Recent Federal Income Tax Developments

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I. ACCOUNTING

A. Accounting Methods

1. Tax Court judicially creates "time value of money" limitations on deductions. Ford Motor Co. v. Commissioner, 102 T.C. 87 (1/31/94) (reviewed, 14-3). Taxpayer purchased in 1980 a number of single premium annuities for $4 million to fund its liability on a total of $24 million of periodic payments arising from tort claim structured settlements. The Commissioner determined (in a year not governed by the §461(h) economic performance rules) that any deduction in excess of the amount paid for the annuities would not clearly reflect income under §446(b), and the court held that the Commissioner did not abuse her discretion. The court based its determination upon a calculation based upon taxpayer's claimed deductions, which showed that the taxpayer was better off because the accidents occurred. Dissent on the ground that the "all events" test was met, and §461(h) is inapplicable.

a. *Sixth Circuit affirms Tax Court's ratification of Commissioner's §446(b) discretion. Ford Motor Co. v. Commissioner, 71 F.3d 209, 95-2 U.S.T.C. ¶50,643 (6th Cir. 12/5/95), aff'g 102 T.C. 87 (1994). Pre-1984 Act accrual of deductions for full amounts of structured settlement agreements made in settlement of automobile accident claims against taxpayer was subject to Commissioner's invocation of her §446(b) authority to change taxpayer from the accrual method to a modified cash basis method -- held to be more favorable to taxpayer than a straight cash method -- with respect to 20 structured settlement agreements. Taxpayer deducted the $10.6 million of payments due under fixed period agreements [with respect to periods of up to 58 years] -- and contended it was entitled to deduct $24.4 million of payments due under both fixed period agreements and lifetime payment agreements [basing lifetime payment agreements upon life expectancy] -- but paid only $4.4 million to fund single premium annuity contracts that covered all payments due under all 20 structured settlement agreements.

(1) The court held that neither (1) the taxpayer's satisfying the all events test, nor (2) the enactment in the 1984 Act of the $461(h) economic performance requirement "to take into account the time value of money," preempted the Commissioner's

' I would like to thank Martin J. McMahon, Jr., Leatherman Professor of Law, University of Kentucky College of Law, Lexington, Kentucky for his wise suggestions for revision of this outline.

* Item of particular interest.
§446(b) authority [on a case-by-case basis] to determine that taxpayer’s method of accounting in this pre-1984 Act year did not clearly reflect income. 71 F.3d at 213-14.

(2) The length of the payment periods would, under taxpayer’s method of accounting, lead to the result that the tax benefit from the deduction would fund the full amounts due in future years and leave taxpayer with a profit. Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969), followed. 71 F.3d at 215-16.

(3) Limited holding. The Sixth Circuit held that the case-by-case approach of the Tax Court’s opinion properly served to limit its holding “to extreme cases such as this one in which the economic results are grossly different from the tax results,” and did not “allow the Commissioner arbitrary or unprincipled discretion.” Id. at 216.

2. Berger v. Commissioner, T.C. Memo. 1996-76 (2/22/96). If an interest in a sole proprietorship is transferred pursuant to a divorce, §1041 does not preclude the application of §446(b) to require the transferor to include previously received but unaccrued income items.

3. *If taxpayer’s method clearly reflects income, Commissioner cannot use §446(b) to put taxpayer on a method that more clearly reflects income. Hospital Corp. of America v. Commissioner, T.C. Memo. 1996-105 (3/7/96). Large chain of for-profit hospitals permitted to use a hybrid method first proposed by an appeals officer during an earlier-year audit [i.e., the percentage of patient receivables to be included in income was equal to the ratio of (a) total revenue in the supply and pharmacy accounts to (b) the total of all patient revenue] because it did clearly reflect the hospital’s income, so Commissioner’s proposed change under §446(b) to an overall accrual method was an abuse of discretion -- even if the overall accrual method more clearly reflects income. (Note: Taxpayer used an accrual method for financial reporting purposes.) The cost of supplies constituted about 15 percent of expenses, and about the same percentage of revenues in each of the years in question. While the use of the hybrid method resulted in a disparity between the income reported under that method and the income that would have been reported under an overall accrual method, the court was satisfied that the hospitals did not attempt to create any distortion and the hospitals did not attempt to create any distortion. Judge Wells rejected the Commissioner’s contention that the taxpayer must show a “substantial identity of results” between the hybrid method it used and the accrual method the Commissioner determines accurately reflects taxpayer’s income, because that test is not required to be met under Ansley-Sheppard-Burgess Co. v. Commissioner, 104 T.C. 367 (1995). (The years in controversy pre-date §448, added by the Tax Reform Act of 1986, which prohibits large C corporations engaged in service business from using the cash method of accounting.)

a. Section 481(a) adjustment is accelerated when hospital to which it relates is sold. Hospital Corp. of America v. Commissioner, 107 T.C. No. 6 (9/12/96). Sale of hospitals requires acceleration of §481(a) adjustment made when hospitals were sold. Judge Wells found that there was a cessation of the business of the hospital sold [although the selling corporation continued to operate
other hospitals], so the balance the §481(a) adjustment may not be spread over the remaining years of the 10-year period of adjustment.

b. You might not believe it when you get your bill, but hospitals do not "sell" medical supplies so they may use the §448 nonaccrual-experience method to account for uncollectible amounts. Hospital Corp. of America v. Commissioner, 107 T.C. No. 8 (9/17/96). Taxpayers were entitled to elect the § 448 nonaccrual-experience method for years 1987 and 1988 for calculating their uncollectible amounts because the do not "sell" medical supplies to their patients, but they are furnished to patients as part of the hospitals’ furnishing medical services. Judge Wells held further that taxpayers were required to use the amended Temp. Reg. §1.448-2T(e)(2) to compute the excluded amount, as opposed to the original temporary regulation; under the amended temporary regulation, the "uncollectible amount" is equal to the year-end receivables multiplied by a fraction equal to (1) “total bad debts sustained during the current and 5 preceding years divided by (2) total accounts receivable earned throughout the same 6-year period, not merely (1) total bad debts divided by (2) total year-end accounts receivable (which would have been the result under the traditional former §166(c) bad debt reserve computed under the Black Motor [v. Commissioner, 41 B.T.A. 300 (1940), aff'd on another issue, 125 F.2d 977 (6th Cir. 1942)] formula). He noted that the ambiguous statute [§448(d)(5)] and legislative history left a gap that was properly filled by the amended temporary regulation, following Chevron U.S.A., Inc. v. National Research Defense Council, Inc., 467 U.S. 837 (1984), because "the choice among reasonable interpretations if for the Commissioner, not the courts.”

4. *Commissioner does not have discretion under §446(b) to determine whether taxpayer’s method of accounting clearly reflects income. Travelers Insurance Co. v. United States, 35 Fed. Cl. 138, 96-1 U.S.T.C. ¶50,231 (Fed. Cl. 3/21/96). Taxpayer, a life, health and accident insurance company taxed under subchapter L, used a particular method to convert Canadian dollars account items from its Canadian branch operations into U.S. currency in several pre-1986 Act [which added §987 to the Code] years. The Commissioner determined that the method used for reporting income from taxpayer’s Canadian operations did not accurately reflect income, and imposed another method under her §446(b) authority. The court held that, parsing §446(b), that two different levels of judicial review of the Commissioner’s determinations are contemplated. The first is whether taxpayer’s regularly used method of accounting clearly reflects income, which is not subject to the Commissioner’s opinion and is to be reviewed de novo. It is only the second determination of what alternative method does clearly reflect income that is subject to the "opinion of the Secretary" and is to be accorded deference. (The court then found that taxpayer’s method did clearly reflect income because it followed Rev. Rul. 75-107, 1975-1 C.B. 32, and nothing in that ruling precludes its use for life insurance companies.) The court did not invalidate Reg. §1.446-1(a)(2) ["... no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income." (emphasis added)], as it might have under the reasoning of RLC Industries Co. v. Commissioner, 95-2 U.S.T.C. ¶50,328 (9th Cir. 6/19/95), aff'g 98 T. C. 457 (1992), where the Commissioner by regulations assumed more discretion than the statute allows for.

5. Insolvent accrual basis taxpayer not allowed to deduct debt. Kellogg v. United States (In re Southwestern States Marketing
Corp.), 77 AFTR2d §96-590 (5th Cir. 3/4/96) (unpublished). Bankrupt (and hopelessly insolvent) accrual basis taxpayer may not deduct a $41 million debt [based upon a DOE claim for price regulation violations and improper crude oil overcharges] to generate a net operating loss carryforward [from 1978 to the years 1979 to 1984, which would lead to an $11 million refund] because taxpayer could never pay the claim because §446(b) [accounting method that does not accurately reflect taxpayer’s income] justifies disallowing a deduction for such an obligation.

6. Section 467 rental agreements

a. *Regulations proposed under §467. IA-292-84*, proposed regulations under §467, relating to the treatment of rent and interest provided for in certain leases of tangible property (61 F.R. 27834, 6/3/96).

b. *Section 467 level rent provisions interpreted: allocation existed so taxpayer not required to use §467 level rents. Piccadilly Cafeterias, Inc. v. United States, 96-2 U.S.T.C. §50,487, (Fed. Cl. 8/19/96). In the first case interpreting the §467 level rent provisions, summary judgment granted to the government. Taxpayer had a number of long-term leases which provided for escalating fixed rents [which were section 467 rental agreements*"], so in the early years of those leases the amount of average annual rent was greater than the amount of fixed rent actually paid. Taxpayer’s original 1986 and 1987 returns deducted the rent actually paid, but claims for refund on Forms 1120X reflected deductions of the average annual rent; however, taxpayer did not file an application for change of accounting method on Form 3115. Held, even if taxpayer were correcting an erroneous accounting method, its retroactive change to the straight-line method of computing its rental deduction still required the Commissioner’s consent. On the §467 issue, the court held that the lease did contain allocation provisions, i.e., the rent payment schedule was adequate to constitute an allocation of a specific amount of rent to each particular year, so use of the straight-line method was not required [unless the Service successfully asserts that taxpayer had a tax avoidance purpose].

c. *Reasonable rent holiday found under §467. Republic Plaza Properties Partnership v. Commissioner, 107 T.C. No. 7(9/16/96). Taxpayer/lessor was entitled to accrue rent for an office building pursuant to the terms of the lease, which provided for zero rent during the first 11-1/2 months of a 24-year, 11-1/2 month lease because the period of zero rent qualifies as a reasonable rent holiday described in §467(b)(5)(C). Judge Chiechi found, based in part on expert testimony, that the zero-rent period granted in the lease was consistent with current [1988] commercial practice in the Denver office market, and that it “enhanced the ability of [related tenant], as sublessor, to grant rent holidays that were consistent with commercial practice.”*

B. Inventories

1. Rotable spare parts held to be depreciable capital assets, reversing *Apollo Computer. Hewlett-Packard Co. v. United States*, 71 F.3d 398, 96-1 U.S.T.C. §50,046 (Fed. Cir. 12/7/95), rev’g *Apollo Computer, Inc. v. United States*, 32 Fed. Cl. 334 (1994). Rotable spare parts used to repair customers’ computers [used only for repairs and kept separate from taxpayer’s regular manufacturing inventory] were §1231 assets eligible for depreciation — and were not
inventory -- because they were not furnished to a customer in exchange for a purchase price, but were used to enable taxpayer to provide better service by avoiding the computer downtime that would be suffered if the customer's original part was merely repaired. The discretion the Commissioner has under §471(a) to order inventory accounting was held to be "not unlimited."

a. Apollo Computer, Inc. v. United States, 32 Fed. Cl. 334, 95-1 U.S.T.C. ¶50,015 (12/7/94), rev'd, 71 F.3d 398, 96-1 U.S.T.C. ¶50,046 (Fed. Cir. 12/7/95). The Commissioner had discretion under §§446(b) and 471 to change the "fixed asset method" used by taxpayer for its rotatable spare parts (under which acquisition costs were capitalized and then depreciated) because that method did not clearly reflect income. Her putting the taxpayer on an inventory method for the rotatable spare parts was proper because the parts were either held for sale or otherwise classifiable as inventory.

2. United States v. Standard, 96-1 U.S.T.C. ¶50,302, 77 A.F.T.R.2d 96-2071 (9th Cir. 4/26/96) (not officially reported), as amended on denial of rehearing, 1996 U.S. App. LEXIS 11807 (5/22/96). The Ninth Circuit applied Max Sobel Wholesale Liquors v. Commissioner, 630 F.2d 670 (9th Cir. 1980), and held that §162(c)(2) applies only to deductions, and does not apply to expenditures to be included in the cost of goods sold. Accordingly one count of the taxpayer-attorney's §7206(1) criminal tax fraud conviction, for including illegal referral payment in cost of goods sold of legal services, was reversed. The court did not discuss the flush language of §263A(a), which bars capitalization into basis of a capital expenses that would not have been deductible by virtue of §162(c)(2) if the expenses had been deductible.

C. Installment Method
1. Kohler Co. v. United States, 34 Fed. Cl. 379, 95-2 U.S.T.C. ¶50,600 (Fed. Cl. 11/3/95). Taxpayer's income was not clearly reflected when its newly-formed subsidiary used the LIFO method of accounting and treated goods purchased at a substantial discount [comprising the entire opening inventory of the subsidiary] the same as goods later manufactured for inventory purposes. Section 481 adjustments were upheld. Hamilton Industries v. Commissioner, 97 T.C. 120 (1991), followed.

2. *When sole shareholder/only employee is imprisoned, paintings are no longer inventory. Andrew Crispo Gallery, Inc. v. Commissioner, 86 F.3d 42, 96-1 U.S.T.C. ¶50,313 (2d Cir. 6/13/96). Taxpayer was entitled to use the installment method to defer recognition of profits derived from an auction of paintings seized and sold by the IRS because it no longer held the paintings primarily for sale to customers in its trade or business after the imprisonment of its sole shareholder for tax fraud. Query: When does inventory of a defunct business become a capital asset?

D. Year of Receipt or Deduction
1. *Taxpayer guaranteed that property transferred to settlement trust would yield $115 million; taxpayer was enabled to deduct that amount in the year of transfer although property transferred was worth only $89.1 million. Valero Energy Corp. v. Commissioner, 78 F.3d 909, 96-1 U.S.T.C. ¶50,076 (5th Cir. 2/7/96) (2-1). Holds that a deduction of $115 million in 1979 -- arising from the transfer of $89.1 million in securities to a settlement trust for the benefit of customers [which trust was guaranteed by taxpayer in the
settlement to eventually yield at least $115 million] established after Texas Railroad Commission determination that taxpayer's customers were due refunds in excess of $1.6 billion -- was inclusive of a $19.8 million payment taxpayer made in 1984 when it became clear that the trust would receive only $95.2 million from the proceeds of the securities. (It appears that the settlement trust was a grantor trust, set up for the reason that the customers [cities and municipal utilities] were not permitted by law to hold securities.) Therefore, the $19.8 million payment was nondeductible in 1984. Dissent on the ground that the $115 million deduction in 1979 was improper under the "all events" test [and known by the Commissioner to be improper before the statute of limitations expired for that year] and, therefore, the deduction of $19.8 million was proper in 1984.

2. *Bank credit card annual membership fees reportable ratably over 12-month period... Barnett Banks of Florida, Inc. v. Commissioner, 106 T.C. No. 4 (2/29/96) (Parker, J.). Refundable [ratably] bank credit card annual membership fees constitute payments for services rendered or made available to cardholders [and not additional interest], so (under Rev. Proc. 71-21, 1971-2 C.B. 549) taxpayer may report these fees in income ratably over the 12-month period after receipt.

   a. ... except where contract provides they were immediately earned. Compare, Signet Banking Corp. v. Commissioner, 106 T.C. No. 5 (2/29/96) (Colvin, J.). Nonrefundable bank credit card annual membership fees, which were paid in consideration of the issuance of a card and the establishment of a credit limit, must be reported in income in the year of receipt.

3. *Payment made to settle a take or pay contract held to be an advance payment, not a deposit. Herbel v. Commissioner, 106 T.C. No. 22 (6/5/96). Taxpayers were the shareholders of Malibu Petroleum, Inc., an S corporation which purchased working interests in various gas wells that were subject to a gas purchase contract with Arkla as buyer. To avoid litigation over a take or pay provision in the contract, Arkla paid $1,850,000 to Malibu, but reserved the right to recoup the payment from future gas purchases under the contract. The payment was refundable if Malibu cancelled the contract or if the property was depleted before recoupment. Held, the $1,850,000 is an advance payment for the purchase of gas -- and not a deposit -- so it is includable in Malibu's income in the year received. The payment was not a mere deposit under Commissioner v. Indianapolis Power & Light, 493 U.S. 203 (1990), because the payor had no control over the conditions triggering a refund. Judge Whalen further held that the payment was not a §636(a) production payment [which would be treated as a loan] because Congress intended [and Reg. §1.636-3(a)(1) provided] that only production payments which constituted an economic interest in the mineral in place would so qualify.

4. Tax Court finds Reg. §1.267(a)-3 invalid. Tate & Lyle, Inc. v. Commissioner, 103 T.C. No. 37 (11/15/94) (reviewed, 9-7). Accrual method taxpayer permitted to deduct interest owed to its [for this purpose under U.K. law, cash method] U.K. parent in the [1985-1987] year in which it was accrued even though the payee was not taxed on the interest in the year accrued by either the U.S. [the interest was exempted from income under the U.S.-U.K. Income Tax Treaty] or the U.K. The government and dissenters argued that under §267(a)(2) [added in 1984] an accrual basis taxpayer is not entitled to deduct accrued interest payable to a related person that was not currently includable
in the payee’s income, and under §267(a)(3) [added in 1986] Treasury was authorized to issue regulations to apply that matching principle where the payee was not a U.S. person; the legislative Reg. §1.267(a)-3 was issued in 1992 under that authority. Judge Ruwe’s “majority” opinion held: (1) the regulation as applied here was invalid because the accrued interest was not includable “by reason of the payee’s method of accounting,” but by reason of the treaty [emphasis in original]; and (2) the retroactive application of the 1992 legislative regulation to the 1985-1987 years violated the Due Process Clause, citing United States v. Carlton, 114 S. Ct. 2018, 94-1 U.S.T.C. §60,169 (1994). Note: 4 of the 9 judges in the majority disagreed with the retroactivity holding.

a. Third Circuit reverses, finds regulation valid. Tate & Lyle, Inc. v. Commissioner, 87 F.3d 99, 96-2 U.S.T.C. ¶50,340 (3d Cir. 6/24/96). The regulation is valid because it is a permissible construction of the statute and is supported by the legislative history. The court further held that the regulation could be promulgated with retroactive effect under §7805(b) in the Secretary’s discretion, and that discretion was not abused because taxpayer had adequate notice within a reasonable time that regulations would be forthcoming which could alter the tax treatment of its interest deductions.

5. *Tax Court decides that refundable entry fees are not prepaid rents. Highland Farms, Inc. v. Commissioner, 106 T.C. No. 12 (4/17/96). Refundable entry fees received by retirement community do not constitute prepaid rent or advance payments that must be reported in the year of receipt, but may be included in income as they become nonrefundable, following Commissioner v. Indianapolis Power & Light, 493 U.S. 203 (1990). But the taxpayer was required to include gains on sales transactions in which it conveyed to residents cluster homes even though the taxpayer was unconditionally obligated to repurchase the homes at not less than 76 percent of the original sales price upon the purchaser’s death or whenever the purchaser decided to sell. The formalities of the transaction indicated that they were true sales even though - because of the taxpayer’s obligation to repurchase the homes, coupled with a prohibition on resale by the purchaser to anyone other than the taxpayer - it was assured that the purchaser would never realize any appreciation in value.

