

# FLORIDA TAX REVIEW

Volume 15

2014

Number 5

## RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION: THE YEAR 2013

“Recent developments are just like ancient history, except they happened less long ago.”

*Martin J. McMahon, Jr.\**

*Ira B. Shepard\*\**

*Daniel L. Simmons\*\*\**

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

*Bruce A. McGovern, Vice President, Associate Dean, and Professor of Law, South Texas College of Law, contributed to this article. Bruce’s contribution is (relative) youth.*

\* James J. Freeland Eminent Scholar in Taxation and Professor of Law, University of Florida Fredric G. Levin College of Law.

\*\* Professor Emeritus, University of Houston Law Center.

\*\*\* Professor of Law Emeritus, University of California Davis School of Law.

<b>I.</b>	<b>ACCOUNTING</b> .....	236
	A. Accounting Methods .....	236
	B. Inventories .....	236
	C. Installment Method .....	236
	D. Year of Inclusion or Deduction.....	236
<b>II.</b>	<b>BUSINESS INCOME AND DEDUCTIONS</b> .....	238
	A. Income .....	238
	B. Deductible Expenses versus Capitalization .....	243
	C. Reasonable Compensation .....	258
	D. Miscellaneous Deductions .....	261
	E. Depreciation & Amortization .....	268
	F. Credits .....	275
	G. Natural Resources Deductions & Credits .....	277
	H. Loss Transactions, Bad Debts, and NOLs .....	277
	I. At-Risk and Passive Activity Losses .....	280
<b>III.</b>	<b>INVESTMENT GAIN AND INCOME</b> .....	284
	A. Gains and Losses .....	284
	B. Interest, Dividends, and Other Current Income .....	286
	C. Profit-Seeking Individual Deductions.....	287
	D. Section 121 .....	287
	E. Section 1031 .....	287
	F. Section 1033 .....	290
	G. Section 1035 .....	291
	H. Miscellaneous .....	291
<b>IV.</b>	<b>COMPENSATION ISSUES</b> .....	291
	A. Fringe Benefits.....	291
	B. Qualified Deferred Compensation Plans.....	295
	C. Nonqualified Deferred Compensation, Section 83, 293and Stock Options .....	295
	D. Individual Retirement Accounts .....	298
<b>V.</b>	<b>PERSONAL INCOME AND DEDUCTIONS</b> .....	301
	A. Rates.....	301
	B. Miscellaneous Income .....	312
	C. Hobby Losses and § 280A Home Office and Vacation Homes.....	318
	D. Deductions and Credits for Personal Expenses.....	320
	E. Divorce Tax Issues.....	324
	F. Education .....	324
	G. Alternative Minimum Tax .....	324
<b>VI.</b>	<b>CORPORATIONS</b> .....	325
	A. Entity and Formation .....	325
	B. Distributions and Redemptions.....	327
	C. Liquidations .....	328

	D. S Corporations .....	329
	E. Mergers, Acquisitions and Reorganizations .....	333
	F. Corporate Divisions .....	333
	G. Affiliated Corporations and Consolidated Returns .....	333
	H. Miscellaneous Corporate Issues.....	340
<b>VII.</b>	<b>PARTNERSHIPS.....</b>	<b>341</b>
	A. Formation and Taxable Years.....	341
	B. Allocations of Distributive Share, Partnership Debt, and Outside Basis.....	348
	C. Distributions and Transactions Between the Partnership and Partners .....	352
	D. Sales of Partnership Interests, Liquidations and Mergers .....	357
	E. Inside Basis Adjustments .....	358
	F. Partnership Audit Rules .....	358
	G. Miscellaneous .....	365
<b>VIII.</b>	<b>TAX SHELTERS.....</b>	<b>367</b>
	A. Tax Shelter Cases and Rulings .....	367
	B. Identified “tax avoidance transactions” .....	378
	C. Disclosure and Settlement.....	378
	D. Tax Shelter Penalties, etc.....	379
<b>IX.</b>	<b>EXEMPT ORGANIZATIONS AND CHARITABLE GIVING.....</b>	<b>384</b>
	A. Exempt Organizations.....	384
	B. Charitable Giving.....	393
<b>X.</b>	<b>TAX PROCEDURE .....</b>	<b>405</b>
	A. Interest, Penalties, and Prosecutions .....	405
	B. Discovery: Summonses and FOIA.....	413
	C. Litigation Costs.....	417
	D. Statutory Notice of Deficiency .....	418
	E. Statute of Limitations.....	419
	F. Liens and Collections.....	423
	G. Innocent Spouse .....	429
	H. Miscellaneous .....	434
<b>XI.</b>	<b>WITHHOLDING AND EXCISE TAXES .....</b>	<b>436</b>
	A. Employment Taxes .....	436
	B. Self-employment Taxes .....	443
	C. Excise Taxes .....	443
<b>XII.</b>	<b>TAX LEGISLATION .....</b>	<b>444</b>
	A. Enacted.....	444

## I. ACCOUNTING

### A. Accounting Methods

1. **Yes, but when is the income recognized when, as often happens, the customer never redeems the gift card?** Rev. Proc. 2013-29, 2013-33 I.R.B. 141 (7/24/13). This revenue procedure allows a taxpayer to defer recognizing in gross income certain advance payments received from the sale of gift cards that are redeemable for goods or services by an unrelated entity. Where a gift card is redeemable by an entity whose financial results are not included in the taxpayer's applicable financial statement, the taxpayer will recognize the payment in income to the extent the gift card is redeemed. For a taxpayer without an applicable financial statement, the taxpayer will recognize the payment in income when it is earned, which, in this situation, is when the gift card is redeemed. Any payment received by the taxpayer that is not recognized in income in the year of receipt, must be recognized in the subsequent year. The revenue procedure modifies and clarifies Rev. Proc. 2011-18, 2011-5 I.R.B. 443, *modifying and clarifying* Rev. Proc. 2004-34, 2004-1 C.B. 991. It is effective for taxable years ending on or after 12/31/10.

### B. Inventories

There were no significant developments regarding this topic during 2013.

### C. Installment Method

There were no significant developments regarding this topic during 2013.

### D. Year of Inclusion or Deduction

1. **Does this case stand for the proposition that if you care enough about the treatment of a deduction item to try to change your accounting method regarding the year of deduction it's "material" for tax purposes even if it's not "material" for financial accounting purposes?** *Veco Corp. v. Commissioner*, 141 T.C. No. 14 (11/20/13). The accrual method taxpayer claimed current expense deductions for a variety of liabilities under a number of contracts performance under which straddled taxable years. On its GAAP financial it accrued the deductions over more than one year. The Tax Court (Judge Marvel) first held that the mere execution of the contract does not necessarily establish the fact of liability. However, the terms of the agreements are relevant in deciding whether and

when the liabilities became fixed under the all events test. Where the taxpayer had not by the end of its year requested that services be performed and amounts were not unconditionally due, the fact of the liability had not been established. Furthermore, the economic performance requirement of § 461(h) foreclosed certain deductions. The taxpayer conceded that it had not satisfied the 3½-month rule of Reg. § 1.461-4(d)(6)(ii) for any of the deductions in issue. Turning to the recurring item exception in § 461(h)(3), the IRS argued that the taxpayer failed to satisfy the economic performance requirement and the materiality or matching requirement of the recurring item exception for all of the disputed deductions. The taxpayer's position was that economic performance with respect to each expense item occurred within 8½ months after the close of its taxable year, as required by § 461(h)(3)(A)(ii)(II), and that each expense item was not material within the meaning of § 461(h)(3)(A)(iv)(I). (The taxpayer conceded that, with one exception, it had not satisfied the matching requirement for any of the disputed deductions.) Section 461(h)(3)(B) provides that the treatment of an item on financial statements should be taken into account in determining if an item is "material." An example in the conference report, H.R. Conf. Rept. No. 98-861, at 874 (1984), 1984-3 C.B. (Vol. 2) 1, 128, explains that if a calendar-year taxpayer enters into a one-year maintenance contract on July 1, 1985, and the amount of the expense is prorated between 1985 and 1986 for financial statement purposes, it also should be prorated for tax purposes. But if the full amount is deducted in 1985 for financial statement purposes because it is not material under generally accepted accounting principles, it may (or may not) be considered an immaterial item for purposes of the exception. Drawing on this example, Judge Marvel concluded that the liabilities giving rise to the disputed deductions were "material" because the taxpayer prorated the liabilities between two years on its financial statements and took an inconsistent position with respect to the liabilities for financial statement and tax reporting purposes. Furthermore, even if the amount of the liabilities was immaterial for financial statement purposes, under Reg. § 1.461-5(b)(4)(iii) "[a] liability that is immaterial for financial statement purposes under generally accepted accounting principles may be material" for purposes of the recurring item exception. "The disputed items resulted from a change of accounting method, which was disclosed on petitioner's financial statement, and the disputed items were treated inconsistently for financial accounting and tax reporting purposes. In addition, the liabilities giving rise to the deductions were accrued over more than one taxable year. Under these circumstances, the liabilities generating the accelerated deductions were material for tax purposes."

**2. The IRS continues successfully to flex the awesome power of § 461(h).** *Suriel v. Commissioner*, 141 T.C. No. 16 (12/4/13). The taxpayer was the sole shareholder of an accrual method S

corporation that was a cigarette importer. The corporation settled tobacco related claims with 46 States, the District of Columbia, the Commonwealth of Puerto Rico, and 4 U.S. territories by entering into the Tobacco Master Settlement Agreement (MSA). It agreed to pay \$242,314,534 in 12 annual instalments from 2005 through 2016. Even though none of the amount was paid, the corporation took the entire amount into account in computing the cost of goods sold. It also deducted \$4,661,190 as interest owed on its obligation; none of the interest was paid. The IRS disallowed the \$242,314,534 deduction on the grounds that economic performance had not yet occurred. The IRS's position was that because the payments were to a qualified settlement fund (QSF), based on § 468B(a) economic performance therefore did not occur until the payments were made. (Section 468B(a) specifically provides: "For purposes of section 461(h), economic performance shall be deemed to occur as qualified payments are made by the taxpayer to a designated settlement fund." *See also* Reg. § 1.468B-3(c)(1).) The taxpayer argued that the obligation arose from the provision of cigarettes to the taxpayer by the manufacturer and that pursuant to § 461(h)(2)(A)(ii) economic performance therefore occurred as the manufacturer provided the cigarettes to the taxpayer. The Tax Court (Judge Goeke) agreed with the IRS. As far as the interest deduction was concerned, Judge Goeke held that where the interest is owed to a QSF, the more specific timing rule in § 468B(a) took precedence over the more general timing rules in §§ 163(a) and 461(a) and disallowed the deduction.

## II. BUSINESS INCOME AND DEDUCTIONS

### A. Income

1. **El Niño has not yet won a major, but he claims a partial victory in the Tax Court.** Garcia v. Commissioner, 140 T.C. 141 (3/14/13). Professional golfer Sergio Garcia, a resident of Switzerland, derived income from an endorsement agreement with TaylorMade Golf Co. The agreement required Garcia to "exclusively wear and use golf products produced by TaylorMade and associated brands (TaylorMade products), and TaylorMade . . . receive[d] the right to use [Garcia's] image, likeness, signature, voice, and any other symbols associated with his identity to promote TaylorMade products." Garcia also was required to make a specified number of personal appearances and to play in a specified number of tournaments each year. An amendment to the endorsement agreement allocated 85 percent of Garcia's compensation to royalties for use of his image rights and 15 percent to his personal services. The government argued that the vast majority of Garcia's income was attributable to his personal services. The Tax Court (Judge Goeke) considered expert reports submitted

by the parties and judicial precedent, including a prior decision of the Tax Court on the same issue in connection with golfer Retief Goosen's endorsement agreement with TaylorMade, *Goosen v. Commissioner*, 136 T.C. 547 (2011) (where Judge Kroupa found a 50%-50% split). The court concluded that 65 percent of Garcia's compensation was royalties and 35percent was compensation for personal services. The court also held that Garcia's royalty income was not, as the government argued, income derived as an entertainer and therefore taxable in the United States under article 17 of the U.S.-Swiss tax treaty, but rather was royalty income that is not taxable in the United States under article 12 of the treaty. The court held that all of Garcia's U.S.-source personal service income was taxable in the United States and rejected as untimely Garcia's argument, raised for the first time in a post-trial brief, that a portion of his service income was not taxable in the United States.

**2. Cash value life-insurance through off-shore insurance companies and LLCs don't produce deductible premiums.** *Salty Brine 1, Ltd. v. United States*, 111 A.F.T.R.2d, 2013-2308 (N.D. Tex. 5/16/13). In a marketed insurance tax shelter arrangement that even *Jenkins & Gilchrist* would not bless with an opinion, the court denied § 162 deductions for premiums paid for business protection insurance issued by off-shore affiliates of Fidelity and Citadel Insurance companies. The policies included cash value life insurance and related annuities that the court found did not protect the business from risk and merely represented an attempt to funnel cash from the businesses to families of the owners. Section 6662 penalties were upheld.

**3. Pay me now or pay me later.** The 2009 ARRA, § 1231(a), added Code § 108(i), which defers and then ratably includes income arising from business indebtedness discharged by the reacquisition of a debt instrument. This provision allows a taxpayer to irrevocably elect to include cancellation of debt income realized in 2009 and 2010 ratably over five tax years, rather than in the year the discharge occurs, if the debt was issued in connection with the conduct of a trade or business or by a corporation. For partnerships and S corporations, the election is made by the partnership or corporation, not by the individual partners or shareholders. I.R.C. § 108(i)(5)(B)(iii). Under the § 108(i) election, income from a debt cancellation in 2009 is recognized beginning in the fifth taxable year following the debt cancellation; the income is recognized ratably in each of 2014 through 2018. Income from a debt cancellation in 2010 is recognized beginning in the fourth taxable year following the debt cancellation; the income is recognized ratably in each of 2014 through 2018. If a taxpayer elects to defer debt cancellation income under § 108(i), the § 108(a) exclusions for bankruptcy, insolvency, qualified farm indebtedness, and

qualified real property business indebtedness do not apply to the year of the election or any subsequent year. I.R.C. § 108(i)(5)(C). Thus, the election cannot be used to move the year of inclusion to a year in which it is expected that one of the exceptions will apply. Once the election is made, inclusion is inevitable; the statute requires acceleration of inclusion to the taxpayer's final return in the event of the intervening death of an individual or liquidation or termination of the business of an entity. § 108(i)(5)(D). The acceleration rule also applies in the event of the sale or exchange or redemption of an interest in a partnership or S corporation by a partner or shareholder.

**a. Many of the questions have been answered.** Rev. Proc. 2009-37, 2009-36 I.R.B. 309 (8/17/09). This revenue procedure provides the exclusive procedure for taxpayers to make § 108(i) elections. Debt cancellation in connection with a property transfer is included in § 108(i). Section 4.04(3) permits partial elections, with the partnership permitted to determine "in any manner" the portion of the COD income that is the "deferred amount" and the portion of the COD income that is the "included amount" with respect to each partner. Section 4.11 permits protective elections where the taxpayer concludes that a particular transaction does not generate COD income but fears that the IRS may determine otherwise. A partner's deferred § 752(b) amount, arising from a decrease in his share of partnership liabilities, will be treated as a current distribution of money in the year that the COD income is included. Taxpayers are allowed an automatic one-year extension from the due date to make the election, and taxpayers who made elections before the issuance of the revenue procedure will be given until 11/16/09 to modify (but not revoke) their existing elections. Corporate taxpayers making a § 108(i) election are required to increase earnings and profits for the year of the election.

**b. Temporary Regulations allocate deferred cancellation of debt income.** T.D. 9498, Application of Section 108(i) to Partnerships and S Corporations, 75 F.R. 49380 (8/13/10). Section 108(i) provides an election to include cancellation of indebtedness income resulting from a reacquisition (broadly defined in § 108(i)(4)) of a debt instrument, issued by a C corporation or other person engaged in a trade or business, ratably over five years beginning with the fifth year following reacquisition occurring in 2009, and the fourth year following reacquisition in 2010. Under § 108(i)(5)(B)(iii) an election is made by the partnership, not the partners individually. Section 108(i)(6) requires a partnership to allocate the COD income to partners according to partnership share on the day immediately preceding reacquisition and provides that the discharge will not trigger



§ 752(b) recognition under § 731 because of a reduction in a partner's share of partnership liabilities.

- Temp. Reg. § 1.108(i)-2T(d)(1) provides five safe harbors where debt instruments issued by a partnership or S corporation will be treated as issued in a trade or business: (1) The gross fair market value of the trade or business assets of the partnership or S corporation represent at least 80 percent of the fair market value of all of its assets on the date of issuance, (2) trade or business expenses of the partnership or S corporation represent at least 80 percent of all expenditures, (3) at least 95 percent of the interest paid on the debt instrument is allocable to trade or business expenditures under the interest allocation rules of Temp. Reg. § 1.163-8T, (4) at least 95 percent of the proceeds from the debt instrument were used to acquire trade or business assets within six months of the issue of the debt, or (5) the partnership or S corporation issued the debt instrument to the seller of a trade or business to acquire the trade or business. Absent anchoring in one of the safe harbors, qualification of a trade or business debt is a matter of facts and circumstances.

- While § 108(i)(5)(B)(iii) requires the election to be made at the partnership level, Temp. Reg. § 1.108(i)-2T(b)(1) allows the partnership to allocate both deferred and included portions of COD income to the partners. The temporary regulations first require that COD income be allocated to the partners in the partnership immediately before the reacquisition in the manner the income would be included in distributive shares under § 704, then the partnership must determine the amount of COD income from the applicable instrument that is the deferred amount includible in the partner's share and the amount that is immediately includible. With respect to deferred COD income of an S corporation, Temp. Reg. § 1.108(i)-2T(c)(1) requires that on an election by the S corporation, deferred income must be shared pro rata on the basis of stock ownership immediately prior to the reacquisition.

- Temp. Reg. § 1.108(i)-2T(b)(2) provides that a partner's basis is not adjusted under § 705(a) to account for the partner's share of partnership deferred COD income until the deferred item is recognized by the partner. Likewise, Temp. Reg. § 1.108(i)-2T(c)(2) provides that neither an S corporation shareholder's basis under § 1367 nor the shareholder's accumulated adjustment account is adjusted for deferred COD income until the shareholder recognizes the deferred COD income.

- Following the rules of Rev. Proc. 2009 37, and applying the rules of § 108(i)(6), Temp. Reg. § 1.108(i)-2T(b)(3) provides that reduction in a partner's share of partnership liabilities is determined under § 752(b) when a debt instrument is reacquired, but that the reduction in liabilities is not treated as a distribution of money until deferred COD income is recognized by the partner. The temporary regulations

provide additional rules for determining a partner's deferred amounts where the partner would recognize § 731 gain in the year of the reacquisition.

- Partners' capital accounts are adjusted as if no § 108(i) election were made.

- Temp. Reg. § 1.108(i)-2T(d)(3) provides that gain attributable to a reduction in a partner's or S corporation shareholder's amount at-risk under § 465(e) will not be taken into account in the year of reacquisition and will be deferred to the date the COD income is recognized.

- In the case of an acceleration event under § 108(i)(5)(D) that requires a partnership or S corporation to recognize deferred items, under Temp. Reg. § 1.108(i)-2T(c)(3) the partners or S corporation shareholders must account for deferred COD income in the year that the accelerating event takes place. In addition, the temporary regulations describe various circumstances in which a partner or S corporation shareholder terminates the interest in the entity that will require acceleration of deferred COD income, including death, liquidation, sale or exchange, redemption, or abandonment.

- Identical proposed regulations were issued simultaneously. REG-144762-09, Application of Section 108(i) to Partnerships and S Corporations, 75 F.R. 49427 (8/13/10).

**c. Significant guidance on a soon to expire beneficial Code section that leaves a nasty hangover.** T.D. 9497, Guidance Regarding Deferred Discharge of Indebtedness Income of Corporations and Deferred Original Issue Discount Deductions, 75 F.R. 49394 (8/13/10). The IRS and Treasury have promulgated Temp. Reg. §§ 1.108(i)-0T through 1.108(i)-3T providing detailed rules for C corporations regarding the acceleration of deferred COD income and deferred OID deductions under § 108(i)(5)(D), and the calculation of earnings and profits as a result of an election under § 108(i). The regulations also provide rules applicable to all taxpayers regarding deferred OID deductions under § 108(i) as a result of a reacquisition of an applicable debt instrument by an issuer or related party.

- Identical proposed regulations were issued simultaneously. REG-142800-09, Guidance Regarding Deferred Discharge of Indebtedness Income of Corporations and Deferred Original Issue Discount Deductions, 75 F.R. 49428 (8/13/10).

**d. Final guidance on an expired Code section.** T.D. 9622, Guidance Regarding Deferred Discharge of Indebtedness Income of Corporations and Deferred Original Issue Discount Deductions, 78 F.R. 39984 (7/2/13). The Treasury Department has finalized the proposed regulations (REG-142800-09, 75 F.R. 49428 (8/13/10)) regarding deferred

COD income of corporations and deferred OID deductions and replaced the Temporary Regulations promulgated in T.D. 9497, 75 F.R. 49394 (8/13/10), without significant changes.

**e. More final guidance on an expired Code section.** T.D. 9623; Application of Section 108(i) to Partnerships and S Corporations 78 F.R. 39973 (7/2/13). The Treasury Department has finalized the proposed regulations (REG-144762-09, 75 F.R. 49427 (8/13/10)) regarding application of § 108(i) to partnerships and S corporations, and has replaced the Temporary Regulations promulgated in T.D. 9498, 75 F.R. 49380 (8/13/10), with some changes.

## **B. Deductible Expenses versus Capitalization**

**1. Temporary and proposed regulations provide extensive rules for the acquisition, production, or improvement of tangible personal property.** T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11), and REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81128 (12/27/11). The Treasury Department has promulgated temporary regulations, generally effective for tax years beginning on or after 1/1/12, addressing capitalization requirements for expenditures to acquire and improve tangible property.

**a. IRS specifies the procedures for adopting new accounting methods under the Temporary Regulations.** Rev. Proc. 2012-19, 2012-14 I.R.B. 689 (3/7/12), *modifying* Rev. Proc. 2011-14, 2011-1 C.B. 330. The IRS has provided lengthy and detailed rules regarding automatic changes in methods of accounting under Temp Reg. §§ 1.162-3T and 4T (materials and supplies), 1.263(a)-1T (capital expenditures in general), 1.263(a)-2T (transaction costs), and 1.263(a)-3T (improvements), all added by T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11). These changes are for taxable years beginning on or after January 1, 2012.

**b. LB&I provides guidance under Rev. Proc. 2012-19.** LB&I-4-0312-004 (3/15/12). This directive to the field applies to taxpayers who adopted a method of accounting relating to the conversion of capitalized assets to repair expense under § 263(a).

**c. Have your clients been wasting time trying to comply with the Temporary Regulations in 2012? Yes, they have. Further guidance announcing that pending final regulations will**

**apply only in years beginning in 2014 and thereafter.** Notice 2012-73, 2012-51 I.R.B. 713 (11/20/12). The IRS announced that pending final regulations will apply to taxable years beginning on or after 1/1/14, but that taxpayers will be permitted to apply the final regulations to taxable years beginning on or after 1/1/12. The notice also indicates that the temporary regulations may be revised with respect to the de minimis rule of § 1.263(a)-2T(g); dispositions under §§ 1.168(i)-1T and 1.168(i)-8T; and the Safe Harbor for Routine Maintenance under § 1.263(a)-3T(g).

**d. Technical amendments to revise the Temporary Regulations. More important, the effective date of the 12/27/11 temporary regulations is delayed to years beginning on or after 1/1/14, with optional retroactive applicability.** T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 77 F.R. 74583 (12/17/12). These include the following explanation: “[T]he IRS and the Treasury are concerned that taxpayers are expending resources to comply with temporary regulations that may not be consistent with forthcoming final regulations.”

**e. An announcement amending regulations — really!?!?** Announcement 2013-7, 2013-3 I.R.B. 308 (1/14/13). This announcement amends the temporary regulations (T.D. 9564), regarding the deduction and capitalization of expenditures under §§ 162(a) and 263(a) relating to tangible property to apply the temporary regulations to taxable years beginning on or after 1/1/14, while permitting taxpayers to apply the temporary regulations for taxable years beginning on or after 1/1/12, and before the applicability date of the final regulations.

**f. A minor fix.** Announcement 2013-4, 2013-4 I.R.B. 440 (1/18/13). The IRS corrected the temporary regulations to provide in § 1.168(i)-1(l)(2) rules for making general asset account elections on Form 4562. The amendment corrects paragraph numbering mistakes.

**g. Finally, final regulations providing extensive rules regarding capitalization of expenses for the acquisition, production, or improvement of tangible personal property, and bright-line distinction of deductible repairs.** T.D. 9636, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 78 F.R. 57686 (9/19/13). The Treasury Department and IRS have promulgated final regulations under § 263(a) addressing capitalization requirements for expenditures to acquire and improve tangible property that were proposed in REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81128

(12/27/11), and replacing the temporary regulations promulgated in T.D. 9564, *Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property*, 76 F.R. 81060 (12/27/11).<sup>1</sup> The temporary regulations originally were to be effective for tax years beginning on or after 1/1/12, with an expiration date of 12/23/14, but T.D. 9564, *Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property*, 77 F.R. 74583 (12/17/12), delayed the effective date to years beginning on or after 1/1/14, with optional retroactive applicability to taxable years beginning on or after 1/1/12. The final regulations generally are effective for taxable years beginning on or after January 1, 2014. The § 263(a) regulations provide detailed capitalization rules and several bright-line standards under §§ 162(a) and 263(a) regarding the acquisition, improvement or repair of tangible real and personal property. The 2011 temporary regulations also revised rules under § 168 regarding disposition of and maintenance of general asset accounts for MACRS property. Except for Reg. § 1.168(i)-7, dealing with multiple asset accounts, these provisions of the temporary regulations (Temp. Regs. §§ 1.168(i)-1T, 1.168(i)-8T), have not been finalized and are still in force. In general, the § 263(a) regulations adopt the provisions of the 2011 and 2008 proposed regulations, but with multiple modifications, including not insignificant redesignation of subsections. Reg. § 1.263(a)-2 provides rules for amounts paid for the acquisition or production of tangible property, and § 1.263(a)-3 provides rules for amounts paid for the improvement of tangible property. However, these new regulations provide many additional rules. The final regulations define material and supplies to treat as deductible (1) the cost of any property with a useful life that does not exceed one year and (2) any item that costs not more than \$200 (the temporary regulations had a \$100 ceiling). They add a book-conformity de minimis rule, a safe-harbor for routine maintenance, and an optional simplified method for regulated taxpayers. The regulations contain provisions defining a unit of property as a key concept and address capitalization of expenditures that improve or restore a unit of property. The final regulations do not provide for or authorize a detailed repair allowance rule, and unlike the temporary regulations do not provide for future I.R.B. guidance regarding industry-specific repair allowance methods.

---

1. The temporary regulations adopt provisions of regulations proposed in 2008 (REG-168745-03, *Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property*, 73 F.R. 12838 (3/7/08)), which were in turn based on a 2006 proposal that was substantially modified by the 2008 proposed regulations (REG-168745-03, *Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property*, 71 F.R. 48590 (8/21/06)).

- *Acquisition and Production Costs.* Reg. § 1.263(a)-2 provides that a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property (as determined under Reg. § 1.263(a)-3(e)), including leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. Amounts paid to create intangible interests in land are treated as capital expenditures. Reg. § 1.263(a)-1(d)(5). Amounts paid for work performed on a unit of property prior to the date the property is placed in service must also be capitalized. Reg. § 1.263(a)-2(d)(1). Transaction costs to facilitate the acquisition of property are expressly required to be capitalized, Reg. § 1.263(a)-2(f), but facilitative expenditures do not include employee compensation or overhead unless the taxpayer elects to capitalize such expenditures or if capitalization is required under § 263A. Expenditures to defend or protect title must be capitalized. Reg. § 1.263(a)-2(e).

- *Selling Expenses.* Reg. § 1.263(a)-1(e) provides for the capitalization of selling expenses as an offset against sales proceeds (except in the case of dealers).

- *Materials and Supplies.* As under the prior rules, Reg. § 1.162-3 allows a deduction for incidental material and supplies in the year an expenditure is made. Materials and supplies are incidental when they are carried on hand and for which no record of consumption is maintained or when not carried in inventory. A deduction for non-incidental materials and supplies is allowed *in the year the property is consumed*. Materials and supplies include tangible property that is (1) a component acquired to repair or improve a unit of tangible property that is not acquired as part of a unit of property, (2) fuel, lubricants, water and similar items that are reasonably expected to be consumed within 12 months, (3) tangible property that is a unit of property with (a) an economic useful life to the taxpayer of not more than 12-months, or (b) that costs not more than \$200 (an embedded de minimis rule), and (4) certain rotatable spare parts. Reg. § 1.162-3(c). Unlike the temporary regulations, which allowed taxpayers to elect to capitalize the cost of each item of material or supply, the final regulations allow an election to capitalize only rotatable, standby, or temporary spare parts (as defined). Items used in the production of other property remain subject to the uniform capitalization rules of § 263A. Reg. § 1.263A-1(b). On sale or disposition, materials and supplies are not treated as capital assets. Reg. § 1.162-3(g).

- *Rotable Spare Parts.* Rotable spare parts are components treated as materials and supplies that are installed in a unit of property, are removable from the unit of property, and are generally repaired and improved for installation in a unit of property or stored for later use. The cost of rotatable spare parts is deductible in the year of the disposition of the part. Reg. § 1.162-3(a)(3). Reg. § 1.162-3(e) provides an elective optional

method of accounting for the treatment of rotatable and temporary spare parts under which (1) the taxpayer deducts the amount paid for the part in the year the part is first installed on a unit of property, (2) in each year the part is removed from a unit of property the taxpayer includes the fair market value of the part in gross income, (3) includes in the basis of the part the value taken into income plus amounts paid to remove the part, (4) includes in the basis of the part any amounts expended to maintain the part, (5) then deducts the basis and any cost incurred to reinstall the part in a unit of property, and finally (6) deducts the basis of the part on final disposition.

- *Financial Accounting De Minimis Rules.* Reg. § 1.263(a)-1(f)(1) allows a taxpayer to elect to deduct expenditures to acquire or produce property (other than land or property produced for resale) if the taxpayer expenses the cost on a certified audited financial statement (including audited financial statements prepared by an independent CPA and used for non-tax purposes and certain financial statements filed with regulatory agencies) pursuant to a written accounting procedure adopted by the taxpayer that treats as expenses amounts paid for (1) property costing less than a specified dollar amount, or (2) property that has an economic useful life of 12 months or less, as long as the amount per invoice (or item) does not exceed \$5,000.<sup>2</sup> Notwithstanding these de minimis rules, any amounts paid for property that is, or is intended to be, incorporated into inventory, or that will be used to manufacture inventory, must be capitalized pursuant to § 263A. Property subject to the de minimis rules cannot be treated on sale or other disposition as a capital or § 1231 asset. A taxpayer who elects to apply the de minimis rule of Reg. § 1.263(a)-1(f) must apply the same de minimis rule to materials and supplies, including rotatable spare parts, which are then not treated as materials or supplies under Reg. § 1.162-3.

- *Unit of Property.* Reg. § 1.263(a)-3(e). The unit of property concept is central to the proposed regulations' requirement that improvements to a unit of property must be capitalized.

- Reg. § 1.263(a)-3(e)(2) provides that a building and its structural components (as defined in Reg. § 1.48-1(e)(2)) are treated as a unit of property.<sup>3</sup> However, the improvement rules must be

---

2. The \$5,000 limit replaces the limit in the 2011 temporary regulations, which was an aggregate amount that did not exceed the lesser of 0.1 percent of the taxpayer's gross receipts or 2 percent of the taxpayer's total depreciation and amortization expense reflected in its financial statement; the 2011 temporary regulations removed a provision in the 2008 proposed regulations requiring that the aggregate amount deducted not materially distort the taxpayer's income for purposes of § 446.

3. Under Reg. § 1.48-1(e)(2), structural components of a building include such parts of a building as walls, partitions, floors, and ceilings, as well as any

separately applied to components of a building including heating, ventilation and air conditioning systems, plumbing systems, electrical systems, elevators and escalators, fire protection and security systems, gas distributions systems, and other systems identified in published guidance. Condominium units and cooperative units are each treated for the owner as a unit of property. Similarly, a leasehold interest in a portion of a building is treated as a unit of property.

- Reg. § 1.263(a)-3(e)(1) defines a unit of property for property other than buildings as including all the components that are functionally interdependent. Components of property are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component. However, a component that is recorded on the taxpayer's books as having a different economic useful life or which is in a different class of property for MACRS depreciation would be treated as a separate unit of property. Thus, for example, all of the component parts of a railroad locomotive constitute a single unit of property, as does a truck trailer and its tires (unless the taxpayer's financial statements treat them as separate property). A special rule applies to "plant property," which is a functionally integrated collection of equipment and machinery used to perform an industrial process; each component (or group of components) that performs a discrete and major function or operation within the functionally interdependent machinery or equipment constitutes a separate unit of property. Determinations of a unit of property with respect to network assets are based on the taxpayer's facts and circumstances unless otherwise provided in published guidance. Network assets include property such as railroad tracks, oil, gas, water and sewage pipelines, power transmission lines, and cable and telephone lines that are owned or leased by taxpayers in those industries.

- *Capitalization of Improvements.*

Expenditures to improve a unit of property must be capitalized. Reg. § 1.263(a)-3(d). Amounts expended for repairs and maintenance of tangible property are deductible if they are not required to be capitalized under Reg. § 1.263(a)-3. Reg. § 1.162-4. Expenditures that improve tangible property and that are required to be capitalized include expenditures that:

---

permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building.



- (1) Result in a “betterment” to a unit of property;
- (2) Restore a unit of property; or
- (3) Adapt the unit of property to a new or different use.

Reg. § 1.263(a)-3(f) provides special rules requiring a lessee to capitalize expenditures for improvements to a unit of leased property. A lessor is required to capitalize the cost of improvements to leased property paid directly or through a construction allowance to the lessee. (The preamble to the 2011 temporary regulations states that the recovery period for an improvement or addition to the “underlying property” begins on the placed-in-service date of the improvement or addition. See I.R.C. § 168(i)(6); Temp. Reg. § 1.168(i)-8T(c)(4)(ii)(E).)

• *Betterment.* Reg. § 1.263(a)-3(j). An expenditure must be capitalized if it results in the “betterment” of a unit of property. An expenditure meets this standard only if it — (1) “[a]meliorates a material condition or defect that either existed prior to the taxpayer’s acquisition of the unit of property or arose during the production of the unit of property ...,” (2) “[r]esults in a material addition ... to the unit of property,” or (3) “[i]s reasonably expected to materially increase the productivity, efficiency, strength, quality or output of the unit of property.”<sup>4</sup> Determination of whether an expenditure results in a betterment is factual and requires a comparison of the condition of the property immediately prior to the circumstance necessitating the expenditure (or the condition of property the last time the taxpayer corrected for normal wear and tear) with the condition of the property after the expenditure. An expenditure that results in a betterment of a component of a building is treated as a betterment to the unit of property consisting of the building and its structural components. If an expenditure is made to counter the effects of normal wear and tear, the betterment determination is made by comparing the condition of the property immediately after the expenditure with its condition after the last time the taxpayer corrected the effects of normal wear and tear, or with its condition when placed in service by the taxpayer (if the taxpayer has not previously corrected the effects of wear and tear). Reg. § 1.263(a)-3(j)(3)(iii)(B). If an expenditure is made in response to a particular event that damaged the property, the betterment determination is made by comparing the condition of the property immediately after the expenditure with its condition immediately before the particular event. Reg. § 1.263(a)-3(j)(3)(iii)(C). Although the 2011 temporary regulations provided

---

4. Former Temp. Reg. § 1.263(a)-3(h)(iii) applied a different standard for the third criterion, finding a betterment if the expenditure “[r]esults in a material increase in capacity ..., productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property.”

that the betterment determination was to be made on the basis of “all the facts and circumstances, including, but not limited to, the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on the unit of property, and the taxpayer’s treatment of the expenditure on its applicable financial statement,” former Temp. Reg. § 1.263(a)-3T(h)(3)(i), this provision was eliminated in the final regulations; nevertheless the preamble states that the “IRS and the Treasury Department believe that an analysis of a taxpayer’s particular facts and circumstances is implicit in the application of all the final regulations governing improvements and need not be specifically provided in the application of the betterment rules.”

- *Restoration.* Reg. § 1.263(a)-3(k). An expenditure must be capitalized as a restoration if it (1) replaces a component for which the taxpayer has deducted a loss, (2) replaces a component the adjusted basis of which has been accounted for in realizing gain or loss on a sale or exchange of the component, (3) repairs damage for which the taxpayer has deducted a casualty loss under § 165, (4) returns the property to its ordinary operating condition after the property has fallen into a state of disrepair and is no longer functional, (5) results in rebuilding the property to a like-new condition at the end of its class life under the § 168(g) alternative depreciation system, or (6) is for the replacement of a major component or structural part of the unit of property. Expenditures to repair damage to a unit of property for which the taxpayer has claimed a casualty loss for the damage must be capitalized only to the extent that (1) the basis of the property for which a loss deduction was allowed exceeds (2) the amounts paid that represent an improvement to the property measured by its condition prior to the casualty. Reg. § 1.263(a)-3(k)(4). In other words, repair costs in excess of the casualty loss deduction that merely restore the property to its pre-casualty condition are deductible, but repair costs equal to the casualty loss must be capitalized.<sup>5</sup> See Reg. § 1.263(a)-3(k)(7), Exs. 3-5. Whether there has been a replacement of a major component or structural part is determined under the facts and circumstances and includes replacement of a major component or structural part that comprises a large portion of the physical structure of the unit of property or that performs a discrete and critical function in the operation of the unit of property. Again, the restoration of a component of a building is treated as a restoration of the unit of property consisting of the building and its structural components.

- *New Use.* Reg. § 1.263(a)-3(l). A unit of property is treated as adapted to a new or different use if the adaptation is not consistent with the taxpayer’s “ordinary use of the unit of property at the

---

5. This differs from the Temporary Regulations under which the full amount of the casualty restoration costs would have been subject to capitalization.

time originally placed in service by the taxpayer.” An expenditure to adapt a building system to a new use must be capitalized.

- *Removal Costs.* The 2011 temporary regulations treated component **removal** costs as an indirect cost that had to be capitalized if the **removal** costs directly benefited or were incurred by reason of an improvement. The final regulations have changed this rule. Reg. § 1.263(a)-3(g)(2) provides that if a taxpayer disposes of a depreciable asset (including a partial disposition under Prop. Reg. § 1.168(i)-1(e)(2)(ix) or Prop. Reg. § 1.168(i)-8(d)) and has taken into account the adjusted basis of the asset or component of the asset in realizing gain or loss, the costs of removing the asset or component are not required to be capitalized. If a taxpayer disposes of a component of a unit of property and the disposal is not a disposition for tax purposes, then the taxpayer must deduct or capitalize the costs of removing the component based on whether the removal costs directly benefit or are incurred by reason of a repair to the unit of property or an improvement to the unit of property.

- *Rehabilitation doctrine is no more.* Reg. § 1.263(a)-3(g)(1) eliminates the judicially created rehabilitation doctrine by providing that, “[I]ndirect costs that do not directly benefit or are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement.” Although the temporary regulations specifically provided that if otherwise deductible repairs benefit or are incurred by reason of an improvement, the cost of the repairs had to be capitalized under § 263A, the final regulations omit this sentence. However, some added examples illustrate when § 263A requires capitalization.

- *Routine Maintenance Safe Harbor.* Reg. § 1.263(a)-3(i)(1) provides safe harbor rules for routine maintenance of a unit of property that is not treated as improving the property. For property other than a building or a structural component of a building, routine maintenance is defined as “the recurring activities that a taxpayer expects to perform as a result of the taxpayer’s use of the unit of property to keep the unit of property in its ordinarily efficient operating condition.” Reg. § 1.263(a)-3(i)(1)(ii). Examples include inspection, cleaning, and testing of the unit, and replacement of parts of the unit. The safe harbor applies to activities that the taxpayer reasonably expects to perform more than once during the class life of the property, as determined under the MACRS alternative depreciation schedule of § 168(g). Routine maintenance includes maintenance with respect to and the use of rotatable spare parts. Routine maintenance excludes activities that follow a basis recovery event similar to the items that are described as restorations.

- *Routine Maintenance Safe Harbor for Buildings.* The 2011 temporary regulations did not provide a routine

maintenance safe harbor for buildings, but the 2013 final regulations provide two safe harbors for buildings. For buildings and structural components of building, routine maintenance is defined as “the recurring activities that a taxpayer expects to perform as a result of the taxpayer’s use of any of the properties ... to keep the building structure or each building system in its ordinarily efficient operating condition.” Reg. § 1.263(a)-3(i)(1)(ii). Examples include the inspection, cleaning, and testing of the building structure or each building system, and the replacement of damaged or worn parts with comparable and commercially available replacement parts. However, the activities are routine only if the taxpayer reasonably expects to perform the activities more than once during the 10-year period beginning at the time the building structure or the building system upon which the routine maintenance is performed is placed in service. Reg. § 1.263(a)-3(i)(1)(ii).

- *Routine Maintenance Safe Harbor for Buildings of “qualifying small taxpayers.”* The 2013 final regulations also provide an additional safe harbor election for building property held by taxpayers with gross receipts of \$10,000,000 or less (“a qualifying small taxpayer”). Reg. § 1.263(a)-3(h). A qualifying small taxpayer may elect to not apply the improvement rules to an eligible building if the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities with respect to the building does not exceed the lesser of \$10,000 or two percent of the unadjusted basis of the building. Eligible building property includes a building that is owned or leased by the qualifying taxpayer, provided the unadjusted basis of the property is \$1,000,000 or less.

- *Repairs.* Reg. § 1.162-4 allows as a deductible repair expense any costs that are not required to be capitalized under Reg. § 1.263(a)-3. The final regulations do not provide for a repair allowance. Temp. Reg. § 1.263(a)-3T(l) provided that taxpayers would be permitted to use a repair allowance method authorized by published guidance in the Federal Register or the Internal Revenue Bulletin. This provision was deleted in finalizing the regulations.

- *Examples.* The regulations are full of examples that seem to cover most of the litigated cases and rulings addressing capitalization versus repair. The examples are necessary to understand the substantive provisions, which, although intended to provide clarity, are not so clearly applied.

- *Effective Dates.* In general, the final regulations apply to taxable years beginning on or after 1/1/14. However, certain rules apply only to amounts paid or incurred in taxable years beginning on or after 1/1/14. The various effective dates are in Regs. §§ 1.162-3(j), 1.162-4(c), 1.162-11(b)(2), 1.165-2(d), 1.167(a)-4(b),

1.167(a)-7(f), 1.167(a)-8(h), 1.168(i)-7(e), 1.263(a)-1(h), 1.263(a)-2(j), 1.263(a)-3(r), 1.263(a)-6(c), 1.263A-1(l), and 1.1016-3(j).

**2. Electricity and hot air — the IRS defines unit of property for generators of steam and electricity.** Rev. Proc. 2013-24, 2013-21 I.R.B. 1142 (4/30/13). Under Temp. Reg. § 1.263(a)-3T, which requires capitalization of expenditures to improve, better, or restore a unit of property, interdependent major components are treated as a part of a unit of property. Temp. Reg. § 1.162-4T allows as a deductible repair expense any costs that are not required to be capitalized under Temp. Reg. § 1.263(a)-3T. In the case of power plants generating steam or electricity, the Revenue Procedure provides a list of properties that will be treated, at the taxpayer's election, as separate units of property within a power station and identifies major components of the units of property. The revenue procedure adds that a taxpayer's method for determining whether an expenditure must be capitalized or is deductible, including the taxpayer's definitions of a unit of property or major components of a unit of property, is a method of accounting under § 446 and will be subject to § 481 adjustments and the automatic consent rules for adopting the unit of property definitions provided in Appendix A of the revenue procedure. In general, the Appendix lists numerous systems within a generating facility (such as turbines) as separate units of property and identifies major components of the units of property. The definitions of Rev. Proc. 2013-24 are limited to determinations for purposes of the capitalization/repair rules and may not be used for other purposes such as depreciation.

**3. Law firm advances of litigation expenses were loans, not deductible expenses.** Humphrey, Farrington & McClain v. Commissioner, T.C. Memo. 2013-23 (1/17/13). The cash method taxpayer plaintiff's law firm maintained a classification system for litigation costs advanced to clients in contingent fee cases. If the firm considered the likelihood of reimbursement to be high, the advanced costs were capitalized. In riskier cases where the firm considered the likelihood of reimbursement to be low, the firm deducted the advanced expenses, and reported reimbursement as income as advances were repaid. The Tax Court (Judge Morrison) held that the advanced litigation costs were loans in all cases, even if eventual recovery of the advances was contingent, and disallowed the deductions. The court found that there was a significant possibility of reimbursement, a factor that supported treating the advances as loans. The court also agreed with the IRS that the treatment of the advances as loans was a change in the taxpayer's method of accounting, which did not clearly reflect income, and, therefore, allowed adjustments under § 481 with respect to prior years. Nonetheless, the court found that the taxpayer's classification method was a reasonable attempt to ascertain the tax treatment of advanced

expenses which qualified for the reasonable cause exception to § 6662 penalties.

**4. Protecting directors from cement shoes in a shareholder class-action arising from a merger subject to capitalization. Why apply modern regulations when old case law will do the trick?** Ash Grove Cement Company v. United States, 111 A.F.T.R.2d 2013-767 (D. Kan. 2/6/13). The taxpayer settled a class action lawsuit by minority shareholders against itself and its directors arising out the acquisition of another corporation in a reorganization. The District Court (Judge Murguia) granted summary judgment for the government, holding that both the settlement payment and litigation expenses incurred by the taxpayer in resolving the class action lawsuit were capital expenditures under § 263. The origin of the claim for which the taxpayer incurred the expenses arose from a capital transaction. Even though the payments related to the taxpayer's 2005 return, the court applied the case law based "origin of the claim" test, *e.g.*, *Woodward v. Commissioner*, 397 U.S. 572 (1970), rather than Reg. § 1.263(a)-5, which was promulgated in 2003. The court held that the litigation expenses arose out of the acquisition transactions and were thus capital expenses under the origin of the claim test. The court rejected the taxpayer's argument that expenses incurred to indemnify directors from legal claims were deductible. The court pointed out that under the taxpayer's approach, "companies could always deduct litigation expense any time a director acting in good faith is sued in connection with a capital transaction so long as the company has an indemnity obligation."

**5. With global warming these plants are growing faster.** Notice 2013-18, 2013-14 I.R.B. 742 (2/19/13); Rev. Proc. 2013-20, 2013-14 I.R.B. 744 (2/19/13). The IRS has revised the categories of "berries" as plants that do not have a pre-productive growth period in excess of two years to segregate blueberry, blackberry, and raspberry plants, and removed papaya plants from the list. Under § 263A(d)(1) and Reg. § 1.263A-4(d) farmers who are not required to use the accrual method of accounting (and who are not tax shelters) are not required to capitalize the costs of raising animals or the costs of producing plants with a pre-productive period of two years or less. The IRS maintains a list of qualifying plants based on the nationwide pre-productive period for plants. The accompanying revenue procedure provides procedures for a taxpayer to obtain automatic consent to not apply § 263A to the production of plants removed from the list of plants that have a nationwide weighted average pre-production period in excess of two years.

**6. Research to eliminate uncertainty is deductible under proposed regulations. What about the uncertainty of tax advice?**

REG-124148-05, Research Expenditures, 78 F.R. 54796 (9/6/13). Section 174 allows either deduction or 60 month amortization of research and experimental expenditures, but under § 174(c) the § 174 deduction is not applicable to expenditures for the acquisition or improvement of land or depreciable property. Reg. § 1.174-2(a)(1) defines research and experimental expenditures as expenditures that represent “research and development costs in the experimental or laboratory sense” and provides in § 1.174-2(b)(1) that depreciation allowances on depreciable property used in research are § 174 expenditures. The proposed regulations would provide that expenditures may qualify under § 174 regardless of whether a resulting product is sold or used in the taxpayer’s trade or business and that the depreciable property rule is an application of the general definition of research and experimental expenditures.

- Prop. Reg. § 1.174-2(a)(1) would provide that the ultimate success, failure, sale or use of a product is not relevant to a determination of eligibility of expenditures as research or experimental expenditures under § 174.

- As an application of the general definition of research expenditures, the depreciable property rule should not be applied to exclude otherwise eligible expenditures.

- Under Reg. § 1.174-(a)(2) research expenditures to develop a product include development of a pilot model. Prop. Reg. § 1.174-2(a)(4) would define a pilot model as “any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product.”

- The proposed regulations would amend Reg. § 1.174-2(a)(1) to “clarify” that production costs after uncertainty is eliminated are not eligible under § 174 by providing that “[c]osts may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated.”

- Prop. Reg. § 1.174-2(a)(5) would adopt a “shrinking back rule” that would provide that research and experimental expenditures for the improvement of a component of a larger design may be eligible under § 174, but uncertainty with respect to a component does not necessarily indicate uncertainty with respect to the product as a whole.

- Although the proposed regulations will be effective on publication of final regulations in the Federal Register, the proposed regulations indicate that the IRS will not challenge expenditures that conform to the proposed regulations.

**7. Custom homes are no different from spec houses, both are subject to the uniform cost capitalization rules.** Frontier Custom Builders, Inc. v. Commissioner, T.C. Memo. 2013-231 (9/30/13). The taxpayer corporation constructed custom homes. It argued that its business model was centered around sales and marketing rather than production related services and asserted that employee salaries and other indirect expenses were not subject to capitalization under § 263A. The Tax Court (Judge Goeke) disagreed. The court stated that the taxpayer's creative design of homes "is ancillary to the physical work and is as much a part of a development project as digging a foundation or completing a structure's frame." Thus the court found that the taxpayer was a producer of property subject to § 263A's capitalization requirements. The court also held that the IRS did not abuse its discretion by treating the taxpayer's deduction of production expenses as an accounting method and requiring the taxpayer to adopt the simplified production and simplified service cost methods of accounting under Reg. §§ 1.263A-2(b)(1) and 1.363A-1(h)(1). The court required an allocation of salaries, bonuses and other expense items between indirect expenses subject to capitalization and operating expenses currently deductible.

**8. Tax expenditures for movies and television.** The Compromise Tax Relief Act of 2010, § 744, extends the election under Code § 181 to expense up to \$15 million of qualified film and television production costs if 75 percent of total compensation is for services performed in the U.S. The limit is \$20 million for production costs incurred in low-income or distressed communities through 2011.

**a. Final regulations come out just in time for the expiration date of the statute.** T.D. 9551, Deduction for Qualified Film and Television Production Costs, 76 F.R. 60721 (9/30/11). Section 181 provides for an election to deduct qualified film or television production costs incurred in productions commenced prior to 1/1/12, as an expense not chargeable to capital account in an amount up to \$15 million for each production, or \$20 million for production expenses incurred in certain low income or distressed county areas. A production qualifies for the election if at least 75 percent of the total compensation for the production is for services performed in the United States by actors, directors, producers, and production personnel. Final regulations §§ 1.181-1 through -6, replacing temporary and proposed regulations, clarify the owner of production costs, the definition of aggregate production costs for purposes of the election and limitations, and provisions applicable to participations and residuals.



**b. Temporary and proposed regulations update the rules.** REG-146297-09, Deduction for Qualified Film and Television Production Costs, 76 F.R. 64879 (10/19/11). The temporary (Temp. Regs. §§ 1.181-0T, 1.181-1T) and proposed regulations clarify that the \$15 million (or \$20 million) limitation under amendments to § 181 applies to limit the aggregate deduction for production costs paid or incurred by all owners of a qualified film or television production for each qualified production, rather than limit the aggregate production costs.

**c. And now, “final” final regulations after the provision expired.** T.D. 9603, Deduction for Qualified Film and Television Production Costs, 77 F.R. 72923 (12/7/12). The final regulations (Reg. §§ 1.181-0, 1.181-1) remove the temporary regulations, and provide that whether production costs qualify for pre- or post-1/1/08 limitations, compensation to actors is allocated to first unit principal photography.

**d. Thank Dodd that special expensing rules for film and television productions were extended to 2012 and 2013.** The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 317, extends through the end of 2013 the election under Code § 181 to expense up to \$15 million of qualified film and television production costs if 75 percent of total compensation is for services performed in the U.S.

- The limit is \$20 million for production costs incurred in low-income or distressed communities. Are any members of the film crew residents of those communities?

**e. No deduction under this terminated provision without a proper election.** Staples v. Commissioner, T.C. Memo 2013-262 (11/18/13). Section 181 allowed a current deduction of otherwise capital expenses incurred for U.S. production of movie or television programming pursuant to an election in the form specified by the IRS. The provision applies to production expenses incurred before 12/31/13. The taxpayer, an attorney, deducted research expenses incurred in developing a series on U.S. history by claiming the expenses on Schedule C, but failed to file the Form 3115 required by Temp. Reg. § 1.181-2T(c)(1). Although the court (Judge Wherry) was willing to consider the doctrine of substantial compliance in attempting to make the § 181 election, the court indicated that since the taxpayer had not begun principal photography in the years at issue, the taxpayer was not entitled to the deduction in any event.

**9. “Candy, Cigarettes, and . . . ?”** City Line Candy & Tobacco Corp. v. Commissioner, 141 T.C. No. 13 (11/19/13). Section 263A(b)(2)(B) provides a small reseller exception to the § 263A uniform capitalization rules, which applies to businesses acquiring goods for resale if

the firm's average annual gross receipts for the three-year period immediately preceding the taxable year do not exceed \$10 million. The Tax Court (Judge Marvel) held that for purposes of determining eligibility for the § 263A(b)(2)(B) small reseller exception the gross receipts of a cigarette wholesaler was required to include the entire sale proceeds from the sale of cigarettes, including the costs of the state cigarette tax stamps the wholesaler was required to purchase. As a result, the wholesaler's gross receipts exceeded the \$10 million ceiling. The cigarette stamp tax costs were indirect costs under Reg. § 1.263A-1(e)(3)(i), properly characterized as handling costs, not selling expenses, which Reg. § 1.263A-1(e)(3)(iii)(A) exempts from the capitalization requirement.

### C. Reasonable Compensation

**1. You can save the failing nursing home, but don't pay yourself too much.** Thousand Oaks Residential Care Home I, Inc. v. Commissioner, T.C. Memo. 2013-10 (1/14/13). The husband and wife shareholders (the Fletchers) took over a failing retirement home and turned it into a profitable operation. In the years at issue the Fletchers each received approximately \$200,000 of compensation plus contributions to a defined benefit plan for each of approximately \$191,000 for services respectively as the overall manager and head nurse. The Tax Court (Judge Wherry) agreed that the compensation to the taxpayers was catch-up compensation for years when the corporation provided little compensation, that the compensation levels were below national norms, that the corporation's cash-flow was marginally sufficient to pay its bills including acquisition indebtedness, but that the Fletchers as the shareholders used all of the profits to pay salaries and never received a dividend. The deciding factor for the court's holding that the compensation was unreasonable was that independent investors would have demanded at least a 10 percent return on their investment and that the compensation packages "did not leave enough of the corporation's assets to be paid back to the hypothetical investor as a return on investment." The court also held that compensation paid to the Fletchers' daughter was unreasonable. The court further declined the IRS's invitation to impose additions to tax under § 6651 and § 6662 accuracy related penalties, finding that the taxpayer reasonably relied on the advice of its accountant (with the exception of penalties related to the compensation paid to the Fletchers' daughter).

**a. And don't press your luck by seeking costs as a prevailing party.** Thousand Oaks Residential Care Home I, Inc. v. Commissioner, T.C. Memo. 2013-156 (6/20/13). The taxpayers moved for reasonable administrative and litigation costs pursuant to § 7430, which

permits the award of such costs to a prevailing party. The IRS “conceded that . . . petitioners ha[d] ‘substantially prevailed with respect to the most significant issues or set of issues in . . . [their] case[s] . . . .’” Nevertheless, the court (Judge Wherry) denied the taxpayers’ motion on the ground that the position of the IRS in the case was reasonable and substantially justified. “The testimony of [the IRS’s] expert, the numerous factual issues surrounding the decision, and the total disallowance of all compensation paid to the owner-employees’ daughter ... demonstrate that [the IRS] acted reasonably given the facts and circumstances.” Therefore § 7430(c)(4)(B) precluded awarding attorney’s fees.

