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Recent Developments in Federal Income Taxation: The Year 2000

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This current 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 year 2000.¹ Most Treasury Regulations, however, are so complex that they cannot be discussed in detail; only the basic topic and fundamental principles are highlighted. Amendments to the Internal Revenue Code generally are not discussed except to the extent that they have either led to administrative rulings and regulations or have affected previously issued rulings and regulations otherwise covered by the outline. The outline focuses primarily on topics of broad general interest—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, but generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

I. ACCOUNTING

A. Accounting Methods

1. Pharmaceuticals administered by physicians are not merchandise; they're supplies used in connection with the rendering of services. *Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner*, 113 T.C. 376 (1999) (11-6 decision). Chemotherapy drugs administered by a cash-method professional medical corporation were not merchandise under Reg. § 1.471-1, so inventory accounting and a hybrid method [accrual method for the chemotherapy drugs and cash method for the balance of taxpayer's business] were not required. Generally, goods sold by a service provider ancillary to the provision of services must be inventoried and accounted for under the accrual method. See *Wilkinson-Beane, Inc. v. Commissioner*, T. C. Memo. 1969-79, *aff'd*, 420 F.2d 352 (1st Cir. 1970) (undertaker's supply of caskets); Rev. Rul. 74-279, 1974-1 C.B. 110

1. 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 2000: ABA Tax Section Midyear Meeting, American Institute on Federal Taxation, American Petroleum Institute, Denver Tax Institute, Houston Bar Association Tax Section, University of Montana Tax Institute, University of North Carolina Tax Institute, Southern Federal Tax Institute, Southwestern Legal Foundation Institute on Oil and Gas Law and Taxation, 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, Tulane Tax Institute, University of Virginia Conference on Federal Taxation, Wednesday Tax Forum (Houston), William & Mary Tax Conference.

(optometrist's supply of glasses and frames). But "giv[ing] significance to the uniqueness of the industry . . . in relation to other service industries," the Tax Court, in a reviewed opinion by Judge Laro, has carved out a special exception for pharmaceuticals – in this case, medicines administered in the course of chemotherapy cancer treatments – furnished by a physician (or hospital) provided as "an integral, indispensable, and inseparable part of the rendering of medical services." The Tax Court, has held that such a transaction is not a "sale of 'merchandise,'" even if the items involved are very expensive [charges for the drugs constituted 26% of taxpayer's gross receipts and were separately invoiced] and thus represent a significant portion of the transactions. Accordingly, such pharmaceuticals need not be inventoried and accounted for (with the taxpayer required to shift to the accrual method), but are supplies that can be expensed under § 162.² The Commissioner abused his discretion in requiring the medicines to be treated as inventory subject to the accrual method when the taxpayer otherwise used the cash method. A critical factor in this result, however, was that the pharmaceuticals could not have been purchased from the taxpayer separately from the associated medical services. The court also noted that the taxpayer kept only a two-week supply.

◦ A dissent by Judge Halpern criticized the majority opinion for, among other things, overturning the Commissioner's discretion in an accounting methods case in which the taxpayer failed to demonstrate that its accounting method clearly reflected income [an issue which Judge Halpern correctly notes was not addressed in the majority opinion]. The dissent further asserted that Reg. § 1.162-3 mandates that the deduction for supplies on hand should be made only as "they are actually consumed and used in operation during the taxable year," as opposed to "incidental materials or supplies on hand, for which no record of consumption is kept," which may be currently deducted. Judge Halpern relies on *Wilkinson-Beane Inc. v. Commissioner*, 420 F.2d 352 (1st Cir. 1970), *aff'g*, T. C. Memo. 1969-79 (funeral home in service business has merchandise when it derives a substantial part of income from the regular purchase and sale of tangible personal property).

a. **Play it again.** *Mid-Del Therapeutic Center, Inc. v. Commissioner*, T. C. Memo 2000-383. On facts essentially the same as those in *Osteopathic Medical Oncology and Hematology, P.C.*, the court reached the same result.

b. **And the IRS acquiesces in the result.** A.O.D. 2000-05 (4/27/00). The IRS acquiesces in the result in *Osteopathic Medical Oncology*

2. In *Hospital Corp. of America v. Commissioner*, 107 T.C. 116 (1996), the Tax Court held that a cash method hospital was not required to use accrual method to account for medical supplies dispensed to patients in course of hospital stay, but did not reach the inventory question.

and Hematology, P.C., and agrees that under circumstances comparable to this case, prescription drugs or similar items administered by healthcare providers are not merchandise under Reg. § 1.471-1. The A.O.D. notes, however, that Reg. § 1.162-3 may require a similarly situated health care provider to treat the cost of prescription drugs or similar items as deferred expenses that are deductible only in the year they are used or consumed.

2. Nor is ready-mixed concrete merchandise held for sale by a contractor. *RACMP Enterprises, Inc. v. Commissioner*, 114 T.C. 211 (2000). The taxpayer was a construction contracting company that constructed concrete foundations, driveways, and walkways. The Tax Court (in a 10-6 reviewed opinion by Judge Parr) rejected the Commissioner's attempt to compel the taxpayer to switch from the cash method to the accrual method and permitted the taxpayer to use the cash method to account for its income and expenses for the cost of ready-mix liquid concrete and other materials. The materials were used up before they were paid for and before the taxpayer reported their expense. Like the road contractor in *Galedrige Construction, Inc. v. Commissioner*, T. C. Memo 1997-240, who was permitted to use the cash method for purchases and sales of emulsified asphalt in connection with road building contracts, RACMP was in the business of providing services, not of selling merchandise, and the ready-mix concrete material was an indispensable and inseparable part of the provision of that service. Fill sand, drain rock, and hardware were not as "ephemeral" as the liquid concrete, but also were indispensable to and inseparable from the services provided by RACMP, even though a *de minimis* amount often remained on hand at the end of a contract. Reg. § 1.471-1 does not provide that any materials that are an income producing factor are *ipso facto* merchandise, citing *Osteopathic Medical Oncology and Hematology, P.C.* In the course of the opinion, the court stated:

[W]here a taxpayer is a "small" corporation permitted to use the cash method under § 448(b)(3), is not required to maintain an inventory, consistently used the cash method of accounting since its incorporation, and has made no attempt to unreasonably prepay expenses or purchase supplies in advance, the taxpayer is not required to show a substantial identity of results between the taxpayer's method of accounting and the method selected by the Commissioner.

• Judge Gerber vigorously dissented on numerous grounds: (1) Taxpayer did not meet the heavier-than-normal burden of showing an abuse of the Commissioner's discretion; (2) the majority's conclusion that the materials involved were merely an inseparable part of petitioner's performance of a service was not supported by the record; (3) the majority's holding and approach may result in unintended preferential tax treatment for a particular industry and/or taxpayers dealing in so-called "ephemeral" products or materials; (4) the holding in *Galedrige Construction*,

Inc. was erroneous and the majority's reliance upon it thus unfounded; and (5) the *RACMP* case was factually distinguishable from *Osteopathic Medical Oncology & Hematology, P.C.*

The essence of Judge Halpern's dissent is captured in the following:

Restaurants do not sell tobacco products anymore, and liquor may give them pause, but can fancy French restaurants (or large food service operations) now argue that they need not inventory their comestibles since they are inherently a service business, with peas, carrots, truffles, and boeuf being integral to that service? What about the proliferation of dot.com businesses, whose added value is generally some service, such as the ability to shop at home for merchandise, such as books or music, that used to require a trip to the store? I fear that our new rule may be misunderstood.

3. But not this time. *Von Euw & L.J. Nunes Trucking, Inc. v. Commissioner*, T. C. Memo 2000-114. The Commissioner did not abuse his discretion in requiring a sand and gravel trucking company that purchased and resold sand and gravel to switch from the cash to the accrual method because the taxpayer primarily sold sand and only incidentally transported it. *RACMP Industries, Inc.* was distinguishable.

4. Yet another construction company is allowed to use the cash method. *Jim Turin & Sons, Inc. v. Commissioner*, 219 F.3d 1103 (9th Cir. 2000). The Court of Appeals affirmed a Tax Court decision that Commissioner abused his discretion in requiring paving company to change from the cash method to the accrual method, reasoning asphalt is not susceptible to being inventoried. The case follows *Galedridge Construction Inc.*, and *RACMP Enterprises, Inc.* and distinguishes *Von Euw & Nunes Trucking, Inc.*

5. Is the IRS aiming for a split in the circuits after the dust settles on the first round of appeals? *Vandra Bros. Construction Co., Inc. v. Commissioner*, T. C. Memo 2000-233. *RACMP Enterprises* was followed on "indistinguishable" facts.

6. This one really "floor" us. Yesterday, emulsified asphalt was not inventory, today carpets are not inventory, tomorrow *Smith v. Commissioner*, T. C. Memo 2000-353. A flooring contractor who installed custom ordered, and often custom designed, flooring was not required to maintain inventories or use the accrual method. Judge Wells found that Smith Carpets was a service provider because all floor coverings were specially ordered from the manufacturer to the customer's specifications and, even though the taxpayer maintained a warehouse [to store the flooring pending

installation], it did not maintain a stock of goods to sell to the public merchandise within the meaning of Reg. § 1.471-1 [although it did maintain a stock of supplies, e.g., padding, glue, etc.]. *RACMP Enterprises, Inc.* was held to be controlling.

7. IRS ends the small-dollar aspect of its crusade against the cash method, but continues the crusade against “small” taxpayers with gross receipts between \$1million and \$5 million. Rev. Proc. 2000-22, 2000-20 I.R.B. 1008. The Commissioner will exercise his discretion to except a “qualifying taxpayer,” i.e., one with average annual gross receipts of \$1 million or less [as determined under Reg. § 1.448-1T(f)(2)(iv), from the requirements of accounting for inventories and using an accrual method of accounting for purchases and sales of merchandise. A business that adopts the cash method under this revenue procedure will treat inventory items as materials and supplies that are *not* incidental under Reg. § 1.162-3. This means that the taxpayer must capitalize the cost of actual purchases of goods or materials to be resold or incorporated into manufactured products and offset the capitalized amounts against the amount realized when the goods are resold, but the taxpayer may deduct currently all other manufacturing and handling costs (including labor, warehousing, and other direct and indirect costs that normally must be capitalized under § 263A). To qualify, the business may not use any method other than the cash method for its books and records and other reports. An automatic change in accounting method to the cash method under Rev. Proc. 2000-22 is effective for tax years ending after 12/16/99.

a. Modified and superseded, with some changes. Rev. Proc. 2001-10, 2001-2 I.R.B. 287, modifies and supersedes Rev. Proc. 2000-22 to clarify that the revenue procedure does not apply to tax shelters. It also clarifies the proper time to take into account the cost of inventoriable items that are treated as supplies that aren't incidental under Reg. § 1.162-3. Further, it clarifies the computation of the adjustment required under § 481(a) in connection with the automatic changes in method of accounting under Rev. Proc. 2001-10. Also, the conformity requirement of § 5.07 has been removed, and § 6.02 has been modified to provide that small businesses using an accrual method of accounting that are not required under § 471 to account for inventories may use the automatic consent provisions to change to the cash method.

8. And you thought there were only two fundamental accounting methods. Well, think again. *Tutor-Saliba Corp. v. Commissioner*, 115 T.C. 1 (2000). The Tax Court upheld Reg. § 1.460-6(c)(2)(vi), which provides that under the percentage of completion method, the “estimated contract price” includes amounts related to contingent rights (i.e., incentive fees or amounts in dispute) and liabilities that have a “reasonable expectancy” of occurring –

whether or not the all events test has been met – because the regulation “harmonizes with the plain language, origin, and purpose of § 460.” The taxpayer argued that the all events test is a fundamental tax principle that cannot be ignored without an express mandate from Congress, but Judge Gerber rejected the argument because “the § 460 version of the percentage of completion method is a self-contained, statutorily created form of accounting method which varies substantially from prior accrual accounting methodology”

9. Final word on that other-worldly accounting method. T.D. 8929, Accounting for Long-Term Contracts, 66 F.R. 2219 (1/10/01). The Treasury has promulgated final regulations, Reg. §§ 1.460-1 through 1.460-6, under § 460. The final regulations generally follow the proposed regulations [Reg-208156-91, 64 F.R. 24096 (5/5/99)] with a number of modifications. Costs are allocated to long-term contracts under a single standard linked to the uniform capitalization rules of § 263A. Subcontracted costs are either direct material or direct labor costs that must be allocated. The look-back rule is modified to apply first in the year in which the long-term contract is completed and accepted. Hybrid contracts involving both the manufacture of personal property and the construction of real property can electively be reported under the percentage of completion method. If the customer breaches before completion, previously reported gross income is reversed and the adjusted basis of the retained property equals previously deducted costs.

10. Section 446(b) denies taxpayers the “license to change freely from one characterization to another when hindsight shows that it is financially advantageous,” or, as Spanky said to Alfalfa, “first thing ya say always counts”. *FPL Group, Inc. v. Commissioner*, 115 T.C. 554 (2000). FPL, a major public utility, followed accounting and regulatory [FERC Uniform System of Accounts] rules and capitalized expenditures for the addition or replacement of “retirement unit” components, as expanded by FPL under permissible elections, of its plant and equipment. Except for using the percentage repair allowance (PRA) provided in Reg. § 1.167(a)-11(d)(2), and a reserve for storm —hurricane, as in Andrew, that is—damage, FPL characterized expenditures as capital for tax purposes using the same method it used for accounting purposes. FPL first claimed additional repair deductions in its petition in response to a deficiency notice on other issues, but never filed a Form 3115. The Commissioner argued that under § 446(e) FPL was impermissibly attempting to materially change an accounting method because FPL had not requested consent and the change was not a “mere correction.” On summary judgment, the Tax Court (Judge Ruwe) upheld the Commissioner’s position. FPL’s Schedule M-1 adjustments for the PRA and storm damage did not establish that regulatory and financial accounting treatment were not the basic accounting method it followed to determine the character of expenditures

[repair vs. capital], as modified by the PRA. The IRS's failure to object to similar changes for other years did not constitute implied consent.

B. Inventories

1. New § 1221(a)(8), enacted in 1999, excludes from capital asset treatment supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer. See III.A., *infra*.

2. REG-107644-98, Dollar-value LIFO Regulations; Inventory Price Index Computation Method, 65 F. R. 31841 (5/19/2000). The Treasury Department released proposed amendments to Reg. § 1.472-8 relating to changes in the inventory price index computation of LIFO dollar-value inventory pools.

C. Installment Method

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

• The legislative history explains the purpose of this change by stating that:

The installment method is inconsistent with the use of the accrual method of accounting and should not be allowed in situations where the disposition of property would otherwise be reported using the accrual method. The Committee is concerned that the continued use of the installment method in such situations would allow a deferral of gain that is inconsistent with the requirement of the accrual method that income be reported in the period it is earned, rather than the period it is received.

• Although this language may sound like Congress had installment sales of goods in the ordinary course of business in mind in enacting the provision, the legislative history specifically notes that under pre-1999 § 453 “[s]ales to customers in the ordinary course of business” were not eligible for the installment method. Thus, it is reasonably clear that the sales Congress had in mind were asset sales other than in the ordinary course of business. Accordingly, the installment method under § 453 is no longer

available to report the disposition of § 1231 property or capital assets used in the trade or business of an accrual method taxpayer.

- For example, if a hardware store business, consisting of inventory, accounts receivable, equipment, land and building, and goodwill is sold “lock, stock, and barrel” for a lump sum payment due in five years, the entire gain on all of the assets (which must be computed separately on each asset) must be reported in the year of the sale, even though under prior law the sales of the equipment (except to the extent of § 1245 recapture), land, building, and goodwill (except to the extent of § 1245 recapture if the goodwill was a § 197 amortizable intangible) could have been reported on the installment method.

a. Guidance on application of denial of installment method to accrual method taxpayers. Notice 2000-26, 2000-17 I.R.B. 954. This notice provides guidance in a Q&A format regarding the application of § 453(a)(2).

- Cash method shareholders of an accrual method corporation may report sales of stock under the installment method, regardless of whether the purchaser makes a § 338(g) election.

- Cash method shareholders of an accrual method S corporation may not report under the installment method if a joint § 338(h)(10) election has been made.

- Cash method partners of an accrual method partnership may report the sale of a partnership interest on the installment method [subject to the limitations of § 453(i)(2) and Rev. Rul. 89-108, 1989-2 C.B. 100].

- Even if an installment obligation provides for contingent payments, an accrual method taxpayer generally may not use the open transaction method of *Burnet v. Logan*, 283 U.S. 404 (1931) to report the gain. Open transaction reporting is available only in those rare and extraordinary cases in which the fair market value of the obligation cannot reasonably be ascertained. See Reg. §§ 1.1001-1(a) and (g); 1.483-4 and 1.1275-4 [for rules concerning the taxpayer’s treatment of the installment obligation].

b. The Installment Tax Correction Act of 2000, signed 12/28/00, retroactively repealed 1999 addition of § 453(a)(2) and restored the availability of § 453 installment reporting to accrual method taxpayers on the same basis that it was available before the 1999 legislation.

2. The Tax Relief Extension Act of 1999 also amended § 453A(d) to apply the “pledge as recognition” rule whenever a taxpayer holding an installment obligation has the right to satisfy all or any portion of his own debt to any creditor by transferring the installment obligation. Unless one of the various special exceptions applies, both the seller and buyer report the OID on

the accrual method. Any gain on the sale of the property itself is reported by an accrual method taxpayer in its entirety in the year of the sale and by a cash method taxpayer either currently or using the installment method under § 453 if the sale is eligible for installment reporting under that Code provision. This provision was not repealed in 2000.

D. Year of Receipt or Deduction

1. **Boylston Market³ still reigns.** *USFreightways Corp. v. Commissioner*, 113 T.C. 329 (1999). An accrual method trucking company was required to capitalize expenditures for licenses and insurance which had an effective period extending beyond the tax year. Judge Nims held that taxpayer's argument – whether or not the argument is well-taken – that the expenditures should be currently deductible if their benefit extends “less than 12 months into the subsequent tax period” is inapplicable to an accrual method taxpayer.

2. *Schlumberger Technology Corp. v. United States*, 195 F.3d 216 (5th Cir. 1999). The taxpayer was not required to accrue a Swiss arbitral award until the period for appeal had expired. Under Swiss law, an arbitral award required judicial confirmation before becoming enforceable and the unappealed award was not judicially confirmed until the period for appeal had lapsed.

3. *Exxon Mobil Corp. v. Commissioner*, 114 T.C. 293 (2000). Taxpayer's 22% share of estimated dismantlement, removal, and restoration costs of \$928 million related to Prudhoe Bay oil field production equipment and facilities were not sufficiently fixed and definite to be accruable under the Reg. § 1.461-1(a)(2) all-events test. Judge Swift further held that taxpayer's share of \$111 million in estimated DRR costs relating specifically to oil wells and to well drilling sites were sufficiently fixed under the all-events test. However, the costs were not accruable as a capital cost because that would constitute an accounting method change for which taxpayer had not received permission, nor were they accruable as a current expense because this would cause a distortion in taxpayer's income.

4. **Clinton tax increase claims another casualty.** *Thomas v. United States*, 213 F.3d 927 (6th Cir. 2000). The Court of Appeals affirmed a district court summary judgment that a “cash option” lottery winner had income in the later year when prize was verified (1993), not [under the “economic benefit” doctrine] in the earlier year in which the ticket was drawn and taxpayer claimed the prize (1992). It took approximately six weeks to process taxpayer's claim. The court found that taxpayer did not have irrevocable rights in any specific fund in 1992 that were greater than general creditors of the fund.

3. 131 F.2d 966 (1st Cir. 1942).

5. *American Express Co. v. United States*, 47 Fed. Cl. 127 (2000). Before 1987, taxpayer included annual credit card fees in income when the fees were billed. In 1987 taxpayer changed its method of accounting on the basis of FASB 91 to include the fees ratably over the 12-month period for which they were billed and sought the Commissioner's approval for the change in accordance with Rev. Proc. 71-21, 1971-2 C.B. 549. The court held the Commissioner's denial of the request to be within his discretion on the ground that Rev. Proc. 71-21 and Gen. Couns. Mem. 39,434 (Oct. 25, 1985) provide an adequate basis for the determination that the fees were not for services. The GCM viewed card fees as payments for credit, not as payments for "contingent services." The court held that *Barnett Banks of Florida v. Commissioner*, 106 T.C. 103 (1996) (allowing ratable inclusion of refundable credit card fees) was decided on its own facts [which are, in fact, difficult to distinguish] and did not as a matter of law require overturning the Commissioner's discretion in this case. The court further noted that the *Barnett Banks* court did not "fully address the question of whether there was an adequate basis for the Commissioner's exercise of discretion under Rev. Proc. 71-21" and that the Court of Federal Claims will not make close factual judgments where there is no abuse of discretion.

6. *Midamerican Energy Co. v. Commissioner*, 114 T.C. 570 (2000). Section 1341 does not apply to rate reductions by public utility to indirectly compensate customers for prior charges that retrospectively were determined to have over-recovered costs and therefor to have been excessive; rate reductions were income reductions, not deductible expenses, and amounts and benefitted customers depended on current consumption, not consumption in year of overcharges. Accord *Florida Progress Corp. v. Commissioner*, 114 T.C. 587 (2000).

7. **You might not be able to have your cake and eat it too, but you can take your accrual deduction and hold back payment of the cash.** *Newhouse Broadcasting Corp. v. Commissioner*, T. C. Memo 2000-244. Taxpayer's Random House subsidiary was contractually obligated to pay book authors royalties on all books sold and not returned, even if payment was never received. Random House accrued deductions for royalties on all books sold in the year. It did not pay authors royalties on all books sold but set up a "reserve" against returns and held back payment for the portion of the royalties attributable to books expected to be returned. The Tax Court (Judge Halpern) rejected the Commissioner's argument that this practice negated satisfaction of the all events test with respect to the amount of royalties equal to the additions to the reserve and not paid. The royalties were legally "owed" to the authors until the books were returned, which was a subsequent event, even if they were not yet payable and might never be payable due to those subsequent events.

8. Taxes now, cash received later – the worst of all possible worlds.

Keith v. Commissioner, 115 T.C. 605 (2000). The taxpayer [through a partnership] sold residential real property through contracts for deed, under which the buyers obtained possession, assumed responsibility for taxes, insurance, and maintenance, and agreed to make monthly payments, with interest, of the purchase price. A warranty deed would be delivered to the buyers only upon full payment; any default by the buyers voided the contracts; the seller could retain, as liquidated damages, all amounts previously received, and the buyer was not liable for the remaining balance. The partnership, whose return indicated it was on the accrual method, did not report any gain attributable to the contracts until the year in which full payment was received and title transferred. Interest payments were included over the term of the contracts. The partnership also depreciated the subject properties during the term of each contract. In a reviewed decision (13-2), the Tax Court held that because under state law the benefits and burdens of ownership passed to the buyers, there was completed sale for tax purposes in the year the contracts were executed. Because the sales were dealer dispositions to which § 453 did not apply, the gain from the dispositions was recognized and reportable in that taxable year. The Tax Court reconsidered, and no longer will follow, its opinion in *Baertschi v. Commissioner*, 49 T.C. 289 (1967), *rev'd*, 412 F.2d 494 (6th Cir. 1969), in which the Tax Court held that the “nonrecourse” nature of the buyer’s obligation precluded passage of the benefits and burdens of ownership.

II. BUSINESS INCOME AND DEDUCTIONS**A. Income**

1. The beginning of a long story. *Estate of Smith v. Commissioner*, 110 T.C. 12 (1998). Algerine Smith, Frankie Allen and Jessamine Allen owned oil royalty interests. When Jessamine died in 1979, Algerine Smith inherited Jessamine’s interest; when Frankie died in 1989, Algerine Smith inherited a portion of Frankie’s interest. In 1988, Exxon sued Algerine (and others) to recover a portion of royalties paid to Algerine Smith, Frankie and Jessamine Allen (and others) from 1975 through 1980. After Algerine died in 1990, Algerine’s estate settled the claims against Algerine, Frankie, and Jessamine. The estate claimed the benefit of § 1341 with respect to the repayment. The Tax Court held that the estate could apply § 1341 only to the repayment of the claims against Algerine. Section 1341 does not apply to repayments of amounts received by and taxed to the taxpayer’s predecessor in interest. Repayments by a beneficiary of an estate of amounts received by and taxed to the decedent and inherited by the beneficiary are not subject to § 1341.

a. **Affirmed and reversed.** *Estate of Smith v. Commissioner*, 198 F.3d 515 (5th Cir. 1999). The value of a reimbursement claim against an estate should not have been limited to a post-death settlement, but should have been determined as of the date of the decedent's death. Judge Weiner further held that the income tax benefit the estate derived under § 1341 for its settlement payment was not a separate estate asset, and that the estate did not have COD income by settling the claim for less than the amount deducted under § 2053.

b. The IRS has non-acquiesced in Fifth Circuit *Smith* decision on the estate tax issue, 2000-19 I.R.B. 962.

c. **Assessment and collection while Tax Court litigation is pending on remand? You betcha, if you don't file an appeal bond.** *Estate of Smith v. Commissioner*, 115 T.C. 342 (2000). In an earlier proceeding, the Tax Court [108 T.C. 412 (1997), supplemented 110 T.C. 12 (1998)] had determined a deficiency. The taxpayer appealed, but did not file an appeal bond, and the IRS proceeded to assess and collect the taxes. The Court of Appeals [198 F.3d 515 (5th Cir. 1999)] reversed and remanded the earlier Tax Court decision for further proceedings without indicating any particular amount of the deficiency that clearly could not be assessed. Normally, if the Tax Court is reversed, a portion of the deficiency disallowed, and the case remanded – even though the litigation is not terminated – under § 7486 the taxpayer may obtain a refund of the “provisionally” collected taxes. In the instant case, the IRS had entered the assessment but had stayed collection pending appeal. Notwithstanding the reversal on appeal, the Tax Court (Judge Ruwe) held that the reversal and remand did not indicate any particular amount of the deficiency that clearly could not be assessed. Accordingly, the assessment was not abated, a refund of the portion paid was not ordered refunded, and collection was not restrained pending the decision on remand.

2. Final regulations on curbing the whipsaw potential of § 110 also make clear that people like us tax professionals are retailers and that back-office and storage spaces are included. T.D. 8901, Qualified Lessee Construction Allowances for Short-Term Leases, 65 F. R. 53584 (8/29/00). The Treasury Department has promulgated final regulations under § 110 [added in 1997] relating to the exclusion for gross income for qualified lease construction payments provided by a lessor to a lessee for the purpose of constructing long-lived improvements pursuant to a short-lived lease. Reg. § 1.110-1. The regulations provide a safe harbor that allows a lessee in a short-term lease of retail space to exclude from income construction allowances it uses to construct qualified long-term property. The safe harbor defines “qualified long-term real property” as nonresidential real property which is part of the rental space and which reverts to the lessor at the termination of the lease. It defines “short-term

lease” as a lease for retail space for 15 years or less. “Retail space” is defined as real property used by a lessee in its trade or business of selling tangible personal property or services to the general public. The regulations impose information reporting requirements on both the lessor and lessee. They also clarify the definition of “retail space” to include offices for hair stylists, insurance agents, stock brokers, bankers, doctors, lawyers, and other professionals. They further clarify that back office spaces are included, as well as the selling floor.

3. Rev. Proc. 2000-33, 2000-36 I.R.B. 257. The acquisition of corporate debt by a beneficiary of a decedent creditor's estate or by a beneficiary of a revocable trust that became irrevocable upon the creditor's death where the beneficiary of the estate is related to the corporate debtor, the decedent creditor was also related to the corporate debtor, but the estate or trust is not related to the corporate debtor, is not an indirect acquisition of the debt by the corporation under Reg. § 1.198-2(b) triggering COD income to the corporation under § 108(e)(4).

B. Deductible Expenses versus Capitalization – *INDOPCO* aftermath: “Deductions are exceptions to the norm of capitalization.” (Blackmun, J.)

1. Is Rev. Rul. 94-38 all it's cracked up to be?⁴ *Dominion Resources, Inc. v. United States*, 48 F. Supp. 2d. 527 (E.D. Va. 1999). The taxpayer incurred environmental remediation expenses to remove asbestos and other contaminants from a site previously used as a power generating station for the purpose of preparing the site of the retired power plant for use as an office building site or for sale. Rev. Rul. 94-38, 1994-1 C.B. 35, generally allows a deduction for environmental remediation costs to remedy the taxpayer's own

4. A definitive, but less-than-comprehensive, post-*INDOPCO* revenue ruling. Rev. Rul. 94-38, 1994-1 C.B. 35. This ruling addresses soil remediation and groundwater treatment costs attributable to pollution caused by the taxpayer, and does not apply to costs attributable to pre-ownership contamination or to costs other than soil remediation and groundwater treatment. It relies upon *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962), which held that costs incurred to restore taxpayer's property to essentially the same condition that existed prior to the contamination were deductible under § 162. The ruling holds that environmental cleanup costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from its business (other than costs attributable to the construction of groundwater treatment facilities) are deductible under § 162 as ordinary and necessary business expenses. The cost of constructing groundwater treatment facilities must be capitalized under §§ 263 and 263A. This ruling applies whether the taxpayer plans to continue its manufacturing operations that discharge the hazardous waste or to discontinue those manufacturing operations and hold the land in an idle state, but it does not apply to costs incurred in anticipation of sale of the land. This ruling supersedes Tech. Adv. Mem. 93-15-004 (Dec. 17, 1992), which required capitalization of cleanup costs for land contaminated with PCBs.

prior pollution. Notwithstanding the revenue ruling, the taxpayer was required to capitalize the expenditures because they did not merely maintain the property, but increased the appraised value of the property from approximately \$1.5 million to approximately \$9 million and prepared it for a new or different use. Rev. Rul. 94-38 was inapplicable because the site was no longer used as a power generating station, nor was such use in the future contemplated by taxpayer.

a. *Dominion Resources affirmed.* *Dominion Resources, Inc. v. United States*, 219 F.3d 359 (4th Cir. 2000). The cleanup costs permitted the property to be utilized in a different way so the improvement is considered a capital expenditure – as opposed to an improvement that only restores value to the property that existed prior to the deterioration [or prior to a discrete event that damaged the property], which is treated as a deductible repair expense. The cleanup altered the character of the property, enabling the property to be put to “a wide range of new uses,” as opposed to keeping the property in its ordinary efficient condition.

b. IRS rules contra to *Dominion Resources*; cleaning up after yourself is currently deductible. Tech. Adv. Mem. 1-05979-99 (Aug. 28, 1999) can be found in Priv. Ltr. Rul. 1999-52-075 (Aug. 28, 1999). Restoration costs allocable to contamination that occurred during taxpayer’s ownership and operation of a manufactured gas plant are currently deductible under § 162 and Reg. § 1.162-4 because these costs merely restored the site to the condition that existed at the time taxpayer acquired the property. The ruling also stated that the plan of rehabilitation doctrine did not apply because of taxpayer’s construction of a new building on the site because “these remediation costs merely are restorative in nature, [and] they do not adapt the property to a new or different use. . . . [they] were not directly related to the construction of the building [but] “to the restoration of the land, an asset separate and apart from the new building.”

c. *United Dairy Farmers, Inc. v. United States*, 107 F. Supp. 2d. 937 (S.D. OH. 2000). Taxpayer incurred environmental remediation expenses to clean up pollution caused by prior owners who operated gas stations on the site of a convenience store. Even though the taxpayer was unaware of the pollution at the time of the purchase and thus “overpaid” for the property, the expenses were required to be capitalized because they “increased the value of the property.” Rev. Rul. 94-38 did not apply.

2. Extending expensing of certain environmental remediation costs.

As originally enacted in 1997, § 198 provides for “expensing of environmental remediation costs . . . which [are] paid or incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site

“applied only to expenditures paid or incurred between 8/5/97, and 12/31/00. In 1999, Congress extended the provision’s sunset date to 12/31/01.

3. ISO costs OK. Rev. Rul. 2000-4, 2000-4 I.R.B. 331. Cost incurred by a taxpayer to obtain, maintain, and renew ISO 9000 [a series of international standards for quality management systems developed by the International Organization for Standardization (ISO) comprised of several specific requirements that are intended to ensure a quality process in providing services or products to an organization’s customers] certification are deductible as ordinary and necessary business expenses under § 162 except to the extent they result in the creation or acquisition of an asset having a useful life substantially beyond the taxable year (e.g., a quality manual). *INDOPCO* does not require capitalization of all such expenses because ISO 9000 certification is neither a separate and distinct asset nor does it result in future benefits that are more than incidental. The benefits are akin to those from training and advertising. Moreover, the mere fact that the certification facilitates expansion of the existing business does not require capitalization.

• Note that the ruling compares as different types of situations, the expenditures in *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973), which it notes were deductible, and those in *FMR Corp. v. Commissioner*, 110 T. C. 402 (1998), which it notes were not deductible, apparently citing *Briarcliff Candy* with approval, notwithstanding the Tax Court’s holding in *Norwest v. Commissioner*, 112 T.C. 89 (1999), *rev’d sub nom. Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), that *INDOPCO* had *sub silentio* overruled *Briarcliff Candy*.

4. And the IRS never mentioned *INDOPCO* in this pro-taxpayer ruling. Rev. Rul. 2000-7, 2000-9 I.R.B. 712. The IRS allowed a current deduction for the cost of removing old telephone poles as part of a project to replace the poles supporting a line with new poles. The removal costs related to the retired assets, not to installation or construction of the new assets, and neither §§ 263 nor 263A applied. Nor did § 280B apply [because the telephone poles were not “buildings”]. The ruling cautions:

The analysis in this ruling does not apply to the removal of a component of a depreciable asset, the costs of which are either deductible or capitalizable based on whether replacement of the component constitutes a repair or an improvement. See § 1.162-4 and § 1.263(a)-1(b).