6. Billing is ministerial act, no method that requires billing is not necessary for accrual when performance is complete. Frank’s Casing Crew and Rental Tools Inc. v. Commissioner, T.C. Memo. 1996-413 (9/16/96). Delayed accrual of income until after billing [when the performance of the sales and services had been completed in an earlier year] by an oil field contractor [who sells oil pipes, leases equipment used in oil fields, and provides crews necessary to operate the leased equipment] violated the all-events test because billing is a “ministerial act” and the income accrued in the year of completion of performance of the sales and services, so Commissioner did not abuse her discretion in changing taxpayer’s method of accounting. Judge Laro distinguished Decision Inc. v. Commissioner, 47 T.C. 58 (1966), because performance of taxpayer’s contract in that case occurred after the billing date, noting that when the Tax Court had previously upheld deferred billing practices, it had done so when the “taxpayers generally operated in a heavily regulated industry or were able to establish wide acceptance within their industry of such an accounting practice.”
II. BUSINESS INCOME AND DEDUCTIONS

A. Depreciation, Depletion and Credits

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

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

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

2. ACRS depreciation allowed for old fiddlesticks used by professional violinists. Simon v. Commissioner, 103 T.C. 247 (8/22/94) (reviewed, 10-7). Taxpayers were entitled to depreciation deductions for their 19th-century violin bows used in their trade or business as full-time professional violinists because the bows are §168 recovery property (in that they are tangible personal property placed in service after 1980 that suffered wear and tear attributable to use in their profession).

   a. Judge Laro's majority opinion distinguished Browning v. Commissioner, T.C. Memo. 1988-293, aff'd, 890 F.2d 1084, 89-2 U.S.T.C. ¶9666 (9th Cir. 1989), which denied depreciation deductions to violins, in that there was no evidence of wear and tear presented by taxpayer in that case, but there was evidence here of such wear and tear. 103 T.C. at 264. In answer to the government's argument that excessive depreciation would be allowed if these antique violin bows could be depreciated over a relatively short period, the court noted that Noyce v. Commissioner, 97 T.C. 670 (1991) rejected the argument that depreciation deductions must be reasonable in amount.
b. Judge Ruwe's concurring opinion noted that ACRS eliminated the obligation by taxpayer to establish an asset's useful life in order to qualify for a $168 deduction.

c. Judge Hamblen's dissenting opinion contends that the violin bows are treasured "works of art" that are inherently nondepreciable, and that $168 allows depreciation only to property that is "of a character subject to the allowance for depreciation provided in §167," and that is only where the wear and tear (or obsolescence) causes a corresponding reduction in the value of an asset and diminishes its useful life.

d. To the same effect is Liddle v. Commissioner, 103 T.C. 285 (8/22/94) (reviewed, 9-8) (ACRS depreciation deduction allowed for 17th-century Ruggeri bass viol used by full-time professional musician; dissent asks what will stop wealthy taxpayers from "stuffing ... their offices with valuable antique furniture which they may write off over the 7-year recovery period now applicable to office furniture?").

e. Liddle affirmed by Third Circuit. Liddle v. Commissioner, 65 F.3d 329, 95-2 U.S.T.C. ¶50,488 (3d Cir. 9/8/95). Affirms Tax Court decision allowing depreciation under $168 ACRS of a 300-year old bass violin. The court held that ACRS was meant to eliminate the questions that surround the estimation of useful life of depreciable property, and that there was no importation of the §167 regulation requirement [that there be a determinable useful life] into §168 [as it existed before the Tax Reform Act of 1986] by reason of the provision defining recovery property as "tangible property of a character subject to the allowance for depreciation."

f. Simon affirmed by Second Circuit. Simon v. Commissioner, 68 F.3d 41, 95-2 U.S.T.C. ¶50,552 (2d Cir. 10/13/95) (2-1). One-hundred-year-old violin bows [purchased in 1985 for $30,000 and $21,000 in excellent condition and appraised in 1990 for $45,000 and $35,000 as collectibles despite their deteriorated condition] were depreciable under ACRS in 1989. The 2d Circuit held it sufficient that the bows were subject to wear and tear in the hands of taxpayers [who were professional musicians], despite a Tax court finding that the bows had "no determinable useful life," because ACRS "eliminated the need to adjudicate matters such as useful life and salvage value." Before ERTA (1981), property was depreciable only if taxpayer could demonstrate a "determinable useful life," and $168 was to apply only to "property of a character subject to the allowance for depreciation." The court was troubled, but not deterred, by the ERTA Conference Report that stated, "Assets that do not decline in value on a predictable basis or that do not have a determinable useful life ... are not depreciable."

g. *AOD CC-1996-009, nonacquiescence in Simon v. Commissioner, 68 F.3d 41 (2d Cir. 1995), as well as in Liddle v. Commissioner, 65 F.3d 329 (3d Cir. 1995), on the ground that the enactment of ACRS merely shortened the recovery period over which an asset is depreciated, but did not convert assets that formerly were not depreciable into assets that are depreciable. The IRS position is that the cases were wrongly decided and the issue should be pursued in other circuits.

Taxpayer, who was in the limousine leasing business, purchased for $400,000 in 1987 three “exotic” cars that were never driven, but were only displayed in car shows and used for promotional photography. The cars included a Gambella Ferrari Testarossa that cost $290,000 and two Lotus. Judge Halpern held that ACRS depreciation on the cars was allowable for years 1987-1990 because, even though not subject to wear and tear, the cars would become obsolete over time and could no longer be shown as the “latest” exotic cars.

4. Real property leasehold improvements held not within ADR system. Walgreen Co. v. Commissioner, 103 T.C. 582 (11/10/94). Leasehold improvements, to the extent they were §1250 property, were not within the ADR system and had to be depreciated as such (except to the extent they were explicitly prescribed into an asset guideline class by regulation, which they were not). But . . .

   a. * . . . reversed because pre-ACRS classification rulings continue to be in effect. Walgreen Co. v. Commissioner, 68 F.3d 1006, 95-2 U.S.T.C. $50,562 (7th Cir. 10/17/95), rev'g and remanding 103 T.C. 582 (1994). Leasehold improvements, such as interior partitions, millwork, acoustic ceilings, floor finishing, and bathroom and lighting fixture, that were “section 1250 property” could nevertheless be 10-year ACRS property to the extent they were classified as “Wholesale and Retail Trade” property -- and not “Building Services” property -- under the pre-ERTA Asset Depreciation Range system.

   b. *Nevertheless, the Commissioner gets her victory. On remand, T.C. Memo. 1996-374 (8/13/96). The Tax Court determined whether any of taxpayer’s leasehold improvements are section 1250 property not classified in Class 65.0 (Building Services), in which event taxpayer is entitled to depreciate it over a 10 year useful life. The court finds interior partitions, ceilings, lighting fixtures and interior floor finishes, all to be Building Services items, with only decor finishes (primarily the decorative canopy system for the restaurants) classified as Wholesale and Retail Trade property. The court refused to address taxpayer’s argument that it was not in the business of providing building services, so none of the property in question falls in that category.

5. *Permission for automatic change of method where taxpayer has claimed less depreciation than allowable; all the unclaimed depreciation is allowable in the year of change. Rev. Proc. 96-31, 1996-20 I.R.B. 11. Procedure for requesting an automatic change in method of computing depreciation or amortization where taxpayer has claimed less depreciation or amortization than allowable. Form 3115 must be submitted to IRS within 180 days of the beginning of the year and copy attached to timely filed tax return. Section 481(a) adjustment (usually negative) to be taken into account in one year.


7. Court decides difference between progress payments (loans) and advance payments (includable in income). Fairchild Industries Inc. v. United States, 71 F.3d 868, 95-2 U.S.T.C. $50,633 (Fed. Cir. 11/29/95). Although §44F research credit is not available
for research "funded by another person" (and Reg. §1.41-5(d)(1) sets the criterion for "funded" as whether the payment for research is "contingent on [its] success"), taxpayer was entitled to the credit for research paid for by the U.S. government's "fixed-price incentive contract" [under which progress payments were refundable in the event of failure]. (In government contracts, a "progress payment" is a loan (not includable in income), but an "advance payment" is includable in income. Presumably advance payments are not refundable.)

8. 1996 Legislation

a. *Increase in dollar limitation for §179 expensing. Small Business Tax Act [see XIV., below, for full citation] ("SBT") §1111 amends §179 to increase the dollar limitation for expensing depreciable business assets in stages from $17,500 to $18,000 in 1997; to $18,500 in 1998; to $19,000 in 1999; to $20,000 in 2000; to $24,000 in 2001 and 2002; and to $25,000 in 2003 and thereafter.

b. *Gas station convenience stores are 15-year property. SBT §1120 amends §168(e)(3)(E) by adding "gas station convenience stores" to "retail motor fuels outlets" already included as 15-year property. Effective for property placed in service on or after the date of enactment, with an election to apply the provision retroactively.

c. *Favorable treatment of abandonment of landlord's leasehold improvements at lease termination. SBT §1121 amends §168(i)(8) to permit the deduction of remaining adjusted basis of leasehold improvements made by the lessor (and irrevocably disposed of or abandoned by the lessee) at the time or the termination of the lease. This differs from the IRS position under prior law that leasehold improvements made by a lessor that constitute structural components must be continued to be depreciated in the same manner as the underlying real property, even if those improvements are retired at the end of the lease term. (Note that leasehold improvements made by the lessee, but not retained, are taken into account to compute gain or loss by the lessee at the termination of the lease.) Effective for leasehold improvements disposed of after 6/12/96, with no inference intended as to the proper treatment of such dispositions made before 6/13/96.

d. New "work opportunity tax credit" replaces targeted jobs credit. SBT §1201 amends §51 to replace the 40 percent targeted jobs credit with the 35 percent "work opportunity tax credit," applicable to qualified individuals who begin work after 9/30/96 and before 10/1/97. An eighth category of food stamp recipients is added to the seven existing targeted groups.

e. Research credit extended through 5/31/97. SBT §1204 extends the $41 research credit for 11 months, for the period 7/1/96 through 5/31/97. It also allows for an elective alternative research credit regime (with lower fixed base percentages and lower credit rates).

f. Extension of §29 credit for synthetic fuel from coal and gas from biomass. SBT §1207 extends the placed-in-service date by 18 months from "before 1/1/97" to "before 7/1/98" (and the binding contract date by one year from "before 1/1/96" to "before 1/1/97") for the $29 tax credit on producing synthetic fuel from coal and producing gas from biomass.
g. Possessions credit terminated. SBT §1601 terminates the §936 Puerto Rico and possessions tax credit, effective for taxable years beginning after 12/31/95, with phase-out rules through taxable years beginning before 1/1/02.

h. *Amendments to the income forecast method of depreciation. SBT §1604 adds new §167(g), which makes amendments to the income forecast method of depreciation, generally effective for property placed in service after 9/13/96. Under this method, the depreciation deduction is determined by multiplying the cost of the property [minus salvage value] by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total estimated income to be derived from the property during its useful life. The amendments are: (1) all estimated income generated by the property [for the first 10 years] must be taken into account in the computation; (2) the adjusted basis amounts to be taken into account must satisfy the §461(h) economic performance standard; and (3) taxpayers will be required to pay (or receive) interest based on the recalculation of depreciation under a "look-back" method. Costs incurred after ten years with respect to unproductive property are deductible. If property remains productive after ten years, a new ten-year period begins.

9. District Court holds unassembled core reactor was placed in service upon delivery. Northern States Power Co. v. United States, 78 AFTR2d 5900, 1996 U.S. Dist. LEXIS 11220 (D. Minn. 7/15/96). Nuclear reactor fuel assemblies, 121 of which comprise the "reactor core," were "placed in service" upon receipt by taxpayer because there were "ready and available" to be placed in a power plant that had been operating for more than ten years. The court held the operational equipment [the assemblies] to be entitled to ITC and depreciation deductions "in the year acquired rather than in the year that it is actually used." It did not matter that the installation and testing process was complicated and time-consuming. The court distinguished cases involving component parts of an uncompleted plant or facility, such as Sealy Power, Ltd. v. Commissioner, 46 F.3d 382 (5th Cir. 1995), because there component parts of a power production facility were held to be not "placed in service" until the entire system reached a condition of readiness.

10. Cushion gas case in which Federal Circuit states why it chooses to follow Fifth and Ninth Circuits. Washington Energy Co. v. United States, 94 F.3d 1557, 96-2 U.S.T.C. §50,473 (Fed. Cir. 8/28/96). Taxpayer was permitted to depreciate only that portion of cushion gas in its underground reservoir that was not economically recoverable, with the remainder treated as inventory. (Taxpayer contended that the cushion gas was a unitary asset, and that salvage value is to be disregarded in computing depreciation.) Judge Michel noted that a decision in taxpayer's favor would have created a direct conflict with the Fifth Circuit's decision in Arkla, Inc. v. United States, 765 F.2d 487 (1985), and that "[a]s a general matter, we do not create conflicts among the circuits without strong cause." He also noted in footnote 6 that the Ninth Circuit, in which taxpayer was located, had a rule similar to that of the Fifth Circuit. Query: Is this a Federal Circuit Golsen rule? (See, Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971).)

11. Texasgulf Inc. v. Commissioner, 107 T.C. No. 5 (9/9/96). The Ontario Mining Tax is creditable under §901 because it meets the requirements of Reg.
§1.901-2(b)(4)(i)(B) in that -- based upon an expert study of OMT tax returns that showed the aggregate amount of processing allowance was three times the aggregate amount of nonrecoverable expenses -- the OMT "permits the recovery of nonrecoverable expenses under a method that is likely to produce an amount that approximates or is greater than the amount of the nonrecoverable expenses." Judge Colvin held that the regulations do not require that the processing allowance must be intended to compensate for nonrecoverable expenses, nor do they provide "that the processing allowance must bear a predictable relationship to the nonrecoverable expenses."

B. Expenses

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

   a. TAM 9544001 (7/21/95). Costs related to the adoption of a just-in-time manufacturing process were required to be capitalized under §263, pursuant to INDOPCO.

   b. *It didn't?* Notice 96-7, 1996-6 I.R.B. 22 (1/19/96). Requests public comment [by 5/6/96] on approaches it should use to address issues raised under §§162 and 263, particularly in light of INDOPCO v. Commissioner, 503 U.S. 79, 92-1 U.S.T.C. 50,113 (1992). The Notice states, "The Service believes that the INDOPCO decision did not change the fundamental legal principles for determining whether a particular expenditure may be deducted or must be capitalized."

   c. **Cleanup consulting fees deductible.** TAM 9627002, revoking TAM 9541005 (9/27/95), which denied a §162 deduction for legal and consulting fees associated with an environmental cleanup. TAM 9627002 followed Rev. Rul. 94-38, 1994-1 C.B. 35, to rule that all the contested costs are currently deductible (1/19/96). The facts were that the land was acquired in a clean condition by taxpayer's predecessor, contaminated by the predecessor, donated to the county for a park, and re-acquired by taxpayer's subsidiary for $1. The ruling held that, because the same taxpayer contaminated the property and incurred the costs, the interim break in ownership did not (of itself) operate to disallow the deduction.

   d. Black Hills Corp. v. Commissioner, 73 F.3d 799, 96-1 U.S.T.C. 85,038 (8th Cir. 1/10/96), aff'g 101 T.C. 173 (1993), modified, 102 T.C. 505 (1994). Affirms finding that [under INDOPCO] premiums for black lung liability insurance coverage produced significant benefits that extended beyond the current tax years, and therefore did not qualify as ordinary and necessary business expenses under §162(a).


   f. *Expenditures that produce substantial future benefits must be capitalized, even if deductibility is otherwise permissible.* Connecticut Mutual Life Insurance Co. v. Commissioner, 106 T.C. No. 27 (6/26/96). Taxpayer was required to capitalize, and could not deduct under §162(a), its $20 million contribution to a
voluntary employees' benefit association (VEBA) trust to provide holiday pay to its employees - an amount sufficient to cover holiday pay for the next 8 to 10 years - because under INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), capitalization is required when the expenditure provides the taxpayer with significant benefits beyond the year of expenditure. Taxpayer argued that its contribution should be deductible because taxpayer's employees, rather than taxpayer, who benefited; Judge Ruwe rejected this argument, stating that holiday pay is closely akin to salary, the most basic obligation any employer undertakes -- distinguishing two cases where the VEBA contribution was for death, disability, severance and educational benefits [that only incidentally benefited the employer]. (Note: This case involved the 1985 tax year, which was not governed by the enactment in 1986 of §§419 and 419A, which barred deductions in years subsequent to 1985 of VEBA contributions that exceeded benefits.)

2. Oil and gas delay rentals must be capitalized under §263A. TAM 9602002 (9/19/95). Delay rentals are not currently deductible, but must be capitalized under §263A [including for years prior to the final §263A regulations] as pre-production costs and included in the depletable basis of the property for which they are paid.


4. Guy Schoenecker, Inc. v. Commissioner, T.C. Memo. 1995-539 (11/14/95). Reasonable compensation case, with difficulties of proof. Compensation deductions in the range of $1 to $1.8 million were reduced by 30 to 50 percent.

5. Does this holding apply to personal services corporations? Donald Palmer Co. v. Commissioner, 96-1 U.S.T.C. ¶50,229 (5th Cir. 4/1/96) (per curiam), aff'g T.C. Memo. 1995-65. Affirms Tax Court decision that only $220,700 [equal to half of the regular salary paid] of an $818,500 bonus paid to plastic packaging corporation's sole shareholder, president and only officer was deductible as reasonable compensation. (The shareholder/employee generated substantially all the corporation's sales; the corporation's only other employees were a secretary, a bookkeeper, and a cleaning person.)

6. *Is a full deduction available to the employer for a cafeteria that provides only meals excludable under §119? Boyd Gaming Corp. v. Commissioner, 106 T.C. No. 19 (5/22/96). On motion for partial summary judgment, held that the cost of meals provided without charge by gambling casinos to employees may be deducted in full [without reduction under §274(n)(1)] if they are within the §132(e) de minimis fringe benefit exception of §274(n)(2)(B), and whether they are within that exception is a question of fact. On the requirement that the annual revenue from the eating facility normally equals or exceeds the direct operating costs, Judge Laro noted that if §119 allows all the employees to exclude the value of the meals from gross income, the eating facility's revenues and expenses will both be zero for purposes of the test.

7. T.D. 8666, final regulations under §274, relating to reimbursement and other expense allowance arrangements for business
meals and entertainment that are disallowed as a deduction under §274(n), and working condition fringe benefit treatment for expenses for club dues and spousal travel that are disallowed as a deduction under §§274(a)(3) and 274(m)(3) (61 F.R. 27005, 5/30/96).

8. Mulne v. Commissioner, T.C. Memo. 1996-320 (7/15/96). Section 280F did not apply by virtue of §280F(d)(3)(A) and a telemarketing sales manager was allowed a §179 deduction for the cost of a computer used exclusively for business purposes in her home office. Even though [because the home office was not her principal place of business] it did not qualify under §280A and thus the exception to treating computers as listed property in §280F(d)(4)(B) did not apply, the home office use of the computer was for the convenience of the employer because the taxpayer had a heavy workload but did not have access to her office in the employer’s business premises after normal business hours.

9. Fountain Valley Transit Mix, Inc. v. Commissioner, T.C. Memo. 1996-244 (7/28/96). The Tax Court applied the “expense of another” doctrine to disallow a lessee’s deductions for maintenance of leased property in a case in which the lease from a related lessor provided that the lessor was to maintain the property. Although the sole articulated ground for the decision was the expense of another doctrine, it is questionable whether the same result would be appropriate in a case in which the parties to the lease were not related and there were no undercurrents of income shifting in the case.

10. Hewett v. Commissioner, T.C. Memo. 1996-110 (3/7/96). The “portion” of the dwelling unit used “exclusively” for a purpose exempted under §280A(c), does not need to be a separate room or to be partitioned off from the remainder of a room that is used for personal living. A piano teacher kept grand piano used exclusively for teaching in an alcove off the living room was covered by the exception in §280A(c)(1) and permitted to deduct an allocable portion of the costs with respect to her home.

11. *Plan succeeds in avoiding §280A limits for rental condominium. Razavi v. Commissioner, 74 F.3d 125, 96-1 U.S.T.C. §50,060 (6th Cir. 1/29/96). The taxpayer used his condominium unit for 27 days and leased it to the management company for the remainder of the year for a percentage of guaranteed minimum of $21,000. The management company rented the condominium to third parties for only 200 days and received $48,327. The court held that the taxpayer did not use the condominium for more than 10 percent of the number of rental days because the lease to management company was for the full year minus personal use days and was a fair rental for that term. Thus 27 days was not more than 10 percent of rental days, which were all 335 remaining days of the year, not the 200 days for which the management company rented out the unit. Note: Problems raised for the §280A(g) exclusion of rental income [for residences rented out for less than 15 days of the year] by the 17-day Atlanta Olympics.

12. Cunningham v. Commissioner, T.C. Memo. 1996-141 (3/20/96). Section 280A(c)(5) applied to limit an S Corporation’s deductions with respect to building in which it conducted an art gallery because the sole shareholder lived in second floor apartment that was not separated from the first floor gallery by a permanent partition but merely by doors in a common hallway; both floors of the building were thus a dwelling unit.
13. *Rent paid to a related party must be reasonable.* Southern Boiler Sales & Service, Inc. v. Commissioner, T.C. Memo. 1996-13 (1/22/96), held that a deduction for rent paid to a related party, the deduction is limited to "reasonable" rental payments, even though §162(a)(3) does not expressly provide this limitation and with out regard to §482 or any specific recharacterization of the nature of the excessive amount. Alondra Indus., Ltd. v. Commissioner, T.C. Memo. 1996-32 (1/29/96) held that rental payments between related parties in excess of a reasonable rent are not "required" and thus are not deductible.

14. Home office deduction for storage of product samples. SBT §1113 amends §280A(c)(2), which allows a home office deduction for a space used as a storage unit for inventory of the taxpayer's business of selling products at retail or wholesale (but only if the home is the sole fixed location of such business), by adding "product samples" to "inventory." Effective for years beginning after 12/31/95.

C. Losses and At Risk

1. Proposed regulations on §469(c)(7) relief for real estate professionals. PS-80-93, proposed regulations under §469(c)(7) [added by the 1993 Act], relating to rules for rental real estate activities of real estate professionals (60 F.R. 2557, 1/10/95). Interests in rental real estate (including limited partnership interests) may be combined with one another into a single activity, but may not generally be combined with other (i.e., non-rental) real estate activities. The combined rental real estate activity remains passive unless taxpayer materially participates in the rental activity; and if there are limited partnership interest(s) in the combined activity, taxpayer must meet the material participation test for limited partnership activities under Temp. Reg. §1.469-5T.


2. TAM 9543003 (7/10/95). Taxpayers did not materially participate in a hotel condominium activity under Temp. Reg. §1.469-5T(a)(3) even though they worked more than 100 hours during the taxable year on their own condominium because at least one full-time employee of the 53-unit activity, e.g., the desk clerk, performed more hours of service for the entire hotel than did the taxpayers for their own condominium.

3. Mordkin v. Commissioner, T.C. Memo. 1996-187 (4/17/96). Personal injury lawyer who spent no more than 135 hours looking after his condominiums and serving as president of his Snowmass condominium association failed to show that he materially participated in the activity. The activity was not a §469(c)(2) rental activity that was per se passive because the average period of customer use was less than 7 days. Nevertheless, he did not materially participate under the facts and circumstances test, despite arguably satisfying the more than 100 hours of work test, because other persons performed management services for compensation. Temp. Reg. §1.469-5T(f)(4)'s requirement of 500 hours for material participation is not invalid.

4. Schaefer v. Commissioner, 105 T.C. 227 (9/13/95). Taxpayer sold his Toyota dealership for slightly over $1 million (plus
and gave a [3-year, 5-mile] covenant not to compete in exchange for about $10,000 per month for a 12-1/2 year period. He contended that the covenant payments were passive activity gross income, and that (former) Temp. Reg. §1.469-2T(c)(7)(iv) [which provided the contrary] was invalid. Judge Raum held the regulation to be valid, finding that the income was similar to earned income or portfolio income, rejecting taxpayer's contention that the definition of earned income in §911(d)(2)(A) [made applicable by §469(e)(3)] as "compensation for personal services actually rendered" was inapplicable to this income which did not involve the rendition of any personal services. The court noted that, based upon authority, it was at least arguable that the performance of a covenant does involve negative services to be treated the same way as positive services, and that a regulation was an appropriate way to resolve the question.