**2. IRS experts prevail on reasonable compensation issues – surprise! And the court found taxpayer’s position on equitable recoupment to be somewhere between “*Dalm* and *Dahmer*.”** K&K Veterinary Supply, Inc. v. Commissioner, T.C. Memo. 2013-84 (3/25/13). The taxpayer, a wholesaler of animal health products, was wholly owned by John Lipsmeyer, who was employed as its chief executive and worked as a principal sales representative. The taxpayer employed John’s wife, Melissa, as vice president, secretary and assistant financial officer, John’s brother David as senior vice president of sales, co-chief executive officer and co-chief operative officer who also handled 50 accounts, and David’s daughter Jennifer as the chief financial officer. Accepting the IRS expert’s evaluation, the Tax Court (Judge Cohen) reduced the corporation’s deductions for compensation paid to the sole shareholder/employee and related parties. The court considered nine factors in evaluating reasonable compensation. Among those factors, the court determined that although John and David had significant experience with the corporation’s operations and were important to its success, the record did not establish that either of them was the primary reason for the taxpayer’s growth. The court acknowledged Jennifer’s importance to the corporation’s success, but stated that the record fell short of establishing that she was exceptionally qualified or the primary reason for the corporation’s growth. The court also stated that the record fell “far short” of establishing Martha’s exceptional qualification or contribution to growth. Rejecting the taxpayer’s expert analysis, the court accepted the prevailing salary comparison figures offered by the IRS expert and the IRS expert’s conclusion of reasonable compensation from comparable companies at the 75th percentile.

- The court also rejected the taxpayer’s assertion of an “equitable recoupment” to reduce the corporation’s tax liability by the amount of lower taxes payable by shareholders if the excess compensation had been distributed to the shareholder as a dividend rather than reported by them as compensation income. The court listed four elements required for equitable recoupment to apply: “(1) the overpayment or deficiency for which recoupment is sought by way of offset is barred by an expired period

of limitation; (2) the time-barred overpayment or deficiency arose out of the same transaction, item, or taxable event as the overpayment or deficiency before the Court; (3) the transaction, item, or taxable event has been inconsistently subjected to two taxes; and (4) if the transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes that the taxpayers should be treated as one.” *United States v. Dalm*, 494 U.S. 596 (1990). The court held that equitable recoupment was not available to the corporation because the denial of the corporate level deduction and the tax on dividends involved two or more taxpayers with insufficient identity of interest to be treated as a single taxpayer. The court observed that a corporation formed for legitimate business purposes and its shareholders are separate entities.

**3. Increasing the value of the company deserves some bonus, but not all of it.** *Aries Communications, Inc. v. Commissioner*, T.C. Memo. 2013-97 (4/10/13). In another case appealable to the Ninth Circuit, the Tax Court (Judge Wherry) applied the five factors of *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983), plus additional consideration of whether an independent investor would compensate the employee at the claimed amount, to reduce the taxpayer’s corporate deduction for compensation to its sole shareholder. The taxpayer sold its radio stations in the year at issue for a price that was \$6 million higher than an initial offer. The taxpayer’s development of the stations and the higher purchase price were attributable to the efforts of the shareholder/CEO, Arthur Astor, who received annual compensation plus a bonus totaling approximately \$6.9 million.

- The court concluded that Astor was the most important employee of the taxpayer and agreed that compensation attributable to prior years’ service as catch-up compensation allowed compensation that need not be reasonable in the year paid. The fact that Astor played a pivotal role in both operating the taxpayer and negotiating the higher price for the sale of assets functioning as an employee of the taxpayer was a factor favoring the taxpayer’s deduction of the compensation.

- The court considered the linear regression analysis of dueling experts regarding comparison with salaries of similar companies, but had difficulty with applying comparisons with publically held companies. The court ultimately concluded that a bonus equivalent to one-third of the negotiated increased sales price was reasonable.

- The court described the character of the company as a large asset-laden complex business with a negative net income and bleak financial picture, a factor that favored the IRS evaluation of reasonable compensation.

- The court indicated that Astor's conflict of interest in protecting the company as a going concern and his interest as owner in garnering the highest price for the assets and receiving the reward as deductible salary favored the IRS.

- The corporation's internal inconsistency in treatment of payments to employees as bonuses at the end of the year when it could predict profits and potential federal income tax liability favored the IRS.

- Finally, as a factor added to the *Elliott* list, the court determined that since the corporation retained sufficient earnings to satisfy an independent investor at 20 percent compound annual return on equity, the independent investor test supported the corporation's level of compensation.

- At the end of the day, the court determined, based on the experts' testimony that Astor's fixed compensation was underpaid but the bonus was unreasonable and allowed a deduction of \$2,660,889. The court also imposed an accuracy related penalty under § 6662(a) finding that the Astor's conversation with the corporation's accountants was not reasonable reliance on a tax professional.

#### **D. Miscellaneous Deductions**

**1. IRS values noncommercial flight.** Rev. Rul. 2013-20, 2013-40 I.R.B. 272 (9/26/13). The value of noncommercial flights on employer owned aircraft is determined by multiplying the cents-per-mile for the applicable period by the appropriate aircraft multiple and adding the applicable terminal charge. The mileage rates for the second half of 2013 are \$0.2654 per mile up to 500 miles, \$0.2024 for 501-1500 miles, then \$0.1946 over 1500 miles. The terminal charge for the second half of 2013 is \$48.53. These are little changed from the rates for the first half of 2013: \$0.2655 per mile up to 500 miles, \$0.2024 for 501-1500 miles, then \$0.1946 over 1500 miles. The terminal charge for the first half of 2013 was \$48.54.

**2. Really bad timing in the real estate appraisal business does not the debt make bad.** *Bishop v. Commissioner*, T.C. Memo. 2013-98 (4/10/13). In April 2006, shortly before leaving his position as President of IMPAC Mortgage Holdings, Inc., where he bought and sold pools of loans, the taxpayer advanced \$300,000 (which he borrowed from a commercial lender) to Landmark Equities Group to assist in developing a public offering of Landmark. Landmark had developed an "Automated Valuation Model" product designed to quickly value mortgage loans for investment banks by aggregating title insurance information. The written note required monthly interest payments and was due in April 2007. Landmark failed to make payments on the note when due in 2006. The

taxpayer indicated in testimony that he reviewed the financial health of Landmark and concluded that it should have been able to pay the interest, even though the real estate market was showing signs of trouble in 2006, but that Landmark would not be able to pay principal in 2006 if the taxpayer had invoked an acceleration clause in the note on default of the interest payments. Judge Laro concluded that the note was a bona fide indebtedness rejecting the IRS assertion that the advance was not a bona fide debt because the note was unsecured, Landmark was unable to borrow from a commercial lender, and the taxpayer did not demand payment in full when Landmark defaulted on interest payments. The court determined, however, that the taxpayer's unsubstantiated testimony regarding Landmark's financial health was insufficient to carry the burden of proof that the loan became worthless in 2006. Because Landmark remained a going concern into 2007, the court indicated that some evidence of Landmark's ability or inability to turn the business around and generate income to pay the note was crucial. The court also sustained the IRS assertion of § 6662(a) penalties indicating that the taxpayer's failure to provide documentary evidence of Landmark's financial health to the taxpayer's CPA who prepared the return claiming the deduction prevented the taxpayer's reasonable reliance on the tax professional.

**3. The threat of impending death does not reduce substantiation requirements.** *Striefel v. Commissioner*, T.C. Memo. 2013-102 (4/11/13). The taxpayer worked as an independent contractor performing field engineering services for an engineering company. The taxpayer's work required travel away from home. The taxpayer received a "traumatic medical diagnosis" and was told that he would likely die soon. On his release from the hospital the taxpayer destroyed all of his old business records that he kept in a file cabinet. While expressing some sympathy regarding the hospitalization, the Tax Court (Judge Kerrigan) refused to accept the taxpayer's testimony and limited bank records as substantiation for automobile travel, meal, and lodging expenses. The court did allow deductions for some lodging expenses where the taxpayer's bank records matched his calendar entries and allowed deduction of per diem for meals on those dates. The court also sustained a § 6662(a) accuracy penalty stating that, "[a]lthough petitioner was understandably upset at the time, his actions were not justifiable, reasonable, or prudent under the circumstances. We find that petitioner acted negligently."

- Query whether his doctor told him to stop buying green bananas, or merely to stop taking out multi-year magazine subscriptions?

- Query whether taxpayer may recover for physician malpractice?

**4. Stock valuation settlement produces imputed interest.** Colorcon, Inc. v. United States, 110 Fed. Cl. 650 (4/30/13). To push out a minority shareholder, DB Trust, the taxpayer undertook a short-form merger of an 84 percent owned subsidiary under Pennsylvania law, which did not require a shareholder vote. After offering the minority interest holder an \$82 million promissory note in 1999 at the time of the merger, the taxpayer in 2002 settled a suit claiming dissenter's rights and other claims with a payment of \$191 million. The taxpayer filed a refund claim asserting that \$31 million of the payment was deductible as imputed interest under § 483. Section 483 requires a taxpayer to impute unstated interest on account of a sale or exchange of property under a contract under which some or all of the payments are due more than one year after the sale or exchange. The IRS conceded that the 1999 merger was a sale or exchange. The IRS argued, however, that the payment was made pursuant to the 2002 settlement agreement in an action that sought to rescind that 1999 merger transaction, rather than payment for the stock in 1999. Looking to Pennsylvania law, the Court of Federal Claims (Judge Firestone) held that the 1999 short-form merger transaction transferred property as a matter of law and that at least a part of the \$191 million settlement was paid for the shares. Granting summary judgment to the taxpayer, the court also held that the IRS did not raise a genuine factual dispute as to whether any portion of the \$191 million payment was attributable to other claims.

**5. A judge lets the jury decide how much of \$126,796,262 of a \$385,147,334 settlement payment under the False Claims Act is compensatory and how much is a nondeductible penalty.** Fresenius Medical Care Holdings, Inc. v. United States, 111 A.F.T.R.2d 2013-1938 (D. Mass. 5/9/13). The taxpayer deducted the full amount of a \$385,147,334 settlement with the government under the False Claims Act (for Medicare and Medicaid fraud), which provides for a penalty of not less than \$5,000 and not more than \$10,000 plus three times the amount of damages the government sustains. The settlement agreement was silent regarding the allocation of the payment between compensatory and punitive amounts, although it did allocate \$65,800,555 to *qui tam* relators' awards. The agreement expressly disclaimed any resolution of the tax treatment of the payment. The IRS allowed a portion of the deduction but disallowed as a fine or similar penalty, which is nondeductible under § 162(f), \$126,796,262 of the claimed deduction. The District Court denied cross motions for summary judgment because "real disputes remained about the purpose of the payments," and on a motion for entry of judgment held that the jury properly determined that \$95,000,000 of the disputed amount of the settlement paid to the government was compensatory and therefore deductible. The court explained that "a manifest agreement is not necessary for [the taxpayer] to establish that all or some portion of the payments at issue were made in

settlement of non-punitive FCA liability.” It concluded that “to determine whether the payments made by [the taxpayer] to the government in excess of the amount already deemed deductible by the IRS were compensatory damages, it was necessary to consider both the language of the settlement agreements and non-contractual evidence regarding the purpose and application of the payments.”

**6. Its quest for § 199 deductions was not to be harried by the IRS. Houdini seals a wine bottle in a basket and escapes with domestic production deductions.** *United States v. Dean*, 945 F. Supp. 2d 1110 (C.D. Cal. 5/7/13). The court granted summary judgment to the taxpayer in the IRS’s § 7405 suit to recover amounts erroneously refunded. The IRS had granted refunds to the taxpayer shareholders of an S corporation claiming § 199 deductions for domestic production activities. The S corporation, Houdini, Inc. (“Houdini”) packages and markets gift baskets with wine and food items. Houdini purchases baskets manufactured to its specifications in China, plus fill materials and wine and food items from various suppliers. Houdini designs and packages gift baskets in its facilities in California. Section 199 provided a deduction for qualified production activities income of 3 percent for the years at issue and provides a deduction of 9 percent currently. “Qualified production activities income” is defined in § 199(c)(1) as the taxpayer’s “domestic production gross receipts” (“DPGR”) minus the related cost of goods sold and other expenses, losses, or deductions. DPGR is defined, in relevant part, as the taxpayer’s gross receipts derived from “any lease, rental, license, sale, exchange, or other disposition of ... qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States.” Reg. § 1.199-3(e)(1) defines manufacturing, etc. as “manufacturing, producing, growing, extracting, installing, developing, improving, and creating [qualified production property (“QPP”)]; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles,” but Reg. § 1.199-3(e)(1) adds that if a taxpayer “performs minor assembly of QPP and the taxpayer engages in no other MPGE [manufactured, produced, grown, or extracted] activity with respect to that QPP [qualified production property], the taxpayer’s packaging, repackaging, labeling, or minor assembly does not qualify as MPGE with respect to that QPP.” The District Court (Judge Selna) rejected the IRS’s argument that Houdini’s assembling gift baskets was merely assembly or packaging activity by noting that, “Houdini makes products suitable for use as gifts using machinery, according to an organized plan and with division of labor. Therefore, Houdini’s production process may qualify as manufacturing or producing.” Also noting that Houdini’s



activities may also qualify as packaging the court stated that, Houdini's "complex production process relies on both assembly line workers and machines. The final products, gift baskets and gift towers, are distinct in form and purpose from the individual items inside. The individual items would typically be purchased by consumers as ordinary groceries. But after Houdini's production process, they are transformed into a gift that is usually given during the holiday season." The court refused to interpret Reg. § 1.199-3(e), Ex. 6, indicating that customizing automobiles with purchased parts is not a manufacturing or production activity, as barring Houdini's § 199 deduction.

**a. Direct mail is not manufacturing, just a pain in the mailbox.** *Advo, Inc. v. Commissioner*, 141 T.C. No. 9 (10/24/13). The issue before the court was the application of the § 199 domestic production deduction to materials manufactured through agreements with contract manufacturers. The taxpayer distributed advertising material both prepared by clients and developed by the taxpayer. Taxpayer developed material was printed for the taxpayer by third party printers. The taxpayer claimed the § 199 domestic production deduction for paper and printing supplies that were manufactured in the United States. The Tax Court (Judge Wherry) agreed with the IRS that the taxpayer's gross receipts attributable to its printed direct mail advertising did not qualify as domestic production gross receipts. Citing Reg. § 1.199-3(f) the court held that where one taxpayer performs qualifying U.S. production activity with another taxpayer, only the taxpayer that has the "benefits and burdens" of the ownership of qualifying production property may claim the deduction. Applying a multifactor test to identify who had ownership of the qualifying property based on case law and with reference to standards under § 936 the court concluded, among other things, that title to the manufactured paper remained with the printers during the printing process, the contract called for "manufacturing" by the printers, the printers had possession of the manufactured material before delivery to the taxpayer (even though the taxpayer controlled the process through its supply of PDF and color files to the printer), the printers bore the risk of damage before delivery of the printed material to the taxpayer, and the printers bore the economic gain or loss on the fixed-price printing contracts. Thus, the printers, and not the purchaser of the printed material, were the taxpayers entitled to the § 199 deduction.

**7. These fees are in the bag for the taxpayer who is in the trade or business of being a whistleblower.** *Bagley v. United States*, 112 A.F.T.R.2d 2013-5602 (C.D. Cal. 8/5/13). The taxpayer was awarded \$27,244,000 plus statutory attorney's fees of \$9,407,295 as a relator in a False Claims Act prosecution of TRW that ultimately resulted in the recovery of \$111 million by the U.S. government. In the taxpayer's refund

suit the court concluded that the taxpayer was engaged in a trade or business of prosecuting the litigation and that the attorney's fees were deductible as ordinary and necessary business expenses under § 162(a). The taxpayer was actively involved with his attorneys in pursuing the claim from 1993 (when the taxpayer was laid off by TRW) and 2003, the year of the award. The court accepted the taxpayer's assertion that he performed the services in order to obtain the award and thus had a good faith expectation of profit from the venture. The taxpayer was said to conduct himself in much the same manner as a lawyer prosecuting a lawsuit and the taxpayer's expertise as an accountant with knowledge of TRW's systems, procedures, and where the bodies were buried, plus his expertise with Federal Acquisition Regulations, were critical to the government's recovery. The court observed the size and amount of the FCA award to the taxpayer "makes it clear that it found his expertise vital to the prosecution of these claims." The fact that the taxpayer knew about the fraudulent claims because he participated in them before he was laid off provided him with the knowledge and skills relevant to the subsequent trade or business. The court further observed that the taxpayer devoted significant time and effort to the activity that did not have recreational or personal aspects, which evidenced an intent to derive a profit. The court indicated that devoting effort to an opportunity to earn a single substantial profit (without a history of similar profit and loss activity) can constitute a trade or business. Finally, the court concluded that the taxpayer's activities were regular and continuous in pursuit of profit.

[I]t is indisputable that Bagley's activity as a relator occurred over a substantial period of time, and during that time period, Bagley devoted much of his time and energy to the tasks and responsibilities of investigating and litigating the FCA lawsuit. He pursued the FCA lawsuit "full time, in good faith, and with regularity," by performing a multitude of tasks: attending meetings, reviewing documents that had been produced, creating and revising documents (memoranda, summaries, and court filings), doing damage calculations, and generally assisting his attorneys and the government in understanding the nature of the fraudulent claims and where they could find the documents and witnesses necessary to effectively litigate the case. This was not a hobby or an activity Bagley engaged in for pleasure or amusement.

- The court also rejected the IRS's assertion that under the origin of the claim test the taxpayer's award had its origin in the taxpayer's role as an informer whose contribution to the *qui tam* action is no different from other types of informants. The court concluded that

the origin of the *qui tam* action is fraud against the government and indicated that the relator “acts as an agent or private attorney general for the government, and is provided an award for the ‘information and services’ provided while prosecuting that claim” and that the taxpayer’s services had the indicia of a business enterprise.

**8. Standard mileage rate rules published in a revenue procedure while the amounts will be disclosed in a separate notice.** Rev. Proc. 2010-51, 2010-51 I.R.B. 883 (12/3/10). The IRS indicated that beginning in 2011 it will publish mileage rates in a separate annual notice. The revenue procedure indicated that a taxpayer may use the business standard mileage rate to substantiate expenses for business use of an automobile in lieu of fixed and variable costs. Parking fees and tolls are deductible as separate items. The basis of an automobile used for business is reduced by a per-mile amount published in the annual notice. Separate rates are provided both for charitable use of an automobile and medical and moving use of an automobile. The revenue procedure also provides details for treating as substantiated a fixed and variable rate allowance for expenses incurred by an employee in driving an automobile owned or leased by the employee in performing services for the employer.

**a. Add one cent per mile from 2012 for 2013 (except for charitable service).** Notice 2012-72, 2012-50 I.R.B. 673 (11/21/12). The standard mileage rate for business miles in 2013 goes up to 56.5 cents per mile and the medical/moving rate goes up to 24 cents per mile. The charitable mileage rate remains fixed by § 170(i) at 14 cents.

**b. And subtract one-half cent per mile from 2013 for 2014 (except for charitable service).** Notice 2013-80, 2013-52 I.R.B. 821 (12/6/13). The standard mileage rate for business miles in 2014 goes down to 56 cents per mile and the medical/moving rate goes down to 23½ cents per mile. Of that business mileage amount, 22 cents is treated as depreciation for purposes of reducing basis. The standard automobile cost for purposes of computing allowances under a fixed and variable rate (FAVR) plan will be \$28,200, and for trucks and vans, \$30,400. The charitable mileage rate remains fixed by § 170(i) at 14 cents.

## E. Depreciation & Amortization

**1. Guidance on expensing qualified real property under § 179 – things would be much simpler if Congress enacted legislation in a timely manner instead of applying rules retroactively.** Notice 2013-59, 2013-40 I.R.B. 297 (9/10/13). Section 179(f) permits a taxpayer to treat “qualified real property” as § 179 property. Accordingly, taxpayers can deduct the cost of qualified real property in the year it is placed in service, subject to applicable limits. The American Taxpayer (and not so grand compromise) Relief Act of 2012 extended the application of § 179(f) from qualified real property placed in service during any taxable year beginning in 2010 or 2011 to qualified real property placed in service during any taxable year beginning in 2010, 2011, 2012 or 2013. Although the maximum cost of § 179 property that a taxpayer can deduct in each of these years is \$500,000 under § 179(b)(1), not more than \$250,000 of the taxpayer’s deductions in each year can be attributable to qualified real property. Prior to enactment of the ATRA of 2012, § 179(f)(4) provided that any portion of a taxpayer’s § 179 deduction attributable to qualified real property that was disallowed by the taxable income limitation of § 179(b)(3) could not be carried over to any taxable year beginning after 2011 and required that any disallowed portion remaining after 2011 be treated as property placed in service on the first day of the taxpayer’s last taxable year beginning in 2011 for purposes of computing depreciation. The ATRA of 2012 amended § 179(f)(4) to provide that any portion of a taxpayer’s § 179 deduction attributable to qualified real property that is disallowed by the taxable income limitation of § 179(b)(3) cannot be carried over to any taxable year beginning after 2013. Thus, taxpayers may be entitled to carry over to taxable years beginning in 2012 or 2013 § 179 deductions attributable to qualified real property that were previously disallowed and that the taxpayer is currently depreciating.

- The notice provides that taxpayers can elect to deduct the cost of qualified real property for any taxable year beginning in 2010, 2011, 2012 or 2013 by filing an original or amended return in accordance with procedures similar to those in Reg. § 1.179-5(c)(2) and section 7 of Rev. Proc. 2008-54, 2008-2 C.B. 722, 725, and can increase a deduction previously taken in those years by filing an amended return. An increase in a deduction taken for a prior tax year is not deemed to be a revocation of the taxpayer’s § 179 election for that year.

- With respect to § 179 deductions attributable to qualified real property that were disallowed by the taxable income limitation of § 179(b)(3) and that a taxpayer currently is depreciating, the notice provides that the taxpayer can continue the current treatment. Alternatively, a taxpayer can amend the return for the last taxable year beginning in 2011 to carry over the disallowed deductions to taxable years

beginning in 2012 or 2013, provided that the period of limitations on assessment is still open for the year of amendment and all affected succeeding years.

- The notice provides guidance on allocating disallowed deductions that are carried over between qualified real property and other § 179 property, and on the tax consequences of dispositions and other transfers of qualified real property, including permitted methodologies for determining the extent to which gain is treated as ordinary income under § 1245.

**2. New accounting and disposition rules for MACRS property.** T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11), and REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81128 (12/27/11). The capitalization and repair regulations (discussed above) provide significant new rules for the maintenance of multiple asset accounts and disposition of property from MACRS single and multiple asset accounts.

- *Accounting for MACRS property.* Consistent with prior rules under Reg. § 1.167-7, Temp. Reg. § 1.168(i)-7T allows taxpayers to account for MACRS property in a single asset account or by combining multiple assets in a multiple asset account. Assets in a multiple asset account must have been placed in service in the same taxable year, have the same recovery period and convention. Assets that are subject to different recovery rules or special limitations, such as automobiles, assets subject to additional first year recovery, or property used partly for personal purposes, may not be combined with assets subject to different recovery provisions. Assets with the same recovery periods and conventions may be combined in a multiple asset account even if the assets have different uses. In addition, the taxpayer is permitted to use as many single and multiple asset accounts as the taxpayer may choose.

- *Dispositions.* Temp. Reg. § 1.168(i)-8T(d) defines a disposition of MACRS property as occurring when the asset is transferred or permanently withdrawn from use in the taxpayer's trade or business or from the production of income. Thus, a disposition includes the sale, exchange, retirement, abandonment, or destruction of an asset. Significantly, the definition of disposition is expanded in the temporary regulation to include the retirement of a structural component of a building.

- *Gain or loss.* Gain or loss on the sale, exchange or conversion of an asset is determined under applicable tax principles. Loss on abandonment is determined from the "adjusted depreciable basis" of the asset (basis adjusted for depreciation). Temp. Reg. § 1.168(i)-8T(d). Recognized loss on other dispositions is the excess of the adjusted

depreciable basis of the asset over fair market value. Identification of the asset disposed of from a multiple asset account, and its basis, is generally determined from the taxpayer's records. Temp. Reg. § 1.168(i)-8T(e) and (f). The temporary regulations provide rules for identifying assets if the taxpayer's records do not do so; a first-in first-out method, a modified FIFO method, a mortality dispersion table method, or any other method designated by the IRS. The asset cannot be larger than a unit of property. In case of a disposition of a structural component of a building, the structural component is the asset disposed of. An improvement placed in service after the asset is treated as a separate asset provided that it is not larger than the unit of property. Temp. Reg. § 1.168(i)-8T(c)(4)(ii)(E). Disposition of an asset in a single asset account terminates depreciation for the asset as of the time of the disposition. Disposition of an asset in a multiple asset account removes the asset from the account as of the beginning of the year of disposition, requires separate depreciation for the asset in the year of disposition, and reduction of the depreciation reserve of the multiple asset account by the unadjusted basis of the disposed asset as of the first day of the taxable year of the disposition. Temp. Reg. § 1.168(i)-8T(g).

- *General Asset Accounts.* Consistent with prior Reg. § 1.168(i)-1, the temporary regulations provide for an election to group assets into one or more general asset accounts. Temp. Reg. § 1.168(i)-1T(c)(2) provides for grouping assets in a general asset account as long as the assets have been placed in service in the same taxable year and have the same recovery period and convention. Assets that are subject to different recovery rules or special limitations, such as automobiles, assets subject to first year recovery, or property used partly for personal purposes, may not be combined with assets subject to different recovery provisions. The temporary regulations do not include the requirement of prior regulations that general asset accounts include only assets in the same asset class. Assets eligible for additional first year depreciation deductions must be grouped with assets eligible for the same first year depreciation deductions and may not be grouped with assets not eligible for additional first year depreciation. Temp. Reg. § 1.168(i)-1T(c)(2)(ii)(D) and (E). The temporary regulations expand existing rules for dispositions of assets from a general asset account to encompass as a disposition the retirement of a structural component of a building. As under existing rules, the temporary regulations treat the basis of any asset disposed of from a general asset account as zero, and any amount realized results in ordinary gain. The taxpayer continues to depreciate assets in the general asset account as if no disposition occurred. Temp. Reg. § 1.168(i)-1T(e)(2). However, consistent with existing regulations, the temporary regulations allow a taxpayer to elect to terminate general asset account treatment on disposition of an asset in a qualifying disposition, in which case gain or loss is recognized under the rules of Temp. Reg. § 1.168(i)-8T. The list of qualifying dispositions

is expanded generally to include any disposition. Temp. Reg. § 1.168(i)-1T(e)(3). In addition, general asset accounts are terminated in certain nonrecognition dispositions and on termination of a partnership under § 708(b)(1)(B). Gain or loss may also be recognized on disposition of all of the assets, or the last asset, in a general asset account. Temp. Reg. § 1.168(i)-1T(e)(3)(ii).

**a. IRS specifies the procedures for adopting new accounting methods under the Temporary Regulations relating to depreciation of tangible property.** Rev. Proc. 2012-20, 2012-14 I.R.B. 700 (3/7/12), *modifying* Rev. Proc. 2011-14, 2011-1 C.B. 330. The IRS has provided lengthy and detailed rules regarding automatic changes in methods of accounting under Temp. Reg. §§ 1.167(a)-4T (amortizing or depreciating leasehold improvements), 1.168(i)-1T (rules for general asset accounts), 1.168(i)-7T (accounting for MACRS property), and 1.168(i)-8T (dispositions of MACRS property), all added by T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11). The automatic change of accounting method of Rev. Proc. 2011-14, 2011-1 C.B. 330, is applicable to property placed in service in a taxable year ending after 12/29/03. With respect to assets placed in service in a taxable year ending before 12/30/03, adopting the methods of the temporary regulations requires an amended return for open years including the placed in service years and all subsequent years. No § 481 adjustment is required or permitted with respect to the amended returns.

**b. LB&I provides guidance under Rev. Proc. 2012-20.** LB&I-4-0312-004 (3/15/12). This directive to the field applies to taxpayers who adopted a method of accounting relating to the conversion of capitalized assets to repair expense under § 263(a).

**c. Have your clients been wasting time trying to comply with the Temporary Regulations in 2012? Yes, they have. Further guidance announcing that pending final regulations will apply only in years beginning in 2014 and thereafter.** Notice 2012-73, 2012-51 I.R.B. 713 (11/20/12). The IRS announced that pending final regulations will apply to taxable years beginning on or after 1/1/14, but that taxpayers will be permitted to apply the final regulations to taxable years beginning on or after 1/1/12. The notice also indicates that the temporary regulations may be revised with respect to the de minimis rule of § 1.263(a)-2T(g); dispositions under §§ 1.168(i)-1T and 1.168(i)-8T; and the Safe Harbor for Routine Maintenance under § 1.263(a)-3T(g).

**d. Technical amendments so revise the Temporary Regulations. More important, the effective date of the**

**12/27/11 temporary regulations is delayed to years beginning on or after 1/1/14, with optional retroactive applicability.** T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 77 F.R. 74583 (12/17/12).

e. **New, new rules relating to accounting for MACRS property.** T.D. 9636, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 78 F.R. 57686 (9/19/13). The Treasury Department and IRS have promulgated final regulations under § 168 for the maintenance of multiple asset accounts that were proposed in REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81128 (12/27/11), and replacing the temporary regulations promulgated in T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11). Consistent with prior rules under Reg. § 1.167-7, and Temp. Reg. § 1.168(i)-7T, final Reg. § 1.168(i)-7 allows taxpayers to account for MACRS property in a single asset account or by combining multiple assets in a multiple asset account. Assets in a multiple asset account must have been placed in service in the same taxable year, and have the same recovery period and convention. Assets that are subject to different recovery rules or special limitations, such as automobiles, assets subject to additional first year recovery, or property used partly for personal purposes, may not be combined with assets subject to different recovery provisions. Assets with the same recovery periods and conventions may be combined in a multiple asset account even if the assets have different uses. In addition, the taxpayer is permitted to use as many single and multiple asset accounts as the taxpayer may choose. The new provisions are effective for years beginning after 1/1/14 with an election to apply them retroactively to years beginning on or after 1/1/12. A taxpayer may choose to apply Temp. Reg. § 1.168(i)-7T to taxable years beginning on or after 1/1/12, and before 1/1/14.

- Temp. Reg. § 1.168(i)-1T(c), dealing with general asset accounts and Temp. Reg. § 1.168(i)-8T(d), dealing with dispositions, both of which were promulgated in T.D. 9564 (12/27/11), and proposed in REG-168745-03 (12/27/11) have not been replaced by final regulations.

**3. No chickening out of the allocation agreement in an applicable asset acquisition — even after a cost segregation study.** Peco Foods, Inc. v. Commissioner, T.C. Memo. 2012-18 (1/17/12). The taxpayer entered into an agreement with the sellers of two poultry processing plants that allocated a large portion of the purchase price to processing plants on which the taxpayer claimed depreciation deductions as nonresidential real



property with a MACRS life of 39 years. The agreements separately listed agreed-upon prices for land, buildings, and machinery and equipment. Subsequently, after a cost segregation study, the taxpayer attempted to change its method of accounting to separate out components of the buildings as equipment and machinery and claim accelerated depreciation on the basis of shorter MACRS recovery periods. The Tax Court (Judge Laro) held that under *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967), and § 1060, unless the taxpayer could show fraud, undue influence, duress, etc., the taxpayer was bound by the purchase price allocation agreement. The court rejected the taxpayer's argument that nothing in § 1060 precluded the taxpayer from segregating components of assets broadly described as a production plant into components consisting of the real property and related equipment and machinery. The court also refused to accept the taxpayer's assertion that the agreements with the sellers should be disregarded because the use of the terms "processing plant building" and "real property improvements" were ambiguous. Finally the court agreed with the IRS that the IRS did not abuse its discretion in prohibiting the taxpayer from adopting depreciation schedules that were inconsistent with the terms of the purchase agreements.

**a. And the Court of Appeals plucks the taxpayer too.** *Peco Foods, Inc. v. Commissioner*, 522 Fed. Appx. 840 (11th Cir. 7/2/13). In a decision by Judge Hill, the Eleventh Circuit affirmed the Tax Court's decision. The Court of Appeals noted that (1) "both agreements contain the statement that the original allocation shall be used 'for all purposes (including financial accounting and tax purposes)," (2) "[t]he parties allocated the purchase price among three assets: 'Real Property: Land,' 'Real Property: Improvements,' and 'Machinery, Equipment, Furnitures [*sic*] and Fixtures,'" (3) Peco intended "Processing Plant Building" to be treated as a single asset when it entered into the agreement, and (4) the term "processing plant building" in the agreements was unambiguous.

**4. The taxpayer's basis in the Three Mile Island nuclear power plant is melted away by the China Syndrome; nuclear decommissioning liabilities are not included in the purchaser's basis until there is economic performance.** *Amergen Energy Co. v. United States*, 113 Fed. Cl. 52 (10/8/13). The taxpayer purchased three nuclear power plants and assumed liability for decommissioning costs in future years. In each transaction, the taxpayer received decommissioning trust funds. In one case the cash purchase price was approximately \$23,000,000 (plus \$77,000,000 in five annual installments for nuclear fuel) and the liabilities exceeded \$530,000,000; the decommissioning trust fund was approximately \$331,000,000. In a second transaction, the cash price was

approximately \$20,000,000 and the liabilities exceeded \$600,000,000; the decommissioning trust fund was approximately \$235,000,000. In the third transaction, the cash price was \$10,000,000 and the liabilities exceeded \$550,000,000; the decommissioning trust fund was approximately \$437,000,000. The only issue was whether Amergen could include a portion of the decommissioning costs to be paid in the future in the depreciable cost basis of the nuclear power plants. The IRS had previously refused to give Amergen a private letter ruling that it could take into account in computing the depreciable cost basis of the nuclear power plants the decommissioning costs to be paid in the future. Amergen argued that only § 1012 was relevant and that the liabilities could be taken into account in basis immediately. The government argued that the all events test of § 461 and the “economic performance” test of § 461(h) controlled the date on which the liabilities could be taken into account. On summary judgment, the Court of Federal Claims (Judge Bush) held for the government. The court reasoned that the plain language of § 461(h) does not limit its application to deductions, but provides that it applies to “any item.” Thus, § 461(h) “is of general applicability,” and applies to determine when liabilities are incurred for the purpose of cost basis calculations. The court’s conclusion was reinforced by its reading of the legislative history of § 461(h) in H.R. Rep. No. 98-432, pt. 2, at 1254–55 (1984), which included a reference to “capital items,” that the court concluded “show[ed] Congress’ concern with the time value of money and revenue losses due to attempts by taxpayers to claim the premature accrual of liabilities, as well as with the administrative challenges of providing a system for the discounted valuation of liabilities that will be satisfied in the future. Second, and more importantly, Congress understood that these concerns were present not only in the timing of deductions for expenses but also in the timing of the accounting of liabilities relevant to capital items.” Furthermore, the court held that the matrix of applicable regulations under §§ 263, 446, and 461 – particularly Reg. § 1.461-1(a)(2)(i), which requires economic performance before an item is includable in basis – were entitled to deference under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), and clearly applied the three-pronged test of § 461 to assumed liabilities for purposes of determining § 1012 cost basis. Finally, the court rejected Amergen’s last ditch argument that economic performance had occurred at the time the plants were purchased because the sellers had “provided property” to it and indicated that economic performance of decommissioning costs does not occur before the nuclear plants are shut down and decommissioning costs are incurred.

- Reg. § 1.263(a)-1(c)(1), as amended in 2013, provides that “In the case of a taxpayer using an accrual method of accounting, the terms amount paid and payment mean a liability incurred (within the meaning of § 1.446-1(c)(1)(ii)). A liability may not be taken into

account under this section prior to the taxable year during which the liability is incurred.” Reg. § 1.446-1(c)(1)(ii) provides that “a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.”

## F. Credits

### 1. Fifty ways to determine when construction begins.

Notice 2013-29, 2013-20 I.R.B. 1085 (4/15/13). The American Taxpayer (and not so grand compromise) Relief Act of 2012 extended the renewable electricity production tax credit of § 45 and the elective § 48 alternative investment tax credit for electricity produced at a qualified facility if construction of the facility is commenced before 1/1/14. Qualified facilities include wind facilities, closed-loop biomass facilities, open-loop biomass facilities, geothermal facilities, landfill gas facilities, trash facilities, hydropower facilities, and marine and hydrokinetic facilities. The notice provides that a taxpayer can demonstrate that construction has commenced by establishing that “physical work of a significant nature” is undertaken, or by meeting a safe harbor that five percent of the cost of a project is incurred before 1/1/14. The IRS may determine that construction has not commenced if the taxpayer does not maintain a continuous program of work. Significant physical work includes excavating foundations and the manufacture of components under a binding written contract that are not components held in inventory by the vendor. Significant physical work includes work on component parts of multiple facilities that will be treated as single project that are integral to the project, such as roads, but not fences or buildings. Significant physical work does not include preliminary work such as planning, design or licensing activities. The safe harbor is available if the taxpayer incurs five percent or more of the total cost of a facility before 1/1/14, and the taxpayer makes continuous progress towards completion of the facility as indicated by relevant facts and circumstances specified in the notice.

- Woe to the taxpayer who incurs cost overruns so that the pre-1/1/14 expenses do not amount to the requisite five percent. The safe harbor is not satisfied if total costs of the facility cause the amount incurred before 1/1/14, to be less than five percent of total cost. However, the credits may be claimed on some but not all of the facilities constituting a single project.

### 2. Funded versus unfunded research for the § 41 credit. Geosyntec Consultants, Inc. v. United States, 112 A.F.T.R.2d 2013-5488 (S.D. Fla. 4/15/13). A magistrate judge granted summary judgment to

the taxpayer and IRS on issues relating to whether research was funded or unfunded for purposes of the § 41 20 percent credit for increased research expenditures. Under § 41(d)(4)(H) the research credit is not available to a taxpayer if another party has funded otherwise qualifying research. Reg. § 1.41-4A(d) provides that, “Amounts payable under any agreement that are contingent on the success of the research and thus considered to be paid for the product or result of the research (see § 1.41-2(e)(2)) are not treated as funding. ...” Reg. § 1.41-4A(d)(1)(iii) provides that an expense is incurred for qualified research under an agreement with third parties only if the agreement requires the taxpayer to bear the expense even if the research is not successful. *Fairchild Industries, Inc. v. U.S.*, 71 F.3d 868, 870 (Fed. Cir. 1995), interprets these regulations to allocate “the tax credit to the person that bears the financial risk of failure of the research to produce the desired product or result.” The magistrate judge held that research expenditures incurred under the taxpayer’s fixed price contracts were eligible for the research credit, and that the research was not subject to funded contracts. Under those contracts the taxpayer was obligated to perform environmental clean-up activities for a fixed price subject to approval of the client. The court observed that, “The nature of fixed-price contracts makes them inherently risky to contractors. Under these types of contracts, to the extent a contractor’s performance is unsuccessful, the contractor must remedy the performance without additional compensation. Thus, these contracts generally place maximum economic risk on contractors who ultimately bear responsibility for all costs and resulting profit or loss.” The magistrate judge also held that research performed under “capped” contracts was funded research. The capped contracts provided for reimbursement of costs up to a capped amount. The court indicated that, “A distinctive feature of the capped contracts at issue is that each one obligates the client to reimburse [taxpayer] for pre-defined tasks at pre-defined rates in accordance with a detailed project budget.” The magistrate judge indicated that the capped contracts were similar to cost plus contracts that placed the risk of failed research on the client, and thus were funded contracts that did not cause the taxpayer to incur research expenditures eligible for the credit.

**3. And the IRS gets ready to start administering national health care.** REG-113792-13, Tax Credit for Employee Health Insurance Expenses of Small Employers, 78 F.R. 52719 (8/26/13). The IRS and Treasury have published Prop Reg. §§ 1.45R-1 through 1.45R-5, which provide comprehensive guidance regarding the § 45R credit, enacted as part of the Patient Protection and Affordable Care Act, available to certain small employers that offer health insurance coverage to their employees. The regulations are proposed to be effective for years beginning after 12/31/13.

However, employers may rely on the proposed regulations for years beginning after 12/31/13, and before 12/31/14.

## **G. Natural Resources Deductions & Credits**

**1. Hurry to get in line for Qualified Advanced Energy Project credits.** Notice 2013-12, 2013-10 I.R.B. 543 (2/7/13). The IRS has announced that phase II of § 48C credits for establishing a manufacturing facility to produce advanced energy property will provide an allocation of \$150,228,397 of credits. Section 48C(a) provides a 30 percent credit for investment in the taxable year in a qualifying advanced energy project certified by the IRS on recommendation by the Department of Energy. The maximum credit for any project is \$30 million. A concept paper must be submitted to DOE (electronically) by 4/9/13. If invited by DOE, the § 48C application must be submitted by 7/23/13. The DOE will rank applications. The highest ranked application will receive the full \$30 million credit, down the list until the amount of available credits is exhausted.

## **H. Loss Transactions, Bad Debts, and NOLs**

**1. Should the IRS tighten banks' bad debt deductions?** Notice 2013-35, 2013-24 I.R.B. 1240 (5/20/13). The IRS is asking for comments about whether the conclusive presumptions of Reg. § 1.166-2(d) regarding worthless bad debts should be revised in light of changes in banking regulation. Reg. §§ 1.166-2(d)(1) and (3) provide conclusive presumptions that bank's bad debts are worthless if either (1) a bank or other regulated corporation charges off a debt in obedience to a specific order or in conformity with established policies of the regulatory authority which confirms the charge-off, or (2) under the book conformity method a bank applies loan loss classification standards that are consistent with regulatory loan loss classification standards of the bank regulator. The conclusive presumptions are based on a policy that there is sufficient similarity between tax standards for the deduction and regulatory standards used to identify a loan that should be charged off. However, in 2004 bank regulators, relying on FASB pronouncements, determined that a security is deemed impaired if its fair value is less than its amortized costs and allowing a charge-off if the difference is other than temporary. In addition, under 2009 FASB guidance, with respect to debt held to maturity the portion of loss related to credit loss is recognized on the income statement while loss attributable to other factors is reported directly on the balance sheet. Among other things, the notice requests comments on whether the bank regulatory standards are sufficiently similar to worthless bad debt standards under § 166 and whether the conclusive presumption standards should be modified or replaced.

**2. To successfully call it a loan, ya gotta prove that ya expected to be repaid.** Shaw v. Commissioner, T.C. Memo. 2013-170 (7/24/13). The taxpayer was the bookkeeper and chief financial officer of a family corporation owned by herself, her mother, and her siblings. She loaned the corporation over \$800,000 under a revolving line of credit, evidenced by an unsecured promissory note, with adequate interest and a specified due date. The funds were to be used to develop a real estate project. At the time the line of credit was established and the funds were advanced, the corporation was encountering financial difficulties, cash flow was tight, and not all creditors could be paid. By the end of the year in which the funds had been advanced, the development project had been “cancelled.” The Tax Court (Judge Lauber) sustained the IRS’s denial of a worthless debt deduction, finding that there was no bona fide debt; the advances either constituted equity or were gifts to the other family-member shareholders. The taxpayer (1) presented no documentary evidence of the corporation’s creditworthiness, (2) did not request collateral despite the corporation’s “questionable financial status,” and (3) did not insist on financial covenants that would condition future line-of-credit advances on the corporation’s adherence to specified income, net worth, or debt-to-equity benchmarks. The taxpayer’s “behavior over the course of 2009 was likewise inconsistent with what one would expect from a third-party lender.” As the corporation’s “finances became more precarious ... rather than moderate her advances, [the taxpayer] left the spigot open.” Finally, the taxpayer made no serious effort to obtain repayment of the advances — “she did not send a letter demanding payment; she did not contact an attorney; and she did not file suit. ... [A] creditor with a genuine expectation of repayment would have acted more aggressively.” Finally, assuming arguendo that the advances were a loan, the taxpayer introduced no evidence of identifiable events indicating worthlessness.

**3. Texas professors denied bad debt deductions for related entity loans.** Herrera v. Commissioner, T.C. Memo. 2012-308 (11/5/12). The Tax Court (Judge Wherry) denied business bad debt deductions under § 166 for advances by one LLC (HSA) to its sister (MTI), both of which were owned by two University of Texas El Paso engineering professors who used the LLCs for consulting and metal fabrication activities. The LLC independently borrowed funds in its own name that were transferred to its related manufacturing entity to pay down a letter of credit originally entered into by both entities. Citing the 13 factors identified by the Fifth Circuit in *Texas Farm Bureau v. United States*, 725 F.2d 307 (5th Cir. 1984), the court found that advances were not bona fide debt, stressing the lack of a promissory note, the lack of a definitive maturity date, the lack of a repayment schedule, de facto subordination of the debt to other creditors, the

absence of a requirement for security, and the fact that the source of payment was tied to the fortunes of the business. The court stressed the fact that no interest was paid as being particularly important.

**a. The Fifth Circuit affirmed.** Herrera v. Commissioner, 112 A.F.T.R.2d 2013-6858 (5th Cir. 11/11/13). The court rejected the taxpayer's additional argument, which was not addressed by the Tax Court, that HSA had agreed to substitute its own note for that of its sister entity and payment of the debt was deductible as a business bad debt under Reg. § 1.166-9(e)(2), which provides that payment as a guarantor or indemnitor under a right of subrogation constitutes a business bad debt. Reiterating the findings of the Tax Court, the court indicated that there was no enforceable duty on the taxpayer to make the payment and that HSA's payments were on its own loan.

**4. It's now impossible as a matter of law to abandon a capital asset. W(h)ither the "sale or exchange" requirement.** Pilgrim's Pride Corp. v. Commissioner, 141 T.C. No. 17 (12/11/13). In 1999, the taxpayer purchased certain stock and securities issued by Southern States Cooperative for \$98.6 million. In 2004, Southern States offered to redeem the stock and securities for less than the taxpayer had paid for them. The taxpayer wanted approximately \$39 million, but Southern States was willing to pay only \$20 million. The negotiations ended without an agreement and the taxpayer "abandoned" the securities and claimed a \$98.6 million ordinary loss deduction. The IRS disallowed the ordinary loss deduction and treated the loss as capital. The Tax Court (Judge Dawson) upheld the IRS's position. The stock and securities were capital assets and § 1234A required that the loss be treated as capital. Section 1234A provides that:

Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—

- (1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
- (2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,

shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement).

- Judge Dawson reasoned that “[s]hares of stock are intangible interests or rights that the owner has in the management, profits, and assets of a corporation, while the certificate of stock is tangible evidence of the stock ownership of the person designated therein and of the rights and liabilities resulting from such ownership,” and that Congress intended “section 1234A to [apply to] terminations of all rights and obligations with respect to property that is a capital asset in the hands of the taxpayer or would be if acquired by the taxpayer, including not only derivative contract rights but also property rights arising from the ownership of the property.”

- The court rejected the taxpayer’s argument that an ordinary loss was allowable under Reg. § 1.165-2(a), because Reg. § 1.165-2(b) disallowed the loss as the surrender of the stock and securities was deemed to be a loss from a sale or exchange of a capital asset pursuant to section 1234A. It also noted that Rev. Rul. 93-80, 1993-2 C.B. 239, which allowed an ordinary loss deduction upon the abandonment of a partnership interest in a partnership that had no debt, was issued four years before § 1234A was amended in 1997 to apply to all property that is (or would be if acquired) a capital asset in the hands of the taxpayer, and thus it did not carry any weight.

## I. AT-RISK AND PASSIVE ACTIVITY LOSSES

**1. Section 183 is a more powerful sword for the IRS than § 469. Disallowance is more powerful than basketing.** Pederson v. Commissioner, T.C. Memo. 2013-54 (2/20/13). The Tax Court (Judge Goeke) upheld the IRS’s application of § 183 to disallow losses claimed with respect to an investment in a marketed horse breeding “program” in which the taxpayer had no direct involvement. The taxpayer did not have a good-faith belief that the horse breeding activity would turn an overall profit; the amount invested was based principally on the amount necessary to produce the desired tax losses; and participation in the breeding program was almost entirely motivated by tax benefits purportedly available to the taxpayer through such participation.

**2. Judge Morrison finds an honest taxpayer.** Montgomery v. Commissioner, T.C. Memo. 2013-151 (6/17/13). Temp. Reg. § 1.469-5T(f)(4) provides that the extent of an individual’s participation in an activity may be established by any reasonable means. “‘Reasonable means’ ... include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.” However, “contemporaneous daily time reports, logs, or similar documents are not required if the extent of such



participation may be established by other reasonable means.” In the instant case, however, Judge Morrison held that material participation had been established without any such documentary evidence being introduced. The taxpayers established material participation by their credible testimony providing details of the nature of the activities they conducted in starting and managing a business. They founded the company, negotiated contracts, hired 250 employees, and conducted daily business, “work[ing] on the business ‘day in and day out.’”

- This case is notable because in most cases claims of material participation without written documentation fall on deaf ears in the courts. *See, e.g., Bailey v. Commissioner*, T.C. Memo. 2001-296 (2001) (log book of visits to rental real estate that did not include contemporaneous record of hours devoted to real estate activity was not sufficient to substantiate that taxpayer devoted requisite number of hours to real estate business; uncorroborated estimates of hours required to perform activities were unreliable because they were prepared years later in anticipation of litigation); *D’Avanzo v. United States*, 67 Fed. Cl. 39 (2005) (taxpayer did not offer contemporaneous written record of number of hours he spent performing personal services with respect to rental properties; noncontemporaneous log book of hours claimed to have been devoted to real estate activities and testimony at trial, alone, are inadequate evidence to establish that taxpayer devoted requisite number of hours to real estate business activities), *aff’d by order*, 215 Fed. Appx. 996 (Fed. Cir. 2007); *Lee v. Commissioner*, T.C. Memo. 2006-193 (2006) (full-time physician and full-time IRS employee could not establish that they worked more than one half of their time in their real estate partnership business; noncontemporaneous time logs submitted at trial that more than doubled hours in log books submitted during audit were not credible); *Goolsby v. Commissioner*, T.C. Memo. 2010-64 (2010) (activity log purporting to document hours of management activity was not credible; it was created after taxpayer’s return was selected for audit and solely for purposes of the case; taxpayer had no contemporaneous records, such as appointment books, calendars, or narrative summaries to support activity log; “[i]ncredibly, the ... activity log lists days during which [the taxpayer] allegedly logged more than 24 hours of work”).

**a. A “ballpark guesstimate” doesn’t let you sing ♪ Yankee Doodle Dandy♪.** *Merino v. Commissioner*, T.C. Memo. 2013-167 (7/16/13). The Tax Court (Judge Wherry) held that the taxpayer failed to prove that he was a real estate professional who materially participated in a real property rental activity, thereby escaping the passive activity loss limitations by way of § 469(c)(7). The taxpayer’s only evidence was his own “summary of hours” that was prepared “using his estimates and his memory as to how much time he spent on certain tasks with respect to the real estate rental activity.” It “was not created from contemporaneous

documentation, but rather it [was] a postevent reconstruction from memory,” that was “less of an approximation and more of a ‘ballpark guesstimate.’”

**b. The Tax Court continues to be hard-nosed regarding contemporaneous records of hours devoted to activities to avoid section 469.** Bartlett v. Commissioner, T.C. Memo 2013-182 (8/8/13). The Tax Court (Judge Kerrigan) rejected a “guesstimate” of hours worked on a ranch. The lack of any contemporaneous records or other records and documentation regarding what the taxpayer specifically did day-to-day and how much time he spent on matters relating to the activity was not cured by estimates made years after the fact in writing or by testimony.

**3. Borrowed funds contributed to S corporation cellular company were neither at-risk nor did they create basis for loss deductions.** Broz v. Commissioner, 137 T.C. 46 (9/1/11). In a structure typical for the industry, the taxpayer was the shareholder of two S corporations, RFB and Alpine, that held FCC licenses to operate cellular networks in rural areas. RFB held licenses directly and was the original business. Alpine and Alpine LLC, a single member LLC owned by the taxpayer, were formed to expand the business. Additional licenses were obtained and held by a number of LLCs (partnerships) that were owned 99 percent by the taxpayer and 1 percent by his brother. Alpine and the LLCs were formed at the insistence of creditors to isolate the liabilities of the thinly capitalized expansion. RFB owned and operated all of the equipment. Alpine and the LLCs owned only licenses, and RFB allocated some of its income to Alpine for use of the licenses. RFB obtained financing to construct cellular equipment and for working capital, and re-lent some of the loan proceeds to Alpine. Alpine and the taxpayer documented the loans from RFB to Alpine as shareholder loans. The taxpayer pledged RFB stock for the loans, but did not guarantee the loans, which were also secured by corporate assets.

- First, for purposes of determining the taxpayer’s basis in Alpine, for purposes of applying the § 1366(d) limitation on passed-through losses, the court (Judge Kroupa) held that (1) the taxpayer had not established that he had borrowed money from the bank that he personally re-lent to Alpine because RFB did not advance the funds to Alpine on the taxpayer’s behalf, i.e., the loan ran directly from RFB to Alpine; and (2) the taxpayer had not made any “economic outlay.” Thus, the loans were not included in the shareholder’s basis to support loss deductions.

- Second, for purposes of determining the taxpayer’s at-risk amount with respect to Alpine, in what was described as an issue of first impression, the court held that the RFB stock pledged for the loans represented pledged property used in the business not eligible to be treated as an amount at-risk by virtue of § 465(b)(2)(A). Since Alpine was formed to expand

RFB's cellular networks, the pledged RFB stock was related to Alpine's business. Thus, because the shareholder did not guarantee the loans to Alpine, the shareholder was not economically or actually at-risk with respect to his involvement with Alpine.

- Third, the court held that Alpine could not deduct interest, expenses, and depreciation during the years at issue because it was not yet engaged in an active trade or business utilizing the licenses it held. The court rejected the taxpayer's argument that operation of cellular networks by RFB could be attributed to Alpine. Acquisition of licenses and related equipment was not sufficient to establish Alpine as engaged in the active conduct of a trade or business. Alpine failed to attach the required statement to the return for the taxable year to claim § 195 amortization of start-up expenses [which it could not have deducted even if it had attached the form because it had not yet commenced business operations].

- Fourth, in another issue that the court described as one of first impression, the court concluded that deductions under § 197 for amortization of the costs of FCC licenses were not available in years in which the taxpayers was not yet engaged in a trade or business. The court concluded that the language of § 197 that provides the deduction "in connection with the conduct of a trade or business" requires that the intangibles "must be used in connection with a business that is being conducted."

**a. "Losses are not tested under the at-risk rules until the shareholder has sufficient basis to deduct them." Broz v. Commissioner, 727 F.3d 621 (6th Cir. 8/23/13).** The Sixth Circuit, in an opinion by Judge Rogers, affirmed, holding that the Tax Court correctly determined that the taxpayer did not have sufficient basis in Alpine to support the claimed passed-through losses. The court also upheld denial of the claimed § 162 expenses and § 197 amortization deductions for the license-holding entities because those entities were not engaged in an active trade or business. The court did not reach the at-risk issue.

- With respect to the § 1366(d) loss limitation issue, the Sixth Circuit found that there was no evidence that at the time the loan to Alpine was made the debt was intended to run directly from Alpine to either Broz or his wholly owned LLC. It was intended to run from Alpine to RFB. "After-the-fact reclassification cannot satisfy the requirement that the debt run directly from the S corporation to the taxpayer/shareholder." Because Broz had insufficient basis to support any passed-through loss deductions, the court did not reach the § 465 at-risk issue, stating that "losses are not tested under the at-risk rules until the shareholder has sufficient basis to deduct them." In dictum that followed, the court noted that "the at-risk limit in § 465 and the basis limit in § 1366(d) are functionally almost identical in the S corporation context."

- Turning to the § 162 expense deductions, the court held that “each entity’s activity must be evaluated individually and not in conjunction with any other entity.” Thus, Alpine’s and the LLC’s activities could not be amalgamated with RFB’s activities. Viewed individually, neither Alpine nor the LLCs conducted any business during the year. Broz chose to employ separate entities for a business reason and could not have “‘the best of both worlds’ by having the Alpine entities treated as separate for purposes of avoiding or distinguishing liabilities, but treated as one entity together with RFB for tax purposes.”

- Finally, turning to the § 197 amortization deductions, the court held that amortization deductions “do not begin upon acquisition of the intangible asset if the intangible asset is not yet held in connection with the conduct of a trade or business, because the assets are in that case not eligible as ‘amortizable section 197 intangibles.’” The court noted that although § 197(a) provides that the deduction is calculated beginning with the month in which the intangible asset is acquired, it allows the deduction only for “amortizable section 197 intangibles,” which are defined in § 197(c) as intangible assets “held in connection with the conduct of a trade or business.” Because the Alpine license-holding entities never actually leased the licenses to Broz’s other businesses, the licenses were never held in connection with a trade or business that was actually being conducted. Thus, the licenses did not qualify as “amortizable section 197 intangibles,” and were ineligible for amortization deductions.

