1995

Recent Federal Income Tax Developments

Ira B. Shepard

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RECENT FEDERAL INCOME TAX DEVELOPMENTS

By

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The College of William & Mary

December 2, 1995
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RECENT FEDERAL INCOME TAX DEVELOPMENTS

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I. Accounting

A. Accounting Methods

*1. Proposed regulations on accounting method changes, now final. IA-42-93, proposed amendments to regulations under §§446(e) and 481, relating to the requirements for changes in a taxpayer's method of accounting (F.R. 12/28/94). Conforms existing regulations to the IRS's long-standing administrative procedures and practices regarding §481(a) adjustments. T.D. 8608, adopts proposed regulations (8/7/95).

*2. Cash method held proper for contractor. Ansley-Sheppard-Burgess Co. v. Commissioner, 104 T.C. No. 17 (3/28/95). General contractor generally maintained its books on the cash method, but was required by bonding company and banks to maintain financial statements using the percentage of completion method. Taxpayer did not maintain an inventory and met the §448(b)(3) $5 million gross receipts test for small service businesses. Judge Wells held that the Commissioner abused her discretion under §446(b) in attempting to require taxpayer to change to the percentage of completion method [not required by §460], particularly since the taxpayer made no attempt to prepay expenses unreasonably. Contra, Independent Contracts, Inc. v. United States, 94-1 U.S.T.C. ¶50,135 (N.D. Ala. 3/2/94).

*3. Commissioner's asserted discretionary authority to readjust timber accounts was improper because regulation was invalid. 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). Reg. §1.611-3(d)(5), which gives Commissioner the discretionary "power to readjust taxpayer's timberland blocks to reach a reasonable depletion allowance," was held invalid as going beyond the rulemaking authority granted in the statute [§811(a)], which -- the court found -- provided only that depletion was to be determined under regulations to be prescribed by the Secretary, and did not give Commissioner the authority to decide individual cases. The court based its

* Item of particular interest.
opinion on the difference under administrative law between run-of-the-mill rulemaking authority [as provided in §611(a)] and authority to adjudicate individual cases [as Commissioner claimed in the regulation found to be invalid]; the court cited §166(a)(2) as an example of the latter, which gives the Commissioner the discretion to decide whether a partially worthless debt may be deducted on a case-by-case basis.

a. **RLC Industries Co. v. Commissioner**, 98 T.C. 457 (4/22/92). Commissioner abused her discretion under §446(b) and Reg. §1.611-3(d)(5) in determining that taxpayer was not entitled to include its California fee timberland together with its Oregon fee timberlands in a single pool for purposes of computing depletion.

4. **Rev. Proc. 95-33, 1995-28 I.R.B. (6/21/95)**. Provides a procedure [available through 10/15/95 for years beginning in 1994] for resellers to obtain consent to a change of accounting method for costs subject to the uniform capitalization rules of §263A. The procedure provides for waiver of the 180-day rule, with the Form 3115 to be attached to taxpayer's original return.

B. **Inventories**

*1. Final "pick and pack" regulations.** T.D. 8559, final regulations under §263A, relating to accounting for costs incurred in producing property and acquiring property for resale (8/2/94). "Pick and pack" costs are excepted from the scope of capitalizable handling costs incurred inside a storage facility.

2. **Apollo Computer, Inc. v. United States**, 32 Fed. Cl. 334, 95-1 U.S.T.C. ¶50,015 (12/7/94). The Commissioner had discretion under §§446(b) and 471 to change the "fixed asset method" used by taxpayer for its rotable 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 rotable spare parts was proper because the parts were either held for sale or otherwise classifiable as inventory.

C. **Installment Method**

1. **Payment of additional 1993 taxes.** Rev. Proc. 94-58, 1994-2 C.B. 745. Provides further guidance to individuals who are liable for additional 1993 income taxes by reason of their election to pay those taxes in three equal installments. Notice 93-51, 1993-2 C.B. 337, explained how to make the election, compute the deferred amount of additional 1993 taxes, and pay the first installment; this revenue procedure explains how to pay the second and third installments.

2. **Shelton v. Commissioner**, 105 T.C. No. 10 (8/16/95). Former 337 sale (and liquidation) by corporation (A) [of which taxpayer was sole shareholder] of its subsidiary's stock to buying corporation (B) [owned by taxpayer's children] in exchange for a promissory note, followed by a sale of the subsidiary's assets for $35 million and [former §337] liquidations of the
subsidiary and B, constituted a §453(e)(1) disposition of property by a related person that triggered the gain on the installment note held by taxpayer.

D. Year of Receipt or Deduction

1. **Houston Industries, Inc. v. United States, 94-2 U.S.T.C. ¶50,526** (Fed. Cl. 10/11/94). Fuel cost overrecoveries (and interest earned thereon) received by a public utility company under a fixed fuel factor scheme instituted by the Texas PUC were not includible in gross income under the claim of right doctrine (as interpreted by Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203, 90-1 U.S.T.C. ¶50,007 (1990)) because taxpayer did not have complete dominion, but was obligated to repay (or credit) the customers directly. The Federal Circuit's *Iowa Southern Utilities Co.*, the Fourth Circuit's *Roeanoke Gas Co.*, and the Tax Court's *Southwest Energy Co.* cases were distinguished.

*2. Attorneys' fees get structured settlement treatment.** Childs v. Commissioner, 103 T.C. 634 (11/14/94). Structured settlement agreements received in payment of attorneys' fees were not includable in income under §83 in the year in which the settlement agreements were effected because the promises to pay under the structured settlements were neither funded nor secured (and thus did not meet the §83 definition of property contained in Reg. §1.83-3(e)), nor were they constructively received.

*3. Tax Court finds Reg. §1.267(a)-3 invalid as applied.** Tate & Lyle, Inc. v. Commissioner, 103 T.C. 656 (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. ¶50,169 (1994). Note: 4 of the 9 judges in the majority disagreed with the retroactivity holding.

5. T.D. 8593, final regulations under §461(h), relating to the effective dates of the economic performance requirement (4/7/95).

6. Chevron Corp. v. Commissioner, 104 T.C. No. 35 (6/27/95). Allocation and apportionment under §861-8 regulations of state taxes (especially, the California unitary income tax, imposing worldwide combined reporting) between domestic and foreign source gross income for §901 foreign tax credit purposes.

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. 721 (6/6/94). Taxpayer was not permitted to follow the literal language of Reg. §1.613-3(a) and use "representative market or field prices" (RMFP) in determining "gross income from the property" for purposes of computing percentage depletion under §613A(b)(1)(B) ["fixed contract" exception]. Even though the regulation states that "the gross income from the property shall be assumed to be equivalent to RMFP" with respect to natural gas transported from the premises prior to sale, the purpose of that provision was to prevent integrated producers from taking depletion deductions on transportation, refining, etc. – and not to permit taxpayer to take depletion based upon a RMFP price much greater than 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, 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.

*2. Allocation held to be binding on taxpayer under Danielson rule. Lane Bryant, Inc. v. United States, 94-2 U.S.T.C. ¶50,481 (Fed. Cir. 9/21/94). Taxpayer purchased 200,000 shares of its stock following an unsuccessful takeover attempt for $22.50 per share, or about $5 per share over market. It sought to deduct the premium as a [pre-§162(k)] business expense or amortizable intangible, but the stock purchase agreement allocated all of the financial consideration to the stock and none of it to non-stock items [such as an agreement to cease litigation and an agreement by the seller not to purchase taxpayer's stock for a fixed period of time]. Therefore, under the Danielson rule, taxpayer could not attack its own allocation in the stock purchase agreement.

*3. 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. 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. Chief 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. Liddle v. Commissioner, 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 . . . ."

4. The Perkin-Elmer Corp. v. Commissioner, 103 T.C. 464 (9/28/94). Held, for purposes of determining the §904 limitation on the foreign tax credit,
taxpayer's research and development expenses had to be allocated to its foreign subsidiaries under the sales method incorporated in Reg. §1.861-8(e)(3)(ii), which regulation was not unreasonable and, therefore, was valid. Taxpayer and its foreign subsidiaries each incurred R&D expenses of about 6 percent of sales, but the method of allocation in the regulations did not take account of the R&D expenses of the subsidiaries and produced an apportionment of R&D expenses to taxpayer of about 5.5 percent of sales and to the foreign subsidiaries of about 9.5 percent of sales.

*5. Final §174 “research and experimental” regulations. T.D. 8562, final regulations under §174, clarifying (prospectively) the definition of "research or experimental expenditures" and providing guidance regarding the §174(e) reasonableness requirement, added by the 1989 Act (9/30/94).

6. T.D. 8563, final regulations under §42, relating to the stacking rules for allocations of housing credit dollar amounts from each state’s housing credit ceiling (9/30/94).

7. T.D. 8566, final regulations under §168(i)(4), relating to the election for maintaining general asset accounts for depreciable assets to which §168 applies (10/7/94).

*8. 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).

*9. Rent-to-own companies limited to MACRS depreciation. ABC Rentals of San Antonio, Inc. v. Commissioner, T.C. Memo. 1994-601. Rent-to-own corporations improperly used the income forecast method to calculate depreciation deductions for property they rented out. The income forecast method is only available for assets such as TV and motion picture films, the useful life of which does not depend on physical wear and tear or the passage of time, and not for consumer durables that produce steady and dependable streams of income. The fact that the assets had a useful life shorter than the 5-year recovery period mandated by MACRS is not a valid argument to avoid the MACRS depreciation mandated by §168.

a. TAM 9338002 (6/10/93). Contracts between a rent-to-own dealer and its customers for durable goods (e.g., TV sets) were properly characterized as conditional sales, not as leases.

b. Rev. Rul. 95-52, 1995-34 I.R.B. 16. Consumer durable property subject to rent-to-own contracts with the general public is 5-year property for §168 cost recovery purposes. The income forecast method is not a permissible method of depreciation. See also, Rev. Proc. 95-38, 1995-34 I.R.B. 25 (optional method of accounting for rent-to-own contracts entered into by rent-to-own dealers for consumer durable property; income is rental income and gain or
loss on sale is not subject to §1231; consent needed to change to this method of accounting).

10. INTL-933-86, proposed regulations under §902, relating to the deemed paid foreign tax credit (F.R. 1/6/95). Reflects the 1986 Act's change to the "pooling" mechanism for all post-1986 undistributed earnings, which delinks the taxes to be credited from the particular profits on which they were paid; instead, the taxes are applied to all of the foreign corporation's accumulated profits. The proposed regulations would apply the pooling rule to pre-1987 accumulated profits as well, following Rev. Rul. 87-14, 1987-1 C.B. 181, and reversing Vulcan v. Commissioner, 96 T.C. 410 (1991), aff'd per curiam, 959 F.2d 973 (11th Cir. 1992).

11. Fifth Circuit adopts generous standard for "placed in service." Sealy Power Ltd v. Commissioner, 95-1 U.S.T.C. ¶50,103 (5th Cir. 2/15/95), nonacquiescence, AOD 1995-10, 1995-33 I.R.B. 4, affg., revg. and remanding T.C. Memo. 1992-168. No particular level of power generation was required in order for an electricity production facility to be considered "placed in service" for purposes of the former biomass energy tax credit and investment tax credit, even though [because of functional deficiencies in its equipment] the amount of electricity produced in 1983 [the year for which the credits were claimed] and in 1984 [the year which the court found the property was placed in service] was too small and sporadic to appear in HL&P’s records for those years.

12. Phillips Petroleum Co. v. Commissioner, 104 T.C. 256 (3/9/95). "Special charge" under Norwegian Petroleum Tax of 1975 qualified as an excess profits tax and was creditable under §901, as were national and municipal taxes imposed under the same statute. The court held that these were not additional royalty payments because no additional rights or benefits were granted to North Sea petroleum license holders.

13. INTL-23-95, proposed amendment of Reg. §1.861-8, relating to the allocation and apportionment of research and experimental expenditures for purposes of determining taxable income from sources within and without the United States (F.R. 5/24/95).

B. Expenses

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

b. **A.E. Staley Mfg. Co. v. Commissioner,** 105 T.C. No. 14 (9/11/95) (reviewed, 12-5). Taxpayer incurred (among other costs) investment bankers' fees and printing costs in response to the unsolicited and hostile (but eventually successful) tender offers to acquire its stock made by Tate & Lyle PLC. These expenditures were held — in an opinion by Judge Halpem — to be capital, for which no deduction under §162(a) was available based upon **INDOPCO, Inc. v. Commissioner,** 503 U.S. 79, 92-1 U.S.T.C. ¶50,113 (1992) (involving a friendly acquisition), because the expenditures were made in connection with a change in ownership with indefinite and extended future consequences to taxpayer, and they are properly to be matched against revenues of a taxable period longer than the taxable year during which they were incurred.

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

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

2. **Real estate development expenditures made before physical work began required to be capitalized.** **Von-Lusk v. Commissioner,** 104 T.C. 207 (2/2/95). Expenditures made by partnership formed to manage, hold and develop for investment 278 acres of raw land were nondeductible and had to be capitalized under §263A because the activities of the partnership were for production of the property — the term "produce" is defined broadly in §263A(g) — and, while no physical change to the property was made during the years in question, the expenditures were taken to begin development of the property and were ancillary to physical work on the land in that the "project can not move forward if these steps are not taken." The expenditures disallowed as deductions were for property taxes and amounts paid to independent contractors for meeting with government officials, obtaining building permits and zoning variances, negotiating permit fees, performing engineering and feasibility studies and drafting architectural plans. **Louisiana Land & Exploration Co. v. Commissioner,** 7 T.C. 507 (1946), aff'd, 161 F.2d 842, 47-1 U.S.T.C. ¶9266 (5th Cir 1947) (geophysical survey costs on property leased to taxpayer had to be capitalized under the forerunner of §263), followed. The court noted that the term "production period" defined in §263A(f)(4)(B) and Notice 88-99, 1988-2 C.B. 422, as beginning when "physical activity is first performed on the property" applies only to the special rules of §263A(f) for allocation of interest to property produced by the taxpayer.
3. T.D. 8584, final regulations under §263A(f), relating to the requirement to capitalize interest with respect to the production of property (12/28/94). Provides for simplification in several respects.

4. Proposed regulations on the scope of the club dues disallowance provision. IA-30-94, proposed regulations under §274(a)(3), relating to the definition of a "club organized for business, pleasure, recreation, or other social purpose" in Code §274(a)(3) [added by 1993 Act §13210] for purposes of the disallowance of a deduction for club dues, effective with respect to amounts paid or incurred after 12/31/93 (8/11/94). Prior to the 1993 Act, dues were disallowed for social, athletic, and sporting clubs under §274(a)(2)(A) leaving exceptions for (1) professional organizations [e.g., bar associations and medical associations], (2) civic or public service organizations [e.g., Kiwanis, Lions, Rotary, etc.], and (3) business luncheon clubs described in Reg. §1.274-2(e)(3)(ii). The proposed regulations interpret Code §274(a)(3) as not affecting dues paid to (1) professional organizations or (2) civic or public service organizations [unless the specific organization has a principal purpose of conducting entertainment activities, or of providing access to entertainment facilities, for members or guests], but as eliminating the deduction for dues paid to (3) business luncheon clubs, as well as for dues paid to airline and hotel clubs.
   a. IA-17-94 and EE-36-94, proposed amendments of regulations under §§61, 132 and 274, relating to reimbursements of expenses for club dues, spousal travel and business meals and entertainment that are disallowed as a deduction to the employer (F.R. 12/16/94). Employer can accept disallowance of deductions for these items, or employer can exercise the option to characterize reimbursements as compensation to the employee.
   b. T.D. 8601, final and temporary regulations relating to the definition of "a club organized for business, pleasure, recreation, or other social purpose" for purposes of the §273(a)(3) disallowance of a deduction for club dues (7/18/95).

