water rights in 1983, could not allocate any portion of the basis of the land to the water rights [under Reg. §1.61-6(a)] to offset the amount realized on the disposition of the water rights in 1992 because the water rights were not vested at the time the land was purchased.

- The only issue on appeal was whether the taxpayer could allocate any portion of the basis of the land to the water rights. The Ninth Circuit (Judge Fletcher) disagreed with the conclusion that no portion of the basis of the land could be allocated to the water rights. It reasoned that if there had not been an expectation of a subsequent allocation of water rights to the land at the time of its purchase, none of the cost of the land would have been apportionable to the water rights. But because there was an expectation an expectation of a subsequent allocation of water rights to the land at the time of its purchase, the land could have commanded a premium that properly should have been allocated to the basis of the water rights. The case was remanded because the Tax Court had entered summary judgment and the record was undeveloped.

- The Ninth Circuit refused to follow Inaja Land Co. v. Commissioner, 9 T.C. 727 (1947), and permit each taxpayer to apply the amount received against his basis in the land. Instead, it remanded for trial to determine what portion of the cost of the land was a premium paid for the water rights later acquired, or whether it is "impracticable or impossible" to determine what that premium may have been.

B. Deductible Expenses versus Capitalization

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

1. **Extending expensing of certain environmental remediation costs.** As originally enacted in 1997, § 198, "expensing of environmental remediation costs . . . which [are] paid or incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site," applied only to expenditures paid or incurred between 8/5/97 and 12/31/00. In 1999, Congress extended the provision's sunset date to 12/31/01.

   a. In the Community Renewal Tax Relief Act of 2000, P.L 106-554, the expiration date of this provision was extended until the end of 2003 and the targeted area requirement was eliminated. This means that expenditures paid or incurred after December 21, 2000, with respect to any Brownfields site but not including a CERCLA site — certified by a State environmental agency to qualify for expensing under § 198.

   b. The 2001 Act extended the expensing under § 198 of environmental remediation costs for Brownfields sites through 12/31/01.

2. **Deductions float down Old Man River.** Ingram Industries Inc. v. Commissioner, T.C. Memo. 2000-323 (10/18/00). Expenses for periodic maintenance of inland barge towboat engines were deductible under § 162 and Reg. § 1.162-4 as repairs rather than being capital expenses. The taxpayer operated over 60 towboats, most of which were purchased used for $2.2 - $2.3 million. The towboats, including the engines if properly maintained, had an expected useful life of 40 years. Maintenance was performed every three or four years, depending on the number of hours of operation but while the engines were still serviceable, at a cost of approximately $100,000 per boat. Replacement used engines would have cost approximately $600,000 per boat, and new engines $1,500,000 per boat. The work was performed mostly by the crews, took about 10-12 days, and did not necessitate dry-docking the boats. The work was not the equivalent of rebuilding or overhauling the engines. The court (Judge Gerber) rejected the Commissioner's argument that the engines should be treated as separate property from the boats themselves. The evidence did not support findings that within the industry engines ordinarily were replaced within the 40-year life of the boats or engines were
evaluated separately from the remainder of the boats in pricing. There was no way to measure any increment in value of a boat resulting from the maintenance. Applying the standards of Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), (nonacq.), 1964-2 C.B. 8, the expenses were deductible.

- For financial reporting purposes, taxpayers accrued the estimated costs of these repairs as expenses for the periods of usage prior to the performance of the maintenance; for federal income tax purposes, taxpayers deducted the costs in the year incurred. The Commissioner determined the costs had to be capitalized and depreciated over the 10-year period beginning with the date the costs were incurred. The Tax Court held that Indopco was irrelevant.

3. *Fly the repaired skies of ....*, Rev. Rul. 2001-4, 2001-3 I.R.B. 295 (12/21/00). The IRS provided significant guidance regarding the dividing line between repair costs deductible under § 162 and replacement and rehabilitation costs that must be capitalized. The ruling dealt with costs incurred by an airline with respect to work on aircraft airframes in three specific situations involving fully depreciated aircraft. At the time the aircraft were placed in service, it was anticipated that, if maintained, they would be useful for up to 25 years. The IRS ruled that heavy maintenance expenses generally are deductible under § 162. But costs incurred in conjunction with a heavy maintenance visit must be capitalized to the extent they materially add to the value of, substantially prolong the useful life of, or adapt the airframe to a new or different use. Costs incurred as part of a plan of rehabilitation, modernization, or improvement also must be capitalized.

- In the first situation, a heavy maintenance, taking 45 days, was performed for the purpose of preventing deterioration of the inherent safety and reliability levels of the airframe. The aircraft was substantially disassembled, inspected, repaired, and reassembled, after which it was tested, and returned to service. Although numerous parts were replaced, the maintenance visit did not extend the useful life of the airframe beyond the originally anticipated 25-year useful life, but merely kept it in an efficient operating condition. It was used for the same purposes and in the same manner as prior to the maintenance. The expenses were fully deductible.

- In the second situation, significant wear and corrosion of fuselage skins necessitated replacement of a significant portion of all of the skin panels of the aircraft, and the work performed materially added to the value of the airframe. While the aircraft was disassembled for the heavy maintenance, it was upgraded by the addition of a cabin smoke and fire detection and suppression system, a ground proximity warning system, and an air phone system to enable passengers to send and receive voice calls, faxes, and other electronic data while in flight. The expenses incurred with respect to this aircraft had to be allocated between the deductible heavy maintenance and the skin replacement and electrical upgrades, which had to be capitalized.

- In the third situation, the aircraft, which was 22 years old and nearing the end of its anticipated useful life, was substantially improved to increase its reliability and extend its useful life. All of the expenses, including what otherwise would have been deductible routine heavy maintenance expenses, on the third aircraft had to be capitalized as part of a plan of general rehabilitation and modernization that materially increased the value and life of the aircraft. In addition, because the work was considered the production of property, under § 263A, allocable indirect costs as well as direct costs had to be capitalized.

4. **A potentially Pyrrhic victory for the Commissioner?** Ashley v. Commissioner, T.C. Memo 2000-376 (12/13/00). The taxpayer purchased a single-family rental property and renovated. When he sold the property 9 years later he claimed a § 1231 loss, by including in basis various operating expenditures such as insurance, refinancing interest, and real estate taxes paid during the renovation period, on the grounds that § 263A required such capitalization because he was in the trade or business of purchasing and restoring homes for resale. On the record, the court (Judge Vasquez) upheld the Commissioner's argument and found that the taxpayer was not engaged in the business of renovating property for resale but was merely an "investor" not subject to § 263A. On the consequently lower basis, taxpayer realized a gain on the sale.

5. **"The exercise of .... a sound and reasonable business practice under which a taxpayer .... acts to minimize its recurring operating costs is not a significant future benefit that requires capitalization of the related nonasset-producing expenditures."** Metrocorp Inc. v. Commissioner, 116 T.C. No. 18 (4/13/01) (reviewed, 10-6-1). Metrocorp acquired the assets of Community [a failed S&L] through a "conversion transaction" in which, as a condition of assumption of Community's deposit liabilities, Metrocorp was required to pay the FDIC an exit fee of $309,565 and an entrance fee of $43,339 [in five annual installments of $71,518], neither of which were refundable, to shift the deposit insurance from the Savings Association Insurance Fund (SAIF) to the Bank Insurance
Fund (BIF). In addition, normal deposit insurance premiums were paid. The Tax Court, in a (10-2-6) reviewed opinion by Judge Laro, upheld the taxpayer’s deduction of the entrance and exit fees, rejecting the Commissioner’s argument that they produced significant long-term benefit and thus were capital. The exit fees were imposed “to protect the integrity of the SAIF” and were a “final premium” for insurance already received, compensating the SAIF for a loss of future premium revenues. The purpose of the entrance fee was “to protect the integrity of the BIF” by preventing dilution of reserves; it was a nonrefundable fee for first year insurance coverage. The majority said it would not “second guess” taxpayer’s management decision to reduce expenses by structuring its acquisition in such a manner that required the payment of the entrance and exit fees rather than in a manner that left the deposits insured by SAIF, which would have resulted in higher annual premiums. The majority specifically noted that its decision was based solely on rejecting the Commissioner’s significant long-term benefit/INDOPOCO argument, and that since the Commissioner had not argued that the expenditures were capital because they were incurred in connection with an asset [core deposits], it would not decide the case on that basis; it reserved any discussion of how the case might be decided if that issue were raised. Nevertheless, the majority pointed out that unlike the case in Lincoln Savings, the payments in the case at bar did not create a fund.

- Judge Ruwe (with five judges joining) dissented on the grounds that the deficiency notice was broad enough to include capitalization on the grounds that the fees related to the acquisition of a separate and distinct asset, and that the Tax Court has inherent power to decide cases on grounds not argued by either part as long as there is no “surprise” or “prejudice.” Judge Ruwe’s dissent found the fees to be capital because they were incident to the acquisition of a separate and distinct asset, and the SAIF exit fees, in any event, were not insurance premiums because Metrocorp never received any insurance benefit from SAIF.

- Judge Halpern’s dissent (with five judges joining) focused on the point that the taxpayer failed to prove that the purpose of the payments was an ordinary and necessary business expense. He reasoned that the entrance and exit fee calculation was complex, the legislative history of the statutes requiring the payments did not clearly articulate their purpose, that the majority’s description of their purposes was surmise, and that the taxpayer thus failed to prove that there was no significant long-term benefit.

- Judge Beghe’s dissent focused on the point that the Commissioner’s broad assertion that the payments produced a long-term benefit inherently included the narrower assertion that the payments were part of the cost of the asset acquisition, and the stipulated record clearly established that the fees were paid in connection with the acquisition of assets. Furthermore, even if the payments were insurance premiums, they were in the nature of prepaid insurance. Thus, the fees should have been capitalized.

But the Tax Court still believes in the capitalization requirement. Lychuk v. Commissioner, 116 T.C. No. 27 (5/31/01) (reviewed opinion, 8-1-7). The taxpayers’ S corporation was in the business of acquiring and servicing multiyear installment contracts from used car dealers. It acquired each contract at 65 percent of its face value and thereafter collected and kept all principal and interest payments. Its primary business activities consisted of credit investigation, credit evaluation, documentation, and monitoring collections on the installment contracts. Its key employees performed credit reviews to decide whether to acquire contracts offered to it and processed payments to the selling car dealers. Over the two years in question, it acquired 1,513 contracts out of 3,982 offered to it. The corporation deducted all of its expenses, but the Commissioner determined that all of the salaries, benefits, and overhead (printing, telephone, computer, rent, and utilities) relating to the corporation’s acquisition of the installment contracts were capital expenditures. [These expenses had been identified by the corporations’ auditors and capitalized for financial accounting.] He also required capitalization of expenditures (i.e., professional fees and commissions relating to an offering of notes in 1993 and a second offering that was planned in 1993 and abandoned in 1994. The Commissioner did not attempt to require capitalization of the salaries, benefits, and overhead attributable to servicing the contracts. In total, the Commissioner capitalized $213,028 out of $280,222 of total compensation and benefits, including virtually all of the amounts attributable to employees other than the president and vice-president, and over two-thirds of the overhead (including rent).

- The Tax Court, in a reviewed opinion by Judge Laro, held that the salaries and benefits were capital expenditures because these items were directly related to the process of anticipated acquisition of assets with expected useful lives exceeding one year. Judge Laro’s opinion was grounded primarily on the principles of Lincoln Savings and Loan Ass’n, Idaho Power Co., Woodward v.
Commissioner and Helvering v. Winmill, 305 U.S. 79 (1938). The court expressly rejected the taxpayer's argument that the salaries and benefits were deductible because they were fixed costs that flowed from employment and were not occasioned by the acquisitions of the contracts, and distinguished the Eighth Circuit's opinion in Wells Fargo & Co., 224 F.3d 874, as involving an important factual distinction. In Wells Fargo, the acquisition in question was "extraordinary" to the taxpayer's business and to the daily course of the employees' duties; they would have been paid the same salaries anyway. PNC Bancorp, Inc., 212 F.3d 822 (3d Cir. 2000), rev'g 110 T.C. 349 (1998), however, was found not to be meaningfully factually distinguishable. Rather, the Tax Court expressly rejected the Third Circuit's holding [that the recurring nature of the salary expenses that were connected to current income removed them from capitalization] and followed its own prior opinion. But the Tax Court nevertheless allowed the overhead expenses to be deducted currently because these items were not directly related to the anticipated acquisitions — they would have been incurred even if the corporation's business had only encompassed servicing the contracts, and their amount did not vary with the number of credit applications processed — and any future benefit received from these expenses was merely "incidental." A loss deduction under § 165(a) was allowed with respect to the portion of the capitalized salaries and benefits that was attributable to installment contracts that were never acquired. The offering expenditures were capital because they produced significant future benefits, but a § 165 loss deduction was allowed with respect to the offering expenditures attributable to the abandoned offering.

- Seven judges, in three separate opinions authored by Judges Ruwe, Halperin, and Beghe, concurred with the court's opinion requiring that the salaries and benefits be capitalized, but dissented from the portion of the opinion allowing the overhead to be deducted. The dissenters would have required capitalization of the overhead as well. Judge Beghe wrote separately only to emphasize the following point:

... It bears observing that the oft-quoted passage in the opinion of the Court of Appeals for the Seventh Circuit in Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212, 217 (7th Cir.1982), rev'g T.C. Memo.1981-255, which includes the statement that "The administrative costs of conceptual rigor are too great," was uttered in the course of sustaining the Commissioner's determination that the costs in issue in that case had to be capitalized. However, the Court of Appeals then suggested that the distinction between recurring and nonrecurring costs might provide the line of demarcation in some cases, but went on to observe that the distinction wouldn't make sense when the taxpayer's sole business was the creation or acquisition of capital assets. Although ACC's business includes the servicing as well as the acquisition of capital assets, the relatively short average time the acquired loans remain outstanding raises questions about administrability, the costs of conceptual rigor, and whether the exercise has been worth the candle.

These musings lead me to suggest the time has come to request respectfully that the Congress step in and enact some bright-line rules that will provide guidance to the business community and the Internal Revenue Service and reduce the burdens of compliance and controversy on the public, the Service, and the courts. Sections 195 and 197 come to mind as possible starting points or models.

- See also, FSA 200136010.

7. Is there a de minimis exception to the rule of capitalization if expensing clearly reflects income? Alacare Home Health Services Inc. v. Commissioner, T.C. Memo 2001-149 (6/22/01). A Medicare-certified home health care agency deducted the cost of $467,000 and $351,000 of numerous purchases of equipment in the years in question. The equipment items each cost $500 or less and had a life of two years or less; and the expensing treatment was consistent with Medicare accounting. The Tax Court (Judge Colvin) upheld the Commissioner's position requiring the expenditures to be capitalized because the taxpayer's treatment did not clearly reflect income. Judge Wells distinguished Union Pacific Railroad Co. v. United States, 208 Ct. Cl. 1 (1975) and Cincinnati, New Orleans & Tex. Pac. Railway Co. v. United States, 191 Ct. Cl. 572 (1970), both of which allowed a railroad to expenses de minimis capital expenditures under an ICC directed accounting method, on the grounds that the deductions in those cases were a much lower percentage of gross receipts — .03% to .07% in the railroad
cases compared with .85% and 71% in the instant case – and that the treatment in the railroad cases clearly reflected income. Nevertheless, penalties were not upheld because taxpayer had consistently followed the method in the past and had reasonably relied on its return preparer.

8. More capitalized environmental remediation costs. United Dairy Farmers, Inc. v. United States, 88 A.F.T.R.2d ___, 2001 WL 1159612107 (6th Cir. 10/3/01), aff'g 107 F. Supp. 2d 937, 2000-1 U.S.T.C. ¶50,538, 85 A.F.T.R.2d 2235 (S.D. Ohio 5/23/00). Taxpayer incurred environmental remediation expenses to clean-up pollution caused by prior owners who operated gas stations on the site of a convenience store. Even though the taxpayer was unaware of the pollution at the time of the purchase and thus "overpaid" for the property, the expenses were required to be capitalized because they "increased the value of the property." Rev. Rul. 94-38, 1994-1 C.B. 35 did not apply. The Sixth Circuit concluded that "when a taxpayer improves property defects that were present when the taxpayer acquired the property, the remediation of those defects are capital in nature. .... [W]hen a taxpayer has improved defects that were present when the taxpayer acquired the property, [Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962)] does not apply." Rather, Dominion Resources, Inc. v. United States, 219 F.3d 359, 2000-2 U.S.T.C. ¶50,633 (4th Cir. 7/19/00), was more apposite.

* On another issue, the court held that accounting fees paid to Ernst & Young in connection with a corporate reorganization incident to making an S election had to be capitalized.

C. Reasonable Compensation

1. *It looks like maybe you can’t always zero out a professional service corporation’s taxable income. Pediatric Surgical Associates P.C. v. Commissioner, T.C. Memo 2001-81 (4/02/01). The Tax Court (Judge Halpern) upheld in part the disallowance of deductions for bonuses to the four shareholder-employees of a medical professional corporation that had 20 employees, including two surgeons who were not shareholders. The question, said the court, was not whether the amounts paid were reasonable but whether they were received for services. Because the shareholder-physicians were not the only physicians, what the physicians could have earned if self-employed was therefore not determinative. Rather, Judge Halpern examined the acts to determine the portion of the corporation’s profit attributable to the services of the nonshareholder-physicians, and disallowed the deduction to that extent.

2. Not all courts accept the hypothetical investor test. Eberl’s Claim Service, Inc. v. Commissioner, 2001-1 US.T.C. ¶50,396, 87 A.F.T.R.2d 2075 (10th Cir. 5/4/01). The taxpayer operated a catastrophic claims adjustment service and paid its sole shareholder $4,340,000 and $2,080,000 in compensation, most of which was contingent, for the years in question. The adjusters employed by taxpayer were compensated five to ten percent above industry standard. Applying a multi-factor test, the Tax Court allowed $2,340,000 and $1,080,00 as reasonable compensation to its sole shareholder. The Court of Appeals, likewise applying a multi-factor test, affirmed. In doing so, the court specifically declined to follow the lead of Exacto Spring Corp. v. Commissioner, 196 F.3d 933 (7th Cir.11/16/99), in which Judge Posner castigated the Tax Court [and other courts] for reliance on "factors" in resolving "reasonable compensation" cases and held that as long as the payments were intended to be compensation the inquiry turns completely on whether a hypothetical investor would be satisfied with the return on the investment that resulted from the employee/shareholder’s management activities.

* The court summarized its approach and contrasted it with that of other circuits:

Whatever the relative wisdom of the two approaches, absent en banc rehearing we are bound to the use of a multi-factor approach by our prior decision in Pepsi-Cola Bottling [578 F.2d 176 (10th Cir. 1976)].

n6 Further, of those Circuits that have embraced an independent investor test, only the Seventh has gone so far as to jettison the multi-factor approach entirely. Others have merely committed to viewing the totality of the circumstances through the "lens" of, Dexsil Corp., 147 F.3d at 101, or "from the perspective of," Elliotts, 716 F.2d at 1245, a hypothetical outsider investor. Those Circuits have retained the totality of the circumstances approach that this Court embraced in Pepsi-Cola Bottling.
3. The court recited factors, but in the end it was all independent investor based analysis. Wagner Construction, Inc. v. Commissioner, T.C. Memo 2001-160 (6/29/01). In a reasonable compensation case [appealable to the Eighth Circuit], the Tax Court (Judge Parr) carefully recited the analysis of the compensation under a ten-factor test. Then, in the conclusion, determined the aggregate amount that was reasonable compensation by (1) calculating the dollar amount of a reasonable return on invested capital (based on the evidence regarding a reasonable rate of return [28.2% before-tax] and the amount of invested capital [beginning of the year equity]), (2) adding together the two officer/shareholders’ compensation for the year and retained earnings for the year, and (3) subtracting the fair return amount from the latter amount. The court simply announced how much of the aggregate reasonable compensation related to each officer/shareholder.

4. Does it look like a trend is developing? Damron Auto Parts, Inc. v. Commissioner, T.C. Memo. 2001-197 (7/30/01). In a reasonable compensation case [appealable to the Eleventh Circuit], the Tax Court (Judge Foley) briefly mentioned analysis various relevant factors. Then, focusing entirely on the 39 percent annual compound rate of return [in appreciation] found that the compensation was reasonable because, according to the Commissioner’s expert, an independent investor would have been satisfied with a 14.3 percent return. Ten percent of aggregate compensation was disallowed, however, because it was for services performed for other related corporations.

D. Miscellaneous Expenses

1. Badell v. Commissioner, T.C. Memo. 2000-303 (9/26/00). Advances by a law firm to its clients to pay for costs were nondeductible loans in the year the advances were made because the amounts were unconditionally repayable. That some clients might have been so destitute that actual collection was “doubtful” did not affect the result. Judge Colvin distinguished Boccardo v. Commissioner, 56 F.3d 1016 (9th Cir. 1995), which held that litigation expenses paid by a law firm on behalf of its client-tort plaintiffs, that law firm would recover only if client prevailed, were deductible business expenses, not loans to the client. In Boccardo the client had no personal obligation to repay advances and firm received only a “gross fee” of one third of the gross recovery.

2. Just a de minimis whipsaw. Leschke v. Commissioner, T.C. Memo 2001-18 (1/26/01). The taxpayer’s S corporation was allowed to deduct the full cost of $61 nut baskets and $100 bills given to employees at Christmas. Section 274(c) did not limit the deduction to $25 because § 102(c) precluded treating as gifts items given to employees. That the employer did not report the nut baskets [which we, but not the court, note possibly could qualify as de minimis fringe benefits under Reg. § 1.132-6] or the $100 bills as compensation on the employees’ Forms W-2 or withhold taxes did not preclude characterizing the items as deductible compensation.

3. New leveraged lease guidelines. Rev. Proc. 2001-28, 2001-19 I.R.B. 1156 (5/7/01). This revenue procedure provides guidelines that the IRS will apply to advance ruling requests to determine whether leveraged lease transactions will be treated as leases for tax purposes. Rev. Proc. 75-21, 1975-1 C.B. 715, is modified and superseded. Among the many requirements is the [continued] requirement that the lessor expects to receive a profit from the transaction apart from the tax benefits arising from the transaction. The most significant change is a modification permitting certain restricted investments in the property by the lessee. Generally speaking “severable investments” are eligible, but investments that render the property “limited [to the lessee’s] use” for substantially its entire useful life are disqualified. Rev. Proc. 2001-29, 2001-19 I.R.B. 1160 (5/7/01), sets forth the information and representations required to be furnished by taxpayers in requests for advance rulings on leveraged lease transactions.

4. The deduction was more than the includible compensation – And it was legal! Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. No. 14 (3/28/00). Pursuant to Reg. § 1.162-25T, an employer-corporation that provided private nonbusiness flights on a company owned airplane to employees was permitted to deduct the cost of providing the flights because the fair market value of the flights was included in the employees’ reported compensation under Reg. § 1.61-21(b). Accordingly, pursuant to § 274(e)(2), the limitations of § 274 did not apply even though the airplane otherwise could be considered to be an entertainment facility. Furthermore the employer’s deduction was not limited to the lesser amount includable by the employees under special fringe benefit valuation rules [Reg. § 1.61-21(g)].

a. Affirmed by: Sutherland Lumber-Southwest, Inc. v. Commissioner, 255 F.3d 495, 2001 U.S. App. LEXIS 14998 (8th Cir. 7/3/01) (per curiam). The court stated:
In this case of first impression, we must determine the amount of expenses corporations may deduct on their income tax returns when they allow their officers to use corporate aircraft for personal vacations. Confronted by this textual ambiguity, the Tax Court employed standard canons of construction. The court found the Commissioner’s general purpose-based arguments less persuasive than the specific extratextual indications that subsection (e)(2) was meant to remove properly reported entertainment expenses from the ambit of subsection (a), and ruled in favor of Sutherland. This conclusion obviated the need to determine whether a corporate aircraft could as a matter of fact and law constitute a “facility used in connection with [entertainment, amusement, or recreation]” under § 274. After a complete review de novo, we agree with the Tax Court’s well-reasoned opinion, and affirm on the basis of the analysis set forth therein. See 114 T.C. 197 (2000). Because we have nothing of substance to add to the Tax Court’s thorough analysis, further discussion is superfluous.

5. United Airlines fares better in the Tax Court than with the Justice Department. UAL Corp. v. Commissioner, 117 T.C. No. 2 (7/13/01) (reviewed opinion; the alignment of the concurring opinions is too convoluted to explain; 3½ dissents). Pursuant to union contracts, United Airlines paid pilots and flight attendants a per diem allowance regardless of whether they were away from home overnight; flight attendants received $1.50 times the number of hours on duty or on flight assignment; pilots received $1.50 per hour and $1.55 per hour after 4/1/86. [United also paid actual overnight lodging expenses.] United did not require employees to substantiate use of the per diem and there was no written substantiation as to the employees’ actual use of the allowances. United originally deducted the per diem payments as travel expenses, and reduced its deductions under § 274(n) after 1987. The Commissioner disallowed the deductions for lack of substantiation, and when United argued that the payments should be fully deductible as compensation, the Commissioner denied the deduction for want of compensatory intent at the time the payments were made, even though reasonableness was not at issue. The majority, in an opinion by Judge Laro, allowed the deduction:

The presence of such a bona fide employment relationship and such a need to pay per diem allowances in order to secure personal services is enough under the facts at hand to persuade us that United paid the per diem allowances to the employees for their services. Respondent places undue emphasis on the fact that the union contracts do not specifically characterize the per diem allowances as personal service compensation. Such a characterization by the parties to the contracts is not dispositive as to the characterization of the per diem allowances for Federal income tax purposes.

The court noted that in a related case pending in the Court of Federal Claims the government was arguing that the same payments were wages for employment tax purposes.

- Judge Ruwe, concurring, cogently, explained that:

[The relevant statute [§ 162(a)(1)] and regulations [Reg. § 1.167-7(a)] do not require an “intent to compensate” as a prerequisite to deductibility under section 162(a)(1). Although an “intent to compensate” requirement has been applied by the courts in numerous cases, the instant situation is factually distinguishable from the situation in those cases which involved corporate payments to shareholders or employees in positions of control. [citations omitted] In the context of corporate payments to shareholders, careful scrutiny is required to determine whether the alleged compensation is in fact a disguised dividend. [As the majority opinion correctly states, the payor’s intent is simply a pertinent factor to consider, not a prerequisite to deductibility]

- Judge Ruwe also thought it necessary to exactly why the payments were not travel expenses, i.e., payments for meals for day-trippers simply cannot be travel expenses, and travel expenses under a nonaccountable plan that exceed the relevant per diem allowances, which the amounts in the case did exceed, must be included by the employee and as a corollary are deductible by the employer.
Dissent. Noting that the period of limitations had expired with respect to the employees [who undoubtedly included nothing], Judge Swift’s dissent focused on the inconsistency of United’s positions, rather than the inconsistency of the government’s positions.

The more significant concern with regard to “inconsistent” characterizations in this case should be with United’s efforts to recharacterize entirely the per diem allowances that United, its employees, and the labor unions, for all other purposes, treated as employee travel expenses. United now, years later, and solely for Federal income tax purposes, attempts to inconsistently treat such travel expenses as employee compensation, outside the scope of the substantiation requirements of section 274(d), and fully deductible under section 162(a)(1).

An extensive body of case law limits a taxpayer’s ability to change the treatment of reported items of income and deductions. [emphasis in original]

Judge Swift also was concerned with the “the casual manner by which the majority opinion bypasses the substantiation requirements of section 274(d).”

Janus-like, the same payments that were deductible compensation in the Tax Court are travel reimbursements exempt from employment tax in the Court of Claims. United Airlines, Inc v. United States, 88 A.F.T.R.2d 5459 (Ct. Cl. 8/10/01). The Commissioner simultaneously treated the payments in UAL Corp., supra, as wages for employment tax purposes. The Court of Federal Claims held that the payments were exempt from FICA and withholding because they were intended to reimburse employees for travel expenses and taxpayer should not be required [under Reg. §§ 31.3401(a)-1(b)(2) and 31.3121(a)-1(h)] retroactively “to demonstrate objective proof” in addition to the union contracts that it had a “reasonable belief” that the reimbursements did not exceed travel expenses. The court noted that in UAL Corp., the taxpayer had prevailed in deducting the entire amount of the per diem as compensation, but that did not affect its reasoning; it stated that United “in the first instance, will elect its preferred treatment of the reimbursements.”

E. Depreciation & Amortization

1. *The IRS is soft on software development. Choose the treatment you prefer. Rev. Proc. 2000-50, 2000-52 I.R.B. 601. The IRS will not disturb the consistent treatment of the cost of developing computer software, either for the taxpayer’s own use or for sale or licensing to others, under one of the following methods. The taxpayer may (1) deduct the expenses under rules similar to those in § 174; or (2) capitalize the expenses and recover them either (a) over 60 months under rules similar to § 174(b), or (b) over 36 months after the software is placed in service under § 167(f)(1). Purchased software that is bundled into the nonseparately stated price of hardware can be treated as hardware. Automatic change of accounting method procedures are available.

2. *How to capitalize $107,748,925 as the cost basis of a $13,865,000 asset. Union Carbide Foreign Sales Corp. v. Commissioner, 115 T.C. 423 (11/08/00). The taxpayer was the lessee of a seagoing vessel built to its specifications. When the lease became onerous, pursuant to the lease terms, taxpayer purchased the vessel for $107,748,925, rather than paying approximately 20 percent more simply to terminate the lease. At the time of the purchase, the vessel (apart from the lease) was worth $13,865,000. The taxpayer capitalized $13,865,000 as the cost of the vessel and deducted the remaining $93,883,295 as lease termination expenses. The Commissioner disallowed the deduction on the grounds that § 167(c)(2) required capitalization of the entire purchase price, and the Tax Court (Judge Gerber) upheld the Commissioner’s position. The court noted that whether it was more or less costly to acquire the vessel or to simply terminate the lease was not relevant to the conclusion. In so holding, the court rejected the taxpayer’s argument that § 167(c)(2) applies only to property acquired subject to a lease that continues in the future, accepting, instead, the Commissioner’s argument that § 167(c)(2) applies whenever property is acquired at a time that it was subject to a lease. Accordingly a lessee of an asset who purchases that asset for the purpose of terminating the lease is subject to § 167(c)(2). The court held alternatively that the same result would be reached wholly apart from § 167(c)(2), rejecting the taxpayer’s argument [based on Cleveland Allerton Hotel, Inc. v. Commissioner, 166 F.2d 805 (6th Cir. 1948)] that the transaction could be bifurcated into two transactions, the termination of the onerous lease and the purchase of the vessel. The court held that in Millinery Center Building Corp. v. Commissioner, 350 U.S. 456 (1956), aff’g 221 F.2d 322 (2nd Cir. 1955), the Supreme Court had implicitly rejected the
holding of Cleveland Allerton Hotel, and that in any event in Millinery Center Building Corp, the Second Circuit, to which appeal of this case would lie, had expressly rejected Cleveland Allerton Hotel.

3. Patton v. Commissioner, 116 T.C. No. 17 (4/13/01). A § 179 election to expense otherwise depreciable assets must be made on the taxpayer's first return for the year or a timely amended return [Reg. § 1.179-5(a)], and cannot be modified without the Commissioner's consent. The Commissioner did not unreasonably withhold consent to modify the original election [to expense a single $4,100 asset] to apply to other capital expenditures that were reclassified as such on audit after taxpayer deducted them as "supplies." [It's also worth noting that although taxpayer originally reported a loss of $38,826 for the year, a bank deposit method audit turned up $135,638 of unreported gross receipts in addition to the erroneous deductions].

4. Section 197 amortization applies to noncompete agreements ancillary to stock redemptions. Frontier Chevrolet Co. v. Commissioner, 116 T.C. No. 23 (5/15/01). 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 through it was for only a 5-year term because the redemption constituted the acquisition of an interest in a trade or business.

F. Credits

1. *The final research credit regulations that weren't*. In T.D. 8930, Credit for Increasing Research Activities, 66 F.R. 280 (1/3/01), the IRS promulgated final regulations relating to the computation of the credit under § 41(c) and the definition of qualified research under § 41(d). The final regulations immediately came under withering criticism from the business sector, and, in an unusual move, in Notice 2001-19, 2001-10 I.R.B. 784 (1/31/01), the Treasury (Secretary O'Neill, himself, actually) announced that it will review the "final" regulations by reconsidering the comments submitted and requesting additional comments on the regulations to be received by 4/2/01. Any additional changes to the regulations will be made in proposed form. The regulations, including any future changes, will not be effective until the review is complete, except for the retroactive effective date [12/31/85] of the taxpayer-friendly changes to internal-use computer software rules. Taxpayers may rely on the final rules pending new regulations.

  - What the suspended final regulations said. The final regulations cover the requirements to qualify for the credit, rules for computing the credit, and rules for electing and revoking the election of the alternative incremental credit, and take into account the Legislative history of the Tax Relief and Extension Act of 1999.

  - The final regulations do not change the definition of gross receipts from that in the Proposed Regulations. REG-105170-97, 63 F.R. 66503 (12/2/98).

  - The final regulations retain the requirement in the proposed regulations that a taxpayer seek to discover information that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field of science or engineering. But, in response to comments regarding the discovery requirement, the final regulations make a number of changes.

  - In order to satisfy the discovery requirement, research must be undertaken for the purpose of discovering information that is beyond the knowledge that should be known to skilled professionals had they performed a reasonable investigation of the existing level of knowledge in the particular field of science or engineering [instead of technology or science], but there is no requirement that a taxpayer actually conduct such an investigation in order to claim the credit. The regulations also state, by example, that trade secrets generally are not within the common knowledge of skilled professionals (because they are not reasonably available to skilled professionals not employed, hired, or licensed by the owner of such trade secrets). Underlying principles of science or engineering used in the research need not be novel. Obtaining a patent [other than a design patent] raises a conclusive taxpayer favorable presumption.

  - The prescribed four-step process in the definition of experimentation in Prop. Reg. § 1.41-4(a)(5) has been eliminated.

  - The requirement of experimental record keeping in Prop. Reg. § 1.41-4(a)(5) has been eliminated.

1 A discovery requirement was applied in United Stationers, Inc. v. United States, 163 F.3d 440 (7th Cir. 1998), cert. denied, 119 S. Ct. 2369 (1999), Norwest v. Commissioner, 110 T.C. 454 (1998), and WICOR, Inc. v. United States, 116 F. Supp. 2d 1028 (E.D. Wis. 2000).
The shrinking-back rule has been modified in response to comments. Reg. § 1.41-4(b).

The exclusion of most activities after commercial production has commenced has been retained. The *per se* exclusion list retains debugging, but not correction of flaws.