### III. INVESTMENT GAIN AND INCOME

#### A. Gains and Losses

1. **What! You mean my money market fund might lose money — a proposed *de minimis* exception from *de mickeymouse* wash sale rules for money market fund losses.** Notice 2013-48, 2013-31 I.R.B. 120 (7/3/13). This Notice proposes a revenue procedure that would provide a *de minimis* exception to the § 1091 wash sale rules for certain redemptions of shares of money market funds that, under regulations proposed by the SEC, would no longer maintain a constant share price. Under the proposed revenue procedure, if a taxpayer realizes a loss upon a redemption of shares in such a fund, and the amount of the loss is not more than 0.5 percent of the taxpayer’s basis in the shares, the IRS will treat the loss as not subject to § 1091. The purpose of the *de minimis* rules is to mitigate tax compliance burdens that may result from the changes in money market fund redemption prices. If the SEC does not adopt its proposed rules in substantially the same form as they have been proposed, the revenue

procedure proposed by the Notice might not be adopted or might be adopted in a materially modified form.

**2. Caught in the zero basis trap for lack of adequate records of stock purchase price. This case is too bad to be true.** United States v. Youngquist, 111 A.F.T.R.2d 2013-2293 (Magistrate D. Or. 4/17/13), *adopted by the court*, 111 A.F.T.R.2d 2013-2467 (D. Ore. 6/21/13). The District Court (Judge Brown) adopted Magistrate Judge Papak's findings and recommendations and held that a taxpayer's basis in stock sold through one of his brokerage accounts was zero because the taxpayer introduced no evidence of the cost of any particular block of shares sold, citing *Coloman v. Commissioner*, 540 F.2d 427 (9th Cir. 1976). The taxpayer's evidence of the amount deposited as the opening cash balance of the brokerage account did not suffice to prove the basis of any block of stock. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), did not apply to allow an estimate of the basis of any of the shares because no authority supported an "aggregate theory of proving basis."

- Taxpayer began his day trading in the brokerage account in question on November 5, 1996 and closed the account on December 20, 1996; nevertheless the IRS found, and the court concluded, that he had \$1,456,076 of income from the account during that period.

**3. Section 1014 means what it says. Lower estate tax today may mean higher income tax tomorrow.** Van Alen v. Commissioner, T.C. Memo. 2013-235 (10/21/13). The taxpayers were the beneficiaries of a trust that was the residuary beneficiary of a decedent's estate. The estate made a special farm use valuation election under § 2032A. Section 1014 provides fair market value at the time of the decedent's death for heirs and beneficiaries, but § 1014(b)(3)(A) requires use of the estate tax value in the case of a special farm use valuation election under § 2032A, which values the land at its then current use as agricultural land. Reg. § 1.1014-3(a) provides that the value of property at the date of death will be the value as appraised for purposes of the Federal estate tax or the alternate value, whichever is applicable. On the sale of a conservation easement on the inherited ranch land by the trust, the Tax Court (Judge Holmes) required the taxpayers to compute their distributive shares of the gain using as basis the lower estate tax value reported under the § 2032A election. The court held that the taxpayers had a "duty of consistency," because as residuary beneficiaries of the trust, they had an economic interest in the lower estate tax valuation and benefitted from the lower estate tax valuation. He rejected their argument that the lower estate tax valuation should not be used because it was erroneous and because the taxpayers did not understand the implications of the reporting position. In addition, the taxpayers' inconsistency led to accuracy related penalties.

**4. You can't have your cake and eat it too.** Moore v. Commissioner, T.C. Memo. 2013-249 (10/30/13). In a somewhat convoluted transaction, the taxpayer purchased some stock of his employer S corporation from another shareholder and paid for the stock with a promissory note for approximately \$5.8 million. The taxpayer agreed to the purchase price on the basis of information that the corporation had provided to him and the corporation's promise that it would lend him the funds for the purchase price. To settle a suit to rescind the loan agreement because of a mutual mistake as to the value of the shares, the corporation reduced the debt to \$1,000,000. When the taxpayer subsequently sold the shares for \$3 million, the question was the taxpayer's initial stock basis, before taking into account § 1367 adjustments (which were to be left to Rule 155 computation). The taxpayer reported a loss of approximately \$1.5 million and the IRS asserted a deficiency based on a \$2 million gain. The Tax Court (Judge Thornton) sustained the IRS's position. Judge Thornton concluded that there was no "absolute indebtedness."

The economic reality of the transactions in question, viewed in their totality, was that Mr. Moore agreed to purchase Mr. Baker's ATS shares as an accommodation to ATS, with an understanding that ATS' funds would be used to pay the nominal purchase price. According to Mr. Moore's own allegations in his subsequent lawsuit against ATS, there was no expectation that he should pay out of his own funds more than the true economic value of the shares, which both he and ATS ultimately agreed was only \$1 million.

- Judge Thornton noted that this result was consistent with the IRS's conclusion in the course of auditing the taxpayer's return for the year the debt was reduced to \$1 million that the taxpayer had not realized any COD income. The holding regarding basis in the year of the sale produced symmetry with the earlier year.

- A § 6662 penalty was not upheld because the court found that the taxpayer had reasonably and in good faith relied on his tax advisors in taking the return position.

#### **B. Interest, Dividends, and Other Current Income**

There were no significant developments regarding this topic during 2013.

### C. Profit-Seeking Individual Deductions

There were no significant developments regarding this topic during 2013.

### D. Section 121

There were no significant developments regarding this topic during 2013.

### E. Section 1031

**1. Rental property occupied by the taxpayer's son was investment property, not personal-use property.** *Adams v. Commissioner*, T.C. Memo. 2013-7 (1/10/13). The taxpayer engaged in a deferred like-kind exchange through an intermediary in which he surrendered a property held for rental and acquired a new residential property that was dilapidated and in need of rehabilitation. The taxpayer and his son entered into an agreement whereby the son and his family could live in the new house after renovations. The son and his family worked on the house an aggregate of 60 hours per week for three months before moving in. The son and his family bore all of the rehabilitation expenses; their services were worth \$3,600. After three months of work, the son's family moved in, resided in the house for three years, and paid rent that was a few hundred dollars per month less than the fair rental value. The IRS took the position that the transaction was not a § 1031 like-kind exchange because the taxpayer acquired the new house for personal purposes – i.e., “with the intention of letting his son and family live there at below market rent” – and that the taxpayer thus must recognize gain on the sale. The Tax Court (Judge Morrison) found that the taxpayer had acquired the new house for investment purposes and that the transaction thus qualified as a § 1031 like-kind exchange. Furthermore, the limitations on deductions imposed by § 280A did not apply to the new house rented to the son. Pursuant to § 280A(d)(2), a taxpayer is treated as using a dwelling unit during the taxable year as a residence if the taxpayer rents the dwelling unit to a family member, unless the taxpayer rents the dwelling unit to the family member “at a fair rental” and for use as that family member's principal residence. The son used the residence as his principal residence and, although the \$1,200 per month cash rent was slightly below market, it was fair rent considering the work that the son had performed with respect to the house. Thus the § 280A(a) prohibition of deductions for dwelling units used as residences did not apply.

**2. Swapping both a personal residence and business property for a new personal residence and business property invokes both § 1031 and § 121 and provides a computational challenge.** Yates III v. Commissioner, T.C. Memo 2013-28 (1/24/13). Through a qualified intermediary, the taxpayers exchanged a property that qualified as a principal residence under § 121 and a business property for a new principal residence and two business properties. The issues in the case dealt mainly with the proper valuations of the properties, which determined the amount of gain realized that was not sheltered by § 1031; and there is nothing noteworthy about the valuation determinations. The important point of the case is that the Tax Court (Judge Goeke) applied Reg. § 1.1031(j)-1(a)(1), which provides that where multiple properties are transferred in a like-kind exchange, the properties are separated and arranged for analysis into “exchange groups” based on shared characteristics. A “residual group” is created if the aggregate fair market value of the properties transferred in all of the exchange groups qualifying for § 1031 treatment differs from the aggregate fair market value of the properties received in all the exchange groups. Both residences were treated as part of the residual group, with the new residence treated as boot, but § 121 applied to provide nonrecognition (for up to \$500,000) of gain on the exchange of the old personal residence for a new one. The exact computations were left to be made under Rule 155.

**3. Tax ain’t horseshoes: When the regulations say thirty years, they don’t mean 21 years and 4 months.** VIP’s Industries Inc. v. Commissioner, T.C. Memo 2013-157 (6/24/13). Through a QI, the taxpayer exchanged a leasehold with 21 years and 4 months remaining for a fee interest in other real estate. The only significant issue was whether the leasehold and fee interests were like-kind under Reg. § 1.1031-1(c), which states that § 1031 nonrecognition can apply to an exchange of a leasehold with 30 years or more to run for a fee interest. Applying *May Department Stores Co. v. Commissioner*, 16 T.C. 547 (1951), which held that a 20-year leasehold was not like-kind to a fee interest, Judge Marvel held that the exchange of a leasehold with 21 years and 4 months remaining for a fee interest in other real estate did not qualify as a like kind exchange.

**4. That the residual method of valuing goodwill was the proper method was a slam dunk for the government, but its valuation amount bounced off the rim when the facts were analyzed by the court.** Deseret Management Corp. v. United States, 112 Fed. Cl. 438 (8/22/13). The taxpayer exchanged a highly appreciated radio station in Los Angeles (KZLA) for several radio stations in St. Louis and reported that pursuant to § 1031 no gain had been recognized. The government asserted that the taxpayer was required to recognize gain with respect to the exchange



of KZLA's goodwill because Reg. § 1.1031(a)-2(c)(2) provides that "[t]he good will or going concern value of a business is not of a like kind to the goodwill or going concern value of another business." The taxpayer took the positions that (1) as a matter of law goodwill never attached to the business of a broadcast radio station, and (2) if goodwill could attach to the business of a broadcast radio station, on the facts the value of the goodwill of KZLA was zero. The parties agreed that the aggregate value of the exchanged property was \$185 million and stipulated that the value of all tangible assets of KZLA was \$3,384,637, and that the value of all intangible assets of KZLA, apart from its FCC License and any goodwill, was \$4,858,317. The taxpayer took the position that the value of the FCC license was the \$176,757,046 that remained after accounting for those other assets, leaving nothing to be assigned to goodwill under the residual method. First, the Court of Federal Claims (Judge Allegra) rejected the taxpayer's argument that as a matter of law goodwill never attached to the business of a broadcast radio station. The taxpayer argued that a radio station can never possess goodwill because audience loyalty is a matter of format and online personalities. Judge Allegra responded

That listeners might flee a station that suddenly changes its format or on-air personalities, however, does not prove plaintiff's point—any more than it would be true to say that other types of businesses cannot have goodwill because they would lose their customers if they fundamentally changed their business plan. Can it be that nationally-recognized restaurant chains lack goodwill because their customers might flee if they radically changed their menus; or that sporting goods stores lack goodwill because they might decide to sell only flowers; or that familiar chains of coffee purveyors lack good will because they would lose their current business if they sold only soda? One would think not. ... Put another way, whether goodwill exists as part of the assets acquired in a transaction cannot depend upon whether the buyer concludes that it is in its best interests to sustain the prior business model—that the prior goodwill must be accounted for if the prior business model is maintained, but not if that model is modified.

• Turning next to the factual valuation issue, Judge Allegra handed the taxpayer a complete victory, based not on the taxpayer's expert's report and analysis, which he had rejected but by using the government's expert's methodology, modified to correct what he found to be errors in the methodology. In the end, applying the residual valuation method, Judge Allegra concluded that the value of the FCC license, determining by discounting the expected net cash flow from the license as if it belonged to a

start-up company, was at least \$176,757,046, leaving nothing to be assigned to goodwill.

**5. The magistrate judge wasn't fooled by the disguised related party exchange.** North Central Rental & Leasing, LLC v. United States, 112 A.F.T.R.2d 2013-7045 (D. N.D. 9/3/13). North Central was an LLC taxed as a partnership owned 99 percent by Butler Machinery Corporation and 1 percent by Mr. Butler personally. Butler Machinery was a dealer in heavy equipment and North Central engaged in equipment leasing. North Central and Butler Machinery engaged in almost 400 transactions that it claimed were entitled to § 1031 like-kind exchange nonrecognition, but the IRS and government took the position that pursuant to the § 1031(f) related-party rules, § 1031 treatment was not available. Each of the transactions followed essentially the same format. North Central desired to dispose of equipment that it had rented out for a number of years (and which had a fair market value in excess of adjusted basis). North Central conveyed the equipment to a QI. The QI sold the truck to the unrelated third-party customer. Butler bought the replacement equipment from Caterpillar under a 180 day payment plan. The QI used the cash from the sale of the equipment to purchase the replacement property from Butler and transferred the replacement property to North Central. North Central then paid any excess of the cost of the replacement property over the sales price of the relinquished property to Butler through adjustment of an intercompany note between Butler and North Central. As structured, the transaction permitted Butler to hold the cash for up to six months until the due date of the Caterpillar invoice for the replacement property. Magistrate Judge Klein held that the transactions allowed the related taxpayers to “cash out” – albeit only for six months – low basis property through basis shifting and that they were structured to avoid the limitations of § 1031(f). She rejected North Central’s claims that there were nontax business reasons for the structure of the transactions. Accordingly, because § 1031(f)(4) disqualifies from nonrecognition “any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of [§ 1031(f)],” the transactions were all taxable.

#### **F. Section 1033**

There were no significant developments regarding this topic during 2013.

### G. Section 1035

There were no significant developments regarding this topic during 2013.

### H. Miscellaneous

**1. Making the straddle rules even more complicated — retroactively for twelve years.** T.D. 9635, Debt That is a Position in Personal Property That is Part of a Straddle, 78 F.R. 54568 (9/5/13). The Treasury has promulgated temporary regulations to provide guidance under § 1092 regarding when an issuer's obligation under a debt instrument may be a position in actively traded personal property and, therefore, may be part of a straddle. Temp. Reg. § 1.1092(d)-1T(d) provides that if a taxpayer is the obligor under a debt instrument one or more payments on which are linked to the value of personal property or a position with respect to personal property, then the taxpayer's obligation under the debt instrument is a position with respect to personal property and may be part of a straddle. The provision applies to straddles established on or after 1/17/01.

- The twelve year retroactivity is based on the fact that the Treasury Decision adopted Prop. Reg. § 1.1092(d)-1(d) in the form proposed on 1/18/01, (REG-105801-00).

## IV. COMPENSATION ISSUES

### A. Fringe Benefits

**1. This ruling is expressly for new mothers.** Announcement 2011-14, 2011-9 I.R.B. 532 (2/10/11). This announcement held that breast pumps and supplies that assist lactation are medical care under § 213(d) because "they are for the purpose of affecting a structure of the body of the lactating woman." The announcement did not refer at all to the health of the baby.

**a. Making what was recently held to be a deductible medical expense into a mandatory freebee. A new mandate under Obamacare makes all this stuff mandatory for group plans, as well as miraculously free for the insureds.** T.D. 9541, Group Health Plans and Health Insurance Issuers Relating to Coverage of Preventive Services Under the Patient Protection and Affordable Care Act, 76 F.R. 46621 (8/3/11). Temp. Reg. § 54.9815-2713T(a)(1)(iv) requires coverage by all group plans of contraceptive, breast-feeding and many other services for women without co-pays and without deductibles. REG-120391-10, Group

Health Plans and Health Insurance Issuers Relating to Coverage of Preventive Services Under the Patient Protection and Affordable Care Act, 76 F.R. 46677 (8/3/11), promulgates identical proposed regulations. The effective date is 8/1/12.

**b. “[Obama says that] your little [Republican] friends are wrong. . . . Yes, Virginia, there is a Santa Claus.”**<sup>6</sup> REG-120391, Coverage of Certain Preventive Services Under the

---

6. “DEAR EDITOR: I am 8 years old.

“Some of my little friends say there is no Santa Claus.

“Papa says, ‘If you see it in THE SUN it’s so.’

“Please tell me the truth; is there a Santa Claus?

“Virginia O’Hanlon.

“115 West Ninety-Fifth Street.”

Virginia, your little friends are wrong. They have been affected by the skepticism of a skeptical age. They do not believe except they see. They think that nothing can be which is not comprehensible by their little minds. All minds, Virginia, whether they be men’s or children’s, are little. In this great universe of ours man is a mere insect, an ant, in his intellect, as compared with the boundless world about him, as measured by the intelligence capable of grasping the whole of truth and knowledge.

Yes, Virginia, there is a Santa Claus. He exists as certainly as love and generosity and devotion exist, and you know that they abound and give to your life its highest beauty and joy. Alas! how dreary would be the world if there were no Santa Claus. It would be as dreary as if there were no Virginias. There would be no childlike faith then, no poetry, no romance to make tolerable this existence. We should have no enjoyment, except in sense and sight. The eternal light with which childhood fills the world would be extinguished.

Not believe in Santa Claus! You might as well not believe in fairies! You might get your papa to hire men to watch in all the chimneys on Christmas Eve to catch Santa Claus, but even if they did not see Santa Claus coming down, what would that prove? Nobody sees Santa Claus, but that is no sign that there is no Santa Claus. The most real things in the world are those that neither children nor men can see. Did you ever see fairies dancing on the lawn? Of course not, but that’s no proof that they are not there. Nobody can conceive or imagine all the wonders there are unseen and unseeable in the world.

You may tear apart the baby’s rattle and see what makes the noise inside, but there is a veil covering the unseen world which not the strongest man, nor even the united strength of all the strongest men that ever lived, could tear apart. Only faith, fancy, poetry, love, romance, can push aside that curtain and view and picture the supernal beauty and glory beyond. Is it all real? Ah, Virginia, in all this world there is nothing else real and abiding.

Affordable Care Act, 78 F.R. 8456 (2/6/13). These proposed regulations would require that insurance companies for tax-exempt religious organizations, including hospitals, universities and schools, provide free contraceptive services to all women insured by them (including students at universities), but would provide that the insurance companies will be reimbursed for the costs of individual contraceptive-only policies by the government. However, HHS Secretary Sibelius stated that the taxpayers would not pay for these reimbursements either. Thus, services that cost \$18,000 per woman would become free under Obamacare.

- Such is the magic power of compound interest.

**c. The Supreme Court will consider the legality under the Religious Freedom Restoration Act of the application of Obamacare's contraceptive mandate to closely held businesses owned by persons who claim their Christian beliefs would be violated by compliance with that mandate.** Hobby Lobby Stores, Inc. v. Sibelius, 723 F.3d 1114 (10th Cir. 6/27/13) (*en banc*), *cert. granted*, 134 S. Ct. 678 (11/26/13). The Tenth Circuit (Judge Tymkovich) held that the Religious Freedom Restoration Act (P.L. 103-141) protects closely held family businesses operated in corporate form from violating their owners' Christian principles by complying with a regulation under the PPACA (Obamacare) that requires them to provide drugs and devices that they believe are abortifacients as part of their employer-sponsored health care plans.

**d. "White House suspends [individual] mandate penalty for those with cancelled health plans."** Individuals whose health insurance plans were canceled by insurers because they did not meet the requirements of the Affordable Care Act will be eligible for an exemption from the individual mandate penalty under § 5000A that takes effect in 2014, the Department of Health and Human Services said late December 19. (2013 TNT 246-5, 12/19/13). The mandate requires everyone to have health insurance or face a tax penalty, the greater of \$95 or 1 percent of income in 2014. The administration will also allow those consumers to sign up for catastrophic coverage. Those bare-bones plans are available to people who are under 30 or qualify for a "hardship exemption." HHS Secretary Kathleen Sebelius said in a letter to Sen. Mark Warner, D-Va., that the administration is granting a "hardship exemption" to Americans whose

---

No Santa Claus! Thank God! he lives, and he lives forever. A thousand years from now, Virginia, nay, ten times ten thousand years from now, he will continue to make glad the heart of childhood. (The [New York] Sun, 9/21/1897, p. 1, unsigned, by Francis Pharcellus Church).

plans were canceled and “might be having difficulty” paying for standard coverage.

**2. You may have trouble with these proposed regulations if you don’t know the meaning of MV, EHB, HAS, HRA, FPL, and “metal level.”** REG-125398-12, Minimum Value of Eligible Employer-Sponsored Plans and Other Rules Regarding the Health Insurance Premium Tax Credit. 78 F.R. 25909 (5/3/13). The IRS has issued proposed regulations on the § 36B health insurance premium tax credit that provide guidance on determining whether health coverage under an eligible employer-sponsored plan provides minimum value.

**3. The IRS provides guidance on the application of the Affordable Care Act’s market reforms to HRAs, EPPs, FSAs, and EAPs—it’s the bee’s knees!** Notice 2013-54, 2013-40 I.R.B. 287 (9/13/13). The Patient Protection and Affordable Care Act amended the Public Health Service Act to implement certain market reforms for group health plans, including requirements that: (1) group health plans not establish any annual limit on the dollar amount of benefits for any individual, and (2) non-grandfathered group health plans provide certain preventive services without imposing any cost-sharing requirements for the services. The notice provides guidance, in Q&A format, on the application of these market reforms to: (1) health reimbursement arrangements (including HRAs integrated with group health plans), (2) group health plans under which employers reimburse employees for premium expenses incurred for an individual health insurance policy (referred to in the notice as “employer payment plans”), and (3) health flexible spending arrangements. The notice also provides guidance on employee assistance programs and on § 125(f)(3), which generally provides that a qualified health plan offered through a health insurance exchange established under the Affordable Care Act is not a qualified benefit that can be offered through a cafeteria plan. The notice applies for plan years beginning on and after 1/1/14, but taxpayers can apply the guidance provided in the notice for all prior periods. The Department of Labor has issued guidance in substantially identical form (Technical Release 2013-03) and the Department of Health and Human Services is issuing guidance indicating that it concurs.

## B. Qualified Deferred Compensation Plans

**1. Some inflation adjusted numbers for 2014.** I.R. 2013-86 (10/31/13).

- Elective deferral in §§ 401(k), 403(b), and 457 plans, remains at \$17,500 with a catch up provision for employees aged 50 or older of \$5,500.

- The limit on contributions to an IRA will be unchanged at \$5,500. The AGI phase out range for employees covered by a workplace retirement plan is increased to \$96,000 and to \$115,000 for employees not covered by a workplace retirement plan. The phase-out range for contributions to a Roth IRA is \$181,000 to \$191,000 for married couples filing jointly, and \$114,000 to \$129,000 for singles and heads of household.

- The annual benefit from a defined benefit plan under § 415 is increased to \$210,000.

- The limit for defined contributions plans is increased to \$52,000.

- The amount of compensation that may be taken into account for various plans is increased to \$260,000, and \$385,000 for government plans.

**2.** Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13). This notice provides temporary nondiscrimination relief for certain “closed” defined benefit pension plans (i.e., those that provide ongoing accruals but that have been amended to limit those accruals to some or all of the employees who participated in the plan on a specified date). Typically, new hires are offered only a defined contribution plan, and the closed defined benefit plan has an increased proportion of highly compensated employees.

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

**1. The Ninth Circuit shows the IRS no deference in its interpretation of its own Regulations.** Schwab v. Commissioner, 715 F.3d 1169 (9th Cir. 4/24/13). The Court of Appeals, in an opinion by Judge M. Smith, affirmed the Tax Court’s decision, rejecting the government’s argument that “because section 72 contemplates the ‘cash value’ of a non-annuity ‘without regard to any surrender charge,’ I.R.C. § 72(e)(3)(A)(i), then section 402(b)(2) must also apply without regard to any surrender charge.” In addition to being an erroneous interpretation of § 72(e)(3)(A), the government’s interpretation of § 402(b)(2) would “read[] the phrase ‘amount actually distributed or made available’ entirely out of section 402(b)(2).” The Court of Appeals also refused to defer to the government’s interpretation of

Reg. § 1.402(b)-1(c) as prohibiting the consideration of surrender charges in valuing a life insurance policy for purposes of § 402(b)(2). The court also rejected the government's argument that surrender charges could not be considered under § 402(b) because in *Matthies v. Commissioner*, 134 T.C. 141 (2010), the Tax Court concluded that, under the pre-2005 regulations, surrender charges should not be considered when valuing a life insurance policy under § 402(a). The Tax Court decided *Matthies* based on the regulation's requirement to account for the "entire cash value" of the policy, while the regulation interpreting § 402(b)(2) contains no such language. Accordingly, the Tax Court "correctly equated the 'amount' in section 402(b)(2) with the fair market value of the policies that were actually distributed." Finally, the Tax Court did not err in the determination of the fair market value of the policies after taking into account the surrender charges.

**2. Substance over form determines that an option to purchase shares of the taxpayer's employer was granted to him by the corporation, not by his ex-wife to whom he transferred the shares in a divorce.** *Davis v. Commissioner*, 716 F.3d 560 (11th Cir. 5/16/13), *aff'g* T.C. Memo. 2011-286. In connection with the taxpayer's divorce, he transferred one-half of his shares of a family corporation of which he was a shareholder and key employee to his ex-wife, who granted him an option to purchase those shares. Contemporaneously, the corporation agreed to grant him an option to purchase additional stock in the corporation as an inducement for him to continue his employment. However, instead of granting him the option, as contemplated by the parties all along, the corporation redeemed the shares transferred to the taxpayer's ex-wife and assumed the obligation under the option from the ex-wife to permit the taxpayer to purchase the shares from the corporation. Subsequently, that option was modified in several significant respects before it ultimately was exercised. The taxpayer did not report income under § 83(a) upon exercise of the option, but the corporation claimed a deduction under § 83(h). The Eleventh Circuit, in an opinion by Judge Ripple, affirmed the Tax Court's decision that the taxpayer was required to recognize income under § 83 and that the corporation was entitled to a deduction. The court rejected the taxpayer's argument that because the option originally was granted to him by his ex-wife incident to their divorce, his exercise of it was shielded from recognition by § 1041, holding instead that it was granted to him in connection with his performance of services. A key fact supporting the holding was that the revised option from the corporation imposed the requirement that the taxpayer notify the corporation in writing if he chose to make a § 83(b) election. Applying substance over form, the court held that the corporation was the true counter-party to the option granted by the ex-wife and that the option from the corporation, with substantially different



rights than those granted by the ex-wife's option, was a different option, despite being termed an "amendment" of the option from the ex-wife. Furthermore, the court added that had the taxpayer exercised the option granted by the ex-wife, its exercise would not have been governed by § 1041, because § 1041 applied only to the initial transfer of stock and the grant of the option; it does not apply to subsequent dispositions of property received in the divorce. The court went on to state that the exercise in that case still would have produced ordinary income. That final conclusion puzzles us, because apart from § 83, the exercise of an option to purchase property, even at a bargain, is not a realization event. But not to worry, the court's *faux pas* was dictum.

**3. A requirement to sell employer stock back at a discount if the employee is sacked for "[f]ailure or refusal by Employee ... to cure by faithfully and diligently performing the usual and customary duties of his employment" is a substantial risk of forfeiture.** Austin v. Commissioner, 141 T.C. No. 18 (12/16/13). The taxpayers received stock in a corporation in a § 351 transaction and entered into employment agreement and restricted stock agreements with the newly formed corporation. The taxpayers received 95 percent of the stock of the corporation and an ESOP acquired 5 percent of the stock for a promissory note. (The transactions occurred before the enactment of § 409(p) in 2004 and the tax years at issue were 2000-2003.) The taxpayers collectively were the entire board of directors of the corporation. The corporation made an S election. The employment agreements provided that upon termination of employment, they would receive less than the full fair market value of their S shares if they were terminated "for cause" during the initial term of the employment agreement; otherwise on termination of employment the taxpayers would receive in exchange for their stock 100 percent of the fair market value, determined by formula. The employment agreements defined termination "for cause" to include not only termination for "[d]ishonesty, fraud, embezzlement, alcohol or substance abuse," but also termination upon "[f]ailure or refusal by Employee ... to cure by faithfully and diligently performing the usual and customary duties of his employment." The stock certificates were legended as restricted stock. The taxpayers took the position that their stock was not fully vested and that pursuant to Reg. § 1.83-1(a)(1) they were not shareholders, with the result that all of the S corporation's income passed through to the ESOP and none passed through to them. The IRS asserted deficiencies based on the ground that the stock was not subject to forfeiture because Reg. § 1.83-3(c)(2) provides that a requirement that stock be forfeited "if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture." The IRS moved for summary judgment that the stock was not subject to a risk of forfeiture, but the Tax Court (Judge Lauber) denied the IRS's motion.

The Court held that the restricted stock agreement and employment agreement together constituted “an earnout restriction that *may* give rise to a ‘substantial risk of forfeiture.’” (Emphasis added). Although the contractual provision addressed termination “for cause,” “termination upon ‘[f]ailure or refusal by Employee ... to cure by faithfully and diligently performing the usual and customary duties of his employment’ falls outside the scope of discharge ‘for cause or for committing a crime’ within the meaning of [Reg. § 1.83-3(c)(2)].” Judge Lauber reasoned that “an employee’s inability or disinclination to work for the agreed-upon term of his employment contract is not a ‘remote’ event that is unlikely to occur.” Moreover, a finding that Reg. § 1.83-3(c)(2) “precludes an earnout restriction from creating a ‘substantial risk of forfeiture’ would make that subparagraph of the regulation inconsistent with the statute.”

- The IRS’s other arguments, including that the taxpayer’s stock was “substantially vested” because as the sole directors of the corporation they could “remove at will any ownership restrictions to which their stock was subject, so that the forfeiture conditions were unlikely to be enforced,” presented issues for trial.

#### **D. Individual Retirement Accounts**

**1. Their IRAs got flecked by a prohibited transaction, which piqued the interest of the IRS.** *Peek v. Commissioner*, 140 T.C. No. 12 (5/9/13). Two unrelated taxpayers, Peek and Fleck, established self-directed IRAs to purchase a business. The IRAs were funded with rollovers from other IRAs and 401(k) accounts. The purchase was accomplished by (1) Peek and Fleck forming a new corporation the stock of which was issued to their IRAs for the cash that had been rolled into the IRAs, and (2) the corporation purchasing the business assets from the seller for cash received from the IRAs, proceeds from a bank loan, and the corporation’s promissory note, which was guaranteed by Peek and Fleck. The IRAs subsequently sold the stock of the corporation, and the IRS asserted deficiencies against Peek and Fleck on the grounds that the IRAs had failed to qualify under § 408 because the loan guarantees were prohibited transactions under § 4975. Section 408(e)(2)(A) provides that an account ceases to qualify as an IRA if “the individual for whose benefit any individual retirement account is established ... engages in any transaction prohibited by section 4975.” Section 4975(c)(1)(B) prohibits “any direct or indirect ... lending of money or other extension of credit between a [retirement] plan and a disqualified person.” The taxpayers argued that the prohibition applies only to an extension of credit that, whether direct (like a loan) or indirect (like a loan guaranty), is “between a plan and a disqualified person,” and that the loan guaranties at issue were between disqualified

persons (Mr. Fleck and Mr. Peek) and an entity other than the plans, i.e., the corporation that was owned by the IRAs, rather than the IRAs themselves. The Tax Court (Judge Gustafson) rejected the taxpayer's argument and upheld the deficiency.

[The taxpayers'] reading of the statute, however, would rob it of its intended breadth. Section 4975(c)(1)(B) prohibits "any direct or indirect \*\*\* extension of credit between a plan and a disqualified person". ... The Supreme Court has observed that when Congress used the phrase "any direct or indirect" in section 4975(c)(1), it thereby employed "broad language" and showed an obvious intention to "prohibit[] something more" than would be reached without it. *Commissioner v. Keystone Consol. Indus., Inc.*, 508 U.S. 152, 159-160 (1993). As the Commissioner points out, if the statute prohibited only a loan or loan guaranty between a disqualified person and the IRA itself, then the prohibition could be easily and abusively avoided simply by having the IRA create a shell subsidiary to whom the disqualified person could then make a loan. That, however, is an obvious evasion that Congress intended to prevent by using the word "indirect". The language of section 4975(c)(1)(B), when given its obvious and intended meaning, prohibited Mr. Fleck and Mr. Peek from making loans or loan guaranties either directly to their IRAs or indirectly to their IRAs by way of the entity owned by the IRAs.

- Accuracy related penalties were upheld.

**2. "[T]his is precisely the kind of self-dealing that section 4975 was enacted to prevent."** *Ellis v. Commissioner*, T.C. Memo. 2013-245 (10/29/13). The taxpayer rolled-over from his 401(k) account to a self-directed IRA approximately \$320,000. The \$320,000 was promptly invested in a newly-formed LLC (which made a check-the-box election to be taxed as a corporation) in which it obtained a 98 percent interest, with an unrelated party holding the remaining 2 percent interest. During the remainder of the year, the LLC, which was engaged in the used car business, paid the taxpayer approximately \$10,000 as compensation for managing the LLC. The used-car LLC also paid rent to another LLC owned by the taxpayer and his family that owned the property on which the used car business was conducted. The Tax Court (Judge Paris) upheld that IRS's determination that the taxpayer had engaged in a transaction with his IRA that was prohibited under § 4975. Section 4975(c) prohibited transactions include any direct or indirect: (1) sale or exchange, or leasing, of any property between a plan and a disqualified person; (2) lending of money or

other extension of credit between a plan and a disqualified person; (3) furnishing of goods, services, or facilities between a plan and a disqualified person; (4) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan; (5) act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interests or for his own account; or (6) receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan. Because the taxpayer exercised control over the IRA, he was a disqualified person as defined in § 4975(e). Although the initial investment in the LLC was not a prohibited transaction because it had no outstanding owners or ownership interests before the initial capital contribution and therefore could not be a disqualified person at the time of the investment, the taxpayer did engage in a prohibited transaction when he caused the LLC to pay him compensation. As a result, pursuant to § 408(e)(2)(A), the IRA ceased to be qualified as of the first day of the taxable year and pursuant to § 408(e)(2)(B) the entire amount was treated as distributed and includable in gross income. Because the taxpayer was not 59½ as of the first day of the year, the 10 percent § 72(t) penalty applied. And for good measure, a 20 percent § 6662(a) negligence penalty was sustained as well.

**3. Honey, I shrunk the IRAs! Divorce is bad enough without learning that your IRAs have been depleted through forged withdrawals and that the IRS is asserting a deficiency. Roberts v. Commissioner, 141 T.C. No. 19 (12/30/13).** The taxpayer and his wife permanently separated in January 2009 and were later divorced. The taxpayer maintained two IRAs. During 2008, a total of approximately \$37,000 was distributed from the IRAs. The distributions were made pursuant to forged withdrawal requests and the checks representing those distributions were endorsed with forged signatures and deposited in a checking account that the taxpayer owned jointly with his wife, but which was used exclusively by his wife. The taxpayer did not know about or authorize the IRA withdrawals at the time they occurred and first learned of them in 2009, when he received Forms 1099-R. The Tax Court (Judge Marvel), considering an issue of first impression, held that the distributions were not includible in the taxpayer's gross income under § 408(d)(1), which provides that the "payee or distributee" must include in gross income in the manner provided under § 72 any amount paid or distributed out of an individual retirement plan. The court rejected the government's argument that the taxpayer was a payee or distributee under *Bunney v. Commissioner*, 114 T.C. 259 (2000), in which the court held that the payee or distributee of an IRA distribution generally is "the participant or beneficiary who, under

the plan, is entitled to receive the distribution.” The court reasoned that the taxpayer was not a payee or distributee within the meaning of § 408(d)(1) because “he did not request, receive, or benefit from the IRA distributions.” (The court found that the taxpayer’s wife received and spent the funds.) The court also rejected the government’s argument that the taxpayer was a payee or distributee because the taxpayer ratified or acquiesced in the IRA withdrawals by: (1) failing to report the forged signatures to the financial institutions in a timely manner or make a claim based on those signatures, and (2) benefitting from the withdrawals in the divorce proceedings, in which the division of assets took into account that the funds went to the taxpayer’s wife. Any ratification or acquiescence, the court reasoned, did not take place until 2009 at the earliest, and therefore could not affect whether the taxpayer was a payee or distributee in 2008, the year for which the deficiency was determined. Because the taxpayer was not subject to tax on the distributions, he also was not subject to the 10% penalty tax imposed on early withdrawals by § 72(t). The court imposed the § 6662(a) accuracy-related penalty based on the taxpayer’s failure to report interest income unrelated to the IRAs, his underreporting of wage income, and his filing of a return for 2008 as a single taxpayer despite the fact that he was married. The 2008 return, which the taxpayer never saw, was prepared and filed by his wife.

## V. PERSONAL INCOME AND DEDUCTIONS

### A. Rates

1. **DOMA could be on its way to the Supreme Court. On the other hand, might this case lead to DOMA becoming the Twenty-Eighth Amendment?** Massachusetts v. United States Dept. of Health and Human Services, 682 F.3d 1 (1st Cir. 5/31/12), *aff’g Gill v. Office of Personnel Management*, 699 F. Supp. 2d 374 (D. Mass. 7/8/10). In an opinion by Judge Boudin, the First Circuit held that § 3 of the Defense of Marriage Act, 1 U.S.C. § 7, which limits the meaning of the word “marriage” to “a legal union between one man and one woman as husband and wife,” and provides that “the word ‘spouse’ refers only to a person of the opposite sex who is a husband or wife” for purposes of all federal laws is an unconstitutional denial of equal protection in violation the equal protection principles embodied in the Due Process Clause of the Fifth Amendment. Joint return filing status under the Code was one of the issues addressed in the case, as well as government benefits available to married individuals, e.g., employee health benefits, social security benefits. The court further ordered:

Anticipating that certiorari will be sought and that Supreme Court review of DOMA is highly likely, the mandate is stayed, maintaining the district court's stay of its injunctive judgment, pending further order of this court.

**a. The Second Circuit agrees in a split decision.** *Windsor v. United States*, 699 F.3d 169 (2d Cir. 10/18/12) (2-1), *cert. granted*, 133 S. Ct. 786 (12/7/12). In an appeal from a grant of summary judgment in a tax refund suit by the District Court for the Southern District of New York, the Second Circuit (Chief Judge Dennis Jacobs) affirmed the grant of summary judgment to the surviving spouse of a same-sex couple that was married in Canada in 2007 and resided in New York at the time of her spouse's death in 2009 who was denied the benefit of the § 2056 marital deduction for federal estate tax on the ground that the Defense of Marriage Act violated the Equal Protection Clause for want of a rational basis.

- The court concluded that review of § 7 required heightened scrutiny because (A) homosexuals as a group have historically endured persecution and discrimination; (B) homosexuality has no relation to aptitude or ability to contribute to society; (C) homosexuals are a discernible group with non-obvious distinguishing characteristics, especially in the subset of those who enter same-sex marriages; and (D) the class remains a politically weakened minority. The circuit court further concluded that the class was quasi-suspect (rather than suspect) based on the weight of the factors and on analogy to the classifications recognized as suspect and quasi-suspect. The circuit court held that the rationale premised on uniformity was not an exceedingly persuasive justification for DOMA, and that DOMA was not substantially related to the important government interest of protecting the fisc.

- Judge Straub dissented on the following basic ground:

The majority holds DOMA unconstitutional, a federal law which formalizes the understanding of marriage in the federal context extant in the Congress, the Presidency, and the Judiciary at the time of DOMA's enactment and, I daresay, throughout our nation's history. If this understanding is to be changed, I believe it is for the American people to do so. . . .

At bottom, the issue here is marriage at the federal level for federal purposes, and not other legitimate interests. The Congress and the President formalized in DOMA, for federal purposes, the basic human condition of joining a man and a woman in a long-term relationship and the only one which is inherently capable of producing another generation

of humanity. Whether that understanding is to continue is for the American people to decide via their choices in electing the Congress and the President. It is not for the Judiciary to search for new standards by which to negate a rational expression of the nation via the Congress.

**b. Same-sex spouses in valid marriages now get to share in marriage penalties and marriage bonuses when filing income tax returns because “the principal purpose and the necessary effect of [DOMA] are to demean those persons who are in a lawful same-sex marriage.”** *United States v. Windsor*, 133 S. Ct. 2675 (6/26/13). The Defense of Marriage Act (DOMA), Pub. L. No. 104–199, 110 Stat. 2419 (1996), defines “marriage” in any act of Congress, which (of course) includes the Code, as a legal union “between one man and one woman” as husband and wife. DOMA also defines the word “spouse” to mean only a person of the “opposite sex” who is a husband or wife. This case involved whether the § 2056 estate tax marital deduction was allowable with respect to a bequest to a same-sex spouse whose marriage to the decedent was recognized under local law. The Supreme Court held that § 3 of DOMA — the provision that limits the meaning of the word “marriage” to “a legal union between one man and one woman as husband and wife,” and provides that “the word ‘spouse’ refers only to a person of the opposite sex who is a husband or wife” — is an unconstitutional denial of equal protection in violation of the Due Process Clause of the Fifth Amendment. As a result, the § 2056 estate tax marital deduction was allowable. It follows that for income tax purposes same-sex married couples whose marriages are recognized by local law are eligible to file a joint return and if they do not file a joint return must file as married filing separately.

- Whether this result applies to a same sex married couple that has moved from a state that recognizes same sex marriage to a state that does not recognize same sex marriage is not entirely clear. The *Windsor* Court limited its holding to the definition of marriage in § 3 of DOMA and did not address § 2, which allows states to refuse to recognize same-sex marriages from other states. Section 2 was not challenged in *Windsor*. Some clue to future guidance might be found in Rev. Rul. 58-66, Rev. Rul. 58-66, 1958-1 C.B. 60, in which the IRS ruled that taxpayers who entered into a common-law marriage in a state that recognized common law marriage would be treated as married for tax purposes even if they later moved to a state in which a ceremony is required to initiate the marital relationship.

- Other questions for a future time include whether same sex spouses can toggle into and out of marriages when they change residence and whether domestic partnerships in some states that are not called marriage will be treated as marriage under federal law.

c. **Shakespeare called it “The Merry Wives of Windsor.” And the IRS interprets *Windsor* broadly – a same-sex marriage celebrated under the laws of one state is a federal tax “marriage” in every state.** Rev. Rul. 2013-17, 2013-38 I.R.B. 201 (8/29/13). In the wake of *United States v. Windsor*, 133 S. Ct. 2675 (2013), the IRS ruled that the marital status of individuals of the same-sex who are lawfully married under the laws of a state that recognizes such marriages will be recognized for all purposes. The ruling held that for Federal tax purposes (1) the terms “spouse,” “husband and wife,” “husband,” and “wife” include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term “marriage” includes such a marriage between individuals of the same sex; and (2) a marriage of same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two individuals of the same sex will be recognized even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages. However the terms “spouse,” “husband and wife,” “husband,” and “wife” do not include individuals (whether of the opposite sex or the same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under the laws of that state, and the term “marriage” does not include such formal relationships.

- Taxpayers may file amended returns, adjusted returns, or claims for credit or refund for any overpayment of tax resulting from this ruling if the statute of limitations is open. The ruling applies retroactively with respect to any employee benefit plan or arrangement or any benefit provided thereunder for purposes of filing original returns, amended returns, adjusted returns, or claims for credit or refund of an overpayment of tax concerning employment tax and income tax with respect to employer-provided health coverage benefits or fringe benefits that were provided by the employer and are excludable from income under §§ 106, 117(d), 119, 129, or 132 based on an individual’s marital status.

d. **Correcting overpayments of FICA taxes and income tax withholding resulting from the *Windsor* decision and Rev. Rul. 2013-17 just got a little easier.** Notice 2013-61, 2013-44 I.R.B. 432 (9/23/13). In the wake of *United States v. Windsor*, 133 S. Ct. 2675 (2013), the IRS issued Rev. Rul. 2013-17, 2013-38 I.R.B. 201 (8/29/13), discussed in section V.A. of this outline, in which it ruled that same-sex couples who are lawfully married under the laws of a state or foreign jurisdiction will be recognized as married for federal tax purposes. Rev. Rul. 2013-17 permits taxpayers to file amended returns, adjusted returns, or claims for credit or refund for any overpayment of tax resulting from the ruling if the statute of limitations is open. The notice provides guidance for



employers and employees to make claims for refunds or adjustments of overpayments of FICA taxes and federal income tax withholding with respect to: (1) health coverage benefits or fringe benefits provided by an employer to a same-sex spouse that are excludable from income under §§ 106, 117(d), 119, 129, or 132 based on an individual's marital status, and (2) remuneration for services performed in the employ of an individual's spouse that are excepted from FICA tax under § 3121(b)(3)(B). To correct overpayments of FICA taxes, employers can use the regular procedures for doing so or special, simplified administrative procedures provided in the notice for correcting overpayments made in 2013 or in prior years. If an employer corrects overpayments of FICA taxes for prior years, the usual requirements apply, including the filing of Form W-2c, Corrected Wage and Tax Statement. Employers cannot correct overpayments of withheld income tax after the end of a calendar year unless the overpayment is attributable to administrative error. Accordingly, an employer can use the special administrative procedures to correct overpayments of income tax withholding only for 2013 and only by repaying or reimbursing the employee during 2013 for the over-collected income tax.

**e. Same sex marriage fringe benefits.** Notice 2014-1 2014-2 I.R.B. 270 (12/17/13). This notice provides guidance in Q&A format regarding the application of § 125 cafeteria plans, including health and dependent care flexible spending arrangements (FSAs), and § 223, relating to health savings accounts (HSAs), to same-sex spouses following *United States v. Windsor*, 570 U.S. \_\_\_, 133 S. Ct. 2675 (2013), and Rev. Rul. 2013-17, 2013-38 I.R.B. 201.

**2. And the IRS starts administering national health care.** T.D. 9632, Shared Responsibility Payment for Not Maintaining Minimum Essential Coverage, 78 F.R. 53646 (8/30/13). The IRS and Treasury have promulgated Reg. §§ 1.5000A-0 through 1.5000A-5 providing comprehensive guidance regarding the requirement to maintain minimum essential coverage under § 5000A, which was enacted by the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010, as amended by the TRICARE Affirmation Act and Public Law 111-173. The regulations provide guidance to individual taxpayers on their liability under § 5000A for the shared responsibility payment for not maintaining minimum essential coverage. The T.D. largely finalizes the rules in REG-148500-12, 78 F.R. 7314 (2/1/13). The regulations are effective on 8/30/13.

**3. Net investment income tax of 3.8 percent.** Section 1411 of the Code, added by the Health Care and Education Reconciliation Act of 2010, imposes a 3.8 percent tax on the net investment income of

individuals, estates, and trusts in taxable years beginning after 12/31/12. For individuals (except nonresident aliens), the tax applies only to the lesser of (1) net investment income or (2) the excess of modified adjusted gross income over a threshold amount. I.R.C. § 1411(a)(1). The threshold amount is \$250,000 for spouses filing a joint return or a surviving spouse, \$125,000 for married individuals filing separate returns, and \$200,000 for single taxpayers (including heads of household). I.R.C. § 1411(b). These threshold amounts for individuals are not adjusted for inflation. Modified adjusted gross income is adjusted gross income increased by the amount of foreign earned income excluded under § 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income). I.R.C. § 1411(d). For estates and trusts, the tax is levied on the lesser of (1) undistributed net investment income, or (2) the excess of adjusted gross income (as defined in § 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins for the tax year (\$11,950 for 2013). I.R.C. § 1411(a)(2). The tax does not apply to a trust that is tax-exempt under § 501, is a charitable remainder trust tax-exempt under § 664, or all of the unexpired interests of which are devoted to charitable purposes. Net investment income is investment income reduced by the deductions properly allocable to that income. Investment income is the sum of (1) gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the tax does not apply), (2) other gross income derived from any trade or business to which the tax applies, and (3) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply. I.R.C. § 1411(c)(1). The § 1411 tax applies to trade or business income from (1) a passive activity, and (2) trading financial instruments or commodities (as defined in § 475(e)(2)). I.R.C. § 1411(c)(2). It does not apply to any other trade or business income. However, income on the investment of working capital is not treated as derived from a trade or business and is subject to tax under § 1411. I.R.C. § 1411(c)(3). Gain or loss from the disposition of a partnership interest or stock in an S corporation is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. I.R.C. § 1411(c)(4). Thus the transferor partner or shareholder takes into account only the net gain or loss attributable to the entity's property that is not attributable to an active trade or business. Investment income does not include any distributions from a qualified retirement plan or any income subject to self-employment tax. I.R.C. § 1411(c)(5) and (6). Unlike self-employment taxes, no part of the § 1411 tax is deductible in computing taxable income under Chapter 1. The tax on net

investment income is subject to the estimated tax provisions. I.R.C. § 6654(a).

**a. Final regulations provide extensive guidance on the § 1411 tax on net investment income.** T.D. 9644, Net Investment Income Tax, 78 F.R. 72394 (12/2/13). The Treasury Department and IRS have issued final regulations under § 1411 regarding the 3.8 percent tax on net investment income. The final regulations generally follow, but make some important changes to, the regulations that were proposed in REG-130507-11, Net Investment Income Tax, 77 F.R. 72612 (12/5/12). The final regulations generally are effective for tax years beginning after 12/31/13. However, § 1411 is effective for tax years beginning after 12/31/12. For tax years beginning before the effective date of the final regulations, taxpayers may rely on either the proposed regulations or the final regulations for purposes of complying with § 1411. However, to the extent taxpayers take a position inconsistent with the final regulations that affects the treatment of an item in a taxable year beginning after 12/31/13, they must make reasonable adjustments to ensure that their liability for the § 1411 tax in the later year is not inappropriately distorted. Such adjustments might be required, for example, to ensure that an item of income or deduction is taken into account only once in determining net investment income.

- *General provisions.* Section 1411 is the only provision in chapter 2A of subtitle A of the Code. Chapter 2A does not contain any other operational or definitional provisions. Except as otherwise provided, all Code provisions that apply for purposes of chapter 1 in determining taxable income as defined in § 63(a) also apply in determining the tax imposed by § 1411. Reg. § 1.1411-1(a).

- *Application to individuals.* Section 1411 applies to individuals but does not apply to nonresident aliens. The regulations provide that dual resident taxpayers (as defined in Reg. § 301.7701(b)-7(a)(1)) who determine that they are residents of a foreign country and therefore entitled to treaty benefits are nonresident aliens for purposes of the § 1411 tax. Reg. § 1.1411-2(a)(2)(i). Dual status individuals who are nonresident aliens for a portion of the taxable year are not subject to the § 1411 tax for the portion of the year during which they are nonresident aliens. Only income received during the portion of the year that they are residents of the U.S. is subject to the tax. Reg. § 1.1411-2(a)(2)(ii). Special rules apply to a U.S. citizen or resident who is married to a nonresident alien. Reg. § 1.1411-2(a)(2)(iii).

- *Application to estates and trusts.* As a general rule, the § 1411 tax applies to all estates and trusts that are subject to the provisions of part I of subchapter J of chapter 1 of subtitle A of the Code. Reg. § 1.1411-3(a)(1)(i). Accordingly, the § 1411 tax does not apply to trusts that are not classified as trusts under the check-the-box regulations (such as business

trusts). In response to comments on the proposed regulations, the final regulations expand the list of estates and trusts that are specifically exempted from the § 1411 tax. Trusts or estates, all of the unexpired interests of which are devoted to charitable purposes, are not subject to the § 1411 tax. Reg. § 1.1411-3(b)(1)(i). The tax also does not apply to trusts that are exempt from taxes imposed by subtitle A of the Code. Reg. § 1.1411-3(b)(1)(ii)-(iv). This is true even if the trust is subject to tax on its unrelated business taxable income. The regulations clarify that grantor trusts are not subject to the tax. The grantor or other person who takes into account the grantor trust's income and deductions is treated as receiving and paying those items directly for purposes of calculating that person's liability for the § 1411 tax. Reg. § 1.1411-3(b)(1)(v). The § 1411 tax does not apply to cemetery perpetual care funds subject to § 642(i), Alaska Native Settlement Trusts that have made an election under § 646, or foreign estates or trusts, but special rules apply to distributions from foreign estates or trusts to U.S. beneficiaries. Reg. § 1.1411-3(b)(1)(vi)-(ix). Special computational rules apply to electing small business trusts. Reg. § 1.1411-3(c). Although charitable remainder trusts are not subject to the tax, annuity and unitrust distributions may be net investment income to the non-charitable beneficiary who receives them. Reg. § 1.1411-3(d).

- The regulations provide detailed rules regarding the calculation of an estate or trust's undistributed net investment income. Reg. § 1.1411-3(e). Generally, the rules for calculating undistributed net investment income are guided by the subchapter J concept of distributable net income, which apportions income between the trust and its beneficiaries.

- The Treasury Department and the IRS reserved two issues related to estates and trusts for further study and have requested comments on both issues. The first is how the § 1411 tax should apply to distributions by foreign trusts of net investment income that was accumulated for the benefit of U.S. beneficiaries. The second issue is the appropriate method of determining whether an estate or trust materially participates in an activity. This issue may be the subject of a separate guidance project under § 469.

- *Net investment income.* Net investment income is investment income reduced by the deductions properly allocable to that income. The regulations provide an exclusive list of deductions that may be properly allocable deductions and provide authority for the identification of additional deductions in published guidance. Reg. § 1.1411-4(f). In response to comments on the proposed regulations, the final regulations permit taxpayers to treat a portion of a net operating loss deduction as a properly allocable deduction. Reg. § 1.1411-4(f)(2)(iv), (h). Net investment income cannot be less than zero. Deductions that exceed investment income can be carried forward only to the extent provided in chapter 1 of the Code. Reg. § 1.1411-4(f)(1)(ii). Deductions carried over to a tax year because they were suspended or

disallowed by other provisions, such as the investment interest, basis, at-risk, or passive activity loss limitations, and allowed for that year in determining adjusted gross income are also allowed in determining net investment income. This is true regardless of whether the taxable year from which the deductions are carried precedes the effective date of § 1411. The Treasury Department and the IRS have issued proposed regulations that address issues related to the treatment of capital loss carryforwards. REG-130843-13, Net Investment Income Tax, 78 F.R. 72451 (12/2/13).

- If items of net investment income (including the properly allocable deductions) pass through to an individual, estate, or trust from a partnership or S corporation, the allocation of the items must be separately stated under § 702 or § 1366. Although the proposed regulations provided detailed guidance on determining the net investment income arising from the disposition of interests in partnerships or S corporations, the Treasury Department and the IRS did not finalize this guidance and instead issued a new proposed regulation that addresses the issue. REG-130843-13, Net Investment Income Tax, 78 F.R. 72451 (12/2/13).

- Because trade or business income from a passive activity is net investment income, the status of activities as passive and the grouping of activities for purposes of the passive activity loss rules are significant. The regulations provide individuals, estates, and trusts with a fresh start to regroup activities in the first tax year that begins after 12/31/13 in which § 1411 would apply to the taxpayer. Reg. § 1.469-11(b)(3)(iv). Regrouping is permitted on an original return or on an amended return if changes on the amended return cause the taxpayer to become subject to the § 1411 tax. Conversely, if a taxpayer regroups activities and it is subsequently determined that the taxpayer is not subject to the § 1411 tax for the year during which regrouping occurred, the regrouping is void and, subject to limited exceptions, has no effect for that year and all future years. Despite comments on the proposed regulations that requested the change, the Treasury Department and the IRS declined to allow partnerships and S corporations to regroup activities.

- The regulations provide a safe harbor for real estate professionals as defined in § 469(c)(7)(B) who participate in rental real estate activities. If a real estate professional participates in rental real estate activities for more than 500 hours during the year (or has participated in such activities for more than 500 hours in any five of the last ten taxable years), then gross rental income from the rental activity and gain or loss from the disposition of property used in the rental activity is deemed to be derived in the ordinary course of a trade or business. Reg. § 1.1411-4(g)(7). A real estate professional who meets the 500 hour threshold would be treated as materially participating in the rental real estate activity under Reg. § 1.469-5T(a)(1), (5). Accordingly, the effect of the safe harbor is that the real estate professional's gross rental income and gain or loss from the disposition of property is not included in net investment income and therefore is not subject to the § 1411 tax. A real estate

professional who fails to satisfy the safe harbor is not precluded from establishing that gross rental income and gain or loss from disposition of property is not included in net investment income.

- *International issues.* Under § 951(a), United States shareholders who own stock in a controlled foreign corporation on the last day of the corporation's taxable year must include in gross income their pro rata share of the CFC's subpart F income. Similarly, United States persons who hold stock of a passive foreign investment company and elect to treat the PFIC as a qualified electing fund must include in gross income currently under § 1293 a pro rata share of the PFIC's earnings and profits. When the CFC or PFIC later distributes its earnings, the shareholders can exclude the distributions from gross income to the extent they previously were taxed on them. These income inclusions and exclusions result in positive and negative stock basis adjustments. Because these income inclusions are not treated as dividends unless expressly provided for in the Code, the regulations do not treat the income inclusions as net investment income for purposes of § 1411. Instead, CFC shareholders and PFIC shareholders who have made a qualified electing fund election must treat actual distributions of previously taxed earnings as net investment income. Reg. § 1.1411-10(c)(2)(i). One effect of this rule is that a CFC or PFIC shareholder can have one stock basis for purposes of chapter 1 of the Code and a different stock basis for purposes of the § 1411 tax. To avoid these complexities, the regulations allow a taxpayer to elect to treat the income inclusions required by § 951(a) and § 1293 as net investment income. Reg. § 1.1411-10(g). In response to comments on the proposed regulations, the final regulations allow taxpayers to make the election on an entity-by-entity basis. The proposed regulations had required the election to apply to all CFCs and PFICs held by the taxpayer, even if acquired subsequent to the election. Once made, the election is irrevocable.