5. Golden parachute payments failed to meet reasonable compensation test. Cline v. Commissioner, 94-2 U.S.T.C. ¶50,468 (7th Cir. 9/2/94), aff'g 100 T.C. 331 (1993). Affirms Tax Court finding of "excess [golden] parachute payments" to Jewell Tea executive in connection with that corporation's acquisition by American Stores Company. The court also rejected taxpayer's attack on the Tax Court finding that the payments failed to meet the §280G(b)(4)(A) "reasonable compensation" exception because that finding properly reflected the congressional conference committee's presumption of unreasonableness which may be rebutted only by clear and convincing evidence.

6. Allied-Signal v. Commissioner, 95-1 U.S.T.C. ¶50,151 (3d Cir. 2/23/95) (2-1) (opinion designated not for publication). Contribution [$8 million] to a private environmental fund formed to remedy the effects of a toxic pesticide manufactured by taxpayer's predecessor was nondeductible by reason of §162(f)'s denial of a deduction for "a fine or similar penalty paid to a
government" because the payment in substance was a quid pro quo for a reduction of a federal court's criminal fine and was not made "voluntarily."

*7. Personal injury lawyers permitted to deduct court costs and expenses when made under "gross fee" contracts. *Boccardo v. Commissioner*, 95-1 U.S.T.C. ¶50,284 (9th Cir. 5/26/95). Personal injury lawyers who agreed to take one-third of the gross recovery and to pay costs out of their share – as opposed to "net fee" contracts where costs were repaid by the clients out of their recovery [under which costs paid were held to be advances which were nondeductible when paid by the lawyers under *Boccardo v. United States*, 12 Cl. Ct. 184 (1987)] – were permitted current §162 deductions for those costs when paid. Judge Noonan held that whether the arrangement violated California ethical rules was irrelevant because these ethical rules were not generally enforced state laws as defined by §162(c).

8. T.D. 8602, final regulations that define "influencing legislation" for purposes of the §162(e) deduction disallowance (7/20/95). Also contains rules for allocating costs and the deductibility of dues paid to certain tax-exempt organizations.

9. Captive insurance scheme held to be a sham. *Malone & Hyde Inc. v. Commissioner*, 95-2 U.S.T.C. ¶50,450 (6th Cir. 8/18/95). Parent and subsidiaries could not deduct insurance premiums paid to an unrelated insurer whose risks were reinsured by parent's wholly-owned (Bermuda) insurance subsidiary because the captive insurance scheme was a sham. The court distinguished its decision in *Humana, Inc. v. Commissioner*, 881 F.2d 247, 89-2 U.S.T.C. ¶9453 (1989), rev'd in part and aff'd in part 88 T.C. 197 (1987), which had allowed subsidiaries [but not the parent] to deduct premiums paid to a (Colorado) captive insurance company, in three respects: (1) taxpayer here had no problems [as did Humana] in obtaining insurance from an unrelated carrier, (2) taxpayer's captive was undercapitalized and Humana's was fully capitalized, and (3) taxpayer here agreed to hold the unrelated primary insurer harmless in the event the captive reinsurer defaulted.

C. Losses and At Risk

*1. Purported waiver of NOL carryback must specifically cite §172. *M. Lane [sic] Powers v. Commissioner*, 43 F.3d 172, 95-1 U.S.T.C. ¶50,086 (5th Cir. 1/26/95). Tax Court erred when it held that taxpayer made an irrevocable election to relinquish the three-year carryback period under then-§172(b)(3)(C) for years 1978 and 1979 by attaching to his 1978 return the statement: "Pursuant to §56(b)(3)(C) [sic], Taxpayer elects to carryforward to 1979 the net operating loss of 1978" and a similar statement to his 1979 return because the Code section cited was nonexistent and there was no citation of §172.

safe harbor, 75% of existing exterior walls and 75% of existing structural framework are required to be retained in place.

*3. Final regulations defining "activity." T.D. 8565, final regulations under §469 (effective 5/11/92), defining the term "activity" for purposes of the passive activity loss limitations (10/3/94). The final regulations make explicit that the same facts and circumstances may result in more than one permissible grouping of activities and clarify the Commissioner's anti-avoidance regrouping authority. The regulations do not address the grouping of rental real estate activities by taxpayers subject to §469(c)(7), added by the 1993 Act.

*4. 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 (F.R. 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.

*5. Substance-over-form applies to deny loss on unexercised option. Berry Petroleum Co., v. Commissioner, 104 T.C. No. 30 (5/22/95). Loss deduction (on expiration of option unexercised) of $1.2 million ostensibly paid for a 1-year option to purchase Oklahoma gas leases at inflated exercise price [$6.9 million for leases worth about $3 million] was denied on substance-over-form grounds because the option was actually part of the purchase price of stock acquired in the same transaction. The seller insisted upon the $1.2 million option payment [plus $3.8 million for the stock – as opposed to $5 million for the stock] as a way of avoiding potential liability for short swing profits under section 16(b) of the Securities Exchange Act of 1934.

D. Business Income

1. Lawinger v. Commissioner, 103 T.C. 428 (9/1/94). Taxpayer not entitled to exclude reduction of her debt with the Farmers Home Administration under the §108(a)(1)(C) exclusion for "qualified farm indebtedness" by reason of her not meeting the §108(g)(2)(B) aggregate gross receipts test because neither cash rent received on her farmland nor credits received under the (Wisconsin) Farmland Preservation Act were attributable to her trade or business of farming.

*2. 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 (6th Cir. 1964), and following United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991) (As used in §108, the term "discharge . . . 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.

3. Conoco, Inc. v. Commissioner, 42 F.3d 972, 95-1 U.S.T.C. ¶50,087 (5th Cir. 1/27/95) (per curiam), affg 102 T.C. 1 (1994); duPont v. Commissioner, 94-2 U.S.T.C. ¶50,620 (3d Cir. 12/8/94). Reg. §1.58-9 applicable to years 1977 through 1986, but not promulgated until 1989 - was a reasonable interpretation of former §58(h), which provided that regulations should include a tax benefit rule for the add-on minimum tax. The regulation required the reduction of unused income tax credits by the amount of minimum tax that would have been due in the year that the credits were incurred before carrying the credits back to prior tax years.

III. Capital Gain and Loss

A. Gehl v. Commissioner, 95-1 U.S.T.C. ¶50,191, 75 AFTR 2d 95-1605 (8th Cir. 3/20/95), affg 102 T.C. 784 (1994). Section 1001 gain equal to the difference between basis and fair market value resulted from insolvent taxpayers' transfer of land by deed in lieu of foreclosure because the transfer was in partial satisfaction of a recourse indebtedness, citing Reg. §1.1001-2(a) and (c), Example (8). Loan balance was 152 [$ thousand]; property and cash with total basis of 52 and total value of 122 were transferred; result was 50 of §1001 gain and 30 of cancellation of indebtedness.

B. Claiming §1244 losses simplified. Notice 94-89, 1994-2 C.B. 560 (9/1/94). Small business shareholders will no longer be required to file a §1244 stock information statement with their income tax returns in order to claim ordinary loss deductions on their stock; Reg. §1.1244(e)-1(b) will be revised to eliminate that requirement and will merely require that sufficient records be maintained to establish that the stock qualifies as section 1244 stock.

1. CO-46-94, proposed amendments of regulations under §1244, relating to the records to be kept and information to be filed with a return claiming ordinary loss on small business stock (F.R. 11/15/94). Removes the
requirement that a taxpayer claiming a §1244 ordinary loss file an 
information statement with the income tax return.

2. T.D. 8594, final regulations under §1244, removing the requirement for 
filing an information statement with the tax return claiming the loss 
(4/27/95).

C. Rev. Rul. 94-63, 1994-2 C.B. 188 (9/27/94). IRS determination that options will be 
treated as §1256 contracts [for mark-to-market purposes] where they are based on 
a stock index and are traded on (or subject to the rules of) a qualified board or 
exchange if (a) the options provide for cash-settlement, and (b) the SEC has 
determined that the stock index is a "broad-based" index. The same rules apply for 
warrants that are based on a stock index.

D. FI-43-94, proposed regulations under §1258, relating to the amount of gain from a 
conversion transaction position that is subject to recharacterization as ordinary 
income (F.R. 12/27/94). Proposed regulations allow taxpayers to net gains and 
losses on positions of certain conversion transactions.

E. T.D. 8586, final regulations under §1254, relating to the tax treatment of gain from 
disposition of certain oil, gas and geothermal properties (1/9/95). Recapture is 
determined at the partner level (aggregate approach), except there is an antiabuse 
rule if the Commissioner determines that there is an allocation with "a principal 
purpose" of avoiding §1254 recapture.

F. Tax considerations inapplicable in bankruptcy court's decision authorizing 
trustee to "abandon" property back to the individual debtor. In re Johnston, 
49 F.3d 538, 75 AFTR 2d 1324 (9th Cir. 3/2/95). Upheld decision authorizing 
bankruptcy chapter 11 trustee to abandon a large residential property which was 
"of inconsequential value and benefit to the estate" under Bankruptcy Code 
§554(a) [11 U.S.C. §554(a)]. Under IRC §1398(f) a transfer from the bankruptcy 
estate to the debtor is not treated as a disposition, so [following an abandonment] 
the burden of tax liability on the eventual disposition of the property would fall upon 
the debtor — and not upon the bankruptcy estate [as it would have, had the 
property not been abandoned]. The Ninth Circuit refused to require the Bankruptcy 
Court to consider the tax consequences in its consideration [and rejection] of the 
argument that the abandonment would burden the debtor's fresh start.

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.

2. Rev. Rul. 95-45, 1995-26 I.R.B. (6/6/95). A corporation’s assumption of its corporate shareholder’s obligation to provide replacement securities to a broker-dealer pursuant to a short sale is the assumption of a liability for purposes of §§357 and 358. The amount of the liability is the proceeds of the short sale. See also, Rev. Rul. 95-26 (partnership’s obligation to deliver replacement securities); Rev. Rul. 95-8 (whether short sale transactions give rise to UBTI).

B. Distributions and Redemptions

*1. Tax Court will not follow 9th Circuit’s Kroy holding. Fort Howard Corp. v. Commissioner, 103 T.C. 345 (8/24/94) (reviewed, 13-2). Amounts paid (other than interest excepted by §162(k)(2)) to finance a leveraged buyout of taxpayer’s stock were nondeductible by reason of §162(k), which prohibits deductions for amounts “paid or incurred by a corporation in connection with the redemption of its stock.” The majority refused to follow the Ninth Circuit’s holdings in In re Kroy (Europe) Ltd., 94-2 U.S.T.C. ¶50,316 (1994), that the “origin” of the financing was in the loan and debt transactions (which were separate from the redemption).

a. Judge Beghe’s dissent is based upon the “well-settled principle[] of tax law” that the disallowed expenses had to be amortized over the periods outstanding of the debt securities and loans to which they relate, the interest on which is deductible under §162(k), which prohibits deductions for amounts "paid or incurred by a corporation in connection with the redemption of its stock." The majority refused to follow the Ninth Circuit’s holdings in In re Kroy (Europe) Ltd., 94-2 U.S.T.C. ¶50,316 (1994), that the "origin" of the financing was in the loan and debt transactions (which were separate from the redemption).

*2. 5th Circuit will not follow Five Star in pre- §162(k) case. United States v. Houston Pipe Line Co., 94-2 U.S.T.C. ¶50,578 (5th Cir. 11/7/94), affg 93-2 U.S.T.C. ¶50,580 (S.D. Tex. 1993). Summary judgment for government affirmed, disallowing deduction for the $124.53 million paid to redeem its stock from Coastal to fend off an attempted takeover. Five Star Mfg. Co. v. Commissioner, 355 F.2d 724, 66-1 U.S.T.C. ¶9191 (5th Cir. 1966), held not applicable because the redemption was not necessary to the corporation’s survival as a going concern.

3. Corporate "inversions" will be dealt with in regulations. Notice 94-93, 1994-2 C.B. 563. The IRS will issue regulations concerning the tax consequences of "corporate inversions," which are transactions that reverse the positions of related corporations. To prevent the circumvention of General Utilities repeal, the regulations will require recognition of income or §311 gain at the time of the (dilutive) inversion transaction based upon the value pulled out of the parent by the shareholders on their exchange of parent stock for newly-issued subsidiary stock.
4. T.D. 8590, final regulations under §246, relating to the reduction in holding period [for purposes of the dividends received deduction] of stock where the taxpayer has diminished its risk by holding one or more other positions with respect to substantially similar or related property (3/17/95). Also contains final regulations under §1092, relating to tax straddles involving stock and substantially similar or related property.

5. Corporation unable to base gain determination for property distributed to a partnership upon the total value of all partnership interests. *Pope & Talbot, Inc. v. Commissioner,* 104 T.C. No. 29 (5/8/95). Taxpayer transferred its Washington timber and land development properties to a newly-formed limited partnership and distributed partnership units to each of its approximately 6,000 shareholders. Judge Ruwe, on summary judgment, held that taxpayer's gain was to be determined under the §311(d) dividend distribution rules based upon the value of the entire property, and not by reference to the value of the partnership units received by each shareholder because the property was transferred by the corporation to the partnership [and not by the corporation to its shareholders, followed by the shareholders' contribution of the property to the partnership].

6. Transfer of appreciated assets to "temporary" shareholder in exchange for taxpayer's stock held "redemption" — and not "sale." *Pabst Brewing Co. v. Commissioner,* T.C. Memo. 1995-239 (6/1/95). Taxpayer transferred appreciated assets to Heileman in exchange for taxpayer's common stock that had been recently acquired by Heileman in a tender offer. Taxpayer argued that the gain was taxed under §1001, measured by the fair market value of the Pabst stock received from Heileman, asserting that Heileman was not a "real" shareholder [because forbidden by antitrust consent decree to hold stock of competitors] and the substance of the transaction was a sale to Heileman that would have been structured as such had other factors made the stock purchase and redemption the only available alternative. The court held (as the Commissioner had asserted) that taxpayer was taxed on redemption gain under §311(d), measured by the fair market value of the transferred assets, following *Esmark, Inc. v. Commissioner,* 90 T.C. 171 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989). (*Esmark* was a pre-1986 Act case, in which taxpayer corporation was able to avoid gain on the sale of an appreciated subsidiary by having Mobil [the purchaser] buy Esmark stock from existing shareholders and [by prearrangement] exchange that Esmark stock for all the stock of the subsidiary. The exchange was treated as a redemption.)

   a. On the issue of valuation of the transferred assets, taxpayer's summary judgment motion denied, on the ground that the "presumed-equivalence-in-value" rule of *United States v. Davis,* 370 U.S. 65 (1962), does not necessarily apply and valuation is an issue of fact to be determined by the court. However, Judge Hamblen urged the parties to settle the valuation issue "as more properly suited for the give and take of the settlement process," citing *Buffalo*
C. Liquidations

1. Substance-over-form does not work for taxpayer, which is held to the transaction it negotiated. Insilco Corp. v. United States (In re Insilco Corp.), 95-1 U.S.T.C. ¶50,272 (5th Cir. 5/15/95). After selling a subsidiary for $96 million cash to corporate purchaser, who made a §338 election, taxpayer acquired common and preferred stock of the corporate purchaser for cash. It took the position on its original 1985 tax return that it sold the subsidiary for a gain of $75 million. In 1991, during the pendency of its voluntary bankruptcy proceedings, taxpayer amended its return, taking the position that under substance-over-form principles, what happened was that it exchanged its subsidiary's stock for cash and stock of the corporate purchaser — arguing that it had control of the corporate purchaser under §304(c)(2)(A) (stock of acquiring corporation received in the exchange counts for control purposes). The court found that taxpayer was bound by its form: it received only cash on the sale, not stock of the corporate purchaser.

D. S Corporations


2. T.D. 8567, final regulations under §1363(d), relating to the recapture of LIFO benefits when a C corporation elects to become an S corporation or transfers LIFO inventory to an S corporation in a tax-free reorganization (10/6/94).