Research with respect to internal-use software that satisfies both the general conditions for credit eligibility and the three-part test is eligible for the credit. The final regulations retain the definition of internal-use software and the additional qualifying test in the proposed regulations, but provide a new exception (pursuant to § 41(d)(4)(E)) under which certain internal-use software used to deliver noncomputer services to customers with features that are not yet offered by a taxpayer's competitors is subject to the additional tests. Following the Conference Report to the 1999 Act, the final regulations clarify that software that is intended to be used to provide noncomputer services to customers is internal-use software, while software that is to be used to provide computer services is not developed primarily for internal use.

The final regulations clarify (1) that the three-part test in the proposed regulations is the high threshold of innovation test, and not a separate requirement, and (2) how the three-part test high threshold of innovation test supplements the discovery requirement. Research with respect to internal-use software is credit eligible only if it is intended to exceed, expand, or refine the common knowledge of skilled professionals (as defined in Reg. § 1.41-4(a)(3)(ii)) to a degree that is substantial and economically significant.

2. **No, you can't have 15 years to amend your return.** *Chrysler Corp. v. Commissioner.* 116 T.C. No. 30 (6/29/01). Chrysler deduction its 1980, 1981, and 1982 tax returns. On July 24, 1995, Chrysler filed amended returns electing to claim the foreign tax credit for those years and amended its 1985 return to claim a refund from a carryover of the foreign tax credits to 1985 (which freed-up ITCs from 1985 to carry forward to future years). The Tax Court (Judge Laro) upheld the Commissioner's determination that the election to claim the foreign tax credit was untimely. The ten year period for electing the foreign tax credit under § 901(a) and § 6511(a) and (d)(3)(A) [extending the period from 3 years to 10 years] begins with the year with respect to which the foreign tax credit is elected, not [as argued by the taxpayer] the later year to which it is carried.

3. **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. No. 3 (6/24/01). Dr. Fran, 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. Fran 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 Fran 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.

4. **Tax credit provisions in the 2001 Act.**
   a. The §51 work opportunity credit was extended through 12/31/01.
   b. The hiring date for eligibility for the §51A welfare-to-work credit was extended through 12/31/01.
   c. New § 45F was added. Starting in 2002, it provides a credit of up to $150,000 to an employer for 25 percent of the employer's "qualified child care expenditures" and 10 percent of the employer's "qualified child care resource and referral expenditures." The credit is available with respect to a broad range of expenditures incurred to provide child care facilities and services for the taxpayer-employer's employees. Myriad special rules, worthy of any direct spending government subsidy program, are imposed on qualification for this tax expenditure, including a recapture of a credit if a facility ceases to used for child care after the credit is allowed with respect to the facility. In general, the benefits received by the employees as result of the expenses for which the employer receives the credit are excludable from gross income under § 129.

5. *Wicor, Inc. v. United States.* 88 A.F.T.R.2d 5474 (7th Cir. 8/14/01), aff'g 116 F. Supp. 2d 1028 (E.D. Wis. 2000). In an opinion by Judge Posner, the Seventh Circuit affirmed the denial of the § 41 research credit to the taxpayer with respect to internal use software that did not "discover" technological information. That Andersen Consulting, which developed software integrating purchase software into a single system for the taxpayer and which[under the contract] owned the source code for
the system software, did not bother to retain a copy of the source code itself was probative that nothing usable by anyone else was "discovered."

G. Natural Resources Deductions & Credits

1. A § 29 credit no-ruling issue. Rev. Proc. 2000-47, 2000-46 I.R.B. 482 (11/13/00). Rev. Proc. 2000-3, § 5, 2000-1 I.R.B. 103, is amplified by adding to the list of issues on which the IRS will not issue advance rulings the question of whether a solid fuel other than coke or a fuel produced from waste coal is a qualified fuel under § 29(c)(1)(C). Waste coal for this purpose is limited to waste coal fines from normal mining and crushing operations and does not include fines produced (for example, by crushing run-of-mine coal) for the purpose of claiming the credit.

a. Rulings will again be available. But Treasury didn't revert to pre-suspension ruling standards. Rev. Proc. 2001-30, 2001-19 I.R.B. 1163 (4/23/01), modified by Rev. Proc. 2001-34. 2001-22 I.R.B. 1293 (5/4/01). The ruling provides the circumstances under which the Service will issue private letter rulings regarding whether a solid fuel produced from coal is a qualified fuel under § 29(c)(1)(C). The circumstances necessary for the Service to issue a private letter ruling include the presence of coal feedstock particles no larger than a specific size, and the performance of specific activities in processing the feedstock in order to effectuate a significant chemical change. The chief requirement is that the fuel be "synthetic." To be synthetic "a fuel must differ significantly in chemical composition, as opposed to physical composition, from the substance used to produce it." Examples of "favorable processes" set forth in the revenue procedure include "gasification" and liquefaction [sic] and production of solvent refined coal that result[s] in substantial chemical changes to the entire coal feedstock rather than changes that affect only the surface of the coal.

b. Eleven days later, the Treasury did revert to pre-suspension ruling standards. The world is again safe for sellers of processes and tax advantages. Rev. Proc. 2001-34 modifies Rev. Proc. 2001-30 to expand the range of sizes of coal feedstock and to eliminate one particular activity as a necessary part of a process that results in a qualified fuel.

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 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 tainted 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.

  **Affirmed in part, reversed in part. Literalism triumphs in the Federal Circuit. Taxpayer celebrates a little bit more. Exxon Mobil2 Corp. v. United States, 244 F.3d 1341, 2001-1 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

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2 This word is silent when the name of the taxpayer is pronounced.
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.

H. Loss Transactions, Bad Debts and NOLs

1. Notice of Proposed Rulemaking, Equity Options with Flexible Terms; Qualified Covered Call Treatment, REG-115560-99, 66 F.R. 4751 (1/18/01). Section 1092(c)(4) excludes from the definition of a straddle writing a qualified covered call option [publicly traded and not deep in the money] and holding the stock covered by the option. The proposed regulations would permit certain equity options with flexible terms – instruments that have been developed by the securities markets since the current regulations were promulgated – to qualify as long as, among other things, the term is not more than one year and options on the underlying equity with standard terms are outstanding.

2. Is reporting interest income a “super factor” in debt/equity analysis? Cerand & Co. v. Commissioner, 254 F.3d 258, 2001-2 U.S.T.C. ¶50,518, 88 A.F.T.R.2d 5061 (D.C. Cir. 6/6/01). The taxpayer advanced over $1 million to three sibling corporation on “open account.” When the sibling corporations went out of business, the taxpayer claimed bad debt deductions. The Tax Court upheld the Commissioner’s disallowance of the deduction, finding that the evidence relating to the transfers did not treating them as loans: there were no debt instruments or signed agreements; no fixed maturity date or repayment schedule, no predetermined interest rate, repayments were inconsistent and appeared dependent on financial success, and the objective likelihood of repayment was low due to thin capitalization and no historical success. The Federal Circuit, applying an abuse of discretion standard, vacated and remanded, stating as follows:

The critical flaw in the tax court’s analysis is its failure *** to consider Cerand’s contemporaneous treatment of sums received from its sister corporations as in part the payment of “interest,” taxable as income to Cerand. Over a period of several years, Cerand received $414,220 from the three corporations, of which it booked more than $175,000 as interest income. ***

Although the tax court abused its discretion by omitting from its analysis a highly significant bit of evidence, we cannot say that, had the court properly weighed this evidence, it necessarily would have reached a different conclusion, because we do not know what weight it assigned to the other evidence.

I. At-Risk and Passive Activity Losses

1. Retroactive application of changed passive activity loss regs upheld again. Sidell v. Commissioner, 225 F.3d 103, 2000-2 U.S.T.C. ¶50,751, 86 A.F.T.R.2d 6229 (1st Cir. 9/22/00), aff’g, T.C. Memo 1999-301 (9/9/99). Sidell was the sole shareholder of KGR, a C corporation in a manufacturing business in which Sidell materially participated. Through a grantor trust, Sidell purchased an historic property that was refurbished and leased to KGR. He claimed § 47 rehabilitation credits to offset rental income received from KGR. The Tax Court upheld the IRS’s application of the self-rental rule of Reg. § 1.469-2(f)(6) and the attribution rule of Reg. § 1.469-4(a) [treating a taxpayer’s activities as including those conducted through C corporations that are subject to § 469, S corporations, and partnerships] to recharacterize the rental income from the property from passive to nonpassive income. Because the taxpayer had no other passive income the rehabilitation credit, which remained passive under § 469(d)(2) and Temp. Reg. § 1.469-3T [in force for the years in question], was unusable. The First Circuit (Judge Selya) affirmed because Reg. § 1.469-2(f)(6) is a legislative regulation [under § 469(l)], which under Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 844 (1984), is entitled to “controlling weight unless [it is] arbitrary, capricious, or manifestly contrary to the statute.” The court upheld the retroactive application of Reg. § 1.469-4(a), adopted in October 1994, to

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1993 and all of 1994. Even though the precise rules in the final regulations differed substantially from those in the proposed regulations (particularly in Reg. § 1.469-4(a)), the proposed regulations "put all concerned parties on clear notice that a sea change was in the wind."

2. The statute was self-executing; the taxpayer doesn’t have to wait for regulations on self-charged management fees. Hillman v. Commissioner, 114 T.C. 103 (2/29/00). The taxpayer’s S corporation performed management services for real estate partnerships in which the taxpayer directly or indirectly was a partner. The taxpayer received pass-through nonpassive income from the S corporation and passthrough passive deductions from the partnerships. Based on § 469(j)(2) and its legislative history, under circumstances analogous to those in Prop. Reg. § 1.469-7, 56 F.R. 14034 (4/5/91), permitting the offsetting of "self-charged" interest incurred in lending transactions, the taxpayer offset passive management fee deductions against the corresponding nonpassive management fee income. Section 469(j)(2) provides that the IRS "shall" promulgate regulations "which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income)." Prop. Reg. § 1.469-7 permits offsetting of "self-charged" interest incurred in lending transactions, but the IRS did not issue any regulation for self-charged items other than interest. Under the proposed regulations, a taxpayer who was both the payor and recipient of interest was allowed, to some extent, to offset passive interest deductions against nonpassive interest income. The Commissioner argued that the taxpayer could not set off the deductions and income because the IRS had not issued regulations for self-charged items other than interest and had thereby limited the offset. The court (Judge Gerber) held that the substantive set-off rule was self-executing and the taxpayer was entitled to offset the passive management deductions against the nonpassive management income. Such self-charged treatment was congressionally intended not only for interest, but also for other appropriate items, and the Commissioner did not argue that there was any distinction of substance between interest and management fees within the self-charged regime.

a. *Well, now, not for this taxpayer and not in the Fourth Circuit.

What “plain meaning” giveth in Gilitz, it taketh away in Hillman. Reversed, 250 F.3d 228, 2001-1 U.S.T.C. ¶50,169; 87 A.F.T.R.2d 1731 (4th Cir. 4/17/01), rehearing en banc denied, 2001 TNT 150-12 (6/30/01). The Court of Appeals (Judge Hamilton) reversed, finding “nothing in the plain language of IRC section 469 suggests that an exception to IRC section 469(a)’s general prohibition against a taxpayer’s deducting passive activity losses from nonpassive activity gains exists where, as in the present case, the taxpayer essentially paid a management fee to himself.” The court reasoned that Hillman’s argument for ignoring the plain language of the statute could prevail only if one of “two extremely narrow exceptions to the Plain Meaning Rule” applied: (1) “when literal application of the statutory language at issue produces an outcome that is demonstrably at odds with clearly expressed congressional intent to the contrary” or (2) “when literal application of the statutory language at issue ‘results in an outcome that can truly be characterized as absurd, i.e., that is so gross as to shock the general moral or common sense.’” In the eyes of the court, neither of those situations was present.

3. *Taracki v. Commissioner, T.C. Memo 2000-358 (11/21/00). Temp. Reg. § 1.469-1T(e)(3)(ii)(D) and (vi)(C) applied to except from the passive activity loss rules equipment rental activity in which the taxpayer materially participated because it was rented to a partnership in which the lessor was a 50 percent partner and which conducted a trade or business. The rental was incidental to a nonrental activity of the taxpayer [conducted through the partnership] and the use and de minimis gross rental tests were met.

4. *An LLC member isn’t a limited partner. Gregg v. United States, 2001-1 U.S.T.C. ¶50,169, 87 A.F.T.R.2d 337, (D. Ore. 11/29/00), order entered, 87 A.F.T.R.2d 857, 2001 U.S. Dist. LEXIS 1644 (D. Ore. 1/5/01). The district court held that Reg. § 1.469-5T(e)(3)(i)(B), defining a limited partner with reference to liability for the entity's debts under state law, does not automatically apply to all members of an LLC. Accordingly, the taxpayer, who founded and financed the LLC, could satisfy the material participation test under any of the seven factors of Reg. § 1.469-5T(a), and was not subject to the rules of Reg. § 1.469-5T(e)(2), applicable to limited partners, who can qualify under only Reg. § 1.469-5T(a) tests (1) [more than 500 hours], (5) [material participation for 5 of preceding 10 years], or (6) [personal service activity in which the taxpayer materially participated in three prior years]. Taking into account only the LLC, taxpayer failed to satisfy the 500-hour test of Reg. § 1.469-5T(a)(1), even though he worked approximately 100 hours in the two-month short taxable year of the LLC's organization, because there is no annualization factor. But taxpayer met that test and the tests of Reg. § 1.469-5T(a)(5) and (6) by combining under Reg. § 1.469-4(c), the LLC's activities with those of a closely held C corporation, engaged in a similar business as the LLC, that taxpayer had controlled and of
which he had been a full time employee prior to forming the LLC. The court rejected the government’s argument that activities need to be conducted simultaneously in order to be grouped.

a. Production of documents from IRS on LLCs ordered to help avoid IRS-asserted penalties. Gregg v. United States, 2000-1 U.S.T.C. ¶50,519, 87 AFTR2d 475 (D. Ore. 5/19/00). The court ordered the IRS to produce “information or statistics with respect to LLCs, partnerships, and S corporations nationwide, which existed for the first year from 1994 through 1996 (the relevant time period), and the tax treatment of these entities.” Taxpayers asserted that this information was relevant in that those other entities were “other, similarly situated taxpayers” to themselves and that it was necessary to compare their own treatment of the pass-through loss to other taxpayers’ treatment to show the “reasonableness” of their own conduct.

III. INVESTMENT GAIN

A. Capital Gain and Loss

1. *A safe harbor for debt modifications; the debt substitute election is now permanent. Rev. Proc. 2000-29, 2000-28 I.R.B. 113 (6/22/00). Eliminates the 6/30/2000 sunset date and makes the debt substitution election of Rev. Proc. 99-18 permanent. Under this election a taxpayer can treat a substitution of debt instruments as a realization event for federal income tax purposes even though there is no “significant modification” under Reg. § 1.1001-3; the taxpayer would not recognize any realized gain or loss immediately, but would take gain or loss into account over the term of the new debt instrument.


   a. Rev. Proc. 99-18, 1999-1 C.B. 736 (3/1/99). Provides for an election to treat a substitution of publicly-traded debt instruments as a realization event for federal income tax purposes, even though it does not result in a significant modification under Reg. § 1.1001-3 (and is, therefore, not an exchange). The election is made by a written agreement between the issuer and the holders of the debt instruments. Under this election, taxpayers do not recognize any realized gain or loss on the date of the substitution, but instead take the gain or loss into account over the term of the new debt instruments. The issuer treats the new instrument as an OID instrument or an instrument with bond premium. The holder takes a substituted basis and treats the new instrument as market discount bond if the redemption price exceeds the substituted basis. The election is applicable to substitutions that occur between 3/1/99 and 6/30/00.

   b. Rev. Proc. 2001-21, 2001-9 I.R.B. 742 (2/26/01), modifies and supersedes Rev. Proc. 99-18 and 2000-29. The significant changes are: (1) the newly issued debt may be issued in a qualified reopening; (2) the outstanding debt may have been issued with premium; and (3) the determination of whether a substitution does or does not result in a significant modification may be made on the substitution date or, in most cases, on the date that is two business days before the date on which the substitution offer commences.

2. *The Corn Products doctrine is dead. Long live the § 1221(a)(7) hedging regulations. Notice of Proposed Rulemaking, Hedging Transactions, REG-107047-00, 66 F.R. 4738 (1/18/01). The Tax Relief Extension Act of 1999 added new § 1221(a)(7) to exclude from the definition of “capital asset” any hedging transaction that has been clearly identified as such before the close of the day on which it was acquired, originated, or entered into. This provision in effect largely codified previously promulgated regulations [Reg. § 1.1221-2]. The Treasury has proposed comprehensive amendments to Reg. § 1.1221-2 to reflect the enactment and legislative history of § 1221(a)(7). The proposed regulations revise the Treasury regulations to reflect the “risk management” standard elucidated in the legislative history.

   • Citing [in the preamble] the legislative history [S. Rep. No. 201, 106th Cong., 1st Sess. 25 (1999)], the proposed regulations claim exclusivity as the means for characterizing gains and losses on hedging transactions as ordinary. If a transaction is outside the regulations, gain or loss from the transaction will not be ordinary even if the property is a surrogate for a non-capital asset, the transaction serves as insurance against a business risk, the transaction serves a hedging function, or the transaction serves a similar function or purpose.

   A hedging transaction is defined generally as a transaction entered into in the normal course of business primarily to manage the risk of interest rate or price changes or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings. The preamble states that the definition will include most common types of business hedges. A transaction satisfies the risk management standard if it reduces risk. To enter into a hedging transaction, the taxpayer must have risk when all of its
operations are considered [i.e., there must be risk on a “macro” basis]. Hedge of a single asset or liability, or pool of assets or liabilities, will be respected as managing risk if the hedge reduces the risk attributable to the item or items being hedged and if the hedge is reasonably calculated to reduce the overall risk of the taxpayer’s operations. Transactions that reverse or counteract hedging transactions also are considered to be hedges.

A transaction that is not entered into primarily to reduce risk is not a hedging transaction unless specifically treated as such in the regulations. The regulations provide, for example, that a so-called “store-on-the-board” transaction, in which a taxpayer disposes of its production output and enters into a long futures contract with respect to the same product, is not a hedging transaction.

A hedge of property or of an obligation is a hedging transaction only if a sale or exchange of the property, or performance or termination of the obligation, could not produce capital gain or loss. [Note that § 1221(a)(8) provides ordinary gain or loss treatment for consumable supplies held or acquired on or after 12/17/99.]

A hedging transaction does not include a transaction entered into to manage risks other than interest rate or price changes, or currency fluctuations, unless a regulation, revenue ruling, or revenue procedure provides otherwise. The regulations do not apply where a taxpayer hedges a dividend stream, the overall profitability of a business unit, or other business risks that do not relate directly to interest rate or price changes or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings.

The acquisition of investment assets may not be a hedging transaction, even though the acquisition may involve some risk reduction, because they typically are not acquired primarily to manage risk. For example, even though a taxpayer’s interest rate risk from a floating rate borrowing may be reduced by the purchase of debt instruments that bear a comparable floating rate, the acquisition of the debt instruments is not a hedging transaction. Ordinary treatment does not apply to gain or loss from the disposition of stock where, for example, the stock is acquired to protect the goodwill or business reputation of the acquirer or to ensure the availability of goods.

The proposed regulations retain the single-entity approach, and the separate-entity election, of the current regulations for hedging by members of a consolidated group.

Pursuant to § 1221(a)(7), the proposed regulations provide that hedging transactions must be identified before the close of the day on which they are entered into. The item, items, or aggregate risk being hedged must be identified no more than 35 days after entering into the hedging transaction. Relief may be granted for inadvertent errors, and, as could have been anticipated, if a taxpayer does not identify a transaction as a hedge but has no reasonable grounds for treating it as anything other than a hedge, the IRS can reclassify the gain as ordinary, but the taxpayer is bound to capital loss treatment by the failure to identify the transaction as a hedge. Likewise, designation of the transaction as a hedge does not entitle the taxpayer to ordinary loss treatment if the transaction is not in fact a hedge.

3. **Post-Corn Products era hedging rules applied.** Pine Creek Farms Ltd v. Commissioner, T.C. Memo. 2001-176 (7/17/01). Transactions in hog futures by a taxpayer engaged in grain farming were not hedges under Reg. § 1.1221-2 because they did not manage risks with respect to price changes in ordinary property. The losses were capital losses. Activities of the corporation’s major shareholder [an individual] or other corporations he controlled are not attributed to the taxpayer corporation. The regulatory hedging rules are exclusive.

4. **New capital gains rates resulting from 2001 Act ordinary income rate reductions.** For years after 2001, the preferential rate schedule for long-term capital gains, taking into account the 8 percent and 18 percent preferential rates under § 1(h)(2), as well as the creation of the new 10 percent bracket and the gradual reduction under § 1(i)(2) of the 28 percent bracket to 27.5 percent for 2001, 27 percent for 2002 and 2003, 26 percent for 2004 and 2005, and 25 percent for 2006 and thereafter, is as follows:
<table>
<thead>
<tr>
<th>Rate</th>
<th>Application</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>Gain on &quot;Small Business Stock,&quot; subject to § 1202 50% exclusion, if otherwise taxable at 10% [beginning in 2002]</td>
</tr>
<tr>
<td>7½%</td>
<td>Gain on &quot;Small Business Stock,&quot; subject to § 1202 50% exclusion, if otherwise taxable at 15%</td>
</tr>
<tr>
<td>8%</td>
<td>Gain on assets held &gt; 5 years if otherwise taxable at 10% or 15%, excluding prior depreciation on real estate</td>
</tr>
<tr>
<td>10%</td>
<td>Gain on assets, other than collectibles, held &gt; one year, if otherwise taxable at 15%, excluding prior depreciation on real estate; and gain on collectibles held &gt; one year if not otherwise taxable at ≥15%</td>
</tr>
<tr>
<td>14%+</td>
<td>Gain on &quot;Small Business Stock,&quot; subject to § 1202 50% exclusion, if otherwise taxable at ≥ 25%, depending on year</td>
</tr>
<tr>
<td>15%</td>
<td>Gain on collectibles and on depreciable real estate held &gt; one year to the extent of prior depreciation deductions, if taxpayer is not otherwise taxed ≥25%</td>
</tr>
<tr>
<td>18%</td>
<td>Gain on assets held &gt; 5 years and with a holding period beginning after Dec. 31, 2000 (with some exceptions), if otherwise taxable ≥25%, excluding prior depreciation on real estate</td>
</tr>
<tr>
<td>20%</td>
<td>Gain on capital assets, other than collectibles, held &gt; one year, if otherwise taxable ≥25%, excluding prior depreciation on real estate</td>
</tr>
<tr>
<td>25%</td>
<td>Gain, to the extent of prior depreciation deductions on depreciable real estate held &gt; one year, if otherwise taxable ≥25%</td>
</tr>
<tr>
<td>28%</td>
<td>Gain, if otherwise taxable at ≥ 25% but not ≥ 28%, on collectibles held &gt; one year</td>
</tr>
</tbody>
</table>

5. **Modified carryover basis at death starting in 2010.** The 2001 Act repealed the estate tax as of 1/1/10. In this context, Congress also enacted § 1022, which will replace § 1014 on 1/1/10. Section 1022(a) sets forth a “general rule” under which the basis of inherited property would be the lesser of the decedent’s adjusted basis for the property or the fair market value of the property on the decedent’s date of death. This general rule, however, is limited by an exception in § 1022(b)(1)(A) that provides an aggregate basis increase of up to $1,300,000 for all of the property passing from the decedent. The resulting basis cannot exceed the property’s fair market value. Section 1022(c) provides a special rule providing an additional basis increase of up to $3,000,000 for property inherited by a surviving spouse of the decedent. This greater spousal basis increase is not available for most terminable interests, although it is available for property passing to certain types of trusts for the benefit of a surviving spouse. Section 1022(d)(4) provides that both the $1,300,000 and $3,000,000 basis increase allowances are subject to adjustment for inflation beginning in 2011, which is a year after the changes in the 2001 Act sunset.

- If a husband and wife own property as joint tenants, the deceased spouse is treated as owning fifty-percent of the property immediately before his or her death. § 1022(d)(1)(B). In the case of other joint tenancies, the decedent is treated as owning a percentage of the property proportionate to the consideration provided to acquire and improve the property. If a husband and wife own property as community property, the deceased spouse is treated as owning all of the property. § 1022((d)(1)(C). This special rule is analogous to § 1014(b)(6) and permits the basis increase to apply to the entire property rather than only to one-half of the surviving spouse’s interest as is the case in common law states.

- The basic $1,300,000 basis increase and the special $3,000,000 spousal basis increase can be pyramided. A surviving spouse who is the sole heir or legatee of the decedent

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4 The 14% rate assumes that the § 1202 exclusion is exactly 50 percent. In some cases the exclusion will be less than 50 percent, and in such cases the exact effective rate varies widely.

5 A taxpayer in the 27.5% bracket for 2001 [27% for 2002 and 2003, 26% for 2004 and 2005, or 25% for 2006 and thereafter] can have collectibles gain taxed at his normal marginal rate if his other capital gains are small enough in amount that the § 1(h) computation of tax liability exceeds the computation under §1(a) - (d), as applicable.

6 The aggregate basis increase is increased by the amount by which the basis of any property exceeds the property's fair market value if a loss would have been allowed under § 165 if the decedent had sold the property, I.R.C. § 1022(b)(2)(C), even though a particular item of property may not take a basis in the hands of the heir that exceeds its fair market value.
thus can obtain an aggregate basis increase of $4,300,000. See § 1022(c)(1). Alternatively, another heir can obtain a basis increase of $1,300,000 while the spouse obtains a basis increase of up to $3,000,000.

• If the aggregate appreciation in all of a decedent’s assets does not exceed the applicable limit, then no problem of apportioning the basis increase among assets arises. But if the aggregate appreciation in the decedent’s assets exceeds the applicable limit, then the basis increase must be apportioned. Section 1022(c) provides that the decedent’s executor shall allocate the basis increase, but provides no rules for how to allocate it.

• Section 1022(d)(1)(C) denies the basis increase with respect to any property received by the decedent by gift, except from the decedent’s spouse, within three years prior to death. (Section 1014(e) currently provides an analogous rule if a decedent acquires property by gift within one year of death.)

B. Interest

1. A tough-nosed step transaction approach in the D.C. Circuit. Del Commercial Properties, Inc. v. Commissioner, 2001-2 U.S.T.C. ¶50,474, 87 A.F.T.R.2d 2451 (D.C. Cir. 6/8/01). The taxpayer structured a loan transaction from one of its subsidiaries as a back-to-back loan from a Canadian affiliate to a Dutch affiliate to itself, for the purpose of bringing the loan under the U.S.-Netherlands treaty, which exempted the interest, rather than the Canadian treaty, which did not. The Eighth Circuit upheld the Tax Court’s decision that the back-to-back structure had no business purpose and should not be respected; the Dutch affiliate was merely a conduit for the loan from the Canadian affiliate. The court interpreted Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938) to stand for the proposition that “a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes.”

C. Section 1031

1. Reverse Exchanges

a. *Outside the Rev. Proc. 2000-37 safe harbor, it's a rainforest. DeCleene v. Commissioner, 115 T.C. 457 (11/17/00). In a purported reverse exchange, the buyer acquired the replacement property from taxpayer (who not only located it, but also purchased it), held it while a new building was constructed on it (financed by taxpayer), and then exchanged it for the relinquished property. The transaction taxpayer and buyer tried to implement was a “reverse exchange” directly without the participation of any third-party facilitator. Judge Beghe held that there was a taxable sale of property, not a like-kind exchange, because the buyer never acquired the benefits and burdens of ownership of the replacement property in that there was an agreement between taxpayer and buyer that the relinquished property and the replacement property were of equal value. Bloomington Coca-Cola Bottling Co. v. Commissioner, 189 F.2d 14 (7th Cir. 1951) (no § 1031 exchange occurs when taxpayer constructs a building on property he already owns), was held to be indistinguishable.

b. *But here’s a PLR umbrella to keep you dry. Benefits and burdens of ownership were defined very broadly. PLR 200111025 (12/8/00). This private letter ruling approved a reverse like-kind exchange that was outside the safe-harbors of Rev. Proc 2000-37 [because the transaction predated the effective date, and because the accommodation party held the property for more than 180 days]. The taxpayer held property on which it had granted an option that contained a like-kind-exchange cooperation agreement. With respect to the replacement property, pursuant to a “real estate acquisition agreement”: (1) the accommodation party financed the acquisition through loans (bearing market-rate interest) from a bank and from the taxpayer; (2) the bank loan was guaranteed by the taxpayer; (3) the taxpayer leased the property from the accommodation party under a triple net lease for one year, with an extension option, at a rental that exceeded the accommodation party’s operating costs (including debt service); (4) the taxpayer and the accommodation party agreed to report income treating the taxpayer as a lessee and the accommodation party as the owner; (5) the taxpayer had the option to purchase the replacement property from the accommodation party at fair market value, which was deemed to be the accommodation party’s acquisition cost if the taxpayer purchased the property within 18 months; (6) if the option terminated without the taxpayer purchasing the property, the accommodation party could sell the property and obtain the benefit of certain loss-limiting contract rights if it followed specified procedures, but if the procedures were not followed or the accommodation party kept the property, it bore the benefits and burdens of economic gain or loss; and (7) the taxpayer would provide the accommodation party general environmental release and indemnification. The IRS ruled that the
transaction qualified as a § 1031 like-kind exchange, citing Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963), and J.H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962), acq., 1963-2 C.B. 4, as authority that reverse exchanges qualified under § 1031. It distinguished DeCleene v. Commissioner, supra, item b., as involving a fact pattern that was not actually a reverse exchange because in that case the purported accommodation party never obtained any benefits and burdens of ownership and there was no integrated plan to obtain the replacement property for the exchanged property. On the PLR facts, there was an intent from the outset to effect a like-kind exchange pursuant to an interdependent integrated plan. Finally, applying the six factor test for agency of National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949), with the gloss on that test provided by Commissioner v. Bollinger, 485 U.S. 340 (1988), the accommodation party was not the taxpayer’s agent.

2. Were these originated in Roswell too? The IRS will not rule that UFIs in real estate – often syndicated – are real estate, rather than partnership interests. Rev. Proc. 2000-46, 2000-44 I.R.B. 438. The IRS will not give advance rulings on whether an undivided fractional interest in real estate is [or is not] an interest in a partnership that is not eligible for like-kind exchange treatment under § 1031. [Rev. Proc. 2000-3, § 5.10, 2000-1 I.R.B. 103 amplified]

- The IRS is concerned that taxpayers are treating as undivided interests in real estate, eligible for § 1031 like-kind exchange treatment, interests in arrangements involving real property that properly should be treated as partnership interests. It intends to study the facts and circumstances relevant to the determination of whether such arrangements are separate entities for federal tax purposes.

- The IRS requests comments regarding the relevance of the following factors in determining whether arrangements involving undivided fractional interests in real property constitute separate entities for federal tax purposes: (1) leasing or management agreements with respect to the property and the relationships between the parties to such agreements and the promoter or organizer of the arrangement; (2) agreements between the promoter or organizer of the arrangement and the holders of the fractional interests or among the holders of the fractional interests, including any contractual restrictions to which the fractional interests are subject, such as waivers of the right to partition, rights of first refusal, and options to put and/or call the fractional interests; and (3) the overall economics of the arrangements, including the sharing of profits and losses from operating the property and appreciation and depreciation in the property’s value.

3. The erosion of the Glass-Steagall Act changes the face of like kind exchanges. REG-107175-00, Definition of Disqualified Person, 66 F.R. 3924 (1/17/01). Proposed Amendments to Reg. § 1.1031(k)-1(k)(4) would generally provide that a bank that is a member of a controlled group that includes an investment banking or brokerage firm as a member will not be a disqualified person [with respect to deferred like-kind exchanges through an intermediary] merely because the investment banking or brokerage firm has provided services to an exchange customer within a two-year period ending on the date of the transfer of the relinquished property by that customer. Proposed effective date: 1/17/01.

4. *Was it a deferred like-kind exchange or an installment sale? Only time will tell. Smalley v. Commissioner, 116 T.C. No. 29 (6/14/01). In 1994, the taxpayer entered into a deferred exchange agreement through a qualified intermediary under which he relinquished timber-cutting rights on land he owned in fee and in 1995 [within the period required by § 1031(a)(3)], the taxpayer received fee simple interests in three parcels of real estate. In 1994, the transferee paid cash to a qualified escrow account as defined in Reg. § 1.1031(k)-1(g)(3). The Commissioner asserted that the taxpayer realized gain in 1994 because the timber cutting rights were personalty and thus not like kind to a fee simple. Finding the relevant state [Georgia] law characterization of whether timber-cutting rights were realty or personalty “less than a seamless web of jurisprudence,” Judge Thornton held that in any event, no income was realized in 1994. At the beginning of the exchange period, the taxpayer had a bona fide intent to enter into a deferred exchange of like-kind property within the meaning of Reg. § 1.1031(k)-1(j)(2)(iv), and under Reg. § 1.1031(k)-1(g)(3) was not in actual or constructive receipt of property in 1994. Whether the transaction was a like-kind exchange or an installment sale with payment received in 1995 was a question left to another day [presumably the year in which the replacement land is sold]. Oh, by the way, by the time the case had been decided, the statute of limitations had run on 1995 [for which year it appears that the taxpayer reported the closing of the transaction as a like-kind exchange, not receipt of an installment payment].
D. Section 1041

1. For just how long are you a "former spouse" "incident to a divorce" under § 1041? Young v. Commissioner, 113 T.C. 152 (8/20/99). A former husband defaulted on a $1.5 million promissory note given to his former wife in a divorce settlement in 1989 and satisfied a judgment on the note by transferring real estate, which he had received in the original divorce, to his former wife in 1992. She subsequently sold the property for $2.2 million. The value of the real estate equaled the sum of the principal of the note, accrued but unpaid interest, the wife's attorney's fees, and certain costs. The Tax Court (Judge Foley) held that the husband's transfer of the real estate was "incident to the divorce." Accordingly, under § 1041, the husband recognized no gain on the transfer and the wife held it at her husband's adjusted basis. The appellate court noted that the issues were as follows:

This case presents two tax questions arising from the settlement of a property dispute between former spouses. The first is whether a 1992 transfer of land from a husband to his former wife constitutes a transfer "incident to" their 1988 divorce for purposes of the nonrecognition of gain rules. The second is whether the wife must include within her gross income the contingent fees paid directly to her attorneys from the proceeds of her subsequent sale of that land. 8

a. Affirmed. 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) (2-1). The Court of Appeals rejected Mrs. Young's argument that she received the property as a "judgment creditor," finding that the only relevant status was her status as a "former spouse." The sole reason for the 1992 transfer of the real estate from Mr. Young to Mrs. Young was to resolve ongoing disputes that originated in the divorce.

Had the Youngs reached this settlement at the time of their divorce, there is no question that this transaction would have fallen under § 1041. There is no reason for the holding to differ here where the same result occurred through two transactions instead of one.