5. Smith v. Commissioner, 65 F.3d 37, 95-2 U.S.T.C. ¶50,517 (5th Cir. 9/25/95). Taxpayer's claim of short term capital loss on the worthlessness of a nonbusiness bad debt [based upon his guarantee of a $750,000 mortgage] was disallowed. Taxpayer claimed that his purchase of the property at a bankruptcy sale (which also served to eliminate a second lien of $367,000) was at a price of $637,000 in excess of the property's fair market value of $235,000, and that the transaction was so structured in order that taxpayer could obtain mortgage financing of $750,000 towards the purchase. The court held that no bad debt loss arose on a purchase, and that taxpayer could not attack the form he used for the transaction.

6. Complementary goods and services received from casino are includable in income, but (as "gains from [wagering] transactions") may be offset by gambling losses. Libutti v. Commissioner, T.C. Memo. 1996-108 (3/7/96). Taxpayer [gambler] could deduct gambling losses under §165(d) to the extent of the complimentary goods and services ("comps") he received from Trump Plaza Casino in Atlantic City. (Losses and comps were, respectively, in the following years: 1987 -- $4.1 million losses and $443,000 comps; 1988 -- $3.1 million losses and $975,000 comps; and 1989 -- $1.2 million losses and $1.1 million comps.) Judge Laro held that the comps were "gains from [wagering] transactions" -- a term that is broader than "gambling winnings" -- because they were increases in wealth arising out of wagering transactions; this is a broader interpretation of the income prong of §165(d) than other cases have provided, but those cases were distinguished because they did not deal with the specific facts here, i.e., a gambler who received comps to induce him to gamble.

7. *Intergraph Corp. v. Commissioner, 106 T.C. No. 16 (5/8/96). Because the deduction for paying a loan guarantee is a §166 bad debt deduction, the guarantor of its Japanese subsidiary's debt was not entitled to a bad debt deduction in the year of payment. The subsidiary continued to operate as a going concern [albeit an insolvent one] and the existence of subrogation rights gave guarantor a right of recovery not shown to be worthless at the time. (Under Reg. §1.166-9(a), it was not necessary for the subrogation rights to be expressly stated in the guarantee agreement.)

8. Buchanan v. Commissioner, 87 F.3d 197, 96-2 U.S.T.C. ¶50,334 (7th Cir. 6/20/96). In an alternative holding disallowing a claimed §166(c) nonbusiness bad debt deduction, the court held that the unpaid balance of a partially collected nonbusiness bad debt cannot be severed from the original debt and treated as a wholly
worthless bad debt. No §166(c) deduction was allowed. This alternative holding was devoid of reasoning or citation to authority and is contrary to prior accepted case law. See Alexander v. Commissioner, 26 T.C. 856 (1956) (acq.) (deduction allowed for $5,500 after only $500 of $6,000 nonbusiness debt was collected); Nash v. Commissioner, 31 T.C. 569 (1958) (deduction allowed for unpaid balance of nonbusiness bad debts that were partially repaid); Crown v. Commissioner, 77 T.C. 582, 600, n.7 (1981) (acq. on other issues) (applying this principle to reimbursement by co-guarantors to reduce bad debt deduction of guarantor who satisfied debt).

9. Moore v. United States, 96-2 U.S.T.C. ¶50,413, 78 APTR2d 5501 (E.D. Va. 6/6/96). A §165 loss by worthlessness deduction might be available with respect to land if the taxpayer can establish that by virtue of changed land use or environmental regulation a “regulatory taking” under Lucas v. South Carolina Coastal Council, 505 US 1003 (1992), has occurred. The deduction was denied because on the facts a regulatory taking did not occur.

10. Schroeder v. Commissioner, T.C. Memo 1996-336 (7/24/96). Section 280B applied and no deduction was allowed for the cost of demolition and debris removal of farm outbuildings no longer used in the business.

11. PS-39-93, proposed regulations under §280B defining the term “structure” for purposes of that provision denying deductions for demolition losses (61 F.R. 31473, 6/20/96).

12. Weyerhaeuser Co. v. United States, 96-2 U.S.T.C. ¶50,420 (Fed. Cir. 8/2/96), aff’g in part, rev’g in part and remanding 32 Fed. Cl. 80 (Fed. Cl. 1994). Holds that the “single, identifiable property” for purposes of determining casualty loss limits is (as contended by taxpayer) the “depletion block” [the area into which taxpayer aggregates it timber according to Reg. §1.611-3(c), such as geographical boundaries], and not (as held by the Court of Federal Claims) the smaller “tree stand” [an aggregation of trees sufficiently homogeneous to be distinguishable from adjoining growth].

D. Business Income

1. Devaluation gains on foreign currency borrowings held not to be cancellation of indebtedness income. Philip Morris Inc. v. Commissioner, 104 T.C. 61 (1/23/95). Gains achieved in foreign currency borrowing transactions solely by reason of the value of the foreign currency decreasing between the date the borrowings were incurred and the date of repayment did not constitute “discharge of indebtedness” income that could be excluded under the former §108(a)(1)(C) qualified business indebtedness exception because the foreign currency obligations were paid in full in the same currency and “exchange gain arises as a result of a transaction separate from the underlying transaction,” distinguishing Kentucky & Indiana Terminal RR v. United States, 330 F.2d 520, 64-1 U.S.T.C. ¶9374 (6th Cir. 1964), and following United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991) (As used in §108, the term “discharge of indebtedness” conveys forgiveness of, or release from an obligation to repay.). Judge Tannenwald stated that the Centennial teaching was that “the discharge of an indebtedness may be the occasion for the realization of income but, unless there is a cancellation or forgiveness of a portion of the indebtedness not reflected in the terms of the indebtedness, such income is not [COD as required by §108(a)].” He also noted that had the borrowed currency been held as
such taxpayer would have had a loss on its value exactly offsetting the economic gain from repayment in the devalued currency. Note: This case did not involve a year governed by §988 [added by the 1986 Act], which would generally treat foreign currency gains as ordinary. Note further that the §108(a)(1)(C) qualified business indebtedness exception was repealed by the 1986 Act.

a. *Affirmed, reluctantly, 71 F.3d 1040, 96-1 U.S.T.C. ¶50,007 (2d Cir. 12/8/95). The court found that the facts in this case were similar to those of United States v. Kirby Lumber Co., 284 U.S. 1 (1931), and felt that (unlike Centennial) this case "appears to be just the type of situation that Congress sought to ameliorate by establishing the tax-deferral mechanism in §108 so that the prospect of immediate tax liability would not discourage businesses from taking advantage of opportunities to repurchase or liquidate their debts at less than face value," quoting Centennial. The court concluded that it was "not at liberty" to decide for taxpayer in light of the Centennial requirement that discharge of indebtedness "requires a forgiveness or release of an obligation of the underlying debt . . . ."

2. *Taxpayer had income in year "loan" payments were made to his partnership because any repayment of the loan was conditional and contingent. Milenbach v. Commissioner, 106 T.C. 184 (3/28/96). Taxpayer was a limited partner of the Los Angeles Raiders during the years 1980-82 (and the partnership's income was to be determined in this consolidated proceeding for the years 1983-89). In 1982, in connection with the negotiation of a lease agreement following the Raiders' move from Oakland to Los Angeles, the Los Angeles Memorial Coliseum Commission agreed to lend the partnership $6.7 million at 10 percent interest, the loan to be paid with 12 percent of the net receipts from luxury suites to be constructed by the Raiders at the LA Coliseum. The suites were never constructed and the lender did not seek repayment until after the Raiders signed a memorandum of agreement with the City of Irwindale to move the team there; the lender's lawsuit was settled in 1990 with the parties entering into a mutual release. Judge Cohen held that there was never a valid debt created because the partnership's obligation to repay the loan was subject to its unlimited discretion and, therefore, conditional and contingent. Held, income to the partnership in the years loan payments were made.

III. CAPITAL GAIN AND LOSS

A. In general

1. Cramer v. Commissioner, 64 F.3d 1406, 95-2 U.S.T.C. ¶50,491 (9th Cir. 9/11/95). Taxpayers' attempted §83(b) [zero income] elections with respect to options were invalid because the options did not have a "readily ascertainable fair market value" and, under Reg. §1.83-7(b)(2) provided that §83 did not apply to the transfer of an option without a readily ascertainable fair market value." The regulation is valid because it was "not plainly inconsistent with, nor an unreasonable interpretation of, §83." Therefore, on the sale of the options, the result is ordinary income, and not capital gain.

deficiency judgment against taxpayer [which was later discharged in bankruptcy].

3. *A sad story from Arkansas. Hutcheson v. Commissioner, T.C. Memo. 1996-127 (3/14/96). On 1/3/89, taxpayer telephoned his Merrill Lynch broker (who was also his first cousin once removed, i.e., his maternal grandfather’s niece) and asked her to sell $100,000 worth of WalMart stock, but she sold 100,000 shares instead. (Taxpayer had about 192,000 shares in his account, worth $6 million at $30 per share; his basis in the stock was about 11 cents per share.) He attempted to get Merrill Lynch to repurchase 96,600 shares in order to effectuate a rescission of the erroneous sale, pursuant to Rev. Rul. 80-58, 1980-1 C.B. 181, but taxpayer himself repurchased the 96,600 shares at $44-1/2 per share on 12/28/89 [with Merrill Lynch waiving commissions] and settled his arbitration claim against Merrill Lynch for $250,000 in 1990. Taxpayer reported gain on only 3,400 shares, but Judge Raum held that he had not rescinded the transaction, putting buyers and seller back into “the relative positions that they would have occupied had no contract been made,” because the 1/3/89 purchasers of the 96,600 shares did not return the stock they received from taxpayer on 12/28/89, and Merrill Lynch was merely taxpayer’s selling agent. Query: What would you do if one of your clients fell into this situation? Could taxpayer have achieved a more satisfactory practical result by acting more promptly?

4. Greene v. United States, 79 F.3d 1348, 96-1 U.S.T.C. ¶50,180 (2d Cir. 4/2/96). Taxpayer was required under §1256 to mark to market regulated futures contracts (and, thus, recognize gain or loss on the entire contract) at the time he donated the long-term gain portion of each contract to his tax-exempt private foundation. The court chose the particular provision [§1256] over the general provision [§1001], and showed that abuse could occur when §1256 is ignored and only the LTCG portion of 60% LTCG/40% STCG property is donated.

5. Is Corn Products dead ... Pike v. United States, 88 F.3d 54, 96-2 U.S.T.C. ¶50,371 (1st Cir. 7/12/96). Summary judgment for government affirmed on the ground that bank stock was not §1221(1) inventory because claimed purpose of “purchasing enough [stock] in certain banks ... to persuade management to ... [form a] holding company” was not “a ‘hedge’ integral to protecting inventory or an inventory-purchase system,” as required by Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988). Losses incurred by an individual on sales of stock of various banks that he purchased with the intent of forming a bank holding company were capital losses. Under taxpayer’s theory, an investor in capital stock with a business motive could recognize ordinary losses, but “Such an alluring door ... was firmly locked in Arkansas Best.”

6. Or is there still life in the old case ... Computervision International Corp. v. Commissioner, T.C. Memo. 1996-131 (3/18/96). At the Commissioner’s behest, the Tax Court appears to have breathed new life into the Corn Products doctrine, although the Computervision decision does not expressly refer to Corn Products. Computervision received warrants to purchase stock in Sun Microsystems as a price rebate on products purchased from Sun under a volume purchase agreement. The warrants were exercisable only after Computervision had purchased a specified amount of products from Sun. The warrants became exercisable in January 1987, and were sold to an underwriter on March 12, 1987. Computervision treated the fair market
value of the warrants on the date they became exercisable, $1,823,172, as a reduction in the cost of goods sold for 1987, but reported the excess of the amount realized over that $1,823,172 as capital gain. Relying on Treas. Reg. §1.471-3(b), the Commissioner treated the entire proceeds of the sale as a reduction in the cost of goods sold during the year the warrants were sold, and the court upheld this treatment without much analysis.

7. IA-26-94, proposed regulations under §1202, relating to the 50-percent exclusion for gain for certain small business stock (61 F.R. 28821, 6/6/96). Corporations would be allowed to redeem de minimis amounts of stock without violating the §1202(c)(3) anti evasion rules, and that redemptions incident to certain events affecting a shareholder would be disregarded in determining whether redemptions exceed the de minimis amounts.

8. *Final debt modification regulations. T.D. 8675, final regulations under §1001, relating to when a modification of a debt instrument is treated as an exchange of the original instrument for a modified instrument (61 F.R. 32926, 6/26/96).

9. *Foreign currency gain on U.K. residence could not be offset by foreign currency loss on its mortgage. Quijano v. United States, 93 F.3d 26, 96-2 U.S.T.C. §50,441 (1st Cir. 8/21/96). For purposes of determining the gain on the sale of taxpayers' U.K. residence, the exchange rate at the date of purchase ($1.49 to 1 pound) was to be used to calculate cost basis (in dollars) and the exchange rate at date of sale ($1.82 to 1 pound, a decline in the value of the dollar) was to be used to calculate the sale price. The court held that the loss on the mortgage loan transaction [more dollars needed to pay off the mortgage than taxpayer borrowed] could not be used to offset the gain from the sale of the real estate [more dollars received than paid], even though the currency loss on the mortgage was mirrored by a currency gain on the house. Section 985(a) requires that all income tax liability determinations are to be made in the "taxpayer's functional currency," which is the U.S. dollar; taxpayers' contention that this was a §988 hedging transaction (which would result in integrated treatment) was rejected because they were not in any business with respect to the house purchase and sale. Nor did taxpayers have a qualified business unit (QBU), required by §985(b)(1) for use of a functional currency other than the U.S. dollar.

IV. CORPORATIONS

A. Entity and Formation

1. Debt-equity swap held to result in gain, not contribution to capital. G.M. Trading Corp. v. Commissioner, 103 T.C. 59 (7/25/94), motion for reconsideration granted. Taxpayer participated in a "Mexican debt-equity swap" transaction at the time its Mexican subsidiary constructed a maquiladora plant for its lambskin processing operations. Taxpayer purchased previously-issued U.S. dollar denominated Mexican Government debt, which it exchanged for Mexican pesos at an extremely favorable exchange rate, subject to the restriction that the pesos could be used by taxpayer's Mexican subsidiary only to construct its maquiladora plant. Taxpayer was taxed on its gain of $410,000, computed as the excess of the value of the pesos received ($1,044,000) over the amount paid for the debt ($634,000), based upon the court's determination that the restrictions
did not reduce taxpayer’s subsidiary’s economic benefit from the pesos.

a. Tax Court adheres to its prior holding. G.M. Trading Corp. v. Commissioner, 106 T.C. No. 13 (4/17/96), reaffirming 103 T.C. 59 (1994). The Mexican pesos received in the exchange were not only for taxpayer’s pledge to construct a plant in Mexico, but also for the surrender of Mexican Government debt. The court held that this surrender constitutes a quid pro quo that “taints what otherwise might have qualified under §118 as a tax free contribution to capital.”

2. Proposed (and now final) regulations on disregarding underwriters on transfers to corporations or partnerships in connection with an offer of stock or partnership interests. CO-26-95, proposed regulations under §§351 [§1.351-1(a)(3)] and 721, relating to transfers of cash to a corporation (or partnership) in transactions intended to qualify under those provisions when there is an offering of stock or partnership interests through an underwriter (60 F.R. 40792, 8/10/95). Final regulations would make obsolete Rev. Rul. 78-294, 1978-2 C.B. 141, which (in Situation 2) held that (in a “firm commitment” underwriting) the underwriter was a transferor [along with the individual owning the sole proprietorship], and that their control was not defeated by the subsequent resale of 50 percent of the stock in a public offering. The proposed regulation would disregard the underwriter in a “qualified underwriting transaction,” which is defined as one in which either the underwriter is an agent of the corporation or the underwriter’s ownership of stock is transitory. (A similar amendment would be made by adding Reg. §1.721-1(c) to the partnership regulations.)

a. T.D. 8665, final regulations under §§351 and 721, concerning transfers of cash to a corporation or partnership when there is an offering of stock or partnership interests through an underwriter (61 F.R. 19188, 5/1/96).

3. Peracchi v. Commissioner, T.C. Memo. 1996-191 (4/22/96). Taxpayers’ unsecured promissory note, contributed to their wholly owned corporation, was not genuine indebtedness because it was not intended to be enforced, so they were required to recognize gain under §357(c)(1) measured by the excess of mortgage debt on the property transferred over their adjusted basis in the property. Judge Nims held that the question of whether a taxpayer’s unsecured promissory note could ever constitute “property” for §357(c) purposes need not be addressed, referring to Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989), rev’g 85 T.C. 824 (1985).

4. T.D. 8663, final regulations under §351(e), relating to transfers to investment companies (61 F.R. 19544, 5/2/96). The final regulations amend the regulations to provide when certain transfers will not cause a diversification of the transferors’ interests.

5. Board of Trade of the City of Chicago v. Commissioner, 106 T.C. No. 21 (5/29/96). Transfer fees payable when a membership in taxable membership corporation that operates a futures exchange are excludable as $118 nontaxable contributions to capital -- and not payments for services -- even though they are mandatory because they were earmarked for reducing taxpayer’s building indebtedness [a capital expenditure], so the payors had an investment motive for
paying the transfer fees and an opportunity to profit from having made the payments.

6. Tax-free customer contributions in aid of constriction. The Small Business Job Protection Act of 1996 amended §118 by adding new §118(c) providing that contributions in aid of construction by customers of water and sewage disposal utilities are not includable in income under §118(b).

7. The FASIT is created. The Small Business Job Protection Act of 1996 §1621 added §§860H, 860I, 860J, 860K and 860L to create a new type of statutory entity called a "financial asset securitization investment trust" (FASIT), which may be used to securitize debt obligations such as credit card receivables, home equity loans and auto loans.

B. Distributions and Redemptions

1. CO-9-96, proposed regulations under §1059 (§1.1059(e)-1) to clarify that the redemptions defined as extraordinary dividends under §1059(e)(1) [non pro rata redemptions and partial liquidations treated as dividends, both of which are so defined without regard to threshold percentage or holding period of the stock] are not limited by the exclusions of §1059(d)(6) [distributions to an original shareholder out of e&p] or §1059(e)(2) [distributions from affiliated corporation out of e&p accumulated during affiliation] (61 F.R. 30845, 6/18/96).

2. *Stock redemption expenses incurred to obtain a loan are amortizable over the period of the loan. Small Business Tax Act §1704(p) amended §162(k) retroactively to follow United States v. Kroy (Europe) Ltd., 27 F.3d 367, 94-2 U.S.T.C. ¶50,316 (9th Cir. 1994) (allowing amortization of fees incurred to obtain a loan to finance a redemption), and to reject Fort Howard Corp v. Commissioner., 103 T.C. 345 (1994) (disallowing the deduction for investment banking fees under similar circumstances). The amendment follows Judge Beghe’s dissent in Fort Howard, which was based on the principle that the expenses were amortizable over the period of loans, the interest on which is deductible under §162(k)(2)(A)(i). The amendment clarifies that §162(k) applies to any acquisition of corporate stock made by either the corporation itself or any 10 percent or more owner, whether the reacquisition is treated as a sale or as a dividend, and regardless of whether the transitions is a reorganization or other transaction.

a. Fort Howard Corp. v. Commissioner, 107 T.C. No. 12 (10/22/96). Judge Ruwe held that the deductions for investment banking fees were deductible in light of the retroactive amendment to §162(k) in the Small Business Job Protection Act of 1996.

C. S Corporations

1. Terminating election proposed regulations. PS-268-82, proposed regulations, relating to the special rule of §1377(a)(2) that permits a "terminating election" that applies §1377(a)(1) as if the taxable year of the S corporation consisted of two taxable years, the first of which ends on the date of the termination (60 F.R. 35882, 7/12/95). The election must be made by all shareholders upon a terminating event, which occurs only if a shareholder’s interest in the S corporation is terminated. Note: In representing a terminating shareholder, consider including in the sale contract a requirement that this election be made.
a. Agreement to terminate year need not be made by "all shareholders," but only by "all affected shareholders." See amendments to S corporation provisions in the Small Business Job Protection Act of 1996.

2. What happens when the IRS cannot locate the S corporation election form? Carroll v. Commissioner, 71 F.3d 1228, 96-1 U.S.T.C. ¶50,010 (6th Cir. 12/26/95). S corporation election form timely mailed to the IRS was ineffective because the IRS has been unable to locate the original form. Only the actual receipt rule -- and not the common law "mailbox rule" -- applies in the 6th and 2d Circuits, except for the §7502 registered or certified mail prima facie rule. The 8th and 9th Circuits do accept the common law mailbox rule. Held: $22,500 deficiency. Moral?

3. S corporation provisions amended. SBT §§1301 through 1317 amend S corporation provisions as follows. These changes are applicable to years beginning after 12/31/96 unless otherwise provided.

a. *75 shareholders. SBT § 1301 amends §1361 to increase the number of permitted shareholders from 35 to 75.

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

c. *Expansion of post-death qualification for trusts to be permitted shareholders. SBT §1303 amends §1361(c)(2)(ii) and (iii) to extend from 60 days to 2 years the post-death holding period that former grantor trusts and testamentary trusts are permitted to be S corporation shareholders.

d. Financial institutions are permitted to hold safe harbor debt. SBT §1304 amends §1361(c)(5)(B)(iii) to permit financial institutions to hold safe harbor debt.

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

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

**g. Post-termination transition period expanded and special audit provisions for subchapter S items repealed (with consistency rule substituted).** SBT §1307(a) amends §1377 to expand the post-termination transition period to include the 120-day period beginning on the date of any determination pursuant to an audit that follows the termination of the S corporation’s election and adjusts a subchapter S item of income, loss or deduction.

**h. TEFRA special audit provisions for S corporations are repealed.** SBT §1307(c) repeals the special audit provisions for subchapter S items and adds new §6037(e), which provides that a shareholder’s return must be consistent with the corporate return, or notify the Secretary of the inconsistency.

