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Recent Developments in Federal Income Taxation* The Year 2003

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* This outline is based on prior current developments outlines presented by the authors at numerous continuing legal education conferences over the past year. Among the conferences at which one or both of the authors presented current developments based on this outline during the year 2003: ABA Tax Section Midyear Meeting, American Institute on Federal Taxation, American Petroleum Institute, Denver Tax Institute, Houston Bar Association Tax Section, Kentucky Institute on Federal Taxation, State Bar of New Mexico Tax Symposium, University of North Carolina Tax Institute, Southern Federal Tax Institute, State Bar of Texas Tax Section, Tax Executives Institute, Tennessee Tax Institute, Texas Society of CPAs (Austin Chapter) Institute, University of Texas Annual Taxation Conference, University of Virginia Conference on Federal Taxation, Wednesday Tax Forum (Houston), William & Mary Tax Conference.

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**RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION:
THE YEAR 2003**

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

I. ACCOUNTING

A. Accounting Methods

1. **Really kind taxpayer-favorable § 481 adjustments.** Rev. Proc. 2002-19, 2002-13 I.R.B. 696 (4/1/02). This revenue procedure modifies Rev. Proc. 97-27, 1997-1 C.B. 680, and Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (1/22/02). It revises the revised rules for obtaining the IRS's consent to changes in accounting methods. The most significant changes to Rev. Proc. 97-27 and Rev. Proc. 2002-9 are: (1) allowing a taxpayer to change its method of accounting prospectively, without audit protection, when the method to be changed is an issue pending for a taxable year under examination or an issue under consideration by either an appeals office or a federal court; and (2) taking negative, i.e., taxpayer-favorable, § 481(a) adjustments into account entirely in the year of change. This revenue procedure was amplified and clarified by Rev. Proc. 2002-54, 2002-35 I.R.B. 432 (8/14/02).

a. **And just a little more for taxpayers in the name of simplicity.** REG-142605-02, Administration Simplification of Section 481(a) Adjustment Periods in Various Regulations, 68 F.R. 25310 (5/12/03). Proposed amendments to regulations under §§ 263A and 448 would allow taxpayers changing a method of accounting to take any § 481(a) adjustments over the same number of taxable years that is provided in the general guidance provided under Rev. Proc. 92-27, 1997-1 C.B. 680 (as modified and amplified by Rev. Proc. 2002-19, 2002-13 I.R.B. 696, and modified by Rev. Proc. 2002-54, 2002-35 I.R.B. 432) for accounting method changes [four years for positive adjustments and one year for negative adjustments].

2. Is it an accounting method or is it not?

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

b. **Another case holding that a reclassification of MACRS property is not a change of accounting method.** Green Forest Manufacturing Inc. v. Commissioner, T.C. Memo. 2003-75 (3/14/03). The Tax

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

● Note that the relief provided by Rev. Proc. 96-31, updated by Rev. Proc. 2002-9, Rev. Proc. 2002-19, and Rev. Proc. 2004-11, *infra*, permits a deduction for all prior allowable depreciation that was erroneously not taken by the taxpayer with respect to an asset owned by the taxpayer. This relief is available to taxpayers who file a Form 3115 for a change of accounting method with their income tax return for the year of sale, or, preferably, at an earlier date.

c. **However, new regulations provide that a change in depreciation will generally constitute a change in accounting method.** T.D. 9105, Changes in Computing Depreciation, 69 F.R. 5 (1/2/04); REG-126459-03, 69 F.R. 42 (1/2/04). These final, temporary and proposed regulations provide that changes in depreciation or amortization generally are changes in accounting method under Reg. § 1.446-1(e). Additionally, these regulations (1) amend Reg. § 1.167(e)-1 to provide that certain changes in depreciation method for property for which depreciation is determined only under § 167 are not changes in accounting method, and (2) amend Reg. § 1.1016-3 to provide that § 1016(a)(2) does not permanently affect a taxpayer's lifetime income for purposes of determining whether a change in depreciation or amortization is a change in method of accounting.

● The useful life exception to the general rule [that a change in depreciation method is a change in accounting] applies only to property for which depreciation is determined under § 167. However, a change to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Code, the regulations, or other guidance published in the Internal Revenue Bulletin is a change in method of accounting.

● Other exceptions include (1) a change in computing depreciation allowances made in the year in which the use of property changes in the hands of the same taxpayer, (2) the making of a late depreciation election or the revocation of a timely valid depreciation election, and (3) a change in the placed-in-service date of an asset.

(1) **Automatic consent procedure to make a change in method of accounting for depreciable or amortizable property after its disposition.** Rev. Proc. 2004-11, 2004-3 I.R.B. 311 (12/31/03). This revenue procedure provides an automatic consent procedure allowing a taxpayer to make a change in method of accounting under § 446(e) for depreciable or amortizable property disposed of in the year of change. This revenue procedure modifies Rev. Proc. 2002-9 (as modified by Rev. Proc. 2002-54, Rev. Proc. 2002-19, Rev. Proc. 2002-33, and as modified and clarified by

Announcement 2002-17), and other revenue procedures to conform to Temp. Reg. § 1.446-1T(e)(2)(ii)(d), and waives the application of the two-year rule set forth in Rev. Rul. 90-38, 1990-1 C.B. 57, for certain changes in depreciation or amortization.

● Extensive portions of the Appendix of Rev. Proc. 2002-9 are deleted and replaced with new language in the Appendix to Rev. Proc. 2004-11.

B. Inventories

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

C. Installment Method

There were no significant developments regarding this topic during 2003.

D. Year of Receipt or Deduction

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

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

the taxable year of sale if the taxpayer ships excess quantities of goods and in the next year the customer agrees to pay for the excess quantities of goods.

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

3. Taxpayer got the deduction, but not § 1341 relief. *Cinergy Corp. v. United States*, 55 Fed. Cl. 489, 91 A.F.T.R.2d 2003-1229, 2003-1 U.S.T.C. ¶50,302 (3/10/03). The Court of Claims held that § 1341 did not apply to repayments to customers of utility charges [additional charges to cover deferred taxes] that were determined by regulatory authorities in subsequent years to have been excessive. The court accepted the IRS's view [see Rev. Rul. 58-226, 1958-1 C.B. 318; Rev. Rul. 67-48, 1967-1 C.B. 50] that when the taxpayer's right to an income item was absolute in the year of inclusion but was undermined by subsequently arising facts, § 1341 does not apply. Section 1341 applies only when the taxpayer had merely an "apparent" right to the income item. Thus, although the repayments were deductible, no rate arbitrage relief was available.

4. Even if the economic performance rules don't get ya, the nonqualified deferred compensation rules might. *Weaver v. Commissioner*, 121 T.C. No. 14 (10/8/03). The taxpayer controlled two corporations, an accrual method calendar year S Corporation (CL) and a cash method July 31 fiscal year C corporation (J). J rendered services to CL and CL deducted the amounts owed to J even though it had not paid the amounts until more than two and one-half months after the close of its taxable year (i.e., by March 15). The Tax Court (Judge Laro) held that the amounts were not deductible in the year the services were rendered because the economic performance requirement of § 461(h) had not been met. Reg. § 1.461-1(a)(2)(iii)(D) and § 404(d) required deferral of the deduction amounts owed to a cash method taxpayer for services until its taxable year the last day of which is within two and one-half months of the day on which the amount is includable in the service provider's gross income if there was a plan or arrangement for the deferral of the payment. Judge Laro emphasized the holding rested on the conclusion that there was such a plan or arrangement between the two entities.

5. Regulations on nonaccrual-experience method applied. *Hospital Corp. of America v. Commissioner*, 348 F.3d 136, 92 A.F.T.R.2d 2003-6705, 2003-2 U.S.T.C. ¶50,702 (6th Cir. 10/30/03), *aff'g* 107 T.C. 116 (9/17/96). The taxpayer-hospitals were entitled to elect the § 448 nonaccrual-experience method for years 1987 and 1988 for calculating their uncollectible amounts because they do not "sell" medical supplies to their patients, but they are furnished to patients as part of the hospitals furnishing medical services. The Sixth Circuit upheld the Tax Court's (Judge Wells) decision that the taxpayers

were required to use the amended Temp. Reg. § 1.448-2T(e)(2) to compute the excluded amount, as opposed to the original temporary regulation; under the amended temporary regulation, the “uncollectible amount” is equal to the year-end receivables multiplied by a fraction equal to (1) total bad debts sustained during the current and 5 preceding years divided by (2) total accounts receivable earned throughout the same 6-year period, not merely (1) total bad debts divided by (2) total year-end accounts receivable (which would have been the result under the traditional former § 166(c) bad debt reserve computed under the *Black Motor v. Commissioner*, 41 B.T.A. 300 (1940), *aff’d on another issue*, 125 F.2d 977 (6th Cir. 1942) formula). Like the Tax Court, the court of appeals concluded that § 448(d)(5) was an ambiguous statute and legislative history left a gap that was properly filled by the amended temporary regulation, following *Chevron U.S.A., Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

We must . . . not substitute our own construction of the tax law where the regulation at issue is reasonable. . . . Several permissible constructions may be reasonable, and where Congress has left gaps, agencies may fill the gaps with necessary rules that are reasonable. . . . [W]e ‘should not interfere with this process,’ . . ., which is what would happen were we to decide whether a method is the better of two possibilities. We need only determine if the one chosen by the Treasury is reasonable. In reviewing the legislative history of the statute and the Treasury Decisions promulgating the regulation, we conclude that the Treasury did not act arbitrarily but selected a reasonable method to measure accounts that should not be accrued from experience.

● The taxpayer also argued that under *United States v. Mead Corp.*, 533 U.S. 218 (2001), the Temporary Regulation was not entitled to *Chevron* deference because it was issued without following the notice and comment process that was involved in *Chevron*, but the court of appeals rejected this application of *Mead*:

The Court made clear, however, that while most of the Supreme Court cases applying *Chevron* involved notice-and-comment rulemaking or formal adjudication, “the want of such procedure . . . does not decide the case, for we have sometimes found reasons for *Chevron* deference even when no such administrative formality was required and none was afforded.” 533 U.S. at 231. . . . The temporary regulations involved in this case were arrived at centrally by the Treasury Department, after careful consideration. They were issued pursuant to statutory authority to “prescribe” needful rules and regulations. See I.R.C. § 7805(a). The regulation was “interpretive” in the same sense that the regulation in *Chevron* was interpretive – it gave content to ambiguous statutory terms. Congress clearly intended that the Treasury Department do so, and *Chevron* deference is therefore appropriate.

6. Section 461(f) deductions for transfers related to contested liabilities. T.D. 9095, Transfers to Provide for Satisfaction of Contested Liabilities, 68 F.R. 65634 (11/21/03); REG-136890-02, 68 F.R. 65645 (11/21/03). The Treasury has promulgated temporary regulations and published identical proposed regulations clarifying issues under § 461(f) and coordinating § 461(f) and § 461(h) [the economic performance requirement]. Temp. Reg. § 1.461-2T(c)(1) and Prop. Reg. § 1.461-2(c)(1) provide that the transfer to a trust of the transferor's debt instrument or stock, or the stock or indebtedness of a related person or corporation, does not give rise to a deduction under § 461(f) with respect to a contested liability. Temp. Reg. § 1.461-2T(e) and Prop. Reg. § 1.461-2(e) provide that a payment to a trust to provide for satisfaction of a contested claim with respect to which the economic performance rules of § 461(h) require payment to the claimant – e.g., tort and workers compensation claims, rebates, prizes and jackpots, warranty claims, etc. – will not result in a deduction under § 461(f).

a. Fudging around with § 461(f), especially when combined with economic performance requirements, makes for a “listed transaction.” Notice 2003-77, 2003-49 I.R.B. 1182 (11/19/03). Certain contested liability trusts used improperly to attempt to accelerate deductions under § 461(f) are identified as “listed transactions.” These transactions include those involving: (1) retention of powers over the trust assets by the taxpayer; (2) transfers of promissory notes to a trust under circumstances indicating the underlying liability is not genuine; (3 and 4) transfers to trusts for contested tort, workers compensation and similar, liabilities for which economic performance requires payment to the claimant, except where the trust is the person to which the liability is owed or payment to the trust discharges the taxpayer's liability to the claimant; and (5) transfers of stock of the taxpayer, or indebtedness or stock issued by a party related to the taxpayer, that are made on or after 11/19/03 to a trust purported to be established under § 461(f).

7. Prepayments for funerals are deposits because they are refundable, albeit rarely refunded. Perry Funeral Home, Inc. v. Commissioner, T.C. Memo. 2003-340 (12/16/03). Applying the principles of Indianapolis Power & Light Co. v. Commissioner, 493 U.S. 203 (1990), Judge Wherry held that refundable prepayments for funerals were excludable deposits even though refunds were rarely requested. The customers, rather than the taxpayer, controlled whether funds would be retained by taxpayer or refunded.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. Maybe the Raiders would have won the Super Bowl if it had been played in the Ninth Circuit's courtroom. Milenbach v. Commissioner, 318 F.3d 924, 91 A.F.T.R.2d 2003-818, 2003-1 U.S.T.C. ¶ 50,229 (9th Cir. 2/6/03), *rev'g in part and aff'g in part* 106 T.C. 184 (1996). The taxpayer was a partner in the Oakland/Los Angeles/ Oakland Raiders. The partnership received a \$6.7 million nonrecourse loan from the Los Angeles Coliseum Commission as part of a package of inducements to move the Raiders from

Oakland to Los Angeles. The loan was repayable only out of net rents received by the Raiders from leases by the Raiders of luxury skyboxes in the Los Angeles Coliseum during the years 1982 through 1986 and was secured only by the suites to be constructed. At the time the loan was made, there were no such skyboxes in the Coliseum. The Raiders partnership was required by the agreement to construct the skyboxes "as soon as practicable as determined by the partnership in its reasonable discretion, having in mind considerations deemed important or significant to the partnership." In fact, the skyboxes were never constructed, and the Tax Court found that there was no evidence that the Coliseum Commission intended to enforce the requirement that they be constructed. Reasoning that this standard for determining when the skyboxes were to be constructed "gave the Raiders great latitude in timing the construction," which amounted to "unlimited discretion," the Tax Court found that the obligation to construct the skyboxes to be illusory. Thus, because the Raiders' obligation to repay the loan was conditional, the Raiders were required to include the funds in gross income upon receipt. On another related issue, the Tax Court held that \$10 million received by the partnership as the first disbursement on a \$115 million nonrecourse loan from the City of Irwindale, made as a part of a package to lure the Raiders to move from the Los Angeles Coliseum, was a true loan even though the loan agreement relieved the Raiders from any obligation to repay the \$10 million if the City of Irwindale failed to advance the remaining funds or to perform certain other acts toward construction of a stadium as required by the loan agreement. At the time the funds were received, they were not under the Raiders' complete dominion and control. The Raiders' obligation to repay was not conditional on their own actions, but could be cancelled by a condition subsequent that was within the lender's control. When the obligation was cancelled in the following year, however, the Raiders realized \$10 million of discharge of indebtedness income.

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

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

● As far as the Irwindale loan was concerned, the Ninth Circuit reversed the holding that COD income was realized by the Raiders in 1988 as "clearly erroneous," because the Tax Court had relied solely on the grounds that a state statute passed in 1988 prevented performance by the City under the plan as proposed. The court of appeals reasoned that under California law the debt might not have been discharged until a subsequent year and remanded the case for a "practical assessment of the facts and circumstances relating to the likelihood of payment." According to the Ninth Circuit, the debt was

not discharged until “when, as a practical matter, it became clear that Irwindale would not be able to fund the entire loan and that the stadium would not be built.”

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

2. Fuel cost over-recoveries are not includible in income. *Cinergy Corp. v. United States*, 55 Fed. Cl. 489, 91 A.F.T.R.2d 2003-1229, 2003-1 U.S.T.C. ¶ 50,302 (3/10/03). Fuel cost over-recoveries (and interest earned thereon) received by a public utility company under a fixed fuel factor scheme instituted by state regulatory authorities [for the benefit of customers, by avoiding large fluctuations in monthly bills] were not includible in gross income under the claim of right doctrine because taxpayer did not have complete dominion, but was obligated to repay or credit the customers accounts. The court followed *Houston Industries, Inc. v. United States*, 125 F.3d 1442 (Fed. Cir. 1997), which also involved fuel surcharges, and distinguished *Iowa Southern Utilities Co. v. United States*, 841 F.2d 1108 (Fed. Cir. 1988), involving a construction surcharge, on the grounds that in that case – as opposed to this case – there was no “unequivocal contractual, statutory, or regulatory duty to repay.”

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

4. Congress might have changed one of the holdings of *Gitlitz*,¹ but the Treasury put another one in the regulations. T.D. 9080, Reduction of Tax Attributes Due to Discharge of Indebtedness, 68 F.R. 42590 (7/18/03). The Treasury has promulgated Temp. Reg. §§ 1.108-7T and 1.1017-1T(b)(4), dealing with reduction in tax attributes under §§ 108(b) and 1017 when COD income is excluded from income under § 108(a)(1)(A)-(C). Examples (and the preamble) indicate that the tax liability for the year of discharge first must be determined without any reduction in attributes in order to identify the amounts, if any, of the tax attributes that will be reduced. “This ordering rule affords the taxpayer the use of certain of its tax attributes described in section 108(b)(2), including any losses carried forward to the taxable year of discharge, for purposes of determining its tax for the taxable year of discharge, before subjecting those attributes to reduction.” Basis reductions under § 1017 occur at the beginning of the taxable year following the year in which the discharge occurred. If a § 381 transaction ends a taxable year

1. *Gitlitz v. Commissioner*, 531 U.S. 206 (2001). See, Job Creation and Worker Assistance Act of 2002, which reverses the result of *Gitlitz* by providing that excluded cancellation of indebtedness income of S corporations does not result a § 1366 adjustment to the basis of stock owned by the shareholders.

in which the distributing or transferor corporation excluded COD income under § 108(a), the basis of the property acquired by the acquiring corporation reflects the reduction under § 1017.

5. United States v. Brown, 348 F.3d 1200, 92 A.F.T.R.2d 2003-6826 (10th Cir. 11/4/03). The Court of Appeals upheld the regulations under § 468B. A receiver's estate may be a qualified settlement fund under § 468B(g) and Reg. § 1.468B-1 if it is established to "resolve" claims—even if the establishment of the fund and the transfer of assets to it does not extinguish claims against the alleged tortfeasor. The creation of a qualified settlement fund is not dependent on the deductibility of amounts transferred to it. As a QSF, the receiver's estate was liable for income taxes.

B. Deductible Expenses versus Capitalization

INDOPCO aftermath: "... deductions are exceptions to the norm of capitalization . . ." *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992) (Blackmun, J.)

1. **Kudos from taxpayers; pans from professors. Treasury abandons the future benefits test of *INDOPCO* – Long live the separate and distinct asset test. Or, do the final regulations go beyond the separate and distinct asset test and interpret *INDOPCO* in a more efficient way?** T.D. 9107, Guidance Regarding Deduction and Capitalization of Expenditures, 69 F.R. 436 (1/5/04), proposed in REG-125638-01, 67 F.R. 77701 (12/19/02). The Treasury Department has promulgated Regs. § 1.263(a)-4 and § 1.263(a)-5, which deal comprehensively with the capitalization of expenditures that relate to intangible assets and "future benefits." These regulations are commonly referred to as the *INDOPCO* regulations, because they are intended to provide bright-line rules to make the standards based approach to capitalization articulated by the Supreme Court in *INDOPCO* more administrable. However, the regulations more aptly might be called the anti-*INDOPCO* regulations, because they reverse the principle, if not the specific holding of *INDOPCO*.

● The Supreme Court in *INDOPCO v. Commissioner*, 503 U.S. 79 (1992), unequivocally rejected the view that capitalization was not required unless the expenditure resulted in the creation or improvement of a "separate and distinct asset," but also clearly announced that "the notion that deductions are exceptions to the norm of capitalization" is embodied in various aspects of the Code and is supported by a long line of Supreme Court precedents. The regulations turn on their head these interpretations of §§ 162, 261, and 263 by the Supreme Court.

a. **Capitalization is an exception to the norm of deductibility.** Under Reg. § 1.263(a)-4(b)(1), the only expenditures that must be capitalized are those incurred (1) to acquire, create, or enhance an intangible, (2) to facilitate in the acquisition, creation, or enhancement of an intangible or (3) that are otherwise identified by the IRS in prospectively effective published guidance. The term "separate and distinct intangible" is limited by Reg. § 1.263(a)-4(b)(3) to "a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state or federal law and the possession and

control of which is intrinsically capable of being sold, transferred, or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business.” The last phrase of this definition presumably excludes business goodwill for the definition of intangible.² The regulations provide extensive lists of the intangibles to which they apply, including, for example, ownership interests in corporations or partnerships, debt instruments, financial interests, options, patents, copyrights, trademarks, franchises, customer lists, covenants not to compete, certain contract rights, government licenses, assembled workforce, and goodwill. See Reg. § 1.263(a)-4(c)(1) and (d). In addition, the regulations specifically provide that any fund or account that may revert to the taxpayer is a separate and distinct intangible. Reg. § 1.263(a)-4(b)(3)(i). On the other hand, expenditures to induce another person to enter into a contract are not required to be capitalized unless the expenditures are listed as expenditures that give rise to a separate and distinct intangible. Reg. § 1.263(a)-4(b)(3)(i). Thus, for example, a signing bonus to induce an employee enter into an employment relationship is not required to be capitalized if the employee is free to leave and go to work for a competitor at any time. Reg. § 1.263(a)-4(d)(6)(vii), Ex. 8.

● In the preamble to the proposed regulations, the Treasury Department explained that “the separate and distinct asset standard has not historically yielded the same level of controversy as the significant future benefit standard,” and that “the separate and distinct asset test is a workable principle in practice.” The preambles to both the proposed and final regulations also explained that the IRS and Treasury Department might in the future identify expenditures that are not listed in the regulations, but for which capitalization is nonetheless appropriate. Capitalization of non-listed expenditures will be required, however, only if (and after) they have been identified in published guidance. Unless an expenditure relating to an intangible asset is listed in the regulations or in such subsequently published guidance, however, capitalization will not be required and a current deduction will be allowed. Thus, under the regulations, capitalization become an exception to the norm of deducting business expenditures

● The only expenses not related to a separate and distinct asset that must be capitalized under the proposed regulations are costs to “facilitate . . . a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization.” Reg. § 1.263(a)-5 separately requires capitalization of any these expenditures, as well as any expenditures to facilitate acquisition of controlling ownership of another trade or business, regardless of whether the acquisition is an acquisition of the assets constituting the business or of the stock of the corporation conducting the business. This category includes only fact patterns analogous to the narrow fact pattern in *INDOPCO* and a number of cases involving similar issues that followed *INDOPCO*. Thus, the future benefits test of *INDOPCO* has been largely abandoned. See, e.g., Reg. § 1.263(a)-4(d)(4) (expenses for certification of products, services or business processes are not subject to capitalization).

● The regulations provide two very important exceptions to the rule requiring capitalization of transaction costs. First,

2. See *Baker v. Commissioner*, 338 F.3d 789 (7th Cir. 2003) (business goodwill cannot exist and be sold separately from business assets to which it could attach).

under a “simplifying convention” that is in fact a major substantive rule, Reg. § 1.263(a)-4(e)(4)(ii) provides that compensation paid to employees (including certain independent contractors who perform employee-like work) and the employer’s associated overhead are never capitalized. Reg. § 1.263(a)-5(d)(2) provides a similar rule with respect to transaction costs involving business acquisitions and restructurings. These provisions reject case law to the contrary and go far beyond the principle of those cases that in certain circumstances have allowed a current deduction for employee compensation that facilitates the acquisition of an intangible asset.³ Moreover, they adopt a rule for dealing with intangible assets that is diametrically opposed to the treatment of transaction costs with respect to tangible assets, which always must be capitalized under either or both of §§ 263(a) or 263A.

● Second, Reg. § 1.263(a)-4(e)(4)(iii) provides an exception that permits *de minimis* transaction costs – defined as costs that do not exceed \$5,000 per transaction (not payee) – to be deducted currently.⁴ In applying this *de minimis* rule, the taxpayer may use an elective pooling method in which the transaction costs of all similar transactions are averaged and all for the costs are deductible as long as the average does not exceed \$5,000. Thus for example, the taxpayer could average fifty \$4,750 expenditures with fifty \$5,250 expenditures and deduct them all because the average of the one hundred expenditures was only \$5,000. To prevent substantial manipulation that would result in current deductions for very significant transaction costs, this pooling method must be elected prospectively, must include all similar transactions, and is available only if the taxpayer reasonably expects to include at least twenty-five transactions. Furthermore, expenditures that are reasonably expected to differ significantly from the average cannot be included. *See* Reg. § 1.263(a)-4(h). For example, a single \$401,000 expenditure could not be averaged with 99 different \$1,000 expenditures to permit a deduction of the \$401,000 expenditure even though the average of the 100 expenditures is only \$5,000 ($[(99 \times \$1,000) + \$401,000] \div 100$).

b. The “whether and which” test shall too pass. Reg. § 1.263(a)-5 significantly changes the scope of § 195 with respect to transaction costs involving business investigation and expansion expenditures (but not start-up costs). The regulations replaced Rev. Rul. 99-23’s “whether and which” standard for determining the point at which expenditures are inherently capital costs of the acquisition of the business with a bright-line rule. Under the regulations, expenses incurred in the process of pursuing an acquisition of a trade or business – whether the acquisition is structured as an acquisition of stock or of assets (and whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) – must be capitalized only if (1) they are “inherently facilitative” of the acquisition or (2) they relate to activities performed on or after the earlier of (a) the date on which a letter

3. *See* *Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999) (disallowing deduction), *rev’d sub nom.*, *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000); *PNC Bancorp, Inc. v. Commissioner*, 110 T.C. 349 (1998) (disallowing deduction), *rev’d*, 212 F.3d 822 (3d Cir. 2000); *Lychuk v. Commissioner*, 116 T.C. 374 (2001) (disallowing deduction).

4. Reg. § 1.263(a)-5(d)(3) provides a similar rule with respect to transaction costs involving business acquisitions and restructurings.

of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target, or (b) the date on which the material terms of the transaction are authorized or approved by the taxpayer's board of directors (or committee of the board of directors) or, if taxpayer is not a corporation, the date on which the material terms of the transaction are authorized or approved by the taxpayer's appropriate governing officials. Expenditures that are "inherently facilitative" include amounts expended to determine the value of the target, drafting transactional documents, or conveying property between the parties. However, a taxpayer is not required to capitalize any portion of its own employee compensation attributable to these activities, and the regulations also provide a *de minimis* rule similar to that applicable to intangibles generally. Reg. § 1.263(a)-5(d)(2) and (3). The preamble indicates that expenses which escape capitalization under Reg. § 1.263(a)-5 nevertheless are not deductible if they are start-up expenses subject to § 195.

c. Depreciation on intangibles with unascertainable useful lives. Reg. § 1.167(a)-3(b) provides a fifteen-year "safe-harbor" amortization period for any capitalized expenses relating to a self-created intangible for which another amortization period is not prescribed by the Code or regulations and for which amortization is not proscribed.

d. The 12-month rule for prepaid expenses. Reg. § 1.263(a)-4(d)(3) requires that prepaid expenses generally be capitalized. However, Reg. § 1.263(a)-4(f) adopts the holding of the Court of Appeals in *U.S. Freightways v. Commissioner*, 270 F.3d 1137 (7th Cir. 2001), and provides that an expenditure to create or enhance intangible rights or benefits that do not extend for more than twelve months after the expenditure is incurred is not required to be capitalized.⁵ Furthermore, the deduction will not be deferred under the "clear reflection of income" standard of § 446(b). Amounts paid to create rights or benefits that extend beyond twelve months must be capitalized in full and deducted ratably over the period benefited. This arbitrary line produces some strange results. Suppose that in March 2004, Taxpayer A pays an insurance premium of \$130,000 for the period from April 1, 2004 through April 30, 2005. Taxpayer B, on the other hand, in December 2004, pays an insurance premium of \$120,000 for the period from December 1, 2004 through November 30, 2005. For 2004, Taxpayer A's deduction is \$90,000. Taxpayer B's deduction for 2004, however, is \$120,000, even though Taxpayer B's prepayment extends further into 2005 than does Taxpayer A's prepayment.