The policy animating § 1041 is clear. Congress has chosen to 'treat a husband and wife [and former husband and wife acting incident to divorce] as one economic unit, and to defer, but not eliminate, the recognition of any gain or loss on interspousal property transfers until the property is conveyed to a third party outside the economic unit.' Blatt v. Commissioner, 102 T.C. 77, 80 (1994) (emphasis added). *** Thus, no taxable event occurred and no gain was realized by either Mr. or Mrs. Young until Mrs. Young sold the 59 acres to a third party.

- Judge Wilkins, in dissent, argued that the 1992 agreement was not a divorce or separation agreement and that this fact raises the presumption that the property transfer was not related to the cessation of the marriage, and that the government failed to show "that the transfer was made to effect the division of [marital] property" as required by Temp. Reg. § 1.1041-1T(b).

*** Because the division of marital property was completed years before the property transfer -- when the parties released their marital claims against one another and Louise accepted the promissory note -- I would hold that the Government failed to make the necessary showing.

A property transfer is not made for the purpose of effecting a marital property division when the marital property division has already been completed. The Youngs completed this division when John delivered the promissory note to Louise. His payments on the

7 John's basis in the property was $130,794. He transferred the land to Louise to satisfy a debt totaling $2,153,845, including $1,500,000 in principal, $344,938 in interest, $300,606.08 in attorney's fees, and $8,300 in collection costs. John reported no capital gain from his use of the appreciated property to satisfy his debt. Louise sold the property for $2,265,000 and reported a $100,000 short-term capital gain and $356,500 in interest income.

8 The question of inclusion of attorney's fees in income is discussed at V.B., below.
note did not transfer marital property; the note itself accomplished that. The 1992 property transfer was made simply to satisfy a judgment between them, for reasons bearing no relationship to the fact that the parties were previously married.

The majority concludes that the 1992 property transfer should not be treated as a taxable event because that would have been the result had Louise agreed to the property transfer as part of the 1989 divorce settlement. The hypothetical transaction offered by the majority and the transaction that actually occurred are not alike. In fact, they differ in the most critical way: In the hypothetical, Louise would have obtained the property as a means of severing her economic union with her former spouse, thereby justifying treatment of the transfer as if it were made within a single economic unit, whereas in the actual transaction, the property was transferred after the Youngs' economic union had already been completely severed.

2. And the Treasury comes to the rescue – Subchapter C principles apply; otherwise, form controls. REG-107151-00, Constructive Transfers and Transfers of Property to a Third Party on Behalf of Spouse, 66 F.R. 40659 (8/3/01). Because of the inconsistent standards applied by the courts in dealing with redemptions of stock incident to a divorce, the Treasury has 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. § 1.1041-1T(c) Q&A-9 no longer will control after the regulations are finalized.

- The proposed regulations apply 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 nontransferring 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 specifically states:

If the rules of the proposed regulations had applied in the Arnés case,9 because the husband did not have a primary and unconditional obligation to purchase the wife's

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9 Ninth Circuit applies § 1041 to exclude gain on wife's stock redemption. Arnés v. United States, 981 F.2d 456, 93-1 U.S.T.C. ¶50,016 (9th Cir. 1992). The Ninth Circuit (Judge Hall) affirmed a district court's grant of summary judgment to taxpayer, holding that the divorce-settlement redemption of taxpayer's stock (in a McDonald's franchise corporation she owned equally with her former husband) qualified for exemption under § 1041. The former husband was held to have been relieved of an obligation by the corporate redemption, so A-9 of Temp. Reg. § 1.1041-1T would treat taxpayer's stock as having been transferred to her former husband, and then retransferred to the corporation (the "third party") in a non-§ 1041 transaction. The $450,000 cash is to be treated as paid to taxpayer by the corporation on behalf of her former husband (and presumably constituting a taxable distribution to her former husband). See Temp. Reg. § 1.1041-1T, A-2, Example (3).

But Tax Court holds § 1041 does not apply to tax her husband on the redemption, so neither is taxed. Arnés v. Commissioner, 102 T.C. 822 (1994) (reviewed, 7 judges dissenting). Redemption of wife's stock [in corporation owned 50-50 by husband and wife] was not a constrictive dividend to husband because he did not have a primary and unconditional obligation to purchase wife's stock, relying on Rev. Rul 69-608, 1969-2 C.B. 42. Dissents on ground that the Ninth Circuit has passed on the legal issue, citing Golsen v. Commissioner, 54 T.C. 742 (1970) aff'd, 455 F.2d 985 (10th Cir. 1971), and on the untenable result that neither stockholder will incur tax consequences as a result of the $450,000 stock redemption.

In this connection, see also Tax Court had held for wife when husband had been obligated to purchase her stock. Hayes v. Commissioner, 101 T.C. 593 (12/29/93). The existence of a provision in their separation agreement obligating husband to purchase wife's stock in their wholly-owned [McDonald's franchise] corporation
results in a constructive dividend to husband when the corporation redeemed wife’s shares and results in tax-free §1041 treatment to wife under Temp. Reg. §1041-1T(c), Q & A.9.

The Tax Court disagrees with the Ninth Circuit’s Ames case, and Judge Beghe has the correct answer. Blatt v. Commissioner, 102 T.C. 77 (1/31/94) (reviewed, 3 judges dissenting). Wife’s redemption (pursuant to a divorce decree) of all her stock in a corporation she owned entirely with her husband was not governed by §1041, and was taxable to her. The court refused to follow the Reg. §1.1041-1T, Q&A 9 theory that the redemption was a transfer to the corporation on behalf of her husband, as held in Ames v. United States, 981 F.2d 456, 93-I U.S.T.C. ¶50,016 (9th Cir. 1993), which the court refused to follow. Judge Beghe’s concurring opinion stated that the proper interpretation of that regulation should be that no redemption should be considered to be “on behalf of” the remaining spouse unless it discharges that spouse’s primary and unconditional obligation to purchase the redeemed stock, as set forth in the examples of Rev. Rul. 69-608, 1969-1 C.B. 42.

’Tis doubly blessed to get redeemed in divorce than in marital bliss. Read v. Commissioner, 114 T.C. 14 (2/4/00). Mr. and Mrs. Read (H & W) owned substantially all of the stock of Mulberry Motor Parts, Inc. (MMP). When they divorced, the final judgment ordered (1) that W sell to H, or at H’s election to MMP or MMP’s ESOP plan, all of her MMP stock, and (2) that H, or at H’s election MMP or MMP’s ESOP plan, pay $838,724 to W ($200,000 down and the balance by interest bearing note). H elected to cause MMP to purchase and pay for W’s stock, and the transaction was so structured. W argued that she was entitled to nonrecognition under §1041(a) and Reg. §1.1041-1T(c), Q & A-9, which treats certain transfers to third parties as a transfer of property by the transferring spouse directly to the nontransferring spouse that qualifies for nonrecognition treatment under §1041 followed by an immediate transfer of the property by the nontransferring spouse to the third party in a transaction that is not subject to §1041 – i.e., H would have a redemption treated as a dividend. H argued that §1041(a) and Reg. §1.1041-1T(c), Q&A-9 were inapplicable because he never had an unconditional obligation to purchase W’s MMP stock, and that accordingly he recognized no income and W recognized gain on the redemption of her stock. The Commissioner took the position that he was a mere stakeholder and had issued deficiency notices to both taxpayers in the joined cases to avoid a whipsaw, but the Commissioner argued that W “has the better argument.”

• The Tax Court in a reviewed opinion (8-7) by Judge Chiechi, agreed with the Commissioner and W. The court held that in cases involving corporate redemptions in a divorce setting, the primary-and-unconditional-obligation standard that generally applies in “bootstrap-acquisitions” [see Rev. Rul. 69-608, 1969-2 C.B. 42] is not the appropriate standard to apply to determine whether the transfer of property by the transferring spouse to a third party is on behalf of the nontransferring spouse within the meaning of Reg. §1.1041-1T(c), Q&A-9. Applying the common, ordinary meaning of the phrase “on behalf of” in Q&A-9, W’s transfer of her stock to MMP was a transfer of property by W to a third party on behalf of H within the meaning of the regulation. Thus, under §1041(a), no gain was recognized by W and H recognized a dividend. The majority reasoned that Hayes v. Commissioner, 101 T.C. 593 (1993), did not limit the treatment of a redemption of one divorcing spouse’s stock as a §1041 transfer by that spouse and a dividend to the nonredeeming spouse. It distinguished Blatt v. Commissioner, 102 T.C. 77 (1994), because in that case the record did not establish that corporation acted on behalf of husband in redeeming wife’s stock; and the majority attempted to distinguish the Tax Court’s prior opinion in Ames v. Commissioner, 102 T.C. 522 (1994), as involving an instance in which the husband did not have an unconditional obligation to acquire the wife’s stock.

• Dissents by Judges Ruwe, Halpern, and Beghe, all argued in one way or another that the primary-and-unconditional-obligation standard that generally applies in bootstrap-acquisitions was the appropriate standard to apply, nothing in Reg. §1.1041-1T(c), Q&A 9 indicated otherwise, and that on the facts H did not have a primary and unconditional obligation to purchase W’s stock.

• A joint dissent by Judges Laro and Marvel argued that Reg. §1.1041-1T(c), Q&A 9, never should apply to redemptions like those in any of these cases.

The wrong answer again, via Judge Hall of the Ninth Circuit, who here defers to the Tax Court. Remember, it all began with the Ninth Circuit’s Ames decision that gave the temporary(?!) regulations under §1041 such a convoluted interpretation. Craven v. United States, 2000-2 U.S.T.C. ¶50,541, 85 A.F.T.R.2d 2229 (11th Cir. 6/19/00). Stock redemption incident to 1989 divorce for $4.8 million in future cash is governed by §1041, so the redeeming spouse does not recognize gain nor (because §1041 applies) does she have imputed interest during the period before receiving cash. The stock redemption agreement between the redeeming spouse and the corporation provided that the payments to be made were without stated interest, and that the corporation would send her Forms 1099-INT stating the amounts of interest imputed to her under §1272. Senior Judge Cynthia Hall (of the 9th Circuit) followed Read to find the redemption was governed by §1041 pursuant to Temp. Reg. §1.1041-1T(c), Q&A-9. The stock redemption agreement provided that since the payments under the note were without stated
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 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.

IV. COMPENSATION ISSUES

A. Employee Compensation and Plans

1. T.D. 8878, Tax Treatment of Cafeteria Plans, 65 F.R. 15548 (3/23/00). Final Reg. § 1.125-4 permits a mid-year cafeteria plan election with respect to medical and group term life insurance by an employee who has a change of status, such as change in marital status or number of dependents, employment, work site, etc., during the year. [Employees generally are permitted to make elections between cash or qualified tax free benefits only at the beginning of the plan year.]

   a. REG-117162-99, Notice of Proposed Rulemaking, Tax Treatment of Cafeteria Plans, 65 F.R. 15587 (3/23/00). Proposed amendments to various subsections of Regs. §§ 1.125-1, -2, and -4 would extend to dependent care assistance and adoption assistance the availability of mid-year cafeteria plan elections based on a change of status, under the same terms that apply to mid-year elections with respect to medical and group term life insurance under Reg. § 1.125-4.

   b. T.D. 8921, 66 F.R. 1837 (1/10/01). The final cafeteria plan regulations under § 125 on midyear election changes modify the March 2000 final regulations to permit employees to elect to increase or decrease group-term life insurance or disability coverage in response to a change-of-status event, including birth, adoption, or death.

2. REG-114697-00, Nondiscrimination Requirements for Certain Defined Contribution Retirement Plans, 65 F.R. 59774 (10/6/00). Proposed regulations prescribe conditions under which "new comparability" defined contribution plans will be permitted to satisfy nondiscrimination requirements based on proposed plan benefits, rather than on actual plan contributions.

3. A little more help for Rabbi trusts. Notice 2000-56, 2000-43 I.R.B. 393 (10/23/00). This notice deals with the application of Reg. § 1.1032-3 if a parent corporation contributes its stock to a rabbi trust established by a subsidiary to provide deferred compensation to the subsidiary's employees. The parent corporation will be considered the grantor and the owner of the parent's stock held in the trust if the parent's stock (1) is subject to the claims of the creditors of the parent corporation, and (2) reverts to the parent on termination of the trust to the extent it is not transferred to an employee. This result obtains even if the parent stock in the trust is also subject to the claims of the subsidiary's creditors. The parent stock will not be considered transferred to the subsidiary used to satisfy the subsidiary's deferred compensation obligation (or when a claim is made against the trust by a creditor of the subsidiary). As a result the immediate transfer requirement of Reg. § 1.1032-3(c)(2) is satisfied with respect to the parent stock. Model language in Rev. Proc. 92-64, 1992-2 C.B. 422, may be modified to take this change into account and an advance ruling may be obtained.

4. Estate of Ashman v. Commissioner, 231 F.3d 541, 2000-2 U.S.T.C. ¶50,806, 86 A.F.T.R.2d 6722 (9th Cir. 10/26/00), aff'g T.C. Memo. 1998-145. In 1990, the taxpayer received a distribution from a qualified plan that she reported as a tax-free rollover from one qualified retirement plan to another [pursuant to § 402(c)]. In fact, the rollover did not comply because the contribution to the new account was not made within the 60 days required by § 402(c)(3). In 1993, when the taxpayer withdrew funds from the new account, she did not report receipt of the distribution. She claimed a basis offset on the grounds that the 1990 transaction did not qualify for tax-free rollover. Because 1993 was a closed year, the Commissioner denied the basis offset on the grounds that the taxpayer was estopped from claiming that the 1990 transaction was a qualified rollover. The Ninth Circuit affirmed the Tax

interest the corporation would send the redeemed wife Forms 1099-INT stating the amounts of interest imputed to her under § 1272, which the corporation did. The parties did not contemplate a §1041 transfer because under Reg. §1.1274-1(b)(iii) the original issue discount rules do not apply to transactions covered by §1041.
Court's application of the "duty of consistency" to disallow the basis offset and require inclusion of the full distribution.

5. *Fundamental changes in the treatment of split-dollar life insurance. Notice 2001-10, 2001-5 I.R.B. 459 (1/9/01). This notice provides interim guidance on split-dollar life insurance contracts. It notes that the P.S. 58 rates no longer reflect the current fair market value of insurance protection. The Notice requires that employer payments be consistently treated as: (1) interest-free loans under § 7872, (2) investments by the employer in the contract, or (3) payments of compensation. The Service had long rejected interest-free loan treatment of the employer investment in the cash value of split dollar life insurance, but the enactment of § 7872 in 1984 enables interest-free loan treatment to be used as a valid model. The alternative is to have the true cost of insurance protection reflected in the employee's income; insurance companies will be required to provide rates at which comparable term policies will be available to the general public (instead of the low-ball rates that had been provided in the past). This notice revokes Rev. Rul. 55-747, 1995-2 C.B. 228, and provides that, after 2001, P.S. 58 rates may not be used.

6. *New comprehensive employee plan correction guidance (EPCRS). Rev. Proc. 2001-17, 2001-7 I.R.B. (1/19/01), modifying and superceding Rev. Proc. 2000-16, 2000-6 I.R.B. 518. Modifications include: (1) allowing master and prototype sponsors and third-party administrators to correct failures affecting more than one plan sponsor; (2) allowing anonymous "John Doe" submissions; (3) adding procedures for SEPs; and (4) allowing retroactive amendments related to hardship withdrawals, employees participating before they are eligible, and ineligible employers who sponsored a 401(k) plan.

7. *A regular snake charmer. T.D. 8928, Failure to Satisfy Continuation Coverage Requirements of Group Health Plans, 2001-8 I.R.B. 685 (12/18/00). Amendments were made to § 4980B COBRA regulations regarding reorganizations, employer withdrawals from multi-employer plans, health flexible spending arrangements, and counting employees for the exception for small employers. The 1999 proposed regulations relating to plans maintained by an employer with fewer than 20 employees in the previous calendar year [employers exempt from COBRA] are adopted as final regulations without change.


9. *Would the Gitlitz Court uphold this Revenue Ruling? Rev. Rul. 2001-6, 2001-6 I.R.B. 491 (1/18/01). Payments in redemption of stock held by an ESOP that are used to make distributions to terminating ESOP participants are not deductible as "applicable dividends" under § 404(k)(1), but are disallowed under § 162(k)(1) [and § 404(k)(5)(A), which authorizes the IRS to disallow a deduction under § 404(k)(1) for any dividend that, in substance, constitutes an evasion of taxation].

*** [T]he treatment of redemption proceeds as "applicable dividends" under section 404(k) would produce such anomalous results that section 404(k) cannot reasonably be construed as encompassing such payments. See, e.g., Helvering v. Hammel, 311 U.S. 504, 510-511 (1941) (The words of a statute must be given "a restricted rather than a literal or usual meaning ... where acceptance of that meaning would lead to absurd results ... or would thwart the obvious purpose of the statute.")

10. *A deductible redemption, thanks to § 83. Riverton Investment Corp. v United States, 2001-1 U.S.T.C. ¶50,318, 87 A.F.T.R.2d 1430 (W.D. Va. 3/6/01). Under § 83 non-lapsing restrictions may so limit the employee's beneficial ownership of property that the property will not be considered ever to have been transferred to the employee. [See Reg. § 1.83-3(a)(5), providing "an indication that no transfer has occurred is the extent to which the consideration to be paid the transferee upon surrendering the property does not approach the fair market value of the property at the time of surrender," and Reg. § 1.83-3(a)(5) providing "an indication that no transfer has occurred is the extent to which the transferee does not incur the risk that the value of the property at the time of the transfer will decline substantially.""] The District Court held that the taxpayer-corporation could deduct the cost of "repurchasing" stock issued to an employee subject to the condition that it be resold to the corporation upon termination of employment at a price equal to the greater of the amount paid by the employee of 60

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percent of book value. The stock was never “transferred”; thus the payment was not in redemption by the
Corporation. The “repurchase” was simply the payment of compensation.

11. The 2001 Act made extensive technical changes in the rules governing qualified
pension plans. The unindexed benefits limit for defined contribution plans has been increased from
$90,000 to $160,000. The unindexed contributions limit for defined benefit plans has been increased
from $30,000 to $40,000. Special rules in new § 414(v) allow increased elective contributions to defined
contribution plans by employees age 50 or older. The amendments to the qualified pension plan rules
permit extensive rollovers between qualified plans and between qualified plans and IRAs as employees
change jobs. More specifically,

- For defined contribution plans, (1) the § 415(c)(1)(A) annual
addition limit was increased from the lesser of 25% of compensation or $35,000 [$30,000 as indexed
through 2001] to the lesser of 100% of compensation or $40,000; (2) the annual elective deferral limitation
on § 401(k) plans, § 403(b) annuities, etc., will be increased to $11,000 in 2002, with annual increases of
$1,000 until $15,000 is reached in 2006 (after which it will be indexed for inflation); and (3) the annual
compensation limit that may be taken into account in determining contributions will be increased from its
current $170,000 to $200,000 in 2002 (and indexed thereafter).

- Employees age 50 and older may make “catch up” additional
elective deferrals of $1,000 for 2002, increasing in $1,000 annual increments to $5,000 in 2006 (and
indexed for inflation thereafter).

- For defined benefit plans, the annual benefit limit will increase
from its current $140,000 [$90,000 as indexed through 2001] to $160,000 in 2002, and the annual
compensation limit that may be taken into account in determining benefits will be increased to $200,000 in
that year as well.

- Employer contributions must be vested more quickly to either (1)
cliff vesting in two years, or (2) gradual vesting at 20 percentage point increments from the second to sixth
year of employment.

- Beginning in 2006, § 401(k) plans and § 403(b) plans may
incorporate a “qualified Roth contribution program” pursuant to which participants may elect to have all or
a portion of their elective deferrals to the plan designated as after-tax “Roth contributions.” Rollovers to
individual Roth IRAs will be permitted.

a. New § 45E was added. It provides a nonrefundable credit (for tax years
beginning after 2001) equal to 50 percent of the first $1,000 of administrative and retirement-education
start-up costs for any small business that adopts a new qualified defined benefit or defined contribution
pension plan. The credit is available only with respect to the first three years of the plan’s existence.
Only employers that did not have more than 100 employees whose compensation exceeded $50,000 in the
preceding year qualify. The plan must cover at least one nonhighly compensated employee in order to
qualify. Thus, the credit is not available to a sole proprietor with no employees, or the owner of single
member LLC that employs only the owner.

- The credit is part of the general business credit. If the credit is
claimed, the one-half of the expenses with respect to which the credit is allowed are automatically
nondeductible; the remaining expenses one-half of the qualifying expenses are deductible to the extent
otherwise allowable.

12. *Qualified retirement planning services will become an excludable fringe
benefit in 2002. Section 132(a)(7), added by the 2001 Act, excludes “qualified retirement planning
services” beginning in 2002. Qualified retirement planning services are defined in § 132(m) as retirement
planning advice or information provided to an employee and his spouse by an employer maintaining a
qualified pension plan. Interestingly, nothing on the face of the statute limits the advice to matters related
the qualified pension plan on which eligibility is based, and the legislative history clearly states that the
information and advice is not so limited. It may extend to retirement income planning generally and how
the employer’s plan fits into the employee’s overall retirement income planning. The exclusion does not,however, extend to tax preparation, accounting, legal and brokerage services related to retirement
planning. The exclusion is subject to a nondiscrimination rule that makes it available to highly
compensated employees “only if the such services are available on substantially the same terms to each
member of the group of employees normally provided education and information regarding the
employer’s qualified employer plan.” The legislative history indicates that under this standard the IRS
should permit employers to limit certain types of advice to individuals nearing retirement.
13. Effective date guidance. Notice 2001-56, 2001-38 I.R.B. 277 (9/17/01). This notice provides guidance regarding application of the effective date rules for amendments to (1) § 401(a)(17) [and related sections], increasing the compensation limit [to $200,000] – effective for plan years beginning on or after 1/1/02, even if the plan uses annual compensation for a period beginning before 1/1/02; (2) § 416, regarding determination of top-heavy status – effective for plan years beginning after 12/31/01, even if the determination date is before 1/1/02, and (3) revisions to the regulations relating to hardship distributions under § 401(k)(2)(B)(i)(IV), as mandated by § 636(a) of EGTRRA – regulations to effective for calendar years beginning after 12/31/01.


B. Individual Retirement Accounts

1. *They’re taking all the fun out of calculating minimum required distributions from plans and IRAs. REG-130477-00 and REG-130481-00, Required Distributions from Retirement Plans, 66 F.R. 3928 (1/17/01). Proposed regulations under § 401(a)(9), etc., substantially simplify the calculation of minimum required distributions from qualified plans, IRAs, and other related retirement savings vehicles. The changes in the proposed regulations are based on the concept of a uniform lifetime distribution period. The regulations provide a single table that any recipient can use to calculate his or her yearly MRD amount by plugging in his or her age and the prior year-end balance of his or her retirement account or IRA. The table eliminates the need to elect recalculation of life expectancy, determine a designated beneficiary by the required beginning date, or satisfy a separate incidental death benefit rule. The proposed regulations will result in reducing MRDs for the vast majority of employees and IRA holders. Although MRDs will be calculated without regard to the beneficiary’s age, the regulations will continue to permit a longer payout period if the beneficiary is a spouse more than 10 years younger than the employee.

2. “Active participation” in a plan turns on accruing any slight benefit, not on having a chance of actually getting anything back from the plan. Wade v. Commissioner, T.C. Memo. 2001-114 (5/14/01). Mrs. Wade, who was a part-time community college teacher, was an active participant in a qualified plan by virtue of an $84.89 mandatory contribution to a defined benefit plan in a year in which she accrued approximately 1/120th of the service required for benefits to vest. As a result both Mrs. and Mr. Wade, whose combined AGI was $77,000, were denied deductions for their $2,000 IRA contributions under the § 219(g) AGI phase-out rule.

3. IRA changes in the 2001 Act

a. Section 25B, which is effective only for the years 2002 through 2006, provides a nonrefundable credit to low- and moderate-income taxpayers making contributions to individual retirement accounts or to employer-sponsored retirement plans. The credit is not available to taxpayers with adjusted gross income over $50,000 (joint returns), $37,500 (heads of households), or $25,000 (all others). Below those ceilings, the credit equals a percentage of the taxpayer’s “qualified retirement savings contributions.” The percentage is 50 percent, 20 percent, or 10 percent, depending on the taxpayer’s AGI, with the percentage decreasing as AGI increases. There are cliff effects as the credit percentage is stepped down. For example, the credit is 50 percent for a married couple with $30,000 AGI; for a married couple with $30,001 AGI the credit is only 20 percent.

* The ceiling on credit-eligible contributions is $2,000 for each eligible individual. To be eligible, an individual must be at least 18 years old, and must not be a dependent or a full-time student. “Qualified retirement savings contributions” include elective contributions under §§ 410(k), 403(b) and 457, voluntary after-tax employee contributions to a qualified retirement plan, and contributions to IRAs (regular and Roth). The amount of credit-eligible contributions is reduced by taxable distributions received by the taxpayer (or the taxpayer’s spouse) from qualified retirement plans or IRAs, during a “testing period” extending over more than three years. Credit eligible contributions are also reduced by nontaxable distributions from a Roth IRA.

* The credit may be used to offset AMT liability, as well as regular
tax liability.

b. The 2001 Act amended § 219 to increase the ceiling on deductible contributions to an IRA account to $3,000 for 2002 through 2004, $4,000 for 2005 through 2007, and $5,000 for 2008 and thereafter. Beginning in 2008, the $5,000 ceiling will be adjusted annually for inflation. In addition, taxpayers age 50 and older may deduct an additional $500 of contributions for 2002 through 2005 and an additional $1,000 for 2006 and thereafter.
c. The 2001 Act made a number of changes in the § 530 Education IRA (EIRA) rules that are effective beginning in 2002. First, the annual limit on contributions was increased from $500 to $2,000. Contributions can qualify for a year as long as they are made during the year or during the following year but before the due date of the tax return for the year to which the contribution relates. § 530(f). Second, the phase-out rules in § 530(c) were modified to provide a phase-out range for married taxpayers filing joint returns that is twice the range for single taxpayers. Thus, the phase-out range for married taxpayers filing jointly is between $190,000 and $220,000 of adjusted gross income. The 18-year old age ceiling on the eligible beneficiary was removed in the case of "special needs" children. In addition, § 530(b)(2) was amended to extend the exemption from tax to distributions for qualified elementary and secondary school expenses, including expenses of attending religious elementary and secondary schools and the purchase of family computers. Finally, a taxpayer may both take advantage of the exclusion under §530(d)(2) and claim the HOPE credit or Lifetime Learning Credit under § 25A on behalf of the same student as long as the distributions from the EIRA are not traced to the expenditures with respect to which the credit is claimed. § 25(d)(2)(C)(i). In other words, both benefits are available as long as qualified expenditures for the year equal or exceed the sum of the distributions from the EIRA and the base on which the § 25A credit is calculated.

V. PERSONAL INCOME AND DEDUCTIONS

A. Miscellaneous Income

1. A man's (woman's) home is his (her) tax free castle. REG-105235-99, Exclusion of Gain From Sale or Exchange of a Principal Residence, 65 F.R. 60136 (10/10/00). Prop. Reg. §§ 1.121-1 through 1.121-4 and 1.1398-3 provide guidance regarding the application of the $250,000 / $500,000 exclusion for gain on the sale of the taxpayer's principal residence. There are no surprises.

2. Praise the Lord and pass the Form 1040. Fullman v. Commissioner, T.C. Memo 2000-340 (11/3/00). Fullman received slightly over $11,000, which he did not report, for playing the organ at during services at two different churches. He claimed that he was a "Minister of Music" and play[s] the organ for the glory of God. *** God does not want His church affiliated with the state." Fullman lost.

3. *COD income on reduction in FmHA mortgage could not be avoided by an agreement to recapture the debt reduction should the farm be sold within ten years. Jelle v. Commissioner, 116 T.C. 163 (1/31/01). Taxpayers owned agricultural property subject to outstanding mortgages totaling $269,828 to the Farmers Home Administration (FmHA) that exceeded the $92,057 net recovery value of the property by $177,772. Upon payment of the net recovery value, the FmHA wrote off the remaining loan balance subject to a "net recovery buyout recapture agreement" under which taxpayers agreed to repay the amounts written off in the event they disposed of the land within a 10-year period and issued a Form 1099-C to taxpayers in the amount of $177,772. Taxpayers argued that they did not have COD income until the expiration of the 10-year period. Judge Nims held that taxpayers had immediate COD income under § 61(a)(12) because there was a present cancellation of liability with only "the mere chance of some future repayment." The recapture agreement was held not to be a substitute for taxpayers' former obligation. An accuracy related penalty was upheld because taxpayers did not report any tax liability nor did they disclose the taxpayers' former obligation. An accuracy related penalty was upheld because taxpayers did not report any tax liability nor did they disclose the

4. *Exempt assets are included for purposes of the § 108(d)(3) insolvency definition; the Service had warned about this in TAM 199932013. Carlson v. Commissioner, 116 T.C. 87 (2/23/01). Taxpayers had capital gain in the amount of $28,621 and discharged indebtedness in the amount of $42,142 upon the foreclosure sale of their fishing vessel. They also owned a fishing permit totaling $269,828 to the Farmers Home Administration (FmHA) that exceeded the $92,057 net recovery value of the property by $177,772. Upon payment of the net recovery value, the FmHA wrote off the remaining loan balance subject to a "net recovery buyout recapture agreement" under which taxpayers agreed to repay the amounts written off in the event they disposed of the land within a 10-year period and issued a Form 1099-C to taxpayers in the amount of $177,772. Taxpayers argued that they did not have COD income until the expiration of the 10-year period. Judge Nims held that taxpayers had immediate COD income under § 61(a)(12) because there was a present cancellation of liability with only "the mere chance of some future repayment." The recapture agreement was held not to be a substitute for taxpayers' former obligation. An accuracy related penalty was upheld because taxpayers did not report any tax liability nor did they disclose the COD income for which they received a Form 1099-C. Taxpayers did not contend that any of the statutory exceptions to COD income was applicable.

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intended that exempt assets are not to be excluded from the calculation in determining whether the taxpayer is insolvent for purposes of § 108.

Although an asset of a debtor may be exempt from the claims of creditors under applicable State law, if that asset and the debtor's other assets exceed the debtor's liabilities, the debtor has the ability to pay an immediate tax on income from discharged indebtedness. In the instant case, immediately preceding the foreclosure sale on February 8, 1993, the aggregate fair market value of petitioners' assets was $875,251, which included petitioners' fishing permit valued at $393,400 that they claim is exempt from the claims of creditors under the law of the State of Alaska. At that time, petitioners' liabilities totaled $515,930. On the record before us, we find that petitioners had the "ability to pay an immediate tax on" . . . the $42,142 of DOI income resulting from the foreclosure sale in question. Requiring petitioners to include that income in their gross income for the year at issue and pay a tax thereon is a result that is consistent with the intention of Congress in enacting section 108(a)(1)(B) and related provisions into the Code.

We hold that the word "assets" as used in the definition of the term "insolvent" in section 108(d)(3) includes assets exempt from the claims of creditors under applicable State law. The parties agree that if we were to so hold, petitioners would not be "insolvent" within the meaning of section 108(d)(3), and the insolvency exception of section 108(a)(1)(B) would not apply to the $42,142 of DOI income resulting from the foreclosure sale in question. Consequently, we sustain respondent's determination to include that DOI income in petitioners' gross income for the year at issue. (footnote omitted)

• Of course, taxpayers could have avoided this result by filing a bankruptcy petition and having the indebtedness cancelled in that proceeding.
• An accuracy related penalty was imposed for taxpayers' failure to include the realized capital gain of $28,621 in income.

Exempt assets counted in insolvency determination. TAM 199935002 (5/3/99). The fair market value of any assets exempt from a creditor's claims under state law is included in determining a taxpayer's insolvency under § 108(d). The contrary conclusion reached in TAM 9130005 was revoked.

5. The tax benefit rule found the pea under the walnut shell. Hornberger v. Commissioner, 87 A.F.T.R.2d 2001-877 (4th Cir. 2/15/01) (per curiam, unpublished), aff'g T.C. Memo. 2000-042. A grantor trust established by the sole beneficiary of an estate paid interest on the estate tax owned by the estate, and the beneficiary deducted the interest payment. When a portion of the interest was later refunded to the estate, which distributed it to the beneficiary, who transferred it to the trust, the beneficiary was required to include the refunded interest in income under the tax benefit rule.

B. Profit-Seeking Individual Deductions
1. The alternative minimum tax ("AMT") trap for attorneys' fees on large recoveries. 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

The individual AMT originally was intended to apply primarily to taxpayers with significant economic income who because of tax shelter investments were paying little or no income taxes. Because of numerous amendments to the AMT and the regular income tax provisions over the years, mostly provisions specifically limiting tax-shelter deductions and credits, the individual AMT currently does not significantly affect investors or businesses. Instead it increasingly affects middle-class wage earners—taxpayers not engaged in tax-shelter or deferral strategies. For 1997 five items that are "personal" in nature and not the result of tax planning strategies—personal exemptions, standard deductions, state and local tax deductions, medical expense deductions, and miscellaneous itemized deductions—collectively comprised 73.4 percent of individual AMT preferences and adjustments. Studies indicate that, by 2007, almost 95 percent of the revenue from AMT preferences and adjustments will be derived from the personal exemption, the standard deduction, state and local taxes, and miscellaneous itemized deductions. See Harvey & Tempalski, The Individual AMT: Why It Matters, 50 Nat. Tax J. 468 (1997); Tax Simplification Recommendations
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 various 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). In Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959); Alexander v. IRS, 72 F.3d 938, 96-1 U.S.T.C. §50,011 (1st Cir. 1995), aff’g T.C. Memo 1995-51.

- 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.

  • Attorney’s fees not included in the income of taxpayer who received a large punitive damages award, at least in the Eleventh Circuits (as derived from pre-split Fifth Circuit precedents), under the Golsen rule. Davis v. Commissioner, T.C. Memo. 1998-248 (7/7/98), aff’d, 210 F.3d 1346, 2000-1 U.S.T.C. §50,431 (4/27/00) (per curiam). Willa Mae Davis recovered $152,000 of compensatory damages and $6 million of punitive damages against two companies that made loans to homeowners in Alabama. Her share of the recovery after legal fees and expenses was $3,039,191. In Davis, which was appealable to the Eleventh Circuit, the Tax Court followed Cotnam under the Golsen rule because under Bonner v. City of Prichard, Alabama, 661 F.2d 1206 (11th Cir. 1981), Fifth Circuit decisions rendered before the Eleventh Circuit was created are binding precedent in the Eleventh Circuit.