- The § 1411 tax cannot be reduced with foreign tax credits because foreign tax credits reduce taxes imposed by chapter 1 of the Code, and § 1411 is located in chapter 2A. Reg. § 1.1411-1(e).

- *See also*, FAQs on the net investment income tax, originally released by the IRS on 11/29/12, 2012 TNT 232-47, and subsequently updated on the IRS web site.

**b. Proposed regulations address specific issues related to the tax on net investment income.** On 11/26/13, the Treasury Department issued proposed regulations regarding the § 1411 tax on net investment income. REG-130843-13, Net Investment Income Tax, 78 F.R. 72451 (12/2/13). The proposed regulations address discrete issues left open in the final regulations issued on the same day. T.D. 9644, Net Investment Income Tax, 78 F.R. 72394 (12/2/13). The proposed regulations generally are proposed to be effective for tax years beginning after 12/31/13.

However, § 1411 is effective for tax years beginning after 12/31/12. Taxpayers may rely on the proposed regulations for purposes of complying with § 1411 until they are issued as final regulations. Some of the significant topics addressed by the proposed regulations are:

- *Gain or loss from dispositions of interests in partnerships and S corporations.* Gain or loss from the disposition of a partnership interest or stock in an S corporation is treated as net investment income only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. I.R.C. 1411(c)(4). The proposed regulations provide detailed rules for determining the transferor partner or shareholder's net investment income from the disposition. Prop. Reg. § 1.1411-7. Generally, if the transferor realizes a gain from the disposition, the gain subject to the § 1411 tax is the lesser of the transferor's recognized gain or the transferor's allocable share of net gain from a deemed sale by the partnership or S corporation of property that would give rise to gain or loss includable in determining the transferor's net investment income. The proposed regulations also provide an optional, simplified reporting method that transferors who meet certain eligibility requirements can use instead of the normal calculation. Generally, the optional, simplified method relies on historic distributive share amounts that the transferor has received from the partnership or S corporation to determine a percentage of the firm's assets that are passive with respect to the transferor and therefore would give rise to net investment income.

- *Partnership payments to partners.* The proposed regulations provide guidance on the treatment of certain payments from partnerships to partners. The treatment of guaranteed payments under § 707(c) depends on whether the payments are for services or the use of capital. Guaranteed payments for the use of capital are included in net investment income; guaranteed payments for services are not included in net investment income regardless of whether the payments are subject to self-employment tax. Prop. Reg. § 1.1411-4(g)(10). The treatment of payments to a retiring partner or to a deceased partner's successor in interest in liquidation of the partner's entire interest in the partnership is governed by how such payments are categorized under § 736. Thus, payments that are treated under § 736(b) as distributions that give rise to gain or loss from the sale or exchange of a partnership interest are analyzed for purposes of § 1411 as gain or loss from the disposition of a partnership interest. Payments that are treated under § 736(a)(1) as a distributive share of income to the partner are analyzed for purposes of § 1411 in the same manner as a partner's distributive share of income, and payments that are treated under § 736(a)(2) as guaranteed payments are analyzed for purposes of § 1411 as guaranteed payments. Prop. Reg. § 1.1411-4(g)(11).

- *Capital loss carryforwards.* When a taxpayer determines net investment income for a taxable year, some capital losses are taken into account in determining net investment income and others

are not. Capital losses that are not taken into account in determining a taxpayer's net investment income include: (1) capital losses arising from the sale or disposition of property used in a trade or business in which the taxpayer materially participates, and (2) capital losses from sales or dispositions of partnership interests or S corporation stock to the extent that the rules as to such sales or dispositions do not treat the losses as part of net investment income. Accordingly, when a taxpayer carries forward capital losses to a later year, the taxpayer must identify what portion of the capital loss carryforward should not be taken into account in determining net investment income in the later year. The proposed regulations impose this requirement and provide examples to illustrate it. Prop. Reg. § 1.1411-4(d)(4)(iii).

- *Charitable Remainder Trusts.* The proposed regulations provide charitable remainder trusts with an optional, simplified method of tracking a beneficiary's net investment income. Prop. Reg. § 1.1411-4(d)(3). They also provide guidance for charitable remainder trusts that have income from a CFC or from a PFIC that is treated as a qualified electing fund. Prop. Reg. § 1.1411-4(d)(2)(ii).

## **B. Miscellaneous Income**

1. **No COD from collateralized welfare benefit fund borrowing.** *Pinn v. Commissioner*, T.C. Memo. 2013-45 (2/11/13). The taxpayer brothers were sole-shareholders and employees of their home construction company. The taxpayers caused the corporation to appoint Local 707 of the National Production Workers Union (of which four office employees became members) to facilitate the creation of an employee death benefit arrangement in which the taxpayers as owner/employees were allowed to participate. The union set up the American Fund as a voluntary employees beneficiary association (VEBA) which provided a trust for guaranteed death benefits. The trust funded several million dollars of death benefits by purchasing life insurance policies. The cost was paid with deductible expenses by the taxpayers' corporation. Each of the taxpayers then borrowed \$500,000 as a hardship loan, justified by them because of unexpected taxes. The loans were repayable with annual \$50,000 quarterly payments plus interest, or as a reduction in death benefits. No payments were made. At the insistence of its independent accountant, the trust reported the loans in 2002 on a schedule to its form 5500 as in default or uncollectable. The Tax Court (Judge Holmes) rejected the IRS assertion that the taxpayers recognized COD income in 2002. The court concluded that the loans remained collectable from the taxpayers' death benefits with the insurance policies provided as collateral. The court rejected the IRS argument that the insurance policies were insufficient because they were owned by the trust, not the taxpayers. The court observed that, "It follows that if a reduction in



the Pinns' death benefits or capture of insurance proceeds owed (in some way) to them is an adequate alternative form of repayment, there should be no COD income just because the Pinns failed to make their quarterly payments—any more than we would find COD income only because a homeowner stopped making payments on a \$50,000 mortgage secured by a house worth a million.” The court held further that, when a debt is collectible and fully secured (where the fair market value of the collateral exceeds the loan balance), default alone will not result in COD income. The court also observed that the trust could collect the full value of the loans with a reduction in the taxpayers' death benefits.

**2. The IRS says that a cut scrape or bruise is all you need for 100 percent exclusion under § 104(a)(2).** Private Letter Ruling 201311006 (released 3/15/13). This ruling dealt with the scope of the exclusion for damages for physical personal injury under § 104 that were paid out of a qualified settlement fund. It involved damages paid to victims of a fire and close relatives and estates of deceased victims. Each of the victims received damages because he or she either suffered a cut, scrape, bruise, or other physical injury in the incident, or inhaled thick smoke and, as a result, suffered smoke inhalation during the fire. With no further explanation than “each of the Victims suffered a personal physical injury or physical sickness as a result of the Incident,” the IRS ruled that 100 percent of the damages were excludable. The ruling made no effort to separate damages for the physical injuries and emotional injuries suffered by the survivors, and it does not mention punitive damages.

**a. Settling an unfiled workers' comp claim is very taxing.** Simpson v. Commissioner, 141 T.C. No. 10 (10/28/13). The taxpayer, who had been discharged by her employer, settled a suit against the employer and received \$262,500 – \$12,500 for lost wages and employment benefits, \$98,000 for “emotional distress, physical and mental disability,” which was based on the amount she could have received as workers' compensation benefits (as well as an additional 25% penalty that could be imposed on the employer for failing to advise her of potential workers' compensation eligibility and benefits) if she had filed such a claim, and \$152,000 of attorney's fees and costs. The taxpayer never filed a workers' compensation claim, and the settlement agreement was not submitted to the California Workers' Compensation Appeals Board (WCAB) for the approval required under the California Labor Code. The Tax Court (Judge Laro) rejected the taxpayer's argument that \$250,000 of the settlement should be excluded under § 104(a)(1) as worker's compensation, reasoning that “[t]he intent of the parties to a settlement of a workers' compensation claim does not necessarily mean that the payment is excludable under section 104(a)(1).” Because the settlement agreement failed to meet the express

requirement of California's workers' compensation laws that approval from the WCAB be obtained, payments received under the agreement could not have been received under or pursuant to the state's workers' compensation act. Rather, the payments were received under a private contract. Turning to the taxpayer's claim that § 104(a)(2) applied to provide an exclusion, the court concluded that the settlement was intended to compensate the taxpayer for both "physical personal injuries and sickness" and emotional distress. It took a guess, using its best judgment, at how much was attributable to personal physical injuries and sickness; because the record "[was] not susceptible of any precisely accurate determination" of the extent to which the settlement was attributable to personal physical injuries and sickness, it found that 10 percent of the \$98,000 was on account of those physical injuries and physical sickness (other than emotional distress). Finally, the court allowed the taxpayer to deduct the full \$152,000 of attorney's fees and court costs as an above the line deduction under § 62(a)(20) because the suit that was settled originally had been brought as a suit for employment discrimination on the basis of gender, age, and harassment in violation of California law.

- **Compare: It looks like damages for physical sickness caused by emotional distress can be excluded if they go beyond mere symptomatic manifestations of the underlying emotional distress.** *Domeny v. Commissioner*, T.C. Memo. 2010-9 (1/13/10). The taxpayer received approximately \$33,000 in settlement of claims for wrongful termination of employment and violations of various civil rights statutes. The taxpayer's former employer paid approximately \$8,000 to her that was reflected on a Form W-2 as employee compensation, \$8,000 to the taxpayer's lawyer, for which no information return was filed, and \$17,000 to the taxpayer that was reflected on a Form 1099-MISC as "nonemployee compensation." The Tax Court (Judge Gerber) held that the \$8,000 paid directly to the taxpayer was includable wage compensation, and the remaining amount was excludable under § 104(a)(2) as damages for physical injuries attributable to exacerbation of multiple sclerosis caused by a hostile work environment. The payor-former employer's intent in settlement of the claim was evidenced by the issuance of separate checks and different information returns; these facts indicated that the former employer intended amount in excess of wages due to be in settlement of tort claims for physical injuries attributable to the exacerbation of multiple sclerosis.

- The legislative history indicates that physical manifestations of emotional distress, such as insomnia, headaches, and stomach disorders, are not to be treated as physical injuries. H.R. Rep. No. 737, 104th Cong., 2d Sess. 143, n.56 (1996).

- **Compare: Having a heart attack can improve your tax health.** *Parkinson v. Commissioner*, T.C. Memo. 2010-142

(6/28/10). The Tax Court (Judge Thornton) held that one-half of the amount received by the taxpayer in settlement of suit for intentional infliction of emotional distress was excludable under § 104(a)(2), because the payor intended it to be compensation for a heart attack suffered as a result of the emotional distress. He reasoned that “a heart attack and its physical aftereffects constitute physical injury or sickness rather than mere subjective sensations or symptoms of emotional distress.” The other one-half of the settlement was not excludable because it was compensation for the emotional distress itself.

- **Compare: The IRS will treat innocent ex-cons better than innocent victims of sexual harassment.** ILM 201045023, Tax Treatment of Compensation to Exonerated Prisoners (11/4/10, released 11/12/10). An individual who was wrongfully convicted of a crime and was wrongfully incarcerated for several years may exclude from gross income under § 104(a)(2) the compensation he receives from the state where “[t]he individual suffered physical injuries and physical sickness while incarcerated.” It may have helped the result that one of the individuals involved, while meeting with IRS officials, suffered a seizure and had to be carried out of the room by paramedics – apparently the result of head injuries sustained while in prison.

- **Compare: Compensation to victims of human trafficking is tax-free. The IRS would have been pilloried if it had ruled the other way.** Notice 2012-12, 2012-6 I.R.B. 365 (1/19/12). Mandatory restitution payments awarded under 18 U.S.C. § 1593, which criminalizes (1) holding a person to a condition of peonage; (2) kidnapping or carrying away a person to sell the person into involuntary servitude or to be held as a slave, (3) providing or obtaining a person’s services or labor by actual or threatened use of certain means including force, physical restraint, serious harm, and abuse of legal process, and (4) sex trafficking of children or by force, fraud, or coercion, are excluded from gross income.

- **But see** P.L.R. 200041022 (7/17/00), which required that a damage award be allocated between (a) damages awarded for the period of sexual harassment without observable injury and (b) damages awarded for the period after an incident of sexual harassment that resulted in physical injury occurred.

3. **“Neither a borrower nor a lender be, for loan oft loses both itself and friend,” and a loan gives rise to excludable COD income, not compensation income.** McAllister v. Commissioner, T.C. Memo. 2013-96 (4/8/13). During 2005, the taxpayer borrowed a total of \$78,849 from his employer and executed promissory notes in favor of the employer. The promissory notes, which did not have repayment dates and did not require interest payments, required the taxpayer to repay the loans from bonuses he earned through incentive plans that formed part of his compensation. The taxpayer’s employment ended in 2007 when his employer encountered financial difficulties. The taxpayer did not report any

portion of the \$78,849 as income on his return for 2007, which he timely filed in March 2008. The employer was acquired by a corporation that issued to the taxpayer in May 2008 a Form 1099-MISC that reported \$78,849 as nonemployee compensation for 2007. The Tax Court (Judge Morrison) rejected the government's contention that the taxpayer's employer paid to the taxpayer in 2007 a constructive bonus, which the taxpayer used to repay the loans. Instead, the court concluded that the taxpayer had \$78,849 of cancellation of indebtedness income in 2007 because the Form 1099-MISC memorialized the decision of the corporation that acquired the employer to forgive the debt. The fact that the Form 1099-MISC classified the income as nonemployee compensation was "a bookkeeping error." The court also concluded that, immediately before the discharge of indebtedness, the taxpayer was insolvent in the amount of \$22,641 and therefore could exclude this portion of the income under § 108(a)(1)(B). The court declined to impose the accuracy-related penalty for a substantial understatement of income tax imposed by § 6662(a) and (b)(2). The court concluded that the taxpayer had reasonable cause for and acted in good faith with respect to the underpayment and therefore was not liable for the accuracy-related penalty pursuant to § 6664(c)(1).

**4. Equal tax rights for nonresident alien gamblers who lose.** Park v. Commissioner, 722 F.3d 384 (D.C. Cir. 7/9/13), *rev'g* 136 T.C. 569 (2011). In an opinion by Judge Kavanaugh, the D.C. Circuit held that a nonresident alien who has gambling winnings in the United States should be treated the same as a U.S. citizen and should be allowed to subtract losses from their wins within a gambling session to arrive at per-session wins or losses. The court rejected the IRS's argument that for purposes of § 871, which taxes non-resident aliens for all "interest . . . , dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income" received from sources in the United States, gambling winnings are computed on a per bet rule. The court quoted IRS Office of Chief Counsel Memorandum AM2008-11 (2008) [CCA 2008-011]: "'We think that the fluctuating wins and losses left in play are not accessions to wealth until the taxpayer redeems her tokens and can definitively calculate' her net gains. ... Because gain or loss may be calculated over a series of wagers, a 'taxpayer who plays the slot machines[] recognizes a wagering gain or loss at the time she redeems her tokens.' ... Therefore, U.S. citizens do not 'treat every play or wager as a taxable event.' ... The result is that U.S. citizens can measure their gambling winnings and losses on a per-session basis.'" The court cited *Shollenberger v. Commissioner*, T.C. Memo. 2009-306, for that same proposition.

- The Tax Court (Judge Cohen) had reasoned that a nonresident alien cannot “deduct or offset gambling losses against gambling winnings,” in part because for a U.S. citizen, the deduction for gambling losses is an itemized deduction. “Thus, a nonresident alien who is not engaged in gambling as a business within the United States is subject to tax under section 871(a)(1) on gross income from gambling without a deduction for gambling losses.” The Tax Court opinion did not address the reasoning of IRS Office of Chief Counsel Memorandum AM2008-11, 4 (2008).

**5. The Tax Court instructs you how *not* to word discrimination suit settlement agreements.** Molina v. Commissioner, T.C. Memo. 2013-226 (9/23/13). In the course of holding that no portion of the proceeds received from settling a discrimination claim against the taxpayer’s former employer were excluded under § 104(a)(2), the Tax Court (Judge Wells) observed that “the nature of underlying claims cannot be determined from a general release that is broad and inclusive,” and “all settlement proceeds are included in gross income where there is a general release but no allocation of settlement proceeds among various claims.”

**6. Atheists unite! Freedom From Religion Foundation, Inc. v. Lew**, 112 A.F.T.R.2d 2013-7103 (W.D. Wisc. 11/21/13). The District Court for the Western District of Wisconsin (Judge Crabb) held that § 107(2), which excludes from gross income a minister’s “rental allowance paid to him as part of his compensation” violates the establishment clause of the First Amendment. The court held that the plaintiff lacked standing to challenge the constitutionality of 107(1), which excludes the rental value of a parsonage provided in kind.

- Stay tuned. This certainly isn’t the end of the story.

**7. National Mortgage Settlement payments to homeowners who got screwed by their lender might or might not be taxable.** Rev. Rul. 2014-2, 2014-2 I.R.B. 255 (12/18/13). This revenue ruling deals with the tax treatment of payments received by homeowners under the National Mortgage Settlement (NMS) between the government and bank mortgage servicers regarding mortgage loan servicing and foreclosure abuses. It addresses several different situations. First, a taxpayer who receives an NMS payment as a result of foreclosure on the taxpayer’s principal residence must include the payment in the amount realized on the foreclosure, but the taxpayer may exclude any resulting gain from gross income to the extent allowed under § 121. Second, if the property contained one or more additional dwelling units that were not used as the taxpayer’s principal residence, the entire NMS payment is allocable to the portion of the

property that the taxpayer used as a principal residence. Third, a taxpayer who receives any portion of a deceased borrower's NMS payment stands in the shoes of the borrower to determine the taxable portion, if any, of the NMS payment. Any taxable amount is income in respect of a decedent (IRD) under § 691(a).

### C. **Hobby Losses and § 280A Home Office and Vacation Homes**

1. **Computing the home office deduction just got easier, but qualifying for it still remains as difficult as ever. This revenue procedure is inadvisable unless the client lives in Dogpatch, Arkansas, or (more generally), if the client can afford your fees, the deduction will easily exceed \$1,500.** Rev. Proc. 2013-13, 2013-6 I.R.B. 478 (1/15/13). This revenue procedure provides an optional safe harbor method that taxpayers may use to determine the amount of expenses deductible under § 280A for business use of a portion of a personal residence, i.e., the "home office deduction," in lieu of calculating, allocating, and substantiating of actual expenses. Taxpayers using the safe harbor method must satisfy all requirements of § 280A for determining eligibility to claim a deduction. Under the revenue procedure, in lieu of depreciation, and allocable repairs, utilities, and insurance, a taxpayer may deduct \$5 per square foot for up to 300 square feet (i.e., a maximum of \$1,500 per year) for the portion of the residence used *exclusively* for business as required by § 280A. A taxpayer electing the safe harbor method for a taxable year cannot deduct any actual expenses related to the qualified business use of that home, but may deduct all of the qualified home mortgage interest and real estate taxes, as well as any allowable casualty losses, as itemized deductions. (Depreciation for the year is treated as zero.) A taxpayer using the safe harbor method may deduct allowable trade or business expenses unrelated to the qualified business use of the home, such as advertising, wages, and supplies. An election for any taxable year is irrevocable, but the election is year-by-year, and changing from the safe harbor method in one year to actual expenses in a succeeding taxable year, or vice-versa, is not a change of accounting method. The safe harbor method does not apply to an employee with a home office if the employee receives from an employer advances, allowances, or reimbursements for expenses for the business use of the employee's home. There are other details and several examples.

- For one of the gotchas that still remains, see *Hamacher v. Commissioner*, 94 T.C. 348 (1990).

2. **What the taxpayer says his tax lawyer said is a "fair" price is not probative evidence.** *DiDonato v. Commissioner*, T.C.

Memo. 2013-11 (1/14/13). Among the many issues in this case, virtually all of which went disastrously for the taxpayer, was the applicability of the § 280A limitation on deductions for personal residences used for mixed business and personal purposes. The taxpayer rented a property to his father as the father's principal residence for the entire year in question. Notwithstanding the general rule in § 280A(d) that a family member's use of a dwelling unit is treated as personal by the taxpayer, § 280(d)(3) provides that a taxpayer is not treated as using the property for personal purposes for any period for which the dwelling unit is rented to the family member for use as the family member's principal residence at a fair rent. The Tax Court (Judge Laro) held that the taxpayer failed to prove that the rent was "fair" because the taxpayer "offered no evidence at trial as to the fair rental value of the ... property other than [his own] testimony that the amount of rent to be charged was set by his tax attorney and, in [his own] view, the rent was fair by virtue of his belief that the property was in "deplorable shape." That testimony alone was unpersuasive, because the legislative history makes clear that the fairness component be determined on the basis of comparable rents in the area. See H.R. Rept. No. 97-404, at 8 (1981).

- **See an earlier opinion in this case.**

DiDonato v. Commissioner, T.C. Memo. 2011-153 (6/29/11). The Tax Court (Judge Laro) denied a 2004 charitable contribution deduction on grounds of lack of substantiation under § 170(f)(8). The alleged donation was memorialized by a 2004 contract between taxpayer and the charitable recipient but the formal transfer did not occur until 2006, when the donation was acknowledged. The 2006 acknowledgment was too late to substantiate a 2004 deduction because it was received by taxpayer after his 2004 federal income tax return was filed.

**3. Section 183 "does not apply only to wealthy taxpayers who engage in unprofitable activities to create 'paper' losses to offset against unrelated income."** Rodriguez v. Commissioner, T.C. Memo. 2013-221 (9/18/13). The facts and ultimate holding of this § 183 hobby loss case involving a horse breeding activity conducted by two partners that spanned 15 years without showing a profit were unremarkable. (Because the purported partnership was a "small partnership" that did not elect to have TEFRA apply, the Tax Court had jurisdiction to review in individual deficiency cases items otherwise subject to partnership-level proceedings, including the disputed losses from the horse-breeding activity.) Every one of the nine factors of Reg. § 1.183-2(b) favored the IRS. However, two aspects of the case stand out. First, the court (Judge Laro) reiterated that § 183 "does not apply only to wealthy taxpayers who engage in unprofitable activities to create 'paper' losses to offset against unrelated income." (This case involved middle-income wage earners.) The analysis simply "compares the income generated by an activity with the taxpayer's taxable income from

sources other than the activity and quer[ies] whether the taxpayer's ability to earn income elsewhere allows her to finance an otherwise unprofitable activity from which she derives some personal or tax benefits." Between 1993 and 2008, the taxpayers together had a combined wage income of \$1.2 million. The horse breeding activity over that period was less than \$15,000, but it incurred more than \$1.6 million in expenses. The taxpayers financed these expenses using their wage income, life insurance proceeds, a home equity loan, and personal savings. "The income and funds from these other sources thus enabled petitioners to engage in their horse-breeding activity that ... ha[d] strong personal elements." The second significant aspect of the case is the court's observations about witnesses' credibility and uncontradicted testimony, with respect to which the court stated as follows:

We determine the credibility of each witness, weigh each piece of evidence, draw appropriate inferences, and choose between conflicting inferences in finding the facts of a case. The mere fact that one party presents unopposed testimony does not necessarily mean that the elicited testimony will result in a finding of fact in that party's favor. We will not accept a witness' testimony on its face if we find that our impression of the witness coupled with our review of the credible facts at hand conveys to us an understanding contrary to the spoken word.

- One witness's testimony was "ambiguous, equivocal, and sometimes evasive," and the other's, while "credible" was "unhelpful and unreliable."

#### **D. Deductions and Credits for Personal Expenses**

**1. Is this a casualty loss in limbo?** Alphonso v. Commissioner, 136 T.C. 247 (3/16/11). The taxpayer owned stock in a N.Y. cooperative housing corporation from which she rented an apartment as her personal residence. When a retaining wall on the grounds of the apartment complex collapsed, the corporation levied an assessment for the cost of repairs, and the taxpayer paid \$26,390, with respect to which she claimed a casualty loss deduction of \$23,188 (reflecting computational limitations in § 163(h)). The IRS disallowed the deduction, and the Tax Court (Judge Chiechi) upheld the disallowance. Judge Chiechi reasoned that under the relevant state law and controlling legal instruments, the taxpayer had no property interest in the retaining wall, which was part of the common grounds — nothing in the lease, the corporation charter and by-laws, or any other governing documents indicated that the taxpayer possessed a leasehold interest, an easement, or any other property interest in the common grounds.



Finally, Judge Chiechi rejected the taxpayer's argument that § 216, which allows cooperative apartment owners to deduct their shares of the real estate taxes and mortgage interest paid by the cooperative corporation, should be extended by judicial interpretation to casualty losses. Although Judge Chiechi rejected the IRS's argument that the absence of a reference to casualty losses in § 216 conclusively determined that it did not apply to casualty losses, after examining the legislative history she concluded that Congress intended § 216 to apply only to interest and real estate taxes.

**a. No, it's not in limbo; the loss is allowed by the Second Circuit.** Alphonso v. Commissioner, 708 F.3d 344 (2d Cir 2/6/13), *rev'g* 136 T.C. 247 (2011). The Second Circuit, in an opinion by Judge KeARSE, reversed the Tax Court's decision. The Court of Appeals concluded that the right of a stockholder in a cooperative housing corporation to use the grounds and to exclude persons who are not tenants or the guests of tenants, coupled with obligations as a tenant stockholder under the cooperative lease, constituted a property interest in the land sufficient to entitle the taxpayer to the claimed casualty loss deduction.

**2. Home mortgage interest is deductible only if you actually pay it.** Smoker v. Commissioner, T.C. Memo. 2013-56 (2/21/13). For the years in question, the taxpayer paid over \$40,000 of home mortgage interest and approximately \$28,000 of home mortgage interest was deferred and capitalized into the principal amount. Although the statutory language of § 163(h)(3) allows a deduction for qualified residence interest that is "paid or accrued" during the taxable year, the Tax Court (Judge Laro) upheld the denial of a deduction for the accrued but unpaid interest, because the taxpayer was an individual on the cash method — which is the method applicable to all individuals with respect to personal expenses. Under well-established precedents, a cash method taxpayer may deduct in any taxable year only interest actually paid during that taxable year. The accrued but unpaid qualified residence interest would not be deductible until actually paid. Inasmuch as no evidence was introduced to show that taxpayer relied on professionals in preparation of his tax return, the accuracy-related penalty was upheld.

**a. See Here, Mr. & Mrs. Hargreaves!** Hargreaves v. Commissioner, T.C. Summ. Op. 2013-37 (5/15/13). Taxpayers purchased a home in California with a "negative amortization loan" from a bank. For the year 2007, they received a substitute Form 1098, which characterized interest as (1) gross interest paid of \$59,554; (2) interest shortage of \$33,288; and (3) net interest paid of \$26,266, with the interest shortage added to the balance of the loan. In their self-prepared federal income tax return for 2007, they deducted the gross interest amount. The Tax

Court (Judge Haines) in this S case held that only the net interest was deductible, but did not uphold the accuracy-related penalty because taxpayer husband “credibly testified that he reported the interest deduction using what he thought the Form 1098 stated.”

**3. The Court of Federal Claims rejects as a “shibboleth”<sup>7</sup> the proposition that whether a “theft” has occurred, for purposes of § 165(c)(3) depends upon whether a theft has occurred under state law.** *Goeller v. United States*, 109 Fed. Cl. 534 (3/20/13). The Court of Federal Claims (Judge Allegra) denied both the taxpayers’ and the government’s cross-motions for summary judgment in a refund suit involving whether the taxpayers suffered a theft loss deductible under § 165(c)(3) as result of a failed investment in a real estate business. The court observed that both the taxpayers and the government accepted, and cited authority for, the proposition that whether a “theft” has occurred, for purposes of § 165(c)(3) depends upon whether a theft has occurred under state law, but disputed whether the controlling law is that of Ohio or of California. However, in denying the motions on the ground that there were material factual issues to be resolved by trial, the court unequivocally rejected the proposition that whether a “theft” has occurred, for purposes of § 165(c)(3) depends upon whether a theft has occurred under state law. Rather, the court held that there was a federal tax law concept of theft based on “a long-standing and well-accepted meaning” of the term theft found in Black’s Law Dictionary, which “defines that term as ‘[t]he fraudulent taking of corporeal personal property belonging to another, from his possession, or from the possession of some person holding the same for him, without his consent, with intent to deprive the owner of the value of the same, and to appropriate it to the use or benefit of the person taking.’” The court also observed that “by the time the 1954 [Internal Revenue] Code was enacted, it also was well-accepted, based on Black’s Law Dictionary that the definition of ‘theft’ includes a crime in which one ‘obtains possession of property by lawful means and thereafter appropriates the property to the taker’s own use.’” Furthermore, “these definitions of ‘theft’ are largely indistinguishable from that employed in the Model Penal Code, which defines a ‘theft’ as occurring where a person ‘unlawfully takes, or exercises unlawful control over, movable property of another with purpose to deprive him thereof.’ ... This is relevant because the Model Code’s provisions have often been

---

7. [5] The Gileadites captured the fords of the Jordan leading to Ephraim, and whenever a survivor of Ephraim said, “Let me cross over,” the men of Gilead asked him, “Are you an Ephraimite?” If he replied, “No,” [6] they said, “All right, say ‘Shibboleth.’” If he said, “Sibboleth,” because he could not pronounce the word correctly, they seized him and killed him at the fords of the Jordan. Forty-two thousand Ephraimites were killed at that time. (Judges 12:5-6 (NIV).)

employed in determining the scope of an offense referenced in a Federal statute.” These “well-accepted definitions of ‘theft’” thus render reference to state law unnecessary. The court concluded that “where a federal statute uses a common-law term of established meaning without otherwise defining it, the practice is to give that term its common meaning,” and saw “no reason why this rule ought not apply to section 165(c)(3).” Nothing in the statutory language, its legislative history, or the relevant regulations suggested otherwise.

- For authorities holding that to claim a theft loss, the taxpayer must prove that a theft occurred under the applicable state law, see, e.g., *Citron v. Commissioner*, 97 T.C. 200 (1991) (mere refusal to return property was not equivalent of embezzlement under state law); *Paine v. Commissioner*, 63 T.C. 736 (1975), *aff'd by order*, 523 F.2d 1053 (5th Cir.1975) (denying a loss deduction under § 165(c)(3) to an investor who purchased publicly traded stock at a price that was inflated by fraudulent financial statements; no “theft” had occurred under state law because the taxpayer failed to prove a causal connection between the misrepresentations and the loss); *Alioto v. Commissioner*, 699 F.3d 948 (6th Cir. 2012) (taxpayer failed to demonstrate that investment loss was due to false statements that would constitute theft under relevant state law); *Estate of Meriano v. Commissioner*, 142 F.3d 651 (3d Cir. 1998) (estate was entitled to theft loss for attorney’s failure to return excessive amounts withdrawn from the estate because a theft occurred under state law; extensive analysis of relevant state law); *Bellis v. Commissioner*, 540 F.2d 448 (9th Cir. 1976) (denying a theft loss deduction because under relevant state law no theft had occurred).

**4. Another case where married filing separately significantly changes the ground rules.** Field v. Commissioner, T.C. Memo. 2013-111 (4/18/13). Married taxpayers must file a joint return in order to claim the § 26 credit for adoption expenses. The Tax Court (Judge Thornton) held that the joint filing requirement does not violate the constitutional right to equal protection even though the married taxpayer who filed separately had adopted a child alone, without her husband also adopting the child.

**5. Standard deduction for 2014.** Rev. Proc., 2013-35, 2013-47 I.R.B. 537 (10/31/13). The standard deduction for 2014 will be \$12,400 for joint returns and surviving spouses, \$6,200 for unmarried individuals and heads of households, and \$6,200 for married individuals filing separately.

**6. Long distance to a remote work site is not travel away from home.** Cor v. Commissioner, T.C. Memo. 2013-240 (10/22/13).

The taxpayer was required to commute daily from his home in Las Vegas to a remote test site in the Nevada desert not served by public transportation. The Tax Court (Judge Cohen) rejected the taxpayer's argument that the extraordinary commuting expense should be allowable as a deduction because of the exceptional nature of the commute compared to ordinary commuting. The court cited the general principle that travel expenses going to or from work on a daily basis are not ordinary business expenses.

#### **E. Divorce Tax Issues**

**1. Here's how to shift taxation of child support payments to the custodial spouse if state law allows it.** DeLong v. Commissioner, T.C. Memo. 2013-70 (3/11/13). The Tax Court (Judge Kroupa) held that an unallocated family support allowance that under California law was intended to provide both spousal and child support that terminated entirely upon the death of the custodial payee spouse, but was not by its terms reduced upon emancipation of the children, was entirely alimony.

**2. Dueling lawyers' letters do not a divorce or separation instrument make.** Faylor v. Commissioner, T.C. Memo. 2013-143 (6/5/13). The Tax Court (Judge Vasquez) held that a series of letters between divorcing spouses' lawyers regarding temporary support prior to the entry of a divorce decree did not constitute a divorce or separation agreement where neither spouse signed two proposed temporary support agreements. Accordingly, payments by the husband to the wife during the pendency of the divorce were not deductible as alimony.

#### **F. Education**

There were no significant developments regarding this topic during 2013.

#### **G. Alternative Minimum Tax**

There were no significant developments regarding this topic during 2013.

## VI. CORPORATIONS

### A. Entity and Formation

**1. Saving the world from double deductions. The details emerge only nine years after Congress acted.** T.D. 9633, Limitations on Duplication of Net Built-in Losses, 78 F.R. 54156 (9/3/13). The Treasury Department has promulgated final regulations, Reg. § 1.362-4, under § 362(e)(2), which was enacted in 2004, with only minor clarifying changes from the proposed regulations (71 F.R. 62067), which were published in 2006. Section 362(e)(2) prevents taxpayers from transmuting a single economic loss into two (or more) tax losses by taking advantage of the dual application of the substituted basis rules in § 358 for stock received in a § 351 transaction and in § 362 for assets transferred to a corporation in a § 351 transaction. If the aggregate basis of the property transferred to a corporation in a § 351 transaction exceeds the aggregate fair market value, the aggregate basis of the property must be reduced to its fair market value. The final regulations include examples illustrating the application of § 362(e)(2) to transactions qualifying as both § 351 transactions and reorganizations, as well as an example illustrating the nonapplicability of § 362(e)(2) to triangular reorganizations that do not include a transfer to which § 362(a) applies. The regulations provide two exceptions to the application of § 362(e)(2). First, a transaction will not be subject to § 362(e)(2) to the extent that the transferor distributes the stock received in the transaction and, in the distribution, no gain or loss is recognized and no person takes the stock or other property with a basis determined by reference to the transferor's basis in the distributed stock. This exception applies principally to distributions subject to § 355(a). In this situation there is no duplicated loss that could be recognized by any taxpayer. Second, a transaction will not be subject to § 362(e)(2) if the transaction is between persons not connected to the United States, the transaction does not become relevant for Federal tax purposes within two years of the transfer, and the transaction is not undertaken pursuant to a plan to reduce or avoid Federal taxes. This exception relates to transfers between foreign subsidiaries. The assumption of a transferor's liabilities by the transferee generally does not affect the application of § 362(e). However, if a § 362(e)(2)(C) election is made, the reduction to stock basis is limited to the amount that the transferee would otherwise reduce its basis in the transferred assets. This prevents the reduction of stock basis attributable to contingent liabilities associated with a trade or business, for which basis is specifically preserved under § 358(h)(2)(A). Furthermore, when the property transferred is an interest in a partnership with liabilities, the final regulations provide that the value of a partnership interest is the sum of cash that the transferee would receive for such interest, increased by any Reg. § 1.752-1 liabilities (as defined in Reg.

§ 1.752-1(a)(4)) of the partnership that are allocated to the transferee with regard to such transferred interest under § 752. See Reg. § 1.362-4(h), Ex. 8(ii). Finally, Reg. § 1.362-4(d) provides details on how to make the § 362(h)(2)(C) election to reduce the transferor's stock basis in lieu of the corporation reducing asset basis; the regulations generally adopt the rules set forth in Notice 2005-70, 2005-2 C.B. 694, and the proposed regulations, but expand those rules significantly. A § 362(e)(2)(C) election is irrevocable. It may be made protectively and will have no effect to the extent it is determined that § 362(e)(2) does not apply. For an election to be effective, (1) prior to filing "a Section 362(e)(2)(C) Statement" the transferor and transferee must enter into a written, binding agreement to elect to apply § 362(e)(2)(C), and (2) detailed requirements for filing the "Section 362(e)(2)(C) Statement," which is required to contain extraordinarily detailed information about the transfer, must be followed. If the transferor is a person required to file a U.S. return for the year of the transfer, the transferor must include the "Section 362(e)(2)(C) Statement" on or with its timely filed (including extensions) original return for the taxable year in which the transfer occurred. There is a long list of the persons required to file the statement if the transferor is not required to file a U.S. return for the year of the transfer.

**2. Built-in losses cannot be "imported" either from offshore or from a U.S. tax-exempt.** REG-161948-05, Limitations on the Importation of Net Built-in Losses, 78 F.R. 54971 (9/9/13). The Treasury Department and IRS have published proposed regulations under §§ 334(b)(1)(B) and 362(e)(1), dealing with the importation of built-in losses in § 332 subsidiary liquidations and § 351 transfers. (These regulations do not deal with § 362(e)(2); Reg. § 1.362-4 deals with § 362(e)(2).) Section 362(e)(1) applies property-by-property to assign each transferred property a fair market value basis rather than the normal § 362(a) transferred basis, if (1) there is net built-in loss in the aggregate transferred properties and (2) gain or loss realized by the transferor with respect to the property was not subject to U.S. income tax immediately prior to the transfer. If a controlled subsidiary is liquidated and (1) there is net built-in loss in the aggregate transferred properties and (2) gain or loss realized by the transferor with respect to the property was not subject to U.S. income tax immediately prior to the transfer, § 334(b)(1)(B) provides the parent with a fair market value basis in properties received in the liquidation.

• Prop. Reg. § 1.362-3 terms the transactions to which § 362(e)(1) applies "loss importation transactions," and the property to which it applies "loss importation property." The proposed regulations use a hypothetical sale analysis to identify loss importation property. The proposed regulations clarify that § 362(e)(1) applies to transfers

by U.S. tax-exempt organizations as well as transfers by foreign persons. The proposed regulations also provide a look-through rule for transfers by grantor trusts, partnerships, and S corporations, and in certain “tax-avoidance” transactions, as well as rules dealing with tiered entities. The proposed regulations clarify that whether a transaction is a loss importation transaction is determined with respect to the aggregate amount of built-in gain and built-in loss in all importation property acquired from all transferors in the transaction, unlike the transferor-by-transferor approach of § 362(e)(2). Detailed basis calculation rules are specified. The proposed regulations are illustrated by nine examples. The rules in Prop. Reg. § 1.362-3 will apply to any transaction occurring on or after the date these regulations are finalized, unless effected pursuant to a binding agreement that was in effect prior to that date and at all times thereafter. Taxpayers may apply the proposed regulations to transactions occurring after 10/22/04 – almost 9 years retroactively.

- Proposed amendments to Reg. § 1.334-1(b) apply similar rules to “loss importation transactions,” and “loss importation property” in § 332 liquidations. All of the examples deal with the liquidation of a foreign subsidiary by a U.S. parent.

## **B. Distributions and Redemptions**

**1. Leona Helmsley, eat your heart out! Welle v. Commissioner, 140 T.C. No. 19 (6/27/13).** The taxpayer was the sole shareholder of Terry Welle Construction, Inc. (TWC). He used TWC to facilitate the construction of a new home for himself and his wife. To keep track of material and other construction costs, the taxpayer caused TWC to open a “cost plus” job account on its books, but he personally acted as the general contractor during construction. The taxpayer personally hired the subcontractors and ordered building supplies from the vendors in TWC’s name. TWC kept track of construction costs and TWC’s framing crew framed the home. The taxpayer reimbursed TWC for its costs, including overhead, but did not pay TWC an amount equal to the profit margin of 6 to 7 percent that TWC normally charged its customers. The IRS asserted that the taxpayer received a constructive dividend from TWC in an amount equal to TWC’s forgone profit. The IRS’s theory was that *Magnon v. Commissioner*, 73 T.C. 980 (1980), which held that a shareholder of a corporation received a constructive dividend when the corporation performed electrical contracting services on the shareholder’s personal property primarily for the shareholder’s own benefit and without any expectation of repayment, stood for the proposition that the amount of the dividend included not only the costs incurred by the corporation, but also an amount equal to the corporation’s customary profit margin. The Tax Court (Judge Marvel) rejected the IRS’s claim, stating that in *Magnon* “we did not hold, and the Commissioner did not assert, that the constructive dividend the

shareholder received included an amount corresponding to the corporation's forgone profit." Judge Marvel held that there was no constructive dividend because "[a] finding that a shareholder received a constructive dividend from a corporation is only appropriate where 'corporate assets are diverted to or for the benefit of a shareholder,'" and that did not occur in this case. Judge Marvel concluded that *Melvin v. Commissioner*, 88 T.C. 63 (1987), *aff'd on other grounds*, 894 F.2d 1072 (9th Cir.1990), in which the rental by a corporation to its shareholders for personal purposes at a rental equal to the corporation's costs with respect to the vehicles resulted in a dividend equal to the amount by which the fair rental values of the automobiles exceeded the reimbursements paid to the corporation, was distinguishable. Judge Marvel's reasoning was as follows:

TWC maintained its corporate infrastructure and workforce for business purposes. Mr. Welle's use of TWC during the construction of petitioners' lakefront home was at most incidental to those purposes. The most that can be said about Mr. Welle's use of TWC is that he used the corporation as a conduit in paying subcontractors and vendors and that he obtained some limited services from corporate employees. Mr. Welle fully reimbursed the corporation for all costs, including overhead, associated with those services, and TWC did not divert actual value otherwise available to it by failing to apply its customary profit margin in determining the amount Mr. Welle had to reimburse the corporation. We therefore conclude that this arrangement did not operate as a vehicle for the distribution of TWC's current or accumulated earnings and profits within the meaning of section 316(a).

- We think the result in this case turns on the fact that, except possibly with respect to the use of TWC's framing crew by the taxpayer, nothing in the facts indicates that the taxpayer's use of TWC's services resulted in TWC forgoing profits that could have been earned from transactions with third parties had TWC not been used by the taxpayer to facilitate construction of his personal residence in the manner he did. In other words, TWC incurred no opportunity costs. Had TWC incurred opportunity costs, the result very well might have been different.

### C. Liquidations

There were no significant developments regarding this topic during 2013.



## D. S Corporations

**1. Realized but unrecognized gain is not tax-exempt income.** Ball v. Commissioner, T.C. Memo. 2013-39 (2/6/13). The taxpayers owned stock of an S corporation that had a wholly-owned subsidiary for which it made a QSub election. They argued that the basis of their S corporation stock had been increased by the amount of built-in gain on the stock of the QSub that went unrecognized pursuant to § 332 as a result of the QSub election, and that the increased basis supported claimed passed-through loss. Their position was based on the argument that the unrecognized gain was tax-exempt income that resulted in a basis increase under § 1367(a)(1)(A). The Tax Court (Judge Kerrigan) rejected the taxpayer's argument, and held that unrecognized gain resulting from a QSub election does not create an item of income or tax-exempt income pursuant to § 1366(a)(1)(A). The court reasoned that nonrecognition rules do not exempt income from taxation but merely defer recognition through substituted basis rules.

**2. S corporation shareholders aren't allowed to just make up their own basis adjustment rules.** Barnes v. Commissioner, T.C. Memo. 2012-80 (3/21/12). The Tax Court (Judge Morrison) agreed with the IRS in holding — unsurprisingly — that there is no upward stock basis adjustment under § 1367 for amounts that are erroneously reported by the shareholder as § 1366 pass-through income but that do not correspond to, but exceed, the shareholder's actual pro rata share of pass-through income. Likewise, § 1367(a)(2)(B) requires an S corporation shareholder to reduce stock basis by any losses that the shareholder is required to take into account under § 1366(a)(1)(A), even if the shareholder does not actually claim the pass-through losses on the shareholder's return. Because the taxpayer had reported gain rather than loss in a prior year in which a very large loss had been passed through, the shareholder had no basis to support passed-through losses in the year in question.

**a. And the D.C. Circuit sees it the same way — “the Barneses paid more in taxes than they owed. But so it goes.”** Barnes v. Commissioner, 712 F.3d 581 (D.C. Cir. 4/5/13). The Court of Appeals affirmed.

Nothing in [sections 1366 and 1367] suggests that a shareholder's basis is not reduced if the shareholder fails to take a deduction for the corporation's losses. Indeed, the fact that the Code explicitly provides that a shareholder's basis is increased by corporate income “only to the extent such amount is included in the shareholder's gross income on his

return,” ... but provides no similar exception for corporate losses, militates against the Barneses’ preferred reading. See *Russello v. United States*, 464 U.S. 16, 23 (1983) (“[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.” (internal quotation marks omitted)). This difference makes sense. Although Congress had every reason to prevent taxpayers from reaping a double benefit by failing to report income while still being credited with an increased basis, it had no reason to permit them to indefinitely delay the realization of losses.

**3. The Third Circuit says that QSub status isn’t “property” under the Bankruptcy Code and tells the Ninth Circuit that it was all wrong when it held that S corporation status was “property” under the Bankruptcy Code.** *In re The Majestic Star Casino, LLC*, 716 F.3d 736 (3d Cir. 5/21/13), *rev’g* 466 B.R. 666 (Bankr. D. Del. 1/24/12). A debtor QSub, but not its parent S corporation, was in bankruptcy. After the bankruptcy petition was filed the parent corporation revoked its S corporation status, which under § 1361(b)(3)(C) automatically terminated the debtor-subsidiary’s QSub status, converting it into a C corporation. The bankruptcy court held that the parent corporation’s action that terminated pass-through tax benefits that the debtor subsidiary had enjoyed was a voidable transfer of estate property in violation of Bankruptcy Code § 549. The debtor’s QSub status was property of the bankruptcy estate, and as a result of the loss of that status the bankruptcy estate was required to, and did, pay state income taxes it would not otherwise have been required to pay. (The corporation had not paid any federal income taxes, but the IRS’s claim for any deficiency would be affected, so the IRS opposed the debtor’s argument that its QSub status was property of the bankruptcy estate.) Accordingly, the revocation of the parent’s status as an S corporation and the termination of the debtor’s status as a QSub were held to be “void and of no effect.” The bankruptcy court relied on *In re Prudential Lines, Inc.*, 107 B.R. 832 (Bankr. S.D.N.Y. 1989), *aff’d*, 928 F.2d 565 (2d Cir. 1991), which held that a subsidiary’s NOL carryforward was property of the subsidiary’s bankruptcy estate and that the parent’s plan to claim a worthless stock deduction, which would have eliminated the NOL would violate the automatic stay, and its progeny holding that S corporation status is “property” and that the termination of an S election can be a voidable transfer. See *In re Bakersfield Westar*, 226 B.R. 227 (B.A.P. 9th Cir. 1998); *In re Frank Funaro Inc.*, 263 B.R. 892 (B.A.P. 8th Cir. 2001); *In re Trans-*

*Lines W., Inc.*, 203 B.R. 653 (Bankr. E.D. Tenn. 1996); *In re Cumberland Farms, Inc.*, 162 B.R. 62 (Bankr. D. Mass. 1993).

- The Third Circuit in an opinion by Judge Jordan, reversed, first finding based on nuances of the Bankruptcy Code, that the Internal Revenue Code, rather than state law, governs whether an entity's tax status is a property interest for purposes of the Bankruptcy Code. The court of appeals concluded that the extension of *Prudential Lines*, by *In re Trans-Lines West, Inc.*, 203 B.R. 653 (Bankr. E.D. Tenn. 1996), and a series of cases that followed it, which held that a corporation's revocation of its S corporation status prior to filing for bankruptcy was a prepetition transfer of property avoidable by the trustee pursuant to Bankruptcy Code § 548 was "untenable." First, NOLs are not contingent at all; a bankrupt corporate debtor has a specific amount of NOL at the time of the bankruptcy filing that are a function of the debtor's operations prior to bankruptcy; the NOLs "are not subject either to revocation by the shareholders or termination by the IRS." In contrast, under § 1362, the shareholders of an S corporation can terminate its status at will, "regardless of how long it has been an S-corp and whatever its pre-bankruptcy operating history has been"; "the tax status of the entity is entirely contingent on the will of the shareholders." Second, NOLs have a readily determinable value that is available to the bankruptcy estate, either as a carryback or a carryforward against future earnings, while the value of the S corporation election is dependent on it not being revoked and the amount and timing of future earnings. NOL carryforwards may be monetized while S corporation status cannot. Third, S corporation status cannot be a property interest because S corporation status can be automatically terminated in a variety of manners by which the corporation can become ineligible to be an S corporation. Fourth, even if S corporation status had some value to the estate, because it allows the debtor corporation to "place its tax liabilities on a non-debtor" shareholder, a "tax classification over which the debtor has no control is not a 'legal or equitable interest[] of the debtor in property' for purposes of § 541 [of the Bankruptcy Code]." Finally, to allow all of the debtor corporation's profits to remain in the bankruptcy estate while transferring the tax liability to the non-debtor shareholders would be inequitable. After so reasoning that S corporation status was not "property" under the Bankruptcy Code, the court of appeals found that "QSub status is an *a fortiori* case." A QSub's continuing status as such is contingent on a number of factors entirely outside of the QSub's control, and a QSub cannot "transfer or otherwise dispose of its QSub status." Thus, QSub status cannot be "property." Furthermore, even if QSub status is property, it could not be property of the bankruptcy estate; it would be property of the subsidiary's S corporation parent. For tax purposes a QSub does not exist. Finally, the court added the coup-de-grâce:

Moreover, allowing QSub status to be treated as the property of the debtor subsidiary rather than the non-debtor parent, as

the Bankruptcy Court did in this case, places remarkable restrictions on the rights of the parent, restrictions that have no foundation in either the I.R.C. or the Code. First, the corporate parent loses not only the statutory right to terminate its subsidiary's QSub election, see I.R.C. § 1361(b)(3)(B), (D), but also its right to terminate its own S-corp election, see *id.* § 1361(d). Second, the corporate parent loses the ability to sell the subsidiary's shares to any purchaser other than an S-corp, and would then be required to sell 100 percent of the shares, because any other sale would trigger the loss of the subsidiary's QSub status. See *id.* § 1361(b)(3)(B). Third, the S-corp parent and its shareholders lose the ability to sell the parent to a C-corporation, partnership, or other non-S-corp entity, to a non-resident alien, or to more than 100 shareholders, because any of those transactions would also trigger the loss of the subsidiary's QSub status. See *id.*, § 1361(b)(1)(B), (C), (A). Filing a bankruptcy petition is not supposed to "expand or change a debtor's interest in an asset; it merely changes the party who holds that interest." *In re Saunders*, 969 F.2d 591, 593 (7th Cir. 1992). But under the Bankruptcy Court's holding in this case, a QSub in bankruptcy can stymie legitimate transactions of its parent as unauthorized transfers of property of the estate, even though the QSub would have had no right to interfere with any of those transactions prior to filing for bankruptcy.

**4. Another taxpayer fails in the never-ending quest for S corporation debt basis without an economic outlay.** Montgomery v. Commissioner, T.C. Memo. 2013-151 (6/17/13). In 2006, the taxpayer guaranteed a loan to an S corporation in which he was a shareholder. The corporation passed through losses to the taxpayer for 2007 in excess of the taxpayer's basis in the stock and loans the taxpayer had made to the corporation. The taxpayer claimed that because the corporation defaulted on the loan in 2008, he defaulted on the guarantee in that year, and in 2009 the creditor obtained a judgment against the taxpayer for \$435,169.54, he should have had a basis increase in that amount for the corporation's debt that he obtained through subordination. Judge Morrison was unimpressed by the argument.

"[I]t is the payment by the guarantor of the guaranteed obligation that gives rise to indebtedness on the part of the debtor to the guarantor. The mere fact that the debtor

defaults and thereby renders the guarantor liable is not sufficient.” [Quoting from *Underwood v. Commissioner*, 63 T.C. 468, 476 (1975), *aff’d*, 535 F.2d 309 (5th Cir. 1976)]. Patrick Montgomery did not make any payments on the SunTrust Bank loan during 2007. Therefore his guarantee of the SunTrust Bank loan did not give rise to a debt to him from Utility Design, Inc., during 2007.

- In partial solace for the taxpayer, at least no § 6662 accuracy-related penalties were assessed by the IRS.

**5. Rev. Proc. spells relief for late elections.** Rev. Proc. 2013-30, 2013-36 I.R.B. 173 (8/14/13). The IRS has consolidated multiple rulings into a single procedure for requesting relief from late S corporation, QSST and QSub elections. In general the procedure requires that a requesting entity has reasonable cause for making a late election and has acted diligently to correct the mistake upon its discovery. The request must be made within 3 years and 75 days of the effective date of the election.

#### **E. Mergers, Acquisitions and Reorganizations**

There were no significant developments regarding this topic during 2013.

#### **F. Corporate Divisions**

There were no significant developments regarding this topic during 2013.

#### **G. Affiliated Corporations and Consolidated Returns**

**1. Twenty-seven years after the authorizing statute was enacted, the Treasury and IRS finalize regulations to prevent triple taxation resulting from sales, exchanges, and distributions of corporate stock resulting from *General Utilities* repeal.** T.D. 9619, Regulations Enabling Elections for Certain Transactions Under Section 336(e), 78 F.R. 28467 (5/15/13). The IRS published regulations under § 336(e). Section 336(e), enacted as part of the TRA 1986 repealing the *General Utilities* doctrine, authorizes regulations allowing a corporation that sells, exchanges, or distributes stock in another corporation (target) meeting the requirements of § 1504(a)(2) to elect to treat the disposition as a sale of all of target’s underlying assets in lieu of treating it as sale, exchange, or distribution of stock, as under § 338(h)(10). The purpose of a § 336(e) election is to prevent creation of a triple layer of taxation — one at the controlled corporation

level, one at the distributing corporation level and, ultimately, one at the shareholder level. Reg. §§ 1.336-0 through 1.336-5 provide the requirements and mechanics for, and consequences of, treating a stock sale, exchange, or distribution that would not otherwise be eligible for a § 338 election, as an asset sale under § 336(e). Under the regulations, the results of a § 336(e) election generally are the same (with certain exceptions) as those of a § 338(h)(10) election. The structure of the regulations resembles that of the § 338(h)(10) regulations regarding the allocation of consideration, application of the asset and stock consistency rules, treatment of minority shareholders, and the availability of the § 453 installment method, although certain definitions and concepts differ to reflect differences between § 336 and § 338(h)(10). Unlike under § 338(h)(10), however, a § 336(e) election is a unilateral election by the seller. A transaction that meets the definition of both a qualified stock disposition and a qualified stock purchase under § 338(d)(3) generally will be treated only as a qualified stock purchase and does not qualify for a § 336(e) election. Reg. § 1.336-1(b)(6)(ii).

- *General Rules.* A qualified stock disposition for which a § 336(e) election may be made is any transaction or series of transactions in which stock meeting the requirements of § 1504(a)(2) (80 percent of voting and value) of a domestic corporation is either sold, exchanged, or distributed, or any combination thereof, by another domestic corporation or the shareholders of an S corporation in a disposition (as defined in Reg. § 1.336-1(b)(5)), during the 12-month disposition period (as defined in Reg. § 1.336-1(b)(7)). (All members of a consolidated group are treated as a single transferor. Reg. § 1.336-2(g)(2)). Stock transferred to a related party (determined after the transfer) is not considered in determining whether there has been a qualified stock disposition. Reg. §§ 1.336-1(b)(5)(i)(C) and 1.336-1(b)(6)(i). A section 336(e) election is available for qualifying dispositions of target stock to non-corporate transferees, as well as to corporate transferees. Reg. § 1.336-1(b)(2)

- Because the regulations require only that stock meeting the requirements of § 1504(a)(2) be transferred, the transferor (or a member of its consolidated group) may retain a portion of the target stock. Reg. §§ 1.336-2(b)(1)(v) and 1.336-2(b)(2)(iv). Furthermore, the regulations allow amounts of target stock transferred to different transferees, in different types of transactions to be aggregated in determining whether there has been a qualified stock disposition. For example, the sale of 50 percent of target's stock to an unrelated person and a distribution of another 30 percent to its unrelated shareholders (who might or might not be the purchasers of the 50 percent that was sold) within a 12-month period would constitute a qualified stock disposition. Reg. § 1.336-1(b)(5).