2. IRS identifies issues to be addressed in forthcoming proposed regulations on tangible property costs. Notice 2004-6, 2004-3 I.R.B. 308 (12/23/03). These issues include [using the numbering from the Notice]: (1) What general principles of capitalization should be applied? (2) What is the appropriate "unit of property"? (3) What is the starting point for determining whether property value is increased or useful life is prolonged? (11) Should the regulations provide "repair allowance" type rules? (12) Should the regulations provide a *de minimis* rule? (13) When should the "plan of rehabilitation" doctrine be applied? (15) Are

5. A taxpayer may elect to capitalize and amortize prepaid expenses that cover a period of twelve months or less. Reg. § 1.263(a)-4(f)(7).

there circumstances where tax treatment should follow financial or regulatory accounting treatment?

3. Go ahead and deduct the cost of asbestos removal – at least as long as you don't change the building's use. Cinergy Corp. v. United States, 55 Fed. Cl. 489, 91 A.F.T.R.2d 2003-1229, 2003-1 U.S.T.C. ¶ 50,302 (3/10/03). The Court of Federal Claims allowed a § 162 deduction for the cost of removing and encapsulating deteriorating fireproofing material that contained asbestos fibers. The fireproofing material did not create a problem for years, but as it deteriorated the danger of the asbestos circulating in the offices increased. The work prevented the asbestos from crumbling or circulating. In allowing the deduction, the court applied the test applied by the Sixth Circuit in United Dairy Farmers, Inc. v. United States, 267 F.3d 510 (6th Cir.2001), and found all of the elements to be met.

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

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

● Note, however, the possibility of deductibility of cleanup costs under § 198 if the site is certified by the state and the expiration date of § 198 is extended beyond the end of 2003.

4. Would you like to fly on a jet without its engines? FedEx Corporation v. United States, 91 A.F.T.R.2d 2003-1940, 2003-1 U.S.T.C. ¶50,405 (W.D. Tenn. 4/7/03). The district court denied the taxpayer's motion for summary judgment that expenditures for its off-wing engine maintenance program were deductible repairs under Reg. § 1.162-4. The court found that there was a genuine issue of fact regarding whether the appropriate unit of property for measuring whether the expenditures added value or materially prolonged life was (1) the entire aircraft, as argued by FedEx, or (2) the jet engines and auxiliary power units, as argued by the government. The court concluded that there is no 'entire vehicle' rule of law requiring that repairs be measured against the entire vehicle rather than against components.

a. You don't have to, at least in Memphis. FedEx Corp. v. United States, 291 F.Supp.2d 699, 92 A.F.T.R.2d 2003-5986, 2003-2 U.S.T.C. ¶50, 697 (W.D. Tenn. 8/27/03). Taxpayer was permitted to deduct the costs of engine shop visits for jet aircraft engine inspection, heavy maintenance and repair because the relevant unit of property was held to be the entire aircraft, not the engine.

5. **Judge Laro draws the line between deductible expenses and capital expenditures.** *D'Angelo v. Commissioner*, T.C. Memo. 2003-295 (10/23/03). In this otherwise unremarkable case, in the context of determining whether certain legal fees were currently deductible or were capital expenditures, Judge Laro articulated the following standards for drawing the line between deductible expenses and capital expenditures:⁶

Just because a particular expense fits within the literal language of section 162, it does not automatically become deductible. This is because other sections, such as section 261, except certain payments from the current deductibility provisions. *INDOPCO, Inc. v. Commissioner*, [503 U.S. 79 (1992)]. Section 261 states that “no deduction shall in any case be allowed in respect of the items specified in this part”, e.g., Part IX, Items Not Deductible. Section 263(a)(1), which is contained in Part IX, generally provides that a deduction is not allowed for “Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.”

As we recently noted in *Lychuk v. Commissioner*, [116 T.C. 374 (201)], the Supreme Court’s mandate as to capitalization requires that an expenditure be capitalized when it (1) creates a separate and distinct asset, (2) produces a significant future benefit, or (3) is incurred “in connection with” the acquisition of a capital asset. See also *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 13 (1974); *Woodward v. Commissioner*, 397 U.S. 572, 575-576 (1970). If any of the three conditions is met, an expense may not be deducted and must be capitalized

C. Reasonable Compensation

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

2. **Haffner’s Service Stations Inc. v. Commissioner**, 326 F.3d 1, 91 A.F.T.R.2d 2003-1461, 2003-1 U.S.T.C. ¶50,333 (1st Cir. 3/31/03). A corporation’s payments to two officers [treasurer and assistant treasurer, who were also wife and husband] were not reasonable compensation. The corporation was founded by the treasurer’s parents and was run by one of their five children. Judge Boudin selected a multifactor test over the *Exacto Spring Corp. v. Commissioner*,

6. Compare T.D. 9108, Guidance Regarding Deduction and Capitalization of Expenditures, 69 F.R. 436 (1/5/04).

196 F.3d 833 (7th Cir. 1999), single factor independent investor test based on the facts and circumstances of this case: Return on equity, while high, was declining in recent years, and the roles played by the two officers was relatively modest.

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

4. T.D. 9083, Golden Parachute Payments, 68 F.R. 45745 (8/14/03). The Treasury Department has promulgated final regulations under § 280G, relating to payments contingent on ownership changes. The effective date is 8/4/03 for payments contingent on ownership changes occurring after 12/31/03. See also, Rev. Proc. 2003-68, 2003-34 I.R.B. 856 (8/1/03) for modified stock option valuation guidance for golden parachute rules.

D. Miscellaneous Expenses

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

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

Polsky treated the full \$19,886,921.85 as the amount realized on the stock. Indeck treated \$15,030,000 as the price of the stock and deducted the remaining \$4,856,922 as interest. The Tax Court (Judge Gale) held that no portion of the \$19,886,921 constituted interest on two alternative grounds: First, the evidence, including Indeck's failure to issue Polsky a Form 1099 for interest, indicated that the parties intended the entire amount to be the stock purchase price. Second, until the settlement agreement was signed, there was no indebtedness within the

meaning of § 163(a) on which interest could accrue – “it was not paid with respect to an existing, legally enforceable obligation for the payment of a principal sum, nor was the amount of the obligation fixed as of the date the purported interest began to accrue.” The court distinguished *Halle v. Commissioner*, 83 F.3d 649 (4th Cir.1996), *rev’g on other grounds Kingstowne v. Commissioner*, T.C. Memo.1994-630, and *Dunlap v. Commissioner*, 74 T.C. 1377 (1980), *rev’d. on other grounds*, 670 F.2d 785 (8th Cir.1982), on the ground that in both of those cases, “there was agreement between the purported debtor and creditor as to the amount of the obligation and its due date, as of the time the purported interest began to accrue.” In contrast, “Indeck’s obligation and its due date were disputed during the period that the bulk of the claimed interest purportedly accrued.”

2. Every buck counts – even if not spent on a Springmaid sheet.⁷ T.D. 9064, Substantiation of Incidental Expenses, 68 F.R. 39011 (7/1/03). Reg. § 1.274-5(j)(3) authorizes the Commissioner to permit taxpayers traveling away from home to use a specified amount for incidental expenses in lieu of substantiating (under § 274(d)) the actual cost of incidental expenses. Applicable to expenses paid or incurred after 9/30/02.

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

4. Fishing trip costs deductible because taxpayer had a business purpose for them, as well as an expectation of future benefits from them. *Townsend Industries Inc. v. United States*, 342 F.3d 890, 92 A.F.T.R.2d 2003-6096, 2003-2 U.S.T.C. ¶50,666 (8th Cir. 9/15/03). The taxpayer manufactured “T-51 printing press attachments,” consisting of approximately 800 parts that give users the ability to print multiple color documents in a single pass through a printing press. Annually for 40 years, it gathered its in-house sales personnel, its outside independent contractor sales people and its engineers and factory workers

7. This refers to one of the most famous advertisements of the last century. Its author was Elliott White Springs, who, after assuming control of his family textile firm, wrote a series of risqué magazine advertisements, including one showing a smiling young Native American woman departing from a hammock [made, of course, from a Springmaid sheet] that was occupied by an exhausted Native American man, captioned “A Buck Well Spent on a Springmaid Sheet.”

for an annual two-day meeting at corporate headquarters, followed by a four-day expense-paid fishing trip. The two-day meeting was often used to introduce new products. Judge Bowman held that the costs of the fishing trip were deductible based upon taxpayer's "realistic expectation to gain concrete future benefits from the trip based on its knowledge of its own small company, its knowledge of the utility of interpersonal interactions that probably would not occur but for the trip, and its knowledge of its own past experience," and the trip qualified as a § 132(d) working condition fringe benefit for the employees who attended.

5. The IRS never seems able to catch up with the movements in the price of gasoline, and more tinkering is in store for 2004. Rev. Proc. 2003-76, 2003-43 I.R.B. 924 (10/27/03), *superseding* Rev. Proc. 2002-61, 2 C.B. 616. The optional standard mileage rate for business use of automobiles will increase on 1/1/04 from 36 cents per mile to 37.5 cents per mile; the mileage rate for medical and moving will increase from 12 cents per mile to 14 cents per mile; and the mileage rate for giving services to a charitable organization will remain at 14 cents per mile. The procedure also revises the limitation on simultaneous use of multiple automobiles to allow a taxpayer using up to four vehicles simultaneously to use the standard mileage rate.

6. Change your globes – Antigua and Barbuda are now part of North America! Rev. Rul. 2003-109, 2003-42 I.R.B. 839 (10/20/23). This revenue ruling supersedes Rev. Rul. 94-56, 1994-2 C.B. 37, and lists all of the geographical areas included in the North American area for purposes of § 274(h), which generally denies any deduction for the cost of attending a "convention, seminar, or similar meeting held outside the 'North American area.'"

7. Florida Progress Corp. v. Commissioner, 348 F.3d 954, 92 A.F.T.R.2d 2003-6583 (11th Cir. 10/21/03) (*per curiam*), *aff'g* 114 T.C. 587 (2000). Section 1341 does not apply to rate reductions by a public utility to indirectly compensate customers for prior charges that retrospectively were determined to have over-recovered costs and, therefore, to have been excessive. Section 1341 does not independently authorize a deduction, but operates only when a deduction is allowed under some other Code section. The Tax Court's finding that rate reductions were income reductions, not deductible expenses, was not erroneous.

8. Electronic employee expense reimbursement arrangement is OK, except for non-itemized hotel bills. Rev. Rul. 2003-106, 2003-44 I.R.B. 936 (11/03/03). This revenue ruling explains when an employer's expense reimbursement arrangement for deductible travel and entertainment expenses that uses electronic receipts and expense reports is an accountable plan under § 62(a)(2)(A) and (C) and the regulations thereunder. Under the plan, the credit card company provides the employer with an electronic receipt for all expenses billed to an employee's business credit card. The electronic receipt contains the date of the charge, the amount of the charge, the merchant's name, the merchant's location, and, if available, an itemization from the merchant of each expense included in the charge. Employees access the database to create an electronic expense report to accompany the electronic receipts associated with their travel and entertainment expenses, and the employees must provide all relevant information

to substantiate the deduction under § 274(d) and the regulations. Employees must be required to submit paper expense reports and receipts for: (1) any expense over \$75 where the nature of the expense is not clear on the face of the electronic receipt; (2) all lodging invoices for which the credit card company does not provide the merchant's electronic itemization of each expense; and (3) any expenses paid for by the employee without using the business credit card; paper receipts and expense reports must contain all required information.

9. Schedule C deficiency interest is nondeductible in the Fifth Circuit. *Alfaro v. Commissioner*, 349 F.3d 225, 92 A.F.T.R.2d 2003-6914, 2003-2 U.S.T.C. ¶50,715 (5th Cir. 11/6/03). The Fifth Circuit held that interest on taxpayers' individual income tax liability that arose from a sole proprietorship belonging to husband is nondeductible personal interest under § 163(h), joining five other circuits in this result. Judge Weiner followed *Robinson v. Commissioner*, 119 T.C. 44 (2002), and all of the other courts that have decided the issue, and upheld the validity of Temp. Reg. § 1.163-9T(b)(2)(i)(A), disallowing a deduction for interest on an individual income tax deficiency, as applied to interest on a deficiency arising from income attributable to a trade or business. He decided that the regulation is a reasonable interpretation of the statute, that it is consistent with the Blue Book, and that Congress has not acted to overturn it in the intervening years since it was promulgated.

E. Depreciation & Amortization

1. The Job Creation and Worker Assistance Act of 2002, Pub. L. 107-47, 115 Stat. 260, provides for additional first-year depreciation of 30 percent for certain property that was acquired after 9/10/01 (and before 9/11/04) and placed in service before 1/1/05. Qualifying property consists of (1) § 168 property with a recovery period of 20 years or less, (2) computer software other than computer software covered by § 197, (3) water utility property, and (4) leasehold improvement property. For passenger automobiles, the § 280F(a)(1)(A)(i) limitation is to be increased by \$4,600. This provision also applies to improvements to used property.

● Depreciation claimed pursuant to this provision may be used for alternative minimum tax purposes even though the 200 percent declining balance depreciation tables are used for the basis remaining after the additional first-year depreciation is taken.

a. Rev. Proc. 2002-33, 2002-20 I.R.B. 963 (5/20/02). This revenue procedure provides procedures for claiming the additional 30 percent first-year depreciation provided by § 168(k) [and § 1400L(b)]. It also explains how a taxpayer may elect not to deduct the additional first-year depreciation for qualified property.

b. Fifty-percent bonus depreciation. Section 168(k)(4), added by the 2003 Act, allows a deduction of fifty percent of the adjusted basis of qualified property (in lieu of the prior 30 percent) placed in service after 5/5/03 and before 1/1/05.

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

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

c. Regulations on bonus depreciation. T.D. 9091, Special Depreciation Allowance, 68 F.R. 52986 (9/8/03); REG-157164, Special Depreciation Allowance, 68 F.R. 53008 (9/8/03). The Treasury has promulgated Temporary Regulations [Temp. Reg. § 1.167(a)-14T (dealing with qualified intangible property); Temp. Reg. § 1.168(k)-1T (dealing with tangible property)] and published identical proposed regulations [Prop. Reg. § 1.167(a)-14; Prop. Reg. § 1.168(k)-1T] dealing with first year bonus depreciation under § 168(k).

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

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

3. The Service agrees that the rotatable spare parts pool used in a maintenance service business is depreciable property, not inventory. Rev. Rul. 2003-37, 2003-15 I.R.B. 717 (4/14/03). The Service will follow *Hewlett Packard, Inc. v. United States*, 71 F.3d 398 (Fed. Cir. 1995), and *Honeywell, Inc. v. Commissioner*, T. C. Memo. 1992-453, *aff'd*, 27 F.3d 571 (8th Cir. 1994), and will treat rotatable spare parts as depreciable assets provided they are used in the taxpayer's maintenance service business and are not held for sale. The ruling seeks comments on the maximum amount of rotatable spare parts sales that should be permitted from a rotatable spare parts pool that is treated as a depreciable asset.

4. The “exhaustion, wear and tear” prerequisite for depreciation is an undemanding standard. And, cost recovery periods are not accounting methods. *O’Shaughnessy v. Commissioner*, 332 F.3d 1125, 91 A.F.T.R.2d 2003-2559, 2003-1 U.S.T.C. ¶50,522 (8th Cir. 6/13/03), *aff’g* 89 A.F.T.R.2d 2002-658, 2002-1 U.S.T.C. ¶50,235 (D. Minn. 9/29/2001). The S corporation in which the taxpayer was a shareholder manufactured glass using a “float process” that involved the use of a molten tin “bath ” that lost volume and purity in the manufacturing process, requiring periodic replenishment. The amount of tin added each year equaled the amount of tin consumed in glass production during the year. The corporation deducted the cost of adding tin to the bath and depreciated the cost

of the original volume of tin. Applying Rev. Rul. 75-491, 1975-2 C.B. 19, which was directly on point, the IRS disallowed the depreciation. The Court of Appeals affirmed the district court's refusal to apply the revenue ruling, because it was not binding and because it predated the ACRS depreciation system, and held that the original volume of tin was depreciable because over time it would have been completely exhausted by volume and purity losses. On another issue, the Court of Appeals reversed the district court and held that reallocation of certain plant assets from one asset category to another for the purposes of MACRS depreciation did not constitute a change in accounting method, following *Brookshire Brothers Holding, Inc. v. Commissioner*, 320 F.3d 507, 91 A.F.T.R.2d 2003-629, 2003-1 U.S.T.C. ¶50,214 (5th Cir. 1/29/03). *But see*, T.D. 9105, at I.A. 2.c.

5. More tangible personal property that the local zoning board and building inspector think is real estate. Cost segregation studies to take advantage of this phenomenon. Rev. Rul 2003-54, 2003-23 I.R.B. 982 (6/9/03). This ruling provides guidance on how the common gasoline pump canopies and their supporting concrete footings – used by 90 percent of gasoline stations – are to be classified for depreciation purposes. Gasoline pump canopies are not inherently permanent structures; for depreciation purposes they are classified as tangible personal property includible in asset class 57.0 of Rev. Proc. 87-56, 1987-2 C.B. 674. The supporting concrete footings are inherently permanent structures classified as land improvements includible in asset class 57.1 of Rev. Proc. 87-56.

● **No Fooling!** Note the recent trend of obtaining a “cost segregation study” to determine the amount and nature of tangible personal property in either an existing or a newly-constructed building. These studies are based on the holding in *Hospital Corporation of America v. Commissioner*, 109 T.C. 21 (1997), *aff'd on another issue*, 348 F.3d 136, 92 A.F.T.R.2d 2003-6705, 2003-2 U.S.T.C. ¶50,702 (6th Cir. 10/30/03). See also, ILM 199921045 (4/1/99) [sic], which held that this determination must be based on facts and circumstances. This is different from component depreciation, which involved separate useful lives for different parts of the real estate. These studies determine whether there is tangible personal property that is part of the building, for purposes of depreciating this tangible personal property separately from the real estate.

6. Section 197 amortization applies to noncompete agreements ancillary to stock redemptions. *Frontier Chevrolet Co. v. Commissioner*, 116 T.C. 289 (5/14/01), *aff'd*, 329 F.3d 1131, 91 A.F.T.R.2d 2003-2338, 2003-1 U.S.T.C. ¶50,490 (9th Cir. 5/28/03).

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

● The Ninth Circuit (Judge Trott) agreed with the Tax Court that taxpayer's redemption was an indirect acquisition of an interest in a trade or business because “the substance of the transaction was to

effect a change of controlling corporate stock ownership,” so taxpayer had to amortize the covenant under § 197.

● Query whether the redemption of less than a controlling amount of stock would result in the acquisition of an interest in a trade or business?

7. Notice 2003-45, 2003-29 I.R.B. 86 (7/21/03). This notice provides for an automatic extension of time until 12/31/03 to amend returns to use the mid-year convention – as opposed to the mid-quarter convention – for property placed in service during 2001 for entities whose third and fourth quarters included 9/11/01 (as permitted by Notice 2001-70, 2001-2 C.B. 437, and Notice 2001-74, 2001-2 C.B. 551). The Treasury and IRS intend to amend the regulations under § 168 to incorporate the guidance provided in this notice, which may be relied upon meanwhile.

a. Similarly, Rev. Proc. 2003-50, 2003-29 I.R.B. 119 (7/21/03), provides an extension until 12/31/03 for taxpayers to claim (or not claim) the additional 30-percent first-year depreciation under § 168(k) or change their selection of § 179 property for the taxable year that included 9/11/01.

8. **Changes in use change MACRS depreciation.** REG-138499-02, Changes in Use Under Section 168(i)(5), 68 F.R. 43047 (7/21/03). The Treasury has published comprehensive proposed regulations to provide rules for determining MACRS depreciation under § 168 when the taxpayer changes the use of the property. Changes in use include: (1) a conversion of personal use property to a business or income-producing use, (2) conversion from business or income-producing to personal use, or (3) a change in use that results in a different recovery period, depreciation method, or both. The regulations will be effective when finalized. Any reasonable method will be acceptable for changes after 12/31/86 and before final regulations are published. However, current Reg. § 1.167(g)-1 limits the depreciable basis of property converted from personal to business use to its fair market value at the time of the conversion.

9. IA 80 Group, Inc. v. United States, 347 F.3d 1067, 92 A.F.T.R.2d 2003-6714, 2003-1 U.S.T.C. ¶ 50,703 (8th Cir. 10/30/03). Section 168(e)(3)(E) provides a 15-year class life to “retail motor fuels outlets,” whether or not food or other items are sold there. A building of more than 1,400 square feet qualifies only if: (1) 50 percent or more of the gross revenues from the property are generated from petroleum sales, or (2) 50 percent or more of the floor space in the property is devoted to petroleum marketing sales. The court of appeals (Judge Smith) held that § 168(e)(3)(E)(iii) applies on a building-by-building basis with respect to a multi-building truck stop that consisted of fuel center buildings, and separate restaurants, stores, and other facilities. Some of the buildings, such as the restaurants, were not 15-year property, even though the gross revenue test was met with respect to the aggregate gross receipts for all the buildings, because neither the gross receipts test nor the floor space test was met with respect to those buildings.

10. **The cost of removing and replacing roof-covering material is deductible.** Campbell v. Commissioner, T.C. Summary Opinion 2002-117

(9/6/02) (nonprecedential pursuant to § 7463(b)). Special Trial Judge Pajak held the \$8,000 expenditure for roofing work done on taxpayer's rent house was a deductible repair, and need not be capitalized. As set forth in the opinion, "The contractors removed the existing top layers of the roof and recovered it with fiberglass sheets and hot asphalt. They made no structural changes to the roof. . . . There was no replacement or substitution of the roof. Petitioner's only purpose in having the work done to the roof was to prevent the leakage and keep her rental house in operating condition and not to prolong the life of the property, increase its value, or make it adaptable to another use."

a. **Same result for costs of spraying roof with foam to prevent future leaks because there was "no replacement or substitution of the roof."** Northen v. Commissioner, T.C. Summary Opinion 2003-113 (8/13/03) (nonprecedential pursuant to § 7463(b)). Special Trial Judge Pajak held that, with respect to the roof of a commercial building, the replacement of 28 sheets of plywood, the removal of all tar and gravel and the spraying of a primer topped with a spray polyurethane foam coating constituted a deductible repair expense. The court followed Oberman Mfg. Co. v. Commissioner, 47 T.C. 471 (1967), in finding that roof work done to prevent leakage – and not to prolong the life of the property, increase its value, or make it adaptable to another use – was deductible because there was no replacement or substitution of the roof.

F. Credits

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

2. **Big brother may be watching your mouth, but he won't give your dentist a tax credit for it.** Fan v. Commissioner, 117 T.C. 32 (7/24/01). Dr. Fan, who had some hearing-impaired patients, purchased an intraoral camera system [consisting of a camera and monitor, video presentations and educational materials] for use in his dental practice [which was an eligible small business as defined in § 44(b)]. The system was useful with respect to all of his patients, but because Dr. Fan considered the system to be a more effective and efficient way to communicate with hearing-impaired patients, he claimed the § 44 disabled access credit for the cost of the system. The Tax Court upheld the Commissioner's disallowance of the credit on the grounds that the system was not an "eligible access expenditure" as defined in § 44(c). Dr. Fan was already ADA compliant; and the system was not marketed, acquired, or used specifically as an auxiliary aid or service to ensure effective communication to comply with the applicable requirements of the ADA.

a. **But he will give your optometrist a tax credit if he purchases an automatic refractor to accommodate disabled patients.** Hubbard v. Commissioner, T.C. Memo. 2003-245 (8/14/03). The Tax Court allowed taxpayer a \$5,000 tax credit under § 44 because his optometry practice is an

eligible small business that falls within the definition of a public accommodation, and he must make reasonable modifications to provide services to disabled individuals. The court noted that in the year before taxpayer purchased the automatic refractor, he had to refer about 30 disabled patients to other optometrists. Judge Swift distinguished *Fan* on the ground that in that case taxpayer was already in compliance with ADA. He also noted that it was irrelevant that taxpayer used the refractor to treat nondisabled patients.

3. Nothing in the statutory structure of the AMT warrants a *de novo* calculation of taxable income. *Ventas, Inc. v. United States*, 57 Fed. Cl. 411, 92 A.F.T.R.2d 2003-5711, 2003-1 U.S.T.C. ¶ 50,513 (Fed. Cl. 7/30/03). Section 280C requires that § 162 deductions be reduced by the amount of the § 51 targeted jobs credit [now Work Opportunity Credit] claimed in computing regular income tax. For the year in question, the taxpayer was subject to the AMT and did not reduce the wage deduction in computing AMTI, because the credit is not allowed against the AMT. The court (Judge Wiese) held that in computing AMTI and tentative AMT for purposes of § 38(c), any reduction in the amount of deductions required by § 280C by virtue of a credit having been claimed with respect to the otherwise deductible expenditure must be taken into account. Judge Wiese rejected the taxpayer's argument that the AMT was a separate tax system, and that since the targeted jobs credit was not allowable under the AMT, the expense deduction should not be disallowed. "Taxable income," which is the starting point for computing AMTI under § 55, is taxable income under the regular income tax. Nothing in the statutory structure provided the adjustment sought by the taxpayer or warranted a *de novo* calculation of taxable income.

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

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

4. A little assistance in identifying new employees that qualify for the work opportunity credit. Rev. Rul. 2003-112, 2003-45 I.R.B. 1007 (11/10/03). An individual whose family receives TANF⁸ assistance for the requisite period meets the requirements to be certified as a qualified IV-A recipient under § 51(d)(2)(A) if the individual is included on the grant and receives assistance for some portion of the specified period.

5. The final research credit regulations that weren't. In T.D. 8930, Credit for Increasing Research Activities, 66 F.R. 280 (1/3/01), the IRS promulgated final regulations relating to the computation of the credit under § 41(c) and the definition of qualified research under § 41(d). The final regulations immediately came under withering criticism from the business sector, and, in an unusual move, in Notice 2001-19, 2001-10 I.R.B. 784, the Treasury (Secretary O'Neill, himself, actually) announced that it will review the "final" regulations by

8. Temporary Assistance for Needy Families (TANF), replaced Aid for Families with Dependent Children (AFDC).

reconsidering the comments submitted and requesting additional comments on the regulations to be received by 4/2/01. Any additional changes to the regulations will be made in proposed form. The regulations, including any future changes, will not be effective until the review is complete, except for the retroactive effective date [12/31/85] of the taxpayer-friendly changes to internal-use computer software rules. Taxpayers may rely on the final rules pending new regulations.

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

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

- The final regulations retain the requirement in the proposed regulations that a taxpayer seek to discover information that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field of science or engineering.⁹ But, in response to comments regarding the discovery requirement, the final regulations make a number of changes.

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

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

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

- The shrinking-back rule has been modified in response to comments. Reg. § 1.41-4(b).

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

- Research with respect to **internal-use software** that satisfies both the general conditions for credit eligibility and the three-part test is eligible for the credit. The final regulations retain the definition of

9. A discovery requirement was applied in *United Stationers, Inc. v. United States*, 163 F.3d 440 (7th Cir. 1998), *cert. denied*, 527 U.S. 1023 (1999), *Norwest Corp. v. Commissioner*, 110 T.C. 454 (1998), and *WIC0-OR, Inc. v. United States*, 116 F. Supp. 2d 1028 (E.D. Wis. 2000), *aff'd*, 263 F.3d 659 (7th Cir. 2001).

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

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

a. The new research credit proposed regulations that are. REG-112991-01, 66 F.R. 66362 (12/26/01). New proposed regulations under § 41 expand the definition of qualified research by eliminating the "discovery test" included in the 1/3/01 regulations.