5. He who lives by the [financial accounting] sword will die by the [tax] sword. *PNC Bancorp, Inc. v. Commissioner*, 110 T.C. 349 (1998). A bank’s loan origination expenditures were incurred in the creation of loans, which were separate and distinct assets that generated revenue over a period beyond the current taxable year. Judge Ruwe held the expenditure must be

capitalized. Taxpayer had argued that they were recurring expenses, so deductible. However, these costs were capitalized for financial accounting purposes, and amortized over the life of the loans, in accordance with SFAS 91 [relating to deferral of loan origination (1) “incremental direct costs” and (2) certain costs related to specified activities of the lender].

a. PNC Bancorp reversed. Consumer and commercial loans are not “separate and distinct assets,” because loan revenue was the bank’s largest revenue source and costs of originating loans were normal costs of doing business. *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822 (3d Cir. 2000), *rev’g* 110 T.C. 349 (1998). The Court of Appeals for the Third Circuit reversed the Tax Court’s decision in *PNC Bancorp* and allowed a current deduction. Judge Rendell reasoned that the loans in question were not “separate and distinct assets” because loan revenue was the bank’s largest revenue source. Origination costs thus were merely the normal and routine costs of doing business that did need to be capitalized. The opinion distinguished *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345 (1971), on the grounds that the “Secondary Reserve fund,” to which Lincoln Savings made the payments and which was the separate asset in that case, existed wholly apart from Lincoln Savings’ business and that PNC’s origination activities did not “create” the loans in the way Lincoln Savings’ payments created the Secondary Reserve fund because PNC’s payments did not become part of the balance of the loan. The court relied on the bank credit card cases [*Colorado Springs Nat’l Bank v. United States*, 505 F.2d 1185, 1190 (10th Cir. 1974); *Iowa-Des Moines Nat’l Bank v. CIR*, 592 F.2d 433 (8th Cir. 1979)], which allowed a current deduction for the expenses incurred by banks to initiate bank credit card lending activities, which the court of appeals concluded continue to have vitality after *INDOPCO*. The court then went on to find that *INDOPCO* itself was not controlling to require capitalization because the future benefit test was not intended by the Supreme Court to be talismanic in all cases. Although the loans themselves may have had lives of several years, the information obtained by the bank as a result of the original fees had a relatively short life — it was not a “permanent betterment or improvement” in the statutory language of § 263(a). And there was no concern regarding distortion of income because of the recurring nature of the expenses.

• While there might be some merit to the Third Circuit’s points that consumer and commercial loan origination is the ordinary everyday activity of a bank and that the regularity of the expenses somewhat limits the potential for distortion, it is equally true that manufacturing cars, the cost of which must be capitalized, is the ordinary everyday activity of General Motors. Likewise, while the Third Circuit may be correct that the credit check and other information gathered in the loan origination process has a life that lasts only until it is used, and thus the expenses to obtain that benefit might be said to have limited future benefit, the same might be said of the expenses

incurred in a title search of real estate to be purchased, and those expenses clearly must be capitalized. Finally, looking through the prism of *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), would indicate that to focus on the life of the information obtained as a result of the loan origination expenditures is myopic. That information, which itself might have had a short life, was a cost of producing the loans, just as the depreciation on the relatively short-lived construction equipment in *Idaho Power* was a cost of the long-lived power plant.

6. The Eighth Circuit uses symbolic [il]logic to divine the true meaning of *INDOPCO*, but allows a deduction to target for friendly takeover expenses. *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), *rev'g Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999).

a. The Tax Court (Judge Laro) held that a takeover target's expenses for investment banking, legal and accounting fees for investigating whether to accede to the takeover were required to be capitalized because all these costs "were sufficiently related to an event that produced a significant long-term benefit," citing *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), and *A.E. Staley Mfg. Co. v. Commissioner*, 105 T.C. 166 (1995), *rev'd and remanded*, 119 F.3d 482 (7th Cir. 1997), *Victory Markets, Inc. v. Commissioner*, 99 T.C. 648 (1992). Even though these costs were not incurred as "direct costs of facilitating the event that produced the long-term benefit" – which would have been required by the 7th Circuit's *Staley* holding – "the costs were essential to the achievement of that benefit." Included among the costs capitalized was a \$150,000 allocation from the salaries paid to nine executives and 73 other officers of the target, attributable to their services on various aspects of the takeover transaction. The taxpayer argued that the salaries were deductible because they would have been incurred anyway. Alternatively, the taxpayer argued that the "business expansion" doctrine was implicitly codified by the enactment of § 195 and that the salaries were deductible under that doctrine (an argument that was a tough row to hoe because taxpayer had conceded that under *INDOPCO* the direct costs were capital expenditures). Expanding the holding in *FMR Corp. v. Commissioner*, 110 T.C. 402 (1998), Judge Laro flatly stated that *INDOPCO* had effectively overruled the line of cases, starting with *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973), that allowed a current deduction for "business expansion" costs, in contrast to start-up costs. Judge Laro added that the enactment of § 195 did not implicitly endorse the deductibility of all business expansion costs.

b. **The Court of Appeals for the Eighth Circuit reversed stating that the Tax Court had illogically read *INDOPCO*.** The Court of Appeals (District Judge Hand sitting by designation) analyzed the precedents and the facts using symbolic logic to conclude that *INDOPCO* did not require

capitalization of expenditures that produced intangible long-term benefits unless the expenditures were “directly” rather than “indirectly” related to the creation of the benefits. The court stated:

The Tax Court went on to hold: 'In accordance with *INDOPCO*, [all] the costs must be capitalized because they are connected to an event (namely, the transaction) that produced a significant long-term benefit. (citation omitted).' This is a misinterpretation of *INDOPCO*. . . .

Therefore, we conclude it was error for the Tax Court to require capitalization of the expenses at issue simply because they were incidentally connected with a future benefit. Instead, the Tax Court should have performed an independent and appropriate legal analysis to determine whether each of the expenditures at issue were “ordinary.” . . .

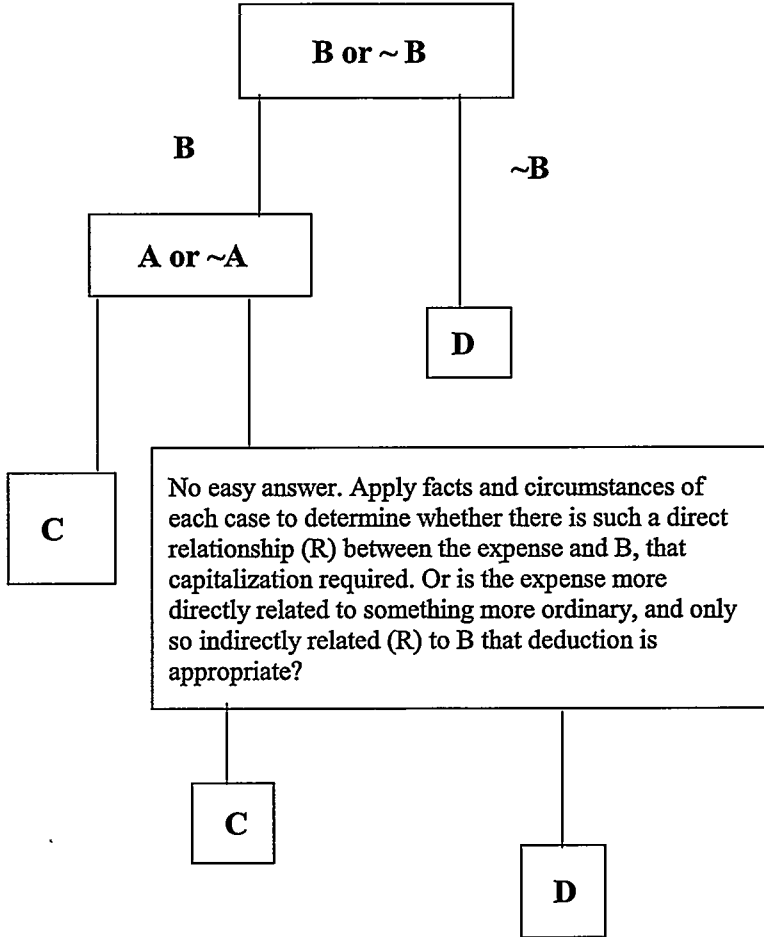
The Tax Court erred when it so easily dismissed a major distinction between the instant case and *INDOPCO*. The *INDOPCO* case addressed costs which were *directly* related to the acquisition, while the instant case involves costs which were only *indirectly* related to the acquisition. (citation omitted). . . .

[W]e certainly agree that payments made by an employer are deductible when they are made to employees, are compensatory in nature, and are directly related to the employment relationship (and only indirectly related to the capital transaction, which provides the long term benefit). Likewise, it is true that, a deductible expense is not converted into a capital expenditure solely because the expense is incurred as part of the terms of a corporate reorganization. Rather, the important consideration in determining the nature of an expenditure for tax purposes is the origin and character of the claim for which the expenditure is incurred. (citations omitted). . . .

In *INDOPCO*, the expenses in question were *directly* related to the transaction which produced the long term benefit. Accordingly, the expenses had to be capitalized. (citation omitted). We conclude that if the expense is *directly* related to the capital transaction (and therefor, the long term benefit), then it should be capitalized. (citation omitted). In this case, there is only an *indirect* relation between the salaries (which originate from the employment relationship) and the acquisition (which provides the long term benefit).⁵

5. Wells Fargo Co., 224 F.3d at 885-87.

The Eighth Circuit's website provides the following diagram to explain its logic [or lack thereof].



LEGEND

A = physical capital ASSET created or enhanced; ~A = NO physical capital ASSET created or enhanced;
 B = BENEFIT beyond the taxable year; ~B = NO Benefit beyond the taxable year;
 R = the expense is directly RELATED to B; ~R = the expense is indirectly related to B;
 C = CAPTIALIZE; D = DEDUCT.

As far as the legal fees were concerned, on appeal the Commissioner conceded, applying the reasoning of Rev. Rul. 99-23, 1999-1 C.B. 998, that by analogy any fees incurred during the "investigatory stage" were deductible.⁶ "Without adopting all of the conclusions in Rev. Rul. 99-23," but thereafter referring to it, the court agreed with the Commissioner, however, that any legal fees incurred by the target corporation after the "final decision" had been made to go forward with the acquisition were subject to capitalization. On the facts, the court held that this decision was made on the date the parties entered into the "Agreement and Plan of Reorganization," but the court stated that this holding was based on the facts and circumstances of the case and was not intended to provide a "bright line rule for determining when a 'final decision' has been made."⁷ It was small victory for the Commissioner. Only \$27,820 of the target corporation's legal expenses were capitalized; the remaining \$83,450, which were incurred prior to the "final decision" were deductible.

◦ Under the Court of Appeals analysis, an expense (1) that is recurring, i.e., ordinary, (2) that neither directly nor indirectly creates a separate and distinct asset and (3) that is only "incidentally" [indirectly] related to producing a future benefit is not a capital expense.

◦ Rev. Rul. 73-580, 1973-2 C.B. 86, which was not discussed or cited by the *Wells Fargo* court, requires that the salary of corporate employees who spend a "substantial" amount of time on acquisition work, e.g., legal accounting and other such activities in connection with acquisitions be capitalized. Nor did the Eighth Circuit cite or discuss *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), in which the Supreme Court held that an electric utility company that owned trucks and other equipment used in part for ordinary maintenance and in part to construct a power plant had to capitalize into the basis of the power plant the portion of depreciation allocable to the use of the equipment in the construction. In reaching its decision, the Court, in part, reasoned:

There can be little question that other construction-related expense items, such as tools, materials, and wages paid construction workers, are to be treated as part of the cost of acquisition of a capital asset. The taxpayer does not dispute this. Of course, reasonable wages paid in the carrying on of a trade or business qualify as a deduction from gross income. § 162(a)(1) of the 1954 Code, 26 U.S.C. § 162(a)(1). (citation omitted). But when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized and are then entitled to be amortized over the life of the capital asset so acquired. (citations omitted). . . .

6. *Wells Fargo & Co.*, 224 F.3d 888.

7. *Id.* at 889.

An additional pertinent factor is that capitalization of construction-related depreciation by the taxpayer who does its own construction work maintains tax parity with the taxpayer who has its construction work done by an independent contractor. The depreciation on the contractor's equipment incurred during the performance of the job will be an element of cost charged by the contractor for his construction services, and the entire cost, of course, must be capitalized by the taxpayer having the construction work performed. The Court of Appeals' holding would lead to disparate treatment among taxpayers because it would allow the firm with sufficient resources to construct its own facilities and to obtain a current deduction, whereas another firm without such resources would be required to capitalize its entire cost including depreciation charged to it by the contractor. *Idaho Power*, 418 U.S. at 22-25.

- In ignoring *Idaho Power*, the Eighth Circuit in *Wells Fargo* is either wrong or has created [whether or not it was trying to do so] a distinction in the treatment of indirect costs of assets and indirect costs of long-term benefits. There is also some indication that the Court of Appeals confused the Tax Court's terminology in *Norwest* (which referred to the expenses as "incidental" in the sense of indirect) and the Supreme Court's acknowledgment that "incidental" long-term benefit does not require capitalization. The adjective is the same but the noun is different.

- The Commissioner's concession, applying the reasoning of Rev. Rul. 99-23, by analogy, that any legal fees incurred during the "investigatory" stage were deductible appears to be a broader concession that *INDOPCO* did not *sub silentio* completely overrule the business expansion doctrine as expounded in the *Briarcliff Candy* line of cases.

7. Antitrust suit legal fees had to be capitalized. *American Stores Co. v. Commissioner*, 114 T.C. 27 (2000). Legal fees incurred in defending against the State of California's federal antitrust suit challenging taxpayer's proposed acquisition of Lucky Stores were required to be capitalized under *INDOPCO* because they were paid in connection with an acquisition. The Federal Trade Commission had approved the acquisition under Hart-Scott-Rodino [15 U.S.C. § 18a] in 1998 and Lucky Stores was acquired by taxpayer in that year, i.e., title was acquired but Lucky Stores continued to be separately operated; the California Attorney General continued to litigate until the matter was settled in 1990. Judge Ruwe held that the "principal difference between a deduction and an item that must be capitalized and amortized is the timing of the recovery of the expenditure," and that the long-term benefits of the acquisition were not

available until 1990 when the Lucky's stores acquired could be integrated into taxpayer's existing operations.

8. Keeping them happy down on the farm. T.D. 8897, Rules for Property Produced in a Farming Business, 65 F. R. 50638 (8/21/00). Corrected regulations issued, T.D. 8897, 65 F. R. 61091 (10/16/2000). These final regulations prove special rules for applying [limiting the application of] § 263A to farming.

9. Deductions float down Old Man River. *Ingram Indus. Inc. v. Commissioner*, T. C. Memo. 2000-323. Expenses for periodic maintenance of inland barge towboat engines were deductible under § 162 and Reg. § 1.162-4 as repairs rather than being capital expenses. The taxpayer operated over 60 towboats, most of which were purchased used for \$2.2 - \$2.3 million. The towboats, including the engines if properly maintained, had an expected useful life of 40 years. Maintenance was performed every three or four years, depending on the number of hours of operation, but while the engines were still serviceable, at a cost of approximately \$100,000 per boat. Replacement used engines would have cost approximately \$600,000 per boat, and new engines \$1,500,000 per boat. The work was performed mostly by the crews, took about 10-12 days, and did not necessitate dry-docking the boats. The work was not the equivalent of rebuilding or overhauling the engines. For financial reporting purposes, the taxpayer accrued the estimated costs of these repairs as expenses for the periods of usage prior to the performance of the maintenance; for federal income tax purposes, the taxpayer deducted the costs in the year incurred. The Commissioner determined the costs had to be capitalized and depreciated over the 10-year period beginning with the date the costs were incurred. The court (Judge Gerber) rejected the Commissioner's argument that the engines should be treated as separate property from the boats themselves. The evidence did not support findings that, within the industry, engines ordinarily were replaced within the 40-year life of the boats or engines were evaluated separately from the remainder of the boats in pricing. There was no way to measure any increment in value of a boat resulting from the maintenance. Applying the standards of *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962), the expenses were deductible. The Tax Court held that *INDOPCO* was irrelevant.

10. Fly the repaired skies of . . . Rev. Rul. 2001-4, 2001-3 I.R.B. 295. The IRS provided significant guidance regarding the dividing line between repair costs deductible under § 162 and replacement and rehabilitation costs that must be capitalized. The ruling dealt with costs incurred by an airline with respect to work on aircraft airframes as part of a heavy maintenance visit [performed approximately every eight years] in three specific situations involving fully depreciated aircraft [aircraft have a 7-year cost recovery period].

At the time the aircraft were placed in service, it was anticipated that, if maintained, they would be useful for up to 25 years. The IRS ruled that heavy maintenance expenses generally are deductible § 162. But costs incurred in conjunction with a heavy maintenance visit must be capitalized to the extent they materially add to the value of, substantially prolong the useful life of, or adapt the airframe to a new or different use. Costs incurred as part of a plan of rehabilitation, modernization, or improvement also must be capitalized.

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

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

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

11. Potentially Pyrrhic victory for the Commissioner? *Ashley v. Commissioner*, T. C. Memo. 2000-376. The taxpayer purchased a single family rental property and renovated it. When he sold the property nine years later he claimed a § 1231 loss by including in basis various operating expenditures such as insurance, refinancing interest, and real estate taxes paid during the renovation period, on the grounds that § 263A required such capitalization because he was in the trade or business of purchasing and restoring homes for resale. On the record, the court (Judge Vasquez) upheld the Commissioner's

argument and found that the taxpayer was not engaged in business but was merely an “investor” not subject to § 263A. On the consequently lower basis, the taxpayer realized a gain on the sale.

C. Reasonable Compensation

1. Throw out all the reasonable comp factors. Judge Posner tells us there’s a single inquiry that answers the question in every case. The Tax Court’s use of a “multi-factor” test was improper. *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999), *rev’g Heitz v. Commissioner*, T.C. Memo. 1998-220 (Gerber, J.). Going a step further than the Second Circuit in *Dexsil Corp. v. Commissioner*, 147 F.3d 96 (2d Cir. 1998), a step that appears to be in the opposite direction in some ways than *Leonard Pipeline Contractors, Ltd. v. Commissioner* 142 F.3d 1133 (9th Cir. 1998), Judge Posner, writing for the Court of Appeals for the Seventh Circuit, castigated the Tax Court for its reliance on “factors” in resolving “reasonable compensation” cases and held that the only relevant inquiry is whether a hypothetical investor would be satisfied with the return on the investment that resulted from the employee/shareholder’s management activities. According to Judge Posner, if the hypothetical investor would have been satisfied with the return, then the compensation, whatever it might have been, is reasonable. Judge Posner concluded that this limited test was sufficient to implement what he perceived to be the sole purpose of § 162(a)(2), to prevent the distribution of dividends (or gifts) in the guise of deductible compensation. Accordingly, a salary of \$1,300,000 and \$1,000,000 in successive years was held to be reasonable on the sole grounds that the IRS expert testified that a hypothetical investor would be satisfied with a 13% return and the corporation’s return on invested capital was 20%. Judge Posner was not content to set forth a test for the Tax Court to apply on remand. He reversed the judgment “with directions to enter judgment for the taxpayer.”

◦ Judge Posner’s opinion infers that, if the rate of return on invested capital is sufficiently above the “market” rate of return (adjusted for risk) and is due to the exertions of the employee/shareholder, there is no limit on the amount payable and deductible as compensation. It does not clearly explain why a hypothetical investor would be happy to see an unrelated manager appropriate the lion’s share of economic rents earned by a firm even though his test appears to allow the lion’s share of economic rents to be distributed as deductible compensation as long as a sufficient portion of the excess profits are retained or paid out as dividends to result in an above-market rate of return to invested capital. This problem may be partially addressed by the court’s acknowledgment that for the payment to be deductible it must have been intended as compensation, rather than a dividend [as held in *O.S.C. & Associates, Inc. v. Commissioner*, 187 F.3d 1116 (9th Cir. 1999), which was not cited by Judge Posner], a requirement that Judge Posner found to have been

satisfied in the instant case through the approval by other shareholders of the salary in question.

2. But multi-factor reasonable compensation tests are alive and well out on the coast, i.e., in the Ninth Circuit. *LabelGraphics, Inc. v. Commissioner*, 221 F.3d 1091 (9th Cir. 2000), aff'g T. C. Memo. 1998-343. The Ninth Circuit (Judge McKeown) affirmed the Tax Court's decision that only \$406,000 out of \$878,913 paid as compensation to the sole shareholder of a corporation in which he was the "heart of the company" was deductible as reasonable compensation. In doing so, the Court of Appeals found that the Tax Court had correctly applied all of the "five broad factors" set forth in *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983).

In *Elliotts*, we set out five broad factors that are relevant to the reasonableness inquiry: (1) the employee's role in the company; (2) a comparison of the employee's salary with those paid by similar companies for similar services; (3) the character and condition of the company; (4) potential conflicts of interest; and (5) evidence of an internal inconsistency in a company's treatment of payments to employees. (citation omitted). No single factor is decisive. (citation omitted). When conducting the reasonableness inquiry, 'it is helpful to consider the matter from the perspective of a hypothetical independent investor. A relevant inquiry is whether an inactive, independent investor would be willing to compensate the employee as he was compensated.' (citation omitted). . . .

3. *Normandie Metal Fabricators, Inc. v. Commissioner*, T. C. Memo. 2000-102. In determining whether a hypothetical investor would be satisfied with the corporation's return to capital, it is misleading to compute a return based on the shareholder/employee's nominal initial contribution to capital [\$119 in this case].

D. Miscellaneous Expenses

1. Notice of Proposed Rulemaking, Qualified Transportation Fringe Benefits, REG-113572-99, 65 F.R. 4388 (1/27/00), corrections issued in 65 F.R. 16545 (3/29/00). Proposed Reg. § 1.132-9 provides in Q&A format extraordinarily detailed rules regarding scope of excludable qualified transportation fringe benefits under § 132(f), including rules regarding elections under § 132(f)(4) between taxable cash and tax-free qualified parking outside of the cafeteria plan rules.

2. The deduction was more than the includable compensation – And it was legal! *Sutherland Lumber-Southwest, Inc. v. Commissioner*, 114 T.C. 197 (2000). Pursuant to Reg. § 1.162-25T, an employer-corporation that provided private nonbusiness flights on a company-owned airplane to employees was permitted to deduct the cost of providing the flights because the fair market value of the flights was included in the employees' reported compensation under Reg. § 1.61-21(b). Accordingly, pursuant to § 274(e)(2), the limitations of § 274 did not apply even though the airplane otherwise could be considered to be an entertainment facility. Furthermore the employer's deduction was not limited to the lesser amount includable by the employees under special fringe benefit valuation rules [Reg. § 1.61-21(g)].

3. *Aleda v. Commissioner*, T. C. Memo. 2000-136. If the taxpayer has no regular place of business in the metropolitan area in which the taxpayer resides, even transportation expenses to travel to temporary job sites in other metropolitan areas are nondeductible commuting costs.

4. *Jorgensen v. Commissioner*, T. C. Memo. 2000-138. A public high school English teacher, who taught in a predominantly Asian-American school, incurred expenses to enroll in and attend University of California Extension courses in Southeast Asia religious traditions and Greek legends that were offered in Southeast Asia and Greece, respectively. The courses of study included lectures, assigned readings, and visits to historical sights. Although credit was available for the courses if the students wrote a topical paper, the taxpayer did not do so and did not seek credit. The expenses of course enrollment and travel were deductible educational expenses under Reg. § 1.162-5 and were not disallowed under § 274(m)(2).

5. Home is where the hearth is, well, where the AC is, since home was in Florida. *Johnson v. Commissioner*, 115 T.C. 210 (2000). The taxpayer was the captain of a merchant ship that sailed worldwide carrying equipment of the U.S. military. He received lodging and meals while on-board the vessel, but paid for his other incidental travel expenses. Based on predecessors of Rev. Proc. 2000-9, 2000-2 I.R.B. 280, which provides that in lieu of substantiating actual travel expenses an employee may use the Federal per diem rates for meal and incidental expense (M & IE) to deduct meal and incidental expenses incurred while away from home, the taxpayer claimed miscellaneous itemized deductions based on the full M & IE rates. (He had no receipts.) The Tax Court (Judge Laro) rejected that Commissioner's argument that Johnson was an itinerant with no tax home from which to be away, and held that his permanent residence, where he resided with his wife and their daughter, was his tax home. He had a legitimate reason for maintaining his personal residence while traveling throughout the world in the course of employment. That the employer

provided meals and lodging excludable under § 119 does not change this result. The court stated:

According to respondent, an employee such as petitioner can never have a tax home because he continually travels to different cities during his employment. We disagree that such continual travel, in and of itself, serves to disqualify a taxpayer from having a tax home for purposes of § 162(a). Regardless of where a taxpayer performs most of his or her work, the fact that he or she maintains financially a fixed personal residence generally means that he or she has a tax home someplace. (citation omitted).

Although the taxpayer's testimony, by itself, supported a finding that he paid incidental travel expenses while away from his tax home, he was denied the use of the full M & IE rates. The deduction is limited to the amounts attributable to incidental expense, which was only \$2 per day in the continental US and between \$1 and \$53 per day in other locations.

6. Only half the cost of Mint Juleps & country ham with beaten biscuits is deductible. *Churchill Downs v. Commissioner*, 115 T.C. 279 (2000). The Tax Court (Judge Laro) held that § 274(n) limited to 50% of the cost Churchill Downs' deduction for the expenses of entertainment [the Kentucky Derby Sport of Kings Gala, press receptions, hospitality tents, winners parties, etc.] in connection with the Kentucky Derby, the Breeders' Cup, and other major horse races. Although Churchill Downs was in the "entertainment business" the expenses for the functions were not part of its entertainment product, which was horse racing. Nor were the costs deductible as entertainment available to the public [§ 274(n)(2), (e)(7) exception] or sold to customers [§ 274(n)(2), (e)(8) exception] because the functions were by invitation only and not open to the public.

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

E. Depreciation & Amortization

1. T.D. 8865, Amortization of Intangible Property, 65 F. R. 38200 (1/25/2000). The Treasury has promulgated final regulations § 1.167(a)-14 [dealing with depreciation of intangibles not subject to § 197] and § 1.197-2 [dealing with rules for amortization under § 197]. The regulations apply to property acquired after 1/25/00. Some highlights:

- For purposes of § 197 a group of assets constitutes a trade or business if (1) their use would constitute a trade or business under § 1060 [if goodwill or going concern value could, under any circumstances, attach to the assets], or (2) they include any franchise, trademark, or trade name [unlike the proposed regulations, which applied this *per se* rule to any customer based intangibles].

- Purchased computer software is amortizable over 15 years if § 197 applies but over 36 months if the software is not a § 197 intangible. Section 197 (rather than Reg. § 1.162-11) applies to costs to acquire a § 197 intangible that is a limited interest in software. Computer software costs bundled in the cost of the computer hardware are capitalized and depreciated as part of the computer hardware.

- Amortization begins no earlier than the first day of the month in which the active trade or business or the activity described in § 212 begins.

- A partnership generally may make curative or remedial allocations to its noncontributing partners of amortization relating to an asset that was amortizable (or a zero-basis intangible that otherwise would have been amortizable) in the hands of the contributor.

- A § 743(b) basis step up in § 197 intangibles generally may be amortized.

- If a right to use a § 197 intangible is obtained under a license entered into as part of a purchase of a trade or business, amounts paid for the right are chargeable to capital account. An exception [not in the proposed regulations] applies to licenses of technology, know-how, and other similar items (including most types of information base). Royalty payments under a contract for the use of § 197 intangibles unconnected with the purchase of a trade or business are not required to be capitalized.

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

bundled into the nonseparately stated price of hardware can be treated as hardware. Automatic change of accounting method procedures are available.

3. How to capitalize \$107,748,925 as the cost basis of a \$13,865,000 asset. *Union Carbide Foreign Sales Corp. v. Commissioner*, 115 T.C. 423 (2000). The taxpayer was the lessee of a seagoing vessel built to its specifications. When the lease became onerous, pursuant to the lease terms, taxpayer purchased the vessel for \$107,748,925, rather than paying approximately 20% more simply to terminate the lease. At the time of the purchase, the vessel (apart from the lease) was worth \$13,865,000. The taxpayer capitalized \$13,865,000 as the cost of the vessel and deducted the remaining \$93,883,295 as lease termination expenses. The Commissioner disallowed the deduction on the grounds that § 167(c)(2) required capitalization of the entire purchase price, and the Tax Court (Judge Gerber) upheld the Commissioner's position. The court noted that whether it was more or less costly to acquire the vessel or to simply terminate the lease was not relevant to the conclusion. In so holding, the court rejected the taxpayer's argument that § 167(c)(2) applies only to property acquired subject to a lease that continues in the future, accepting, instead, the Commissioner's argument that § 167(c)(2) applies whenever property is acquired at a time that it was subject to a lease. Accordingly, a lessee of an asset who purchases that asset for the purpose of terminating the lease is subject to § 167(c)(2). The court held alternatively that the same result would be reached wholly apart from § 167(c)(2), rejecting the taxpayer's argument [based on *Cleveland Allerton Hotel, Inc. v. Commissioner*, 166 F.2d 805 (6th Cir. 1948)] that the transaction could be bifurcated into two transactions, the termination of the onerous lease and the purchase of the vessel. The court held that in *Millinery Center Building Corp. v. Commissioner*, 350 U.S. 456 (1956), *aff'g* 221 F.2d 322 (2nd Cir. 1955), the Supreme Court had implicitly rejected the holding of *Cleveland Allerton Hotel*, and that in any event in *Millinery Center Building Corp.*, the Second Circuit, to which appeal of this case would lie, had expressly rejected *Cleveland Allerton Hotel*.

F. Credits

1. The Tax Relief Extension Act of 1999, 26 U.S.C. § 41, extended the increased investment expenditures credit through 6/30/04. The 1999 Act also extended the credit to expenditures incurred in Puerto Rico and United States possessions (subject to limitations in § 280C(c)(1) disallowing expenditures taken into account in determining the § 41 credit from being taken into account in computing certain other credits). Special rules in § 41(d) limit (1) the availability of the credit generated by activities incurred between 7/1/99 and 9/30/00 to offset tax payments due before 10/1/00, and (2) the availability of the credit generated by activities incurred between 10/1/00 and 9/30/01 to offset tax

payments due before 10/1/01. This limitation pushes the credits into the following federal fiscal year to defer their impact on the surplus.

2. The IRS explains how to cope with a politically motivated deferral of extended credits that pushed the credits into the following federal fiscal year to defer their impact on the “surplus.” Notice 2001-2, 2001-2 I.R.B. 265. The Tax Relief Extension Act of 1999 extended the § 41 increased investment expenditures credit through 6/30/04. Special rules in § 41(d) limit (1) the availability of the credit generated by activities incurred between 7/1/99 and 9/30/00 to offset tax payments due before 10/1/00, and (2) the availability of the credit generated by activities incurred between 10/1/00 and 9/30/01 to offset tax payments due before 10/1/01. The notice provides guidance for computing § 41 credit for years that include the suspension period.

3. The Tax Relief Extension Act of 1999, 26 U.S.C. § 45, extended the § 45 “electricity produced from renewable resources” credit to any facility originally placed in service by the taxpayer before 1/1/02. The credit also has been extended to electricity produced from poultry waste [the CS subcredit?] at a facility originally placed in service after 12/31/99 and before 1/1/02.

4. “World headquarters” requires international operations. *Payless Cashways Inc. v. Commissioner*, 114 T.C. 72 (2000). The ITC under the TRA 1986 § 204(a)(7) rifleshot provision was denied for the costs of equipping and furnishing a corporation’s “world headquarters” because taxpayer lacked substantial international operations. Judge Ruwe held that this necessitated having either employees stationed outside the United States or exports or foreign source income or liability for foreign taxes or a foreign permanent establishment or foreign subsidiaries or foreign joint ventures.

G. Natural Resources Deductions & Credits

1. *S/V Drilling Partners v. Commissioner*, 114 T.C. 83 (2000) (reviewed, 13-2). The partnership produced and sold 15,483 barrel equivalents of gas from a tight formation and 16,927 barrel equivalents from a tight formation that was also Devonian shale. It claimed a § 29 credit not indexed for inflation for the 15,483 barrel equivalents from the tight formation and a double credit (\$3 + \$3 indexed for inflation) for each barrel equivalent produced from the tight formation that was also Devonian shale. In a reviewed opinion by Judge Colvin (with two differing dissents), the Tax Court held that § 29 does not provide a double credit for gas produced from a tight formation that is Devonian shale. Only one credit, based on production from Devonian shale, which is indexed for inflation, is allowed. But the court rejected the Commissioner’s argument that taxpayer’s credit was limited to the greater of (1)

\$3 unindexed on the full 32,410 barrel equivalents from a tight formation or (2) \$3 indexed on the 16,927 barrel equivalents from Devonian shale.

- Judge Foley dissented on the double credit issue and Judge Vasquez dissented on the indexing issue.

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

b. Same issue in Court of Federal Claims. *Exxon Corp. v. United States*, 33 Fed. Cl. 250 (4/11/95). On the same issue, the Court of Federal Claims 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 (Fed. Cir. 6/20/96), *cert. denied*, 520 U.S. 1119 (3/17/97), *rev’g and remanding* 33 Fed. Cl. 250, (1995). The court found that Exxon 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 (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 wasn't 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 judgement, in which the government argued that Reg. § 613-3(a) did not apply to post-1974 depletion allowed under the fixed-contract exception.