3. T.D. 8579, final regulations under §1374, relating to the tax imposed on an S corporation's net recognized built-in gain (12/23/94).

4. Hitchins v. Commissioner, 103 T.C. 711 (12/22/94). Taxpayer loaned $34,000 to a C corporation; the C corporation was owed money by an S corporation. As part of the payment of its debt to the C corporation, the S corporation assumed liability for the $34,000 note payable to taxpayer — but the C corporation was not relieved of its liability to taxpayer nor did the S corporation execute a note to taxpayer. Held, the $34,000 loan cannot be included in taxpayer's [a shareholder of the S corporation] "basis of ... indebtedness of the S corporation to the shareholder" in determining the amount of S corporation losses which taxpayer could deduct under §1366(d). The court's reasoning was based upon the continued existence of taxpayer's rights against the C corporation on the loan, which distinguishes Gilday v. Commissioner, T.C. Memo. 1982-242 and Rev. Rul. 75-144, 1975-1 C.B. 277; the court noted that taxpayer could have succeeded had he entered into a novation releasing the C corporation from liability and obtaining a replacement note from the S corporation, or had he
loaned $34,000 to the S corporation to pay the C corporation to (in turn) repay its debt to taxpayer.

5. Rev. Rul. 95-5, 1995-2 I.R.B. (12/21/94). Partnership gains under §731(a) arising from distributions of money greater than the adjusted basis of a partner's interest in the partnership (and S corporation shareholder gains under §1368(b)(2) arising from distributions of money in excess of the adjusted basis of the shareholder's stock in the corporation) are treated for §469 passive activity loss purposes under Temp. Reg. §1.469-2T(e)(3) as gain from a disposition of an interest in each of the entity's trade or business, rental, or investment activities.

6. Rev. Rul. 95-14, 1995-6 I.R.B. 29. When a shareholder of an S corporation receives proceeds in a redemption that is characterized as a distribution under §301, the entire redemption is treated as a distribution for purposes of §1368 that reduces the corporation's AAA [accumulated adjustments account].

7. 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 (F.R. 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.

8. T.D. 8600, final regulations relating to the definition of an S corporation under §1361 (7/20/95).

9. Twenty-Three Nineteen Creekside, Inc. v. Commissioner, 95-2 U.S.T.C. ¶50,372 (9th Cir. 7/7/95). Person who owned the largest profits interest in an S corporation at the close of the corporation's 6/30/84 fiscal year was (in the absence of designation) its tax matters partner, even though he sold his shares to another shareholder in the second half of 1984.

10. Argo Sales Co. v. Commissioner, 105 T.C. No. 7 (8/2/95). C corporation changed its accounting method, which required a §481(a) adjustment spread over 6 years. It elected S corporation status 3 years later. Held, the remaining §481(a) adjustments are §1374 recognized built-in gain because they are items of income attributable to periods before the first year for which the corporation was an S corporation within the meaning of §1374(d)(5).

E. Affiliated Corporations

*1. Major changes to consolidated returns regulations intercompany transactions system proposed. CO-11-91, proposed consolidated return regulations, revising the intercompany transaction system [Reg. §1.1502-13, etc.] to more clearly reflect consolidated taxable income, together with revisions of the regulations under §267(f) which limit losses and deductions from comparable transactions between members of a controlled group (59 F.R. 18011, 4/15/94). The proposed regulations replace the current
mechanical rules with a matching rule and an acceleration rule, which will unify the rules applicable to "period" transactions (e.g., payment of currently deducted interest), sales of property and performance of capitalized services, and transactions involving the stock or obligations of members. To the timing issue that is currently treated on a single entity basis [i.e., as if the separate corporations were divisions of a single corporation] will be added character, source and other attributes, with only the amount and location of items remaining to be treated on a separate entity basis. The matching rule treats items occurring between the separate corporations as if they occurred between divisions of the same corporation, and the acceleration rule takes items into account immediately to the extent that they cannot be taken into account under the matching rule.

1. T.D. 8597, final regulations amending the intercompany transaction system of the consolidated return regulations (7/12/95). Also revises the regulations under §267(f), limiting losses and deductions from transactions between members of a controlled group, under which losses are to be taken account in the same manner as is provided in the timing provisions of Reg. §1.1502-13.

2. Final regulations on consolidated return investment adjustment system. T.D. 8560, final regulations under §1502, amending the consolidated return investment adjustment system, including the rules for earnings and profits and excess loss accounts (8/12/94). Stock basis and E&P determinations are delinked, with investment adjustments determined by reference to (a) taxable income or loss, (b) tax-exempt income, (c) noncapital, nondeductible expenses, and (d) distributions.

3. T.D. 8598 and CO-24-95, temporary and proposed regulations, relating to rules for disallowing loss and excluding gain for certain transactions involving stock of the common parent of a consolidated group (7/12/95).

4. Amorient Inc. v. Commissioner, 103 T.C. 161 (8/9/94). An S corporation was acquired by a consolidated group on 8/31/82, at which time its S election was terminated. The loss attributable to the former S corporation's short period 9/1/82 through 2/28/83 was not includible in the consolidated net operating loss that was carried back to the group's 1980 year because Reg. §1.1502-79(a)(1)(l) provides for that loss to be apportioned to the former S corporation "[f]or the loss can be carried under the principles of section 172(b) ... to a separate return year of a corporation," and former §1373(d) provided that there were no §172 deductions allowed in computing taxable income but also provided that S corporation years were counted as years to which an NOL could be carried back or over. Current §1371(b) provides that no carryforwards or carrybacks exist at the corporate level for S years, but that S years are counted as elapsed years for that purpose.

5. CSI Hydrostatic Testers, Inc. v. Commissioner, 103 T.C. 398 (8/30/94), aff'd per curiam, 95-2 U.S.T.C. ¶50,476 (5th Cir. 8/30/95). Held, based upon the implications of §312(l) "earnings and profits ... shall not include income from the discharge of indebtedness to the extent of the amount..."
applied to reduce basis under §1017" and upon Reg. §1.1502-32 [investment adjustment regulation], that Commissioner is bound by her own regulation, so parent may make a positive adjustment to its investment in subsidiary (thereby eliminating the [Reg. §1.1502-19] excess loss account in subsidiary's stock) based upon the inclusion of the subsidiary's cancellation of debt (COD) income in its earnings and profits (E&P), even though the COD income was excluded from gross income under §108 by reason of the subsidiary's insolvency.

a. Note that Section 1503(e), added by the 1987 Act, provides that E&P of a member of a consolidated group does not included any amount excluded from gross income under §108 to the extent the amount so excluded was not applied to reduce tax attributes (other than basis in property). That provision applies prospectively, and was not applied to this case. Had it been so applied, the subsidiary's COD income would not be included in its E&P for purposes of determining its parent's excess loss account, fn. 9.

b. Note further that T.D. 8560 (8/24/94) changed the Reg. §1.1502-32 investment adjustment system from one based upon subsidiary's E&P to one based upon taxable income or loss, tax-exempt income, nondeductible expenses, and distributions, i.e., a system similar to the basis adjustments of a partner's partnership interest or an S shareholder's stock.


F. Section 482

1. Announcement 95-9, 1995-7 I.R.B. (1/26/95). The IRS is considering the issuance of two new revenue procedures relating to assistance provided by "competent authority," the first to update procedures and the second to amend procedures for obtaining relief under Rev. Proc. 65-17, 1965-1 C.B. 833 [which provides for tax-free repatriation of amounts allocated from a foreign corporation to a U.S related corporation following a §482 allocation].

*2. Tax Court continues to refuse recognition to team players' PSCs. Leavell v. Commissioner, 104 T.C. 140 (1/30/95) (reviewed, 9-5). Professional basketball player, whose personal service corporation executed an NBA Uniform Player Contract with the Houston Rockets to furnish his services, was an employee of the Rockets and therefor taxable on the income of his PSC received from the Rockets because - based upon all the facts and circumstances [including player's personal guarantee of his corporation's contract with the Rockets and the lack of a written agreement between the player and his PSC] - the Rockets had the right to control the "manner and means" by which the player's personal services were to be rendered. Sargent v. Commissioner, 93 T.C. 572 (1989), rev'd, 929 F.2d, 91-1 U.S.T.C. ¶50,168 (8th Cir. 1991), followed. Commissioner disavowed reliance on §269A, which (as the concurring opinion noted)
would allow the reallocation of income from a PSC to a service-provider owner if substantially all of the services were performed for one other entity and the principal purpose for the arrangement was tax avoidance. Judge Laro, who originally tried the case, dissented and followed the 8th Circuit’s holding in Sargent, which respected the contractual relationship between the player and his PSC.

3. “Your mother wears . . .” Altama Delta Corp. v. Commissioner, 104 T.C. 424 (4/11/95). Manufacturer of combat boots had properly elected the §936(h)(5)(C) cost sharing method for its Puerto Rican subsidiary that manufactured “uppers” in a timely-filed return, as held by Judge Scott. The return was allegedly mailed on the last day with a certified-mail metered postmark and not date-stamped as received by the IRS Philadelphia Service Center until 15 days later; however, seven other returns mailed at the same time were date-stamped as received by other IRS offices three or four days later and there were no mail delays to Philadelphia. The §482 allocation was made based upon the cost-plus method, following the IRS abandonment of the contract manufacturing theory it used in the notice of deficiency.

G. Reorganizations and Corporate Divisions

1. CO-993-71, proposed regulations under §§358, 1032 and 1502, relating to the rules for adjusting the basis of a controlling corporation in the stock of a controlled corporation as the result of certain triangular reorganizations involving the stock of the controlling corporation (F.R. 12/23/94). Withdraws 1/2/81 proposed regulations, but retains the over-the-top model of those proposed regulations; however, in contrast to the mechanical rules employed in the 1981 proposed regulations, the new proposed regulations set forth general rules for adjusting basis that will produce similar tax results.

2. 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 (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.

3. Continuity of interest found in merger of actively traded corporation. J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1/24/95). Taxpayer’s $530 million loss on its Conoco stock [$92 - $73 per share] – acquired in a cash tender offer that was later exchanged for duPont stock [after it was clear that the duPont subsidiary had been tendered more than 50 percent of the Conoco stock for cash and duPont stock] in a duPont subsidiary’s competing tender offer for Conoco stock – could not be recognized because taxpayer’s stock was disposed of in a tax-free merger under the
forward subsidiary merger rules of §368(a)(1)(A) and §368(a)(2)(D) and, more specifically, the continuity of interest requirement was satisfied where 54 percent of the outstanding Conoco stock (including taxpayer's tendered 32 percent of the Conoco stock) was acquired by the subsidiary in exchange for duPont stock.

a. Judge Nims held that the two-step acquisition of Conoco [cash and stock tender offer by duPont subsidiary for Conoco stock, followed by statutory merger of Conoco into the subsidiary] were all part of a single plan of reorganization, not separate transactions as taxpayer contended.

b. Taxpayer contended that its own acquisition of 32 percent of the Conoco shares for cash and the duPont subsidiary's acquisition of 46 percent for cash destroyed the continuity of interest requisite for a valid reorganization. However, Judge Nims noted that although 78 percent of the Conoco stock had changed hands for cash pursuant to the competing tender offers, 54 percent of the Conoco equity remained in corporate solution in the form of duPont shares received in exchange for Conoco shares (providing the continuity of interest). Superior Coach of Florida, Inc. v. Commissioner, 80 T.C. 895 (1983), distinguished because the majority shareholders of the acquirer were acting on its behalf when they purchased target stock for cash while Seagram was not acting on duPont's behalf when it purchased Conoco stock for cash. Judge Nims concluded that looking only to "historic" shareholder identity to determine continuity would make suspect all tax-free reorganizations of corporations whose stock was actively traded, citing Helvering v. Alabama Asphalitic Limestone Co., 315 U.S. 179 (1942), for the proposition that continuity of interest was not solely limited to "historic shareholders" (there, unsecured creditors).

c. Note Seagram's tax plan in its 1995 redemption of duPont shares for cash plus a like number of duPont warrants. The redemption [under §§318(a)(4) (option attribution rule) and 302] was to be treated as a dividend [taxable at 10.5% after the §243 dividends received deduction], and not as a sale [gain taxable at 35%].

H. Loss Corporations and Debt Cancellation

1. Berry Petroleum Co. v. Commissioner, 104 T.C. No. 30 (5/22/95). Taxpayer's purchase price for loss corporation owning four heavy-oil properties for $6.5 million governed its value for purposes applying the percentage of value rules of the [post-1986] net operating loss carryover provisions of §382 – not the higher $11.9 million value contended by taxpayer. The §382(c) "continuity of business" requirement was met even though the loss corporation immediately sold its most valuable property. That property was not considered a "nonbusiness asset" for purposes of the §382(l)(4) [antistuffing] reduction in value rule because it was sold by taxpayer, not by the loss corporation prior to the ownership change.
V. **Employee Compensation and Plans**

*A. Retirement Protection Act of 1994*


2. Announcement 95-23, 1995-13 I.R.B. 26. Except for determination letters for terminating plans, all IRS determination, etc. letters will not consider any amendments that were made by the Uruguay Round Agreements Act, Pub. L. 103-465, which implemented the Uruguay Round of GATT. Favorable letters issued for such plans may not be relied upon with respect to whether the plans satisfy the amended requirements.

3. Rev. Rul. 95-28, 1995-14 I.R.B. 4. Mortality table to be used under amended §412(l)(7)(C), relating to the additional funding requirements for underfunded single employer defined benefit pension plans with more than 100 participants, as amended by the Uruguay Round Agreements Act, Pub. L. 103-465 (GATT) [which included the Retirement Protection Act of 1994].


7. T.D. 8591 and EE-12-95, temporary and proposed regulations that provide guidance to employers in determining the present value of an employee's benefit under a qualified defined benefit pension plan, to reflect changes made by the Retirement Protection Act of 1994.

8. Department of Labor proposed regulations to implement the new notice requirement for underfunded plans under ERISA §4011, as it was amended by §775 of the Retirement Protection Act of 1994 (60 F.R. 16026, 3/28/95). Small plans are exempted for 1994 and 1995 plan years.

*B. VCR program for operational defects.* Rev. Proc. 94-62, 19942 C.B. 778 (9/8/94). Extends indefinitely the Voluntary Compliance Resolution (VCR) procedure. Individually designed plans must have received a favorable determination letter (and must not have been substantially amended afterwards) to be eligible for the program. Section 6 of the procedure contains a Standardized VCR Procedure, which provides for specifically-listed corrections for the standard defects listed in section 8.

D. $1 million compensation deduction limitation. EE-61-93, proposed amendments of regulations under §162(m), relating to the disallowance of deductions for employee remuneration in excess of $1 million (F.R. 12/2/94).

*E. Actuarial Estimates

1. Actuarial estimates upheld by Fifth Circuit. Vinson & Elkins v. Commissioner, 7 F.3d 1235, 93-2 U.S.T.C. ¶50,632 (5th Cir. 11/29/93), aff'g 99 T.C. 9 (1992). The 5th Circuit affirmed holding that actuarial estimates for funding individual defined benefit plans of law firm's partners were not unreasonable. Court rejected Commissioner's contention that the §412(c)(3) "best estimate" test was substantive, holding it to be procedural (referring to the actuary's best estimate), in an opinion written by Judge Sneed (of the Ninth Circuit).

2. A second circuit court decision finds for the taxpayer on the actuarial assumptions issue. Wachtell, Lipton, Rosen & Katz v. Commissioner, 94-1 U.S.T.C. ¶50,272 (2d Cir. 6/6/94). Affirms as not clearly erroneous Tax Court findings that actuarial assumptions with respect to individual defined benefit plans of law firm's partners were not substantially unreasonable and did not violate "the ceiling placed on tax deductible contributions by highly paid individuals." The court also found that §412(c) was not violated when the assumption used by the actuary is at the conservative end of the range of reasonable assumptions, provided it is the actuary's best estimate of the anticipated plan experience.

