Recent Federal Income Tax Developments

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I. Accounting

A. Accounting Methods

1. Independent Contracts, Inc. v. United States, 94-1 U.S.T.C. ¶50,135 (N.D. Ala. 3/2/94). Commissioner did not abuse her discretion under §446(b) in requiring an air conditioning subcontractor to change its method of accounting from the cash method to the accrual method because the cash method did not clearly reflect income, and the systems sold and installed were inventory — albeit not on-site inventory. Taxpayer's average balance of accounts receivable was more than ten times greater than its average balance of accounts payable, largely as a result of its having made large payments on its accounts payable toward the end of the tax year.


3. TAM 9416006 (1/4/94). Motion picture director did not perform services in the field of performing arts because he did not perform his services in front of an audience, so that corporation employing the services of the director was not a qualified personal service corporation within the meaning of §448(d)(2)(A) [for purposes of being permitted use of the cash method and for purposes of being denied use of graduated corporate rates].

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. Inventory shrinkage estimates are not necessarily improper, but whether they reflect income is a question of fact. Dayton Hudson Corp. v. Commissioner, 101 T.C. 462 (11/18/93) (reviewed, 12-4). The majority refuses to grant the Commissioner's motion for summary judgment that would have denied a retailer the use of "shrinkage estimates" to reduce its perpetual inventory count by reason
of estimated losses occurring between the time of taking the physical inventory and yearend. The court held that the issue of whether this practice clearly reflects income under Reg. §1.471-2(a) is an issue of fact. (The Commissioner would allow an adjustment for shrinkage only upon the occasion of a physical inventory. Taxpayer argued that Reg. §1.471-2(d) provides that physical inventories do not have to be performed at yearend, but only at "reasonable intervals.") The dissent states that estimates for shrinkages are "prohibited reserves," and relies upon Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 79-1 U.S.T.C. ¶9139 (1979), noting that the Thor taxpayer adjusted its current total inventory by value estimates and the taxpayer here adjusted that figure by number estimates. The dissent further notes that observed shrinkages could be taken, but not probable shrinkages.


C. Installment Method

1. Payment of additional 1993 taxes. Rev. Proc. 94-58, 1994-38 I.R.B. 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.

D. Year of Receipt or Deduction


2. T.D. 8505 and FI-72-93, temporary and proposed regulations under §475, relating to compliance by dealers in securities with the mark-to-market requirements enacted by the 1993 Act (12/28/92). See also Rev. Rul. 94-7, 1994-3 I.R.B. (12/30/93).

3. Rev. Rul. 93-84, 1993-39 I.R.B. 5. A cash basis taxpayer must report the gain or loss realized from a year-end sale of stock or securities, traded on an established securities market, in the year in which the trade date falls. Section 453(k), added by the Tax Reform Act of 1986, provides that any installment obligation arising out of such a sale is ineligible for the installment method.
*4. Tax Court judicially creates "time value of money" limitations on deductions. Ford Motor Co. v. Commissioner, 102 T.C. 87 (1/31/94) (reviewed, 14-3). Taxpayer purchased in 1980 a number of single premium annuities for $4 million to fund its liability on a total of $24 million of periodic payments arising from tort claim structured settlements. The Commissioner determined (in a year not governed by the §461(h) economic performance rules) that any deduction in excess of the amount paid for the annuities would not clearly reflect income under §446(b), and the court held that the Commissioner did not abuse her discretion. The court based its determination upon a calculation based upon taxpayer's claimed deductions, which showed that the taxpayer was better off because the accidents occurred. Dissent on the ground that the "all events" test was met, and §461(h) is inapplicable.

5. Maxus Energy Corp. v. United States, 94-2 U.S.T.C 50,393 (Fed. Cir. 7/29/94). Accrual basis chemical manufacturer could not deduct in 1984 settlement costs resulting from Agent Orange class action tort suit because: (a) at the time it furnished a letter of credit, its option to withdraw from the settlement agreement had not yet expired, so deduction under §461(f) was not proper, and (b) by the time the option to withdraw had expired, §461(h) had been enacted (and §461(f) had been modified to indicate it was subject to §461(h)), adding an "economic performance" test requiring actual payment for deducting a tort liability. But government's argument that the 1985 cash payment to a settlement fund was not deductible because §461(h) allows for a deduction only when payment is disbursed to individual claimants -- the sole exception to which is payment to a §468B "designated" settlement fund, which requires an election -- failed because taxpayer's liability was effectively discharged by payment to the fund.

6. Fromson v. United States, 94-2 U.S.T.C §50,425 (Fed. Cl. 8/9/94). Cashier's check received by taxpayer on 12/30/86 in partial payment of patent infringement judgment was includable in income in the year of receipt because it was not subject to substantial limitations or restrictions. Taxpayer's subjective beliefs that cashing the check might prejudice his right to appeal the award, or that it constituted an accord and satisfaction that would have prevented taxpayer from collecting court costs and post-judgment interest, were not reasonable.

II. Business Income and Deductions

A. Depreciation, Depletion and Credits

*1. Intangibles

a. T.D. 8528 and PS-55-93, temporary and proposed regulations under §197, relating to procedures for making elections (1) to have §197 apply to intangible property acquisitions after 7/25/91 and (2) to not have §197 apply to intangible property acquisitions under a binding contract that was in effect on 8/10/93 (3/10/94). See also Notice 94-41, 1994-18 I.R.B. 7 (4/11/94) (relating to elections with respect to intangible assets
acquired by partnerships); Notice 94-80, 1994-39 I.R.B. (9/8/94). Modifies temporary regulations providing guidance on retroactive regulations to amortize intangible property under §197 to incorporate rules relating to elections involving foreign corporations.

b. **The IRS offers to settle pre-§197 intangibles cases. IR-94-9 (2/9/94).** IRS announces its settlement offer on the treatment of intangibles not governed by §197. The offer generally is for the greater of (1) a 15% reduction in the basis of amortized intangibles, or (2) a 50% cost recovery adjustment to the basis of amortized intangibles. See IR-94-29 (3/29/94), which modifies the pre-§197 intangibles settlement offer contained in IR-94-9 (2/9/94) by limiting it to acquisitions for which the IRS raises an intangibles issue in audits begun before 4/1/94.

c. **Meredith Corp. v. Commissioner,** 102 T.C. 406 (3/14/94). Applying *Newark Morning Ledger,* the acquirer of the assets of Ladies' Home Journal magazine (1) was able to show basis and useful life of subscriber relationships, but (2) was unable to show claimed value and useful life of its employment relationship with the magazine's editor [$25,700,000 claimed value vs. $135,000 allowed value] and (3) was also unable to adduce the strong proof necessary to support its allocation of additional consideration to noncompetition agreements with the selling corporation and its 83% shareholder.

d. **Ithaca Industries, Inc. v. Commissioner,** 17 F.3d 684, 94-1 U.S.T.C. ¶50,100 (4th Cir. 2/23/94). Corporation's "workforce in place" was not an amortizable asset because it did not have a limited useful life that could be reasonably estimated.

e. **Tele-Communications, Inc. v. Commissioner,** 12 F.3d 1005, 94-1 U.S.T.C. ¶50,020 (10th Cir. 12/27/93), aff'd 95 T.C. 495 (1990). CATV franchises granted by local governments are eligible for §1253 amortization because the statutory definition of "franchise" is not limited to private business franchises.

f. **Kraft, Inc. v. United States,** 94-1 U.S.T.C. ¶50,080 (Fed. Cl. 1/28/94). Taxpayer generally not allowed abandonment losses for intangible assets acquired by purchasing local dairy companies in the 1920s and 1930s because it could not prove that the assets were actually abandoned, or, if abandoned, properly valued and severable from goodwill.

*2. **Tar sands oil not eligible for credit. Texaco Inc. v. Commissioner,** 101 T.C. 571 (12/15/93). "Oil produced from tar sands" was defined by Judge Whitaker for purposes of the §44D [now §29] alternative fuel production credit as "highly viscous hydrocarbon that is 'not recoverable in its natural state by conventional oil well production methods including currently enhanced recovery techniques'" [under a 1976 Federal Energy Administration ruling]. High viscosity crude oil that could be economically produced using either conventional or enhanced oil
recovery methods did not constitute an "alternative energy source" within the meaning of §44D because Congress did not intend to encourage the production of crude oil, but intended to encourage the development of crude oil substitutes.

*3. Offshore platform fabricating costs qualify as IDC depletion. Net income limitation on sulphur depletion includes net income from oil and gas produced on the same property. Louisiana Land and Exploration Co. v. Commissioner, 102 T.C. 21 (1/19/94). The nonmaterial costs of fabricating modules that are structural components of an offshore drilling and production platform are deductible as §263(c) intangible drilling and development costs, as are the nonmaterial costs of installing equipment housed in these modules. Taxpayer's income from sales of sulphur extracted from hydrogen sulfide gas produced in oil and gas wells qualifies as gross income from mining, and is eligible for §613 percentage depletion; moreover, for purposes of the §613(a) limitation on percentage depletion to 50% of the taxable income from the property, income from sales of all minerals produced [oil, gas and sulphur] are to be included.

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


6. T.D. 8503 and EE-71-93, temporary and proposed regulations under §45B, relating to the §38 business tax credit allowable for employer FICA taxes paid by food and beverage establishments on tips received by their employees (12/22/93).

*7. Allocations held to be binding on taxpayers under Danielson rule. Allocations.

a. North American Rayon Corp. v. Commissioner, 12F.3d 583, 94-1 U.S.T.C. ¶50,014 (6th Cir. 12/21/93). Taxpayer/purchaser is bound for depreciation purposes by the allocation of purchase price set forth in the
asset sale agreement, pursuant to the Danielson rule, despite evidence that the [non-arm's length] allocation did not reflect economic reality.

b. **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.

8. Rev. Rul. 94-8, 1994-5 I.R.B. 5. No retroactive certifications for the §51 targeted jobs credit for the period between 6/30/92 and 8/10/93, which is the period of retroactive reinstatement of the credit by the 1993 Act.

9. **Collins Music Co. v. Commissioner, 21 F.3d 1330, 94-1 U.S.T.C. ¶50,179** (4th Cir. 4/15/94). IRS failure to promulgate a new class life for coin-operated video games was not subject to review, so they were classified as 5-year property under ACRS as either 10-year recreation property or as §1245 property not otherwise classified.

10. **Comshare, Inc. v. United States, 94-2 U.S.T.C. ¶50,318** (6th Cir. 6/27/94), rev'd 92-1 U.S.T.C. ¶50,107. Computer company held entitled to accelerated depreciation and investment tax credit for purchased "master source code tapes and discs" which it used to manufacture software products for its customers because the encoded information (source codes) did not exist as property separate from the tapes and discs on which the source codes were placed, so the tapes and discs were items of tangible personal property used in the manufacture of its stock in trade for sale to customers (similar to dies used for striking coins or templates used for making autos). **Texas Instruments, Inc. v. United States, 551 F.2d 599, 77-1 U.S.T.C. ¶9384** (1977), followed.

*11. ACRS depreciation allowed for old fiddlesticks used by professional violinists. **Simon v. Commissioner, 103 T.C. No. 15 (8/22/94)** (reviewed, 9-7). 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, and 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. No. 16 (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?").

B. Expenses

*1. Capitalization and INDOPCO

a. An obvious, but unfortunately necessary, post-Indopco revenue ruling. Rev. Rul. 94-12, 1994-8 I.R.B. 5. The IRS held that the INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039, 92-1 U.S.T.C. ¶50,113 (1992) decision does not affect the treatment of incidental repair costs as business expenses, which are generally deductible under §162 even though they may have some future benefit.

b. A definitive, but less-than-comprehensive, post-Indopco revenue ruling. Rev. Rul. 94-38, 1994-25 I.R.B. 4 (6/2/94). This ruling addresses soil remediation and groundwater treatment costs attributable to pollution caused by the taxpayer, and does not apply to costs attributable to pre-ownership contamination or to costs other than soil remediation and groundwater treatment. It relies upon Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), which held that costs incurred to restore taxpayer’s property to essentially the same condition that existed prior to the contamination were deductible under §162. The ruling holds that environmental cleanup costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from its business (other than costs attributable to the construction of groundwater treatment facilities) are deductible under §162 as ordinary and necessary business expenses. The cost of construction groundwater treatment facilities must be capitalized under §§263 and 263A. This ruling applies whether the taxpayer plans to continue its manufacturing operations that discharge the hazardous waste or to discontinue those manufacturing operations and hold the land in an idle state, but it does not apply to costs incurred in anticipation of sale of the land. This ruling
supersedes TAM 9315004 (12/17/92), which required capitalization of cleanup costs for land contaminated with PCBs.

c. Supplemental opinion requires black lung liability insurance premiums to be capitalized under INDOPCO. Black Hills Corp. v. Commissioner, 102 T.C. 505 (3/29/94), supplementing 101 T.C. 173 (8/3/93). A portion of front-end loaded "premiums" paid for black lung liability to a Bermuda insurance company formed by a group of surface coal mine operators, 9.5% of the common stock of which was owned by taxpayer, were not currently deductible because they created a reserve account (which constituted a distinct asset) and, therefore, were capital expenditures. The original opinion had required capitalization under Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345, 71-1 U.S.T.C. ¶9476 (1971); that opinion was incorrect in its finding that taxpayer had the power to cancel the policy and obtain a refund, so its reliance on Lincoln Savings was inappropriate. However, Judge Halpern held that the ultimate conclusion remains the same, based upon INDOPCO because the premium payments produced "significant benefits ... that extended beyond the tax year in question" such as the guaranteed option to renew the policy, the relationship of the prepayments to the mine-closing year and the possibility of taxpayer obtaining a refund. (The reason for the front-loading was that black lung disease is generally not totally disabling, so most miners make no claims prior to their separation from the workforce [which typically occurs disproportionately when the particular mine at which they are working closes].)

d. Payments to grandfathered low-royalty franchise holder need not be capitalized. T.J. Enterprises, Inc. v. Commissioner, 101 T.C. 581 (12/16/93). Payments made by purchaser of minority interests in H & R Block franchises [and holder of option to purchase remaining stock] to seller who retained majority interests in 5% royalty H & R Block franchises were deductible as a §162(a) ordinary and necessary business expense where they were made to induce seller to refrain from causing an "event of increase" [to a 10% royalty]. Judge Ruwe refused Commissioner's argument that the payments should be capitalized under INDOPCO because the payments did not preclude seller from causing an "event of increase" in the future.