On the government's motion for summary judgement, the court (Senior Judge Gibson) held that: (1) absent evidence that the regulation systematically causes a material distortion of the "gross income from the property," Reg. § 1.613-3(a) was not facially invalid as applied to percentage depletion deduction pursuant to 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 the regulation produced a result that was arbitrary, capricious, or manifestly contrary to 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 the Exxon's 1975 "gas well gas Production" — comprising 90.24% of the gas in issue — was comparable or superior to gas produced and sold generally through the region; only 9.74% [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' lease 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 Mobil⁸ Corp. v. United States*, 244 F.3d 1341 (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 argument that applying Reg. § 1.613-3(a) 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.

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

3. Delay rentals meet the uniform capitalization rules. Notice of Proposed Rulemaking, Depletion; Treatment of Delay Rentals, REG-103882-99, 65 F. R. 6090 (2/8/00). The Service has released Proposed Reg. § 1.612-3(c)(2), which would conform the regulations on delay rentals to the requirements of § 263A. Current Reg. § 1.612-3(c)(2) allows a payor to elect to deduct a delay rental as an expense or charge it to depletable capital account under § 266. In contrast, § 263A, which was enacted after current Reg. § 1.612-3(c)(2) was finalized, requires a delay rental to be capitalized in some circumstances. [The uniform capitalization rules of § 263A generally require the capitalization of all direct costs and certain indirect costs properly allocable to property produced by the taxpayer.] The proposed regulations would provide that the payor of a delay rental may elect to currently expense the delay rental or charge it to depletable capital account under § 266 to the extent that § 263A does not require capitalization. Capitalization may be required even though production (development) has not yet begun. Reg. § 1.263A-2(a)(3)(ii).

a. Industry Specialization Paper for the Petroleum Industry (9/19/97). The Service concluded that delay rentals under oil and gas leases held for development, that are incurred in tax years beginning after 12/31/93, are required to be capitalized and added to the depletable basis of the property to which they relate.

b. Tech. Adv. Mem. 9602002 (1995). Delay rentals paid by the taxpayer are pre-production costs subject to capitalization under § 263A as costs of producing oil and gas property.

4. Marginal Production Depletion Rates. Notice 2000-50, 2000-38 I.R.B. 291. Percentage depletion [15%] remains available to independent producers and royalty owners under § 613A(c). Section 613A(c)(6) increases the percentage depletion rate on oil or gas that is “marginal production,” by one percentage point, to a maximum rate of 25%, for each dollar by which the “reference price” for crude oil – generally speaking, average wellhead price per barrel for domestic crude oil B for the preceding calendar year falls below \$20. The applicable percentage for purposes of determining percentage depletion for oil and gas produced from marginal properties in 2000 is 19% [down from 24% for 1999].

5. Section 43 Inflation Adjustment. Notice 2000-51, 2000-38 I.R.B. 291. The § 43 credit for domestic “enhanced oil recovery costs” equals 15% of qualified costs for the taxable year. The credit is subject to phase-out for any taxable year in which the reference price of crude oil (determined under § 29(d)(2)(C)) for the prior year exceeds \$28 (adjusted for inflation); the credit is wholly phased out if the reference price of oil equals or exceeds \$34, adjusted

for inflation. The enhanced oil recovery credit for taxable years beginning in 2000 is determined without reference to the phase-out.

6. *Shell Petroleum, Inc. v. United States*, 46 Fed. Cl. 719 (2000). Shell claimed a refund for the § 29 credit for oil produced from tar sands. By interrogatory, Shell sought disclosure from the IRS of (1) other taxpayers' § 43(c)(2)(B) certificates, on the grounds that information in the certificates was "directly related" to its rebuttal of the government's contention that Shell's wells produced "crude oil" rather than "oil from tar sands [as defined in FEA 1976-4⁹]" and (2) information in other taxpayers' certificates concerning production methods that "directly related" to Shell's claim that it produced oil with technology that was not "widely available." [Shell also contested the government's claim of the scope of production techniques that qualified.] The government claimed that disclosure was prohibited by § 6103. The court denied the first disclosure on the grounds that information from other taxpayers about other wells could not help Shell rebut the government's contention, but with respect to the second request, § 6103(h)(4)(B) [permitting disclosure of return information "directly related" to resolution of an issue in the proceeding] arguably permitted disclosure and Shell was entitled to *in camera* review of the certificates to determine whether the certificates contained such information in sufficient detail. To determine whether Shell used technology that was not "widely available" requires an analysis of the technology used by other companies, including Shell's competitors. Production method information could be separated from the remainder of the § 43 certificate information, thereby allowing the government to produce the information without violating § 6103.

a. **Further proceedings.** 47 Fed. Cl. 812 (2000). The court denied motions by the government and Berry Petroleum, as an intervener, for reconsideration of its order compelling the production of the certificates for *in camera* inspection. Judge Damich found that there was no manifest error. The court found that the inspection and disclosure would not violate the purposes of § 6103, which "must be understood within the context of a post-Watergate backlash against the use of information contained in tax returns for purposes of political advantage and intimidation." Further, § 6103(h)(4)(B) does not require that the taxpayer requesting discovery be "directly related" to the taxpayer whose returns are being sought, and that the standard for "directly related" was similar to, but not exactly the same as, the standard for admissible evidence under the Federal Rules of Evidence, not a higher standard. Any information in

9. FEA 1976-4 states that "tar sands" are: "The several rock types that contain an extremely viscous hydrocarbon which is not recoverable in its natural state by conventional oil well production methods including currently used enhanced recovery techniques. The hydrocarbon-bearing rocks are variously known as bitumen-rocks, oil impregnated rocks, oil sands and rock asphalt."

the certificates that was not directly related to Shell's claims would be redacted by the court. The opinion noted that the court was sympathetic to Berry's concerns about revealing trade secrets, but found that issue premature because the earlier order required an in camera inspection by the court, but not disclosure to Shell.

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

a. Rulings will now be given. Rev. Proc. 201-30, 2001-19 I.R.B. (4/23/01), *modified* by Rev. Proc. 2001-34, 2001-22 I.R.B. (5/4/01). These revenue procedures provide 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."

◦ 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.

H. Loss Transactions, Bad Debts and NOLs

1. Behold the mighty powers of the Bankruptcy Trustee. He avoids irrevocable elections in a single bound. *United States v. Sims (In re Feiler)*, 218 F.3d 948 (9th Cir. 2000), *aff'g* 230 B.R. 164 (9th Cir. BAP. 1999). A prepetition election to waive a net operating loss carryback—allegedly "irrevocable" under § 172—may nevertheless be avoided by the bankruptcy trustee as a fraudulent transfer pursuant to 11 U.S.C. § 548(a)(2). Under § 1398, the bankruptcy estate succeeds to tax attributes of the debtor, including the "net

operating loss carryovers determined under § 172.” The court followed *in re Russell*, 927 F.2d 413 (8th Cir. 1991). Although the election to waive an NOL carryback under § 172(b)(3)(C) is irrevocable, if it was made within one year prior to the taxpayer’s bankruptcy, § 1398(g)(1), providing that the bankruptcy estate succeeds to the debtor-taxpayer’s NOLs, does not displace § 548(a)(2) of the Bankruptcy Act. The tax refund the NOL carryback could have produced is property and the United States is a transferee by virtue of not having paid the refund that otherwise would have been paid and available to creditors.

2. *Culley v. United States*, 222 F.3d 1331 (Fed. Cir. 2000). The taxpayer orchestrated a bribery and kickback scheme under which his corporation overcharged customers for products. Subsequently he sold the business for a price that was based in part on the artificially inflated earnings. When the scheme fell apart, as part of a combined settlement of the criminal charges and civil suits, the taxpayer agreed to make restitution to the customers and the purchaser of the business. He was allowed a § 165 loss deduction, but not the benefits of § 1341. Section 1341 applies only if it appeared to the taxpayer himself at the time of receipt that he had an unrestricted right to the funds subsequently repaid. Thus, a deduction for restitution of funds obtained by fraud is not subject to § 1341, even though it may have appeared to the defrauded parties at the time that they paid him that the taxpayer had an unrestricted right to the funds.

I. At-Risk and Passive Activity Losses

1. *Connor v. Commissioner*, 218 F.3d 733 (7th Cir. 2000). The Seventh Circuit upheld the Commissioner’s interpretation of the 1992 versions of Proposed Reg. §§ 1.469-4(a), -4(c)(2) and -2(f)(6) (1992) to recharacterize as nonpassive income rental income received from a C corporation in which the taxpayers materially participated. [This result is clearly mandated by the final Regulations section, see *Fransen v. United States*, 191 F.3d 599 (5th Cir. 1999).] The “written binding contract” exception in Reg. § 1.469-11(c)(1)(ii) did not apply on the facts because the lease was unenforceable under state law.

2. **Retroactive application of changed passive activity loss regs upheld again** *Sidell v. Commissioner*, 225 F.3d 103 (1st Cir. 2000), *aff’g* T. C. Memo. 1999-301. Sidell was the sole shareholder of KGR, a C corporation in a manufacturing business in which Sidell materially participated. Through a grantor trust, Sidell purchased an historic property that was refurbished and leased to KGR. He claimed § 47 rehabilitation credits to offset rental income received from KGR. The Tax Court upheld the IRS’s application of the self-rental rule of Reg. § 1.469-2(f)(6) and the attribution rule of Reg. § 1.469-4(a) [treating a taxpayer’s activities as including those conducted through C corporations that are subject to § 469, S corporations, and partnerships] to

recharacterize the rental income from the property from passive to nonpassive income. Because the taxpayer had no other passive income the rehabilitation credit, which remained passive under § 469(d)(2) and Temporary Reg. § 1.469-3T [in force for the years in question], was unusable. The First Circuit (Judge Selya) affirmed. Reg. § 1.469-2(f)(6) is a legislative regulation [under § 469(I)], which under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984), is entitled to “controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.”¹⁰ The court upheld the retroactive application of Reg. § 1.469-4(a), adopted in October 1994, to 1993 and all of 1994. Even though the precise rules in the final regulations differed substantially from those in the proposed regulations (particularly in Reg. § 1.469-4(a)), the proposed regulations “put all concerned parties on clear notice that a sea change was in the wind.”

3. *Kosonen v. Commissioner*, T. C. Memo. 2000-107. The aggregation of losses from seven rental real estate properties on Schedule E [as active losses under § 469(c)(7)] did not constitute an election to treat the activities, which were recharacterized by the IRS and Tax Court as passive activities because the taxpayer did not materially participate, as a single activity. An election must clearly notify the IRS that the election is being made. That the IRS had not yet published guidance regarding how to make the election did not affect the decision.

4. **The statute was self-executing; the taxpayer doesn't have to wait for Regs.** *Hillman v. Commissioner*, 114 T.C. 103 (2000). The taxpayer's S corporation performed management services for real estate partnerships in which the taxpayer directly or indirectly was a partner. The taxpayer received passthrough nonpassive income from the S corporation and passthrough passive deductions from the partnerships. Based on § 469(I)(2) and its legislative history, under circumstances analogous to those in Proposed Reg. § 1.469-7 [56 F. R. 14034 (4/5/91)] permitting the offsetting of “self-charged” interest incurred in lending transactions, the taxpayer offset passive management fee deductions against the corresponding nonpassive management fee income. Section 469(I)(2) provides that the IRS “shall” promulgate regulations “which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income).” Proposed Reg. § 1.469-7 permits offsetting of “self-charged” interest incurred in lending transactions, but the IRS did not issue any regulation for self-charged items other than interest. Under the proposed regulations, a taxpayer who was both the payor and recipient of interest was allowed, to some extent, to offset passive interest deductions against nonpassive

10. *Accord* *Fransen v. United States*, 191 F.3d 599 (5th Cir. 1999); *Krukowski v. Commissioner*, 114 T.C. No. 366 (2000); *Schwalbach v. Commissioner*, 111 T.C. 215 (1998).

interest income. The Commissioner argued that the taxpayer could not set off the deductions and income because the IRS had not issued regulations for self-charged items other than interest and had thereby limited the offset. The court (Judge Gerber) held that the substantive set-off rule was self-executing and the taxpayer was entitled to offset the passive management deductions against the nonpassive management income. Such self-charged treatment was congressionally intended not only for interest, but also for other appropriate items, and the Commissioner did not argue that there was any distinction of substance between interest and management fees within the self-charged regime.

a. Well, now, not for this taxpayer and not in the Fourth Circuit. What “plain meaning” giveth in *Giltitz*,¹¹ it taketh away in *Hillman*. Reversed, 250 F.3d 228 (4th Cir. 2001). The Court of Appeals (Judge Hamilton) reversed, finding “nothing in the plain language of IRC section 469 suggests that an exception to IRC section 469(a)’s general prohibition against a taxpayer’s deducting passive activity losses from nonpassive activity gains exists where, as in the present case, the taxpayer essentially paid a management fee to himself.” The court reasoned that Hillmans’ argument for ignoring the plain language of the statute could prevail only if one of “two extremely narrow exceptions to the Plain Meaning Rule” applied: (1) “when literal application of the statutory language at issue produces an outcome that is demonstrably at odds with clearly expressed congressional intent to the contrary” or (2) “when literal application of the statutory language at issue ‘results in an outcome that can truly be characterized as absurd, i.e., that is so gross as to shock the general moral or common sense.’” In the eyes of the court, neither of those situations was present.

5. An S corporation and 116 partnerships are a single activity. *Glick v. United States*, 96 F. Supp. 2d. 850 (S.D. Ind. 2000). In 1992 and 1993, the taxpayer was a partner in 116 limited partnerships that owned rental real estate. In 79 of the partnerships, the taxpayer held a “controlling” general partnership interest and in 33 of them, the taxpayer held a 1% general partnership interest. The court agreed with the taxpayer that under Reg. § 1.469-2(d) the partnerships could be aggregated with an S Corporation, in which the taxpayer owned 93.6% of the stock, and in which taxpayer materially participated, which permitted the taxpayer to claim the losses from the partnerships against nonpassive income. The S corporation was formed specifically for the purpose of managing the limited partnership’s rental properties and did so. Thus, the partnerships and the S corporation were “an “appropriate economic unit” under the regulations. The entities were “so substantially intertwined that to separate their income for tax purposes would unfairly deny them the benefits of § 469’s limitations.” In

11. 121 S. Ct. 701 (2001), discussed *infra* VI.D.2.

addition, the S corporation's trade or business activities, i.e., managing the real estate, were "insubstantial" relative to the partnership's rental activities because the S corporation's gross income was less than 11% of that of the partnerships and the fair market value of the S corporation's assets was approximately 3% of that of the partnerships'. That the S corporation's activities were "essential" to the partnerships did not as a matter of law render the S corporation's activities not relatively insubstantial. [Note that after 1993, § 497(c)(7) might moot this issue for a taxpayer who is engaged in the real estate business.]

6. Both a co-owner and borrower from your co-owner be ye not. *Van Wyk v. Commissioner*, 113 T.C. 440 (1999). The taxpayer and another person each owned 50% of the stock of an S corporation engaged in the farming business. Taxpayer and his wife borrowed funds from the other shareholder and his wife and lent them to the corporation, after which taxpayer attempted to claim passed-through losses against the debt basis under § 1366(d)(1)(B). The Tax Court (Judge Wells) held that pursuant to § 465(b)(3), the taxpayer shareholder was not at risk for amounts lent to the corporation because he borrowed the funds from another shareholder (and that shareholder's spouse, from whom borrowing is treated in the same manner as borrowing from the husband under § 465(b)(3)(c)) to re-lend them to the corporation. The taxpayer was thus denied a current deduction for losses passed through under § 1366. Money that is borrowed from a third party by the taxpayer on his own credit and then invested or contributed by the taxpayer to an activity is not governed by § 465(b)(1)(A), but rather is treated as borrowing with respect to the activity and will be considered to be at risk only if the borrowing transaction passes muster under the several other subsections of § 465 dealing with the treatment of borrowed funds. The negligence penalty was not upheld because "the complexity of § 465 and the lack of express guidance in the regulations, led [taxpayers] to an honest mistake."

7. A double loss. *More v. Commissioner*, 115 T.C. 125 (2000). The taxpayer was an individual Lloyds of London underwriter who pledged stock to secure a letter of credit posted to show he could cover claims. When he incurred losses on claims paid, the issuer of the letter of credit sold the stock. Because the stock had been acquired before underwriting activity began, the gain was portfolio income under § 469(e)(1)(A) and Reg. § 1.469-2T(c)(3)(i)(C), which could not be offset by the passive activity losses from the insurance claims. The stock was not property used in the trade or business of insurance underwriting, and the gain was not derived in the ordinary course of business. The court noted, however, that income generated in the ordinary course by the investment component of a reinsurance business is not portfolio income. Thus if the stock had been purchased with premiums from the insurance business and acquired and held for the purpose of "showing means" to cover potential losses, gain might have been passive.

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

III. INVESTMENT GAIN

A. Capital Gain and Loss

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

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

2. **Restructured Section 1221. The exceptions listed in § 1221(a)(1) through (8) are exclusive, so common-law exceptions are no longer available.** *Corn Products* exception codified in § 1221(a)(7). The Tax Relief Extension Act of 1999 restructured § 1221 to create a subsection (a) in which the categories of property that are not capital assets are listed and a subsection (b) providing certain definitions relating to the some of the categories of assets

in § 1221(a). The 1999 Act also added three additional categories of assets, listed in § 1221(a)(6)-(8) that are excluded from the definition of “capital asset.”

- New § 1221(a)(6) excludes any “commodities derivative financial instrument” held by a commodities derivatives dealer, unless (1) it is established to the satisfaction of Commissioner that the particular instrument in question had no connection to the activities of the dealer as a dealer, and (2) the instrument was clearly identified in the dealer’s records as having no connection to the dealer activities before the close of the day on which it was acquired, originated, or entered into.

- Section 1221(b)(1) defines a “commodities derivatives dealer” as any person that regularly offers to enter into, assume, offset, assign or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business. A “commodities derivative financial instrument” is defined in § 1221(b)(2) as any contract or financial instrument with respect to commodities, the value or settlement price of which is calculated by reference to any combination of a fixed rate, price, or amount, or a variable rate, price, or amount, which is based on current, objectively determinable financial or economic information. This definition includes instruments such as swaps, caps, floors, options, futures contracts, forward contracts, and similar financial instruments with respect to commodities, but it does not include shares of stock in a corporation; a beneficial interest in a partnership or trust; a note, bond, debenture, or other evidence of indebtedness; or a contract to which § 1256 applies.

- New § 1221(a)(7) excludes any hedging transaction that has been clearly identified as such before the close of the day on which it was acquired, originated, or entered into. This provision in effect largely codifies previously promulgated regulations [Reg. § 1.1221-2], but changes the definition of a hedging transaction somewhat from that provided in the regulations. Presumably the negative inference is that if a hedging transaction has not been so identified, it will be a capital asset.

- Section 1221(b)(2) codifies the definition of “a hedging transaction” in generally the same manner as Reg. § 1.1221-2, but broadens the scope by abandoning the “risk reduction” standard of the regulations to one of “risk management” with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred) by the taxpayer. In addition, § 1221(b)(2)(A)(iii) permits the IRS to expand by regulations the definition to include transactions entered into primarily to manage other risks. Congress did not intend that the “risk management” based definition of a hedging transaction extend to “speculative transactions or other transactions not entered into in the normal course of a taxpayer’s trade or business.”

- Section 1221(b)(2)(B), requires the Treasury to issue regulations requiring proper characterization of (1) transactions that are in fact hedging transactions but which have not been properly identified, and (2) transactions that have been identified by the

taxpayer as hedging transactions but which in fact are not hedging transactions. Thus, the identification or non-identification of an asset as a hedging transaction presumably will only create a presumption one way or the other. Because the accompanying committee reports express congressional concern that taxpayers may seek to “whipsaw” the Treasury, the identification rule is highlighted as important. Thus, the recharacterization pursuant to regulations issued under § 1221(b)(2)(B) very well may turn out to be a sword only for the Treasury, with the taxpayer’s identification (or non-identification) being only a partial shield.

- New § 1221(a)(8) excludes supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer. This subsection is more closely related to § 1221(a)(1) (as § 1221(1) was renumbered in 1999), which excludes inventory, stock in trade, and property held primarily for sale to customers in the ordinary course of business, but which does not expressly exclude stocks of previously expensed supplies used in the course of providing services. This new provision eliminates any question in this regard, relegating supplies to ordinary asset characterization. This assures that hedging transactions with respect to such supplies, for example, jet fuel for an airline, would be ordinary transactions. In a number of cases, supplies consumed by the taxpayer or the taxpayer’s customer in the course of providing services have been held not to be inventory for purposes of accounting method rules, and these cases raise the question of whether such supplies, which have been expensed upon purchase, are capital assets. Section 1221(a)(1) does not expressly exclude stocks of previously expensed supplies used in the course of providing services, and neither does § 1221(a)(2).

3. New section 1260. In 1999 Congress enacted new § 1260 in response to its concerns with the use of derivative contracts—forward contracts, notional principal contracts, and other similar arrangements with respect to property that provides the investor with the same or similar economic benefits as owning the property directly—by taxpayers in arrangements designed primarily to convert what otherwise would be ordinary income and short-term capital gain into long-term capital gain.

- Congress was particularly concerned with derivative contracts with respect to partnerships and other pass-thru entities that might have resulted in the taxpayer being taxed more favorably than if he actually had acquired an ownership interest in the entity. These transactions escaped the ambit of § 1258, which only applies to transactions in which the taxpayer’s expected return is attributable solely to the time value of his net investment.

- One example of a conversion transaction involving a derivative contract is when a taxpayer enters into an arrangement with a securities dealer whereby the dealer agrees to pay the taxpayer any appreciation with respect to a notional investment in a hedge fund. In return, the

taxpayer agrees to pay the securities dealer any depreciation in the value of the notional investment. The arrangement lasts for more than one year. The taxpayer is substantially in the same economic position as if he or she owned the interest in the hedge fund. However, the taxpayer may treat any appreciation resulting from the contractual arrangement as long-term capital gain. Moreover, any tax attributable to such gain is deferred until the arrangement is terminated.

- Section 1260 presents a double-barreled attack on such transactions. First, § 1260(a)(1) limits the amount of gain with respect to any “constructive ownership transaction with respect to any financial asset” that may be characterized as long-term capital gain. The amount of gain that may be characterized as long-term capital gain is limited to the “net underlying long-term capital gain,” essentially the amount of gain that would have been long-term capital gain if, during the term of the derivative contract, the taxpayer had held the underlying assets directly. Any gain in excess of this amount is ordinary income. Second, § 1260(b) imposes an interest charge with respect to deferral effected during years the transaction remained open on any gain treated as ordinary income, as opposed to capital gain, under § 1260(a)(1).

4. Capital gains rules on sales of interests in passthrough entities are final, with some modifications. T.D. 8902, Capital Gains, Partnership, Subchapter S, and Trust Provisions, 65 F.R. 57092 (9/21/00). The Treasury has promulgated final regulations on capital gain on sale of passthrough entities. The look-through provisions will not apply to the redemption of a partnership interest. The allocation of a divided holding period [where a partner acquired portions of an interest at different times] continues to be the rule, but exceptions are provided (1) to permit a partner to reduce cash contributions made during the year before the sale by cash distributions received during the same period on a LIFO basis, and (2) to permit the IRS to provide additional exceptions in published guidance for other cash contributions. The final regulations also provide that deemed contributions and distributions of cash under § 752(a) and (b) are not to be taken into account.

a. Don't you just love dealing with the nuances of multiple capital gains rates? REG-106527-98, Capital Gains, Partnership, Subchapter S, and Trust Provisions, 64 F. R. 43117 (8/9/99). [Effective for transactions on or after the date the final regulations are published.]

(1) Proposed Reg. § 1(h)-1, deals with rates applicable to sales of interests in entities that own property subject to different capital gains rates under § 1(h) for taxable years ending after 5/6/97.

- Pursuant to § 1(h)(6)(b), any gain from the sale of an interest in a partnership, an S corporation, or a trust that has been held for more than one year (or more than 18 months for relevant periods in 1997) that is attributable to unrealized appreciation in the value of collectibles held by

the entity is treated as gain from the sale or exchange of a collectible [applying rules similar to § 751(a) to determine the amount of that gain]. The amount of collectibles gain equals the collectibles gain that would be allocated to the selling partner, shareholder, or beneficiary [with respect to the portion of the transferred interest that is subject to long-term capital gain] if the entity had sold all of its collectibles in a taxable transaction immediately before the transfer of the interest. If the partner, S corporation shareholder, or trust beneficiary recognizes less than all of the gain upon the sale of its interest, a proportionate part of the gain is treated as collectibles gain.

• Under § 1(h)(7)(A), the amount of long-term capital gain (not otherwise treated as ordinary income under § 751(a)) that would be treated as if § 1250 applied to all depreciation is unrecaptured § 1250 [capital] gain, subject to a maximum rate of 25%. The proposed regulations follow H. Rep. No. 105-356, 105th Cong. 1st Sess. (1997), at 16, fn. 11; S. Rep. No. 105-174, 105th Cong. 2d Sess. (1998), at 149, fn. 65, and provide that upon the sale of a partnership interest held for more than one year, the amount of the gain that would have been ordinary income under § 751(a) if the partnership's unrecaptured § 1250 gain had been ordinary income is treated as unrecaptured § 1250 gain by the selling partner. The amount of the overall gain that is unrecaptured § 1250 gain equals the amount that would have been the partner's share of unrecaptured § 1250 gain if the partnership had sold all of its § 1250 property in a taxable transaction immediately before the transfer of the partnership interest. If the partner recognizes less than all of the gain upon the sale of the interest, a proportionate part of the gain is treated as unrecaptured § 1250 gain. However, for purposes of applying § 1(h)(7)(B) [which limits unrecaptured § 1250 gain to the taxpayer's net § 1231 gain] a selling partner's gain from the sale of a partnership interest that results in § 1250 capital gain is not treated as § 1231 gain even if § 1231 would apply to a disposition of the underlying partnership property. The Treasury believes that although § 1(h)(7) requires a "look-thru rule" for determining the capital gain rate applicable to the sale of a partnership interest while no "look-thru rule" applies for applying § 1231, "[a]nomalous results would follow if § 1250 capital gain derived from the sale of a partnership interest were treated as § 1231 gain for purposes of applying the limitation in § 1(h)(7)(B) but not for purposes of actually applying § 1231."

(2) Proposed Reg. § 1.1223-3, deals with the holding periods of partnership interests acquired at different times in multiple transactions. A partner has a single basis in a partnership interest [Rev. Rul. 84-53, 1984-1 C.B. 159], even if the partner acquired portions of the interest at different times or acquired the interest in a single transaction that gave rise to different holding periods under § 1223 partnership. If a partner sells the entire partnership interest, any capital gain or loss is divided between long-term and short-term capital gain or loss in the same proportions as the holding period of

the interest in the partnership is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less. The portion of a partnership interest to which a holding period relates is a percentage that equals the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates divided by the fair market value of the entire partnership interest (determined immediately after that transaction). A selling partner may use the actual holding period of the portion of a partnership interest sold if the partnership is a “publicly traded partnership” [see § 7704(b)], the partnership interest is divided into identifiable units with ascertainable holding periods, and the selling partner can identify the portion of the interest transferred. Otherwise, the holding periods of the transferred interest must be divided in the same ratio as the holding periods of the partner’s entire partnership interest. The preamble notes that IRS may apply judicial doctrines, e.g., substance over form or step transaction, or Reg. § 1.701-2 to attack abusive transactions designed to shift gain from the portion of a partnership interest with a short-term holding period to the portion with a long-term holding period.

B. Interest

1. Rev. Proc. 99-43, 1999-47 I.R.B. 579. The Service has issued modified guidance regarding the application of § 6621(d) with respect to interest accruing before 12/1/98.

a. Rev. Proc. 2000-26, 2000-24 I.R.B. 1257. The Service has published procedures for applying the zero net interest rate under § 6621(d) for interest accruing on or after 10/1/99.

2. Rev. Rul. 99-40, 1999-40 I.R.B. 443, *modifying and superseding* Rev. Rul. 84-58 and Rev. Rul. 88-98. When a taxpayer reports an overpayment on its income tax return, interest will be assessed on that portion of a subsequently determined deficiency for the overpayment return year that is less than or equal to the overpayment as of: (1) the date on which the Service refunds the overpayment without interest; or (2) the date on which the overpayment is applied to the succeeding year’s estimated taxes; interest will be assessed on any remaining portion of the deficiency from the original due date of the tax for the overpayment return year.

3. T.D. 8886, Use of Actuarial Tables in Valuing Annuities, Interests for Life or Terms of Years, and Remainder or Reversionary Interests, 65 F.R. 36908 (1/12/00), corrected, 65 F.R. 58222 (9/28/00). The Treasury has promulgated final regulations under § 7520 revising the actuarial tables to be used in valuing annuities, interests for life or terms of years, and remainder or reversionary interests. The regulations apply to interests created after 4/30/00.

The revision was necessary because § 7520(c)(3) requires the tables to be revised not less frequently than once each 10 years.

4. *Security State Bank v. Commissioner*, 214 F.3d 1254 (10th Cir. 2000), *aff'g* 111 T.C. 210 (1998). Section 1281, imposing the OID rules on certain short-term debt instruments, applies only to investment type debt instruments, not to undiscounted “loans” with stated interest that have been “made” in the ordinary course of a cash method lender’s business.

5. **Equity kicker to lender creates OID.** *Custom Chrome, Inc. v. Commissioner*, 217 F.3d 1117 (9th Cir. 2000), *aff'g in part and vacating and remanding in part* T.C. Memo 1998-317. Warrants to purchase stock granted by a corporate borrower to lender to provide additional compensation to lender for making a risky loan resulted in the “price paid” by the lender for the borrower’s note [under § 1273(b)] being less than the stated principal amount of the note. Thus, the obligation was an OID instrument. The warrants, even though not publicly traded, properly were valued at the time of issuance, not the time of exercise, because § 83 and Reg. § 1.83-7 apply only to warrants issued in exchange for services. But the Tax Court erred in finding that because the warrants were “at the money” at the time of issuance and the lender carried them on its books at only \$1,000, they had no value – thus disallowing the taxpayer any deduction for accrued OID [which the taxpayer first sought in the Tax Court proceeding]. Under any well established financial method for valuing options, the warrants had value. Remanded.

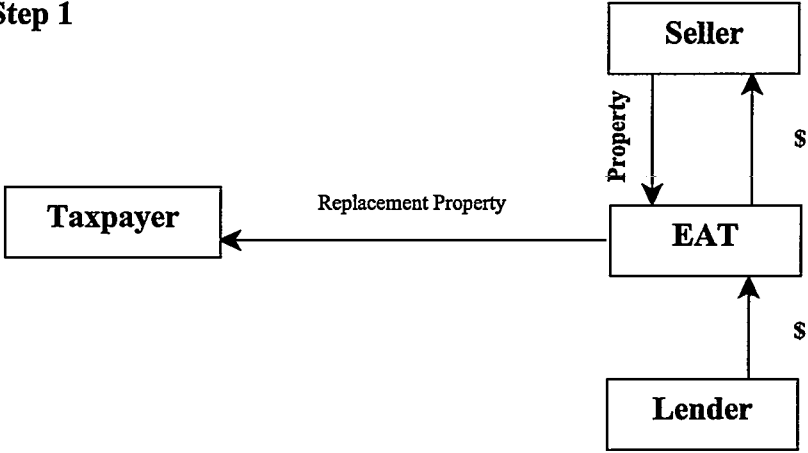
C. Section 1031 Like-Kind Exchanges

1. **Depreciation for MACRS property acquired in a § 1031 exchange of MACRS property, or acquired in replacement of involuntarily converted MACRS property to which § 1033 applies.** Notice 2000-4, 2000-3 I.R.B. 313. To the extent the taxpayer’s basis in the acquired MACRS property does not exceed the taxpayer’s adjusted basis in the exchanged or involuntarily converted MACRS property, the acquired property is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, the exchanged or involuntarily converted property. Any additional basis in the acquired property is treated as newly purchased MACRS property. [This is the same method as provided for ACRS property in Proposed Reg. § 1.168-5(f) (1984).] Effective for acquired MACRS property placed in service on or after 1/3/00 in a like-kind exchange of MACRS property under § 1031 or as a result of an involuntary conversion of MACRS property under § 1033. For property acquired before 1/3/00, taxpayers who treated the entire basis as new MACRS property may continue to do so, or may change accounting methods to conform.

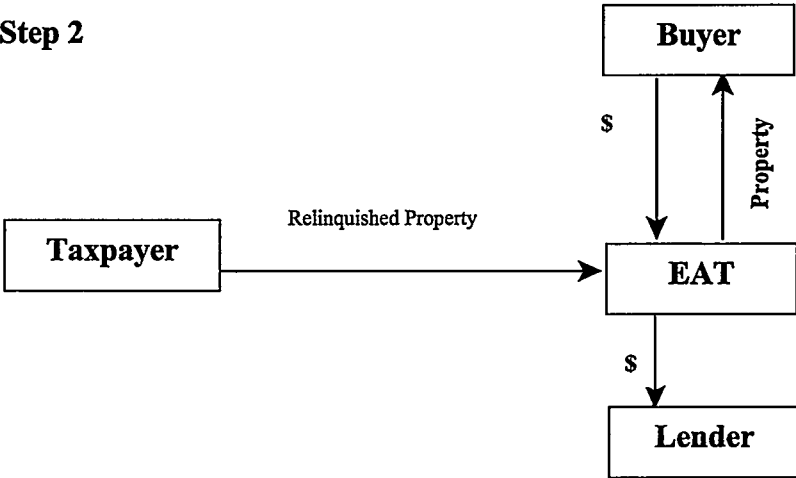
2. Tech. Adv. Mem. 200035005 (May 5, 2000). The exchange of FCC radio licenses for an FCC television license is a like-kind exchange under § 1031. The revenue agent had contended that the exchange of FCC licenses also involve an exchange of all the station's radio or TC property [including programming content, advertising contracts, etc.], while the taxpayer argued that the underlying property to which the licenses related was the tangible personal property consisting of transmitters, towers and antenna [described in the same Product Classes 3663 and 3441 as in the SIC Manual].