3. And a third circuit court... Rhoades, McKee & Boer v. United States, 95-1 U.S.T.C. ¶50,027 (6th Cir. 1/10/95), aff'g, rev'g and remanding 822 F. Supp. 455, 93-2 U.S.T.C. ¶50,425 (W.D. Mich. 1993). Follows 5th and 2d Circuits in requiring actuarial assumptions with respect to individual defined benefit plans to be reasonable in the aggregate — as opposed to being "not substantially unreasonable" and required that this determination be made on an annual basis. Remanded for this determination in light of errors with respect to retirement age and mortality table errors. The court held the "actuary's best estimate" test to be procedural, and not substantive.

4. . . . and a fourth! Citrus Valley Estates Inc. v. Commissioner, 95-1 U.S.T.C. ¶50,132 (9th Cir. 3/8/95), aff'g and remanding 99 T.C. 379 (1992). The best estimate provision of §412(c)(3) is satisfied by actuarial assumptions that fell on the conservative end of the acceptable range. Two of the 12 cases were remanded for a determination as to whether past employment was properly counted towards the §415 maximum benefit. Judge Hall's opinion disagrees with the holding in Mirza [882 F.2d 229, 89-2 U.S.T.C. ¶9492 (7th Cir. 1989)] that §415(b) limits must be taken into account in allocating plan benefits between normal cost and past service liability, stating:
an individual defined benefit plan that does not assume past service liability may, consistent with the unit credit funding method, allocate to normal cost the entire amount of benefits that accrue in a particular plan year and take an immediate deduction under §404(a).

The court noted that the type of large, up-front funding that occurred in these cases is not possible after the 1986 Act amendment to §415(b)(5) in which the §415(b)(1) dollar limitation is phased in over the first 10 years of participation in the plan rather than 10 years of service with the plan sponsor.

5. The end of a “noble experiment.” IR-95-43 (6/7/95). IRS announced that it will expedite the resolution of more than 2,000 pending small pension plan cases involving actuarial assumptions (following the Solicitor General's decision that the government will not seek certiorari in the Citrus Valley Estates case).

**F.** Employer allowed current deduction for “interest” accrued on nonqualified deferred compensation; rehearing granted. Albertson's Inc. v. Commissioner, 94-1 U.S.T.C. ¶50,016 (9th Cir. 12/30/93), rev'g 95 T.C. 415 (1990). Taxpayer is entitled to claim current deductions for interest-like obligations that had accrued under nonqualified deferred compensation agreements made with certain of its top executives and directors. The court held that: (1) the additional payments were §163 interest because they were "compensation for the use or for forbearance of money," and (2) the timing restrictions of §§404(a)(5) and (d) did not prohibit taking the deductions because these restrictions apply to compensation deductions but not to §163 interest deductions. Motion for rehearing granted, 3/31/94.

1. Notice 94-38, 1994-17 I.R.B. 21. The IRS has suspended acceptance of requests for a change in accounting method from taxpayers that seek to follow the Albertson's decision.

2. Opinion on rehearing vacates earlier decision allowing deduction. Albertsons Inc. v. Commissioner, 42 F.3d 537, 94-2 U.S.T.C. ¶50,619 (9th Cir. 12/5/94), vacating on rehearing 94-1 U.S.T.C. ¶50,016 (9th Cir. 12/30/93) and aff'g 95 T.C. 415 (1990). Held, on rehearing, accrual method taxpayer is not entitled to claim current deductions for interest-like accruals under nonqualified deferred compensation agreements with certain of its top executives and directors because the "matching principle" of income to recipients and deductions to payor is the key to §404(a)(5) and (d), and "to hold the additional amounts to be deductible would contravene the clear purpose of the taxation scheme Congress created to govern deferred compensation plans." The court refused "to adopt a plain language interpretation of a statutory provision that directly undercuts the clear purpose of the statute."

**G.** VEBA safe harbor may not be used. General Signal Corp v. Commissioner, 103 T.C. 216 (8/22/94). Taxpayer was not entitled to use the §419A(c)(5)(B)(ii) safe harbor limitation [of 35% of qualified direct costs for the immediately preceding
taxable year] in computing an addition to its account limit for incurred but unpaid medical claims because the so-called "safe harbor" only allows taxpayer to claim amounts at or below this threshold without obtaining an actuarial certificate, and does not allow taxpayers to create reserves that are not themselves reasonable.

H. Wellons, M.D., S.C. v. Commissioner, 94-2 U.S.T.C. ¶50,402 (7th Cir. 8/4/94). Amounts contributed by cardiovascular surgeon ($194,000 in each of two years) to a severance plan trust that paid no benefits because no employees were terminated during that period were not deductible as ordinary and necessary business expenses, but had to be deducted under §404(a)(5) only in the years payments were made to employees.

I. Furlong v. Commissioner, 94-2 U.S.T.C. ¶50,491 (7th Cir. 9/19/94). Retroactive application of §72(p)(1)(A) [enacted 9/3/82, effective 8/13/82] to a loan taken from a qualified pension plan was constitutional because the provision did not constitute a "wholly new tax" and, at the time the loan was taken out (8/25/82), it was reasonably foreseeable that the loan would be taxable. The court noted that the final form of the provision was passed by both houses of Congress on 8/19/82, six days before the loan transaction.

*J. “Rules” for FICA payment on deferred compensation in year earned. Notice 94-96, 1994-2 C.B. 564. The FICA/FUTA obligation on nonqualified deferred compensation is to be taken into account as of the later of (1) when the services are performed and (2) when there is no substantial risk of forfeiture of the right to the amount of deferred compensation. The IRS will not challenge an employer determination of FICA/FUTA liability based on a reasonable, good faith interpretation of §§3121(v)(2) and 3306(r)(2).

K. Proposed and final amendments to §83(h) regulations. EE-81-88, proposed amendments of regulations under §83(h) to eliminate the special rule that requires an employer to deduct and withhold income tax as a prerequisite for claiming a deduction for property transferred to an employee in connection with the performance of services (F.R. 12/5/94). The employer, however, must file a timely Form W-2 or Form 1099. T.D. 8599, final regulations amending Reg. §1.83-6 adopted (7/18/95).

L. T.D. 8581, amending final regulations governing cash or deferred arrangements (CODAs) and employee and matching contributions under employee plans (12/22/94).

M. Announcement 95-33, 1995-19 I.R.B. Final examination guidelines that the IRS will use when examining employee plans for joint and survivor issues and for single-sum distribution requirements. The IRS has also issued proposed guidelines pertaining to ESOPs, top-heavy plans, tax sheltered annuities, and limitations for defined contribution plans.

*N. ERISA plan amendment procedure – consisting of standard reservation clause – approved. Curtiss-Wright Corp. v. Schoonejongen, 115 S. Ct. 1223 (U.S., 3/6/95), rev’g and remanding 18 F.3d 1034 (3d Cir. (1994). Employee benefit plan was properly amended to eliminate postretirement health care coverage. ERISA §402(b)(3) requires plan documents to contain a valid
procedure for amending [the] plan, and for identifying the persons who have
authority to amend the plan." The standard reservation clause contained in the
plan constitution and in a few secondary documents, "The Company reserves the
right at any time and from time to time to modify or amend, in whole or in part, any
or all of the provisions of the Plan," was unanimously held to have established a
procedure for amending the plan. This procedure was that the plan could be
amended by those persons who, under established principles of corporate law,
have authority to act on behalf of the company.

5/30/95). Doctors were unsuccessful in arguing that one of two plans for which
excessive duplicate contributions were deducted was unqualified [although IRS
determination letters had been received for both plans] in order to avoid
overfunding penalties. The doctors argued that, because the two plans were part
of the same controlled group, the contributions in excess of §415 limits caused the
disqualification.

P. **Rollover to spouse's IRA, not done pursuant to prior QDRO, fails to qualify.**
**Radoni v. Commissioner,** 105 T.C. No. 3 (7/24/95). Lump sum distribution to
employee from qualified profit sharing plan, followed by its transfer within 60 days
to employee's wife' IRA does not qualify as a tax-free rollover under either
§402(a)(5) (because IRA must be for the employee's benefit) or §402(a)(6)(F) (not
pursuant to QDRO because [among other defects] the court order was issued
subsequent to the distribution).

Q. **Brotman v. Commissioner,** 105 T.C. No. 12 (8/24/95). Taxpayer received a cash
payment from a profit-sharing plan in which her ex-husband participated pursuant
to a purported QDRO. She subsequently sued her ex-husband and the plan
administrator in federal district court on whether the purported QDRO complied
with ERISA §206(d)(3), on which the court granted summary judgment for the
defendants based on the conclusion that the order met the ERISA definition of a
QDRO. Held, taxpayer is collaterally estopped by that decision from contending
that the order did not comply with I.R.C. §414(p) [which mirrors ERISA §206(d)(3)],
but is not collaterally estopped from attacking the tax-exempt status of the plan.

R. T.D. 8619, final regulations relating to eligible rollover distributions from tax-
qualified retirement plans and §403(b) annuities to reflect the changes made by the
Unemployment Compensation Amendments of 1992 [20 percent income tax
withholding on "eligible rollover distributions"] (9/15/95). See also, T.D. 8620 and
EE-24-93, temporary and proposed regulations relating to the notice, consent and
election requirements under §411 and to the notice and election requirements of
§417 [based, in part, upon Notice 93-26] (9/15/95).

VI. **Exempt Organizations and Charitable Giving**

* A. **Substantiation requirement relief applies for 1994 tax year.** Notice 95-15,
requirement for the 1994 tax year for taxpayers who either (1) obtain proper written
acknowledgment by 10/16/95 or (2) make a good-faith effort (such as by sending
the charity a letter request) to obtain proper written acknowledgment by 10/16/95.
*B. Proposed substantiation regulations. IA-44-94, proposed regulations under §170(f)(8) on substantiation of charitable contributions (8/4/95). Follows United States v. American Bar Endowment, 477 U.S. 105 (1986), to determine whether payment is deductible, i.e., (1) the taxpayer must intend to make a payment in an amount that exceeds the fair market value of goods or services received in return, and (2) must actually make a payment in an amount that exceeds that fair market value. Permits benefits to be disregarded if given as part of an annual membership in return for a payment of $75 or less and consists of (1) admission to events open only to members for which the cost per person is $6.60 or less (with COLA, as provided for low cost articles under §513(h)(2)(C)), or (2) rights or privileges members can exercise frequently, e.g., free admission to a museum.

*C. “Royalty” payments not UBIT... Sierra Club, Inc. v. Commissioner, 103 T.C. 307 (8/24/94). Consideration received by tax-exempt organization on account of its participation in an "affinity card" program was royalty income, and not UBIT, following Disabled American Veterans v. Commissioner, 94 T.C. 60 (1990), rev’d on other grounds, 942 F.2d 309, 91-2 U.S.T.C. ¶50,336 (6th Cir. 1991).

*D. ... but payments not royalties. Texas Farm Bureau v. United States, 95-1 U.S.T.C. ¶50,297 (5th Cir. 6/1/95), 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.

E. Step transaction doctrine applied where ultimate result was intended, even though parties were not bound. Hearst Corp. v. United States, 93-1 U.S.T.C. ¶50,303 (Fed. Cl. 5/4/93). Taxpayer failed to show the value of its Hearst Metrotöne News File Library contributed to UCLA exceeded the $1.8 million allowed by the IRS. Although the donation took place in four deliveries over the years 1981-1985, the step transaction doctrine was applied to make sales occurring after the first (1981) delivery irrelevant for comparison purposes because “the substance of the transaction [revealed] that the ultimate result was intended from the outset,” following King Enterprises, Inc. v. United States, 418 F.2d 511, 69-2 U.S.T.C. ¶9720 (Cl. Cl. 1969) (which did not restrict the step transaction doctrine to situations where the parties have a binding commitment to take steps remaining after the first step).

1. But, reversed on step transaction issue. Hearst Corp. v. United States, 1994 U.S. App. LEXIS 25788 (Fed. Cir. 9/15/94) (unpublished), vacating and remanding 93-1 U.S.T.C. ¶50,303 (Fed. Cl. 1993). The court held the step transaction doctrine inapplicable because “[T]he essential purpose of the step transaction doctrine is to assure that the tax consequences of a transaction turn on its substance rather than its form,” and in this case substance and form did not diverge. The court held that, under Reg. §1.170A-1(b), "ordinarily, a contribution is made at the time delivery is effected," so it remanded for a determination of fair market value at each of the delivery dates.
*F. Michigan state education trust for college tuition held to be exempt from federal income taxation. State of Michigan v. United States, 94-2 U.S.T.C. ¶50,583 (6th Cir. 11/8/94) (2-1), rev'g and remanding 92-2 U.S.T.C. ¶50,424 (D. Mich. 1992). State education trust that guaranteed the payment of college tuition for children of parents who invest in the trust (by entering into advance tuition payment contracts) was not liable for federal income tax because Congress did not choose to tax the investment income of state agencies. Purchasers pay a stipulated sum, reflecting the number of years for which tuition is to be prepaid and the number of years before the beneficiary is expected to enter college. The Service had ruled in Ltr. Rul. 8825027 (3/29/88) that purchasers had no income or benefit at the time they executed their contracts [although they had income when tuition was paid from the trust], but that the trust's investment income was subject to federal income tax.

G. EE-48-90, proposed amendments to regulations, regarding excise taxes, etc., under §§4955, 6582 and 7409 [added by the 1987 Act], imposed upon political expenditures made by §501(c)(3) organizations (F.R. 12/14/94).

H. EE-41-86, proposed amendments of regulations under §§508 and 6033, relating to the definition of "integrated auxiliary" for purposes of exempting certain tax-exempt organizations, i.e., integrated auxiliaries of a church, from filing information returns (F.R. 12/15/94). Adopts the rules of Rev. Proc. 86-23, 1986-1 C.B. 564.

I. EE-56-94, proposed amendments to Reg. §53.4941(d)-2, clarifying the IRS position that it generally will not be self-dealing, or treated as the payment of compensation, if a private foundation indemnifies or provides [director's and officer's liability] insurance to a foundation manager in any civil proceeding arising out of the manager's performance of services on behalf of the foundation (F.R. 1/3/95).


K. Notice 95-1, 1995-2 I.R.B. (12/21/94). Proposed revenue procedure that would, if finalized, allow a taxpayer who had already contributed an item of art appraised at $50,000 or more to request from the IRS a "Statement of Value" that could be relied upon. The applicable user fee would be $3,000.

L. Newhall Unitrust v. Commissioner, 104 T.C. 236 (3/6/95). Charitable remainder unitrust under §664(d)(2) that received income as a member of three limited partnerships was in receipt of UBTI under §512(c), and (worse), under §664(c) as interpreted by Reg. §1.664-1(c) [held to be valid], it was taxable as a complex trust on its entire income.

M. Housing Pioneers v. Commissioner, 95-1 U.S.T.C. ¶50,126 (9th Cir. 3/7/95). Nonprofit corporation organized to provide affordable housing to "low income and handicapped persons" fails to qualify for §501(c)(3) tax-exempt status because it had a substantial nonexempt purpose of providing part of its federal and state tax benefits to its for-profit partner who was relieved of the necessity of maintaining rents at a level sufficient to cover operating expenses.
N. Rev. Proc. 95-21, 1995-15 I.R.B. 22 (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.


*P. Retaining professional sports team in town is a burden of government. Ltr. Ruls. 9530024, 9530025, and 9530026. Keeping Kansas City Royals baseball team in Kansas City served the charitable purpose of lessening the burdens of government. See also Ltr. Ruls. 9537035 through 9537053 (donor advisory funds not subject to chapter 42 excise taxes).

VII. Interest

A. Flood v. United States, 94-2 U.S.T.C. ¶50,454 (9th Cir. 8/31/94). Investment interest in excess of taxable income in the year paid, but "not allowable as a deduction" by reason of §163(d), may be carried over in full to subsequent years, following the Fourth Circuit Beyer case and the Federal Circuit Sharp case, despite "weak" legislative history to the contrary.