- Treasury and IRS have eliminated in these proposed regulations the requirement that qualified research must be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering. Rather, Treasury and the IRS believe that the requirement that qualified research be "undertaken for the purpose of discovering information which is technological in nature" is intended to distinguish technological research, which may qualify for the research credit, from non-technological research, which does not.

- The proposed regulations repeat the requirement from Reg. § 1.174-2(a)(1) by stating that research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty, for purposes of this requirement, exists if the information available to the taxpayer does not establish the capability or method of developing or improving the business component, or the appropriate design of the business component.

- The proposed regulations revise the shrinking-back rule to conform it to the rule in the legislative history to the 1986 Act. These proposed regulations also reiterate that the shrinking-back rule may not itself be applied as a reason to exclude research activities from credit eligibility.

- No separate research credit-specific documentation requirement is included in these proposed regulations.

- The preamble notes that the Service will not generally challenge return positions that are consistent with the proposed regulations.

b. New final research credit regulations retain the requirement that experimentation "must be an evaluative process . . . capable of evaluating more than one alternative." They validate the old joke: "How's your wife?" "Compared with whom?" T.D. 9104, Credit for Increasing

Research Activities, 69 F.R. 22 (1/2/04). The final research credit regulations generally retain the provisions of the December 2001 proposed regulations. The rules for internal-use software are not included in these regulations, but are the subject of an advanced notice of proposed rulemaking.

- They require a process of experimentation directed at resolving uncertainty regarding the taxpayer's development or improvement of a business component that fundamentally relies on the principles of the physical or biological sciences, engineering, or computer science. One or more alternatives intended to eliminate that uncertainty must be identified, and a process of evaluating the alternatives must also be identified. The process may involve, e.g., modeling, simulation, or a systematic trial-and-error methodology.

c. ANPRM on internal-use software. REG-153656-03, Credit for Increasing Research Activities, 69 F.R. 43 (1/2/04). The Treasury Department has published an advance notice of proposed rulemaking under § 41(d)(4)(E), seeking comments on the definition of internal-use software for research credit purposes.

G. Natural Resources Deductions & Credits

1. To “produce” or to “transport” gas, that is the question. *Saginaw Bay Pipeline Co. v. United States*, 338 F.3d 600, 92 A.F.T.R.2d 2003-5613, 2003-2 U.S.T.C. ¶50,592 (6th Cir. 7/30/03), *rev'g* 88 A.F.T.R.2d 2001-6019, 2001-2 U.S.T.C. ¶ 50,642 (E.D.Mich. 8/23/01)

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

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

a. Non-producer must use 15-year recovery period. *Clajon Gas Co. L.P. v. Commissioner*, 119 T.C. 197 (10/25/02) (reviewed, 10-5). The Tax Court in a decision by Judge Halpern upheld the government's notices of final partnership administrative adjustment in determining that the recovery period for gathering pipeline systems owned and operated by a non-producer were transportation property with a 15-year recovery period, and not natural gas production property with a 7-year recovery period. The court adhered to its

decision in *Duke Energy Natural Gas Corp. v. Commissioner*, 109 T.C. 416 (1997), *rev'd*, 172 F.3d 1255 (10th Cir. 1999), and refused to follow the Tenth Circuit's reversal. The majority held that Clajon's use of the pipeline system was relevant, and inasmuch as Clajon was not a producer, the pipeline system could not have been part of the production system.

- Judge Wells' dissent was based upon the Tenth Circuit's plain language analysis in *Duke Energy* of Rev. Proc. 87-56, 1987-2 C.B. 674, which only requires that the assets be "used" by natural gas producers to qualify for 7-year depreciation. The Tax Court majority requires that the asset be both owned and used by a natural gas producer. Judge Wells notes that the Tax Court held in *Rauenhorst v. Commissioner*, 119 T.C. 157 (10/7/02), that "the Commissioner may not choose to litigate against an official position the Commissioner has published without first revising or revoking that position."

- Judge Foley's dissent was based upon similar grounds, that the asset meets the regulatory requirement even though Clajon was not a producer.

b. Tax Court holding reversed by the Eighth Circuit: 7-year recovery period for gathering pipelines. *Clajon Gas. Co., LP v. Commissioner*, 354 F.3d 786, 93 A.F.T.R.2d 2004-396, 2004-1 U.S.T.C. ¶50,123 (8th Cir. 1/12/04). The court followed the Eighth Circuit's *Duke Energy* case and the Sixth Circuit's *Saganaw Bay Pipeline* case.

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

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

b. Same issue in Court of Federal Claims. *Exxon Corp. v. United States*, 33 Fed. Cl. 250, 75 A.F.T.R.2d 95-1733, 95-1 U.S.T.C. ¶50,245 (Fed. Cl. 4/11/95). On the same issue, the court held, that while the amount upon which depletion can be taken is not necessarily limited by actual gross income [21 cents], the RMFP calculated by Exxon [41 cents] was not a reasonable basis upon which depletion may be taken and [based upon the burden of proof] the complaint was dismissed. **But reversed**

c. Federal Circuit holds that RMFP which exceeds actual gross receipts is not precluded, nor is it per se “unreasonable.” *Exxon Corp. v. United States*, 88 F.3d 968, 77 A.F.T.R.2d 96-2521, 96-2 U.S.T.C. ¶50,324 (Fed. Cir. 6/20/96), cert. denied 520 U.S. 1119 (3/17/97), rev’g and remanding 33 Fed. Cl. 250, 95-1 U.S.T.C. ¶50,245 (Fed. Cl. 1995). The court held that the taxpayer was entitled to calculate its depletion deduction based upon an RMFP of 39 cents based upon the wellhead price that would be realized by nonintegrated producers. The court further held that the Court of Federal Claims should not have limited the price by making an independent assessment of the reasonableness of the price because the §611(a) language “reasonable allowance . . . in each case” refers to the different types of depletable resource, not to individual taxpayers.

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

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

After trial, the court held:

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

contract qualified as a “fixed contract” because the contract price did not in fact increase after February 1, 1975.

- Second: For calculating Exxon’s 1975 percentage depletion allowance, the RMFP is \$0.6831 per thousand cubic feet (Mcf) of natural gas that is eligible for percentage depletion. (1) The Texas Gulf Coast/East Texas region, rather than the entire state, constituted a “market area that was geographically ‘representative’” of Exxon’s 1975 production from the properties at issue. (2) In determining whether that region was the relevant market area, Judge Gibson found that Exxon’s 1975 “gas well gas production” – comprising 90.24 percent of the gas in issue – was comparable or superior to gas produced and sold generally through the region; only 9.74 percent [casinghead gas] was not comparable and must be excluded from the computation of Exxon’s allowance. (3) After determining the appropriate RMFP transaction sample and adjusting for the pre-sale costs of compression and dehydration, the court held that the RMFP for purposes of Reg. §1.613-3(a) was \$0.6831 per Mcf.

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

e. **Affirmed in part, reversed in part. Literalism triumphs in the Federal Circuit. Taxpayer celebrates a little bit more.** Exxon Mobil Corp. v. United States, 244 F.3d 1341, 87 A.F.T.R.2d 1508, 2001-1 U.S.T.C. ¶50,348 (Fed. Cir. 4/3/01). The Federal Circuit affirmed the Court of Federal Claims holding that percentage depletion should be calculated with respect to a RMFP that exceed the taxpayer’s actual sale price. Judge Michel rejected the government’s argument that Reg. §1.613-3(a) here would lead to “absurd results,” and would “thwart the obvious purpose” of the 1975 Act by noting that Treasury considered, but declined to fix, the “perceived anomaly.” He so held because “it is not the province of this court to remedy anomalies in the tax laws that Congress and the [Treasury] have refrained from correcting.” The 1975 addition of §613A “may have changed pre-1975 law by redefining what kinds of gas are eligible for percentage depletion, nothing in the regulation changes . . . the method of computing the AMOUNT of percentage depletion or eligible gas.” (emphasis in original)

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

f. **The District Court for the Northern District of Texas permits percentage depletion based on the RMFP, but not for the HL&P and SWEPCO contracts.** *Exxon Mobil Corp. v. United States*, 253 F.Supp.2d 915, 2003-2 U.S.T.C. ¶ 50,260 (N.D.Tex. 3/10/03). In this refund action for the 1976 year, the court found that natural gas sold under 18 fixed price, long-term contracts was eligible for percentage depletion based upon the representative market or field price ("RMFP"). The court, however, found that two additional contracts [with HL&P and SWEPCO] were not "fixed contracts" because taxpayer failed to meet its burden of proving by clear and convincing evidence that the prices thereunder were not subject to adjustment to reflect the increase in liabilities of Exxon for federal income tax after 1974 by reason of the [1975 Act] repeal of percentage depletion.

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

a. **Rulings will again be available. But Treasury didn't revert to pre-suspension ruling standards.** Rev. Proc. 2001-30, 2001-19 I.R.B. 1163 (4/23/01), *modified by* Rev. Proc. 2001-34, 2001-22 I.R.B. 1293 (5/8/01). The ruling provides the circumstances under which the Service will issue private letter rulings regarding whether a solid fuel produced from coal is a qualified fuel under § 29(c)(1)(C). The circumstances necessary for the Service to issue a private letter ruling include the presence of coal feedstock particles no larger than a specific size, and the performance of specific activities in processing the feedstock in order to effectuate a significant chemical change. The chief requirement is that the fuel be "synthetic." To be synthetic "a fuel must differ significantly in chemical composition, as opposed to physical composition, from the substance used to produce it." Examples of "favorable processes" set forth in the revenue procedure include "gasification [sic] and liquefaction [sic] and production of solvent refined coal that result[s] in substantial chemical changes to the entire coal feedstock rather than changes that affect only the surface of the coal."

b. **Eleven days later, the Treasury reverted to pre-suspension ruling standards.** Rev. Proc. 2001-34 modifies Rev. Proc. 2001-30 to expand the range of sizes of coal feedstock and to eliminate one particular activity as a necessary part of a process that results in a qualified fuel.

c. **IRS looks again at coal-based syngases – or, is it syngases?** Announcement 2003-46, 2003-30 I.R.B. 222 (7/28/03). IRS suspends issuance of letter rulings related to the § 29 tax credit for the production of solid synthetic fuels produced from coal pending review of tests that purportedly show that the processes resulted in significant chemical change.

d. Someone holds the “kies” to IRS continuation of rulings in this area – at least for the time being. Announcement 2003-70, 2003-46 I.R.B. 1090 (10/29/03). In so doing, the Announcement states:

The Service has finished the review started with Announcement 2003-46. As a result of this review, the Service has determined that the test procedures and results used by taxpayers are scientifically valid if the procedures are applied in a consistent and unbiased manner. The Service believes, however, that the processes approved under its long standing ruling practice and as set forth in Rev. Proc. 2001-30 do not produce the level of chemical change required by § 29(c)(1)(C) and Rev. Rul. 86-100. Nevertheless, the Service continues to recognize that many taxpayers and their investors have relied on its longstanding ruling practice to make investments. Therefore, the Service will continue to issue rulings on significant chemical change but only under the guidelines set forth in Rev. Proc. 2001-30 as modified by Rev. Proc. 2001-34.

Although the Service will resume its ruling practice, the Service has continuing concerns regarding the sampling and data/record retention practices prevalent in the synthetic fuels industry. Accordingly, in order to receive future rulings, taxpayers will be required to (i) maintain sampling and quality control procedures that conform to ASTM or other appropriate industry guidelines at their synthetic fuel production facilities, (ii) obtain regular reports from independent laboratories that have analyzed the synthetic fuel produced in such facilities to verify that the coal used to produce the fuel undergoes a significant chemical change, consistent with prior ruling practice, and (iii) maintain records and data underlying the reports that taxpayers obtain from independent laboratories including raw FTIR data, and processed FTIR data sufficient to document the selection of absorption peaks and integration points. The Service also plans to issue guidance extending these requirements to taxpayers already holding rulings on the issue of significant chemical change. In addition to these requirements, the Service is considering whether to impose certain requirements on laboratories used by taxpayers to demonstrate significant chemical change, consistent with prior ruling practice, such as requiring that the laboratories be accredited by the NIST National Voluntary Laboratory Accreditation Program.

H. Loss Transactions, Bad Debts and NOLs

There were no significant developments regarding this topic during 2003.

I. At-Risk and Passive Activity Losses

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

2. **Soon (or eventually), no amounts borrowed from your partner will increase your at-risk amount.** REG-209377-89, At-Risk Limitations; Interest Other Than That of a Creditor, 68 F.R. 40583 (7/8/03). Section 465(b)(3) provides that amounts borrowed for use in an activity do not increase the borrower’s amount at risk in an activity listed in § 465(c)(1) [(1) motion-picture films or videotapes; (2) farming; (3) leasing § 1245 property; (4) oil and gas resources and geothermal deposits] if the lender has an interest other than that of a creditor in the activity or if the lender is related to a person (other than the borrower) who has a disqualifying interest in the activity. Section 465(c)(3)(D) provides that § 465(b)(3) applies to activities to which § 465 is extended by § 453(c)(3)(A) – all other business and profit seeking activities – only to the extent provided in regulations; *Alexander v. Commissioner*, 95 T.C. 467 (1990), *aff’d by order sub nom. Stell v. Commissioner*, 999 F.2d 544 (9th Cir. 1993), held that until regulations were issued, §465(b)(3) does not apply to activities other than those described in § 465(c)(1). The revisions to Prop. Reg. § 1.465-8 and 1.465-20 would apply § 465(b)(3) to the activities described in § 465(c)(3)(A). The regulation will be effective when finalized.

III. INVESTMENT GAIN

A. Capital Gain and Loss

1. **This collar just plain clean works.** Rev. Rul. 2003-7, 2003-5 I.R.B. 363 (1/16/03). The IRS ruled that a shareholder has neither sold stock currently nor caused a constructive sale of stock under § 1259 where he (1) receives a fixed amount of cash, (2) simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date [but which does provide a “collar” on the number of shares of stock to be delivered, in effect providing a “collar” on the ultimate sale price], (3) pledges the maximum number of shares for which delivery could be required, (4) has the unrestricted right to deliver the pledged shares or to substitute cash or other shares on the delivery date, and (5) is not economically compelled to deliver the pledged shares.

● There was not a sale of the pledged shares because the shareholder was not required to relinquish the pledged shares but had an unrestricted right to reacquire them by delivering cash or other shares. There was not a constructive sale under § 1259(c)(1)(C) because due to the variation in the number of shares that might be delivered, the agreement was not a contract to deliver a substantially fixed amount of property for purposes of § 1259(d)(1).

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

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

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

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

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

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

5. Welter v. Commissioner, T.C. Memo. 2003-299 (10/29/03). Grain commodity trading by the shareholder of a corporation engaged in the grain farming business were not hedging transactions under the predecessor of Reg. § 1.1221-2 because they were effected through the shareholder's personal brokerage account. The gains and losses (net losses) were capital.

● The same result would occur under current Reg. § 1.1221-2.

B. Section 121

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

C. Section 1031

1. **Safe-harbor deferred like in-kind exchanges for car rental companies.** Rev. Proc. 2003-39, 2003-22 I.R.B. 971 (6/2/03). This revenue procedure provides safe harbor rules allowing under § 1031 with respect to programs involving ongoing exchanges of tangible personal property using a single intermediary ("LKE Programs"). [For background information on this revenue procedure, see Attorneys Request Guidance for Like-kind Exchange Programs, 2002 TNT 78-22 (4/1/02).]

D. Section 1035

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

E. Section 1041

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

[I]f the rules of the proposed regulations had applied in the *Arnes* case,¹⁰ because the husband did not have a primary and unconditional obligation to purchase the wife's stock, the redemption would have been taxed in accordance with its form

10. *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992), *not applied by Tax Court*, *Arnes v. Commissioner*, 102 T.C. 522 (1994) (reviewed, 7 judges dissenting).

with the result that the wife would have incurred the tax consequences of the redemption.

- A special rule applies if an *effective* divorce or separation instrument, or a written agreement between the spouses [executed before the due dates of their returns], requires the spouses to file their federal income tax returns in a consistent manner that treats the stock as being redeemed from the continuing shareholder spouse rather than from the spouse from whom it was actually redeemed. In such a case spouses and former spouses will treat a redemption that otherwise would be taxed according to its form as a redemption from the continuing shareholder spouse involving (1) a deemed § 1041 transfer of the stock by the redeemed spouse to the continuing shareholder spouse, and (2) a deemed § 1041 transfer by the continuing shareholder spouse to the redeemed spouse of the redemption proceeds.

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

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

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

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. **IRS revokes Notice 2001-10 and for future arrangements will require taxation under one of two mutually exclusive regimes.** Notice 2002-8, 2002-4 I.R.B. 398 (1/28/02), *revoking* Notice 2001-10, 2001-5 I.R.B. 459. When the Treasury and Service publish proposed regulations providing comprehensive guidance regarding the tax treatment of split-dollar life insurance arrangements, the regulations will provide the following in employment-related arrangements:

- If the employer is formally designated as owner of the life insurance contract, then the employer will be treated as

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

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

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

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

b. Crackdown on split-dollar life insurance arrangements that are designed to understate the value of benefits for income or gift tax purposes. Notice 2002-59, 2002-36 I.R.B. 481 (9/9/02). The IRS held that neither the premium rates in Table 2001 nor the insurer’s lower published premium rates may be relied on to value the insured’s current life insurance protection for the “purpose of establishing the value of policy benefits to which another party may be entitled.” Under reverse split-dollar arrangements, one party with a right to current life insurance protection may use various techniques to confer policy benefits other than current life insurance protection on another party, but using such techniques to understate the value of other policy benefits “distorts the income, employment, or gift tax consequences of the arrangement.”

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

c. Equity split-dollar proposed regulations. REG-164754-01, Split-Dollar Life Insurance Arrangements, 68 F.R. 24898 (5/8/03). Supplement

the 2002 proposed regulations to provide guidance on the valuation of economic benefits under an equity split-dollar life insurance arrangement. Under an equity split-dollar arrangement, the payments by the owner of the policy establish a pool of assets in which the non-owner has rights of withdrawal, borrowing, surrender, assignment or the like; in addition, this pool of assets may be also placed beyond the reach of the owner's creditors. The proposed regulations provide that the non-owner "has current access to any portion of the policy cash that is directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors." "Access" is thus to be broadly construed.

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

d. Final split-dollar regulations are effective on 9/17/03.

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

(1) Rev. Rul. 2003-105, 2003-40 I.R.B. 696 (9/12/03). This revenue ruling renders prior guidance in this area obsolete. In the case of any split-dollar life insurance arrangement entered into on or before 9/17/03, taxpayers may continue to rely on prior revenue rulings to the extent described in Notice 2002-8, but only if the arrangement is not materially modified after that date.

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

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

Similar amounts received from a state agency are excludable under the administrative general welfare exclusion; and similar amounts received from a charity are excluded under §102.

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

a. You don't need a prescription to be reimbursed by a health FSA for over-the-counter drugs. Rev. Rul. 2003-102, 2003-38 I.R.B. 559 (9/22/03). The test for reimbursement by a health FSA under § 105(b) for drugs simply requires that they be obtained for "medical care" as defined in section 213(d)," and does not require that they satisfy the requirement of § 213(b) which permits an amount paid for a medicine or drug to be taken into account for purposes of the § 213 deduction "only if the medicine or drug is a prescribed drug or insulin."

b. Contrast reimbursement plans with deductibility under § 213. Under § 213 a prescription is required for medicines and drugs to be deductible. Rev. Rul. 2003-58, 2003-22 I.R.B. 959 (6/2/03). Amounts paid by an individual for medicines that may be purchased without a prescription of a physician, e.g., aspirin, are not deductible under § 213 of the Code, even when the taxpayer's physician instructs the taxpayer to take the medication to alleviate a medical problem. See V.E., below.

5. Guidance on Health Savings Accounts. Notice 2004-2, 2004-2 I.R.B. 269 (1/12/04). The IRS has issued guidance in Q&A form on Health Savings Accounts under new § 223 (added by § 1201 of the **Medicare Prescription Drug, Improvement, and Modernization Act of 2003**, Pub. L. 108-173, 117 Stat. 2066). This guidance provides basic information about HSAs. This new provision offers health-spending accounts without the "use it or lose it" requirement of health FSAs.

B. Qualified Deferred Compensation Plans

1. **EPCRS updated again.** Rev. Proc. 2003-44, 2003-25 I.R.B. 1051 (6/23/03), *updating and superseding* Rev. Proc. 2002-47, 2002-29 I.R.B. 133. This iteration of the Employee Plans Compliance Resolution System will be generally effective 10/1/03.

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

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

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

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

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

b. **Courts find that Xerox and IBM cash balance plans violate ERISA.** Berger v. Xerox Corporation Retirement Income Guarantee Plan,

338 F.3d 755, 2003-2 U.S.T.C. ¶ 50,597 (7th Cir. 8/1/03) (plan violates ERISA because method of determining an ex-employee's benefit if a lump sum under \$25,000 is chosen on leaving before retirement); Cooper v. IBM Personal Pension Plan, 274 F.Supp.2d 1010, 2003-2 U.S.T.C. ¶50,576 (S.D. Ill. 8/1/03) (plan violates ERISA § 240(b)(1)(G) [reduction of accrued benefit solely on increases in age or service] and 240(b)(1)(H) [rate of benefit accrual decreases once a certain age is attained]).

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

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

1. Just exactly what does "included" mean? Robinson v. United States, 52 Fed. Cl. 725, 90 A.F.T.R.2d. 2002-5003, 2002-2 U.S.T.C. ¶50,524 (6/24/02). The Court of Federal Claims followed Venture Funding, Ltd. v. Commissioner, 110 T.C. 236 (1998), *aff'd per curiam*, 198 F.3d 248 (6th Cir. 1999), *cert. denied*, 530 U.S. 1205 (2000), to hold that §83(h) allows a deduction for the value of a compensatory transfer of restricted stock to an employee only when the amount of the discount is actually "included" by the employee, not when the amount is "includable" but not reported as income by the employee. Since the employee was appealing from an unfavorable audit with respect to the income item attributable to the year of the transfer [in which the employee-COO had made a § 83(b) election and reported the bargain element as zero, giving notice to himself as a representative of the corporation, even though the taxpayers owned all of the remaining stock of the S corporation – 90 percent], the fact of inclusion was not yet established and the refund claim was not ripe. Taxpayers claimed that employee received restricted stock worth \$28 million for \$2 million and made the § 83(b) zero election without advising them or anyone else at the corporation at the time; taxpayers did not find out about the § 83(b) election until negotiating the COO's termination three years later (when they sent the COO an amended Form W-2).

a. Reversed and Reg. § 1.83-6(a) invalidated. "Included" means included under law, not included in fact. Robinson v. United States, 335 F.3d 1365, 92 A.F.T.R.2d 2003-5349, 2003-2 U.S.T.C. ¶50,590 (Fed. Cir. 7/15/03). The Federal Circuit (Judge Bryson) reversed. The court reasoned that since a deduction under § 162 for compensation paid is allowed whether or not the employee actually includes the amount in income, the word "included" in § 83(h)

refers only to whether the amount was properly includable by the employee under § 61. In support of this proposition, the court quoted the legislative history of § 83(h): “The allowable deduction is *the amount which the employee is required to recognize as income*. The deduction is to be allowed in the employer’s accounting period which includes the close of the taxable year in which the employee recognizes the income.” S. Rep. No. 91-522, 91st Cong., 1st Sess. 123 (1969) [emphasis added], focusing on the italicized language. The court also cited the Bluebook for support.

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

2. Rev. Rul. 2003-98, 2003-34 I.R.B. 378 (8/25/03). This revenue ruling deals with the corporation entitled to claim the deduction under § 83(h) when a nonstatutory stock option with no ascertainable value granted to an employee of T is exercised or settled after T has been acquired by P. In three situations, after the acquisition of the T stock, T survives as a subsidiary [for which there was no § 338 election made]. In all three cases, T was entitled to the deduction without regard to whether the employee received cash from T to settle the option or the employee exchanged the T option for a P option that was later exercised. In the fourth situation, T merged into P and the employee exchanged the T option for a P option that was later exercised; in that case P was entitled to the deduction.

D. Individual Retirement Accounts

1. **Guidance for waivers of the 60-day rollover period.** Rev. Proc. 2003-16, 2003-4 I.R.B. 359 (1/27/03). The IRS has provided guidance in applying for a waiver of the 60-day rollover period for IRAs and pension plan distributions, including when automatic waivers will be granted.

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

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. **Dividends received are to be taxed at capital gains rates.** The 2003 Act added § 1(h)(11), which provides that dividends received by taxpayers other than corporations generally will be taxed at the same rate as long-term capital gains, i.e., 15 percent for taxpayers otherwise taxable at a rate greater than 15

percent; and five percent for taxpayers otherwise at 10 or 15 percent (with a special zero percent rate for 10- and 15-percent bracket taxpayers in 2008). This rate applies to dividends received from domestic and qualified foreign corporations for purposes of both the regular tax and the alternative minimum tax. A dividend is treated as investment income for purposes of determining the amount of deductible investment interest under § 163(d) only if the taxpayer elects to treat the dividend as not eligible for the reduced rates. The provision is effective for taxable years beginning after 12/31/02, and beginning before 1/1/09.

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

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

Under [§ 1(h)(11)], dividends received by an individual shareholder from domestic [and qualified foreign¹¹] corporations are taxed at the same rates that apply to net capital gain. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, under the provision, dividends will be taxed at rates of five and 15 percent.

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

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

11. Qualified foreign corporations include those “eligible for the benefits of a comprehensive income tax treaty [other than the Barbados treaty]” and those paid “with respect to stock that is readily tradable on an established securities market in the United States [including those whose stock is traded in the form of American Depository Receipts].”

- The 15- and 25-percent rates under § 11 on corporate taxable income of \$75,000 or less make it advantageous to pay dividends out of corporate earnings, as opposed to paying “zeroing out” the corporation with shareholder/employee compensation. This strategy does not work for professional services corporations, the income of which is taxed at a flat rate of 35 percent.

- Note that the 60-day holding period cannot be satisfied by stock that is acquired one day before the ex-dividend date. This anomaly is to be retroactively corrected in the Tax Technical Corrections Bill (H.R. 3654), which was introduced by Ways & Means Committee Chair Thomas and ranking minority member Rangel. 2003 TNT 236-1.

b. Investment income § 163(d) limitations may lead to a taxpayer election to have dividends taxed at regular rates. The existence of a preferential rate for dividends gives rise to tax arbitrage possibilities similar to those that arise when an interest deduction is allowed with respect investments that produce only tax-favored capital gains, for which § 163(d) historically has limited interest deductions. Accordingly, the **2003 Act** amended § 163(d)(4) to exclude from the definition of net investment income any dividends that are taxed at preferential rates under § 1(h). However, §§ 1(h)(11)(D)(i) and 163(d)(4)(B) allow taxpayers to elect to forgo the preferential rates for dividends and to treat the dividends as investment income for purposes of § 163(d). If a taxpayer does not have other investment income against which investment interest may be deducted under § 163(d), it may be to the taxpayer’s advantage to elect not to have the preferential rates under § 1(h) apply to an amount of dividend income equal to the amount of investment interest that otherwise would be nondeductible by virtue of § 163(d).

c. Payments in lieu of dividends are not eligible for the exclusion. See §§ 6042(a) and 6045(d), relating to statements required to be furnished by brokers regarding these payments. Notice 2003-67, 2003-40 I.R.B. 752 (9/16/03). This notice provides guidance for brokers and individuals regarding payments in lieu of dividends (sometimes called “substitute payments”). Brokers are essentially given a pass for 2003 reporting as to whether a payment is a dividend [on Form 1099-DIV] or a payment in lieu of a dividend [in Box 8 of Form 1099-MISC], but must adopt proper procedures by 2004, Brokers will be permitted to treat shares as loaned first by tax-indifferent customers, then by other customers using the random lottery method provided in existing Reg. § 1.6045-2(f)(2)(ii)(B).

d. Qualified foreign corporations include those “eligible for the benefits of a comprehensive income tax treaty [other than the Barbados treaty].” Notice 2003-69, 2003-42 I.R.B. 851 (10/20/23). This notice provides a list of U.S. income tax treaties meeting the requirements of § 1(h)(11)(C)(i)(II), which results in treating foreign corporations as a “qualified foreign corporation” dividends from which are eligible for the 5 / 15 percent maximum rates.

e. Stock that is readily tradable on an established securities market in the United States [including stock that is traded in the

form of American Depository Receipts]. Notice 2003-71, 2003-43 I.R.B. 922 (10/27/03). This notice defines what it means "to be readily tradable on an established securities market in the United States for purposes of determining whether dividends on stock of a foreign corporation are eligible for the 5 / 15 percent preferential rates.

f. Simplified 2003 reporting procedures for QFCs. Notice 2003-79, 2003-50 I.R.B. 1206 (12/15/03). This notice provides guidance regarding simplified 2003 reporting procedures for dividends paid by "qualified foreign corporations" and corporations whose stock is readily tradable on an established U.S. securities market.

g. T.D. 9103, Information Statements for Certain Substitute Payments, 68 F.R. 74847 (12/29/03). The Treasury Department has promulgated final regulations on information reporting under § 6045(d) for payments in lieu of dividends made to individuals on or after 1/1/03. These regulations provide that, pending issuance of further amendments to Reg. § 1.6045-2, brokers may rely on Notice 2003-67 to comply with information reporting requirements under § 6045(d).