- *Election.* The election is made by the seller and the target by entering into a binding written agreement before the due

date of the tax return for the year of the stock disposition and filing a required statement of election with the tax return for the appropriate year. The consent of both seller and the target (on behalf of the buyer) are required to avoid surprises to the buyer. An election for an S corporation target requires a binding written agreement between the target S corporation and all of the S corporation shareholders, including shareholders who do not sell stock, before the due date of the tax return for the year of the stock disposition and an election statement attached to the return for the year of the disposition. In both cases, the target must retain a copy of the written agreement. If the seller and target are members of a consolidated group, the seller and target must enter into a binding written agreement, retained by the parent of the consolidated group, and the common parent of the group must attach an election statement to the consolidated return for the year of the disposition. Reg. § 1.336-2(h).

- *Sales or Exchanges of Target Stock.* In general, if a seller sells or exchanges target stock in a qualified stock disposition, the treatment of old target, seller, and purchaser are similar to the treatment of old target (old T), S, and P under § 338(h)(10). If a § 336(e) election is made, the sale or exchange of target stock is disregarded. Instead, target (old target) is treated as selling all of its assets to an unrelated corporation in a single transaction at the close of the disposition date (the deemed asset disposition). Old target recognizes the deemed disposition tax consequences from the deemed asset disposition on the disposition date while it is a subsidiary of seller. In the case of a deemed asset sale by a Subchapter S corporation, the tax consequences of the deemed asset sale pass through to the S corporation shareholders. See Reg. § 1.336-2(b)(1)(A). Old target is then treated as liquidating into seller which in most cases will be treated as a § 332 liquidation to which § 337 (or § 336) applies. Additionally, the deemed purchase of the assets of old target by new target constitutes a deemed purchase of any subsidiary stock owned by target, and a § 336(e) election may be made for the deemed purchase of the stock of a target subsidiary if it constitutes a qualified stock disposition. A § 336(e) election generally does not affect the tax consequences, e.g., stock basis, to a purchaser of target stock.

- *Distributions of Target Stock Not Subject to § 355.* A § 336(e) election can be made for a taxable distribution of target stock (e.g., dividend, redemption, liquidation), but the election does not affect the tax treatment of the shareholders. Special rules assure that the tax consequences to a distributee are the same as if no § 336(e) election was made. If a distribution is a qualified stock disposition, the distributing corporation is treated as purchasing from new target (immediately after the deemed liquidation of old target) the amount of stock distributed and to have distributed the new target stock to its shareholders. The distributing corporation recognizes no gain or loss on the distribution (old target having recognized gain on the deemed asset sale). Reg. § 1.336-2(b)(1)(iv). If the distribution is a § 301 distribution, the portion that is a dividend may be affected by the difference

between (1) the § 311 gain, and thus E&P, that would have been recognized on a stock distribution and (2) the gain, and thus E&P, that results from the deemed asset disposition and liquidation of target. See Reg. § 1.336-2(c). Realized losses on the deemed asset disposition are allowed to offset realized gains, Reg. § 1.336-2(b)(1)(i)(B)(2)(i). However, the regulations disallow a net loss recognized on the deemed asset disposition in proportion to the amount of stock disposed of by the seller in one or more distributions during the 12-month disposition period. Reg. § 1.336-2(b)(1)(i)(B)(2)(ii).

- *Section 355 Distributions.* The regulations allow a corporation that would otherwise recognize gain with respect to a qualified stock disposition resulting, in whole or in part, from a disposition described in § 355(d)(2) or (e)(2) to make a § 336(e) election. However, to preserve the E&P allocation consequences of a § 355 distribution under Reg. § 1.312-10, the regulations provide special rules. Old target is not deemed to liquidate into the distributing corporation, but is treated as acquiring all of its assets from an unrelated person and the distributing corporation is treated as distributing the stock of the controlled corporation (old target) to its shareholders. Reg. § 1.336-2(b)(2)(i)(A). Because the controlled corporation (old target) is not treated as liquidated, it will retain its tax attributes despite the § 336(e) election. Furthermore, the controlled corporation will take into account the effects of the deemed asset disposition to adjust its E&P immediately before allocating E&P pursuant to Reg. § 1.312-10. Reg. § 1.336-2(b)(2)(vi). Net losses from the deemed asset sale will be recognized only in relation to the amount of stock sold or exchanged in the qualified stock disposition during the 12-month disposition period. Reg. §§ 1.336-2(b)(2)(i)(B)(2)(iii). However, if the controlled corporation (old target) has any subsidiaries for which a § 336(e) election is made, the general deemed asset disposition methodology shall apply. This prevents taxpayers from effectively electing whether the attributes of the lower tier subsidiary become those of target, by doing an actual sale of target subsidiary's assets followed by a liquidation of target subsidiary, or remain with target subsidiary, by making a § 336(e) election for target subsidiary.

- *Intragroup Transfers Prior to External Dispositions.* If target stock is transferred within an affiliated group and is then transferred outside the affiliated group, a § 336(e) election is not available for the intragroup transfer (because a qualified stock disposition may not be made between related sellers and purchasers). Even if a § 336(e) election is made for the transfer outside of the group, the affiliated group would recognize gain both on target's assets and the target stock. To solve this problem the final regulations modify Reg. § 1.1502-13(f)(5)(ii)(C) to allow a § 1.1502-13(f)(5) election to treat the deemed liquidation of target into the seller as a taxable liquidation in order to provide the consolidated group with a stock loss to offset some, if not all, of the intragroup seller's stock gain from the intragroup transaction. Reg. § 1.336-2(b)(2)(i)(A)(2) also provides that in the case of a



§ 355(d)(2) or (e)(2) transaction that is preceded by an intragroup transaction, for purposes of the § 1.1502-13(f)(5) election, immediately after the deemed asset disposition of target's assets, target is deemed to liquidate into seller, which provides seller with a stock loss that can offset some or all of the group's intercompany gain on the transfer of target stock.

- *Aggregate Deemed Asset Disposition Price (ADADP) and Adjusted Grossed Up Basis (AGUB).* To calculate old target's gain under a § 336(e) election, the regulations define a new term, "aggregate deemed asset disposition price" (ADADP). New target's asset basis is determined with reference to adjusted grossed up basis (AGUB), as used in § 338 and Reg. § 1.338-5. Under Reg. §§ 1.336-3 and 1.336-4, ADADP and AGUB are determined similarly to the way ADSP and AGUB are determined under the § 338 regulations. The regulations account for the lack of an actual amount realized on a stock distribution by treating the grossed-up amount realized as including in the amount realized the fair market value of distributed target stock on the date of distribution. Reg. § 1.336-3(c)(1)(i)(B). In addition, because in the case of a § 336(e) election (unlike in the case of a § 338 election, where there is only one purchasing corporation and it is relatively easy to determine the purchaser's basis in nonrecently purchased stock in order to determine AGUB), there can be multiple purchasers or distributees who acquired target stock prior to the 12-month disposition period, the regulations provide that "nonrecently disposed stock," which has a similar meaning to the term "nonrecently purchased stock" in § 338(b)(6)(B), includes only stock in a target corporation held by a purchaser (or a related person) who owns (with § 318(a) attribution, except § 318(a)(4)), at least 10 percent of the total voting power or value of the stock of target that is not recently disposed stock. Reg. § 1.336-1(b)(18).

- New target is treated as acquiring all of its assets from an unrelated person in a single transaction at the close of the disposition date, but before the deemed liquidation (or, in the case of a § 355 distribution, before the distribution) in exchange for an amount equal to the AGUB. With certain modifications, Reg. § 1.336-4 generally resembles Reg. § 1.338-5 to determine target's AGUB. New target allocates AGUB among its assets in the same manner as in Reg. §§ 1.338-6 and 1.338-7. Reg. §§ 1.336-2(b)(1)(ii) and 1.336-2(b)(2)(ii).

- Any stock retained by a seller (or a member of its consolidated group) or an S corporation shareholder is treated as acquired by the seller on the day after the disposition date at its fair market value, which is a proportionate amount of the grossed-up amount realized on the transfer under the § 336(e) election. Reg. §§ 1.336-2(b)(1)(v) and 1.336-2(b)(2)(iv). A continuing minority shareholder is generally unaffected by the § 336(e) election. Reg. § 1.336-2(d).

- A holder of nonrecently disposed stock may irrevocably elect (similarly to under § 338) to treat the nonrecently disposed stock as being sold on the disposition date. Reg. § 1.336-4(c). The gain recognition election is mandatory if a purchaser owns (after applying § 318(a), other than § 318(a)(4)) 80 percent or more of the voting power or value of target stock. Reg. §§ 1.336-1(b)(15) and 1.336-4(c).

- A taxpayer will be allowed to make a protective § 336(e) election if it is unsure whether a transaction constitutes a qualified stock disposition, e.g. the disposition date is the first day of the 12-month disposition period that may span two taxable years. A protective election will have no effect if the transaction does not constitute a qualified stock disposition, but it will otherwise be binding and irrevocable. Reg. § 1.336-2(j).

- *Correction to Reg. § 1.338-5.* Reg. § 1.338-5(d)(3)(ii) is corrected to use the grossed-up basis of recently purchased stock in determining the basis amount, rather than the non-grossed-up basis.

- *Effective date.* The regulations apply to any qualified stock disposition for which the disposition date is on or after May 15, 2013.

**2. The Eleventh Circuit interprets a tax sharing agreement. You don't often see cases like this.** *Zucker v. FDIC*, 727 F.3d 1100 (11th Cir. 8/15/13). This case involved the interpretation of a tax sharing agreement (TSA) among members of a consolidated group. The TSA provided that although the parent holding company would file the group's tax return, a bank subsidiary would pay all income taxes for the group and receive contributions from other members of the group and the bank would pay any member of the group that member's share of any refund. The day after the bank was closed and the FDIC appointed its receiver, the holding company filed for Bankruptcy Act Chapter 11 protection. Subsequently, the holding company received a refund, which it treated as part of the bankruptcy estate rather than paying it to the FDIC (as the bank's successor) for distribution pursuant to the TSA. The Eleventh Circuit, in an opinion by Judge Tjoflat, reversed the Bankruptcy Court and held that the refund was not part of the holding company's bankruptcy estate; the refund was to be paid over to the FDIC for distribution to the group's members in accordance with the TSA. Interpreting the TSA contract under the controlling Delaware law, the court found that although the TSA did not contain a provision expressly requiring the holding company to forward the tax refunds to the bank, that was what the parties intended. Thus, the court concluded:

The relationship between the Holding Company and the Bank is not a debtor-creditor relationship. When the Holding Company received the tax refunds, it held the funds intact—

as if in escrow—for the benefit of the Bank and thus the remaining members of the Consolidated Group. The parties intended that the Holding Company would promptly forward the refunds to the Bank so that the Bank could, in turn, forward them on to the Group’s members. In the Bank’s hands, the tax refunds occupied the same status as they did in the Holding Company’s hands—they were tax refunds for distribution in accordance with the TSA.

**3. The Tax Court invokes a “common law” doctrine to disallow a double deduction for the same economic loss.** Duquesne Light Holdings, Inc. v. Commissioner, T.C. Memo. 2013-216 (9/11/13). Duquesne was the common parent of a consolidated group of corporations. Duquesne held 1.2 million shares of AquaSource, which until 2001 was a wholly-owned member of the group. In 2001, Duquesne sold 50,000 shares of AquaSource, in which it claimed to have a basis of \$206,402,100 to Lehman Brothers—remember them—for \$4,000,000 and claimed a \$202,402,100 capital loss. Duquesne filed an application for tentative refund, in which it carried back from 2001 \$161,640,702 to year 2000, \$135,267,183 of which was attributable to the 2001 stock loss in question, and the IRS paid a tentative refund. Subsequently, AquaSource, while still a member of the group, sold various assets resulting in aggregate recognized losses exceeding \$235,000,000, which were claimed on Duquesne’s consolidated return, which were carried back to 2000. The IRS determined that the 2001 loss on the disposition of 50,000 shares of AquaSource stock (approximately 4 percent of the stock) recognized by the common parent was a loss attributable to the fact that there was built-in loss in the underlying assets of AquaSource, and that under the doctrine of *Charles Iffeld Co. v. Hernandez*, 292 U.S. 62 (1934), the group was not permitted to take the duplicative losses upon the subsequent sale of the underlying assets that were sold in 2002. The Tax Court (Judge Chiechi) upheld the IRS’s determination, relying in part on *Thrifty Oil v. Commissioner*, 139 T.C. 198 (2012). In doing so, it held that *Charles Iffeld Co.* continues to be “a vital canon of statutory construction in tax law,” even after the implementation of former Reg. § 1.1502-32. The court rejected the taxpayer’s argument that *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), supported allowing the deduction, and that the disallowance of double deductions could be effected only through the promulgation of valid regulations. Although the court acknowledged that former Temp. Reg. § 1.1502-35T, which was in effect for the years in question, did not disallow the losses, nothing prohibited the court from disallowing duplicate deductions for the same economic loss under *Charles Iffeld Co.* Finally, the court held that even though the statute of limitations had expired for 2000 – the year to which losses had been carried

back – the period was still open pursuant to § 6501(h) and § 6501(k), thereby allowing the tentative refund to be assessable.

## H. Miscellaneous Corporate Issues

1. **There goes corporate letter ruling practice!** Rev. Proc. 2013-32, 2013-28 I.R.B. 55 (6/25/13), modifying Rev. Proc. 2013-1, 2013-1 I.R.B. 116. The IRS will no longer rule on whether a transaction qualifies for nonrecognition treatment under §§ 332, 351, 355, or 1036, or on whether a transaction constitutes a reorganization within the meaning of § 368, regardless of whether the transaction presents a significant issue and regardless of whether the transaction is an integral part of a larger transaction that involves other issues upon which the IRS will rule. However, the IRS will rule on one or more issues under those sections to the extent that such issue or issues are significant. There is no limit on the number of significant issues that may be the subject of a single letter ruling. A “significant issue is an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction.”

2. “[A]doption of these exceptions [to § 382(g)] is appropriate because these transactions do not introduce new capital into the loss corporation and because direct or indirect ownership of the loss corporation becomes less concentrated, thus diminishing the opportunity for loss trafficking.” T.D. 9638, Application of the Segregation Rules to Small Shareholders, 78 F.R. 62418 (10/22/13). The Treasury Department has promulgated amendments to Reg. § 1.382-3 (proposed in REG-149625-10, Application of the Segregation Rules to Small Shareholders, 76 F.R. 72362 (11/23/11)). The amendments to Reg. § 1.382-3 reduce the complexity of applying § 382 in tracking transactions involving small amounts of stock of a loss corporation. Reg. § 1.382-3 provides that all shareholders who do not individually own 5 percent of a loss corporation are grouped together and treated as a single “public group” 5-percent shareholder. However, Temp. Reg. § 1.382-2T segregates into two or more public groups any public group of less than 5 percent stockholders that can be separately identified as having acquired their stock in a particular transaction. The amendments to the regulations provide that the segregation rule does not apply to transfers of a loss corporation’s stock to non-5-percent shareholders by 5-percent shareholders, or entities that directly or indirectly own at least 5 percent of a loss corporation whose owners (excluding those who are 5-percent shareholders of a loss corporation) own, in the aggregate, 5 percent or more of a loss corporation. The amendments to the regulations also provide that the segregation rules do not apply to transfers of ownership interests in 5-percent entities to shareholders who are not themselves 5-

percent shareholders. The proposed regulations also provide a special exception under which a loss corporation may annually redeem 10 percent of the value of its stock, or 10 percent of the shares of a particular class of stock, without triggering the segregation rules and the creation of new 5-percent groups. This redemption rule also applies to redemptions of not more than 10 percent of the value (or class of stock) of an entity that is a 5-percent owner of the loss corporation. The amendments also extend the 10-percent limitation for the application of the small issuance exception to issuances of stock by a 5-percent entity, calculated by reference to the value of the stock of the issuing entity. Transactions that under the prior version of the regulations resulted in the creation of a new public group, and thus a possible owner shift, now are simply folded into the existing public groups, thereby reducing the chance of an ownership change. The amendments also add an anti-abuse rule to the small issuance (issuance of stock that does not exceed 10 percent of the total value (or 10 percent of the class) of the corporation's outstanding stock at the beginning of the taxable year) exception. The effective dates for various amendments vary, with some effective as early as 11/4/92, and others effective 10/22/13.

## VII. PARTNERSHIPS

### A. Formation and Taxable Years

**1. Final regulations cover noncompensatory options on partnership interests.** T.D. 9612, Noncompensatory Partnership Options, 78 F.R. 7997 (2/5/13). Final regulations under § 721 generally provide for nonrecognition of gain or loss to the partnership or option holder on the exercise of a noncompensatory stock option that grants the holder the right to acquire an interest in the issuer (defined as an option not issued in connection with the performance of services) on the transfer of money or property to the partnership. The regulations also address the maintenance of partnership capital accounts and the determination of partners' distributive shares. As a brief and horribly incomplete summary of the lengthy regulation—

- The regulations provide that § 721 does not apply to the transfer of property in exchange for an option or the satisfaction of a partnership obligation by issuance of an option. The transfer or satisfaction will result in recognition of gain or loss to the option recipient and open transaction treatment with respect to the partnership. The regulations do provide for § 721 treatment for the receipt of convertible equity in exchange for property.

- Section 721 does not apply to the issuance of an option for accrued but unpaid interest, interest on convertible debt, rent, or royalties.

- The nonrecognition rule of § 721 does not apply to the exercise of a noncompensatory option issued by a disregarded entity that would become a partnership if the option were exercised.

- The investment partnership rules of § 721(b) apply to cause recognition if the partnership would be treated as an investment company.

- Cash settlement of a noncompensatory option is treated as a sale or exchange of the option under § 1234 rather than as a contribution to a partnership.

- Lapse of a noncompensatory option is treated as recognition of gain to the partnership and a loss to the option holder to the extent of the option premium. For this purpose, proposed regulations under § 1234 would treat partnership interests as securities for purposes of § 1234 (REG-106918-08, Treatment of Grantor of an Option on a Partnership Interest, 78 F.R. 8060 (2/5/13)).

- Redemption of an interest following exercise of a noncompensatory option may be treated as a disguised sale. In addition, general tax principles will apply to determine the nature of the transaction if the exercise price of a noncompensatory option exceeds the capital account received by the option holder.

- The regulations permit revaluation of partnership capital accounts on issuance of a noncompensatory option and provide further that any revaluation of partnership capital accounts must take into account the fair market value of any outstanding noncompensatory options. The value of partnership property must be adjusted to reflect the difference (if any) between the value of outstanding noncompensatory options and the amount paid by the option holder as consideration for the option.

- The regulations require corrective allocations to account for any shift in partners' capital accounts that results from capital account reallocations pursuant to exercise of a noncompensatory option. Corrective allocations to the option holder can only include items properly allocable to a partner who suffered a capital account reduction.

- Noncompensatory options are generally not characterized as partnership equity. However, an option holder will be treated as a partner if the option holder's rights are "substantially similar" to rights afforded to a partner, and there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and option holder's aggregate Federal tax liabilities under the facts and circumstances. The relevant facts and circumstances include the likelihood that the option would be exercised. The regulations contain a couple of safe harbors indicating that an option is not reasonably expected to be recognized (exercisable more than 24 months after the measurement date with a strike price equal to or greater than 110 percent of

the value of the interest, or the strike price is equal to or greater than fair market value of the interest on the exercise date). The facts and circumstances determination whether an option holder has partner attributes includes whether the option holder has managerial rights in the partnership and rights to share in partnership profits through current and liquidating distributions, and has partnership obligations.

**2. Even the used car salesman has to provide evidence of partnership status.** *Azimzadeh v. Commissioner*, T.C. Memo. 2013-169 (7/23/13). The Tax Court (Judge Holmes) rejected the taxpayer's assertion that his small California used car business was a partnership with a person called Barghi, who also was in the automobile sales business. The court indicated that partnership status was a question of Federal tax law, regardless of whether the taxpayers formed a separate state law entity, and applied the eight factors of *Luna v. Commissioner*, 42 T.C. 1067 (1964), to answer the ultimate test of *Commissioner v. Culbertson*, 337 U.S. 733 (1949), described as "whether the parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise." Looking to the *Luna* factors the court determined that the absence of a partnership agreement weighed against partnership status, the lack of proof regarding mutual contributions to the venture was neutral, Barghi's authority to write checks as control over income favored partnership status, that proof of the nature of the relationship with Barghi as a co-proprietor or supplier "left only the muddiest of tracks," the absence of K-1s and other partnership return filings, the absence of partnership books indicating Barghi's interest in the enterprise, weighed against partnership status, and the absence of evidence of Barghi's joint control other than signature authority on the checking account was a neutral factor. Thus, only one of the *Luna* factors supported partnership status while the rest were negative or neutral. The partnership went down by the count. The court also affirmed the IRS's reconstruction of the taxpayer's income from bank deposits and the IRS's denial of cost of goods sold and other claims.

**3. You can be partners without realizing you are. And if it turns out to be your benefit, you can change your tune in the course of litigation.** *Jimastowlo Oil, LLC v. Commissioner*, T.C. Memo. 2013-195 (8/26/13). The taxpayer LLCs purchased percentage working interests in oil and gas leaseholds operated by Energytec on a cooperative basis—i.e., as an economic activity collectively owned and cooperatively exploited) for the working interest owners—but there was no formal written joint operating agreement executed by the working interest owners. To carry out the actual operation of the wells Energytec employed another company. The operating company was supposed to collect oil from the wells in tanks, sell the collected oil, offset operating expenses against sale proceeds, and

apportion what remained among the working interest owners in proportion to their percentage interests. No working interest owner could take in kind or sell on its own its share of any oil production. When Energytec subsequently presented the LLCs and the other working interest owners in the leaseholds with draft joint operating agreements formally designating its wholly owned subsidiary as operator of the wells, many of the leasehold owners, including the LLCs, would not execute the draft agreements. In actual operation most of the working interest owners, including the LLCs, initially received recurring payments that did not vary with production, oil and gas prices, or operating expenses. Eventually, Energytec notified the working interest owners that the recurring payments had exceeded the net revenue that was due to them and that subsequent revenue distributions would be applied against the outstanding balance due to Energytec. Alternatively, the affected working interest owners could “pay the outstanding balance due Energytec and subsequently receive revenue distributions based upon actual revenues less applicable lease operating expenses.” The LLCs opted to pay the amount due to Energytec. The issue before the Tax Court (Judge Halpern) was whether the informal joint operating agreement was a partnership. If so, FPAA to the LLCs denying deductions and treating reported losses as passive activity losses under § 469 were invalid because no FPAA had been issued with respect to the joint venture.

The principle ... that [the Tax Court] lack[s] jurisdiction to redetermine affected items attributable to a source partnership before the source partnership-level proceedings have been completed, applies even when the members of the source partnership have failed to recognize that they have created a separate entity (i.e., a partnership) for Federal income tax purposes and have not, therefore, filed a partnership return on its behalf, and the Commissioner has neither conducted a source partnership-level audit nor issued an FPAA to it.

Judge Halpern held that the joint operating agreement constituted a partnership under § 761(a) and that FPAA to the LLCs were invalid. To exploit the working interests, the co-owners cooperated, with Energytec acting as common agent operating the wells for the working interest owners. No owner could take his share of production in kind or sell it independently of the other owners, and they were not merely sharing expenses. They were jointly carrying on a trade or business and dividing the proceeds therefrom. Thus, the working interest owners “jointly carried on a trade or business, dividing the proceeds therefrom among themselves, each trade or business constituted for Federal tax purposes an entity separate from the co-owners of



the appurtenant working interest.” Because there was no argument that the resulting entity should be classified as a trust (or otherwise specially classified), the entity must have been classified as either a partnership or a corporation under Reg. § 301.7701-2(a), and because it was a domestic business entity with more than two members that was not a per se corporation (and did not elect to be classified as a corporation), it was, by default, a partnership pursuant to Reg. § 301.7701-3(a) and (b)(1).

**4. Section 47 historic rehabilitation credits were allowed to an LLC (taxed as a partnership) in which Pitney Bowes was a 99.9 percent member despite an IRS challenge under the anti-abuse provisions of Reg. § 1.701-2, but it was too late to keep the Miss America Pageant in Atlantic City.** Historic Boardwalk Hall, LLC v. Commissioner, 136 T.C. 1 (1/3/11). The Tax Court (Judge Goeke) held that the ownership interest on the historic East Hall of the Atlantic City Boardwalk Hall under a 35-year lease belonging to the New Jersey Sports and Exposition Authority could be transferred to Historic Boardwalk Hall, LLC, in which Pitney Bowes (through a subsidiary and an LLC) was the 99.9 percent member (and the NJSEA was the 0.1 percent member). Along with ownership went the § 47 Federal tax credit of 20 percent of the qualified rehabilitation expenditures incurred in transforming the run-down East Hall from a flat-floor convention space to a “special events facility” that could host concerts, sporting events, and other civic events. Pitney Bowes became the 99.9 percent member of Historic Boardwalk Hall, LLC, following an offering memorandum sent to nineteen large corporations, which described the transaction as a “sale” of tax credits (although that description was not repeated in any of the subsequent documents relating to the transaction). NJSEA lent about \$57 million to Historic Boardwalk Hall, and Pitney Bowes made capital contributions of more than \$18 million to that LLC, as well as an investor loan of about \$1.2 million. In that offering memorandum, losses were projected over the first decade of operation of East Hall. The IRS argued that the bulk of the Pitney Bowes contributions were paid out to NJSEA as a “development fee” and that the entire transaction was a sham because NJSEA was going to develop East Hall regardless of whether Pitney Bowes made its capital contributions and loan.

- Judge Goeke held that one of the purposes of § 47 was “to encourage taxpayers to participate in what would otherwise be an unprofitable activity,” and the rehabilitation of East Hall was a success, leading to the conclusion that Historic Boardwalk had objective economic substance. He also held that “Pitney Bowes and NJSEA, in good faith and acting with a business purpose, intended to join together in the present conduct of a business enterprise” and that while the offering memorandum used the term “sale,” “it was used in the context of describing an investment transaction.” Finally, Judge Goeke used Reg. § 1.701-2(d), Example (6),

involving two high-bracket taxpayers who joined with a corporation to form a partnership to own and operate a building that qualifies for § 42 low-income housing credits, to conclude that Reg. § 1.701-2 did not apply to the Historic Boardwalk transaction because that regulation “clearly contemplate[s] a situation in which a partnership is used to transfer valuable tax attributes from an entity that cannot use them . . . to [a taxpayer] who can . . . .”

- Query whether “economic substance” requirements are applicable when the tax benefits take the form of tax credits enacted to encourage specific types of investments?

a. “[T]he sharp eyes of the law’ require more from parties than just putting on the ‘habiliments of a partnership whenever it advantages them to be treated as partners underneath.’ ... Indeed, *Culbertson* requires that a partner ‘really and truly intend[] to ... shar[e] in the profits and losses’ of the enterprise. ... And, after looking to the substance of the interests at play in this case, we conclude that, because Pitney Bowes lacked a meaningful stake in either the success or failure of Historic Boardwalk Hall, it was not a bona fide partner.” Historic Boardwalk Hall LLC v. Commissioner, 694 F.3d 425 (3d Cir. 8/27/12), cert. denied, 5/28/13. In a unanimous opinion by Judge Jordan, the Third Circuit reversed the Tax Court and held that Pitney Bowes was not a bona fide partner in Historic Boardwalk Hall LLC. The court’s reasoning was based on the *Culbertson* test [*Commissioner v. Culbertson*, 337 U.S. 733 (1949)], as applied by the Second Circuit in *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 232 (2d Cir. 2006) (*Castle Harbour II*), to find that the Dutch banks were not partners, and the reasoning of the Fourth Circuit in *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), to find that the investors who acquired the Virginia Historic Rehabilitation credits through the partnership bore no “true entrepreneurial risk,” which the Third Circuit concluded was a characteristic of a true partner under the *Culbertson* test. The Third Circuit concluded that Pitney Bowes was not a partner because, based on an analysis of the facts, as the transaction was structured, (1) Pitney Bowes “had no meaningful downside risk because it was, for all intents and purposes, certain to recoup the contributions it had made to HBH and to receive the primary benefit it sought — the HRTCs or their cash equivalent,” and (2) Pitney Bowes’s “avoidance of all meaningful downside risk in HBH was accompanied by a dearth of any meaningful upside potential.” The analysis was highly factual and based on substance over form. As for downside risk, the Court of Appeals reversed as clearly erroneous the Tax Court’s finding that Pitney Bowes bore a risk because it might not receive an agreed upon 3 percent preferred return on its contributions to HBH. Referring to *Virginia Historic Tax Credit Fund*, the Third Circuit treated the 3 percent preferred return as a

“return on investment” that was not a “share in partnership profits,” which pointed to the conclusion that Pitney Bowes did not face any true entrepreneurial risk. As for upside potential, applying the substance over form doctrine, the court concluded that “although in form PB had the potential to receive the fair market value of its interest . . . in reality, PB could never expect to share in any upside.” The court noted that it was mindful “of Congress’s goal of encouraging rehabilitation of historic buildings,” and that its holding might “jeopardize the viability of future historic rehabilitation projects,” but the court observed that it was not the tax credit provision itself that was under attack, but rather the particular transaction transferring the benefits of the credit in the manner that it had.

- The opinion makes it very clear that the decision was based on applying the “substance over form” doctrine rather than the “economic substance” doctrine to determine that Pitney Bowes was not a partner.

**b. The IRS is gilding the lily of its *Historic Boardwalk* victory.** FAA 20124002F, 2013 TNT 41-18 (dated 8/30/12; released 10/5/12). This Field Attorney Advice dealt with whether a taxpayer was a partner in a partnership that generated § 47 historic rehabilitation tax credits. The FAA held that under the *Culbertson* doctrine, as applied in *Castle Harbour*, the taxpayer was not a partner. The taxpayer had no meaningful downside risk in that it is assured of receiving the benefit of its bargain, and it had no upside potential. All it could receive was its specified priority return. Alternatively, the purported partnership was a sham; it served no business purpose. Its only purpose was to effect a sale of the rehabilitation tax credits to the taxpayer. *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), which held that a sale-leaseback transaction involving solar energy equipment had economic substance even though the investment had a negative rate of return before taking into account tax benefits, was distinguished on the ground that the transaction at issue in *Sacks* otherwise had economic substance in terms of risk and reward. In reaching the conclusion, the FAA states as follows:

In any event, the notion that a court may consider tax benefits in evaluating the economic substance of a transaction involving — or of a purported partnership engaged in — tax-favored activity finds no support apart from *Sacks*. Two circuits, in analyzing the economic substance of American Depository Receipts (ADR) transactions, determined that it was inappropriate to deduct the cost of foreseeable foreign taxes imposed on the transaction in determining the expected pre-tax profit of the transaction. See *Compaq Computer Corp. v. Commissioner*,

277 F.3d 778 (5th Cir. 2001) and IES Industries, Inc. v. United States, 253 F.3d 350 (8th Cir. 2001). These holdings address the calculation of pre-tax profit to be used in determining whether transactions resulted in pre-tax economic losses; they do not stand for the proposition that United States tax credits may serve as a substitute for economic profit. As such, these cases do not adopt the court's holding in Sacks that a court may consider tax benefits in evaluating the economic substance of a transaction involving — or of a purported partnership engaged in — tax-favored activity.

- This position is absurd because the purpose of tax credits is to encourage taxpayers to engage in otherwise unprofitable activities. A holding that an activity that is unprofitable before taking tax credits into consideration lacks economic substance defeats that purpose.

**c. The IRS now provides a Safe Harbor under which it will not use its *Historic Boardwalk* victory to challenge allocations of § 47 rehabilitation credits to investor partners.** Rev. Proc. 2014-12, 2014-3 I.R.B. 415 (12/31/13). This revenue procedure specifies the conditions under which the IRS will not challenge partnership allocations of § 47 rehabilitation credits. Section 4 of the revenue procedure contains the requirements for the Safe Harbor. It defines investors as partnership partners (other than principals) (§4.01); provides for an investor's minimum partnership interest (§4.02); provides for an investor's minimum unconditional contribution of 20 percent of the investor's total expected capital contribution before the date the building is placed in service (§4.03); and requires that at least 75 percent of the investor's total expected capital contribution be fixed in amount before the building is placed in service (§4.04).

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

**1. Consistency for small minds – allocations to foreign partners, withholding at one rate, taxable at another.** Ann. 2013-30, 2013-21 I.R.B. 1134 (4/24/13). Partnership income effectively connected to a U.S. trade or business allocable to a foreign partner is subject to withholding at the highest rate specified in §§ 1 or 11. Fiscal year partnerships for a year beginning in 2012 must withhold at rates in effect for 2012. Foreign partners who include partnership income for a partnership year

ending in 2013, however, are subject to tax at the 2013 rates as increased by the American Taxpayer (and not so grand compromise) Relief Act of 2012.

2. **“This appears to be an issue of first impression as no case has specifically decided whether the transferor or the transferee of a nonvested partnership capital interest must include in gross income the undistributed partnership profit or loss allocations attributable to the partnership capital interest.”** Crescent Holdings, LLC v. Commissioner, 141 T.C. No. 15 (12/2/13). This TEFRA partnership case addressed the treatment of partnership income recognized while a partner held a two percent restricted membership interest received for services that was forfeitable, and thus not vested, and for which no § 83(b) election had been made. An individual (Fields) received a two percent capital interest in a partnership (Crescent Holdings LLC) as compensation for entering into a contract to provide services to a lower-tier entity (Crescent Resources LLC). Field’s membership interest in Crescent Holdings would be forfeited if he terminated his employment with Crescent Resources before three years after the formation of Crescent Holdings. His interest was nontransferable until the forfeiture restrictions lapsed. He was entitled to the same distributions as other holders of member interests and that any distributions he received were not subject to forfeiture. No § 83(b) election was made. Crescent Holdings issued Schedules K-1 allocating \$423,611 of ordinary business income to Fields for 2006 and \$3,608,218 for 2007 as his § 702 distributive share of the partnership’s income. No distributions were made. Fields did not believe that the Schedules K-1 were proper because he did not believe that he was a partner for tax purposes. Fields argued that § 83 applied to his interest in Crescent Holdings and because his right to the interest never vested, he was not the owner of the interest under Reg. § 1.83-1(a)(1) and should not be allocated any partnership profits or losses attributable to the interest for the years at issue. The partnership argued that § 83 did not apply to Fields’ interest because it was a profits-only interest and that under Rev. Proc. 93-27, 1993-2 C.B. 343, Fields was liable for tax on his share of the undistributed profits of Crescent Holdings for the years at issue. Alternatively, the partnership argued that if Rev. Proc. 93-27 did not apply, then Reg. § 1.721-1(b)(1) controlled and Fields thus was the owner of the interest. The IRS argued that Rev. Proc. 93-27 and Rev. Proc. 2001-43, 2001-2 C.B. 191, apply only to partnership profits interests and are inapplicable to a partnership capital interest, and that Fields’ interest in Crescent Holdings was a capital interest. The IRS’s position was that Field’s capital interest was subject to § 83 and that because under Reg. § 1.83-1(a)(1) he was not the owner of the interest, no profit or loss should have been allocated to him for the years at issue. The Tax Court (Judge Ruwe) held for Fields and the IRS on all counts.

- First, the court held that Fields' interest was a capital interest, not a profits interest. Under Rev. Proc. 93-27, a capital interest is "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership." Under the contractual terms of the Crescent Holding LLC agreement, absent "priority capital contributions," of which there were none, the LLC members were entitled to receive liquidating distributions equal to their percentage interests. Thus, the fact that Fields did not have any initial capital account did not mean that he did not have a capital interest. If Crescent Holdings had liquidated immediately after Fields received his interest, he would have received a share of the proceeds. Thus, Rev. Proc. 2001-43 and Rev. Proc. 93-27 were not applicable.

- Second, the court held that a partnership capital interest is "property" for purposes of § 83, citing *Larson v. Commissioner*, T.C. Memo. 1988-387 and *Campbell v. Commissioner*, T.C. Memo. 1990-162, *aff'd in part, rev'd in part on other grounds*, 943 F.2d 815 (8th Cir. 1991), and Reg. § 1.83-1(a)(1) applied to Fields' interest in Crescent Holdings. Reg. § 1.83-1(a)(1) provides that "[u]ntil such property becomes substantially vested, the transferor shall be regarded as the owner of such property." The court rejected the argument that the absence of a reference to partnership interests in the legislative history of § 83 indicated that Congress did not intend § 83 to apply to partnership interests.

- Third, the court held that although neither § 83 nor Reg. § 1.83-1(a)(1) specifically addressed the issue, the transferee of a nonvested partnership capital interest does not recognize in income the undistributed partnership profit or loss allocations attributable to that interest. In this case Fields' right to receive the undistributed income allocations attributable to the interest was subject to the same substantial risk of forfeiture as his right to the partnership interest itself; if he forfeited his right to the interest, then he would also forfeit his right to receive any benefit from the undistributed income allocations. The undistributed income allocations were subject to the same substantial risk of forfeiture as the two percent interest in Crescent Holdings. The court noted that had Fields continued his employment until the interest vested, the fair market value of the interest includable in gross income at that time would have included the undistributed income.

- Fourth, the court held that under Reg. § 1.83-1(a)(1) undistributed partnership allocations attributable to a nonvested partnership capital interest are included in the gross income of the transferor. Based on the contractual provisions regarding the formation of the two LLCs, Crescent Holdings was the transferor. Accordingly, the profits and losses attributable to the forfeitable two percent interest should be allocated to the other LLC members (partners) in accordance with their distributive shares (which in this case were pro rata to their percentage interests).

**3. Proposed regulations allocate liabilities among multiple parties and among related parties.** REG-136984-12, Section 752 and Related Party Rules, 78 F.R. 76092 (12/16/13). The IRS has proposed regulations to address allocation of the risk of economic loss for purposes of allocating partnership liabilities to a partner's basis. Under Reg. § 1.752-2(a) a partner is allocated a share of recourse liability to the extent that the partner or a related person bears the economic risk of loss. A liability is nonrecourse when no partner or related person bears an economic risk of loss.

- *Multiple Parties* Under Prop. Reg. § 1.752-2(a)(2) where multiple partners bear the economic risk of loss with respect to the same liability, the amount of the liability will be taken into account only once, and if the total amount of liability borne by the partners exceeds the amount of the liability, the economic risk of loss to be borne by each partner would be determined by multiplying the amount of the liability by a fraction determined by dividing the amount of the economic risk of loss of a partner over the sum of the amount of loss borne by all partners. Thus, as illustrated by an example in the proposed regulations, where partner A guarantees the full \$1,000 of a bank loan to the AB partnership and partner B guarantees \$500 of the liability, the amount of the liability allocable to A is \$667 ( $\$1,000 \times \$1,000/\$1,500$ ) and the amount of the liability allocable to B is \$333 ( $\$1,000 \times \$500/\$1,500$ ). Prop. Reg. § 1.752-2(i) would be amended to provide that where a liability of a lower-tier partnership is allocated both to the upper-tier partnership and to a partner who bears economic risk of loss as a partner in both the upper-tier and lower-tier partnerships, the basis resulting from such a liability will be allocated directly to the partner of the lower-tier partnership rather than to the upper-tier partnership.

- *Related Persons* Under Reg. § 1.704-4(b)(1) an individual and a corporation are treated as related persons if the individual is an 80 percent or greater shareholder. Where the corporation is a lender to a partnership or has a payment obligation with respect to a partnership liability, Prop. Reg. § 1.752-4(b)(1)(iv) would disregard the application of § 267(c)(1) that provides that stock owned by a partnership is treated as owned proportionately by its partners. As a result, a partner in a partnership that owns 80 percent of the stock of the corporate lender will not be treated as related to the corporation that bears the economic risk of loss. Prop. Reg. § 1.752-4(b)(2) would provide that if a person who is a lender or has a payment obligation for a partnership liability is related to more than one partner, the liability will be shared equally among the related partners. This rule revises the existing provision that allocates the liability to the partner with the highest percentage of related ownership. In addition, the rule of Reg. § 1.752-4(b)(2)(iii), which provides that persons owning interests in the same partnership are not treated as related persons for purposes of determining economic risk for partnership liabilities would be modified to apply only to persons who bear the economic

risk for a liability as a lender or have a payment obligation for the partnership liability.

- The proposed regulations are to be effective on the date final regulations are published in the Federal Register.

### C. Distributions and Transactions Between the Partnership and Partners

1. **DAD follows the Son of Boss into the tax shelter abyss.** Superior Trading, LLC v. Commissioner, 137 T.C. 70 (9/1/11). This case involved a so-called distressed asset/debt (DAD) tax shelter structure created by John Rogers, tax lawyer and purported international finance expert. The Tax Court (Judge Wherry) described the structure by noting that, “true to the poet’s sentiment that ‘The Child is father of the Man’, the DAD deal seems to be considerably more attenuated in its scope, and far less brazen in its reach, than the Son of BOSS transaction.” At the top of Rogers’ pyramid, Warwick Trading, LLC acquired uncollectable receivables from a bankrupt Brazilian retailer under a contribution arrangement. Warwick claimed a transferred basis in the receivables equal to their face value under § 723. The receivables were then contributed through multiple tiers of trading companies, interests in which were sold to individual investors. Not long after the contribution transaction, the interest of the Brazilian retailer in Warwick was redeemed, but no § 754 election to adjust basis under § 743(b) was made. Ultimately the individual investors claimed loss deductions though their interests in the trading company partnerships as the receivables were liquidated at their depreciated value through an accommodating party. These transactions occurred before the October 2004 revisions to §§ 704(c), 734 and 743 (requiring allocations of built-in loss only to the contributing party, limiting basis to FMV at the time of contribution, and requiring mandatory basis adjustments on distributions involving substantial basis reductions). The court found multiple grounds on which to undo these transactions.

- First, the court held that the original contribution of the receivables was not a partnership transaction under § 721 with § 723 transferred basis, but was instead a sale. The court concluded that the Brazilian retailer was never a partner in a partnership with a joint-profit motive, and thus the transfer of the receivables in the initial transaction was not a § 721 contribution to a partnership.

- The Brazilian retailer’s receipt of money within two years of the transfer of the receivables supported recharacterization of the transaction as a sale under § 707(a)(2)(B).



- From the Brazilian retailer's financial statements the court found that the receivables had a zero basis at the time of the contribution in any event.

- And if that was not enough, the court collapsed the transaction under the step-transaction doctrine into a single transaction that consisted of a sale of the receivables for the amount of cash payments eventually made to the Brazilian retailer on redemption of its interest. Thus, Warwick's basis in the receivables was no higher than the cash payment, which the taxpayer failed to substantiate, resulting in a zero basis.

- Interestingly, the court concluded that it was not necessary to address the broad judicial economic substance doctrine that other courts had used to disallow the tax benefits of the Son-of-Boss cases. The court said that, "Because of a DAD deal's comparatively modest grab and highly stylized garb, we can safely address its sought-after tax characterization without resorting to sweeping economic substance arguments" and added that, "we need only look at the substance lurking behind the posited form, and where appropriate, step together artificially separated transactions, to get to the proper tax characterization."

- All of that was followed by an accuracy-related penalty under § 6662.

**a. The Seventh Circuit goes back to the generic economic substance doctrine and addresses the penalties.** Superior Trading, LLC v. Commissioner, 728 F.3d 676 (7th Cir. 8/26/13). Rather than focus on the technical application of the partnership provisions, with a generic tax shelter analysis, Judge Posner stated flat out that the partnership was a sham and said that, "If the only aim and effect are to beat taxes, the partnership is disregarded for tax purposes." The court's opinion is interesting for its holding on the § 6662 40 percent gross valuation misstatement penalty. The Seventh Circuit joined the majority view that "a taxpayer who overstates basis *and* participates in sham transactions, as in this case, should be punished at least as severely as one who does only the former." The minority view was that the gross valuation penalty applied only applicable to an overstatement of value and thus was not applicable to deficiencies attributable to transactions that lack economic substance. As discussed in section VIII.D. of this outline, in Woods v. United States, 134 S. Ct. 557 (12/3/13), *rev'g* 471 Fed. Appx. 320 (5th Cir. 6/6/12), the Supreme Court resolved the conflict among the circuits.

- In a warning that might be applicable to our headlines, Judge Posner also chided the Tax Court by saying in a parenthetical, "We note with disapproval the loquacity of, and lame attempts at humor in, the Tax Court's opinion, which include making fun of Rogers' name, as in the section title 'Mr. Rogers' Neighborhood.'"

**b. And the money hidden in Mr. Rogers' house is taxable to him.** Rogers v. Commissioner, 728 F.3d 673 (7th Cir. 8/26/13). John Rogers, the promoter of the DAD shelter in *Superior Trading*, was the sole shareholder of an S corporation, Portfolio Properties, Inc. (PPI), which received \$2.4 million in payments from investors in the DAD shelter. Of that money, \$1.2 million was transferred to the LLC that was the general partner in the shelter as the purchase price for the depreciated receivables used in the shelter. Rogers argued that the full \$2.4 million was held in trust for the shelter partnership, Warwick. The Seventh Circuit (Judge Posner) agreed that the money actually transferred to Warwick was received by PPI impressed with a fiduciary obligation and therefore not taxable to PPI. However, the court stated that the Tax Court was not required to believe Rogers' testimony that the funds not transferred to Warwick were held in trust. The Tax Court's conclusion was bolstered by the fact that a portion of the funds was distributed to Rogers. Judge Posner also remarked on the "minuteness" of the \$500 § 6662 penalty imposed on Rogers' \$269,107 tax deficiency.

**c. The Tax Court again finds a disguised sale in the DAD transaction.** Buyuk L.L.C. v. Commissioner, T.C. Memo. 2013-253 (11/6/13). Judge Laro held that the DAD (distressed debt structure) marketed by BDO Seidman failed to provide its promised basis step up under alternative holdings that the acquisition of high-basis, low-value receivables was a disguised sale under § 707(a)(2)(B), the transaction was in substance an installment sale of the receivables, and the transaction lacked economic substance. Under the DAD structure a Russian utility company, Saratov, transferred distressed receivables to an LLC formed with Gramercy Advisors LLC in exchange for a partnership interest in the LLC. This master LLC then transferred its interest in the receivables to a second LLC in exchange for a membership interest in the second LLC. Gramercy was a one percent member of the second LLC. The tax shelter investor would acquire a 90 percent interest in the second LLC for cash. After the cash contribution the Russian company was redeemed from the master LLC for cash. The second level LLC would transfer the receivables to a third level LLC for a 99 percent interest in that entity. The third level LLC would then exchange the receivables for interests in other Gramercy assets and claim a loss, which was passed through to the tax shelter investor.

• *Section 707(a)(2)(B)*. As it held in *Superior Trading LLC v. Commissioner*, 137 T.C. 70 (2011), *aff'd*, 728 F.3d 676 (7th Cir. 8/26/13), the court concluded that the transfer of receivables by the Russian company to the master LLC was a transfer of property followed by the related distribution of cash treated as a disguised sale under § 707(a)(2)(B). This resulted in a basis for the receivables in the LLC equivalent to the cash

distributed to the Russian company rather than the company's higher basis. The court cited the two-year presumption of Reg. § 1.707-3(c), which the taxpayer failed to overcome. The court also indicated that the contribution and cash distribution were "reciprocal transfers." Further, the court found that the receivables were not at risk in the master LLC and the cash transfers to the Russian company bore no relationship to the entrepreneurial risks of the partnership operations. The court also pointed out that the collection of the receivables was reassigned to the Russian company so that Gramercy's lack of due diligence with respect to the collectability of the receivables indicated that Gramercy was never serious about collecting in order to derive a joint profit on the transaction. Rather than conducting a detailed analysis of the 10 facts and circumstances enumerated in Reg. § 1.707-3(f), the court stated that, "the crucial and common theme to be gleaned from the 10 facts and circumstances in the regulations and their examples is that if, at the time of the earlier transfer, it was reasonably certain that the transferor would receive cash or other consideration for the property transferred of an amount determinable with reasonable certainty, the related transfers will be reclassified as a sale."

- *Substance over form and step transaction.* Using a similar analysis the court held that the substance of the whole transaction, including the contribution and distribution of cash, was an installment sale of the receivables. The court stated, "[t]he amount of cash Saratov would receive was already determined at the time of the initial transfer. It was virtually certain from the outset that BDO would be able to collect sufficient money from buyers interested in the tax attributes of the receivables to fund the promised consideration to Saratov. Thus, the overall transaction was in substance an installment sale of the receivables." The court found that the various steps could be collapsed into a single transaction under the end result test and the interdependence test.

- *Economic Substance.* Consistent with the Seventh Circuit's holding in *Superior Trading*, the court concluded that the transaction lacked economic substance under both the objective test (a transaction has economic substance for Federal income tax purposes if the transaction offers a reasonable opportunity for pretax profit) and the subjective test (whether the taxpayer has subjective nontax reasons for entering into the transaction and whether the taxpayer has a legitimate profit motive for doing so). Based on testimony of expert witnesses the court held that there was no realistic possibility for the transaction to break even absent tax benefits. In addition, the court held that the taxpayers did not show any valid business purpose for engaging in the transaction, based in part on the absence of any due diligence with respect to collecting the receivables and transferring the funds to the U.S. master LLC.

- The court sustained § 6662(a) and (b) accuracy and substantial valuation misstatement penalties.

**2. It's difficult to claim you are not a partner when you agree in writing to receive a K-1.** Cahill v. Commissioner, T.C. Memo. 2013-220 (9/18/13). The taxpayer entered into a convoluted memorandum agreement with a partnership (FC) that provided the taxpayer with cash payments — termed a “drawdown”— aggregating to \$175,000. The agreement required the taxpayer to repay the “drawdown” out of future income of the venture that was allocated to him and that outstanding balances would bear interest, while also specifically providing that FC, which changed its name to CFC, would report any draws on a Schedule K-1, Partner's Share of Income, Deductions, Credits, etc., or a Form 1099-MISC, Miscellaneous Income. However, under a formula provided by the terms of the agreement, \$125,000 of the drawdown was not subject to repayment. CFC reported the \$175,000 paid to the taxpayer as a guaranteed payment to a partner and issued a Schedule K-1 reporting a guaranteed payment of \$175,000. Eventually, the relationship soured and the taxpayer refused to sign a formal partnership agreement. The taxpayer did not report any of the \$175,000, and the IRS asserted a deficiency. The Tax Court (Judge Kerrigan) upheld the deficiency, rejecting the taxpayer's arguments that he was not partner and that the \$175,000 was received as a loan. Even though the taxpayer never signed the formal partnership agreement, the memorandum provided the mechanism under which he would share in the profits of FC/CFC and specifically provided that FC/CFC would issue petitioner a Form 1099-MISC or a Schedule K-1 with respect to any money he received, and there was no evidence that he ever objected to receiving a Schedule K-1 on the grounds that he was not a partner. Finally, that FC changed its name to CFC evidenced that he was a partner (the other partners' names being Christie and Friemann). Of the \$175,000, \$125,000 was unquestionably a § 707(c) guaranteed payment because under the terms of the agreement, that amount would have been paid to the taxpayer even if had been an employee; that amount was earned by FC/CFC pursuant to a flat fee (plus expenses) contract with a third-party that called for the taxpayer's services and under the terms of the FC/CFC agreement the gross amount of the fee was to be allocated directly to the taxpayer. The remaining \$50,000 was not a loan because no agreement provided any definite date of repayment or a manner of repayment other than from future FC/CFC income allocated to the taxpayer. Furthermore, the memorandum agreement expressly stated that any draws would be considered income to the taxpayer. The taxpayer also lost on a variety of other issues, none of which presented any interesting points. A § 6662(a) negligence penalty was upheld.

#### D. Sales of Partnership Interests, Liquidations and Mergers

**1. No bingo for Mingo! Former PWC consultant was required to recognize ordinary income attributable to her interest in partnership unrealized receivables on her receipt of convertible promissory notes in connection with the sale of the PWC consulting business to IBM.** *Mingo v. Commissioner*, T.C. Memo. 2013-149 (6/12/13). The taxpayer was a partner in the management consulting and technology services business (consulting business) of PWC until PWC sold its consulting business to IBM. The sale was structured by PWC transferring its consulting business to a newly formed partnership, PwCC, the partners of which were subsidiaries of PWC. Among the assets PWC transferred to PwCC were its consulting business' uncollected accounts receivable for services it had previously rendered (unrealized receivables). PWC then transferred to each of the 417 consulting partners an interest in PwCC and cash in exchange for the partner's interest in PWC. The taxpayer was one of the partners who received a partnership interest in PwCC and cash from PWC in exchange for her partnership interest in PWC. Then the PWC subsidiaries sold their interests in PwCC to IBM, and the 417 consulting partners sold their interests in PwCC to IBM in exchange for convertible promissory notes. The value of the taxpayer's partnership interest in PwCC was \$832,090, of which \$126,240 was attributable to her interest in partnership unrealized receivables, which were uncollected accounts receivable for services. The taxpayer reported her entire gain on the sale under the § 453 installment method, but the IRS asserted a deficiency on the ground that the gain on the § 751(c) unrealized receivables was not eligible for installment reporting. The Tax Court (Judge Paris) held that § 453 installment reporting is not available for gains attributable to § 751(c) unrealized receivables that represent uncollected cash-method accounts receivable for services. The court relied on *Sorensen v. Commissioner*, 22 T.C. 321 (1954), which held that installment reporting was not available with respect to the sale of options to purchase stock that had been granted as compensation for the taxpayer's services, because "[t]he provisions of section [453] relate only to the reporting of income arising from the sale of property on the installment basis. Those provisions do not in anywise purport to relate to the reporting of income arising by way of compensation for services."

- Furthermore, the IRS's determination that the gain attributable to the unrealized receivables was not eligible for § 453 installment sale reporting, after the taxpayer had reported on the installment method, was a change of accounting method subject to § 481(a). As a result the court sustained the IRS's adjustment for the year 2003, the year the IRS initiated the change, even though the gain properly was reportable in 2002, the

year of the sale. The court cited *Bosamia v. Commissioner*, 661 F.3d 250 (5th Cir. 2011), *aff'g* T.C. Memo. 2010-218, for the principle that a § 481(a) adjustment may include amounts attributable to tax years outside the statute of limitations on assessments.

- Finally, because the taxpayer was required to recognize \$126,240 of ordinary income relating to partnership unrealized receivables in 2003, the taxpayer was entitled to increase the basis of the note by that amount, which reduced the reported long-term capital gain for the year in which the note was satisfied by conversion into IBM stock.

**2. A partnership termination is only a termination for some purposes.** REG-126285-12. Partnerships; Start-up Expenditures; Organization and Syndication Fees, 78 F.R. 73753 (12/9/13). Proposed amendments to Reg. §§ 1.195-2(a), 1.708-1(b)(6), and 1.709-1(b)(3) would provide that on a technical termination of a partnership under § 708(b)(1)(B) caused by a sale or exchange of 50 percent or more of partnership interests within a 12-month period, the new partnership deemed to be formed as a continuation of the terminated partnership under Reg. § 1.708-1(b)(4), would continue to amortize § 195 start-up expenses and § 709 organization expenses using the same amortization period adopted by the terminated partnership. The proposed regulation clarifies that the terminated partnership may not claim a § 165 loss deduction for any unamortized start-up or organization expenses. The IRS reasoned in the Preamble that the technical termination of a partnership under § 708(b)(1)(B) is not a cessation of the trade or business to which the start-up and organizational expenses relate. The Preamble also points out that this treatment is consistent with the amortization of § 197 intangibles to the extent of the transferor's adjusted basis, which continues in the new partnership over the remainder of the transferor's 15-year amortization period. When final, the regulations will be applied to technical terminations that occur after 12/9/13.

#### **E. Inside Basis Adjustments**

There were no significant developments regarding this topic during 2013.

#### **F. Partnership Audit Rules**

**1. Penalties assessed on outside basis adjustments are not a partnership item.** *Arbitrage Trading, LLC v. United States*, 108 Fed. Cl. 588 (1/30/13). Following *Petaluma FX Partners*, and *Tigers Eye Trading LLC*, the Court of Federal Claims held in this Son of Boss TEFRA proceeding that the court lacked jurisdiction to consider the application

§ 6662 accuracy related penalties on adjustments to the taxpayer's outside basis, which is an affected item in the partnership proceeding. The court further held that it had jurisdiction to consider accuracy related penalties related to adjustment of the disregarded partnership's losses and other deductions.