B. Rev. Rul. 95-16, 1995-8 I.R.B. 4. After a succession of defeats, the IRS conceded that the carryover of a taxpayer's disallowed investment interest to a succeeding taxable year under §163(d) is not limited by the taxpayer's taxable income in the year in which the interest was paid or accrued. The concession applies to both the pre-1986 Act and post-1986 Act versions of §163(d).

*C. Conduit financing regulations proposed, and now final. INTL-64-93, proposed regulations under §7701(l), relating to conduit financing arrangements (F.R. 10/14/94). Section 7701(l) was added by the 1993 Act and authorizes Treasury to "prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties," i.e., permit the IRS to disregard [for purposes of §§871, 881, 1441 and 1442] the participation of one or more persons in a conduit financing arrangement, where such recharacterization is appropriate to prevent tax avoidance. T.D. 8611, final conduit financing regulations adopt proposed regulations with few substantive changes (8/11/95). They do create a presumption that an unrelated (intermediate) financing entity engaged in a substantial trade or business does not know (or have reason to know) of a conduit financing transaction. See also, Rev. Rul. 95-56, 1995-36 I.R.B., which lists rulings on back-to-back loans rendered obsolete by final conduit financing regulations.

D. City of New York v. Commissioner, 103 T.C. 481 (10/11/94). On declaratory judgment, a bond issue of $100 million of which $15 million will be advanced to nongovernmental borrowers at low interest rates for purposes of rehabilitating low-income housing units does not meet the §141(c) provision limiting such loans to the lesser of $5 million or 5 percent of the bond issue proceeds. The city argued that, because the advances will be at 0-3 percent interest and the borrowing at 8.5
percent interest, the present value of all the payments the city will receive from the borrowers in repayment equals $4.8 million, with the remaining $10.2 million constituting a grant from the city to the borrowers [grants are not limited by §141(c)]. The court held that the loans may not be bifurcated, so they were in the amount of $15 million, based upon the plain meaning of the statutory language. The court noted that Congress was able to use time-value-of-money concepts when it chose, and it chose not to use these concepts in §141(c).

E. 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 (F.R. 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.

F. FI-33-94, proposed amendments to Reg. §1.1275-1, relating to the federal income tax treatment [i.e., for original issue discount purposes] of annuity contracts not issued by insurance companies. See also NationsBank v. Variable Annuity Life Ins. Co., 115 S. Ct. 810 (U.S. 1/18/95) (upholding Comptroller of the Currency determination that national banks may serve as agents in the sale of annuities).

G. Tippen v. Commissioner, 104 T.C. 518 (4/27/95). Payments of $850 per month by attorney in chapter 11 bankruptcy were not deductible as Schedule C business interest. The IRS had a secured interest in the $20,000 of receivables of the law practice, and the monthly payments were ordered as “adequate protection” to secure the IRS interest in that property that was susceptible to devaluation in the debtor’s hands. The attorney had argued that the payments were for his use of the receivables, and were therefore deductible as business interest. The court held that they were not equivalent to interest and, even if interest, were personal interest, following Commissioner v. Polk, 60-1 U.S.T.C. ¶9398 (10th Cir. 1960) (interest on tax deficiency deductible as business expense under §162 only where deficiency resulted from taxpayer’s understatement of business income).

H. Interest on Schedule C income tax underpayments is per se nondeductible personal interest. Miller v. Commissioner, 95-2 U.S.T.C. ¶50,485 (8th Cir. 9/5/95), affg 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].

*H.*
VIII. Nontaxable Exchanges

*A. Separated husband was required to reinvest only his half of the proceeds of the sale of personal residence, but is jointly liable for gain on wife’s half that was not reinvested. *Murphy v. Commissioner*, 103 T.C. 111 (8/12/94). Taxpayer and his then-wife realized a gain on the sale of their jointly owned residence on which they deferred recognition pursuant to §1034 by indicating their intention to purchase another residence within the 2-year permitted period. They were subsequently separated, following which taxpayer purchased a personal residence for himself and filed an amended joint return [which his wife refused to sign] reporting additional income to the extent taxpayer’s 1/2 share of the proceeds was not reinvested in the new residence; his wife did not purchase a new residence within the 2-year period. Held, taxpayer was entitled to compute his gain on sale of the jointly owned residence by taking into account only his 1/2 allocable share of the basis and net proceeds from the sale of the residence, Rev. Rul. 74-250, 1974-1 C.B. 202, but he was jointly and severally liable under §6013(d)(3) for the tax attributable to wife’s allocable 1/2 share of realized gain (all of which was immediately recognized).

Facts: Sale price = 475; cost = 290; H’s replacement house cost = 200; W did not purchase new house.

Comm’r: 475 AR - 290 AB = 185 gain (all recognized).

Taxpayer: 237 AR(1/2) - 145 AB(1/2) = 92 gain (55 of which is excluded under §1034, and 37 of which is recognized).

Court:: Recognize H’s 37 gain + W’s 92 gain = 129 total gain.

B. *Snowa v. Commissioner*, T.C. Memo. 1995-336 (7/25/95). Woman was required to recognize the entire gain on the sale of her prior residence because she did not maintain a new residence with her former husband, and her purchase of a new residence with her new husband did not suffice because only her half of the new residence counted as reinvestment. Taxpayer contended that she could have avoided gain recognition by acquiring the new residence in her name alone and later transferring an interest to her new husband, but the court stated that she did not do that.

C. Rev. Rul. 95-22, 1995-12 I.R.B. (2/28/95). Taxpayer must reinvest insurance proceeds, received upon the destruction of taxpayer’s principal residence and its separately scheduled contents as the result of a Presidentially declared disaster, in a replacement residence or any type of replacement contents (or both) in order to defer gain recognition under §1033. Under §1033(h)(1)(A)(ii), taxpayer recognizes no gain upon the receipt of insurance proceeds for unscheduled contents, regardless of the use to which he puts those proceeds.

IX. Partnerships

A. *Partnership Audit Rules*
1. Alexander v. United States, 95-1 U.S.T.C. ¶50,105 (5th Cir. 2/15/95), rev'g and remanding, 829 F. Supp. 199, 93-2 U.S.T.C. ¶50,536 (1993). On 5/18/88, taxpayer signed a Form 870-P settlement agreement, which was held to have converted the pertinent partnership items into nonpartnership items. About one year after payment of the resulting deficiency, taxpayer learned that the statute of limitations had expired on 4/15/88 [because of IRS failure to secure a proper extension] and brought a timely suit for refund. Held, the settlement did not completely waive taxpayer's right to a refund, but merely cemented the treatment of the partnership items.

2. Medical & Business Facilities, Ltd. v. Commissioner, 95-2 U.S.T.C. ¶50,394 (5th Cir. 7/25/95). Consents to extend the statute of limitations signed by a general partner [who had not been designated as TMP by the corporation] were not valid because another general partner had a larger profit interest.

B. Miscellaneous

*1. Limited liability companies


b. Revenue Procedure governing LLC classification rulings. Rev. Proc. 95-10, 1995-3 I.R.B. (12/28/94), modifying Rev. Proc. 89-12, 1989-1 C.B. 798 (which does not apply to LLC ruling requests). Conditions under which the IRS will consider a ruling request that relates to the classification of a domestic or foreign limited liability company as a partnership for federal tax purposes. The LLC must have at least two members and meet the conditions relating to the four corporate characteristics.

c. Rev. Rul. 95-37, 1995-17 I.R.B. 10, amplifying Rev. Ruls. 84-52 and 86-101. Guidance on the federal income tax consequences of the conversion of an interest in a domestic partnership into a domestic limited liability company that is classified as a partnership. There is no §708 termination of the partnership, its tax year does not close, and it continues to use the same taxpayer identification number.

d. EE-45-94, proposed regulations under §1402 [adding Reg. 1.1402(a)-18], relating to self-employment tax on [partnership-classified] limited liability company members (F.R. 12/29/94). Generally, a member's distributive share is subject to SECA tax; however, a member is treated as a limited partner for purposes of
the §1402(a)(13) limited partner exception if (1) the member is not a manager and (2) the entity could have been formed as a limited partnership [rather than an LLC] in the same jurisdiction and the member could have qualified as a limited partner in that limited partnership under applicable law.

e. Rev. Rul. 95-55, 1995-35 I.R.B. 13. New York general partnership, following its registration as a New York limited liability partnership, was classified as a partnership under the general rules of Reg. §301.7701-2. The partnership did not terminate under §708(b).

*2. Check the box? Notice 95-14, 1995-14 I.R.B. (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.

3. T.D. 8585, final regulations under §704(c), relating to the remedial allocation method with respect to property contributed by a partner to a partnership (12/27/94).

4. PS-76-92 and PS-51-93, proposed regulations under §§704 and 737, relating to the recognition of gain or loss on certain distributions of contributed property by a partnership under §704(c)(1)(B) and recognition of gain on certain distributions to a contributing partner under §737 (F.R. 1/9/95). Section 704(c)(1)(B) [added by the 1989 Act] provides for the contributing partner to recognize gain or loss on the distribution of the contributed property to another partner within 5 years. Section 737 requires the partner contributing appreciated property to recognize gain on the distribution of any property to him within 5 years to the extent of the lesser of (a) the net precontribution gain on the contributed property or (b) the excess of the value of the distributed property over the adjusted basis of the partner's partnership interest.

*5. 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 Halpem 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. *Antiabuse regulation*

a. Did the IRS hit a nerve? PS-27-94, proposed regulations §1.701-2, relating to an anti-abuse rule under subchapter K of the Internal Revenue Code (59 F.R. 25581, 5/17/94). Provides that "if a partnership is formed or availed of in connection with a transaction or series of related transactions . . . with a principal purpose of substantially reducing the present value of the partners' aggregated federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can disregard the form of the transaction." The Commissioner would be able to recast the transaction for federal tax purposes as appropriate based upon all of the facts and circumstances, "even if the taxpayer complies with the literal language of one or more of the provisions of the Internal Revenue Code or the regulations thereunder . . ." "The Commissioner can continue to assert and to rely upon applicable judicial principles and authorities (for example, the substance over form, step transaction, and sham transaction doctrines) to challenge abusive transactions."

i. Announcement 94-87, 1994-27 I.R.B. 124 (6/13/94). The IRS will use the Industry Specialization Program to provide National Office oversight of issues that arise from these proposed partnership antiabuse rules, with a new ISP team for partnership audits.

b. Same nerve, but with a little Novocain. T.D. 8588, final regulation (Reg. §1.701-2), providing an anti-abuse rule under subchapter K (12/29/94). Modifies proposed regulation as follows:

i. Final regulation provides that proper reflection of income will be treated as satisfied with respect to the tax consequences of a partnership that is bona fide and reflects substance where the ultimate tax results are clearly contemplated by a partnership tax provision, e.g., §732, the elective feature of §754 and the value-equals-basis rule in the §704(b) regulation. Also, the final regulation no longer provides that
the provisions of subchapter K are not intended to permit taxpayers "to use the existence of the partnerships to avoid the purposes of other provisions of the ... Code" – a provision intended to address aggregate/entity issues; instead, a new paragraph (e) is added to confirm the Commissioner's authority to treat a partnership as an aggregate of its partners as appropriate to carry out the purpose of any provision of the Code or regulations where there is abuse of entity treatment. Paragraph (f) contains examples: Ex. 1 – aggregate treatment to carry out purpose of §163(e)(5) high yield discount provision; Ex. 2 – same for §1059 extraordinary dividend provision; but Ex. 3 – OK to use partnership to subject U.S. shareholders to the look-through rules for foreign tax credit purposes [instead of the controlled foreign corporation rules].

ii. Paragraph (c) now sets forth several of the factors indicating that taxpayers had a purpose to reduce substantially their aggregate federal tax liability in a manner inconsistent with the intent of subchapter K.

iii. Numerous examples are contained in paragraph (d), including transactions that are consistent with the intent of subchapter K. Ex. 1 – OK to avoid entity-level tax; Ex. 2 – OK to avoid sub S shareholder requirements; Ex. 3 – OK to avoid indirect foreign tax credit in favor of the direct credit; Ex. 4 – OK to avoid corporate gain recognition rules of §§351(e) and 357(c); Ex. 5 – family partnership to conduct joint business activities OK, including use of valuation discount for gifts; but Ex. 6 – not OK to use family partnership for gifts of partial interests in vacation home; Ex. 7 – special allocations OK; Ex. 8 – special allocations with respect to nonrecourse financing of building that qualifies for §42 low-income housing credit OK; Ex. 9 – Partner with nominal interest and temporary partner in partnership used to generate artificial losses and shelter income from federal taxation not OK; Ex. 10 – plan to duplicate losses through absence of §754 election not OK; but Ex. 11 – failure to make §754 election OK; Ex. 12 – use of basis adjustments under §732 OK; but Ex. 13 – use of §732 under plan to distort basis allocations artificially not OK.

c. Anti-abuse regulation does not apply to transfer taxes. Announcement 95-8, 1995-7 I.R.B. (1/23/95). The partnership antiabuse regulation, Reg. §1.701-2, applies solely to income taxes; therefore, Examples 5 and 6 will be deleted because the regulation does not apply to transfer taxes.

i. T.D. 8592, final regulation amending Reg. §1.701-2 [the partnership antiabuse regulation] by removing Examples (5) and (6) [relating to transfer taxes] and adding Reg. §1.701-
2(h), which states that the regulation applies solely to income taxes (4/13/95).

7. Vecchio v. Commissioner, 103 T.C. 170 (8/15/94). Partnership's allocation of gain recognized in the year of the installment sale of its real property did not have substantial economic effect, so the gain had to be allocated in accordance with the partners' interests in the partnership under §704(b) resulting in $13,000 in additional gain to taxpayer. However, Commissioner's attempt to allocate $1,467,000 of additional gain from the sale to taxpayer for reasons including his post-sale acquisition of another partner's interest did not succeed because sufficient gain had to be allocated to the selling partner to bring its capital account to zero, with only the remainder allocated in accordance with the partners' interests.

8. T.D. 8678, final regulations amending Reg. §1.761-2, relating to the requirements that must be met by co-producers of natural gas subject to a joint operating agreement in order to make or maintain a §761 election out of subchapter K (12/22/94). Co-producers must use either the cumulative gas balancing method (cumulative method) or, (with the Commissioner's permission [to ensure that co-producers with different taxable year-ends properly take income and deductions into account]), the annual gas balancing method (annual method). Contains an anti-abuse rule under which the §761 election of co-producers using the cumulative method can be revoked if there is a determination that "a principal purpose" of shifting income, deductions, or credits is to avoid tax.

9. Rev. Rul. 95-24, 1995-13 I.R.B. 4 (3/8/95). Distribution to a partner of a bond in liquidation of its partnership interest is treated as an exchange for purposes of the §171(b)(4) amortizable bond premium provision and, for purposes of that provision, the partner's basis in the bond is limited to its fair market value immediately after the exchange. Cf., Reg. §1.1272-2(b)(6). For other purposes, the partner's basis in the bond is determined under §732 [basis of property distributed equals the basis of the partnership interest minus any money distributed in the same transaction].

10. Rev. Rul. 95-26, 1995-14 I.R.B. 6. The short sale of securities through a broker on a national securities exchange by a partnership creates a §752 partnership liability because the partnership has an obligation to return the borrowed securities. (The liability is presumably equal to the amount of cash received by the partnership in the short sale.)

11. Rev. Rul. 95-41, 1995-23 I.R.B. (5/17/95). First-tier allocations of nonrecourse liabilities under Reg. §1.752-3(a)(1) are not affected by §704(c). Second-tier allocations under Reg. §1.752-3(a)(2) must take into account remedial allocations of gain that would be made to contributing partner under Reg. §1.704-3(d), but not curative allocations under Reg. §1.704-3(c). Third-tier allocations under Reg. §1.752-3(a)(3) may or may not have to take §704(c) into account depending upon the method used for the allocations.
12. PS-013-88, proposed regulations under §7704 [added by the 1987 Act], relating the classification of certain publicly traded partnerships as corporations (F.R. 5/2/95).