2. Lobbying payments
a. T.D. 8511 and IA-60-93, temporary and proposed regulations under §162(e), relating to the deductibility of dues paid to tax-exempt organizations that participate in political campaigns or engage in lobbying or similar activities (58 F.R. 68294, 12/27/93). See also IA-57-93, proposed regulations §1.162-28, relating to allocation of costs to lobbying expenses (58 F.R. 68330, 12/27/93).

b. IA-23-94, proposed regulations under §162(e), defining the phrase "influencing legislation" for purposes of the deduction disallowance for certain amounts so paid or incurred (59 F.R. 24992, 5/13/94).
Disallowance of antitrust damage payments under §162(g) depends upon the scope of the nolo plea. *Flintkote Co. v. United States,* 7 F.3d 870, 93-2 U.S.T.C. ¶50,566 (9th Cir. 10/18/93). Affirms summary judgment for government and upholds the disallowance under §162(g) of 2/3 of the civil antitrust settlement paid with respect to the same gypsum wallboard antitrust conspiracy to which taxpayer pleaded nolo contendere. Taxpayer argued that the 1973 indictment covered only the 1968-73 five-year statutory period, while the civil actions went back to the 1950's, necessitating apportionment of the settlement payment; however, the indictment alleged a conspiracy beginning prior to 1960 and taxpayer admitted this allegation by its nolo plea. Taxpayer also argued that the criminal indictment alleged a violation of §1 of the Sherman Act, while the civil actions alleged violations of other antitrust provisions as well; the court held the various claims were merely different ways of characterizing a single antitrust harm under a single set of core activities engaged in by taxpayers.

Home office guidance. Rev. Rul. 94-24, 1994-15 I.R.B. 5. Guidance for determining what constitutes a principal place of business for purposes of the home office deduction under the principles of *Commissioner v. Soliman,* 113 S. Ct. 701, 93-1 U.S.T.C. ¶50,014 (1993). Self-employed plumber's office is not (Situation 1); teacher's office is not even though teacher spends more time there than at school (Situation 2); self-employed author's office is (Situation 3); and self-employed retailer of costume jewelry's office is because she spends more time there and sells to customers there and at other business locations (Situation 4).

Logger's commuting costs within national forest "metropolitan area" are deductible! *Walker v. Commissioner,* 101 T.C. 537 (12/13/93), on rehearing of T.C. Memo. 1993-311 (7/15/93). Professional tree cutter in various locations of Black Hills National Forest was entitled to deduct transportation expenses between his residence and the various job sites ["temporary work locations"] pursuant to Commissioner's position in Rev. Rul. 90-23, 1990-1 C.B. 28, even though under case law [e.g., *Commissioner v. Soliman,* 113 S.Ct. 701, 93-1 U.S.T.C. ¶50,014 (1993)] taxpayer's residence was not his principal place of business (but it was his "regular place of business"). At the Commissioner's urging, the forest was treated as a "metropolitan area" [because costs of travel from home to a temporary work location outside the metropolitan area are deductible], but the Commissioner disagreed with the court's holding that Rev. Rul. 90-23 constituted a concession by the Commissioner that costs of travel from home to a temporary work location within the metropolitan area were deductible.

a. IRS modifies rules for deductibility of commuting expenses. Rev. Rul. 94-47, 1994-29 I.R.B. 6 (6/30/94). The IRS will not follow *Walker v. Commissioner,* 101 T.C. 537 (1993), to the extent that the case applied Rev. Rul. 90-23, 1990-1 C.B. 28, to permit daily transportation expenses to be deducted in a situation where taxpayer's only regular place of business was located at his residence — but that residence was not his principal place of business. The ruling held that
transportation expenses incurred in going between taxpayer's residence and a work location are nondeductible commuting expenses, but deductibility will be allowed in the following three situations: (1) transportation between taxpayer's residence and a TEMPORARY work location OUTSIDE the metropolitan area, (2) transportation between taxpayer's residence and a TEMPORARY work location where taxpayer has one or more regular work locations away from his residence, or (3) transportation between residence and a work location (whether REGULAR OR TEMPORARY) where taxpayer's residence is his principal place of business under §280A(c)(1)(A).

*6. 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.

*7. 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), affg 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.

C. Losses and At Risk

1. Branum v. Commissioner, 13 F.3d 805, 94-1 U.S.T.C. ¶50,163 (5th Cir. 4/5/94), affg T.C. Memo. 1993-8. Fifth Circuit holds that taxpayer's subjective intent was irrelevant when it held him to a §172(b)(3) election to relinquish carrybacks of both regular and AMT NOLs based upon his attempt to make a [subsequently ruled to be impermissible] split election to relinquish his carryback of regular tax NOLs, but not his carryback of AMT NOLs, despite his contention that he preferred under the circumstances to make no election at all. Judge
Wisdom concluded by quoting Judge Goldberg, "Our federal tax code may appear to operate with a rigidity that makes its collectors bereft of human pity, conscience, or compassion; its operation is also an illustration that ours is a government of laws, not men."

*2. Abnormal retirement loss sustained shortly before building was demolished held not subject to §280B disallowance. De Cou v. Commissioner, 103 T.C. No. 6 (7/27/94). Taxpayer's $85,987 adjusted basis in its recently-purchased [March 1984] building leased to a topless bar was deductible as an abnormal retirement loss in April 1985 when city inspectors, sicced on the building by taxpayer, found serious building code violations necessitating the building's abandonment; the court held that the loss was not a disallowed §280B demolition loss. Only the $17,665 actual cost of the October 1985 demolition had to be added to the basis of the land.

3. Martuccio v. Commissioner, 94-2 U.S.T.C. ¶50,374 (6th Cir. 7/28/94). Taxpayer was found to be at risk for the recourse portion of his installment note given in a computer equipment sale-leaseback transaction because he would have been the payor of last resort if the transaction had gone sour.

D. Business Income

1. 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.

2. Rev. Rul. 94-16, 1994-12 I.R.B. 4. An unincorporated Indian tribe or an Indian tribal corporation organized under §17 of the Indian Reorganization Act of 1934, 25 U.S.C. §477, is not subject to federal income tax on the income earned in the conduct of commercial businesses on or off the tribe's reservation, but a corporation organized by an Indian tribe under state law is subject to federal income tax on its income wherever earned.

III. Capital Gain and Loss

*A. Temporary regulations: Business hedges produce ordinary gain. T.D. 8493, temporary regulations under §§1221, 1233 and 1234, clarifying the character of gain or loss from business hedges (as a result of the decision in Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 88-1 U.S.T.C. ¶9210 (1988)) (58 F.R. 54037, 10/20/93). They provide for non-capital asset characterization of property that is part of a hedging transaction (under the §1256(e)(2)(A) concept, i.e., one entered into in the normal course of business primarily to reduce the risk of interest rate or price changes or currency fluctuations with respect to ordinary property, ordinary obligations or taxpayer's borrowings (excluding §1231 assets, the ordinary income produced by a capital asset, and non-inventory supplies [which are capital assets])). A same-day identification and record-keeping requirement is provided for hedging transactions entered into after 1/1/94. See also FI-46-93, proposed regulations under §§1221, 1233, 1234 and 1256, which cross-reference T.D. 8493 and contain special identification requirements for specific types of
hedging transactions (58 F.R. 54075, 10/20/93). See also FL-54-93, proposed regulations under §§446 and 461, relating to accounting for business hedging transactions (58 F.R. 54077, 10/20/93).

* B. Final business hedging regulations generally follow temporary regulations. T.D. 8555, final regulations under §1221, relating to clarifying the character of gain or loss from business hedges (7/13/94). See also, T.D. 8554 (7/13/94) (final regulations §1.446-4, relating to accounting for business hedging transactions); FL-34-94 (7/13/94) (proposed regulations relating to the character and timing of gain or loss from business hedges entered into by members of a consolidated group).


D. Gehl v. Commissioner, 102 T.C. No. 37 (6/22/94). Insolvent taxpayers who transferred appreciated property to a creditor in satisfaction of a recourse liability were taxable on §61(a)(3) gain [as a §1001 "sale or exchange"] on the excess of the fair market value over the basis of the property, following Danenberg v. Commissioner, 73 T.C. 370 (1979), with the excess of debt over fair market value treated as cancellation of indebtedness under §61(a)(12) based upon bifurcation pursuant to Reg. §1.1001-2(a)(2) & (c), Example (8). Judge Tannenwald found that paragraphs (3) and (12) of §61(a) were "separate, independent, and not overlapping provisions in respect of the includability of a particular item in income," and only after it is determined that §61(a)(12) applies does the question of insolvency under §108 arise. Note: The opinion did not cite Aizawa v. Commissioner, 99 T.C. 197 (1992) (Tannenwald, J.), where bifurcation was employed on the rationale that the "key to resolution of the issue... lies in the recognition that, in this case, there is a clear separation between the foreclosure sale and the unpaid recourse liability for mortgage principal which survives... [In earlier] cases, the courts concluded that such survival did not exist and that the discharge of the recourse liability was closely related to, and should be considered an integral part of, the foreclosure sale [resulting in non-bifurcation]. However, the Commissioner conceded that the excess of the debt over fair market value was §61(a)(12) income.

E. Claiming §1244 losses simplified. Notice 94-89, 1994-38 I.R.B. (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.

IV. Corporations

A. Entity and Formation

1. Notice 94-47, 1994-19 I.R.B. 9 (4/18/94). IRS will scrutinize financial instruments designed to be treated as debt for federal income tax purposes, but as equity for regulatory, rating agency, or financial accounting purposes. Particular emphasis will be placed upon those that rely on Rev. Rul. 85-119,
1985-2 C.B. 60, which permitted repayment at maturity in issuer's stock at maturity; the Notice stated that Rev. Rul 85-119 would be limited to its facts, noting that the holder in the ruling had the option of receiving repayment in either cash or stock. The Notice also stated that the 50-year maturities approved as debt in Monow RR v. Commissioner, 55 T.C. 345 (1970), acq., 1973-2 C.B. 3, could not be relied upon in different circumstances. Under attack in the Notice are so-called MIPS (monthly income preferred shares), which are advertised as "tax deductible preferred stock," having 50- to 100-year maturity, deep subordination and delay of 18 months to 5 years in interest payments; these are issued by the borrower to an offshore partnership in which the borrower is a partner and in which outside investors hold preferred partnership interests. See also, Notice 94-48, 1994-19 I.R.B. 10, which attacks so-called reverse MIPS, in which the partnership is the issuer of the debt and a domestic corporation would issue preferred equity to the partnership to secure the debt. The Notice would treat the partnership as nonexistent and would treat the domestic corporation as the direct issuer of equity.

2. Debt-equity swap held to result in gain, not contribution to capital. G.M. Trading Corp. v. Commissioner, 103 T.C. No. 4 (7/25/94). 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.

B. Distributions and Redemptions

*1. The scope of §162(k) is limited. In re Kroy (Europe) Limited, 94-2 U.S.T.C. ¶50,316 (9th Cir. 6/14/94), rev'd 92-2 U.S.T.C. ¶50,611 (DC) and 92-1 U.S.T.C. ¶50,146 (BC-DC). The district court erred in concluding that loan fees incurred as compensation for services rendered to Kroy by its investment banker and lenders were nondeductible by reason of §162(k). They were, instead, incurred in a separate and independent borrowing transaction, and were not incurred in connection with a stock redemption to which §162(k) is applicable. The guarantee fees were considered to be payments for services. Section 162(k) was enacted to codify and clarify existing law (and to overrule Five Star Mfg. Co. v. Commissioner, 355 F.2d 724 (5th Cir. 1966)), which had held that the funds paid to redeem stock in order to defeat an outside threat to the survival of the corporation were deductible as §162(a) ordinary and necessary business expenses. The Ninth Circuit held that §162(k) should not be extended to costs incurred in borrowing funds where the loan proceeds are used to redeem stock. Note: The court concluded that guarantee fees were payments for services.
Note: Centel Communications Co. v. Commissioner, 90-2 U.S.T.C. ¶50,603
(7th Cir. 1990), aff'd 92 T.C. 612 (1989) (holding §83 inapplicable to property received as guarantee fees because not in connection with the performance of services).

*2. Tax Court will not follow 9th Circuit's Kroy holding. Fort Howard Corp. v. Commissioner, 103 T.C. No. 18 (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). 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)(2)(A)(i).