3. **Look ma, "I'm an EAT in a QEAA!" A safe harbor for reverse exchanges is created by the IRS.** Rev. Proc. 2000-37, 2000-40 I.R.B. 308. The IRS has provided safe-harbor guidance blessing § 1031 treatment for reverse *Starker* exchanges, i.e., when the replacement property is received by an "exchange accommodation titleholder" ("EAT") before the taxpayer transfers the property to be disposed of in the exchange [a situation not covered in Reg. § 1.1031(k)-1], if the required conditions have been met.

Step 1



Step 2



- An “exchange accommodation titleholder” (“EAT”) may be, but need not be, a qualified intermediary [as defined in Reg. § 1.1031(k)-1(g)(4)], but may not be a disqualified party [as defined in Reg. § 1.1031(k)-1(k)] and must be either subject to tax or a partnership or S corporation more than 90% owned by persons subject to tax. Under the Revenue Procedure the exchange accommodation titleholder will be treated as the owner of the property if the property is held in a “Qualified Exchange Accommodation Arrangement.” The EAT must hold legal or beneficial title to the property, i.e., “qualified indicia of ownership.”

- The QEAA must be entered into in writing within five days of the EAT acquiring qualified indicia of ownership, the relinquished property must be identified [consistently with the principles of Reg. § 1.1031(k)-1(g)(4)] within 45 days of the exchange accommodation titleholder acquiring qualified indicia of ownership, and the exchange must be completed within 180 days of the intermediary acquiring qualified indicia of ownership.

- The taxpayer (or a disqualified party) can guarantee the accommodation party’s debt, advance funds to the accommodation party to pay the purchase price, lease the property from the accommodation party, supervise the property or construction, and provide certain arrangements to protect the accommodation party against risk of loss from fluctuations in value.

- A transaction can qualify under both the Revenue Procedure and the regulations if the accommodation party is a qualified intermediary who holds both properties simultaneously for a period not in excess of 180 days.

- No inference is to be drawn regarding the treatment of a transaction not covered by the safe harbor. Effective 9/15/00.

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

the deferred exchange regulations under § 1031(a)(3) do not apply to reverse exchanges, and that Rev. Proc. 2000-37 is prospective only.

4. No rulings that syndicated fractional interests in real estate are real estate rather than partnership interests. Rev. Proc. 2000-46, 2000-44 I.R.B. 438. The IRS will not give advance rulings on whether an undivided fractional interest in real estate is [or is not] an interest in a partnership that is not eligible for like-kind exchange treatment under § 1031. [Rev. Proc. 2000-3, § 5.10, 2000-1 I.R.B. 103 amplified]. The IRS is concerned that taxpayers are treating as undivided interests in real estate, eligible for § 1031 like-kind exchange treatment, interests in arrangements involving real property that properly should be treated as partnership interests. It intends to study the facts and circumstances relevant to the determination of whether such arrangements are separate entities for federal tax purposes. The IRS requests comments regarding the relevance of the following factors in determining whether arrangements involving undivided fractional interests in real property constitute separate entities for federal tax purposes: (1) leasing or management agreements with respect to the property and the relationships between the parties to such agreements and the promoter or organizer of the arrangement; (2) agreements between the promoter or organizer of the arrangement and the holders of the fractional interests or among the holders of the fractional interests, including any contractual restrictions to which the fractional interests are subject, such as waivers of the right to partition, rights of first refusal, and options to put and/or call the fractional interests; and (3) the overall economics of the arrangements, including the sharing of profits and losses from operating the property and appreciation and depreciation in the property's value.

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

D. Section 1041

1. 'Tis doubly blessed to get redeemed in divorce than in marital bliss. *Read v. Commissioner*, 114 T.C. 14 (2000). Mr. and Mrs. Read (H & W) owned substantially all of the stock of Mulberry Motor Parts, Inc. (MMP). When they divorced, the final judgment ordered (1) that W sell to H, or at H's

election to MMP or MMP's ESOP plan, all of her MMP stock, and (2) that H, or at H's election MMP or MMP's ESOP plan, pay \$838,724 to W (\$200,000 down and the balance by interest-bearing note). H elected to cause MMP to purchase and pay for W's stock, and the transaction was so structured. W argued that she was entitled to nonrecognition under § 1041(a) and Reg. § 1.1041-1T(c), Q&A-9, which treats certain transfers to third parties as a transfer of property by the transferring spouse directly to the nontransferring spouse that qualifies for nonrecognition treatment under § 1041 followed by an immediate transfer of the property by the nontransferring spouse to the third party in a transaction that is not subject to § 1041 – i.e., H would have a redemption treated as a dividend. H argued that § 1041(a) and Reg. § 1.1041-1T(c), Q&A-9 were inapplicable because he never had an unconditional obligation to purchase W's MMP stock, and that accordingly he recognized no income and W recognized gain on the redemption of her stock. The Commissioner took the position that he was a mere stakeholder and had issued deficiency notices to both taxpayers in the joined cases to avoid a whipsaw, but the Commissioner argued that W “has the better argument.”

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

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

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

2. The wrong answer again, via Judge Hall of the Ninth Circuit, who here defers to the Tax Court – as has been so seldom her wont. Remember, it all began with the Ninth Circuit’s *Arnes* decision that gave the temporary(?) regulations under § 1041 such a convoluted interpretation.¹² *Craven v. United States*, 215 F.3d 1201 (11th Cir. 2000) A stock redemption for \$4.8 million in future cash, incident to a 1989 divorce, was governed by § 1041. Thus, the redeeming spouse did not recognize gain nor (because § 1041 applies) did she have imputed interest during the period before receiving cash. The stock redemption agreement between the redeeming spouse

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

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

Tax Court had held for wife when husband had been obligated to purchase her stock. *Hayes v. Commissioner*, 101 T.C. 593 (1993). The existence of a provision in their separation agreement obligating husband to purchase wife’s stock in their wholly-owned [McDonald’s franchise] corporation results in a constructive dividend to husband when the corporation redeemed wife’s shares and results in tax-free § 1041 treatment to wife under Temp. Reg. § 1041-1T(c), Q&A 9.

The Tax Court disagrees with the Ninth Circuit’s *Arnes* decision, and Judge Beghe has the correct answer. *Blatt v. Commissioner*, 102 T.C. 77 (1994) (reviewed, 3 judges dissenting). Wife’s redemption (pursuant to a divorce decree) of all her stock in a corporation she owned entirely with her husband was not governed by § 1041, and was taxable to her. The court refused to follow the Reg. § 1.1041-1T, Q&A 9 theory that the redemption was a transfer to the corporation on behalf of her husband, as held in *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1993), in which the court refused to follow. Judge Beghe’s concurring opinion stated that the proper interpretation of that regulation should be that no redemption should be considered to be “on behalf of” the remaining spouse unless it discharges that spouse’s primary and unconditional obligation to purchase the redeemed stock, as set forth in the examples of Rev. Rul. 69-608, 1969-1 C.B. 42.

and the corporation provided that the payments were to be made without stated interest and that the corporation would send the wife Forms 1099-INT stating the amounts of interest imputed to her under § 1272. Senior Judge Cynthia Hall (of the 9th Circuit) followed *Read, supra*, to find the redemption was governed by § 1041 pursuant to Temporary Reg. § 1.1041-1T(c), Q&A-9.

◦ It appears that the intention of the parties in 1989 was to have the redemption treated as a taxable redemption by the redeeming spouse, and to have the wife taxed on the gain. The stock redemption agreement provided that since the payments under the note were without stated interest the corporation would send the redeemed wife Forms 1099-INT stating the amounts of interest imputed to her under § 1272, which the corporation did. The parties did not contemplate a § 1041 transfer because under Reg. § 1.1274-1(b)(iii) the original issue discount rules do not apply to transaction covered by § 1041.

a. The nuances of §§ 301 and 302 elude yet another court when § 1041 is pulled over the judge's eyes. *Craven v. United States*, 70 F. Supp. 2d 1323 (N.D. Ga. 1999). The court followed the Ninth Circuit's decision in *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992), to apply § 1041 to provide nonrecognition on redemption pursuant to divorce decree of wife's 47% of stock of a corporation controlled by husband. The court reasoned that the purpose of the redemption was to effect a division of marital property and thus § 1041 applied to the wife. The opinion states that the proper treatment of the husband, i.e., whether the husband had a constructive dividend by reason of the redemption, was not before the court and, in any event, was not relevant to the proper treatment of the wife's redemption. The court did get right that § 1041 did apply to the OID component of the promissory note that the wife received in exchange for the redeemed stock.

3. Another "income item" exception to § 1041? Field Service Advice 200005006 (11/1/99). The IRS concludes that *United States v. Davis*, 370 U.S. 65 (1962), is still alive when it comes to transactions not involving property and that this is just an assignment of (compensation) income. When an ex-husband transfers stock options to his ex-wife incident to a divorce, he has § 83 ordinary income on their FMV at that time, and she gets a carryover basis under § 1041(b). (If the options originally were incentive options, they automatically become nonqualified upon transfer.) Neither spouse will be taxed when the options are exercised, but she will recognize capital gain on the sale of the stock. Her basis is the sum of her carryover basis and the exercise price. The FSA analogizes the result from the transfer of savings bonds with accrued interest. Rev. Rul. 87-112, 1987-2 C.B. 207.

◦ When ex-wife later exercised the options, employer issued a Form 1099 to the ex-husband. He included the gain on his tax return and filed a refund claim. Under *United States v. Davis*, 370 U.S. 65

(1962), the stock options were exchanged for the release of other marital rights or property. Therefore, the transfer was at arm's length and subject to the § 83 rule that stock options are taxable on transfer. When the ex-wife exercised the options, it was not a taxable event. Instead, the Service said, when the stock received is sold she will realize gain on the difference between the stock's selling price and her basis, which is the sum of her carryover basis from the husband's taxable transfer and the exercise price. Anticipating an argument that § 1041 shields the husband from tax, the Service remarked that the options were compensation. Section 1041 only deals with the nonrecognition of gain or loss in an interspousal transfer, not with excluding income. The Service also noted that the assignment of income doctrine overrides § 1041. The FSA reasons that under *United States v. Davis*, which was overruled with respect to transfers of property by the enactment of § 1041, the stock options were exchanged for the release of other marital rights or property; thus they were an income item, not "property," so the transfer was taxable to the husband.

- The are two internal inconsistencies in the reasoning of the FSA. First, under pre-§ 1041 law, the transferee spouse took a FMV basis, not a carryover basis. Rev. Rul. 67-221, 1967-2 C.B. 63. Second, under *Berger v. Commissioner*, T.C. Memo. 1996-076, under the § 1041 regime, if the transferor spouse recognizes gain on the transfer of an income item, the transferee spouse is entitled to a stepped-up basis.

E. Section 1042

1. Rev. Rul. 2000-18, 2000-14 I.R.B. 847. If a taxpayer who has sold stock to an ESOP or cooperative and has elected to defer the recognition of gain under § 1042(a) subsequently transfers qualified replacement property to a partnership in exchange for a partnership interest, the transfer to the partnership is a disposition of the qualified replacement property resulting in recapture of the deferred gain under § 1042(e).

IV. COMPENSATION ISSUES

A. Employee Compensation and Plans

1. REG-109101-98, Special Rules Regarding Optional Forms of Benefit Under Qualified Retirement Plans, 65 F.R. 16546 (3/29/00). The Treasury issued proposed regulations under § 411(d)(6), permitting qualified plans to eliminate some alternative forms of benefits.

- a. T.D. 8900, Special Rules Regarding Optional Forms of Benefit Under Qualified Retirement Plans, 65 F.R. 54100 (8/31/00). The Treasury promulgated final regulations that permit qualified defined

contribution plans to be amended to eliminate some alternative forms of benefit and to permit transfers between defined contribution plans that were not permitted under prior final regulations.

2. T.D. 8880, Relief From Disqualification for Plans Accepting Rollovers, 65 F.R. 21312 (4/21/00). The Treasury promulgated final regulations under § 401(a)(31) to provide specific rules that grant relief from disqualification to an eligible retirement plan that inadvertently accepts an invalid rollover contribution. The regulations clarify that it is not necessary for a distributing plan to have a favorable IRS determination letter in order for a plan administrator of a receiving plan to reach a reasonable conclusion that a contribution is a valid rollover contribution.

3. T.D. 8878, Tax Treatment of Cafeteria Plans, 65 F. R. 15548, 2000-15 I.R.B. 857 (3/23/00). Final Reg. § 1.125-4 permits mid-year cafeteria plan elections with respect to medical and group term life insurance by an employee who has a change of status, such as change in marital status or number of dependents, employment, work site, etc., during the year. [Employees generally are permitted to make elections between cash or qualified tax free benefits only at the beginning of the plan year.]

a. REG-117162-99, Notice of Proposed Rulemaking, Tax Treatment of Cafeteria Plans, 65 F.R. 11587 (3/23/00). The Treasury issued proposed amendments to various subsections of Reg. §§ 1.125-1, -2, and -4 that would extend to dependent care assistance and adoption assistance the availability of mid-year cafeteria plan elections based on a change of status, under the same terms that apply to mid-year elections with respect to medical and group term life insurance under Reg. § 1.125-4.

b. T.D. 8921, Tax Treatment of Cafeteria Plans, 66 F.R. 1837 (1/10/01). The March 2000 final regulations have been modified to permit employees to elect to increase or decrease group-term life insurance or disability coverage in response to a change-of-status event, including birth, adoption, or death.

4. **Same desk rule limited by Treasury, but it will take Congress to eliminate the rule completely.** Rev. Rul. 2000-27, I.R.B. 1016. An employer's sale of less than 85% of the assets in a trade or business does not constitute a sale of substantially all the assets within the meaning of § 401(k)(10)(A)(ii), so the prohibition of distributions on the ground of separation from service under the "same-desk" rule will not be applied under those circumstances.

5. Notice 2000-32, 2000-26 I.R.B. 1274. This notice provides permanent relief and guidance relating to the exception to the definition of

“eligible rollover distribution” for hardship distributions. The exception was added in 1998 to §§ 402(c)(4) and 403(b)(8)(B).

6. Rev. Proc. 2000-27, 2000-26 I.R.B. 1272. This revenue procedure opens the IRS determination process for individually designed pension plans for amendments incorporating legislative changes from 1994 to 1998. It extends the remedial amendment period for one more year, i.e., to the last day of the first plan year beginning after 12/31/00. (The deadline for master and prototype plans is not extended beyond the 12/31/00 deadline set forth in Rev. Proc. 2000-20.)

7. T.D. 8891, Increase In Cash-Out Limit Under Sections 411(a)(7), 411(a)(11), and 417(e)(1) for Qualified Retirement Plans, 65 F.R. 44679 (7/19/00). The Treasury has promulgated final regulations relating to the increased cash-out limit. The regulations increase from \$3,500 to \$5,000 the limit on distributions from qualified retirement plans that can be made without participant or spousal consent.

8. T.D. 8894, Loans From a Qualified Employer Plan to Plan Participants or Beneficiaries, 65 F.R. 46588 (7/31/00). The Treasury promulgated final regulations in Q&A form under § 72(p) relating to plan loans.

a. REG-116495-99, Proposed Rules, Loans From a Qualified Employer Plan to Plan Participants or Beneficiaries, 65 F.R. 46677 (7/31/00). The Treasury has issued proposed modifications of T.D. 8894 relating to suspended loan repayments during a participant’s military service, to unrepaid loans treated as distributions, and to multiple plan loan arrangements.

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

10. A little more help for Rabbi trusts. Notice 2000-56, 2000-43 I.R.B. 393. This notice deals with the application of Reg. § 1.1032-3 if a parent corporation contributes its stock to a rabbi trust established by a subsidiary to provide deferred compensation to the subsidiary’s employees. The parent corporation will be considered the grantor and the owner of the parent’s stock held in the trust if the parent’s stock (1) is subject to the claims of the creditors of the parent corporation, and (2) reverts to the parent on termination of the trust to the extent it is not transferred to an employee. This result obtains even if the parent stock in the trust is also subject to the claims of the subsidiary’s creditors.

The parent stock will not be considered transferred to the subsidiary used to satisfy the subsidiary's deferred compensation obligation (or when a claim is made against the trust by a creditor of the subsidiary). As a result the immediate transfer requirement of Reg. § 1.1032-3(c)(2) is satisfied with respect to the parent stock. Model language in Rev. Proc. 92-64, 1992-2 C.B. 422, may be modified to take this change into account and an advance ruling may be obtained.

11. *Estate of Ashman v. Commissioner*, 231 F.3d 541 (9th Cir. 2000), *aff'g*, T.C. Memo. 1998-145. In 1990, the taxpayer received a distribution from a qualified plan that she reported as a tax-free rollover from one qualified retirement plan to another [pursuant to § 402(c)]. In fact, the rollover did not comply because the contribution to the new account was not made within the 60 days required by § 402(c)(3). In 1993, when the taxpayer withdrew funds from the new account, she did not report receipt of the distribution. She claimed a basis offset on the grounds that the 1990 transaction did not qualify for tax-free rollover. Because 1993 was a closed year, the Commissioner denied the basis offset on the grounds that the taxpayer was estopped from claiming that the 1990 transaction was a qualified rollover. The Ninth Circuit affirmed the Tax Court's application of the "duty of consistency" to disallow the basis offset and require inclusion of the full distribution.

12. **Fundamental changes in the treatment of split-dollar life insurance.** Notice 2001-10, 2001-5 I.R.B. 459. This notice provides interim guidance on split-dollar life insurance contracts. It notes that the P.S. 58 rates no longer reflect current fair market value of insurance protection. The notice requires that employer payments be consistently treated as: (1) interest-free loans under § 7872, (2) investments by the employer in the contract, or (3) payments of compensation. The Service had long rejected interest-free loan treatment of the employer investment in the cash value of split-dollar life insurance, but the enactment of § 7872 in 1984 enables interest-free loan treatment to be used as a valid model. The alternative is to have the true cost of insurance protection reflected in the employee's income; insurance companies will be required to provide rates at which comparable term policies will be available to the general public (instead of the low-ball rates that had been provided in the past).

B. Individual Retirement Accounts

1. **Was this Bunney dumb?** *Bunney v. Commissioner*, 114 T.C. 259 (2000). While he was married, the taxpayer established an IRA using community property. When he was divorced, the decree required him to pay over to former spouse one-half of the balance of the IRA. The one-half of community funds paid to the former spouse were not taxable to the former

spouse on distribution of the funds to the husband followed by his transfer of them to the wife pursuant to the court judgment that ordered the funds “to be divided equally between the parties.” The taxpayer-participant was taxed on the entire distribution. Judge Laro held that recognition of community property interests for federal income tax purposes would conflict with the application of § 408, which defines an IRA as a trust created or organized “for the exclusive benefit of an individual or his beneficiaries.” The court held, additionally, that the QDRO-like provisions of § 408(d)(6) were inapplicable because there was no transfer of the IRA participant’s “interest” in the IRA to his spouse.

2. Notice 2000-30, 2000-25 I.R.B. 1266. This notice specifies a new consistent method to be used by IRA trustees for reporting IRA recharacterizations [trustee-to-trustee transfers] and reconversions [a conversion is the transfer, by rollover or other means, of an amount in a nonRoth IRA to a Roth IRA (which is treated as a distribution from the nonRoth IRA); a reconversion is a conversion from a nonRoth IRA to a Roth IRA of an amount that had previously been recharacterized as a contribution to the nonRoth IRA after having been earlier converted to a Roth IRA] occurring after 2000. Reporting of distributions on Form 1099-R, and reporting of contributions on Form 5498.

3. Notice 2000-39, 2000-30 I.R.B. 132. This notice provides guidance permitting a new method for calculating the net income attributable to post-1999 IRA contributions that are distributed as a returned contribution or recharacterized as a contribution to a different-type IRA.

4. They’re taking all the fun out of calculating minimum required distributions from plans and IRAs. REG-130477-00 and; REG-130481-00, Required Distributions from Retirement Plans, 65 F.R. 3928 (1/17/01). Proposed regulations under § 401(a)(9), etc. would substantially simplify the calculation of minimum required distributions (MRD) from qualified plans, IRAs, and other related retirement savings vehicles. The changes in the proposed regulations are based on the concept of a uniform lifetime distribution period. The regulations provide a single table that any recipient can use to calculate their yearly MRD amount by plugging in their age and the prior year-end balance of their retirement account or IRA. The table eliminates the need to elect recalculation of life expectancy, determine a designated beneficiary by the required beginning date, or satisfy a separate incidental death benefit rule. The proposed regulations will result in reducing MRDs for the vast majority of employees and IRA holders. Although MRDs will be calculated without regard to the beneficiary's age, the regulations will continue to permit a longer payout period if the beneficiary is a spouse more than 10 years younger than the employee.

V. PERSONAL INCOME AND DEDUCTIONS

A. Miscellaneous Income

1. *Nielsen v. Commissioner*, 114 T.C. 159 (2000). The taxpayer's residence was condemned by the State of South Dakota for purposes of a federally aided highway construction project. As a result of the condemnation, the taxpayer received \$65,000 [for a year not governed by current § 121]. Subsequently, the taxpayer received an additional \$100,000 of supplemental relocation assistance payments under the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970, Pub. L. No. 91-646, 84 Stat. 1894. The taxpayer claimed that not only was the \$100,000 excludable under the provisions of the Relocation Act exempting payments thereunder from income [42 U.S.C. § 301], but that the \$65,000 received for her home in the condemnation proceeding was likewise exempt, and she reported no capital gain on the disposition of her home. The Tax Court upheld that Commissioner's determination that the \$65,000 was not exempt and that the taxpayer recognized a gain to the extent that the payment exceeded her basis in her residence.

2. *Warren v. Commissioner*, 114 T.C. 343 (2000) (reviewed, 14-3). If a parsonage allowance is paid to a minister, under § 107(2) it is excludable up to the amount of eligible expenses actually paid out of the allowance, even though the amount of the allowance exceeds the "fair rental value" of the parsonage, which can occur when the allowance covers mortgage payments in full, as well as real estate taxes, maintenance, utilities, and furnishings for a home owned by the minister. The court rejected the Commissioner's argument that the exclusion under § 107(2) was limited to the \$58,000 rental value of the minister's home where between \$76,000 and \$80,000 of total compensation of \$77,000 to \$99,000 designated as an annual parsonage allowance over three taxable years was expended on qualifying expenditures. The excess of the designated allowance over actual housing expenditures was taxable.

3. **Additional amount of severance payments treated as recovery for wrongful discharge.** *Greer v. United States*, 207 F.3d 322 (6th Cir. 2000). The court held that the additional amount of severance payments [in excess of the amount taxpayer would have been ordinarily entitled to—\$331,968 as compared to \$51,000] was received in settlement of taxpayer's tort claim for wrongful discharge. Taxpayer was transferred from the position of Ashland Oil's environmental compliance director after completing many negative environmental compliance audits of his employer's petroleum operations; he was discharged because "he did not fit in."

4. Making the world safe for toasters. The “kinder and gentler” IRS that emerged from the Internal Revenue Service Restructuring and Reform Act of 1998 says that free toasters – at least really cheap free toasters – from your bank aren’t income. Rev. Proc. 2000-30, 2000-28 I.R.B. 113. On the grounds of “administrative convenience,” the IRS will not require a bank depositor who receives a *de minimis* premium to include the value of the premium in gross income. Nor will the depositor be required to reduce the basis in the account by the *de minimis* premium. [A basis reduction would have rendered the account an OID instrument.] The financial institution that provides a *de minimis* premium is not required to report it as interest under § 6049. For these purposes, a “*de minimis* premium” is a non-cash inducement, provided by a financial institution to a depositor to open or add to an account, that does not have a cost to the financial institution in excess of \$10 for a deposit of less than \$5,000 or \$20 for a deposit of \$5,000 or more.

5. New Regs clarify 1954 provision that many didn’t realize was so ambiguous. T.D. 8890, Definition of a Grantor, 65 F.R. 41332 (7/5/00). The Treasury has promulgated Reg. § 1.671-2(e), dealing with the identification of the grantor of a trust for purposes of the grantor trust rules. The term “grantor” includes any person that directly or indirectly makes a gratuitous transfer of cash or property to a trust, whether or not the person created the trust. If a person creates or funds a trust on behalf of another person, both of them are treated as grantors of the trust, unless the person who created a trust made no gratuitous transfers to it. A gratuitous transfer is any transfer other than a transfer for fair market value. A transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. An interest in the trust is not property received from the trust.

- “Grantor” includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in investment trusts described in Reg. § 301.7701-4(c), liquidating trusts described in Reg. § 301.7701-4(d), or environmental remediation trusts described in Reg. § 301.7701-4(e).

- If a partnership or corporation makes a gratuitous transfer to a trust for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust.

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

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

B. Deductions and Credits

1. The individual AMT originally was intended to apply primarily to taxpayers with significant economic income who because of tax shelter investments were paying little or no income taxes. Because of numerous amendments to the AMT and the regular income tax provisions over the years, mostly provisions specifically limiting tax-shelter deductions and credits, the individual AMT currently does not significantly affect investors or businesses. Instead it increasingly affects middle-class wage earners – taxpayers not engaged in tax-shelter or deferral strategies. For 1997 five items that are “personal” in nature and not the result of tax planning strategies – personal exemptions, standard deductions, state and local tax deductions, medical expense deductions, and miscellaneous itemized deductions – collectively comprised 73.4% of individual AMT preferences and adjustments. Studies indicate that, by 2007, almost 95% of the revenue from AMT preferences and adjustments will be derived from the personal exemption, the standard deduction, state and local taxes, and miscellaneous itemized deductions. See Harvey & Tempalski, *The Individual AMT: Why It Matters*, 50 Nat. Tax J. 468 (1997); *Tax Simplification Recommendations From ABA, AICPA, and TEI*, LEXIS, TAX ANA, 202000 TNT 39-82 (Feb. 28, 2000). Because the individual AMT so widely misses its original mark while adding inordinate complexity to the tax system for middle-class wage earners due to its interaction with limitations on the various personal credits, there is growing sentiment for its repeal, even among tax “reformers” who originally supported the enactment of the individual AMT.

a. The alternative minimum tax (“AMT”) trap for attorneys’ fees on large recoveries. *Alexander v. IRS*, 72 F.3d 938 (1st Cir. 1995), *aff’d*, T.C. Memo. 1995-51. Attorney’s fees are miscellaneous itemized deductions, and may not be deducted for AMT purposes. The entire recovery of \$250,000, of which \$245,000 was retained by taxpayer’s lawyer as legal fees, was required to be included in gross income. The attorney’s fees were allowable only as a miscellaneous itemized deduction.

b. Attorney’s fees not included in the income of taxpayer who received a large punitive damages award, at least in the Fifth and Eleventh Circuits (as derived from pre-split Fifth Circuit precedents),

under the *Golsen* rule. *Davis v. Commissioner*, T.C. Memo. 1998-248. Willie Mae Barlow Davis recovered \$152,000 of compensatory damages and \$6 million of punitive damages against two companies that made loans to homeowners in Alabama. Her share of the recovery after legal fees and expenses was \$3,039,191. 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. 1993). 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. In *Davis*, which was appealable to the Eleventh Circuit, the Tax Court followed *Cotnam* under the *Golsen* rule because under *Bonner v. City of Prichard, Alabama*, 661 F.2d 1206 (11th Cir. 1981), Fifth Circuit decisions rendered before the Eleventh Circuit was created are binding precedent in the Eleventh Circuit.

c. The Eleventh Circuit affirms *Davis*. *Davis v. Commissioner*, 210 F.3d 1346 (2000) (per curiam). The Eleventh Circuit Court of Appeals held that it was bound by *Cotnam*. The IRS argued in the alternative that taxpayer made a taxable disposition of her property in [time-barred] 1989, and that the *Burnet v. Logan* open transaction doctrine applied. The court held that *Burnet v. Logan* applies only when both the asset exchanged and the asset received have an unascertainable value, and "the IRS provided no proof that the values of either the cause of action or the attorneys' services were unascertainable."

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

d. But, not so fast. Tax Court says case involving attorney's fees paid under Texas common law is not bound by *Cotnam*, which involved Alabama law which by statute gives attorneys a substantive right to fees based on their lien. *Srivastava v. Commissioner*, T.C. Memo. 1998-362. The taxpayers were not entitled to exclude the 40% of their settlement proceeds from a personal injury lawsuit that they assigned to their attorneys. Under the Texas common law on attorneys' liens, no ownership interest was transferred to the

attorneys. Judge Parr held that *Cotnam v. Commissioner, supra*, was inapplicable to this case under the Golsen rule because the Texas common law [giving no ownership rights to the attorneys] differed from the Alabama statutory law [“the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them.”]. The attorneys’ fees are deductible for regular income tax only as a miscellaneous itemized deduction governed by § 67, and not deductible at all for alternative minimum tax (“AMT”) purposes. On the issue of allocating the settlement that was entered into after the damage award by the trial court, the Commissioner proposed a method of allocation, suggesting that “it is presumed that actual damages would be paid before prejudgment interest, postjudgment interest, or punitive damages, and that prejudgment interest would be paid before punitive damages.”

◦ To the same effect under Arizona common law attorneys’ liens is *Sinyard v. Commissioner*, T.C. Memo. 1998-364 (Swift, J.).

e. Fifth Circuit: Texas common law lien not subject to AMT trap. *Srivastava* reversed in split decision based upon *Cotnam*. *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000) (2-1). As a matter of original impression, the majority (Judge Jerry Smith) would have included contingent fees in taxpayer’s gross income under the anticipatory assignment of income doctrine, just as non-contingent attorney’s fees included in a damage award are includable in gross income. However, Judge Smith held that *Cotnam* cannot be distinguished because there is no difference in the “economic reality facing the taxpayer-plaintiff” between Alabama and Texas attorney’s liens and any distinction between them does not affect the analysis required by the anticipatory assignment of income doctrine.

◦ 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.

f. The Sixth Circuit creates a split in the circuits on the AMT trap for attorney’s fees. *Estate of Clarks v. Commissioner*, 202 F.3d 854 (6th Cir. 2000). The Sixth Circuit applied *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959) to hold that the taxpayer was not required to include the portion of the taxable interest attached to a damage award excluded under § 104(a)(2) that was paid directly to the taxpayer’s attorney. The Sixth Circuit 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*. The court then went on, however, to provide an arguably broader explanation for its decision, concluding that the opinions representing the weight of authority, e.g., *Baylin v. Commissioner*, 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 an arm's length transaction. The court stated:

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

g. Tax Court: Wisconsin attorney's fees subject to the AMT trap because of assignment of income doctrine. Tax Court majority holds that it was Congress's doing; dissents state that courts can cure the problem. *Kenseth v. Commissioner*, 114 T.C. 399 (2000) (reviewed, 8-5). The Tax Court adheres to its holdings that contingent attorney's fees paid in an age discrimination settlement are includable in taxpayer's gross income. Judge Ruwe specifically declined to follow the Sixth Circuit's *Estate of Clarks* case, and held that taxpayer had income which he could not assign. Judge Chabot dissented on the ground that the assignment of income doctrine was court-made, so the court could grant relief. Judge Beghe (who tried the case) dissented on the ground that taxpayer lacked control over the attorney's share, so it would not be reasonable to include it in his income.

h. Ninth Circuit: Alaska statutory lien law requires entire recovery to be included in taxpayer's gross income. *Coady v. Commissioner*, (9th Cir. 2000). Attorneys' fees awarded on a wrongful termination suit under Alaska law do not reduce the amount includable in taxpayer's income. Instead, the attorneys' fees are deductible as miscellaneous itemized deductions. The court refused to follow *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), and *Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000), but chose instead to follow *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995), and *Alexander v. IRS*, 72 F.3d 938 (1st Cir. 1995). Alaska's statutory attorney's lien provisions do not create a superior lien or ownership interest in the cause of action – as they do in Alabama and Michigan – but specifically subordinate the lien to “the rights existing between the parties to the action or proceeding.”

• *Accord Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000). The portion of a taxable damage award retained by the taxpayer's attorney as a contingent fee under California attorney's fee lien law was includable in taxpayer's income, following *Coady*. The Sixth Circuit decision in *Estate of Clarks* was distinguished on the grounds of the different attorney's fee lien law involved there and the inherent conflict with *Estate of Clarks* was ignored.

i. But Cotnam doesn't apply to all Alabama attorney's fees. Wait a minute, yes it does. *Foster v. United States*, 106 F. Supp. 2d. 1234 (N.D. Ala. 2000), *aff'd in part, rev'd in part*, 249 F.3d 1275 (11th Cir. 2001). Taxpayer received a favorable jury verdict that included \$1,000,000 of [taxable] punitive damages. Under an Alabama statute, the trial judge reduced the punitive damage award to \$250,000. Taxpayer had agreed to pay her attorney a contingent fee of 50% for the trial. For the appeal, the contingent fee arrangement was amended to treat all post-judgment interest collected as an additional contingent fee. The district court held that under *Cotnam* the taxpayer could treat the originally agreed upon contingent fee as excluded from gross income and received directly by the attorney, but the post judgment interest paid as the additional contingent fee was includable in gross income and deductible under § 212. At the point that contingent fee arrangement was negotiated, the taxpayer's claim, which had been upheld by the jury, had value and the "uncertainties" of the appellate process were not sufficient to displace the applicability of the assignment of income principles.