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

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

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

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

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

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

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

B. Miscellaneous Income

1. You have to prove that the damages were received for a physical personal injury. Prasil v. Commissioner, T.C. Memo. 2003-100 (4/9/03). The taxpayer received \$7,650 to settle a sex discrimination claim against her employer. The court held that § 104(a)(2) did not exclude the payment. The record was devoid of any evidence to corroborate the taxpayer's "own self-serving testimony . . . that [the employer's] sex discrimination caused a physical injury to or the physical sickness of Mrs. Prasil." Furthermore, the settlement agreement referred only to the sex discrimination claim and "did not specifically carve out any portion of the settlement payment as a settlement on account of personal physical injury or physical sickness, let alone make reference to a physical injury or a physical sickness" ¹²

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

12. See TAM 200041022 (7/17/00) for some indication as to what the IRS might consider a physical injury.

3. How not to behave when dealing with an issue for which there is no precedent. *Roco v. Commissioner*, 121 T.C. 160 (9/11/03). Qui tam payments are includable in gross income, and taxpayer is penalized for not doing so – despite the absence of any precedent – in large part because the taxpayer sought a private letter ruling and withdrew his request after being advised that the Service would rule adversely.

4. Dennis Rodman is a supporting actor in what might be a far-reaching Tax Court case; only Walter Matthau and Jack Lemmon can do justice to this script. Rodman's nickname might change from "the worm" to "the squirrel." *Amos v. Commissioner*, T.C. Memo. 2003-329 (12/1/03). The taxpayer was a television cameraman who was kicked in the groin and injured by Dennis Rodman after Rodman ran out of bounds and tripped, landing on the taxpayer – i.e., the kick took extra effort by Rodman. The taxpayer settled any claims he had against Rodman for \$200,000. The settlement agreement expressly provided that Rodman paid the taxpayer a portion of the settlement amount at issue in return for his agreement not to: (1) defame Rodman, (2) disclose the existence or the terms of the settlement agreement, (3) publicize facts relating to the incident, or (4) assist in any criminal prosecution against Rodman with respect to the incident. The Tax Court (Judge Chiechi) characterized these provisions collectively as "the nonphysical injury provisions," and found that \$80,000 of the settlement was attributable to these provisions and that only \$120,000 of the settlement was "on account of" personal physical injury and therefore excludable.

C. Profit-Seeking Individual Deductions

1. The alternative minimum tax ("AMT") trap for attorneys' fees on large recoveries.

a. Cases decided in past years by the First, Fourth, Seventh, Eighth, Ninth, Tenth and Federal Circuits sprang the AMT trap. Attorney's fees incurred by an individual in a nonbusiness profit-seeking transaction are [§ 212] miscellaneous itemized deductions [§67] and may not be deducted for AMT purposes. To avoid this result, taxpayers in a number of cases in recent years have argued the portion of a taxable damage award retained by the taxpayer-plaintiff's attorney as a contingent fee is excluded from the taxpayer-plaintiff's income and treated as income earned directly by the attorney. The Tax Court and most Courts of Appeals have reached conflicting results on this question. Generally, the Tax Court holds that attorney's fee awards paid directly to a plaintiff's attorney [or the portion of a damage award that is the attorney's contingent fee that is so paid] are nevertheless includable in the litigant's gross income, and that the taxpayer then may claim a deduction, subject to any applicable limitations, including disallowance of the deduction for AMT purposes if it is a § 212 deduction. *Bagley v. Commissioner*, 105 T.C. 396 (1995), *aff'd* 121 F.3d 393 (8th Cir. 1997). *Accord Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995), *aff'g* 30 Fed. Cl. 248 (1993); *Alexander v. IRS*, 72 F.3d 938, 96-1 U.S.T.C. ¶50,011 (1st Cir. 1995), *aff'g* T.C. Memo. 1995-51; *Coady v. Commissioner*, 213 F.3d 1187, 2000-1 U.S.T.C. ¶50,528 (9th Cir. 2000), *aff'g* T.C. Memo. 1998-291; *Benci-Woodward v. Commissioner*, 219 F.3d 941, 2000-2 U.S.T.C. ¶50,595 (9th Cir. 2000), *aff'g* T.C. Memo. 1998-395, *cert. denied*, 531 U.S. 1112 (2001);

Kenseth v. Commissioner, 259 F.3d 881, 88 A.F.T.R.2d 2001-5378, 2001-2 U.S.T.C. ¶50,570 (7th Cir. 8/7/01), *aff'g* 114 T.C. 399 (5/24/00) (reviewed, 8-5); *Young v. Commissioner*, 240 F.3d 369, 87 A.F.T.R.2d 2001-889, 2001-1 U.S.T.C. ¶50,244 (4th Cir. 2/16/01), *aff'g*, 113 T.C. 152 (8/20/99); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312, 88 A.F.T.R.2d 2001-7983, 2002-1 U.S.T.C. ¶50,351 (10th Cir. 12/19/01), *aff'g* T.C. Memo. 2000-180 (6/12/01), *cert. denied*, 535 U.S. 1056 (5/13/02).

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

(1) In *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), however, the Fifth Circuit held that attorney's fees so paid directly to a plaintiff's attorney are not includable by the litigant. The court of appeals reasoned that under the Alabama attorney's lien law, the ownership of the portion of the award representing attorney's fees vested in the attorney *ab initio*. Subsequently, in *Srivastava v. Commissioner*, 220 F.3d 353, 86 A.F.T.R.2d 2000-5410, 2000-2 U.S.T.C. ¶50,597 (5th Cir. 2000) (2-1), *rev'g* T.C. Memo. 1998-362, a majority decision of a Fifth Circuit panel held that *Cotnam* applied to attorneys' fees under Texas law because there is no difference in the "economic reality facing the taxpayer-plaintiff" between Alabama and Texas attorney's liens and any distinction between them does not affect the analysis required by the anticipatory assignment of income doctrine. A dissent by Judge Dennis distinguished *Cotnam* on the ground that Alabama law gives the holders of attorney's liens greater power than does Texas law.

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

c. In the Eleventh Circuit (as derived from pre-split Fifth Circuit precedents¹³), under the *Golsen* rule, attorney's fees are not included in the income of an Alabama taxpayer who received a large punitive damages award. *Davis v. Commissioner*, 210 F.3d 1346, 85 A.F.T.R.2d 2000-1567, 2000-1 U.S.T.C. ¶50,431 (4/27/00) (per curiam), *aff'g* T.C. Memo. 1998-248

13. Under *Bonner v. City of Prichard*, Alabama, 661 F.2d 1206 (11th Cir. 1981), Fifth Circuit decisions rendered before the Eleventh Circuit was created are binding precedent in the Eleventh Circuit.

(7/7/98). The Eleventh Circuit panel held that, with respect to Alabama taxpayers, it was bound by *Cotnam*.

(1) In *Foster v. United States*, 249 F.3d 1275, 1278, 87 A.F.T.R.2d 2001-2011, 2001-1 U.S.T.C. ¶50,392 (11th Cir.2001), the Eleventh Circuit followed *Davis* in a subsequent case involving another Alabama taxpayer.

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

(1) **Yes, it is now up to the Second Circuit because in Connecticut the client must include contingent attorney's fee in gross income.** *Parmanand v. Capewell Components, LLC*, 289 F.Supp.2d 35, 92 A.F.T.R.2d 2003-6594 (D. Conn. 9/10/03). In a suit for taxable damages in which the plaintiff prevailed, in the context of ruling the on motions regarding information return reporting requirements, the District Court (Judge Dorsey) held that the portion of the award paid to the plaintiff's attorney was includable in the plaintiff's gross income because under Connecticut law the attorney had no equitable ownership in the judgment.

(2) **Raymond reversed by the Second Circuit, which follows the majority rule.** *Raymond v. United States*, 355 F.3d 107, 93 A.F.T.R.2d 2004-416, 2004-1 U.S.T.C. ¶50,124 (2d Cir. 1/13/04). Taxpayer-plaintiff was required to include the gross recovery in gross income because he received "money's worth" for the fee diverted to attorney. State attorney's fee lien law was analyzed but was not solely determinative. The taxpayer had sufficient control of the source of funds to require full inclusion in gross income.

e. **Now we discover that in the Ninth Circuit it all depends on which state's attorney's lien law controls.** *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 8/27/03), *rev'g* T.C. Memo. 2002-5, *cert. granted*, 124 S. Ct. 1713 (3/29/04). In a case involving attorney's fees subject to Oregon attorney's fee lien law, the Ninth Circuit (Judge Thomas) held the portion of a taxable damage award (for wrongful discharge from employment) retained by the attorney as a contingent fee was not includable in the taxpayer-plaintiff's gross income. Judge Thomas found that the nature of the attorney's fee lien was determinative. Examining relevant state law, he concluded that under Oregon law, the attorney's

claim to the fee was even stronger than under Alabama law. Therefore he applied the Fifth Circuit's decision in *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir.1959), holding that contingent attorney's fees paid directly to an attorney were not includable in the client's gross income because Alabama attorney's fee lien law vested title in the attorney *ab initio*. Judge Thomas declined to apply the Ninth Circuit's precedents in *Benci-Woodward v. Commissioner*, 219 F.3d 941, (9th Cir.2000), *cert. denied*, 531 U.S. 1112 (2001), and *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir.2000), on the grounds that Oregon attorney's fee lien law was significantly different than that of California and Alaska, which were relevant in those cases.

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

f. Now we know how to exclude California contingent attorney's fees – move to the Sixth Circuit in before petitioning the Tax Court! *Banks v. Commissioner*, 345 F.3d 373, 92 A.F.T.R.2d 2003-6298, 2003-3 U.S.T.C. ¶ 50,675 (6th Cir. 9/30/03), *cert. granted*, 124 S. Ct. 1712 (3/29/04). The Sixth Circuit followed the Fifth Circuit's decision in *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000), and reaffirmed that the Sixth Circuit's holding in *Estate of Clarks v. Commissioner*, 202 F.3d 854 (6th Cir. 2000), was based on a broader principle than the ground that state attorney's fee lien law determines whether the taxpayer-plaintiff can exclude attorney's fees. The taxpayer, who lived in Michigan when he filed his Tax Court petition, but who had previously been employed in California and had settled a wrongful termination suit brought in California for taxable tort damages under California law, was allowed to exclude the contingent attorney's fees, even though they were governed by California law and the Ninth Circuit would have reached a contrary conclusion under *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000).

g. The expense of suing your former employer might be "attributable" to the trade or business of being an employee, but it's not "incurred by the employee in connection with the performance of services as an employee of the employer." *Biehl v. Commissioner*, 118 T.C. 467 (5/30/02). The taxpayer successfully sued his former employer for wrongful termination and, in addition to damages, pursuant to his employment contract, the employer was required to pay his attorney's fees. The taxpayer [who lived in the Ninth Circuit, which has already ruled that successful plaintiffs cannot exclude attorney's fees, *see, e.g., Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001)] attempted to avoid the AMT trap on miscellaneous itemized deductions by arguing that the attorney's fees were employer reimbursement of a § 162 employee business plan excludable under an accountable plan pursuant to § 62(c) and Reg. § 1.62-2(c) and

(d). Judge Beghe held that that even though the expenses were § 162 employee business expenses because they were “attributable” to his trade or business of being an employee, the expenses did not meet the requirement of Reg. § 1.62-2(d) that the expenses be “paid or incurred by the employee in connection with the performance of services as an employee of the employer.” This latter requirement is met only if the expenses were incurred on the employer’s behalf, which clearly was not true in this case. Furthermore, it cannot be met if the expenses are incurred after the employment relationship has been terminated, which was true in this case.

(1) **And the Ninth Circuit agrees.** Biehl v. Commissioner, 351 F.3d 982, 92 A.F.T.R.2d 2003-7280, 2004-1 U.S.T.C. ¶50,109 (9th Cir. 12/12/03). The Ninth Circuit (Judge Trott) affirmed following essentially the same reasoning as Judge Beghe in the Tax Court. In contrast to § 62(a)(1), which requires only that an expense be “attributable to a trade or business,” § 62(a)(2)(A) applies only to reimbursement of expenses incurred in performing duties for or on behalf of the taxpayer’s employer. The legislative history supports Treas. Reg. § 1.62-2(d).

2. **A nondeductible estate administration expense.** Schwan v. United States, 264 F.Supp.2d 887, 91 A.F.T.R.2d 2003-1658, 2003-1 U.S.T.C. ¶50,362 (D. S.D. 3/16/03). Interest, required by a state statute, on a specific legacy payable from an estate to the legatee when the legacy is not paid within a statutorily specified period, is not deductible under either § 163 or § 212.

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

1. **Section 183 sent the claimed loss deduction to Davy Jones’s locker.** Magassy v. Commissioner, T.C. Memo. 2004-4 (1/5/04). Judge Foley applied § 183 to disallowing a claimed § 1231 loss on the sale of a yacht.

E. Deductions and Credits for Personal Expenses

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

incurred in the administration of trusts. Instead, it asks whether costs are commonly incurred outside the administration of trusts.” The Fourth Circuit followed *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001), and declined to follow *William J. O’Neill Revocable Trust v. Commissioner*, 994 F.2d 302 (6th Cir. 1993), *rev’g* 98 T.C. 227 (1992). Judge King noted that “investment advice fees are commonly incurred outside the administration of trusts.”

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

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

3. **Grandma’s big teeth may not be whitened with tax-deductible dollars, but the costs of breast reconstruction surgery and vision correction surgery are deductible.** Rev. Rul. 2003-57, 2003-22 I.R.B. 959 (6/2/03). Costs for breast reconstruction surgery following a mastectomy for cancer and for vision correction surgery are deductible medical care expenses under § 213. Costs to whiten teeth discolored as a result of age are not medical care expenses under § 213(d) and are not deductible.

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

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

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

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

● In 2005, the credit is reduced to \$700, but then increases in steps to \$1,000 for 2010. See § 24 (a)(2). However, these

changes sunset on 12/31/10. Thus, absent further congressional action the amount of the credit reverts to \$500 in 2011.

6. Advance refund of the increased amount of 2003 child credit.

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

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

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

● Under the common law rule, a person attains an age on the day before his or her birthday. In her 2003 Report, the National Taxpayer Advocate recommends legislation to add a new subsection to § 7701 adopting the birthday rule. 2004 TNT 12-122.

8. The dependency exemption may be released by the custodial parent in favor of the child’s father to whom she was never married. King v. Commissioner, 121 T.C. No. 12 (9/26/03). The support tests of § 152(e) apply to the unmarried parents of a minor child. This is because § 152(e)(1)(A)(iii) provides that § 152(e) applies to “parents . . . who live apart at all times during the last 6 months of the calendar year.” Inasmuch as the custodial parent released her claim to exemption on Form 8332 for 1987 and “future years,” Judge Goeke held that the non-custodial parent was entitled to the exemption deduction for the child.

● Note that the current version of Form 8332 contains instructions that the form should not be used by parents who never married each other.

a. The Service will change Form 8332 in accordance with the King decision. On 11/13/03, the IRS announced a change to the Internal Revenue Manual that Form 8332 for 2003 is being revised by deleting all references to the requirement that the custodial and non-custodial parents must be or have been married to each other before the special support tests apply.

9. Is the kid like a car with respect to recordkeeping? ‘He do the entries in different inks.’¹⁴ McCullar v. Commissioner, T.C. Memo. 2003-272 (9/17/03). If parents are divorced, §152(e) provides that custodial parent is ordinarily entitled to claim the children as dependents. In a ‘split-custody’ case, the father proved that he had physical custody of a child for more than one-half of the

14. Cf., Charles Dickens, Our Mutual Friend (“He do the police in different voices.”). This was the working title of T.S. Eliot’s, “The Waste Land.”

year through a detailed logbook – with entries written in different ink and typed in different fonts – covering the times the child was in his custody. Judge Halpern stated, “Petitioner’s log gives detailed descriptions about the time he spent with and without his daughter each day of 1998, written in different ink and typed in different fonts. Respondent argues that the log contains errors. Given the testimony of both petitioner and his ex-wife, we have determined that petitioner is a credible witness and that his log is valid and not fabricated.”

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

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

2. Notice 2003-53, 2003-33 I.R.B. (7/31/03). This notice provides guidance for reporting requirements and transitional rules applicable to Coverdell Education Savings Accounts (“CESAs”) under § 530.

VI. CORPORATIONS

A. Entity and Formation

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

have qualified for nonrecognition. In the instant case, however, W's transfer of the business assets to Z was not necessary for W and X to combine their businesses in a holding company structure that would have qualified under § 351. If in exchange for Y stock, W had transferred the assets to Y and X had transferred \$30x to Y, and Y had transferred the business to Z in exchange for all of the Z stock, the transfers would have qualified under § 351. [See Rev. Rul. 83-34; Rev. Rul. 77-449.]

2. An ANPRM announcing that the Treasury intends to amend the Code via regulations – and this time it might actually have the statutory authority to do so. REG-100818-01, Liabilities Assumed in Certain Transactions, 68 F.R. 23931 (5/6/03). The IRS and Treasury are concerned that §§ 357(d) and 362(d) [providing rules for determining the amount of liability treated as assumed for purposes of §§ 357, 358(d), 358(h), 362(d), 368(a)(1)(C), and 368(a)(2)(B)], enacted as part of the Miscellaneous Trade and Technical Corrections Act of 1999, Public Law 106-36, 113 Stat. 127, do not always produce appropriate results and that it might be desirable to modify certain rules by regulation, as permitted by § 357(d)(3). This notice explains the issues and the rules the IRS and Treasury are considering proposing. The major proposals are as follows:

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

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

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

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

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

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

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

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

B. Distributions and Redemptions

1. **The Tax Court is bearish on Merrill Lynch.** Merrill Lynch & Co., Inc. v. Commissioner, 120 T.C. 12 (1/15/03). In 1986 and 1987 Merrill Lynch structured several transactions to sell certain assets of first-tier and second-tier subsidiaries and not only eliminate any tax on the gains, but to create losses. To take advantage of the interaction of the consolidated return regulations and § 304 [before the promulgation of Reg. § 1.1502-80(b), rendering § 304 inoperative in consolidated returns], Merrill Lynch caused the subsidiaries holding the assets to drop the assets to be retained into new lower level subsidiaries [in § 351 transactions], following which the new subsidiaries were sold cross chain to other Merrill Lynch subsidiaries. The sales proceeds were then distributed to its parent by the subsidiary to be sold, and that subsidiary was then sold. The plan was that the cross chain sale would be recharacterized as a dividend under § 304, which would result in a basis increase under Reg. §§ 1.1502-32 and -33 [as then in effect] in the stock of the subsidiaries to be sold. The IRS did not contest that § 304 applied, but responded that the “distributions” coupled with the sales of the subsidiaries outside the group were part of a firm and fixed plan by the subsidiaries that were sold outside the group to dispose of the stock of the lower tier subsidiaries that had been sold cross chain. Therefore, even after applying § 304 the distributions were treated as amounts received in a redemption under §302(b)(3) [applying *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954)]. The Tax Court (Judge Marvel) held that under the principles of *Niedermeyer v. Commissioner*, 62 T.C. 280 (1974), a firm and fixed plan existed with respect to every such sale and held for the IRS.

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

stock and the sales of the target corporations were part of the same seamless web of corporate activity intended by petitioner to culminate in the sale of the target corporations outside the consolidated group.

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

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

C. Liquidations

1. Rev. Rul. 2003-125, 2003-52 I.R.B. 1243 (12/29/03). This revenue ruling holds that when an election is made to change the classification of an entity from a corporation to a disregarded entity, the shareholder of such entity is allowed a worthless security deduction under § 165(g)(3) if the fair market value of the assets of the entity (including intangible assets such as goodwill and going concern value) does not exceed the entity's liabilities. In that case, in the deemed liquidation of the entity the shareholder receives no distribution on its stock.

D. S Corporations

1. Excusing late elections is now simpler. Rev. Proc. 2003-43, 2003-23 I.R.B. 998 (6/9/03). This revenue procedure provides a simplified method for taxpayers to request relief for late S corporation elections, ESBT elections, QSST elections and Qsub elections. Generally, relief is provided if the request for relief is filed within 24 months of the due date of the election.

2. When your S corporation goes into bankruptcy, watch out! Mourad v. Commissioner, 121 T.C. 1 (7/2/03). The filing of a bankruptcy petition by taxpayer's wholly-owned S corporation for a chapter 11 plan of reorganization (in which an independent trustee was appointed by the Bankruptcy Court) neither terminates an S election nor creates a separate taxable entity. Judge Ruwe held that the taxpayer is liable for the tax on the sale by the S corporation of its principal assets.

● Query: How could taxpayer have planned this better?

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

4. T.D. 9081; REG-129709-03, Prohibited Allocations of Securities in an S Corporation, 68 F.R. 42970 (7/21/03). The Treasury Department has promulgated temporary regulations and published identical proposed regulations under § 409(p) concerning requirements for ESOPs holding stock of S corporations. The regulations prohibit allocations or accruals to the ESOP for any year that "meaningful benefits" are not provided to rank-and-file employees. The temporary and proposed regulations provide rules defining terms, such as "synthetic equity" and "disqualified persons."

5. Four-year spread for short-year income occasioned by a change in the annual accounting period to the calendar year during a transition period. Rev. Proc. 2003-79, 2003-45 I.R.B. 1036 (11/10/03). Rev. Proc. 2002-38, 2002-1 C.B. 1037, and Rev. Proc. 2002-39, 2002-1 C.B. 1046, provide procedures for an corporation to change its annual accounting period if its current taxable year no longer qualifies as a natural business year (or, for certain S corporations, an ownership taxable year). This new revenue procedure provides procedures under which a shareholder of such an S corporation may elect to take into account ratably over four taxable years the shareholder's income from the S corporation that is attributable to the short taxable year ending on or after May 10, 2002, but before June 1, 2004.

E. Affiliated Corporations

1. Suspended loss rules to be promulgated. Notice 2002-18, 2002-12 I.R.B. 644 (3/25/02). The Service announced that it and the Treasury

intend to issue regulations that will prevent a consolidated group from obtaining a tax benefit from both the utilization of a loss

from the disposition of stock (or another asset that reflects the basis of stock) and the utilization of a loss or deduction with respect to another asset that reflects the same economic loss. For example, where a member of a group contributes built-in loss assets to another member of the group in exchange for stock of such member in a transaction in which the basis of such stock is determined, directly or indirectly, in whole or in part, by reference to the basis of such assets and the transferor member sells such stock without causing the deconsolidation of the transferee, the group may benefit from the built-in loss in the contributed assets more than once. It is expected that the regulations will defer or otherwise limit utilization of the loss on the stock in such transactions and other transactions that facilitate the group's utilization of a single loss more than once.

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

b. **Final regulations on suspended losses.** T.D. 9048, Guidance Under Section 1502; Suspension of Losses on Certain Stock Dispositions, 68 F.R. 12287 (3/14/03); Reg-131478-02, 68 F.R. 12324 (3/14/03).¹⁵ The Treasury Department has promulgated Temp. § 1.1502-35T, amended various provisions, and published identical proposed regulations that: (1) require a consolidated group to redetermine the basis in subsidiary stock it owns immediately before certain transactions involving the subsidiary; and (2) suspend certain losses that the group recognizes on the disposition of subsidiary stock. These regulations implement Notice 2002-18, 2002-12 I.R.B. 644.

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

● If a group member owns loss shares in a subsidiary before the subsidiary deconsolidates, the basis of the subsidiary's stock held by members of the group immediately before the deconsolidation must be redetermined as follows: (1) the group's basis in subsidiary loss shares is reduced

15. We are indebted to Prof. Don Leatherman, University of Tennessee College of Law, for assistance with this description. Any errors that remain are our own.

by the “reallocable basis amount;” and (2) the “reallocable basis amount” is allocated (a) to increase the basis of all preferred shares of the subsidiary held by members of the group after the transfer to increase the basis of each share to its value immediately before the transfer, and then (b) to increase the group’s basis in common shares in the subsidiary so that to the extent possible each share has the same ratio of basis to value. The “reallocable basis amount” is the lesser of (1) the aggregate loss in the group’s subsidiary loss shares immediately before the deconsolidation, or (2) the subsidiary’s items of deduction and loss that the group took into account in computing its basis adjustments for any subsidiary shares that were not loss shares. The basis redetermination rule does not apply if, among other things, the group disposes of all of its subsidiary stock to nonmembers in a single taxable year in one or more fully taxable transactions, or is allowed a worthless stock deduction with respect to all of its subsidiary stock (other than any transferred stock).

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

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

- All of the rules are subject to various exceptions and tiering rules. The regulations are generally effective after March 7, 2002, but only if the return is due after March 14, 2003.

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

• The analytical methodology of the *Textron* opinion is at odds with Tax Court Judge Wells's opinions in *CSI Hydrostatic Testers v. Commissioner*, 103 T.C. 398 (1994) and *Intermet Corp. v. Commissioner*, 111 T.C. 294 (12/8/98), *rev'd*, 209 F.3d 901 (6th Cir. 4/20/00).¹⁶ Those cases strictly construed the consolidated return regulations even though the results were difficult to support theoretically. In contrast, in *Textron*, Judge Laro interpreted Reg. § 1.1502-14(d)(4)(i) in a manner that is difficult to justify under the literal language, but which reached a sensible theoretical result [under the single-entity theory of consolidated returns. He concluded that Reg. § 1.1502-14(d)(4)(i) required PR to defer its loss on the redemption of the obligation it received for its AVCO stock even though one of the conditions for that section to apply is that the obligation "never have been held by a nonmember." Since PR acquired the obligation before it became a member of the *Textron* group that redeemed the obligation, Judge Laro's conclusion that membership status was determined at the time that the obligation was redeemed effectively read out of the rule the word. He could have more effectively reached the same result by looking to former Reg. § 1.1502-13(f)(2) to note that the AVCO group was a predecessor group to the *Textron*, so that Paul Revere should not have been considered ever to have been a nonmember.