3. Mazzocchi Bus Co. v. Commissioner, 14 F.3d 923, 94-1 U.S.T.C. ¶50,058 (3d Cir. 1/27/94). Cash method company was not allowed to reduce its e&p for accrued but unpaid taxes, interest and penalties because it was required to use the same accounting method in calculating its e&p as it did in determining its taxable income, following Reg. §1.312-6(a).

4. Rev. Rul. 94-28, 1994-19 I.R.B. 4 (4/18/94). The 45-day holding period for obtaining the benefit of the §243(a) dividends-received deduction will be suspended under §246(c)(4) where taxpayer holds an instrument that affords it the rights of a creditor and was not stock for corporate law purposes, but was stock for federal income tax purposes. The holder is treated as having either an option to sell or a contractual obligation to sell the instrument for purposes of §246(c)(4). The Ruling distinguishes both mandatorily redeemable preferred stock and dutch auction preferred stock [see Rev. Rul. 90-27, 1990-1 C.B. 51]. (which neither has a fixed payment on a specified date nor affords the holder creditors' rights)

5. CO-8-91, proposed amendments of regulations under §305, relating to constructive distributions on preferred stock, specifically concerning the treatment of stock callable at a premium at the option of the issuer (59 F.R. 32160, 6/22/94). If it is "more likely than not" the an issuer will exercise its call option, then the call premium is equivalent to a periodic return on the stock that should be taxed over time as a distribution (as would a mandatory redemption provision), unless the redemption provision is solely in the nature of a penalty for premature redemption.

6. Corporate "inversions" will be dealt with in regulations. Notice 94-93, 1994-41 I.R.B. 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. But see Bhada v. Commissioner, 892 F.2d. 39 (6th Cir. 1989) (McDermott transaction).

C. Liquidations

*1. Final §338 consistency regulations. T.D. 8515, final regulations under §338, relating to the stock and asset consistency rules (1/12/94). Section 338(h)(10) elections may be made by targets that are S corporations, with the deemed sale gain reportable on the target’s final S corporation return.

D. S Corporations

1. Estate Planning

a. Rev. Rul. 93-79, 1993-36 I.R.B. 5. A state court order, which retroactively reforms a trust to meet the requirements of a QSST (e.g., one that originally provided that trust corpus may be distributed to a person other than the current income beneficiary), does not have retroactive effect for purposes of determining the trust’s eligibility to be an S corporation shareholder.

b. Rev. Proc. 94-23, 1994-10 I.R.B. 17. Automatic §1362(f) inadvertent termination relief is provided to corporations whose S corporation status has been terminated because its stock was transferred to a trust whose current income beneficiary inadvertently failed to file a timely QSST election.

2. Giovanini v. United States, 9 F.3d 783, 93-2 U.S.T.C. ¶50,600 (9th Cir. 11/4/93). Investment tax credit recapture does not take place upon the merger of S corporation into C corporation, inasmuch as the merger is a transaction to which §381(a) applies and §47(b)(2) provides for an exception to recapture for such transactions.

3. T.D. 8508, final regulations under §§1367 and 1368, relating to adjustments to the basis of a shareholder’s S corporation stock and indebtedness, and the treatment of distributions by an S corporation to its shareholders (12/30/93).

4. Bugaboo Timber Co. v. Commissioner, 101 T.C. 474 (11/22/93). Consents to extend statute of limitations for S corporations (under the §6244 S corporation unified audit and litigation procedures) signed by the president and treasurer [who were both shareholders] were valid to bind the corporation under its by-laws in accordance with Oregon law.

separate S corporations that organized a partnership for the joint operation of a business because "the purpose of the number of shareholders requirement is to restrict S corporation status to corporations with a limited number of shareholders so as to obtain administrative simplicity in the administration of the corporation's tax affairs," which is not affected by the corporation's participation in a partnership with other S corporation partners.


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.

*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. Amorient Inc. v. Commissioner, 103 T.C. No. 11 (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)(i) provides for that loss to be apportioned to the former S corporation "[i]f [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.

F. Section 482

*1. Vast forests will have to be felled to provide the paper for documentation under these (more flexible) final transfer pricing regulations. T.D. 8552, final §482 transfer pricing regulations, relating to tangible and intangible property (59 F.R. 34971, 7/8/94). These regulations have maximized the extent to which relevant information may be taken into account in evaluating taxpayers’ results under the arm’s length standard, so "the emphasis on comparability and the importance of the best method rule are increased; because ex ante restrictions will no longer prohibit the use of potentially less reliable information or methodologies, it is critically important that the best method rule be applied to select the most reliable measure of an arm’s length result from the available evidence." See also, T.D. 8551 and IL-21-91, temporary and proposed regulations under §6662(e), providing guidance on the accuracy-related penalty for §482 transfer price adjustments (59 F.R. 35066, 7/8/94).
   a. T.D. 8519 and IL-21-91, temporary and proposed regulations under §§6662(e) and (h) and 6664, relating to the imposition of the accuracy-related penalties for §482 adjustments 59 F.R. 4791 (2/2/94).

*2. Aramco Advantage not subject to §482. Exxon Corp v. Commissioner, T.C. Memo. 1993-616 (12/22/93). Taxpayers Exxon and Texaco prevail in the "Aramco Advantage" cases based on their defense that since Saudi Arabian law prohibited profitable resale of oil, any §482 allocation requiring violation of law must fall under Commissioner v. First Security Bank of Utah, 405 U.S. 394, 72-1 U.S.T.C. 9292A (1972). The government contended that sales to affiliates not taxed by the United States at artificially low prices, followed their sales of refined oil at market prices, indicated tax avoidance. The court found that foreign law resulted in Exxon losing control over the prices at which intercompany transfers of oil could be made.

*3. The Commissioner loses another §482 case. Seagate Technology, Inc. v. Commissioner, 102 T.C. 149 (2/8/94). Commissioner’s §482 allocation of income from Singapore component-manufacturing subsidiary to U.S. hard-drive manufacturing parent was arbitrary, capricious, and unreasonable, but she did not generally bear the burden of proof. The court made some minimal adjustments, but generally upheld taxpayer’s pricing and royalty structure.

4. Central de Gas de Chihuahua, S.A. v. Commissioner, 102 T.C. No. 19 (4/4/94). Taxpayer Mexican corporation rented a fleet of tractors and trailers located in the U.S. to another Mexican corporation under control of the same parent without receiving rental payments. Following Commissioner’s §482 allocation of fair rental value to taxpayer, taxpayer was considered to have "received" rent taxable at the 30% rate pursuant to §881 (which taxes rents and other passive income
received by a foreign corporation from sources within the U.S.) even though no rent was actually received.


G. Reorganizations and Corporate Divisions

H. Loss Corporations and Debt Cancellation

1. T.D. 8490, final and temporary regulations under §382, relating to the segregation of public groups after issuances of stock by loss corporations for purposes of determining whether a §382 ownership change has occurred, 58 F.R. 51571 (10/1/93).

2. T.D. 8529, final regulations under §382(l)(5), relating to whether stock of a loss corporation is owned as a result of being a qualified creditor (3/17/94).

3. T.D. 8530, final and temporary regulations under §382(l)(6), relating to the value of a loss corporation following an ownership change to which that section applies (3/17/94).

4. T.D. 8531, final regulations under §382, relating to rules regarding treatment of options in determining whether a loss corporation has an ownership change (3/17/94).

5. T.D. 8532, final regulations under §108(e)(8), relating to the stock-for-debt exception (3/17/94). Note that this exception was repealed, effective after 12/31/94, by the 1993 Act.

6. T.D. 8546, final regulations under §382, relating to the rules for allocating NOL or taxable income and net capital loss or gain within the taxable year in which a loss corporation has an ownership change under §382 (6/21/94).

7. No tax avoidance under §269 found. United States v. Federated Department Stores, 94-2 U.S.T.C ¶50,418 (S.D. Ohio 7/18/94). Affirms bankruptcy court finding that the factors supporting a business purpose for Federated’s acquisition of Twin Fair Distributors Corporation stock outweighed the factors supporting a tax purpose, so (under §269) the evasion or avoidance of income tax was not the principal purpose behind the acquisition.

I. Accumulated Earnings Tax

*1. Widely-held company’s accumulations were not for improper purpose; stock redemption purpose approved. Technalysis Corp. v. Commissioner, 101 T.C. 397 (11/4/93). While the accumulated earnings tax can be applied to a widely held [but 25% board-owned] public company and taxpayer [computer
programming service business] had an accumulation of earnings and profits which exceeded its reasonable needs, the accumulated earnings tax did not apply because taxpayer was not formed or availed of to avoid income tax with respect to its shareholders. The court noted that the corporation paid cash dividends of about 30% of current earnings, that its board and officers were conservative, and that they did not consider sophisticated tax aspects to maximize a return for shareholders' investment. The court allowed $1.8 million for the reasonable need of "stock redemption."

J. Foreign Corporations

1. 

Unisys Corp. v. United States, 94-1 U.S.T.C ¶50,069 (Fed. Cl. 2/4/94). The court found the legislative regulations under §952(d) valid in that they establish the "manner" in which a U.S. shareholder must reduce the e&p of a controlled foreign corporation to determine its share of any deficits in the chain of CFCs because such regulations cannot be invalidated on equity or policy grounds, but only if they are arbitrary, capricious or in excess of the IRS's authority.

*2. Using controlled partnerships instead of controlled foreign corporations enables avoidance of subpart F taxes on foreign base company income. Brown Group Inc. v. Commissioner, 102 T.C. No. 24 (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.

V. Employee Compensation and Plans

*A. Nondiscrimination, etc.


5. T.D. 8548, amendments to final regulations under §414(r), relating to a single employer’s qualified separate lines of business (QSLOBs) for purposes of applying the §410(b) minimum coverage requirements and the §401(a)(26) minimum participation requirements (6/23/94).

*B. Withholding on Rollovers.

1. 30-day period may be waived. Notice 93-26, 1993-18 I.R.B. 11 (4/14/93). Permits a participant to waive the §411(a)(11) thirty-day time period for consenting to a distribution and providing the §402(f) written explanation under the 1992 Unemployment Compensation Amendments. The plan administrator will not be required to enforce the 30-day waiting period provided that the participant (1) is given the opportunity to consider the election of a direct rollover for at least 30 days after the notice is provided, and (2) is informed of his or her right to this period for making the decision.


*C. VCR program for operational defects. Rev. Proc. 92-89, 1992-46 I.R.B. 47 (10/28/92). Experimental voluntary compliance resolution (VCR) program to permit employers to correct retirement plan operational defects in order to avoid IRS action towards plan disqualification, available through 12/31/93. The plan sponsor will pay a fixed voluntary compliance fee (between $500 and $10,000) and will receive a compliance statement describing the terms of full correction. The 12/21/91 closing agreement program (CAP) will not be available for defects eligible for correction under the VCR program.

standardized correction procedure for certain defects, and extends the last day of
the VCR Program to 12/31/94.

Agreement Program (published in Internal Revenue Manual, chapter 11 at
7(10)54) that retirement plan sponsors may use to voluntarily correct plan
defects. Permits closing agreements with respect to repeated, deliberate or
flagrant violations that are voluntarily requested before the plan is under
examination, but not for violations considered to be egregious or which involve
diversion of trust assets. Correction of defects must be made for all years [and
not just taxable years], but the monetary sanction will be limited to a significantly
reduced percentage of the minimum payment account. Unrelated plan defects
discovered by the IRS while considering the voluntary request are open for IRS
action as defects not voluntarily brought forward by the plan sponsor. Also
describes the relationship of this program with the Voluntarily Compliance
Resolution Program.

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. $150,000 plan compensation limitation

1. EE-6-93, proposed amendments of regulations [T.D. 8362 (9/19/91)] under
§401(a)(17), relating to the $150,000 compensation limit for tax-qualified
retirement plans (58 F.R. 69302, 12/30/93).

2. T.D. 8547, amendments to final regulations under §401(a)(17), relating to the
compensation limit for tax-qualified retirement plans (6/23/94).

E. $1 million compensation deduction limitation

1. EE-61-93, proposed regulations under §162(m), relating to the disallowance of
deductions for employee remuneration in excess of $1 million (58 F.R. 66310,
12/20/93). They provide that performance-based compensation may not be paid
by "discount" options or restricted stock.

provides rules on the application of the §162(m) $1 million limitation on the
deduction of executive compensation, will be modified to provide that (1)
performance goals will not be treated as "preestablished" if they are established
after 25% of the period of the service has elapsed, and (2) "disinterested"
directors will continue to be treated as "outside" directors until the first post-
7/1/94 shareholders’ meeting.
F. Tax Court imposes §4975 prohibited transactions penalty for ESOP self-dealing. Zabolotny v. Commissioner, 97 T.C. 385 (9/30/91) (reviewed, 7 judges dissenting). Sale of farmland and mineral rights by taxpayers to the ESOP of their family farm operating corporation resulted in imposition of both first-tier (5%) and second-tier (100%) §4975(a) excise tax on the prohibited transaction and their failure to make correction; the §6651(a)(1) penalty for failure to file excise tax returns was not imposed because that failure was due to reasonable cause. Dissent on the ground that taxpayers were, at the time of the sale and for 2 years thereafter, the only beneficiaries of the ESOP trust.