**i. S corporations may be members of an affiliated group, and, therefore, will be permitted to hold subsidiaries.** SBT §1308 repeals §1361(b)(2)(A), which had defined as an “ineligible corporation” any member of an affiliated group. This will permit S corporations to hold both C-corporation and [100%] S-corporation subsidiaries. A C corporation subsidiary will be permitted to join in the filing of a consolidated return with any other affiliated C corporations. Any S corporation whose stock is owned by another S corporation must be a “qualified S corporation subsidiary” [wholly-owned, and for which the parent S corporation makes an election], which will be treated as being part of the parent S corporation -- and not as a separate corporation.

**j. Treatment of distributions during loss years.** SBT §1309 amends §1366 to modify the treatment of distributions during loss years, by taking adjustments for distributions into account before adjustments for losses.

**k. Treatment of S corporations under subchapter C.** SBT §1310 amends §1371(a)(2) to provide that S corporations will be generally treated “as corporations” [as opposed to “as individuals” under prior law] for purposes of subchapter C. Therefore, S corporations may liquidate their C corporation subsidiaries tax-free under §§332 and 337.

**l. Earnings and profits accumulated during S years before 1983 are eliminated.** SBT §1311 amends §§1362 and 1375 to eliminate earnings and profits accumulated during S years prior to 1983.

**m. Carryover of disallowed losses and deductions under the at-risk rules.** SBT §1312 amends §1366 to allow the carryover of disallowed losses and deductions under the at-risk rules.

**n. Adjustment of basis of inherited stock for items of IRD.** SBT §1313 amends §1367 to provide for the adjustment of basis of inherited stock for items of IRD, effective for persons dying after
the date of enactment. This follows the rule for basis of inherited partnership interests.

o. §1237 relief for subdivided real property available to S corporations. SBT §1314 amends §1237 to make S corporations eligible for rules applicable to real property subdivided for sale by noncorporate taxpayers.

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

q. *Qualified plan trusts and charities will become eligible to be S shareholders. SBT §1316 amends §1361(b)(1) and (c) to make organizations described in §401(a) [qualified retirement plan trusts] and in §501(c)(3) [public charities and private foundations] eligible to be S corporation shareholders (with (1) income, loss, etc. flowing through from the S corporation, and (2) gain or loss on the disposition of the S corporation stock, included in UBTI, per new §512(e)). Applicable to years beginning after 12/31/97. Each tax-exempt organization will be considered as one shareholder. Certain of the tax rules applicable to ESOPs will not apply with respect to S corporation stock held by the ESOP.

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

D. Affiliated Corporations

E. Section 482
1. T.D. 8656, (61 F.R. 4876, 2/9/96). Final and temporary regulations under §6662, providing guidance under §6662(e) for net §482 transfer price adjustments. The final regulations retain the requirement that taxpayers who select and apply a specified method must make a reasonable effort to determine the potential applicability of other specified methods, but this need not involve a thorough analysis under each such method. Taxpayers need use only data available before the end of the tax year, and need not continue to search for data thereafter; however, if taxpayer obtains data between
the end of the tax year and the date on which the tax return is filed, this data must be included in its principal documents (to be provided to the IRS on request). For service transactions, need not declare any specified method on the tax return.

2. T.D. 8670, amendments to final regulations under §482 to repeal the "active conduct" rule of Reg. §1.482-7(c) for participation in a cost sharing arrangement (61 F.R. 21955, 5/9/96).

F. Reorganizations and Corporate Divisions

1. Proposed regulations: Yoc Heating reversed; continuity of interest exists. CO-62-94, proposed regulations §1.338-2(c)(3), relating to whether the continuity of interest requirement is met when target assets are transferred to the purchasing corporation (or another member of the same affiliated group) following a qualified stock purchase if a §338 election is not made (60 F.R. 9309, 2/17/95). The proposed regulation would reverse Yoc Heating v. Commissioner, 61 T.C. 168 (1973), by establishing that §338 replaces any nonstatutory treatment of a stock purchase as an asset purchase. Continuity of interest treatment would be granted to the corporate 80+% purchaser only, and not to minority shareholders.


2. Rev. Rul. 95-69, 1995-42 I.R.B. 4. Satisfaction of the Reg. §1.368-1(b) continuity of proprietary interest requirement is not affected by a partnership's distribution of stock received in a reorganization to its partners in accordance with their interests in the partnership. The distribution was made in order that the surviving corporation in a merger can qualify as a small business corporation eligible to elect to be an S corporation.


4. Rev. Rul. 96-29, 1996-24 I.R.B. 5 (5/22/96). A reincorporation [in another state] transaction qualifies as an F reorganization even though it was a step in a public offering/redemption transaction (Situation 1) or in a transaction in which another business was acquired (Situation 2). Rev. Rul. 79-250, 1979-2 C.B. 156, did not apply the step-transaction doctrine because "the economic motivation supporting each transaction is sufficiently meaningful on its own account, and is not dependent upon the other transaction for its substantiation." The 1979 ruling was intended to address the unique status of reorganizations under §368(a)(1)(F), and was not intended to reflect the application of the step-transaction doctrine in other contexts.


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be respected for federal income tax purposes where there had been no negotiations regarding the acquisition with the distributing corporation and the former subsidiaries voted on the merger after the distribution and were free to vote their stock for or against the merger. Section 7805(b) relief will be considered by the Service on a case-by-case basis.

6. Rev. Proc. 96-39, 1996-33 I.R.B. (7/23/96). The Service will no longer issue advance rulings (pending further study) under §355 if there have been negotiations, agreements or arrangements which, if treated as consummated before the distribution, would result in the distribution of stock or securities of a corporation not controlled by the distributing corporation.

7. Rev. Proc. 96-43, 1996-35 I.R.B. (8/8/96). The Service will ordinarily no longer issue advance rulings on whether a distribution satisfies §355 when the gross assets of the trades or businesses relied upon to satisfy the active trade or business requirement of §355(b) have a fair market value that is less than 5 percent of the total fair market value of the gross assets of the corporation directly conducting the trades or businesses. The Service may rule favorably if it can be established that those trades or businesses are not de minimis compared with the other assets or activities of the corporation and its subsidiaries.

V. EMPLOYEE COMPENSATION AND PLANS

A. In General

1. In re Solomon, 67 F.3d 1128 (4th Cir. 10/23/95) (2-1). Retired physician sued for $160 million for sexual misconduct with patients would not be required to withdraw $1.4 million from his IRAs for the benefit of the patients [who were his sole creditors] in a Chapter 13 bankruptcy.

2. Plan disqualification for lack of a formality; Tax Court no longer adheres to Baetens. Fazi v. Commissioner, 102 T.C. 695 (5/19/94) (reviewed, 14-0) ("Fazi I"). Taxpayer's [wholly-owned] corporate dental practice had a prototype pension plan, which was found to be unqualified at the time of a $1.1 million distribution to taxpayer in 1987 because plan amendments required by the 1982 Act's (TEFRA) top-heavy provisions and the 1984 DEFRA and REA provisions, while made to the prototype plan, were not formally adopted by the corporate plan through a so-called “joinder agreement” made between the corporate plan and the insurance company trustee of the prototype plan -- even though, in operation, the corporate plan complied with the amended prototype plan.

   a. The entire amount of the distribution was taxable despite the taxpayer's attempted rollover to an individual retirement account; the Tax Court will no longer follow its holding in Baetens v. Commissioner, 82 T.C. 152 (1984), rev'd, 777 F.2d 1160, 85-2 U.S.T.C. ¶9847 (6th Cir. 1985), that taxes only those portions of the distribution which were accumulated while the trust was disqualified. 102 T.C. at 710-14. The Tax Court now agrees with the 5th, 6th and 7th Circuits, but not the 2d Circuit.

   b. Fazi I clarified: amount merged from qualified plan to disqualified plan not taxable until distributed. Fazi v. Commissioner, 105 T.C. No. 29 (12/19/95), clarifying 102 T.C. No. 31 (1994). Plan 2 [a profit sharing plan that was frozen in 1982] was in 1986 merged into Plan 1 [a money purchase plan, which was held to be
unqualified for years 1985, 1986 and 1987 for the corporation’s failure to adopt formally a plan complying with TEFRA, DEFRA and REA changes]. In Fazi I, the Commissioner conceded that the taxable distribution made in 1987 should not include 1985 and 1986 contributions because these would be taxable in the years that contributions were made to an unqualified trust, and included in 1986 contributions the amount in Plan 2 (merged into Plan 1). Judge Vasquez held that the merged amount was not taxable in 1986 because the merger of an exempt trust into a nonexempt trust was not a contribution by the employer. The court refused to apply the doctrine of “judicial estoppel” against taxpayers because the court was not misled or whipsawed by taxpayers, but “any loss to the revenue has been the direct result of [Commissioner’s] erroneous concession in Fazi I.” The court held that, because the amount in Plan 2 was not includable in income in 1986, there was insufficient omitted income in 1986 for the six-year statute of limitations to apply.

3. *IRS makes up its mind on FICA/FUTA taxes on nonqualified deferred compensation. EE-142-87, 61 F.R. 2194, and EE-55-95, 61 F.R. 2214 (1/25/96). Proposed regulations under §§3121(v)(2) and 3306(r), relating to when amounts deferred under nonqualified plans are taken into account as “wages” for purposes of FICA and FUTA purposes. In interpreting the statutory provision that wages are taken into account as of the later of: (1) when the services are performed, or (2) when there is no significant risk of forfeiture of the rights to such amounts, the proposed regulations state that where it is difficult to determine the present value of a benefit – e.g., where a benefit can fluctuate depending on the varying amount of a qualified plan benefit – the present value of the benefit need not be included in wages until it becomes “reasonably ascertainable.”

4. *Inclusion of “domestic partners” does not disqualify health plan, but does result in inclusion of cost of partner’s coverage in employee’s income. Ltr. Rul. 9603011 (10/18/95). Inclusion of “domestic partners” in a health plan does not disqualify the plan for the $106 exclusion [of amounts contributed by employer for health insurance benefits of employees, their spouses and dependents], but it will result in inclusion in the employee’s income of the excess of the fair market value of domestic partner coverage over the amount paid for such coverage unless the domestic partner (1) is recognized as a spouse under state law or (2) is qualified as a dependent under §152.

5. IRS rules that single premium collateral assignment split-dollar life insurance generates income to employee. TAM 9604001 (9/8/95). Collateral assignment split-dollar life insurance arrangement [policy owned by employee’s trust, with assignment to employer as security for employer’s loan (of the premium)], for single premium policy results in the inclusion in employee’s income of (a) an amount equal to the one-year term cost of declining life insurance and (b) any cash surrender buildup in the policy that exceeds the amount returnable to employer when the arrangement is discontinued.

6. *Supreme Court opens a litigation window for individuals. Varity Corp. v. Howe, 116 S. Ct. 1065 (U.S. 3/19/96) (6-3). Beneficiaries of a firm’s welfare benefit plan [retiree medical] were permitted under ERISA §§404 and 502(a)(3) to be reinstated in their employer’s welfare benefit plan, after they were tricked into withdrawing [and transferring to an underfunded subsidiary] by their employer, who was the plan’s administrator. The Court (by Justice Breyer) held that (1) the employer was acting in its capacity as an
ERISA fiduciary when it significantly and deliberately misled the beneficiaries, (2) the employer violated the fiduciary obligations that ERISA §404 imposes upon plan administrators, and (3) ERISA §502(a)(3) authorizes lawsuits seeking relief for individual beneficiaries harmed by an administrator's breach of fiduciary obligations. Dissent by Justice Thomas on the ground that recovery was only authorized under ERISA §§409 and 502(a)(2) by "the plan as an entity," and not by individual plan participants.


8. Announcement 96-26, 1996-17 I.R.B. 13. Provides information relating to refunds of the §4972 excise tax for nondeductible contributions that were retroactively exempted from the tax by the Retirement Protection Act of 1994.

9. Boggs v. Boggs, 82 F.3d 90, 1996 U.S. App. LEXIS 8664 (5th Cir. 4/17/96) (2-1). Judge Wisdom's majority opinion held that the anti-alienation provision of ERISA did not preempt Louisiana community property law, so employee's widow's survivor's annuity -- to the extent it represented the community property interest belonging to employee's first wife (who died during his employment, leaving 2/3 of her estate to the employee [her husband] in a lifetime usufruct) -- was subject to a possible accounting and award of some portion of the retirement benefits to the three sons of the first wife as owners of the naked or reversionary interest in the portion of her estate over which employee held a usufruct. Judge King dissented on the ground that the widow's rights under ERISA -- which were to have been applied uniformly nationwide -- were not only "tenuously, remotely or peripherally" affected by Louisiana law, but rather, "They have been gutted." The dissent would have followed Ablamis v. Roper, 937 F.2d 1450 (9th Cir. 1991). and DOL Advisory Opinion #90-46A (12/4/90) on this issue.

10. Dwyer v. Commissioner, 106 T.C. No. 18 (5/15/96). Severe depression did not constitute a disability under §72(m)(7) [which provided that an individual is to be considered disabled "if he is unable to engage in any substantial gainful activity by reason on any medically determinable physical or mental impairment"], so the 10 percent tax under §72(t) on premature distributions from an IRA was applied. Judge Nims held that taxpayer's losing $94,000 as a stock trader in 1989 was not inconsistent with "gainful activity."

11. Gallade v. Commissioner, 106 T.C. No. 20 (5/28/96). Taxpayer executed a "waiver" of his fully vested, accrued benefits in favor of his wholly owned corporation on the termination of the pension plan operated by the corporation [in which he participated] because of the corporation's poor financial condition. Held, ERISA's anti-alienation provisions prohibited the assignment of taxpayer's benefits to the corporation, and taxpayer received a taxable distribution because he had an unconditional right to receive the benefits and contributed them to the corporation. Judge Gerber further held that the Commissioner abused her discretion by failing to waive the substantial understatement penalty.
12. Early retirement benefits may be conditioned upon waiver of claims against the employer. Lockheed Corp. v. Spink, 116 S. Ct. 1783 (U.S. 6/10/96). ERISA does not prevent an employer from conditioning the receipt of early retirement benefits upon plan participants’ waiver of employment claims because plan sponsors [Lockheed and its directors] were not acting as fiduciaries when they amended the plan to impose the waiver of employment claims as a condition of receiving early retirement benefits. Justice Thomas’ majority opinion further held that the 1986 Act’s repeal of ERISA’s age-based exclusion provision did not require that previously excluded employees -- Spink was 61 when reemployed by Lockheed in 1979 -- receive credit for their pre-1988 [effective date of 1986 repeal] service years.

13. Lear Eye Clinic, Ltd. v. Commissioner, 106 T.C. No. 23 (6/10/96), on remand from Citrus Valley Estates, Inc. v. Commissioner, 49 F.3d 1410, 95-1 U.S.T.C. ¶50,132 (9th Cir. 1995), aff’g in part and remanding in part 99 T.C. 379 (1992). Decided whether the plan participants properly counted their previous employment towards the §415(b) maximum benefit limitations.

14. Held not to be a QDRO. Was it because divorce court refused to modify its order over wife’s objection? Hawkins v. Commissioner, 102 T.C. 61 (1/27/94). On the distribution of $1 million from husband’s dental practice pension plan to wife pursuant to New Mexico domestic relations court order upon their divorce, husband was taxed because the order did not clearly create or recognize wife’s rights as an alternate payee to plan benefits (as is required by §414(p)), but merely stated that wife was to receive $1 million “from Husband’s share of the ... plan.” But, reversed . . .

a. *Tenth Circuit holds it was a QDRO based upon construction of its language. Hawkins v. Commissioner, 96-1 U.S.T.C. ¶50,316 (10th Cir. 6/14/96), rev’g 102 T.C. 61 (1994). On construing the words contained in the marital dissolution decree, “Wife shall receive as her separate property . . . $1,000,000 from Husband’s share of the pension plan,” the Tenth Circuit held those words sufficient to “create, recognize or assign to her the right to receive benefits under the plan” for qualified domestic relations order (QDRO) purposes because neither an expressed intent to reallocate the tax burden of a pension distribution nor the words “alternate payee” are required by §414(p)(1)(A)(i). The court further held the language, “Husband shall immediately allow Wife to take possession of the property transferred [to her] by this Agreement,” was sufficiently precise to meet the §414(p)(2) requirement that it “clearly specify certain facts.” Therefore, wife was taxed on the plan distribution.

15. Eyler v. Commissioner, 88 F.3d 445, 96-2 U.S.T.C. ¶50,353 (7th Cir. 7/2/96). Taxpayer was subject to the $4975 prohibited transaction excise tax because he failed to meet the burden of establishing that his sale of employer-issued securities to his corporation’s ESOP was for adequate consideration because the $14.50 price paid by the ESOP was not a fair market value. That figure was mentioned by Prudential-Bache as a price for an initial public offering that did not occur, including changes from the time the prospectus was filed by the underwriters as well as a discount for lack of marketability.

a. Simplified distribution rules. SBT §§1401-1404, the “simplified distribution rules”:

b. 5-year averaging repealed. Repeal 5-year averaging for lump-sum distributions from qualified plans, effective for years beginning after 12/31/98;

c. Exclusion for employer-provided death benefit under §101(b) is repealed. Repeal the §101(b) $5,000 exclusion for employer-provided death benefits, effective with respect to decedents dying after the date of enactment;

d. Simplified method for basis recovery. Provide a simplified method for basis recovery on payments from qualified plans, effective with respect to annuity starting dates beginning 90 days after the date of enactment; and

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

17. Increased access to retirement savings plans. SBT §§1421-1427, the “increased access to retirement savings plans” provisions:

a. SIMPLE retirement plans. Establish SIMPLE retirement plans for employees of small employers in IRA form, effective for years beginning after 12/31/96. Eligible if 100 or fewer employees with $5,000 of compensation in preceding year and do not maintain another qualified plan; employee before-tax contributions limited to $6,000 (indexed). Employer must either match employee contributions at 100 percent up to 3 percent (may lower to 1 percent in 2 out of 5 years with advance notice) or non-matching employer contribution of 2 percent for each employee with $5,000 or more compensation. May be either an IRA or part of a 401(k) plan. Effective for tax years beginning after 12/31/96;

b. Tax-exempts may maintain 401(k) plans. Permit tax-exempt organizations (except state and local governments to maintain 401(k) plans, effective for plan years beginning after 12/31/96; and

c. Spousal IRA contribution limit increased from $250 to $2,000. Increases the maximum deductible spousal IRA contribution from $250 $2,000, effective for taxable years beginning after 12/31/96.

18. Nondiscrimination provisions. SBT §§1431-1434, the “nondiscrimination” provisions:

a. Highly compensated definition modified, with election to include/exclude recipients of more than $80,000 annual compensation but are not in the top 20 percent of employees. Modify
the definition of “highly compensated” from prior law’s (i) 5 percent owners, (ii) recipients of more than $100,000 annual compensation, (iii) recipients of more than $66,000 annual compensation and in the top 20 percent of employees in compensation, (iv) any officer who received annual compensation in excess of $60,000, and (v) the highest paid officer, to (i) 5 percent owners, and (ii) recipients of more than $80,000 annual compensation (who are within/not within the top 20 percent of employees in compensation, based upon an annual election). Therefore, an employer can elect to treat employees with more than $80,000 in annual compensation [but not in the top 20 percent] as either highly compensated or not highly compensated on a year-by-year basis. This election would be of interest to employers [such as law firms] who have more than 20 percent of employees who are paid more than $80,000 per year.

(1) Repeals the family aggregation rules with respect to relatives of 5 percent owners for purposes of the $150,000 limit on compensation that may be taken into account under a qualified plan. Effective for years beginning after 12/31/96.

b. Minimum participation rule for SLOBs. Modify the §401(a)(26) minimum participation rule [must benefit the lesser of (1) 50 employees, or (2) the greater of 40 percent of all employees or 2 employees] to provide that it applies only to defined benefit pension plans. The requirement that a line of business has at least 50 employees will no longer apply for the separate line of business (SLOB) determination. Effective for years beginning after 12/31/96.

c. May use prior year data for nondiscrimination testing. Modify the special nondiscrimination tests applicable to 401(k) plans by providing that prior year data -- instead of current year data -- is to be used [with a special rule for the first plan year], effective for years beginning after 12/31/96.

(1) They provide two safe harbor tests to satisfy those special nondiscrimination tests. The first safe harbor is that the plan satisfies a notice requirement and either (1) satisfies a “matching contribution” requirement or (2) the employer contributes at least 3 percent of compensation for each nonhighly compensated eligible employee without regard to whether the employee makes elective contributions. There is also a second safe harbor. Effective for years beginning after 12/31/98.

(2) There is a new rule with respect to the distribution of excess contributions (and excess aggregate contributions), effective for years beginning after 12/31/96.

d. Treats elective deferrals to 401(k) plans, etc., as compensation for purposes of the $150,000 limit. Provides that elective deferrals to §401(k) plans and similar arrangements, elective contributions to nonqualified deferred compensation plans of tax-exempt employers and State and local governments (§457 plans), and salary reduction contributions to a cafeteria plan are treated as compensation for purposes of the limits on contributions and benefits, effective for years beginning after 12/31/97.