X. Personal and Individual Income and Deductions

A. Miscellaneous Deductions and Credits

*1. Status of ministers for §67 two-percent floor on miscellaneous itemized deductions purposes. Weber v. Commissioner, 103 T.C. 378 (8/25/94). Ordained minister of United Methodist Church was held to be an employee of the UMC for federal income tax purposes, so his expenses constitute miscellaneous itemized deductions subject to the §67 two-percent floor. But see Shelley v. Commissioner, T.C. Memo 1994-432 (8/25/94) (International Pentecostal Holiness Church minister held to be an independent contractor because the IPHC did not have the same type of relationship with its ministers as did the UMC with Weber).

*2. Weber affirmed. Weber v. Commissioner, 95-2 U.S.T.C. ¶50,409 (4th Cir. 7/31/95) (2-1). Affirms per curiam Tax Court decision [103 T.C. 378 (1994)] holding United Methodist Church minister, paid by his congregation, to be an employee of the Methodist Annual Conference which guarantees him an annual salary. Dissent based upon Shelley v. Commissioner, T.C. Memo. 1994-432, appeal pending (11th Cir. 1995), where minister of International Pentecostal Holiness Church was held to be an independent contractor.


4. Baylin v. United States, 95-1 U.S.T.C. ¶50,023 (Fed. Cir. 1/5/95). Affirms summary judgment for the government that legal fees in a condemnation proceeding were a capital expenditure, and that the partnership's gross income included the portion of the condemnation award paid to its attorney as a contingent fee. After a jury award of $3.9 million, the case was settled on appeal, and the partnership received $10.6 million principal and $6.3 million interest. It sought to allocate the $4.0 million of legal fees ratably between principal and interest. Held, under the [Gilmore] "origin of claim" doctrine, the purpose of the proceeding was to recover the value of the property, not to obtain interest; therefore, there was to be no allocation because the attorney spent only a minimal amount of time on the interest portion of the claim. The legal fees served only to reduce the amount of gain on the condemnation — all of which was deferred under §1033.

5. Ranciato v. Commissioner, 95-1 U.S.T.C. ¶50,194 (2d Cir. 4/7/95), vacating and remanding T.C. Memo. 1993-536. Losses from pet store owned by electrician/real estate agent could be deductible (and not limited by §183) because business was run with profit motive — despite its "sloppy operation" and long period of losses — because of taxpayer's moderate financial status and the store's profitability during its first 18 years of operation.
6. **Hawronsky v. Commissioner**, 105 T.C. No. 8 (8/8/95). Physician who received a tax-exempt scholarship from the Indian Health Services Scholarship Program, pursuant to which he agreed to serve for 4 years in the Indian Health Service, was not permitted to deduct the treble damages he was required to pay the Department of Health and Human Services when he breached his service obligation because the payment was a §162(f) civil penalty.

7. **Fincher v. Commissioner**, 105 T.C. No. 11 (8/24/95). Corporate officer of S&L who lost uninsured deposits in his institution could not deduct his losses as casualty losses under §165(l) because he was not a “qualified individual” entitled to ordinary loss treatment under that provision.

B. **Miscellaneous Income**

*1. Discrimination damages*

a. Seventh Circuit, reversing Tax Court, holds age discrimination damages not excluded from income under §104(a)(2). **Downey v. United States**, 94-2 U.S.T.C. ¶50,441 (7th Cir. 8/30/94), rev’d 100 T.C. 634. Damages received in settlement of litigation under the Age Discrimination in Employment Act (ADEA), both the back pay and liquidated damages payments, are not excludable from taxation under §104(a)(2) because litigants under ADEA may not recover the broad range of compensatory damages for intangible elements of injury that characterize tort-type personal injury recoveries, which was a requirement for exclusion of Title VII damages under the holding of **United States v. Burke**, 112 S. Ct. 1867, 92-1 U.S.T.C. ¶50,254 (1992).

b. . . . But Ninth Circuit holds to the contrary. **Schmitz v. Commissioner**, 94-2 U.S.T.C. ¶50,455 (9th Cir. 8/30/94). The entire settlement received in an ADEA lawsuit, both back pay and liquidated damages, is excludable under §104(a)(2) because both the back pay and the liquidated damages [payable where the violation is willful] serve to compensate the victim of a tort-type injury, with the liquidated damages proportionate to plaintiff’s economic injury (and not to defendant’s wealth, as are punitive damages).

c. Supreme Court holds that age discrimination damages are not excludable under §104(a)(2). **Commissioner v. Schleier**, 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.


e. McKean v. United States, 95-2 U.S.T.C. ¶50,382 (Fed. Cl. 6/23/95). Cash payments of backpay to former flight attendants in settlement of a [pre-1991 amendments to Title VII of the Civil Rights Act of 1964] class action gender discrimination suit (based upon termination of employment upon marriage) are includible in gross income in their entirety — even where a portion of the backpay represents lost nontaxable fringe benefits — because cash received in lieu of fringe benefits may be used however taxpayers see fit, and therefore is taxable to them.

*2. Punitive damages. (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.)

a. Sixth Circuit: Punitive damages excludable under §104(a)(2). Horton v. Commissioner, 94-2 U.S.T.C. ¶50,440 (6th Cir. 8/29/94) (2-1), affg 100 T.C. 93 (1993). Punitive damages received by Kentucky homeowners after their home exploded due to the gross negligence of the gas company were excludable from income as §104(a)(2) personal injury damages because punitive damages in Kentucky "serve both to compensate the injured party and punish the wrongdoer."

i. Horton v. Commissioner, 100 T.C. 93 (2/9/93) (reviewed, 15-3). Taxpayers injured in a fire resulting from a gas explosion caused by utility's negligence could exclude $500,000 punitive damages under §104(a)(2) because the punitive damages were awarded by reason of a tort-type personal injury suit. Miller v. Commissioner, 93 T.C. 330 (1989), rev'd, 90-2 U.S.T.C. ¶50,515 (4th Cir. 1990), adhered to; the court tentatively distinguished the Fourth Circuit holding on the ground that Maryland punitive damages (in Miller) were "purely punitive," while Kentucky
punitive damages (this case) serve both to compensate the injured party and to punish the wrongdoer.

b. Federal Circuit: Punitive damages not excludable under §104(a)(2). *Reese v. United States*, 24 F.3d 228, 94-1 U.S.T.C. ¶50,232 (Fed. Cir. 5/16/94). Taxpayer was required to include in gross income punitive damages awarded to her in settlement of a suit ruled against her former employer for gender discrimination, sexual harassment and intentional infliction of emotional distress because the punitive damages were not received as compensation for personal injuries or sickness

i. *Reese v. United States*, 93-2 U.S.T.C. ¶50,447 (Fed. Cl. 7/29/93). Punitive damages received in 1987 by taxpayer in settlement (after trial) of her suit for sex discrimination, sexual harassment and intentional infliction of emotional distress were includable in gross income. The court based this conclusion on three reasons: (1) exceptions to §61 should be construed narrowly; (2) the title and subject matter of §104 focus exclusively on payments received as compensation for injuries or sickness; and (3) the historical context of the 1918 enactment of the predecessor to §104(a)(2) suggests an intention to exclude only compensatory payments. In 1989, §104(a) was amended to deny exclusion under §104(a)(2) of any punitive damages "in connection with a case not involving physical injury or physical sickness."

c. Ninth Circuit holds that punitive damages are not excluded from income under §104(a)(2). *Hawkins v. United States*, 94-2 U.S.T.C. ¶50,386 (9th Cir. 7/19/94) (2-1), rev'g and remanding 93-1 U.S.T.C. ¶50,208 D. Ariz. 1993). Punitive damages [$3.5 million] in insurance bad faith (tort) lawsuit against Allstate [in which $15,000 compensatory damages was also received] are not excludable under §104(a)(2) because they are "not necessarily awarded 'on account of' personal injury but are awarded 'on account of' the tortfeasor's egregious conduct."

d. Fifth Circuit: Punitive damages under Mississippi law not excludable under §104(a)(2). *Wesson v. United States*, 95-1 U.S.T.C. ¶50,186, 75 AFTR 2d 95-1540 (5th Cir. 3/30/95). Punitive damages awarded in a bad faith cause of action under Mississippi law are not excludable under §104(a)(2) because they were not awarded to compensate the taxpayer/plaintiff for her personal injuries, but to reward the taxpayer/plaintiff for bringing the tortfeasor to justice. Suit on life insurance policy canceled for nonpayment of premium 1-1/2 months before insured's death; the jury found that the company erroneously failed to utilize a premium loan provision and awarded $87,136 compensatory damages and $8 million [reduced to $1.5 million] punitive damages.
Punitive damages of $1.5 million received by beneficiaries of a life insurance policy in a bad-faith breach of contract action against Mutual Life Insurance Company of New York were not excludable from gross income under §104(a)(2) because under Mississippi law punitive damages are awarded not to recompense but to punish and deter.

**e.** Fifth Circuit holds punitive damages under Texas law not excludable from gross income under §104(a)(2). *Estate of Moore v. Commissioner*, 95-1 U.S.T.C. ¶50,299 (5th Cir. 6/2/95), rev’g T.C. Memo. 1994-4. Punitive damages awarded to the sole shareholder and president of a highway construction company in a malicious prosecution suit were not excludable from gross income under §104(a)(2) because under Texas law punitive damages are not compensatory. *Wesson v. United States*, 48 F.3d 894, 95-1 U.S.T.C. ¶50,186 (5th Cir. 1995), followed.

**3. Allocation of damage settlements**

**a.** General release payments by employer are not excludable. *Taggi v. United States*, 94-2 U.S.T.C. ¶50,470 (2d Cir. 9/12/94), aff’g 94-1 U.S.T.C. ¶50,085 (S.D. N.Y. 11/4/93). Amount of $19,800 [in addition to the $29,700 he received as a termination payment] received by terminated AT&T employee for signing a release of any claims he might have in connection with his employment or termination was not excludable under §104(a)(2) as an amount received on account of age discrimination because employee had made no ADEA claims against AT&T at the time he signed the release so there was no settlement in lieu of a legal suit or action based upon tort or tort type rights.

**b.** *Every v. United States*, 95-1 U.S.T.C. ¶50,229, 75 AFTR 2d 95-1639 (9th Cir. 4/4/95) (unpublished memorandum). Alaska salmon fishermen could not exclude their class action Exxon Valdez settlement award under §104(a)(2) because there was no evidence that they made any personal injury claims and the record did not show that Exxon knew that the settlement was for anything other than business losses.

**c.** Damages allocated between ordinary income and capital gain. *Gail v. United States*, 95-2 U.S.T.C. ¶50,458 (10th Cir. 6/27/95). Taxpayer received $250,000 compensatory and $65,000 punitive damages from defendants who forged her name on an oil and gas lease and kept the royalties. Held, the compensatory damages should be allocated between: (1) royalties taxpayer would have received [ordinary income], and (2) the amount of the diminution to the value of her real property [capital gain].

**4. Damages interest**
a. 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. 6/9/94), but instead adopted the analysis of Judge Beghe's dissent.

i. 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).

5. T.D. 8569, final regulations under §55, relating the computation of alternative minimum taxable income with respect to items that are determined by reference to adjusted gross income (11/23/94).


7. Estate of Reinke v. Commissioner, 95-1 U.S.T.C. ¶50,064 (8th Cir. 1/26/95). Coal lease payments received by lessor in connection with "surface use agreement" were ordinary income from rents and royalties in the absence of enough evidence to enable the court to estimate an amount as compensation for damages inflicted on the land during strip mining.

8. Chin v. United States, 95-1 U.S.T.C. ¶50,302 (9th Cir. 6/7/95). Although taxpayer (a world renowned specialist in malariology) entered into personal services contract with U.S. Agency for International Development to serve as malaria control officer to Pakistan, he was entitled to the §911 exclusion for amounts received under the contract because he was not an AID employee because AID did not intend to control (nor did it actually control) his activities. Language to the contrary in the personal services contract was ignored because the contract was improperly used in this nonemployee situation for the reason that it was easily and quickly entered into..

9. Life insurance premium kickbacks – taxation of insured and agent. The insured is taxable on whole life insurance premiums that were kicked back by the agent (whose commissions equaled 115% of first year premiums). Woodbury v. United States, 93-2 U.S.T.C. ¶50,528 (D. N.D. 8/30/93), aff'd per curiam without published opinion, 27 F.3d 572 (8th Cir. 1994). Taxpayers paid the first year premiums on two universal life policies, which premiums were rebated to them by their life insurance agents (who received commission of 115% of the first year premiums). The illegal rebates were includable in taxpayers' income because they either (1) shared in the agents' commissions or (2) received free universal life coverage for one year with a fair market value equal to the premiums paid. The court rejected taxpayers' arguments that the rebates were either: (1)
nontaxable reductions in purchase price or (2) income only in the value of
term insurance for one year. Alex v. Commissioner, 628 F.2d 1222, 80-2
U.S.T.C. ¶9689 (9th Cir. 1980) (dictum), followed in that the court there
saw no inequity in taxing the insureds on the amounts they received from
agents.

a. Insured is taxed on full premium rebated. Wentz v.
Commissioner, 105 T.C. 1 (7/5/95). Follows Woodbury on similar
facts (under the Golson rule). The fact that taxpayer was himself a
licensed insurance agent did not change the result because the
kickbacks were not gifts, citing Commissioner v. Duberstein, 363

b. Agent taxed on kicked-back commissions. Note, that life
insurance agent is also taxable on the commissions that are
received and kicked back — kickback not deductible by reason of
§162(c).

c. But, agent not taxed on waived commissions. Worden v.
Commissioner, 2 F.3d 359, 93-2 U.S.T.C. ¶50,521 (10th Cir.
8/30/93), rev'g and remanding T.C. Memo. 1992-447. Insurance
agent who sold first year coverage on life insurance policies "at
cost," remitting only the "net premium" [gross premium minus "basic
commission"] to the life insurance company was not taxable on the
"basic commission" income he had waived in contracts with his
clients. Taxpayer was not in constructive possession of the
commissions because his contract with the insurance company
permitted him to remit only the "net premium." Alex v.
Commissioner, 628 F.2d 1222, 80-2 U.S.T.C. ¶9689 (9th Cir.
1980), distinguished because there the agent was either (1) in
actual receipt of the commissions before passing them on to his
clients or (2) reported the commissions as income and deducted
the discounts in violation of §162(c). (Taxpayer made money on
"override commissions," which he received when his clients paid
subsequent years' premiums.)

10. Foreman v. United States, 95-2 U.S.T.C. ¶50,386 (Fed. Cir. 7/19/95) (2-1).
The court split on whether the "grandfather clause" contained in the
Revenue Act of 1962 [which generally placed a ceiling on the amount of
foreign earned income which could be excluded from taxation] allowed
exclusion of reimbursed moving expenses received in 1982 by reason of
taxpayer's 1952 contract providing for such reimbursement upon
termination of employment, which reimbursement could have been
excluded from income before the 1962 Act. The majority held that the
Foreign Earned Income Act of 1978, which completely overhauled the §911
exclusion, implicitly repealed the grandfather clause of the 1962 Act.
Dissent on the ground that repeal by implication is strongly disfavored and
that the 1978 amendments were entirely prospective and did not address
the grandfathered right to exclude income.
A. Penalties and Prosecutions

1. GL-32-94, proposed amendments of regulations under §3505, relating to the liability of lenders, sureties, or other third persons for withholding taxes when those persons have supplied funds for the specific purpose of paying wages to the employees of the borrower (F.R. 11/22/94). Revises maximum liability of the lender to 25% of the funds supplied, and changes the period of limitations from six to ten years.