1. Eighth Circuit reverses second-tier §4975 excise tax, holding that prohibited transaction was self-correcting. Zabolotny v. Commissioner, 93-2 U.S.T.C. ¶50,567 (8th Cir. 10/18/93), aff’g and rev’g 97 T.C. 385 (1991). Affirms Tax Court holding that the Zabolotnys were liable for the §4975(a) [5%] first-tier excise tax, but reverses on the §4975(b) [100%] second-tier excise tax applicable where there is a failure to correct the prohibited transaction within the designated correction period. Both parties agree that the Zabolotnys, disqualified persons, sold unencumbered property to the ESOP, a qualified plan, and were liable for the first-tier tax for the 1981 year. The court held the transaction to be self-correcting, requiring no affirmative action, because §4975(f)(5) defines "correction" to mean "undoing the transaction to the extent possible," and under this "unusual set of circumstances" the 5/20/81 prohibited transaction was corrected by the end of the 1981 taxable year; the transaction was highly profitable to the ESOP and to unravel it would place the plan in a worse condition than if the disqualified persons had acted under the highest fiduciary standards. The court held that there was no liability, either for the 1982-86 first-tier tax or for the second-tier tax.

a. Nonacquiescence, 1994-22 I.R.B. 4, concerning whether prohibited transaction was corrected under §4975(f).

G. 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. **Rubin v. Commissioner,** 103 T.C. No. 13 (8/15/94). Taxpayer's S corporation's reliance on uncertified preliminary information supplied by its actuaries in making a $56,000 contribution to its qualified retirement plan was not reasonable, and the actuaries' final revised amount of about $20,000 (based upon a change in the interest assumption from 6% to 8.25%) on the Schedule B attached to the Form 550-R for the plan year was held to limit the amount deductible. Taxpayers were held to be prevented by Reg. §1.404(a)-3(c) from amending the Schedule B.

**H.** Community property law prevails over ERISA to tax nonemployee/wife on non-QDRO distribution to her from qualified plan of husband's employer. **Powell v. Commissioner,** 101 T.C. 489 (11/29/93). Pre-Retirement Equity Act of 1984 [i.e., non-QDRO] distribution of wife's share of community property interest in §401(a) qualified savings plan of husband's employer is taxable to wife as a "distributee" under §402(a)(1), despite the proceeds being initially received by husband and later transferred to wife, because California community property law prevails over ERISA provisions dealing with preemption (ERISA §514) and alienation (I.R.C. §401(a)(13)). The court distinguished **Darby v. Commissioner,** 97 T.C. 51 (1991), which held a similar distribution taxable to husband, as not involving community property (but, rather, involving property awarded to former wife in a pre-REA Michigan divorce decree).

**I.** Why wasn't it a QDRO? What about **Powell?** **Hawkins v. Commissioner,** 102 T.C. 61 (1/27/94). On the distribution of $1 million from husband's dental practice pension plan to wife pursuant to New Mexico domestic relations court order upon their divorce, husband was taxed because the order did not clearly create or recognize wife's rights as an alternate payee to plan benefits (as is required by §414(p)), but merely stated that wife was to receive $1 million "from Husband's share of the ...plan."

**J.** **Janpol v. Commissioner,** 101 T.C. 518 (12/7/93). Disqualified persons who lent money and guaranteed bank loans are liable for (5%) first-tier §4975(a) excise taxes on prohibited transactions in amounts based upon (1) new loans made in each year, and (2) old loans that remained outstanding during the year.

**K.** 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'd 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.

*L.* Plan disqualification for lack of a formality; Tax Court no longer adheres to *Baetens,* Fazi v. Commissioner, 102 T.C. No. 31 (5/19/94) (reviewed, 14-0). Taxpayer's [wholly-owned] corporate dental practice had a prototype pension plan, which was found to be unqualified at the time of a $1.1 million distribution to taxpayer in 1987 because plan amendments required by the 1982 Act's (TEFRA) top-heavy provisions and the 1984 DEFRA and REA provisions, while made to the prototype plan, were not formally adopted by the corporate plan through a so-called "joinder agreement" made between the corporate plan and the insurance company trustee of the prototype plan—even though, in operation, the corporate plan complied with the amended prototype plan.

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


O. *General Signal Corp v. Commissioner,* 103 T.C. No. 14 (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.

P. *Wallons, 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.

VI. **Exempt Organizations and Charitable Giving**

*A.* Second Circuit splits the unsplittable by permitting "LTCG only" donation of §1256 commodities futures contracts. *Greene v. United States,* 806 F. Supp. 1165, 93-1 U.S.T.C. ¶50,033 (S.D. N.Y. 11/24/92). Charitable contribution to private operating foundation of only the long-term capital gains portion of commodities futures
contracts characterized by §1256 as 60% long-term and 40% short-term capital gain, which were immediately sold by the private foundation, did not result in the taxation of the long-term capital gain to the donor on either the "anticipatory assignment of income" or the "step transaction" theory. The donors had received a 1974 private letter ruling that they were entitled to a full FMV charitable contribution deduction and no gain was to be recognized when the charity sold the futures contracts. Affirmed, 94-1 U.S.T.C ¶50,022 (2d Cir. 1/6/94). The court refused to consider Commissioner's argument that §1256(c) triggered income on the transfer to the charity because it was first raised on appeal.

B. Crop share rents are not subject to UBIT. Affirmed, Moore Charitable Trust v. United States, 9 F.3d 623, 93-2 U.S.T.C. ¶50,601 (7th Cir. 11/3/93). The rent received by a charitable trust under a crop-share lease ("a typical sharecropping agreement") is not unrelated business income because the trust’s return from the land is not dependent in part on the income from the farming operation, with the tenant having many expenses beyond those shared by the trust. The IRS acquiesced in this decision, with respect to the joint venture and the §512(b)(3)(B)(ii) [rent dependent on income or profits] issues, 1994-13 I.R.B. 5.


1. Internal Revenue News Release IR-93-121 (12/21/93). Publication 1771 (Charitable Contributions – Substantiation and Disclosure Requirements) was developed to assist charities in complying with the new charitable contribution rules.

2. T.D. 8544 and IA-74-93, temporary and proposed regulations under §170(f)(8), relating to the substantiation requirement for charitable contributions of $250 or more (59 F.R. 27458, 5/27/94).

D. Mrs. Philippines Home for Senior Citizens, Inc. v. United States, 94-1 U.S.T.C ¶50,065 (D. Md. 12/9/93). Jeopardy assessments against tax-exempt charitable organizations for employment taxes and unrelated business income tax liabilities for their fund-raising casino night operations were reasonable because the organizations used paid workers, rather than volunteers.

E. Doherty v. Commissioner, 16 F.3d 338, 94-1 U.S.T.C. ¶50,112 (9th Cir. 2/8/94). In determining the value of a painting donated to charity, Tax Court did not err in considering expert testimony concerning authenticity even though authenticity had not been questioned until after the date of the contribution because otherwise taxpayers could have their own valuations accepted by keeping other appraisers from seeing the artwork prior to the donation.

F. The Nationalist Movement v. Commissioner, 102 T.C. No. 22 (4/11/94). On declaratory judgment, §501(c)(3) status denied to white nationalist organization because it is not educational under the criteria set forth in Rev. Proc. 86-43, 1986-2 C.B. 729, in that (1) the organization’s newsletter [which constitutes a substantial portion of its
overall activities] presents viewpoints unsupported by facts, (2) the facts that purport to support its viewpoints are distorted, (3) its presentations make substantial use of inflammatory terms and the conclusions expressed are based upon strong emotional feelings, and (4) the approach used is not aimed at developing an understanding on the part of the intended audience because it does not consider their background or training in the subject matter.

G. T.D. 8539, final regulations under §514, relating the application of §514(c)(9)(E) to partnerships in which one or more, but not all, of the partners are qualified tax-exempt organizations (5/11/94).

H. Paratransit Insurance Corp. v. Commissioner, 102 T.C. No. 34 (6/14/94). Nonprofit mutual benefit insurance corporation which provides automobile liability insurance to its members, all of which are tax-exempt social service organizations that furnish transportation to the elderly, handicapped, needy, etc., is not exempt under §501(c) because §501(m) precludes exemption for organizations, a substantial part of whose activities consists of providing "commercial-type insurance."

*I.* Purchaser of property held for contribution was not a dealer. Pasqualini v. Commissioner, 103 T.C. No. 1 (7/18/94). Taxpayers purchased 180,000 Christmas cards for $30,000 at a U.S. Customs Service auction, held the cards for slightly more than one year, donated them in bulk to a charity, and claimed a §170 charitable contribution deduction for their $1,890,000 import duty valuation. Held, the §170(e)(1)(A) limitation [i.e., reduction of the contribution by the amount that would not have been long term capital gain had the property been sold for its fair market value] does not apply because the cards were not ordinary income property based upon standard investor-dealer analysis, not following Rev. Ruls. 79-256 & 419, 1972-2 C.B. 105 & 107.

1. The Tax Court did reduce the value of the Christmas cards to $67,500, Pasqualini v. Commissioner, T.C. Memo. 1994-323 (7/18/94). The court stated, "[taxpayers] should have known that deducting 63 times the cost of the cards was too good to be true." Valuation overstatement and §6621(c) additional interest penalties were also imposed.

J. Sierra Club, Inc. v. Commissioner, 103 T.C. No. 17 (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).

K. Geisinger Health Plan v. Commissioner, 94-2 U.S.T.C. ¶50,398 (3d Cir. 7/27/94). Health maintenance organization is not entitled to federal tax exemption under §501(c)(3) as an integral part of a comprehensive care system serving a portion of Pennsylvania. The test for an organization's exemption on this ground is if: "its relationship to [the system] somehow enhances its own exempt character to the point that, when the boost provided by the parent is added to the contribution made by the subsidiary itself, the subsidiary would be entitled to [the] exemption."
VII. Interest

A. Consolidated Edison Co. of N.Y. v. United States, 93-1 U.S.T.C. ¶50,034 (S.D. N.Y. 11/19/92) (Wood, J.). Discounts (at 8% annual rates) given by New York City to induce taxpayer to prepay its real property tax installments constituted §103 tax-exempt interest payments from N.Y.C. to taxpayer. The prepayments were treated as loans, with the entire undiscounted amounts of its tax liabilities deductible under §164(a)(1) as property taxes paid or accrued.

1. Consolidated Edison Co. of N.Y., Inc. v. United States, 10 F.3d 68, 93-2 U.S.T.C ¶50,644 (2d Cir. 11/23/93), aff'g and rev'g 93-1 U.S.T.C. ¶50,034 (S.D.N.Y. 1992). Discounts for prepayments of NYC property taxes were not excludable from gross income as §103(a) tax-exempt interest on a municipal obligation because (1) the City did not exercise its borrowing power in the course of the prepayment plan, and (2) taxpayer decided at the time to avoid being a creditor. Taxpayer was held bound by the form it chose to avoid the risks associated with an extension of credit, and was required to include the economic benefit it received from the discounts in income under §61; accordingly, the taxpayer was entitled to deduct the entire amount of property taxes under §164(a)(1).

*B. Interest on money borrowed by employee to buy his employer's stock is §163(d) investment interest. Rev. Rul. 93-68, 1993-33 I.R.B. 4. If [a non-dealer in stocks] individual borrows money to purchase C corporation stock in order to protect his employment with the corporation, the interest on the loan is §163(d) investment interest because §163(d)(5)(A) provides that stock (which generally produces dividend income) is property held for investment regardless of the individual's motives for purchasing or holding the stock. The ruling further states that, had the interest not been investment interest, it would have been §163(h)(1) nondeductible personal interest.


*D. Seller-paid points deductible by buyer. Rev. Proc. 94-27, 1994-15 I.R.B. 17, modifying Rev. Proc. 92-12, 1992-1 C.B. 663. Individuals who purchased homes after 12/31/90 may claim an income tax deduction for "seller-paid points." These points should be viewed as an adjustment to the purchase price of the home, and treated as if the seller had paid the amount of the points to the buyer, who in turn used the cash to pay the points charged by the lender.
VIII. Nontaxable Exchanges

*A.* Ninth Circuit applies §1041 to exclude gain on wife's redemption of stock. *Ames v. United States*, 981 F.2d 456, 93-1 U.S.T.C. ¶50,016 (9th Cir. 12/11/92). Affirms district court's grant of summary judgment to taxpayer, holding that the divorce-settlement redemption of taxpayer's stock (in a McDonald's franchise corporation she owned equally with her former husband) qualified for exemption under §1041. The franchisor (McDonald's) required that upon the divorce the non-operating spouse, here the wife, was required to terminate her stock ownership in the franchise corporation. The former husband was held to have been relieved of an obligation by the corporate redemption, so A-9 of Temp. Reg. §1.1041-1T would treat taxpayer's stock as having been transferred to her former husband, and then retransferred to the corporation (the "third party") in a non-§1041 transaction. The $450,000 cash is to be treated as paid to taxpayer by the corporation on behalf of her former husband (and presumably constituting a taxable distribution to her former husband). But see Temp. Reg. §1.1041-1T, A-2, Example (3), which provides that a sale between one spouse and the other spouse's wholly-owned corporation is not governed by §1041 unless the sale is recharacterized under general tax principles, such as the step transaction doctrine.