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

16. We are indebted to Prof. Don Leatherman, University of Tennessee College of Law, for insightful suggestions regarding the analysis of the *Textron* case.

adopts the acceleration rule of Reg. § 1.1502-13(d). The loss might, however, be subject to the anti-avoidance rules of both Reg. § 1.267(f)-1(h) and § 1.1502-13(h).

a. Exactly when the taxpayer wanted it to, says the court of appeals. “Plain meaning” carries the day. Reversed. Textron v. United States, 336 F.3d 26, 92 A.F.T.R.2d 2003-5373, 2003-2 U.S.T.C. ¶ 50,571 (1st Cir. 7/16/03). The Court of Appeals (Judge Porfilio) applied *Gitliz* style “plain meaning” analysis to interpreting the regulations and allowed the loss deduction. Since former Reg. § 1.1504-14(d)(4)(i)(c) required that the note never have been held by a nonmember, and PR was a nonmember when it acquired the note, the condition in the regulation for deferring the loss had not been satisfied.

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

4. Schizophrenic temporary regulations for consolidated group discharge of indebtedness income and reduction of attributes. T.D. 9089, Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group, 68 F.R. 52487 (9/4/03). The Treasury Department has promulgated temporary regulations under § 1502, amending Temp. Reg. § 1.1502-19T(b) and (h), Temp. Reg. § 1.1502-21T(b), and Temp. Reg. § 1.1502-32T, and adding Temp. Reg. § 1.1502-28T, governing the application of § 108 when a member of a consolidated group realizes discharge of indebtedness income. The regulations provide that the amount of discharge of indebtedness income excluded from gross income in the case in which the debtor-corporation is insolvent is determined based on the assets and liabilities of only the member with discharge of indebtedness income. However, applying an interpretation of *Dominion Industries, Inc. v. United States*, 532 U.S. 822 (2001), the regulations provide that the group’s consolidated attributes in their entirety are subject to reduction under § 108(b), but the attributes attributable to the debtor member are the first attributes reduced. The regulations also adopt a look-through rule that applies if the debtor member’s attribute that is reduced is the basis of stock of another group member. In this case, corresponding adjustments are made to the attributes attributable to the lower-tier member. Identical proposed regulations have been published. 68 F.R. 52542 (9/4/03).

a. Temporary regulations are amended. T.D. 9098, Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group, 68 F.R. 69024 (12/11/03). Temp. Reg. § 1.1502-28T(a)(4) provides that when a member of a consolidated group realizes COD income excluded under § 108(a), after the reduction of the tax attributes attributable to the debtor member under § 108(b), tax attributes attributable to other members other than the debtor member (other than asset basis) that arose in a separate return year or that arose (or are treated as arising) in a separate return limitation year to the extent that no SRLY limitation applies to the use of such attributes by the group are subject to reduction. The regulations are generally effective as of 8/29/03.

5. Sixth Circuit holds ITC recapture is proper despite seemingly-contradictory consolidated returns regulations. Aeroquip-Vickers, Inc. v.

Commissioner, 347 F.3d 173, 92 A.F.T.R.2d 2003-6555, 2003-2 U.S.T.C. ¶50,693 (6th Cir. 10/20/03) (2-1), *rev'g Trinova Corp. v. Commissioner*, 108 T.C. 68 (2/27/97). Taxpayer transferred all of its assets relating to a glass manufacturing business, including property for which it had previously claimed investment tax credits, into a wholly-owned subsidiary, and then transferred the stock of the subsidiary outside the consolidated group.

● The Tax Court determined that taxpayer was not liable for ITC recapture because pursuant to Reg. § 1.1502-3(f)(2)(i) “a transfer of section 38 property from one member of the group to another member of such group during a consolidated return year shall not be treated as a disposition or cessation within the meaning of section 47(a)(1).” It also followed Example (5) of that regulation, which permitted the sale of all the stock of the subsidiary to a third party in a subsequent year without ITC recapture. It refused to follow Rev. Rul. 82-20, 1982-1 C.B. 6, which held the contrary where the spin-off of the subsidiary “immediately” follows the asset transfer.

● The Sixth Circuit followed the Second and Ninth Circuits in finding that Rev. Rul 82-20 is entitled to receive “some deference,” and under the “end-result test” variation of the step transaction doctrine, the transaction “must be treated as a single unit.” Therefore, inasmuch as taxpayer entered into the transaction to move the section 38 property out of the consolidated group, ITC recapture is appropriate.

F. Reorganizations

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

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

● Nevertheless, the new regulations introduce significant definitional jargon. The term “disregarded entity” means a business entity (as defined in Reg. § 301.7701-2(a)) that is disregarded as an entity separate from its owner for federal tax purposes, including single member

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

● These regulations became effective on January 24, 2003.

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

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

.....

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

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

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

4. **Mutual-to-Stock F reorganization followed by a second reorganization is OK (Part I)**. Rev. Rul. 2003-19, 2003-7 I.R.B. 468 (2/18/03).

● Situation 1 involved the conversion of a mutual insurance company to a stock insurance company. The mutual amended its articles of incorporation to authorize the issuance of stock and changed its name. Members of the mutual exchanged their interests for all the stock company's voting common stock, but persons holding mutual membership interests under contracts covered by § 403(b) or § 408(b) received policy credits in exchange for those interests. The IRS ruled that the conversion was either a § 368(a)(1)(E) recapitalization or a § 368(a)(1)(F) reorganization.

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

● In Situation 3 Mutual Holding Company owned all of the stock of Stock Holding Company, which owned all of the stock of Stock Company 1, a stock insurance company. Mutual Company amended its

articles to authorize the issuance of stock and changed its name to Stock Company 2; Mutual Company's members received Mutual Holding Company interests in exchange for their Mutual Company interests; Stock Company 2 issued all of its stock directly to Mutual Holding Company; and Mutual Holding Company transferred all of its Stock Company 2 stock to Stock Holding Company in exchange for voting stock of Stock Holding Company. The conversion from Mutual Company to Stock Company 2 qualified as a reorganization under both § 368(a)(1)(E) and § 368(a)(1)(F). In addition, Mutual Holding Company's acquisition of either an interest equivalent to the stock of Stock Company 2 or the actual stock of Stock Company 2 qualified as a § 368(a)(1)(B) reorganization. Mutual Holding Company's transfer of its Stock Company 2 stock to Stock Holding Company qualified as both a § 368(a)(1)(B) reorganization and as a § 351 transfer.

5. Mutual-to-Stock F reorganization followed by a second reorganization is OK (Part II). Rev. Rul. 2003-48, 2003-19 I.R.B. 863 (5/12/03). The revenue ruling applied the principles developed in Rev. Rul. 2003-19, 2003-7 I.R.B. 468 (2/18/03), to the conversion of mutual savings banks to stock banks, as well as the adoption of holding company structures. The initial conversion and creation of a holding company qualified under § 351 and under § 368(a)(1)(E) and (F).

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

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

6. Turning off the step transaction doctrine when the acquirer so chooses. T.D. 9071, Effect of Elections in Certain Multi-step Transactions, 68 F.R. 40766 (7/9/03). Temp. Reg. § 1.338(h)(10)-10T(c)(2) provides that the step transaction doctrine will not be applied if a taxpayer makes a valid § 338(h)(10) election with respect to a stock acquisition that, standing alone, is a qualified stock purchase, even if the transaction is part of a multi-step transaction that would otherwise qualify as a reorganization. The effective date of these temporary regulations is 7/9/03. See also, REG-143679-02, for proposed regulations that mirror the temporary regulations. The principles underlying Rev. Rul. 2001-46, 2001-2 C.B. 321, are reflected in these regulations.

G. Corporate Divisions

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

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

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

2. **Bricks to clicks business expansion passes the SMOAKE test.**¹⁷ Rev. Rul. 2003-38, 2003-17 I.R.B. 811 (4/28/03). Corporation D operated a retail shoe store business in shopping malls and other locations, under the name "D" for more than five years. D's business enjoyed favorable name recognition, customer loyalty, and goodwill in the retail shoe market. D created an Internet web site and began selling shoes at retail through the Internet. To take advantage of D's name recognition, customer loyalty, and established goodwill, and to enhance the web site's chances for success, the web site was named "D.com." To a significant extent, the operation of the web site drew upon D's experience and know-how. Two years later, D transferred the web site based business's assets and liabilities to C, a newly formed controlled subsidiary, and spun-off C pro rata. The IRS ruled that under Reg. § 1.355-3(b)(3)(ii), the Internet sales operation was an expansion of the retail store business, not a new business. Thus, each of D and C was engaged in the active conduct of a five-year trade or business. See Rev. Rul. 2003-18 and § 1.355-3(c), Examples (7) and (8). The products and the principal business activities of the retail shoe store business and the internet-based business were the

17. Shared (1) subject matter; (2) operational activities; and (3) knowledge and experience.

same. Although selling shoes on the Internet required some know-how different from operating a retail store (different marketing approaches, distribution chains, and technical operations issues), the web site's operation drew significantly on D's existing experience and know-how, and its success would depend largely on D's pre-existing goodwill.

● The analytical model used by the Revenue Ruling to determine that the clicks business was an expansion of the bricks business was based on analyzing the extent that the two shared (1) subject matter; (2) operational activities; and (3) knowledge and experience. [The SMOAKE test?] The first two were met and the third was not, but the deficiency was cured by the overlapping goodwill.

3. Beef for the boy and grass for the girl equals business purpose. Rev. Rul. 2003-52, 2003-22 I.R.B. 960 (6/2/03). The IRS ruled that the business purpose requirement of Reg. § 1.355-2(b) was satisfied in the following circumstances. X Corporation was engaged in the farming business, consisting of breeding and raising livestock and growing grain, for more than five years. The stock of X was owned equally by Father, age 68, Mother, age 67, Son, and Daughter. Father and Mother participated in some major management decisions, but Son and Daughter performed most of the management. Son and Daughter generally cooperated and operated the farm without disruption, but they disagreed about the appropriate future direction of the farming business. Son wanted to expand the livestock business, while Daughter wanted to sell the livestock business and concentrate on the grain business. The disagreement prevented them from developing, as they saw fit, the business in which each of them was most interested. Father and Mother were neutral regarding the disagreement, but because of the disagreement, they wanted to bequeath separate interests in the farm business to the children. For reasons unrelated to the farm, Son and Daughter's husband dislike each other. Although this did not impair the farm's operation, Father and Mother believed that requiring Son and Daughter to run a single business together was eventually likely to cause family discord. To enable Son and Daughter each to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested, to further the estate planning goals of Father and Mother, and to promote family harmony, X transfers the livestock business to a newly formed wholly owned subsidiary, Y Corporation, and X distributed 50 percent of the Y stock to Son in exchange for all of his X stock. The remaining Y stock was distributed equally to Father and Mother in exchange for half of their X stock. Thereafter, Father and Mother (who each owned 25 percent of the outstanding stock of X and Y) continued to participate in some major management decisions related to the business of each corporation. Daughter, who had no interest in the livestock corporation, managed and operated X, and Son managed and operated Y and had no interest in X. Father and Mother amended their wills to devise their Y stock to Son and their X stock to Daughter. The IRS reasoned that the distribution eliminated a disagreement that prevented the development of the business and "allowed each sibling to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested, with the expectation that each business would benefit. Therefore, although the distribution is intended, in part, to further the personal estate planning of Father and Mother and to promote family

harmony, it is motivated in substantial part by a real and substantial non-Federal tax purpose that is germane to the business of X.”

4. You only have to be pure of mind at the time of the distribution. Rev. Rul. 2003-55, 2003-22 I.R.B. 961 (6/2/03). The IRS ruled that the business purpose requirement of Reg. § 1.355-2(b) is satisfied if the distribution of the stock of a controlled corporation is, at the time of the distribution, motivated, in whole or substantial part, by a corporate business purpose, but that purpose cannot be achieved as the result of an unexpected change in circumstances following the distribution. “The regulations do not require that the corporation in fact succeed in meeting its corporate business purpose, as long as, at the time of the distribution, such a purpose exists and motivates, in whole or substantial part, the distribution.” The specific facts were as follows. D, a publicly traded corporation conducted two businesses directly and a third business through its wholly owned subsidiary, C. To invest in plant and equipment and to make acquisitions, C had to raise a substantial amount of capital. D’s investment banker advised D that the best way to raise this capital was by a public offering of C stock after C was separated from D. D distributed the C stock to its shareholders, and C prepared to offer its stock to the public, with a target date approximately six months after the distribution. Following the distribution and before the offering could be undertaken, market conditions unexpectedly deteriorated to such an extent that the public offering was postponed. One year after the distribution, conditions still had not improved sufficiently to permit the offering to go forward and C funded its capital needs through the sale of debentures.

5. Management focus is a business purpose. Rev. Rul. 2003-74, 2003-29 I.R.B. 77 (7/21/03). Distributing is a publicly traded corporation that conducts a software technology business. Controlled is a wholly-owned subsidiary of Distributing and conducts a paper products business. Management of each corporation would prefer to concentrate its efforts solely on the business conducted by that corporation, but the ownership of Controlled by Distributing prevents Distributing’s management from concentrating solely on the software business. Held, the distribution of the stock of a controlled corporation by a distributing corporation to enable the management of each corporation to concentrate on its own business satisfies the business purpose requirement of Reg. § 1.355-2(b).

6. Competing for investors and lenders is a business purpose. Rev. Rul. 2003-75, 2003-29 I.R.B. 79 (7/21/03). Distributing is a publicly traded corporation that conducts a pharmaceuticals business. Controlled is a wholly-owned subsidiary of Distributing and conducts a cosmetics business. These businesses compete for capital from borrowing and internal cash flows. The distribution of the stock of a controlled corporation to resolve a capital allocation problem between the two corporations satisfies the business purpose requirement of Reg. § 1.355-2(b).

7. Private letter rulings under § 355 will be harder to come by after August 8th. Rev. Proc. 2003-48, 2003-29 I.R.B. 86 (7/21/03). This revenue procedure notes that in the past the IRS has not adhered to its policy of not giving “comfort rulings” in the § 355 area. It sets up a one-year pilot program for rulings postmarked after 8/8/03 of not ruling on three issues with respect to corporate

divisions. The National Office will not determine (1) whether a proposed or completed distribution of the stock of a controlled corporation is being carried out for one or more corporate business purposes, (2) whether the transaction is used principally as a device, or (3) whether the distribution and an acquisition are part of a plan under § 355(e).

8. “Nephew of Morris Trust” transaction is blessed. Rev. Rul. 2003-79, 2003-29 I.R.B. 80 (7/21/03). A spin-off of one of two business of equal size by means of a transfer of the assets of one of the businesses to a controlled corporation, followed by the acquisition of substantially all the assets of the controlled corporation by an unrelated corporation in the same business, meets all the requirements of §§ 368(a)(1)(D), 355(a), and 368(a)(1)(C) – even though an acquisition of the same properties from the distributing corporation would have failed this requirement if the transfer of those properties had not been made to the controlled corporation.

9. Pesticides and baby food? A statement of facts that only a tax professor could have invented! Rev. Rul. 2003-110, 2003-46 I.R.B. 1083 (11/17/03). A publicly traded corporation that conducted a pesticide business spun-off its controlled subsidiary that conducted a baby food business to deal with “public perception problems” that caused potential baby food buyers from dealing with the subsidiary as long as it was affiliated with a pesticide producer. In determining whether the distribution of the stock of the controlled corporation satisfied the business purpose requirement in Reg. § 1.355-2(b), which requires that the distribution be motivated, in whole or substantial part, by one or more corporate business purposes, the fact that § 355 permits the distributing corporation to distribute the stock of a controlled corporation without recognition of gain otherwise required under § 311(b) does not present a potential for the avoidance of Federal taxes.

H. Personal Holding Companies and Accumulated Earnings Tax

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

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

3. Debt aversion avoids AET. *Otto Candies, LLC v. United States*, 288 F.Supp.2d 730, 91 A.F.T.R.2d 2003-2520, 2003-1 U.S.T.C. ¶50,516 (E.D. La. 5/28/03). The taxpayer [an LLC taxed as an S corporation that was a successor to a C corporation], a family corporation with three shareholders that was “one of the leading providers of marine transportation in the Gulf of Mexico,” was held not to be liable for the § 531 accumulated earnings tax. The corporation, which had accumulated reserves of between \$15 and \$21 million during the years in question, was engaged in a volatile business and the dominant shareholder was conservative and avoided debt. Accumulations were required to fund necessary periodic fleet replacement, including newer vessels with modern technology meeting customer

demands, new ventures into related businesses, and to internally fund future redemptions [under a contract] upon the death of a shareholder.

4. Advanced Delivery and Chemical Systems of Nevada, Inc. v. Commissioner, T.C. Memo. 2003-250 (8/20/03). The taxpayer-holding company was not liable for accumulated earnings tax. Under Reg. § 1.537-3(b), the business activities of its subsidiaries and partnerships in which it was a partner were attributed to the taxpayer. In light of the rapid growth of the affiliates' businesses, the accumulations did not exceed the taxpayer's reasonable needs for expansion of the affiliates, and on the particular facts [including a reorganization to reduce state taxes], even if the accumulations did exceed the taxpayer's reasonable needs, there was not tax avoidance purpose.

I. Miscellaneous Corporate Issues

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

2. **The Tax Court continues on its capitalization spree.** Illinois Tool Works Inc. v. Commissioner, 117 T.C. 39 (7/31/01). The taxpayer acquired the assets of another corporation [for approximately \$126 million] in a taxable transaction in which the taxpayer assumed the target's liabilities, including a contingent liability for a patent infringement claim, [*Lemelson v. Champion Spark Plug Co.*, 975 F.2d 869 (1992)], for which it established a reserve of \$350,000. Subsequently, the taxpayer, as the target's successor was held liable for damages, interest, and court costs [totaling over \$17 million], which it paid. The Tax Court (Judge Cohen) upheld the Commissioner's treatment requiring capitalization of the payments as a cost of acquiring the assets rather than a deductible expense, even though the parties had not adjusted the purchase price to reflect the contingent liability. The liability was known, was considered in setting the price, and was expressly assumed. That the taxpayer considered it highly unlikely that it would be called upon to pay was not relevant.

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

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

a. **Affirmed.** 355 F.3d 997, 93 A.F.T.R.2d 2004-548, 2004-1 U.S.T.C. ¶50,130 (7th Cir. 1/21/04). The Seventh Circuit held that the contingent liability was one that taxpayer was aware of when it acquired the assets of the DeVilbiss Co., and taxpayer's payment of the liability was a cost of acquiring the

business assets and had to be capitalized. The court followed *David R. Webb Co. v. Commissioner*, 708 F.2d 1254 (7th Cir. 1983), *aff'g* 77 T.C. 1134 (1981), noting that *Webb* stood for the proposition that, “generally, the payment of a liability of a preceding owner of property by the person acquiring such property, whether or not such liability was fixed or contingent at the time such property was acquired, is not an ordinary and necessary business expense.” (emphasis in original)

● Judge Kanne, in footnote 4 of the opinion, defends Tax Court Judge Cohen against taxpayer’s attack that she failed “to engage in the appropriate open-minded, fact-based inquiry advocated [by the 7th Circuit in *A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482 (1997)].”

We find it curious that ITW would choose to attack Judge Cohen for failing to engage in the appropriate open-minded, fact-based inquiry advocated in *Staley*. Judge Cohen, who served as trial judge in the *Staley* case, as well as here, dissented from the tax court opinion from which the *Staley* appeal was taken. *A.E. Staley Mfg. Co. v. Commissioner*, 105 T.C. 166, 210 (1995) (Cohen, J., dissenting). It was her dissent that this Court cited favorably in its ruling reversing the tax court. *See Staley*, 119 F.3d at 491 n.8. And, in her closing instructions to the parties about their posttrial briefs in the present matter, she discusses *Staley* and its possible implications, describing her involvement in that case. (Tr. at 214-15.)

VII. PARTNERSHIPS

A. Formation and Taxable Years

There were no significant developments regarding this topic during 2003.

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

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

to the basis of tiered partnerships to prevent evasion of their purpose where a corporation acquires an indirect interest in its own stock through a chain of partnerships and gain or loss from the sale of stock is subsequently allocated to the corporation. The regulation is effective retroactively to gain or loss allocated on sales or exchanges of stock occurring after 12/6/99.

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

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

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

731. [If the relinquished liability and the replacement liability are nonrecourse, under Reg. § 1.704-2(d), the partnership minimum gain on the last day of the first taxable year of the partnership is computed by using the replacement property and its tax basis as determined under § 1031(d) and the replacement nonrecourse liability (but only to the extent of the relinquished nonrecourse liability).] A net increase in a partner's share of partnership liability is taken into account under § 752(a) in the year in which the partnership receives the replacement property.

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

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

4. Defining the term "liability" in § 752 and fighting duplication and acceleration of losses through partnerships after June 24, 2003. REG-106736-00, Assumption of Partner Liabilities, 68 F.R. 37434 (6/24/03). The Treasury has proposed extraordinarily complex, verging on incomprehensible, regulations: (1) defining liabilities under § 752; (2) dealing with a partnership's assumption of certain fixed and contingent obligations in exchange for a partnership interest [Prop. Reg. § 1.752-7]; and (3) providing rules under § 358(h) for assumptions of liabilities by corporations from partners and partnerships [Prop. Reg. § 1.358-7]. Reg. § 1.752-1(a)(1)(i) would be amended to include the principles of Rev. Rul. 88-77, 1988-2 C.B. 128; an obligation is a liability to the extent that incurring the obligation: (1) creates or increases the basis of any of the obligor's assets (including cash); (2) gives rise to an immediate deduction; or (3) gives rise to an expense that is not deductible in computing taxable income and is not properly chargeable to capital. Prop. Reg. § 1.752-7 deals with the assumption by a partnership of a partner's fixed or contingent obligation to make payment that is not one of the three types described in Reg. § 1.752-1(a)(1)(i) [including accrual method liabilities the deduction for which was deferred under § 453(h)]. Unlike Temp. Reg. § 1.752-6T, the proposed regulations do not reduce the partner's outside basis when the partnership assumes a § 1.752-7 liability. If the partnership satisfies the liability while the partner remains in the partnership, the deduction with respect to the built-in loss associated with the § 1.752-7 liability is allocated

to the partner, reducing that partner's outside basis. Alternatively, if one of three events occurs that separate the partner from the liability, then the partner's outside basis is reduced immediately before the occurrence of the event. The events are: (1) a disposition (or partial disposition) of the partnership interest by the partner, (2) a liquidation of the partner's partnership interest, and (3) the assumption (or partial assumption) of the liability by another partner. The basis reduction generally is the lesser of (1) the excess of the partner's basis in the partnership interest over the adjusted value of the interest, or (2) the remaining built-in loss associated with the liability. (In the event of a partial disposition, the reduction is pro rated.) Thereafter, to the extent of the remaining built-in loss associated with the liability, the partnership (or the assuming partner) is not entitled to any deduction or capital expense upon satisfaction (or economic performance) of the liability, but if the partnership notifies the partner, the partner is entitled to a loss or deduction. If another partner assumed the liability, the partnership must immediately reduce the basis of its assets by the built-in loss, and upon satisfaction, the assuming partner must make certain basis adjustments to his partnership interest. There are exceptions for (1) transfer of the trade or business with which the liability is associated is transferred to the partnership, and (2) *de minimis* transactions (liabilities less than 10 percent of the partnership's assets or \$1,000,000). Unlike under the temporary regulations, there is no exception for transactions in which substantially all of the assets with which the liability is associated are contributed to the partnership. When finalized, the regulations will be effective for transactions occurring after 6/24/03.

5. “[O]ne brother got the . . . income without paying all of the tax, while the other brother paid the tax without getting any of the income.” *Estate of Ballantyne v. Commissioner*, 341 F.3d 802, 92 A.F.T.R. 2d 2003-5694, 2004-1 U.S.T.C. ¶50,120 (8th Cir. 8/7/03), *aff'g* T.C. Memo. 2002-160 (6/24/02). The decedent taxpayer (Melvin) and his brother (Russell) for many years operated a partnership that engaged in the oil and gas business, run by the decedent, and the farming business, run by the decedent's brother. The partnership was an oral partnership, and the brothers consistently reported as equal partners, even though the decedent consistently withdrew the profits from the oil and gas business and decedent's brother consistently withdrew the profits from the farming business. After the decedent's death, the estate took the position that all of the income from the farming activity was reportable as the decedent's brother's distributive share. Because the partnership did not maintain capital accounts, the allocation lacked economic substance, and the partners' interests in the partnership were determined under the facts and circumstances test of Reg. § 1.704-1(b)(3). Based on the evidence, the estate could not overcome the presumption that the partners were equal partners. There was no record of capital contributions; the amount of profits of each activity varied from year to year, as did withdrawals but the partners' economic interests and interests in cash flow could not be determined because the partnership books and records were inadequate. However, the “facts” – mostly the witnesses' “beliefs” that the brothers were 50/50 partners – indicated that they were to share liquidating distributions equally. That factor, combined with the brothers long-time consistent reporting as equal partners and the absence of any evidence that the brothers' reporting position involved tax avoidance, was sufficient to convince Judge Ruwe that they were equal partners.

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

6. REG-160330-02, Section 704(c), Installment Obligations and Contributed Contracts, 68 F.R. 65864 (11/24/03). The Treasury has published proposed amendments to Reg. § 1.704-3(a)(8) clarifying that if a partnership disposes of § 704(c) property in exchange for an installment obligation the installment obligation is § 704(c) property; likewise if a partner contributes a contract that is § 704(c) property and pursuant to the contract the partnership obtains property in a transaction in which less than all of the gain or loss is recognized, the property is § 704(c) property. Proposed amendments to Reg. § 1.704-4(d)(1) provide that an installment obligation received by a partnership and property acquired pursuant to a contributed contract are treated as § 704(c) property for purposes of § 704(c)(1)(B) to the extent that the installment obligation or the acquired property is § 704(c) property under Reg. § 1.704-3(a)(8). The regulations are effective as of 11/24/03.

C. Distributions and Transactions Between the Partnership and Partners

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

● Upon exercise, the option holder is treated as contributing property in the form of the premium, the exercise price, and the option privilege to the partnership in exchange for the partnership interest, and § 721 applies, even if the conversion results in a shift of capital from the old partners to the option holder. The conversion right in convertible debt or convertible equity is taken into account for tax purposes as part of the underlying instrument. (The proposed regulations do not deal with the consequences of a right

to convert partnership debt into an interest in the issuing partnership to the extent of any accrued but unpaid interest on the debt.) An amendment to Reg. § 1.1271-1(e) would treat partnership interests as stock for purposes of the special OID rules for convertible debt instruments. Section 721 does not apply to the lapse of an option; the lapse of an option results in recognition of income by the partnership and the recognition of loss by the former option holder.

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

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

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

distributive share of partnership losses and deductions may be limited by §§ 704(b) and (d) to the amount paid for the option.

- The proposed regulations do not apply to options issued by single member LLCs.
- The regulations will apply to noncompensatory options issued on or after the date final regulations are published.

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

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

D. Sales of Partnership Interests, Liquidations and Mergers

There were no significant developments regarding this topic during 2003.

E. Inside Basis Adjustments

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

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

F. Partnership Audit Rules

1. **Even the IRS doesn’t know when it has to have a partnership level audit in order to send a valid deficiency notice to a partner.** Katz v. Commissioner, 335 F.3d 1121, 92 A.F.T.R.2d 2003-5153, 2003-2 U.S.T.C. ¶50,557 (10th Cir. 7/7/03), *rev’g* 116 T.C. 5 (2001). The Commissioner disallowed the taxpayer’s losses claimed as a distributive share of partnership income in 1990, the year he filed a bankruptcy petition, on the grounds that the distributive share for the entire partnership taxable year was reportable by bankruptcy estate.

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

held that the entire distributive share of partnership losses was properly reportable by the bankruptcy estate.

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

G. Miscellaneous

1. **Four-year spread for short-year income occasioned by a change in the annual accounting period to the calendar year during a transition period.** Rev. Proc. 2003-79, 2003-45 I.R.B. 1036 (11/10/03). Rev. Proc. 2002-38, 2002-1 C.B. 1037, and Rev. Proc. 2002-39, 2002-1 C.B. 1046, provide procedures for a partnership to change its annual accounting period if its current taxable year no longer qualifies as a natural business year. This new revenue procedure provides procedures under which a partner in such a partnership may elect to take into account ratably over four taxable years the partner’s share of income from the partnership that is attributable to the short taxable year ending on or after May 10, 2002, but before June 1, 2004.