2. United States v. Nordbrook, 94-2 U.S.T.C. ¶50,532 (9th Cir. 10/11/94). Affirms district court judgment against a tax return preparer (1) upholding IRS assessment of $75,000 under §6695 and (2) imposing a lifetime injunction under §7407(b) prohibiting the preparation of tax returns for others, by reason of his continual noncompliance with IRS requests under §6107(b) for information regarding the tax returns he had prepared.

3. Standards for corporate tax shelter penalty avoidance tightened. IA-55-94, proposed regulations under §§6662 and 6664, relating to when a taxpayer may rely upon the advice of others, as evidence of "reasonable cause and good faith," with respect to the substantial understatement penalty for tax shelter items of a corporation (F.R. 1/4/95). Implements changes made by §744 of Title VII of the GATT implementing legislation, which tightens standards applicable to corporate tax shelters to provide that "legal justification" may be taken into account only if (a) there is substantial authority for the treatment and (b) the corporation reasonably believes in good faith that the treatment is more likely than not the proper treatment.

   a. T.D. 8617, final regulations implementing changes to the §6662 accuracy-related penalty made by OBRA 1993 and the GATT Act (8/31/95).

4. Fisher v. Commissioner, 95-1 U.S.T.C. ¶50,113 (10th Cir. 1/23/95), rev'g and remanding T.C. Memo. 92-740. On assessment of [former §6661] substantial understatement penalties, remanded to require the Commissioner to reconsider the taxpayers' request for waiver [for which they had a credible argument] and to provide a written explanation for her decision. The Tax Court's finding — that there were adequate reasons for the Commissioner to have refused to waive the penalty — was held to be insufficient.

5. Estate of Owen v. Commissioner, 104 T.C. 498 (4/20/95). Undervaluation penalty for underreporting the value of a bank account [by deducting three undelivered gift checks found in decedent's car, each in the amount of $10,000, from the reported value of the account for estate tax purposes] was properly applied under former §6660 (now, §6662(g)).

6. Sloan v. Commissioner, 95-1 U.S.T.C. ¶50,251 (7th Cir. 4/24/95). "Typical tax protesters" who in the jurat of filed returns wrote "denials and disclaimers" of tax liability were properly denied joint return status and the IRS properly refused to accept those returns.
7. Announcement 95-41, 1995-21 I.R.B. 20. The IRS will continue through 9/30/96 its program to respond to requests for fact-of-filing information from firms in the tax professional community with respect to their employees and associates, i.e., partners.

8. Boatman v. Commissioner, T.C. Memo. 1995-356 (8/1/95). Doctor was liable for §6651 penalty for failure to timely file his 1990 tax return because the IRS properly voided his automatic extension of time to file because he failed to properly estimate his tax liability on the Form 4868 by remitting only $60,000 when his 1990 tax liability was $118,601 and his 1989 tax liability was $108,817. Taxpayer could not claim reliance on their accountant's advice because (1) he furnished no information to the accountant and (2) United States v. Boyle, 469 U.S. 241 (1985), holds that failing to timely file is generally not excused by relying on an accountant (or lawyer).

9. Allen v. United States, 95-1 U.S.T.C. ¶50,253 (11th Cir. 5/9/95). Refund of improperly assessed fraud penalties for 1975 and 1976 could be offset by levying delinquency and negligence penalties for those tax years [with respect to which taxpayer was criminally convicted, but on which the statute of limitations had run] because the government may reduce a refund by a setoff based upon “any tax payment ‘which might have been properly assessed and demanded.’”

10. Osteen v. Commissioner, 95-2 U.S.T.C. ¶50,465 (11th Cir. 8/25/95). Tax Court's upholding of assessment of [former §6661] substantial understatement penalty with respect to deductions taken by taxpayers in a horse breeding operation that was held to lack profit objective was reversed. The Eleventh Circuit found that there were both facts and law favorable to taxpayer's position, and the Tax Court's upholding of the penalty without “[articulation of] some consistent and workable test to justify the imposition of [the penalty] in all or nothing situations of this kind” was improper.

B. Summons

*1. Cash Payment Reporting

a. United States v. Sepenuk, 94-2 U.S.T.C. ¶50,422 (D. Ore. 8/2/94). Clients' identities were not protected by privilege for Form 8300 cash fee reporting purposes because attorney was unable to show (1) that such disclosure would provide a last link to an ongoing criminal investigation or (2) that the identity would ordinarily be considered to be part of the usual privileged information between attorney and client.

b. T.D. 8572 and IA-57-94, temporary and proposed regulations under §6050I, relating to the information reporting requirements of court clerks upon receipt of more that $10,000 in cash bail (12/12/94).
c. Attorney required to reveal one client's name, but another client's name protected by privilege. *United States v. Sindel*, 75 AFTR 2d ¶95-737 (8th Cir. 4/28/95). Based upon an examination of lawyer's in-camera testimony about special circumstances, the Eighth Circuit held that he need not release information to the IRS on Forms 8300 [required by §6050I] about two cash payments of $10,000 each made by his client Jane Doe because he could not do so without revealing the substance of a confidential communication [based upon the federal common law of attorney-client privilege, and not upon Rule 1.6 of the Missouri Rules of Professional Conduct]. With respect to a $53,160 cash payment made by John Doe, there was no privilege and the court rejected constitutional arguments under the Sixth, Fifth and First Amendments.

*d. Government assertions held “pretextual”; lawyers not required to reveal clients' names. *United States v. Gertner*, 95-2 U.S.T.C. ¶50,499 (1st Cir. 9/13/95). Lawyers [including one subsequently named to the federal district court bench] were not required in summons enforcement proceedings to disclose the identify of clients who paid large legal fees in cash because the government's boilerplate documentation linking the summonses to an investigation into the law firm's tax liability was "pretextual" to avoid complying with the John Doe summons requirements of §7609(f) [(1) summons relates to investigation of particular person or group of persons, (2) reasonable basis for believing failure to comply with internal revenue law, and (3) information not readily available from other sources] and insufficient to rebut the lawyers' detailed proofs that "the IRS's sole purpose in pursuing the summonses was to gain information about the lawyers' unnamed client." Similar boilerplate documentation had been approved in *United States v. Ritchie*, 15 F.3d 592, 94-1 U.S.T.C. ¶50,076 (6th Cir. 2/3/94).

*2. It is not a second inspection if it arises incidental to the examination of another year. *Digby v. Commissioner*, 103 T.C. No. 24 (9/7/94). No written notice under §7605(b) was necessary where, after an IRS agent examined taxpayers' 1987 return and determined a deficiency (which was paid), a second IRS agent auditing taxpayers' 1988 return with respect to loss pass-throughs from an S corporation determined that taxpayers had inadequate basis to claim losses in both the 1987 and 1988 years and disallowed the 1987 loss. The Tax Court held that review of the same records for another taxable year that results in a proposed deficiency for an already examined year is not a second inspection within the meaning of §7605(b).

3. *United States v. Administrative Enterprises, Inc.*, 95-1 U.S.T.C. ¶50,083 (7th Cir. 2/2/95). Summons issued by IRS to [Burton Kanter's] tax return preparer was enforceable even though there was a 3-1/2 year delay between the issuance of the summons and the enforcement proceeding because there was no expiration date on the summons. Latches was not applicable because the return preparer was not prejudiced by the delay.
The summons sought documents relating to "transactions with" Kanter, his family members, trusts, which the return preparer interpreted as meaning only transactions between herself and Kanter, etc.; Judge Posner stated that while grammar favored the return preparer, the district court ruling [that transactions between Kanter and his relatives or trusts were covered] was more sensible.

*4. The Tax Court takes navel gazing to a new height; attorney-client privilege and work product doctrines applied. *Bernardo v. Commissioner*, 104 T.C. No. 33 (6/20/95) (Wells, J.). Taxpayers claimed a $593,000 charitable contribution deduction for the donation of a 21-foot granite sculpture by Dimitri Hadzi entitled "Omphalos" [navel] to the Massachusetts Bay Transportation Authority; the sculpture is currently situated in Harvard Square. The Commissioner contended that the deduction should be limited to $100,000. Commissioner sought documents from CPA, Lawyer and Appraiser. CPA was taxpayer's regular return preparer; Lawyer was retained in connection with this gift; Appraiser was retained by Lawyer [but not paid by him]. Held:

a. Attorney-client privilege does not exist with respect to CPA communications because he was taxpayers' primary representative and did not have a letter of engagement from Lawyer. Privilege exists with respect to Lawyer and Appraiser, but it was waived with respect to documents intended to be disclosed to the IRS in the taxpayers' return.

b. Commissioner contended that only documents prepared after the notice of deficiency was issued were prepared in anticipation of litigation, to be eligible for work product protection; the court held that documents prepared after the IRS informed taxpayers of the Art Advisory Panel's findings were prepared in anticipation of litigation.

c. With respect to information sought by taxpayers, IRS counsel's notes were work product, draft notices of deficiency were irrelevant in that they would not lead to the discovery of admissible evidence, appeals officer's memorandum was work product prepared in response to IRS counsel comments.

d. Art Advisory Panel notes were discoverable because executive privilege exists to protect candor of intragovernmental communications; confidentiality of the Panel's meetings is provided only to protect the disclosure of confidential tax return information.

5. *Speck v. United States*, 95-2 U.S.T.C. ¶50,341 (9th Cir. 6/26/95). Owners of a taxicab company have no right to "quash" IRS's use of "circular letters" [drafted in compliance with IRM section 347.2] because the letters are not §7602 summonses (to which the §7609 third-party summons provisions would apply), and taxpayers have no general right to intervene whenever the IRS makes inquiries of third parties.
C. Litigation Costs

*1. Litigation costs awarded when government is "circuit shopping." Albritton v. Commissioner, 94-2 U.S.T.C. ¶50,550 (5th Cir. 10/25/94) (per curiam). On government's appeal from Tax Court holding that §163(d) carryover is not limited by taxable income in the year it arose, held that government's appeal constitutes "circuit-shopping" at taxpayer's expense in the hopes of creating a circuit conflict, and invites taxpayer's counsel to file application for §7430 litigation costs, stating "... while Commissioner is free by law to relitigate prior lost issues in other circuits, [s]he does so at the risk of incurring the obligation to reimburse the taxpayer." Query whether taxpayer could meet the $2 million or under net worth requirement of 28 U.S.C. §2412(d)(1)(B)(i), made applicable by §7430(c)(4)(A)(iii).

2. Bouterie v. Commissioner, 94-2 U.S.T.C. ¶50,580 (5th Cir. 11/18/94), rev'd T.C. Memo. 1993-510. Litigation costs awarded taxpayer in opposing IRS determination that half her ex-husband's insurance renewal commissions were income to her because she had not yet (actually or constructively) received the commissions and the commissions were not (Louisiana) community property, but rather property subject to a co-ownership interest. The IRS was "wholly unjustified" in taking the position that the commissions were community property based upon the court ruling in taxpayer's divorce [which so stated], because IRS lawyers in Louisiana should have known that when Louisiana courts said "community property" they meant "property subject to a co-ownership interest." Even though husband did not file tax returns for the years in question, the court held that IRS taking contradictory positions with respect to the commission income was not justified to avoid a whipsaw situation.

*3. Fifth Circuit adheres to $75 per hour. M. Lane [sic] Powers v. Commissioner, 43 F.3d 172, 95-1 U.S.T.C. ¶50,086 (5th Cir. 1/26/95). Tax Court reversed and litigation costs for three of four time periods in question were awarded, as were litigation costs on appeal. However, expertise in tax law is not a "special factor" as to warrant hourly rates for his attorneys higher than the statutory rates ($75 plus COLA) because almost all attorneys seeking compensation under §7430 possess an expertise in tax law, distinguishing Bode v. United States, 919 F.2d 1044 (5th Cir. 1990), distinguished because that tax case also required "a special knowledge of the quarterhorse industry."

a. Powers v. Commissioner, 95-1 U.S.T.C. ¶50,300 (5th Cir. 4/13/95). Taxpayer entitled to recover litigation costs because IRS position was unreasonable, based upon the percentage of the issues upon which he prevailed.

4. Nalle v. Commissioner, 95-2 U.S.T.C. ¶50,333 (5th Cir. 6/20/95). Litigation costs denied because the IRS's defense of the disputed regulation was not substantially unjustified.

5. Nicholson v. Commissioner, 95-2 U.S.T.C. ¶50,403 (3d Cir. 7/24/95). Litigation costs awarded to tax shelter investor because IRS was
unreasonable in determining he was not at risk because he was at risk under an "economic reality test."

D. Statutory Notice

1. **Gille v. United States**, 94-2 U.S.T.C. ¶50,428 (10th Cir. 8/17/94). Notice of deficiency was valid where sent to taxpayer's to the address listed in taxpayer's last tax return filed even though taxpayer's wife notified the IRS of a new address for herself [which she used listed in subsequent married-filing-separate returns] because the IRS – though it must use reasonable diligence – need not rely on address information about taxpayer submitted by a third party.

2. **Estate of Mitchell v. Commissioner**, 103 T.C. 520 (10/26/94). The extended due date of estate tax return was Saturday, July 21, 1990; the return was sent by certified mail in an envelope which bore a postmark of Friday, July 20, 1990 and was delivered to the IRS on Monday, July 23, 1990; the notice of deficiency was mailed to the estate on Saturday, July 21, 1993 [sic: 7/21/93 is a Wednesday]. Held, the notice of deficiency was timely because the 7/20/90 date of mailing is the date of filing under §7502 only where the return is both mailed or postmarked on or before its due date and delivered after the filing date prescribed "under authority of any provision of the internal revenue laws," which did not apply here because the due date of the return is extended by §7503 [act to be performed on Sat., Sun. or holiday is timely performed if done on the next succeeding day which is not a Sat., Sun. or holiday] to Monday 7/23/90, so the estate tax return is deemed filed on the date it was delivered to the IRS, Monday 7/23/90.

*3. Appeals court finds statutory notice valid, but extends time to file petition to Tax Court. **Gaw v. Commissioner**, 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.

*4. Taxpayer who refuses certified mail from IRS is held to have "actual notice" of the notice of deficiency. **Patmon & Young v. Commissioner**, 95-1 U.S.T.C. ¶50,275 (6th Cir. 5/23/95), aff'd T.C. Memo. 1993-143. Notice of deficiency (whether or not sent to "last known address") held valid under §6212 if taxpayer had "actual notice" of the notice of deficiency. Taxpayer received notice of the certified mail and refused delivery [as opposed to merely leaving it unclaimed]; that was held sufficient because
taxpayer should not be allowed to defeat actual notice by refusing to accept
delivery when it receives the "notice of the notice."

E. Statute of Limitations

1. **Clark v. United States**, 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.

2. **Lundy v. IRS**, 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.

3. **Kelley v. Commissioner**, 95-1 U.S.T.C. ¶50,062 (9th Cir. 1/23/95), aff'g T.C. Memo. 1990-158. Tax Court had limited equitable power to reform Forms 872-A to extend the statute of limitations where the computer-generated forms had a printed reference to the 1979 tax year and handwritten references to the 1978 and 1980 tax years. **Buchine v. Commissioner**, 20 F.3d 173, 94-1 U.S.T.C. ¶50,221 (5th Cir. 1994), followed.

4. **Kaggen v. IRS**, 95-1 U.S.T.C. ¶50,304 (2d Cir. 6/6/95). Taxpayers agreed to extend the §6502 period for collection after assessment. During the extended period, Congress [in the 1990 Act] extended the statute from six to 10 years. The 10-year period expired 10 years from the date of the assessment because the statute was open at the time the legislation was enacted. On a separate issue, the §6335 “notice of seizure” requirement was satisfied after levy upon bank accounts by the bank giving notice in the monthly statements sent after the levies had been honored.