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

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

*D.* The Tax Court holds that §1041 does not apply to tax the husband in *Ames* on his wife's redemption, so neither spouse is taxed. *Ames v. Commissioner*, 102 T.C. No. 20 (4/5/94) (reviewed, 7 judges dissenting). Redemption of wife's stock [in corporation owned 50-50 by husband and wife] was not a constructive dividend to husband because he did not have a primary and unconditional obligation to purchase wife's stock, relying on Rev. Rul 69-608, 1969-2 C.B. 42. Dissents on ground that the Ninth Circuit has passed on the legal issue, citing *Golsen v. Commissioner*, 54 T.C. 742 (1970) aff'd, 455 F.2d 985, 71-2 U.S.T.C. ¶9497 (10th Cir. 1971), and on the untenable result that neither stockholder will incur tax consequences as a result of the $450,000 stock redemption.
E. **Yonadi v. Commissioner**, 21 F.3d 1292, 94-1 U.S.T.C. ¶50,183 (3d Cir. 4/14/94). Under pre-1984 Act law, divorcing wife who received a one-third interest in her husband's appreciated business assets under New Jersey court's "equitable distribution" was considered to have received the assets from a division of co-owned assets — rather than in a pre-§1041 Davis-type transfer — so she took the property at a carry-over basis and was liable for the capital gains tax on the appreciation realized upon the sale of her one-third interest in the assets.

F. T.D.8535, final and temporary regulations under §1031(a)(3), relating to the coordination of deferred like-kind exchanges with the §453 installment sale rules (4/19/94).

*G. Quasi-geriatric bound by unnecessary §121 election made by her 1979 return preparer, so §121 was unavailable in 1988 when it was really needed. **Robarts v. Commissioner**, 103 T.C. No. 5 (7/27/94). Summary judgment awarded to Commission, holding that taxpayer was precluded from electing §121 exclusion of $112,363 gain on the 1988 sale of her residence because her CPA (without her knowledge) elected a §121 exclusion on her [closed-year] 1979 return, based upon her sale of an earlier residence, even though the gain on the 1979 sale would have been mandatorily deferred by reason of §1034.

*H. 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. No. 8 (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).

IX. **Partnerships**

A. **Partnership Audit Rules**

1. **Boyd v. Commissioner**, 101 T.C. 365 (11/1/93). Second notice of deficiency to partners of a TEFRA partnership was not precluded by §6212(c) because §6230(a)(2)(C) specifically allows assessment of items for a year which have become nonpartnership items even though the first (non-TEFRA) notice of deficiency to taxpayer/partners was barred by the statute of limitations. (The TEFRA notice of final partnership administrative adjustment was timely because the partnership did not file a partnership return for the year in question; taxpayers did not elect to be subject to the partnership proceeding, so their
deduction of the partnership loss was converted to a nonpartnership item and
Commissioner validly issued the second notice of deficiency within one year of
the conversion.)

2. *McKnight v. Commissioner*, 7 F.3d 447, 93-2 U.S.T.C. ¶50,626 (5th Cir.
11/22/93). The TEFRA small partnership exemption applies where the "same
share rule" is met for the year in question even though capital accounts were held
in a different ratio. Temp Reg. §301.6231(a)-IT does not conflict with either
§6231(a)(3) or Reg. §301.6231(a)(3)-1(a)(1).

(Fed. Cir. 2/8/94). No valid petitions in the Court of Federal Claims were filed
by any of the limited partners because they were filed within the 90-day exclusive
period and none of the limited partners was a TMP.

B. Miscellaneous

*1. Limited Liability Companies.* Cookie-cutter rulings under various bulletproof
and flexible LLC statutes.

may or may not be treated as a partnership, by reason of that state's
flexible statute. See also Rev. Rul. 93-92, 1993-42 I.R.B. 11
(Oklahoma); Rev. Rul. 93-93, 1993-42 I.R.B. 13 (Arizona); Rev. Rul.
(Louisiana).

Jersey LLCs under flexible statute.

I.R.B. 129 (6/29/94). Provides a safe harbor that may be used to determine a
"majority in interest" of a limited partnership for purposes of the Reg.
§301.7701-2(b)(1) test for continuity of life, allowing dissolution to be avoided
by either "the remaining general partners" or "at least a majority in interest of
the remaining partners" agreeing to continue the partnership. The safe harbor
is "remaining partners owning a majority of the profits interests and a majority
of the capital interests owned by all the remaining partners," with (1) profits
determined "based upon any reasonable estimate of profits from the date of the
dissolution event to the projected termination of the partnership" under the
partnership agreement in effect as of the date of the dissolution event and (2)
capital determined as of the date of the dissolution event.

*3. Amount of entire year's guaranteed payments had to be multiplied
when annualized for §443 purposes.* *Leonard L. Politte, M.D., Inc. v.
Commissioner*, 101 T.C. 359 (10/27/93). Taxpayer PSC had been filing its
returns on the basis of a fiscal year ended August 31, and was a general partner
in a calendar year medical partnership. During 1988, taxpayer was required by
§§441(i) and 444. to change its accounting period to a calendar year, and was consequently required to file a short-period tax return and annualize its September-December 1988 income under §443. Taxpayer was required under §443(b)(1) and (3) to annualize the §707(c) guaranteed payments received from the partnership for the entire 1988 year — includable in taxpayer’s income on December 31, 1988 by virtue of §706(a) — even though this has the effect of including 36 months of income for purposes of determining the tax rate for the short period. The court noted that taxpayer did not avail itself of §443(b)(2), under which taxpayer could have based its tax on its actual net income for the 12-month period beginning with the first day of the short period.

*4. LOSS ON ABANDONMENT OR WORTHLESSNESS OF PARTNERSHIP INTEREST. Rev. Rul. 93-80, 1993-38 I.R.B. 5 (11/10/93), clarifying and superseding Rev. Rul. 70-355, 1970-2 C.B. 51. A loss incurred on the abandonment or worthlessness of a partnership interest is an ordinary loss if “sale or exchange” treatment does not apply. If there is an actual or deemed distribution to the partner [e.g., where partner under §752 is deemed to receive a decrease in his share of partnership liabilities], or if the transaction is otherwise in substance a sale or exchange, the partner’s loss is capital (except as provided in §751(b)).

*5. FINAL 704(C) REGULATIONS. T.D. 8500, final regulations under §704(c), relating to allocations reflecting built-in gain or loss on property contributed to a partnership (12/21/93). See also, T.D. 8501 and PS-56-93, temporary and proposed §704(c) regulations, relating to the “remedial allocation method” alternative to the “deferred sale method” of the final regulations (12/21/93).

6. Rev. Rul. 93-90, 1993-41 I.R.B. 7. A partnership which is considered terminated under §707(b)(1)(B), by reason of more than 50% of the partnership interests having been sold or exchanged within a 12-month period, is not subject to a Reg. §1.704-2(f) minimum gain chargeback because the minimum gain is accounted for by the partners upon their receipt of deemed distributions on the partnership termination.

7. Rev. Rul. 94-4, 1994-2 I.R.B. 21. A deemed distribution of money under §752(b) resulting from a decrease in a partner’s share of partnership liabilities is treated as a partnership draw to the extent of the partner’s share of income for the year, which is taken into account at the end of the partnership year.

8. Doesn’t insolvency help at all? Babin v. Commissioner, 23 F.3d 1032, 94-1 U.S.T.C. ¶50,224 (6th Cir. 5/6/94). Insolvent general partner in a limited partnership was not entitled to increase the basis of his partnership interest to reflect his distributive share of partnership cancellation of indebtedness income, which distributive share was excluded from gross income under the §108 insolvency exception and, therefore, could not increase his partnership basis [as partner contended under §705(a)(1)(A)]. Consequently, he realized a capital gain because the decrease in his share of partnership liabilities constituted under §752(b) a deemed distribution of money, which exceeded the basis of his partnership interest.
*9. 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."


10. Vecchio v. Commissioner, 103 T.C. No. 12 (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.

X. Personal and Individual Income and Deductions

A. Miscellaneous Deductions and Credits


a. If employment away from home in a single location is realistically expected to last (and does in fact last) for 1 year or less, employment is temporary [and the expenses are deductible under §162(a)(2)] (Situation 1).

b. However, if realistically expected to last for more than 1 year, the employment away from home is indefinite [and the expenses are nondeductible], regardless of whether it actually exceeds 1 year (Situation 2).
c. If initially realistically expected to last for 1 year or less, but at some later date the expectation is changed to more than 1 year, the employment will be treated as temporary [expenses deductible] until the date that the taxpayer's realistic expectation changes (Situation 3). Will this really work on an agent?

2. Rev. Rul. 93-75, 1993-35 I.R.B. 4 (10/25/93). If taxpayer's itemized deductions were reduced by the §68(a) overall deduction limitation [i.e., 3% of AGI in excess of $100,000, limited to 80%of susceptible deductions] and taxpayer subsequently recovers all or a portion of the previously-deducted amounts (e.g., state income taxes), the recovery is generally fully includable in gross income under the tax benefit rule. More specifically, the portion of the recovery includable in the year of receipt equals the difference between (a) the prior year's [post-$68$] itemized deductions and (b) the deductions that would have been claimed [i.e., the greater of (1) the post-$68$ itemized deductions or (2) the standard deduction] had the taxpayer paid the proper amount in the prior year and not received a recovery in a subsequent year.

*3. Nonacquiescence in full deductibility by trusts of investment advisor fees. O'Neill Trust v. Commissioner, 93-1 U.S.T.C. ¶50,332 (6th Cir. 6/2/93), rev'd 98 T.C. 227 (1992). Investment advisor fees paid by trust where trustees lacked investment experience met the §67(e) exception to the §67(a) two-percent floor, and are deductible in full because they would not have been incurred if the property had not been held in trust.


*4. Status of ministers for §67 two-percent floor purposes. Weber v. Commissioner, 103 T.C. No. 19 (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).

B. Miscellaneous Income

*1. Punitive damages

  a. Tax Court: Punitive damages excludable under §104(a)(2)... Horton v. Commissioner, 100 T.C. 93 (2/9/93) (reviewed, 15-3), aff'd (6th Cir. 8/29/94) (2-1). 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. ... and affirmed by the Sixth Circuit. Horton v. Commissioner, 94-2 U.S.T.C. ¶50,440 (6th Cir. 8/29/94) (2-1), aff'g 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."

c. But Court of Federal Claims and Federal Circuit: Punitive damages not excludable under §104(a)(2). 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."

i. Affirmed, Reese v. United States, 24 F.3d 228, 94-1 U.S.T.C ¶50,232 (Fed. Cl. 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. (Note: The 1989 Act amendment denying exclusion under §104(a)(2) of punitive damages in connection with a case not involving physical injury or physical sickness was not applicable).

d. 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 excludible 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."
e. District Court: Punitive damages not excludable under §104(a)(2). Estate of Wesson v. United States, 843 F. Supp. 1119, 94-1 U.S.T.C ¶50,139 (D. Miss. 2/8/94). 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.

*2. Discrimination damages

a. Tax Court holds age discrimination damages excludable under §104(a)(2). Downey v. Commissioner, 100 T.C. 634 (6/29/93) (reviewed, 11-4 (concurrences) - 2 (dissents)), supplementing 97 T.C. 150 (1991). The entire amount of damages received by airline pilot under the Age Discrimination in Employment Act of 1967 was excludable under §104(a)(2).

b. Seventh Circuit, reversing, holds age discrimination damages not excludable from income under §104(a)(2). Downey v. United States, 94-2 U.S.T.C ¶50,441 (7th Cir. 8/30/94), rev'g 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 excludible 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).

c. But Ninth Circuit holds to the contrary. Schmitz v. Commissioner, 94-2 U.S.T.C. ¶____, 1994 U.S. App. LEXIS 23814 (9th Cir. 8/30/94). The entire settlement received in an ADEA lawsuit, both back pay and liquidated damages, is excludible 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).

d. Shaw v. United States, 94-1 U.S.T.C ¶50,196 (M.D. Ala. 4/5/94). Liquidated damages under the Age Discrimination in Employment Act were punitive in nature and, therefore, did not result from a personal injury and were not excludable under §104(a)(2). (Liquidated damages are awarded in ADEA cases in addition to back pay when the violation was willful.) But see, Bennett v. United States, 94-1 U.S.T.C ¶50,044 (Fed. Cl. 1/5/94) (Age discrimination damages received by airline pilots from their former employer are excludable from income under §104(a)(2)).
e. Comprehensive Revenue Ruling on tax treatment of discrimination damages awarded under 1991 amendments to the Civil Rights Act. Rev. Rul. 93-88, 1993-41 I.R.B. 4. Compensatory damages, including back pay, received in satisfaction of a claim of "disparate treatment" gender discrimination [discriminatory treatment by employer] under Title VII of the Civil Rights Act of 1964, as amended in 1991, are excludable from gross income as §104(a)(2) damages for personal injury — even if the compensatory damages are limited to back pay. However, back pay received by a victim of "disparate impact" gender discrimination [classification of employees not necessary for business purposes that tends to discriminate on the basis of race, color, religion, sex, or national origin] is not excludable from gross income. Compensatory damages, including back pay, received in satisfaction of a claim of racial discrimination under 42 U.S.C. §1981 and title VII of the Civil Rights Act of 1964 are excludable from gross income as §104(a)(c) damages for personal injury — even if the compensatory damages are limited to back pay. Similar results will apply under the Americans With Disabilities Act, 42 U.S.C. §12101-12213.