19. Miscellaneous provisions. SBT §§1441-1461, the “miscellaneous” provisions include:

a. SBT §1441 amends §401(d) to eliminate the special aggregation rules that apply to plans maintained by owner employees of
unincorporated businesses that do not apply to other qualified plans, effective for years beginning after 12/31/96.

b. SBT §1442 conforms the vesting rules for multiemployer plans to the rules applicable to other qualified plans, with varying effective dates.

c. SBT §1445 provides for the gradually-increasing $415 social security retirement age to be the uniform retirement age for determining whether subsidized early retirement benefits and joint and survivor annuities violate the §401(a)(4) general nondiscrimination rules, effective for years beginning after 12/31/96.

d. SBT §1449 corrects the GATT interest and mortality rate provisions in the Retirement Protection Act of 1994, effective as if included in that Act.

e. SBT §1450 permits participants in §403(b) tax-sheltered annuity plans to enter into more than one salary reduction agreement in a taxable year [effective for taxable years beginning after 12/31/96-5], and provides that the $9,500 annual limit on elective deferrals for §403(b) plans be applied to each tax-sheltered annuity contract -- as opposed to the annual limit applying to the plan under current law -- effective for years beginning after 12/31/95, with 90 days after enactment for compliance. No inference is intended as to whether the exclusion of elective deferrals from gross income by employees who have not exceeded the annual limit is affected to the extent other employees have exceeded the annual limit prior to years beginning in 1996

f. Permits waiver of minimum 30-day waiting period when explanation is provided after the annuity starting date. SBT §1451 codifies the provision in Temporary Regulations to provide that a participant may elect (with any applicable spousal consent) to waive the minimum 30-day waiting period for distributions following the date the explanation was provided, as long as the distribution begins more than 7 days after the explanation was provided. It also permits that the explanation may be provided after the annuity starting date, to allow retroactive payments of benefits. Effective with respect to plan years beginning after 12/31/96.

g. §415(e) combined plan limit repealed. SBT §1452 repeals the §415(e) combined plan limit [the lesser of 1.25 times the $90,000 maximum benefit and 1.4 times the high 3 years’ average compensation] where a single employee has both a defined benefit plan and a defined contribution plan, effective with respect to limitation years beginning after 12/31/99. Meanwhile, the §4980A excise tax on excess distributions is suspended for distributions received in 1997, 1998 and 1999.

h. Initial level §4975(a) tax on prohibited transactions is increased from 5 percent to 10 percent. SBT §1453 increases the initial level §4975(a) tax on prohibited transactions from 5 percent to 10 percent, effective for transactions occurring after the date of enactment.

i. New test for leased employees. SBT §1454 replaces the §414(m) test for a "leased employee" as one who performs services of a type "historically performed" by employees in the recipient's business field with a test under which an individual is not considered a leased employee unless the individual's services are performed under
the primary direction or control of the service recipient, effective for years beginning after 12/31/96 (with exception for relationships that have been previously determined by IRS ruling not to involve leased employees).

j. Treasury must provide sample language that is also "simple language" for spousal consents and QDROs. SBT §1457 requires Treasury to provide sample language [that is also simple language] for inclusion in a spousal consent form and in a qualified domestic relations order, the sample language to be developed no later than 1/1/97.

k. SBT §1459 provides alternative nondiscrimination rules for 401(k) plans that provide for early participation, effective for plan years beginning after 12/31/98.

1. Date for making plan amendments extended through the end of 1997. SBT §1465 extends the date for making plan amendments required by the pension simplification provisions of this Act, by providing that the amendments are not required to be made before the first plan year beginning on or after 1/1/98 (1/1/00 for governmental plans).

20. Interest exclusion on loans to ESOPs repealed. SBT §1602 repeals the §133 50-percent interest exclusion on loans to ESOPs used to acquire employer securities, effective for loans made after the day of enactment with grandfather provision for written binding agreements in effect before 6/10/96.

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

22. Self-employed health insurance deduction increases from 30 percent to 80 percent. HIPAA §311 amends §162(1) to increase the self-employed health insurance deductibility percentage from 30 percent to 40 percent in 1997; to 45 percent in 1998 through 2002; to 50 percent in 2003; to 60 percent in 2004; to 70 percent in 2005; to 80 percent in 2006 and thereafter.

23. More ways to avoid the 10 percent additional tax on distributions. HIPAA §361 amends §72(t) to exclude from the 10 percent additional tax those distributions made from IRAs which are used to pay financially devastating medical expenses (including health insurance for the individual and dependents for unemployed individuals). Effective for taxable years beginning after 12/31/96.
24. Abraham v. Exxon Corp., 85 F.3d 1126, 78 AFTR2d §96-5324 (5th Cir. 6/10/96). On summary judgment, held that leased employees [who "report to Exxon supervisors, have Exxon business cards and play on the Exxon softball team] are not entitled to pension plan benefits even though Exxon conceded for purposes of its motion that the plaintiffs were "common law employees" of Exxon. The court refused to follow Renda v. Adam Meldrum & Anderson Co., 806 F. Supp. 1071 (W.D. N.Y. 1992) (holding that ERISA §1052(a)(1)(A) forbids employers to discriminate against leased employees when designing an ERISA plan), because ERISA §1052(a) does not prevent employers from denying participation in an ERISA plan if the employer does so on a basis other than age or length of service.

25. Rev. Rul. 96-47, 1996-40 I.R.B. (9/16/96). Pension plan that automatically invests the funds of its ex-employees in the money market fund is a "significant detriment" imposed by the plan on a participant who does not consent to a distribution, and therefore fails to satisfy the §411(a)(11) consent requirements.

26. REG-245562-26, proposed amendments to Reg. §1.401(a)(31)-1, providing guidance on the qualification of retirement plans that accept rollover contributions from employees (61 F.R. 49279). Acceptance of rollover contributions, in appropriate circumstances [e.g., where the plan administrator reasonably concludes that a distribution meets the other requirements to be an eligible rollover distribution, or is a rollover contribution from an employee within 60 days from the date of distribution from a plan, or is a rollover contribution from a conduit IRS], will not affect a plan’s qualification.

VI. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING


   a. *Sierra Club affirmed on mailing list rental issue, but remanded on "affinity card" program income issue. Sierra Club Inc. v. Commissioner, 86 F.3d 1526, 96-1 U.S.T.C. §50,326 (9th Cir. 6/20/96). Royalties received from mailing list rentals were not UBTI because, although the court interpreted the §512(b)(2) exclusion of "royalties" as limited to royalties received as compensation for the use of property, the Sierra Club received these payments for use of its mailing lists, and not for services performed. On the issue of income from the organization’s affinity credit card program, remanded for factual findings, including a determination as to whether endorsement services were required from the organization [in addition to licensing its name and logo and permitting the use of its mailing lists].

   b. Fifth Circuit holds that payments are not royalties. Texas Farm Bureau v. United States, 53 F.3d 120, 95-1 U.S.T.C. §50,297 (5th Cir. 6/7/95), reversing the district court. Payments to a §501(c)(5) tax-exempt agricultural association from partially-owned life and casualty insurance companies constituted unrelated business taxable income, and not royalty payments (as a
matter of law) because the agreements under which the payments were received stated that the association would furnish "influence and prestige," as well as administrative and clerical services.

c. Oregon State University Alumni Ass'n Inc. v. Commissioner, T.C. Memo. 1996-34 (1/30/96). Income from affinity credit card program is royalty income, not UBIT.

2. Rev. Proc. 95-21, 1995-1 C.B. 686 (3/23/95). The Service will not treat dues payments from associate [usually, but not necessarily, non-voting] members of §501(c)(6) [labor and agricultural organizations] as unrelated business taxable income unless the associate member category has been formed or availed of for the [organization's] principal purpose of producing unrelated business income.

a. National League of Postmasters of the United States v. Commissioner, 86 F.3d 59, 96-1 U.S.T.C. ¶50,317 (4th Cir. 6/14/96). Dues received from "Limited Benefit Members" for the sole benefit of participation in organization's health insurance plan were unrelated business taxable income (UBTI) because the provision of health benefits [and some other miscellaneous benefits of no real use] to persons who are not members in any other sense cannot be substantially related to the organization's tax-exempt purpose.

3. Lucky Stores, Inc. v. Commissioner, 105 T.C. No. 28 (12/19/95). Retail grocery corporation allowed to base its deduction on the full retail price of 4-day-old bread donated to charities [soup kitchens and homeless shelters] because it regularly sells 4-day-old bread in its stores without price discount. (Section 170(e)(3) allows a deduction in the amount of the basis plus one-half of unrealized appreciation -- but not more than twice the basis -- for certain inventory items donated to qualified charities.) The court refused to accept a valuation based upon the industry practice of selling 3-day-old bread at a 50% discount on discount racks or in thrift stores. Rev. Rul. 85-8, 1985-1 C.B. 59 (holding that products donated shortly before the products' expiration date had to be reduced to take the impending expiration into account in determining value for §170(e)(3) purposes), distinguished on the ground that the expiration date for bread was not legally required.

4. Florida Hospital Trust Fund v. Commissioner, 71 F.3d 808, 96-1 U.S.T.C. ¶50,023 (1/2/96), aff'g 103 T.C. 140 (1994). Trust funds organized to provide a vehicle for member hospitals reciprocally to "self" insure each other on a group basis against liability and workers' compensation claims do not qualify as §501(e) tax-exempt "cooperative hospital service organizations" because they are not engaged in purchasing insurance on a group basis as contemplated under §501(e)(1)(A).

5. TAM 9609007 (12/6/95). Section 501(c)(3) public charity's fund raising letters violated prohibition against intervention in a political campaign (and were political expenditures for purposes of the §4955(d)(1) excise tax). Charity contended that the politically oriented statements served only to give a sense of urgency to fund raising appeals, there being no motivation to intervene in political campaigns. This argument was rejected, based upon Rev. Rul. 76-456, 1976-2 C.B. 151, and Association of the Bar of the City of New York v. Commissioner, 858 F.2d 876 (2d Cir. 1988).
6. **Taxable organization may spin off an exempt portion.**

Bob Jones University Museum & Gallery, Inc. v. Commissioner, T.C. Memo. 1996-247 (5/29/96). Petitioner corporation that took over the operations of an art museum on the campus of a "university whose tax exemption was revoked [461 U.S. 574 (1983)]" nevertheless qualified for exemption under §501(c)(3) where a majority of its five directors were not affiliated with the university because the university does not derive an impermissible benefit from the museum's operation. Neither the payment of [below-market] rent to the university nor the enhancement of the university's reputation constituted such a benefit. Judge Foley stated that a museum was not an essential part of a university and that he would have concern if a cafeteria or bookstore spun-off from a taxable corporation sought exempt status. He further held that there was no rule that taxable corporations may not have financial dealings with spun-off tax-exempt organizations.

7. **IRS leaves prepaid tuition plans without guidance.**

Rev. Proc. 96-34, 1996-26 I.R.B. 14. The IRS will not rule on whether prepaid tuition plans are state entities [and, if not, how they are treated for federal tax purposes], and whether any contract under the plan is a debt instrument [and, if so, how interest or OID attributable to the contract is treated for federal tax purposes].

   a. *But Congress legislates favorably; tax treatment of State tuition programs is blessed by new legislation.* SBT §1806 adds new §529 to provide that "qualified State tuition programs" are exempt from taxation (except for §511 UBIT), following Michigan v. United States, 40 F.3d 817 (6th Cir. 1994). These state-established programs permit a contributor to make cash contributions to provide for future payment of a designated beneficiary's "qualified higher education expenses," i.e., tuition, fees, books and equipment required for attendance at a college, university or area vocational education school (as defined in §135(c)(3)). Amounts distributed are includible in the gross income of the distributee (i.e., the beneficiary where benefits are furnished to him or her under the plan) under the §72 annuity provisions. The value of any interest in a qualified program is includible in the contributor's gross estate. The waiver (or payment to an educational institution) of qualified educational expenses is treated as eligible for the $2503(e) exclusion from treatment as a transfer of property by gift. Effective for tax years ending after 8/20/96.

8. **Penalty on amounts of private excess benefits.**

Taxpayer Bill of Rights 2 ("T2") [see XIV., below, for full citation] §1311 adds new §4958 to provide for intermediate sanctions short of disqualification for "excess benefit transactions." There is a 25 percent excise tax on the person receiving the benefit and a 10 percent excise tax on the organization's manager, with an additional 200 percent excise tax if the excess benefit is not corrected. An excise benefit transaction includes, but is not limited to, the payment of unreasonably high compensation to a person in a position to influence the organization. Applies to §501(c)(3) charitable organizations other than private foundations [already covered], as well as to §501(c)(4) social welfare organizations. Effective to inurement occurring on or after 9/14/95, with a grandfather through the end of 1996 for written contracts binding on that date and at all times thereafter.
9. Full deduction for contributions of appreciated stock to private foundations is extended for 11 months. SBT §1206 extends the special rule in §170(e)(5) to allow a full fair market value deduction for contributions of qualified appreciated stock made to private foundations to the 11-month period 7/1/96 through 5/31/97.

10. American Academy of Family Physicians v. United States, 91 F.3d 1155, 96-2 U.S.T.C. ¶50,414 (8th Cir. 8/6/96). Section 501(c)(6) physicians' organization did not have income subject to the §511 unrelated business income tax from sponsorship of group insurance plans because the organization did not have the profit motive required for a trade or business and its involvement in the insurance plans was not extensive. The organization lent its endorsement and sold its mailing lists for fair market value, but did not market or administer the insurance policies.

VII. INTEREST

A. In General

1. Interest on Schedule C income tax underpayments.

   a. *Interest on Schedule C income tax underpayments is per se nondeductible personal interest. Miller v. United States, 65 F.3d 687, 95-2 U.S.T.C. ¶50,485 (8th Cir. 9/5/95), aff'g 95-1 U.S.T.C. ¶50,068 (D. N.D. 8/1/94). The district court had denied a business expense deduction with respect to interest incurred on an income tax deficiency because the deficiency was not properly attributable to taxpayer's [farming] trade or business, but the court held that Temp. Reg. §1.163-9T(b)(2)(i)(A) was invalid to the extent it provided that interest on an underpayment of noncorporate income tax was per se nondeductible personal interest. The Eighth Circuit affirmed, but based its opinion on the validity of the regulation as a "permissible construction" of §163(h)(2)(A) under an "implicit legislative delegation of authority to the Commissioner to clarify whether income tax deficiency interest [is properly allocable to a trade or business]," finding the regulation to be consistent with the 1986 statutory provision, with its legislative history [and Bluebook], and with the 1988 amendment of the definition of "personal interest" [that expressed no dissatisfaction with the regulatory rule that interest on income tax deficiencies constituted personal interest per se].

   b. *Interest on federal income tax deficiencies arising from Schedule C errors was properly allocable to business indebtedness; Temp. Reg. §1.163-9T(b)(2)(i)(A) -- providing that personal interest includes interest paid on underpayments of individual federal income taxes -- was held to be invalid as it was here applied. Redlark v. Commissioner, 106 T.C. No. 2 (1/11/96) (reviewed, 11-7). The 1986 Act provision for nondeductibility of personal interest [§163(h)] did not make any substantive change in earlier case law [e.g., Standing v. Commissioner, 28 T.C. 789 (1957), aff'd, 259 F.2d 450, 58-2 U.S.T.C. ¶9835 (4th Cir. 1958)] holding that interest on a federal income tax deficiency resulting in part from improper reporting of income from a sole proprietorship was deductible as a business expense. Therefore, Temp. Reg. §1.163-9T(b)(2)(i)(A), which provided that interest on deficiencies in individual federal income tax is nondeductible personal interest, is invalid as applied to interest on a deficiency arising from a Schedule C adjustment. Dissents on the ground that the regulation is a reasonable interpretation of an ambiguous statute. Compare, Professional Equities, Inc. v. Commissioner, 89 T.C. 165 (1987) (reviewed, 16-0),
acq. 1988-2 C.B. 1 (wraparound mortgage regulation promulgated subsequent to the Installment Sales Revision Act of 1980 is invalid because it attempts to revise prior case law without express statutory authorization).

2. Northern Indiana Public Service Co. v. Commissioner, 105 T.C. 341 (11/6/95). Undercapitalized Netherlands Antilles finance subsidiary used for Eurodollar borrowings was recognized as a separate entity, and not merely as a conduit.

3. *Payments made to defer closing of stock purchase agreement held to be interest. Halle v. Commissioner, 83 F.3d 649, 96-1 U.S.T.C. ¶50,250 (4th Cir. 5/6/96) (2-1), rev'g and remanding T.C. Memo. 1994-630. The majority held that partnership [in which taxpayer was a partner] may deduct as interest $900,000 in payments [four months at $225,000 per month] it made to defer the closing date of a stock purchase agreement that obligated it to buy all of a corporation’s stock for $29 million. The partnership was formed by a real estate developer, and the target corporation’s sole asset was a tract of land which the developer believed was suitable for development. The stock purchase contract had a liquidated damages provision that limited damages in the event of the partnership’s default to the $3 million downpayment and “any monthly installments already paid to defer the settlement date” as “liquidated damages.” The majority held that the economic substance of the stock purchase agreement imposed indebtedness upon the partnership -- although the monthly payments were not characterized as interest -- because the amount of liquidated damages was greater than any actual damages the selling stockholders would have suffered. The majority distinguished this case from Midkiff v. Commissioner, 96 T.C. 724 (1991), aff’d sub nom Noguchi v. Commissioner, 992 F.2d 226 (9th Cir. 1993), where taxpayers did not have indebtedness until the transaction closed because they would have sacrificed only a nominal amount [1.2% of the settlement price] had they defaulted. Dissent on the ground of the Tax Court’s decision, that the $900,000 in settlement deferment payments resembled amounts paid to retain the “option to complete or not complete the transaction,” and the sellers retained the risk that the fair market value of the stock (and the land) would rise or fall; the dissent stated that the price for the risk was 13 percent of the purchase price, which was a reasonable amount to pay for an option. Query: How did the seller report the $900,000 in payments?

4. Greenberg v. Commissioner, T.C. Memo. 1996-281 (6/19/96). Payments received by Ponzi scheme “investors” constitute a return of capital, and not “interest” as labeled by the schemer’s trustee in bankruptcy on Forms 1099-INT, because the payments were not for “the use or forbearance of money,” but were made to conceal the schemer’s fraudulent misappropriation of taxpayers’ money.

5. Contingent payment debt regulations proposed. FI-59-91, proposed amendments of Reg. §1.1275-4, relating to the tax treatment of contingent payment debt instruments (59 F.R. 64884, 12/16/94). Provides separate rules for debt instruments issued for cash or publicly traded property and for debt instruments that are issued for nonpublicly traded property.

a. . . . and made final. T.D. 8674, final regulations under §1275, relating to the tax treatment of debt instruments that provide for one or more contingent payments (61 F.R.
These regulations provide specifically that they do not apply to state-sponsored prepaid tuition plans.

6. Bye-bye to leveraged company-wide COLI. HIPAA §501 amends §264 to deny the deduction for interest on loans with respect to company-owned life insurance. Exception for key person insurance. Phased-in effective dates and interest rates.

7. Davison v. Commissioner, 107 T.C. No. 4 (8/26/96). Cash basis farm properties partnership [owned equally by three Peat, Marwick partners] was not entitled to interest deduction where the funds used to satisfy the interest obligation were borrowed for that purpose from the same lender to whom the interest obligation was owed. Although the partnership claimed to have had "unrestricted control" of the borrowed funds, Judge Ruwe held that unrestricted control in any meaningful sense was not possible because use of the borrowed funds for any purpose other than paying interest would have resulted in default on the underlying loan and the partnership going out of business. There was no "payment" of interest, but merely a postponement of the interest payment. Battelstein v. IRS, 631 F.2d 1182 (5th Cir. 1980) (en banc), and Wilkerson v. Commissioner, 655 F.2d 980 (9th Cir. 1981), followed.

8. Notice 96-51, 1996-42 I.R.B. (9/25/96). Describes how the inflation-indexed debt instruments that are expected to be issued by Treasury will be treated in proposed and temporary regulations under §§1275(d) and 1286. One of two methods, the coupon bond method or the discount bond method, will apply to account for qualified stated interest and the OID that accrues on the debt instrument based on changes in the principal amount of the debt instrument and constant yield principles.

VIII. NONTAXABLE EXCHANGES

A. Section 1031

1. Wittig v. Commissioner, T.C. Memo. 1995-461 (9/27/95), opinion withdrawn 11/5/95. No offsetting of boot received with new mortgages placed on the acquired property in a §1031 exchange; boot recognition required. However, the taxpayer's lawyer's service as intermediary did not disqualify the exchange.

2. Christensen v. Commissioner, T.C. Memo. 1996-254 (6/3/96). If an attempted like-kind exchange fails to qualify under §1031(a)(3) because the taxpayer did not receive the new property until after the required date, e.g., due date of his return for the year of the exchange, the exchange will be treated as an installment sale and §453 reporting will be available if the transaction otherwise qualifies.

3. Paullus v. Commissioner, T.C. Memo. 1996-419 (9/17/96). Judge Gerber held that a country club was not a dealer in real property, so its exchange of the so-called unit 10 property qualified for §1031 treatment because it was not held for sale in the ordinary course of its real estate trade or business [because it was held for a relatively long period of time (4 years) and was acquired for investment purposes], although the court found it "troublesome" that the country club maintained a sales office and had a list of persons interested in buying lots.

B. Section 1033
1. Rev. Rul. 96-32, 1996-25 I.R.B. 5. If the dwelling portion of taxpayer’s principal residence is destroyed and the remaining land portion is sold within the §1033 period, the sale is treated as part of the involuntary conversion of the principal residence to which §1033 may apply to defer gain recognition. Mortgage interest payments will continue to qualify for §163(h) treatment for a reasonable period pending either (1) the sale of the land or (2) the reconstruction [reoccupation] of the destroyed dwelling.

2. *Presidentially declared disasters -- which seemed to have occurred weekly in 1996 -- will now allow a broad range for investment of insurance proceeds received for the destruction of investment or business property. SBT §1119 amends §1033(h) to expand the special rule for property damaged in Presidential declared disasters by extending the provisions now applicable to personal residences, [i.e., increased replacement period (from 2 years to 4 years), treatment of insurance proceeds as a common fund and expansion of the definition of “similar property”] to apply to all “property held for productive use in a trade or business or for investment.” Effective upon enactment.

3. §1033 basis adjustment rules. SBT §1610 modifies the basis adjustment rules under §1033 involuntary conversion deferral with respect to stock used as replacement property. Applicable to taxable years beginning after 12/31/95.