**2. Rely on the IRS for legal advice, you lose.**

Kearney Partners Fund, LLC v. United States, 111 A.F.T.R.2d 2013-1408 (M.D. Fla. 3/27/13), *reconsideration denied*, 111 A.F.T.R.2d 2013-2043 (M.D. Fla. 5/20/13). The taxpayer invested in a tax shelter scheme called "Family Office Customized" (FOCUS) program" by acquiring a direct interest in an LLC called Nebraska Partners, which included indirect interests in Lincoln Partners LLC owned 99% by Nebraska, and Kearney Partners LLC, owned 99% by Lincoln. On initiation of a TEFRA audit procedure (which the court referred to as "TERFA"), the IRS mailed the required Notice of Beginning of Administrative Proceedings (NBAP) to the partnerships but not to the partners. Section 6223(a) requires notice of initiation of an audit at least 120 days before issuance of a Final Partnership Administrative Adjustments (FPAA) to partners whose names and addresses are furnished to the IRS. Section 6223(e) allows a partner who was not provided a required notice to opt-out of the partnership proceeding. In issuing its FPAA to Kearney Partners, the IRS attached a cover letter indicating that since the taxpayer had not been issued an NBAP the taxpayer was entitled to opt-out of the partnership proceeding, which he elected to do. However, shortly after the taxpayer notified the IRS of his election to opt-out, the IRS sent a letter to the taxpayer indicating that it erred in informing the taxpayer of an election to opt-out because the taxpayer was not directly entitled to an NBAP in the first instance. The taxpayer's petition to the Tax Court following a separately issued notice of deficiency was dismissed for lack of jurisdiction but the basis for the decision was not specified. The District Court rejected the taxpayer's motion that the court lacked jurisdiction over the taxpayer in the partnership proceeding because of the taxpayer's election to opt-out. First, the court rejected the taxpayer's argument that the IRS was collaterally estopped from asserting jurisdiction in the partnership proceeding. The court concluded that since the basis for the Tax Court's determination that it lacked jurisdiction over the notice of deficiency issued to the taxpayer was not clear, the issue was not fully litigated in the Tax Court and, therefore, collateral estoppel did not apply. The court then found that the taxpayer was not initially entitled to receive an NBAP because the partnership failed either to provide the names and addresses of partners on a partnership return or by separate statement as required by § 6223(c). Further, the court held that the IRS is not required to search its records for other information that may be available to it that identifies the names and addresses of partners. That applies even if the IRS is

aware of the partner's identity. Finally, the court indicated that, "While the Agency's error (subsequently rescinded) is regrettable to the extent it muddied the waters, it does not alter the fact that there was no legal obligation to provide the NBAP to [the taxpayer] in the first place and the letter to the contrary does not change that circumstance."

**a. Strike two, same partner, different argument.** Kearney Partners Fund, LLC v. United States, 111 A.F.T.R.2d 2013-1789 (M.D. Fla. 4/25/13). In this action the court denied summary judgment motions by the partnerships and the 99 percent partner challenging IRS assertions that the FOCus investment lacked economic substance so that all of the gains and losses emanating from the tax shelter should be disregarded and alternatively that if the losses allocated to the partner are respected then under the step transaction doctrine gains recognized before the partner acquired his interest should also be allocated to the partner. The transaction involved offsetting straddle gains allocated to one owner (and eliminated on the owner's return) and losses, allocated to the later acquiring partner. The court noted that both IRS positions are predicated on the conclusion that FOCus is an abusive tax shelter and observed that both the economic substance doctrine and the step transaction theory have been applied to give effect to both the cost and income functions of a transaction or to neither. The court concluded that the IRS offered sufficient evidence to create a material issue over whether the 99 percent partner intended to benefit from the inception of the transaction and that the losses were generated through an interrelated series of transactions. Further, citing the partnership anti-abuse rule of Reg. § 1.701-2 as a complement to the economic substance doctrine, the court indicated that the IRS may disregard the entire transaction.

**b. And a win for the taxpayer in another court on an earlier date.** Kearney Partners Fund, LLC v. United States, 111 A.F.T.R.2d 2013-1780 (N.J. 7/13/12). A magistrate judge denied the IRS's motion to compel production of documents reflecting communications between the 99 percent partner and Rabner, Allcorn, Baumgart & Ben-Asher, P.C. The court concluded that the documents were protected by the attorney-client privilege and rejected the IRS's argument that the firm was providing financial advice after an *in camera* review. The court found that the attorney was providing legal and tax advice. The court also held that even if the partner were a party in the Florida TEFRA litigation, the partner did not waive the attorney-client privilege by intending to call the attorney as a witness in that matter because the partner would not rely on the attorney's advice in that case. The court also held that the documents were prepared in



anticipation of litigation because of the aggressive nature of the tax shelter program.

c. **And a partial loss and partial win for the taxpayer who seems to have unlimited attorney fee resources for pre-trial motions.** *Kearney Partners Fund, LLC v. United States*, 111 A.F.T.R.2d 2013-1963 (M.D. Fla. 5/10/13). In this round the court denied the taxpayer's objection to a magistrate's ruling that certain documents sought by the taxpayer from the IRS were protected under the "deliberative process privilege." The privilege attaches to documents that precede an agency's final determination or outcome on a policy or legal matter and which reflect the give-and-take of the consultative process that is antecedent to final agency action. After in *in camera* review of the requested documents, the court found that all of the documents, except one, were subject to the privilege reflecting inter-agency opinions and recommendations of IRS investigators, examiners and counsel at the Office of Chief Counsel that preceded the IRS's final determination of the taxpayer's tax obligations concerning the FOCus partnerships and application of accuracy related penalties. The court rejected the taxpayer's argument that lower-level determinations relating to tax-return examinations were not subject to the privilege, noting that the entire body of work of auditors are subject to the deliberative process privilege. However, a legal memorandum written by Debra Butler, Associate Chief Counsel Procedure and Administration, in response to a request for assistance as to whether accuracy related penalties could be imposed on taxpayers notwithstanding their disclosure of participation in the FOCus partnerships, was described by the court as the type of legal document relied upon by recipients as statements of law and public policy that are not pre-decisional and therefore not subject to the privilege. The court cited *Tax Analysts v. Internal Revenue Service*, 117 F.3d 607 (D.C. Cir. 1997) holding that Field Service Advice Memoranda could not be viewed as pre-decisional because the documents represented statements of the agency's legal position. The court described the document as follows:

Similarly, the memorandum here reflects the Office of the Chief Counsel's statements of law and assessments of Plaintiffs' tax obligations. The opinion appears to be in its final form, with no visible marks or edits. The tone of the document is impersonal with distinct conclusion, facts, and law and analysis sections. Although the memorandum indicates that it may not be used or cited as precedent, the document is a representation of the IRS's legal position in this case. And even if the document precedes the IRS's final

decisions in Plaintiffs' case, there is no indication that it precedes the Agency's final legal position.

- The court also found that although the memorandum was subject to the attorney-client privilege, it should be produced because it reflects the IRS's final legal position regarding the taxpayer's tax obligations. The court also upheld the magistrate's ruling that other documents from an attorney in the Office of Chief Counsel advising revenue agents were not protected by the attorney-client privilege and subject to disclosure. The court indicated that it was unable to ascertain whether the attorney conducted factual and legal analysis as counsel to the revenue agents or as one of the revenue agents, and that the IRS thus failed to meet its burden of identifying the underlying facts demonstrating the existence of the privilege.

**d. And the waiver of penalties raises issues that may or may not be considered in the partnership proceeding.** Kearney Partners Fund, LLC v. United States, 946 F. Supp. 2d 1302 (M.D. Fla. 5/22/13). In this decision the court determined that it had jurisdiction to determine under Ann. 2002-2, 2002-1 C.B. 304, whether voluntary disclosure filed by the partner entitled him to waiver of accuracy related penalties under the terms of the Announcement. The court held that since the Announcement consists of an agency directive designed to confer important benefits to taxpayers who disclose their involvement in tax shelters in exchange for the waiver of penalties, the thrust of the Announcement was to provide a benefit to taxpayers, not to internally regulate IRS affairs. In addition, the specific procedures and requirements enumerated in the Announcement provided the necessary law to evaluate the taxpayer's eligibility for penalty waiver. Thus, the court determined that it may review whether the taxpayer's voluntary disclosure satisfied the Announcement's requirements. In addition, however, the court considered whether the penalty provisions were subject to review in the partnership level proceeding, or whether it lacked subject matter jurisdiction to determine the penalty as a partner item. That question turned on whether the partner who provided the disclosure had authority under the LLC agreements to disclose on behalf of the partnership so that the disclosure was a partnership matter. The court determined that question depended on a showing of facts not in the record on summary judgment and thus denied summary judgment on the penalty issue.

- The court also held that it did not have jurisdiction to review whether the IRS followed its own internal procedures for reviewing penalty waivers, as the IRS internal memorandum requiring approval of the Director of Field Operations for penalties, which were determined at the Office of Chief Counsel instead, represented internal general statements of policy and rules governing internal agency operations that do not have the force of law and, therefore, are not binding on the agency.

**3. Wise guys respond to the wrong notice, it's their problem even though the IRS made the mistake.** Wise Guys Holdings, LLC v. Commissioner, 140 T.C. 193 (4/22/13). The IRS mailed a FPAA to the tax matters partner from one office, and nine months later sent a second notice from a different office. The first and second FPAA's were similar in content, set forth the same adjustments, but contained different contact information for the IRS. After the deadline for challenging the first FPAA had expired, the taxpayer filed a petition in response to the second FPAA. Too bad says the court (Judge Thornton). Section 6223(f) provides that, "If the Secretary mails a notice of final partnership administrative adjustment for a partnership taxable year with respect to a partner, the Secretary may not mail another such notice to such partner with respect to the same taxable year of the same partnership in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact." Thus, concluded the court, the second FPAA is invalid and the taxpayer failed to file a timely petition in response to the first FPAA. Reasoning from cases considering a statutory notice of deficiency, the court indicated that the Tax Court's jurisdiction proceeds from a valid petition, which must be filed from a valid statutory notice (citing *Stamm Int'l Corp. v. Commissioner*, 84 T.C. 248, 252 (1985)). The court also indicated that it does not have authority to apply equitable principles such as estoppel to acquire jurisdiction.

**4. The IRS doesn't have to search for the addresses of notice partners.** Taurus FX Partners, LLC v. Commissioner, T.C. Memo. 2013-168 (7/22/13). Bricolage Capital, LLC was the tax matters partner (TMP) and FX Trading Co., LLC was a notice partner of Taurus FX Partners LLC. Richard Postma was the sole member of FX Trading Co., which was thereby a disregarded entity. The IRS sent both the notice of beginning of administrative proceeding and the notice of final partnership administrative adjustment (FPAA) to the tax matters partner and the notice partner, plus Postma, to the addresses shown on the partnership's 2000 return, the year under review. Postma filed a petition with the Tax Court as a partner other than the TMP after the 150 day period for filing had expired. The court (Judge Buch) rejected Postma's assertion that the FPAA was invalid because the IRS did not mail the notices to the addresses shown on the partnership's 2001 return, the partner's last known address, which was different than the addresses on the 2000 return subject to the audit. Section 6223(c)(1) provides that the IRS "shall use the names, addresses, and profits interest shown on the partnership return" and § 6223(c)(2) provides that the IRS shall use such additional information furnished to it under regulations. Temp. Reg. § 301.6223(c)-1T(a) required a written statement to the Service Center where the partnership return was filed that identified the partners, the years involved, and provided addresses. The court held that in the absence of the

notice required by the regulations, it was sufficient for the IRS to mail the FPAA to the tax matters partner and the notice partner at the addresses shown on the partnership's 2000 return, notwithstanding the fact that the partnership's 2001 return had different addresses. The court stated that, "[a]lthough the Commissioner may use other information in its possession, he is not obligated to search his records for information that is not expressly furnished on the 2000 return or pursuant to the regulations," citing Temp. Reg. § 301.6223(c)-1T(f). The court also rejected Postma's argument that he should have received a copy of the FPAA as a notice partner. The court indicated that Postma was not identified as an indirect partner in a statement to the IRS as required by Temp. Reg. § 301.6623(c)-1T, even though Postma was named on the Schedule K-1 as the contact person for FX Trading, the disregarded entity in which Postma was the sole member. The court indicated that the language of Temp. Reg. § 301.6223(c)-1T(f), which provides that the IRS "may use other information in its possession," does not create an obligation on the IRS to search its records for information not expressly provided under the regulations. The court ultimately held that the FPAA was valid and that the court lacked jurisdiction to hear the case because Postma's petition was filed more than 150 days after the FPAA was issued to the TMP.

**5. The grantor of a trust is not a partner under TEFRA audit rules.** Sugarloaf Fund, LLC, JetStream Business Limited v. Commissioner, 141 T.C. No. 4 (9/5/13). This TEFRA audit case is an offshoot of the John Rogers Depreciated Asset/Debt (DAD) tax shelter rejected by the courts in *Superior Trading* (discussed in Part C of this section). In the DAD shelter, Sugarloaf LLC transferred depressed Brazilian receivables to Main Trust (an Illinois common law business trust) which in turn allocated the receivables to a Sub-Trust. The taxpayer Elmes (who was represented by Rogers) transferred cash to the Main trust for the entire interest in Sub-Trust. Elmes claimed a § 166 bad debt deduction for the receivables. The deduction depended upon the transferred basis of the receivables from Sugarloaf. The Tax Court (Judge Wherry) rejected Elmes's assertion that he was a partner in Sugarloaf because his basis in the receivables was dependent on Sugarloaf's basis. For purposes of participating in a TEFRA proceeding, a partner is defined in § 6231(a)(2) as "any other person whose income tax liability \*\*\* is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership." Partners also include indirect partners, defined by § 6231(a)(10) to include "person[s] holding an interest in a partnership through 1 or more pass-thru partners." The court concluded that Elmes's Sub-Trust had no interest in the Sugarloaf partnership. The court also concluded that a trust is not necessarily a partner merely because the trust

received assets from the partnership. The court indicated that the fact that assets were transferred to the trusts did not depend upon any legal relationship among Elmes, the trusts and the partnership. The court distinguished the relationship of other investors in the DAD shelter, noting that in other cases before the court each of those investors owned an interest in a trading company through one or more pass-through partners.

**6. Thirty years after investing in a tax shelter, the taxpayers find no help from the courts.** Acute Care Specialists II v. United States, 727 F.3d 802 (7th Cir. 8/22/13). In the mid-1980's the taxpayers invested in tax shelters created by American Agri-Corp. which were found by the Tax Court in a partnership proceeding to lack economic substance and amount to nothing more than tax-avoidance schemes, with appropriate penalties. The taxpayers filed suit in the District Court challenging deficiency assessments resulting from the partnership proceeding. The court affirmed District Court holdings that it lacked subject matter jurisdiction because the taxpayers' assertions regarding statutes of limitations and penalties were partnership-level determinations.

## G. Miscellaneous

**1. The First Circuit intrudes on tax law in an ERISA case between private litigants and may resolve carried interest issues.** Sun Capital Partners III, L.P. v. New England Teamsters and Trucking Industry Pension Fund, 724 F.3d 129 (1st Cir. 7/24/13). In an ERISA case two private equity funds organized as limited partnerships sought to withdraw from liability for contributions to the Teamsters multi-employer plans on the grounds that the funds were merely passive investors in a bankrupt company owned by one of the funds. In a decision that could have implications for application of tax principles, the court affirmed summary judgment that at least one of the funds was not merely a passive investor in the bankrupt portfolio company. Under the Multiemployer Pension Plan Amendment Act of 1990 (29 U.S.C. § 1381 *et. seq.*) (MPAA) all employees of trades or businesses that are under common control are treated as employed by a single employer that becomes liable for obligations under defined benefit plans. Applying the principles of *Commissioner v. Groetzinger*, 480 U.S. 23 (1987), the court concluded that the private equity fund was in the trade or business of developing companies and selling them at a profit. Along the way the court rejected the equity funds' argument that investing was not a trade or business under either *Higgins v. Commissioner*, 312 U.S. 212 (1941), or *Whipple v. Commissioner*, 373 U.S. 193 (1963). The court distinguished *Higgins* by indicating that the taxpayer in that case was not engaged in the management of the companies represented in the taxpayer's investment portfolio. The court concluded that *Whipple* did not

bar trade or business status because, paraphrasing the language of *Whipple*, the funds “did not simply devote time or energy to [the bankrupt company] ‘without more.’ Rather they were able to funnel management and consulting fees to [the fund’s] general partner and its subsidiary.” Quoting from Rosenthal, “Taxing Private Equity Funds as Corporate Developers,” Tax Notes, Jan. 21, 2013 at 361, the court stated that, “[P]rivate equity funds are active enough to be in a trade or business.”

- While the court was clear that it based its opinion on its independent interpretation of the MPAA, the court deferred under the standard of *Skidmore v. Swift*, 323 U.S. 134 (1944) (the weight of the agency opinion depends upon its thoroughness and validity of its reasoning), to a 2007 PBGC letter concluding that an equity fund was engaged in a trade or business under the *Groetzinger* two-part test based on findings that the fund was engaged in an activity with the primary purpose of income or profit and that it conducted that activity with continuity and regularity. The PPGC letter indicated that the size of the fund involved in the ruling, the size of its profits, and the management fees paid to the general partner of the fund established the requisite continuity and regularity.

- The court rejected the equity funds’ assertion that the phrase “trade or business” must have a uniform interpretation across federal statutes in the context of the application of *Higgins* and *Whipple*. Nonetheless, the court found no inconsistency in its interpretation of trade or business under those cases and *Groetzinger*, which leaves wide open the possibility that fees and the profits interests of an equity fund represent ordinary income derived from services in the trade or business of acquiring and managing business operations.

**2. Hiding abusive shelter transactions behind disregarded entities makes the indirect partner an unidentified partner for statute of limitations purposes.** Gaugh Properties L.P. v. Commissioner, 139 T.C. 219 (9/10/12). The taxpayers invested in KPMG/Jenkins & Gilchrist currency options tax shelters through a partnership consisting of two disregarded LLCs and a wholly owned corporation. After the IRS caught up with the taxpayers from information obtained through a John Doe summons issued to Jenkins & Gilchrist, the IRS asserted that the statute of limitations remained open with respect to the taxpayers under § 6229(e), which extends the limitation period for one year after the name and address of a partner is furnished to the IRS where (1) the name address and TIN of the partner is not “furnished” on the partnership return and the IRS has sent notice of an FPAA within the statute of limitations, or (2) the taxpayer has taken an inconsistent position and fails to provide the notice required by § 6222(b). The Tax Court (Judge Goeke) held that the statute remained open under both provisions. Following the holding

in *Costello v. United States*, 765 F. Supp. 1003 (C.D. Cal. 1991), the court held that, although Schedule K-1s are required only for direct partners, an indirect partner who is not identified on a partnership return remains an “unidentified partner” for purposes of § 6229(e)(1). The court rejected the taxpayer’s argument that because the IRS was in possession of identifying information from applications for taxpayer identification numbers for the disregarded entities (Forms SS-4) and information from Jenkins and Gilchrist and KPMG John Doe summonses more than one year before issuing assessment notices. The court upheld the validity of requirements in Temp. Reg. § 301.6223(c)-1T that information be “filed” with the IRS at the Service Center where the taxpayer’s returns are filed and that the identifying information be specific. The court interpreted § 6229(e)’s use of term “furnished” as sufficiently close to the filing requirement of the temporary regulations to indicate that the regulation was a valid exercise of administrative authority under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) and § 7805(a).

- The court also held that the taxpayer took an inconsistent position on returns reporting the partnership transactions because of the way the partnership netted contributions of long and short options which the taxpayer reported separately in claiming basis increases. As a result, the taxpayer was found to have failed to provide the statement required by § 6222(b) thereby extending the statute of limitations under § 6229(e)(2).

- The court also rejected the taxpayer’s arguments that the IRS was estopped from assessing a deficiency because of (1) IRS delays in issuing Notice 2000-44, 2000-2 C.B. 255 (notifying taxpayers of the issues raised by the shelter transaction); (2) because of the long period before the IRS issued an FPAA to the taxpayer’s partnership; or (3) because the IRS had withheld and destroyed evidence or placed witnesses beyond the reach of the taxpayer because of criminal investigations.

**a. Affirmed by the D.C. Circuit.** *Gaughf Properties L.P. v. Commissioner*, 738 F.3d 415 (D.C. Cir. 12/27/13), *aff’g* 139 T.C. 219 (9/10/12). In an interlocutory appeal, the D.C. Circuit (Judge Henderson) affirmed the Tax Court and held that the Gaughfs were “unidentified partners” who took positions on their own tax returns that were inconsistent with those of the partnership in its returns.

## VIII. TAX SHELTERS

### A. Tax Shelter Cases and Rulings

**1. Had this opinion been issued on October 25th, the taxpayer might have had a chance. However, the opinion was issued on March 14th, so success was not in the cards.** *Crispin v.*

Commissioner, T.C. Memo. 2012-70 (3/14/12), on appeal to the Third Circuit. The taxpayer, an experienced CPA, entered into a CARDS transaction in 2001 to shield about \$7 million of shared fees (ordinary) income from his wholly owned S corporation that engaged in a business related to a pool of collateralized mortgage obligations. The promoter was a longtime friend who did not charge the taxpayer any fee to participate in the CARDS transaction. The Tax Court (Judge Kroupa) held that the transaction lacked economic substance because it lacked business purpose and profit expectation, stating, “[w]e have consistently held that CARDS transactions lack economic substance,” and noting that an appeal in this case lies in the Third Circuit, which decided *ACM P’ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998).

- Judge Kroupa also upheld the 40 percent gross valuation misstatement accuracy-related penalty. The tax opinion the taxpayer received from his advisors relied on “false representations [the taxpayer] made,” including that he had a business purpose for entering into the CARDS transaction and that he anticipated earning a profit, absent tax benefits, from the CARDS transaction, which were “material to the conclusions reached in the tax opinion.” Furthermore, the taxpayer had not actually relied on the opinion.

**a. This opinion was issued on February 25th and amended on March 19th so the taxpayer was again out of luck.** Crispin v. Commissioner, 708 F.3d 507 (3d Cir. 2/25/13), amended by 2013 U.S. App. LEXIS 5341 (3d Cir. 3/19/13). The Third Circuit (Judge Jordan) upheld the Tax Court determination that the CARDS transaction failed both the objective and subjective tests for economic substance. The Third Circuit further found that the Tax Court did not abuse its discretion in deciding not to credit either taxpayer’s evidence as to business purpose [in that he approached the lender to substitute aircraft for cash as collateral] or the expert opinion by taxpayer’s expert [in that potential profit could be generated by using the CARDS loan proceeds to purchase aircraft]. The penalty issue was decided against taxpayer, following *Gustashaw v. Commissioner*, 696 F.3d 1124 (11th Cir. 9/28/12).

- Judge Jordan concluded:

“When, as here, a taxpayer is presented with what would appear to be a fabulous opportunity to avoid tax obligations, he should recognize that he proceeds at his own peril.” *Neonatology Assocs.*, 299 F.3d at 234. Crispin gambled at CARDS and lost, and he is liable for both the underpayment of his taxes and the accuracy-related penalty as determined by the Commissioner.



**2. Taxpayer victory in the Court of Federal Claims in a lease-in, lease-out (LILO) transaction with a Dutch utility. On appeal, the taxpayer is likely to hit a Dutch wall, i.e., a [Timothy] Dyk. Consolidated Edison Co. of New York v. United States, 90 Fed. Cl. 228 (10/21/09).** The Court of Federal Claims (Judge Horn), in a long and detailed opinion, held that, under the particular facts of this case, the LILO transaction taxpayer entered into with a Dutch utility had economic substance, i.e., that no decision as to whether particular options would be exercised was “pre-ordained” and that taxpayer “bore the burdens and benefits of ownership.” In finding that taxpayer had shown that the transaction was a true lease and should be respected, she distinguished factually other LILO cases decided for the government, such as *BB & T Corporation v. United States*, 523 F.3d 461 (4th Cir. 2008), and *AWG Leasing Trust v. United States*, 592 F. Supp. 2d 953 (N.D. Ohio 2008).

- A large portion of the opinion consists of Judge Horn’s analysis of the expert evidence, with pointed criticism of one expert who “failed to conduct in-depth studies of the ... [t]ransaction and gave almost automatic and generalized conclusions on the flaws of LILO and SILO transactions for tax purposes.”

- Alleged “spoliation of evidence” in 2000 by reason of a switch in e-mail systems without preserving all of the then-existing e-mails, and the desire to protect 1997 memoranda as work product, came into conflict with a bad result for the credibility of an in-house lawyer. (“He was considered by the court an unreliable witness, perhaps willing to write or say whatever he thought would assist his then current assignment.”) The court found that litigation was not reasonably anticipated until 2002 at the earliest because negotiations in connection with the IRS audit were ongoing until at least that year. The 1997 memoranda were ordered disclosed.

**a. And, indeed, as expected, the shelter crashes against the Dutch Wall in the form of Judge Timothy Dyk! Consolidated Edison Co. of New York, Inc. v. United States, 703 F.3d 1367 (Fed. Cir. 1/9/13).** In an opinion by Judge Dyk, the Federal Circuit reversed Judge Horn. The court applied the substance-over-form doctrine under its decision in *Wells Fargo & Co. v. United States*, 641 F.3d 1319 (Fed. Cir. 2011), to disallow ConEd’s claimed deductions for rent and interest. Because there was a reasonable likelihood that the tax-indifferent entity in the LILO Transaction (the lessor of the master lease) would exercise its purchase option at the conclusion of the ConEd sublease, the master lease was illusory. Therefore, the LILO Transaction did not constitute a true lease and ConEd’s rent deductions were disallowed. The interest deductions were disallowed because the loan proceeds effectively remained in an account to satisfy ConEd’s loan obligation to the lender; ConEd did not have the use of the funds. Therefore, there was no genuine indebtedness. The case was

remanded to the Court of Federal Claims for the limited purpose of determining only the refund of previously paid interest ConEd might be entitled to receive.

- While Judge Horn failed to stick her finger into the dike belonging to the Dutch utility, Judge Dyk shoved his thumb all the way into Judge Horn. In so doing, he also trashed the Deloitte & Touche appraisal report relied upon by ConEd.

**3. A Tax Court judge sees a MidCoast deal as immune from transferee liability.** Frank Sawyer Trust of May 1992 v. Commissioner, T.C. Memo. 2011-298 (12/27/11). The Tax Court (Judge Goeke) refused to uphold transferee liability against the shareholders of a corporation who sold the stock of the corporation engaged to a midco (Fortrend, which was brought into the deal by the infamous MidCoast to provide financing) after an asset sale. He found that the shareholders knew little about the mechanics of the transaction and exercised due diligence.

The trust representatives believed Fortrend's attorneys to be from prestigious and reputable law firms. They assumed that Fortrend must have had some method of offsetting the taxable gains within the corporations. They performed due diligence with respect to Fortrend to ensure that Fortrend was not a scam operation and that Fortrend had the financial capacity to purchase the stock. The trust representatives believed Fortrend assumed the risk of overpaying for the Tax corporations if they did not have a legal way for offsetting or reducing the tax liabilities.

- Judge Goeke applied state fraudulent conveyance law to determine whether the transactions should be collapsed and concluded that they should not, because the IRS, which has the burden of proof in transferee liability cases, did not prove that "the purported transferee had either actual or constructive knowledge of the entire scheme." Because in this case the transaction was structured in such a manner that the corporation never made any payments to the shareholders, there was no actual or constructive fraudulent transfer to the shareholders. Finally, turning to federal tax law, Judge Goeke held that "substance over form and its related doctrines [were] not applicable," because the transaction was an arm's length stock sale between the shareholders and a purchaser in which the parties agreed that the purchaser would be responsible for reporting and paying the corporation's income taxes. "There was no preconceived plan to avoid taxation ... ." Judge Goeke distinguished *Feldman v. Commissioner*, T.C. Memo. 2011-297 (2011), because in that case "[i]t was 'absolutely clear' that the taxpayer was aware the stock purchaser had no intention of ever paying the tax liabilities [and] the taxpayer did not conduct thorough due diligence of the stock purchaser ... ."

**a. But the First Circuit says Judge Goeke misunderstood Massachusetts law and tells him to try a different analysis.** Frank Sawyer Trust of May 1992 v. Commissioner, 712 F.3d 597 (3/29/13). The First Circuit, in an opinion by Judge Lynch, vacated and remanded the Tax Court's decision. The Court of Appeals held that the Tax Court correctly looked to Massachusetts law to determine whether the Trust could be held liable for the corporations' taxes and penalties, rejecting the IRS's argument that the Tax Court should have applied the federal tax substance-over-form doctrine to determine whether the Trust should be considered a "transferee" of the four corporations' assets. However, the Court of Appeals held that the Tax Court erred in construing Massachusetts fraudulent transfer law (which is the Uniform Fraudulent Transfer Act) to require, as a prerequisite for the Trust's liability, either (1) that the Trust knew of the new shareholders' scheme or (2) that the corporations transferred assets directly to the Trust. The IRS had presented evidence of fraudulent transfers from the four corporations to the midco entities, and the midco entities purchased the four corporations from the Trust. The Court of Appeals concluded that if on remand the Tax Court were to find that at the time of the purchases, the assets of these midco entities were unreasonably small in light of their liabilities and that the midco entities did not receive reasonably equivalent value in exchange for the purchase prices, then the Trust could be held liable for taxes and penalties assessed upon the four corporations regardless of whether it had any knowledge of the new shareholders' scheme.

**b. Uh oh, it's midco! The Second Circuit says taxpayers can't act like the three monkeys.** Diebold Foundation, Inc. Commissioner, 736 F.3d 172 (2d Cir. 11/14/13), vacating and remanding Salus Mundi Foundation v. Commissioner, T.C. Memo. 2012-61. The Second Circuit, in an opinion by Judge Poller, vacated a Tax Court decision holding that the shareholders of a corporation, and a transferee of a shareholder, that sold stock in a midco transaction were subject to § 6901 transferee liability for the corporate level taxes that were avoided. As an initial matter, the Second Circuit overruled its holding in Bausch & Lomb Inc. v. Commissioner, 933 F.2d 1084 (2d Cir. 1991) that mixed questions of law and fact are reviewed under a clearly erroneous standard when reviewing a Tax Court decision, and held that Tax Court fact findings are reviewed for clear error, "but that mixed questions of law and fact are reviewed de novo, to the extent that the alleged error is in the misunderstanding of a legal standard." The Tax Court had held that because there was no conveyance from the corporation to the shareholders, under the relevant state fraudulent conveyance law (New York, NYUFCA) there was no state law liability in law or equity, and thus the successor foundations were not liable as transferees. The Tax Court did not address federal law, but concluded that

because there was no state law liability, it was immaterial to the outcome of the case if the shareholder was a transferee under the terms of § 6901. The Second Circuit concluded that the two prongs of § 6901 are independent and that the Tax Court did not err by only addressing the liability prong. Section 6901 exists only if: (1) the party is a transferee under § 6901, and (2) the party is subject to liability at law or in equity. Federal tax law controls the first prong, while the second prong is determined by the applicable state law. If there was not a “conveyance” under state law, it did not matter whether or not the selling shareholder was a “transferee” as defined by § 6901(h). But then the Second Circuit differed with the Tax Court and held that state law transferee liability *might* have existed. Under the NYUFCA “[i]t is well established that multilateral transactions may under appropriate circumstances be ‘collapsed’” and treated as phases of a single transaction for analysis.” Under New York law, a transaction can be collapsed if (1) the consideration received from the first transferee [is] “reconveyed by the [party owing the liability] for less than fair consideration or with an actual intent to defraud creditors,” and “the transferee in the leg of the transaction sought to be voided [has] actual or constructive knowledge of the entire scheme that renders her exchange with the debtor fraudulent.” The Second Circuit found that it was clear that the first element had been met and that the crucial issue was whether the shareholders had “actual or constructive knowledge of the entire scheme that renders [the] exchange ... fraudulent.” In this respect the Second Circuit held that the shareholders had such constructive knowledge.

[W]e must now assess whether the Shareholders had actual or constructive knowledge of the entire scheme. The Tax Court concluded they did not. This assessment is a mixed question of law and fact, assessing whether based upon the facts as determined by the Tax Court, the Shareholders had constructive or actual knowledge as a matter of law. Therefore, we review *de novo* the Tax Court’s determination that the Shareholders did not have constructive knowledge, but review for clear error the factual findings that underpin the determination.

Concluding that a party had constructive knowledge does not require a showing that the party had actual knowledge of a scheme; rather, it is sufficient if, based upon the surrounding circumstances, they “should have known” about the entire scheme. *HBE Leasing*, 48 F.3d at 636 (internal quotation marks omitted). Constructive knowledge in this context also includes “inquiry knowledge”—that is, where transferees “were aware of circumstances that should

have led them to inquire further into the circumstances of the transaction, but ... failed to make such inquiry. . . .

The Tax Court did not sufficiently address the totality of the circumstances from all of the facts, which that court had already laid out itself. ... [i]t is of great import that the Shareholders recognized the “problem” of the tax liability arising from the built-in gains on the assets ... . The Shareholders specifically sought out parties that could help them avoid the tax liability inherent in a C Corp holding appreciated assets. ... The parties to this transaction were extremely sophisticated actors, deploying a stable of tax attorneys from two different firms in order to limit their tax liabilities. ... Considering their sophistication, their negotiations with multiple partners to structure the deal, their recognition of the fact that the amount of money they would ultimately receive for an asset or stock sale would be reduced based on the need to pay the C Corp tax liability, and the huge amount of money involved, among other things, it is obvious that the parties knew, or at least should have known but for active avoidance, that the entire scheme was fraudulent and would have left Double D unable to pay its tax liability.

. . . To conclude that these circumstances did not constitute constructive knowledge would do away with the distinction between actual and constructive knowledge, and, at times, the Tax Court’s opinion seems to directly make this mistake. The facts in this case strongly suggest that the parties actually knew that tax liability would be illegitimately avoided, and in any event, as a matter of law, plainly demonstrate that the parties “should have known” that this was a fraudulent scheme, designed to let both buyer of the assets and seller of the stock avoid the tax liability inherent in a C Corp holding appreciated assets and leave the former shell of the corporation, now held by a Midco, without assets to satisfy that liability.

- Because the Tax Court had determined that there was no state law liability, it did not consider the other questions determinative to the case. Accordingly, the Second Circuit remanded to the Tax Court to determine whether the shareholders were transferees under § 6901 and to resolve other procedural issues.

**4. Welfare for tax litigators — another generic tax shelter litigated to the bitter end.** Nevada Partners Fund, L.L.C. v. United States, 720 F.3d 594 (5th Cir. 6/24/13), *vacated and remanded for*

*reconsideration*, 134 S. Ct. 903 (2014). The Fifth Circuit in an opinion by Judge Dennis, affirmed a District Court decision, 714 F. Supp. 2d 598 (S.D. Miss. 2010), denying the taxpayer's deduction for losses purportedly generated by a KPMG FOCus tax shelter transaction. The shelter involved three tiers of partnerships and foreign currency transaction straddles that produced offsetting economic gains and losses. A transitory partner would recognize the gains while the taxpayer would recognize the losses through an inflated partnership basis. The transaction was substantially similar to the listed transaction described in Notice 2000-44, 2000-2 C.B. 255. The Court of Appeals concluded that the District Court "did not err legally or factually in determining that the partnerships failed to meet their burden of proving that the transactions giving rise to the \$18 million tax loss in question had economic substance." The District Court correctly held that the transactions "served no other purpose than to provide the structure through which Williams could enjoy the reduction of his tax burden for that year." That in subsequent years the taxpayer made significant profits from currency transactions and other investments effected through the tax shelter promoter was not relevant; the later year's transactions were separate transactions. A § 6662 negligence penalty was upheld notwithstanding that Arnold & Porter had issued an opinion that the losses "more likely than not" would be allowable. The taxpayer, Williams, was not a partner at the time the opinion letter was issued. Furthermore, "the partnerships could not reasonably rely on Arnold & Porter's tax opinions in good faith because Williams and the partnerships failed to prove by a preponderance of the evidence that they supplied the professional with all pertinent information necessary to assess the purpose and elements of the transactions at issue as they were actually effectuated."

**5. You say SILO/LILO, but the courts keep singing bye-bye tax benefits.** John Hancock Life Insurance Company v. Commissioner, 141 T.C. No. 1 (8/5/13). This case was the first SILO/LILO transaction to come before the Tax Court. After detailed fact findings and an examination of the various Courts of Appeals opinions in earlier SILO/LILO cases, the Tax Court (Judge Haines) held for the IRS. In each of four different transactions, the substance of the transaction was not consistent with its form. There was only *de minimis* risk to the taxpayer and the terms of the agreements assured that the taxpayer would receive its expected return on its equity investments. The Tax Court stated:

This guaranteed return is not indicative of a leasehold or ownership interest. Rather, it is reflective of what is better described as a very intricate loan from John Hancock to the lessee counterparties.

- Thus – even though the court did find that the transactions had economic substance – because the taxpayer was in substance a lender, its claimed deductions for rent, interest and depreciation were disallowed.

**6. Another tax shelter strategy bites the dust – isn't it about time for frivolous litigation penalties to start being assessed against big corporations for this detritus (a more polite word than some of us would use)?** WFC Holdings Corp. v. United States, 728 F.3d 736 (8th Cir. 8/22/13). The court affirmed a district court ruling that a KPMG contingent liability tax reduction strategy sold to Wells Fargo Bank failed to produce claimed capital loss deductions because the transaction lacked economic substance.

**7. The STARS are blacked out by the economic substance doctrine.** Bank of New York Mellon Corp. v. Commissioner, 140 T.C. 15 (2/11/13). In a case described as a case of first impression in the Tax Court, the court (Judge Kroupa) denied the taxpayer's claimed foreign tax credits and other tax benefits artificially generated through a "STARS" tax-shelter transaction developed and marketed by KPMG. The transaction that generated the purported foreign tax credit lacked economic substance. The taxpayer's control and management over the transferred assets did not materially change as a result of the transaction and the STARS structure had no effect on the income stream generated by the assets; the assets would have generated the same income regardless of being transferred. "Thus, income from the STARS assets was not an incremental benefit of STARS." The court rejected the taxpayer's argument that the STARS structure was security for a loan from Barclays Bank, finding that the loan proceeds were not used to purchase the STARS assets and that the loan was adequately secured by other assets. Thus the loan was a separate transaction from the STARS transaction, which standing by itself lacked economic substance. Furthermore, the STARS transaction still lacked economic substance even if the STARS structure and the loan were evaluated as an integrated transaction.

The STARS transaction was a complicated scheme centered around arbitrating domestic and foreign tax law inconsistencies. The U.K. taxes at issue did not arise from any substantive foreign activity. Indeed, they were produced through pre-arranged circular flows from assets held, controlled and managed within the United States. We conclude that Congress did not intend to provide foreign tax credits for transactions such as STARS.

- Finally, the claimed transactional expenses, the zero coupon swap interest expense, and the U.K. taxes that were incurred in furtherance of the STARS transaction were not deductible. “Expenses incurred in furtherance of a transaction that is disregarded for a lack of economic substance are not deductible.”

**a. But on reconsideration, the taxpayer wins a skirmish after the major battle is over.** Bank of New York Mellon Corp. v. Commissioner, T.C. Memo. 2013-225 (9/23/13). The Tax Court (Judge Kroupa) granted the taxpayer’s motion for reconsideration of its decision, 140 T.C. 15 (2/11/13), which disallowed the taxpayer’s claimed STARS tax shelter deductions, but only with respect to the disallowance in the earlier decision of interest deductions with respect to a loan incurred as part of the STARS transaction. In the earlier proceeding the taxpayer maintained that it did not deduct interest on the loan because it argued that the loan interest and the spread should be treated as though they were paid under an integrated contract. The Tax Court bifurcated the STARS transaction into the loan and the STARS structure, and found that the loan proceeds were available for the taxpayer’s use throughout the STARS transaction. Based on this finding the taxpayer argued that an interest deduction should be allowed, reasoning that the loan was not necessary for the STARS structure to produce the disallowed foreign tax credits, and thus loan served a purpose beyond the creation of tax benefits. The court agreed with this argument and allowed the deduction.

**b. Another STARS deal is rejected completely.** Salem Financial, Inc. v. United States, 112 Fed. Cl. 543 (9/20/13). The Court of Federal Claims (Judge Wheeler) – in a very looong opinion – concluded that “[n]o aspect of the STARS transaction has any economic reality.” Furthermore, because the taxpayer “was engaged in an economically meaningless tax shelter ... the negligence accuracy-related penalty of § 6662(b)(1) and the substantial understatement accuracy-related penalty of § 6662(b)(2) apply, and that the defenses of reasonable basis, substantial authority, and reasonable cause and good faith are not available [to the taxpayer].”

**c. But a different court – with a judge of Irish descent – sees the STARS deal and grants partial summary judgment for the taxpayer; only the Shadow [and the First Circuit] knows what comes next.** Santander Holdings U.S.A. v. United States, 112 A.F.T.R.2d 2013-6530 (D. Mass. 10/17/13). A key element in whether a STARS transaction has a reasonable prospect for profit, and thus might not run afoul of the economic substance doctrine, is whether the payment from Barclays



(the counterparty) to the taxpayer of an amount equal to one-half of the U.K. taxes paid by the taxpayer effectively reduced the taxpayer's payment of the U.K. taxes as a rebate. (We will not go into the details of the economic analysis.) Suffice it to say that the government's position was that "the Barclays payment was not 'in substance' a payment by Barclays at all, but rather it was 'effectively' a rebate of taxes originating from the U.K. tax authorities. The theory is that Barclays was only able to make the payment because of the tax credits *it* had received from the U.K." The District Court (Judge O'Toole) found the government's argument on this point "wholly unconvincing," and held that the Barclays payment was not in any way a rebate to the taxpayer of U.K. taxes, citing Reg. § 1.901-2(f)(2), which provides: "Tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability." Accordingly, he ruled that the Barclays payment to the taxpayer "should be accounted for as revenue to [the taxpayer] in assessing whether [the taxpayer] had a reasonable prospect of profit in the transaction." He also rejected the government's argument that the entire transaction was a "sham" "concocted to manufacture a bogus foreign tax credit," because he found that argument to be foreclosed by his finding that "[i]f the Barclays payment is included in the calculation of pre-tax profitability, then there was a reasonable prospect of profit as to the trust transaction, giving it economic substance." Finally, Judge O'Toole concluded that under First Circuit precedent, if a transaction that had "objective economic substance," the economic substance doctrine could not be applied to deny the tax benefits of the transaction on "subjective" grounds, although he acknowledged that the First Circuit might revisit the issue and "would perhaps move a bit away from a rigid 'objective only' test to one that is primarily objective but has room for consideration of subjective factors where necessary or appropriate."

**8. The mighty sword of economic substance strikes down yet another tax shelter. This is getting to be really old news.** Blum v. Commissioner, 737 F.3d 1303 (10th Cir. 12/18/13). The taxpayer sold a business and recognized a capital gain of approximately \$45 million. KPMG, which had already been preparing the taxpayer's tax returns for a few years, then sold him an OPIS tax shelter to reduce his taxes. The Tenth Circuit was unconcerned with the technical mechanics of the transaction and described the deal as follows:

The OPIS shelter is designed to create large, artificial losses for taxpayers by allowing them to claim a large basis in certain assets. These artificial losses offset actual capital gains, reducing the tax liability of the participating taxpayer.  
... There are technical rules that allow certain related parties

in a financial transaction to claim a basis that, in reality, does not reflect the amount that the party paid for the asset. In fact, the party might not have actually purchased the asset at all. OPIS took advantage of this technical rule to allow clients to pay a relatively small amount of money in order to claim a disproportionately large basis and to use that basis to shelter their own otherwise taxable income. See generally Staff of S. Comm. on Gov't Affairs, Permanent Subcomm. on Investigations, 108th Cong., Rep. on U.S. Tax Shelter Industry 5-10, 28 (Comm. Print 2003) [hereinafter Senate Report].

Individual components of this transaction presented the possibility of profit. No one, however, argues that profits were likely. Indeed, while the parties dispute the method used to calculate the likelihood of profit, both agree profits were unlikely. Rather, according to Mr. Blum, the small chance of huge profits justified the risk of such an investment.

- The court concluded as follows:

We are unconvinced [that Mr. Blum lacked the subjective motivation to generate a profit from OPIS] and find ourselves arriving at the same conclusion arrived at by the IRS, the U.S. Senate Committee on Governmental Affairs, and the Tax Court. The OPIS transaction in this case was a sham designed to reduce Mr. Blum's tax liability, and it lacked any reasonable probability of generating a profit.

- A gross misvaluation penalty, as well as a negligence penalty, was upheld. "Mr. Blum still relied on a company that was not independent, he signed an opinion letter that he knew or should have known contained a material misrepresentation, and he claims to have relied on advice that he didn't receive until after he filed his taxes."

#### **B. Identified "tax avoidance transactions"**

There were no significant developments regarding this topic during 2013.

#### **C. Disclosure and Settlement**

There were no significant developments regarding this topic during 2013.

#### D. Tax Shelter Penalties, etc.

1. **The Tax Court now agrees with the majority of circuits on the 40 percent gross valuation overstatement penalty, leaving the Fifth and Ninth Circuits standing alone together.** AHG Investments LLC v. Commissioner, 140 T.C. 73 (3/14/13). In a unanimous reviewed opinion by Judge Goeke, the Tax Court overruled its prior decisions in *Todd v. Commissioner*, 89 T.C. 912 (1987), *aff'd*, 862 F.2d 540 (5th Cir. 1988), and *McCrary v. Commissioner*, 92 T.C. 827 (1989), and held that a taxpayer may not avoid a 40 percent gross valuation misstatement penalty under § 6662(h) by conceding a deduction or credit on grounds unrelated to value or basis of property. The Tax Court was persuaded that in its earlier cases it had misinterpreted a passage in the GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, which stated “The portion of a tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability. Thus, the underpayment resulting from a valuation overstatement will be determined by comparing the taxpayer’s (1) actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation overstatement. The difference between these two amounts will be the underpayment that is attributable to the valuation overstatement.” Upon reconsidering the issue in *AHG Investments*, the Tax Court quoted with approval the Federal Circuit opinion in *Alpha I, L.P. v. United States*, 682 F.3d 1009 (Fed. Cir. 2012), which stated:

The Blue Book, in sum, offers the unremarkable proposition that, when the IRS disallows two different deductions, but only one disallowance is based on a valuation misstatement, the valuation misstatement penalty should apply only to the deduction taken on the valuation misstatement, not the other deduction, which is unrelated to valuation misstatement.

The court in *Todd* mistakenly applied that simple rule to a situation in which the same deduction is disallowed based on both valuation misstatement-and non-valuation-misstatement theories.

• The Tax Court holding in *AHG Investments* follows the rule adopted by the majority of the Circuit Courts of Appeal. See, e.g., *Fidelity International Currency Advisor A Fund LLC v. United States*, 661 F.3d 667 (1st Cir. 2011); *Alpha I LP v. United States*, 682 F.3d 1009 (Fed. Cir. 2012); and *Gustashaw v. Commissioner*, 696 F.3d 1124 (11th Cir. 2012). The Fifth Circuit and Ninth Circuit follow the rule that The Tax Court established in *Todd* but repudiated in *AHG Investments LLC*. See

*Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988); *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990).

**a. The Supreme Court will take up the conflict between the Fifth and Ninth Circuits, on the one hand, and the Tax Court and the other Circuits, on the other hand.** *Woods v. United States*, 471 Fed. Appx. 320 (5th Cir. 6/6/12), *rev'd*, 134 S. Ct. 557 (12/3/13). This case presented the issue of the applicability of the valuation overstatement penalty, more specifically whether tax underpayments are “attributable to” overstatements of basis when the inflated basis claim has been disallowed based on a finding that the underlying transactions lacked economic substance. The Fifth Circuit in a per curiam opinion held that the issue was well-settled and required no discussion in light of *Bemont Invs., L.L.C. v. United States*, 679 F.3d 339 (5th Cir. 4/26/12); *Heasley v. Commissioner*, 902 F.2d 382 (5th Cir. 1990); and *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988). The Court also added a second question for the parties to brief: “Whether the district court had jurisdiction in this case under 26 U.S.C. § 6226 to consider the substantial valuation misstatement penalty.” This issue involves the general question under TEFRA of which issues are to be resolved in a partner-level proceeding and which should be resolved at the partnership level.

- Any Supreme Court resolution of the 40-percent-penalty issue will be less important for years governed by § 7701(o), which provides for a 40-percent penalty on transactions lacking economic substance.

**b. The Seventh Circuit joins the majority.** *Superior Trading, LLC v. Commissioner*, 728 F.3d 676 (7th Cir. 8/26/13). In an opinion by Judge Posner the Seventh Circuit applied the 40 percent gross valuation misstatement penalty to a partnership tax shelter disregarded under the economic substance doctrine. The court opined that “a taxpayer who overstates basis *and* participates in sham transactions, as in this case, should be punished at least as severely as one who does only the former.”

**2. The Supreme Court [unnecessarily?] addresses an issue of statutory interpretation that has implications far beyond the specific context of the case.** *United States v. Woods*, 134 S. Ct. 557 (12/3/13). In a unanimous opinion by Justice Scalia, the Court held (1) that pursuant to § 6226(f), which provides that a court in partnership-level TEFRA proceeding has jurisdiction to determine “the applicability of any penalty . . . which relates to an adjustment to a partnership item,” the applicability of the § 6662(b)(3) valuation overstatement penalty could be determined at the partnership level, and (2) that the § 6662(b)(3) valuation

overstatement penalty applies to an underpayment resulting from a basis-inflating transaction that is disregarded for lack of economic substance.

• On the jurisdictional issue, the court noted that the TEFRA partnership-level determination maybe be provisional, stating that:

TEFRA gives courts in partnership-level proceedings jurisdiction to determine the applicability of any penalty that could result from an adjustment to a partnership item, even if imposing the penalty would also require determining affected or non-partnership items such as outside basis. The partnership level applicability determination, we stress, is provisional: the court may decide only whether adjustments properly made at the partnership level have the potential to trigger the penalty. Each partner remains free to raise, in subsequent, partner-level proceedings, any reasons why the penalty may not be imposed on him specifically.

• Turning to the substantive issue, Justice Scalia wrote that “[t]he penalty’s plain language makes it applicable here.” For the year at issue, § 6662(e)(1)(A) provides that “there is a substantial valuation misstatement under chapter 1 if . . . the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).” (Section 6662(e)(1)(A) now has a 150 percent threshold.)

[T]he COBRA transactions were designed to generate losses by enabling the partners to claim a high outside basis in the partnerships. But once the partnerships were deemed not to exist for tax purposes, no partner could legitimately claim an outside basis greater than zero. Accordingly, if a partner used an outside basis figure greater than zero to claim losses on his tax return, and if deducting those losses caused the partner to underpay his taxes, then the resulting underpayment would be “attributable to” the partner’s having claimed an “adjusted basis” in the partnerships that exceeded “the correct amount of such . . . adjusted basis.”

• Justice Scalia rejected the taxpayer’s argument that the valuation misstatement had to be a “factual” one that excluded threshold legal determinations, and held that “the valuation-misstatement penalty encompasses legal as well as factual misstatements of adjusted basis.” He noted that the holding did not render superfluous the § 6662(b)(6) penalty for transactions lacking in economic substance that was enacted in 2010. “The new penalty covers all sham transactions, including those

that do not cause the taxpayer to misrepresent value or basis; thus, it can apply in situations where the valuation misstatement penalty cannot.”

- Finally, Justice Scalia went out of his way to trash the taxpayer’s reliance on the Bluebook for the Economic Recovery Tax Act of 1981, which explained in part the scope of the valuation misstatement penalty. Although he found the particular language in the Bluebook to which the taxpayer had pointed to be unpersuasive, he generally disparaged reliance on the Bluebook for anything more than its persuasive power.

Blue Books are prepared by the staff of the Joint Committee on Taxation as commentaries on recently passed tax laws. They are “written after passage of the legislation and therefore d[o] not inform the decisions of the members of Congress who vot[e] in favor of the [law].” *Flood v. United States*, 33 F.3d 1174, 1178 (CA9 1994). We have held that such “[p]ost-enactment legislative history (a contradiction in terms) is not a legitimate tool of statutory interpretation.” *Bruesewitz v. Wyeth LLC*, 562 U. S. \_\_\_, \_\_\_ (2011) (slip op. at 17-18); accord, *Federal Nat. Mortgage Assn. v. United States*, 379 F.3d 1303, 1309 (CA Fed. 2004) (dismissing Blue Book as “a post-enactment explanation”). While we have relied on similar documents in the past, see *FPC v. Memphis Light, Gas & Water Div.*, 411 U.S. 458, 471-472 (1973), our more recent precedents disapprove of that practice. Of course the Blue Book, like a law review article, may be relevant to the extent it is persuasive. But the passage at issue here does not persuade. It concerns a situation quite different from the one we confront: two separate, non overlapping underpayments, only one of which is attributable to a valuation misstatement.

- This discussion of the Bluebook in the text of the opinion is particularly notable because Justice Scalia dismissed in a footnote the taxpayer’s arguments based on legislative history. “Whether or not legislative history is ever relevant, it need not be consulted when, as here, the statutory text is unambiguous.”

**3. A total loss for this taxpayer was in the CARDS.** *Kerman v. Commissioner*, 713 F.3d 849 (6th Cir. 4/8/13), *cert. denied*, 2014 WL 102428, (1/13/14). The Sixth Circuit (Judge Ludington) decided the substantive issues in favor of the government, and the 40 percent valuation overstatement penalty was applied.

**4. Even if *Krause* is sour, partners are still liable for increased interest on substantial underpayments attributable to tax motivated transactions.** *Bush v. United States*, 717 F.3d 920 (Fed. Cir. 5/30/13). In an opinion by Judge Newman, the Court of Appeals affirmed the Court of Federal Claims, which dismissed the suit under § 7422(h) on the basis that it lacked jurisdiction under the TEFRA audit rules. *Bush v. United States*, 101 Fed. Cl. 791 (11/14/11). The taxpayers, who were partners of the Denver-based Dillon Oil Technology Partnership, challenged the IRS's assessment of enhanced interest for tax years 1983 and 1984 pursuant to former § 6621(c). Former § 6621(c) imposed an increased rate of interest "with respect to any substantial underpayment attributable to tax motivated transactions." The IRS had issued FPAA's to Dillon Oil for tax years 1983 and 1984 and to other similarly situated Denver-based partnerships disallowing losses of the partnerships. Dillon Oil and the other partnerships filed petitions in the Tax Court. The Tax Court proceedings were stayed pending resolution of *Krause v. Commissioner*, 99 T.C. 132 (1992), which was a test case for over 2,000 related cases. In *Krause*, the Tax Court disallowed losses of the partnerships under § 183 because the partnerships' activities lacked profit objectives and upheld the imposition of increased interest under former § 6621(c). After the *Krause* decision, several partnerships in the Tax Court proceeding involving Dillon Oil moved to compel the IRS to settle based on terms to which the IRS had agreed in some cases prior to the *Krause* decision. These terms allowed the partnerships to take deductions up to the amount of cash invested and imposed no penalties other than increased interest under former § 6621(c) (or its predecessor provision). (After *Krause*, the IRS settled by disallowing *all* deductions and imposing increased interest.) The Tax Court denied these motions and noted that it previously had concluded that partners who had not settled with the IRS prior to *Krause* were bound by the *Krause* decision. *Vulcan Oil Tech. Partners v. Commissioner*, 110 T.C. 153, 154-55 (1998). The Tax Court proceedings involving Dillon Oil ultimately were dismissed for lack of prosecution, and the Dillon Oil partners did not appeal the dismissal. The IRS later sent Form 4549A to the Dillon Oil partners informing them that they would be assessed increased interest under former § 6621(c). The Dillon Oil partners paid the interest and brought a refund action in the Court of Federal Claims, in which they argued that the *Krause* decision was "wrong as a matter of law" and that they were not bound by it. They noted that the Fifth Circuit, in a separate proceeding involving other partnerships, had held (contrary to other Circuits) that the Tax Court in *Krause* had erred in imposing increased interest pursuant to former § 6621(c) because the regulations under that provision permitted increased interest when losses were "disallowed for any period under section 183," and the deductions in *Krause* were not in fact disallowed under § 183, which by its terms applies to activities engaged in by individuals and S corporations. *Copeland v.*

*Commissioner*, 290 F.3d 326 (5th Cir. 2002). The Federal Circuit rejected the taxpayers' arguments and agreed with the Court of Federal Claims that the Dillon Oil partners were bound by the *Krause* decision, including its conclusion regarding the imposition of increased interest under former § 6621(c). The court reasoned that the Dillon Oil partners lost their opportunity to challenge *Krause* when their Tax Court proceeding was dismissed for lack of prosecution. To set aside the IRS's imposition of increased interest for tax motivated transactions, the court stated, would require relitigating the Tax Court's decision to bind Dillon Oil to the *Krause* decision. The court concluded that whether the Dillon Oil partnership is bound by *Krause* is a partnership level issue that must be determined at the partnership level rather than at the partner level.

## IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

### A. Exempt Organizations

1. **Hock mir nicht kein CHNA!**<sup>8</sup> REG-106499-12, Community Health Needs Assessments for Charitable Hospitals, 78 F.R. 20523 (4/5/13). These proposed amendments to Reg. §§ 1.509(r)-1 through -7 provide detailed guidance to charitable hospital organizations on the community health needs assessment (CHNA) requirements, and related excise tax and reporting obligations, enacted as part of the Patient Protection and Affordable Care Act of 2010.

• Each § 501(c)(3) hospital organization is required to meet four general requirements on a facility-by-facility basis:

- establish written financial assistance and emergency medical care policies;
- limit amounts charged for emergency or other medically necessary care to individuals eligible for assistance under the hospital's financial assistance policy;
- make reasonable efforts to determine whether an individual is eligible for assistance under the hospital's financial assistance policy before engaging in extraordinary collection actions against the individual; and
- conduct a community health needs assessment (CHNA) and adopt an implementation strategy at least once every three years. (These CHNA requirements are effective for tax years beginning after 3/23/12.)

---

8. Or, chinik. Literally, "Don't knock my teakettle!" Or, "Stop bothering me!"



**2. The ABA loses another tax case.** ABA Retirement Funds v. United States, 111 A.F.T.R.2d 2013-1815 (N.D. Ill. 4/25/13). The District Court held that the ABA Retirement Funds (formerly known as the American Bar Retirement Association), a not-for-profit corporation that creates and maintains IRS-approved master tax-qualified retirement plans for adoption by lawyers and law firms, does not qualify as a tax-exempt “business league” under § 501(c)(6). To be a tax exempt business league, Reg. § 1.501(c)(6)-1 requires that an organization be (1) of persons having a common business interest; (2) whose purpose is to promote the common business interest; (3) not organized for profit; (4) that does not engage in a regular business of a kind ordinarily conducted for profit; (5) whose activities are directed to the improvement of business conditions at one or more lines of a business as distinguished from the performance of particular services for individual persons; and (6) of the same general class as a chamber of commerce or a board of trade. The court found that ABA Retirement Funds was engaged in a business generally carried on for profit. It competed with other retirement funds, and it “sought market share, not market welfare.” The fees for its services were paid by individuals in proportion to the benefits they derived from those services. Most significantly, the court found that its activities were directed principally to individual lawyers and law firms rather than to promoting the well-being of the legal profession generally: “The requirement to promote the welfare of the general industry surely demands more than offering goods or services that may enhance the individual practices of the attorneys who purchase them.”

- Although the ABA lost in the Supreme Court, *United States v. American Bar Endowment*, 477 U.S. 105 (1986) (American Bar Endowment’s income from life insurance policy dividends retained represent profits from the insurance program rather than charitable donations from your members. The court further stated that if the members were given a choice between allowing the American Bar Endowment to retain the dividends and having the dividends refunded to them, then the dividends retained might constitute charitable donations rather than unrelated business income.), it changed its insurance arrangements to achieve the same result by permitting cash refunds to policyholders who claimed them in writing each year, P.L.R. 8725056 (3/25/87).

**3. Will Superman<sup>9</sup> arrive in time to share an aperitif with Lois Lerner? Not before she took the entire fifth for herself.** IRS official admitted to using political criteria to target certain applicants for § 501(c)(4) status, and stated that this was known to upper-level officials in 2011. Lois Lerner is now on paid administrative leave, having reportedly

---

9. The person from the Planet Krypton.

refused to resign from the IRS. Under questioning by Congress in 2012, Commissioner Douglas Shulman denied that political criteria were used to target certain applications, even though he attended 157 (or more, or fewer) Easter Egg Rolls at the White House during his term as Commissioner of Internal Revenue. A TIGTA report on this practice was released.

- In a prepared statement dated 5/21/13 for testimony before the Senate Finance Committee on the following day, the Treasury Inspector General for Tax Administration, J. Russell George, concluded that the IRS has still not satisfactorily resolved the problems identified in the report:

IRS's Response to Our Recommendations

TIGTA made nine recommendations to provide more assurance that applications are processed in a fair and impartial manner in the future without unreasonable delay. The IRS agreed to seven of our nine recommendations and proposed alternative corrective actions for two of our recommendations. However, we do not agree that the alternative corrective actions will accomplish the intent of the recommendations. One of these recommendations was that the IRS should clearly document the reason applications are chosen for further review for potential political campaign intervention. The second was that the IRS should develop specific guidance for specialists processing potential political cases and publish the guidance on the Internet. Further, the IRS's response also states that issues discussed in the report have been resolved. We disagree with this assertion. Until all of our recommendations are fully implemented and the numerous applications that were open as of December 2012 are closed, we do not consider the concerns in this report to be resolved. In addition, as part of our mission, TIGTA will also determine whether any criminal activity or administrative misconduct occurred during this process. The attached TIGTA report includes additional information on all nine recommendations and the IRS's planned corrective actions and completion dates.

- Superman, using Treasury Secretary Lew as a conduit, asked Acting Commissioner of Internal Revenue Steven Miller to resign, and Daniel Werfel was appointed as Acting Commissioner effective 5/22/13. Although he is a lawyer and worked in the Department of Justice Civil Rights Division, Werfel has absolutely no prior tax experience.

- Included among the "two rogue agents in Cincinnati" are Holly Paz (Acting Director of Rulings and Agreements at the IRS's Tax-Exempt and Government Entities Division, fired; replaced 6/10/13 as

acting director by Karen Schiller, who was director for exam planning and delivery at the IRS Small Business/Self-Employed Division), Carter Hull (Washington IRS lawyer who was overruled by Washington superiors when he recommended making decisions on § 501(c)(4) applications without additional scrutiny, retiring), Sarah Hall Ingram (who always seemed to be doing something other than work her title called for), and Joseph Grant (Commissioner of Tax Exempt and Government Entities division and Lois Lerner's boss, retired on 6/3/13).

**a. The only scandal at the IRS is that it appears to be knuckling under to pressure and declining to enforce the law, and no one can force it to do what's right.** FS-2013-8 (6/24/13). The IRS announced that it is offering certain organizations that have applied for § 501(c)(4) status an optional fast-track method to obtain tax-exempt status. The IRS will offer the expedited option to groups that have had their applications pending for more than 120 days and involve possible political campaign intervention or issue advocacy.”

This “safe-harbor” option will provide certain groups an approved determination letter granting them 501(c)(4) status within two weeks if they certify they devote 60 percent or more of both their spending and time on activities that promote social welfare as defined by Section 501(c)(4). At the same time, *they must certify that political campaign intervention involves 40 percent or less of both their spending and time.* These thresholds apply for past, current and future years of operation. Solely for the purpose of determining eligibility for the expedited procedure, an organization must count, among other things, any public communication identifying a candidate that occurred within 60 days prior to a general election or 30 days prior to a primary as political campaign intervention. (Emphasis added)

- Section 501(c)(4) allows tax-exempt status for “[c]ivic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare . . . .” In a bit of Orwellian logic, Reg. § 1.501(c)(4)-1(a)(2)(i), redefines “exclusively” as “primarily,” but it really is doubtful that the language of the regulation was intended to allow any political activities. It most likely was intended to preserve tax-exempt status for organizations subject to UBIT. See Ellen Aprill, *The IRS's Tea Party Tax Row: How 'Exclusively' Became 'Primarily'*, <http://www.psmag.com/politics/the-irss-tea-party-tax-row-how-exclusively-became-primarily-59451/>. At least

some of us<sup>10</sup> believe that if the IRS had done so at the outset – years ago – it could have said zero, nada political activities allowed under the Code and regulations language.

**b. These allegations are unanswerable.** Van Hollen v. Internal Revenue Service (D. D.C., No. 1:13-cv-01276, filed 8/21/13). Representative Chris Van Hollen (D.-MD) and three nonprofit organizations filed a complaint in a District Court for the District of Columbia seeking declaratory, injunctive, and mandamus relief against the IRS and Treasury Department for allowing tax-exempt organizations to expend substantial sums on electoral activity, claiming it is contrary to the plain meaning of § 501(c)(4). The introduction to the complaint summarizes the cause of action as follows:

1. Plaintiffs Chris Van Hollen, Democracy 21, Campaign Legal Center, and Public Citizen bring this action under the Administrative Procedure Act (APA), 5 U.S.C. §§ 702, 703, 704, and 706(1) & (2)(A), to compel agency action unlawfully withheld and unreasonably delayed, and to set aside agency action that is contrary to law. Defendant Internal Revenue Service (IRS) has for many years violated the Internal Revenue Code (IRC) by allowing tax-exempt social welfare organizations to expend substantial sums on electoral activity. The IRC provides that tax-exempt social welfare organizations must be “exclusively” engaged in “promotion of social welfare.” IRC § 501(c)(4). The IRS’s implementing regulation recognizes that electoral activity does not fall within the scope of activity promoting social welfare. Treasury Regulation (TR) § 1.501(c)(4)-1(a)(2)(ii). But the IRS’s regulation also purports to provide that an organization operates “exclusively” to promote social welfare as long as it is operated “primarily” for social

---

10. Guess which two. Ira still believes what Celia Roady said when she said that Lois Lerner did not plant her question at the ABA Tax Section meeting because Ellen Aprill vouched for Celia’s credibility. He still believes Jay Carney when he echoed Lois Lerner’s conclusion that the entire so-called scandal consisted in the actions of a couple of rogue agents in Cincinnati. He believes everything that Lois Lerner and Holly Paz said, and sees no need to question either one further. He continues to believe Elijah Cummings and Sander Levin when they said that progressive groups were treated as badly as (or worse than) Tea Party groups, and that Darryl Issa is blowing up the so-called scandal beyond all proportion because nothing wrong happened. Inasmuch as none of these organizations were entitled to § 501(c)(4) status, what difference does it make?

welfare purposes. *Id.* § 1.501(c)(4)-1(a)(2)(i). By redefining “exclusively” as “primarily” in violation of the clear terms of its governing statutes, the IRS permits tax-exempt social welfare organizations to engage in substantial electoral activities in contravention of the law and court decisions interpreting it.

2. Instead of amending its rules to conform to the requirements of IRC section 501(c)(4), the IRS has recently taken action with precisely the opposite effect: It has issued a directive providing a “safe harbor” for certain organizations seeking exemption under section 501(c)(4) if they spend no more than 40% of their time and expenditures on electoral campaign activities and stating that even organizations that expend more than this percentage on electoral campaign intervention may qualify for tax-exempt status under section 501(c)(4) because the IRS may consider them to be “primarily” engaged in social welfare activities. The IRS’s new directive confirms that the IRS interprets its regulation to allow substantial electoral campaign intervention by section 501(c)(4) organizations -- intervention up to and in some circumstances exceeding 40% of their activity -- despite the statutory requirement that they be exclusively engaged in social welfare activities. The IRS’s action thus makes the extent of the conflict between its regulation and the statute even more explicit and will injure the plaintiffs by fostering increased electoral campaign spending without donor disclosure by ostensible section 501(c)(4) organizations. The plaintiffs therefore request that the Court declare the IRS’s new “safe harbor” directive unlawful insofar as it permits section 501(c)(4) organizations to spend amounts up to and exceeding 40% of their time and money on electoral campaign intervention.

**c. The Taxpayer Advocate weighs in.**

National Taxpayer Advocate, Special Report to Congress, Political Activity and the Rights of Applicants for Tax-Exempt Status, [www.TaxpayerAdvocate.irs.gov/2014ObjectivesReport](http://www.TaxpayerAdvocate.irs.gov/2014ObjectivesReport) (6/30/13). The Taxpayer Advocate identified several categories of problems including, among others: (1) the legal standard under the statute that a § 501(c)(4) exclusively engage in promoting social welfare, interpreted as “primarily” engaged in promoting the common good is ambiguous, and there is no guidance as to the degree of permissible political activity, (2) unlike the case where an application for § 501(c)(3) status is rejected, there is no process for

judicial review that might provide guidance, (3) the IRS as a tax agency may not be the most qualified governmental agency to make inherently controversial determinations about political activity, (4) the form 1024 application for recognition of exempt status does not include questions to identify excessive political activity, which is difficult to assess before operations have commenced, (5) EO failed to publically disclose its procedures and there are no checks and balances with regard to taxpayer rights, and (6) EO management failed to install an adequate inventory management system and failed to ensure that requests for guidance received a timely response.

**d. Proposed regulations to exclude conservative organizations from § 501(c)(4) status, while leaving relatively undisturbed the many liberal organizations whose applications sailed through while a couple of rogue IRS agents in Cincinnati were playing games with applications from conservative organizations seeking such status.** REG-134417-13, Guidance for Tax-Exempt Social Welfare Organizations on Candidate-Related Political Activities, 78 F.R. 71535 (11/29/13). The proposed regulations would revise Reg. § 1.501(c)(4)-1(a)(2)(ii) to state that “[t]he promotion of social welfare does not include direct or indirect candidate-related political activity.” They state that communications which expressly support a clearly identified candidate of a political party would be considered candidate-related political activity, as would communications that are made within 60 days of a general election (or within 30 days of a primary contest) and that clearly identify a candidate or party. Contributions reportable under campaign finance laws and grants to § 527 political organizations and other exempt entities that are politically active also would be considered political, as would voter registration and get-out-the-vote drives, distribution of materials prepared by or for candidates or by a § 527 organization, preparation or distribution of voter guides that refer to candidates (or to parties in a general election), and events a candidate attends that are held within 60 days of an election or within 30 days of a primary.

• The preamble to the proposed regulations says:

The Treasury Department and the IRS are considering whether the current section 501(c)(4) regulations should be modified in this regard and, if the “primarily” standard is retained, whether the standard should be defined with more precision or revised to mirror the standard under the section 501(c)(3) regulations. Given the potential impact on organizations currently recognized as described in section

501(c)(4) of any change in the “primarily” standard, the Treasury Department and the IRS wish to receive comments from a broad range of organizations before deciding how to proceed. Accordingly, the Treasury Department and the IRS invite comments from the public on what proportion of an organization's activities must promote social welfare for an organization to qualify under section 501(c)(4) and whether additional limits should be imposed on any or all activities that do not further social welfare. The Treasury Department and the IRS also request comments on how to measure the activities of organizations seeking to qualify as section 501(c)(4) social welfare organizations for these purposes.

- See, also, *b.*, above, in which there is a description of a lawsuit to force the IRS to adopt regulations to prohibit § 501(c)(4) organizations from engaging in any political activity. On 12/6/13, the plaintiffs announced that they were dropping their unanswerable lawsuit.

**4. It was really a partner of the home sellers, not a charitable partner.** *Partners in Charity, Inc. v. Commissioner*, 141 T.C. No. 2 (8/26/13). PIC was established as a nonprofit corporation under state law and received a determination that it was a § 501(c)(3) organization based on its claim its primary activity was to provide down-payment assistance grants to home buyers. PIC's “down payment assistance” program provided home buyers with funds to use for down payments for home purchases. In practice, however, PIC obtained those funds (along with a fee) from home sellers. PIC provided down-payment assistance grants where the seller was not reimbursing the down payment and paying PIC's fee in only two-tenths of 1% of its transactions. The IRS retroactively revoked PIC's tax-exempt status on the ground that PIC was not operated exclusively for a charitable purpose. The Tax Court (Judge Gustafson) upheld that revocation and held further that the IRS did not abuse its discretion in retroactively revoking its determination that PIC was a § 501(c)(3) organization. In its operation, PIC failed to serve a charitable class, and a substantial amount of its activity did not further a charitable purpose, but rather furthered instead an unrelated business. PIC did not limit its grants to low-income home buyers. PIC engaged in two overlapping but distinct forms of activities: (1) activities that ultimately benefited the buyers — grants and homeowner education, and (2) activities that ultimately benefited the sellers — providing ready buyers, and promoting faster sales at generally higher prices. PIC's transactions with sellers generated revenues of over \$28 million in 2002 and \$32 million in 2003 and were clearly substantial. Even if PIC's buyer-benefitting activities served an exempt purpose, PIC's seller-benefitting activities failed to further an exempt purpose and defeated the argument that PIC was operated exclusively for a charitable purpose. “PIC's primary purpose was to broker

as many transactions as possible and thus to generate significant net profits, regardless of whether the transactions achieved a charitable end.”

**5. The gymnastics booster club suffered the tax equivalent of a fall from the balance beam.** Capital Gymnastics Booster Club, Inc. v. Commissioner, T.C. Memo. 2013-193 (8/26/13). Capital Gymnastics Booster Club, Inc. was formed to support the activities of young athletes from approximately 240 families. Its members were the parents of the young athletes. The athletes were all on teams from one local private gym, to which each family individually paid tuition and other fees. These teams competed in meets, which required substantial additional funds that Capital Gymnastics collected and administered. Parents of athletes who wanted to participate on the teams that were operated out of that private gym were required to be members of Capital Gymnastics. Each family paid an annual assessment to cover the entry fees to compete in the meets and to offset the estimated expenditures for the coaches’ travel. A family could satisfy its assessment either by paying cash or by participating in Capital Gymnastics fund-raising program. The amount that a family raised was credited against the assessment. Fund-raising-generated net profits reduced the assessment between 50% and 70% for the families that fund-raised. Families that did not fund-raise paid the full assessment. In the taxpayer’s suit for a declaratory judgment that it was a § 501(c)(3) organization, the Tax Court (Judge Gustafson) upheld the IRS’s determination that Capital Gymnastics was not operated exclusively for exempt purposes. Its net earnings inured to the benefit of its fund-raising parent members, and it conferred substantial private benefit on children of those fund-raising families.

**6. Vexatious litigation for personal purposes does not serve charitable purposes, as established by multiple IRS requests for information. Although he was entitled to a review of the IRS denial of § 501(c)(3) status – unlike seekers of § 501(c)(4) status – Mr. Huggins lost in the Tax Court.** Council for Education v. Commissioner, T.C. Memo. 2013-283 (12/16/13). Following his failure to graduate from the University of California Santa Barbara, between 1993 and 2002 Harold Huggins initiated a series of claims and lawsuits against the University, its Academic Senate (which one of us twice chaired), the California Student Aid Commission, and the Western Association of Schools and Colleges, alleging that the defendants coerced him into withdrawing from UCSB, extorted students loans through grade fraud and intimidation and violated RICO and the False Claims Act. The Tax Court (Special Trial Judge Guy) pointed out that all of these claims were dismissed and that Mr. Huggins was declared by the Federal District Court to be a vexatious litigant. In 2006 Mr. Huggins



organized the petitioner as a nonprofit mutual benefit corporation to investigate academic fraud with the specific purpose to investigate and report fraudulent activities relating to student loan programs, advocate for student loan recipients, and enforce Department of Education accreditation standards for all students regardless of race or ethnicity. In 2008, the petitioner sought recognition of the organization as a charitable organization under § 501(c)(3). Petitioner continued to file claims similar to Mr. Huggins prior actions, and formed a “Special Committee 1868” to gather evidence that former UC Regent Ward Connerly (who was a leading advocate of California’s proposition 209 that prohibited race and gender based discrimination in public employment, education, and contracting) was an unregistered foreign agent, abused his position as a Regent and had personal financial interest in matters before the UC Board of Regents and had organized so-called civil rights organizations to deceive California voters. Following multiple administrative inquiries for information regarding petitioner’s activities, the IRS denied the claim for exemption. The court affirmed the denial. The court recognized that an organization may qualify for charitable status where in carrying out its primary purpose the organization advocates social or civic changes or presents opinions on controversial issues. The court also observed that the IRS recognizes that organizations that provide legal services or engage in litigation may serve a charitable purpose. However, the court noted that where an individual creates and controls the affairs of an organization without an independent board of directors “there is an obvious opportunity for abuse.” The court stated that “[p]rominent among petitioner’s shortcomings are the lack of a formal business plan and an independent board of directors to provide operational guidance and oversight.” The court further indicated that Mr. Huggins, acting as petitioner’s sole officer, director, and employee, did not demonstrate the skills to conduct petitioner’s operations to achieve its charitable purpose to further the public good. Indeed, the court indicated that it “would be hard pressed to say that petitioner’s operations do not more than incidentally further Mr. Huggins’ private interests.”

## **B. Charitable Giving**

**1. What part of “perpetuity” don’t you understand?! Belk v. Commissioner, 140 T.C. 1 (1/28/13).** The taxpayers claimed a charitable contribution deduction for the grant of a conservation easement on 184.627 acres of a golf course to a qualified organization. Specifically, they agreed not to develop the golf course. However, the conservation easement agreement permitted the taxpayers, with the donee’s consent, to remove portions of the golf course from the easement and replace them with property not theretofore subject to the conservation easement. The IRS disallowed the deduction, and the Tax Court (Judge Vasquez) upheld the

IRS's disallowance of the deduction. Section 170(h)(1)(A) requires the contribution of a "qualified" real property interest, and to be a "qualified" real property interest, § 170(h)(2)(C) requires that the conservation easement limit in perpetuity the use that may be made of the property. Section 170(h)(2)(C) precluded the deduction because the taxpayers did not donate an interest in real property subject to a use restriction granted in perpetuity. Because the conservation easement agreement allowed the parties to change the property subject to the conservation easement, it did not meet the perpetuity requirement. The court rejected the taxpayers' argument the deduction nevertheless should be allowed because the substitution clause permitted only substitutions that would not harm the conservation purposes of the conservation easement. The court reasoned that the § 170(h)(5) requirement that the conservation purpose be protected in perpetuity is separate and distinct from the § 170(h)(2)(C) requirement that there be real property subject to a use restriction in perpetuity, and the taxpayers' conveyance failed to satisfy § 170(h)(2)(C). Satisfying § 170(h)(5) does not necessarily affect whether there is a qualified real property interest. Furthermore, it was argued that any substitution required the donee's consent: "There is nothing in the Code, the regulations, or the legislative history to suggest that section 170(h)(2)(C) is to be read to require that the interest in property donated be a restriction on the use of the real property granted in perpetuity unless the parties agree otherwise. The requirements of section 170(h) apply even if taxpayers and qualified organizations wish to agree otherwise."

- The IRS was represented in this case by one of Professor McMahon's former research assistants. The Tax Court judge was one of Professor Shepard's former research assistants. [So there, Marty!]

**a. Reconsideration denied.** Belk v. Commissioner, T.C. Memo. 2013-154 (6/19/13). Judge Vasquez denied the taxpayer's motion for reconsideration. First, the taxpayer argued that the original opinion misinterpreted § 170(h)(2)(C), arguing that the Code and regulations do "not require the donation of an interest in 'an identifiable, unchanging, static piece of real property.'" The taxpayer argued that as long as it "agree[d] not to develop 184.627 acres of land, the Court (and the Internal Revenue Service (IRS)) should not be concerned with what land actually comprises those 184.627 acres." Judge Vasquez reiterated that the court had "rejected the notion of such 'floating easements' ... and found that section 170(h)(2)(C) requires that taxpayers donate an interest in an identifiable, specific piece of real property." Not being bound by any rule that arguments had to be consistent, the taxpayer's second argument was that because the taxpayer had intended to obtain a deduction for granting the conservation easement the court had misinterpreted the conveyance and

applicable state law as permitting a substitution. This argument also fell on deaf ears: “Our interpretation of the parties’ intention is governed by what the parties actually included in the conservation easement agreement. It is well settled that a taxpayer’s expectations and hopes as to the tax treatment of his conduct in themselves are not determinative.” Finally, the taxpayer argued that the original opinion “fail[ed] to consider that an element of trust and confidence is placed in a qualified organization that it will continue to carry out its mission to protect and conserve property.” Judge Vasquez responded, “Because the parties have agreed petitioners are able to substitute land, there is no restriction on the golf course in perpetuity that we can trust SMNLT to enforce.”

**2. A “gotcha” for the IRS! The Tax Court just says “no” to deductions for contributions of conservation easements on mortgaged properties.** Kaufman v. Commissioner, 134 T.C. 182 (4/26/10). The Tax Court (Judge Halpern) held that as a matter of law no charitable contribution deduction is allowable for the conveyance of an otherwise qualifying conveyance of a facade conservation easement if the property is subject to a mortgage and the mortgagee has a prior claim to condemnation and insurance proceeds. Because the mortgage has priority over the easement, the easement is not protected in perpetuity – which is required by § 170(h)(5)(A). The deduction cannot be salvaged by proof that the taxpayer likely would satisfy the debt secured by the mortgage.

**b. Plea for a mulligan is rejected!** Kaufman v. Commissioner, 136 T.C. 294 (4/4/11). On the taxpayers’ motion for reconsideration, the Tax Court (Judge Halpern) in a lengthy and thorough opinion reaffirmed its earlier decision that the conservation easement failed the perpetuity requirement in Reg. § 1.170A-14(g)(6), because under the loan documents, the bank that held the mortgage on the property expressly retained a “‘prior claim’ to all insurance proceeds as a result of any casualty, hazard, or accident occurring to or about the property and all proceeds of condemnation,” and agreement also provided that “the bank was entitled to those proceeds ‘in preference’ to [the donee organization] until the mortgage was satisfied and discharged.” The court also disallowed a deduction in 2003, but allowed the deduction in 2004, for a cash contribution to the donee of the conservation easement in 2003 because the amount of the cash payment was subject to refund if the appraised value of the easement was zero, and the appraisal was not determined until 2004. The court also rejected the IRS’s argument that the taxpayers received a *quid pro quo* for the cash contribution in the form of the donee organization accepting and processing their application, providing them with a form preservation restriction agreement, undertaking to obtain approvals from the necessary government authorities, securing the lender agreement from the bank, giving

the taxpayers basic tax advice, and providing them with a list of approved appraisers. The facts in evidence did not demonstrate a *quid pro quo*, because, among other things, many of the tasks had been undertaken by the organization before the check was received.

- Finally, the court declined to uphold the § 6662 accuracy related penalties asserted by the IRS for the taxpayers' overstatement of the amount of the contribution for the conservation easement, but sustained the negligence penalty for the 2003 deduction for the cash payment. Because the issue of whether any deduction was allowed for the easement, regardless of its value, was a matter of law decided in the case as a matter of first impression, the taxpayers were not negligent, had reasonable cause, and acted in good faith.

**c. The taxpayer wins the battle in the Court of Appeals with an excellent discussion of charitable contributions of easements on mortgaged property, but still might lose the war.** Kaufman v. Shulman, 687 F.3d 21 (1st Cir. 7/19/12). The First Circuit, however, in an opinion by Judge Boudin, disagreed with the Tax Court, holding that a mortgagee's right to satisfy the mortgage lien before the donee of the conservation easement is entitled to any amount from the sales or condemnation proceeds from the property does not necessarily defeat the charitable contribution deduction. Judge Boudin's opinion noted that "the Kaufmans had no power to make the mortgage-holding bank give up its own protection against fire or condemnation and, more striking, no power to defeat tax liens that the city might use to reach the same insurance proceeds – tax liens being superior to most prior claims, 1 Powell on Real Property § 10B.06[6] (Michael Allan Wolf ed., Matthew Bender & Co. 2012), including in Massachusetts the claims of the mortgage holder."<sup>11</sup> The opinion continued by observing that

[G]iven the ubiquity of super-priority for tax liens, the IRS's reading of its regulation would appear to doom practically all donations of easements, which is surely contrary to the purpose of Congress. We normally defer to an agency's reasonable reading of its own regulations, *e.g.*, *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 220 (2001), but cannot find reasonable an impromptu reading that is not compelled and would defeat the purpose of the statute, as we think is the case here.

---

11. We include the citation to Powell on Real Property in the quotation because Michael Allan Wolf is a colleague of Professor McMahon's, and the UF Dean rewards faculty members based, in part, on their citation count.

Thus, the First Circuit rejected the Tax Court's requirement that the donee of the conservation easement have "an absolute right" (136 T.C. at 313), holding that a "grant that is absolute against the owner-donor" is sufficient "and almost the same as an absolute one where third-party claims (here, the bank's or the city's) are contingent and unlikely."

- The First Circuit went on to reject the IRS's argument that contribution also failed to qualify for a charitable contribution deduction because a provision in the agreement between the Kaufmans and the donee trust stated that "nothing herein contained shall be construed to limit the [Trust's] right to give its consent (e.g., to changes in the Façade) or to abandon some or all of its rights hereunder," citing *Commissioner v. Simmons*, 646 F.3d 6 (D.C. Cir. 2011), which reasoned that such clauses permitting consent and abandonment "have no discrete effect upon the perpetuity of the easements: Any donee might fail to enforce a conservation easement, with or without a clause stating it may consent to a change or abandon its rights, and a tax-exempt organization would do so at its peril." (quoting 646 F.3d at 10).

- The court also rejected various scattershot IRS arguments that the substantiation rules had not been met.

- However, the Court of Appeals did not necessarily hand the taxpayers a final victory. It remanded the case to the Tax Court on the valuation issue.

When the Kaufmans donated the easement, their home was already subject to South End Landmark District rules that severely restrict the alterations that property owners can make to the exteriors of historic buildings in the neighborhood. These rules provide that "[a]ll proposed changes or alterations" to "all elements of [the] facade, ... the front yard ... and the portions of roofs that are visible from public streets" will be "subject to review" by the local landmark district commission.

Under the *Standards and Criteria*, property owners of South End buildings have an obligation to retain and repair the original steps, stairs, railings, balustrades, balconies, entryways, transoms, sidelights, exterior walls, windows, roofs, and front-yard fences (along with certain "other features"); and, when the damaged elements are beyond repair, property owners may only replace them with elements that look like the originals. Given these pre-existing legal obligations the Tax Court might well find on remand that the Kaufmans' easement was worth little or nothing.

- The court took note of the fact that in persuading the Kaufmans to grant the easement, “a Trust representative told the Kaufmans that experience showed that such easements did not reduce resale value, and this could easily be the IRS’s opening argument in a valuation trial.”

**3. The old adage “better late than never” didn’t save the taxpayer’s deduction for a conservation easement on mortgaged property.** *Mitchell v. Commissioner*, 138 T.C. 324 (4/3/12). In 2003, the taxpayer contributed a conservation easement on over 180 acres of unimproved land to a qualified organization. The property was subject to a mortgage, but the mortgagee did not subordinate the mortgage to the conservation easement deed until 2005. The taxpayer claimed a charitable contribution deduction on her 2003 Federal income tax return, which the IRS disallowed. The taxpayer argued that she had met the requirement of Reg. § 1.170A-14(g)(2) requiring subordination of a mortgage to the conservation easement because Reg. § 1.170A-14(g)(3) should apply to determine whether the requirements of Reg. § 1.170A-14(g)(2) had been satisfied. Reg. § 1.170A-14(g)(3) provides that a deduction will not be disallowed merely because on the date of the gift there is the possibility that the interest will be defeated so long as on that date the possibility of defeat is so remote as to be negligible. The taxpayer argued that the probability of her defaulting on the mortgage was so remote as to be negligible, and that the possibility should be disregarded under the so-remote-as-to-be-negligible standard in determining whether the conservation easement is enforceable in perpetuity. The Tax Court (Judge Haines) held that the so-remote-as-to-be-negligible standard of Reg. § 1.170A-14(g)(3) does not apply to determine whether the requirements of Reg. § 1.170A-14(g)(2), requiring subordination of a mortgage to the conservation easement, have been satisfied, citing *Kaufman v. Commissioner*, 136 T.C. 294 (2011), *Kaufman v. Commissioner*, 134 T.C. 182 (2010), *Carpenter v. Commissioner*, T.C. Memo. 2012-1, and distinguishing *Simmons v. Commissioner*, T.C. Memo. 2009-208, *aff’d*, 646 F.3d 6 (D.C. Cir. 2011). Thus, the taxpayer did not meet the requirements of Reg. § 1.170A-14(g)(2), and the deduction was denied. However, the taxpayer was not liable for a § 6662 accuracy related penalty. She “attempted to comply with the requirements for making a charitable contribution of a conservation easement,” she hired an accountant and an appraiser, but she “inadvertently failed to obtain[] a subordination agreement” and “upon being made aware of the need for a subordination agreement she promptly obtained one.” She acted with reasonable cause and in good faith.

**a. And the subsequent First Circuit decision in *Kaufman* doesn’t change the result.** *Mitchell v. Commissioner*, T.C. Memo. 2013-204 (8/29/13). In a supplemental memorandum opinion, the

Tax Court (Judge Haines) denied the taxpayer's motion for reconsideration. The taxpayer argued that the Tax Court erred in relying on *Kaufman v. Commissioner*, 136 T.C. 294 (2011) (*Kaufman II*), which was affirmed in part, vacated in part, and remanded in part by the First Circuit in *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012) (*Kaufman III*), because *Kaufman III* was an intervening change in the law. In rejecting the taxpayer's argument Judge Haines concluded that *Kaufman III* addressed different issues from *Mitchell*. *Kaufman III* addressed the proper interpretation of the proceeds requirement in Reg. § 1.170A-14(g)(6), in particular, the breadth of the donee organization's entitlement to proceeds from the sale, exchange, or involuntary conversion of property following the judicial extinguishment of a perpetual conservation restriction burdening the property. But *Kaufman III* did not state a general rule that protecting the proceeds from an extinguishment of a conservation easement would satisfy the in-perpetuity requirements of Reg. § 1.170A-14(g), which was the basis on which *Mitchell* was decided.

**b. The Tax Court sticks by its guns on the mortgaged property conservation easement issue.** *Minnick v. Commissioner*, T.C. Memo. 2012-345 (12/17/12). Once again, the Tax Court (Judge Morrison) held that pursuant to Reg. § 1.170A-14(g)(2), no charitable contribution deduction is allowable for the donation of a conservation easement where a mortgage encumbering the property has not been subordinated to the interest of the donee of the easement. The court emphasized its holding in *Mitchell v. Commissioner*, 138 T.C. 324 (4/3/12), that the unlikelihood of default is irrelevant.

**4. No "take backs" allowed if you want an allowable charitable contribution.** *Graev v. Commissioner*, 140 T.C. No. 17 (6/24/13). The taxpayers contributed a facade conservation easement on property to the National Architectural Trust (NAT), a qualified charitable organization, along with a cash contribution. The conservation deed stated that "*nothing herein contained shall be constructed to limit the Grantee's right to give its consent (e.g., to changes in a Protected Facade(s)) or to abandon some or all of its rights hereunder*" [Emphasis added by the court], and NAT gave the taxpayers a letter stating: "In the event the IRS disallows the tax deductions in their entirety, we will promptly refund your entire cash endowment contribution and join with you to immediately remove the facade conservation easement from the property's title." Prior to the taxpayers making the donation, their accountants had advised them that in Notice 2004-41, 2004-2 C.B. 31, the IRS had announced increased scrutiny of deductions for conservation easement donations, and the taxpayers asked for and received from NAT assurance that their donation would be deductible. However, the year after the donation was made NAT sent the taxpayers a

letter, which they had taken deliberate steps to obtain, stating that “[i]t has recently been brought to our attention by our attorney that this offer of a refund may adversely affect the deductibility of the cash contribution as a charitable gift.” Subsequently, the IRS disallowed the deductions of the facade easement and the cash as conditional gifts, and the Tax Court (Judge Gustafson) upheld the disallowance of the deductions. Under Reg. § 1.170A-1(e), a contribution that might be defeated by a subsequent event will be considered to have been “made” only if at the time of the contribution the possibility that it will be defeated is “so remote as to be negligible.” Taking into account all of the facts and circumstances, including the enforceability of the side-agreement letter, the likelihood it would be honored by NAT even if it were unenforceable, the wording of the deed, and the various grounds on which the IRS might disallow a deduction for the contribution wholly apart from its conditionality, Judge Gustafson found that the likelihood that the condition would occur was not so remote as to be negligible at the time of the contribution. The court found that Notice 2004-41 made it clear that the contribution “would be subject to heightened scrutiny and that if any of the Graevs’ positions were susceptible to challenge, the Commissioner would likely enforce a contrary position,” and the taxpayers’ communications with NAT, which stated that his accountants “have advised [him] to be very cautious” reflected their understanding of this possibility. Because the condition requiring return was enforceable and NAT would act as promised in the letter, the contribution was conditional and the deductions were disallowed.

**a. Conditionally revocable conservation easements are no-good.** *Carpenter v. Commissioner*, T.C. Memo. 2012-1 (1/3/12). Conservation easements that could be extinguished by the mutual consent of the donor taxpayer and the donee organization failed as a matter of law to comply with the enforceability in perpetuity requirements under Reg. § 1.170A-14(g). The easements were not protected in perpetuity and thus were not qualified conservation contributions under § 170(h)(1).

**b. And the subsequent First Circuit decision in *Kaufman* doesn’t change the result.** *Carpenter v. Commissioner*, T.C. Memo. 2013-172 (7/25/13). Judge Haines denied the taxpayer’s motion for reconsideration. The taxpayer argued that in its earlier opinion the Tax Court had erred in relying on *Kaufman v. Commissioner*, 136 T.C. 294 (2011) (*Kaufman II*), which was affirmed in part, vacated in part, and remanded in part by the Court of Appeals for the First Circuit in *Kaufman v. Commissioner*, 687 F.3d 21 (1st Cir. 2012) (*Kaufman III*). Specifically, the taxpayer argued that the First Circuit’s emphasis on the destination of proceeds upon extinguishment of a conservation easement in *Kaufman III*,



required the Tax Court to “take an overall approach in analyzing the in-perpetuity requirement of section 170(h)(5)(A) and section 1.170A-14(g), Income Tax Regs., and focus on any proceeds resulting from an extinguishment of the conservation easements.” Judge Haines concluded, however, that *Kaufman III* did not support the taxpayer’s argument that “putting into the hands of the parties to a conservation agreement the authority to determine when to extinguish the conservation easement so long as the donee organization gets its share of the proceeds of a subsequent sale,” because in *Kaufman III* the First Circuit limited its holding to situations in which the easement is extinguished by judicial proceeding.

**5. You need an appraisal of the right property – here stock, and not real estate.** *Estate of Evenchik v. Commissioner*, T.C. Memo. 2013-34 (2/4/13). The taxpayer donated shares of stock in a corporation to a charity. The donated shares constituted approximately 72 percent of the outstanding stock. The corporation’s only assets were two apartment buildings. They attached appraisals for each building to their tax return, but never had obtained an appraisal of the stock. The Tax Court (Judge Holmes) upheld the denial of a charitable contribution deduction because the appraisals failed to comply with the qualified appraisal requirement in Reg. § 1.170A-13(c)(3)(ii). The appraisals valued the wrong property. The stock was the property that had to have been appraised. Furthermore the appraisals did not take into account the effect that the contribution of less than all of the stock might have had on value of the donated property. In addition, the appraisals failed to (1) provide a sufficient description of the property or (2) state the date or expected date of the contribution and the value of the property on those dates. Finally, the substantial compliance doctrine could not save the deduction. “This is not a case where the taxpayers provided most of the information but left out one insignificant datum. . . . This is a case where the appraisals had gaping holes of required information.”

**6. Quid-pro-quo can be in the favorable governmental action.** *Pollard v. Commissioner*, T.C. Memo. 2013-38 (2/6/13). The Tax Court (Judge Jacobs) upheld the denial of a charitable contribution deduction for the conveyance to the county government of two conservation easements with respect to a 67 acre farm property that the taxpayer owned. The granting of the conservation easements to the county was part of a quid pro quo exchange for the county approving the taxpayer’s subdivision exemption request that would allow him to build a second home on the property. Statements of the county commissioners during the course of public hearings indicated that the subdivision exemption would not have been approved if the taxpayer had not granted a conservation easement to the county. The approval of the subdivision exemption request was a substantial

benefit to the taxpayer. He did not convey the conservation easements “for detached and disinterested motives but rather to secure a personal benefit.”

**7. Typos don’t render a contemporaneous written acknowledgment defective.** Crimi v. Commissioner, T.C. Memo. 2013-51 (2/14/13). The taxpayer conveyed a conservation easement to a qualified donee through a bargain purchase. After first dissecting all of the experts’ reports to expose their errors, the Tax Court (Judge Laro) determined the value of the contribution. Turning to the question of whether the requirements of a contemporaneous written acknowledgment required by § 170(f)(8) and a qualified appraisal required by § 170(f)(11) had been met, the court found for the taxpayer despite imperfect documentation. The court rejected the IRS’s argument that the written acknowledgment had not been signed by a representative of the donee, finding that the signer was an agent of the donee. The court rejected the IRS’s contention that a typographical error in the description of the property was grounds for denying the deduction in light of the fact that the appraisal and the Form 8283 attached to the return provided the accurate description of the contributed property. The court rejected the IRS’s assertion that the contemporaneous written acknowledgment was defective because although it stated that the easement was valued at \$2,950,000, in consideration for which the donee provided a cash consideration of \$1,550,000, leaving a charitable contribution of \$1.4 million, it failed to state whether the donee organization provided other goods, services, or valuable consideration. Finally, the court applied the substantial compliance doctrine to determine that the qualified appraisal requirement had been met despite the fact that the appraisal was for an earlier year because the taxpayer relied on a long-time CPA and tax advisor and had no reason to doubt them when they told him that an updated appraisal would not provide a different value. That a subsequent valuation prepared by the taxpayer’s expert produced a value much higher than the earlier appraisal indicated that it was reasonable for the taxpayer to believe the earlier appraisal “was not stale in substance and thus a good appraisal.”

**8. If you are both the contributor and the president of the charity, you must send yourself a contemporaneous written acknowledgment. Note how our attention has been shifted from ferrets to ferrets.** Villareale v. Commissioner, T.C. Memo. 2013-74 (3/12/13). The taxpayer was a co-founder of NDM Ferret Rescue & Sanctuary, Inc. (NDM), an animal rescue organization that specializes in rescuing ferrets. During the year in issue, when she was NDM’s president, she contributed \$10,022 to NDM by electronic funds transfers. Twenty-seven contributions (totaling \$2,393) were for less than \$250 and 17 (totaling \$7,629) were for \$250 or more. The dates and amounts of the transfers were reflected in the taxpayer’s

and NDM's bank statements, but NDM never provided the taxpayer with a contemporaneous written acknowledgment containing a description of any property contributed, a statement as to whether any goods or services were provided in consideration, and a description and good-faith estimate of the value of any goods or services provided in consideration as required by § 170(f)(8). Accordingly, the Tax Court (Judge Vasquez) upheld the IRS's denial of the \$7,629 of contributions that were for \$250 or more. The court found it "immaterial" that taxpayer was on both sides of the transaction and rejected her contention that as the president of NDM "it would have been futile to issue herself a statement that expressly provided that no goods or services were provided in exchange for her contributions." The deduction for the \$2,393 of contribution that were in individual amounts of less than \$250 was allowed.

- **Do you remember? A touch of *Cohan* [?], with a cap, for the Cat Woman's unreimbursed charitable volunteer expenses.** *Van Dusen v. Commissioner*, 136 T.C. 515 (2011). The taxpayer claimed charitable contribution deductions for out-of-pocket expenses incurred in caring for "foster cats" as a volunteer on behalf of Fix Our Ferals, a § 501(c)(3) organization. The Tax Court (Judge Morrison) applied the "substantial compliance doctrine" to allow a deduction for expenses incurred by a volunteer providing services to a charitable organization, even though the taxpayer's records did not strictly meet the specific requirements of Reg. § 170A-13(a)(1). The taxpayer's documents were "legitimate substitutes for canceled checks," because they contained all of the information that would have been on a canceled check — the name of the payee, the date of the payment, and the amount of the payment. Although the regulation requiring substantiation records to reflect the name of the donee was not written with unreimbursed volunteer expenses in mind, because the amounts expended exceeded \$250 and the taxpayer failed to satisfy requirements of § 170(f)(8)(a) and Reg. § 1.170A-13(f)(1) for substantiation in the form of a contemporaneous written acknowledgment from the charitable organization, the deductible amount for each separate expenditure was limited to \$250.

- Query whether prudent planning in the future should be: "If it flies or floats, don't own – rent; if it barks or meows, don't adopt – foster."

**9. Quid pro quo can be very intangible.** Boone Operations Co., L.L.C. v. Commissioner, T.C. Memo. 2013-101 (4/11/13). The taxpayer transferred fill dirt to the City of Tucson in a bargain sale and claimed a charitable contribution deduction for the difference between the appraised fair market value of the fill dirt and the cash purchase price. The fill dirt was used in the process of closing a City of Tucson landfill that was adjacent to the landfill operated by the taxpayer. The Tax Court (Judge Marvel) upheld denial of the deduction on almost every conceivable ground.

First, the substantiation requirements of § 170(f)(8)(B) had not been met. Although the written agreement between the taxpayer and the City of Tucson stated the amount of cash Tucson agreed to pay for the fill, it also stated that Tucson provided goods and services in exchange for the contribution of fill, but lacked a good-faith estimate of the value of those goods and services. Furthermore, the Forms 8283 did not refer to any benefits received by the taxpayer in addition to the cash sale price. Second, the appraisal was not a qualified appraisal because, among other deficiencies, it used the wrong comparables and was based on the fair market value of delivered fill dirt, including transportation, but the taxpayer had deducted the transportation, which was the major component of the value of delivered fill dirt, as a business expense. Third, in addition to the cash price, the taxpayer received valuable consideration in the form of (1) a nonconforming use permit for the continued operation of its landfill, (2) the dismissal of a pending civil suit, (3) the City of Tucson's agreement not to pursue any criminal charges, and (4) indirect benefits from the City of Tucson closing its landfill and maintaining and monitoring the methane gas system on the taxpayer's landfill. Accordingly, the taxpayer failed to prove that the fill dirt was sold to the City of Tucson at a bargain price.

**10. If at first you don't succeed try again. If the Tax Court got reversed in another case appealable to the same Circuit, it just might work.** *Friedberg v. Commissioner*, T.C. Memo. 2013-224 (9/23/13). The Tax Court (Judge Wells) granted the taxpayer's motion to reconsider the court's prior decision holding that the appraisal the taxpayer obtained and submitted in connection with a claimed deduction for the contribution was not a qualified appraisal, T.C. Memo. 2011-238, and granted summary judgment that the appraisal was a qualified appraisal within the meaning of Reg. § 1.170A-13(c)(3). The earlier decision was based in part on *Scheidelman v. Commissioner*, T.C. Memo. 2010-151, *vacated and remanded*, 682 F.3d 189 (2d Cir. 2012). In *Scheidelman*, and in the earlier decision involving the taxpayer, the Tax Court held that the mechanical application of a percentage diminution to the fair market value before donation of a facade easement does not constitute a proper valuation method under Reg. § 1.170A-13(c)(3). But in vacating the Tax Court's decision in *Scheidelman*, the Second Circuit held that Reg. § 1.170A-13(c)(3)(ii)(K) does not require a specific method of valuation be used in the appraisal or that the IRS must believe it to be reliable; the regulation's requirement is fulfilled if the appraiser's analysis is present, even if the IRS and the court finds it to be unconvincing. Because this case is appealable to the Second Circuit, applying *Golsen v. Commissioner*, 54 T.C. 742 (1970), the decision of the Second Circuit in *Scheidelman* was an intervening change in the law. Because the appraisal included a specific basis for the appraiser's valuation

as required by Reg. § 1.170A-13(c)(3)(ii)(K), it was a qualified appraisal. Under the Second Circuit's opinion in *Scheidelman*, an appraisal's "accuracy and reliability" while relevant to the court's analysis of valuation, are irrelevant as to whether the appraisal is "qualified" under Reg. § 1.170A-13(c)(3).

**11. The facade, the whole facade, and nothing but the facade.** 61 York Acquisition, LLC v. Commissioner, T.C. Memo. 2013-266 (11/19/13). The partnership contributed to a qualified organization a facade easement covering the portion of a building that it owned. The partnership did not own the entire building. The Tax Court (Judge Laro) upheld the disallowance of a charitable contribution deduction because § 170(h)(4)(B) provides that to qualify for a deduction a facade easement must "include[] a restriction which preserves the *entire* exterior of the building (including the front, sides, rear, and height of the building)." (Emphasis added.) The partnership could not, and did not, grant a valid easement restricting the entire exterior of the building when the partnership did not own the entire exterior.

## X. TAX PROCEDURE

### A. Interest, Penalties, and Prosecutions

**1. Did Owen Fiore fraudulently "welch" on his taxes? Judge Holmes said "Yes."** Fiore v. Commissioner, T.C. Memo. 2013-21 (1/17/13). The Tax Court (Judge Holmes) found that former estate planning lawyer Owen Fiore filed fraudulent 1996 and 1997 income tax returns; Fiore had pleaded guilty to evasion of 1999 taxes but claimed that he did not owe fraud penalties for the earlier years. Fiore had total control of the finances of his law firm and did not delegate even the most mundane tasks, e.g., preparation of checks for signature, to anyone else, but claimed that he simply was "a horrible recordkeeper." In a detailed and analytic opinion, Judge Holmes decided the issue on the grounds that Fiore was short of cash during the 1996-1997 period and admittedly engaged in "willful blindness" to the possibility that he was underreporting his income; he also repeatedly stalled during the IRS examination of his tax returns. His opinion concludes:

And with particular weight given to this willful blindness we find that the Commissioner has met his burden of proving by clear and convincing evidence that Fiore filed fraudulent returns. We cannot accept that a person of Fiore's intelligence, training, and experience was not aware when he filed his returns for 1996 and 1997 —at a time when he knew his need for cash was ballooning — that there was a

high probability that he was underreporting his income. And we find that he deliberately avoided steps that would have confirmed that underreporting, since all he had to do was read his monthly bank statements to verify the accuracy of his estimates of taxable income that he put on his returns.

- From the website of Owen G. Fiore, JD:

For over four decades, Owen Fiore was a tax and estate planning lawyer in California, representing families and business entities in developing and implementing tax sensitive wealth succession, preservation and management plans, including using FLPs, LLCs, corporations and trusts in planning. He also had an active practice in tax controversies, especially those involving gift and estate taxes, evidenced by being lead counsel in a number of Tax Court cases, such as *Cristofani*, *Schauerhamer* and *Fontana*.

As the result of a personal income tax case leading to a plea agreement-based conviction and subsequent 14 months incarceration, Owen now is involved as a non-lawyer consultant to professional advisors and their clients in tax and estate planning matters. \*\*\*

Owen lives in Syringa, ID with his wife, Mary Ann, enjoying being on the Middle Fork of Idaho's wild and scenic Clearwater River.

- Section 10.24(a) of Circular 230 provides that "A practitioner may not, knowingly and directly or indirectly: (a) Accept assistance from or assist any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter or matters constituting practice before the Internal Revenue Service."

**2. A sole shareholder gets 87 months of room and board from the federal government for fraudulently treating as independent contractors workers who were really employees.** United States v. Deleon, 704 F.3d 189 (1st Cir. 1/11/13). The First Circuit, in an opinion by Judge Stahl, affirmed the fraud conviction under § 7206(2), and various other criminal statutes, of a corporation's sole shareholder. The corporation paid most of its workers directly with checks and did not withhold payroll taxes from their wages or report or remit such taxes to the IRS. The shareholder told the tax preparers that the unreported payroll workers were independent contractors for whom she was not required to remit payroll taxes. The tax return preparers recorded the checks to individuals on the unreported payroll as a business expense and issued a Form 1099 to each of those workers. The shareholder will get room and board from the federal government for 87 months.

**3. Taxpayer's reliance on his CPA, who did a little (\$1.2 million) embezzling on the side, was reasonable; therefore, no penalties for underreporting income were imposed. Thomas v. Commissioner, T.C. Memo. 2013-60 (2/26/13).** The Tax Court (Judge Gerber) stated the considerations for reasonable cause penalty avoidance based upon reliance upon a tax professional as follows:

To establish reasonable cause through reliance on the advice of a tax adviser, the taxpayer must meet the following three-prong test, laid out in *Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. at 98-99: (1) the adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer relied in good faith on the adviser's judgment. Finally, petitioner bears the burden of proof with respect to the defenses to the accuracy-related penalties. See *Higbee v. Commissioner*, 116 T.C. 438, 447 (2001).

Petitioner met and became familiar with Steeves, his tax preparer, during 2003 when they began working together in a real estate investment business. After working with Steeves for some time, petitioner began his own businesses, which involved the same type of business activity in which he had worked with Steeves. Steeves was a certified public accountant and had seven years of experience in the same type of businesses as petitioner. Petitioner, having worked with Steeves and being aware of his professional background and experience, exclusively relied upon him to maintain his records, handle his business financial matters, and prepare his returns. Under these circumstances we find that it was reasonable for petitioner to perceive Steeves as a competent professional and to rely on him.

Petitioner was reasonable in his reliance upon Steeves to correctly and accurately prepare his books. Petitioner understood that those books were used in the preparation of his 2006 and 2007 income tax returns. In addition, petitioners provided Steeves with all other information Steeves requested that was necessary to complete their returns, including the amounts of mortgage interest and interest income and Forms W-2. Accordingly, petitioner was satisfied that Steeves had all necessary and accurate information needed to correctly prepare petitioners'

income tax returns. We find that petitioner's efforts were sufficient to ensure his return preparer had adequate and accurate information.

Finally, we consider whether petitioner relied in good faith upon Steeves' judgment. In the setting of this case, there came a time when petitioner had doubts about the accuracy and quality of Steeves' recordkeeping. Ultimately, petitioner believed that Steeves was guilty of theft, fraud, and misappropriation of his money. However, his doubts about Steeves' ability or honesty did not arise until sometime after the 2006 and 2007 income tax returns were filed and respondent was conducting an audit examination of the returns. At the outset of that examination, petitioner continued to believe in and rely upon Steeves, to whom petitioner gave a power of attorney to represent him before the IRS.

Under these circumstances we hold that petitioner has carried his burden of showing reasonable reliance on the advice of a professional as a defense to the accuracy-related penalties for 2006 and 2007. Accordingly, petitioner is not liable for an accuracy-related penalty on any underpayment for 2006 or 2007.

**4. CPA's incorrect advice about an estate return extended filing deadline does not excuse the late filing penalty imposed on the executor.** *Knappe v. United States*, 713 F.3d 1164 (9th Cir. 4/4/13). The Ninth Circuit (Judge Paez) held that reasonable cause did not exist to abate a late filing penalty where the CPA mistakenly told the executor that he had secured a twelve-month extension of both the filing and payment deadlines. The extended payment deadline was correct, but an extension of the filing deadline is limited to six months – unless the executor was out of the country, an exception that did not apply here. Judge Paez followed *United States v. Boyle*, 469 U.S. 241 (1985), which held that advice about a filing deadline was “nonsubstantive advice” which does not constitute reasonable cause for relying upon his tax advisor's determination of the extended filing deadline date. He quoted *Boyle* as follows:

Reliance by a lay person on a lawyer is of course common; but that reliance cannot function as a substitute for compliance with an unambiguous statute. . . . It requires no special training or effort to ascertain a deadline and make sure that it is met. The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent,



and such reliance is not “reasonable cause” for a late filing under § 6651(a)(1).

• Judge Paez used a second rationale to justify his holding:

We acknowledge that the result today imposes a heavy burden on executors, who will affirmatively have to ensure that their agents’ interpretations of filing and payment deadlines are accurate if they want to avoid penalties. This burden is justified by the government’s substantial interest in ensuring that returns are timely filed. *See Boyle*, 469 U.S. at 249.

Moreover, any other result would reward collusion between culpable executors and their agents. In cases like this one, lawyers and accountants would be incentivized to claim that they gave erroneous advice to the executor whether or not they did in fact. The agent who fell on his sword would risk nothing, because the waiver of the penalty would leave the executor without damages. Even in cases in which executors and their agents did not actively collude to propound a contrived misrepresentation defense, negligent agents would be unilaterally incentivized to persist in giving erroneous advice to their clients, even if they realized their error.

• Note that *Boyle* contains strong language permitting a taxpayer to rely on his tax advisor’s substantive advice, and does not require the taxpayer to obtain a “second opinion”

**5. Sometimes actual receipt is necessary, mailing of a notice by the IRS is not game, set, match.** Lepore v. Commissioner, T.C. Memo. 2013-135 (5/30/13). In this CDP review, Judge Morrison held that the IRS improperly denied the taxpayer an opportunity to contest his liability for § 6672 trust fund penalty taxes at the CDP hearing, finding that the taxpayer had never had a previous opportunity to contest the liability because he had never actually received a Letter 1153. The taxpayer testified that he never saw the Letter 1153 or knew that it had arrived at his home, but the IRS argued that the determination by the Appeals Office was based on the legal conclusion that receipt by the taxpayer’s son of the Letter 1153, for which he signed, mailed to the taxpayer’s house constituted receipt by the taxpayer. Judge Morrison found the taxpayer’s testimony credible, as was the taxpayer’s son’s testimony that he “did not give the Letter 1153 to his father personally and that he instead ‘threw’ the Letter 1153 ‘somewhere’ in the basement.”