*3. Allocation of damage settlements

a. Tax Court refuses to follow unilateral state court allocation of damages, and does the allocation itself. Robinson v. Commissioner, 102 T.C. 116 (2/2/94). Tax Court not bound under Commissioner v. Estate of Bosch, 387 U.S. 456, 67-2 U.S.T.C. ¶12,472 (1967) by the state court "final judgment" allocation of damages received by taxpayers (95% to mental anguish and 5% to lost profits) in a lawsuit against a bank for improperly holding back collateral after receiving payment on the loan secured by that collateral. The parties settled for $10 million following a jury verdict of $59 million, and the state court allocated the items in its final judgment in accordance with taxpayers' uncontested submission. The Tax Court allocated damages based upon the jury verdict (discounting the $50 million punitive damage award), finding about 37% excludable from income under §104(a)(2) as "tortlike personal injuries" (and applicable punitive damages).

b. No exclusion where there are no facts supporting allocation. Guidry v. Commissioner, T.C. Memo. 1994-127 (3/28/94). Unallocated damages of $925,000 received from Exxon Baytown Credit Union by reason of usury and conversion were not excludable from income under §104(a)(2) because usury is not a personal injury and taxpayer failed to show what portion of the damages received were on account of the conversion (which may be a tortlike personal injury, damages for which are excludable under §104(a)(2)). The determination of whether the damages are received on account of a tortlike personal injury is factual, following Knuckles v. Commissioner, 349 F.2d 610, 65-2 U.S.T.C. ¶9629 (10th Cir. 1965).
c. But Tax Court follows negotiated state court allocation. McKay v. Commissioner, 102 T.C. 465 (3/29/94). Taxpayer who sued Ashland Oil for wrongful termination, seeking damages for breach of contract and RICO violations [which culminated in a jury award of more than $43 million], properly apportioned $12.25 million of the $16.74 million settlement he received from Ashland Oil to the tort claim of wrongful discharge, which was excludable from income under §104(a)(2) as payment for a tort-type personal injury. The court further held that deductions for legal expenses constituted itemized deductions, not deductions from gross income.

d. 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’d 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.

*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.

5. Lazore v. Commissioner, 11 F.3d 1180, 93-2 U.S.T.C. ¶50,669 (3d Cir. 12/6/93). Mohawk Indians are not exempted from federal income taxation by virtue of Article I, §2, cl. 3 of the U.S. Constitution [continued in §2 of the Fourteenth Amendment], which refers to "Indians not taxed," because the reference is descriptive [describing the fact that some Indians are not taxed by the state in which they reside] and exemption from federal taxation can only be found in applicable laws and treaties [but none were here applicable].


7. IA-4-94, proposed regulations under §55, relating to the alternative minimum tax for individuals and other noncorporate taxpayers (59 F.R. 12880, 3/18/94). Prop. Reg. §1.55-1(a) provides that, in general, all IRC provisions that apply in determining regular taxable income also apply in determining AMTI. In prior years the AMT was treated as a tax system separate from and parallel to the
regular tax system, but that entailed "extreme complexity and increased recordkeeping burdens," so these proposed regulations provide that AGI for computing AMTI is equal to AGI for regular tax purposes. See also, Notice 94-28, 1994-14 I.R.B. 13 (3/15/94) (two special rules for noncorporate taxpayers computing AMTI for tax years beginning before 1994); cf., Notice 94-27, 1994-14 I.R.B. 13 (3/15/94) (ACE-LIFO recapture adjustment).

8. Rev. Rul. 94-42, 1994-27 I.R.B. 5 (6/17/94). Amounts received by owners of bonds issued by a political subdivision of a state who contract with a third party for insurance in the event that the issuer defaults are not excludable from gross income under §103 if the agreement is not incidental or is in substance a separate debt instrument or similar investment when purchased.

XI. Procedure, Penalties and Prosecutions

A. Penalties and Prosecutions

*1. A district court reacts to §6672 precedent. Unger v. United States, 94-1 U.S.T.C. ¶50,176 (S.D.N.Y. 2/9/94). Section 6672 penalty of more than $1 million was upheld against the then-twenty-eight-year-old chief financial officer of 200-person advertising agency who paid other creditors instead of paying withholding taxes because the coked-up advertising agency CEO, who had hired him seven years earlier as a $10,000 assistant to the controller, so directed him. The court held the result was required by Hochstein v. United States, 900 F.2d 543, 90-1 U.S.T.C. ¶50,205 (2d Cir. 1990), although it agreed that "personal liability for such a sum is a very harsh penalty for a person who essentially acted as a cabin boy on a sinking ship." Hochstein had held that it was sufficient for liability that the individual have significant control over the disbursement of funds, and that his belief that he lacked authority to sign checks to the government without the CEO's consent was irrelevant. Judge Knapp lamented his inability to adopt the dissent in Hochstein and stated, "[s]o far as we can determine, the only course open to [Unger] is to migrate to some more civilized country and try to start life over again."

*2. Section 3505 liability imposed upon bank permitting same-day availability of uncollected deposits. Mercantile Bank of Kansas City v. United States, 94-2 U.S.T.C. ¶50,379 (W.D. Mo. 6/21/94) and 94-2 U.S.T.C. ¶50,423 (W.D. Mo. 8/11/94). On motions for summary judgment, bank and two bank officers were not liable under §6672 for trucking company's unpaid withheld payroll taxes of over $1 million because bank's power to control cash receipts was insufficient for liability because actual exercise of control over taxpayer's disbursements has been required in the decided cases. However, the making of uncollected deposits available on the same day ("same-day availability") constituted the supplying of funds to the trucking company [the bank levied a service charge for same-day availability based on a floating rate of interest on the uncollected funds], so partial summary judgment for the government was granted on its §3505 counterclaim that the bank "supply[d] funds to pay wages knowing that federal employment taxer were not going to be paid."
*3. Whether K-1 preparer is also a preparer of the partners' individual returns is a fact question. Adler & Drobný, Ltd. v. United States, 9 F.3d 627, 93-2 U.S.T.C. ¶50,602 (7th Cir. 11/5/93), rev'd 792 F. Supp. 579, 92-2 U.S.T.C. ¶50,378 (N.D. Ill. 1992). Accounting firm that promoted two R & D tax shelters (as well as preparing the K-1 and Schedule E for the shelters) were possibly "income tax return preparers" of the individual investors' returns, which issue was remanded to the district court that had granted summary judgment on the ground that a single K-1 or Schedule E figure could not be "substantial preparation." The district court was directed to compare the "length, complexity and tax impact" of the individual entry with the "length, complexity and tax impact" of each investor's return as a whole to determine whether the accounting firm's entry constituted a "substantial portion" of that return.

*4. Estate tax undervaluation penalty (for being 39% off) should have been waived because the Commissioner's notice of deficiency and her Tax Court position were twice as wrong. Estate of Jung v. Commissioner, 101 T.C. 412 (11/10/93). Commissioner's refusal to waive the former §6660 estate tax valuation penalty [now in §6662(g) and (h)(2)(C)] was an abuse of discretion because the valuation was made in good faith and (more doubtfully) there was in the expert's report a reasonable basis for the valuation claimed on the return - even though it was a $1.7 million, or 39%, undervaluation -- in light of the Commissioner's 89% overvaluation in her notice of deficiency (and 82% overvaluation on brief). The court valued the entire Jung Corp. on 10/9/84 at about $33 million (and allowed a 35% lack of marketability discount for decedent's 20% interest); the Jung Corp.'s assets were sold in December 1986 for net liquidation proceeds of about $64 million.

5. United States v. Running, 7 F.3d 1293, 93-2 U.S.T.C. ¶50,568 (7th Cir. 10/13/93). Corporate officer not responsible for the §6672 (100%) penalty where he acknowledged the corporation's financial difficulties but resigned "rather than subject himself to the obvious risk that the employment taxes may go unpaid...."

6. Fiatarulo v. United States, 8 F.3d 1930, 93-2 U.S.T.C. ¶50,627 (2d Cir. 11/3/93). Taxpayers involved in a joint venture with a construction company were not §6672 responsible persons because they did not have significant control over the company's finances.

7. Richey v. United States, 9 F.3d 1407, 93-2 U.S.T.C. ¶50,647 (9th Cir. 11/22/93). Tax return preparer who had been convicted under §7206 [aiding and abetting the preparation of fraudulent tax returns] was collaterally stopped from relitigating the issue of willfulness in a civil action for abatement of the §6694(b) [willful understatement] tax preparer penalty.

8. Stallard v. United States, 12 F.3d 489, 94-1 U.S.T.C. ¶50,056 (5th Cir. 1/31/94) (per curiam). Assessment for penalties under §6672 was invalid where it was made with respect to the wrong taxable period, the period ending 6/30/83 instead of the correct period ending 3/31/82. This holding was not meant to affect the
typical case in which the government assesses a taxpayer for the last of several periods for which he had a §6672 liability, see, e.g., Vaglica v. United States, 15 F.3d 181, 94-1 U.S.T.C 150,114 (5th Cir. 1/20/94) (per curiam). The court concluded, "Bureaucratic ineptitude and indifference — coupled with judicial admissions made as part of a confused litigation strategy — have combined to produce an untenable argument by the government: that the assessment of a penalty tax under §6672 need not refer to particular tax periods to be valid. We reject this argument as unsound, contrary to precedent, and contrary to the strictures of the IRS’s own regulations."

9. Sloan v. Commissioner, 102 T.C. 137 (2/7/94). Section 6673 penalty imposed upon taxpayer who filed Forms 1040 with specific disclaimer of the jurat, because signed Forms 1040 submitted just before trial by nonfilers in order to elect joint filing status were not "returns."

*10. How not to litigate in the Tax Court. Bagby v. Commissioner, 102 T.C. No. 23 (4/12/94). Taxpayer’s willful misconduct in the Tax Court proceeding of falsifying documents and deliberately misrepresenting material facts manifested an intent to evade tax, so fraud was proven by clear and convincing evidence. This misconduct, combined with taxpayer’s inaction for long periods of time, indicated that he had initiated Tax Court proceedings primarily for delay; the maximum $25,000 penalty under §6673(a)(1) was imposed because taxpayer’s misconduct was so egregious.

11. Mauerman v. Commissioner, 22 F.3d 1001, 94-1 U.S.T.C. §50,222 (10th Cir. 4/25/94), rev’g T.C. Memo. 1993-23. Commissioner abused her discretion in failing to waive the penalty for substantial understatement of tax under §6661(c) for a physician who invested in reinsurance contracts administered by a company that provided prepaid legal services and deducted his payments currently, as opposed to amortizing them where physician relied upon independent attorneys and accountants and did not attempt to limit the scope of his advisors’ research.

12. Rev. Rul. 94-46, 1994-29 I.R.B. (7/6/94). Taxpayers making electronic fund transfers of federal tax deposits through either debit transactions or credit transactions may have any §6656 late deposit penalties abated where they can establish (through recorded telephone instructions or saved electronic instructions) that they provided timely payment instructions (with appropriate information) to the bank. See also, T.D. 8553, temporary regulations under §6302, relating to the deposit of taxes by electronic funds transfer (7/6/94).

13. United States v. Wexler, 94-2 U.S.T.C §50,361 (3d Cir. 7/14/94). Mandamus issued to require the trial court to eliminate a proposed (criminal) jury instruction adopted in a pre-trial order that was erroneous in stating that interest expense incurred in a transaction with no business purpose and no reasonable possibility of profit is deductible if it is a genuine indebtedness.

14. Alsheskie v. United States, 94-2 U.S.T.C §50,387 (9th Cir. 7/29/94) (2-1). Affirms district court holding that corporate president was not a responsible person under §6672 where parent corporation denied him authority to pay taxes.
B. **Summons**

1. *United States v. C.E. Hobbs Foundation*, 7 F.3d 169, 93-2 U.S.T.C ¶50,588 (9th Cir. 10/12/93), rev'd 91-2 U.S.T.C. ¶50,444 (E.D. Wash. 1991). Order denying summons enforcement with respect to religious organization was reversed because the IRS met its burden under §7611 of initiating valid church tax inquiry and explaining why examination of requested documents is necessary to a competent investigation. The court found the IRS purpose to be proper, i.e., to determine whether the organization is in fact a church (rather than a private social club organized to foster illegal sexual activity between adult church members and minors).

2. IR-93-113 (12/7/93). Announcement that IRS will begin assessing the intentional disregard penalty against attorneys who do not file (or file incomplete) Forms 8300 reporting the receipt of more than $10,000 in cash, as required by §6050I.


4. *United States v. Sindel*, 94-2 U.S.T.C. ¶50,300 (E.D. Mo. 5/13/94). Summons enforced requiring attorney to identify on Forms 8300 the source of cash payments of more than $10,000, as required by §6050I.

*5. 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).

C. **Litigation Costs**

*1. Litigation fees denied in case of first impression. *Estate of Wall v. Commissioner*, 102 T.C. 391 (3/7/94). Litigation costs were denied in case holding that Rev. Rul. 79-353, 1979-2 C.B. 325, was invalid because Commissioner's position was substantially justified in case a of first impression.

a. Tax Court refuses to follow Rev. Rul. 79-353, holding that the power to replace corporate trustee is not the power to control corporate trustee. *Estate of Wall v. Commissioner*, 101 T.C. 300 (10/12/93).
The court refused to follow Rev. Rul. 79-353, 1979-2 C.B. 325, which held that where the settlor of a trust reserved the power to remove the corporate trustee at will and appoint another corporate trustee [and the trustee had the power to distribute income and principal at will (unlimited by an ascertainable standard)], the trust property would be included in settlor's gross estate under §§2036 and 2038. Byrum v. United States, 408 U.S. 125, 72-2 U.S.T.C. ¶12,859 (1972), followed with respect to its according little importance to the settlor's retained power to replace the independent corporate trustee with another trustee and its holding that a §2036(a)(2) right connotes "an ascertainable and legally enforceable power." Judge Nims also noted the trustee's exclusive obligation to the interests of the beneficiaries.