  • The Eleventh Circuit affirms Davis. The Eleventh Circuit panel held that it was bound by Cotnam. The IRS argued in the alternative that taxpayer made a taxable disposition of her property in [time-barred] 1989, and that the Burnet v. Logan open transaction applied. The court held that Burnet v. Logan applies only when both the asset exchanged and the asset received have an unascertainable value, and “the IRS provided no proof that the values of either the cause of action or the attorneys’ services were unascertainable.”

  • The problem is that those values are unascertainable at the time taxpayer entered into a contingent fee agreement with her counsel. Does §83 apply to the agreement? Yes, as to the lawyer; and yes, as to the taxpayer’s deduction. Would a §83(b) election made at the time of the contingent fee agreement help? No, it would cap taxpayer’s deduction, and it is questionable whether it would cap the amount realized on the exchange. See Gregg D. Polsky, “Taxing Contingent Attorneys’ Fees: Many Courts Are Getting it Wrong,” 89 Tax Notes 917 (November 13, 2000).

b. But, does Cotnam apply to a Fifth Circuit case arising in Texas instead of Alabama? The Tax Court thought no, but it was wrong. Srivastava v. Commissioner, T.C. Memo. 1998-362 (10/6/98), rev’d 220 F.3d 353, 2000-2 U.S.T.C. §50,597 (5th Cir. 7/21/00) (2-1). The Tax Court held that the taxpayers were not entitled to exclude the 40 percent of their settlement proceeds from a personal injury lawsuit that they assigned to their attorneys. Under the Texas common law on attorneys’ liens, no ownership interest was transferred to the attorneys. Judge Parr held that Cotnam v. Commissioner, supra, was inapplicable to this case under the Golsen rule because the Texas common law [giving no ownership rights to the attorneys] differed from the Alabama statutory law ["the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them."]]. The Fifth Circuit Court of Appeals reversed. As a matter of original impression, the majority (Judge Jerry Smith) would have included contingent fees in taxpayer’s gross income under the anticipatory assignment of income doctrine, as are non-contingent attorney’s fees includable in gross income. However, Judge Smith held that Cotnam cannot be distinguished 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.

From ABA, AICPA, and TEI, LEXIS, TAX ANA, 202000 TNT 39-82 (Feb. 28, 2000). Because the individual AMT so widely misses its original mark while adding inordinate complexity to the tax system for middle-class wage earners due to its interaction with limitations on the various personal credits, there is growing sentiment for its repeal, even among tax "reformers" who originally supported the enactment of the individual AMT.
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.

c. Another Circuit frees the taxpayer from the AMT trap for attorney’s fees. Estate of Clarks v. Commissioner, 202 F.3d 854, 2000-1 U.S.T.C. ¶50,158, 85 A.F.T.R.2d 405 (6th Cir. 1/13/00). The Sixth Circuit applied Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959), to hold that the taxpayer was not required to include the portion of the taxable interest attached to a damage award excluded under §104(a)(2) that was paid directly to the taxpayer’s attorney. Although the Sixth Circuit discussed the particularities of the attorney’s fee statutory lien law in Cotnam, the court found the Michigan attorney’s fees common law lien law to be similar to the Alabama law involved in Cotnam. The court stated that it was following Cotnam, and went on to provide an arguably broader explanation for its decision, concluding that the opinions representing the weight of authority, e.g., Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995), inappropriately relied on the assignment of income doctrine cases, e.g., Lucas v. Earl, 281 U.S. 111 (1930) and Helvering v. Horst, 311 U.S. 112 (1940), which, while relevant in family transactions, were not relevant in a arm’s length transaction.

The present transaction under scrutiny is more like a division of property than an assignment of income. Here the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract. Here the lawyer’s income is the result of his own personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation. The income should be charged to the one who earned it and received it, not as under the government’s theory of the case, to one who neither received it nor earned it. The situation is no different from the transfer of a one-third interest in real estate that is thereafter leased to a tenant.

d. Tax Court: Wisconsin attorney’s fees subject to the AMT trap because of assignment of income doctrine. Tax Court majority holds that it was Congress’s doing; dissents state that courts can cure the problem. Kenseth v. Commissioner, 114 T.C. 399 (5/24/00) (reviewed, 8-5). The Tax Court adheres to its holdings that contingent attorney’s fees paid in an age discrimination settlement are includible in taxpayer’s gross income. Judge Ruwe specifically declined to follow the Sixth Circuit’s Estate of Clarks case, and held that taxpayer had income that he could not assign. Judge Chabot dissented on the ground that the assignment of income doctrine was court-made, so the court could grant relief. Judge Beghe (who tried the case) dissented on the ground that taxpayer lacked control over the attorney’s share, so it would not be reasonable to include it in his income.

e. And the Seventh Circuit gives no relief either. Affirmed, 88 A.F.T.R.2d 5376 (7th Cir. 8/7/01). The Seventh Circuit affirmed the Tax Court decision.

[Kenseth] concedes as he must that had he paid the law firm on an hourly basis, the fee would have been an expense. It would have been a deduction from, not a reduction of, his gross income ***. We cannot see what difference it makes that the expense happened to be contingent rather than fixed. If a firm pays a salesman on a commission basis, the sales income he generates is income to the firm and his commissions are a deductible expense, even though they were contingent on his making sales. Of course there is a sense in which contingent compensation constitutes the recipient a kind of joint venturer of the payor. But the plaintiff concedes, as again he must, that Wisconsin law does not make the contingent-fee lawyer a joint owner of his client’s claim in the legal sense any more than the commission salesman is a joint owner of his employer’s accounts receivable. ***

There is nothing exotic about this analysis—nothing, indeed, that depends on the particular contractual setting, that of a contingent-fee contract with a lawyer, out of which this case arises. The settlement of Kenseth’s age-discrimination suit against his former employer presumably replaced lost income, which would have been taxable; and many of the expenses of producing that income, such as the cost of commuting, would not have been deductible. So incomplete deductibility here is not surprising or anomalous or inappropriate. We mentioned the commissioned salesman; consider now
the operation of a construction business. All receipts are counted as gross income, and
outlays to subcontractors and materialmen are deductible, even though these
subcontractors have liens on the work and even though the general contractor could say
that he just "assigns" a part of the job to the sub. ***

Enough; for in any event it is not a feasible judicial undertaking to achieve global equity
in taxation *** especially when the means suggested for eliminating one inequity (that
which Kenseth argues is created by the alternative minimum income tax) consists of
creating another inequity (differential treatment for purposes of that tax of fixed and
contingent legal fees). And if it were a feasible judicial undertaking, it still would not be
a proper one, equity in taxation being a political rather than a jural concept. Indeed the
cases that reject the Tax Court's position seem based on little more than sympathy for
taxpayers. *** [The Cotnam] rationale badly flunks the test of neutral principles. It is
often the case that to obtain income from an asset one must hire a skilled agent and pay
him up front; that expense is a deductible expense, not an exclusion from income.

f. And the Ninth Circuit springs the trap: Alaska statutory lien law
requires entire recovery to be included in taxpayer's gross income. Coady v. Commissioner, 213
F.3d 1187, 2000-1 U.S.T.C. ¶50,528 (9th Cir. 6/14/00). Attorneys' fees awarded on a wrongful
termination suit under Alaska law do not reduce the amount includable in taxpayer's income. Instead, the
attorneys' fees are deductible as miscellaneous itemized deductions. The court refused to follow Cotnam
v. Commissioner, 263 F.2d 119 (5th Cir. 1959), and Clarks v. United States, 202 F.3d 854 (6th Cir.
2000), but chose instead to follow Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995), and Alexander
v. IRS, 72 F.3d 938 (1st Cir. 1995). Alaska's statutory attorney's lien provisions do not create a superior
lien or ownership interest in the cause of action - as they do in Alabama and Michigan - but specifically
subordinates the lien to "the rights existing between the parties to the action or proceeding." Accord
Benci-Woodward v. Commissioner, 219 F.3d 941, 2000-2 U.S.T.C. ¶50,595 (9th Cir. 7/18/00) (The
portion of a taxable damage award retained by the taxpayer's attorney as a contingent fee under
California attorney's fee lien law was includable in taxpayer's income, following Coady. The Sixth
Circuit decision in Estate of Clarks was distinguished on the grounds of the different attorney's fee lien
law involved there and the inherent conflict with Estate of Clarks was ignored.).

g. Fourth Circuit joins the Tax Court, Ninth, and First. Gross income
includes attorney's fees. 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'g, 113 T.C. 152 (8/20/99). A former husband defaulted on a
$1.5 million promissory note given his former wife in a divorce settlement in 1989 and satisfied a
judgment on the note by transferring real estate, which he had received in the original divorce, to his
former wife in 1992. The value of the real estate equaled the sum of the principal of the note, accrued but
unpaid interest, the wife's attorney's fees, and certain costs. The Tax Court held that under Old Colony
Trust Co., 279 U.S. 716 (1929), the wife recognized gross income equal to the value the property
attributable to her attorney's fees and costs. In affirming the Tax Court's decision, the Court of Appeals
for the Fourth Circuit rejected Mrs. Young's argument that it should follow the reasoning of Cotnam v.
Commissioner, 263 F.2d 119 (5th Cir. 1959), to exclude the amount, noting that only the Sixth Circuit in
Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000), has followed Cotnam and expressly
joined the circuits that have rejected Cotnam.

h. The Eleventh Circuit applies Cotnam in another Alabama case.
We're still waiting to hear what the Eleventh has to say if the case arises in Georgia or Florida.
Foster v. United States, 87 A.F.T.R.2d 2011 (11th Cir. 4/10/01), rev'd, 2000-1 U.S.T.C. ¶50,353, 85
A.F.T.R.2d 1649 (N.D. Ala. 3/13/00). Taxpayer received a favorable jury verdict that included
$1,000,000 of [taxable] punitive damages. Under an Alabama statute, the trial judge reduced the punitive
damage award to $250,000, which was later restored to $1,000,000 when the statute was found to be
unconstitutional. Taxpayer had agreed to pay her attorney a contingent fee of 50% for the trial. For the
appeal, the contingent fee arrangement was amended to treat all post-judgment interest collected as an
additional contingent fee.

• The district court held that under Cotnam [263 F.2d 119 (5th Cir. 1959)], the taxpayer could treat the originally agreed upon contingent as excluded from gross income and received directly by the attorney, but the post judgment interest paid as the additional contingent fee was includable in gross income and deductible under §212. At the point that contingent fee arrangement was
negotiated, the taxpayer's claim, which had been upheld by the jury, had value and the "uncertainties" of the appellate process were not sufficient to displace the applicability of the assignment of income principles.

The Court of Appeals affirmed the District Court except with respect to the post judgment interest paid as the additional contingent fee. The Court of Appeals held that the post-judgment agreement was analogous to a pretrial contingency fee agreement, and thus, because the case arose in Alabama, under Cotnam the interest retained by the attorney as the fee was not includable in the taxpayer's gross income. The taxpayer was entitled to her litigation costs under §7430 because the IRS was not substantially justified in litigating the issue in the Eleventh Circuit on the basis of attempting to overturn Cotnam as wrongly decided.

2. Who says it's a “net” income tax? What happened to those §212 deductions? Mellon Bank, N.A. v. United States, 47 Fed. Cl. 186, 2000-2 U.S.T.C. ¶50,642, 86 A.F.T.R.2d 5321 (Fed. Cl. 7/17/00). Investment advisor's fees incurred by a trust are excluded from the §67 haircut on miscellaneous itemized deductions only if the expenses "would not have been incurred if the property were not held in such trust. The Court of Federal Claims (Judge Andewelt) reached a conclusion similar to that of the Tax Court and contrary to the Sixth Circuit in William J. O’Neill Revocable Trust v. Commissioner, 98 T.C. 227 (1992) (investment adviser fees paid by irrevocable trust are not “administration fees” excluded from §67 disallowance rules by §67(e)), rev’d, 994 F.2d 302 (6th Cir. 1993) (investment adviser’s fees that would not have been incurred if property had not been held in trust are not subject to 2 percent floor pursuant to §67(e)). Nevertheless the Court of Federal Claims declined to grant summary judgment for the government because it would not take judicial notice of the fact that individuals often pay investment advisory fees.

a. Bet you the bank won’t use this concession in its advertising. 86 A.F.T.R.2d 6432 (Cl. Ct. 9/18/00). On further proceedings, summary judgment was granted to the government because the taxpayer stipulated that its evidence would not meet the requisite legal standard to prevail.

b. Affirmed. Now there's a split in the circuits. 2001-2 U.S.T.C. ¶50,621, 88 A.F.T.R.2d 5800 (Fed. Cir. 9/7/01). The Federal Circuit (Judge Meyer) rejected the taxpayer’s argument that investment advisory fees are deductible to a trust without regard to the two percent floor of § 67 because they are occasioned by the trustee fulfilling its fiduciary duty. The court reasoned 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 “focuses not on the relationship between the trust and costs, but the type of costs, and whether those costs would have been incurred even if the assets were not held in a trust.” Only those trust-related administrative expenses “that are unique to the administration of a trust and not customarily incurred outside of trusts” are fully deductible. The court concluded that the plain language of the statute compelled the result, and found nothing to the contrary in the legislative history.

3. Not so smarty after all. Geary v. Commissioner. 235 F.3d 1207, 2001-1 U.S.T.C. ¶50,162, 86 A.F.T.R.2d 7357 (9th Cir. 12/27/00). A San Francisco police officer incurred expenses to put an initiative on the local ballot that would allow him to patrol his beat in North Beach using a ventriloquist’s dummy to assist in breaking down language / cultural barriers in the neighborhood. The dummy’s name was “Puppet Officer Brendan O’Smarty.” Apparently Geary’s supervisors ordered him to stop using the puppet “because it makes the department look stupid.” So Geary took the issue directly to San Francisco voters – and won. The expenses were disallowed under §162(e)(1)(C) as nondeductible lobbying expenses (i.e., this provision disallows business deductions for expenses incurred “in connection with any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums”).

4. Loose lips sink ships. O’Connell v. Commissioner, T.C. Memo 2001-158 (6/29/01). The taxpayer was an insurance agent; he also was an avid fisherman who particularly enjoyed billfish (e.g., marlin, and sailfish) tournaments. His S corporation, which owned and occasionally chartered out an ocean going fishing yacht which was used primarily for sport fishing by the taxpayer, lost approximately $1.4 million over seven years. The losses were disallowed under §183. Notably the court quoted an interview the taxpayer gave for MARLIN magazine, in which he stated:

You have to be in competitive offshore fishing for the sport * * * not the money.
What you win could never cover the expenses. That’s just a drop in the bucket! * * * If you’re in tournament fishing for the money, you’ll go broke.* * *
In my mind, it is inconceivable to make any money at tournament fishing ** *. This is strictly a sport. If a guy only fished one or two tournaments in a year and he won one of them, then he might end up in the black for that year ** *. If you fish them a lot, though, it is really tough.

Nuf said!

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

1. It doesn’t have to be fun to be a hobby. Dirks v. Commissioner, T.C. Memo 2000-356 (11/15/00). Taxpayers’ [public school teacher and nurse] apiary and tree-farming activities that were conducted in an unbusinesslike manner and consistently produced losses were not conducted for profit even though taxpayer derived no personal pleasure or recreation from the activities.

2. Music may be a spirit without space, but the space in which it is created is deductible. Popov v. Commissioner, 246 F.3d 1190, 2001-1 U.S.T.C. ¶ 50,353, 87 A.F.T.R.2d 1735 (9th Cir. 4/17/01). The taxpayer was allowed a home office deduction for the portion of the rent on her one bedroom apartment (which was occupied by the taxpayer, her husband and four-year-old child) attributable to the living room because the living room was used exclusively to practice the violin in connection with her work as a professional violinist for orchestras and recording studios. The court found that her living room was her principal place of business under the Soliman [506 U.S. 168 (1993)] test. The “point of delivery” test does not apply to professional musicians because, quoting the German poet Heinrich Heine, “music stands ‘halfway between thought and phenomenon, between spirit and matter, a sort of nebulous mediator, like and unlike each of the things it mediates – spirit that requires manifestation in time, and matter that can do without space.’” Since most of the taxpayer’s time was spent practicing in her living room – where of course her four-year-old daughter never never got underfoot – that was her principal place of business and the deduction was allowed under § 280A.

D. Deductions and Credits for Personal Expenses

1. Is the EITC welfare or is it a tax refund? It matters in bankruptcy. Wood v. Jones (In re Montgomery), 224 F.3d 1193, 2000-2 U.S.T.C. ¶50,865, 86 A.F.T.R.2d 6007 (10th Cir. 9/11/00), aff’g In re Montgomery, 219 B.R. 913, 98-1 U.S.T.C. ¶50,389, 81 A.F.T.R.2d 1649 (BAP 10th Cir. 4/21/98). As a result of the advance availability of the EIC under §3507, even if a taxpayer does not claim advance credits under that provision, a refund attributable to the taxpayer’s EIC upon filing a tax return can become part of the taxpayer’s bankruptcy estate for the portion of the year to which the EIC relates that was prior to the date the taxpayer filed for bankruptcy.

2. Deduction and credit provisions in the 2001 Act include:

a. For 2001 through 2004, the 2001 Act increased the alternative minimum tax exemption amount to $35,750 for single taxpayers and $45,000 for married taxpayers filing joint returns.

b. The 2001 Act made amended § 137 (the exclusion for employer provided benefits under an adoption assistance program) to make it a “permanent” provision, subject, however, to sunset in 2011 like all of the other provisions of the 2001 Act. In addition, the ceiling on the exclusion was increased to $10,000, subject to an annual inflation adjustment. The phase-out rule was amended to begin the phase-out when the employee’s adjusted gross income exceeds $150,000, subject to an annual inflation adjustment. Apart from the inflation adjustment, the exclusion is completely phased out when the employee’s adjusted gross income exceeds $190,000.

c. The 2001 Act added a special deduction for qualified tuition and related expenses in § 222. Section 222 operates completely independently of the rules of Reg. § 1.162-5 and is intended primarily to provide a deduction for parents who pay college tuition for their dependent children. The deduction is available to students who are not claimed as dependents by another taxpayer and pay their own tuition. See § 222(c)(3). The deduction is limited to tuition and related academic fees and does not extend to room and board. See § 222(d)(1), cross referencing to § 25A(g)(2). As is true with respect to the other tax expenditure provisions intended to subsidize higher education expenses, the deduction is not available for high-income taxpayers. Unlike most other tax expenditure benefits, which are phased-out over an income range, however, the § 222 deduction is subject to a cliff-effect disallowance rule. For 2002 and 2003, the maximum deduction is $3,000 for single taxpayers whose

Note: Heine left his estate to his wife on condition that she remarry, explaining in his will that as a consequence “there will be at least one man to regret my death.” His last words were, “Of course God will forgive me; that’s His job.”
adjusted gross income does not exceed $65,000 and for married taxpayers filing a joint return whose gross income does not exceed $130,000. Taxpayers whose adjusted gross income exceeds those ceilings may not claim any deduction whatsoever. For 2004 and 2005, a maximum deduction of $4,000 is allowed for single taxpayer whose adjusted gross income does not exceed $65,000 and for married taxpayers filing a joint return whose gross income does not exceed $130,000. A maximum deduction of $2,000 is allowed for single taxpayers whose adjusted gross income does not exceed $80,000 and for married taxpayers filing a joint return whose gross income does not exceed $160,000. Taxpayers whose adjusted gross income exceeds the applicable $80,000 or $160,000 ceiling may not claim any deduction. Section 222(c) provides elaborate rules designed to deny the deduction if the taxpayer claims the $ 25A HOPE scholarship or lifetime learning credit. Section 222(c) also reduces the deduction by any exclusions under § 135, text page 344, § 529, text page 1214, or § 530, text page 342. The § 222 deduction is allowed in reducing gross income to adjusted gross income; a taxpayer is not required to itemize deductions to claim the § 222 qualified tuition deduction. Section 222 sunsets completely after 2005.

d. Personal Income Phaseout (PEP) is itself phased-out from 2006 through 2010. The 2001 Act amended § 151 to phase-out over time the reduction of the amount allowable as personal exemptions under § 151(d) to increasingly lesser percentages — to 2/3 of the base formulaic reduction amount in 2006 and 2007 and 1/3 of the base formulaic reduction amount in 2008 and 2009. The reduction of personal exemptions is completely eliminated in 2010. See I.R.C. § 151(d) and (f). Like all of the amendments in the 2001 Act, however, these changes sunset on December 31, 2010. Thus, absent further congressional action § 151(d) would be revived in its current form in 2011.

e. Marriage penalty relief: the standard deduction. The 2001 Act increases the basic standard deduction for married couples filing a joint return to twice the basic standard deduction for unmarried individuals filing a single return. The effective date of the increase is delayed to 2005 and even then it is phased in over five years, with the result that the full effect of the change will not be in force until 2009. Like all of the other amendments to the Code in the 2001 Act, however, these changes sunset on December 31, 2010.

f. Marriage penalty relief: the 15 percent bracket. The 2001 Act increased the width of the 15 percent rate bracket for married couples filing jointly relative to unmarried individuals filing a single return. The upper limit of the 15 percent bracket for married couples filing a joint return will be double upper limit of the 15 percent bracket for unmarried individuals filing a single return. The effective date is delayed to 2005, and then it is phased in over five years, with the result that the full effect of the changes will not be in force until 2009. Like all of the other amendments to the Code in the 2001 Act, however, these changes sunset on December 31, 2010.

g. Pease phase-out. The 2001 Act amended § 68 to phase-out the reduction in itemized deductions to increasingly lesser percentages — to 2/3 of the base formulaic amount in 2006 and 2007 and 1/3 of the base formulaic amount in 2008 and 2009 — before eliminating the operation of § 68 completely in 2010. See § 68(f) and (g).

h. Child credit increased, made partially refundable, and made creditable against both regular tax and AMT. The amount of the credit was increased to $600 for taxable years 2001 through 2004, and is scheduled to increase in steps to $1,000 for 2010.

• The 2001 Act amended § 24 to provide for partial refundability of the child credit in 2001 through 2010. For 2001 through 2004, the credit is refundable to the extent of ten percent of the taxpayer’s income in excess of $10,000 (indexed for inflation beginning in 2002). I.R.C. § 24(d)(1)(B)(i). For 2005 through 2010, the percentage increases to 15 percent. Section 24(d) continues to allow families with three or more children a refundable child credit equal to amount by which social security taxes exceed the sum of nonrefundable credits and the earned income credit if that amount exceeds the amount otherwise refundable. I.R.C. §24(d)(1)(B)(ii).

• The child credit has been amended to be creditable against both the regular tax and the alternative minimum tax. See § 24(b)(3)

i. Earned income tax credit (EITC). The 2001 Act made a number of changes in the earned income tax credit. First, the “modified gross income concept” in § 32(a)(2)(B), upon which the phase-out is based, was eliminated and the phase-out is based simply on adjusted gross income. This is a major simplification. Second, the “marriage penalty” imposed by triggering or accelerating the phase-out when an eligible taxpayer married and filed a joint return with a spouse who had income that affected the phase-out was mitigated somewhat by the addition of § 32(b)(2)(B), which provides higher thresholds for triggering the phase-out on joint returns than on single and head of
household returns claiming the credit.\textsuperscript{12} The "earned income" base for the credit is now limited to earned income that is included in gross income. § 32(c)(2)(A).

- The 2001 Act simplified the definition of "qualifying child" by broadening the relationships that qualify. In addition to a child, grandchild, stepchild, or foster child, brothers, sisters, step brothers and sisters, and descendants of any of them can qualify if the taxpayer cares for the person as the taxpayer's own child. § 32(c)(3)(B).

j. The deadline for establishing an Medical Savings Account has been extended to 2002. Section 62(a)(18) was added by the 2001 Act to allow a deduction for contributions to an MSA by a taxpayer who does not itemize deductions.

k. The 2001 Act amended the § 221 deduction for interest on educational loans in two significant respects. First, § 221(d), which limited the availability of the deduction to interest paid for the first sixty months of the loan repayment period, was repealed. Second, the phase-out range under § 221(b) was increased. For years after 2001, the deduction is phased out for single taxpayers whose "modified" adjusted gross income exceeds $50,000 and for married taxpayers filing a joint return whose modified gross income exceeds $100,000. The deduction is completely phased out for single taxpayers whose modified adjusted gross income exceeds $65,000 and for married taxpayers filing a joint return whose modified adjusted gross income exceeds $130,000. These phase-out thresholds continue to be indexed for inflation after 2001. See §221(g).

3. Starting in 2003, the 2001 Act increased the § 21 dependent care credit percentage to 35 percent of eligible expenses. The Act also increased the ceiling amount of employment-related expenses that qualify for the credit to $3,000 if there is only one qualifying individual or $6,000 if there are two or more qualifying individuals in the household. The maximum dependent care credit thus is $1,050 in the case of one qualifying individual and $2,100 in the case of two or more qualifying individuals. Under the 2001 Act, the reduction in the credit begins at $15,000 of adjusted gross income rather than $10,000. Thus, a taxpayer with more than $38,000 of adjusted gross income is entitled to a credit of only 20 percent of employment-related qualifying expenses.

4. The 2001 Act made the § 23 adoption credit a “permanent” provision, subject to sunset after 2010 like all of the other provisions of the 2001 Act. In addition, the 2001 Act increased the ceiling on the credit to $10,000, subject to an annual inflation adjustment. Starting in 2003, a $10,000 (as adjusted for inflation) credit is allowed with respect to the adoption of a "special needs" child even if no qualified adoption expenses have been incurred. § 23(a)(1)(B).

- The 2001 Act amended §23(b)(2) to begin the phase-out of the adoption credit at an adjusted gross income of $150,000, subject to an annual inflation adjustment. Apart from the inflation adjustment, it is now completely phased out when adjusted gross income exceeds $190,000.

VI. CORPORATIONS

A. Entity and Formation

1. No more double-counting § 357(c) gains in basis. P.L. 106-36, the Miscellaneous Trade and Technical Corrections Act of 1999 amended § 357(c) and added new § 357(d) to provide statutory rules for determining when and the extent to which a debt of the transferor has been assumed by the transferee corporation for purposes of determining both the transferor’s gain under § 357(c) and the corporate transferee’s step-up in basis under § 362(a) that results from the transferor’s recognition of gain. For a recourse debt, the debt has been assumed only if, based on all the facts and circumstances, the transferee corporation has agreed to pay the debt regardless of whether or not the transferor shareholder has been relieved of liability viz-a-viz the creditor. The transferee corporation is treated as assuming any nonrecourse debt encumbering property it receives, but the amount of the debt assumed is reduced by the lesser of (1) the amount of the debt secured by assets not transferred to the corporation that another person or corporation has agreed to (and is expected to) satisfy, or (2) the fair market value of the other assets secured by the debt. These rules limit the increased basis to the fair market value of the property transferred. Abuses had resulted where properties subject to liabilities were transferred to different corporations, with the result that both corporations increased basis by the same liabilities. This amendment is applicable to transfers made after 10/18/98.

\textsuperscript{12} The beginning and end of the phase-out range is increased by $1,000 in 2002, 2003 and 2004, by $2,000 in 2005, 2006 and 2007, and by $3,000 for years after 2007.
a. The Community Renewal Tax Relief Act of 2000 added new § 358(h), which provides special rules for assumption of liabilities to which § 358(d) does not apply and prevents duplication of loss through assumption of liabilities giving rise to a deduction. Section 358(h) is applicable to assumptions of liability after October 18, 1999, or such later date as may be provided in comparable rules applicable to partnerships and S corporations to be prescribed.

2. T.D. 8936, Definition of Contribution in Aid of Construction Under Section 118(c), 66 F.R. 2252 (1/11/01). Final Reg. § 1.118-2, deals with the exclusion from gross income of qualified contributions in aid of construction received by a regulated public utility that provides water or sewage services.

3. Read the dictum; the 1999 amendments to §§ 357(c) and 358(d) wouldn’t have changed the result. Seggerman Farms, Inc. v. Commissioner, T.C. Memo. 2001-99 (4/25/01). The Tax Court (Judge Cohen) held that § 357(c) requires gain recognition when the liabilities assumed by the corporation exceed the transferor shareholder’s basis in the property even if the transferor remains liable as a guarantor. Although the case arose prior to the 1999 amendments to § 357(c) and (d), the court noted that the result would not be different under the current statute. The court stated:

In 1999, Congress enacted changes to section 357(c) that were effective for transactions occurring after October 18, 1998. See Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. 106-36, sec. 3001(e), 113 Stat. 127, 184. The amendment struck the words “plus the amount of liabilities to which the property is subject,” from section 357(c)(1) and essentially provided relief for the taxpayer who transferred assets subject to liabilities and remained personally liable on the debt, but where the corporation did not assume the liability. Id. sec. 3001(d)(4), 113 Stat. 182. Congress also added section 357(d), which provides guidance in determining the amount of liabilities that are assumed and states in section 357(d)(1)(A) that “a recourse liability (or portion thereof) shall be treated as having been assumed if * * * the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability”. Id. sec. 3001(b), 113 Stat. 182.

The 1999 amendment does not apply to these cases, because the transactions in these cases occurred in 1993. Even if section 357(d)(1)(A) as enacted in 1999 did apply, petitioners’ personal liability on the debt that was transferred to the corporation would continue [sic] to be irrelevant. Even after congressional amendments to section 357, Congress has refrained from providing relief to taxpayers in petitioners’ situation.

B. Distributions and Redemptions

1. T.D. 8924, Liabilities Assumed in Certain Corporate Transactions, 66 F.R. 723 (1/3/01). Temp. Reg. § 1.301-1T(g) applies rules similar to those of § 357(d) [for determining when a liability is assumed] for purposes of determining when the amount of a distribution will be reduced under § 301(b). [Identical proposed regulations in REG-106791-00 (1/3/01).] A recourse debt has been assumed only if, based on all the facts and circumstances, the transferee has agreed to pay the debt regardless of whether or not the transferor has been relieved of liability vis-à-vis the creditor. A transferee is treated as assuming any nonrecourse debt encumbering property it receives, but the amount of the debt assumed is reduced by the lesser of: (1) the amount of the debt secured by assets not transferred that another person or corporation has agreed (and is expected to) satisfy, or (2) the fair market value of the other assets secured by the debt.

2. *E&P is more than just an esoteric accounting concept. Rev. Rul. 2001-1, 2001-9 I.R.B. 726 (2/26/01). Corporate E&P is reduced to reflect the corporation’s deduction under §§ 83(h) and 162 when an employee receives stock upon exercise of a nonstatutory stock option. Because this item reduces earnings and profits, § 56(g)(4)(C)(i) does not disallow the deduction of the item in computing adjusted current earnings for AMT purposes.

3. Not only did the corporation not get a bad debt deduction, but the controlling shareholder had dividend income. Purported loans between sibling corporations were really constructive dividends. Shedd v. Commissioner, T.C. Memo 2000-292 (9/18/00). Mr. & Mrs. Shedd each owned 50% of the stock of J&J and Mr. Shedd owned 100 percent of the stock of TLC, both of which were engaged in the freight-forwarding business. J&J advanced over $100,000 to TLC, which
never repaid the advances. The Tax Court (Judge Gerber) not only denied J&J a bad debt deduction because the advances served no corporate business purpose, but also treated the transaction as a constructive dividend to Shedd and a contribution by him to TLC.

4. **Don't you forget it! Section 304 trumps § 351.** Combrink v. Commissioner, 1116 T.C. No. 24 (5/15/01), withdrawn and reissued 117 T.C. No. 8 (8/23/01). The taxpayer owned all the stock of two corporations, Cost Oil and Links Investments. Over a number of years, Cost Oil had lent the taxpayer approximately $175,000. The taxpayer, in turn, had lent approximately $89,000 of that amount, plus an additional $163,000, to Links Investments, which made book entries of accounts payable to the taxpayer and issued promissory notes to him. Subsequently, approximately $175,000 of the loan from the taxpayer to Links Investments was converted to additional paid-in capital (without the issuance of any shares) and the corporate indebtedness of Links Investments to the taxpayer was reduced to approximately $77,000. Shortly thereafter, the taxpayer transferred all his stock in Links Investments to Cost Oil in exchange for Cost Oil discharging him from his $175,000 debt obligation. The Tax Court (Judge Nims) held that the transfer of the Links Investments stock to Cost Oil in exchange for Cost Oil’s release of the taxpayer’s indebtedness was a redemption and a distribution of property under §§ 304 and 317(a). The taxpayer argued that the exception in § 304(b)(3)(B) applied because the transfer could be treated as a § 351 transaction in which Cost Oil “assumed” the taxpayer’s debt to Cost Oil and the debt was traceable to his acquisition of stock in Links Investments. Judge Nims granted him only limited relief. The court accepted the recapitalization as establishing that $174,000 was used to acquire Links Investment stock within the meaning of § 304(b)(3)(B)(i). But because the $89,000 of the assumed liability from the taxpayer to Cost Oil that was traceable to the taxpayer’s investment in Links Investments exceeded the $77,000 debt from Links Investment to Cost Oil that continued to remain outstanding after the transaction, only $12,000 of the $174,000 debt “assumed” by Cost Oil had been used to acquire stock or equity in Links Investment. Thus, because the taxpayer was the sole stockholder before and after the transfer, $161,000 of the discharged / assumed debt from the taxpayer to Cost Oil was characterized as a dividend under §§ 302(d) and 301.

C. **Liquidations**

1. REG-110659-00, Proposed Regulations, Amendment, Check the Box Regulations, 66 F.R. 3959 (1/16/01). Prop. Reg. § 301.7701-3(g)(2)(ii) would provide that if an unincorporated entity that previously had elected to be taxed as a corporation elects to convert to a partnership, it is treated as distributing all of its assets to its shareholders in a taxable liquidation, followed by the contribution of all the assets to a newly formed partnership. If the entity elects to convert from a corporation to a disregarded entity, it is deemed to have distributed its assets to its owner. Sections 332 and 337 can apply if the owner is a corporation. To facilitate application of § 332, the proposed regulations provide that a plan of liquidation is deemed to have been adopted immediately before the deemed liquidation resulting from the election to change entity classification, unless a formal plan of liquidation that contemplates the filing of the elective change was adopted at an earlier date.