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

j. Whether a profit-seeking expense is deductible under § 162 or, on the other hand, under § 212, and thereby subject to the myriad of more restrictive ancillary rules, turns on the "origin and character of the claim for which the expense was incurred and whether the claim bears a sufficient nexus to the taxpayer's business." *Guill v. Commissioner*, 112 T.C. 325 (1999). Taxpayer was a sole proprietor/independent contractor insurance agent who after having been fired by an insurance company sued the insurance company and collected compensatory damages for breach of contract and conversion of business profits, together with punitive damages. The taxpayer deducted his legal fees on Schedule C, but the IRS took the position that the taxpayer's attorney's fees were deductible under § 212 as itemized deductions

[subject to the myriad of limitations on deductibility of miscellaneous itemized deduction]. The Tax Court (Judge Laro), in what was described as a case of first impression, held that under a variation of the ubiquitous “origin of the claim” test, the attorney’s fees were deductible above the line under § 162.

• One wonders how this was a case of first impression since in *Srivastava v. Commissioner*, T.C. Memo. 1998-362, the Tax Court held that plaintiff’s attorney’s fees incurred in a defamation suit were § 212 expenses, not § 162 expenses *even though the defamation related to the taxpayer’s conduct of his medical practice*, obviously a trade or business. The court reasoned that whether the defamatory attack was on the personal reputation or the professional reputation, the defamation is personal in nature even though it may have derivative consequences for the business, relying on *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983) and *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986), *aff’d*, 848 F.2d 81 (6th Cir. 1988). But, in *Fabry v. Commissioner*, 111 T.C. 305 (1998), the Tax Court held that “injury to business reputation” [which in that case resulted from the effect on the taxpayer’s products of defective products purchased from a supplier] is not as a matter of law a “personal injury.” One further wonders how this aspect of *Srivastava* can be reconciled with *Guill* and *Fabry* other than as an idiosyncratic anomaly attributable to the torturous history of the interpretation of § 104(a)(2).

2. *Noons v. Commissioner*, T.C. Memo. 2000-106. Legal fees to defend criminal charges arising out of the allegedly fraudulent acquisition by a FSLIC employee of an underperforming promissory note from the original lender, which had been placed in receivership by FSLIC, were deductible as a miscellaneous itemized deduction, not as a § 162 trade or business deduction, because the taxpayer was not in the trade or business of acquiring and selling promissory notes. The deduction was disallowed under the AMT.

3. TTREA ‘98 § 2001 amends § 26(a) to allow nonrefundable personal credits fully against regular tax liability during 1998, and amends § 24(d)(2) to provide that the additional [\$400] child tax credit is not reduced by AMT during 1998.

a. **1999 Act.** For taxable years beginning in 2000 and 2001 the child and education credits may offset the excess of regular tax liability over AMT. For years after 2001, the rule reverts to the pre-1998 rule, under which the credits may offset only the excess of regular tax liability over AMT liability.

4. **It’s just business – nothing personal (even though he also went to burlesque shows just to listen to the band).** At least Gladstone did not try to deduct expenses incurred in his quest to save prostitutes. *Vitale v. Commissioner*, T.C. Memo. 1999-131, *aff’d by order*, 217 F.3d 843 (4th Cir. 2000). A Treasury department budget analyst engaged in a part-time activity

writing a book about legalized prostitution, titled “Searchlight Nevada,” which was published and marketed and in researching and writing a sequel entitled “Nevada Nights, San Joaquin Dawn.” Judge Fay found that taxpayer was engaged in the activity for profit and that he was allowed to deduct most of his expenses (including expenses in excess of income from the activity), even though not all were documented; the *Cohan* rule was applied. Amounts paid to prostitutes for “interviews,” however, were nondeductible as inherently personal expenses, even to the extent documented by a journal and credit card receipts.

5. All he needed was a little cooperation from his ex – wonder why he didn’t get it. *Miller v. Commissioner*, 114 T.C. 184 (2000). Under § 152(e)(2) the actual signature of the custodial spouse on the declaration [Form 8332] is crucial to shifting the dependency exemption to the noncustodial spouse. Even though a state court order, which had been signed by the custodial former spouse’s attorney, allocated the dependency exemptions to the noncustodial father, the noncustodial father was not entitled to claim the dependency exemptions with respect to his children, even though he attached a copy of the court order to his return, because his former wife had not personally signed a waiver of her right to claim the exemptions.

6. Maybe if he’d trampled down some of their shrubs in making good his escape. *Chamales v. Commissioner*, T.C. Memo. 2000-33. O.J. Simpson’s neighbors in the Brentwood section of Los Angeles could not deduct as a casualty loss the diminution in value of their home that they attributed to the murder of Nichole Brown Simpson and Ronald Goldman and the subsequent focus on O.J. Simpson as a suspect.

7. *Strange v. Commissioner*, 114 T.C. 206 (2000). The taxpayer paid nonresident state income taxes to nine states on net royalty income derived from interests in oil and gas wells located within those states. In calculating total net royalty income, and thus AGI, the taxpayer deducted the state income taxes they paid. The Tax Court (Judge Parr) held that the revision of § 164 by the Revenue Act of 1964 did not alter the pre-existing law under which state income taxes were deductible only as itemized deductions. State nonresident income taxes [unlike property taxes] are not “attributable” to property held for the production of royalties and, therefore, are not deductible under § 62(a)(4) in computing AGI.

8. Rev. Rul. 2000-24, 2000-19 I.R.B. 963 Expenses (registration and transportation) incurred to attend a medical conference relating to the chronic disease of the taxpayer’s dependent are deductible medical expenses if the costs are primarily for and essential to the medical care of the dependent. The cost of meals and lodging while attending the conference is not deductible because

neither the taxpayer nor the taxpayer's dependent is receiving medical treatment.

9. Did the Bible foresee the Internal Revenue Code? *Miller v. Commissioner*, 114 T.C. 511 (2000). The taxpayers held a religious belief that a social security number was the "mark of the Beast" warned against in the Bible at Revelations 13:16-17 and consequently refused to obtain social security numbers for their children. Their religious beliefs, which did not meet the requirements of § 1402(g) to excuse them from participation in the Social Security system, however, did not excuse them from complying with the § 151(e) requirement to provide an SSN as a condition for claiming the dependency exemption for their children. The requirement that taxpayers provide an SSN for children claimed as dependents, rather than a TIN, which the taxpayers were willing to obtain but which the IRS would not issue because children were eligible for an SSN, did not violate the Religious Freedom Restoration Act because the government has a compelling interest in preventing improper claims of dependency exemptions and administering the system in a uniform and fair manner. *Davis v. Commissioner*, T.C. Memo. 2000-210, reached the same result.

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

a. And the taxpayer concedes. 86 A.F.T.R.2d 6432, 2001-1 U.S.T.C. ¶ 50,153 (Fed. Cl. 9/18/00). On further proceedings after remand, summary judgment was granted to government because Mellon Bank stipulated that its evidence would not meet the requisite legal standard [determined in the Federal Circuit's opinion] to prevail.

11. No carrots for Mr. Ed helps taxpayer prove that horse breeding is a business, not a hobby. *Jordan v. Commissioner*, T.C. Memo. 2000-206.

A thoroughbred horse breeding activity conducted by taxpayers who did not have “any affectionate attachment to any of their race horses in particular, or to horses in general” and did not use their horses for farm or recreational purposes was conducted with a profit-seeking motive. It was not improbable that taxpayers’ cumulative losses could be recovered by a single successful foal, and the court could “see no other reason why [taxpayers] would have engaged in the activity and incurred the resulting expenses unless for profit.”

12. Listen to your parents and always tell the truth. *Novak v. Commissioner*, T.C. Memo. 2000-234. The taxpayer was a physician whose Arabian horse breeding activity losses were disallowed despite the fact that he was an expert in horse breeding and hired many experts. Among other things, he did not have a business plan and admitted that he would never be able to recoup the losses – more than \$1.2 million over 12 years, without a single profitable year. He also admitted that he became a doctor instead of a school teacher because while he was in college he father advised him “if you ever want to have horses you can’t be a school teacher, you’ve got to find a job where you can make some money, be a doctor or a dentist.”

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

14. No, you can’t report your W-2 income on schedule C to beat the § 67 haircut on deducting employee business expenses. *D’Acquisto v. Commissioner*, T.C. Memo. 2000-239. A TV commercial voice-over actor was an employee of numerous employers, not an independent contractor, because he did not control how the scripts were performed. His right to pick and choose which jobs to accept did not render him an independent contractor. And he received numerous W-2s without protesting to the issuing employers.

15. The sound and the fury. ILM 200038059 (9/22/00), *modifying* ILM 200034029 (7/25/00). The first legal memorandum determined that the parents of a kidnapped child may take a dependency exemption for the year of the kidnapping, but not thereafter because they may not meet the § 152(a) support test for the child. The second legal memorandum determines that where the child was kidnapped by a stranger, i.e., where no individual other than the parents has legal custody of the child or would be entitled to claim a dependency exemption, “it should ordinarily be presumed that the parents have incurred sufficient expenses for the support of the child to satisfy the support requirement of § 152(a).”

a. Who would oppose this bill just before Election Day? On 9/26/00, the House unanimously passed H.R. 5117 to permit the parents to continue to claim the dependency exemption, the child credit, the earned income credit, and their filing status for later years [during the child's minority] in which the child remains missing after being kidnapped by a non-family member.

b. The provision was enacted as part of the Community Renewal Act of 2000.

16. Is the EITC welfare or is it a tax refund? It matters in bankruptcy. *Williamson v. Jones*, 224 F.3d 1193 (10th Cir. 2000), *aff'g In re Montgomery*, 219 B.R. 913 (BAP 10th Cir. 1998). As result of the advance availability of the EITC under § 3507, even if a taxpayer does not claim advance credits under that provision, a refund attributable to the taxpayer's EITC upon filing a tax return can become part of the taxpayer's bankruptcy estate for the portion of the year to which the EITC relates that was prior to the date the taxpayer filed for bankruptcy.

17. Not so smarty after all. *Geary v. Commissioner*, 235 F.3d 1207 (9th Cir. 2000). This case dealt with expenses incurred by a San Francisco police officer to put an initiative on the local ballot that would allow him to patrol his beat in North Beach using a ventriloquist's dummy to assist in breaking down language/cultural barriers in the neighborhood. The dummy's name was "Puppet Officer Brendan O'Smarty." Apparently Geary's supervisors ordered him to stop using the puppet "because it makes the department look stupid." Geary took the issue directly to San Francisco voters – and won. The expenses of his public referendum were disallowed under § 162(e)(1)(C) as nondeductible lobbying expenses (i.e., this provision disallows business deductions for expenses incurred "in connection with any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums").

VI. CORPORATIONS

A. Entity and Formation

1. No more double-counting § 357(c) gains in basis. Pub. L. No. 106-36, the Miscellaneous Trade and Technical Corrections Act of 1999, amended § 357(c) and added new § 357(d) to limit basis increases attributable to assumption of liabilities not to exceed the fair market value of the property transferred. Abuses had resulted where properties subject to liabilities were transferred to different corporations, with the result that both corporations

increased basis by the same liabilities. The provision is applicable to transfers made after 10/18/98.

B. Distributions and Redemptions

1. T.D. 8924, *Liabilities Assumed in Certain Corporate Transactions*, 66 F. R. 723 (1/3/00), corrected, 66 F. R. 10190 (2/14/01). Temporary Reg. § 1.301-1T(g) applies rules similar to those of § 357(d) [for determining when a liability is assumed] for purposes of determining when the amount of a distribution will be reduced under § 301(b). [Identical proposed regulations in REG-106791-00 (1/3/01).] A recourse debt has been assumed only if, based on all the facts and circumstances, the transferee has agreed to pay the debt regardless of whether or not the transferor has been relieved of liability vis-à-vis the creditor. A transferee is treated as assuming any nonrecourse debt encumbering property it receives, but the amount of the debt assumed is reduced by the lesser of (1) the amount of the debt secured by assets not transferred that another person or corporation has agreed (and is expected to) satisfy, or (2) the fair market value of the other assets secured by the debt.

2. *Sharewell, Inc. v. Commissioner*, T.C. Memo. 1999-413. One of taxpayer's shareholder-employees retired and his stock was redeemed pursuant to a contract calling for the retiring shareholder to be paid \$1.3 million, of which \$300,000 was deferred and represented by an assignment of certain accounts receivable. Twelve days after the agreement was signed, the taxpayer and the retiring shareholder executed a letter agreement denominated "non-compete agreement," whereby the retiring shareholder agreed not to compete for three years in consideration of the \$300,000 of accounts receivable referred to in the shareholder agreement. The court held that even though the retiring shareholder reported the entire \$1.3 million as amount realized on redemption of his stock, because there was (1) evidence of mutual mistake, (2) the non-compete agreement was subsequent to, not prior to, the purchase agreement, and (3) together the two written documents created an ambiguity, the *Danielson* [378 F.2d 771 (3d Cir. 1967)] rule, which had been adopted by the circuit to which the case was appealable, did not apply. On the facts, the parties had agreed to allocate \$300,000 to the non-compete agreement, and because they had no tax adverse interests, i.e., the amount allocated to the non-compete would be deferred but the stock purchase price would not be deferred, the allocation would be respected and taxpayer allowed an amortization deduction.

3. **Doctors are still pathologically addicted to tax shelters doomed to failure. Failed VEBA life insurance-based tax shelter results in constructive dividends.** *Neonatology Associates, P.A. v. Commissioner*, 115 T.C. 43 (2000). In these consolidated cases, several employer/participants [doctors and medical professional associations] made contributions to separate

plans formed under two purported [§ 419A(f)(6) ten-or-more-employer] VEBAs “crafted by ... insurance salesmen ... and marketed to professional small business owners as a viable tax planning device.” Each plan provided that a covered employee [usually a shareholder of the corporate employer] would receive term life insurance benefits. But the premiums on the underlying insurance policies substantially exceeded the cost of term life insurance because they funded not only the purchase of term insurance, but also “credits” that, together with interest on the account in which the excess amounts were set aside, would be applied to convert, at the employee-beneficiary’s option, the term insurance into individual universal life policies with cash value, for each of the individual insureds. The conversion credits were earned over 120 months, but substantially vested only in the fifth year. As a result, after five years, a policyholder could withdraw any earned amount or borrow against it with no out-of-pocket expense. Judge Laro found that the plans were “marketed to professional, small business owners as a viable tax planning device [and] [t]he VEBA scheme was subscribed to by varied small businesses whose employee/owners sought primarily the advertised tax benefits and tax-free asset accumulation. The subject VEBAs were not designed, marketed, purchased, or sold as a means for an employer to provide welfare benefits to its employees.” The court disallowed all of the § 162 deductions for contributions to the plan in excess of the cost of group term life insurance [which was allowable under Reg. § 1.162-10(a)]. The remainder of the contributions constituted distributions of “excess cash for the benefit of the employee/owners.” As far as the corporate employers and their shareholder/employees who were plan beneficiaries were concerned, the excess contributions were constructive dividends in the year that the amounts were contributed to the plan. Judge Laro found no evidence that there was any intent that the excess amounts were compensation and found that the evidence positively supported the finding that the purpose and operations of the plans was to surreptitiously provide a tax-free savings device to the shareholder employees. That there was some possibility of forfeiture of the conversion credits [by failure to convert] and that they did not augment death benefits under the term life insurance part of the plan did not alter this conclusion. The forfeitability concepts of § 83 do not apply to distributions [in contrast to compensation] from a corporation to a shareholder-employee.

• Section 6662(a) and (b)(1) penalties for negligence and intentional disregard of the rules and regulations were upheld. “Reliance” on the advice of the life insurance salesman (who was not a tax professional) regarding the tax consequences of the plan was not “reasonable.” Nor does the preparation of returns by a CPA necessarily constitute “reliance” on the advice of a competent professional. The mere preparation of a return by a CPA does not mean that he has “opined” on any or all of the items reported in the return. But, Judge Laro declined to impose \$25,000 penalties under § 6673(a)(1)(B) for frivolous and groundless litigation because taxpayers did reasonably rely on the advice of trial counsel that their positions had merit.

4. Not enough business purpose for a corporate expenditure and too much personal benefit for the shareholder = constructive dividend. Tax Court finds a constructive dividend by reason of the corporation's payment that conferred an economic benefit on the shareholder. *Hood v. Commissioner*, 115 T.C. 172 (2000) (reviewed, no dissents). A corporation's payment of legal fees for the defense of its sole shareholder against a tax evasion charge from income unreported from the predecessor sole proprietorship was held to be a constructive dividend to the shareholder and therefore not deductible by the corporation. From 1978 through 1988 Hood had operated a sole proprietorship that was incorporated as HIF in 1988. Hood was sole shareholder and president. He was an indispensable employee of the corporation. There was no express agreement by HIF to assume the proprietorship's debts, but HIF paid the accounts receivable in the ordinary course. After HIF was incorporated, Hood was indicted and tried, but acquitted, for criminal tax evasion [§ 7201] and false declaration [§ 7206(1)] arising from the alleged failure to report income from the sole proprietorship. HIF paid Hood's legal fees in connection with the criminal charges. The Tax Court (Judge Gale) held that the payment of legal fees was a constructive dividend because it primarily benefitted the sole shareholder. The legal fees were Hood's obligation and HIF was not protecting its own interests – it had not been indicted. Therefore, the corporation could not deduct the expenses. Even though Hood was indispensable to the corporation's business, the payment of his legal fees was not necessary because he had adequate personal assets. The court followed the Fifth Circuit's decision in *Jack's Maintenance Contractors, Inc. v. Commissioner*, 703 F.2d 154 (5th Cir. 1983), *rev'g per curiam* T. C. Memo. 1981-349, and to the extent it was inconsistent overruled its own prior opinion. Judge Gale held that the earlier Tax Court decision should not be followed because there was insufficient consideration given to the possibility of a constructive dividend in that case.

◦ The Tax Court opinion in *Jack's Maintenance* found the legal fees to be deductible because the criminal charge had its origin in a business (rather than personal) situation; query whether tax evasion by a sole proprietor is a business-related matter. Therefore, the Tax Court in the earlier case permitted the legal fees to be deducted by the corporation because the shareholder was "essential" to the corporation's operation. In the current case, the Tax Court found that the payment was made primarily for the benefit of the shareholder.

5. More on constructive dividends. And a possible concession that fees to defend criminal tax fraud cases are deductible by sole proprietors. *Midwest Stainless, Inc. v. Commissioner*, T.C. Memo. 2000-314. The owner of a sole proprietorship incorporated the business but continued to directly receive payments for jobs in progress at the time the business was incorporated. The corporation treated the receipts as its own for book and tax purposes and entered

a receivable from the shareholder on its books [which the parties stipulated was a valid debt]. The shareholder was indicted for failing to report income of the sole proprietorship on his pre-incorporation personal income tax returns and paid his own legal fees. However, the corporation claimed a deduction for the amount of the legal fees and correspondingly reduced the receivable from the shareholder. The parties agreed that the corporation was not entitled to deduct the legal defense fees and that shareholder was entitled to deduct them on his personal returns as schedule C expenses. The Tax Court (Judge Beghe) held that the reduction of the receivable on the corporation's books was a constructive dividend to the shareholder because it increased his net worth. The court rejected the taxpayer's legal argument that a constructive dividend cannot arise without a corporate outlay, as well as the taxpayer's factual argument that the book entry made by the corporation's accountant reducing the debt was equivocal.

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

C. Liquidations

1. New § 1060/§ 338 rules. Now there's seven classes of assets, instead of five. REG-107069-97, Purchase Price Allocations in Deemed Actual Asset Acquisitions, 64 F.R. 43461 (8/10/99). The Treasury issued proposed amendments to the regulations under §§ 338 and 1060. Under the proposed regulations, there will be a total of seven classes of assets possible in an acquisition. Proposed Reg. § 1.338-1 through -10, § 1.338(h)(10)-(1) and § 1.1060-1 are intended to clarify the treatment of, and provide consistent rules (where possible) for, both deemed and actual asset acquisitions under §§ 338 and 1060. The IRS identified three major deficiencies in the current regulations: (1) their statement of tax accounting rules and their relationship to tax accounting rules for asset purchases outside of § 338; (2) the effects of the allocation rules; and (3) their lack of a complete model for the deemed asset sale (and, in the case of § 338(h)(10) elections, the deemed liquidation) from which tax consequences not specifically set forth in the regulations can be determined. The proposed regulations also take into account amendments to the Code enacted since the different portions of the current regulations were promulgated.

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

• The seven asset classes are: Class I – cash and cash equivalents; Class II – CDs, securities, foreign currency; Class III – accounts receivable, mortgages, credit card receivables; Class IV – inventory; Class V – all assets not included in the other classes; Class VI – § 197 assets other than goodwill and going concern value; Class VII – § 197 goodwill and going concern value. The change relates to the addition of two new classes of “fast pay” assets, which must receive basis up to fair market value before there is any basis allocated to tangible property.

a. Purchase price allocations in deemed and actual asset acquisitions are promulgated as temporary regulations. T.D. 8858, Purchase Price Allocations in Deemed and Actual Asset Acquisitions, 65 F. R. 1236 (1/7/00). The proposed regulations were promulgated as Temporary Regulations pending further review of comments on the proposed regulations and promulgation of final regulations. Effective 1/6/00.

2. Good news, bad news. *Robson v. Commissioner*, T.C. Memo. 2000-201. If a corporation cancels a debt of a shareholder to the corporation in connection with the complete liquidation of the corporation, the transaction is not treated as cancellation of indebtedness income under § 61(a)(12) subject to § 108. Rather, the amount of the canceled debt is treated as an amount realized in exchange for the stock pursuant to the liquidation under § 331, which results in capital gain treatment.

3. REG-110659-00, Proposed Regulations, Amendment, Check the Box Regulations, 66 F.R. 3959 (1/17/01). Proposed Reg. § 301.7701-3(g)(2)(ii) would provide that if an unincorporated entity that previously had elected to be taxed as a corporation elects to convert to a partnership, it is treated as distributing all of its assets to its shareholders in a taxable liquidation, followed by the contribution of all the assets to a newly formed partnership. If the entity elects to convert from a corporation to a disregarded entity, it is deemed to have distributed its assets to its owner. Sections 332 and 337 can apply if the owner is a corporation. To facilitate application of § 332, the proposed regulations provide that a plan of liquidation is deemed to have been adopted immediately before the deemed liquidation resulting from the election to change entity

classification, unless a formal plan of liquidation that contemplates the filing of the elective change was adopted at an earlier date.

D. S Corporations

1. Final Passthrough and Basis Adjustment Regulations. T.D. 8852, Passthrough of Items of an S Corporation to its Shareholders, 64 F.R. 71641 (12/22/99) [proposed in REG-209446-82, 63 F.R. 44181 (8/18/98)]. Amended Regs. §§ 1.1366-1 through 1.1366-5, 1.1367-1(e), (f), (g), (h) and (j), 1.1366-3, 1.1368-1(d), (e), 1.1368-2, 1.1368-3, and 1.1368-4, deal comprehensively with the passthrough of subchapter S corporation income and basis adjustments. The final regulations adopt the proposed regulations with a few modifications. The final regulations clarify that the allocation of any tax under § 1375 is based on the total net passive investment income for the taxable year. The final regulations make clear that when a net negative adjustment occurs, the AAA is adjusted to take into account distributions before the AAA is adjusted to take into account any net negative adjustment. Reg. § 1.1366-1(a)(2)(viii), as amended, provides that COD income excluded at the corporate level under § 108 is not “tax exempt” income for purposes of §§ 1366 and 1367.

2. Cancellation of indebtedness income of insolvent S corporations.

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

b. The Tax Court followed its reviewed decision in *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff’d*, 182 F.3d 1152 (10th Cir. 1999), which held that a shareholder of an insolvent S corporation may not increase his stock basis under §§ 1367(a)(1)(A) and 1366(a)(1)(A) by the amount of his pro rata share of the corporation’s [excluded under § 108(a)] discharge of indebtedness income on the theory that the COD income was passed-through exempt income. The Tax Court agreed with the IRS that § 108(d)(7)(A) requires that the exclusion of income apply at the S corporation level, so that the reduction of tax attributes applied by § 108(b) also applies at the corporate level

and the discharge of indebtedness income never passes through to the shareholder. Section 108, through the attribute reduction rules, is generally intended to defer the recognition of income, not to exempt it totally from income.

c. Affirmed. 182 F.3d 1143 (10th Cir. 1999). The Court of Appeals for the Tenth Circuit affirmed, but on different reasoning. It assumed that the COD income was “tax exempt income” under § 1366(a)(1)(A), which potentially could pass through to the shareholders and increase basis. The court agreed with the Commissioner and the Tax Court, however, that § 108(d)(7)(A) requires that the exclusion of income apply at the S corporation level, so that the reduction of tax attributes applied by § 108(b) also applies at the corporate level and the discharge of indebtedness income never passes through to the shareholder. The court further concluded that § 108(d)(4)(A) merely requires that attribute reduction is the last step in the calculations, it does not necessarily defer the attribute reduction until the year following the year in which the excluded COD income is realized. Thus, there was no corporate level income to pass through to the shareholders and to increase their bases. Furthermore, the reduction in tax attributes under § 108(b) absorbed the shareholders’ losses carried over from prior years under § 1366(d)(1).

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

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

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

3. No surprise here. *Ding v. Commissioner*, 200 F.3d 587 (9th Cir. 1999). For purposes of computing self employment tax, a shareholder/employee of an S corporation cannot deduct passed through S corporation losses against Schedule C income from a sole proprietorship. Rev. Rul. 59-221, 1959-1 C.B. 225, followed.

4. *Grojean v. Commissioner*, T.C. Memo 1999-425. An S corporation shareholder who acquired a loan participation interest in a loan from a bank to his wholly-owned S corporation, as required by the lender, by borrowing from the bank was a mere guarantor. The shareholder’s note and the corporation’s note had identical terms and the bank automatically credited payments on the corporation’s note against the shareholder’s note. No cash passed hands between the shareholder and bank in the circular transaction, and shareholder made no economic outlay. The shareholder acquired no additional basis to support passed through losses.

5. Proposed regulations regarding the QSub election have been finalized. T.D. 8869, Subchapter S Subsidiaries, 65 F. R. 3843 (1/25/00) [proposed in REG-251698-96, 63 F. R. 19864]. A qualified subchapter S subsidiary (QSub) is any domestic corporation that (1) is not an ineligible corporation, (2) is wholly owned by an S corporation, and (3) for which the parent S corporation elects to treat as a QSub. Section 1361(b)(3)(B). Election procedures are described in Reg. § 1.1361-3(a). A corporation for which a QSub election is made is not treated as a separate corporation. Transactions between the S corporation parent and the qualified S corporation subsidiary are not taken into account for tax purposes. All assets, liabilities, and items of income, deduction, and credit of the QSub are treated as assets, liabilities, and items of

income, deduction, and credit of the parent S corporation. Reg. § 1.1361-4(a)(1). The existence of the stock of a QSub is ignored for tax purposes. Reg. § 1.1361-4(a)(4). If a QSub election is made for a newly formed subsidiary, the subsidiary is treated as a QSub from its inception—the parent and subsidiary both are treated as if the subsidiary never had been formed. In the case of a preexisting subsidiary, as a result of a QSub election the subsidiary is deemed to have liquidated under §§ 332 and 337 immediately before the election is effective. Reg. § 1.1361-4(a)(2), (b).

- Reg. § 1.1361-3(a)(4) allows the effective date of a QSub election to be any specified date within two months and 15 days prior to, or not more than 12 months after, the date the election is made. Unlike an S election, a QSub election does not have to be made within two months and 15 days of the beginning of a taxable year.

- A QSub election may be revoked as of any specified date within two months and 15 days prior to, or not more than 12 months after, the date of the revocation. Reg. § 1.1361-3(b)(2). A QSub that ceases to qualify under § 1361(b)(3)(B) or whose election has been revoked is treated as a new corporation that has acquired all of its assets and assumed all of its liabilities from its S corporation parent in exchange for the subsidiary's stock immediately before the cessation of QSub status. Section 1361(b)(3)(C); Reg. § 1.1361-5(b)(1). This hypothetical transaction is governed by general income tax principles, including § 351 and its associated sections. For purposes of determining control under § 351, equity instruments that are not treated as a second class of stock under § 1361(b)(2)(D) are disregarded. The regulations also provide that the step transaction doctrine is applicable. Thus a disposition of the stock of the former QSub will affect application of § 351. Reg. § 1.1361-5(b)(3), Ex. (1). A QSub whose election has terminated may not have a QSub election made with respect to it (or, if its stock is acquired by eligible shareholders, make an S election itself) before its fifth taxable year that begins after the first taxable year for which the termination is effective without the Service's consent. Section 1361(b)(3)(D); Reg. § 1.1361-5(c). If a QSub election is terminated by reason of the disposition of the stock of the subsidiary by the parent, the new owners may make an immediate S election, without the consent of the IRS, provided that there has been no intervening period in which the corporation was a C corporation. Reg. § 1.1361-5(c)(2).

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

7. When Subchapter S and Subchapter K collided, the aggregate theory of partnership taxation was applied. *Coggin Automotive Corp. v. Commissioner*, 115 T.C. No. 28 (2000). Taxpayer originally was a holding company that had a number of controlled subsidiaries engaged in the retail sale of motor vehicles. The subsidiaries maintained their inventories under the LIFO method, and all of the corporations filed a consolidated return. In 1993, the taxpayer restructured to make an S election. Six new S corporations were formed to become the general partners in six limited partnerships. Each subsidiary contributed its dealership assets to a limited partnership in exchange for a limited partnership interest, following which the subsidiaries were liquidated and the taxpayer became the limited partner in each. The Commissioner asserted that the taxpayer's conversion to an S corporation triggered the inclusion of the affiliated group's pre-S-election LIFO reserves (approximately \$5 million) under § 1363(d). The Commissioner argued alternatively (1) that the restructuring should be disregarded because it had no purpose independent of tax consequences, and (2) that under the aggregate approach to partnerships, a pro rata share of the pre-S-election LIFO reserves (approximately \$4.8 million) was attributable to the taxpayer as a partner. The Tax Court (Judge Jacobs) rejected the Commissioner's first argument, holding that the restructuring was a genuine multiple-party transaction with economic substance, compelled by business realities and imbued with tax-independent considerations. But Judge Jacobs accepted the Commissioner's second argument, holding that application of the aggregate approach [rather than the entity approach] to partnership taxation furthered the purpose of § 1363(d). Thus, the taxpayer was treated as owning a pro rata share of the partnerships' inventories and as a result of its election it was required to include \$4.8 million of LIFO recapture.

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

determining the relevant Congressional intent in enacting the non-subchapter K provision involved in each case.

E. Affiliated Corporations

1. REG-106219-98, Acquisition of an S Corporation by a Member of a Consolidated Group, 63 F.R. 69581 (12/17/98). The Treasury has issued proposed regulations amending Reg. § 1.1502-76 on consolidated group acquisition of 80% or more of an S corporation's stock. The proposed regulations provide that the S corporation becomes a member of the group at the beginning of the day of its acquisition and its tax year ends at the end of the previous day.

a. T.D. 8842, Acquisition of an S Corporation by a Member of a Consolidate Group, 64 F.R. 61205 (11/10/99). Final consolidated return regulations, amending Reg. § 1.1502-76, provide specific rules that apply to the acquisition of the stock of an S corporation by a member of the consolidated group.

2. **Losses suffered by a profitable corporation were not part of a group's consolidated net operating loss.** *Intermet Corp. v. Commissioner*, 111 T.C. 294 (1998). For 1992, the taxpayer's consolidated group reported a consolidated net operating loss of nearly \$26 million. Three of the members of the group reported positive taxable income but reported deductions of \$1,226,000 that arguably were specified liability loss deduction items within the meaning of § 172(f)(1). [The items were state and local taxes and interest on federal taxes relating to a year more than three years before 1992.] Judge Wells held that under Reg. §§ 1.1502-12 and 1.1502-21A, the group's specified liability losses did not include the deductions in question because members of the group that reported positive separate taxable income did not contribute to the group's consolidated NOL. Accordingly, the 10-year carryback period of § 172(b)(1)(C) did not apply with respect to a portion of the consolidated NOL equal to the items in question. [The court did not reach the question of whether the items were specified liability losses under § 172(f)(1), as in effect for 1992, in the first place.]

a. **But on appeal the taxpayer wins.** 209 F.3d 901 (6th Cir. 2000). The Court of Appeals assumed that the losses in question were specified liability losses [because the Tax Court did not reach the issue], and allowed them to be carried back. The court reasoned that the subsidiary's specified liability loss deduction items reduced the subsidiary's separate taxable income dollar-for-dollar and thus contributed to the consolidated NOL. An individual component member's taxable income has no independent significance; it is merely a step in computing the consolidated NOL. There was no basis in Reg.

§ 1.1502-21A for treating a specified liability loss as constituting part of the consolidated NOL when the member that incurred the deduction had negative taxable income but not when that member had positive separate taxable income [as long as a SRLY year is not involved].

3. On the same issue, the Fourth Circuit reversed a district court decision and found in favor of the Government. *United Dominion Industries, Inc. v. United States*, 208 F.3d 452 (4th Cir. 2000). A consolidated group may not carry back separate return product liability expenses, i.e., product liability expenditures by profitable corporations, because these do not enter into the consolidated net operating loss, and the statute speaks of specified liability losses – not specified liability expenses. Instead, only that portion of a member’s separate net operating loss attributable to specified liability losses may enter into the computation of the portion of the consolidated NOL attributable to specified liability losses.

4. And the Supreme Court appears to have developed a taste for corporate tax cases. Certiorari was granted to the Fourth Circuit in *United Dominion Industries, Inc.*, 121 S. Ct. 562 (2000).