2. **Price v. Commissioner,** 102 T.C. No. 27 (4/21/94). Litigation costs denied because Commissioner's position was substantially justified up to and including the time she conceded the significant substantive issue [small period actuarial assumptions] because none of the four cases which the Government had lost at the trial level were final at the time of the concession.

3. **Bragg v. Commissioner,** 102 T.C. No. 32 (5/24/94). Taxpayers who lost 5 of the 7 issues related to the deduction for the donation of a hull (and almost lost the 6th and were only partially successful on the 7th) were not entitled to §7430 litigation costs (awarded only to a "prevailing party"). While the court did not impose sanctions on taxpayer's counsel under §6673(a)(2), it threatened to do so for similar motions with no basis for success in fact or in law.

4. T.D. 8542, final regulations under §7430, relating to the recovery of reasonable administrative costs incurred by taxpayers in connection with an administrative proceeding within the IRS (6/6/94). T.D. 8543, amendments to final regulations under §7430, relating to the exhaustion of administrative remedies available within the IRS for purposes of attorneys' fee awards under §7430 (6/6/94).

D. **Statutory Notice**

1. **Armstrong v. Commissioner,** 15 F.3d 970, 94-1 U.S.T.C. ¶50,083 (10th Cir. 2/2/94). Notice of deficiency was valid because it was mailed to taxpayer's "last known address" at the time it was mailed, and IRS was not required to send duplicate notices to every address of which it had knowledge or to conduct further research after the notice was returned "unclaimed."

2. **Hempel v. United States,** 14 F.3d 572, 94-1 U.S.T.C. ¶50,091 (11th Cir. 2/16/94). Assessments made against individuals who participated in a tax shelter were valid even though IRS had not first issued a notice of deficiency because taxpayers had unconditionally waived their right to receive a deficiency notice in a closing agreement. Individuals agreed in that closing agreement to be bound by the result in another case and further agreed to assessment for 365 days after the conclusion of that other case notwithstanding the expiration of any period of limitation. The court held the assessment made two years after the conclusion
of the other case to be timely, because the individuals had extended the statute on Forms 872-A and did not submit their Forms 872-T until two months before the assessment was made.

3. Murray v. Commissioner, 24 F.3d 901, 94-1 U.S.T.C. ¶50,243 (7th Cir. 5/13/94). Taxpayer received §6331(d) notices of intent to levy on account of underpayment of tax resulting from the overstatement of the withholding credit, which overstatement is to be treated as a computational error. Therefore the notices do not give rise to jurisdiction to file a Tax Court petition, §6213(b)(1).

E. Statute of Limitations

1. Mecom v. Commissioner, 101 T.C. 374 (11/3/93). Extensions of statute limitations on Forms 872 and 872-A were held valid despite taxpayer’s argument that there was no "meeting of their minds" between himself and the Commission because he believed favorable adjustments would result from the extensions. The court also rejected taxpayer’s arguments of: (1) improper signatories [on behalf of Commissioner], (2) laches, (3) and restricted waiver arguments.

2. Rosser v. United States, 9 F.3d 1519, 94-1 U.S.T.C ¶50,002 (12/28/93), rev’g 91-2 U.S.T.C ¶50,421 (N.D. Ala. 1991). Tax refund suit brought more than two years from the date that the IRS sent, by certified mail, a notice of disallowance of taxpayer’s refund claim was barred by limitations even though taxpayer never received the notice. The limitations period was not tolled because the IRS issued a second notice of disallowance because the second notice did not indicate that taxpayer had two years from the date of the second notice to file suit.

3. Colestock v. Commissioner, 102 T.C. 380 (3/1/94). Commissioner is not precluded from determining a deficiency attributable to a disallowed depreciation deduction in a statutory notice of deficiency dated 5-1/2 years after the return was filed if there is omitted income in excess of 25% of the gross income stated in the return and, under §6501(e)(1)(A), the 6-year statute applies because the deficiency does not have to relate to the omitted income.

*4. The statute of limitations for gift taxes may be four years. O’Neal v. Commissioner, 102 T.C. No. 28 (4/28/94). Donors made gifts of stock to their grandchildren and paid the gift taxes of $1.6 million. The period of limitations for gift tax and generation-skipping transfer tax (GSTT) expired on 4/15/91 without any assertion by the IRS of failure to pay tax and without any request for an extension of time. Within the following year, an appraiser retained by the IRS concluded that the true value of the gifts was about seven times the amount reported, and on 4/13/92 notices of transferee liability were sent to the grandchildren. Held, in denying transferees’ motions for summary judgment, that §6324(b) imposes personal liability on the donee (to the extent of the value of the gift) if gift tax or GSTT is not paid when due and that §6901 extends the period of limitations for assessment of a deficiency against the donee for 1 year after the expiration of the period of limitations against the donor, so the notices
of transferee liability were not barred by the statute of limitations. Section 2504(c), which makes final for gift tax purposes the valuation of taxes gifts upon which the statute of limitations has expired, is inapplicable here because that section refers to gifts made in a period preceding the year in issue.

5. **Kaggen v. IRS**, 94-1 U.S.T.C. ¶50,269 (E.D. N.Y. 5/18/94). The §6502 six-year period for collection after assessment made on 4/12/82 was scheduled to expire on 4/12/88, except that waivers signed by taxpayers extended it to 12/31/91; on 9/5/90 the six-year period was amended to ten years by Congress in OBRA 1990. Held, notices of levy issued on 1/2/92 and 1/9/92 were proper.

6. The word is "impleader." **United States v. Hodgekins**, 94-2 U.S.T.C ¶50,317 (7th Cir. 6/29/94). Court affirms the enforcement on summary judgment of a proviso on the extension of the statute of limitations for assessing §6672 penalty, that the government could only reopen the case if it decided to "interplead" Hodgekins in future litigation, by refusing to ignore the plain language and substitute "implead." Affirms §7430 attorney’s fee award.

F. **Miscellaneous**

*1. Innocent Spouse*

a. **Weasel might pop off, so mom is innocent spouse in the 11th Circuit. Kistner v. Commissioner**, 12 F.3d 1342, 94-1 U.S.T.C. ¶50,059 (11th Cir. 1/31/94), rev’d T.C. Memo. 1991-463. Taxpayer Lucille Kistner, formerly married to one George Weasel, was held to be entitled to §6013(e) innocent spouse treatment despite their living an affluent life while reporting significant net losses on their joint tax returns. The court held that spousal abuse, even when not arising to the level of coercion, furnishes a basis for allowing innocent spouse relief.

b. **But not innocent spouse in the Tax Court when spousal abuse does not constitute duress. Wiksell v. Commissioner**, T.C. Memo. 1994-99 (3/9/94). Wife unsuccessfully sought §6013(e) innocent spouse treatment with respect to omitted income from husband’s diversion of funds from an investment scam because she knew about the diversions at the time she signed the returns, and she did not show she signed the returns under duress despite presenting testimony about the spousal abuse to which she was subjected during her marriage (but which lacked nexus to her signing of the returns). Indeed, one of the tax returns was signed by wife while husband was in county jail.

c. **She’s not an innocent spouse in the 5th Circuit under either the Price or the Bokum approach. Park v. Commissioner**, 25 F.3d 1289, 94-2 U.S.T.C. ¶50,320 (5th Cir. 6/30/94). Wife was not (§6013(e)) innocent spouse with respect to GNMA (5:1) tax shelter investments under either the approach of **Price v. Commissioner**, 887 F.2d 959, 89-2 U.S.T.C. ¶9598 (9th Cir. 1989) (whether a reasonably prudent person in her
position would be led to question the legitimacy of the deduction), or that of *Bokum v. Commissioner*, 94 T.C. 126 (1990), aff'd on other grounds, 992 F.2d 1132, 93-2 U.S.T.C. ¶50,374 (11th Cir. 1993) (whether she had reason to know of the underlying circumstances which gave rise to the deduction), because she did not establish she had no "reason to know" of the substantial understatement. The court, therefore, did not determine which approach should govern §6013(e) deduction cases.

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

*3. Somebody doesn’t like taxpayer. It must substantiate favorable RAR adjustments in the Court of Federal Claims. *Sara Lee Corp. v. United States*, 93-2 U.S.T.C. ¶50,560 (Fed. Cl. 9/16/93). Taxpayer’s motion for partial summary judgment denied on the ground that a refund determination in a Revenue Agent’s Report did not create a rebuttable presumption in a subsequent refund action because the RAR is the work of a revenue agent, not a final action by the Commissioner. Taxpayer was required to substantiate each favorable RAR adjustment claimed in the refund suit.

63, 58-2 U.S.T.C. ¶9606 (1958), aff'd on reh'.g, 362 U.S. 145, 60-1 U.S.T.C. ¶9347 (1960), does not require prepayment of interest and penalties when the taxpayer disputes only the tax assessment. The court held taxpayers must prepay interest or penalties only if they assert a claim over assessed interest or penalties on grounds not fully determined by the claim for recovery of the tax principal.

5. GL-708-88, proposed regulations under §6159, relating to payment of federal tax liabilities in installments where the IRS determines that this will facilitate collection of the tax liabilities (F.R. 12/2/93).

6. Announcement 93-144, 1993-39 I.R.B. 12. Notice of hearing on proposed procedures to: (1) allow taxpayers to request early referral of an issue from Examination to Appeals, and (2) allow taxpayers to request the involvement of Appeals in "competent authority" issues involving foreign taxing jurisdictions.

7. T.D. 8507, final regulations under §6050H, relating to information reporting requirements for reimbursements of interest paid on qualified mortgages (12/28/93).


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

*10. Fifth Circuit holds that Tax Court has equitable powers within its limited jurisdiction. Buchine v. Commissioner, 20 F.3d 173, 94-1 U.S.T.C. ¶50,221 (5th Cir. 5/9/94), aff'g T.C. Memo. 1992-36. Tax Court did not improperly expand its limited jurisdiction by reforming a Form 872-A consent form to extend the limitation period for assessment of taxes because it was not exercising "general equitable powers" to take jurisdiction over a matter not provided for by statute, but merely applying "equitable principles" to a case over which it had jurisdiction. The Fifth Circuit further held that the Tax Court did not clearly err in finding that a written agreement to extend the limitation period existed between each of the taxpayers and the IRS.
11. GL-351-90, proposed regulations under §7426, relating to civil actions by persons other than taxpayers (F.R. 12/23/93).


13. T.D. 8509 and IA-62-93, temporary and proposed regulations under §§108(c), 163(d), 1044(a) and 6655(e), relating to the time and manner of making certain elections under the 1993 Act (F.R. 12/27/93).


15. Bax v. Commissioner, 13 F.3d 54, 94-1 U.S.T.C. §50,018 (2d Cir. 12/27/93). Tax Court jurisdiction under §7481(c) to redetermine interest is predicated upon payment of the interest, and taxpayers could not assert claim for §6404 waiver of interest without paying the interest.

16. United States v. Bryant, 15 F.3d 756, 94-1 U.S.T.C. §50,057 (8th Cir. 2/1/94). Affirms summary judgment, finding that transfer by taxpayers of substantially all their real and personal property (including their residence) in trust to their four children for nominal consideration constituted a fraudulent conveyance under Arkansas law.


19. Final regulations on practice before the IRS — Circular 230. T.D. 8545, final regulations on practice before the IRS [Circular 230] (6/15/94). Changed from 10/8/92 proposed regulations in that they: (1) require nonsigning practitioners to advise clients of opportunity to avoid §6662 penalties by disclosure, (2) do not require practitioners to give penalty advice in writing, (3) permit contingent fees for claims for refund [other than those made on original returns] or for amended returns if the practitioner reasonably anticipates; at the time the fee arrangement is entered into, that the return will receive substantive review by the IRS, (4) relaxes the scheduling requirements for dealing with complaints by the Director of Practice, and (5) revises the definition of "return" in §10.2(g) to include an amended return.
*20. Did government trial lawyers make a mistake? DuFresne v. Commissioner, 26 F.3d 105, 94-1 U.S.T.C. ¶50,286 (9th Cir. 6/14/94), vacating and remanding an unpublished Tax Court decision. Tax Court erred in denying Commissioner's 6/9/92 motions to vacate its decision in test cases in which it disallowed interest deductions claimed by numerous investors [primarily commercial airline pilots] in tax shelter programs sponsored by Henry Kersting when it was revealed that two of the test case litigants had entered into secret agreements with IRS district counsel lawyers to reduce tax deficiencies to generate substantial refunds, which would be used to pay litigants' legal fees. Tax Court was ordered to conduct an evidentiary hearing to determine "the full extent of the admitted wrong done by the government trial lawyers."

*21. Detrimental reliance does not cause retroactive legislation to violate due process. United States v. Carlton, 114 S. Ct. 2018, 94-1 U.S.T.C. ¶60,619 (U.S. 6/13/94). The retroactive application of a 12/22/87 amendment to §2057 [which granted an estate tax deduction for half the proceeds of "any sale of employer securities by the executor of an estate" to an ESOP, originally adopted as part of the Tax Reform Act of 1986 on 10/22/86 and applicable to any estate filing a timely return after that date], which amendment required that the securities sold to the ESOP have been "directly owned" by the decedent immediately before death," does not violate the Due Process Clause of the Fifth Amendment because Congress did not act with improper motives, but merely corrected a mistake made in the original §2057. Carlton's detrimental reliance on the original §2057 does not cause due process to be infringed because taxpayers do not have vested rights in the Internal Revenue Code. Carlton had bought the MCI securities on 12/10/86 and filed the estate tax return on 12/29/86; on 1/5/87 the IRS announced in Notice 87-13, 1987-1 C.B. 432, 442, that it would treat the deduction as available only to estates of decedents who owned the securities in question immediately before death. Justice Scalia concurs on the ground that the Due Process Clause "guarantees no substantive rights, but only (as it says) process."