D. **S Corporations**

1. **Cancellation of indebtedness income of insolvent S corporations**

   a. “Because the Code’s plain text permits the taxpayers here to receive these benefits, we need not address this policy concern [“that, if shareholders were permitted to pass through the discharge of indebtedness income before reducing any tax attributes, the shareholders would wrongly experience a ‘double windfall’”].” Gitlitz v. Commissioner, 121 S. Ct. 701, 2001-1 U.S.T.C. ¶50,147, 87 A.F.T.R.2d 417 (1/9/01). Gitlitz and Winn each owned 50 percent of the stock of an S corporation that realized $2,021,096 of COD income. At that time the corporation was insolvent to the extent of $2,181,748. Thus all of the COD income was excluded under § 108(a)(1)(B). Both shareholders had carried losses that had been suspended under § 1366(d)(1) as well as operating losses that would be further suspended unless the excluded COD income increased their basis in their stock under § 1367(a)(1).

   b. **The Tax Court followed its reviewed decision in Nelson v. Commissioner, 110 T.C. 114 (1998), aff'd, 182 F.3d 1152 (10th Cir. 7/6/99), which held that a shareholder of an insolvent S corporation may not increase his stock basis under §§ 1367(a)(1)(A) and 1366(a)(1)(A) by the amount of his pro rata share of the corporation’s [excluded under § 108(a)] discharge of indebtedness income on the theory that the COD income was passed-through exempt income. The Tax Court agreed with the IRS that § 108(d)(7)(A) requires that the exclusion of income applies at the S corporation level, so that the reduction of tax attributes applied by § 108(b) also applies at the corporate level and the discharge of indebtedness income never passes through to the shareholder.**
Section 108, through the attribute reduction rules, is generally intended to defer the recognition of income, not to exempt it totally from income.

c. Affirmed. 182 F.3d 1152, 99-2 U.S.T.C. ¶50,646, 84 A.F.T.R.2d 5067 (10th Cir. 8/6/99). The Court of Appeals for the Tenth Circuit affirmed, but on different reasoning. It assumed that the COD income was “tax exempt income” under § 1366(a)(1)(A) that potentially could pass through to the shareholders and increase basis. [In 7] The court agreed with the Commissioner and the Tax Court, however, that § 108(d)(7)(A) requires that the exclusion of income applies at the S corporation level, so that the reduction of tax attributes applied by § 108(b) also applies at the corporate level and the discharge of indebtedness income never passes through to the shareholder. The court further concluded that § 108(d)(4)(A) merely requires that attribute reduction is the last step in the calculations; it does not necessarily defer the attribute reduction until the year following the year in which the excluded COD income is realized. Thus, there was no corporate level income to pass through to the shareholders and to increase their basis. Furthermore, the reduction in tax attributes under § 108(b) absorbed the shareholders losses carried over from prior years under § 1366(d)(1).

d. *Reversed – A total victory for the taxpayers.* The Supreme Court, in an 8-1 decision by Justice Thomas, held that the statute’s plain language establishes that COD income realized by an insolvent S Corporation that is excluded under § 108(a) is an item of tax-exempt income that passes through to shareholders under § 1366(a)(1)(A) and increases their bases in the S corporation’s stock under § 1367. Furthermore, the pass-through occurs before the reduction of the S corporation’s tax attributes under § 108(b), and thus shareholder’s carried-over losses [which § 108(d)(7)(B) treats as a corporate NOL for purposes of § 108(b)] to the year in which the COD occurs may be deducted against the basis increase without reduction in that year. Any suspended losses remaining then will be treated as the S corporation’s net operating loss and reduced by the discharged debt amount.

- Justice Breyer dissented and would have held that § 108(d)(7)(A) [applying § 108(a), (b), (c), and (g) at the corporate level precludes any pass through of COD income realized by an insolvent S corporation. In response to the majority’s last paragraph, he stated, “it is ... difficult to see why, given the fact that the “plain language” admits either interpretation, we should ignore the policy consequences ... The arguments from plain text on both sides here produce ambiguity, not certainty. And other things being equal, we should read ambiguous statutes as closing, not maintaining, tax loopholes. Such is an appropriate understanding of Congress’ likely intent.”

- *And the reasoning of the opinion should partially invalidate Reg. § 1.1366-1(a)(2)(viii). As part of its effort to deal with this issue, in T.D. 8852, 64 F.R. 71641 (12/22/99), the Treasury amended Reg. § 1.1366-1(a)(2)(viii) to provide that COD income excluded at the corporate level under § 108 is not “tax exempt” income for purposes of §§ 1366 and 1367. Although the opinion is not a model of clarity, the last sentence states that “the Codes’ plain text permits the taxpayers here to receive these benefits.” This would indicate that the Treasury has no power to alter the result by regulation. But at another point, integral to the analysis the opinion states: “This section [§ 1366] expressly includes ‘tax-exempt’ income, but this inclusion does not mean that the statute must therefore exclude ‘tax-deferred’ income. The section is worded broadly enough to include any item of income, even tax-deferred income, that ‘could affect the liability for tax of any shareholder.’” This language is not nearly so definitive as to the clarity of the statutory language and leaves open the possibility that the courts might not invalidate the regulation. But we doubt it.

2. S corporations aren’t always corporations. Rev. Rul. 2000-43, 2000-41 I.R.B. 333. An accrual-method S corporation may not elect under § 170(a)(2) to treat a charitable contribution as paid in the year authorized by the S corporation’s Board of Directors if the contribution is paid by the S corporation after the close of the taxable year. Section 1363(b) requires S corporations to compute taxable income in the same manner as individuals [to whom § 170(a)(2) does not apply].

3. When Subchapter S and Subchapter K collided, the aggregate theory of partnership taxation was applied. Coggin Automotive Corp. v. Commissioner, 115 T.C. 349 (10/18/00), on appeal to the 11th Circuit. Taxpayer originally was a holding company that had a number of controlled subsidiaries engaged in the retail sale of motor vehicles. The subsidiaries maintained their inventories under the LIFO method, and all of the corporations filed a consolidated return. In 1993, the taxpayer restructured to make an S election. Six new S corporations were formed to become the general partners in six limited partnerships. Each subsidiary contributed its dealership assets to a limited partnership in exchange for a limited partnership interest, following which the subsidiaries were liquidated and the taxpayer became the limited partner in each. The Commissioner asserted that the taxpayer’s conversion to an S corporation triggered the inclusion of the affiliated group’s pre-S-election LIFO reserves (approximately $5 million) under § 1363(d). The Commissioner argued alternatively (1)
that the restructuring should be disregarded because it had no purpose independent of tax consequences, and that (2) under the aggregate approach to partnerships, a pro rata share of the pre-S-election LIFO reserves (approximately $4.8 million) was attributable to the taxpayer as a partner. The Tax Court (Judge Jacobs) rejected the Commissioner’s first argument, holding that the restructuring was a genuine multiple-party transaction with economic substance, compelled by business realities and imbued with tax-independent considerations. But Judge Jacobs accepted the Commissioner’s second argument, holding that application of the aggregate approach [rather than the entity approach] to partnership taxation furthered the purpose of § 1363(d). Thus, the taxpayer was treated as owning a pro rata share of the partnerships’ inventories and as a result of its election it was required to include $4.8 million of LIFO recapture.

In reaching its decision regarding Subchapter K, the Tax Court followed Casel v. Commissioner, 79 T.C. 424 (1982), applying the aggregate approach to apply § 267 to disallow losses between related parties; Holiday Village Shopping Center v. United States, 773 F.2d 276 (Fed. Cir. 1985), applying the aggregate approach for purposes of determining depreciation recapture when a corporation distributed a partnership interest to its shareholders; and Unger v. Commissioner, 936 F.2d 1316 (D.C. Cir.1991) in determining permanent establishment. It distinguished as inapposite the entity approach applied in P.D.B. Sports, Ltd. v. Commissioner, 109 T.C. 423 (1997), for purposes of applying § 1056; Madison Gas & Elec. Co. v. Commissioner, 72 T.C. 521, 564 (1979), aff’d, 633 F.2d 512 (7th Cir.1980), applying the entity approach in determining whether expenditures deductible under § 162 or nondenotable start-up expenditures, and the Eighth Circuit’s decision in Brown Group, Inc. & Subs. v. Commissioner, 77 F.3d 217 (8th Cir.1996), rev’g 104 T.C. 105 (1995), concluding that the entity approach, rather than the aggregate approach, should be used in characterizing income (subpart F income) earned by a partnership. The differences, the court found, were based on determining the relevant Congressional intent in enacting the non-subchapter K provision involved in each case.

4. Gitlitz notwithstanding, sometimes the shareholder still needs a real economic outlay to get the deductions. Grojean v. Commissioner, 248 F.3d 572, 87 A.F.T.R.2d 1673, 2001-1 U.S.T.C. ¶50,355 (7th Cir. 4/13/01), aff’d T.C. Memo. 1999-425 (12/29/99). An S corporation shareholder, rather than guaranteeing a loan from a bank to his wholly-owned S corporation, as initially demanded by the lending bank, instead acquired a $1.2 million loan participation interest in the bank’s $10 million loan to the corporation. The participation was financed by a borrowing from the bank at an interest rate identical to the interest rate on the loan to the corporation, and the participation was subordinated to the bank’s interest. The shareholder’s note and the corporation’s note had identical terms and the bank automatically credited payments on the corporation’s note against the shareholder’s note. No cash passed hands between the shareholder and bank in the circular transaction, and shareholder made no economic outlay. If the loan was repaid, the two loans would cancel out and the taxpayer never would receive or be out any cash. If the S corporation defaulted, the shareholder would have to make good to the bank a portion of its loss equal to the loan to the shareholder. According to Judge Posner, “business realities’ cast Grojean in the role of guarantor rather than lender; no business realities compelled him to recharacterize his guarantee as a loan participation.” The shareholder thus acquired no additional basis to support passed-through losses. In the course of his analysis, Judge Posner wrote:

The difference between a loan and a guaranty may seem a fine one, since, when the amount is the same, the lender and guarantor assume the same risk (subject to a possible wrinkle, concerning bankruptcy). The difference between the two transactional forms may seem to amount only to this: the loan supplies funds to the borrower, and the guaranty enables funds to be supplied to the borrower. That is indeed the main difference, but it is not trivial or nominal (“formal”).

At a high enough level of abstraction, it is true, the difference between providing and enabling the provision of funding may disappear. Indeed, at that level, the difference between equity and debt, as methods of corporate financing, disappears. But at the operational level, because of various frictions that some economic models disregard, such as transaction and liquidity costs, really is a substantive and not merely a formal difference between lending and guaranteeing. In contrast, the difference between a guaranty and the form that Grojean’s loan participation assumed was nothing but the label. It was a purely formal difference, and in federal taxation substance prevails over form.
5. REG 251701-96, Electing Small Business Trust, 65 F.R. 82963 (12/29/00). Proposed Reg. § 1.641(c)-1 and proposed amendments to Reg. § 1.1361-1 implement § 1361(f) permitting electing small business trusts to be permitted S corporation shareholders. A QSST can convert to an ESST; an ESST can convert to a QSST if it qualifies.

6. REG-106431-01, Qualified Subchapter S Election for Testamentary Trusts, 66 F.R. 44565 (8/23/01). These proposed regulations would amend Reg. § 1.1361-1 to reflect amendments to §1361 in 1996 permitting a testamentary trust or a former qualified subpart E trust, whether or not the entire corpus was included in the deceased owner's gross estate, to be a permitted S corporation shareholder for a 2-year period [rather than 60 days]. The proposed regulations eliminate the special rules for determining whether trusts consisting of community property qualify for the 2-year period. The proposed regulations also provide that former qualified subpart E trusts and testamentary trusts can continue as permitted shareholders after the end of the 2-year period through a QSST election under § 1361(d) or an electing small business trust election under § 1361(e), if eligible. The QSST election must be made within the 16-day-and-2-month period following the end of the s-year period.

7. Normal operating income of a timber, coal or iron-ore mining company is not §1374 built-in gain. Rev. Rul. 2001-50 (10/10/01). The §1374 built in gains tax does not apply when a former C corporation (or S corporation that acquired the property from a C corporation) cuts and sells timber during the 10-year recognition period and recognizes gain under § 631(a), (b), or (c) with respect to a timber cutting contract or disposal of timber, coal or iron ore with a retained economic interest. The IRS applied by analogy Reg. § 1.1374-4(a)(3), Ex. (1), which provides that the extraction and oil from a working interest held on the conversion date is not subject to § 1374. Section 631 was intended to provide a tax benefit for operating income and there is not indication that the deemed capital gain treatment was intended to result in application of § 1374.

8. So there are carryovers from sub-C to sub-S years after all. St. Charles Investment Co. v. Commissioner, 232 F.3d 773 (10th Cir. 10/14/00), rev'd 110 T.C. 46 (1998). The Tax Court held that pursuant to § 1371(b)(1), an S corporation that was subject to § 469 as a closely held C corporation prior to its S election cannot use passive activity loss carryovers from the period it was a C corporation. The Tenth Circuit reversed. Because § 469(b) expressly provides that the carryover of suspended passive activity losses shall be treated as an item with respect to the activity in the next year except as otherwise provided in this section [§ 469], the limitation on carryovers from C corporation years to S corporation years in § 1371(b)(1) was inapplicable. The suspended passive activity losses from subchapter C years were available during subchapter S years [subject to the §469 limitations applicable to those years].

E. Affiliated Corporations.

1. *The “single entity” approach of consolidated returns carries the day. United Dominion Industries, Inc. v. United States, 121 S. Ct. 1934, 2001-1 U.S.T.C. ¶50,430, 87 A.F.T.R.2d 2377 (6/4/01), rev'd 208 F.3d 452, 2000-1 U.S.T.C. ¶50,310 (4th Cir. 3/24/00). The taxpayer was the parent of a consolidated group that reported NOLs for four consecutive years during which a portion of the deductions were product liability expenses (PLEs) incurred by profitable members of the group. Product liability losses (PLLs) — which are the lesser of the taxpayer’s PLEs or the taxpayer’s NOL — can be carried back 10 years under § 172(b)(1) [rather than the normal 2 years]. The taxpayer (1) calculated its CNOL under Reg. § 1.1502-11(a), and (2) aggregated its individual members’ PLEs. Because the CNOL was greater than the sum of its members’ PLEs, the taxpayer treated the full amount of the PLEs as consolidated PLLs eligible for 10-year carryback.

- The Court of Appeals for the Fourth Circuit held that under Reg. §§ 1.1502-12 and 1.1502-21A the consolidated group could not carry back PLEs incurred by the profitable members because they did not enter into the consolidated NOL. The court reasoned that § 172 refers to specified liability losses, not to specified liability expenses. Only that portion of a member’s separate net operating loss attributable to specified liability losses could be taken into account in computing the portion of the consolidated NOL attributable to specified liability losses.

- The Supreme Court reversed, applying a “single entity approach” to allow the 10-year carryback. Justice Souter’s opinion reasoned that there is only a single definition of consolidated net operating loss in Reg. § 1.1502-21(f) and no definition in the consolidated return regulations of a component member’s separate NOL. He rejected the government’s argument that an individual group member’s separate taxable income (STI) under Reg. § 1.1502-12, is analogous to a “separate” NOL, and that accordingly a member having positive STI could have no product liability losses. Since there is no NOL below the CNOL, there is nothing for comparison with PLEs to produce PLL at any...
stage before the CNOL calculation. Nothing in the Code or regulations indicated the essential relationship between NOL and PLL for a consolidated group will differ from their relationship for a conventional corporate taxpayer. The fact that several member companies throwing off large PLEs also, when considered separately, generated positive taxable income was of no significance.

- Justice Thomas concurred in the case with the following opinion:

I agree with the Court that the Internal Revenue Code provision and the corresponding Treasury Regulations that control consolidated filings are best interpreted as requiring a single-entity approach in calculating product liability loss. I write separately, however, because I respectfully disagree with the dissent's suggestion that, when a provision of the Code and the corresponding regulations are ambiguous, this Court should defer to the Government's interpretation. See post, at 1-2. At a bare minimum, in cases such as this one, in which the complex statutory and regulatory scheme lends itself to any number of interpretations, we should be inclined to rely on the traditional canon that construes revenue-raising laws against their drafter. See Leavell v. Blades, 237 Mo. 695, 700-701, 141 S.W. 893, 894 (1911) ("When the tax gatherer puts his finger on the citizen, he must also put his finger on the law permitting it"); United States v. Merriam, 263 U.S. 179, 188, 68 L. Ed. 240, 44 S. Ct. 69 (1923) ("If the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer"); Bowers v. New York & Albany Litarage Co., 273 U.S. 346, 350, 71 L. Ed. 676, 47 S. Ct. 389 (1927) ("The provision is part of a taxing statute; and such laws are to be interpreted liberally in favor of the taxpayers"). Accord American Net & Twine Co. v. Worthington, 141 U.S. 468, 474, 35 L. Ed. 821, 12 S. Ct. 55 (1891); Benziger v. United States, 192 U.S. 38, 55, 48 L. Ed. 331, 24 S. Ct. 189 (1904).

- Justice Stevens, in his dissent, responded in the following footnote:

JUSTICE THOMAS accurately points to a tradition of cases construing "revenue-raising laws" against their drafter. See ante, at 1 (THOMAS, J., concurring). However, when the ambiguous provision in question is not one that imposes tax liability but rather one that crafts an exception from a general revenue duty for the benefit of some taxpayers, a countervailing tradition suggests that the ambiguity should be resolved in the government's favor. See, e.g., INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84, 117 L. Ed. 2d 226, 112 S. Ct. 1039 (1992); Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593, 87 L. Ed. 1607, 63 S. Ct. 1279 (1943); Deputy v. Du Pont, 308 U.S. 488, 493, 84 L. Ed. 416, 60 S. Ct. 363 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440, 78 L. Ed. 1348, 54 S. Ct. 788 (1934); Woolford Realty Co. v. Rose, 286 U.S. 319, 326, 76 L. Ed. 1128, 52 S. Ct. 568 (1932).

a. Tax Court had ruled to the contrary, but the Sixth Circuit had reversed and also held for the taxpayer. Internet Corp. v. Commissioner, 111 T.C. 294 (12/8/98), rev'd, 209 F.3d 901, 2000-2 U.S.T.C. ¶50,382, 85 A.F.T.R.2d 1387 (6th Cir. 4/20/00). Judge Wells held that under Reg. §§ 1.1502-12 and 1.1502-21A, a consolidate group's specified liability losses did not include deductions attributable to members of the group that reported positive separate taxable income because the deductions did not contribute to the group's consolidated NOL. The Court of Appeals reversed and allowed them to be carried back under the special rule. The court reasoned that the subsidiary's specified liability loss deduction items reduced the subsidiary's separate taxable income dollar-for-dollar and thus contributed to the consolidated NOL. An individual component member's taxable income has no independent significance; it is merely a step in computing the consolidated NOL. There was no basis in Reg. § 1.1502-21A for treating a specified liability loss as constituting part of the consolidated NOL when the member that incurred the deduction had negative taxable income but not when that member had positive separate taxable income [as long as a SRLY year is not involved].

(1) Internet Corp. v. Commissioner, 117 T.C. 13 (10/2/01), on remand from 209 F.3d 961 (6th Cir. 4/20/00). Under the pre-1999 version of § 172(f), state tax deficiencies and interest on state and federal tax deficiencies were a specified liability losses subject to a 10-year carryback. Judge Wells followed Host Marriott Corp. v. United States, 113 F.Supp.2d 790
But the Federal Circuit doesn’t appear to buy into the single entity theory. Regulation § 1.1502-20, which prohibited recognition of loss in the transactions involving, inter alia, “duplicated losses,” was held to be “manifestly contrary to the statute.” Rite Aid Corp. v. United States, 255 F.3d 1357, 2001-2 U.S.T.C. ¶50,516, 88 A.F.T.R.2d 5058 (Fed. Cir. 6/6/01), rev’g 46 Fed. Cl. 500, 2000-1 U.S.T.C. ¶50,429, 85 A.F.T.R.2d 1439 (Fed. Cl. 4/21/00). Rite Aid sold a subsidiary (Encore) and realized a taxable loss of $33 million and an “economic loss” of $22 million, which it claimed should be deductible. Reg. § 1.1502-20, subject to certain exceptions, disallows any loss realized by a member of a consolidated group upon the disposition of the stock of a subsidiary. Under Reg. § 1.1502-20, the amount of loss that is disallowed is limited to the sum of (1) income or gain resulting from “extraordinary gains dispositions,” which are defined as dispositions of capital assets, depreciable property used in the trade or business, certain bulk asset dispositions, and discharge of indebtedness income, (2) positive investment adjustments (other than those attributable to extraordinary gain dispositions), and (3) “duplicated loss,” which is the aggregate of the subsidiary’s asset bases and loss carryovers over the value of the subsidiary’s assets. Any losses in excess of these amounts are deductible. Reg. § 1.1502-20 is designed to prevent “duplicated losses” — the deduction by both the parent and subsidiary of the same economic loss. The Court of Federal Claims upheld the validity of Reg. § 1.1502-20 and because Encore’s built-in loss of $28 million [as calculated by Rite-Aid] exceeded Rite-Aids’ economic loss, no loss deduction was allowed. The court pointed out that Rite Aid could have avoided Reg. § 1.1502-20 by finding a buyer who would agree to a § 338(h)(10) election.

- The Federal Circuit (Judge Meyer) reversed, declaring the “duplicated loss factor” in Reg. § 1.1502-20 invalid because it disallows a loss that is otherwise allowed by § 165 and is “manifestly contrary to the statute.” Because “realization of the loss [on the stock sale] does not stem from the filing of a consolidated return, ... the denial of the deduction imposes a tax on income that otherwise would not be taxed,” something that § 1502 does not authorize the Treasury to do. The Federal Circuit summarily rejected the government’s argument that Reg. § 1.1502-20 is necessary to prevent a double deduction, stating that the subsidiary’s future deductions were not created by the consolidated return rules because the same duplication occurs outside the consolidated return context, and Congress has addressed the problem by the enactment of §§ 382 and 383. Judge Mayer concluded that “the duplicated loss factor distorts rather than reflects the tax liability of consolidated groups and contravenes Congress’ otherwise uniform treatment of limiting deductions from the subsidiary’s losses.”

- B. John Williams of Shearman & Sterling – the new IRS Chief Counsel – represented the taxpayer.

- In Chief Counsel Notice CC-2001-042 (8/30/01), the Service has advised chief counsel attorneys that it does not agree with the Federal Circuit decision in Rite Aid Corp. v. United States and that it has filed a petition for rehearing en banc with the Federal Circuit. The Chief Counsel Notice characterizes the decision as follows:

  The loss disallowance rule (“LDR”) is a legislative regulation authorized by sections 337(d) and 1502. The LDR limits the amount of loss that a member of a consolidated group may deduct with respect to a disposition of subsidiary stock. The LDR generally provides that such loss is allowable only to the extent it exceeds the sum of three amounts: Positive Investment Adjustments (PIA), Extraordinary Gain Dispositions (EGD), and duplicated loss.

In Rite Aid Corp. v. United States, the Federal Circuit held that the duplicated loss component of the LDR was an invalid exercise of regulatory authority. The court stated that the Secretary’s authority to promulgate consolidated return regulations is limited to addressing problems created from the filing of a consolidated return. The court reasoned that because the loss at issue would have been deductible if realized by a taxpayer filing a separate return, the disallowance of the loss by the duplicated loss factor of the LDR was not authorized by the statute.
3. REG-103805-99, Agent for Consolidated Group, 65 F.R. 57755 (9/25/00). Proposed Reg. §§ 1.1502-77 and -78 would clarify and supplement the rules concerning the agent for a consolidated group and the designation of a new agent for the group. Under the proposed regulations, the common parent remains the agent as long as it continues to exist as a corporation, even if it ceases to be the common parent. The common parent also is the agent for any corporation improperly included in the consolidated return. The proposed regulations continue the current rule that if the common parent ceases to exist it may designate another member of the group as its successor agent. If no such designation is made, the IRS may designate the successor agent. The current rule permitting the remaining members to designate the successor agent will be removed, effective upon publication of final regulations. The proposed regulations would deal with the Interlake Corp. [112 T.C. 103 (1999)] problem by providing that a refund resulting from a carryback of a NOL under § 172 should be paid to the common parent or agent for the carryback year.


F. Reorganizations and Corporate Divisions

1. *The wrath of General Utilities* repeal rewritten. REG-107566-00, Notice of Proposed Regulations, Guidance Under Section 355(e): Recognition of Gain on Certain Distributions of Stock or Securities In Connection with an Acquisition, 66 F.R. 76 (1/2/01). The Treasury has revised Prop. Reg. § 355-7 and withdrawn proposed regulations issued in REG-116733-98 (64 F.R. 46155, 8/24/99). The new proposed regulations provide that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. They include nonexclusive lists of facts and circumstances to be considered in making the determination and six safe harbors.

- If an acquisition follows a distribution, the distribution and acquisition are considered part of a plan if the distributing corporation (D), the controlled corporation (C), or any of their controlling shareholders intended on the date of the distribution that the acquisition or a similar acquisition occur in connection with the distribution. If an acquisition precedes a distribution, the distribution and acquisition are considered part of a plan if D, C, or any of their controlling shareholders intended on the date of the acquisition that a distribution occur in connection with the acquisition. All acquisitions of stock of a corporation that are pursuant to a plan are aggregated to determine whether the 50 percent threshold of § 355(e)(2)(A)(ii) is met.

- **Facts and Circumstances** — There are two nonexclusive lists of factors to consider, one list tends to demonstrate that a distribution and an acquisition are part of a plan and the other list tends to demonstrate that a distribution and an acquisition are not part of a plan. The weight of the factors varies and the determination does not depend on merely counting factors.

- **Factors indicating a plan**: Six factors [3 with respect to pre-acquisition distributions and 2 with respect to post-acquisition distributions] focus on whether D, C, or their respective controlling shareholders discussed the second transaction of the pair with outside parties before the first transaction occurred. The seventh factor considers whether the distribution was motivated by a purpose to facilitate the acquisition or a similar acquisition of D or C; evidence of such a purpose exists if there was a reasonable certainty that within 6 months after the distribution an acquisition would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding an acquisition. Elaborate "operating rules" describe the impact of numerous scenarios. The eighth factor considers whether an acquisition and a distribution occurred within 6 months of each other, or whether there was an agreement, understanding, arrangement, or substantial negotiations regarding the second transaction (or, if an acquisition is the second transaction, a similar acquisition) within 6 months after the first transaction. The ninth factor considers whether the debt allocation between D and C made an acquisition of D or C likely in order to service the debt.

- **Factors indicating the absence of a plan**: Five factors [3 with respect to pre-acquisition distributions and 2 with respect to post-acquisition distributions] focus on the absence of any discussions between D, C, or their respective controlling shareholders, with outside parties regarding the second transaction of the pair before the first transaction occurred. One of the factors in each category is that there was an identifiable, unexpected change in market or business conditions after the first transactions that resulted in the second, unexpected transaction. The sixth nonplan factor is the existence of a real and substantial corporate business purpose, other than a purpose to facilitate the acquisition or a similar acquisition, for the distribution [using principles similar Reg. § 1.355-2(b)(1)]. The seventh factor is
that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a previously proposed similar acquisition.

Safe harbors: A distribution and an acquisition are not part of a plan if they are described in one of the safe harbors.

(1) An acquisition more than 6 months after a distribution if there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution and the distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate an acquisition is not part of a plan. This safe harbor applies if the distribution was motivated in whole or substantial part by a nonacquisition business purpose.

(2) An acquisition more than 6 months after a distribution for which there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution is not part of a plan. This safe harbor applies where the distribution was motivated in whole or substantial part by a business purpose to facilitate an acquisition of no more than 33% of the stock of either D or C, and no more than 20 percent of the stock of the corporation whose stock was acquired in the acquisition that motivated the distribution was either acquired or the subject of an agreement, understanding, arrangement, or substantial negotiations before a date that is 6 months after the distribution.

(3) An acquisition more than 2 years after a distribution if there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter is not part of a plan.

(4) An acquisition more than 2 years before a distribution if there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within 6 months thereafter is not part of a plan.

(5) If D or C is listed on an established market, an acquisition if the stock is transferred between shareholders of D or C who are not 5-percent shareholders is not part of a plan. This safe harbor is subject to certain exceptions.

(6) An acquisition of stock by an employee or director in connection with the performance of services, including an acquisition resulting from the exercise of certain compensatory stock options, is not part of a plan.

For all purposes, depending on all relevant facts and circumstances, parties can have an agreement, understanding, or arrangement even though they have not reached agreement on all terms. Under certain circumstances, such as in public offerings or auctions of D or C stock, an agreement, understanding, arrangement, or substantial negotiations can exist regarding an acquisition even if the acquirer has not been specifically identified. Special rules deal with options. These proposed rules are to be effective upon the publication of final regulations.

a. And apparently the government thinks it did a better job on the regulations the second time around. T.D. 8960, Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection With an Acquisition, 66 F.R. 40590 (8/3/01). The Treasury has promulgated temporary regulations identical to the Proposed Regulations, except that the temporary regulations reserve § 1.355-7(e)(6) (suspension of the running of any time period during which there is a substantial diminution of risk of loss under the principles of § 355(d)(6)(B)) and Example 7 of the Proposed Regulations (interpreting the term “similar acquisition” in the context of a situation involving multiple acquisitions).

2. When the statute is unhelpful, call on the legislative history of a related provision for some help. Rev. Rul. 2001-24, 2001-22 I.R.B. 1290 (3/4/01). The IRS ruled that the parent acquiring corporation in a § 368(a)(2)(D) forward triangular merger may drop the acquisition subsidiary into a different subsidiary. Under Reg. § 1.368-1(d)(4), the continuity of business enterprise requirement is met. Reg. § 1.368-2(f) provides that a corporation remains a “party to the reorganization” if following an acquisition, stock or assets are transferred in a transaction described in Reg. § 1.368-2(k), but Reg. § 1.368-2(k) refers only to reverse triangular mergers under § 368(a)(2)(E). If the transaction were recast under the step transaction doctrine as a merger into a second tier subsidiary, the parent would not be a party to the reorganization. Because the legislative history of § 368(a)(2)(E) suggests that forward and reverse triangular mergers should be treated similarly, the IRS will not apply the step transaction doctrine. The transaction qualifies under § 368(a)(2)(D). Section 368(a)(2)(C), which does not apply, is permissive rather than restrictive.

otherwise qualified under § 368(a)(2)(E) was not disqualified by virtue of the fact that immediately after the merger and as part of a plan that included the merger, the surviving target corporation sold fifty percent of its operating assets to an unrelated corporation for cash. The IRS concluded that Rev. Rul. 88-48, 1988-1 C.B. 117, should be applied to conclude that the "substantially all of the properties" requirement had been met when 50 percent of the target's assets were sold for cash immediately before the acquisition and the cash was transferred to the acquirer along with the other assets. The reasoning of Rev. Rul. 2001-25 was as follows.

Section 368(a)(2)(E) uses the term "holds" rather than the term "acquisition" as do §§ 368(a)(1)(C) and 368(a)(2)(D) because it would be inapposite to require the surviving corporation to "acquire" its own properties. The "holds" requirement of § 368(a)(2)(E) does not impose requirements on the surviving corporation before and after the merger that would not have applied had such corporation transferred its properties to another corporation in a reorganization under § 368(a)(1)(C) or a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D).

4. Has the Service elevated King Enterprises to a rule of law? Is it sauce for the goose as well as for the gander? Rev. Rul. 2001-26, 2001-23 I.R.B. 1297 (5/25/01). The I.R.S. has ruled that a two-step acquisition involving a voting stock for stock tender offer exchange for 51 percent of the outstanding T corporation stock, followed by a merger of a P subsidiary into T in which the remaining 49 percent of the T shareholders receive two-third P stock and one-third cash (the cash being 16.67 percent of total consideration) can qualify as a § 368(a)(2)(E) reverse triangular merger. The ruling assumes that all requirements for a reorganization under § 368(a)(1)(A) and 368(a)(2)(E), other than the requirement under § 368(a)(2)(E)(ii) that P acquire control of T in exchange for its voting stock in the transaction, have been satisfied. The ruling also assumes that under general principles of tax law, including the step transaction doctrine as applied in King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969), the tender offer and the statutory merger are treated as an integrated acquisition by P of all of the T stock. The ruling reaches the same result in a situation in which before the merger, S initiates the tender offer for T stock and, in the tender offer, acquires 51 percent of the T stock for P stock provided by P.

5. From qualified stop purchase to tax-free merger with a wave of step transaction doctrine's magic wand. Rev. Rul. 2001-46 (9/25/01). P acquired T by merging P's shell subsidiary S into T in a reverse triangular merger in which the T shareholder's receive 70 percent P voting stock and 30 percent cash (the Acquisition Merger). Following the acquisition, "as part of the plan," T merges into P (the Upstream Merger). The ruling assumes that (1) "absent some prohibition against the application of the step transaction doctrine, the step transaction doctrine would apply to treat the Acquisition Merger and the Upstream Merger as a single integrated acquisition by [P] of all the assets of T," and (2) "the single integrated transaction would satisfy the nonstatutory requirements of a reorganization under §368(a)." The ruling holds that Acquisition Merger is not a qualified stock purchase under § 338 followed by a § 332 liquidation, but instead is a statutory merger of T into P under § 368(a)(1)(A). No § 338 election is available. The ruling reaches the same result — type (A) merger if the T shareholders receive solely P voting stock (instead of a §368(a)(1)(E) reverse triangular merger).

- The IRS applied Rev. Rul. 67-274, 1967-2 C.B. 141, holding that if P the stock of T in exchange P voting stock and thereafter liquidates T into P, the transaction is a type (C) reorganization rather than a type (B) reorganization. It distinguished Rev. Rul. 90-95, 1990-2 C.B. 67 (Situation 2), holding that the cash merger of a newly formed wholly owned S into T followed by the merger of T into P will be treated as a qualified stock purchase of T followed by a § 332 liquidation of T.
- Pursuant to § 7805(b) the IRS will not apply the ruling to challenge a taxpayer's contrary position with respect to an acquisition before 9/25/01, or acquisition of stock of the target corporation meeting the requirements of § 1504(a)(2) by the purchasing corporation pursuant to a written agreement binding on 9/24/01 if: (1) a timely § 338(g) or (h)(10) or § 338(g) has been filed and (2) the taxpayer does not take an inconsistent position.
- The IRS is considering whether to issue regulations that reflect the principles of the ruling, but nevertheless allow § 338(h)(10) elections pursuant to a written agreement that requires or permits the § 338(h)(10) election.

6. The "active business" of REIT. Rev. Rul. 2001-29, 2001-26 I.R.B. 1348 (6/25/01). A REIT can be engaged in the active conduct of a trade or business within the meaning of § 355(b) solely by virtue of functions with respect to rental activity that produces income qualifying as
rents from real property within the meaning of § 856(d) of the Code. Rev. Rul. 73-236, 1973-1 C.B. 183 is obsoleted. "The obsolescence of Rev. Rul. 73-236, which denied § 355 treatment to a distribution of stock by a C corporation that converted to a REIT because the REIT was not engaged in the active conduct of a trade or business, does not imply a view as to whether a distribution of stock involving a REIT election by the distributing or controlled corporation would otherwise satisfy the requirements of § 355, including the corporate business purpose requirement of § 1.355-2(b)."

G. Personal Holding Companies and Accumulated Earnings Tax

1. A PHC in 1996 and 1997? What was this guy thinking? Calypso Music, Inc. v. Commissioner, T.C. Memo 2000-293 (9/20/00). The taxpayer-corporations' sole shareholder was a highly regarded motion picture music editor. In 1996 and 1997, 74% and 76% of the taxpayer's income was derived from contracts to perform movie music editing that specifically required the work to be performed by the shareholder-employee. The § 542 personal holding company tax applied to the corporation's undistributed earnings. But the § 6662 accuracy related penalties were not upheld because taxpayer reasonably relied on its CPA to prepare the returns, which did not self assess the PHC tax.