VIII. TAX SHELTERS

A. Tax Shelter Cases

1. **Tax shelter benefits from § 453 contingent sale partnership tax shelter not allowed because the tax shelter is a sham and “serves no economic purpose other than tax savings.” Merrill Lynch’s persistence overcomes initial doubts of tax department.** ACM Partnership v. Commissioner, T.C. Memo. 1997-115 (3/5/97) *aff’d in part, rev’d in part*, 157 F.3d 231, 82 A.F.T.R.2d 98-6682, 98-2 U.S.T.C. ¶50,790 (3d Cir. 10/13/98) (2-1), *cert. denied*, 526 U.S. 1017 (3/22/99). Judge Laro found a § 453 contingent sale partnership tax shelter to be a prearranged sham, “tax-driven and devoid of economic purpose,” and “serv[ing] no economic purpose other than tax savings,” following Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967). Under the scheme to shelter Colgate’s \$105 million 1988 capital gain, a partnership was formed in 1989; its three partners were affiliates of (a) a foreign bank (about

90%), (b) Colgate (about 9%), and (c) Merrill Lynch (about 1%). A bank note was purchased by the partnership and immediately sold for a large immediate payment and much smaller future contingent payments. Under the contingent payment sale provisions of the temporary regulations [§ 15a.453-1(c)] the partnership's basis was to be allocated ratably over the several years in which contingent payments could be made, resulting in a large 1989 installment sale gain to the partnership. The lion's share of that installment sale gain was allocated to the foreign bank (which was not taxable on U.S. source capital gain), followed by the redemption of the foreign bank's partnership interest. This left Colgate as the 90 percent partner. In 1991, the installment sale obligation was sold by the partnership, triggering about \$100 million of capital losses, which Colgate attempted to use to shelter its 1988 capital gain.

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

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

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

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

a. D.C. Circuit remands Saba for reconsideration in light of its opinion in ASA Investerings. Saba Partnership v. Commissioner, 273 F.3d 1135, 88 A.F.T.R.2d 2001-7318, 2002-1 U.S.T.C. ¶50,145 (D.C. Cir. 12/21/01), *remanding for reconsideration in light of ASA Investerings* T.C. Memo. 1999-359 (10/27/99), *on remand to* T.C. Memo. 2003-31 (2/11/03). The court felt

this case was indistinguishable from *ASA Investerings*, which was decided on a sham partnership theory, as opposed to Judge Nims' decision in the Tax Court, which was grounded on a sham transaction theory. The court of appeals refused to simply affirm the Tax Court's decision on the alternative ground that the partnerships were shams. Even the government conceded that the sham transaction and sham partnership approaches yield different results; the adjustments under the sham transaction theory would be different from those under the sham partnership theory [although the government apparently conceded at oral argument that under either approach, Brunswick could deduct actual losses from the transactions]. The government argued that the court of appeals should apply *ASA Investerings* to hold that the partnerships were shams, and remand the case to the Tax Court for the limited purpose of determining the amount of any necessary adjustments. But the court of appeals accepted the taxpayer's argument that the "question of whether 'an entity should be regarded as a partnership for federal tax purposes is inherently factual,'" and remanded to allow the taxpayer to address the question to the trial court, even though it doubted that the Tax Court's "findings are inadequate because of 'significant differences'" alleged by the taxpayer "between the actions of Brunswick in this case and those of [the taxpayer] in *ASA*." Indeed, the court of appeals opinion said: "As far as we can tell, the only difference between this case and *ASA* is that Brunswick and ABN did not meet in Bermuda." In remanding, Judge Tatel foreshadowed what he expected to be the result on remand:

In any case, *ASA* makes clear that "the absence of a nontax business purpose is fatal" to the argument that the Commissioner should respect an entity for federal tax purposes. . . . Here, the Tax Court specifically found "overwhelming evidence in the record that Saba and Otrabanda were organized solely to generate tax benefits for Brunswick." . . . Arguably, this broader finding subsumes any factual differences that might exist between this case and *ASA*. [citations omitted].

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

- Note the effect of this opinion on the

Boca Investerings case, below.

b. On remand, the same result, following the Court of Appeals' instructions. T.C. Memo. 2003-31 (2/11/03). On remand Judge Nims again denied the deductions. He found the case indistinguishable from *ASA Inversterings*. The partnerships were not recognized for tax purposes because they had no business purpose other than tax avoidance. The minimal business activity

of the partnership with respect to commercial paper did not amount to a nontax purpose.

4. Same arrangement as earlier failed shelters, different trial court judge – it’s a business deal, not a shelter. Boca Investerings Partnership v. United States, 167 F. Supp. 2d 298, 88 A.F.T.R.2d 2001-6252, 2001-2 U.S.T.C. ¶50,690 (D. D.C. 10/5/01). American Home Products [now Wyeth] entered into a Merrill Lynch marketed tax shelter virtually identical to those in ACM Partnership v. Commissioner, 157 F.3d 231, 82 A.F.T.R.2d 98-6682, 98-2 U.S.T.C. ¶50,790 (3d Cir. 10/13/98), *aff’d* T.C. Memo. 1997-115 (3/5/97), *cert. denied*, 526 U.S. 1017 (1999), ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 2000-1 U.S.T.C. ¶50,185 (D.C. Cir. 2/1/00), *aff’d* T.C. Memo. 1998-305 (8/20/98), and Saba Partnership v. Commissioner, T.C. Memo. 1999-359 (10/27/99), *judgment vacated by* 273 F.3d 1135 (D.C. Cir. 2001), *on remand to* T.C. Memo. 2003-31. The losses from the transaction sheltered the gain on the sale of a corporate subsidiary. Judge Friedman held that a valid partnership existed and that the losses were allowable because he found that the taxpayer had both a business purpose and an objective profit potential in entering into the transaction.

a. Reversed: ASA Investerings is followed. Boca Investerings Partnership v. United States, 314 F.3d 625, 91 A.F.T.R.2d 2003-444, 2003-1 U.S.T.C. ¶50,181 (1/10/03). The D.C. Circuit held that the district court “erred as a matter of law when it did not properly apply the holding of ASA Investerings, requiring that a legitimate non-tax business necessity exist for the creation of the otherwise sham entity inserted into the partnership for tax avoidance reasons in order to meet the intent test of Commissioner v. Culbertson, 337 U.S. 733 (1949), as applied to this type of partnership transaction.” Judge Sentelle quoted ASA to make clear that “the absence of a nontax business purpose” is fatal to an argument that the Commissioner should respect an entity for federal tax purposes.

5. Lease-strip transaction by pseudo-black box intermediary fails in the Tax Court; affirmed by Second Circuit. Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (12/28/01), *aff’d by summary order*, 320 F.3d 282, 90 A.F.T.R.2d 2002-7702, 2003-1 U.S.T.C. ¶50,137 (2d Cir. 12/13/02) (per curiam), *publication status changed by the court from unpublished to published*, (2d Cir. 2/24/03). The taxpayer corporation’s stock was sold to an intermediary [which then merged downstream], following which its assets were sold to the prearranged ultimate purchaser. To offset the gains realized on the asset sale, the taxpayer acquired by a § 351 transaction interests in certain equipment leaseback transactions [secured by trusts that resulted in a circular cash flow] that had no foreseeable value, which it immediately transferred to a Dutch bank, the sole consideration for which was assumption of taxpayer’s obligations [of which there were in reality none]. Taxpayer claimed a \$22 million ordinary business expense deduction as a result of the transfer of the leaseback interests. The deduction was denied because the transactions lacked business purpose and economic substance under “any version” of the tests. Judge Swift held that the transaction lacked business purpose and economic substance even as measured against the Eleventh Circuit’s broad articulation of the test in UPS of America, Inc. v. Commissioner, 254 F.3d 1014 (11th Cir. 2001), that “a transaction has a ‘business purpose’ when

we are talking about a going concern . . . , as long as it figures in a bona fide, profit-seeking business.”

6. The Tax Court hammers another shelter, and in the process tells us the “purpose” of the legislative plan.” Andantech L.L.C. v. Commissioner, T.C. Memo. 2002-97 (4/9/02), *aff’d and remanded*, 331 F.3d 972, 91 A.F.T.R.2d 2003-2623, 2003-1 U.S.T.C. ¶50,530 (D.C. Cir. 6/17/03). Norwest, through its equipment-leasing subsidiary, engaged in a complex [seven PowerPoint slides worth] purchase and leaseback tax shelter transaction involving 40 IBM mainframe computers already under lease to end-users. The promoter [Comdisco] sold the computers for cash and notes to an LLC owned by two nonresident aliens, which leased them back to the promoter, who retained all responsibilities to the end-users; the LLC sold the stream of rental payment to be received for net present value, thereby accelerating income realization, and applied the proceeds to the balance due on the note. Less than three months later, one of the nonresident aliens [indirectly] transferred his 2 percent LLC interest to a trust established by promoter, and Norwest, through a subsidiary, acquired the remaining 98 percent interest in the LLC [thereby closing the taxable year in which the income had been realized] for an amount roughly equal to one half of one percent of the approximately \$122 million basis of the computers. Norwest subsequently reported its distributive share of depreciation deductions, but was allocated no income. After three years, the computers were reconveyed to the promoter, pursuant to an “early termination option,” which the court found the “economics of the transaction . . . mandate[d],” and the LLC was liquidated.

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

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

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

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

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

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

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

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

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

● The Third Circuit Court of Appeals (Judge Ambro) affirmed on the ground that the "COLI policies lacked economic substance and therefore were economic shams." [The court did not reach the issue

of whether the transactions were factual shams.] The court dismissed out of hand the need to examine the “intersection of . . . statutory details.”

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

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

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

● Finally, the court rejected the taxpayer’s argument that because “the transaction had objective non-tax economic effects . . . the Court must not look further,” and that the district court improperly applied a subjective analysis. Rather, the Court of Appeals read *Gregory* to permit an inquiry into motive. “If Congress intends to encourage an activity, and to use taxpayers’ desire to avoid taxes as a means to do it, then a subjective motive of tax avoidance is permissible. But to engage in an activity solely for the purpose of avoiding taxes where that is not the statute’s goal is to conduct an economic sham.” Because the court found that nothing in statute to indicate that Congress intended to encourage leveraged COLI investments, the inquiry into motive was proper. In this regard, it was significant that “the plan was marketed as a tax-driven investment.” Because

the COLI “plan had no net effect on Camelot’s economic position, . . . it fails the objective prong of the economic sham analysis.” Because there was no “legitimate business purpose behind the plan, . . . it fails the subjective prong as well.” Penalties were also upheld.

a. But a District Court finds for the taxpayer in an incredible opinion. Dow Chemical Co. v. United States, 250 F. Supp. 2d 748, 91 A.F.T.R.2d 2003-1489, 2003-1 U.S.T.C. ¶50,346 (E.D. Mich. 3/31/03). In a carefully detailed opinion, Judge Lawson found that Dow did correctly almost everything that Camelot and AEP did incorrectly. The interest rate on policy loans was not unreasonably high, and a positive pre-tax cash flow was expected. The court found that there was a business purpose for the COLI arrangements, i.e., to provide retiree benefits. The premiums for the first three years were payable with policy loans and the premiums for years four through seven were payable 90% with partial [cash] withdrawals (from policies whose cash value had been previously borrowed) and 10% with cash from the taxpayer. Judge Lawson found that the partial withdrawals were “shams in fact” because there was no cash value left in the policies to borrow, but that the § 264(c)(1) test was met because of the payments of 10% of the premiums by taxpayer with its own cash in years four through seven. The court found that the § 264(c)(1) safe harbor did not require level premiums over the first seven years and that the “premium” for each of years four to seven was the 10% paid in cash. Judge Lawson found that Reg. § 1.264-4(c)(1)(ii) (which required level premiums) was invalid, and he rejected the holding in both *CM Holdings* and *AEP* that the four-out-of-seven test required level premiums.

● In finding that taxpayer expected a positive pre-tax cash flow, Judge Lawson refused to admit into evidence a statement in taxpayer’s protest that could have led to a contrary conclusion on the ground that Rule 408 of the Federal Rules of Evidence provides that statements made during settlement negotiations are inadmissible at trial.

b. There’s no harm in asking? Not from asking Judge Lawson! Dow Chemical Co. v. United States, 278 F.Supp.2d 844, 92 A.F.T.R.2d 2003-6418, 2003-2 U.S.T.C. ¶ 50,681 (E.D. Mich. 8/12/03). The government’s motion to amend the court’s judgment was granted in part and denied in part, but left intact the same judgment and basic result. Ironically, since the motion opened up all findings of fact, Judge Lawson reversed his earlier finding that the partial withdrawals in years four through seven were “shams in fact,” thus making moot the government’s argument relating to the logical consequences of this earlier finding, i.e., that taxpayer did not meet the four-of-seven test because it did not pay the entire premium in each of years four through seven from its own funds.

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

d. **One of the costs of COLI in Texas is that the employer does not have an insurable interest in ordinary employees.** Mayo v. Hartford Life Insurance Co., 354 F.3d 400 (5th Cir. 1/5/04). Wal-Mart employee's estate sued Wal-Mart on the claim that the life insurance policy on the employee's life was void on the ground that it violated the Texas insurable interest doctrine. In such a case, Texas law applies the equitable remedy of constructive trust to enable recovery by the lawful beneficiary of the proceeds unlawfully procured by a named beneficiary that lacks an insurable interest. The district court concluded that the policy was void because Wal-Mart lacked a sufficient financial interest in the lives of its rank-and-file employees.

B. Identified "tax avoidance transactions."

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

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

3. **Lease strips are made a listed transaction.** Notice 2003-55, 2003-34 I.R.B. 395 (7/21/03), *superseding* Notice 95-53, 1995-2 C.B. 354. The IRS has concluded – based upon its victories in *Andantech L.L.C. v. Commissioner*, 331 F.3d 972 (D.C. Cir. 2003), and *Nicole Rose Corp. v. Commissioner*, 320 F.3d 282 (2d Cir. 2002) – that lease strips improperly separate income from related deductions. The notice also states that the IRS may challenge lease strips on other grounds, including (1) assignments or accelerations of future payments as financings, (2) lack of a valid partnership, and (3) judicial doctrines such as lack of business purpose, step transaction, sham, etc.

a. **But not on § 482 grounds.** Rev. Rul. 2003-96, 2003-34 I.R.B. 386 (7/21/03). The IRS has concluded the inapplicability of the § 482 rationale of Notice 95-53 because an agreement between unrelated parties to arbitrarily shift income or deductions "does not by itself evidence the type of control necessary to satisfy [§ 482]."

4. Restates and updates the list of 24 transactions determined by the IRS to be "listed transactions." Notice 2003-76, 2003-49 I.R.B. 1181 (11/7/03), *supplementing and superseding* Notice 2001-51, 2001-34 I.R.B. 190 (8/3/01). The IRS has identified 24 listed transactions for purposes of Reg. §§ 1.6011-4(b)(2) and 301.6111-2(b)(2). As restated and updated, the list includes: (1) Rev. Rul. 90-105, 1990-2 C.B. 69, transactions (deductions for contributions to certain pension plans attributable to future year's compensation); (2) Notice 95-34, 1995-1 C.B. 309, certain trust arrangements (purported multiple employer welfare benefit funds); (3) Notice 98-5, 1998-1 C.B. 334, transactions in which the expected economic profit is insubstantial in comparison to the value of the expected FTCs; (4) *ASA* *Investerings*-type and *ACM*-type transactions; (5) Prop. Reg. § 1.643(a)-8 transactions involving distributions from charitable remainder trusts; (6) Notice 99-59, 1999-2 C.B. 761, transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays that they have in fact recovered (the PwC so-called BOSS tax shelter); (7) Reg. § 1.7701(1)-3 fast-pay arrangements; (8) Rev. Rul. 2000-12, 2000-11 I.R.B. 744, certain transactions involving the acquisition of two debt instruments the values of which are expected to change significantly at about the same time in opposite directions; (9) Notice 2000-44, 2000-36 I.R.B. 255, transactions generating losses resulting from artificially inflating the basis of partnership interests (the KPMG so-called BLIPS¹⁸ tax shelter); (10) Notice 2000-60, 2000-49 I.R.B. 568, transactions involving the purchase of a parent corporation's stock by a subsidiary, a subsequent transfer of the purchased parent stock from the subsidiary to the parent's employees, and the eventual liquidation or sale of the subsidiary; (11) Notice 2000-61, 2000-49 I.R.B. 569, transactions purporting to apply § 935 to Guamanian trusts; (12) Notice 2001-16, 2001-9 I.R.B. 730, intermediary sales transactions; (13) Notice 2001-17, 2001-9 I.R.B. 730, contingent liability § 351 transfer transactions; (14) Notice 2001-45, 2001-33 I.R.B. 129, certain redemptions of stock in transactions not subject to U.S. tax in which the basis of the redeemed stock purports to shift to a U.S. taxpayer; (15) Notice 2002-21, 2002-1 C.B. 730, transactions involving the use of a loan assumption agreement to inflate basis in assets acquired from another party in order to claim losses; (16) Notice 2002-35, 2002-1 C.B. 992, transactions involving the use of a notional principal contract to claim current deductions for periodic payments made by a taxpayer while disregarding the accrual of a right to receive offsetting future payments; (17) Notice 2002-50, 2002-2 C.B. 98, transactions involving the use of a straddle, a tiered partnership structure, a transitory partner and the absence of a § 754 election to claim a permanent non-economic loss, and similar transactions identified in Notice 2002-65, 2002-2 C.B. 690, and Notice 2003-54, 2003-33 I.R.B. 363; (18) Rev. Rul. 2002-69, 2002-2 C.B. 760, *modifying and superseding* Rev. Rul. 99-14, 1999-1 C.B. 835, lease-in/lease-out [LILO] transactions); (19) Notice 2002-70, 2002-2 C.B. 765, transactions involving reinsurance arrangements between a taxpayer and the taxpayer's own reinsurance company; (20) Rev. Rul. 2003-6, 2003-3 I.R.B. 286, arrangements involving the transfer of ESOPs that hold stock in an S corporation for the purpose of claiming eligibility for the delayed effective date of § 409(p); (21) Notice 2003-22, 2003-18 I.R.B. 851, arrangements involving foreign leasing companies used to evade or avoid federal income and employment taxes; (22) Notice 2003-24, 2003-18 I.R.B. 853, arrangements that purportedly

18. See 2003 TNT 112-12.

qualify as collectively bargained welfare benefit funds excepted from the account limits of §§ 419 and 419A; (23) Notice 2003-47, 2003-30 I.R.B. 132, transactions involving compensatory stock options and related persons to avoid or evade federal income and employment taxes; and (24) Notice 2003-55, 2003-34 I.R.B. 395, *modifying and superseding* Notice 95-53, 1995-2 C.B. 334, transactions in which one participant claims to realize rental income and another participant claims the deductions related to that income (often referred to as “lease strips”).

5. In less than a month after Notice 2003-76, here’s another one! Notice 2003-77, 2003-49 I.R.B. 1182 (11/19/03), *clarified* (12/1/03). Certain contested liability trusts used improperly to attempt to accelerate deductions under § 461(f) are identified as “listed transactions.” See I.D., above, for contested liability trusts used for an attempted acceleration of deductions under § 461(f).

6. And, yet one more! Notice 2003-81, 2003-51 I.R.B. 1123 (12/4/03). This transaction involves the purchase by the taxpayer of offsetting options on foreign currency (which are § 1256 contracts) [the “purchased options”] and the receipt of premiums by the taxpayer for writing offsetting options on a different foreign currency that has a very high positive correlation with the first currency, but which is not traded through regulated futures contracts (which are not § 1256 contracts) [the “written options”]. The taxpayer assigns to a charity both (1) the purchased option that has a loss (which is marked to market when it is assigned to the charity and recognized by the taxpayer) and (2) the offsetting written option that has a gain (which is limited to the premium received for the option, and which the taxpayer does not recognize).

7. S corporation stock owned by ESOPs that fail to provide benefits to rank-and-file employees. Rev. Rul. 2003-4, 2004-6 I.R.B. 414 (1/23/04). Ownership structures of S corporations designed to allow taxpayers to take advantage of the tax-exempt status of the S corporation that results from the ownership of its outstanding stock by the ESOP but which result in the ESOP not providing benefits to rank-and-file employees will cause the S corporation income to be taxed to the person who earned it. Transactions that are the same or substantially similar to the following transaction are identified as “listed transactions.” These are transactions in which (i) at least 50 percent of the outstanding shares of an S corporation are employer securities held by an ESOP, (ii) the profits of the S corporation generated by the business activities of a specific individual are accumulated and held for the benefit of that individual in a QSub or similar entity, (iii) these profits are not paid to the individual as compensation within 2-1/2 months after the end of the year in which earned, and (iv) the individual has rights to acquire shares of stock of the QSub or similar entity representing 50 percent or more of the fair market value of the stock of such QSub or similar entity.

8. Abusive Roth IRA transactions are listed transactions. Notice 2004-8, 2004-4 I.R.B. 333 (12/31/03). In these transactions a taxpayer who owns a pre-existing business sells property from the business, such as accounts receivable, for less than fair market value to a corporation owned by taxpayer’s Roth IRA. The Notice applies to any arrangement between the Roth IRA and the taxpayer that has the effect of transferring value to the corporation owned by the

Roth IRA that is comparable to a contribution to the Roth IRA that exceeds the statutory limits on such contributions contained in § 408A.

9. SILO transactions. Interestingly enough, sale-in, lease-out (SILO) deals [under which a tax-exempt or foreign entity sells property to the taxpayer and leases it back, with the lessee depositing collateral in defeasance of its obligation] were not made “listed transactions,” although President Bush’s budget proposal seeks a legislative remedy for this widespread perceived abuse. 2004 TNT 19-3.

10. See I.D., above, for a “listed transaction” relating to contested liability trusts and VII.D., below, for additional “listed transactions” aimed at individuals.

C. Disclosure and Settlement

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

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

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

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

(1) T.D. 9018 and REG-103736-00, Requirement to Maintain a List of Investors in Potentially Abusive Tax Shelters, 67 F.R. 64807 and 64842 (10/22/02). The IRS has promulgated conforming temporary and proposed regulations, which modify the list maintenance requirements under § 6112.

2. February 2003 final regulations. T.D. 9046, Tax Shelter Regulations, 68 F.R. 10161 (2/28/03). This Treasury decision modifies and finalizes the rules relating to tax shelter disclosure statements to be filed with tax returns under § 6011(a), as well as the rules relating to the registration of confidential corporate tax shelters under § 6111(d) and the resulting list maintenance requirements under § 6112. The amendments retain the six disclosure categories contained in the October 2002 temporary regulations, see 1.a., above, with the following modifications: (1) they delete the clarification that a claim of privilege does not cause a transaction to be confidential because a privilege does not restrict the taxpayer's ability to disclose the tax treatment or tax structure of the transaction; (2) they change the focus to provide that this refers to refunds of fees to be received back from a person who stated what the tax consequences of the transaction would be, or from the person on whose behalf the statement was made; (3) a list of the loss which need not be taken into account for reporting is contained in Rev. Proc. 2003-24, 2003-11 I.R.B. 599 (3/17/03); (4) a list of the transactions with significant book-tax difference which need not be taken into account for reporting is contained in Rev. Proc. 2003-25, 2003-11 I.R.B. 601 (3/17/03).

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

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

under this paragraph (b)(3) if written authorization to disclose is provided to the taxpayer in accordance with this paragraph (b)(3)(iii) and the transaction is not otherwise confidential.

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

a. Rules on disclosure of confidential transactions are clarified. T.D. 9108, Confidential Transactions, 68 F.R. 75128 (12/30/03). Reg. § 1.6011-4(b)(3) provides that certain confidential transactions are reportable transactions that are subject to the disclosure rules under § 1.6011-4 and the list maintenance rules under § 301.6112-1. Under the February 2003 regulations, a confidential transaction is a transaction that is offered under conditions of confidentiality. (The February 2003 regulations also provided that there was a presumption of non-confidentiality if the taxpayer receives written authorization to disclose the tax treatment and tax structure of the transaction.)

- Under these amended final regulations, the confidentiality filter is limited to situations in which an advisor is paid a large fee and imposes a limitation on disclosure that protects the confidentiality of the advisor's tax strategies.

- Transactions in which confidentiality is imposed by a party to the transaction acting in such capacity will no longer be reportable. Further, the exceptions and presumption language have been removed because they no longer are necessary under this narrower rule.

- Effective 12/29/03.

3. Warm-up the photocopier for those tax accrual workpapers. Announcement 2002-63, 2002-27 I.R.B. 72 (7/8/02). In auditing returns filed after 7/1/02 that claim any tax benefits from a "listed transaction," see Notice 2001-51, 2001-34 I.R.B. 190, the IRS may request tax accrual workpapers. Listed transactions will be determined "at the time of the request." Neither the attorney client privilege nor the § 7525 tax practitioner privilege protects the confidentiality of the workpapers.

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

4. "The IRS and Treasury believe that taxpayers have improperly relied on opinions or advice issued by tax advisors to establish reasonable cause and good faith as a basis for avoiding the accuracy-related penalty." REG-126016-01, Establishing Defenses to the Imposition of the Accuracy-Related Penalty, 67 F.R. 79894 (12/31/02). The Treasury Department has published proposed amendments to the regulations under §§ 6662 and 6664 [Regs. §§ 1.6662-3; 1.6664-4] to limit the available defenses to an accuracy-related penalty when a taxpayer (1) fails to disclose a reportable transaction or (2) fails to disclose that it has taken a position on a return based upon a regulation being invalid. Under the proposed amendments, a taxpayer who takes a position that a regulation is invalid cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under § 6664(c) with respect to that position unless

the position was disclosed on a return (including disclosing the position that the regulation in question is invalid). A taxpayer who engages in a reportable transaction [See Temp. Reg. § 1.6011-4T] cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under § 6664(c) with respect to the transaction unless the transaction was disclosed pursuant to the § 6011 regulations. Finally, a taxpayer who engages in a reportable transaction cannot rely on the realistic possibility standard under § 6662 to avoid the accuracy-related penalty for negligence or disregard of rules or regulations if the position regarding the reportable transaction is contrary to a revenue ruling or notice. When finalized, the amendments will apply to returns filed after 12/30/02, with respect to transactions entered into after 12/31/02.

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

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

a. Regulations are now final. T.D. 9109, Establishing Defenses to the Imposition of the Accuracy-Related Penalty, 68 F.R. 75126 (12/30/03). The key provision is as follows:

§ 1.6664-4 -- Reasonable cause and good faith exception to section 6662 penalties.

. . . .c) *Reliance on opinion or advice* -(1) *Facts and circumstances; minimum requirements.* All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. For example, the taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on tax advice was reasonable and made in good faith. In no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied,

however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law. . . . In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

(iii) *Reliance on the invalidity of a regulation.* A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed, in accordance with § 1.6662-3(c)(2), the position that the regulation in question is invalid.

b. Penalty Policy Statement issued by Commissioner Mark W. Everson goes beyond the regulations to provide that taxpayers may not rely on the advice of a “conflicted” tax advisor. Penalty Policy Statement issued by Commissioner Mark W. Everson to the LMSB and SB/SE Commissioners, 2003 TNT 249-9 (12/30/03). This document instructs IRS employees that taxpayers may not rely on the advice of a tax advisor who has a financial arrangement or referral agreement with a tax shelter promoter because his independent judgment is compromised. Moreover, the IRS will question the reasonableness and good faith of taxpayers who know or have reason to know that the tax advisor is not independent, and will not accept taxpayer reliance on an opinion from a non-independent tax advisor as proof of “reasonable cause and good faith.” See, § 6664(c).