*22. Grantor trust reporting requirements simplified. PS-79-93, proposed regulations under §§671, 6012 and 6109, relating to the method of reporting for grantor trusts (F.R. 7/22/94). Reporting burden will be reduced by expanding the exceptions to the requirement of filing Form 1041, i.e., (1) if one owner, if the trustee furnishes the owner's TIN to all payors (with no further return filing required), and (2) by furnishing the trust's TIN to all payors (with the requirement of filing Forms 1099 showing the trust as payor to each owner of the trust).

*23. 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. ¶____ (11th Cir. 8/29/94), aff'g and rev'g 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 Baptiste's
brother, Baptiste v. Commissioner, 94-2 U.S.T.C. ¶60,173 (8th Cir.
7/12/94).

*24. Rules allow offsets of underpayments by tax refunds for interest-computation
interest due on an underpayment when the taxpayer has previously received a tax
refund with interest for the same tax year.

Updated policies and procedures governing participants in the 1995 electronic
filing program for Form 1040.

XII. Tax Shelters
A. Coleman v. Commissioner, 16 F.3d 821, 94-1 U.S.T.C. ¶50,090 (2d Cir. 2/23/94).
Computer leasing tax shelter was a sham.

B. Harris v. Commissioner, 16 F.3d 75, 94-1 U.S.T.C. ¶50,118 (5th Cir. 3/10/94).
Limited partner of research and development partnership denied deductions under §174
because the partnership did not expend the funds "in connection with" its trade or
business of developing and exploiting cement technology because it was always intended
that the corporation that performed the research work have the option of obtaining a
perpetual exclusive license of the resulting technology and "[a single] prearranged deal
does not evidence the continuity and regularity found in trades or businesses."

supporting pad owned by a taxpayer that is originally placed in service after 12/31/93 and
before 7/1/99 is a separate qualified facility under §45(c)(3). (The Energy Policy Act
of 1992 added §45, which provides a credit for electricity produced from certain
renewable resources, i.e., wind and closed-loop biomass.)

D. Hildebrand v. Commissioner, 94-2 U.S.T.C. ¶50,305 ((10th Cir. 6/22/94), aff'g Krause
recovery limited partnerships under §183 for lack of profit objective.

E. Hudson v. Commissioner, 103 T.C. No. 7 (7/27/94). Purported promissory notes
associated with an investment in educational master audio tapes lacked economic
substance and did not constitute genuine indebtedness.

F. Ferguson v. Commissioner, 94-2 U.S.T.C. ¶50,357 (2d Cir. 7/13/94). Affirms
disallowance of deductions of partnerships involved in a network of entities allegedly
created to pursue production of an alternative energy source known as K-Fuel.
G. **Levien v. Commissioner**, 103 T.C. No. 9 (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.

XIII. **Withholding and Excise Taxes**

A. T.D. 8504, final regulations under §6011, etc., relating to the reporting and depositing of federal employment taxes (12/22/93).

B. **Spiegelman v. Commissioner**, 102 T.C. 394 (3/8/94). Post-doctoral fellowship grant from Columbia University which allowed taxpayer to pursue independent research is not subject to §1401 self-employment tax because scholarship and fellowship grants are not "wages" for FICA and FUTA purposes, even though otherwise taxable, unless §117(c) applies by reason of services required as a condition of the grant. Columbia University’s designation of the funds as "nonemployee compensation" was not governing.

C. **Hall v. Commissioner**, 94-2 U.S.T.C. ¶50,392 (10th Cir. 7/19/94), rev’g T.C. Memo. 1993-360. Individual who returned to the ministry after a five-year absence, was ordained in a new church and accepted a new belief in opposition to public insurance was entitled to file a §1402(e) exemption from the self-employment tax at that time.

XIV. **Tax Legislation**

A. H.R. 3419, the Tax Simplification and Technical Corrections Bill of 1993 was passed by the House on 5/17/94.

XV. **Trusts, Estates & Gifts** (Selected items)

A. **Gross Estate**

*1. Tax Court refuses to follow Rev. Rul. 79-353, holding that the power to replace corporate trustee is not the power to control corporate trustee. **Estate of Wall v. Commissioner**, 101 T.C. 300 (10/12/93). The court refused to follow Rev. Rul. 79-353, 1979-2 C.B. 325, which held that where the settlor of a trust reserved the power to remove the corporate trustee at will and appoint another corporate trustee [and the trustee had the power to distribute income and principal at will (unlimited by an ascertainable standard)], the trust property would be included in settlor’s gross estate under §§2036 and 2038. **Byrum v. United States**, 408 U.S. 125, 72-2 U.S.T.C. ¶12,859 (1972), followed with respect to its according little importance to the settlor’s retained power to replace the independent corporate trustee with another trustee and its holding that a §2036(a)(2) right connotes "an ascertainable and legally enforceable power." Judge Nims also noted the trustee’s exclusive obligation to the interests of the beneficiaries.
2. **Estate of Holl v. Commissioner**, 101 T.C. 455 (11/15/93). On remand from the Tenth Circuit, the Tax Court determined the in-place value of oil and gas reserves as of the date of severance for purposes of inclusion in gross estate on the §2032 alternate valuation date, the appeals court having held the use of "the actual sales prices as of the date of sale" to be erroneous. The actual net proceeds of $980,000 were to be discounted to $869,000 by using a present value discount factor of 95% and a risk factor of 93%, as opposed to taxpayer's contended 75% and 60-75% factors, respectively. (Taxpayer's experts testified that they would not advise a client to sell at their $373,000-$583,000 values.)

3. Special use valuation and minority discounts not available in conjunction. **Estate of Hoover v. Commissioner**, 102 T.C. No. 36 (6/21/94). Decedent held a 26% interest in a limited partnership that owned and operated a large ranch. Her estate made a §2032A special use valuation election. It could not use a 30% minority interest discount in conjunction with the §2032A reduction in value. **Estate of Maddox v. Commissioner**, 93 T.C. 228 (1989), followed and clarified to the effect that both discounts could not be taken, regardless of the sequence in which the estate claims the discounts.

**B. Estate Tax Credits and Deductions**

1. **Estate of Hubert v. Commissioner**, 101 T.C. 314 (10/19/93) (reviewed, 15-2). The estate tax marital and charitable deductions are to be reduced only by the portion of administration expenses allocated to principal, and not the amounts allocated to income. **Estate of Street v. Commissioner**, 974 F. 2d 723, 92-2 U.S.T.C. ¶60,112 (6th Cir. 1992), rev'd T.C. Memo. 1998-553, not followed. Note Rev. Rul. 93-48, 1993-24 I.R.B. 9, holding that the payment of interest on estate and inheritance taxes allocated to income does not reduce the marital deduction. To the same effect is **Estate of Allen v. Commissioner**, 101 T.C. 351 (10/20/93).

*2. Detrimental reliance does not cause retroactive legislation to violate due process. **United States v. Carlton**, 114 S. Ct. 2018, 94-1 U.S.T.C. ¶60,619 (U.S. 6/13/94). The retroactive application of a 12/22/87 amendment to §2057 [which granted an estate tax deduction for half the proceeds of "any sale of employer securities by the executor of an estate" to an ESOP, originally adopted as part of the Tax Reform Act of 1986 on 10/22/86 and applicable to any estate filing a timely return after that date], which amendment required that the securities sold to the ESOP have been "directly owned" by the decedent immediately before death," does not violate the Due Process Clause of the Fifth Amendment because Congress did not act with improper motives, but merely corrected a mistake made in the original §2057. Carlton's detrimental reliance on the original §2057 does not cause due process to be infringed because taxpayers do not have vested rights in the Internal Revenue Code. Carlton had bought the MCI securities on 12/10/86 and filed the estate tax return on 12/29/86; on 1/5/87 the IRS announced in Notice 87-13, 1987-1 C.B. 432, 442, that it would treat the deduction as available only to estates of decedents who owned the securities in question immediately before death. Justice Scalia concurs.
on the ground that the Due Process Clause "guarantees no substantive rights, but only (as it says) process."

3. "Stub period" income passing to remainder beneficiary disqualifies QTIP marital deduction. Estate of Shelfer v. Commissioner, 103 T.C. No. 2 (7/19/94) (reviewed, 10-6). The Tax Court decided to adhere to its holding in Estate of Howard v. Commissioner, 91 T.C. 329 (1988), rev'd, 910 F.2d 633, 90-2 U.S.T.C. ¶60,033 (9th Cir. 1990), holding that a trust is not §2056(b)(7) qualified terminable interest property where the income accumulating between the last distribution date and the date of the surviving spouse's death passed to the trust's remainder beneficiary and allowing the surviving spouse's estate to exclude the otherwise includable [§2044] trust property from its §2031 gross estate. The majority (Laro, J.) held that the proposed regulations to the contrary "are not entitled to our deference, and in fact carry no more weight than an argument advanced by respondent on brief" and that the final regulations are effective only with respect to decedents dying after 3/1/94. (The Tax Simplification and Technical Corrections Bill of 1993, H.R. 3419, 103d Cong., 1st Sess. §603(a)(1) and (e), would codify the rule in the final regulations.)

C. Gift Tax

1. If a disclaimer is too late, when is the gift made? Irvine v. United States, 981 F.2d 991, 93-1 U.S.T.C. ¶60,126 (8th Cir. 12/28/92) (en banc, five judges dissenting), cert. granted 6/14/93, on rehearing of 936 F.2d 343, 91-2 U.S.T.C. ¶60,074 (8th Cir. 1991), affg 818 F. Supp. 272, 89-2 U.S.T.C. ¶13,818 (D. Minn. 1989). Donee's disclaimer of remainder interest in trust created in 1917, made within two months of the interest vesting in 1979, was not a taxable transfer for Federal gift tax purposes because the contingent remainder was created prior to the Gift Tax Act of 1932, and was never subject to Federal gift tax, so Reg. §25.2511-1(c)(2) was inapplicable and state law governed the validity of the disclaimer.

   a. Reversed, 114 S. Ct. 1473, 94-1 U.S.T.C. ¶60,163 (U.S. 4/20/94). Disclaimer of remainder interest in trust created before enactment of gift tax is a taxable transfer because the transfer [of the interest created before enactment of the gift tax] took place after the enactment of the gift tax.

2. Estate of Robinson v. Commissioner, 101 T.C. 499 (12/2/93). Decedent made gifts of real property by deed to her nine children and grandchildren in 1982 and 1983, but claimed 25 annual exclusions by reason of implied trusts in favor of her 16 great-grandchildren; she was limited to nine annual exclusions because she failed under Georgia law to prove the existence of the implied trusts. The §6501(e)(2) six-year period of limitations was inapplicable because decedent did not omit anything from the amount of total gift, and moreover adequately disclosed the 25 claimed annual exclusions. For estate tax purposes, however, the amount of "adjusted taxable gifts" under §2001(b)(1) is to be calculated by using only nine annual exclusions under the principle that the basis for tax
liability in a prior barred period may be recomputed for the purpose of calculating the tax liability for an open period. Estate of Prince v. Commissioner, T.C. Memo. 1991-208, aff'd sub nom. Levin v. Commissioner, 986 F.2d 91, 93-1 U.S.T.C.: ¶60,128 (4th Cir. 1993), followed. Section 2504(c) was inapplicable because a question of valuation was not involved.

3. Autin v. Commissioner, 102 T.C. No. 35 (6/14/94). Donor held liable for gift tax for 1988 on the record transfer of 51 shares of the stock of a closely held corporation to his son, despite a secret 1974 agreement [in the form of a notarized Louisiana "counter letter"] that son was the equitable owner of all 100 shares of the [then newly-formed] corporation's stock, because donor retained dominion and control over, and substantial ownership of, the 51 shares by his actions from 1974 to 1988. The Commissioner did not plead estoppel. No negligence penalty for not filing gift tax returns because donor relied on the advice of his professional advisors.

D. Miscellaneous

1. Crown Income Charitable Fund v. Commissioner, 8 F.3d 571, 93-2 U.S.T.C. ¶50,645 (7th Cir. 10/29/93). Charitable lead trust was not entitled to §642 charitable income tax deductions for (commutation) payments in excess of the annual annuity required under terms of the trust instrument because of the potential abuse of the trustees commuting at the initial table rate used to calculate the value of the initial charitable gift at times when the market interest rate falls below that table rate.

2. T.D. 8540, final regulations under §7520, relating to the valuation of annuities, interests for life or terms of years, and remainder or reversionary interests (6/9/94).

3. Peterson Marital Trust v. Commissioner, 102 T.C. No. 38 (6/28/94). Generation-skipping transfer tax held applicable to transfers from marital trust to grandchildren's trusts pursuant to the terms of Mr. Peterson's will (effective at his 1974 death) by virtue of Mrs. Peterson's death on 9/5/87 without exercising her power of appointment because she "constructively added" the trust property to the marital trust at her death, which was after the 1986 Act's 9/25/85 effective date applicable to such transfers.