2. Knight Furniture Co. v. Commissioner, T.C. Memo 2001-19 (1/29/01). The accumulated earnings tax assessed by the Commissioner was not upheld because the taxpayer was reasonably accumulating earnings to redeem dissenting minority shareholders and had a history of funding redemptions with cash.

H. Corporate General

1. Notice 2000-12, 2000-9 I.R.B. 727 (2/11/00). A pilot program existed for pre-filing agreements (PFAs), under which large businesses may request examination and resolution of specific issues relating to tax returns expected to be filed between September and December 2000. These PFAs would be treated as closing agreements, and would be characterized as confidential return information under § 6103(b)(2)(A).

a. *PFAs available for all LMSB taxpayers. Rev. Proc. 2001-22, 2001-9 I.R.B. 745 (2/26/01). This procedure permits a taxpayer subject to the jurisdiction of the IRS Large and Mid-Size Business Division (LMSB) to request the examination of specific issues relating to a tax return before the return is timely filed. If the taxpayer and the Service are able to resolve the examined issues prior to the filing of the return, the taxpayer and the IRS may finalize their resolution by executing an LMSB Pre-Filing Agreement. It applies only to issues involving the application of well-settled principles of law; it does not apply to issues involving questions of law that are not well settled with respect to the material facts of the issue. LMSB PFAs are closing agreements under § 7121, and must comply with Rev. Proc. 68-16, 1968-1 C.B. 770.

b. The Community Renewal Tax Relief Act of 2000 added § 6103(b)(2)(D) to provide specifically that these closing agreements (as are these pre-filing agreements) would be treated as confidential return information.

2. The final § 338 and § 1060 regulations provide only minor changes from the 2000 temporary regulations. T.D. 8940, Purchase Price Allocations in Deemed and Actual Asset Acquisitions, 66 F.R. 9925 (2/13/01). Final regulations §§ 1.338-1 through -10, 1.338(h)(10)-(1) and 1.1060-1, [proposed in REG-107069-97, 64 F.R. 43462 (8/10/99), and promulgated as temporary regulations (effective 1/6/00) in T.D. 8858, 65 F.R. 1236 (1/7/00)] clarify the treatment of, and provide consistent rules (where possible) for, both deemed and actual asset acquisitions under §§ 338 and 1060.

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

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

- The seven classes are: Class I – cash and cash equivalents; Class II – CDs, securities, foreign currency; Class III – assets the target marks-to-market annually for tax purposes and debt obligations held by the taxpayer, [generally including accounts receivable, mortgages, credit card receivables], but not including debt instruments issued by a related person [determined after the acquisition], contingent debt instruments, or convertible debt; Class IV – inventory; Class V – all assets not included in the other classes and the stock of target affiliates; Class VI – section 197 assets other than goodwill and going concern value; and Class VII – section 197 goodwill and going concern value. The change relates to the addition of two new classes of “fast pay” assets, which must receive basis up to fair market value before there is any basis allocated to tangible property.

- Reg. §§ 1.338-4T and 1.338-5T significantly revise the calculations of aggregate deemed sale price (ADSP) and adjusted grossed-up basis (AGUB), as well as various aspects of tax treatment of the deemed asset sale. Under the new regulations, ADSP is the grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation’s recently purchased target stock. Amount realized is determined as if old target itself were the selling shareholder. General tax law principles apply in determining the timing and amount of the elements of ADSP, and that ADSP is redetermined at such time and in such amount as an increase or decrease to the individual constituent elements of the definition of ADSP would be required under general principles of tax law. The new regulations also provide a parallel rule for AGUB. These changes may result in increased disparities between ADSP and AGUB if there is nonrecently purchased stock of the target involved.

- Old target’s liabilities are taken into account in calculating ADSP as if old target sold its assets to an unrelated person for consideration that included the unrelated person’s assumption of, or taking subject to, the liabilities. To be taken into account in AGUB, a liability must be a liability of target that is properly taken into account in calculating ADSP if there is nonrecently purchased stock of the target involved.

3. **The Tax Court continues on its capitalization spree.** Illinois Tool Works Inc. v. Commissioner, 117 T.C. No. 4 (6/31/01). The taxpayer acquired the assets of another corporation [for approximately $126 million] in a taxable transaction in which the taxpayer assumed the target’s liabilities, including a contingent liability for a patent infringement claim, [Lemelson v. Champion Spark Plug Co., 975 F.2d 869 (1992)], for which it established a reserve of $350,000. Subsequently, the taxpayer, as the target’s successor, was held liable for damages, interest, and court costs [totaling over $17 million], which it paid. The Tax Court (Judge Cohen) upheld the Commissioner’s treatment requiring capitalization of the payments as a cost of acquiring the assets rather than a deductible expense, even though the parties had not adjusted the purchase price to reflect the contingent liability. The liability was considered in setting the price, and was expressly assumed. That the taxpayer considered it highly unlikely that it would be called upon to pay was not relevant.

- The Commissioner conceded the deductibility of the judgment in two respects: (1) pre-judgment interest accruing after the acquisition date was deductible; and (2) to the extent that the additional purchase price was allocable to assets the taxpayer had disposed of, the judgment was deductible.

- Note that in many, if not most, cases, the disposition of a portion of target’s assets will not affect the characterization of the payments because, under § 1060 and Reg. § 1.1060-1, the capitalized contingent liability will be allocated to Class VI and VII amortizable intangibles for which no loss is allowed until the complete disposition of all such intangibles acquired from the target. See § 197(f)(1). The grounds for the Commissioner’s concession were not clearly articulated in the opinion.

**VII. PARTNERSHIPS**

A. **Formation and Taxable Years**

1. REG-104876-00, Proposed Regulations, Taxable Years of Partner and Partnership; Foreign Partners, 66 F.R. 3920 (1/17/01). For purposes of applying § 706(b) to determine the partnership’s permitted year, Prop. Reg. § 1.706-4 would generally disregard foreign partners who are not subject to U.S taxation on a net basis, i.e., foreign partners who are not allocated any effectively
connected income or, if claiming treaty benefits, that do not have a permanent establishment. These rules do not apply if the partnership year would be determined with reference to domestic partners no one of which holds at least a 10-percent interest and which in the aggregate hold less than 20 percent of the interests.

2. The profits-only partnership interest safe-harbor is dredged a little wider. Rev. Proc. 2001-43, 2001-34 I.R.B. 191 (8/3/01), clarifying Rev. Proc. 93-27, 1993-2 C.B. 343. This revenue procedure provides that whether an interest granted to a service provider is a profits interest is determined at the time the interest is granted, even if, at that time, the interest is substantially nonvested [under Reg. § 1.83-3(b)]. If the requirements of Rev. Proc. 93-27 are met the IRS will not treat the grant of the interest or the event that causes the interest to become substantially vested as a taxable event for the partner or the partnership. Taxpayers to which this revenue procedure applies do not need to file a § 83(b) election.

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

1. Notice of proposed rulemaking, allocation of partnership debt. REG-103831-99, 66 F.R. 2081 (1/13/00) Prop. Reg. § 1.752-3(b) would solve problems that have arisen in determining how to determine the amount of § 704(c) minimum gain under Reg. § 1.752-3(a)(2) when a partnership holds multiple properties subject to a single nonrecourse liability. This problem typically occurs when a partnership that holds several properties subject to individual mortgages refinances the individual liabilities with a single nonrecourse mortgage. Under the proposed regulations, a partnership that holds multiple properties subject to a single liability may allocate the liability among the properties using any reasonable method. A method is not reasonable if it allocates to any property an amount that exceeds the fair market value of the property. Thus, for example, the liability may be allocated to the properties based on the relative fair market value of each property. The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate liability under Treas. Reg. § 1.752-3(a)(2). Once a liability is allocated among the properties, a partnership may not change the method for allocating the liability. If, however, one of the properties ceases to be subject to the liability, the portion of the liability originally allocated to that property must be reallocated to the properties still subject to the liability.

a. Made final. T.D. 8906, final regulations under § 752, relating to the allocation of nonrecourse liabilities by a partnership, 66 F.R. 64888 (10/31/00). These regulations revise and clarify the rules under tier three of the three-tiered allocation structure. Final Reg. § 1.752-3(a)(3) also provides that an excess nonrecourse liability may be allocated under the third tier in accordance with excess reverse § 704(c) gain as well as with respect to § 704(c) gain. The final regulations also provide that the rules in Reg. § 1.752-3(a)(3) do not apply to disguised sales under Reg. § 11.707-5(a)(2)(ii).

2. REG-106702-00, Determination of Basis of Partner's Interest; Special Rules, 66 F.R. 315 (1/3/01). Prop. Reg. § 1.705 would 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, then 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 proposed regulation is to be effective retroactively to gain or loss allocated on sales or exchanges of stock occurring after 12/06/99.

3. The § 704(b) regulations are so complicated that even the IRS doesn't understand them! Interhotel Co., Ltd. v. Commissioner, T.C. Memo 2001-151 (6/22/01), on remand from 221 F.3d 1348, 87 A.F.T.R.2d 2001-807, 2001-1 U.S.T.C. ¶50,501 (9th Cir. 2000), vacating, T.C. Memo. 1997-44. The taxpayer was a partnership whose primary assets were interests in two lower tier partnerships, one of which owned a hotel subject to a nonrecourse mortgage and with respect to which the upper tier partnership in question was subject to a minimum gain chargeback. The upper tier partnership agreement provided for liquidation according to positive capital account balances but neither required the restoration of negative capital accounts nor provided a qualified income offset as required by Reg. § 1.704-1(b)(2)(ii)(d). A's pro rata partnership interest was stated as 85 percent and B's interest was stated as 15 percent but, prior to June 20, 1991, pursuant to a special allocation, the partnership income was allocated 1 percent to A and 99 percent to B, while losses were allocated 85 percent to A and 15
percent to B. As of June 20, 1991, A’s capital account was negative $5,920,614, and B’s capital account was positive $14,879,392. As of June 21, 1991, B’s partnership interest was transferred to C, who succeeded to B’s capital account, and the partnership agreement was amended to allocate all partnership income to any partner with a negative capital account, i.e., A, and thereafter in proportion to the partners’ pro rata interests, i.e., 85 percent to A and 15 percent to C.

- In the first Tax Court opinion, Judge Jacobs held that the allocation of all of the post-June 20, 1991 income to A should not be respected, and the partnership’s income was allocated in accordance with the partners’ interests in the partnership. Because the partnership agreement provided for capital accounts and required liquidating distributions only to partners with positive capital accounts, the hypothetical liquidation test of Reg. § 1.704-1(b)(3)(iii) was applied. Accordingly, 99 percent of the income was allocated to C, the only partner with a positive capital account. The court held that in applying the hypothetical liquidation test, for purposes of adjusting the partners’ capital accounts, a minimum gain chargeback of a lower tier partnership, i.e., a partnership in which the partnership in question owned an interest, was not triggered because lower tier partnerships are not treated as hypothetically liquidating when applying the hypothetical liquidation test.

- The Court of Appeals vacated because the IRS conceded “that it erred in convincing the Tax Court to refrain from including a minimum gain chargeback in the court’s calculations for purposes of the comparative liquidation test.”

- On remand. Judge Jacobs reaffirmed that the allocations did not have substantial economic effect under Reg. § 1.704-1(b)(2) because the partnership agreement did not require restoration of negative capital accounts or provide a qualified income offset. But in applying the comparative liquidation test, the deemed liquidation of the upper-tier partnership was treated as triggering its share of the minimum gain chargeback of the lower-tier partnerships, and that amount of minimum gain was allocated among the partners to determine their capital accounts pursuant to the hypothetical liquidation. Because A would have been allocated the first $5,920,614 of minimum gain in a hypothetical liquidation, allocation of all of the income to A as long as A had a negative capital account was permitted under the regulations. Judge Jacob rejected numerous IRS arguments regarding the constructions of the § 704(b) regulations that he [quite correctly in our opinion] characterized as “erroneous” readings of the regulations.

C. Distributions and Transactions Between the Partnership and Partners

1. Is § 381 an alter ego talisman? Rev. Rul. 2000-44, 2000-41 I.R.B. 336. A corporation that acquires assets of another corporation in a tax-free transaction described in § 381(a) [e.g., a parent that acquires its subsidiary’s assets in a § 332 liquidation or the acquirer in a statutory merger type A reorganization] succeeds to a liquidated corporation’s status for purposes of applying the exception for reimbursements of pre-formation expenditures and determining whether a liability is a qualified liability under the § 707(a)(2)(B) disguised sale regulations [Reg. §§ 1.707-4(d), -5(a)(6)].

D. Sales of Partnership Interests, Liquidations and Mergers

1. *Form controls partnership mergers and divisions. T.D. 8925, Partnership Mergers and Divisions, 2001-6 I.R.B. 496 (1/301). Final Reg. § 1.708-1(c) and amendments to § 1.752-1(f) and (g) [proposed in REG-1111199-99]. The tax consequences of mergers of partnerships depend on the form followed under the laws of the applicable jurisdiction, either the “Assets-Over Form” or the “Assets-Up Form” [even if none of the merged partnerships are treated as continuing for Federal income tax purposes]. Generally, [and if no particular form is chosen] the Assets-Over Form applies. (This approach is consistent with the treatment of partnership to corporation elective conversions under the check-the-box regulations and technical terminations under § 708(b)(1)(B)). But, if as part of the merger, the partnership titles the assets in the partners’ names, the Assets-Up Form applies. If partnerships use the Interests-Over Form to accomplish the result of a merger, the partnerships will be treated as following the Assets-Over Form for Federal income tax purposes.

- Under the Assets-Up Form, partners recognize gain under §§ 704(c)(1)(B) and 737 (and incur state or local transfer taxes) when the terminating partnership distributes the assets to the partners. However, under the Assets-Over Form, gain under §§ 704(c)(1)(B) and 737 is not triggered. See §§ 1.704-4(c)(4) and 1.737-2(b). Because the adjusted basis of the assets contributed to the resulting partnership is determined first by reference to § 732 (as a result of the liquidation) and then § 723 (by virtue of the contribution), the adjusted basis of the assets contributed may not be the same as the adjusted basis of the assets in the terminating partnership if the partners’ aggregate adjusted basis of their interests in the terminating partnership does not equal the terminating partnership’s adjusted basis in its
assets. Under the Assets-Over Form, because the resulting partnership's adjusted basis in the assets it receives is determined solely under § 723, the adjusted basis of the assets in the resulting partnership is the same as the adjusted basis of the assets in the terminating partnership.

- When two or more partnerships merge under the Assets-Over Form, increases or decreases in partnership liabilities associated with the merger are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under § 752. A partner in the terminating partnership will recognize gain on the contribution under § 731 only if the net § 752 deemed distribution exceeds that partner's adjusted basis of its interest in the resulting partnership.

- If the merger agreement (or some other contemporaneous agreement) specifies that the resulting partnership is purchasing an exiting partner's interest in the terminating partnership and the amount paid for the interest, the transaction will be treated as a sale of the exiting partner's interest to the resulting partnership.

- Form also will be followed, and the resulting differing tax consequences respected with regard to corporate divisions if the partnership undertakes the steps of either the Assets-Over Form or the Assets-Up Form. Gain under §§ 704(c)(1)(B) and 737 often may be triggered when § 704(c) property or substituted § 704(c) property is distributed to certain partners in the context of partnership divisions. If a partnership divides, the transfer to one new partnership can follow the Assets-Over Form while the transfer to the other follows the Assets-Up Form. All resulting partnerships are bound by the original partnership's elections.

- The rules are generally effective as of 1/4/01, with an elective effective date of 1/11/00.

E. Inside Basis Adjustments

1. Notice of proposed rulemaking, applying section 197 to partnerships. REG-100163-00, 63 F.R. 3903 (1/25/00). Prop. Reg. § 1.197-2(b)(12)(ii) discusses when the § 197(f)(9) anti-churning rules will be applied to basis increase for § 197 amortizable intangibles under § 732(b) or § 734(b).

   a. T.D. 8907, 65 F.R. 69667 (11/20/00). The Treasury has finalized regulations (Reg. § 1.197-2(h)(12)) on the application of the anti-churning rules for section 197 intangible property to partnership transactions involving §§ 732(b) and 734(b). The final regulations change the fraction used to determine a continuing partner's share of a § 734(b) basis adjustment. The fraction now compares a continuing partner's post-distribution capital account as determined under § 704(b) and Reg. § 1.704-1(b)(2)(iv) to the aggregate of all of the continuing partners' post-distribution capital accounts. If the partnership does not maintain capital accounts in accordance with Reg. § 1.704-1(b)(3), the fraction is determined by reference to the partner's overall interest in the partnership under Reg. § 1.704-1(b)(3). T.D. 8907 is effective November 20, 2000.

F. Partnership Audit Rules

1. And you thought the Partnership level audit rules were procedural simplification. GAF Corp. v. Commissioner, 114 T.C. 519 (6/29/00) (reviewed, 10-3). The question was whether the transfer of property to a partnership [Rhone-Poulenc Surfactants & Specialties, L.P.] was to be treated as a sale or as a contribution to capital – an $80 million question. The IRS issued both a statutory notice to GAF and an FPAA to the partnership. Judge Ruwe, for the majority, decided that a deficiency notice based on "affected items" issued prior to completion of the related partnership-level proceedings is invalid, so the Tax Court proceeding based on the deficiency notice must be dismissed for lack of jurisdiction.

   - Judge Halpern, in dissent, would overrule the Maxwell v. Commissioner, 87 T.C. 783 (1986), line of cases to the extent they hold the Tax Court lacks subject matter jurisdiction to redetermine a deficiency attributable until the related partnership proceeding is completed. The minority would not dismiss, but only defer proceeding until consideration of the affected items is appropriate.

   a. Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner, 114 T.C. 533 (6/29/00) (reviewed, 8-6). This case deals with GAF's motion for summary judgment [based upon the running of the statute of limitations] in the partnership level proceeding, which was denied. The majority did not view dismissal of the partner-level case as mooting the partnership-level case.

   b. Appeal dismissed because there was no case or controversy. Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner, 2001-1 U.S.T.C. ¶50,412, 87 A.F.T.R.2d 2023
(3rd Cir. 5/1/01), dismissing appeal from 114 T.C. 533 (6/29/00). The Tax Court certified the denial of GAF’s motion for summary judgment for interlocutory appeal under § 7482(a). The Court of Appeals held that the petition for interlocutory appeal was improvidently granted because the Tax Court had reserved for decision issues [whether the partnership was a sham and the transaction in question was a sale and not a contribution followed by a distribution] that would affect the ripeness for appeal. If the transaction were a sale, § 6233(a) would not extend the partnership audit rules to GAF because it never held an interest in the purported partnership.

2. Joint return doesn’t make one spouse’s income the other’s. When items become nonpartnership items for the partner spouse, they necessarily become so with respect to the nonpartner spouse. Callaway v. Commissioner, 231 F.3d 106, 2000-2 U.S.T.C. 50,744, 86 A.F.T.R.2d 6148 (2d Cir. 9/15/00), rev’g T.C. Memo. 1998-99. Taxpayer’s late husband owned a partnership interest as separate property but his distributive share of income was reported on a joint return. After the husband died, his estate filed a request for prompt assessment, and, as a result, under § 6231(b)(1)(D), (c)(1), and Reg. § 301.6231(c)-8T, his share of the partnership’s items became nonpartnership items [a point not contested by the Commissioner]. In a case of first impression in the courts of appeals, the issue was whether the conversion of the husband’s partnership items into nonpartnership items also applies for purposes of assessing against the wife deficiencies attributable to the partnership items. The court held that where only one spouse owned an interest in partnership items, the conversion of those partnership items into nonpartnership items necessarily converts into nonpartnership items with respect to the other spouse, as well, all the items taken into account on the joint return by reason of the partnership interest. As a consequence: (1) pursuant to § 6230(a)(2)(A)(ii) the regular deficiency notice procedures applied, and (2) under § 6229(f) the statute of limitations expired one year after the items became nonpartnership items. On the facts “precautionary” assessments, later computational adjustments, and a later affected items deficiency notice, all issued after the FPAA and more than one year after the items became nonpartnership items, were time barred, with respect to the taxpayer as well as with respect to her deceased spouse’s estate.

G. Miscellaneous

1. The form was all the substance that was necessary. Estate of Strangi v. Commissioner, 115 T.C. 478 (11/30/00) (reviewed, 9-5). The decedent established a family limited partnership two months before he died, transferring cash, securities, life insurance policies, annuities, real estate, and partnership interests; cash and securities were 75 percent of the value. Decedent held a 99 percent interest as a limited partner and a corporation owned 47 percent by decedent and 53 percent by his wife, as trustee, held a 1 percent general partnership interest. The partnership distributed a substantial portion of its assets soon after the decedent’s death. The IRS rejected the estate’s discounted valuation based on the position that under the economic substance and business purpose doctrines the existence of the partnership should be ignored. The FLP was held valid for estate tax purposes, § 2703 did not apply to the agreement, and the transfer to the partnership was not a gift (and the [33% for lack of marketability and lack of control] discounts were acceptable). Assets included securities, real estate, insurance policies, annuities, and partnerships.

- In a reviewed opinion (7-2-5) by Judge Cohen, the Tax Court rejected the estate’s claims that the partnership was formed to protect the assets from claims or will contests, as well as the estate’s argument that the partnership was a joint investment vehicle. She also found that the management of the assets was not the purpose for the formation of the partnership. For active business was conducted by the partnership. Nevertheless, the existence of the partnership was respected because

SFLP [the partnership] was validly formed under State law. The formalities were followed, and the proverbial “i’s were dotted” and “t’s were crossed.” The partnership, as a legal matter, changed the relationships between decedent and his heirs and decedent and actual and potential creditors. Regardless of subjective intentions, the partnership had sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of decedent’s assets, and we do not disregard it in this case.

- However, once past this issue [and other structural estate tax issues] the court accepted the Commissioner’s lesser discount rather than the large one claimed by the estate.

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Judge Laro, concurring, foreseeing the mischief the majority opinion could cause in income tax cases, would have limited the holding that the partnership had enough substance to be recognized for estate and gift tax purposes.

Judge Ruwe, in dissent, would have found a taxable gift under § 2512(b), in the amount of any diminution in value of the assets, because that value was transferred to other family members by the overall arrangement.

Judge Parr’s dissent described the transactions as “a mere paper arrangement” that did not limit the decedent’s control over the assets.

Judge Beghe’s dissenting opinion would have applied the end result version of the step transaction doctrine to include the partnership assets directly in the decedent’s estate.

[U]nder the end-result test, the formally separate steps of the transaction (the creation and funding of the partnership within 2 months of Mr. Strangi’s death, the substantial outright distributions to the estate and to the children, and the carving up of the Merrill Lynch account) that were employed to achieve Mr. Strangi’s testamentary objectives should be collapsed and viewed as a single integrated transaction: the transfer at Mr. Strangi’s death of the underlying assets.

Under this analysis, there is no valuation issue.

2. Knight v. Commissioner. 115 T.C. 506 (11/30/00) (reviewed, 12-1). In another FLP valuation case, involving gift tax valuation, the Tax Court, in a reviewed opinion (10-2-1), by Judge Colvin, upheld the validity of the limited partnership’s existence solely on the ground that it was a valid partnership under state [Texas] law. The opinion distinguished ASA Investering Partnership and ACM Partnership without explaining the particular basis for the distinction.

A family limited partnership formed with a family ranch and two family homes qualified as a partnership, but Judge Colvin found the gifts to the children’s trusts should be reduced by minority and lack of marketability discounts totaling 15%, not the 44% claimed by taxpayers.

VIII. TAX SHELTERS

A. Corporate Tax Shelters

1. Tax shelter benefits from § 453 contingent sale partnership tax shelter not allowed because the tax shelter is a sham and “serves no economic purpose other than tax savings.” Merrill Lynch’s persistence overcomes initial doubts of tax department. ACM Partnership v. Commissioner, T.C. Memo. 1997-115 (3/5/97) aff’d, 157 F.3d 231, 98-2 U.S.T.C. §50,790 (3d Cir. 10/13/98) (2-1), cert. denied, 526 U.S. 1017 (1999). Judge Laro found a § 453 contingent sale partnership tax shelter to be a prearranged sham, “tax-driven and devoid of economic purpose,” and “serv[ing] no economic purpose other than tax savings,” following Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), 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 over which contingent payments could be made, resulting in a large 1989 installment sale gain to the partnership. The lion’s share of that installment sale gain was allocated to the foreign bank (which was not taxable on U.S. source capital gain), followed by the redemption of the foreign bank’s partnership interest. This left Colgate as the 90-percent partner. In 1991, the installment sale obligation was sold by the partnership, triggering about $100 million of capital losses, which Colgate attempted to use to shelter its 1988 capital gain.

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.

a. Merrill Lynch pays for the contingent installment sale tax shelter. News Release IR-2001-74 (8/28/01). IRS announced that Merrill Lynch agreed to settle a penalty case the IRS had brought against it under §§ 6700 [promoting abusive tax shelters, etc.], 6701 [aiding and
abating understate of tax liability], 6707 [failure to furnish information regarding tax shelters by persons subject to the requirement to register a tax shelter under § 6111] and 6708 [failure to maintain lists of investors in potentially abusive tax shelters] for the 1989-1990 promotion of the contingent installment sale shelter in ACM Partnership v. Commissioner, 157 F.3d 231 (8th Cir. 1998), cert. denied, 526 U.S. 1017 (1999), and other cases.

2. *Modifications of Circular 230 are proposed, including the standards for providing advice regarding tax shelters; firms will be required to have procedures to ensure compliance. REG-111835-99, proposed Circular 230 regulations, 66 F.R. 3276 (1/12/01). Changes proposed to Circular 230 include:

- § 10.21 would require practitioners to advise a client who had not complied with revenue laws of the manner in which the error or omission may be corrected and the possible consequences of not taking such corrective action.
- § 10.24 would limit the dissociation from a disbarred or suspended person only to matters constituting practice before the IRS.
- New § 10.35 would prescribe new standards for tax shelter opinions at the more-likely-than-not (or higher) level of confidence. These would include a requirement to make inquiry as to all relevant facts, and be satisfied that the material facts are accurately and completely described in the opinion. The regulations under §§ 6662 and 6664 will be modified to provide that only opinions that satisfy the standards of Circular 230 may be relied upon.
- § 10.33 would apply to all tax shelter opinions not governed by new § 10.35, and would also provide a series of requirements for compliance.
- § 10.36 would require that a practitioner who is a member of, associated with, or employed by a firm must take reasonable steps, consistent with his or her authority and responsibility for the firm’s practice advising clients regarding matters arising under the Federal tax laws, to make certain that the firm has adequate procedures in effect for purposes of ensuring compliance with §§ 10.33, 10.34, and 10.35.

3. Corporate tax shelter disclosure and registration requirements.


- Under the August 2000 amendments, only promoters that are classified as organizers under section 6111(e)(1) are required to register tax shelters.
- The August 2000 amendments to Reg. §301.6111-2T limit the definition of a tax shelter promoter to persons who participate in the organization, management or sale of a tax shelter under §6111(e)(1) and Reg. § 301.6111-1T (Q&A-26 through Q&A-33), or are related to such person under §§267 or 707(b).

- Under the August 2000 amendments, an organizer or seller of an interest in a shelter is not required to (but may) list any investor in a tax shelter that §(2) is not required to register under §6111, (2) is not a listed transaction described in Reg. §301.6111-2T(b)(2), and (3) is not a listed transaction described in Reg. §301.6111-1T A-57A, if (a) the total consideration paid to all organizers and sellers with respect to such investor’s acquisition of the interest is less than $25,000, or (2) the organizer reasonably believes that (A) such investor’s acquisition of the interest will not result in a reduction of tax liability of any corporation (or corporations) that exceeds (i) $1 million in any single taxable year or (ii) a total of $2 million for any combination of taxable years, or (B) will not result in a reduction of the income tax liability of any noncorporate taxpayer (or taxpayers) that exceeds (i) $250,000 in any single taxable year or (ii) a total of $500,000 for any combination of taxable years.


- Temp. Reg. §301.6111-2T defines these as “any transaction” [including “all the factual elements necessary to support the tax benefits that are expected to be claimed
with respect to any entity, plan, or arrangement”): (i) a significant purpose of which is the avoidance of evasion of Federal income tax; (ii) that is offered to any potential participant under conditions of confidentiality; and (iii) for which the tax shelter promoters may receive aggregate fees in excess of $100,000. Registration is to be on Form 8264, “Application for Registration of a Tax Shelter.

- Avoidance or evasion transactions include (1) “listed transactions” [see, e.g., Notice 2000-15]; and (2) transactions structured to produce Federal income tax benefits that constitute an important part of the intended results of the transaction and that the promoter expects it to be presented in substantially similar form to more than one potential participant (unless the participant is expected to participate in the ordinary course of its business in a form consistent with customary commercial practice and there is a “generally accepted understanding” that the Federal income tax benefits are allowable) “; as modified in August 2001, this exception is not foreclosed by “an IRS position that would be merely arguable of that would constitute merely a colorable claim. As originally promulgated, the exception to structured transactions required that the understanding that the expected Federal income tax benefits are allowable for substantially similar transactions be “long-standing”, but his requirement was eliminated by the August 2001 modifications and replaced by a requirement that to be generally accepted the structure of the transaction and the treatment has to have been in the public domain for a “period of years.” Also, as originally promulgated, the regulations included transactions lacking economic substance — transactions in which the expected pre-tax profit (after foreign taxes and transaction costs) is insignificant relative to the present value of the expected net Federal income tax savings, but this requirement was removed by the August 2001 modifications because the Treasury believed that transactions in this category would be included in the structured transactions category.

- Registration will not be required for “excepted transactions,” which are (1) those [excluding listed transactions] for which the promoter reasonably determines that there is no basis under the standard imposed on taxpayers under Reg. 1.6662-3(b)(3) for denial of any significant portion of the expected Federal income tax benefits” [thus this exception is not foreclosed by “an IRS position that would be merely arguable of that would constitute merely a colorable claim”]; or (2) those transactions that the IRS has determined are not subject to registration requirements. A ruling request procedure is provided. Prior to the August 2001 modifications the standard under exception (1) was “no reasonable basis” under applicable Federal tax law.

- “Conditions of confidentiality” is a facts and circumstances determination, with an exception for written agreements expressly authorizing disclosure. Under the August 2000 modifications, restrictions on disclosure of the structure or tax aspects of the transaction reasonably necessary to comply with securities laws are not considered to be a confidentiality agreement. The August 2001 modifications expanded the requirements for authorization of disclosure required to avoid the presumption of confidentiality be adding that any and all materials of any kind, including opinions and analyses provided to the offerees must be subject to disclosure to avoid the presumption.

- Under the August 2000 modifications, an exclusivity agreement (i.e., an agreement requiring the offeree to pay a fee to a promoter if the offeree engages in the transaction, whether or not the offeree uses the promoter’s services) is a condition of confidentiality. But an exclusivity arrangement ordinarily will not result in an offer being treated as made under conditions of confidentiality if it provides express written authorization for disclosure. Limitations on disclosure or use constitute a condition of confidentiality only if the limitations relate to the structure or tax aspects of the transaction and the limitations are for the benefit of any person other than the offeree.

- Registration is to be made not later than the day on which the first offering for sale is made, with extensions generally until 8/26/00.

c. Red Flagging Returns. T.D. 8877, Tax Shelter Disclosure Statements, 65 F.R. 11205 (3/2/00), modified by T.D. 8896, Modification of Tax Shelter Rules, 65 F.R. 49909 (8/16/00), effective 8/11/00), modified by T.D. 8896, Modification of Tax Shelter Rules II, 66 F.R. 41133 (8/7/01) [modifications effective 8/2/01; but taxpayers may rely on modifications after 2/28/00]; REG-103735-00, 65 F.R. 11269 (3/2/00). Temporary and proposed regulations under §6011 require corporations to attach statements to their Federal corporate income tax returns that disclose tax shelters.

- Temp. Reg. §1.6011-4T was issued under §§6001 [required records provision] and 6011(a) [general requirement of return or statement]. It requires that, for “reportable transactions,” corporations must both attach a disclosure statement to their tax returns [separately mailing a copy to the IRS Large & Mid-Size Business Division] and retain all related documents until the expiration of the statute of limitations. Related documents include all marketing materials, all written analyses, all correspondence, etc. Under the August 2000 modifications, the required records include all documents and
other records related to a transaction subject to disclosure under the regulations that are material to an understanding of the facts of the transaction, the expected tax treatment of the transaction, or the corporation’s decision to participate in the transaction.

- A “reportable transaction” is either: (1) a “listed transaction” [see, e.g., Notice 2000-15, 2000-12 I.R.B. 826], or (2) another reportable transaction if it possesses at least two of six of the following characteristics: (a) confidentiality; (b) protection against the possibility that intended tax benefits will not be sustained (including rescission rights, refunds of fees, insurance protection, indemnities other than customary non-promoter indemnities); (c) promoter fees in excess of $100,000; (d) expected tax treatment expected to differ by more than $5 million from book treatment; and (e) the participation of a tax indifferent person. As originally promulgated the regulations also included as a factor that the expected characterization for U.S. income tax purposes differs from that for foreign taxes; this factor was eliminated by the August 2001 modifications.

- Four exceptions are provided: (1) Transactions in the ordinary course of business in a form consistent with customary commercial practice if the taxpayer “reasonably determines” that it would have participated irrespective of the expected Federal income tax benefits; (2) Transactions [in ordinary course and customary commercial practice] if the taxpayer “reasonably determines” that there is a generally-accepted understanding that the expected Federal income tax benefits are allowable for substantially similar transactions; (3) Transactions for which the taxpayer “reasonably determines” that there is “no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits”; as modified in August 2001, this exception is not foreclosed by “an IRS position that would be merely arguable of that would constitute merely a colorable claim”; (4) Transactions identified in published guidance as being exempt from disclosure. As originally promulgated, the regulations required that the understanding that the expected Federal income tax benefits are allowable for substantially similar transactions in exception (3) be “long-standing”, but its requirement was eliminated by the August 2001 modifications and replaced by a requirement that to be generally accepted the structure of the transaction and the treatment has to have been in the public domain for a “period of years.”

d. *Identified “tax avoidance transactions.”*


(2) Notice 2000-60, 2000-49 I.R.B. 568 (11/16/00). IRS identifies and “lists” another tax shelter involving a parent, a subsidiary and an unrelated company. Parent and unrelated transfer cash to the sub, reducing parent’s ownership in the subsidiary to less than 80%. Sub then uses cash to purchase parent stock from parent shareholders and then transfers parent stock to parent employees to cover parent’s stock-based compensation obligations. The sub then liquidates. Parent claims a capital loss in the stock of the sub because the value of the sub has been reduced by the transfers to parent’s employees. Sub claims a capital loss on the sale of its remaining parent stock because it treats transfers to parent employees as contributions of capital to the parent under Reg. § 1.83-6(d). The IRS ruled that the transfers to parent’s employees are properly characterized as distributions by the sub to the parent, followed by compensatory transfers by the parent to its employees. Alternatively, the IRS says it can disregard the steps in the transaction and treat it as a redemption by the parent.