5. Consolidated return duplicated loss disallowance Regs are valid. *Rite Aid Corp. v. United States*, 46 Fed. Cl. 500 (2000). Reg. § 1.1502-20, which, subject to certain exceptions, disallows *any* loss realized by a member of a consolidated group upon the disposition of the stock of a subsidiary, is valid and is not in derogation of § 165. Under Reg. § 1.1502-20, the amount of loss that is disallowed is limited to the sum of (1) income or gain resulting from “extraordinary gains dispositions,” which are defined as dispositions of capital assets, depreciable property used in the trade or business, certain bulk asset dispositions, and discharge of indebtedness income, (2) positive investment adjustments (other than those attributable to extraordinary gain dispositions), and (3) “duplicated loss,” which is the aggregate of the subsidiary’s asset bases and loss carryovers over the value of the subsidiary’s assets. Any losses in excess of these amounts are deductible. Reg. § 1.1502-20 is designed to prevent “duplicated losses” — the deduction by both the parent and subsidiary of the same economic loss. Rite Aid sold a subsidiary (Encore) and realized a taxable loss of \$33 million and an “economic loss” of \$22 million, which it claimed should be deductible. The court held that because Encore’s built-in loss of \$28 million [as calculated by Rite-Aid] exceeded Rite-Aids’ economic loss, no loss deduction was allowed. The court pointed out that Rite Aid could have avoided Reg. § 1.1502-20 by finding a buyer who would agree to a § 338(h)(10) election.

6. Zero basis no more. T.D. 8883, Guidance Under Section 1032 Relating to the Treatment of a Disposition by One Corporation of the Stock of

Another Corporation in a Taxable Transaction, 65 F. R. 31073 (5/16/00). The Treasury has promulgated final regulations under § 1032 on use of parent's stock by subsidiary to acquire property or services. If an acquiring corporation receives its parent corporation's stock in a § 362(a) transaction and "immediately" transfers the stock for money or other property in a purchase-type transaction, the transaction is treated as if the acquiring corporation had purchased the issuing [parent] corporation's stock at FMV with cash contributed by the issuing corporation immediately before the transaction.

7. So just when will this suspended loss be allowed? *Textron, Inc. v. Commissioner*, 115 T.C. 104 (2000). In 1967, when AVCO acquired Paul Revere (PR) and PR became part of the AVCO group, PR owned four 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 AVCO had been acquired by *Textron*, 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 (1998), rev'd, 209 F.3d 901(6th Cir. 2000).¹³ 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

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

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 “nonmember”. 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 PR 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 7/12/95, 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 were 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) 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).

8. Notice 2000-53, 2000-38 I.R.B. 293. The IRS will promulgate regulations providing elective transitional relief from retroactive repeal of the SRLY rules when §§ 382 or 383 applies, as provided in T.D. 8823, Consolidated Returns—Limitations on the Use of Certain Losses and Deductions, 64 F.R. 36092 (7/2/99), amending Reg. §§ 1.1502-15, -21, and -22.

9. REG-103805-99, Agent for Consolidated Group, 65 F.R. 57755 (9/26/00). Proposed Reg. §§ 1.1502-77 and -78 would clarify and supplement the rules concerning the agent for a consolidated group and the designation of a new agent for the group. Under the proposed regulations the common parent remains the agent as long as it continues to exist as a corporation, even if it ceases to be the common parent. The common parent also is the agent for any corporation improperly included in the consolidated return. The proposed regulations continue the current rule that if the common parent ceases to exist it may designate another member of the group as its successor agent. If no such designation is made, the IRS may designate the successor agent. The current rule permitting the remaining members to designate the successor agent will be removed. Effective upon publication of final regulations. The proposed regulations would deal with the *Interlake Corp.* [112 T.C. 103 (1999)] problem by providing that a refund resulting from a carryback of a NOL under § 172 should be paid to the common parent or agent for the carryback year.

F. Section 482

1. The Tax Relief Extension Act of 1999 amended § 6103(b)(2) to include within the definition of “return information” an advance pricing agreement (APA) under § 482 as well the application and any background information submitted in connection with the application for the APA.

G. Reorganizations and Corporate Divisions

1. What, a little theoretical consistency across types of reorganizations – What will they think of next? REG-115086-98, The Solely for Voting Stock Requirement in Certain Corporate Reorganizations, 64 F. R. 31770 (6/14/99), Proposed Reg. § 1.368-2(d)(4)(i)-(iii) would vitiate the application of the *Bausch & Lomb* doctrine in § 368(a)(1)(C) stock-for-asset reorganizations. The new rules will be effective upon publication of final regulations, subject to the usual grandfathering of transactions pursuant to a binding agreement at that time.

◦ *Bausch & Lomb Optical Co. v. Commissioner*, 30 T.C. 602 (1958), *aff'd*, 267 F.2d 75 (2d Cir.), cert. denied, 361 U.S. 835 (1959), upheld the IRS’s position in Rev. Rul. 54-396, 1954-2 C.B. 147, that the acquisition of assets of a partially controlled subsidiary cannot not qualify as a tax-free reorganization under § 368(a)(1)(C). The rationale of the *Bausch & Lomb* doctrine is that the acquisition violates the solely for voting stock requirement, because the parent corporation acquires only part of the subsidiary’s assets in exchange for its voting stock, with the remaining portion of the subsidiary’s assets being acquired in a liquidating distribution in exchange for previously held stock of the subsidiary.

◦ The *Bausch & Lomb* doctrine has been criticized because (1) a transaction in which a parent corporation converts an indirect ownership interest in a subsidiary’s assets to a direct interest does not resemble a sale, and (2) the taxable treatment of the “upstream” type C reorganization under the *Bausch & Lomb* doctrine is inconsistent with the tax-free treatment of the “upstream” type A reorganization.

◦ Under the proposed regulations, preexisting ownership of a portion of a target corporation’s stock by an acquiring corporation generally will not negate satisfaction of the solely for voting stock requirement in a C reorganization. If in connection with a potential C reorganization the acquiring corporation acquires any target corporation’s stock for consideration other than its own voting stock (or its parent’s voting stock if the parent’s stock is used in attempted C reorganization), whether from a shareholder of the target corporation or from the target corporation itself, such consideration will be treated as money or other property exchanged by the acquiring corporation for the target corporation’s assets for purposes of applying the boot limitation in § 368(a)(2)(B). Whether there has been an

acquisition in connection with a potential C reorganization of a target corporation's stock for consideration other than voting stock will be made on the basis of all of the facts and circumstances.

a. Notice 2000-1, 2000-2 I.R.B. 288. The effective date of the proposed regulations was changed to transactions occurring after 12/31/99. Taxpayers may also obtain letter rulings permitting them to apply the proposed regulations to transfers taking place on or after 6/11/99.

b. **Regulations are made final.** T.D. 8885, *The Solely for Voting Stock Requirement in Certain Corporate Reorganizations*, 65 F.R. 31805 (5/19/00). The *Bausch & Lomb* repeal regulations on creeping C reorganizations were finalized.

2. Divisive transactions fail to qualify as A reorganizations despite being accomplished under a state [Texas] "merger" statute. Rev. Rul. 2000-5, 2000-5 I.R.B. 436. Transactions in which (1) a target corporation "merges" under state law with and into an acquiring corporation [but does not go out of existence], or (2) a target corporation "merges" under state law with and into two or more acquiring corporations [and goes out of existence], do not qualify as mergers under § 368(a)(1)(A).

a. **Definition of "merger" revised in new proposed regulation.** REG-106186-98, *Certain Corporate Reorganizations Involving Disregarded Entities*, 65 F.R. 31115 (5/16/00). Proposed Reg. § 1.368-2(b)(1) would be revised to require that by operation of state, etc. merger law "the transaction must result in one corporation acquiring the assets of the merging corporation and the merging corporation ceasing to exist" [with similar requirements for consolidations]. Mergers involving disregarded entities are not A reorganizations. They may qualify as type C reorganizations if the requirements are met.

- These proposed regulations would encompass the matters ruled upon in Rev. Rul. 2000-5, relating to the Texas "merger" statute.

3. What continuity of interest? Rev. Rul. 99-58, 1999-2 C.B. 701. The open market purchase of its shares by a publicly traded corporation following a tax-free reorganization in which the shareholders of the target corporation received 50% cash and 50% stock does not violate the continuity of interest requirement under Reg. § 1.368-1(e), even though the acquiring corporation's intent to repurchase shares [to prevent dilution] had been announced prior to the reorganization, because the repurchase was not negotiated with the target or its shareholders and there was no "understanding" between the acquiring corporation and the target shareholders that their ownership would be transitory.

4. Guidance under § 356 relating to the treatment of nonqualified preferred stock and other preferred stock in certain exchanges and distributions. T.D. 8904, Treatment of Nonqualified Preferred Stock and Other Preferred Stock in Certain Exchanges and Distributions, 65 F.R. 58650 (10/2/00) [Proposed in REG-105089-99, 65 F. R. 4203 (1/26/00)]. The Taxpayer Relief Act of 1997 amended §§ 351, 354, 355, 356, and 1036 to provide that nonqualified preferred stock (as defined in § 351(g)(2)) (NQPS) received in an exchange or distribution will not be treated as stock or securities but, instead, will be treated as “other property” or “boot.” Under §§ 354(a)(2)(C), 355(a)(3)(D), and 356(e)(2), NQPS is treated as stock, and not other property, in cases where the NQPS is received in exchange for, or in a distribution with respect to, NQPS. As a result, the receipt of NQPS in exchange for NQPS will not result in gain or loss recognition. NQPS (as defined in § 351(g)(2)) received in an exchange will not be treated as stock or securities but, instead, will be treated as “other property” or “boot.” As a result, the receipt of NQPS stock will result in recognition of gain under § 356 unless a specified exception applies. Sections 354(a)(2)(C), 355(a)(3)(D), and 356(e)(2) provide that NQPS is treated as stock rather than as other property in cases where the NQPS is received in exchange for, or as a distribution on, other NQPS. As a result, the receipt of NQPS in such an exchange will not result in recognition of gain or loss under §§ 355 or 356. Regulations §§ 1.354-1(f), 1.355-1(d), and 1.356-7(c) provide additional rules to deal with various aspects of exchanges of NQPS in reorganizations. Under the general rule in the regulations, the nonrecognition rule applies only if NQPS is received with respect to “substantially similar” NQPS. Stock is substantially identical if two conditions are met: (1) the stock received does not contain any terms which, in relation to the terms of the stock previously held, decrease the period in which a redemption or purchase right will be exercised, increase the likelihood that such a right will be exercised, or accelerate the timing of the returns from the stock instrument (including the receipt of dividends or other distributions); (2) as a result of the receipt of the stock, the exercise of the right or obligation does not become more likely than not to occur within a 20-year period beginning on the issue date of the stock previously held. Stock described in § 351(g)(2) is NQPS for these purposes regardless of the date on which the stock is issued.

5. A cozy change in the COSI Regulations. T.D. 8898, Continuity of Interest, 65 F. R. 52909 (8/31/00). Final amendments to the COSI regulations, Reg. § 1.368-1(e)(1)(ii) and (e)(6), Ex.9, [generally effective 8/30/00] deal with the effect of pre-reorganization redemptions on the continuity of shareholder interest requirement in corporate reorganizations. The proposed and temporary regulations had provided that, for purposes of determining whether the shareholder continuity of interest requirement had been satisfied in connection with a potential reorganization, a shareholder’s proprietary interest in the target corporation (T) would not be treated as preserved if prior to and in connection

with the acquisition the shareholder's stock was redeemed or to the extent that an extraordinary distribution is made with respect to the stock. In essence, the temporary and proposed regulations treated preacquisition redemptions and distributions as if they were cash boot payments by the acquiring corporation.

• In response to critical comments [including some emphasizing the practice of withdrawing as much of the AAA as possible before the acquisition of an S corporation by a C corporation], the final regulations are substantially different. Final Regs. § 1.368-1(e)(1)(ii) provides that in the event of a preacquisition redemption of its stock or extraordinary distribution by the target corporation (other than one held by the acquirer (P)) the shareholder's proprietary interest is not preserved only to the extent that consideration received prior to the potential reorganization is treated as boot received from P (or a related party) in exchange for T stock for purposes of § 356 (or would be so treated if the T shareholder also had received P stock in exchange for T stock owned by the shareholder [thus dealing with pre-acquisition complete redemptions of one or more shareholders]). All of the facts and circumstances, as well as other sections of the regulations and general principles of tax law, are taken into account in making this determination.

6. Backing into control within 5 years of the spin-off backed them right out of § 355. *McLaulin v. Commissioner*, 115 T.C. 255 (2000). The taxpayers were shareholders of RPI, an S corporation. Until 1993, RPI owned 50% of the stock of Sunbelt (a C corporation); the other 50% was owned by Hutto. In 1993, after protracted negotiations regarding whether RPI should purchase Hutto's stock in Sunbelt or Hutto should purchase RPI's Sunbelt stock, Sunbelt redeemed all of Hutto's stock for cash [\$828,943], which was borrowed from RPI, and property [\$101,000], leaving RPI as Sunbelt's sole shareholder. Later on the same day as the redemption, RPI distributed all of the stock of Sunbelt to RPI's three equal shareholders – the taxpayers — in a transaction intended to qualify as a tax-free spinoff under § 355. The stated purposes of the distribution were to relieve RPI from any potential liabilities arising from Sunbelt's operations, to prepare Sunbelt to go public, and to preserve RPI's S election [the controlling version of § 1361(b) for the year in question prohibited the parent of an affiliated group from being an S corporation].

• The Tax Court (Judge Halpern) held that because RPI's distribution of the stock of Sunbelt occurred less than five years after RPI acquired control of Sunbelt in a transaction in which gain or loss was recognized [i.e., the redemption of Hutto's stock], the distribution failed to satisfy the active business requirement of § 355(a)(1)(C) and (b)(2)(D)(ii). Judge Halpern rejected the taxpayer's "blanket assertion" that a redemption of stock of the other shareholder's stock, thereby backing the parent into control of the subsidiary, never could be treated as the acquisition of control within five years in a taxable transaction. He likewise declined to follow the

Commissioner's argument directly to apply Rev. Rul. 57-144, 1957-1C.B. 123, which would treat any instance in which a redemption resulted in the acquisition of control within five years as a disqualifying acquisition. Rather, he emphasized the negotiations leading up to the transaction and the fact that the cash for the redemption came from RPI to conclude that in this case there was no difference between the transaction as it occurred and a direct purchase by RPI. Accordingly, § 335(c)(1) did not apply to provide nonrecognition at the corporate level; under § 311(b), RPI recognized gain on the distribution of the Sunbelt stock, and the gain passed through to the RPI shareholders under § 1366(a). [The court did not address the Commissioner's argument that the shareholders failed to prove that the distribution was designed to achieve a corporate business purpose as required by Reg. § 1.355-2(b).]

7. No COBE, not even close. *Honbarrier v. Commissioner*, 115 T.C. 300 (2000). The taxpayer was the sole shareholder of T Corp., which for many years prior to 1988 was in the freight trucking business. Between 1988 and 1990, T Corp. liquidated its freight business and invested the proceeds from the sale of its operating assets in tax-exempt bonds and a municipal bond fund. [T Corp. had been an S corporation until 1992; starting in 1993 T was a C corporation.] On 12/31/93, T Corp. was merged into A Corp., a trucking company in which the taxpayer owned the majority of the stock [his wife and children owning the remainder], in a transaction in which the taxpayer received solely A Corp. stock. A Corp. was an S corporation. Two months before the merger, T Corp. held approximately \$7.35 million of tax-exempt bonds and bond funds and a small amount of cash. On the day of the merger, T liquidated one of its tax-exempt bond funds and its municipal bond fund, and its assets consisted of \$2,415,321 in cash, \$4,849,146 in tax-exempt bonds, \$37,800 in interest and dividends receivable, \$18,926 in money funds, and an ICC operating authority. Before the merger, A Corp. did not hold any tax-exempt bonds; it held cash balances in short-term investments, such as CDs. Immediately following the merger, A Corp. distributed \$7 million to its shareholders, which they treated as a tax-free distribution from T's AAA [which exceeded \$10 million] under § 1368(c)(1). The distribution consisted of \$2,450,854 in cash and tax-exempt bonds worth \$4,549,146 that had been acquired from T Corp. Within four months, A Corp. disposed of the remaining tax-exempt bonds that it acquired from T Corp. The taxpayer and the corporations treated the transaction as a tax-free reorganization under § 368(a)(1)(A).

• The Tax Court (Judge Ruwe) upheld the Commissioner's assertion that the merger was not a tax-free reorganization because the COBE requirement of Reg. § 1.368-1(d) had not been satisfied. T Corp. had abandoned its trucking business long before the merger and had entered into the business of holding tax-exempt bonds and bond funds. This investment business was T Corp.'s historic business at the time of the merger.

A Corp. neither continued the T Corp.'s historic business nor used a significant portion of T Corp.'s historic business assets in a business conducted by A Corp. Therefore, the taxpayer recognized all of the gain realized gain with respect to the T stock disposed of in the merger. T Corp. did not realize any gain in merger because the basis of its assets equaled their fair market value.

8. The wrath of *General Utilities* repeal rewritten. REG-107566-00, Notice of Proposed Regulations, Guidance Under § 355(e): Recognition of Gain on Certain Distributions of Stock or Securities In Connections with an Acquisition, 66 F.R. 66 (1/2/01). Revised Prop. Regs. §§ 1.355-7 and withdrawing proposed regulations issued in REG-116733-98, 64 F. R. 46155 (8/24/99). The new proposed regulations provide that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. They include nonexclusive lists of facts and circumstances to be considered in making the determination and six safe harbors.

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

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

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

or substantial negotiations regarding the second transaction (or, if an acquisition is the second transaction, a similar acquisition) within six months after the first transaction. The ninth considers whether the debt allocation between D and C made an acquisition of D or C likely in order to service the debt.

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

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

- (1) An acquisition more than six months after a distribution if there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is six months after the distribution and the distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate an acquisition. This safe harbor applies if the distribution was motivated in whole or substantial part by a nonacquisition business purpose.

- (2) An acquisition more than six months after a distribution for which there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is six months after the distribution. This safe harbor applies where the distribution was motivated in whole or substantial part by a business purpose to facilitate an acquisition of no more than 33% of the stock of either D or C, and no more than 20% of the stock of the corporation whose stock was acquired in the acquisition that motivated the distribution was either acquired or the subject of an agreement, understanding, arrangement, or substantial negotiations before a date that is six months after the distribution.

- (3) An acquisition more than two years after a distribution if there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within six months thereafter.

- (4) An acquisition more than two years before a distribution if there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within six months thereafter.

(5) If D or C is listed on an established market, an acquisition if the stock is transferred between shareholders of D or C who are not 5% shareholders (subject to certain exceptions).

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

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

H. Personal Holding Companies

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

VII. PARTNERSHIPS

A. Partnership Audit Rules

1. *GAF Corp. v. Commissioner*, 114 T.C. 519 (2000) (reviewed, 10-3). The question was whether the transfer of property to the partnership was to be treated as a sale or as a contribution to capital – an \$80 million question. The IRS issued both a statutory notice to GAF Corp. and an FPAA to the partnership. Judge Ruwe, for the majority, decided that a deficiency notice based on “affected items” issued prior to completion of the related partnership-level proceedings is invalid, so the Tax Court proceeding based on the deficiency notice must be dismissed for lack of jurisdiction.

- Judge Halpern, in dissent, would have overruled the *Maxwell v. Commissioner*, 87 T.C. 783 (1986), line of cases to the extent they hold that the Tax Court lacks subject matter jurisdiction to redetermine a deficiency attributable to an “affected item” until the related

partnership proceeding is completed. The minority would not have dismissed the case, but only would have deferred proceeding until consideration of the affected items was appropriate.

• The related case of *Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner*, 114 T.C. 533 (2000) (reviewed, 8-6), dealt with a partner's motion for summary judgment based upon the running of the statute of limitations, which was denied. The majority did not see dismissal of the partner-level case as mooted the partnership-level case.

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

3. REG-104867-00, Taxable Years of Partner and Partnership; Foreign Partners, 66 F.R. 3920 (1/17/01). Proposed Reg. § 1.706-4 would generally disregard foreign partners who are not subject to U.S. taxation on a net basis, i.e., foreign partners who are not allocated any effectively connected income or, if claiming treaty benefits, that do not have a permanent establishment, for purposes of applying § 706(b) to determine the partnership's permitted year. These rules do not apply if the partnership year would be determined with reference to domestic partners no one of which holds at least a 10% interest and which in the aggregate hold less than 20% of the interests.

B. Miscellaneous

1. Partnership § 179 passthrough is limited to the taxable income of the partnership. *Hayden v. Commissioner*, 204 F.3d 772 (7th Cir. 2000), *aff'g*, 112 T.C. 115 (1999). The court upheld the validity of Reg. § 1.179-2(c)(2), which limits the § 179 deduction passed through to partners to the taxable income of the partnership. The result was dictated by §§ 179(b)(3)(A) and 179(d)(8) themselves.

2. Notice of proposed rulemaking, allocation of partnership debt. REG-103831-99, Allocation of Partnership Debt, 65 F. R. 2081 (1/13/00). Proposed Reg. § 1.752-3(b) would solve problems that have arisen in determining how to determine the amount of § 704(c) minimum gain under Reg. § 1.752-3(a)(2) when a partnership holds multiple properties subject to a single nonrecourse liability. This problem typically occurs when a partnership that holds several properties subject to individual mortgages refinances the individual liabilities with a single nonrecourse mortgage. Under the proposed regulations a partnership that holds multiple properties subject to a single liability may allocate the liability among the properties using any reasonable method. A method is not reasonable if it allocates to any property an amount that exceeds the fair market value of the property. Thus, for example, the liability may be allocated to the properties based on the relative fair market value of each property. The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate liability under Reg. § 1.752-3(a)(2). Once a liability is allocated among the properties, a partnership may not change the method for allocating the liability. If, however, one of the properties ceases to be subject to the liability, the portion of the liability originally allocated to that property must be reallocated to the properties still subject to the liability.

a. Finalized. T.D. 8906, Allocation of Partnership Debt, 65 F.R. 64888 (10/31/00). The Treasury has promulgated final regulations under § 752 relating to the allocation of nonrecourse liabilities by a partnership. The regulation revises and clarifies the rules under tier three of the three-tiered allocation structure. Regs. § 1.752-3(a)(3) also provides that an excess nonrecourse liability may be allocated under the third tier in accordance with excess reverse § 704(c) gain as well as with respect to § 704(c) gain. The final regulations also provide that the rules in Reg. § 1.752-3(a)(3) do not apply to disguised sales under Reg. § 1.707-5(a)(2)(ii).

3. Notice of proposed rulemaking, applying § 197 to partnerships. REG-100163-00, Applying Section 197 to Partnerships, 65 F.R. 3903 (1/25/00). The Treasury issued Prop. Regs. § 1.197-2(h)(12)(ii) regarding when the

§ 197(f)(9) anti-churning rules will be applied to basis increases for § 197 amortizable intangibles under § 732(b) or § 734(b).

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

4. REG-107872-99, *Coordination of Sections 755 and 1060 Relating to Allocation of Basis Adjustments Among Partnership Assets*, 65 F.R. 17829 (4/5/00). The Treasury has promulgated proposed regulations relating to the allocation of basis adjustments among partnership assets under § 755, which implement § 1060(d) [which applies the residual method to partnership transactions in connection with determining the value of § 197 intangibles].

◦ Proposed Reg. § 1.755-2 [to replace Temporary Reg. § 1.755-2T] implements § 1060(d), by applying the residual basis allocation method to all allocations of § 743(b) [and § 734(d)] inside basis adjustments under § 755. These proposed regulations determine the value of the partnership's individual assets, which value is in turn used to determine the allocation under Reg. § 1.755-1 of the inside basis adjustment. Under the proposed regulations, the amount paid for the transferred partnership interest is the benchmark for valuing all of the partnership's assets. The partnership's assets are valued in five tiers: (1) cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions; (2) partnership assets other than cash equivalents, capital assets, § 1231(b) property, and § 197 intangibles (i.e., ordinary income property other than § 1245 recapture and other items treated as unrealized receivables under the flush language of § 751(c)); (3) capital assets and § 1231(b) property other than § 197 intangibles; (4) § 197 intangibles other than goodwill and going concern value; (5) goodwill and going concern value.

5. *Gulley v. Commissioner*, T.C. Memo. 2000-190. Even though under the relevant state law [Texas], a general partner of a limited partnership ceased to be a partner in a partnership upon the partner's bankruptcy, the bankruptcy of the sole general partner of a limited partnership did not terminate the

partnership under § 708(b)(1)(A) because the partnership did not wind up its affairs until a later year. The succession of the chapter 7 bankruptcy estate to the bankrupt partner's 66.67% partnership interest under § 1398 was not a "transfer" resulting in a termination of the partnership under § 708(b)(1)(B). The bankrupt partner's partnership year did not close under § 706(c)(2)(A). Section 706(d) did not apply either. Thus, the passed-through partnership loss for the entire year was allocated to the bankruptcy estate.

6. Penny-wise and pound foolish. How to vaporize depreciation deductions. *Jeyapalan v. Commissioner*, T.C. Memo. 2000-207. The taxpayers formed a partnership to purchase and operate an apartment building. The acquisition was substantially debt financed. Subsequently, to obtain limited tort liability, the partners formed an S corporation and began conducting the rental activity through the corporation. Although title to the building never was transferred to the corporation [because the lender demanded a \$10,000 fee to transfer the liability], the partnership filed a final tax return and the taxpayers held out the corporation as the owner and operator of the building. Only the taxpayer's cash contributions to the S corporation were taken into account in determining the basis limitation on passed-through losses under § 1366(d), and most of the operating losses were disallowed at the shareholder level. [Note that if the partnership had been liquidated and the apartment transferred to the corporation, the shareholders' initial § 358 basis in their stock would have indirectly included the amount of the purchase-money debt on the building].

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

8. REG-106702-00, Determination of Basis of Partner's Interest; Special Rules, 66 F. R. 315 (1/3/01). Prop. Reg. § 1.705-2 would prevent what the IRS has determined to be "inappropriate" increases or decreases in the adjusted basis of a corporate partner's interest in a partnership [consistent with Notice 99-57, 1999-2 C.B. 692] resulting from the partnership's disposition of the corporate partner's stock [under the general principles of Rev. Rul. 99-57, 1999-2 C.B. 678], when: (1) a corporation acquires an interest in a partnership that holds stock in the corporation, (2) the partnership doesn't have a § 754 election in effect for the year in which the corporation acquires the interest, and (3) the partnership later sells or exchanges the stock, then the increase or decrease in the corporation's adjusted basis in its partnership interest resulting

from the sale or exchange of the stock equals the amount of gain or loss that the corporate partner would have recognized (absent the application of § 1032) if, for the tax year in which the corporation acquired the interest, a § 754 election had been in effect. The rule would be effective retroactively to gain or loss allocated on sales or exchanges of stock occurring after 12/06/99.

9. Form controls partnership mergers and divisions. T.D. 8925, Partnership Mergers and Divisions, 66 F.R. 715 (1/4/01). The Treasury has promulgated final Reg. §§ 1.708-1(c) and amendments to § 1.752-1(f) and (g). The tax consequences of mergers of partnerships depend on the form followed under the laws of the applicable jurisdiction, either the “assets-over form” or the “assets-up form” [even if none of the merged partnerships are treated as continuing for Federal income tax purposes]. Generally, [and if no particular form is chosen] the assets-over form applies. (This approach is consistent with the treatment of partnership to corporation elective conversions under the check-the-box regulations and technical terminations under § 708(b)(1)(B).) But, if as part of the merger, the partnership titles the assets in the partners’ names, the assets-up form applies. If partnerships use the interest-over form to accomplish the result of a merger, the partnerships will be treated as following the assets-over form for Federal income tax purposes.

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

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

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

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

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

10. The form was all the substance that was necessary. *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000) (reviewed, 9-5). The decedent established a family limited partnership two months before he died, transferring cash, securities, life insurance policies, annuities, real estate, and partnership interests; cash and securities were 75% of the value. Decedent held a 99% interest as a limited partner and a corporation owned 47% by decedent and 53% by his wife, as trustee, held a 1% general partnership interest. The partnership distributed a substantial portion of its assets soon after the decedent's death. The IRS rejected the estate's discounted valuation based on the position that under the economic substance and business purpose doctrines the existence of the partnership should be ignored. The FLP was held to be valid for estate tax purposes, § 2703 did not apply to the agreement, and the transfer to the partnership was not a gift, and discounts [33% for lack of marketability and lack of control] were acceptable.

- In a reviewed opinion by Judge Cohen, the Tax Court rejected the estate's claims that the partnership was formed to protect the assets from claims or will contests, as well as the estate's argument that the partnership was a joint investment vehicle. She also found that the management of the assets was not the purpose for the formation of the partnership. No active business was conducted by the partnership. Nevertheless, the existence of the partnership was respected.

SFLP [the partnership] was validly formed under State law. The formalities were followed, and the proverbial "i's were dotted" and "t's were crossed." The partnership, as a legal matter, changed the relationships between decedent and his heirs and decedent and actual and potential creditors. Regardless of subjective intentions, the partnership had

sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of decedent's assets, and we do not disregard it in this case.

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

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

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

- Judge Parr's dissent described the transactions as "a mere paper arrangement" that did not limit the decedent's control over the assets.

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

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

Under Judge Beghe's analysis, there is no valuation issue.

11. *Knight v. Commissioner*, 115 T.C. 506 (2000) (reviewed, 12-1). In another family limited partnership valuation case, involving gift tax valuation, the Tax Court, in a reviewed opinion, by Judge Colvin upheld the validity of the limited partnership's existence solely on the ground that it was a valid partnership under state [Texas] law. The opinion distinguished *ASA Investering's Partnership* and *ACM Partnership* without explaining the particular basis for the distinction.

VIII. TAX SHELTERS

A. Corporate Tax Shelters

1. Tax shelter benefits from § 453 contingent sale partnership tax shelter not allowed because the tax shelter is a sham and “serves no economic purpose other than tax savings.” Merrill Lynch’s persistence overcomes initial doubts of tax department. *ACM Partnership v. Commissioner*, T.C. Memo. 1997-115. Judge Laro found a § 453 contingent sale partnership tax shelter to be a prearranged sham, “tax-driven and devoid of economic purpose,” “serv[ing] no economic purpose other than tax savings,” following *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966). Under the scheme to shelter Colgate’s \$105 million 1988 capital gain, a partnership was formed in 1989; its three partners were affiliates of (a) a foreign bank (about 90%), (b) Colgate (about 9%), and (c) Merrill Lynch (about 1%). A bank note was purchased by the partnership and immediately sold for a large immediate payment and much smaller future contingent payments. Under the contingent payment sale provisions of the temporary regulations [§ 15a.453-1(c)] the partnership’s basis was to be allocated ratably over the several years over which contingent payments could be made, resulting in a large 1989 installment sale gain to the partnership. The lion’s share of that installment sale gain was allocated to the foreign bank (which was not taxable on U.S. source capital gain), followed by the redemption of the foreign bank’s partnership interest. This left Colgate as the 90% 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.

a. ACM affirmed by Third Circuit, except for determination that out-of-pocket amounts are deductible. *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998) (2-1), *aff’g* and *rev’g* T. C. Memo. 1997-115. The Third Circuit affirmed the Tax Court on its 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.

2. Judge Foley finds another Merrill Lynch § 453 partnership plan does not work because, under the facts, there was no partnership. *ASA Investorings Partnership v. Commissioner*, T.C. Memo. 1998-305. 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 Investorings Partnership v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000). 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 activity for a purpose other than tax avoidance. The court held that there was a single business purpose rule.

3. Judge Nims follows ACM to deny benefits to Brunswick. *Saba Partnership v. Commissioner*, T.C. Memo. 1999-359. Brunswick's transactions 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.

4. Step-down preferred [fast-pay stock] to be recharacterized. REG-104072-97, Recharacterizing Financing Arrangements Involving Fast-Pay Stock, 64 F. R. 805 (1/6/99). Proposed Regulations that recharacterize for tax purposes financing arrangements involving fast-pay stock. Economically, fast-pay stock is self-amortizing because distributions are in part a return on investment and in part a return of the investment, which understates the taxable income on the benefitted stock during the initial period. The proposed regulations follow Notice 97-21, 1997-1 C.B. 407, except for using a different model that treats the benefitted shareholders as first issuing the financing instruments in exchange for cash equal to the fast-pay stock's fair market value, and then as contributing the cash to the corporation (which increases their basis in the benefitted stock). Grandfather that limits taxable income to that provided in Notice 97-21 until these regulations become final.

a. Finalized. T.D. 8853, Recharacterizing Financing Arrangements Involving Fast-Pay Stock, 65 F.R. 1310 (1/10/00). The final regulations simplify the definition of "fast-pay arrangement" to any arrangement by which a corporation has fast-pay stock outstanding for any part of its taxable year. They change the rule in the proposed regulations that any redemption that results in dividend treatment results in fast-pay stock. Stock is not fast-pay stock solely because a redemption results in dividend treatment exists unless there is a principal purpose to achieve the effect of fast-pay stock. Effective date, 2/27/97 (with some transition relief).

5. Springstein isn't the only BOSS; tax avoidance using distributions of encumbered property. Notice 99-59, 1999-52 I.R.B. 761,

advises taxpayers that losses from “BOSS” product transactions are not properly deductible. The notice describes the BOSS product as follows:

In one typical arrangement, taxpayers act through a partnership to contribute cash to a foreign corporation, which has been formed for the purpose of carrying out the transaction, in exchange for the common stock of that corporation. Another party contributes additional capital to the corporation in exchange for the preferred stock of that corporation. The foreign corporation then acquires additional capital by borrowing from a bank and grants the bank a security interest in securities acquired by the foreign corporation that have a value equal to the amount of the borrowing. Thereafter, the foreign corporation makes a distribution of the encumbered securities to the partnership that holds its common stock. The effect of the distribution, combined with fees and other transaction costs incurred at the corporate level, is to reduce the remaining value of the foreign corporation’s common stock to zero or a minimal amount. Although the distributed securities are encumbered by the bank debt (and the taxpayers or their partnership may be secondarily liable for the debt as guarantors), the foreign corporation has sufficient other assets to repay the debt, and it is the understanding of all parties that the foreign corporation will repay the debt with such other assets.