5. Proposed revisions to Circular 230 related to tax shelters require disclosures in tax shelter opinions of relationship between practitioner and promoter, etc. REG-122379-02, Regulations Governing Practice Before the Internal Revenue Service, 68 F.R. 75186 (12/30/03). New proposed amendments to circular 230 differ from the 1/12/01 proposed amendments in several ways: (1) § 10.33 prescribes best practices for all tax advisors; (2) § 10.35 combines and modifies the standards applicable to “marketed” and “more likely than not” tax shelter opinions from former §§ 10.33 and 10.35; (3) § 10.36 contains the revised procedures for ensuring compliance with §§ 10.33 and 10.35; and (4) new § 10.37 contains provisions relating to advisory committees to the Office of Professional Responsibility.

● Under § 10.33 “best practices” include: (1) communicating clearly with the client regarding the terms of the engagement and the form and scope of the advice or assistance to be rendered; (2) establishing the relevant facts, including evaluating the reasonableness of any assumptions or representations; (3) relating applicable law, including potentially applicable judicial doctrines, to the relevant facts; (4) arriving at a conclusion supported by the law and the facts; (5) advising the client regarding the import of the conclusions reached; and (6) acting fairly and with integrity in practice before the IRS.

- Tax shelter opinions covered by § 10.35 are more-likely-than-not and marketed tax shelter opinions; they, however, do not include preliminary advice provided pursuant to an engagement in which the practitioner is expected subsequently to provide an opinion that satisfies § 10.35. The definition of “tax shelter,” tracking the one found in § 6662 which was contained in the 2001 proposed regulations, remains the same. The requirements for tax shelter opinions include: (1) identifying and considering all relevant facts and not relying on any unreasonable factual assumptions or representations; (2) relating the applicable law to the relevant facts in a reasonable manner; (3) considering all material Federal tax issues and reaching a conclusion supported by the facts and the law with respect to each issue; and (4) providing an overall conclusion as to the Federal tax treatment of each tax shelter item, and the reasons for that conclusion and providing an overall conclusion as to the Federal tax treatment of each tax shelter item and the reasons for that conclusion.

- Under § 10.35(d), a practitioner must disclose any compensation arrangement he may have with any person (other than the client for whom the opinion is prepared) with respect to the tax shelter discussed in the opinion, as well as any other referral arrangement relating thereto. The practitioner must also disclose that a marketed opinion may not be sufficient for a taxpayer to use for the purpose of avoiding penalties under § 6662(d), and must also state that taxpayers should seek advice from their own tax advisors. A limited scope opinion must also disclose that additional issues may exist and that the opinion cannot be used for penalty-avoidance purposes.

- Under § 10.36 procedures to ensure compliance are required to be followed by tax advisors with responsibility for overseeing a firm’s practice before the IRS. These include ensuring that the firm has adequate procedures in effect for purposes of complying with § 10.35.

- Under § 10.37 the Director of the Office of Professional Responsibility is authorized to establish advisory committees to review and make recommendations regarding professional standards or best practices for tax advisors. They may also, more particularly, advise the Director whether a practitioner may have violated §§ 10.35 or 10.36.

a. **Here comes Cono!** Treasury and IRS announced the appointment of Caplin & Drysdale partner Cono R. Namorato as director of the IRS’s Office of Professional Responsibility on 12/29/03. 2003 TNT 249-1.

D. Individual Tax Shelters

1. **Government misconduct amounting to fraud does not require a showing of prejudice to justify relief. Tax shelter investors entitled to the same deal received by the taxpayers who cooperated with the government.** Dixon v. Commissioner, 316 F.3d 1041, 91 A.F.T.R.2d 2003-569, 2003-1 U.S.T.C. ¶50,194 (9th Cir. 1/17/03), *remanding* T.C. Memo. 2000-116 and T.C. Memo. 1999-101. The Ninth Circuit reversed the Tax Court finding that misconduct by IRS attorneys during the trial of test cases [secretly allowing the deduction of attorney’s fees in exchange for taxpayer cooperation] constituted harmless error. The tax shelter was one designed and administered by Honolulu businessman Henry Kersting, in which participants purchased stock with loans from entities financed by two layers of promissory notes, resulting in their claiming

interest deductions on their individual returns. Judge Hawkins held that the taxpayers demonstrated fraud by the IRS attorneys and that a demonstration of prejudice was unnecessary. The Tax Court was directed to enter judgment in favor of taxpayers on terms equivalent to the secret settlement agreements entered into with the test case taxpayers who cooperated with the government.

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

2. **Faux foreign.** Notice 2003-22, 2003-18 I.R.B. 851 (4/4/03). This notice addresses an abusive arrangement designed to evade income and employment taxes on compensation income through the use of unrelated conduit domestic and foreign employee leasing companies. The taxpayer purports to terminate his employment relationship with his employer, to enter into an employment relationship with a foreign employee leasing corporation, which leases the employee to a domestic employee leasing corporation, which it then leases the employee to his original employer. Domestic leasing pays taxpayer substantially less than the original employer and remits the balance (less a fee) to the foreign company, which (1) claims treaty benefits resulting in no US tax because it has no effectively connected income, and (2) effectively sets-aside the funds for the taxpayer's benefit. The IRS will challenge these (and similar) arrangements on a variety of theories, and will impose penalties. The arrangements are "listed transactions."

3. **Sale of nonqualified stock option to related person is a listed transaction. Arrangements heavily promoted to executives to defer the tax on the option gain by selling the option to a related person for a long-term unsecured note, and claiming that the option gain is not taxable until payments are made on the note.**

a. **The IRS attacks the E&Y, *inter alia*, nonstatutory stock option deferral shelter, Act I.** Notice 2003-47, 2003-30 I.R.B. 132 (7/1/03). Transactions involving the transfer of nonstatutory stock options to a related person in exchange for a long-term, unsecured deferred payment obligation are not arm's length transactions for purposes of Reg. § 1.83-7. The receipt of the deferred payment obligation will not result in a deferral of the recognition of income arising from the transfer. "[T]he IRS will argue that the option recipient recognizes income to the extent that the amount of the deferred payment obligation transferred to the option recipient, plus any cash or other property received by the individual, exceeds the amount, if any, the option recipient paid for the option." The transactions (and any substantially similar transactions) are "listed transactions" for purposes of Reg. §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2).

b. **Act II: The IRS hammers the nonstatutory stock option deferral shelter.** T.D. 9067, Transfers of Compensatory Options, 68 F.R. 39453 (7/2/03). Temp. Reg. § 1.83-7T provides that a sale or other disposition of

a nonstatutory stock option to a related person will not be treated as a transaction that closes the application of § 83 with respect to the option. A person is related to the service provider if: (1) the person and the service provider bear a relationship to each other that is specified in § 267(b) or § 707(b)(1), modified to replace “50 percent” with “20 percent” and to treat the spouse of any family member as a family member for purposes of constructive stock ownership under § 267(c)(4), or (2) the service provider and the person are engaged in trades or businesses under common control (as defined in § 52(a) and (b)), excepting the service recipient with respect to the option or the grantor of the option. The effective date is 7/2/03.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

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

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

2. **Joint venture did not result in loss of tax exemption for charity hospital despite its failure to meet the criteria of Revenue Ruling 98-15.** St. David's Health Care System v. United States, 89 A.F.T.R.2d 2002-2998, 2002-1 U.S.T.C. ¶50,452 (W.D. Tex. 6/7/02). Summary judgment was granted to a community-owned, not-for-profit hospital on its tax-exempt status. The hospital's entering into a limited partnership with HCA, Inc. [a for-profit health care company], in which it had general and limited partnership interests of 49.5 percent and in which the for-profit partner was the managing partner, did not result in forfeiture of hospital's § 501(c)(3) exemption. The court held that the community benefit standard did not absolutely require a community board, and that St. David's satisfied this standard even though it appointed only half the board members where the chairman's seat was reserved for a St. David's appointee. There was language

in the partnership agreement requiring all the partnership's hospitals to operate in accordance with the community benefit standard outline in Rev. Rul. 69-45, 1969-2 C.B. 117, and St. David's could unilaterally dissolve the partnership if they failed to do so.

● Query whether Rev. Rul. 98-15, 1998-1 C.B. 718, which provides an example of an acceptable joint venture in which the nonprofit partner has numerical control of the board, will still be considered valid. See also, *Redlands Surgical Services v. Commissioner*, 113 T.C. 47 (1999), *aff'd per curiam*, 242 F.3d 904, 87 AFTR2d ¶2001-642, 2001-1 U.S.T.C. ¶50,271 (9th Cir. 2001).

a. **Litigation costs were ordered.** St. David's Health Care System v. United States, 90 A.F.T.R.2d 2002-6878, 2002-2 U.S.T.C. ¶ 50,745 (W.D. Tex. 9/20/02). The district court ordered the United States to pay \$951,000 in litigation costs under § 7430 to St. David's. Judge Nowlin held that novelty of the issues did not necessarily mean that any position that the government took was reasonable, concluding,

Finally, the United States argues that, since this case involved novel issues, it is more likely that its position was substantially justified. While it is true that some of the specific issues had a hint of novelty to them, that does not mean that any position taken on those issues is reasonable. To the extent that there were novel issues in this case, settled law clearly applied and disposed of those issues.

b. **Fifth Circuit vacates the district court's summary judgment ruling and its award of attorney's fees, and remands for trial. Exempt organization must have control of joint venture.** St. David's Health Care System v. United States, 349 F.3d 232, 92 A.F.T.R.2d 2003-6865, 2003-2 U.S.T.C. ¶50, 713 (5th Cir. 11/7/03). In vacating the district court decision, Judge Garza's opinion relied upon Rev. Rul. 98-15 and found that the central issue was not whether the partnership between St. David's and Columbia/HCA Healthcare Corporation provided some charitable services, but rather whether the activities substantially further the profits-seeking interests of the for-profit partner. The opinion further analyzed facts that showed it was likely that St. David's had, as a practical matter, ceded control over the partnership to HCA – particularly with respect to a noncompete provision in the partnership dissolution rights, which would have prevented either party from competing in the Austin area for two years and would have been inconvenient for HCA but disastrous for St. David's.

B. Charitable Giving

1. **Professor donates his patent to the university, but . . . Contributions of partial interests in patents aren't deductible.** Rev. Rul. 2003-28, 2003-11 I.R.B. 594 (2/26/03). No deduction is allowed under § 170 for a charitable contribution of (1) a license to use a patent, if the taxpayer retains any substantial right in the patent [e.g., a right to license to others], or (2) a patent subject to a conditional reversion [e.g., a contribution of a patent to a university subject to a reversion if a particular faculty member ceases to be a member of the

faculty within 15 years], unless the likelihood of the reversion is so remote as to be negligible. Both of these transfers are transfers of partial interests, a deduction for which is disallowed by § 170(f)(3). A § 170 deduction is allowable for a charitable contribution of a patent subject to a license or transfer restriction generally [e.g., a restriction of transfer or licensing for 3 years], but the restriction reduces what would otherwise be the value of the patent.

X. TAX PROCEDURE

A. Interest, Penalties and Prosecutions

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

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

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

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

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

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

5. **The Tax Court just says "no" to impermissible stacking of penalties.** Said v. Commissioner, T.C. Memo. 2003-148 (5/22/03). Where one spouse is liable for the civil fraud penalty on the entire underpayment relating to a joint return, the § 6662 accuracy related penalty cannot be assessed against the other spouse with respect to any part of the understatement.

6. **Hot dog! No hot interest here.** Med James, Inc. v. Commissioner, 121 T.C. 147 (9/9/03). Section 6621(c) increases the interest on corporate deficiencies to 5 percent above the short-term Federal rate [instead of the normal 3 percent] if the deficiency exceeds \$100,000. The Tax Court (Judge Goeke) held that the increased ["hot"] interest under § 6621(c) does not apply where an NOL that arose in a year before the deficiency notice was sent is carried back to reduce the deficiency, which otherwise would have exceeded \$100,000, to less than \$100,000.

7. **Mendes v. Commissioner**, 121 T.C. 308 (12/11/03) (reviewed, 3 dissents). In an opinion by Judge Halpern, the majority held that a late return filed after a deficiency notice has been issued is not taken into account in determining whether the addition to tax for underpayment of estimated taxes is avoided under § 6654(d)(1)(B) even if the return shows that the tax due for the year was zero. The penalty can be collected pursuant to deficiency notice on underlying tax liability. Judge Foley (joined by Judges Laro and Marvel) dissented on the grounds that the literal requirements of § 6654(d)(1)(B) had been met by the late filed return, and that the proper question was whether the late filed return was indeed a valid return, i.e., was it merely an attempt to avoid the penalty without an honest and reasonable attempt to comply with the requirements for a return.

B. Discovery: Summonses and FOIA

1. **The PwC deal.** IR-2002-82 (6/27/02). The IRS announced in a news release that it cut a deal with PricewaterhouseCoopers (PwC) to resolve tax shelter registration and list maintenance issues. The IRS news release, which is similar to one issued last August regarding Merrill Lynch, says that "without admitting or denying liability, PwC has agreed to make a 'substantial payment' to

the IRS to resolve issues in connection with advice rendered to clients dating back to 1995.” Under the agreement, PwC will provide to the IRS certain client information in response to summonses. According to the release, PwC also will “work with the IRS to develop processes to ensure ongoing compliance with [the shelter registration and investor list maintenance requirements].”

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

b. **The KPMG deal.** Rumored, but not here yet.¹⁹

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

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

a. **Decision on whether proposed intervenors could claim “identity” privilege under § 7525.** United States v. BDO Seidman, 91 A.F.T.R.2d 2003-1651, 2003-1 U.S.T.C. ¶50,255 (N.D. Ill. 2/4/03). Judge Holderman decided that there are four criteria as to whether client identity is privileged on a document-by-document basis: (1) Whether the purpose of the representation was to provide tax advice? [must be “yes” to be privileged]; (2) whether revealing identity would reveal client’s motives for seeking tax advice [must be “yes”]; (3) whether the IRS could determine that clients participated in the transactions without obtaining their names from BDO [must be “no”]; and (4) whether the document was generated for the purpose of preparing tax returns [must be “no”]. Findings for each *in camera* document followed.

b. **Affirmed. Seventh Circuit say tax shelter disclosure rules virtually preclude assertions of identity privilege by tax shelter investors.** United States v. BDO Seidman, 337 F.3d 802, 92 A.F.T.R.2d 2003-5443, 2003-2 U.S.T.C. ¶50,582 (7th Cir. 7/23/03). The Court of Appeals (Judge Ripple) affirmed

19. As of February 22, 2004.

the district court's determination that the investors failed to establish that a confidential communication would be disclosed if their identities were revealed. Disclosure of their identities would disclose to the IRS only that they had participated in one of the tax shelters described in the summonses, but no confidential communication could be inferred from that information alone. The court distinguished *In re Grand Jury Proceeding (Cherney)*, 898 F.2d 565 (7th Cir.1990); *Tillotson v. Boughner*, 350 F.2d 663 (7th Cir.1965), as cases in which "the Government already knew much about the substance of the communications between the attorney and his unidentified client," from this case, where "the IRS knows relatively little about the interactions between BDO and the [the investors], the nature of their relationship, or the substance of their conversations." Furthermore, none of the summonsed documents were subject to any other independent claim of privilege beyond identity. Then, in sweeping language, the court concluded that the tax shelter disclosure rules virtually preclude assertions of identity privilege by tax shelter investors.

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

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

c. You don't have to be a criminal to claim identity privilege in Chicago. *United States v. Arthur Andersen, LLP*, 273 F.Supp.2d 955, 92 A.F.T.R.2d 2003-5207, 2003-2 U.S.T.C. ¶ 50553 (N.D. Ill. 7/2/03). Investors in tax shelters promoted by Arthur Andersen successfully intervened anonymously and asserted identity privilege under § 7525 when the IRS sought to enforce an administrative summons to obtain the lists of investors. The court (Judge Castillio) rejected the government's argument [based on *In re Grand Jury Proceeding*

(*Cherney*), 898 F.2d 565 (7th Cir.1990); *Tillotson v. Boughner*, 350 F.2d 663 (7th Cir.1965)] that identity privilege can exist only where the client has engaged in past criminal conduct, and applied the four part test of *United States v. BDO Seidman*, 91 A.F.T.R.2d 2003-1016, 20031 U.S.T.C. ¶50,255 (N.D. Ill. 2/4/03). (N.D. Ill. 2003) [*United States v. BDO Seidman*, 92 A.F.T.R.2d 2003-5443 (7th Cir. 7/2/03)]. Judge Castillo concluded that “revealing the clients’ identities would reveal their motives for seeking tax advice [because] [t]he IRS is seeking information, including the identities . . . in an effort to determine whether or not Andersen was complying with the IRS regulations governing potentially abusive tax shelters. . . . Under these circumstances, it is difficult to see how revealing the identities of the Poes and the Does could amount to anything less than a revelation of their motivations in seeking Andersen’s tax advice-to invest in potentially abusive tax shelters. This motivation, the “very substantive reason that the client sought . . . advice in the first place,” is confidential and therefore privileged under § 7525. Judge Castillo held further that Reg. § 301.6112-1T Q & A-17(b) provides that the § 7525 privilege trumps the requirements of § 6112. Finally, he rejected the government’s argument that the crime-fraud exception to privilege applied because there was no *prima facie* showing of a crime.

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

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

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

4. Are you practicing law or practicing tax when you write that opinion letter? United States v. KPMG LLP, 237 F.Supp.2d 35, 91 A.F.T.R.2d 2003-317, 2003-1 U.S.T.C ¶50,174 (D. D.C. 12/20/02). The IRS served administrative summonses on KPMG in connection with investigating KPMG’s promotion and participation in tax shelters and sought judicial enforcement when it determined that KPMG had not complied. KPMG withheld documents that

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

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

a. **A subsequent KPMG magistrate's opinion.** *United States v. KPMG LLP*, 92 A.F.T.R.2d 2003-6498, 2003-2 U.S.T.C. ¶50,691 (D. D.C. 10/8/03). KPMG's documents were reviewed by a special master, who found some of them protected by attorney-client privilege and some by § 7525.

5. **District court finds subject-matter waiver of privilege in all communications between two corporations and their outside tax counsel by reason of the assertion of a "reasonable cause" defense.** *In re: G-I Holdings Inc.*, 218, F.R. 428, 92 A.F.T.R.2d 2003-6451, 2004-1 USTC ¶ 50,154 (D. N.J. 7/18/03). The court (Judge Bassler) refused to bifurcate discovery and trial on the issue of penalties pending resolution of the substantive tax issues because the debtors waived any attorney-client privilege with respect to their outside tax counsel [Bill McKee and Will Nelson] by asserting a "reasonable cause" defense that placed attorney-client communications at issue. The court further found that the debtors' communications with Michael Baldasaro [an accountant then with Arthur Andersen] are not privileged under *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961), because he was hired as a consultant – his expertise in partnership transactions taxation was too great to consider him as a "translator or facilitator."

6. **Magistrate denies government's motion to compel discovery of 63 documents, including some between taxpayer's in-house attorneys and Deloitte & Touche.** *The Black & Decker Corp. v. United States*, 219 F.R. 87, 92

A.F.T.R.2d 2003-6426, 2003-2 U.S.T.C. ¶ 50,659 (D. Md. 9/15/03). In the course of the taxpayer's refund suit arising from a series of transactions involving special purpose entities formed to manage employee health care benefits, the government sought discovery of numerous documents prepared by Deloitte & Touche, which taxpayer had retained to give advice regarding the transaction. First, certain communications to taxpayer's in house counsel were not subject to attorney-client privilege under the *Kovel* doctrine, because the accounting firm's advice was not necessary to facilitate communications between the taxpayer's attorney and its non-attorney officers. The evidence that many of the communications in question were directed to non-attorney employees of the taxpayer supported this conclusion. Furthermore, the documents were not "'translation' services' but were hybrid . . . tax and business advice."

● Taxpayer, with the assistance of Deloitte & Touche, created special purpose entities to manage its employee and retiree health care benefits and claimed a large capital loss, as well as a total federal tax refund of about \$57 million for the years 1995 through 2000. The taxpayer did provide a "short opinion" from D&T, and subsequently offered to provide a "long opinion" from D&Y on the transaction and refused to produce 63 other documents. (The production of the "long opinion" was conditioned on an agreement that the government would not assert that such disclosure does not constitute a subject matter waiver, a condition the government refused.) After reviewing the documents in camera, the magistrate held that the attorney-client privilege [in its derivative form under *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961)] was inapplicable because D&T was not primarily providing "translation" services to assist the in-house attorneys in rendering legal advice to the taxpayer, but was instead providing tax and business advice to the taxpayer. However, the work product doctrine was held to apply to the documents [53 of which were opinion work product and 10 of which were fact work product], and there was no waiver of this protection by the provision of the "short" opinion letter to the government.

● Nevertheless, the documents were protected under the work product doctrine. The government conceded that the documents had been prepared in anticipation of litigation, but argued that the "privilege" for work product had been waived. The court held that the work product doctrine can be waived where the party puts the work "in issue," but that the work in question had not been put in issue. That the documents may have related to an opinion letter on which the taxpayer was going to rely in an effort to avoid penalties — and with respect to which the taxpayer thus waived privilege — did not result in waiving the work product doctrine, which is "broader and more robust than the attorney-client privilege." However, the court did not explain, however, how an accounting firm's work became "attorney work product." This is significant because the § 7525 privilege [which was not expressly raised in the case] does not have a "work product" variant.

● The opinion discusses four factors relevant to the applicability of the derivative privilege: (1) whether the advice was provided to the counsel or the client; (2) whether the in-house counsel also acts as a corporate officer; (3) whether the accountant is regularly employed as the client's auditor or advisor; and (4) which parties initiated or received the communications.

7. **Long-Term Capital Holdings rulings.** Long-Term Capital Holdings v. United States, 90 A.F.T.R.2d 2002-7446, 2003-1 U.S.T.C. ¶ 50,105

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

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

8. Attorney-client privilege and work product doctrine can shield documents from the IRS, but you’ve got to have a privilege log. *Toler v. United States*, 91 A.F.T.R.2d 2003-2262, 2003-1 U.S.T.C. ¶50,476 (S.D. Ohio 4/29/03). In connection with a criminal investigation [prior to a referral to the Justice Department], the IRS issued a summons seeking the taxpayer’s documents, including all records used or resulting from preparation of the taxpayer’s tax returns, to Kiesling, an accountant-attorney, who had advised the taxpayer on various tax matters in his capacity as an attorney. Kiesling represented the taxpayer in the criminal matter until August 2000, when the taxpayer retained another law firm, “SZD,” which in turn retained Kiesling. Because prior to August 2000, Kiesling did not possess any of the documents in question, the summons was quashed in that regard. However, if Kiesling possessed any documents or obtained

any information described in the summons that were created or obtained after the taxpayer retained SZD – a fact that was not admitted – the documents and information were protected by the attorney-client privilege to the extent that they “serve[d] to disclose confidential legal communications between [taxpayer] and SZD,” since Kiesling was SZD’s agent. Furthermore, to the extent any relevant documents were prepared or created to assist in defending against the possible criminal charges, they were protected by the work product doctrine, regardless of whether Kiesling was acting as an attorney or accountant after being retained by SZD. However, because the taxpayer failed to provide a privilege log, the motion to quash was denied, without prejudice to renew following preparation of a disclosure log. Finally, the pre-existing documents that were gathered after August 2000 were not protected by the Fifth Amendment because the “fact that the contents of such documents, to the extent they exist, may be incriminating does not render the production of those documents incriminating.”

9. A lawyer’s description and opinion regarding a prepackaged tax shelter transaction is not privileged. *Doe #1 v. Wachovia Corporation*, 268 F.Supp.2d 627, 92 A.F.T.R.2d 2003-5125, 2003-2 U.S.T.C. ¶50,558 (W.D. N.C. 6/24/03). The IRS served an administrative summons on Wachovia seeking investor lists, documents, and other information relating to potentially abusive tax shelters under Reg. § 301.6112-1T. Investors argued that disclosure of their names would “be tantamount to disclosure of privileged information” provided by them to KPMG [§ 7525 privilege] and to Jenkins & Gilchrist [attorney-client privilege], and that other confidential privileged information would be disclosed by compliance with the summons. The court found that there was no attorney-client relationship between the investors and Jenkins & Gilchrist. Rather, Jenkins & Gilchrist “appear[ed] to have merely sold a package to them which contained a description of the transaction and a memorandum as to the potential tax consequences stemming from the transaction.” There was no evidence that any investor “ever had so much as a conversation with an attorney at J & G,” and there was nothing uniquely tied to the individual investors’ financial situation. The package contained no confidential information, was sent to all investors without any individual tailoring, and was delivered by Wachovia, not Jenkins & Gilchrist.

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

● Similarly, the § 7525 privilege did not apply with respect to KPMG. First, the privilege only applies in cases by or against the government and before the IRS. This was a suit by investors seeking an injunction against Wachovia, not a proceeding in which the United States appeared, and the issuance of an administrative summons to a bank is not a “tax proceeding” before the IRS. Second, the privilege does not apply “to any written communication between a federally authorized tax practitioner and a director, shareholder, officer, or employee, agent, or representative of a corporation in

connection with the promotion of the direct or indirect participation of such corporation in any tax shelter," which exactly described this cases. Third, KPMG did not provide any advice other than in the context of return preparation, which is not privileged.

● On 6/26/03, the investors filed a notice of intent to appeal.

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

11. A § 7602 summons solely for a criminal investigation is OK! *Scotty's Contracting and Stone, Inc. v. United States*, 326 F.3d 785, 91 A.F.T.R.2d 2003-2047, 2003-1 U.S.T.C. ¶50,413 (6th Cir. 4/24/03). The IRS issued summonses to accountants for Scotty's Contracting and its owner, Scott, "to determine whether . . . has unreported federal income tax liabilities . . . , and whether . . . Scott has committed any offense under the internal revenue laws." The Court of Appeals (Judge Gibbons) rejected the government's argument that Scotty's Contracting lacked standing to challenge the summonses because they were issued for the sole purpose of a criminal investigation of Scott, not Scotty's. However, the court held that under § 7602, as amended in 1982, the IRS may validly issue a summons pursuant for the sole purpose of a criminal investigation, as long as the case has not yet been referred to the Justice Department. Accord: *United States v. Millman*, 822 F.2d 305, 308 (2d Cir.1987); *Pickel v. United States*, 746 F.2d 176, 183-84 (3d Cir.1984); *United States v. G & G Adver. Co.*, 762 F.2d 632 (8th Cir. 1985); *United States v. Schmidt*, 816 F.2d 1477 (10th Cir.1987); *La Mura v. United States*, 765 F.2d 974 (11th Cir.1985).

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

C. Litigation Costs

1. Frivolous arguments are painful to lawyers' pocketbooks. *Takaba v. Commissioner*, 119 T.C. 285 (12/16/02). Judge Halpern *sua sponte* awarded the government excess attorneys costs of \$10,500, **payable by taxpayer's counsel**, under § 6673(a)(2), where counsel continued to press a

frivolous “§ 861 argument” [that only income earned from possessions, corporations, or the Federal government is subject to tax] originally advanced by the taxpayer acting *pro se*.

2. **It will warm your heart to know that the sword to push the IRS to settle has a keen edge.** Gladden v. Commissioner, 120 T.C. 446 (6/27/03). The taxpayer made a “qualified offer” under § 7430(c)(4)(E), and after a judicial decision relating to issues pertinent to the substantive tax adjustment the parties finally settled the substantive tax adjustment for less than the offer. Temp. Reg. § 1.7430-7T(a) provides that “[t]he provisions of the qualified offer rule do not apply if the taxpayer’s liability under the judgment . . . is determined exclusively pursuant to a settlement . . .” Because legal arguments and issues relating to the substantive issues were litigated and decided by a court, the judgment was not regarded as merely pursuant to a settlement. Thus the taxpayer’s qualified offer was not limited by the settlement limitation on qualified offers in section § 7430(c)(4)(E)(ii)(I). Accordingly, the taxpayers qualified as a prevailing party under § 7430(c)(4) by reason of section 7430(c)(4)(E).