(3) Intermediary transactions tax shelters. Sellers of stock and buyers of assets will now have to care about what is in the black box between them. Notice 2001-16, 2001-9 I.R.B. 730 (1/18/01). The IRS will challenge the purported tax results of intermediary transactions tax shelters. The transactions generally involve a shareholder who desires to sell stock of a target corporation, an intermediary corporation, and a buyer who desires to purchase the assets, but not the stock, of the target. The shareholder purports to sell the stock of the target to the intermediary. The target then purports to sell some or all of its assets to the buyer. The buyer claims a basis in the target assets equal to its purchase price.

- Under one version of this transaction, the target is included as a member of the affiliated group that includes the intermediary, which files a consolidated return, and the group reports losses (or credits) to offset the gain (or tax) resulting from the target’s sale of assets. In another form of the transaction, the intermediary may be an entity that is not subject to tax and that liquidates the target with no reported gain on the sale of the target’s assets.
Transactions that are the same as or similar to the one described in the notice are "listed transactions." Temp. Reg. §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2).

(4) **Contingent liability tax shelters.** Notice 2001-17, 2001-9 I.R.B. 730 (1/18/01). The IRS will disallow losses generated by contingent liability tax shelters. The shelter transactions involve the transfer of a high basis asset to a corporation in exchange for stock of the transferee corporation, and the transferee corporation's assumption of a liability that the transferor has not yet taken into account for federal income tax purposes. The transferor typically remains liable on the underlying obligation. The basis and fair market value of the transferred asset, which may be a security of another member of the same affiliated group of corporations, are generally only marginally greater than the present value of the assumed liability. Therefore, the value of the stock of the transferee received by the transferor is minimal relative to the basis and fair market value of the asset transferred to the transferee corporation.

(5) Note IRS Coordinated Issue Paper on Lease-Stripping Transactions, 7/21/00.

(6) **ITA [IRS Technical Assistance – Chief Counsel Advice]**

200117039 (3/13/01). A partnership's transfer of a stripped lease to a corporation [following a typical lease stripping transaction as described in Notice 95-53, 1995-2 C.B. 334] is a taxable exchange and does not qualify under § 351. More specifically, the partnership transferred the note it held from the lease stripping to a controlled corporation in exchange for stock and the corporation's assumption of the partnership's obligation to make lease payments. The Service concluded that the exchange was substantially similar to the exchange in the contingent liability tax shelter discussed in Notice 2001-17, 2001-9 I.R.B. 730. There was no real purpose for the transactions apart from the creation of an asset, the stock, with a basis in excess of value to generate a tax loss and, therefore, the exchange is taxable. The Service further concluded that even if § 351 did apply, the partnership's basis in the stock would be reduced by the amount of the obligation to make rental payments assumed by the corporation under § 358(d)(1) or the assumption would be a distribution of money under § 357(b) that reduces the partnership's basis in the stock under § 358(a).

(7) **"Customary" leasing transactions need not be registered as tax shelters.** Notice 2001-18, 2001-9 I.R.B. 731 (1/18/01). This notice provides an exception from the registration requirements of §6111(d) and the list maintenance requirement of §6112 for certain customary leasing transactions. The exception applies to a leasing transaction that (1) is a lease or sale leaseback between an owner-lessee of tangible personal property and a lessee who is the user of the property; (2) contains terms that are consistent with customary commercial practice for the leasing of similar items of property; (3) qualifies as a lease for federal income tax purposes under Rev. Proc. 75-21, 1975-1 C.B. 71513 or under case law; (4) is not the same as or substantially similar to a listed transaction under Reg. § 301.6111-2T(b)(2), including a lease strip or lease in/lease out transaction; and (5) has a lessor and lessee who agree to consistently report the transaction as a lease.

(8) **Basis shifting tax shelter is listed.** Notice 2001-45, 2001-33 I.R.B. 129 (7/27/01). This Notice announces that the IRS will disallow benefits from certain "basis shifting" tax shelter transactions that involve a series of pre-arranged steps with the purpose of creating an artificially high tax basis in stock. The transaction involves the use of the attribution rules of § 318 to increase the basis of stock owned by a taxpayer that claims a loss (or reduced gain) upon disposition of that stock. There is a redemption of stock is owned by another person that is tax indifferent. Purportedly as a result of the application of the attribution rules of § 318 [e.g., the other person is foreign corporation of which the taxpayer owns an option to acquire 50% or more] the redemption of stock is claimed to be a dividend under § 301 rather than an exchange under § 302(a). The taxpayer takes the position that under Reg. § 1.302-2(c) the basis of the redeemed stock is added to its basis for stock in the redeeming corporation.

(9) **Some of these are still being peddled to your clients.** Notice 2001-51, 2001-34 I.R.B. 190 (8/20/01), superseding Notice 2000-15. The IRS has identified sixteen listed transactions for purposes of 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 Investernings-type and

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ACM-type transactions; (6) Treas. Reg. § 1.643(a)-8 transactions involving distributions from charitable

4. The $67,000,000 deficiency. United Parcel Service v. Commissioner, T.C. Memo 1999-268 (8/9/99), rev'd, 254 F.3d 1014, 87 A.F.T.R.2d 2001-2565, 2001-2 U.S.T.C. $50,475 (11th Cir. 6/20/01). UPS generally limits its liability for damages to goods in transit to $100, but customers may pay [and UPS collects] “excess value charges” (EVCs) to insure the packages for greater amounts [even though UPS is not licensed as an insurance company]. Prior to 1984, UPS retained all of the EVCs, paid claims, and reported the income and deduction items on its return. Beginning in 1984 UPS restructured the manner in which it dealt with and reported EVCs. Although it did not change its practices for dealing with customers in handling receipts and claims, beginning in 1984 UPS remitted net [of claims paid] EVCs collected from customers and other shippers to an unrelated insurance company (National Union), which in turn, after deducting certain fees, remitted the net EVCs as a reinsurance premium to OPL. OPL was a Bermuda insurance company that was formed by UPS and 97.33% owned by UPS's 14,000 shareholders who received OPL stock as a dividend in a taxable spin-off. The OPL stock was subject to restrictions on transfer. After this arrangement was established, UPS did not report as income the $99,794,790 of EVCs collected and remitted to National Union in 1984, etc. However, UPS performed the same EVC functions and activities that it had performed before 1984 [when it had included the EVCs in income], and it remained responsible for bad debts or uncollectible items because neither National Union nor OPL had any control over the customers' premium payments.

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

b. *UPS is upset on appeal; Eleventh Circuit reverses. Was Gregory a Pyrrhic victory for the government? UPS rejoices. But Eleventh Circuit remands for consideration
of the §482 issue. More news to follow? The Eleventh Circuit (Judge Cox) held that the arrangement “had sufficient economic substance to merit respect in taxation.” It created an obligation enforceable by an unrelated party, National Union. UPS and National Union had real insurance policies that gave National Union the right to receive the EVCs that UPS collected. The court noted that, contrary to the Tax Court’s opinion, OPL was an independently taxable entity not under UPS’s control and UPS lost the stream of income it had earlier gained from the excess-value charges. The court therefore concluded that the transaction was not a sham transfer in which the taxpayer retained the benefits of the income forgone.

- The Eleventh Circuit concluded the insurance policy between UPS and National Union was a “real insurance policy ... that gave National Union the right to receive the excess-value charges that UPS collected.” That National Union faced “slim” odds of losing money did not affect that conclusion, and “[a] history of not losing money on a policy is no guarantee of such a future.”
- Even if National Union was merely a conduit for transmission of the excess-value payments from UPS to OPL, the court considered OPL to be independently taxable entity that was not under UPS’s control. UPS really did lose the income it previously reaped from excess-value charges. The court found this fact to distinguish the case “from the paradigmatic sham transfers of income, in which the taxpayer retains the benefits of the income it has ostensibly forgone.”
- Finally, the Eleventh Circuit found that the Tax Court had misapplied the business purpose test. The appearance of the EVC transactions to customers was not relevant.

... The tax court’s narrow notion of “business purpose” -- which is admittedly implied by the phrase’s plain language -- stretches the economic substance doctrine farther than it has been stretched. A “business purpose” does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a “business purpose,” when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business. See ACM P’ship v. Comm’r, 157 F.3d 231, 251 (3d Cir. 1998). This concept of “business purpose” is a necessary corollary to the venerable axiom that tax-planning is permissible. See Gregory v. Helvering, 293 U.S. 465, 469, 55 S. Ct. 266, 267 (1935) (“The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.”). The Code treats lots of categories of economically similar behavior differently. ... There may be no tax-independent reason for a taxpayer to choose between these different ways of financing the business, but it does not mean that the taxpayer lacks a “business purpose.” To conclude otherwise would prohibit tax-planning. ...

The transaction under challenge here simply altered the form of an existing, bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax-avoidance motive.

- Judge Ryskamp dissented, stating that the overwhelming evidence demonstrates that UPS’s reinsurance arrangements with National Union and OPL had no economic significance or business purpose outside of UPS’s desire to avoid federal income and was therefore a sham transaction.

5. Corporate Owned Life Insurance (“COLI”)  
   a. Deductions for interest on policy loans under Winn-Dixie’s pre-1996 HIPAA leveraged COLI program were denied.

   (1) Tax Court denies “pre-amendment” benefits “retroactively.” The transaction lacked economic substance and business purpose, and thus was a sham for tax purposes. Winn-Dixie Stores Inc. v. Commissioner, 113 T.C. 254 (10/19/99). In 1993, taxpayer entered into a broad-based leveraged corporate-owned life insurance group plan covering approximately 36,000 of its employees. The decision to shift from its existing “key-person” COLI program of individual policies [covering 615 managers] was made pursuant to a proposal that emphasized the “tax arbitrage created when deductible policy loan interest is paid to finance non-taxable policy gains.” The proposal
indicated that taxpayer would have a pre-tax loss totaling $755 million for its 1993-2052 years, but would have total after-tax earnings of more than $2.2 billion for the same period (as the result of total projected income tax savings of more than $3 billion). The COLI policies were terminated in 1997, following 1996 legislation that impacted the plan.

- Judge Ruwe held that the COLI program lacked substance and business purpose, and thus was a sham. He rejected taxpayer's argument that the policies could conceivably produce pre-tax benefits if some catastrophe were to occur that would produce large, unexpected death benefits. "We are convinced that this was so improbable as to be unrealistic and therefore had no economic significance." The court further found that the possible use of projected after-tax earnings to fund employee benefit plans would not cause the COLI plan to have economic substance, noting that, if so, "every sham tax-shelter device might succeed." In light of the $3,000 per year premium paid to insure each employee or former employee, it was irrelevant that there was a relatively small death benefit of $5,000 paid with respect to each dead employee or former employee. Judge Ruwe rejected taxpayer's position that the §264 safe-harbor test protected its interest deductions. He noted that the right to an interest deduction is governed by §163 [and not §264], citing Knetsch v. United States, 364 U.S. 361 (1960). He further quoted, "But we do not agree with [taxpayer's] assertion that the legislative history should be turned into an open-ended license applicable without regard to the substance of the transaction ... Knetsch ... involved transactions without substance. Congress, in enacting section 264(a)(3), struck at transactions with substance. It is a reductio ad absurdum to reason, as [taxpayer] does, that Congress simultaneously struck down a warm body and breathed life into [taxpayer's] cadaver."

(2) Affirmed by the Eleventh Circuit, which holds that - even though the UPS insurance scheme has business reality - the COLI tax shelter is a sham. Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313, 87 A.F.T.R.2d 2626, 2001-1 U.S.T.C. ¶50, (11th Cir. 6/28/01) (per curiam). The Eleventh Circuit rejected taxpayer's primary argument that Congress specifically authorized the interest deduction if the 4-out-of-7 rule of §264. It concluded that in Knetsch the Supreme Court clearly "rejected an argument based on section 264 that is at least a cousin of Winn-Dixie's present contention ... that Congress's failure to close a loophole in section 264 equated to blessing the loophole." The Eleventh Circuit concluded that Knetsch stood for the proposition that "that the sham-transaction doctrine does apply to indebtedness that generates interest sought to be deducted under section 163(a), even if the interest deduction is not yet prohibited by section 264."

- The Eleventh Circuit held that the Tax Court properly applied the sham transaction doctrine:

That doctrine provides that a transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, or if the transaction serves no business purpose. ..... The doctrine has few bright lines, but "[i]t is clear that transactions whose sole function is to produce tax deductions are substantive shams." [Kirchman v. Comm'r, 862 F.2d 1486, 1492 (11th Cir. 1989)] That was, as we read the tax court's opinion, the rule the tax court followed. Nor did the court misapply the rule in concluding that the broad-based COLI program had no "function" other than generating interest deductions.

The tax court found, without challenge here, that the program could never generate a pretax profit. That was what Winn-Dixie thought as it set up the program, and it is the most plausible explanation for Winn-Dixie's withdrawal after the 1996 changes to the tax law threatened the tax benefits Winn-Dixie was receiving. No finding of the tax court suggests, furthermore, that the broad-based COLI program answered any business need of Winn-Dixie, such as indemnifying it for loss of key employees. ... [T]herefore, the broad-based COLI program lacked sufficient economic substance to be respected for tax purposes, and the tax court did not err in so concluding

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14 Bye-bye to leveraged company-wide COLI. The Health Insurance Portability and Accountability Act of 1996 §501 amended §264 to deny the deduction for interest on loans with respect to company-owned life insurance. There is an exception for key person insurance. Phased-in future effective dates and interest rates are provided. The Tax and Trade Relief Extension Act of 1998 §4003(i) further amended §264 to expand the definition of "unborrowed [insurance] policy cash value" to include "inside buildup," for purposes of the COLI pro rata interest disallowance rules.
b. Another COLI falls ill. IRS v. CM Holdings Inc. (In re CM Holdings Inc.), 254 B.R. 578, 2000-2 U.S.T.C. ¶50,791, 86 A.F.T.R.2d 6470 (D. Del. 10/16/00), on appeal to the 3d Circuit. 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 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 court specifically rejected the IRS’s argument that it should apply the “generic tax shelter test” of Rose v. Commissioner, 88 T.C. 386 (1987), aff’d, 868 F.2d 851 (6th Cir. 1989), to disallow the deductions, and questioned whether the Tax Court would continue to apply that test. Rather, the court exhaustively analyzed the facts.

- The §264(c)(1) “four-out-of-seven” safe harbor test was not met because the premiums in years 4 through 7 were paid through so-called “loading dividends.” Pursuant to its COLI plan CMI purchased individual, whole life insurance policies, of which it was the owner and beneficiary, on 1,400 employees. In the first three policy years, 1991-1993, CMI paid premiums largely through non recourse policy loans. In the fourth through seventh policy years, CMI “paid” the annual premiums largely through a combination of partial withdrawals and loading dividends [premium rebates to CMI]. The court (Judge Schwartz) found that the loans for the first three years were real, but that the loading dividends were factual shams that were created by circular accounting treatment, and that there thus was a substantial shortfall in the payment of annual premiums due in years four through seven. Thus, §264(a) applied to disallow the deductions because the premiums were financed by systematic borrowing on the policies. The §264 (c)(1) exception “if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium was paid) is paid under such plan by means of indebtedness” did not apply. The court accepted the IRS’ argument that “annual premiums due” means the nominal annual premiums due less the ‘loading dividends’ that were offset against the contract premiums,” rather than CMI’s argument that annual premiums due meant the “contract-specified premiums.” These were circular netting transactions for the sole purpose of reducing the annual cash premiums paid in those years, and were factual shams.


6. A Goldman Sachs shelter bites the dust. Salina Partnership, LP, FPL Group, Inc. v. Commissioner, T.C. Memo. 2000-352 (11/14/00). FPL Group, Inc., incurred a large capital loss on the sale of a subsidiary. A partnership [Salina] formed by two affiliates of ABN [Dutch bank, acting on behalf of Goldman Sachs] for the benefit of FPL took a short position in U.S. Treasury bills and FPL purchased a 98% limited partnership interest. FPL claimed that through a constructive liquidation under §708(b)(1)(B) and pre-1987 Reg. §1.708-1 it had a special §732(b) downward basis adjustment to reflect a basis equal to its cash purchase price. Salina then closed its short position and claimed it realized STCG of $344 million [$337 million of which was allocated to FPL and used by FPL against its capital loss]. Salina was then liquidated after pursuing a sophisticated investment strategy, with FPL claiming large ordinary losses that were usable because of its $337 million outside basis by reason of the STCG allocated to it. Because the partnership continued for two years after the transactions described above, during which period it managed a variety of financial assets producing for FPL an economic profits apart from tax benefits, Judge Jacobs held that the partnership was not a sham. However, Judge Jacobs upheld the Commissioner’s position [applying Rev. Rul. 95-26, 1995-1995-1 C.B. 31] that the partnership’s obligation to return the Treasury bills that it sold short was a partnership liability under § 752, contrary to its treatment otherwise by FPL in calculating its basis in its partnership interest. Accordingly, FPL was denied the § 732(d) negative basis adjustment and the capital loss was disallowed.

7. Some American Depository Receipts (ADR) arbitrage transactions lack economic substance, some don’t.
a. New Rule in the Tax Court: No More Mr. Nice Guy! (Ms. Nice Gal?). Royal Dutch Shell ADRs peddled by an investment banking firm lacked economic substance. Compaq. Computer Corp. v. Commissioner. 113 T.C. 214 (9/21/99). Compaq recognized a $232 million long-term capital gain in 1992. Shortly afterwards, an investment firm [Twenty-First Securities Corp.] contacted the Compaq Treasury Department with the suggestion that it take advantage of an ADR arbitrage transaction. (American Depository Receipts are transferable units in a trust that represent ownership of foreign stock.) This involved purchases of $888 million of Royal Dutch Shell ADRs cum dividend, followed by sales of those ADRs ex dividend within the hour for $868 million. Compaq then carried back $20 million of loss against the previously recognized gain. It also claimed a $3.4 million foreign tax credit for taxes withheld from the $22.5 million dividend received. Judge Cohen held that the transaction lacked economic substance because the net cash flow from the transaction without regard to tax consequences was a $1.5 million loss. The foreign tax credit was denied and a negligence penalty was imposed.

- Judge Cohen considered it important that Compaq did not perform a cash flow analysis, nor did it investigate the investment. She noted that Compaq shredded the spreadsheet provided by the promoter and “has chosen not to disclose any communications” indicating any reliance on the advice of its tax department or counsel. These factors were also important to the court in upholding a negligence penalty.

- Judge Cohen quoted ACM Partnership for the proposition that the business purpose requirement of the economic substance doctrine is only satisfied when “the transaction [is]rationally related to a useful nontax purpose that is plausible in light on the taxpayer’s conduct and ... economic situation.” She continued, “This inquiry takes into account whether the taxpayer conducts itself in a realistic and legitimate business fashion, thoroughly considering and analyzing the ramifications of a questionable transaction, before proceeding with the transaction,” citing the UPS case.

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

b. But the Eighth Circuit looks at different ADR deals peddled by the same investment banker and concludes that they did have economic substance. Was the difference that taxpayer satisfied the new “two-meeting rule,” or was it that taxpayer sought outside advice on securities law and tax law, or was it that foreign withholding taxes did not reduce the amount of dividend income received (so taxpayer had a pre-tax profit)? Risk minimization was seen as “prudence,” as opposed to “sham.” IES Industries v. United States, 253 F.3d 350, 2001-1 U.S.T.C. ¶50,471, 87 A.F.T.R.2d 2492 (8th Cir. 6/14/01), rev’g 84 A.F.T.R.2d 6445, 2001-1 U.S.T.C. ¶50,470 (N.D. Iowa 9/22/99). Taxpayer purchased the ADRs from tax-exempt organizations, which paid no U.S. taxes, but were subject to foreign withholding on the dividends. The ADR arbitrage transaction created foreign tax credits (as in the Compaq case). On a motion for summary judgment by the government, Judge McManus held that the ADR transactions “did not change IES’s economic position except for the transactions having resulted in the transfer of the claim to the foreign tax credit to IES.” The court also did not permit deduction of taxpayer’s out-of-pocket costs.

- The Eighth Circuit reversed, finding a business purpose and distinguishing Compaq. First, the court rejected the government’s argument that “the tax benefits that were the sole reason for the transactions, [because] each series of ADR trade pairs resulted, as pre-planned, in an economic loss.” It rejected the government’s view that “IES purchased only the right to the net dividend—not the gross dividend”—a view which if accepted would result in IES realizing an economic benefit only if it received the foreign tax credit. Rather, the court concluded that the profitability of the transaction should be analyzed by considering the gross income realized by IES, not the cash flow. It concluded that “the economic benefit to IES was the amount of the gross dividend, before the foreign taxes were paid. ... The fact that the taxes were withheld, and then paid, by the foreign corporation that issued the stock represented by the ADRs, so that IES received only 85% of the dividend in cash, is of no consequence to IES’s liability for the tax. ... Because the entire amount of the ADR dividends was income to IES, the ADR transactions resulted in a profit, an economic benefit to IES.”

- Second, the Eighth Circuit concluded that the proper inquiry when applying the business purpose test is “whether the taxpayer was induced to commit capital for reasons only
relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved.” The court described the business purpose test as “a subjective economic substance test,” and invoked Gregory [293 U.S. 465, 469 (1935)] for the proposition that “the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted,” concluding that a “taxpayer’s subjective intent to avoid taxes thus will not by itself determine whether there was a business purpose to a transaction.”

- The court rejected the government’s argument that the transactions were shams because there was no risk of loss, focusing on the legal, as opposed to economic, risk of nonpayment of the dividends, and distinguishing Compaq by stating: “The risk may have been minimal, but that was in part because IES did its homework before engaging in the transactions. Company officials met twice with Twenty-First representatives and studied the materials provided. After that, IES consulted its outside accountants and its securities counsel for reassurances about the legality of the transactions and their tax consequences.” The court noted that IES did its own investigation and rejected some of the ADR trades that Twenty-First proposed. That IES structured the transactions [e.g., making some trades when the U.S. markets were closed, in order to avoid the risk of fluctuations in market price of the ADRs between the purchase and sale and to prevent a third party from attempting to break up the trades] to avoid “any more risk than necessary,” was characterized as “good business judgment consistent with a subjective intent to treat the ADR trades as money-making transactions.” The court was “not prepared to say that a transaction should be tagged a sham for tax purposes merely because it does not involve excessive risk.” Finally, the court emphasized that all of the parties involved were unrelated to IES and engaged in “legitimate business, and the transactions were at arms’ length.

- In a footnote, the court noted that in 1997, Congress amended § 901(k) to increase to at least sixteen days the amount of time an ADR must be held within a thirty-day period that includes the dividend record date in order for the foreign taxes paid on the dividend to qualify for the foreign tax credit. But it attached no importance to that change either way.

B. Individual Tax Shelters
1. Notice 2000-61, 2000-49 I.R.B. 569 (11/21/00). The IRS moved to shut down the Guam Resident Trust Tax Shelter by ruling that the single filing rule contained in § 935 applies solely to individuals with Guam connections, and not to trusts. The scheme under which a trust seeks to avoid the Guam Resident Trust Tax Shelter by stating: “The risk may have been minimal, but that was in part because IES did its homework before engaging in the transactions. Company officials met twice with Twenty-First representatives and studied the materials provided. After that, IES consulted its outside accountants and its securities counsel for reassurances about the legality of the transactions and their tax consequences.” The court noted that IES did its own investigation and rejected some of the ADR trades that Twenty-First proposed. That IES structured the transactions [e.g., making some trades when the U.S. markets were closed, in order to avoid the risk of fluctuations in market price of the ADRs between the purchase and sale and to prevent a third party from attempting to break up the trades] to avoid “any more risk than necessary,” was characterized as “good business judgment consistent with a subjective intent to treat the ADR trades as money-making transactions.” The court was “not prepared to say that a transaction should be tagged a sham for tax purposes merely because it does not involve excessive risk.” Finally, the court emphasized that all of the parties involved were unrelated to IES and engaged in “legitimate business, and the transactions were at arms’ length.

2. Straddle losses outside of § 1092 disallowed where neither economic substance nor profit motive were present. Keeler v. Commissioner, 243 F.3d 1212, 87 A.F.T.R.2d 1224 (10th Cir. 3/13/01), aff’g T.C. Memo 1999-18. The Tenth Circuit upheld the disallowance of losses incurred by the taxpayer in a stock derivatives straddle program for years before § 1092 was extended to straddles involving stock. The transactions were found not to have any economic substance or profit motive, because, among other reasons, their “raison d’etre was tax avoidance.” [In late 1981 the taxpayer closed out the loss side of transactions realizing losses of $7,598,940 — an amount within $3,600 of his gross income; his 1982 losses offset 97% of his gross income.] The offsetting gains were consistently rolled forward. In addition, the transactions were so closely matched, in an artificial market maintained by the promoter, as to negate the possibility of realizing a pre-tax profit. Finally, the taxpayer paid significant up-front fees, and had a significant noninterest-bearing margin deposit.


IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations
1. Intermediate sanctions regulations are out; break out the supply of 1099s. REG-246256-96; T.D. 8920, proposed and temporary regulations under § 4958, which permits the IRS to impose excise taxes against disqualified persons who participate in excess benefit transactions with section 501(c)(3) and 501(c)(4) organizations (66 F.R. 2144 & 2173, 1/10/01). These rules reflect the spirit under which § 4958 was enacted, which was to tax “excess” benefits provided by charities to insiders (including board members); these “excess” benefits also include benefits provided to insiders that are not reported as compensation.
2. *Not-for-Profits have to pick their partners carefully, and pay attention to the governing structure of the partnership. Redlands Surgical Services v. Commissioner, 113 T.C. 47 (7/19/99). Redlands Surgical Services (RSS) was a nonprofit corporation that was affiliated with a nonprofit hospital. RSS’s sole activity was participating as the co-general partner with a for-profit corporation in a limited partnership that was the general partner of an operating partnership that owned and operated an ambulatory surgery center. Nothing in the partnership agreements or any of the other agreements related to the operation of the surgery center, established any obligation that charitable purposes be put ahead of economic objectives in the surgery center’s operations, and the profits of both partnerships were distributable to for-profit partners as well as RSS. After an exhaustive review of the terms of the partnership agreements, relevant contracts, and the actual management practices, on the facts RSS was found to have ceded effective control over the operations of the partnerships and thus the surgery center to for-profit parties. RSS had surrendered the ability to cause the surgery center to respond to community needs and nothing required the surgery center management to be guided by any charitable or community benefit, goal, policy, or objective. An impermissible private benefit was conferred. The Tax Court (Judge Thornton) reasoned:

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

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

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

• The reasoning of the whole hospital joint venture ruling was applied. Rev. Rul. 98-15, 1998-1 C.B. 718 (3/4/98) (Two fact patterns: Situation I concludes that the exempt hospital will continue to be exempt where it will receive an interest in the combined operation equal in value to the assets it contributed and the board structure gives control of the joint venture to the exempt organization’s appointees. There is a loss of exemption in Situation 2, where the joint venture’s governing documents do not require that it serve charitable purposes, board control rests with the taxable entity, and the taxable entity may unilaterally renew the management agreement. Both conclusions depend on "facts and circumstances.


Specifically, we adopt the tax court’s holding that appellant Redlands Surgical Services “has ceded effective control over the operations of the partnerships and the surgery center to private parties, conferring impermissible private benefit. [Redlands Surgical Services] is therefore not operated exclusively for exempt purposes within the meaning of sec. 501(c)(3), I.R.C. 1986."*** We also affirm the tax court’s conclusion that the benefit conferred on private parties by the surgery center’s operations prevents Redlands Surgical Services from attaining tax exempt status under the integral part doctrine.

[requiring registration with the IRS of certain political organization] and (j) [requiring political organizations to disclose contribution, with a penalty for failure to comply] are unconstitutional and a preliminary injunction against their enforcement. The government raised the anti-injunction act, § 7421(a), as a defense. The district court [Judge Vollmer], held that the anti-injunction act did not bar the suit because (1) § 527(j) imposes a penalty rather than laying a tax and § 6671(a) did not apply to treat this penalty as a tax, and (2) a contributor [who joined in the suit on the grounds that he would be less inclined to contribute if his contribution were disclosed] lacked any other vehicle for challenging the provisions. Section 527(i), however, is a tax statute, because it confers taxable status on political organizations, and the challenge to it was subject to the Anti-Injunction Act, but individual plaintiffs lacked standing to challenge § 527(i).

B. Charitable Giving

1. *Abusive charitable remainder trusts curtailed. REG-116125-99, Prevention of Abuse of Charitable Remainder Trusts, 64 F.R. 56718 (10/21/99). The Treasury issued proposed regulations under §§ 643 and 664 to combat abuses in the use of charitable remainder trusts that occur when distributions in excess of income are made to non-charitable beneficiaries where the trustee borrows money or enters into a forward sale of the trust assets. The trust would be treated as having sold a pro rata portion of its assets to the extent that the distribution (1) is not characterized as income under § 664(b), and (2) is made from amounts received by the trust that are neither (a) a return of basis nor (b) attributable to a deductible charitable contribution made in cash.


2. REG-106513-00, Definition of Income for Trust Purposes, 66 F.R. 10396 (2/15/01). Proposed regulations would revise the definition of income under § 643(b) to take into account recent changes in the definition under state law of trust accounting income. Special rules address problems of pooled income funds and charitable remainder unitrusts.

X. TAX PROCEDURE

A. Penalties and Prosecutions

1. 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 and two corporate executives 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."15

a. So far, he is unable to wriggle out, the way he did 25 years ago when he was acquitted by a jury.15 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 unnamed 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 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 in the Seventh and Eleventh.

2. A warning shot across the bow: Section 6673 sanctions will be applied to frivolous section 6330 [and section 6320] petitions. Pierson v. Commissioner, 115 T.C. 576 (12/14/00). Taxpayer's petition to review IRS's decision to levy, alleging no liability, was dismissed for failure to respond to an earlier deficiency notice, following Goza v. Commissioner, 114 T.C. 176 (2000). Because taxpayer made only tax protestor type arguments, the court (Judge Wells) raised the issue of § 6673 sanctions for a frivolous petition. But because its jurisdiction over § 6330 actions is so new, sanctions were not imposed, but the court strongly warned that it would do so in the future.

3. Maybe if she'd been able to delay the trial until after Mel Carnahan was elected to the Senate. Luce v. Luce, 119 F. Supp. 2d 779, 2000-2 U.S.T.C 50,847, 86 A.F.T.R.2d 6977

15 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).
(S.D. Ohio 10/27/00). The sole officer and majority shareholder of a corporation was a responsible person under § 6672 even though she testified that her deceased husband made all the business decisions and she could not question those decisions.

4. IR-2001-19 (2/12/01). The Service warns taxpayers not to fall victim to eight commonly used tax scams. They include (1) No taxes being withheld from your wages; (2) "I don't pay taxes"; (3) African-Americans get a special tax refund; (4) "Pay the tax, then get the prize"; (5) "Untax yourself for $49.95"; (6) Social Security tax scheme; (7) "I can get you a big refund . . . for a fee!"; and (8) IRS "Agent" comes to your house to collect. To drop a dime, call 1-800-829-0433, except for #1 (1-800-829-1040) and #8 (1-800-366-4484).

5. You, too, can get free room and board for ten years if you are "misunderstood" by your employees. United States v. McLeod, 251 F.3d 78, 87 AFTR2d 2274 (2d Cir. 5/21/01). The tax loss caused by defendant tax preparer added up to $7,578,925, so the punishment totaled 121 months.

At the sentencing hearing, however, McLeod challenged the inclusion of the tax loss resulting from the civil audit and disclaimed responsibility for the false returns covered by the audit. He testified that the willingness of his employees to claim false deductions could have only resulted from a misunderstanding. The Government rebutted McLeod's claim with the testimony of an IRS agent who testified that the employees told him that McLeod taught them how to prepare returns: to assign the client a refund that is approximately half of their tax due, to give clients charitable deductions equal to approximately ten percent of their income, and to use names of child care providers from a list McLeod supplied, names unknown to the taxpayers.

B. Discovery: Summons and FOIA

1. T.D. 8935, Disclosure of Returns and Return Information to Designee of Taxpayer, 2001-8 I.R.B. 702 (12/29/00). Section 6103(c), as amended in 1996, authorizes the IRS to disclose return information to the taxpayer's designee upon the taxpayer's request, whether or not the designation and request is in writing. Temp. Reg. § 301.6103(c)-1T provides procedures for the disclosure of return information pursuant to taxpayer's request. Also, simultaneously issued as Proposed Regulations, REG-103320-00, 2001-8 I.R.B. 714 (12/29/00).

2. Depositions in the Tax Court! But the circumstances were unusual. GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner, 117 T.C. No. 1 (7/5/01) The joint application of the taxpayer and IRS to perpetuate taxpayer's officers testimony by deposition was granted even though a deficiency notice had not been issued. The matter was contentious, the § 482 dispute was likely to go to trial, and the executives were foreign residents of advanced age whose testimony was likely to be lost. Finally, there was no evidence that the depositions served a discovery purpose.

C. Litigation Costs

1. Be careful not to over-empathize with your client. Nis Family Trust v. Commissioner, 115 T.C. 523 (12/04/00). After filing a Tax Court petition, taxpayers, who were represented by counsel abandoned their return positions and relied on a strategy of noncooperation and delay, undertaken behind a smokescreen of frivolous tax-protester arguments. The taxpayer's attorney, [according to the Tax Court] in bad faith, aided in that strategy by making additional meritless tax-protester arguments, making meritless motions and responses to motions, and abusing the court's subpoena power. In addition to upholding § 6662 accuracy related penalties, the Tax Court imposed a $25,000 penalty under § 6673(a)(1) for instituting and maintaining these proceedings primarily for delay and taking frivolous and groundless positions. In addition, pursuant to § 6673(a)(2) taxpayer's counsel was ordered to personally pay $10,643.75 for the Commissioner's excess attorney's fees reasonably incurred as a result of her course of conduct.

2. The high price of excessive zeal in representing a client. Johnson v. Commissioner, 116 T.C. 111 (2/27/01). In a case involving defense of a sham trust arrangement, Judge Cohen imposed sanctions and costs under § 6673 in the amount of $8,587.50 of IRS counsel expenses [at $150 per hour] and $807.06 of expenses against taxpayer's counsel [Joe Alfred Izen, Jr.], who was described, with citations to prior cases, as "having a long history of involvement with sham trusts" for multiplying the proceedings "unreasonably and vexatiously" by "pursuing claims that have been rejected so frequently that they are "entirely without colorable pretext or basis and are taken for reasons
of harassment or delay or for other improper purposes" and by "chronic failure to comply with discovery orders."