5. **United States v. Wright**, 95-1 U.S.T.C. ¶50,334 (7th Cir. 6/14/95). IRS was not time-barred in suing to collect from a bankrupt partnership's partners [who were never in bankruptcy] because the bankruptcy tolled the partnership's statute of limitations and the partners were derivatively liable for the partnership's liabilities. Statute of limitations for collection from alleged partners of bankrupt partnership remained open for 11 years because its running as against the partnership was suspended during the
bankruptcy and there is only one underlying period per tax debt, no matter how many different persons may be liable on the debt.

- Closing agreement does not terminate Form 872-A extension. *Silverman v. Commissioner*, 105 T.C. No. 13 (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].

F. **Miscellaneous**

- **Innocent Spouse**
  
  a. Non-spouse not entitled to innocent spouse provision, but remanded for consideration of equitable relief. *Freck v. IRS*, 94-2 U.S.T.C. ¶50,518 (3d Cir. 10/6/94), vacating and remanding 810 F. Supp. 597, 93-1 U.S.T.C. ¶50,049 (M.D. Pa. 1993). Unmarried woman, who filed joint returns with one Cameron (whose common law wife she innocently but erroneously thought she was) and had no income herself, could not rely on the §6013(e) innocent spouse provision because she was not a spouse. On remand, the district court was ordered to consider whether equitable principles limited the IRS's possible recovery from her to the difference between Cameron's tax liability as a single filer and the liability the IRS incorrectly assessed against him by reason of taxpayer's innocent misrepresentation of the couple's right to joint filing status.

  b. Husband's estate lacks standing to challenge ex-wife's innocent spouse claim. *Estate of Ravetti v. United States*, 94-2 U.S.T.C. ¶50,524 (9th Cir. 10/11/94). Estate of deceased husband lacked standing to challenge IRS determination that the decedent's ex-wife was an innocent spouse because the determination did not affect the husband's liability for taxes owed [which was joint and several, regardless of whether wife was an innocent spouse]. (The divorce decree provided for the spouses to share equally on any past tax liabilities, except that husband was solely liable if wife "should be judicially determined to be an 'innocent spouse' in relationship to such tax [liability]." The court further stated that res judicata would not apply because husband's estate was not a party in wife's innocent spouse adjudication.)

  c. Tax shelter investor's wife properly relied on his advisors. *Friedman v. Commissioner*, 95-1 U.S.T.C. ¶50,235 (2d Cir. 4/26/95), reversing and remanding Tax Court. Innocent spouse treatment found for wife of tax shelter investor who took almost $3,500,000 of deductions based upon an investment of $170,000. Wife was held to have made proper inquiry about the deductions when she asked her husband about them and was told that they
were from a tax shelter and "not to worry about them," and she properly relied upon the accountant and financial experts advising her husband.

d. Attorney's ex-wife not innocent spouse. Bliss v. Commissioner, 95-2 U.S.T.C. ¶50,370 (2d Cir. 7/12/95) (2-1). Attorney's ex-wife was not an innocent spouse because (1) her attorney had subpoenaed her husband's firm's financial statements which showed he had substantially more compensation from the firm than reported on their tax return, and (2) she benefited from the understatement by splitting a refund with her ex-husband during the divorce proceedings.

"2. 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. ¶50,085 (5th Cir. 12/29/92) (2-1), affg, 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.

a. 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].
3. Improper Disclosure of §6103 Tax Return Information

a. **Hrubec v. National Railroad Passenger Corp.,** 75 AFTR 2d 95-1527 (7th Cir. 3/13/95). Taxpayer's federal damage suit against Amtrak employees for wrongful acquisition and disclosure of his tax return information was dismissed because the §6103 ban on unauthorized disclosures was inapplicable to persons who obtained taxpayer information improperly.

*b.* Circular letters not sent in good faith. **Barrett v. United States,** 95-1 U.S.T.C. ¶50,232 (5th Cir. 4/20/95), rev'd 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.

c. **United States v. Bischoff,** 95-1 U.S.T.C. ¶50,308 (5th Cir. 4/26/95) (opinion designated as not for publication). Affirms dismissal of [Federal Rules of Criminal Procedure] Rule 6(e) [violation of grand jury secrecy] claims without prejudice because remedy is filing suit against official in individual capacity. Reverses dismissal of §6103 claims and remands because district court interpreted "return information" too narrowly in that there does not have to be a nexus between the disclosed information and an investigation of possible criminal tax offenses; the disclosed information merely has to be data that the IRS has collected about a return.

*4. Transferee liability is limited to that amount received by the transferee, plus interest,... **Baptiste v. Commissioner,** 29 F.3d 1533, 94-2 U.S.T.C. ¶60,178 (11th Cir. 8/29/94), aff'd and rev'd 100 T.C. 252 (1993). Recipient of proceeds of an insurance policy on his father's life in the amount of $50,000 in 1981 was liable as a transferee under §6324(a)(2) for unpaid estate taxes up to that amount [based upon a 1988 stipulated Tax Court decision that the amount of $62,378.48 was due for estate taxes on his father's estate], plus interest from the 1982 due date of the estate tax return because the interest liability is not subject to the "value of the assets" limitation contained in §6324(a)(2) (which itself is governed by the §6901(a) transferee liability provisions that allow for the imposition of §6601 interest as if the transferee liability were a tax liability).

a. ... or just to the amount received. A contrary result was reached by the Eighth Circuit in an appeal from the Tax Court decision by
5. **Rules allow offsets of underpayments by tax refunds for interest-computation purposes.** Rev. Rul. 94-60, 1994-2 C.B. 89 (9/2/94). Rules for calculating the interest due on an underpayment when the taxpayer has previously received a tax refund with interest for the same tax year.


7. **Kmart Corp. v. United States,** 94-2 U.S.T.C. ¶50,502 (Fed. Cl. 8/11/94). Summary judgment granted to government with respect to refund claim on WIN credit following the Form 870-AD waiver of restrictions on assessment for years in which two issues [$482 and WIN credit] were open based upon equitable estoppel because the execution of the form was based upon mutual concession and there was no reservation of the WIN credit issue on the reverse side of Form 870-AD (as required byIRM 8822) — even though the appeals officer involved submitted an affidavit that he believed that taxpayer did not forfeit its legal remedies with respect to the WIN credit issue.

8. **GL-548-87,** proposed regulations under §6867, relating to the presumptions (for jeopardy and termination returns purposes) that arise where the owner of a large amount of cash or its equivalent is not identified (F.R. 9/29/94).

9. **Argabright v. United States,** 94-2 U.S.T.C. ¶50,476 (9th Cir. 9/14/94). Decisions to abate interest by reason of IRS's delay of assessment under §6404(e)(1) are committed to IRS discretion by law and judicial review is precluded, following the Tenth Circuit in Selman and the Eleventh Circuit in Horton Homes, Inc. [§6404(e) authorizes IRS to abate interest, but does not mandate it, nor does it provide a meaningful standard against which to judge the IRS's exercise of discretion].

10. T.D. 8568, final regulations under §6334, regarding property exempt from levy (10/20/94).

11. T.D. 8571, amendments of regulations under §6050H, relating to the reporting requirements for recipients of prepaid interest in the form of points paid on residential mortgages [including seller-paid points] (F.R. 12/7/94).


Examination Program (CEP) cases that are already in the Appeals administrative process and that are not docketed in any court.

14. **United States v. Forma**, 42 F.3d 759, 95-1 U.S.T.C. ¶50,012 (2d Cir. 12/19/94), vacating and remanding 93-1 U.S.T.C. ¶50,076 (S.D.N.Y. 1993). Taxpayers may not obtain an affirmative recovery for their tax counterclaim in an action brought by the government to recover tax deficiencies because the district court lacked subject matter jurisdiction over the counterclaim in the absence of a payment in full and the filing of an administrative claim for refund with the IRS. Held: sovereign immunity is not waived as to counterclaims by the filing of a claim by the government.


16. **Hemmings v. Commissioner**, 104 T.C. 221 (2/6/95). Government is not precluded from issuing a notice of deficiency with respect to tax years that had been the subject of a district court refund suit that concluded in summary judgment for the government because the claim for unassessed additional taxes is not a compulsory counterclaim in a refund suit. Inasmuch as the first action ended in government’s favor, it is not bound by collateral estoppel. (The case arose out of ContiCommodity Services trading accounts which taxpayers contended were fictitious in litigation with Conti and they contended were legitimate in their district court refund claim.)

17. T.D. 8589, final regulations relating to user fees for entering into, restructuring, or reinstating installment agreements with the IRS (2/10/95).

18. **O’Bryant v. United States**, 49 F.3d 340, 95-1 U.S.T.C. ¶50,143 (7th Cir. 3/13/95). IRS could not use §6502 [based upon the original assessment] to collect an erroneous refund of the payment made by taxpayer because the assessment was extinguished when taxpayers paid their liability. The IRS in these circumstances may proceed by a §7405 erroneous refund action or a new assessment.

19. IRS News Release IR-95-38 (5/3/95). Consolidation of seven existing regional headquarters into four on 10/1/95, as well as consolidation of 63 district headquarters offices into 33. The current three Texas offices will keep the same boundaries, but Austin will be renamed South Texas and Dallas, North Texas.

*20. IRS appraisers are not subject to “gotcha” under a state appraisal licensing statute. **Utilicorp United Inc. v. Commissioner**, 104 T.C. No. 32 (6/7/95). Taxpayer sought to exclude from evidence the reports and testimony of Commissioner’s expert witnesses with respect to allocation of the price paid for a 50% interest in a hydroelectric project located in Maine because they did not have State of Maine appraisal licenses, and Maine makes it unlawful for any person without a license to appraise for a fee real property located in the state (with an exception for real estate agents and brokers who prepare appraisals or opinions for other than for federally...
related transactions). Motion denied because the purposes of the Maine statute were to protect consumers and to meet the 1989 FIRREA requirement (following the S&L bailout) that appraisers be licensed, so the statute was inapplicable to the Commissioner's expert witnesses.

XII. Tax Shelters

A. **Levien v. Commissioner**, 103 T.C. 120 (8/12/94) (reviewed, 2 judges concurring). Taxpayer's "at risk" amount for losses on a computer leasing transaction was limited under §465(b)(4) because he was protected against economic loss by the presence of offsetting payments and bookkeeping entries, the circularity of the transaction and the existence of payment guarantees.

B. **Segal v. Commissioner**, 41 F.3d 1144, 94-2 U.S.T.C. ¶50,621 (7th Cir. 12/2/94). A partner of a partnership organized in 1977 by Calvin Eisenberg could not include what were nominally recourse obligations in his basis for depreciation of a purchased motion picture film ["North Dallas Forty"] because the debt did not represent a bona fide capital investment in that it would become nonrecourse when the movie was sold to television. **Durkin v. Commissioner**, 872 F.2d, 89-1 U.S.T.C. ¶9227 (7th Cir. 1989), followed.

C. **Goldman v. Commissioner**, 39 F.3d 402, 94-2 U.S.T.C. ¶50,577 (2d Cir. 11/2/94); **David v. Commissioner**, 95-1 U.S.T.C. ¶50,063 (2d Cir. 1/3/95). Negligence penalties imposed with respect to a tax shelter investment in a leveraged oil and gas venture, despite purported reliance on accountants, because accountants were not knowledgeable about the oil and gas business.

D. **Overhauser v. United States**, 95-1 U.S.T.C. ¶50,090 (7th Cir. 1/18/95). On the settlement of a food transport container tax shelter, the agreement stated: "Any future cash payments required by a court of law with respect to notes financing the purchase of the containers, will be allowed either as a depreciation expense or an operating expense starting in the year paid." Taxpayer paid $225,000 in 1990 and wanted to add that amount to its original basis and take additional depreciation in the years 1981 through 1986. Both parties argued grammatical rules based upon the absence of a comma after "depreciation expense." Judge Posner noted that the draftsman was not a grammarian [based upon the comma after "containers"], and affirmed the holding that depreciation could begin only in the 1990 year.

E. **Scoggins v. Commissioner**, 95-1 U.S.T.C. ¶50,061 (9th Cir. 2/1/95), rev'g T.C. Memo. 1991-263. Partners [inventors] were allowed to deduct their distributive shares of §174 research and development expenditures made by their partnership for epitaxical reactors because the partnership demonstrated a "realistic prospect" of subsequently entering into its own business with the fruits of the research. The two-person partnership contracted with a corporation [75% owned by the two partners] to perform up to $500,000 of research [to be paid by the partnership] to develop the new technology, and the partnership was to retain ownership, giving the corporation a nonexclusive license to market the technology for 15 months as well as an option to acquire the technology for $5 million (beginning 3 months after the license expired). The court distinguished **Kantor v. Commissioner**, 998 F.2d 1514, 93-2 U.S.T.C. ¶50,433 (9th Cir. 1993) ($5,000 option price was low relative...
to over $3 million cost of research); the Scoggins transaction was not a tax shelter despite its being structured like one.

F. **Johnson v. United States,** 95-1 U.S.T.C. ¶50,109 (Fed. Cl. 2/15/95). Leveraged leases of solar energy equipment were shams.

**XIII. Withholding and Excise Taxes**

A. **Milligan v. Commissioner,** 94-2 U.S.T.C. ¶50,565 (9th Cir. 10/25/94). Amounts received by retired [independent contractor] casualty and general insurance agent as termination payments were not self-employment income because termination payments did not "derive" from taxpayer's prior business activity within the meaning of the §§1401-1403 self-employment tax in that they were not tied to the quantity or quality of taxpayer's prior labor — rather than the mere fact that the taxpayer worked for the payer — but depended, instead, upon the successor agent's future business efforts to retain taxpayer's customers. **Ercson v. Commissioner,** 64 T.C.M. (CCH) 963 (1992), aff'd without opinion 1 F.3d 1231 (1st Cir. 1993), distinguished.

B. T.D. 8577 and EE-45-93, temporary and proposed regulations under §3402, relating to the establishment of systems by employers that permit employees to make changes to their Forms W-4 electronically (12/20/94).

C. EE-83-89, proposed amendments of regulations under §§6051 and 6071, accelerating the time for furnishing wage statements to both employees and the Social Security Administration upon the termination of an employer's operations ((F.R. 12/22/94). Forms W-2 and W-3 will have to be filed at the time required for filing the final Form 941.

D. **IBM v. United States,** 59 F.3d 1234, 95-2 U.S.T.C. ¶____ (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.

**XIV. Tax Legislation**

A. **Bankruptcy Reform Act.** Public Law 103-394, Bankruptcy Reform Act of 1994. Clarifies when IRS may collect taxes from a debtor without violating the automatic stay, specifies the circumstances under which IRS may be sued for damages for violating the automatic stay, makes minor adjustments to the statutory ordering of priority claims [alimony and child support goes from general claim to seventh priority, with tax claims lowered from seventh priority to eighth priority], etc.

B. **Nanny Tax Act.** The Social Security Domestic Employment Reform Act of 1994 (P.L. 103-387) was signed by President Clinton on 10/22/94. It eliminates the quarterly filing and payment requirements (effective for 1995, this is to be done on the employer's Form 1040), and the $50 per quarter threshold was raised to $1,000 per year (effective for the entire 1994 year). effective 1995, household employment by workers under age 18 are exempted from Social Security and
Medicare taxes, regardless of how much they earn, unless household employment is the worker's principal occupation. This law does not directly affect any state unemployment tax filing requirements.

C. **GATT implementing legislation.** Various amendments to the Code made by the Uruguay Round Agreements Act, Pub. L. 103-465, which implemented the Uruguay Round of GATT.

D. **Self-employed health insurance deduction.** P.L. 104-7 (H.R. 831), permanently extends the deduction for the health insurance costs of self-employed individuals and repeals the provisions [§1071] permitting nonrecognition of gain on sales and exchanges effectuating FCC policies, signed by President Clinton 4/11/95.

E. **Pending Legislation**


2. H.R. 1215, the Contract With America Tax Relief Bill of 1995, passed by the House on 4/5/95.


5. S. 1060, Lobbying Disclosure Act of 1995, passed the Senate on 7/25/95. Would prohibit federal grants to §501(c)(4) [social welfare] organizations that lobby the federal government.