C. Section 1034

1. How does §1034 applying when breaking up is hard to do? Perry v. Commissioner, 91 F.3d 1996, 96-2 U.S.T.C. ¶50,405 (9th Cir. 7/31/96) (sale of residence four years after taxpayer moved out to reside with soon-to-be new wife). The taxpayer vacated the marital abode as a result of divorce but retained an ownership interest while his or her former spouse resided. He lived with his new wife for four years prior to his former wife’s abandonment of the original marital abode and its sale. He was held to have abandoned the former home as a principal residence, because the facts did not indicate that the taxpayer ever intended to return to his original abode, and thus denied §1034 treatment upon the sale of the home.

a. Judge Hall held “that once a taxpayer leaves his marital home, permanently and with no intention to return, pursuant to a divorce settlement which gives the other spouse exclusive occupancy and which does not mandate that the house immediately be sold, the taxpayer cannot avail himself of the nonrecognition provision in §1034(a) with respect to that property [because that property is not taxpayer’s principal residence].” The exception where sale of the house was prevented by forces beyond taxpayer’s control was inapplicable.

2. Bowers v. Commissioner, T.C. Memo. 1996-333 (7/24/96). Taxpayer moved out of the family home in October 1987, following his divorce. The divorce decree awarded the right of occupancy to his former wife, who vacated the home in July, 1989. From October 1987 until he purchased a new residence in January, 1989, taxpayer resided in a number of locations with his new wife. Taxpayer was not entitled to §1034 rollover upon sale of prior residence in December 1989 because it was not his principal residence at any time after October 1989.

D. Section 1041
1. Kochansky v. Commissioner, 96-2 U.S.T.C. ¶50,431 (9th Cir. 8/13/96). Affirms Tax Court determination that the entire amount of a contingent fee earned by taxpayer/lawyer is taxable to him, despite the fact that a portion of the contingent fee was to be distributed to his former wife pursuant to a divorce settlement. This was an assignment of income subject to the rule of Lucas v. Earl, 281 U.S. 111 (1930), under which income is taxable to the person who earns it, where only the right to receive the income was transferred to taxpayer's former wife. It was not an "uncertain, doubtful and contingent" claim, such as the claim for disputed overages transferred by a construction subcontractor to a successor corporation, which [in Jones v. Commissioner, 306 F.2d 292 (5th Cir. 1962), was held taxable to the transferee corporation, and not to the subcontractor. However, the imposition of the negligence penalty was reversed because language in the Jones case may have led the taxpayer to believe the assignment was valid for income tax purposes.

IX. PARTNERSHIPS
A. Partnership Audit Rules
B. Miscellaneous
1. Check the box? Notice 95-14, 1995-1 C.B. 297 (3/29/95). IRS is considering amending the classification regulations to allow taxpayers to treat domestic unincorporated business organizations as partnerships or as associations on an elective basis, and is considering similar rules for foreign business organizations.

a. *Check the box proposed regulations are finally out, and they were worth waiting for. PS-43-95, proposed regulations under §7701 that would implement the check-the-box entity classification proposal announced in Notice 95-14, 1995-1 C.B. 297 (5/9/96). Elective rules being provided for unincorporated organizations (including organizations that have a single owner), which may be treated as (1) associations or (2) partnerships (or "nothing", i.e., a sole proprietorship or a branch). The default in the absence of an affirmative election is "partnership or nothing" treatment, which is usually desired. Foreign organizations are to be similarly treated, except that certain listed foreign limited liability entities would always be classified as corporations.

2. Using controlled partnerships instead of controlled foreign corporations enables avoidance of subpart F taxes on foreign base company income. Brown Group Inc. v. Commissioner, 102 T.C. 616 (4/12/94). Under pre-1986 Act law, taxpayer's wholly-owned subsidiary [controlled foreign corporation] does not have (foreign base company) subpart F income by reason of its distributive share of income from a Brazilian partnership [which the CFC controls by virtue of 88% ownership] that acts as purchasing agent for taxpayer with respect to footwear manufactured in Brazil because §954(d)(3) did not then define a partnership owned by a CFC as a "related person" and, more significantly, the entity theory of partnership taxation applies so the determination of whether the CFC's share of the partnership's income is subpart F income is to be made at the partnership level. The court held that subpart F income is defined "in the case of any controlled foreign corporation," and that partnerships could not ever have subpart F income. The government contended that, under the aggregate theory of partnership taxation, the existence of the partnership should be ignored and the CFC should be treated as if it had engaged in the partnership's activities. Note: Opinion withdrawn.
a. Tax Court vacates earlier decision, but splits evenly on aggregate-entity issue. Brown Group, Inc. v. Commissioner, 104 T.C. 105 (1/25/95) (reviewed, 9-3), on reconsideration of 102 T.C. 616 (1994). Affiliated group’s share of foreign partnership’s income was subpart F income; the aggregate theory of partnership should apply because that theory furthers the purposes of subpart F. Judge Halpern discusses the aggregate and entity theories of partnership. The three concurring judges would use the literal terms of §954 to reach the same result, disagreeing with the majority’s aggregate-entity conclusion.

b. Eighth Circuit reverses Tax Court and finds for taxpayer. Brown Group, Inc. v. Commissioner, 77 F.3d 217, 96-1 U.S.T.C. ¶50,055 (8th Cir. 1/25/96, as corrected 2/6/96), rev’g 104 T.C. 105 (1995). Tax Court erred in ignoring the partnership entity [foreign partnership 88 percent owned by Panamanian subsidiary CFC of which taxpayer was the sole U.S. shareholder] in characterizing earnings attributable to the partnership’s purchase of shoes in Brazil and resale to taxpayer as subpart F income because subpart F income (as here pertinent) requires sales between “related persons” and pre-1986 Act §954(d)(3) did not include in the definition of “related person” a partnership controlled by a CFC. The court held the anti-abuse regulation §1.701-2 to be inapplicable to transactions occurring before its 1994 effective dates (5/12/94 for §1.701-2 [in general] and 12/29/94 for §1.701-2(e) [IRS can treat a partnership as an aggregation of its partners]). The court did have dictum in footnotes that indicated it agreed with the Tax Court dissent, which noted agreement with the entity theory of partnerships and disagreement with the aggregate theory.

c. Notice 96-39, 1996-32 I.R.B. (8/5/96). The Service will issue regulations under Subpart F (§951 et. seq.) describing how the aggregate approach to partnerships applies to determine the treatment of a controlled foreign corporation’s distributive share of partnership income. The Service also announced that it disagreed with the decision in Brown Group, Inc. v. Commissioner, 77 F.3d 217, 96-1 U.S.T.C. ¶50,055 (8th Cir. 1/25/96), because to permit a CFC to avoid subpart F by earning income through a partnership would be contrary to the purposes of subpart F.

3. Rev. Proc. 96-12, 1996-3 I.R.B. 30 (12/18/95). Effective 1/16/96, the IRS will no longer issue rulings as to whether -- in connection with the transfer of a life insurance policy to an unincorporated organization -- (1) the organization will be treated as a partnership, or (2) the transfer will be exempt from the §101 transfer for value rules, when substantially all of the organization’s assets consist of life insurance policies on the lives of the members.

4. T.D. 8642, 1996-7 I.R.B. 4 (12/22/95). Final regulations under §§704(c)(1)(B) and 737, relating to the recognition of gain or loss on certain distributions of contributed property by a partnership and to the recognition of gain on certain distributions to a contributing partner.

5. PS-2-95, proposed regulations under §731(c), relating to the treatment of a distribution of marketable securities [as money, for purposes of §§731(a)(1) and 737] by a partnership (61 F.R. 28, 12/29/95).
6. *Rev. Rul. 96-10, 1996-4 I.R.B. 26 (1/4/96). With respect to disallowed losses under §707(b)(1) on sales of partnership property to a related partnership, the basis of each partner’s interest is decreased (but not below zero) under §705(a)(2) by the partner’s share of that loss. With respect to gain not recognized [under §§707(b)(1) and 267(d)] upon resale of the property at a gain by the related partnership, the basis of each partner’s interest is increased under §705(a)(1) by the partner’s share of that gain.

7. *Rev. Rul. 96-11, 1996-4 I.R.B. 28 (1/4/96). If a partnership makes a charitable contribution of unencumbered property [which is not subject to the §170(e)(1) limitations], the basis of each partner’s interest is decreased (but not below zero) by the partner’s share of the partnership’s basis in the property contributed. This is because the contribution is not taken into account in computing the partnership’s taxable income, so it results in a permanent decrease in the aggregate basis of its assets without any further tax effect; therefore, a basis reduction is necessary to avoid discontinuity between the inside and outside bases of the partnership.

8. TAM 9619002 (1/31/96). When a bankruptcy court discharges a partner from his share of a partnership recourse debt, the partner’s tax consequences are determined under §§731 and 752; they are not determined under §§61(a)(12) and 108(a) because the partnership did not have any income from debt discharge that would be passed on to the partner under §702. Therefore, the partner has §1001 gain -- not discharge of indebtedness income.

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

X. PERSONAL AND INDIVIDUAL INCOME AND DEDUCTIONS

A. Miscellaneous Deductions and Credits

1. Payments made under §6672 are nondeductible §162(f) penalties. Duncan v. Commissioner, 68 F.3d 315, 95-2 U.S.T.C. ¶50,547 (9th Cir. 10/12/95). Taxpayer could not deduct amounts he paid under §6672 with respect to his corporations’ unpaid federal withholding taxes as §166(d) nonbusiness bad debts. The Tax Court had held that the payments were penalties and not deductible, regardless of whether they might otherwise qualify as bad debts, because allowing such deductions “would only encourage the wrongful refusal to pay over
taxes withheld pursuant to federal law," following Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958). The Ninth Circuit affirmed, rejecting taxpayer arguments that: (1) IRS Policy Statement P-5-60 provides that §6672 penalties "will be used only as a collection device" and that the obligation would be collected only once [because that is only administrative largesse and §6672 creates a penalty separate from the corporations' underlying tax obligations], and (2) United States v. Sotelo, 436 U.S. 268 (1978), held the §6672 liability to be a "tax" for bankruptcy purposes [but not dischargeable under the bankruptcy laws for the same policy reason the payments are not deductible under the tax laws]. The court allowed payments made to satisfy state (Oregon) employment tax liability to be deducted, because Oregon law placed liability on the responsible person from the outset [by defining him as an "employer"] and the obligation is, therefore, not a "penalty."

2. Westbrook v. Commissioner, 68 F.3d 868, 95-2 U.S.T.C. ¶50,587 (5th Cir. 10/30/95), aff'g T.C. Memo. 1993-634. Affirms Tax Court holding of hobby farm losses disallowed and substantial understatement penalty imposed.

3. *Legal fees paid in settling breach of employment contract dispute do not offset the taxable award, but are only allowed as a miscellaneous itemized deduction, subject to the $67 floor. Alexander v. IRS, 72 F.3d 938, 96-1 U.S.T.C. ¶50,011 (1st Cir. 12/22/95). Legal fees paid in settling employment contract dispute were deductible only as a $67 miscellaneous itemized deduction, and not as an offset to the settlement proceeds [or, as taxpayer characterized it, an expenditure properly charged to the capital account of taxpayer's "valuable intangible assets" under §§1001 and 1016]. Therefore, as a miscellaneous itemized deduction, the legal fee is not deductible for AMT purposes. (Settlement was $250,000 for contract damages and $100,000 for age discrimination, out of which attorneys fees allocable 95 percent [$245,100] to contract damages and 5 percent to discrimination damages were paid; the allocation was based upon taxpayer's lawyers' time records.)

4. The bride may have been radiant, but the beaming groom could not carry her over the threshold because they had no home. Baugh v. Commissioner, T.C. Memo. 1996-70 (2/21/96). Nuclear plant radiation protection technicians who worked at various nuclear plants during shutdowns could not exclude (or deduct under the §162(a)(2) away from home provision) per diem/travel amounts. Held: taxpayers were itinerant workers who did not have a home "from which to be away" because they did not incur additional and duplicate living expenses.

5. Beatty v. Commissioner, 106 T.C. 268 (4/17/96). Taxpayer was a county sheriff, who was paid a salary of $30,566. He was required to provide meals to all prisoners in the county jail and received per diem per prisoner meal allowances of $109,952; if he was able to provide meals for less than the per diem, he was permitted to keep the difference. The taxpayer reported that he provided the meals as an independent contractor and reported the meal allowances and the cost of the prisoner's meals on Schedule C, but the Commissioner argued that the meal allowances were additional compensation and the cost of the prisoners' meals was an employee business expense, deductible only after taking into account all of the limitation, and not deductible at all in computing alternative minimum tax. Held: It was irrelevant whether the sheriff provided the meals as an independent contractor or as an employee because the cost of the
prisoner's meals was a cost of goods sold, not a §162 expenses, and thus was not subject to any of the limitations governing employee business expenses. Only the profit from providing the meals was included in taxpayer's gross income.

6. Keller v. Commissioner, T.C. Memo 1996-300 (6/27/96). Section 274(m)(2) barred a college professor from deducting the costs of a sabbatical in Spain where he wrote a play about the European perspective on the Gulf War because his purpose while in Spain was to learn about the European perspective, which was squarely within Congress' intent in enacting §274(m)(2) barring deductions for travel as a form of education.

7. Looby v. Commissioner, T.C. Memo. 1996-207 (4/30/96). Legal fees incurred by a residuary legatee of an estate to seek removal of the executor for self dealing, charging excessive fees, and mismanagement of the estate were not deductible. The expenses were incurred to increase the size of the inherited estate and were either personal or capital.

8. Long-term care provisions. HIPAA §321 adds §7702B to treat long-term care insurance as accident and health insurance and HIPAA §322 amends §213(d) to treat qualified long-term care services as medical care (applicable to benefits paid after 12/31/96). HIPAA§323 adds §6050Q to require an information return to be filed by the payor of benefits.

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

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

11. Jasko v. Commissioner, 107 T.C. No. 3 (8/20/96). Legal fees incurred in obtaining recovery of insurance proceeds after taxpayers' principal residence was destroyed by fire were not deductible under §212 as amounts expended for the production of income, but -- under the origin of claim doctrine -- the legal fees "represent capital expenditures nondeductible under section 263 and an offset against the gain represented by the insurance proceeds, none of which [taxpayers] recognized in the taxable year before [the court]."

12. Espinosa v. Commissioner, 107 T.C. No. 9 (9/24/96). Nonresident alien's deductions were disallowed under §874(a) because he failed to file timely returns, although he suffered net losses from his rental properties in the U.S. and his late-filed returns contained §871(d) elections.

B. Miscellaneous Income

1. Discrimination, etc. damages
a. Supreme Court holds that age discrimination damages are not excludable under §104(a)(2); Court redefines eligibility for exclusion, holding that statute requires a personal injury [in addition to a "tort"]. Commissioner v. Schleier, 115 S. Ct. 2159, 95-1 U.S.T.C. ¶50,309 (U.S. 6/14/95) (6-3). Neither part of age discrimination recovery is excludable from gross income. Back wages were not "on account of" any personal injury because airline pilot’s turning 60 is not a personal injury, nor is being fired for turning 60 a personal injury. Therefore, the recovery of back wages is independent of any personal injury. The liquidated damages portion (payable only for "willful" violations) was intended by Congress to be "punitive in nature." The reference in Reg. §1.104-1(c) to "tort or tort type rights" does not eliminate the statutory requirement of "received . . . on account of personal injuries or sickness," but is an additional requirement. The Court noted that United States v. Burke, 504 U.S. 229, 92-1 U.S.T.C. ¶50,254 (1992), merely dealt with the sex discrimination claim not being based upon "tort or tort type rights"; it stated that satisfaction of the Burke inquiry is a necessary, but not a sufficient condition. The Court noted, however, that Rev. Rul. 93-88, 1993-2 C.B. 61, "seems to rely on the same reading of Burke urged by [taxpayer]," but stated that interpretive rulings do not have the force of regulations and may not be used to overturn the plain language of a statute.

(1) Ruling on tax treatment of discrimination damages after 1991 amendments to the Civil Rights Act. Rev. Rul. 93-88, 1993-41 I.R.B. 4. Compensatory damages, including back pay, received in satisfaction of a claim of "disparate treatment" gender discrimination [discriminatory treatment by employer] under Title VII of the Civil Rights Act of 1964, as amended in 1991, are excludable from gross income as §104(a)(2) damages for personal injury -- even if the compensatory damages are limited to back pay. However, back pay received by a victim of "dis disparate impact" gender discrimination [classification of employees not necessary for business purposes that tends to discriminate on the basis of race, color, religion, sex, or national origin] is not excludable from gross income. Compensatory damages, including back pay, received in satisfaction of a claim of racial discrimination under 42 U.S.C. §1981 and title VII of the Civil Rights Act of 1964 are excludable from gross income as §104(a)(2) damages for personal injury -- even if the compensatory damages are limited to back pay. Similar results will apply under the Americans With Disabilities Act, 42 U.S.C. §§12101-12213.


b. Damages received from labor union excludable. Banks v. United States, 81 F.3d 874, 96-1 U.S.T.C. ¶50,212 (9th Cir. 4/16/96) (2-1). Damages received from labor union for breach of its duty of fair representation were excludable from gross income under §104(a)(2) because the damages were to compensate for the union’s unfair and arbitrary treatment of taxpayer, that the injuries suffered were personal injuries and the settlement was of a tort-like cause of action. (The majority noted that unions do not pay wages.) Dissent on the ground that taxpayer suffered a non-physical personal injury, but his lost wages were the result of his discharge and the union’s failure to grieve; the personal injury did not affect the amount of

c. Dotson v. United States, 87 F.3d 682, 96-2 U.S.T.C. ¶50,359 (5th Cir. 6/27/96) (2-1). Reverses District Court (S.D. Texas) grant of government’s summary judgment motion that damages received pursuant to ERISA §§502(a) and 510 do not meet the §104(a)(2) personal injury exclusion from income because they were not "tort-like." The remand was for the District Court to determine the degree to which the award represented lost wages [to be taxable] as distinguished from impairment of earning ability [to be excludable].

d. TAM 9634002 (4/1/96). Damages in settlement of a plant closing action brought under RICO held taxable, and not personal injury damages excludable under §104(a)(2).

e. *Congress says discrimination damages are taxable; §104(a)(2) exclusion inapplicable to punitive damages, as well as to damages not attributable to physical injuries or sickness -- and emotional distress is not physical injury or sickness. SBT §1605 amends §104(a)(2) to repeal the exclusion for punitive damages and for damages not attributable to physical injuries or sickness, effective for amounts received after the date of enactment except for amounts received under a written binding agreement, court decree or mediation award on or before 9/13/95. Emotional distress (as such) is not to be treated as a physical injury or physical sickness, but amounts received to reimburse for medical expenses may be excluded. Exception for wrongful death awards made in states in which only punitive damages may be awarded in wrongful death actions, i.e., Alabama.

2. Punitive damages

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

b. *Congress says punitive damages are taxable. For repeal of exclusion for punitive damages, see X.B.1.e., above. (Note: The 1989 Act amended §104(a)(2) to deny exclusion of punitive damages in connection with a case not involving physical injury or physical sickness.)

3. Allocation of damage settlements

a. Court upholds allocation to punitive damages based upon facts, even though no allocation to punitive damages was made by either of the parties to the tort action. Bagley v. Commissioner, 105 T.C. No. 27 (12/11/95) (reviewed, 18-0). Allocates $1 million of recovery for tortious interference with future employment to compensatory damages and $500,000 to punitive damages. The Tax Court held that its decision in Horton v. Commissioner, 100 T.C. 93 (1993), aff’d, 33 F.3d 625, 94-2 U.S.T.C. ¶50,440 (6th Cir. 1994) (punitive damages are excludable from income under §104(a)(2) if
the underlying claim is based on tort or tort-type rights) was effectively overruled by Commissioner v. Schleier, 115 S. Ct. 2159, 95-1 U.S.T.C. §50,309 (1995). Although there was no allocation to punitive damages in the tort case settlement, the Tax Court found that it was in the interests of both parties not to show an amount allocated to punitive damages; the Tax Court held that the $1 million awarded by the jury for compensatory damages would be so allocated in the settlement and the remaining $500,000 would be allocated to punitive damages in light of the jury award for punitive damages of 2-1/2 to 5 times the amount of compensatory damages.

b. Tax Court follows negotiated state court allocation. McKay v. Commissioner, 102 T.C. 465 (3/28/94). Taxpayer who sued Ashland Oil for wrongful termination, seeking damages for breach of contract and RICO violations [which culminated in a jury award of more than $43 million], properly apportioned $12.25 million of the $16.74 million settlement he received from Ashland Oil to the tort claim of wrongful discharge, which was excludable from income under §104(a)(2) as payment for a tort-type personal injury. The court further held that deductions for legal expenses constituted itemized deductions, not deductions from gross income.

(1) But, reversed because “wrongful discharge” tort was not a personal injury. McKay v. Commissioner, 84 F.3d 433, 96-1 U.S.T.C. §50,279 (5th Cir. 4/10/96) (per curiam) (unpublished opinion), vacating and remanding 102 T.C. 465 (1994). Under Commissioner v. Schleier, 115 S. Ct. 2159 (U.S. 1995), the settlement payment was not “received on account of personal injuries” within the meaning of §104(a)(2) and the Tax Court erred as a matter of law in deciding to the contrary.

c. Corporation not entitled to §104(a)(2) exclusion. P & X Markets, Inc. v. Commissioner, 106 T.C. No. 26 (6/13/96). The court held that a corporation operating a retail grocery store could not exclude damages received for malicious prosecution, etc. as personal injury damages under §104(a)(2) even though the corporation had only one shareholder. Judge Laro held that when taxpayer chose to do business in corporate form it assumed both the benefits and the burdens of that form, and that the form would not be ignored under the facts of this case.

d. Milenbach v. Commissioner, 106 T.C. 184 (3/28/96). Damages received by the Oakland Raiders partnership in settlement of a suit against the City of Oakland for inverse condemnation of the Oakland Raiders football team were taxable as damages in lieu of lost profits. Although the settlement agreement stated that its purpose was to resolve a claim involving “restoration of lost franchise value,” the taxpayer’s damage study indicated that claim was based on lost profits.