3. Request that Appeals conference if you expect to prevail and want to collect attorney's fees. Haas & Associates Accountancy Corp. v. Commissioner, 117 T.C. No. 5 (8/10/01). The taxpayer substantially prevailed on the merits in a deficiency proceeding and sought attorney's fees. In the deficiency proceeding, the taxpayer failed to request an Appeals conference, but did make a "qualified offer" pursuant to §7430(c)(4)(E) [which deems the taxpayer to have substantially prevailed if the deficiency is determined to be less than the offer]. The Tax Court (Judge Swift) held that, consistent with Treas. Reg. §301.7430-1(b)(1), failure to request an Appeals conference was, on the facts, a failure to exhaust administrative remedies barring recovery of attorney's fees. Making a "qualified offer" under §7430(c)(4)(E) does not constitute in and of itself constitute an exhaustion of administrative remedies.

D. Statutory Notice

1. Going Postal? Heaven help us! T.D. 8939, Definition of Last Known Address, 66 F.R. 2817 (12/11/00). Under amended Reg. §301.6212-2, a taxpayer's last known address is the address that appears on the taxpayer's most recently filed and properly processed Federal tax return, unless the taxpayer has given the IRS clear and concise notification of a different address [nonmandatorily Form 8822 may be used]. If, however, the IRS obtains a different address through the United States Postal Service National Change of Address database, that will be the taxpayer's last known address, unless the taxpayer has given the IRS clear and concise notification of a different address. These rules will apply to determine the taxpayer's last known address not only for purposes of deficiency notices, but also for purposes of other notices, statements, and documents mailed by the IRS to a taxpayer's last known address pursuant to the Code or regulations. See also Rev. Proc. 2001-8 I.R.B. 708 (1/17/01).

2. *An optional statutory provision? Rochelle v. Commissioner, 116 T.C. No. 26 (5/21/01). Section 3463(a) of the IRS Restructuring and Reform Act of 1998, an uncodified provision, states 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." The taxpayer received an otherwise valid deficiency notice that omitted the last date for filing a Tax Court petition and filed his petition 56 days late. In a reviewed opinion (10-6) by Judge Vasquez, the Tax Court held that the deficiency notice nevertheless was valid and dismissed the taxpayer's untimely petition. The court held that §6213(a) [providing that a petition filed by the date indicated on the deficiency notice as the last date is timely] does not result in unlimited time to file a petition if no due date is specified. The taxpayer was not confused, mislead, or prejudiced by the notice or the absence of a specified petition filing date.

- Judge Chabot (joined by Gale and Marvell) dissented, basically on the grounds that "shall" means "shall" and "each" means "each" and that failure to do what the IRS is directed to do must have consequences, specifically, rendering the deficiency notice invalid. Judge Swift would have found the notice valid but would have allowed a "reasonable extension" of time to file as the consequence of noncompliance with §3463(a) of the 1998 Act and would have found the petition timely. Judges Foley and Colvin would have found that the deficiency notice was valid, but that there was no outside date for filing a petition.

E. Statute of Limitations

1. Final regulations under §7502 relating to the treatment of a timely mailing as a timely filing. TD 8932, Timely Mailing Treated as Timely Filed/Electronic Postmark, 66 F.R. 2257 (1/11/01). Under amended Reg. §301.7502-1, in certain situations, a claim for credit or refund made on a late filed original income tax return will be treated as timely filed on the postmark date for purposes of §6511(b)(2)(A) [consistent with Weisbart v. United States, 222 F.3d 93 (2d Cir. 2000)]. The same rule will apply to claims for credit or refund made on late filed original tax returns other than income tax returns, including Form 720, Quarterly Federal Excise Tax Return, and Form 706, U.S. Estate Tax Return. Late filed original tax returns also will be treated as filed on the postmark date.

2. Just where on the return do you find "gross income"? Harlan v. Commissioner, 116 T.C. 31 (1/17/01). This case involved the calculation of gross income for purposes of determining whether the six-year statute of limitations in §6501(e)(1)(A) applied. The Tax Court (Judge Chabot), in a matter of first impression, held that pursuant to §702(c) the gross income of a partner in a

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16 The USCPS NCOA database is a computerized record of changes of address for a thirty-six month period obtained from USPS Form 3575, "Official Mail Forwarding Change of Address Form."
partnership (the upper tier partnership) that holds an interest in another partnership (the lower tier partnership) includes the upper tier partnership's distributive share of the gross income of the lower tier partnership and not merely the gross income of the upper tier partnership.

F. Liens and Collections

1. Van Es v. Commissioner, 115 T.C. 324 (10/13/00). Section 6330(d) does not confer on the Tax Court jurisdiction to review an Appeals decision not to stay a levy pursuant to an assessed § 6702 frivolous return penalty. Section 6330(d) does not expand the Tax Court’s jurisdiction to types of taxes over which the Tax Court does not ordinarily have jurisdiction.

2. Katz v. Commissioner, 115 T.C. .329 (10/13/00). Section 6320(d) confers on the Tax Court jurisdiction to review an Appeals decision not to abate interest in connection with an appeal under § 6320 of a filing of a lien. The Commissioner’s refusal to abate interest under § 6404 is appealable to the Tax Court under §§ 6404(i) and 7481(c). Retitigation of the underlying deficiency stipulated in prior decision was barred by res judicata.

3. Sections 6220 / 6230 judicial review has a bite as well as a bark. Mesa Oil Inc. v. United States, 2001-1 U.S.T.C. ¶50,130, 86 A.F.T.R.2d 7312 (D. Colo. 12/5/00). The district court (Judge Babcock) held that the IRS Appeals Officer had abused her discretion in failing to grant relief from a proposed levy [for unpaid employment taxes] pursuant to a §§ 6220 / 6230 hearing because the requirement of § 6330(c)(3) that the government’s collection concerns be balanced against the intrusiveness of the collection had not been satisfied. The Appeals Officer’s decision was based on the fact that the IRS had followed proper procedures but it did not take into account the impact that the levy would have on Mesa’s continued operation as a going business. The court also stated that there must be enough information in the IRS documentation to permit a court to draw conclusions about whether the Appeals Officer had abused her discretion.


4. A hearing isn’t always a hearing. Moorhaus v. Commissioner, 116 T.C. No. 20 (4/23/01). The Tax Court held that the fact that the IRS has accorded the taxpayer an “equivalent hearing” following an untimely request for a § 6330 hearing following a notice of intent to levy does not constitute a waiver of the of the time deadline for requesting a hearing. Furthermore, a husband and wife are separate taxpayers for purposes of § 6330. Separate notices of intent to levy may be issued to each of them at different time with different time deadlines for requesting a hearing, and one can timely request an hearing while the other’s request is not timely.

5. Begging for release of tax liens. T.D. 8951, Withdrawal of Notice of Federal Tax Lien in Certain Circumstances, 66 F.R. 33464 (6/22/01). Reg. § 301.6323(j)-1 clarifies the standards under which the Commissioner will withdraw a lien pursuant to § 6323(j). The regulations provide that the procedure and form to be followed by a taxpayer in filing a written request for withdrawal of a tax lien will be prescribed by the Commissioner, but set forth minimum required information.

6. Effective date controversy. Parker v. Commissioner, 117 T.C. No. 6 (8/21/01). The IRS filed a lien against the taxpayer’s property before the effective date of §§ 6320 and 6330; after the effective date the IRS notified the taxpayer of its intent to levy on the property and provided the taxpayer an administrative hearing under §6330. When the Appeals issued a notice of determination that there was no reason not to levy, the taxpayer petitioned the Tax Court for review. The Commissioner argued that the court lacked jurisdiction because the lien was filed before the effective date of §§ 6320 and 6330 and the lien and levy were a single continuing collection action. The Tax Court (Judge Laro) rejected the Commissioner’s argument and held that it had jurisdiction under § 6330 to review the determination to levy because liens and levies are separate actions within the collection process. The court did not reach the merits.

G. Innocent Spouse

1. When the legislative history is ambiguous, read the statute. Tax Court majority holds that the test for knowledge under the § 6015(c)(3)(C) separate liability election is the same as that under former § 6015(e)(1)(C), which is that knowledge of an item of omitted income is sufficient to deny relief even if the spouse has no reason to believe that the way the item was reported on the return was correct. Cheshire v. Commissioner, 115 T.C. 183 (8/30/00) (reviewed, 11-4), on appeal to the 5th Circuit. A spouse who has actual knowledge of the transaction giving rise to omitted income has “reason to know” of the understatement and is not entitled to innocent spouse relief under § 6015(b). The taxpayer's proposed standard based on a prudent taxpayer being expected to know
of the understatement was rejected as providing too broad an escape hatch form liability. More importantly, the Tax Court (Judge Jacobs) held that for the spouse to be denied apportioned liability relief, § 6015(c)(3)(C) does not require actual knowledge of whether the entry on the return is or is not correct. The applicable knowledge standard under § 6015(c)(3)(C) is “an actual and clear awareness (as opposed to reason to know) of the existence of an item which gives rise to the deficiency (or portion thereof).” Thus because when the spouse seeking apportioned liability in Cheshire signed the joint return, she was aware of the amount, the source, and the date of receipt of a retirement distribution received by her then husband, she was denied apportioned liability, even though at that time she misunderstood how much of the retirement distribution properly was taxable and thus did not know that the amount of income was understated. The court declined to follow a statement in H. Conf. Rept. 105-599, at 253 (1998) that “if the IRS proves that the electing spouse had actual knowledge that an item on a return is incorrect, the election will not apply to the extent any deficiency is attributable to such item.” The court did, however, find that the Commissioner abused his discretion in failing to grant equitable relief from penalties under § 6015(f), even though the failure to grant equitable relief on the underlying deficiency was not an abuse of discretion. The taxpayer relied on her husband’s description of the tax consequences of the transaction and his representations that he had been advised by a CPA and had no reason to doubt him.

- Judge Jacobs writing for the majority held that the wife was properly denied innocent spouse treatment under § 6015(c)(3)(C) where she had knowledge that her husband had received a distribution from his retirement plan. The wife was told by her husband that their accountant had advised him that amounts used to pay off the mortgage could be excluded from income the same way that the portion of the distribution that was “rolled over” was treated. The majority held that the wife does not need to have knowledge of the tax consequences of the item or that the entry on the return is incorrect. The court relied on former § 6013 cases, such as Wiksell v. Commissioner, 215 F.3d 1335 (9th Cir. 2000), aff’d without published opinion T.C. Memo. 1999-32, and Bokum v. Commissioner, 94 T.C. 126 (1990), aff’d, 992 F.2d 1132 (11th Cir. 1993), to the effect that knowledge of the legal consequences of an item may be presumed if the spouse has knowledge of the item.

- The dissenting opinions (Judges Parr, Colvin, Marvel, and Gale), based on the legislative history, would limit denial of relief under § 6015(c)(3)(C) to cases in which the spouse actually knew of the understatement of the item. Judge Colvin’s dissent is based upon the conclusion that § 6015(c) was enacted to make clear that the spouse must have had “actual knowledge that the treatment of the item on the tax return was incorrect” in order to be denied innocent spouse treatment.

2. *But a little ray of mercy shines through.* Martin v. Commissioner, T.C. Memo. 2000-346 (11/08/00). Section 6015(e) relief was granted to a wife who had only superficial incomplete knowledge of a complex transaction in which her husband disposed of stock in a purported § 351 transaction, which was designed to fraudulently deceive state insurance regulators, without the actual receipt of any cash or property by either spouse.

3. But hark, what light through yonder window breaks. Braden v. Commissioner, T.C. Memo 2001-069 (3/22/01). Judge Marvel held that innocent spouse relief was available under § 6015(b)(1) to a husband who prepared a joint tax return that omitted distributions received by his wife from her deceased father’s IRA, and from which he received no benefit. Because the husband had no knowledge of his [ex by the time case arose] father-in-law’s financial affairs and the estate’s attorney [an ex-IRS special agent] had led him to believe that the funds received by the wife were a nontaxable inheritance, the husband did not have “reason to know” under § 6015(b)(1)(C), even though he knew of the receipt, because he did not know that the receipt was from an IRA. Judge Marvel distinguished Chesire v. Commissioner, 115 T.C. 183 (8/30/00) as involving a case in which the spouse denied innocent spouse relief knew of the source of the receipt but misunderstood its includability.

4. **"Actual knowledge" in § 6015(c)(3)(C) means what it says.** Culver v. Commissioner, 116 T.C. 189 (4/02/01). A husband was granted apportioned liability under § 6015(c) because he had no actual knowledge of his wife’s embezzlement income, even though she channeled funds through their joint account and the total deposits to their account substantially exceeded their combined salaries. Section 6015(c)(3)(C) permits the Commissioner to defeat the apportioned liability election only if the Commissioner carries the burden of proof by a preponderance of the evidence that the spouse seeking apportioned liability had actual knowledge — not merely reason to know — of the unreported amounts received by the other spouse. Even though the husband should have inquired about the source of the funds, the standard under § 6015(c)(3)(C) “is not that of a hypothetical, reasonable person, but only that of the [spouse’s] subjective knowledge.”
5. *Cheshire* interpreted: On further proceedings, wife is granted § 6015(c) relief because she couldn’t read her husband’s mind. *King v. Commissioner*, 116 T.C. 198 (4/10/01). Deductions attributable to taxpayer’s husband’s activities had been disallowed [under § 183(a)] because the husband lacked a profit motive. Wife sought apportioned liability under § 6015(e) and the Commissioner disallowed the claim under § 6015(c)(3)(C) because the wife knew of her husband’s activity and that the deduction appeared on the return. The Tax Court held that where the deficiency is attributable to a deduction disallowed under § 183, the Commissioner must prove more than that the spouse seeking relief knew of the deduction. The Commissioner must prove that the spouse seeking relief knew or believed that the other spouse was not engaged in the activity primarily for profit.

* Judge Ruwe adopted Special Trial Judge Cuvillion’s opinion, which held that taxpayer met all the requirements for § 6015(c) apportioned liability relief because the Commissioner could not demonstrate that taxpayer had actual knowledge of the item giving rise to the deficiency at the time she signed the return. Where the fact giving rise to the disallowance was her husband’s lack of a profit object at the time he claimed a loss from a cattle-raising activity, the Commissioner was required to show that wife had actual knowledge of this “lack of profit objective,” which noted that the *Cheshire* standard “is an actual and clear awareness (as opposed to reason to know) of the existence of an item which gives rise to the deficiency (or a portion thereof).” The opinion noted that a footnote in *Cheshire*—an omitted income case—stated, “We leave to another day the manner in which the actual knowledge standard will be applied in erroneous deduction cases.” The spouse will be determined to have actual knowledge of the item if she only lacks knowledge of the legal (tax) consequences of the operative facts.

6. Only one bite at the innocent spouse apple. *Vetrano v. Commissioner*, 116 T.C. 272 (4/25/01). Section 6017(g)(2) precludes any spouse who has meaningfully participated in a court proceeding involving the taxable year in issue from subsequently electing either innocent spouse relief under § 6015(b) or apportioned liability under § 6015(e). This *res judicata*-like bar precludes a subsequent stand alone petition to the Tax Court, under § 6015(e), for innocent spouse relief or apportioned liability. A taxpayer is limited to a single administrative and judicial process to resolve all issues under § 6015 Thus, the Tax Court (Judge Whalen) denied the wife’s motion to dismiss, without prejudice, her innocent spouse election raised in deficiency proceeding because dismissal would have to be with prejudice.

7. Another route to innocent spouse relief. *Estate of Wenner v. Commissioner*, 116 T.C. No. 22 (5/14/01). The Tax Court (Judge Laro) held that once its jurisdiction has been properly invoked under § 6404(i) by a petition to review the Commissioner’s failure to abate interest, the taxpayer is entitled to raise available affirmative defenses to the underlying tax liability as well. Mrs. Wenner, who had previously paid the underlying deficiency, was allowed to seek innocent spouse relief under § 6015 with respect to the underlying tax liability, even though she had not previously requested administrative relief. A prior request for administrative relief is required only for a stand-alone petition under § 6015(e).

8. *Proposed § 6015 regulations.* REG-10946-98, Relief From Joint and Several Liability. 66 F.R. 3888 (1/17/01). The Treasury has published proposed regulations under § 6015 to reflect changes in the law made by the IRS Restructuring and Reform Act of 1998, where § 6013(e) was replaced with § 6015. They clarify that case law interpreting the language under former § 6013(e) will be used to interpret that same language under § 6015. Also, “knowledge or reason to know” of an understatement exists only when either the requesting spouse actually knew of the erroneous item giving rise to the understatement, or a reasonable person in similar circumstances would have known of the item. Knowledge of an item under the proposed regulations would be knowledge of the receipt or expenditure. The proposed regulations would further amend Reg. § 1.6013-4 to clarify that if a spouse asserts and establishes that he or she signed a joint return under duress, then the return is not a joint return, and he or she is not jointly and severally liable. Relief must be requested within two years from the first collection activity, but not before the taxpayer receives a notification of an audit or notice that there might be outstanding liability. Finally, the proposed regulations would provide that the nonrequesting spouse must be given notice that the requesting spouse has filed a claim for relief and be given an opportunity to participate in the proceedings. At the request of one spouse, the IRS would omit from shared documents information that would reasonably identify that spouse’s location.

H. Miscellaneous

encountered by Appeals Officers during the course of an administrative appeal provide guidance on the prohibition of ex parte communications between IRS Appeals Officers and other IRS employees. This was issued pursuant to the directive in § 1001(a)(4) of the Internal Revenue Service Restructuring and Reform Act of 1998 to develop a plan to prohibit such communications that appear to compromise the independence of Appeals Officers. Appeals Officers may speak to lawyers in Office of Chief Counsel, but the Appeals Officers are to “remain responsible for independent evaluation of the strengths and weaknesses of specific issues or positions in the case, or of the case as a whole, and for making independent judgments concerning the hazards of litigation.” The prohibition has no impact on the procedures relating to the Appeals process for cases docketed in the Tax Court.

- Appeals retains procedures for (a) returning cases that are not ready for Appeals consideration, (b) raising certain new issues, and (c) seeking review and comments from the originating IRS function with respect to new information or evidence furnished by the taxpayer or representative.

- Appeals continues to be able to obtain legal advice from the Office of Chief Counsel, subject to limitations designed to ensure that the advice to Appeals is not provided by the same field attorneys who previously gave advice on the same issue to the IRS officials who made the determination Appeals is reviewing.

- IRS counsel who previously provided advice to Exam will be treated as part of Exam for this purpose.

- Commissioner and others responsible for overall IRS operations (including Appeals) may continue to communicate ex parte with Appeals in order to fulfill their responsibilities.

- This revenue procedure is effective for communications between Appeals Officers and other Internal Revenue Service employees that take place after October 23, 2000.

2. REG-246249-96, Information Reporting Requirements for Certain Payments Made on Behalf of Another Person, Payments to Joint Payees, and Payments of Gross Proceeds From Sales Involving Investment Advisers, 65 F.R. 61292 (10/16/00). Proposed amendments to Reg. §§ 1.6041-1, -3; 1.6045-1, -2; 1.6049-4; 301.3406(a)-2, and other correlative sections would (1) clarify who is the payee for information reporting purposes if a check or other instrument is made payable to joint payees; (2) provide information reporting requirements for escrow agents and other persons making payments on behalf of another person; and (3) clarify that the amount to be reported paid is the gross amount of the payment. Proposed regulations under § 6045 would remove investment advisers from the list of exempt recipients.

3. ILM 200046037 (10/15/00) sets forth in detail the calculation method for injured spouse relief in a community property state (Form 8379). Injured spouses are joint filers whose joint refunds have been seized to pay certain of their spouses' nontax debts, such as past-due child or spousal support or a federal loan.

4. Nis Family Trust v. Commissioner, 115 T.C. 523 (12/04/00). As a general rule, where there are no material issues of fact and resolution of the case turns solely on legal issues, the burden of proof rule of § 7491 is irrelevant. Thus § 7491 did not affect the Commissioner's burden on motion for judgment on the pleadings, which can be granted only if there are no material issues of fact.

5. Shwarz v. United States, 234 F.3d 428, 2001-1 U.S.T.C. ¶50,111, 86 A.F.T.R.2d 7191 (9th Cir. 12/8/00). Section 7433 provides the exclusive remedy, and § 7431 does not apply, if an unauthorized disclosure of tax return information occurs in connection with collection activities.

6. Extended Time for Use of the Revised Form W-9. Announcement 2001-15, 2001-8 I.R.B. 715. This announcement advises persons required to file information returns of the availability and required use of Form W-9, Request for Taxpayer Identification Number and Certification (Rev. December, 2000). In response to payor concerns about implementing the new certification requirements, the use of revised Form W-9 is optional until July 1, 2001. The major change to the form is that under Part III, Certification, a payee must now certify that he or she is a U.S. person (including a U.S. resident alien). Payors must use the revised Form W-9 for all new solicitations after June 30, 2001. A foreign person may not use Form W-9 to furnish his or her taxpayer identification number to the payor after December 31, 2000. Instead, foreign payees must use the appropriate Form W-8.

7. Section 7491 was all bark and no bite here. Higbee v. Commissioner, 116 TC 438, 446 (6/6/01) (Vasquez, J.). The burden of proof was not shifted to the Commissioner under § 7491 because the taxpayer did not have required documentary evidence to support claimed casualty loss, charitable contribution, unreimbursed employee business expense and rental activity expense deductions.
Furthermore, § 7491(c), which provides that the Commissioner bears the “burden of production” with respect to any penalties, requires only that the Commissioner must “[c]ome forward with sufficient evidence indicating that it is appropriate to impose the relevant penalty” but “need not introduce evidence regarding reasonable cause, substantial authority, or similar provisions,” negating the penalty. The negligence penalty was sustained.

8. The quality of equity is not strained. Estate of Branson v. Commissioner, 88 A.F.T.R.2d 5726 (9th Cir. 9/5/01). The Ninth Circuit held that Commissioner v. Gooch Milling & Elevator Co., 320 US 418, 420 (1943), in which the Supreme Court has held that [under the predecessor of § 6214(b)] the Tax Court lacks jurisdiction to apply equitable recoupment in income tax cases, does not bar equitable recoupment of an income tax overpayment for same year as estate tax deficiency. (The Sixth Circuit has held to the contrary in Estate of Mueller v. CIR, 153 F.3d 302 (6th Cir. 1998.) The estate’s estate tax underpayment [resulting from an undervaluation of an asset] and the beneficiary’s income tax overpayment [resulting form the consequent lower-than-appropriate §1014 basis] were a single transaction to which equitable recoupment applied.

9. Notice 2001-26, 2001-40 I.R.B. 307 (10/1/01). The IRS has published an updated list of designated private delivery services that qualify for the timely mailing is timely filing or payment rule of § 7502. UPS Worldwide Express Plus and UPS Worldwide Express have been added to the list.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. *How will this affect service in Cocco Pazzo? Same interpretation as Federal and Eleventh Circuits. 330 West Hubbard Restaurant Corp. v United States, 203 F.3d 990, 2001-1 U.S.T.C. ¶50,225, 85 A.F.T.R.2d 859 (7th Cir. 2/15/00). Under §§ 3111(a) & (b) and 3121(q), the IRS could validly assess the employer’s share of FICA with respect to restaurant employees’ unreported tips on the basis of an aggregate computation, without determining individual employees’ shares. Following both the Federal and Eleventh Circuits, the Seventh Circuit held that the IRS is authorized to collect FICA taxes on a single transaction to which equitable recoupment applied.

2. *But that same interpretation isn’t reasonable on the West Coast. Fior D’Italia, Inc. v. United States, 242 F.3d 844, 2001-1 U.S.T.C. ¶50,261, 87 A.F.T.R.2d 1118 (9th Cir. 3/7/01) (2-1), motion for rehearing pending, aff’g 21 F. Supp. 2d 1097 (N.D. Calif. 9/18/98) (The IRS lacks authority to assess the employer’s share of FICA without determining the tip income of individual employees). The IRS assessment of FICA taxes on unreported tips income, which was determined by applying the average tip rate on credit card receipts, applying that rate to the employer’s gross receipts, and then subtracting reported employee tip income was invalid. Judge Kozinski held that the IRS lacks authority to assess employer FICA taxes on an estimated aggregate basis because the IRS method does not account for tips that might be outside the “wage band” [which excludes tips of less than $20 per month or above the social security wage base] from FICA tax. The IRS method does not account for the fact that cash tips are usually less than credit card tips, that tip sharing with busboys, dishwashers, etc. may result in employees receiving less than $20 per month, or “for an upscale restaurant like Fior D’Italia” how many employees’ tips exceeded the social security wage base. Section 446 authority is unavailing to the IRS because it does not apply to FICA taxes, and the negative implication of § 446 not applying to FICA taxes is that the IRS has no authority to rely on estimates in assessing FICA taxes. Nor does § 3121(q) provide any such authority. Although the IRS can assess the employer’s share of FICA taxes without assessing a deficiency against the employees, it may not do so without auditing the employees’ records to determine tip income on an employee-by-employee basis.

This does not mean that the IRS may assess the employer only if it also assesses each of its employees. Three other circuits have rejected this argument and, for reasons well expressed in those opinions, we reject it as well. See 330 West Hubbard Restaurant Corp. v. United States, 203 F.3d 990, 995 (7th Cir. 2000); Bubble Room Inc., 159 F.3d at 565; Morrison Restaurants, Inc. v. United States, 118 F.3d 1526, 1529 (11th Cir. 1997). As the government correctly points out, the employer’s portion of FICA is separate from the employee’s, and the IRS need not collect the one as a condition for collecting the other. Having audited an employee and determined the precise amount of FICA wages the employee has received, the IRS may then choose to assess only the employer, only the employee, or both. If the IRS cannot or will not assess the employee for additional

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FICA tax, this will not jeopardize its right to assess the employer. That having been said, it does not follow that the IRS can dispense with auditing the employees’ records or otherwise determining the amount each employee earned in tips. For the reasons explained, there is no way to determine the employer’s FICA tax liability without making an employee-by-employee determination of the taxable tips each has earned. An aggregate assessment based on inaccurate estimates, as used by the IRS in this case, is simply not authorized. (footnotes omitted)

* Judge McKeown, in dissent, would have followed **330 West Hubbard Restaurant Corp. v. United States**, 203 F.3d 990 (7th Cir. 2000); **Bubble Room, Inc. v. United States**, 159 F.3d 553 (Fed. Cir. 1998); and **Morrison Restaurants, Inc. v. United States**, 118 F.3d 1526 (11th Cir. 1997), all of which upheld as reasonable IRS assessments based on similar methodology.

Every circuit court that has addressed the aggregate assessment issue has come to the opposite conclusion from the majority. The majority’s attempt to avoid the weight of circuit authority by suggesting that its position is somehow in line with that of 330 West Hubbard Restaurant and Morrison Restaurants is transparently unsuccessful. See Maj. Op. at 2892 n.9 (“our holding is entirely consistent with those of the Seventh and Eleventh Circuits”). As noted above, both the Seventh and Eleventh Circuits held that the IRS has the authority to use the aggregate method with respect to unreported tip income without determining the under-reporting by individual employees and crediting their wage history accounts. See 330 West Hubbard Restaurant, 203 F.3d at 994, 997; Morrison Restaurants, 118 F.3d at 1529-30. Although the majority agrees that the IRS need not assess the employees in order to assess the employer, the majority concludes that the IRS may not rely on the aggregate method and must AUDIT the employees. See Maj. Op. at 2892 & n.9. Requiring an audit is simply another way of saying that the IRS cannot estimate and that the only way the IRS can assess taxes on unreported or under-reported tips is to undertake an individual accounting of employees. This view can hardly be viewed as “entirely consistent” with that of the Seventh and Eleventh Circuits. The IRS’s authority to use the aggregate method was at the heart of the cases in those circuits. The majority’s recharacterization can only pretend consistency with these cases.

3. **Tax Court exercises its new worker classification jurisdiction.** Neely v. Commissioner, 115 T.C. 287 (9/27/00). The Tax Court (Judge Vasquez) decided that it has jurisdiction under its new § 7436 “worker classification” jurisdiction to decide (in the context of the case) whether the IRS is barred by the § 6501 statute of limitations from assessing a deficiency based upon worker classification because the statute of limitations is an affirmative defense.

a. Neely v. Commissioner, 116 T.C. 79 (2/13/01). In exercising its jurisdiction over worker classification cases under § 7436 pursuant to Neely v. Commissioner, 115 T.C. 287 (9/27/00), the Tax Court held that the Commissioner was barred from assessing additional employment taxes by the three-year statute of limitations under in § 6501(a) because the elements of fraud were not present. The court (Judge Vasquez) rejected the Commissioner’s argument that the failure of taxpayer’s air conditioning contracting business to report as wages and pay employment taxes with respect to cash payments to three workers who demanded to be paid in cash was fraudulent. The elements of fraud are the same in an employment tax case as in the income, estate and gift tax context. Taxpayer filed Forms-1099 with respect to the workers, who were not regular workers but were hired by foremen at the jobsites, to which they reported directly for work, honestly believed the workers to be “independent contractors,” and fully cooperated with the revenue agent assigned to the case.

4. **Not all includible employee compensation is “wages” subject to withholding.** HB&R, Inc. v. United States, 229 F.3d 688, 2000-2 U.S.T.C. ¶50,795 (8th Cir. 10/12/00). Travel expenses between the continental US and Alaska paid by an employer on behalf of Alaskan North Slope oil worker employees were excluded from “wages” subject to withholding and FICA under § 3401 and Reg. § 31.3401(a)-1(b) and Code § 3121(a), respectively, even if oil workers could not exclude travel expenses as a working condition fringe benefit under § 132(a)(3) because the travel was “commuting”. [Reg. § 31.3401(a)-1(b)(2) provides that “[a]mounts paid specifically--either as advances or reimbursements--for traveling or other bona fide ordinary and necessary expenses incurred or reasonably expected to be incurred in the business of the employer are not wages and are not subject to withholding.”] The court held that the withholding regulations applied to exclude the airfares from
"wages" because the regulations “do not expressly distinguish between commuting from home to work, and other employee traveling, so long as the expense is ordinary and necessary to the business of the employer. … [V]iewed from the perspective of HB&R … the employee airfare expenses were incurred regularly and necessarily in [its] business ….”


6. Yer out!!! United States v. Cleveland Indians Baseball Co., 121 S. Ct. 1433, 2001-1 U.S.T.C. ¶50,341, 87 A.F.T.R.2d 1706 (4/17/01), rev’g 215 F.3d 1325, 2001-1 U.S.T.C. ¶50,469, 85 A.F.T.R.2d 1761 (6th Cir. 5/10/00). An award of back pay to baseball players under a settlement is subject to FICA and FUTA taxes in the year the settlement award is paid, and not the year that the wages should have been paid. The Supreme Court (Justice Ginsburg) deferred to the IRS long-standing interpretation of Reg. §§ 31.3111-3 & -2(c) and 31.3301-2(c) & -3(b) as reflected in Rev. Rul. 89-35, 1989-1 C.B. 280 and Rev. Rul. 78-336, 1978-2 C.B. 255, even thought the regulations themselves do not expressly apply to back pay.

7. United States v. Hatter, 121 S. Ct. 1782, 87 A.F.T.R.2d 2227 (5/21/01). In a case that has been dragging on nearly a decade, the Supreme Court held that application of Medicare taxes to federal judges taking office before 1983 is constitutional, but that application of increased social security taxes to federal judges taking office before 1984 is unconstitutional under Art. III, sec. 1.

8. North Dakota State University v. United States, 255 F.3d 599, 2001-1 U.S.T.C. ¶50,485, 87 A.F.T.R.2d 2522 (8th Cir. 6/18/01). Early retirement payments to tenured faculty members were held not to constitute wages subject to FICA withholding because that the retirement payments to tenured faculty members were payments for a property interest.

9. When a per diem isn’t really a per diem, it’s wages. Worldwide Labor Support of Mississippi, Inc v. United States, 2001-2 U.S.T.C. ¶50,463, 87 A.F.T.R.2d 2401 (S.D. Miss. 5/15/01). Per diem travel expense payments to non-local employees by taxpayer, which provided temporary skilled labor to various business were wages, subject to employment tax, and not employee expense reimbursement. The per diem amounts were not paid under an accountable plan [Reg. § 1.62-2] and were not eligible for the safe harbor in Reg. § 1.62-2(f), because the amount was determined with respect to hours worked and the term of employment, not anticipated expenses.

10. Janus-like payments were deductible compensation in a Tax Court case but now are travel reimbursements exempt from employment tax in the Court of Claims. United Airlines, Inc v. United States, 88 A.F.T.R.2d 5459 (Ct. Cl. 8/10/01). See II.D., supra.

B. Self-employment

C. Excise Taxes
   1. REG-106892-00 contains proposed regulations relating to the requirements for excise tax deposits, 66 F.R. 10650 (2/16/01).

XII. TAX LEGISLATION

A. Vetoed

B. Enacted
   1. H.R. 4986, the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, was signed by President Clinton on 11/15/00. This law applies to transactions occurring after 9/30/00, in response to the 2/24/00 World Trade Organization appellate ruling that FSCs are a prohibited export subsidy because FSC benefits are contingent on exporting property.

   2. The Community Renewal Tax Relief Act of 2000, P.L. 106-554, was signed by President Clinton on 12/28/00.

   3. The Installment Tax Correction Act of 2000 was signed by President Clinton on 12/28/00.

   4. The Economic Growth and Tax Relief Reconciliation Act of 2001 was signed by President Bush on 6/7/01.

   • The changes in the 2001 Act were intended to reduce tax revenues by $1.35 trillion during the period from for 2001 through 2010. The most significant provisions of the 2001
Act were a substantial reduction in income tax rates, and the complete repeal of the federal estate tax (but not the federal gift tax). Many of the amendments enacted in 2001 have delayed effective dates. To reduce the immediate budgetary impact of the drastic rate reductions, most of the income tax rate reductions are phased-in over five years and take full effect in 2006. Estate tax rates are scheduled to be reduced moderately, and the exemption will be increased significantly, between 2001 and 2009, with the estate tax to be completely repealed effective in 2010. For reasons having to do primarily with Congressional procedural rules, however, unlike most other modern amendments to the Internal Revenue Code, every amendment to the Code enacted in the Economic Growth and Tax Reconciliation Act of 2001 is scheduled to sunset on December 31, 2010. Thus, absent further Congressional action, on January 1, 2011, all of the changes implemented by the 2001 Act are automatically repealed and the Code reverts to its pre-2001 Act provisions. Some of the phase-in rules take so long that many provisions, such as the repeal of the estate tax, will be in full effect for only one year before they are scheduled to sunset.

C. Pending
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