For example, if the taxpayers’ partnership had contributed \$100x for the common stock of the foreign corporation, the partnership might receive a distribution of securities with a fair market value of approximately \$100x, and that distribution would have the economic effect of reducing the remaining value of the foreign corporation’s common stock to zero. Nonetheless, because the distribution to the partnership is subject to the bank debt, the parties take the position, pursuant to § 301(b)(2), that the amount of the distribution is zero for purposes of § 301. On that theory, no part of the distribution is treated either as a dividend or as a reduction of stock basis under § 301(c).

The partnership is treated as having subsequently disposed of the stock of the foreign corporation, giving rise to a tax loss equal to the excess of the partnership’s original basis in the stock (\$100x in the example) over the fair market value of the common stock after the distribution of securities (zero). The deemed disposition of the stock may be based upon an election under Reg. § 301.7701-3(c) to change the federal income tax classification of the foreign corporation from a corporation to

a partnership, giving rise to a deemed liquidation of the foreign corporation, or by treating the partnership as a trader in securities which elects under § 475(f) to treat the securities that it holds, including the stock of the foreign corporation, as having been sold for their fair market value on the last business day of the taxable year.

Thereafter, typically in a later taxable year, the bank debt is repaid out of other assets held by the foreign corporation. Although the parties previously treated the debt as reducing the amount of the earlier distribution from the foreign corporation, promoters advise taxpayers to take the position that the foreign corporation's repayment of the debt is not treated as a distribution on its common stock.

- The PriceWaterhouseCoopers description of the BOSS product was published at 1999 TNT 233-58 (12/6/99).

6. ABA Tax Section recommendation to amend Circular 230, to provide new minimum standards for practitioners who provide “more likely than not” opinions used in the offering materials for corporate tax shelters (11/1/99). The recommended language would require the practitioner “to evaluate and take account of all relevant facts; to relate the applicable law to those facts; to consider, to the extent relevant and appropriate, both the substance and the purpose of the plan or arrangement; to identify and discuss all material tax issues; to identify and discuss the relevance and persuasiveness of the legal authority pertinent to the facts and material tax issues; and to contain a reasoned analysis of whether applicable authority supports the position taken by the taxpayer.” The recommendation further provides that “it would be unreasonable for a practitioner merely to assume the existence of a business purpose for a transaction if business purpose is a material fact.”

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

- Amended § 10.21 would require practitioners to advise a client who had not complied with revenue laws of the manner in which the error or omission may be corrected and the possible consequences of not taking such corrective action.

- Amended § 10.24 would limit the dissociation from a disbarred or suspended person only to matters constituting practice before the IRS.

- New § 10.35 would prescribe new standards

for tax shelter opinions at the more-likely-than-not (or higher) level of confidence. These would include a requirement to make inquiry as to all relevant facts, and be satisfied that the material facts are accurately and completely described in the opinion. The Regulations under §§ 6662 and 6664 will be modified to provide that only opinions that satisfy the standards of Circular 230 may be relied upon.

- Amended § 10.33 would apply to all tax shelter opinions not governed by new § 10.35, and would also provide a series of requirements for compliance.

8. Corporate tax shelter disclosure and registration requirements.

Announcement 2000-12, 2000-12 I.R.B. 835 Announcement of three sets of temporary and proposed regulations relating to disclosure and registration requirements for corporate tax shelters, as well as a notice of listed transactions.

a. Lists. T.D. 8875, Requirements To Maintain List of Investors in Potentially Abusive Tax Shelters, 65 F. R. 11211 (3/2/00), modified by T.D. 8896, Modification of Tax Shelter Rules, 65 F. R. 49909 (8/16/00) (modifications effective (8/11/00), and Notice 2000-11, I.R.B. 761, and REG-103736-00, Requirement to Maintain Lists of Inventors in Potentially Abusive Tax Shelters, Correction, 65 F.R. 17617 (4/4/00), and Notice 2000-11, I.R.B. 768. The Treasury has promulgated temporary and proposed regulations under § 6112 amends Temporary Reg. § 301-6112-1T, [in Q&A form] to require promoters to maintain a list of investors in “potentially abusive tax shelters.” It relies on the Temporary Reg. § 301.6111-2T definitions.

- Under the August 2000 amendments, only promoters that are classified as organizers under § 6111(e)(1) are required to register tax shelters.

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

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

income tax liability of any noncorporate taxpayer (or taxpayers) that exceeds (i) \$250,000 in any single taxable year or (ii) a total of \$500,000 for any combination of taxable years.

b. Registration. T.D. 8876, Corporate Tax Shelter Registration, 65 F. R. 11215 (3/2/00), and REG-110311-98, Corporate Tax Shelter Registration, 65 F.R. 11272 (3/2/00). The Treasury has promulgated temporary and proposed regulations under § 6111(d) on registration of “confidential corporate tax shelters”. Modified by T.D. 8896, Modification of Tax Shelter Rules, 65 F. R. 49909 (8/16/00), effective 8/11/00.

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

◦ Avoidance or evasion transactions include (1) “listed transactions” [see, e.g., Notice 2000-15, *infra*]; (2) transactions lacking economic substance if the expected pre-tax profit (after foreign taxes and transaction costs) is insignificant relative to the present value of the expected net Federal income tax savings; or (3) if the transaction has been structured to produce Federal income tax benefits that constitute an important part of the intended results of the transaction and the promoter expects it to be presented in substantially similar form to more than one potential participant (unless the participant is expected to participate in the ordinary course of its business in a form consistent with customary commercial practice and there is a “long-standing and generally accepted understanding” that the Federal income tax benefits are allowable).

◦ Registration will not be required for “excepted transactions,” which are those for which “there is no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits,” or those transactions which the IRS has determined are not subject to registration requirements. A ruling request procedure is provided.

◦ “Conditions of confidentiality” is a facts and circumstances determination, with an exception for written agreements expressly authorizing disclosure. Under the August 2000 modifications, restrictions on disclosure of the structure or tax aspects of the transaction reasonably necessary to comply with securities laws are not considered to be a confidentiality agreement.

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

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

c. Red Flagging Returns. T.D. 8877, Tax Shelter Disclosure Statements, 65 F.R. 11205 (3/2/00), and REG-103735-00, Modification of Tax Shelter Rules, 65 F.R. 11269 (3/2/00). Temporary and proposed regulations under § 6011 requiring corporations to attach statements to their Federal corporate income tax returns that disclose tax shelters. Modified by T.D. 8896, Modification of Tax Shelter Rules, 65 F.R. 49909, (8/16/00), effective 8/11/00.

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

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

◦ Four exceptions are provided: (1) Transactions in the ordinary course of business in a form consistent with customary commercial practice if the taxpayer “reasonably determines” that it would have participated irrespective of the expected Federal income tax benefits; (2) Transactions in [ordinary course and customary commercial practice] if the taxpayer “reasonably determines” that there is a long-standing and generally accepted understanding that the expected Federal income tax benefits are allowable for substantially similar transactions; (3) Transactions for which the taxpayer “reasonably determines” that there is “no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits”; (4) Transactions identified in published guidance as being exempt from disclosure.

d. Identified “tax avoidance transactions.” Notice 2000-15, 2000-12 I.R.B. 826. The IRS has published a list of tax transactions that it has determined to be tax avoidance transactions. Ten transactions are on the list, including “lease strips,” certain Notice 98-5 transactions, *ACM*-type transactions, certain charitable remainder trust distributions, lease-in/lease-out transactions, Notice 99-59 encumbered property distributions, fast-pay stock arrangements, and Rev. Rul. 2000-12, 2000-11 I.R.B. 774, debt straddle transactions.

9. Rev. Rul. 2000-12, 2000-11 I.R.B. 744. Loss on sale of debt straddle tax shelter [also called a “bull-bear bond” transaction] cannot be claimed. The shelter involves the taxpayer corporation purchasing two private placement debt instruments structured using reset provisions that will cause the value of the notes to move in opposite directions.

10. **Baby BOSS is a fraud too!** Notice 2000-44, 2000-36 I.R.B. 255. “Artificial” capital losses generated by baby BOSS transactions will not be allowed.

◦ Scheme #1: The taxpayer purports to borrow at a premium interest rate. For example, a lender gives the taxpayer \$3,000 and the parties treat the stated principal amount of the loan as only \$2,000, with the remaining \$1,000 that must be repaid representing interest. The taxpayer contributes the loan proceeds into a partnership, which assumes the liability, and uses the proceeds to purchase an investment asset worth \$3,000. The taxpayer/partner takes the position under §§ 705(a)(2), 722, and 752(b) his basis in his partnership interest is \$1,000 [the \$3,000 cash contribution minus the \$2,000 assumed liability], even though the value of the partnership interest is zero. The taxpayer then sells the partnership interest for a nominal amount, claiming a \$1,000 capital loss. [Everyone apparently ignores the \$1,000 discrepancy between the cash proceeds of the loan and the \$2,000 “principal amount,” which has to produce income to someone sometime.]

- **Scheme #2:** The taxpayer simultaneously purchases a call option and writes an offsetting call option, both of which are then contributed to a partnership. The taxpayer takes the position that the basis of the partnership interest equals the basis of the purchased call option, unreduced by the liability associated with the written call option, i.e., that the partnership did not assume a liability when it took responsibility for the written call option. The taxpayer then uses this artificially high basis to claim a capital loss on the sale of his partnership interest. [Compare Rev. Rul. 95-26, 1995-1 C.B. 131, holding that a partnership's short sale of securities creates a liability.]

- Notice 2000-44 disallows the losses [under §§ 165(a) and (c)] produced by both of these baby BOSS transactions as artificial, citing, in the case of individuals, *Fox v. Commissioner*, 82 T.C. 1001 (1984), holding that § 165(c)(2) requires a primary profit motive for a loss from a particular transaction to be deductible. The notice also cites Reg. § 1.702-2 [the partnership anti-abuse rules]. The government also is reexamining the partnership basis rules.

- **Compound indicia of criminal tax fraud?** The government believes that the Baby BOSS transactions were not being individually reported on schedule D, but instead have been buried in grantor trusts. For example, an individual taxpayer with an unrealized capital gain contributes both the appreciated assets and the baby BOSS partnership interest into a grantor trust, which sells both, and the individual reports only the net gain or loss from the grantor trust's transactions on his return, rather than breaking out gains and losses separately, as is required [by Reg. § 1.671-2]. Treasury Department officials suggest that criminal penalties might apply to this kind of reporting, which willfully conceals the facts.

- **Changes coming to tax shelter disclosure rules.** The recently proposed corporate tax shelter disclosure rules will be changed by dropping of the requirement that a shelter be marketed to a corporation to trigger the requirement that a promoter maintain a customer list. Under the amended regulations, a customer list would have to be maintained for a shelter that is exclusively peddled to individuals, provided threshold amounts of fees and tax savings are met.

11. Notice 2000-60, 2000-49 I.R.B. 568. The IRS has identified and "listed" another tax shelter involving a parent, a subsidiary and an unrelated company. Parent and unrelated transfer cash to the subsidiary, reducing parent's ownership in the subsidiary to less than 89%. The subsidiary then uses cash to purchase parent stock from parent shareholders and then transfers parent stock to parent employees to cover parent's stock-based compensation obligations. The subsidiary then liquidates. Parent claims a capital loss in the stock of the subsidiary because the value of the subsidiary has been reduced by the transfers to parent's employees. Subsidiary claims a capital loss on the sale of its remaining parent stock because it treats transfers to parent employees as

contributions of capital to the parent under Reg. § 1.83-6(d). The IRS held that the transfers to parent's employees are properly characterized as distributions by the subsidiary to the parent, followed by compensatory transfers by the parent to its employees. Alternatively, the IRS says it can disregard the steps in the transaction and treat it as a redemption by the parent.

12. Corporate Owned Life Insurance ("COLI").

a. Tax Court denies "pre-amendment" benefits "retroactively." The Tax Court determined that pre-1996 HIPAA leveraged corporate-owned life insurance program lacked economic substance and business purpose, and thus was a sham for tax purposes. Deductions for interest on policy loans were denied. *Winn-Dixie Stores Inc. v. Commissioner*, 113 T.C. 254 (1999). In 1993, taxpayer entered into a broad-based leveraged corporate-owned life insurance ("COLI") group plan covering approximately 36,000 of its employees. The decision to shift from its existing "key-person" COLI program of individual policies [covering 615 managers] was made pursuant to a proposal that emphasized the "tax arbitrage created when deductible policy loan interest is paid to finance non-taxable policy gains." The proposal indicated that taxpayer would have pre-tax loss totaling \$755 million for its 1993-2052 years, but would have total after-tax earnings of more than \$2.2 billion for the same period (as the result of total projected income tax savings of more than \$3 billion). The COLI policies were terminated in 1997, following 1996 legislation that impacted the plan. Judge Ruwe held that the COLI program lacked substance and business purpose, and thus was a sham.

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

absurdum to reason, as [taxpayer] does, that Congress simultaneously struck down a warm body and breathed life into [taxpayer's] cadaver.”

(1) **Bye-bye to leveraged company-wide COLI.** The Health Insurance Portability and Accountability Act of 1996, § 501 amended § 264 to deny the deduction for interest on loans with respect to company-owned life insurance. There is an exception for key person insurance. There are phase-in future effective dates and interest rates.

(2) The Tax and Trade Relief Extension Act of 1998, § 4003(i), further amended § 264 to expand the definition of “unborrowed [insurance] policy cash value” to include “inside buildup,” for purposes of the COLI pro rata interest disallowance rules.

b. *IRS v. CM Holdings Inc. (In re CM Holdings, Inc.)*, 254 B.R. 578, 2000-2 U.S.T.C. ¶ 50,791, 86 A.F.T.R.2d 2000-6470 (D. Del.). In CMI's bankruptcy, the IRS filed proofs of claim for taxes based on the disallowance of interest deductions CMI claimed for its COLI plan. The court held that 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.

• Notably the court specifically rejected the IRS's argument that it should apply the “generic tax shelter test” of *Rose v. Commissioner*, 88 T.C. 386 (1987), *aff'd*, 868 F.2d 851 (6th Cir. 1989), to disallow the deductions, and questioned whether the Tax Court would continue to apply that test. Rather, the court exhaustively analyzed the facts.

• In addition, the § 264(c)(1) “four-out-of-seven” safe harbor test was not met because the premiums in years four through seven were paid through so-called “loading dividends.” Pursuant to its COLI plan CMI purchased individual, whole life insurance policies, of which it was the owner and beneficiary, on 1,400 employees. In the first three policy years, 1991-1993, CMI paid premiums largely through nonrecourse policy loans. In the fourth through seventh policy years, CMI “paid” the annual premiums largely through a combination of partial withdrawals and loading dividends [premium rebates to CMI]. The IRS determined that CMI's COLI plan was a “no pay” plan under which premiums and interest were funded by policy loans out in connection with life insurance policies. The court (Judge Schwartz) found that the loans for the first three years were real, but that the loading dividends

were factual shams that were created by circular accounting treatment, and that there thus was a substantial shortfall in the payment of annual premiums due in years four through seven. Accordingly, § 264(a) applied to disallow the deductions because the premiums were financed by systematic borrowing on the policies. The § 264 (c)(1) exception “if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium . . . was paid) is paid under such plan by means of indebtedness” did not apply. The court accepted the IRS’ argument that “‘annual premiums due’ means the nominal annual premiums due less the ‘loading dividends’ that were offset against the contract premiums,” rather than CMI’s argument that annual premiums due meant the “contract-specified premiums.” These were circular netting transactions for the sole purpose of reducing the annual cash premiums paid in those years, and were factual shams.

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

14. Intermediary transactions tax shelters will be targeted. Sellers of stock and buyers of assets will now have to care about what is in the black box between them. Notice 2001-16, 2001-9 I.R.B. 730. The Service has announced that it intends to challenge the purported tax results of intermediary transactions tax shelters. The transactions generally involve a shareholder who desires to sell stock of a target corporation, an intermediary corporation, and a

buyer who desires to purchase the assets, but not the stock, of the target. The shareholder purports to sell the stock of the target to the intermediary. The target then purports to sell some or all of its assets to the buyer. The buyer claims a basis in the target assets equal to its purchase price. Under one version of this transaction, the target is included as a member of the affiliated group that includes the intermediary, which files a consolidated return, and the group reports losses (or credits) to offset the gain (or tax) resulting from the target's sale of assets. In another form of the transaction, the intermediary may be an entity that is not subject to tax and that liquidates the target with no reported gain on the sale of the target's assets. Further, transactions that are the same as or similar to the one described in the notice are "listed transactions" Temporary Reg. §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2).

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

16. "Customary" leasing transactions need not be registered as tax shelters. Notice 2001-18, 2001-9 I.R.B. 731. This notice provides an exception from the registration requirements of § 6111(d) and the list maintenance requirement of § 6112 for certain customary leasing transactions. The exception applies to a leasing transaction that (1) is a lease or sale leaseback between an owner-lessor of tangible personal property and a lessee who is the user of the property; (2) contains terms that are consistent with customary commercial practice for the leasing of similar items of property; (3) qualifies as a lease for federal income tax purposes under Rev. Proc. 75-21, 1975-1 C.B. 715, or under case law; (4) is not the same as or substantially similar to a listed transaction under Reg. § 301.6111-2T(b)(2), including a lease strip or lease in/lease out transaction; and (5) has a lessor and lessee who agree to consistently report the transaction as a lease.

B. Individual Tax Shelters

1. *United States v. Estate Preservation Services*, 202 F.3d 1093 (9th Cir. 2000) (Sneed, J.). The Ninth Circuit affirmed preliminary injunctions under

§ 6700 ordered by the district court against the promoter, attorney, and CPA who were involved in the marketing and sale of abusive tax shelters, i.e., asset protection trusts. Promotional materials advised that assets transferred tax-free into such trusts took a fair market value basis. “The APT manual represented that taxpayers could transfer equipment into an APT at no cost to the trust, and thereby give the trust a higher basis in the equipment than it had in the hands of the taxpayer. The district court did not commit clear error in holding these statements to be fraudulent.”

2. Lawyer/tax shelter partners were negligent because they did not reasonably rely on NYU tax professor Guy Maxfield. *Addington v. Commissioner*, 205 F.3d 54 (2d Cir. 2000). Three partners of NYC law firm Sann & Howe did not reasonably rely on Maxfield, who was “of counsel” to the firm, for their investment in the “Plastic Recycling” programs [transactions involving the sale and leaseback of Sentinal recyclers]. Although they learned of the programs from Maxfield and allegedly relied on his investigation, Maxfield had disclaimed knowledge of the plastics industry and questioned whether the offering materials correctly valued the recycling machines. Judge Sotomayor held that the taxpayers – particularly in light of their own sophistication—should have recognized the necessity of performing their own investigations and that their reliance on Maxfield was objectively unreasonable. Maxfield testified that he viewed his role as a “conveyor of information and . . . impressions,” and that he had “made it very clear” to the taxpayers that the investment was “their business decision,” and not his. The court further held that taxpayers could not justifiably rely on John Taggart, who had been retained to draft the offering memoranda and tax opinions for the partnerships in the programs and owned a 6.66% interest in one of the partnerships, because it should have been clear to the taxpayers that Taggart could not advise them because of a conflict of interest.

3. Notice 2000-61, 2000-49 I.R.B. 569. The IRS has moved to shut down the Guam Resident Trust Tax Shelter by ruling that the single filing rule contained in § 935 applies solely to individuals with Guam connections, and not to trusts. The scheme under which a trust seeks to avoid both U.S. and Guamanian tax liability was identified as a listed transaction for purposes of Temporary Reg. §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2). The government of Guam was complicit in this tax scheme by issuing certificates entitling holders to a rebate of all income taxes paid to Guam provided that half of the rebated taxes are kept on deposit in Guam for five years.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. T.D. 8874, Travel and Tour Activities of Tax-Exempt Organization, 65 F. R. 5771 (2/7/00). Final regulations under § 513 clarify when the travel and tour activities of tax-exempt organizations are substantially related to the purposes for which exemption was granted and provides needed guidance for tax-exempt organizations concerning when travel tour activities may be subject to tax as an unrelated trade or business. The final regulations do not impose additional record-keeping requirements. However, examples in the final regulations illustrate that contemporaneous documentation showing how an organization develops, promotes and operates the travel tour, is relevant to the facts and circumstances analysis.

2. REG-209601-92, Taxation of Tax-Exempt Organizations' Income From Corporate Sponsorship, 65 F. R. 11012 (3/2/00). The Treasury has published proposed regulations relating to the unrelated business income tax treatment of sponsorship payments received by exempt organizations. The 1997 Act added Code § 513(i), which provided that unrelated trade or business does not include the activity of soliciting and receiving qualified sponsorship payments. Being an "exclusive sponsor" is OK, but being an "exclusive provider" is not. Admission parties and pro-am playing spots are not OK. Advertising [e.g., the address and phone number of a sponsor that included the statement "For your music needs give them a call today at 555-1234"] on a noncommercial broadcasting station is not OK.

3. **All the charm and subtlety of John Rocker.** *Branch Ministries v. Commissioner*, 211 F.3d 137 (D.C. Cir. 2000). The IRS did not abuse its discretion in revoking a church's tax-exempt status on the ground that the church took out an anti-Clinton ad a few days before the 1992 presidential election. Judge Buckley noted that the church could have created a related § 501(c)(4) organization to do the same thing, but could not have used its tax-fee dollars for that purpose. An Equal Protection Clause argument on selective prosecution was rejected because "widespread and widely reported involvement by other churches in political campaigns" was held not comparable to placing advertisements in newspapers with nationwide circulation opposing a candidate and soliciting tax deductible contributions to defray the cost of the advertisements.

4. *Quality Auditing Co. v. Commissioner*, 114 T.C. 498 (2000). A nonprofit corporation organized to audit structural steel fabricators pursuant to a quality certification program administered by the [§ 501(c)(6)] American Institute of Steel Construction is not a § 501(c)(3) organization because it does

not lessen the burdens of government nor confer benefits to the general public, but furthers the private interests of the steel fabricators. Judge Nims held that “the presence of a single nonexempt purpose, if substantial in nature, precludes exempt status, regardless of the number or importance of truly exempt purposes.”

5. Priv. Ltr. Rul. 200037053. The IRS issued a private letter ruling that concluded that contributions to a donor advised fund qualified as “public support” under § 509(a)(1) to help the charity attain public charity status and to avoid private foundation status. The ruling was not issued to a community foundation but to a charity whose principal charitable purpose is to maintain a comprehensive web site where visitors can obtain information about charitable organizations.

6. Intermediate sanctions regulations are out; break out the supply of 1099s. REG- 246256-96, Excise Taxes on Excess Benefit Transactions, 66 F.R. 2173 (1/10/01); T.D. 8920, Excise Taxes on Excess Benefit Transactions, 66 F. R. 2144 (1/10/01). The Treasury has issued proposed and temporary regulations under § 4958, which permits the IRS to impose excise taxes against disqualified persons who participate in excess benefit transactions with § 501(c)(3) and 501(c)(4) organizations. These rules reflect the spirit under which § 4958 was enacted, which was to tax “excess” benefits provided by charities to insiders (including board members); these “excess” benefits also include benefits provided to insiders that are not reported as compensation.

7. President Clinton signed (on 7/1/00) H.R. Res. 4762, 106 Pub. L. 230, 114 Stat. 477, adding new § 527(j), which requires reporting and disclosure by “section 527” political organizations of expenditures and contributions. Naturally, § 501(c)(5) labor unions’ political expenditures are not covered by legislation.

a. IR-2000-50. Form 8871 is prescribed for filings by § 527 political organizations.

B. Charitable Giving

1. The IRS goes after charitable split-dollar life insurance arrangements with all guns blazing. Notice 99-36, 1999-1 C.B. 1284. The IRS “advises” taxpayers and § 170(c) organizations (including § 501(c)(3) charities) that certain charitable split-dollar insurance transactions that purport to produce charitable contribution deductions under § 170 or § 2522 will not produce the tax benefits advertised by their promoters and may lead to penalties. The targeted transactions generally involve transfers of funds to a charity, with the understanding that the charity will use the funds to pay premiums on a cash

value life insurance policy that benefits both the charity and the taxpayer's family. In a related transaction, the charity enters into a split-dollar agreement (usually with a trust) that specifies the portion of the insurance policy premiums to be paid by parties related to the donor and the portion to be paid by the charity and the extent to which each party can exercise standard policyholder rights. Commonly the noncharitable beneficiaries enjoy disproportionately high percentages of the cash-surrender value and death benefits relative to the percentage of premiums paid. Although there is no express obligation that the taxpayer will transfer funds to the charity to cover premium payments, or requiring the charity to use funds transferred by the taxpayer for that purpose, both parties understand that this will occur.

a. This result was codified by the enactment of Code § 170(f)(10) in the Tax Relief Extension Act of 1999. The legislative history explains that Congress was concerned about an abusive scheme referred to as charitable split-dollar life insurance, and the provision is designed to stop "the spread of this scheme," and goes on to state that "the provision restates present law." Section 170(f)(10) expressly denies a charitable contribution deduction for any transfer to a charity if (1) either (a) the charity directly or indirectly pays or paid any premium on a life insurance, annuity or endowment contract in connection with the transfer or (b) there is an understanding or expectation that any person will directly or indirectly pay any premium on any such contract, and (2) any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family (broadly defined in § 170(f)(10)(H) to include all lineal descendants of the taxpayer's or the taxpayer's spouse's grandparents and the spouses of all such descendants), or any other person (other than another charitable organization) chosen by the transferor. Section 170(f)(10)(D) provides an exception in certain cases in which a charitable organization purchases an annuity contract to fund an obligation to pay a charitable gift annuity. Section 170(f)(10)(E) provides an exception for transfers to certain charitable remainder trusts that possess all of the incidents of ownership of the contracts in question and are entitled to receive all payments under the contracts. Congress capped off its attack on these abusive schemes by imposing a punitive excise tax on the charities that participated in them; § 170(f)(10)(F) imposes on a charitable organization an excise tax equal to 100% of the amount of the premiums paid by the organization on any life insurance, annuity, or endowment contract, if the premiums are paid in connection with a transfer for which a deduction is disallowed under § 170(f)(10)(A). This excise tax applies *regardless of when the transfer to the charitable organization was made.*

b. Notice 2000-24, 2000-17 I.R.B. 952. This notice provides guidance to help charitable organizations comply with the information reporting requirements imposed in connection with § 170(f)(10). The reporting requirements apply to charitable organizations that pay premiums after 2/8/99,

in connection with subject split-dollar life insurance, annuity, and endowment contracts.

c. **Announcement 2000-82, 2000-42 I.R.B. 385.** Organizations that pay premiums on § 170(f)(10) “personal benefit contracts” must report on Form 8870. For taxable years prior to 2000, Form 8879 must be filed within 90 days of 10/16/00.

2. Abusive charitable remainder trusts curtailed. REG-116125-99, Prevention of Abuse of Charitable Remainder Trusts, 64 F. R. 56718 (10/21/1999). The Treasury has issued proposed regulations under §§ 643 and 664 to combat abuses in the use of charitable remainder trusts that occur when distributions in excess of income are made to non-charitable beneficiaries where the trustee borrows money or enters into a forward sale of the trust assets. The trust would be treated as having sold a pro rata portion of its assets to the extent that the distribution (1) is not characterized as income under § 664(b), and (2) is made from amount received by the trust that is neither (a) a return of basis nor (b) attributable to a deductible charitable contribution made in cash.

a. **Regulations now final.** T.D. 8926, Prevention of Abuse of Charitable Remainder Trusts, 66 F. R. 1034 (1/5/01). The Treasury has finalized the regulations under § 664 relating to the elimination of abusive transactions involving charitable remainder trusts.

3. Ghoul trusts rejected. REG-100291-00, Lifetime Charitable Lead Trusts, 65 F. R. 17835 (4/5/00). The Treasury has issued proposed amendments to Reg. § 25.2522(c)-3, relating to the definitions of a guaranteed annuity interest and a unitrust interest for purposes of the income, gift, and estate tax charitable deductions. The proposed regulation restricts the permissible terms for charitable lead trusts in order to eliminate the potential for abuse [e.g., artificially inflating the charitable deduction by using as a measuring life the life of an unrelated individual who is seriously ill but not “terminally ill” under the § 7520 regulations; thus the charitable interest is valued based on the actuarial tables. The proposed regulations limit the permissible term for guaranteed annuity interests and unitrust interests to either (1) a specified term of years, or (2) the life of one or more of the following individuals living at the date of the transfer: (a) the donor, (b) the donor’s spouse, or (c) a lineal ancestor of all the remainder beneficiaries. The limitation on permissible measuring lives does not apply to a charitable guaranteed annuity interest or unitrust interest payable under a charitable remainder trust described in § 664. An interest for a specified term of years can qualify even if subject to a “savings clause” intended to ensure compliance with a rule against perpetuities, as long as the savings clause uses a period for vesting of 21 years after the deaths of measuring lives who are

selected to maximize, rather than limit, the term of the trust. When finalized the rules will be effective as of 4/4/00.

4. Taxpayers should have sued IRS officials like the Scientologists did. *Sklar v. Commissioner*, T.C. Memo. 2000-118. The court relied on *Hernandez v. Commissioner*, 490 U.S. 680 (1989), and found that the Church of Scientology settlement was irrelevant because the “auditing” involved there was “not identical [to the general, including religious, education involved in the case at hand] in their organization, structure or purpose.”

X. TAX PROCEDURE

A. Penalties and Prosecutions

1. *Vinick v. United States*, 205 F.3d 1 (1st Cir. 2000). A district court determination that the taxpayer was a responsible person under § 6672 was reversed because it applied an improper legal standard. The court of appeals held that the responsible person penalty applies only to persons who exercise daily management of the decisions regarding the payment of debts. Although the taxpayer was a shareholder, director, held the title of treasurer, had the authority to write checks and to hire and fire employees, and, as the corporation’s accountant, filed its employment tax returns, during the quarters in question, he did not exercise decision-making control over payment of the corporation’s debts [even though he did exercise such control during subsequent quarters].

2. **Burton Kanter in trouble again.** *Investment Research Associates, Ltd. v. Commissioner*, T.C. Memo. 1999-407. In a 600-page opinion Burton Kanter was held liable for the § 6653 fraud penalty by reason of his being “the architect who planned and executed the elaborate scheme with respect to the kickback income payments In our view, what we have here, purely and simply, is a concerted effort by an experienced tax lawyer and two corporate executives to defeat and evade the payments of taxes and to cover up their illegal acts so that the corporations [employing the two corporate executives] and the Federal Government would be unable to discover them.”

a. **So far, he is unable to wriggle out, the way he did 25 years ago when he was acquitted by a jury.**¹⁴ 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

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

motion on conversations with two unnamed Tax Court judges that the original draft opinion from the special trial judge was changed by Judge Dawson before he adopted it. They were turned down because the Tax Court held that the documents related to its internal deliberative processes. Tax Court Order denying motion, 2001 TNT 23-31 (4/26/00) and (on reconsideration) 2001 TNT 23-30 (8/30/00). Taxpayers are seeking mandamus from three circuits, but have so far been unsuccessful.

3. *Remington v. United States*, 210 F.3d 281 (5th Cir. 2000). A partner who was not subject to liability under § 6672 was nevertheless liable for law firm's delinquent payroll taxes because § 6672 does not preempt the state law under which general partners are liable for partnership debts.

4. *United States v. Tenzer*, 127 F.3d 222 (2d Cir. 1997). The dismissal of failure-to-file indictment of an experienced Long Island tax attorney was reversed. Judge Miner held that defendant was not entitled to the benefit of the IRS "voluntary disclosure" policy because he had not paid his taxes or made "bona fide arrangements to pay." Moral: don't be too cute because that can adversely impact a voluntary disclosure; that policy requires taxpayer to be currently compliant and to have made a reasonable offer as to past unsatisfied taxes.

a. On subsequent appeal after sentencing on remand. *United States v. Tenzer*, 213 F.3d 34 (2d Cir. 2000). The conviction was upheld. New evidence that Tenzer's offer in compromise proposal had been "returned as unprocessable" rather than "rejected" was not material to prior holding that no agreement to pay had been made. But the sentence was vacated and the case remanded for reconsideration of whether sentence should be reduced below guidelines based on mitigating circumstances of Tenzer's offer to settle with IRS, negotiations to pay, and "good intentions" and the IRS' decision to terminate negotiations with respect to Tenzer's offer.

5. **One set of books is required, two is pretty strong evidence of fraud, as well as a big help to the IRS in reconstructing income.** *Karcho v. Commissioner*, T.C. Memo. 2000-213. Taxpayer operated a video arcade business. The gross receipts deposited in his bank account matched the aggregate amounts shown on his "Daily Income Reports" provided to his accountant and reported for tax purposes. A second set of "Daily Income Reports," which reflected substantially higher income, matched the total cash shown on the "Meter Reading Sheets" for the video games, and even reconciled the differences between the disparate gross receipts. Taxpayer pleaded guilty to criminal tax fraud. The civil case was a slam-dunk for the IRS.

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

7. Be careful not to over-empathize with your client. *Nis Family Trust v. Commissioner*, 115 T.C. 523 (2000). After filing a Tax Court petition, taxpayers, who were represented by counsel, abandoned their return positions and relied on a strategy of noncooperation and delay, undertaken behind a smokescreen of frivolous tax-protester arguments. The taxpayers' attorney [according to the Tax Court] in bad faith aided in that strategy by making additional meritless tax-protester arguments, making meritless motions and responses to motions, and abusing the court's subpoena power. Furthermore, pursuant to upholding § 6662 accuracy related penalties, the Tax Court imposed a \$25,000 penalty under § 6673(a)(1) for instituting and maintaining these proceedings primarily for delay and taking frivolous and groundless positions. In addition, pursuant to § 6673(a)(2) taxpayers' counsel was ordered to personally pay \$10,643.75 for the Commissioner's excess attorney's fees reasonably incurred as a result of her course of conduct.