4. Damages interest

a. Statutory prejudgment interest is part of personal injury damages and excluded from gross income under §104(a)(2). Brabson v. United States, 94-2 U.S.T.C. §50,446 (D. Colo. 8/15/94). Mandatory statutory prejudgment interest awarded in personal injury case under Colorado law was excludable under §104(a)(2) because it is in reality an element of compensatory damages, and not interest. The court declined to follow the majority in Kovacs v. Commissioner, 100 T.C. 124 (1993), aff’d in unpublished opinion, (6th Cir. 6/7/94),
but instead adopted the analysis of Judge Beghe’s dissent. Following the Kovacs majority are Forest v. Commissioner, T.C. Memo. 1995-377 (8/8/95), and Delaney v. Commissioner, T.C. Memo. 1995-378 (8/8/95).

(1) Reversed, following Kovacs. Brabson v. United States, 73 F.3d 1040, 96-1 U.S.T.C. ¶50,038 (10th Cir. 1/11/96). Reverses district court, and holds (in a thoughtful opinion) that statutorily mandated prejudgment interest is not an element of personal injury damages and, therefore, does not fall within the §104(a)(2) exclusion. Kovacs v. Commissioner, 100 T.C. 124 (1993), aff’d without published opinion, 25 F.3d 1048 (6th Cir. 1994), followed.

5. Goodwin v. United States, 67 F.3d 149, 95-2 U.S.T.C. ¶50,534 (8th Cir. 10/4/95). Affirms summary judgment holding that minister was taxable on “gifts” made to him on three “special occasion” days during the year by church members despite stipulations that church members (1) made the gifts “out of love, respect, admiration and like impulses and . . . not . . . out of any sense of obligation or fear that [taxpayer] will leave their parish if he is not compensated beyond his yearly salary,” and (2) did not deduct the money they gave the taxpayers as a charitable contribution. The court applied the [alleged] “objective, no-talisman approach” of Commissioner v. Duberstein, 363 U.S. 278 (1960), in finding the payments to be income because they were “gathered by congregation leaders in a routinized, highly structured program” and were large in relation to taxpayer’s salary. It found summary judgment to be appropriate where “no reasonable jury could conclude that these payments were excludable.” The court held that the plain language of §102(c)(1) [no exclusion of any amount transferred by an employer to an employee], although enacted to address other fact situations, might have been applicable here except that the church members were not taxpayer’s employer.


7. Contract to purchase stock was §83 property when taxpayer was personally obligated to pay the purchase price. Theophilos v. Commissioner, 85 F.3d 440, 96-1 U.S.T.C. ¶50,293 (9th Cir. 5/31/96). A contract to purchase stock was property under §83 — and not an option — when taxpayer became personally obligated to pay the purchase price, regardless of whether he thought the stock remained an attractive purchase. The stock was valued on the contract date, not the closing date more than six months later.

8. Employer-provided educational assistance exclusion extended to 5/31/97, and modified to make graduate courses ineligible. SBT §1202 extends the expiration date of the §127 exclusion of benefits under employer-provided educational assistance programs from 12/31/94 to 5/31/97 [but only for courses beginning before 7/1/97]. Graduate level courses [e.g., law, business, etc.] beginning after 6/30/96 will not be eligible for the exclusion of benefits.
9. Charley v. Commissioner, 91 F.3d 72, 96-2 U.S.T.C. ¶50,399 (9th Cir. 7/24/96). The taxpayer was the president and majority shareholder of corporation. He arranged for a travel agent to bill the corporation for first class airfare when he traveled on corporate business, but the corporation bought coach tickets and the taxpayer upgraded to first class using frequent flyer miles from business travel. He received a cash rebate from the travel agency of the spread between the price of coach and first class tickets. Held, cash receipts were income, either as additional compensation from employer or from sale of zero basis frequent flyer miles.

10. Expatriation tax rules are tightened by treating the wealthy as having a tax avoidance purpose unless the individual falls within an exception and requests a ruling within one year of loss of citizenship. HIPPA §511 amends §877 to revise the expatriation tax rules for individuals who lose United States citizenship, which provide generally that the individual shall continue to be taxed as a citizen for the following 10 years. The amended provision is generally effective for individuals losing citizenship on or after 2/6/95. Individuals with average annual income greater than $100,000, or net worth of $500,000 or more are treated as having a tax avoidance purpose unless the individual falls within an exception [e.g., dual citizen, long-term foreign resident, renunciation upon reaching age of majority] and a ruling request is submitted within the 1-year period beginning on the date of the loss of citizenship.

11. When it's time to stop buying green bananas: Exclusion from income of accelerated death benefits for the terminally ill and (within limits) for the chronically ill. HIPAA §331 adds new §101(g) to exclude from income certain accelerated death benefits paid with respect to life insurance policies, including sales of life insurance policies to viatical settlement companies. It covers both the terminally ill (defined as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less) and chronically ill (but only to the extent of payments for costs incurred for qualified long-term care services provided), applicable to amounts received after 12/31/96.

XI. PROCEDURE, PENALTIES AND PROSECUTIONS

A. Penalties and Prosecutions

1. *Automatic extensions of time to file held void because taxpayer did not use a reasonable method to estimate tax liability; IRS not estopped by acquiescence in taxpayer's method of estimating in prior years. Healey v. Commissioner, T.C. Memo. 1996-260 (6/6/96). Law firm senior partner failed to use a reasonable method to estimate tax liability when filing automatic extension Forms 4868, so the forms were invalid and the §6651(a) failure to timely file penalty applied. (Amounts reported on Forms 4868 were between 1/3 and 2/3 of tax reported on Forms 1040 for the three years in question.)

2. Child penalized because her parents failed to file tax returns for her. Bassett v. Commissioner, 67 F.3d 29, 95-2 U.S.T.C. ¶50,532 (2d Cir. 10/7/95) [2-1]. Failure to file [i.e., lateness and negligence] penalties affirmed against child actress whose parents failed [without reasonable cause] in their §6012(b)(2) responsibility to file income tax returns for her. The court refused to apply the exception permitted in United States v. Boyle, 469 U.S. 241 (1985), that "a disability alone could well be an acceptable excuse for a late filing," because it was her parents -- and not the taxpayer -- who had
the duty to file the tax returns. Dissent on the ground that a
taxpayer should not be penalized for circumstances beyond her control,
and the assumption that parents act in pursuit of their children's
best interests is not necessarily correct [particularly when the
failure to pay taxes may serve to enrich the parents, and not the
child].

3. Durrett v. Commissioner, 71 F.3d 515, 96-1 U.S.T.C.
§50,040 (5th Cir. 1/2/96). Increased interest [under former §6621(c)]
on underpayment attributable to "tax motivated transaction" [sham or
fraudulent transaction] upheld. Negligence penalty reversed because
taxpayer was acting reasonably in claiming the deductions in reliance
on advice from "experts" and was not required to seek a "second
opinion." Chamberlain v. Commissioner, 66 F.3d 729 (5th Cir. 1995),
followed.

4. Lauckner v. United States, 68 F.3d 69, 96-2 U.S.T.C.
§50,364 (3d Cir. 10/23/95) (per curiam), acquiescence, AOD CC-1996-
006. Statute of limitations for §6672 assessments starts running with
the filing of the underlying employer's quarterly employment tax
return.

5. Is whether a statement is "materially" false for
purposes of the §7206(1) penalty a question of fact or law?

a. United States v. DiRico, 78 F.3d 732, 96-1
U.S.T.C. §50,149 (1st Cir. 3/11/96), held that whether a statement on
a return is "material" is a mixed question of law and fact to be
decided by the jury.

b. United States v. Klausner, 80 F.3d 55, 96-1
U.S.T.C. §50,173 (2d Cir. 3/27/96), held that whether false itemized
deductions knowingly claimed by a CPA on his own initiative in
preparing a client's tax return were material is a question of law
because a false deduction will inevitably affect tax liability.

6. Finley v. United States, 82 F.3d 966, 96-1 U.S.T.C.
§50,245 (10th Cir. 5/1/96). A responsible person's re-delegation of
his duty to remit taxes to a subordinate [whom the responsible person
already knew had failed to remit taxes] was so irresponsible as to be
"willful" as a matter of law. Judgment entered for the government
"notwithstanding a jury verdict in the taxpayer's favor" was affirmed.

7. Changes to the §6672 responsible person penalty. T2
§§901-904 amend §6672 to increased rights, remedies and exemptions for
responsible persons penalized under Code §6672, including (1)
disclosure of IRS attempts to recover taxes from a third party, (2)
creation of a federal right of contribution as among multiple
responsible persons, and (3) volunteer board members of tax exempt
organizations are exempted from the penalty if they were acting solely
in an honorary capacity, did not participate in day-to-day financial
operations and did not have actual knowledge of the failure to pay
trust fund taxes.

B. Summons

1. Cash Payment Reporting

Blackman, 72 F.3d 1418, 96-1 U.S.T.C. §50,018 (9th Cir. 12/29/95).
Affirms summons enforcement on lawyer requiring him to provide
information as to the client-payors of cash of more than $10,000
pursuant to §6050I on Forms 8300. The court rejected lawyer’s contention that the IRS was not investigating his firm’s tax liability, and was therefore required to use the §7609(f) “John Doe summons” procedure because there was no “compelling evidence” to support lawyer’s allegations concerning the IRS’s motives for its investigation sufficient to overturn the district court’s finding of legitimacy.

b. Tedder & Associates, Inc. v. United States, 77 F.3d 1166, 96-1 U.S.T.C. ¶50,135 (9th Cir. 2/27/96). Affirms district court finding that third-party summons to law firm’s bank could be complied with by furnishing sought-for information to the district court, which redacted client names because these names were not relevant to the audit of the law firm’s return.

c. Gerald B. Lefcourt, P.C. v. United States, 96-2 U.S.T.C. ¶50,345 (S.D. N.Y. 5/13/96). Attorney’s refund suit for refund of $25,000 penalty paid for failure to identify client who made cash payments on Form 8300 dismissed on summary judgment, even though the information required by §6050I is claimed to be privileged [in the absence of special circumstances under which there is a direct link between the disclosure and the revelation of a confidential communication, or where the disclosure of client-identifying information would directly incriminate the client by providing the last link in an existing chain of evidence against the client]. “The fact remains that attorneys not wishing to file 8300 Forms may insist on payment by check.”

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

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

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

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

3. United States v. Kao, 81 F.3d 114, 96-1 U.S.T.C. ¶50,203 (9th Cir. 4/11/96). The IRS cannot evade §7609 procedures by using its §7602 summons power to compel taxpayer to sign consent forms authorizing release of records by third party record-keepers whom IRS could summons under §7609.

C. Litigation Costs

1. Attorney’s fees in excess of $75 per hour approved, but quietly. First Interstate Bank of California v. Purewell Investment, Inc., 96-1 U.S.T.C. ¶50,129 (9th Cir. 1/26/96) (unpublished). Affirms $7430 attorney’s fee award of $270 per hour for experienced San Francisco tax litigator (whose experience included cases involving liens and levies) associated with a Hong Kong firm. (District court had found that these factors were necessary in order to resolve the case efficiently.) [Related case to Gaw v. Commissioner, see D., below.]

2. Swanson v. Commissioner, 106 T.C. 76 (2/14/96). Taxpayer’s failure to seek an appeals conference was not a failure to exhaust administrative remedies because no 30 day letter was issued before the deficiency notice was issued. The net worth ceiling is determined with respect to purchase price of assets, not fair market value.

3. United States v. Yochum (In re Yochum), 89 F.3d 661, 96-2 U.S.T.C. ¶50,390 (9th Cir. 7/16/96). Bankruptcy courts have jurisdiction to award $7430 attorneys’ fees because they are units of the district courts, but bankruptcy court erred in awarding such fees because the IRS was justified in bringing claim.

4. Congress raises attorneys fees to $110 per hour, among other changes. T2 §§ 701-703 amend §7430 to make changes in attorney fee awards, including (1) placing the burden of proof on the Service that it was substantially justified in maintaining its position and (2) raising the statutory rate for attorney’s fees from $75 to $110 per hour (indexed for inflation after 1996).

D. Statutory Notice

1. Appeals court finds statutory notice valid, but extends time to file petition to Tax Court. Gaw v. Commissioner, 45 F.3d 461, 95-1 U.S.T.C. ¶50,059 (D.C. Cir. 1/31/95), rev’g and remanding T.C. Memo. 1993-379. IRS did not exercise reasonable diligence in complying with its equitable obligation to send a statutory notice to taxpayers’ last known address when it sent a $28 million deficiency notice to their Hong Kong address after being advised they would be in Burma for a prolonged period. IRS should have contacted taxpayers’ Hong Kong law firm (which had written it) to inform it that the IRS needed a power of attorney in order to provide the firm with a copy of the deficiency notice. Taxpayer filed a tax court petition 11 days after receiving a copy of the deficiency notice during collection procedures. Held: the statutory notice was valid to toll the §6503(a)(1) statute of limitations, but the time to file the
petition did not begin to run until the taxpayers actually received a copy of the notice.

a. Action on Decision 1996-004 -- Nonacquiescence in Gaw. The IRS takes the position that the time for filing a Tax Court petition is established by statute, and the Code does not provide for the tolling or suspension of the time to file a petition.

2. *Taxpayer who refuses delivery of mail from IRS is held to have "actual notice" of the notice of deficiency. Erhard v. Commissioner, 87 F.3d 273, 96-2 U.S.T.C. ¶50,331 (9th Cir. 6/20/96). Taxpayer was considered to have "actual notice" of two notices of deficiency when she received a letter [allegedly misaddressed] containing the notices, and [upon the advice of her attorney] refused delivery of the letter and never opened it. Judge Hall held that this was sufficient for taxpayer to have received actual notice, based upon Patmon & Young Professional Corp. v. Commissioner, 55 F.3d 216 (6th Cir. 1995).

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

E. Statute of Limitations

1. Can a taxpayer keep an erroneous refund? If the IRS makes an erroneous refund to a taxpayer, it clearly can recover the amount erroneously refunded through a suit for an erroneous refund under §7405 or by assessing a new deficiency if the statute of limitations on the year with respect to which the refund was made has not expired. But, if the IRS erroneously refunds a payment of a previously assessed deficiency and then seeks to recover the erroneous refund based on the prior assessment, the taxpayer may be able to keep the refund.

a. Taxpayer has windfall when assessment is mistakenly extinguished by misapplying a payment meant for another year to the year assessed; when the mistake was corrected, the assessment did not revive. Clark v. United States, 63 F.3d 83, 95-1 U.S.T.C. ¶50,037 (D. N.H. 12/13/94), aff'd, 95-2 U.S.T.C. ¶50,469 (1st Cir. 8/29/95). IRS barred from collecting a timely-assessed tax liability for 1985 where it mistakenly extinguished the liability by misapplying a payment intended for the 1986 tax year. The 1985 liability was not revived when the IRS corrected its mistake by crediting the payment to 1986. The court noted that the taxpayer received an undeserved windfall because he made only one payment and benefited twice, but the court was not about to do anything to prevent it from happening.

b. Bilzerian v. United States, 86 F3d 1067, 96-2 U.S.T.C. ¶50,356 (11th Cir. 7/1/96). An erroneous refund cannot be collected by the IRS on the basis of the prior assessment -- the payment extinguishes the deficiency that was assessed -- and the IRS
must either reassess the tax and issue a new deficiency notice if the statute of limitations has not expired, which is unlikely, or resort to an erroneous refund suit. The erroneous refund does not revive the extinguished assessment.

c. But what if the taxpayer gives back the erroneous refund and then wants it back.

(1) Singleton v. United States, 96-1 U.S.T.C. ¶50,320, 77 AFTR2d 2508 (E.D. N.C. 5/8/96), held that a taxpayer who voluntarily repays an erroneous refund based on an IRS assessment without issuance of a deficiency notice has waived the defective procedure and could not recover the repaid erroneous refund. Repayment constituted a waiver of the procedural defect.

(2) Stanley v. United States, 35 Fed. Cl. 493, 96-1 U.S.T.C. ¶50,273 (Fed. Cl. 5/1/96), held that a taxpayer can recover a voluntary repayment of an erroneous refund if IRS did not follow proper procedures in seeking repayment.

2. Fourth Circuit: Nonfiler who was overwithheld may obtain refund 2-1/2 years after return was due. Lundy v. IRS, 45 F.3d 856, 95-1 U.S.T.C. ¶50,085 (4th Cir. 1/30/95), cert. granted, 115 S. Ct. 2244 (5/30/95), rev'g and remanding T.C. Memo. 1993-278. Taxpayer received a deficiency notice a little after two years from the date his tax return was due; he filed his tax return shortly thereafter and sought a refund of amounts withheld. Held: the Tax Court had jurisdiction to determine the amount of taxpayer's overpayment and order a refund because taxpayer paid his taxes within three years prior to the date of the mailing of the deficiency notice; §6512(b)(3)(B) did not mandate a two-year refund period in the Tax Court while the Court of Federal Claims and the district courts would have applied a three-year period under §6511(b)(2). Richards [94-2 U.S.T.C. ¶50,542] and Miller [94-2 U.S.T.C. ¶50,566] not followed.

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

3. Terminating Form 872-A extensions

a. Closing agreement does not terminate Form 872-A extension. Silverman v. Commissioner, 105 T.C. 157 (9/6/95). A closing agreement permitting assessment of taxes within one year did not terminate taxpayers' indefinite extension of the period of limitations by Forms 872-A. The limitations period remained open for 90 days after taxpayers submitted Forms 872-T, and the notices of deficiency were issued within that period [although later than one year after the closing agreement, which contained no language addressing the Forms 872-A].
(1) . . . and First Circuit affirms. Silverman v. Commissioner, 96-2 U.S.T.C. ¶50,327 (1st Cir. 6/20/96). A Form 906 closing agreement will not terminate indefinite extensions made with Forms 872-A. The court stated that if taxpayers "had intended to limit IRS to the time specified in the Form 906 closing agreement, they need simply have filed Forms 872-T, as they eventually did."

b. Forms 872-T may not be filed into an IRS rathole. Coggin v. Commissioner, 71 F.3d 855, 96-1 U.S.T.C. ¶50,033 (11th Cir. 1/4/96). Forms 872-T sent by experienced tax attorney (who chaired ABA Tax Section's Natural Resources Subcommittee on Coal Taxation) to collections agent no longer involved in his case "for [her] case file [which was limited to collection of a deficiency related to his deduction of alimony]" were ineffective to terminate his extensions on Forms 872-A because he did not send the forms to the "Internal Revenue Service office considering the case" (as required by the forms' instructions). Notice of deficiency issued by the Commissioner within 90 days of the discovery of the termination notices was timely. Return receipt that stated that the addressee was “[Collection Agent’s name] Attn: Chief Examination Division” did not provide constructive notice to the IRS when the envelope containing the Forms 872-T was addressed to “[Collection Agent’s name] Internal Revenue Service Revenue Agent” because there is no requirement that the IRS cross-check every return receipt with its matching envelope.

4. Equitable tolling

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

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

5. Fruit of the Loom, Inc. v. Commissioner, 72 F.3d 1338, 96-1 U.S.T.C. ¶50,037 (7th Cir. 1/5/96). Transferee’s predecessor (taxpayer) sold assets in 1966 for a $19 million promissory note that was cancelled in 1967, but took the $19 million deduction in 1966. On audit, the IRS disallowed the 1966 deduction, but agreed to an overassessment for 1967 -- with respect to which $10 million was
subsequently refunded following Joint Committee approval. However, the IRS could not rely on the §§1311-1314 mitigation of limitations provisions to make a determination disallowing a double deduction for the closed 1966 year because the double deduction arose because of the Commissioner’s failure to send a timely notice of deficiency before making its assessment for 1966 (which was ruled to be illegal and the IRS was required to refund all amounts collected pursuant to it). The court held there was no “determination” affecting the 1967 year for which the deduction was actually taken because the court’s ruling was simply about the ineffectiveness of the assessment for the 1966 year, and further held that taxpayer did not take inconsistent positions.

6. Mitigation of limitations under §§1311-1314 not available to lawyer who underreported value of stock received from client in 1974 and failed to deduct loss in 1977 when stock became worthless. Is any other relief available? Koss v. United States, 69 F.3d 705, 95-2 U.S.T.C. §50,599 (3d Cir. 11/7/95). Taxpayer/lawyer received 22,000 shares of client stock in 1974, and reported the stock’s value at $4,400 (2 cents per share), and in 1977 the IRS began an examination of the 1974 return. The client stock became worthless in 1977, but taxpayer did not claim a loss on his 1977 tax return. A deficiency of about $50,000 was asserted, based upon valuing the client stock at $110,000 ($5 per share), which was sustained by the Tax Court (and Third Circuit), becoming final in 1990. In 1991, taxpayer filed an amended return for the 1977 year that (1) indicated the worthlessness of the client stock and (2) filed an amended return for the 1974 year that requested an adjustment based on the carryback of the net operating loss to 1974. Held, this suit is barred by the statute of limitations and mitigation of limitations is inapplicable because, inter alia, the IRS did not maintain inconsistent positions (but merely accepted a 1977 return that did not indicate that the client stock was worthless). Judge Greeenberg noted, in conclusion, that it was stated on oral argument that taxpayer’s debt to the IRS exceeded $300,000 (because of the inclusion of interest) and continued as follows:

Yet, it is very possible that, but for the operation of the non-substantive, highly technical procedural provisions that have been applied, [taxpayer] would not owe this money. We are disturbed by the harsh result. Perhaps [taxpayer], under the unusually oppressive circumstances here, still may obtain administrative relief from the IRS, or some other authority. [69 F.3d at 711]

7. *Bachner v. Commissioner, 81 F.3d 1274, 96-1 U.S.T.C. §50,217 (3d Cir. 4/17/96). Section 6512(a) confers jurisdiction on the Tax Court to determine that there was an overpayment for a year if after receipt of a deficiency notice the taxpayer files a petition in the Tax Court, even though the assessment itself is held to be barred by the statute of limitations.