3. **Florida Country Clubs, Inc. v. Commissioner**, 122 T.C. No. 3 (2/3/04). Even though § 7430(c)(2) provides that reasonable administrative cost include costs incurred after the IRS sends a 30-day letter, attorney’s fees are not available with respect to a case in which the IRS has issued a 30-day letter but which has been settled without either a deficiency notice or Appeals decision having been issued. Although the definition of “reasonable administrative costs” includes costs incurred from the date of the 30-day letter, the government still has not “taken a position” for purposes of § 7430(c)(7) until a deficiency notice or Appeals decision has been issued, and thus the taxpayer cannot be a “prevailing party” as defined in § 7430(c)(4).

D. Statutory Notice

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

E. Statute of Limitations

1. **The Eighth Circuit rejects a thirty-year-old Revenue Ruling.** Kaffenberger v. United States, 314 F.3d 944, 91 A.F.T.R.2d 2003-374, 2003-1 U.S.T.C. ¶50,164 (8th Cir. 1/3/03). Section 6532(a) allows the IRS to agree to an extension of time [beyond the normal two year period of limitations] for filing a refund suit. In Rev. Rul. 71-57, 1971-1 C.B. 405, the IRS ruled that such an agreement was valid only if the agreement is executed before the statutory time

expired. The court of appeals held that Rev. Rul. 71-57 misconstrues § 6532(a)(2), and that an agreement to extend the statute of limitations executed by the IRS after it had expired was valid. The court reasoned that § 6501, the provision limiting the period for the IRS's to assess taxes allows the period to be extended "by subsequent agreements in writing made before the expiration of the period previously agreed upon," but that § 6532(a)(2) contains no such language; and the inference therefore is that the agreement need not be entered into before the period expires, because to "do so renders the above quoted portion of § 6501 'insignificant, if not wholly superfluous.'"

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

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

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

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

6. **No Mulligan for the Tax Court and the IRS.** **Carroll v. United States**, 339 F.3d 61, 92 A.F.T.R.2d 2003-5650, 2003-2 U.S.T.C. ¶50,608 (2d Cir. 8/5/03). For purposes of suspending the statute of limitations for deficiencies pending a Tax Court order in a docketed case, the order is entered under § 7459 when it is signed, docketed, and served, even if the document itself is undated due to a clerical error. The Tax Court's order vacating its earlier undated order and

reentering the original order did not restart the statute of limitations – either because the Tax Court had no jurisdiction to vacate its first order or because the second order was a “non-substantive housekeeping document” – and the assessment was untimely.

7. When does a taxpayer become subject to the “duty of consistency” rule? Banks v. Commissioner, 345 F.3d 373, 92 A.F.T.R.2d 2003-6298, 2003-2 U.S.T.C. ¶50,705 (6th Cir. 9/30/03), *rev’g* T.C. Memo. 2001-48. The Sixth Circuit held that the duty of consistency rule does not apply when the taxpayer merely makes a mistake of law that the Commissioner does not challenge (a “mutual mistake of law”), rather than an affirmative misrepresentation; in such a case the taxpayer subsequently may claim the deduction in the proper year, even though the year of the erroneous deduction is closed. The taxpayer originally claimed an alimony deduction in 1993, when an amount escrowed with the state court was paid to his ex-wife; in a subsequent Tax Court proceeding with respect to 1990, the taxpayer claimed the deduction properly should have been allowed under § 461(f) in 1990 when the amount was paid over to the state court. The case was remanded for a finding on whether the taxpayer made a misrepresentation or there was merely a mutual mistake of law [and whether the payment actually was alimony].

8. Martin v. Commissioner, T.C. Memo. 2003-288 (10/8/03). An unauthorized Tax Court petition filed by the taxpayer’s former wife’s attorney with respect to a statutory notice relating to a year for which they filed a joint return, and which was dismissed with respect to the taxpayer on his motion, nevertheless [pursuant to § 6503(a)(1)] suspended the statute of limitations on assessment.

9. The statute of limitations remains suspended until the IRS acknowledges the withdrawal of an offer in compromise. United States v. Donovan, 92 A.F.T.R.2d 2003-6762 (6th Cir. 10/31/03). Form 656, on which an offer in compromise is submitted provides that the statute of limitations is suspended “while the offer is pending (see (m) above) . . . and for one additional year beyond each of the time periods identified in this paragraph.” Paragraph (m) provides: “The offer is pending starting with the date an authorized IRS official signs this form and accepts my/our waiver of the statutory periods of limitation. The offer remains pending until an authorized IRS official accepts, rejects or acknowledges withdrawal of the offer in writing.” The court of appeals (Judge Boggs) held that when the taxpayer withdrew his offer on April 18, 2000, the statute of limitations continued to be suspended until the IRS acknowledged the withdrawal on April 28, 2000. As a result, the statute of limitations expired the day after the suit for collection was filed, not nine days earlier.

F. Liens and Collections

1. A QDRO creates an interest in a pension fund that trumps a later federal tax lien. United States v. Taylor, 338 F.3d 947, 92 A.F.T.R.2d 2003-5606, 2003-2 U.S.T.C. ¶50,636 (8th Cir. 7/31/03). When the IRS attempted to levy on a delinquent taxpayer’s pension fund, his ex-wife, who had an interest in the fund under a valid QDRO, intervened. The court (Judge Riley) held that as a result of the QDRO, the ex-wife was a “judgment lien creditor” with a perfected interest,

regardless of whether she had satisfied state law perfection requirements. Furthermore, a modification of the QDRO related back to the date of the original QDRO. Accordingly, her claim had priority over a subsequent federal tax lien.

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

3. It can be expensive to seek judicial review of a §§ 6320/6330 due process hearing primarily for purposes of delay. Roberts v. Commissioner, 329 F.3d 1224, 91 A.F.T.R.2d 2003-1673, 2003-1 U.S.T.C. ¶50,359 (11th Cir. 3/13/03), *aff'g* 118 T.C. 365 (5/3/02). In reviewing the Appeals Officer’s decision in a §§ 6320/6330 due process hearing that collection of a tax shown on the return but not paid was warranted, Judge Chiechi held that a computer generated record of assessment on Form RACS 006 complied with the requirements of Reg. § 301.6203-1; a signed Assessment Certificate, Form 23C, is not required. A \$10,000 penalty under § 6673(a)(1) was imposed on the taxpayer for petitioning for review of the §§ 6320/6330 due process hearing primarily for purposes of delay. The Court of Appeals affirmed, finding the taxpayer’s due process claims without merit and that the Tax Court did not abuse its discretion in imposing sanctions.

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

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

6. You have a right to make an oral recording of the frivolous arguments you make in a due process hearing, even if you can’t do so in an ordinary Appeals conference. Keene v. Commissioner, 121 T.C. 8 (7/8/03). In a reviewed opinion (Judge Dawson) adopting the opinion of Special Trial Judge Armen, the Tax Court held that § 7521(a)(1) provides taxpayers the right to audio

record a § 6330 due process hearing. Several concurrences pointed out that the holding did not invalidate any other IRS procedures or regulations regarding the ordinary Appeals process.

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

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

7. Sometimes it’s a return, sometimes it isn’t. Swanson v. Commissioner, 121 T.C. 111 (8/28/03). A substitute for a return prepared by the IRS pursuant to § 6020 is not a return for purposes of § 523(a)(1)(B) of the Bankruptcy Act. Because the taxpayer had not filed any returns for the year in issue, he was not discharged from his income tax liabilities by the discharge in bankruptcy.

8. Procedures for submitting an offer in compromise. Rev. Proc. 2003-71, 2003-36 I.R.B. 517 (9/8/03). This revenue procedure explains the procedures for submitting an offer in compromise, and the procedures followed by the IRS in processing the offer. It is effective as of 8/21/03, except the fee provisions, which are effective 11/1/03.

9. Rev. Rul. 2003-108, 2003-44 I.R.B. 963 (11/3/03). For purposes of § 6323(a), a purchaser, holder of a security interest, mechanic’s lienor or judgment lien creditor is protected against a statutory tax lien for which a notice of federal tax lien has not been filed notwithstanding actual knowledge of the statutory tax lien.

10. Montgomery v. Commissioner, 122 T.C. No. 1 (1/22/04). Because no deficiency notice is issued when the IRS attempts to collect unpaid taxes shown as due on the return filed by the taxpayer, at a § 6330 collection due process hearing the taxpayer may challenge the existence or amount of the tax liability reported on the original tax return. The taxpayer’s did not have any other opportunity to “contest” the liability.

G. Innocent Spouse

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

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

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

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

5. “[S]ince refunds are included in the relief provided under section 6015, . . . a request for relief under section 6015 encompasses a request for a refund of tax to the extent permitted under section 6015.” Washington v. Commissioner, 120 T.C. 137 (4/21/03). The taxpayer and her then husband filed a joint return for 1989, reflecting her salary income and his self-employment income, that showed tax owed, but did not pay the tax, beyond the wage withholding on the taxpayer’s salary. The IRS garnished the taxpayer’s wages and applied overpayments of her tax from 1992 and 1994-98 to the unpaid 1989 tax liability. The IRS denied the taxpayer’s request for § 6015 equitable relief. Judge Jacobs held that the IRS had abused its discretion because it had not taken into account the extent of the economic hardship that the taxpayer would suffer if relief were not granted and the facts established that the unpaid tax was attributable to the taxpayer’s former husband’s income and she had no knowledge of reason to believe at the time the returns was signed that he would not pay it. No factors in Rev. Proc. 2000-15, 2000-1 C.B. 447 or Reg. § 301.6343-1 weighed against granting relief. The court also rejected the IRS’s argument that even if the taxpayer was entitled to relief under § 6015(f), the provision did not apply to the portion of the tax liability that was paid on or before July 22, 1998 [the date of enactment of Internal Revenue Service Restructuring and Reform Act of 1998], for which she was seeking a refund. Section 6015 applies to the full amount of any preexisting tax liability for a particular taxable year, if any of that liability remained unpaid as of July 28, 1998, and not just to the portion of tax liability that remained unpaid thereafter [following *Flores v. United States*, 51 Fed. Cl. 49 (2001)]. However,

pursuant to § 6015(g)(1) the taxpayer's right to a refund was limited to amounts for which claims were filed within the periods in § 6511 – in this case amounts paid within two years prior to filing the refund claim. Taxpayer's letters to a revenue officer seeking to have her account placed on "uncollectible status" and requesting abatement of interest and penalties on the grounds that her husband owned the taxes constituted a sufficient informal refund request.

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

7. You might be able to wriggle out of a closing agreement under the power of § 6015. Hopkins v. Commissioner, 120 T.C. 451 (6/30/03). The taxpayer-wife (Yvonne) filed a request for innocent spouse relief under § 6015 with respect to 1982 and 1983. The taxpayers had reported losses from a partnership for those years; in 1988 they signed a closing agreement under § 7121 with respect to adjustments relating to the deductions. In a subsequent bankruptcy the taxpayer-wife sought innocent spouse relief under former § 6013(e), but the bankruptcy court, in a decision that was affirmed [*In re Hopkins*, 146 F.3d 729 (9th Cir.1998)], held that the closing agreement precluded innocent spouse relief. In the instant case the Commissioner argued that the closing agreement precluded a claim for relief under § 6015, and also argued that *res judicata* and collateral estoppel precluded the taxpayer's claim. Judge Ruwe held that a closing agreement entered into prior to the effective date of § 6015 does not preclude the taxpayer from seeking § 6015 innocent spouse relief, which may be available for any tax that remained unpaid as of 6/22/98. Nor did *res judicata* or collateral estoppel preclude the claim.

8. When they both have income and erroneous deductions, how do you apportion liability? Hopkins v. Commissioner, 121 T.C. 73 (7/29/03). Mr. and Mrs. Hopkins filed a joint return on which he claimed erroneous deductions passed-through from a partnership and she claimed erroneous NOL deductions. Mrs. Hopkins (Marianne) was denied innocent spouse relief under § 6015(b), but was granted some apportioned liability relief under § 6015(c). She was granted relief from tax liability attributable to Mr. Hopkins' erroneous partnership deductions except for the portion, if any, that offset her income. She was liable for any deficiencies attributable to her erroneous NOL deductions to the extent they offset her income, but she was relieved of liability for any remaining portion of the deficiencies attributable to the NOL that offsets his income. Decision was entered under Rule 155.

9. But you can't wriggle out of a prior judgment in a stand alone innocent spouse petition. Just one bite at the innocent spouse apple. Turner

v. Commissioner, 121 T.C. 43 (7/11/03). Judge Cohen held that a taxpayer who had failed to raise a innocent spouse claim in a prior district court proceeding instituted by the IRS to reduce an assessment to judgment was barred by *res judicata* from raising the claim in a stand alone petition if the taxpayer participated meaningfully in the prior action. Because Mr. Thurner had meaningfully participated, his claim was barred; whether Mrs. Thurner had materially participated could not be determined on a motion for summary judgment. On another issue, the court held that § 6015 relief is not available for tax liabilities that had been paid prior to 6/22/98.

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

11. “Equitable relief” revenue procedure. Rev. Proc. 2003-61, 2003-32 I.R.B. 296 (7/24/03). Rules for spouses requesting equitable relief from income tax liability under § 6015(f) or its community-property equivalent, § 66(c).

12. Zogman v. Commissioner, T.C. Memo. 2003-268 (9/12/03). The Tax Court denied § 6015(c) apportioned innocent spouse relief with respect to an understatement attributable to the taxpayer’s spouse’s omitted social security benefits because the taxpayer had actual knowledge of the amount of spouse’s social security benefits.

13. Principal purpose of separation was to transfer assets under the guise of state family law. Ohrman v. Commissioner, T.C. Memo. 2003-301 (10/29/03). Section 6015(c)(4) provides that an allocated liability election under § 6015(c) is ineffective to the extent of the value of property transferred from the spouse to whom an erroneous item is attributable to the spouse making the election, if the principal purpose of the transfer was tax avoidance. Any transfer occurring after the date one year before the taxpayer receives a thirty-day letter proposing a deficiency is presumed to have the proscribed purpose regardless of its actual motivation, unless the transfer was pursuant to a divorce or separation *and* the taxpayer proves that it did not have the proscribed purpose. Judge Cohen held that a transfer of assets pursuant to legal separation within one year before taxpayers received a thirty-day letter, after which the spouses continued to reside together, was subject to the § 5015(c)(4) exception to apportioned liability because the principal purpose for the legal separation was to transfer assets under the guise of state family law.

14. Election not made within two years of first collection activity. Campbell v. Commissioner, 121 T.C. 290 (11/24/03). Pursuant to §§ 6015(b)(1)(E) and (c)(3)(B) [and Rev. Proc. 2000-15, § 5, 2001-1 C.B. 447], an innocent spouse election must be made within two years of the IRS's first collection activity against the individual making the election. In this case, Judge Foley held that an offset of an overpayment for one year as credit against an unpaid tax liability for another year, pursuant to § 6402(a), is a collection activity. As a result, the taxpayer's election was not timely.

15. Ewing v. Commissioner, 122 T.C. No. 2 (1/28/04). In a reviewed opinion by Judge Colvin, the Tax Court held that even though the standard for reviewing the Commissioner's failure to grant equitable relief under § 6015(f) is abuse of discretion, the Tax Court's review is not necessarily limited to the facts that were in the administrative record. Judges Halpern, Holmes, Chiechi, and Foley dissented.

16. They're literally dying to try to get § 6015(c) relief. Jonson's Estate v. Commissioner, 118 T.C. 106 (2/8/02). In an innocent spouse case involving tax shelter deductions that was appealable to the Tenth Circuit, the Tax Court applied the Ninth Circuit's liberal standard from *Price v. Commissioner*, 887 F.2d 959 (9th Cir. 1989), requiring only that a spouse seeking relief "establish that she did not know and had no reason to know that the deduction would give rise to a substantial understatement," on the basis of a favorable citation to *Price* in an unpublished Tenth Circuit opinion. However, the Tax Court denied § 6015(b) relief because the spouse was well educated, active in her husband's financial affairs, had full knowledge of the facts of the investment, and benefited from the understatement. The deceased wife's personal representative [her husband] made a § 6015(c) apportioned liability election more than 12 months after her death [and the Commissioner did not challenge the representative's procedural right to make the election], but § 6015(c) relief was denied. The personal representative "stepped into the shoes" of the deceased spouse, and she did not qualify for § 6015(c) relief because at the time of her death she and her husband were not divorced or separated and were members of the same household. Although H. Rept. No. 105-559 at page 252, n.16 states that a taxpayer is no longer married if he or she is widowed, Congress did not intend § 6015(c) to apply to the estate of a spouse who was "happily married" at the time of death. Equitable relief under § 6015(f) also was denied.

a. Affirmed, but possibly on different grounds. 353 F.3d 1181, 93 A.F.T.R.2d 2004-323, 2004-1 U.S.T.C. ¶50,122 (10th Cir. 12/30/03). The Tenth Circuit (Judge Hartz) affirmed, but the reasoning might [or might not be] slightly different. The court of appeals concluded that although the estate could perform the act of filing request for relief, it could not satisfy the condition that the "individual" seeking relief was "no longer married to" or "not a member of the same household as" the other the spouse. Only an "individual" can meet that condition and an "individual" is a living being, not a decedent's estate. Thus, there was no individual eligible for relief.

H. Miscellaneous

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

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

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

- Rule 1: Chief Counsel attorneys may not argue contrary to final guidance; they should generally follow final or temporary regulations in force even if the Service has subsequently issued proposed regulations which might yield a different result;

- Rule 2: proposed regulations have no legal effect unless and until they are adopted; proposed regulations should not be the subject of PLRs and TAMs;

- Rule 3: if there are no final or temporary regulations, Chief Counsel attorneys may not take a position that is inconsistent with proposed regulations;

- Rule 4: perceived conflict between proposed regulations and final guidance (or between two or more pieces of nonregulatory final guidance) should be coordinated;

- Rule 5: case law invalidating or disagreeing with the Service's published guidance does not alter rule 1 or 3; and

- Rule 6: The government's authority to resolve cases through settlement or other dispute resolution mechanisms remains unchanged, so long as the rules set forth above are not violated.

2. Just how detailed a finding on the burden of proof issue does the Eighth Circuit want the Tax Court to make? Griffin v. Commissioner, 315 F.3d 1017, 91 A.F.T.R.2d 2003-486, 2003-1 U.S.T.C. ¶50,186 (8th Cir. 1/14/03), *rev'g* T.C. Memo. 2002-6 (1/8/02). Reversing the Tax Court, the Eighth Circuit, in a *per curiam* opinion, held that the taxpayer had introduced credible evidence that payments of real estate taxes on property owned by an S corporation in which he was a shareholder were made in his capacity as a proprietor of a business, not in his capacity as a shareholder. (If the payments had been made in his capacity as a proprietor they could have been deductible.) The court accepted the Commissioner's definition of "credible evidence": "the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision

on the issue *if no contrary evidence were submitted* (without regard to the judicial presumption of IRS correctness)”, and found this standard satisfied by the testimony of the taxpayer and his accountant. The Commissioner had cross examined the taxpayer’s witnesses, but had not introduced any evidence. The case was remanded to the Tax Court for further proceedings to determine if the Commissioner met the burden of proof, even though the Tax Court opinion, in a footnote, stated that its decision would have been the same if the Commissioner had borne the burden of proof. Perhaps tipping its hand that it wanted the taxpayer to win, the Court of Appeals admonished the Tax Court that “[i]f the same conclusion is reached by the tax court without a new hearing, an explanation is warranted as to how the existing record justifies the conclusion that the Commissioner has met his burden of proof.”

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

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

[employing the two corporate executives] and the Federal Government would be unable to discover them.”

a. So far, he is unable to wriggle out, the way he did 25 years ago when he was acquitted by a jury.²⁰ The taxpayers subsequently moved to have access to the special trial judge’s “reports, draft opinions, or similar documents” prepared under Tax Court Rule 183(b). They based their motion on conversations with two unnamed²¹ Tax Court judges that the original draft opinion from the special trial judge was changed by Judge Dawson before he adopted it. They were turned down because the Tax Court held that the documents were related to its internal deliberative processes. See, Tax Court Order denying motion, 2001 TNT 23-31 (4/26/00) and (on reconsideration) 2001 TNT 23-30 (8/30/00). Taxpayers sought mandamus from the Fifth, Seventh and Eleventh Circuits, but were unsuccessful.

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

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

The record reveals, and we accept as true, that the underlying report adopted by the Tax Court is Special Trial Judge Couvillion’s. Petitioners-Appellants have not demonstrated that

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

21. Kanter’s attorney revealed the names of the two judges when asked at oral argument to the Seventh Circuit as Tax Court Judge Julian Jacobs and Chief Special Trial Judge Peter J. Panuthos. See the text at footnote 1 of Judge Cudahy’s dissent in the Seventh Circuit *Kanter Estate* opinion, below.

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

c. **And the Tax Court's procedures are vindicated and taxpayer Kanter's Estate²¹ loses on appeal on the fraud issue in the Eleventh Circuit Estate of Kanter v. Commissioner**, 337 F.3d 833, 92 A.F.T.R.2d 2003-5459, 2003-2 U.S.T.C. ¶50,605 (7th Cir. 7/24/03) (per curiam) (2-1), *aff'g in part and rev'g in part* T.C. Memo. 1999-407. The court found the nondisclosure of the special trial judge's original report to be proper, following the Eleventh Circuit's *Ballard* opinion. It affirmed the findings on deficiencies, fraud and penalties, but reversed on the issue of the deductibility of Kanter's expenses for his involvement in the aborted sale of a purported John Trumbull painting of George Washington because "Kanter has shown a distinct proclivity to seek income and profit through activities similar to the failed sale of the painting."

(1) **The Supremes will sing on Kanter's grave.** Certiorari was granted. 124 S.Ct. 2066 (4/26/04).

d. **And the Tax Court's procedures are vindicated but taxpayer Lisle's Estate wins on appeal on the fraud issue in the Fifth Circuit. Estate of Lisle v. Commissioner**, 341 F.3d 364, 92 A.F.T.R.2d 2003-5566, 2003-2 U.S.T.C. ¶50,606 (5th Cir. 7/30/03), *aff'g in part and rev'g in part* T.C. Memo. 1999-407. The Fifth Circuit (Judge Higginbotham) followed the Eleventh and Seventh Circuits on the nondisclosure of the special trial judge's original report by the Tax Court. It affirmed the findings of deficiencies, except for the deficiency in a closed year because the government's proof of Lisle's fraud did not rise to the level of "clear and convincing evidence."

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

Even if we held there was a meeting of the minds, we would deny the estate's motion because the "settlement" was never signed or approved by, or even submitted to, any IRS official

21. Burton Kanter died on October 31, 2001.

authorized to approve it. *Gardner v. Commissioner*, 75 T.C. 475, 479 (1980).

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

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

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

7. The TEFRA notice wasn't an unauthorized disclosure even if some of the recipients turned out not to be partners. *Abelein v. United States*, 323 F.3d 1210, 91 A.F.T.R.2d 2003-1476, 2003-1 U.S.T.C. ¶50,331 (9th Cir. 3/27/03). The taxpayer, an investor in a tax shelter partnership of which the IRS was conducting a TEFRA audit, claimed the mailing of final partnership administrative adjustment (FPAA) forms to all persons who the IRS believed might have been partners entitled to notice improperly disclosed confidential tax return information because some notices went to people who were not partners. There was no doubt that return information had been disclosed, but the IRS argued that the § 6103(h)(4) exception for disclosure in administrative proceedings applied. The Court of Appeals (Judge Fernandez) held that the administrative proceeding exception applied because (1) the taxpayers were parties to the administrative proceeding, and (2) under § 6231 the IRS must notify all persons who the IRS believes to be partners in the partnership undergoing the TEFRA audit.

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

9. **The ACLU unsuccessfully tries to protect Irwin Schiff's right to pander fraudulent tax-scams.** United States v. Schiff, 269 F.Supp.2d 1262, 92 A.F.T.R.2d 2003-5047, 2003-2 U.S.T.C. ¶50,551 (D. Nev. 6/16/03). The United States obtained an injunction against Irwin Schiff, an infamous fraudulent tax-scam promoter. Schiff falsely stated that income earned by individuals is not subject to federal income taxes, advised customers to file zero-income tax returns, assisted them in submitting false W-4 forms to stop withholding taxes from wages, helped them prepare other fraudulent tax documents, and urged customers to inundate the IRS, federal courts and Department of Justice with frivolous lawsuits and hearings. The First Amendment did not prevent an injunction against the promotion of the tax scam though publication and sale of Schiff's book, *THE FEDERAL MAFIA*, even though the Nevada ACLU vigorously argued that Schiff should not be censored. The IRS identified nearly 5,000 zero-income federal income tax returns filed by approximately 3,100 of Schiff's customers during the past three years using a two-page attachment referenced in *THE FEDERAL MAFIA*.

10. **You have a choice of forum for review of the Commissioner's refusal to abate interest.** Beall v. United States, 336 F.3d 419, 92 A.F.T.R.2d 2003-5001, 2003-2 U.S.T.C. ¶ 50,551 (5th Cir. 6/27/03). The Fifth Circuit (Judge Garwood) held that a district court has jurisdiction in a refund suit to review for abuse of discretion the Commissioner's refusal to abate interest. Judge Garwood reasoned that the grant of jurisdiction to the Tax Court in § 6404(h) was not exclusive.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

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

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

- On the same day the Tax Court handed down five almost identical cases involving other clients of Joseph M Grey: Mike Graham Trucking, Inc. v. Commissioner, T.C. Memo. 2003-49 (2/26/03); Superior Proside, Inc. v. Commissioner, T.C. Memo. 2003-50 (2/26/03); Specialty Transport & Delivery Services, Inc. v. Commissioner, T.C. Memo. 2003-51 (2/26/03); Nu-Look Design, Inc. v. Commissioner, T.C. Memo. 2003-52 (2/26/03); Water-Pure Systems, Inc. v. Commissioner, T.C. Memo. 2003-53 (2/26/03).

2. **"Nothing in the language or legislative history of section 530 leads us to the conclusion that denial of section 530 relief was meant to be an**

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

3. Both the taxpayer and the Commissioner argued against Tax Court jurisdiction, but they were both wrong. Charlotte’s Office Boutique v. Commissioner, 121 T.C. 89 (8/4/03). The Commissioner asserted a deficiency for unreported employment taxes and additions to tax for 1995 through 1998, and the taxpayer petitioned the Tax Court under § 7436(a) for a determination of employment status. Thereafter, the taxpayer conceded that the person whose status was in question for 1996 through 1998 was an employee, and the parties agreed that the Tax Court lacked jurisdiction over those years because the taxpayer did not dispute the employment status during those years. The Commissioner argued that the Tax Court’s jurisdiction under § 7436(a) extends only to cases in which a taxpayer asserts that an individual performing services for the taxpayer is a nonemployee and the Commissioner has determined that the individual is an employee. The Tax Court (Judge Laro) held that the agreement of the parties as to jurisdiction is not dispositive. Section 7436(a) confers not only jurisdiction to determine whether an individual providing services is an employee, but also whether an employer is entitled to relief under § 530 of the Revenue Act of 1978, and the correct amounts of employment taxes. The court went on to find that purported royalties were wages, that § 530 relief was not available, and that penalties were warranted.

B. Self-employment

There were no significant developments regarding this topic during 2003.

C. Excise Taxes

There were no significant developments regarding this topic during 2003.

XII. TAX LEGISLATION

A. Enacted

1. **The Jobs and Growth Tax Relief Reconciliation Act of 2003** (“JGTRRA” or the “2003 Act”), Pub. L. 108-27, 117 Stat. 752 was signed by President Bush on 5/28/03.

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

2. **The Military Family Tax Relief Act of 2003**, Pub. L. 108-121, 117 Stat 1335, was signed by President Bush on 11/10/03.

3. **The Medicare Prescription Drug, Improvement, and Modernization Act of 2003**, Pub. L. 108-173, 117 Stat. 2066 was signed by President Bush on 12/8/03.