8. Maybe if she'd been able to delay the trial until after Mel Carnahan was elected to the Senate. *Luce v. Luce*, 119 F. Supp. 2d. 779 (S.D. Ohio 2000). The sole officer and majority shareholder of a corporation was a responsible person under § 6672 even though she testified that her deceased husband made all the business decisions and she could not question those decisions.

B. Discovery: Summonses and FOIA

1. The 1998 Act, § 3417, adds new Code § 7602(c), which requires the IRS to give "reasonable notice in advance to the taxpayer that contacts with persons other than the taxpayer may be made," and to require that the IRS provide a record of such contacts periodically or on request.

a. The IRS can mess up if it makes third-party contacts without notifying taxpayers in advance; it can also mess up when it sends a prophylactic letter to an unnecessarily large number of taxpayers about possible third-party contacts. IR-1999-19. The Service will revise a letter for taxpayers to "more clearly spell out the circumstances surrounding third-party

contacts about liability.” Beginning 1/18/99, letters began going out to taxpayers stating that the IRS “may need to contact third parties [which] may include, but are not limited to, neighbors, employers, employees and banks.” Commissioner Rossotti stated that the letter “mistakenly raised taxpayer concerns about privacy issues.”

b. The 15-point solution? IR-2000-08. The IRS will release 15 different clearer, specialized versions of letters and notices alerting taxpayers that third parties might be contacted as part of the collection or examination process. Letters 3164 A through M and Notices 1219A and 1219B are the designations.

2. *Tax Analysts v. IRS*, 99-2 U.S.T.C. ¶ 50,794, 84 A.F.T.R.2d 99-5457 (D.D.C. 1999), *affirmed in part, vacated in part*, and remanded, 214 F.3d 179 (D.C. Cir. 2000). The closing agreement between Christian Broadcasting Network and the IRS relating to termination of tax liability in connection with CBN’s application for restoration of tax exempt status was return information that was not disclosable under FOIA.

3. **A little privacy remains. A taxpayer who is not under investigation and who has no legal relationship to any other taxpayer under investigation is entitled to notice of a third-party summons issued by the IRS to the taxpayer’s bank with respect to an IRS investigation of another taxpayer.** *Ip v. United States*, 205 F.3d 1168 (9th Cir. 2000). Ip’s fiancé was a jewelry agent for Diamond Trade Ltd. (DTL). Ip was not an employee, owner, or officer of DTL. The IRS assessed a tax liability against DTL and issued third-party summonses to two banks requesting information relating to DTL and its agents. Believing that Ip deposited DTL sales proceeds into her bank accounts on DTL’s behalf, the IRS also summoned Ip’s bank records. Ip filed a petition to quash the summonses on the grounds of improper service and lack of notice.

• The district court dismissed the petition, concluding that Ip was not entitled to notice under § 4609(c)(2)(D) [then § 4609(c)(2)(B)] because the summonses were issued “in aid of the collection” of DTL’s tax liability.

• The Court of Appeals (Judge Aldisert) reversed, holding that Ip was entitled to notice under § 7609(a) because she had no legal relationship to DTL. The court rejected the IRS’s argument that the literal language of § 7609(c)(2)(D)(i) dispenses with the notice requirement any time a third-party summons is issued “in aid of the collection” of any assessed tax liability. Rather, the court held that the notice exception applies only when the assessed taxpayer “has a recognizable [legal] interest” in the summoned records. Accepting the IRS’s interpretation would render meaningless the express language of § 7609(c)(2)(B)(ii) which dispenses with notice when a summons is “in aid of the collection of ‘the liability . . . of any transferee or

fiduciary of any person . . . in clause (i).” The appeals court distinguished the instant case from *Barmes v. United States*, 199 F.3d 386 (7th Cir. 1999), on which the IRS relied. Unlike in *Barmes*, there was no fiduciary relationship between Ip and DTL, nor did DTL have any recognizable legal interest in Ip’s bank account.

C. Statutory Notice

1. Going Postal? REG-104939-99, Definition of Last Known Address, 64 F. R. 63768 (11/22/99). The Treasury has issued proposed regulations defining “last known address” in relation to the mailing of notices of deficiency and other notices, statements and documents. Under these proposed regulations, the Service would annually update its address records from the U.S. Postal Service’s National Change of Address database.

a. Rev. Proc. 2001-18, 2001-8 I.R.B. 708. The IRS has provided guidance explaining how to inform it of a change of address.

2. Should taxpayer’s lawyer have ignored the undated 90-day letter and let the statute of limitations expire? *Smith v. Commissioner*, 114 T.C. 489 (2000). A deficiency notice that failed to include a date in the section entitled “Last Day to File a Petition With the United States Tax Court” is valid where the taxpayers received the notice prior to the expiration of the § 6501 limitations period and filed a timely Tax Court petition. Judge Foley held that Congress failed to prescribe what the consequences of IRS failure to follow the requirement of § 3463(a) of the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685, 767, that “The Secretary . . . 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 with the Tax Court.”

D. Statute of Limitations

1. Estimated tax payments are tax “payments” on the due date of the return and the statute of limitations stop watch on refunds starts ticking. *Baral v. United States*, 120 S. Ct. 1006 (2000). Under § 6513(b) estimated tax payments are deemed to have been “paid” on the due date (including extensions) for the taxpayer’s return, not on the later date on which a delinquent return is filed. Thus, a refund of overpayments of estimated taxes was time barred by § 6511(b)(2)(A) because the taxpayer’s return seeking the refund was delinquent by more than three years (after taking into account the automatic extension period).

2. A refund claim made on a delinquent return by definition has been filed within three years of filing the return. *Weisbart v. United States*,

222 F.3d 83 (2d Cir. 2000). The Second Circuit held that a return filed more than three years after its due date and which sought a refund of over-withholding was a timely refund claim under § 6511(a), a position that even the government conceded was correct [following Rev. Rul. 76-511, 1976-2 C.B. 428]. The refund claim remains limited, however, by the look-back rule of § 6511(b), which limits the amount of the refund to taxes paid within a period equal to three years, plus any period for which the filing date was extended, prior to filing the claim. Thus, because the taxpayer had been granted a four month automatic extension of the time to file and had filed his return exactly three years and four months after the unextended due date, the § 6511(b) limitation did not apply. In determining when the refund claim/return was filed, the court interpreted Reg. § 301.6402-3(a)(5) and § 301.7502-1 to apply the timely mailed/timely filed mailbox rule to a refund claim in the form of a delinquent return. *Contra Miller v. United States*, 38 F.3d 473 (9th Cir. 1994), holding that if a return is not filed within two years of the due date, a refund claim for withheld taxes made in the delinquent return is time barred under § 6511(a).

a. IRS acquiesces and announces that it will no longer argue that § 7502(a) does not apply under facts such as those in *Weisbart*. A.O.D. 2000-09 (11/13/00). “Accordingly, the Service will apply the timely mailing/timely filing rule of § 7502(a) in such cases and treat claims for refund included on delinquent original returns as filed on the date of mailing for purposes of § 6511(b)(2)(A).”

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

E. Liens and Collections

1. Federal law, not state law, determines extent of tax lien. *Pletz v. United States*, 221 F.3d 1114 (9th Cir. 2000). A tax lien against one spouse who owns property with the other spouse, against whom there is no deficiency, as tenant by the entirety is a lien against the taxpayer’s present interest. The tax lien is not limited to the debtor/taxpayer’s survivorship interest to which a state

law creditor's judgment lien would have been limited. The lien can be foreclosed by sale of the entire property as long as the other spouse is compensated.

2. Section 6330 doesn't give the taxpayer two bites at the underlying tax liability. *Goza v. Commissioner*, 114 T.C. 176 (2000). The Tax Court has jurisdiction to review the Commissioner's determination not to accord a hearing under § 6230 in response to taxpayer's claims that a previously assessed deficiency was unconstitutional. Pursuant to § 6330(c)(2)(B), the taxpayer was not entitled to contest the underlying tax liability in a § 6330 proceeding because the taxpayer had received a valid deficiency notice for the year in question and did not petition the Tax Court for a redetermination.

3. *Offiler v. Commissioner*, 114 T.C. 492 (2000). The taxpayer's failure to request a § 6330 review by Appeals within 30 days of receipt of notice of intent to levy by the IRS bars the taxpayer from subsequently seeking review by Tax Court; under § 6330(d), the Tax Court's jurisdiction to review IRS levies is limited to review of determinations by Appeals.

4. Nor can the taxpayer say "I'll take mine later." *Sego v. Commissioner*, 114 T.C. 603 (2000). The Tax Court lacked jurisdiction to review a notice of intent to levy under § 6330 because the taxpayer had consciously refused delivery of the notice of deficiency.

5. Section 6330 hearings before Appeals are informal. *Davis v. Commissioner*, 115 T.C. 35 (2000). A taxpayer's right to a pre-levy hearing before an Appeals office under § 6330 does not include the right to subpoena and (cross)examine witnesses as part of the hearing. When it enacted § 6330, Congress was aware of the informal nature of Appeals hearings. In the absence of any showing by the taxpayer of irregularity in the assessments, the Appeals officer may rely on Form 4340 to verify the proper assessment of tax.

6. This guy needs a lawyer—or, at least, a calendar. *McCone v. Commissioner*, 115 T.C. 114 (2000). Section 6330(d)(1) extends the period for appealing an adverse decision in an Appeals hearing before levy under § 6330 for an additional 30 days after a determination of another court, e.g., a district court, that an appeal filed in that court was filed in the wrong court, i.e., because the appeal related to unpaid income tax and the district court had no jurisdiction. If the appeal to the wrong court is untimely as well, the additional 30 day extension to appeal to the Tax Court does not apply. [McCone's *pro se* Tax Court petition was also filed more than 30 days after the district court dismissed.]

7. *Van Es v. Commissioner*, 115 T.C. 324 (2000). Section 6330(d) does not confer on the Tax Court jurisdiction to review an Appeals decision not to stay a levy pursuant to an assessed § 6702 frivolous return penalty. Section 6330(d) does not expand the Tax Court's jurisdiction to types of taxes over which the Tax Court does not ordinarily have jurisdiction.

8. *Katz v. Commissioner*, 115 T.C. 329 (2000). Section 6320(d) confers on the Tax Court jurisdiction to review Appeals decision not to abate interest in connection with an appeal under § 6320 of a filing of a lien. The Commissioner's refusal to abate interest under § 6404 is appealable to Tax Court under §§ 6404(i) and 7481(c). Relitigation of the underlying deficiency stipulated in prior decision was barred by *res judicata*.

9. **Sections 6220/6230 judicial review has a bite as well as a bark.** *Mesa Oil, Inc. v. United States*, 86 A.F.T.R.2d 7312 (D. Colo. 2000). The district court (Judge Babcock) held that the IRS Appeals Officer had abused her discretion in failing to grant relief from a proposed levy [for unpaid employment taxes] pursuant to a §§ 6220/6230 hearing because the requirement of § 6330(c)(3) that the government's collection concerns be balanced against the intrusiveness of the collection had not been satisfied. The Appeals Officer's decision was based on the fact that the IRS had followed proper procedures but it did not take into account the impact the levy would have on Mesa's continued operation as a going business.

F. Innocent Spouse

1. **You still can't get innocent spouse relief if you had reason to know of the understatement and enjoyed the benefit of the unreported income.** *Butler v. Commissioner*, 114 T.C. 276 (2000). The taxpayer, who was the wife of a physician who owned an S corporation that conducted a gardening business, petitioned for innocent spouse relief with respect to unreported income that should have been passed-through from her husband's S corporation. The petition was filed under § 6013(e), but was treated as an election under § 6015(b)(1) because the case was still pending on effective date of § 6015(b)(1). Relief was denied because the wife, who had a college education and owned and operated her own S corporation, was responsible for family finances, including tax return preparation, enjoyed a high standard of living, and since the husband concealed no financial information from her and she had actual knowledge of the transaction giving rise to the unreported income, had reason to know of the understatement. The court also held that as part of a deficiency proceeding in which the taxpayer has affirmatively raised the innocent spouse defense, the Tax court has jurisdiction to review the Commissioner's denial of equitable relief under § 6015(f). Section 6015(e) does not limit review to denial of relief under § 6015(b) or (c). The court will apply

an “abuse of discretion” standard. For the same reason that relief was denied under § 6015(b)(1), the court found that the Commissioner had not abused his discretion under § 6015(f).

2. *Fernandez v. Commissioner*, 114 T.C. 324 (2000). Section § 6015(e)(1)(A) confers jurisdiction to review the Commissioner’s denial of equitable relief in a “stand alone” petition, apart from any deficiency determination, even though the taxpayer could not qualify for relief under § 6015(b) or (c) because of failure to file a proper election.

a. A.O.D. 2000-06, 2000 TNT 190-14 (9/29/00). The IRS acquiesces in *Fernandez*, and now agrees that it will no longer contest the Tax Court’s jurisdiction to review claims for equitable relief under § 6015(f) if the requirements of § 6015(e) are met.

3. *Charlton v. Commissioner*, 114 T.C. 333 (2000). A husband who prepared a joint tax return on which income from his [now former] wife’s sole proprietorship was understated was not entitled to innocent spouse relief under § 6015(b) because even though he relied on wife’s inaccurate summary he had access to the business’ books and therefore had reason to know of the understatement, citing case law under former § 6013(e)(1)(C) as support. However, apportioned liability under § 6015(c) and (d) was available because the husband did not have actual knowledge of understatement because other conditions prerequisite had been met and request for apportioned liability was timely. The court also held that it had jurisdiction to review the Commissioner’s denial of § 6015(f) relief for the wife.

a. **And the Service throws in the towel.** The IRS has announced that it will no longer challenge the Tax Court’s jurisdiction [as it did in *Butler*, *Fernandez*, and *Charlton*] to review denials of claims for innocent spouse relief under § 6015(f), regardless of whether an election was made under § 6015(b) or (c). 2000 TNT 111-8 (6/8/00).

4. *Corson v. Commissioner*, 114 T.C. 354 (2000). Where one spouse elects innocent spouse status and the Commissioner grants such relief in a stipulated settlement of a case docketed in the Tax Court, the non-electing spouse should be afforded an opportunity to litigate the Commissioner’s decision to grant relief from joint and several liability to the electing spouse. Judge Nims held that § 6015(e)(4) grants the non-electing spouse some “participatory entitlement.” In a docketed Tax Court case, the non-electing spouse has the “opportunity to become a party” in order that he may have his day in court, particularly in a stipulated settlement, which is “subject to the Court’s discretionary review and may be rejected in the interests of justice.”

5. More self-executing statutes in the form of directives to promulgate rules. *King v. Commissioner*, 115 T.C. 118 (2000). Mr. & Mrs. King received separate deficiency notices after they were divorced. Mr. King did not contest the deficiency, but Mrs. King filed a free-standing § 6015(e) petition in the Tax Court that sought innocent spouse relief but did not contest the deficiency. Section 6015(e)(4) directs the Tax Court to establish rules under which a spouse who joined in the joint return but is not seeking innocent spouse relief receives notice and an opportunity to intervene as a party to petition filed by the other spouse seeking innocent spouse relief. Interim Rules 324(a) and 325(b) deal with notice and intervention, respectively, but are not yet complete. The Tax Court has interpreted § 6015(e) to be self-operative to require the Commissioner to notify the other spouse (or former spouse) of his or her right to intervene to contest the claim for relief “whenever in the course of any proceeding before the Court, a taxpayer raises a claim for relief from joint liability under § 6015 and the other spouse or former spouse is not a party.”

a. A.O.D. 2000-07, 2000 TNT 190-13 (9/29/00). The IRS has acquiesced in *King*, and stated that it would apply the notice and intervention rules to all cases in which an innocent spouse issue is raised.

6. When the legislative history is ambiguous, read the statute. Tax Court majority holds that the test for knowledge under the § 6015(c)(3)(C) separate liability election is the same as that under former § 6013(e)(1)(C), which is that knowledge of an item of omitted income is sufficient to deny relief even if the spouse has no reason to believe that the way the item was reported on the return was correct. *Cheshire v. Commissioner*, 115 T.C. 183 (2000) (reviewed, 11-4). A spouse who has actual knowledge of the transaction giving rise to omitted income has “reason to know” of the understatement and is not entitled to innocent spouse relief under § 6015(b). The taxpayer’s proposed standard based on a prudent taxpayer being expected to know of the understatement was rejected as providing too broad an escape hatch from liability. More importantly, the Tax Court (Judge Jacobs) held that for the spouse to be denied apportioned liability relief, § 6015(c)(3)(C) does not require actual knowledge of whether the entry on the return is or is not correct. The applicable knowledge standard under § 6015(c)(3)(C) is “an actual and clear awareness (as opposed to reason to know) of the existence of an item which gives rise to the deficiency (or portion thereof).” Thus because when the spouse seeking apportioned liability in *Cheshire* signed the joint return, she was aware of the amount, the source, and the date of receipt of a retirement distribution received by her then husband, she was denied apportioned liability, even though at that time she misunderstood how much of the retirement distribution properly was taxable and thus did not know that the amount of income was understated. Wife was told by her husband that their accountant had advised him that amounts used to pay off mortgage could be excluded from income the same way

that the portion of the distribution that was “rolled over” was treated. The majority held that wife does not need to have knowledge of the tax consequences of the item or that the entry on the return is incorrect. The court relied on former § 6013 cases, such as *Wiksell v. Commissioner*, 215 F.3d 1335 (9th Cir. 2000), *aff’g without published opinion* T.C. Memo. 1999-32, and *Bokum v. Commissioner*, 94 T.C. 126 (1990), *aff’d*, 992 F.2d 1132 (11th Cir. 1993), to the effect that knowledge of the legal consequences of an item may be presumed if the spouse has knowledge of the item. The court declined to follow a statement in H. Conf. Rept. 105-599, at 253 (1998) that “if the IRS proves that the electing spouse had actual knowledge that an item on a return is incorrect, the election will not apply to the extent any deficiency is attributable to such item.” The court did however, find Commissioner abused his discretion in failing to grant equitable relief from penalties under § 6015(f), even though the failure to grant equitable relief on the underlying deficiency was not an abuse of discretion. The taxpayer relied on her husband’s description of the tax consequences of the transaction and his representations that he had been advised by a CPA and had no reason to doubt him.

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

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

8. REG-106446-98, Relief From Joint and Several Liability, 66 F.R. 3888 (1/17/01). Proposed regulations under § 6015 relating to innocent spouse relief. The proposed regulations reflect changes in the law made by the IRS Restructuring and Reform Act of 1998, which repealed § 6013(e) and replaced it with § 6015. They clarify that case law interpreting the language under former § 6013(e) will be used to interpret that same language under § 6015. Also, “knowledge or reason to know” of an understatement exists only when either the requesting spouse actually knew of the erroneous item giving rise to the understatement, or a reasonable person in similar circumstances would have known of the item. Knowledge of an item under the proposed regulations would be knowledge of the receipt or expenditure. The proposed regulations would further amend Reg. § 1.6013-4 to clarify that if a spouse asserts and establishes

that he or she signed a joint return under duress, then the return is not a joint return, and he or she is not jointly and severally liable. Relief must be requested within two years from the first collection activity, but not before the taxpayer receives a notification of an audit or notice that there might be outstanding liability. Finally, the proposed regulations would provide that the nonrequesting spouse must be given notice that the requesting spouse has filed a claim for relief and be given an opportunity to participate in the proceedings. At the request of one spouse, the IRS would omit from shared documents information that would reasonably identify that spouse's location.

G. Miscellaneous

1. The quality of mercy is not strained *Little v. Commissioner*, 113 T.C. 474 (1999). The taxpayer was the administrator of an estate. During administration of the estate, he received information indicating possible income tax liabilities of the estate, which he provided to the estate's lawyer, who erroneously and repeatedly advised taxpayer that the estate had no tax liabilities and advised him to make disbursements and distributions. Acting in good faith, taxpayer followed this advice and eventually closed the estate without paying the estate's income tax liabilities. The IRS sought to impose the unpaid income tax liabilities on the administrator under 31 U.S.C. § 3713(b) [which imposes personal liability on a fiduciary who pays others before paying claims of the United States]. Noting that a long line of cases has limited liability under 31 U.S.C. § 3713(b) to situations in which a fiduciary knowingly disregards debts due to the United States, the Tax Court (Judge Ruwe) declined to hold the taxpayer liable. In this case the taxpayer-fiduciary reasonably and in good faith relied on an attorney's advice there were no debts due to the United States before paying other claims, and he thus did not knowingly disregard debts due to the United States.

2. Checkbox Initiative to begin with the 2001 Filing Season. IR-2000-23, 2000 I.R.B. LEXIS 132 (4/13/00). Paid preparers, with their clients' permission, would be allowed to work directly with the IRS to resolve tax return processing issues. A checkbox would permit taxpayers to designate their paid individual preparer to resolve such issues.

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

4. Corporation suspended for failure to pay state income taxes lacked the capacity to file a petition to the Tax Court. *David Dung Le, M.D., Inc. v. Commissioner*, 114 T.C. 268 (2000). A corporation the state charter of which had been suspended for nonpayment of state taxes lacked capacity to file a petition in the Tax Court because under state law it lacked the capacity to bring suit. The reinstatement of its charter after the 90 day period for filing a Tax Court petition did not validate the petition filed during suspension and did not toll the 90 day period for filing the petition.

5. Notice 2000-35, 2000-29 I.R.B. 118. The procedures for issuing letter rulings, determination letters, and information letters, as well as for furnishing technical advice, continue to apply despite the reorganization of the Office of Chief Counsel.

6. Take those Tax Court requests for admissions seriously, or forever hold your peace. *United States v. Boyce*, 2000-1 U.S.T.C. ¶ 50,341, 85 A.F.T.R.2d 1938 (S. D. Cal. 2000). Res judicata attaches to a Tax Court judgment based on the taxpayer's failure to answer requests for admission, which, as a result of the taxpayer's failure to answer, under the Tax Court rules were deemed to be true. Summary judgment to reduce assessment to a judgment was granted.

7. Bye-bye Bivens. *Shreiber v. Mastrogiovanni*, 214 F.3d 148 (3d Cir. 2000). A *Bivens* action does not lie against an IRS agent for alleged violations of a taxpayer's constitutional rights in the course of making an assessment because Congress has created an extensive scheme [e.g., § 7433] providing remedies to a taxpayer complaining of the conduct of government officials in connection with tax assessments and collections.

8. No ex parte communications between Exam and Appeals. Rev. Proc. 2000-43, 2000-43 I.R.B. 404. Twenty-nine Q&As that address situations frequently encountered by Appeals Officers during the course of an administrative appeal provide guidance on the prohibition of ex parte communications between IRS Appeals Officers and other IRS employees. This was issued pursuant to the directive in § 1001(a)(4) of the the Internal Revenue Service Restructuring and Reform Act of 1998 to develop a plan to prohibit such communications that appear to compromise the independence of Appeals Officers. Appeals Officers may speak to lawyers in Office of Chief Counsel, but the Appeals Officers are to "remain responsible for independent evaluation of the strengths and weaknesses of specific issues or positions in the case, or of the case as a whole, and for making independent judgments concerning the hazards of litigation." The prohibition has no impact on the procedures relating to the Appeals process for cases docketed in the Tax Court.

- Appeals retains procedures for (a) returning

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

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

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

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

- Effective for communications between Appeals Officers and other Internal Revenue Service employees that place after 10/23/00.

9. REG-246249-96, Information Reporting Requirements for Certain Payments Made on Behalf of Another Person, Payments to Joint Payees, and Payments of Gross Proceeds From Sales Involving Investment Advisers, 65 F. R. 61292, (10/16/00). Proposed amendments to Reg. §§ 1.6041-1, -3; 1.6045-1, -2; 1.6049-4; 31.3406(a)-2, and other correlative sections would (1) clarify who is the payee for information reporting purposes if a check or other instrument is made payable to joint payees; (2) provide information reporting requirements for escrow agents and other persons making payments on behalf of another person; and (3) clarify that the amount to be reported paid is the gross amount of the payment. Proposed regulations under § 6045 would remove investment advisers from the list of exempt recipients.

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

11. *Nis Family Trust v. Commissioner*, 115 T.C. 523 (2000). As a general rule, where there are no material issues of fact and resolution of the case turns on solely on legal issues, the burden of proof rule of § 7491 is irrelevant. Thus, § 7491 did not affect the Commissioner's burden on motion for judgment on the pleadings, which can be granted only if there are no material issues of fact.

12. *Shwarz v. United States*, 234 F.3d 428 (9th Cir. 2000). Section 7433 provides the exclusive remedy, and § 7431 does not apply, if an unauthorized disclosure of tax return information occurs in connection with collection activities.

13. **Extended Time for Use of the Revised Form W-9.** Announcement 2001-15, 2001-8 I.R.B. 715. This announcement advises persons required to file information returns of the availability and required use of Form W-9, Request for Taxpayer Identification Number and Certification (Rev. Dec. 2000). In response to payor concerns about implementing the new certification requirements, the use of revised Form W-9 is optional until 7/1/01. The major change to the form is that under Part III, Certification, a payee must now certify that he or she is a U.S. person (including a U.S. resident alien). Payors must use the revised Form W-9 for all new solicitations after 6/30/01. A foreign person may not use Form W-9 to furnish his or her taxpayer identification number to the payor after 12/31/00. Instead, foreign payees must use the appropriate Form W-8.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. **Court defers to reasonable IRS interpretation.** *Morrison Restaurants, Inc. v. United States*, 118 F.3d 1526 (11th Cir. 1997). Under § 3111(a) & (b) and 3121(q), the IRS could validly assess employer's share of FICA with respect to restaurant employees' unreported tips on the basis of an aggregate computation, without determining individual employees' shares.

a. *Fior D'Italia Inc. v. United States*, 21 F. Supp. 2d. 1097, (N.D. Cal. 1998), holds that the IRS lacks authority to assess employer's share of FICA without determining the tip income of individual employees.

b. *Bubble Room Inc. v. United States*, 159 F.3d 553 (Fed. Cir. 1998). The IRS has statutory authority to assess FICA taxes against an employer without determining the tip income of individual employees and awarding wage credits to the employees.

c. **Is the Northern District of Florida still in the Eleventh Circuit?** *Quietwater Entertainment, Inc. v. United States*, 80 F. Supp. 2d. 1323 (N.D. Fla. 1999). The IRS determined a deficiency in the employer's share of FICA taxes for tips to employees in its restaurant. In doing so, the IRS used a modified *McQuatters* formula [T. C. Memo. 1973-240], on an aggregate basis, a methodology approved by the Eleventh Circuit in *Morrison Restaurants v.*

United States, 118 F.3d 1526 (11th Cir. 1997), and presumed a 12% tip rate for cash bills and a 16% rate for credit card bills. District Court Judge Vinson held that the 11th Circuit got it wrong in *Morrison Restaurants* and that § 6053(c), which requires withholding by the employer of the employee's share of FICA based on a presumed 8% tip rate implicitly caps the assessment of the employer's share at 8% as well and prescribes the only available allocation methods, implicitly proscribing aggregate assessments of the employer's share.

d. The answer is yes! *Quietwater* reversed *per curiam*. *Quietwater Entertainment, Inc. v. United States*, 220 F.3d 592 2000-2 U.S.T.C. ¶ 50,540, 85 A.F.T.R.2d 2195 (11th Cir. 2000) (unpublished). The Court of Appeals held that *Morrison* controlled this case and reversed with directions to enter summary judgment for the government.

e. How will this affect service in Cocco Pazzo? 330 *West Hubbard Restaurant Corp. v. United States*, 203 F.3d 990 (7th Cir. 2000). Under §§ 3111(a) & (b) and 3121(q), IRS could validly assess employer's share of FICA with respect to restaurant employees' unreported tips on the basis of an aggregate computation, without determining individual employees' shares. Deferring to both the Federal and Eleventh Circuits, held that the IRS is authorized to collect an employer's FICA taxes without first assessing individual employees and crediting their Social Securities earnings records. Judge Coffey also deferred to the IRS interpretation of § 3121(q).

2. *American Airlines Inc. v. United States*, 204 F.3d 1103 (Fed. Cir. 2000), *rev'g and remanding in part and aff'g in part*, 40 Fed. Cl. 712 (1998). On summary judgment, the Court of Claims held that as an employer American Airlines was liable for withholding and FICA taxes on per diem payments provided to employees under collective bargaining agreements; exclusion was limited to \$14 per day (as allowed by Reg. § 1.274-5 as then in effect) because the per diem payments were not excludable as working condition fringe benefits as amounts reasonably expected to be incurred on an overnight trip; other per diem allowances were not excludable as working condition fringe benefits because they were paid in connection with turnaround trips that did not require "sleep or rest." It also held that credit card vouchers [of \$100 per employee] did not constitute *de minimis* fringe benefits because the employer could have easily accounted for them, a result confirmed by the subsequently-issued Reg. § 1.132-6T(c). On the first issue, the Federal Circuit reversed and remanded, holding that the Court of Claims erred in holding that there was not a factual dispute regarding whether American reasonably believed its per diem was less than or equal to the employee's expenses. But it affirmed the holding that the per diem allowances, for which substantiation was not required, could not be working condition fringe benefits. On the second [turn-around per diem] and third [AmEx vouchers] issues, the Federal Circuit affirmed.

3. *Wuebker v. Commissioner*, 205 F.3d 897 (6th Cir. 2000), *rev'g* 110 T.C. 431 (1998). The taxpayer was a farmer who received payments for enrolling land in the Conservation Reserve Program ("CRP") under the Food Security Act of 1995, removing the land from production and establishing a vegetative cover.

- The Tax Court held that the payments were rents from real estate, even though related to farming to farming activities, and pursuant to Reg. § 1.1402(a)-4(d) were not subject to self employment tax. Frederick Wuebker and his wife owned 258 acres of land, of which 214 acres was tillable; the rest of the land was highly erodible. After years of farming the property, the Wuebkers agreed to enroll their tillable land into the CRP in 1991. In exchange for annual payments, the Wuebkers established and maintained vegetative cover; disallowed grazing, harvesting, and other commercial use of the ground cover; and controlled weeds, insects, and pests. Under the CRP agreement, the Wuebkers were required to turn the soil and plant seed in 1992; the Wuebkers used their existing farming equipment to accomplish these tasks. Thereafter, the upkeep was minimal. The Wuebkers received \$18,000 per year in CRP payments in 1992 and 1993, which they reported as farm rental income that was not subject to self-employment tax. The IRS determined that the amounts received under the CRP plan constituted income from the trade or business of farming that was subject to self-employment tax under § 1401. The Tax Court held that the payments were rental payments excludable from self-employment income under § 1402. The IRS appealed.

- The Sixth Circuit reversed. Judge Gilman held that the CRP payments constituted self-employment income, concluding that the income was derived from the Wuebkers' trade or business of farming. Contrary to the Tax Court's conclusion, the appeals court found that there was a sufficient nexus between the CRP payments and the Wuebkers' farming operations, noting that the couple was actively engaged in the farming business both before and during the term of their CRP agreement. The agreement, Judge Gilman pointed out, merely required the Wuebkers to perform ongoing tasks with respect to the land placed in the CRP. Thus, the CRP payments were "'in connection with' and had a 'direct nexus to' [the Wuebkers'] ongoing trade or business," the court concluded. Rejecting the Wuebkers' argument to the contrary, Judge Gilman concluded that the CRP payments were not "rent" because they were not made in exchange for the "use or occupancy of property." The appeals court disagreed with the notion that the restrictions the Agriculture Department imposed on the Wuebkers' use of their land constituted "use" by the agency, pointing out that the couple continued to maintain control over and free access to their land. Judge Gilman also disagreed with the Tax Court's determination that the Wuebkers' service-performance obligations under the CRP agreement were insignificant and merely incidental to the contract's primary purpose. The essence of the CRP, the court explained, was to prevent participants from farming the enrolled property and to require them to perform

various activities in connection with the land continuously throughout the life of the contract. Thus, Judge Gilman reasoned, the Wuebkers' maintenance obligations were significant and the payments were compensation for their labor.

◦ Dissenting, Circuit Judge Nathaniel R. Jones found that the substantial and wide-ranging limitations the CRP imposed on the Wuebkers' use of their land constituted "use" by the Agriculture Department as contemplated by the ordinary definition of "rent."

4. A reverse reasonable comp case; salaries paid to S corporation shareholder-employees must not be too low! *Joly v. Commissioner*, 211 F.3d 1269 (6th Cir. 2000), *aff'g* T. C. Memo. 1998-361. The taxpayers were shareholders of an S corporation who performed services for the corporation but drew no salaries. A portion of the shareholders' profit shares was recharacterized as salary, giving rise to employment tax liability. The assessment of accuracy related penalties was upheld.

5. *Neely v. Commissioner*, 115 T.C. 287 (2000). The Tax Court (Judge Vasquez) decided that it has jurisdiction under its new § 7436 "worker classification" jurisdiction to decide (in the context of the case) whether the IRS is barred by the § 6501 statute of limitations from assessing a deficiency based upon worker classification because the statute of limitations is an affirmative defense.

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

7. The scheme worked until a labor dispute arose. *United States v. Kontny*, 238 F.3d 815 (7th Cir. 2001). Judge Posner upheld a criminal conviction and sentencing for fraudulent nonpayment of payroll taxes. Kontny thought he could beat both the Fair Labor Standards Act and the IRC by not paying time-and-a-half for overtime but just not reporting or withholding on straight-time pay for overtime hours.