8. *Don’t forget the duty of consistency Eagan v. United States, 80 F.3d 13, 96-1 U.S.T.C. §50,184 (1st Cir. 3/29/96) Taxpayer was an insurance agent for an insurance company that made contributions to a 401(k) plan on his behalf, which taxpayer claimed were tax-free contributions on his behalf as an employee. After in a related case involving employment taxes the Commissioner conceded that the taxpayer was an independent contractor in year the contributions were made. The taxpayer attempted to exclude the distributions from
income as a return of capital, arguing that the earlier exclusion, now time barred, was erroneous. Held: A taxpayer is bound by the duty of consistency if the taxpayer makes a representation or reports a position, on which the government relies, and (after the statute of limitations has run) the taxpayer attempts to change the previous representation to the detriment of the government. In such a case the government may treat the original representation as correct even if it is not. The distributions were taxable.

F. Miscellaneous

1. Innocent Spouse

   a. Tax understatement arising from overstatement of cost of goods sold is omitted income, and does not arise from a claimed "deduction, credit or basis." In re Lilly (Lilly v. IRS), 76 F.3d 568, 96-1 U.S.T.C. ¶50,113 (4th Cir. 2/20/96). Upholds innocent spouse claim based upon overstatement of cost of goods sold -- even though taxpayer failed to produce evidence that the overstatement of COGS was without any basis in fact or law [as is required under §6013(e)(2)(B) for understatements in tax stemming from claims of deduction, credit or basis] -- because an overstatement of COGS is a §6013(e)(2)(A) omission of an item of gross income. The court held that COGS is an inventory accounting concept, not "basis" (which determines a taxpayer's capital stake in property and has the same meaning in §6013(e)(2)(B) as it has in §§1011-1023). Query: §1013 (Basis of property included in inventory: "If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.")?

   b. Wiksell v. Commissioner, 90 F.3d 1459, 96-2 U.S.T.C. ¶50,398 (9th Cir. 7/25/96), permitted "apportioned" innocent spouse relief because spouse had reason to know of a substantial understatement of income but no reason to know that the magnitude of the understatement was as great as it was.

2. Improper Disclosure of §6103 Tax Return Information

   a. Circular letters not sent in good faith. Barrett v. United States, 51 F.3d 475, 95-1 U.S.T.C. ¶50,232 (5th Cir. 4/20/95), rev'g and remanding 93-1 U.S.T.C. ¶50,291 (S.D. Tex. 1993). Circular letter to 386 patients of a plastic surgeon that requested information and informed them that the surgeon was being criminally investigated improperly disclosed tax return information because it was not necessary for the letters to say that the investigation was criminal. The court found that the letters were not sent in good faith because the requirements of the Internal Revenue Manual were not followed, particularly the requirement that the Chief of the CID approve the content of all circular letters; however, approved letters under the relevant IRM provision would have contained "Special Agent" and "Criminal Investigation Division" in the signature block. Also found pertinent was the fact that letters were sent to patients in three years not under investigation, as well as patients in the two years that were.

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

(2) Contra to Fifth Circuit’s Barrett holding, disclosures were “necessary.” Rhodes v. United States, 903 F. Supp. 819, 95-2 U.S.T.C. ¶50,622 (M.D. Pa. 10/13/95). District court adheres to its earlier opinion, which was based on Judge Harmon’s 1993 opinion in Barrett [93-1 U.S.T.C ¶50,291] that was reversed by the Fifth Circuit, 3.b., above. Contrary to the Fifth Circuit’s holding that nonconformity with prescribed procedures renders disclosures in circular letters unauthorized, the court held that disclosures in circular letters may be “necessary” to get the desired responses, i.e., the Fifth Circuit used an overly restrictive definition of “necessary” as applies to §6103.

b. *Tax return information once disclosed in a federal tax lien becomes public, so republication is exempt from confidentiality requirements. Rowley v. United States, 76 F.3d 796, 96-1 U.S.T.C. ¶50,123 (6th Cir. 2/27/96). Affirms summary judgment for United States in taxpayers’ §7431(a) suit for wrongful disclosure of tax return information because, after a federal tax lien is filed and recorded, the taxpayers’ return information contained therein becomes a matter of public record and republication is exempt from confidentiality requirements. Follows Ninth Circuit [Lampert v. United States, 854 F.2d 335 (1988), and Schrambling Accountancy Corp. v. United States, 937 F.2d 1485 (1991)], and refuses to follow the Tenth [Rodgers v. Hyatt, 697 F.2d 899 (1983)] and Fourth Circuits [Mallas v. United States, 993 F.2d 1111 (1993)]; Rodgers v. Hyatt and Mallas were also distinguished on the ground that recording a tax lien (which is designed to provide public notice) is quantitatively different from disclosures made in judicial proceedings (which are only incidentally made public).

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

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

(2) *Judgment against individual defendants entered in accordance with jury verdict. Johnson v. Sawyer, 96-2 U.S.T.C. ¶50,337 (S.D. Tex. 5/15/96). Action for damages against five individual IRS employees (who participated in the issuance of press releases) under §6103(a) [and former §7217] results in a verdict of $6 million of compensatory damages and a total of $3 million of punitive damages. Judge Hoyt held that Judge Singleton’s findings of fact in the Federal Tort Claims action [with respect to what the individual defendants did] had not been overturned by the Fifth Circuit, and castigated the U.S. Attorney from the Department of Justice for "insist[ing], in an unprofessional and disingenuous way, that the opposite was true."

do. Ryan v. United States, 74 F.3d 1161, 96-1 U.S.T.C. ¶50,126 (11th Cir. 2/14/96). Only information that has been processed by the IRS can be return information. Section 6103 does not apply to information regarding tax liability collected by a United States attorney from other sources, such as potential witnesses in a criminal trial, even if an IRS special agent assisted the U.S. attorney.

3. Cluck v. Commissioner, 105 T.C. 324 (10/30/95). Taxpayer filed a joint return with her husband and a deficiency was sought with respect to the sale of property he had inherited from his mother, who died in 1983. Her husband stipulated in the estate tax proceeding that the property had a fair market value of $355,000 at the date of his mother’s death. Husband’s tax liability for the year of the sale was adjudicated in the bankruptcy court. In this Tax Court proceeding, taxpayer-wife claimed that the property was actually worth $625,000 at her mother-in-law’s death. The court held that she was bound by the stipulation under the [quasi-estoppel] “duty of consistency” because she and her husband had “closely aligned legal and economic interests.”

4. Daccarett-Ghia v. Commissioner, 70 F.3d 621, 95-2 U.S.T.C. ¶50,626 (D.C. Cir. 11/28/95). Taxpayer, a citizen and resident of Colombia, was a fugitive from a money laundering indictment in a New Jersey federal court. He petitioned the Tax Court for a redetermination of a deficiency based upon a jeopardy assessment, but the Tax Court dismissed under the fugitive disentitlement doctrine. Reversed, because there was no connection

5. T.D. 8651, temporary regulations under §6081, reflecting simpler procedures for an individual to obtain an automatic extension of time to file a federal income tax return (1/4/96). Extensions may be obtained without remitting the unpaid amount of tax estimated to be due and without signing the Form 4868.

6. Closing agreement that was "final and conclusive" did not protect against subsequent retroactive legislation reducing the amount of credit taxpayer could use, where there was no dispute as to the amount of credit. United States v. National Steel Corp., 75 F.3d 1146, 96-1 U.S.T.C. ¶50,071 (7th Cir. 2/1/96) (Posner, CJ). Form 906 closing agreement in connection with the payment of an anticipatory refund of 1987 taxes [prior to taxpayer filing its 1987 tax return] (based upon provision to apply certain unused tax credits for steel manufacturers in 1987 years, contained in §212(a) of the Tax Reform Act of 1986) did not bar government suit for refund when the Technical and Miscellaneous Revenue Act of 1988 retroactively amended that provision to exclude tax credits that accrued in 1986. The provision in the closing agreement that it was "final and conclusive" applied to the points agreed to by the parties, i.e., a waiver of the statute of limitations, a quick release of the claimed overpayment, and a three-year period for taxpayer's investment of the tax savings in steel manufacture.

7. Pert v. Commissioner, 105 T.C. 370 (11/15/95). Closing agreement made with transferor binds the transferee (who may not contest the deficiencies established by the §7121 closing agreement, except on the grounds available to the parties to the closing agreement (fraud, malfeasance, or misrepresentation of a material fact).

8. *IRS may, but is not required to, net interest on overpayments and underpayments. Northern States Power Co. v. United States, 73 F.3d 764, 96-1 U.S.T.C. ¶50,022 (8th Cir. 1/2/96). The court looked at the text of the Code -- and ignored legislative history because the Code provisions were unambiguous -- to find that IRS not required to credit overpayments against liabilities of other tax years for §6601(f) interest-netting purposes because the IRS has discretion to [but is not required to] credit outstanding overpayments against outstanding underpayments under §6402(a). The "netting" method of interest calculation would have entitled taxpayer to an additional $460,000 -- based upon a tax payment of about $23 million that gave rise to previously unclaimed tax credits of about $9 million.

9. T.D. 8654, final regulations under §6050P, relating to the reporting of cancellation of indebtedness income by financial entities (1/3/96). An exclusive list of eight identifiable events is provided, including bankruptcy discharge, expiration of statute of limitations, extinguishment pursuant to an election of foreclosure remedies, creditor decision to discontinue collection activity, etc.

10. *No relief for taxpayer who sees a familiar face from his past at the government's counsel table. Harker v. Commissioner, 82 F.3d 806, 96-1 U.S.T.C. ¶50,244 (8th Cir. 5/3/96). The Tax Court [Rule 201(a)] has adopted the Model Rules of Professional Conduct, so [under Model Rule 1.11(c)(1)] an IRS attorney who had been an associate in
the [four-person] law firm that represented taxpayers in criminal proceedings, but was not personally and substantially involved in their criminal tax cases while at the law firm, was not disqualified from representing the Commissioner in their deficiency trial in the Tax Court. The result would have been otherwise under the old Model Code of Professional Responsibility. Judge Bowman concluded by noting that the government did not use "its best judgment" in assigning the attorney to the case and should have assigned another attorney.

11. 1996 Legislation

a. *Taxpayer Advocate. T2 §§101 and 102 amend §§7802 and 7811 to establish the office of Taxpayer Advocate, with authority to order the Service to take any action that is permitted by law and is necessary to relieve significant financial hardship. Effective on the date of enactment.

b. *Installment agreements. T2 §§201 and 202 amend §6159 to require the Service to notify a taxpayer of its reasons for terminating, modifying or altering an existing installment agreement at least 30 days before doing so [effective 6 months after date of enactment, but Reg. §301.6159-1 already requires the Service to do this], and to establish procedures for review of installment agreement procedures [effective 1/1/97].

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

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

d. Interest-free period after notice and demand extended. T2 §303 amends §6601 to extend the interest-free period after the date of a notice and demand from 10 days to 21 calendar days, if the amount of tax is less than $100,000, or otherwise to 10 business days. Effective for notices and demands issued after 12/31/96.

e. *Disclosure of collection authority related to a joint return. T2 §403 added §6013(e)(8) to provide for disclosure of collection activity with respect to one spouse [who had filed a joint return] to the other spouse, where the spouses are divorced or separated. Effective on date of enactment.

f. Lien and levy changes. T2 §§ 501 and 502 make lien and levy changes, effective on the date of enactment.

g. Offers in compromise. T2 §503 amends §7122 to increase from $500 to $50,000 the threshold amount of unpaid tax for which an offer in compromise must be approved by the Office of Chief Counsel, effective upon enactment.
h. *Remedies for recipients of false information returns. T2 §§601-602 and 1201 provide increased remedies for taxpayers who receive false 1099s: (1) T2 §601 adds new §7434 to provide for civil damage suits against fraudulent filers of false information returns (with minimum damages of $5,000); (2) T2 §602 adds new §6201(d) which requires the IRS to conduct a “reasonable investigation” of disputed information returns; and (3) T2 §1201 amends numerous Code sections to add a requirement that the telephone number of the “information contact” person of the filer be included on the information return. Effective on date of enactment, except that T2 §1201 applies to statements required to be furnished after 12/31/96.

i. Relief from retroactive regulations. T2 §1101 amends §7805 to provide relief under certain circumstances from the retroactive application of regulations.

j. Remedy where government entices taxpayer’s representative into furnishing client taxpayer information. T2 §1203 provides a remedy [of up to $500,000] where a taxpayer representative is “enticed” into furnishing client taxpayer information.

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

1. Extends mathematical or clerical error procedures. SBT §1614 provides that the mathematical or clerical error procedures are to be used for dependency exemptions and filing status when correct taxpayer identification numbers are not provided, effective for tax returns for which the due date (without regard to extensions) is 30 days or more after enactment.

12. Estate of Leggett v. United States, 96-2 U.S.T.C. ¶, 78 AFTR2d 6344, U.S. Dist. LEXIS 12833 (S.D. Tex. 8/22/96). Continuing tax lien under §6321 against an estate beneficiary [dating from before testator’s death] is not defeated by the beneficiary’s disclaimer under Texas probate law. To the same effect under Pennsylvania law, Tinari v. United States, 96-2 U.S.T.C. ¶50,460, 78 AFTR2d ¶96-5349 (E.D. Pa. 8/15/96) (the court rejects the “fiction” that a disclaimer relates back to the time of death because beneficiary had a vested property interest at the moment of death).

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

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

14. Pen Coal Corp. v. Commissioner, 107 T.C. No. 14 (11/6/96). The Tax Court held that it lacks jurisdiction under §6214 to redetermine a corporation’s liability for increased interest on large corporate overpayments (imposed under §6221(c)).

XII. TAX SHELTERS

A. In General

1. A rare taxpayer victory in a shelter case. Sacks v. Commissioner, 69 F.3d 982, 95-2 U.S.T.C. ¶50,586 (9th Cir. 10/31/95), rev’g and remanding T.C. Memo. 1992-596. Sale-leasebacks of solar energy devices were not sham transactions, based upon taxpayer’s personal liability for the entire purchase price, the lack of grossly inflated price [price was mid-range], and possible profitability on an after-tax basis. The court rejected the argument that absence of pre-tax profitability indicates lack of economic substance; it stated that Congress purposely used tax incentives to change investors’ conduct and the government should not “take away with the executive hand what it gives with the legislative.”

2. Oral settlement in Tax Court proceeding was not worth the paper it wasn’t written on. Allen v. United States, 96-1 U.S.T.C. ¶50,172 (Fed. Cir. 2/27/96) (2-1). Taxpayer deducted $40,000 in 1980 based upon a gold-mining tax shelter investment of $10,000 cash and a $30,000 promissory note. Taxpayer and Appeals were in conflict whether the $30,000 was deductible in 1980 or in the year of payment. Taxpayer orally agreed to the Appeals position and judgment was entered against taxpayer for the 1980 tax due on the disallowed $30,000 deduction. Taxpayer later attempted to deduct the $30,000 in an amended return for 1986 [which was the year taxpayer made payment on the promissory note]. Held, there was never an agreement as to the year in which the payment could be deducted, so there was no enforceable agreement permitting taxpayer to take the deduction, although taxpayer settled another 1980 gold-mining tax shelter controversy on the basis of deductibility of payment on the promissory note in the year payment was made. (The question of whether Tax Court settlements affecting years other than those before the Tax Court are ever enforceable absent compliance with the §7121 closing agreement procedure was not reached by the court.) Dissent on the ground that the incomplete paperwork was either “simple oversight or sharp practice” -- with sharp practice being “inconceivable” -- so the courts should be able to intervene to remedy the oversight.
XIII. WITHHOLDING AND EXCISE TAXES

A. Employee/Independent Contractor

1. Section 3508 applied to direct sellers. Smoky Mountain Secrets, Inc. v. United States, 910 F. Supp. 1316, 95-2 U.S.T.C. ¶50,573 (E.D. Tenn. 9/28/95). Telemarketers and delivery persons [who worked on commission, and were not paid for unsuccessful attempted deliveries or for deliveries where the customer refused to pay] for a Tennessee gourmet food seller were independent contractors because they were a "direct sellers" under §3508, which requires (1) sales of consumer products in the home or other than from a permanent retail establishment, (2) substantially all remuneration was commissions, and (3) services must be performed pursuant to a written contract.

2. Hospital Resource Personnel, Inc. v. United States, 68 F.3d 421, 95-2 U.S.T.C. ¶50,594 (11th Cir. 11/3/95). Provider of specialized nurses to hospitals in need of temporary additional staffing established a reasonable basis under §530 of the Revenue Act of 1978 for treating the nurses as independent contractors, falling within the safe haven of §530(a)(2) in two respects: (1) judicial precedent, a published ruling and "technical advice" of several attorneys and a CPA [sic!!]; and (2) the common law factors indicating a lack of control of the manner and means of the nurses' work. District court's permanent injunction against IRS collection of remaining employment taxes assessed violated the §7421 Anti-Injunction Act.

3. Boles Trucking Inc. v. United States, 77 F.3d 236, 96-1 U.S.T.C. ¶50,112 (8th Cir. 2/22/96). The burden of proof on taxpayer asserting a "reasonable basis" for improper classifying employees as independent contractors under §530 of the Revenue Act of 1978 is the same "preponderance of the evidence" standard that exists for other tax cases, not the standard contained in the instruction given, "[taxpayer] need only show that the evidence of a reasonable basis is just as likely true than not true. In other words, even if the evidence weighs out evenly, you must find that [taxpayer] had a reasonable basis . . . ."

4. IRS releases draft training manual on worker classification (including the relief available under §530 of the Revenue Act of 1978) (2/28/96). With respect to §530, before that provision can become an issue, the worker must be an employee under §3121(d) but the employer need not concede or agree to the determination in order for §530 relief to be available. With respect to industry practice, taxpayer must show how it knew the industry practice and when it knew it (taxpayer cannot have relied on industry practice if it did not become aware of it until after beginning to treat workers as independent contractors).

5. Springfield v. United States, 88 F.3d 750, 96-2 U.S.T.C. ¶50,354 (9th Cir. 7/3/96). Salesmen working in independent used car dealerships were independent contractors under §530 of the Revenue Act of 1978, reversing the district court conclusion to the contrary because it was based only on evidence that franchise dealerships that sell used cars treated their salesmen as employees (and did not contradict taxpayer's evidence that independent dealerships in the San Diego area generally treated their salesmen as independent contractors). "When the government ignores a taxpayer's contentions as to the real world conditions of the marketplace,
despite the requirements of Congress that it consider them, it invites the result reached here.”

6. **Newspaper distributors and carriers are §3508 direct sellers.** SBT §1118 amends §3508 by treating newspaper (or shopping news) distributors and carriers as “direct sellers,” who are eligible to treat workers as independent contractors, effective for services performed after 12/31/95.

7. **Relief from employment taxes under §530 of the Revenue Act of 1978.** SBT §1122 modifies §530 of the Revenue Act of 1978, to provide, *inter alia*, that employee classification is not a prerequisite to obtaining the benefits of that provision, but that a post-1966 audit may not be relied upon unless it included an examination for employment tax purposes. Effective 1/1/97, without inference of the proper treatment for disputes from earlier periods.

**B. Excise Tax**

1. **Excise tax on insurance premiums paid to foreign insurers on exported goods is unconstitutional under the Export Clause.** International Business Machines Corp. v. United States, 59 F.3d 1234, 95-2 U.S.T.C. ¶70,048 (Fed. Cir. 7/10/95). Section 4371, which imposes a four percent excise tax on the premiums paid to foreign insurers, is invalid as it is applied to casualty insurance on goods in the export stream by reason of the Export Clause of the Constitution (Article I, Section 9, Clause 5, ["No Tax or Duty shall be laid on Articles exported from any State."] because it is in effect a tax upon the exported products themselves.

   a. **Affirmed by the Supreme Court.** United States v. International Business Machines Corp., ___ S. Ct. ___, 116 S. Ct. 1793, 96-1 U.S.T.C. ¶70,059 (U.S. 6/10/96) (6-2). The opinion of the Court stated that the Export Clause, in broad language, expressly prohibits Congress from laying any tax or duty on exports. Justice Thomas rejected the government’s argument that the Framers intended the Clause to narrowly alleviated the fear of northern repression through taxation of southern exports by prohibiting only discriminatory taxes, and stated that the better reading is that the Framers sought to alleviated their concerns by completely denying to Congress the power to tax exports at all.

2. **Luxury automobile tax.** SBT § 1607 extends the phasedown of the $4001 luxury passenger automobile tax from 1999 to 2002.

3. **Too late to buy your airline tickets for 1996, but not too late to buy them for 1997.** SB §1609 re-imposes the airport trust fund excise taxes at pre-1996 rates through 12/31/96, effective 7 days after enactment.

**XIV. TAX LEGISLATION**

**A. Enacted**

1. **Lobbying expenditure reporting.** P.L. 104-65 (S. 1060), 109 Stat. 691, Lobbying Disclosure Act of 1995 was signed by President Clinton on 12/19/95. The (Istook Amendment) provision that would have prohibited federal grants to §501(c)(4) [social welfare] organizations which lobby the federal government was eliminated. Section 15 of the Act permits lobbying organizations to report on their expenditures to Congress by making good faith estimates based on the tax reporting system.
2. State income taxation of pension income. P.L. 104-95 (H.R. 394), 109 Stat. 979 [codified at 4 U.S.C. §114], which prohibits a state from imposing income taxation on "retirement [pension] income" of a retiree who is no longer a resident or domiciliary of that state, signed by President Clinton on 1/10/96.

3. The Taxpayer Bill of Rights 2 ("T2"), P.L. 104-168, was signed by President Clinton on 7/30/96.

4. Small Business Job Protection Act of 1996 ("Small Business Tax Act" or "SBT"), P.L. 104-188, was signed by President Clinton on 8/20/96.

5. The Health Insurance Portability and Accountability Act of 1996 ("Health Act" or "HIPAA"), P.L. 104-191, was signed by President Clinton on 8/21/96.


B. Vetoed

1. Contract With America. H.R. 1215, the Contract With America Tax Relief Bill of 1995, passed by the House on 4/5/95; included in H.R. 2491, the Seven Year Balanced Budget Reconciliation Bill of 1995, vetoed by President Clinton on 12/6/95.