- Although the opinion notes that if the IRS mails the Letter 1153 to the taxpayer's last known address (I.R.C. § 6212(b)), the notification requirement is satisfied even if the person did not actually receive the notice. I.R.C. § 6672(b)(1). *Mason v. Commissioner*, 132 T.C. 301 (2009), held that unless the taxpayer deliberately refuses to accept its delivery, a Letter 1153 will be considered as having provided a prior opportunity to dispute liability for the underlying trust fund recovery penalty only if it is actually received. Thus, even though the letter not only was mailed certified mail by the IRS to the taxpayer's last known address and was delivered there and signed for by his son, actual receipt was necessary. In essence, § 6672(b) is not relevant in the CDP context.<sup>12</sup> In *Mason*, the IRS mailed the Form 1153 by certified mail to the taxpayer's last known address, but the letter was returned to the IRS undelivered and marked "unclaimed." Nevertheless, in *Mason* the Tax Court allowed the taxpayer to challenge the merits of the § 6672 penalty liability. It held: "a section 6672(b)(1) notice that was not received, but not deliberately refused, by a taxpayer does not constitute an opportunity to dispute that taxpayer's liability [for CDP purposes]." That sounds like an "actual receipt" rule. The facts of *Lepore* were a step closer to actual receipt by the taxpayer than the facts of *Mason*. Nonetheless, the *Lepore* facts fall short of actual receipt.

**a. But deliberately avoiding receipt of a Letter 1153 is game, set, and match for the IRS.** *Giaquinto v. Commissioner*, T.C. Memo. 2013-150 (6/12/13). The IRS mailed a Letter 1153 and Form 2751, Proposed Assessment of Trust Fund Recovery Penalty, to the taxpayer's last known address. The letter was returned as unclaimed. Subsequently, the IRS sent by certified mail to the taxpayer's residence Forms 3552, Notice of Tax Due on Federal Tax Return. The letter was returned as unclaimed. Subsequently, the IRS sent by certified mail to the taxpayer's residence a Letter 3172, Notice of Federal Tax Lien Filing and Your Right to a Hearing Under IRC 6320 (lien notice). The letter was delivered to petitioner. The taxpayer asked for a CDP hearing, but at the hearing was denied any opportunity to contest liability because he had a prior opportunity to dispute it. The taxpayer sought review of the determination sustaining the levy. The Tax Court (Judge Marvel) upheld the IRS's determination, holding that the taxpayer had a prior opportunity to dispute the underlying liability. The taxpayer argued that he was entitled to contest his liability for the § 6672 trust fund recovery penalties in the CDP hearing because he never received the Letter 1153 sent to him by certified mail. *Mason v. Commissioner*, 132 T.C. 301 (2009), was inapplicable because on the facts in this case, the taxpayer's failure to claim delivery of the certified

---

12. We are indebted to Professor Steve Johnson of Florida State University School of Law for helping us with the analysis that follows.

mail was deliberate. The taxpayer was fully aware that the IRS was considering whether to assert § 6672 trust fund recovery penalties against him, and either ignored or failed to claim at least one, and possibly two, USPS Forms 3849 that the mail carrier left for him with respect to the notices sent to him by certified mail.

**6. You gotta get your whole act together before filing a Tax Court petition. There's no second act in a Court of Claims refund suit.** The Cheesecake Factory, Inc. v. United States, 111 Fed. Cl. 686 (7/3/13). The taxpayer sought a refund of interest and late payment penalties assessed for 2005. It previously had received a deficiency notice that did not reference the late payment penalty, and the 2005 year had been litigated and settled in the Tax Court. In the Court of Federal Claims, the taxpayer argued that § 6512(a), which bars a suit for a refund or credit of income tax for a taxable year with respect to which the taxpayer has filed a petition in the Tax Court in response to a notice of deficiency, did not apply in this case because the deficiency notice “had nothing to do with either of the interest and penalty assessments.” The Court of Federal Claims (Judge Hewitt) held that the suit was barred by § 6512(a) because, once invoked, the Tax Court’s jurisdiction “extends to the entire subject of the correct tax for the particular year. . . . It is immaterial whether ‘the Commissioner issue[d] a Notice of Deficiency with respect to the penalties [and interest] . . . which are the subject of this Complaint.’”

**7. This accountant forgot the old maxim: “If someone has to go to jail, it better be the client.”** United States v. Favato, 533 Fed. Appx. 127 (3d Cir. 8/5/13). The Court of Appeals upheld the conviction of a BDO accountant under § 7212(a) for obstructing tax law administration by knowingly preparing for a client returns that claimed depreciation on a yacht held for personal use and that claimed false charitable contribution deductions.

**8. Negligence penalty is based on the amount the taxpayer actually underpaid.** Snow v. Commissioner, 141 T.C. No. 6 (9/19/13), supplementing T.C. Memo. 2013-114 (4/22/13). In the earlier proceeding a deficiency was determined and a § 6662(a) negligence penalty was sustained. The instant proceeding involved a disputed Rule 155 computation that turned on the computation of the “underpayment” as defined by § 6664(a) and Reg. § 1.6664-2 on which the penalty would be computed. Based on his return, the taxpayer had received a refund of \$16,684.65 that included \$5,567 of claimed withheld income tax that was never actually withheld. The earlier proceeding determined that his tax liability properly was \$12,968. The Tax Court (Judge Ruwe) held that the underpayment as defined in Reg. § 1.6664-2(a) is equal to the true amount

the government was deprived of as a result of the taxpayer's return. Accordingly, the § 6662 penalty was imposed on an "underpayment" of \$18,535 — the \$12,968 tax liability plus the \$5,567 that was improperly refunded as a result of the taxpayer's erroneous return.

**9. Surprising news – a deficiency is not the same thing as an underpayment. And fraudulently claimed refundable credits avoid a § 6662 accuracy related penalty.** *Rand v. Commissioner*, 141 T.C. No. 12 (11/17/13). The husband and wife taxpayers filed an income tax return correctly reporting taxable income of zero, \$144 of self-employment taxes due, and claiming refundable EITC of \$4,824, refundable child credit of \$1,447, and a recovery rebate credit of \$1,200. They claimed and received a refund of \$7,327. In the course of audit and the Tax Court litigation, the taxpayers conceded that they were not entitled to any credits. The only issue was whether there was an "underpayment" on which § 6662 accuracy-related adjustments could be computed. "Underpayment" as defined by § 6664(a) is determined with reference to: (1) the "tax imposed;" (2) "the amount shown as the tax by the taxpayer on his return;" (3) "amounts not so shown previously assessed (or collected without assessment);" and (4) "the amount of rebates made." The parties agreed that the "tax imposed" was zero, the "amounts not so shown previously assessed" was zero, and "the amount of rebates made" was zero. The point of contention was what was "the amount shown as the tax." The IRS argued that Reg. § 1.6664-2(c) should be interpreted to mean that claims for the refundable credits should be included in the computation of the amount shown as tax on their return, which would result in a negative tax liability of \$7,327. The taxpayer's argued that credits claimed on a return are excluded from the computation of the amount of tax shown on the return, and that as a result the tax shown on the return was \$144. Alternatively, the taxpayers argued that while the three types of credits they claimed are part of the amount shown as tax on the return when calculating an underpayment, the tax shown on a return cannot be negative when calculating an underpayment because Congress expressly failed to incorporate a provision like § 6211(b) in the definition of an underpayment. (This position also was advanced in an amicus brief by the Cardozo Tax Clinic.) In a reviewed opinion (10-5) by Judge Buch, the Tax Court accepted the taxpayer's alternative argument. After first deciding that credits can reduce the amount shown as tax on the return, it then went on to hold that for purposes of § 6664, unlike under § 6211(b), any excess of the refundable credits claimed as compared to the amount to which the taxpayer was entitled is not treated as a negative tax. Accordingly, the underpayment was limited to the amount of the taxpayers' self-employment tax that was offset by the refundable credits. In so doing, the court refused to defer to the IRS's interpretation of its regulations, although it noted that "our conclusion breaks

the historical link between the definitions of a deficiency and an underpayment.” Judge Buch wrote that the court’s decision was further supported by the “rule of lenity,” under which “statutes that impose a penalty are to be construed in favor of the more lenient punishment.”

- Judge Gustafson (joined by Judges Halpern and Goeke) dissented, concluding that no penalty should have been imposed because the “tax” shown on the return should not be reduced by the credits. The dissent concluded that no “underpayment” results from offsetting the tax due as shown on the return with refundable credits. Under this view, there is no § 6662 penalty for claiming credits to which the taxpayer is not entitled.

- Judge Morrison (joined by Judge Colvin) would have found an underpayment in the full amount of the refundable credits. This dissent concluded that the majority’s interpretation of ambiguous statutes left an unwarranted gap in the penalty system that did not reflect congressional intent.

The purpose of the section 6662 penalty is to deter taxpayers from taking questionable tax return positions that they hope that the IRS will not discover. . . . In the case of refundable credits, the claimants hope that the IRS will write them a refund check (as the IRS did for Rand and Klugman). False claims of credits on returns are as difficult for the IRS to detect as falsely reported items of gross income or deductions. Treating a false claim of credits as part of the “tax shown” on the return, and treating a false claim to refundable credits as potentially a report of negative tax, are consistent with the purpose of section 6662.

## **B. Discovery: Summonses and FOIA**

- 1. TAWs for UTPs — some protected, some not.** Wells Fargo & Co. v. United States, 112 A.F.T.R.2d 2013-5380 (D. Minn. 6/4/13). The IRS issued summonses to obtain information from Wells Fargo and KPMG related to Wells Fargo’s financial reporting and its undisclosed tax positions. Wells Fargo turned over some information, but filed a petition to quash the summons issued to KPMG on a variety of grounds, including that information was protected by the work product doctrine and was subject to attorney-client privilege. The court (Judge Tunheim) held that the IRS had established a legitimate purpose in seeking Wells Fargo’s tax accrual workpapers. Wells Fargo’s tax returns and UTPs were complex and “Wells Fargo ha[d] claimed tax benefits from listed transactions and engaged in other questionable tax practices in the past.” Wells Fargo failed to establish that the Schedule M-3 and Form 8886 would allow the IRS to identify all transactions related to the UTPs, and the IRS did not have to prove that the

tax accrual workpapers were “critical” to its ability to discover Wells Fargo’s tax positions. Turning to the work product issues, the court first held that Wells Fargo’s identification of UTPs around the time it entered into business transactions was not a task prepared in anticipation of litigation but rather an event that occurred in the ordinary course of business. Thus, the identity of the UTPs, and the process for identifying them, was not protected. However, after reviewing the TAWs relating to the UTPs, the court concluded that the recognition and measurement analysis reflected in its TAWs was prepared in anticipation of litigation, and thus was protected. The court further held that Wells Fargo’s state and local TAWs were not relevant to its federal tax liability and thus quashed the summonses with respect to those documents.

**2. The IRS is allowed a do-over in examining the taxpayer’s documents.** *Action Recycling, Inc. v. United States*, 721 F.3d 1142 (9th Cir. 7/9/13). In declining to quash a summons as unnecessarily repetitive under § 7605(b), the Ninth Circuit rejected the taxpayer’s argument that the IRS already “possessed” the summonsed information simply because a revenue agent had previously reviewed the documents.

**3. LB&I directive contains new mandatory Information Document Request (“IDR”) enforcement procedures.** LB&I-04-1113-009 (11/4/13). When a taxpayer does not timely respond to an IDR that (1) is issue focused, (2) has been discussed with the taxpayer, and (3) contains a response date that has been discussed with the taxpayer (and, in most instances, had been mutually agreed upon), then a mandatory procedure (with no exceptions) must follow, including (1) a Delinquency Notice, (2) a Pre-Summons Letter, and (3) a Summons.

- These procedures take effect 1/2/14, but examiners will not issue delinquency notices before 2/3/14.

- The advantage of this procedure to the taxpayer is that the specific issues under consideration must be discussed before IDRs are issued. The disadvantage is that there are extremely short mandatory time limits which are triggered once the examining agent determines that the taxpayer has not timely responded to an IDR.

**4. You can’t hide your foreign bank account records behind the Fifth Amendment.** *M.H. v. United States*, 648 F.3d 1067 (9th Cir. 8/19/11), *cert. denied* (6/25/12). M.H. was the target of a grand jury investigation seeking to determine whether he used secret Swiss bank accounts to evade paying federal taxes. The District Court granted a motion to compel his compliance with a grand jury subpoena *duces tecum* demanding that he produce certain records related to his foreign bank accounts. The District Court declined to condition its order compelling

production upon a grant of limited immunity and, pursuant to the recalcitrant witness statute, 28 U.S.C. § 1826, held him in contempt for refusing to comply. The Ninth Circuit upheld the District Court order. The Court of Appeals held that “[b]ecause the records sought through the subpoena fall under the Required Records Doctrine, the Fifth Amendment privilege against self-incrimination is inapplicable, and M.H. may not invoke it to resist compliance with the subpoena’s command.” The records were required to be kept pursuant to the predecessor of 31 C.F.R. § 1010.420.

- The opinion stated:

There is nothing inherently illegal about having or being a beneficiary of an offshore foreign banking account. According to the Government, § 1010.420 applies to “hundreds of thousands of foreign bank accounts—over half a million in 2009.” Nothing about having a foreign bank account on its own suggests a person is engaged in illegal activity. That fact distinguishes this case from *Marchetti* and *Grosso*, where the activity being regulated—gambling—was almost universally illegal, so that paying a tax on gambling wagers necessarily implicated a person in criminal activity. Admitting to having a foreign bank account carries no such risk. That the information contained in the required record may ultimately lead to criminal charges does not convert an essentially regulatory regulation into a criminal one.

**a. When the government asks, ya gotta pony up the name(s) on your foreign bank accounts, the account numbers, the name and address of the banks, the type of account, and the maximum value of each such account during each year.** In re: Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011, 691 F.3d 903 (7th Cir. 8/27/12), *cert. denied*, 133 S. Ct. 2338 (5/13/13). In an opinion by Judge Bauer, the Seventh Circuit held that the compulsory production of foreign bank account records required to be maintained under the Bank Secrecy Act of 1970 does not violate a taxpayer’s Fifth Amendment privilege against self-incrimination. The required records doctrine overrode any act of production privilege. A grand jury subpoena seeking the taxpayer’s bank records issued in connection with an investigation into whether he used secret offshore bank accounts to evade his federal income taxes was enforced.

**b. A third decision going the same way.** In re: Grand Jury Subpoena, 696 F.3d 428 (5th Cir. 9/21/12). The Fifth Circuit (Judge Dennis), in reversing a district court, declined to create a circuit split and held that the required records doctrine applied; the individual was

required to produce foreign bank records subpoenaed in the IRS's investigation into whether he used secret Swiss bank accounts [with UBS] to evade his federal income taxes. The court's reasoning was that the Bank Secrecy Act's record-keeping requirement is "essentially regulatory," the records sought are of a kind "customarily kept" by account holders, and the records have assumed "public aspects"; this is so even though one purpose of the BSA was to aid law enforcement officials in pursuing criminal investigations.

**c. The Second Circuit held that owners of secret offshore foreign bank accounts are not "inherently suspect" of tax evasion or of anything else illegal.** United States v. John Doe, 2013 WL 6670733 (2d Cir. 12/19/13). The Second Circuit (Judge Wesley) held that the required records exception to the Fifth Amendment applied, and that production of foreign bank records was required. Judge Wesley stated:

The record keeping regulation at issue here, 31 C.F.R. section 1010.420, targets those engaged in the lawful activity of owning a foreign bank account. "There is nothing inherently illegal about having or being a beneficiary of an offshore foreign bank account." M.H., 648 F.3d at 1074. Doe's protestations notwithstanding, owners of these accounts are not "inherently suspect" and the statute is "essentially regulatory."

Doe's argument that the statute is criminally focused has some force. The BSA [Bank Secrecy Act] declares that its purpose is "to require certain reports or records where they have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, including analysis, to protect against international terrorism." 31 U.S.C. section 5311. It does list "criminal investigations" first, but this multifaceted statute clearly contributes to civil and intelligence efforts wholly unrelated to any criminal purpose.

Although portions of the statute's legislative history support Doe's characterization of the BSA as focused on criminal activity, "[t]he Supreme Court has already considered and rejected these arguments as they relate to the BSA generally." M.H., 648 F.3d at 1074 (citing *Cal. Bankers' Ass'n v. Shultz*, 416 U.S. 21, 76-77 (1974)). Moreover, "the question is not whether Congress was subjectively concerned about crime when enacting the



BSA's recordkeeping and reporting provisions, but rather whether these requirements apply exclusively or almost exclusively to people engaged in criminal activity." Grand Jury Proceedings, No. 4-10, 707 F.3d at 1271; accord Grand Jury Subpoena, 696 F.3d at 434. Looking beyond "Congressional subjective intent" -- if there could be such a thing -- the BSA has considerable regulatory utility outside of the criminal justice context.

The question becomes whether a statute with mixed criminal and civil purposes can be "essentially regulatory" with respect to the required records exception. We agree with our sister circuits: the fact "[t]hat a statute relates both to criminal law and to civil regulatory matters does not strip the statute of its status as 'essentially regulatory.'" Grand Jury Proceedings, No. 4-10, 707 F.3d at 1270. Because people owning foreign bank accounts are not inherently guilty of criminal activity, the BSA's applicable recordkeeping requirement, designed to facilitate "criminal, tax, or regulatory investigations or proceedings, or [] the conduct of intelligence or counterintelligence activities," 31 U.S.C. section 5311, is still essentially regulatory. (footnote omitted)

- These were records that were routinely maintained and made available to government agents upon request by those German Jews who held secret accounts in Swiss banks during the 1930s and 1940s.

**d. No circuit conflicts yet; the fifth case was from the Fourth Circuit.** United States v. Under Seal, 737 F.3d 330 (4th Cir. 12/13/13). The Fourth Circuit (Judge Agee) agreed with the other circuits that have dealt with this issue, and held that the required records doctrine overrode the Fifth Amendment privilege against self-incrimination of a couple who held an account (successively) in two Swiss private banks.

### C. Litigation Costs

**1. When the IRS cuts the taxpayer a break in settling a case, the taxpayer is not a "prevailing party."** Knudsen v. Commissioner, T.C. Memo. 2013-87 (4/1/13). On 5/14/09, the IRS denied the taxpayer's Hamilton request for § 6015(f) relief on the ground that she had failed to seek relief within the two year period required by Reg. § 1.6015-5(b)(1). The taxpayer sought review in the Tax Court and on 3/15/11 the IRS stipulated that the taxpayer qualified for complete relief under § 6015(f) for all subject years if the two-year deadline was invalid. On 7/25/11 "the IRS

announced as a policy directive that the Department of the Treasury would expand the two-year deadline ‘in the interest of tax administration and \*\*\* not reflective of any doubt concerning the authority of the Service to impose the two-year deadline’ and that the two-year deadline would no longer be enforced in cases docketed in [the Tax Court].” See Chief Counsel Notice CC-2011-017 (July 25, 2011); Notice 2011-70, 2011-32 I.R.B. 135. In August 2011 the IRS conceded that the taxpayer was entitled to relief. Thereafter, the taxpayer sought attorney’s fees under § 7430, but the Tax Court (Judge Thornton) denied the taxpayer’s motion for attorney’s fees because she was not a “prevailing party” as required by the statute. Section 7430 provides that a taxpayer qualifies as a prevailing party only if either (1) the taxpayer has made a “qualified offer” or (2) the IRS’s position is not substantially justified, but the taxpayer relied on only the qualified offer rule. However, the qualified offer rule does not apply where the judgment is issued pursuant to a settlement, § 7430(c)(4)(E)(ii)(I), and the court held that the judgment in this case was based on a “settlement.”

#### **D. Statutory Notice of Deficiency**

**1. Are you “outside of the United States” if you live in another country but are visiting the United States when a deficiency notice is sent to your U.S. post office box?** Smith v. Commissioner, 140 T.C. 48 (2/28/13). Section 6213(a) gives the taxpayer 90 days, or if the notice is addressed to a person outside the United States, 150 days, after the mailing of a deficiency notice to file a Tax Court petition. Prior to August 2007, the taxpayer lived in San Francisco. In 2007, the taxpayer moved from San Francisco to Canada and became a permanent resident of Canada. However, she continued to own a home and maintained a post office box in San Francisco. In late December 2007, the taxpayer returned to San Francisco briefly to complete moving her furniture to Canada. While she was in San Francisco, the IRS mailed a deficiency notice relating to the year 2000 to her San Francisco post office box. The respondent stated that the taxpayer had until March 26, 2008 (i.e., 90 days), to file a Tax Court petition. The taxpayer failed to pick up the notice before returning to Canada on 1/8/08. On 5/2/08, the taxpayer received a copy of the deficiency notice, and on 5/23/08, she filed a Tax Court petition. The IRS filed a motion to dismiss for lack of jurisdiction, contending that the petition was not timely filed. The taxpayer objected and contended that, pursuant to § 6213(a), she was entitled to 150, rather than 90, days to file a petition. In a reviewed opinion (7-1-5) by Judge Foley, the Tax Court held that the 150-day period applied to the taxpayer because at the time the deficiency notice was sent she was a permanent resident of Canada. The majority cited *Hamilton v. Commissioner*, 13 T.C. 747 (1949), which held that “the 150-day period

applies to a taxpayer who regularly resides outside the United States but who through fortuitous circumstance happened to be physically in one of the States of the Union on the particular day the deficiency notice was mailed to him.

- Judge Halpern, in a dissent joined by three other judges, would have held that the petition was not timely. The dissent reasoned that the taxpayer “was present in the United States for a two-week period bracketing both the mailing and delivery of the notice to her address (a U.S. address) last known to the Commissioner, and, in the light of the words actually used by Congress and the relevant case law, that is sufficient for me to conclude that the notice was not addressed to a person outside the United States.” The dissent concluded that “the 150-day rule applies either when the taxpayer is out of the country or when the address on the notice is a foreign address,” and that “out of the country means ‘physically located outside the United States’” Under this reasoning “residence” is irrelevant. “Absence from the United States, resulting in delay, is what matters.”

**2. A website reference is as good as the address and phone number the statute requires on a deficiency notice. The statute is sooo 20th Century.** John C. Hom and Associates, Inc. v. Commissioner, 140 T.C. No. 11 (5/7/13). Section 6212(a) requires that a deficiency notice inform the taxpayer of the taxpayer’s right to contact a local office of the National Taxpayer Advocate and provide the location and phone number of the appropriate office. The taxpayer argued that a deficiency notice was invalid because the inclusion of a web-site address where the address and telephone number of the local office of the National Taxpayer Advocate may be found did not comply with the statutory requirement. The Tax Court (Judge Cohen) held that the deficiency notice was valid. Section 6212 does not provide that a deficiency notice sent without the specified information is invalid. The taxpayer was not prejudiced by the form of the deficiency notice because the information described in § 6212(a) was made available, “although in a manner that may not be sufficient for a taxpayer without access to a computer or knowledge of how to access a Web site.” But the notice was not misleading, and the taxpayer was able to file, and did file, a timely Tax Court petition.

## **E. Statute of Limitations**

**1. Don’t screw up your certified mail customer receipt.** Stocker v. United States, 705 F.3d 225 (6th Cir. 1/17/13). On 10/15/07, the taxpayers mailed an amended return requesting a refund for 2003; their 2003 tax return had been timely mailed on 10/15/04. The IRS acknowledged that it received the amended return on 10/25/07, but rejected the refund claim on the ground that the request was untimely under §

6511(a), asserting that the envelope was postmarked October 19 — four days late. The taxpayers could not avail themselves of the timely mailed, timely filed rule of § 7502(a) because they could not produce a postmarked envelope; this was because the IRS, by its own admission, had not retained the envelope in which the return had been received. Nor could they present the customer copies of a certified mail receipts, because although they claimed to have sent the amended return by certified mail, they had — in a tragic comedy or errors — failed to present to the post office the customers' copy of the certified mail receipt to get them date-stamped. The Sixth Circuit, in an opinion by Judge Rosen, held that the taxpayers were not entitled to introduce extrinsic evidence of timely mailing of the refund request. The court followed the decisions of other courts holding that the exceptions provided by § 7502 are “exclusive and complete.” *See, e.g. Deutsch v. Commissioner*, 599 F.2d 44 (2d Cir. 1979), and other cases cited therein. The court noted that in any event, the extrinsic evidence put forward by the taxpayers did “not purport to establish the fact of significance under § 7502(a)(1) — namely, the ‘date of the United States postmark’ on their amended 2003 return — but instead is directed at the separate factual question of when they presented this return to the post office for mailing.” Thus, the denial of the refund was upheld.

**2. You must react quickly to a jeopardy assessment if you want judicial review.** *Abraitis v. United States*, 709 F.3d 641 (6th Cir. 3/4/13). The Sixth Circuit, in an opinion by Judge Cook, held that the availability of judicial review under § 7429(b) requires that the taxpayer either have made a timely request for administrative review or exhausted administrative remedies prior to seeking judicial review of the jeopardy assessment. (The statute permits the taxpayer to seek judicial review within 90 days after either (1) the sixteenth day after the taxpayer's request to the IRS for administrative review or (2) the day the IRS notifies the taxpayer of its determination on administrative review.) Furthermore, the court held that the requirement in § 7429(a)(2) that the taxpayer's request for administrative review must be filed within 30 days after receiving the written statement from the IRS explaining the jeopardy assessment is not subject to equitable tolling.

**3. A sad story about employee misclassification.** *Karagozian v. Commissioner*, T.C. Memo. 2013-164 (7/8/13). The taxpayer's employer mischaracterized him as an independent contractor from 2002 through 2008. The taxpayer filed tax returns as an independent contractor, paying self-employment tax. After the taxpayer filed an amended return for 2008, treating himself as an employee, the IRS assessed liability for the employer's share of unpaid FICA taxes for 2008 against the taxpayer.

In a CDP review, the Tax Court (Judge Kerrigan) held that the taxpayer could not invoke equitable recoupment to reduce the 2008 liability for unpaid FICA taxes by overpaid FICA taxes for earlier years, when he filed tax returns as an independent contractor. Although the FICA taxes “paid in the time-barred years were paid on the same type of transaction (i.e., compensation ...) as in 2008, ... the overpaid FICA taxes from 2002 through 2007 are separate transactions, separate items, and separate taxable events from [the taxpayer’s] 2008 tax deficiency.”

**4. The pro se taxpayer won on the jurisdictional issue but lost on the merits.** Boeri v. United States, 724 F.3d 1367 (Fed. Cir. 7/31/13). The Federal Circuit, in an opinion by Judge Clevenger, held that the three-year “look-back” period of § 6511(b)(2)(A) limiting the amount of credit or refund is not a “statutory time limitation[]” but rather a “substantive limitation[] on the amount of recovery.” The look-back provision is not jurisdictional and does not preclude the court from hearing the taxpayer’s claim. The taxpayer lost on the merits.

**5. There was no statute of limitations because the return was fraudulent, even though the taxpayer didn’t know it.** City Wide Transit, Inc. v. Commissioner, 709 F.3d 102 (2d Cir. 3/1/13), *rev’g* T.C. Memo. 2011-279. The Second Circuit, in an opinion by Judge Wesley, held that the § 6501(c) extended period of limitations for assessing taxes due to a willful attempt to defeat or evade tax applied where the corporation’s accountant, who had been given a power of attorney, filed fraudulent employment tax returns to further his embezzlement scheme. (The scheme itself is not worth explaining.) The court explained: “The statute is agnostic as to the attendant motivations for submitting a fraudulent return and only requires that the Commissioner prove a fraudulent return was filed with an intent to evade, that is avoid, paying a tax otherwise due.”

- In the Tax Court proceeding, Judge Vasquez had found that the IRS had not proved by clear and convincing evidence that the accountant’s filing of the employment tax returns was “conduct intended to defeat or evade [the] taxes” rather than “an incidental consequence or secondary effect of his embezzlement scheme.” He accepted the taxpayer’s argument that the accountant “intended only to cover up his embezzlement scheme and not defeat or evade petitioner’s taxes.”

- In an earlier case, Allen v. Commissioner, 128 T.C. 37 (2007), the Tax Court held that under § 6501(c)(1), the limitations period remained open indefinitely regardless of whether it was the taxpayer or the taxpayer’s tax return preparer who had the intent to evade tax.

**a. But the Court of Federal Claims says “nuts” to the Second Circuit and Tax Court.** BASR Partnership v. United

States, 113 Fed. Cl. 181 (9/30/13). The IRS issued an FPAA after the §§ 6501(a)/6229 period of limitation had expired. The government asserted that the extended period for assessment under § 6501(c)(1) for fraud applied by reason of the fraudulent intent of the taxpayer's advisors who designed a tax shelter transaction and one of whom prepared the return. The government relied on *City Wide Transit, Inc. v. Commissioner*, 709 F.3d 102 (2d Cir. 2013), and *Allen v. Commissioner*, 128 T.C. 37 (2007) in support of its argument. In *City Wide Transit*, the Second Circuit held that the fraudulent intent required to extend the statute of limitations under § 6501(c)(1) is not limited to the taxpayer. In that case the tax preparer's fraudulent intent triggered the extended period in § 6501(c)(1), even though the preparer's primary motive was his own benefit rather than the taxpayer's. The Tax Court reached the same conclusion in *Allen*, where it stated: "Nothing in the plain meaning of the statute suggests the limitations period is extended only in the case of the taxpayer's fraud. The statute keys the extension to the fraudulent nature of the return, not to the identity of the perpetrator of the fraud." However, in the instant case, without reaching the question of whether the taxpayer's advisors harbored fraudulent intent, the Court of Federal Claims rejected that proposition and held that even though there was no question that "BASR's partnership return included false or fraudulent items," the extended statute of limitations did not apply. Judge Barden concluded that "the meaning of 'intent to evade tax,' as that text is used in I.R.C. § 6501(c), is limited to instances in which the taxpayer has the requisite intent to commit fraud." Referring to the Second Circuit's decision in *City Wide Transit* and the Tax Court's decision in *Allen*, she said, "These cases, however, are not binding upon this court." Because the government conceded that the taxpayers in this case did not have fraudulent intent, the § 6501(a) three-year period for assessment applied and the FPAA was time barred.

**6. What was I thinking, signing as the TMP!? An ostensible TMP who executed consents to extend the period of limitations on assessment of partnership items may not, in fact, have been the TMP, but the consents were valid because he was authorized to sign them.** Peking Investment Fund, LLC v. Commissioner, T.C. Memo. 2013-288 (12/23/13). As the Tax Matters Partner (TMP) of Peking Investment Fund, LLC (PIF), an LLC taxed as a partnership, an individual named Li Chien Tsai executed Forms 872-P, Consents to Extend the Time to Assess Tax Attributable to Partnership Items, which extended until December 31, 2008, the § 6229(a) period of limitations on assessment with respect to partnership items for certain taxable years. On December 30, 2008, the IRS sent a notice of final partnership administrative adjustment (FPAA) denying loss deductions claimed by PIF. Among other issues in the case, the

Tax Court (Judge Halpern) considered whether Mr. Tsai's execution of the Forms 872-P effectively extended the period of limitations on assessment pursuant to § 6229(b)(1)(B), which provides that the period of limitations can be extended "with respect to all partners, by an agreement entered into by the Secretary and the tax matters partner (or any other person authorized by the partnership in writing to enter into such an agreement)." Mr. Tsai, who was granted leave to participate in the case in an earlier proceeding, asserted that the Forms 872-P he executed were invalid and did not effectively extend the period of limitations on assessment because: (1) he was ineligible to be PIF's TMP when he signed them because he had no direct ownership interest in PIF and therefore was not a general partner or member-manager of PIF, and (2) he was not otherwise authorized to sign them. The government challenged only the second assertion. The court concluded that a letter to the IRS from PIF's former TMP, who was the member-manager of PIF, was sufficient authorization within the meaning of § 6229(b)(1)(B). In that letter, the former TMP resigned and appointed Mr. Tsai as TMP. The court reasoned that, although the letter might not have been effective to appoint Mr. Tsai as TMP, it nevertheless expressed the former TMP's (and therefore PIF's) intent to authorize Mr. Tsai to exercise the same authority as the former TMP, including the authority to execute the Form 872-P consents. In reaching this conclusion, the court examined an analogous situation involving a limited partnership in *Investment Engineers, Ltd. v. Commissioner*, T.C. Memo. 1994-255. Based on the former TMP's resignation and its holding out of Mr. Tsai as the TMP, the court also concluded that PIF was "estopped from denying his authority as PIF's ostensible TMP to execute the Form 872-P consents for the years in issue."

## F. Liens and Collections

**1. Does this case portend that most single-member LLCs are mere nominee owners on behalf of their single member?** *Berkshire Bank v. Town of Ludlow*, 708 F.3d 249 (1st Cir. 1/11/13). The First Circuit, in an opinion by Judge Stahl, affirmed a District Court decision holding that a tax lien against the owner of a single-member LLC (which was a disregarded entity) filed in 2009 was superior to a judgment lien on land owned by the LLC arising in 2010. On the facts the LLC was a mere nominee for its owner: (1) the owner transferred the property to the LLC for no consideration, (2) no one else had any interest in the LLC, made decisions for it, or benefitted from its income, (3) the LLC operated out of its owner's home, (4) the owner exercised total control over the LLC's property and its development, (5) the owner had complete use and enjoyment of the property, as evidenced by his formulation and execution of the plan to subdivide the property and sell off the lots, (6) the LLC did not interfere with the owner's use of the property, (7) the owner used 10 to 15 percent of the revenue from

the LLC to pay his personal expenses; (8) the owner of the LLC treated the property as if it belonged to him, (9) the owner testified that he set up the LLC and transferred title to the property solely to avoid legal liability “in case somebody got hurt on the property,” and (10) the LLC’s bank account was not in its own name, but in the owner’s name.

**2. The obligation to pay income taxes has priority over a religious obligation to tithe.** Thompson v. Commissioner, 140 T.C. 173 (3/4/13). In reviewing a CDP hearing, the Tax Court (Judge Ruwe) held that it was not an abuse of discretion for the settlement officer to reject the taxpayer’s contention that his (1) monthly tithing to his (the Mormon) Church and (2) monthly payments for his children’s college expenses should be excluded from the monthly amount available to satisfy his unpaid tax liabilities. The court rejected the argument that failure to allow tithing as a necessary expense violated the taxpayer’s First Amendment right to religious freedom and the Religious Freedom and Restoration Act of 1993.

The Commissioner’s interest in expeditiously collecting taxes is especially compelling given the specific facts of this case. Petitioner has a long history of not paying his income tax liabilities. As of the date of trial petitioner still had not paid his income tax liabilities for the taxable years 1992, 1995, 1996, 1999, and 2000. Additionally, respondent has assessed trust fund recovery penalties under section 6672 against petitioner for seven different tax periods.

**3. BLIPS and bankruptcy: hiding assets after learning losses may be disallowed can make the subsequent tax liability non-dischargeable.** Vaughn v. United States, 111 A.F.T.R.2d 2013-1481 (D. Colo. 3/29/13). The taxpayer used losses from a KPMG BLIPS tax shelter to offset gain from the 1999 sale of his interest in a cable company. After being informed by KPMG of the release of Notice 2000-44, 2000-2 C.B. 255, which identified losses in BLIPS-type tax shelters as nondeductible, and learning that the IRS was auditing the cable company’s former CFO, who also had used BLIPS losses to offset gain, the taxpayer purchased a \$1.7 million home titled in his fiancée’s name. After KPMG advised the taxpayer to disclose his BLIPS investment, but before he disclosed it, the taxpayer funded a \$1.5 million trust for his stepdaughter. He also spent significant amounts on jewelry and home furnishings. The taxpayer later filed a chapter 11 bankruptcy petition and the IRS filed a proof of claim in that proceeding in the amount of \$14,359,592. Under 11 U.S.C. § 523(a)(1)(C), a tax debt is not dischargeable in bankruptcy if the debtor either made a fraudulent return or willfully attempted to evade or defeat the



tax. The Bankruptcy Court held that the taxpayer's tax liability was non-dischargeable on both grounds. The District Court affirmed the Bankruptcy Court's determination solely on the ground that the taxpayer had willfully attempted to evade or defeat tax. The District Court rejected the taxpayer's contention that he could not have willfully attempted to evade or defeat tax because there had been no assessment or quantification of his tax liability when he depleted his assets.

**4. A good reason not to be the fiduciary of any estates or trusts that you represent.** *United States v. Tyler*, 528 Fed. Appx. 193 (3d Cir. 6/11/13). The Court of Appeals, in an opinion by Judge Jordan, held that 31 U.S.C. § 3713 imposes personal liability on an executor who distributes all of the funds from an estate thereby rendering the estate unable to pay the taxes due from the estate (including unpaid tax liabilities of the decedent), even though such a distribution "is not, strictly speaking, the payment of a debt," to which the statute refers. The court relied on *United States v. Coppola*, 85 F.3d 1015 (2d Cir. 1996), which reached the same result.

- To avoid this problem, executors should consider filing Form 4810, Request for Prompt Assessment, and Form 5495, Request for Discharge from Personal Liabilities.

**5. Who says the income tax is uniform throughout the country. Sometimes state law determines from whom the IRS can collect.** *Fourth Investments, LP v. United States*, 720 F.3d 1058 (9th Cir. 6/13/13). The Court of Appeals, in an opinion by Judge M. Smith, affirmed a District Court in favor of the government in a quiet title action in which the plaintiff partnerships sought to remove a tax lien on properties to which the partnerships held title. The lien was for back taxes of married individuals from whom partnerships had received properties without consideration. The court rejected the government's argument that nominee status was to be determined under federal common law, and held that the relevant state law controlled the determination of whether title to the property was held as a nominee. Nevertheless, the court concluded that the partnerships held the properties as nominees of the taxpayers under California law, which was the controlling state law.

- As for the controlling law, a similar result has been reached by other Circuits that have addressed the issue. See *Berkshire Bank v. Town of Ludlow*, 708 F.3d 249 (1st Cir. 2013) (clarifying that state law, rather than federal law, provides the "substantive rules" of nominee doctrine); *Holman v. United States*, 505 F.3d 1060 (10th Cir. 2007) (rejecting the government's argument that a "uniform federal rule should ... govern whether the nominee theory is to apply," and remanding for application of Utah law); *Spotts v. United States*, 429 F.3d 248 (6th Cir. 2005) ("Because there is no

indication that the district court applied [state] law before determining the scope of the federal tax lien we must reverse.”).

**6. Unremitted withholding determined in criminal tax fraud trial was credible for determining civil tax liability.** Dixon v. Commissioner, T.C. Memo. 2013-207 (9/3/13). In reviewing an IRS CDP determination, the Tax Court (Judge Holmes) held that the Dixons were entitled to a credit against their 1992 through 1995 income tax liability for \$510,896 determined in their criminal tax fraud trial to have been withheld by their corporate employer (which they controlled) but not remitted. The withholding had been determined as part of the tax-loss computation from the then-still-extant books and records, even though many records subsequently disappeared before the CDP hearing. As part of their sentencing the taxpayers agreed to pay that sum to the corporation in 1999 and 2000, and the corporation remitted the funds to the IRS with a designation that the funds be applied to the corporation’s employment taxes for the years in question with respect to the taxpayers as representing withheld taxes.

**a. An employer can designate which employee’s withholding taxes it has paid.** Dixon v. Commissioner, 141 T.C. No. 3 (9/3/13). In a related case reviewing the same CDP determination, the Tax Court, in a reviewed opinion by Judge Lauber (11-1-3), held that “when an employer pays in a later year the nonwithheld income tax of an employee for an earlier year, the employee as a matter of law is not entitled to a credit under section 31.” That did not, however, resolve the matter. In 1999 and 2000 the Dixons had remitted to the employer corporation \$91,233 to be applied to their 1992 through 1995 income tax liabilities – the amount of their income tax liabilities in excess the amounts for which the court in the related Tax Court memorandum opinion held that the corporation had withheld (but not remitted). The corporation remitted the funds to the IRS with a designation that they be applied to the corporation’s employment taxes for the years in question with respect to the taxpayers as representing withheld taxes. But the payment was outside the period prescribed by § 6205(a)(1) for making a “proper adjustment” to under-withholding. The IRS applied the payment to other corporate tax liabilities. Nevertheless, the court held that the taxpayers should have received a credit of \$91,223 against their 1992 through 1995 income tax liabilities by virtue of the corporation’s designated payments. It rejected the IRS’s argument that “there is no legal basis for insisting that the IRS honor the designation of a delinquent employment tax payment toward the income tax liability of a specific employee.” However, the taxpayer’s remained liable for interest and penalties attributable to the late payment.

- Judges Holmes, Buch, and Halpern dissented, and would have held that the relevant statutory scheme does not allow the corporation to designate a payment for its own benefit and also for the benefit of the employees.

**7. It's going to cost more to apply not to pay the taxes you rightfully owe.** REG-144990-12, User Fees for Processing Installment Agreements and Offers in Compromise, 78 F.R. 53702 (8/30/13). Proposed amendments to Reg. § 300.1(b) would increase the fee for entering into an installment agreement. The fee before 1/1/14 is \$105. The fee for entering into an installment agreement on or after 1/1/14 would be \$120. Proposed amendments to Reg. § 300.2(b) would increase the fee for restructuring or reinstating an installment agreement. Before 1/1/14 the fees is \$45. The fee for entering into an installment agreement on or after 1/1/14 would be \$50. Proposed amendments to Reg. § 300.3(b) would increase the fee for processing an offer in compromise. Before 1/1/14 the fee is \$150. The fee for processing an offer in compromise on or after 1/1/14 would be \$186.

**8. No late mandatory mulligan on an unprocessable OIC.** Reed v. Commissioner, 141 T.C. No. 7 (9/23/13). In a case of first impression, the Tax Court (Judge Kroupa), in reviewing a CDP determination, held that the IRS cannot be required to reopen in a CDP hearing an offer-in-compromise (OIC) based on doubt as to collectability when the OIC was rejected as unprocessable years before the CDP hearing commenced. There was no abuse of discretion.

**9. “Our review of the overall record leaves us with a firm sense that petitioner has not been treated in a fair and rational manner.”** Szekely v. Commissioner, T.C. Memo. 2013-227 (9/24/13). This case was a review of a CDP determination to file a tax lien. The self-employed taxpayer filed tax returns for 2006 through 2010 reporting his income but making no payments. Beginning in 2011 he began making estimated tax payments. In that year he also contacted the Taxpayer Advocate Service to seek advice on making an offer in compromise. When the IRS contacted him to advise him of his right to a CDP hearing, he submitted IRS Form 12153, Request for a Collection Due Process or Equivalent Hearing, and attached to his letter his previous communications with TAS, as well as copies of checks and payment vouchers for his estimated tax payments for 2011 in an effort to persuade the IRS to resolve his tax liabilities for prior years. By a letter dated Feb. 3, 2012 the IRS Appeals Office notified the taxpayer that a CDP hearing had been scheduled and that he needed to complete and submit a Form 433-A together with supporting documentation and three months of bank statements. The letter from the IRS stated that collection alternatives would not be considered

unless the documents were received within 14 days from the date of the letter. The taxpayer complied. During the CDP hearing the Appeals Officer informed the taxpayer that he needed to submit a Form 656, Offer in Compromise, and another Form 433-A—this time, Form 433-A (OIC)—before a collection alternative could be considered. On Feb. 28, 2012, the Appeals Officer sent the taxpayer a follow-up letter with the forms, asking the taxpayer to complete and submit these forms, with supporting documentation and the required payments by March 13, 2012. Unlike the earlier letter, the February 28 letter did not warn the taxpayer of any negative consequences if he failed to submit all of the required information by March 13. When the taxpayer had not submitted the forms and documentation by March 13, the Appeals Officer concluded that the filing of the lien should be sustained and the IRS sent a determination letter. The Tax Court (Judge Lauber) remanded the case for a supplemental CDP hearing to consider the taxpayer's OIC. He noted that although the Tax Court has approved allowing a taxpayer only 14 days to submit documentation in CDP, a 14-day deadline must be applied using a rule of reason.

The SO [Appeals Officer] knew that petitioner's liabilities were properly reported; that he had previously worked with TAS to receive assistance; that he was eager to work out a compromise of his tax liabilities; that he was current on his 2011 tax liability; and that he had responded timely to her previous requests for documents and information. Armed with this knowledge, the SO should not have lightly assumed, when petitioner's OIC package did not arrive on March 13, that he had decided to walk away from his efforts to secure a compromise. ... All that was required was a two-minute phone call to inquire whether petitioner needed a little more time.

**10. When the U.S.P.S. Form 3877 isn't properly completed, it's not enough to prove that the IRS sent the deficiency notice.** *Meyer v. Commissioner*, T.C. Memo. 2013-268 (11/25/13). This case was a review of a CDP determination to proceed with a levy. The taxpayer had not filed a tax return and the IRS prepared a substitute for return. The taxpayer claimed that he never received a deficiency notice. The IRS could not produce a copy of the deficiency notice, but the Appeals Officer conducting the hearing relied on a Form 4340, Certificate of Assessments, Payments, and Other Specified Matters, to verify that the Commissioner had properly assessed the tax, and a U.S.P.S. Form 3877 that listed, along with others, the taxpayer's name and address to verify that the deficiency notice had been properly mailed. The taxpayer argued that this determination was

an abuse of discretion, because the Appeals Officer did not meet his obligation to verify that the IRS properly issued and mailed a notice of deficiency to him. Citing *Hoyle v. Commissioner*, 131 T.C. 197 (2008), the Tax Court (Judge Holmes) held that “the Appeals officer could not rely on ‘computerized records’ like the Form 4340, ... but ‘[t]he Appeals officer may be required to examine underlying documents.’” Examining the Form 3877 was a step in the right direction according to Judge Holmes, but because the existence of the deficiency notice was in dispute and as a factual matter the Form 3877 itself appeared not to have been properly completed, in this case that one additional step did not suffice. Because the administrative record did not show that the Appeals Officer relied on anything else to verify proper mailing, the case was remanded to the Appeals Officer to independently verify that a deficiency notice was properly issued and mailed.

### G. Innocent Spouse

1. **The significant benefit of getting to own your home free and clear of a mortgage lien precludes equitable relief.** Haggerty v. Commissioner, 505 Fed. Appx. 335 (5th Cir. 1/3/13). The taxpayer sought § 6015(f) equitable relief for taxes due with respect to her late husband’s premature IRA withdrawal that was reported on their joint return for the year of his death. She had no knowledge of the withdrawal and the use of the funds to pay off a second mortgage lien on their home, which as a result of his death she owned outright, until after her husband’s death. In a per curiam opinion, the Fifth Circuit upheld denial of relief. Because the taxpayer signed and filed the return after her husband’s death and the income tax liability was properly reported but not paid, she knew that her husband would not pay the tax liability. The key to the holding, however, was that the taxpayer received a significant economic benefit when her husband paid off the second mortgage against their home.

2. **APA, schmay PA! The Tax Court’s review of § 6015(f) relief denial is de novo and new evidence is admissible.** Wilson v. Commissioner, 705 F.3d 980 (9th Cir. 1/15/13). The Ninth Circuit in a divided opinion (2-1) by Judge Thomas, held that, in reviewing the IRS’s denial of § 6015 innocent spouse relief, the Tax Court properly considered new evidence outside the administrative record and correctly applied a de novo standard of review in determining the taxpayer’s eligibility for § 6015(f) equitable relief. The court reasoned as follows:

Section 6015(e)’s jurisdictional grant to determine whether equitable relief is warranted in a § 6015(f) case must be read alongside subsection (f)’s mandate to consider the totality of the circumstances before making an equitable relief

determination. “Taking into account all the facts and circumstances” is not possible if the Tax Court can review only the evidence available at the time of the Commissioner’s prior determination.

- The majority also rejected the IRS’s argument that the Administrative Procedure Act applied to limit the Tax Court’s review. The court reasoned that the “extensive legislative history of [§§ 6015(e) and (f)] demonstrates that the special procedures enacted by Congress displace application of the APA in innocent spouse tax relief cases, and the APA does not apply.” The court emphasized that at no time prior to the Tax Court proceeding is there a formal administrative procedure at which the taxpayer can present the case before an administrative law judge; and at no time during the administrative process is the taxpayer afforded the right to conduct discovery, present live testimony under oath, subpoena witnesses for trial, or conduct cross-examination. These procedures are available only in the Tax Court. Finally, the Ninth Circuit acknowledged that “a de novo scope of evidentiary review is incompatible with an abuse of discretion standard,” but concluded that “the nature of equitable relief ... favors de novo review.”

The Tax Court must be able to compile a de novo record if it is to consider “all the facts and circumstances” when deciding whether a taxpayer is entitled to relief from joint liability under § 6015(f), but it is pointless to do so if it can only review the Commissioner’s denial of equitable relief for an abuse of discretion. The only way for the Tax Court to proceed de novo when hearing petitions for relief under § 6015(f) is by applying both a de novo standard and scope of review.

- Accordingly, the Ninth Circuit affirmed the Tax Court’s decision granting relief.

- Judge Bybee dissented, arguing that the Administrative Procedure Act applied, and the Tax Court as a reviewing court is limited to the administrative record and a review for abuse of discretion by the IRS.

- In *Commissioner v. Neal*, 557 F.3d 1262 (11th Cir. 2009), the Eleventh Circuit, the only other circuit that has considered the scope of the Tax Court’s review in § 6015(f) cases, reached the same conclusion as the Ninth Circuit majority.

**a. The IRS throws in the towel on another innocent spouse procedural rule.** CC-2013-011 (6/7/13). This Chief Counsel Notice provides that IRS attorneys will no longer argue (1) that the

Tax Court should limit its review of § 6015(f) determinations to abuse of discretion or (2) the Tax Court should limit its review to evidence in the administrative record.

• This reflects the IRS's acquiescence in *Wilson v. Commissioner*, 705 F.3d 980 (9th Cir. 2013), *aff'g* T.C. Memo. 2010-134, in AOD 2012-07; 2013-25 I.R.B. i.

**3. Innocent spouses have longer to seek equity than to prove their innocence.** REG-132251-11, Relief From Joint and Several Liability, 78 F.R. 49242 (8/12/13). The Treasury Department has published proposed amendments to Reg. §§ 1.66-4 and 1.6015-5 that would enshrine in the regulations the relief provided by Notice 2011-70, 2011-32 I.R.B. 125, providing that the otherwise applicable two-year deadline for seeking § 6015 relief (or the equivalent under § 66(c) with respect to income from community property) does not apply to equitable relief under § 6015(f) (or the equivalent under § 66(c)). Prop. Reg. § 1.6015-5(b)(2) provides that if a requesting spouse files a request for equitable relief under Reg. § 1.6015-4 within the period of limitations on collection, the IRS will consider the request, but any relief in the form of a tax credit or refund depends on whether the limitation period for credit or refund was also open as of the date the claim for relief was filed and the other requirements relating to credits or refunds are satisfied. In cases in which the limitation period for credit or refund is the longer of the two periods and is open when a request for equitable relief is filed, the request can be considered for a potential refund or credit of any amounts collected or otherwise paid by the requesting spouse during the applicable look-back period of § 6511(b)(2), even if the collection period is closed. If a request for equitable relief is filed after the expiration of the period of limitations for collection of a joint tax liability, the IRS is barred from collecting any remaining unpaid tax from the requesting spouse. Similarly, if a request for equitable relief under Reg. § 1.6015-4 is filed after the expiration of the limitation period for a credit or refund, § 6511(b)(1) bars the IRS from allowing, and a taxpayer from receiving, a credit or refund. The IRS will not consider an individual's request to be equitably relieved from a tax that is no longer legally collectible. The proposed regulations have no effect on the two-year deadline to elect relief under § 6015(b) (and Reg. § 1.6015-2) or § 6015(c) (and Reg. § 1.6015-3).

**4. The IRS is attempting to be more equitable in granting innocent spouse relief.** Notice 2012-8, 2012-4 I.R.B. 309 (1/6/12). This notice provides a proposed revenue procedure that will supersede Rev. Proc. 2003-61, 2003-2 C.B. 296, which provides guidance regarding § 6015(f) relief from joint and several liability. The factors used in making § 6015(f) innocent spouse relief determinations will be revised "to ensure that requests for innocent spouse relief are granted under section 6015(f)

when the facts and circumstances warrant and that, when appropriate, requests are granted in the initial stage of the administrative process.” The revenue procedure expands how the IRS will take into account abuse and financial control by the nonrequesting spouse in determining whether equitable relief is warranted, because when a requesting spouse has been abused by the nonrequesting spouse, the requesting spouse may not have been able to challenge the treatment of any items on the joint return, question the payment of the taxes reported as due on the joint return, or challenge the nonrequesting spouse’s assurance regarding the payment of the taxes. Furthermore, a lack of financial control may have a similar impact on the requesting spouse’s ability to satisfy joint tax liabilities. Thus, the proposed revenue procedure provides that abuse or lack of financial control may mitigate other factors that might otherwise weigh against granting § 6015(f) equitable relief. The proposed revenue procedure also provides for certain streamlined case determinations; new guidance on the potential impact of economic hardship; and the weight to be accorded to certain factual circumstances in determining equitable relief.

- Until the revenue procedure is finalized, the IRS will apply the provisions in the proposed revenue procedure instead of Rev. Proc. 2003-61 in evaluating claims for equitable relief. But if a taxpayer would receive more favorable treatment under one or more of the factors provided in Rev. Proc. 2003-61 and so advises the IRS, the IRS will apply those factors from Rev. Proc. 2003-61, until the new revenue procedure is finalized.

**a. The Tax Court tells the IRS that even if it wants to make a taxpayer favorable change to a Revenue Procedure, it needs to finalize it, not just publish a proposed Revenue Procedure.** Deihl v. Commissioner, T.C. Memo. 2012-176 (6/21/12). The Tax Court (Judge Marvel) declined to apply the provisions of the proposed revenue procedure set forth in Notice 2012-8, 2012-4 I.R.B. 309, in determining whether the taxpayer was entitled to equitable relief under § 6015(f) and instead applied Rev. Proc. 2003-61, 2003-2 C.B. 296, “in view of the fact that the proposed revenue procedure is not final and because the comment period under the notice only recently closed.” It did, however, note “how the analysis used in Rev. Proc. 2003-61 ... would change if the proposed revenue procedure in Notice 2012-8 ... had actually been finalized.” But on the facts the proposed changes did not affect the conclusion that relief was not warranted.

**b. More equitable and streamlined equitable relief is finally here!** Rev. Proc. 2013-34, 2013-43 I.R.B. 397 (9/16/13). The IRS has finalized, with some changes, the revenue procedure proposed in Notice 2012-8, 2012-4 I.R.B. 309 to modify and supersede Rev. Proc. 2003-



61, 2003-2 C.B. 296, to provide guidance regarding equitable relief under (1) § 6015(f) from joint and several liability, and (2) § 66(c) from income tax liability resulting from the operation of community property law to taxpayers domiciled in a community property state who do not file a joint return. The factors used in making the determinations have been revised “to ensure that requests for innocent spouse relief are granted under section 6015(f) when the facts and circumstances warrant and that, when appropriate, requests are granted in the initial stage of the administrative process.” The revenue procedure expands how the IRS will take into account abuse and financial control by the nonrequesting spouse in determining whether equitable relief is warranted, because when a requesting spouse has been abused by the nonrequesting spouse, the requesting spouse may not have been able to challenge the treatment of any items on the joint return, question the payment of the taxes reported as due on the joint return, or challenge the nonrequesting spouse’s assurance regarding the payment of the taxes. Furthermore, a lack of financial control may have a similar impact on the requesting spouse’s ability to satisfy joint tax liabilities. Thus, the revenue procedure provides that abuse or lack of financial control may mitigate other factors that might otherwise weigh against granting § 6015(f) equitable relief. The revenue procedure also provides for certain streamlined case determinations for both understatement, as well as underpayments, of tax; new guidance on the potential impact of economic hardship; and the weight to be accorded to certain factual circumstances in determining equitable relief. Very significantly, any significant benefit a requesting spouse may have received from the unpaid tax or understatement will not weigh against relief (will be neutral) if the nonrequesting spouse abused the requesting spouse or maintained financial control and made the decisions regarding living a more lavish lifestyle. A request for equitable relief under § 6015(f) or § 66(c) must be filed before the expiration of the period of limitation for collection under § 6502 to the extent the taxpayer seeks relief from an outstanding liability, or before the expiration of the period of limitation for credit or refund under § 6511 to the extent the taxpayer seeks a refund of taxes paid.

- Rev. Proc. 2013-34 is effective for requests for relief filed on or after 9/16/13. It also is effective for requests for equitable relief pending on 9/16/13 with the IRS, Appeals, or in a docketed case.

- Notice 2012-8 provided that until the revenue procedure was finalized, the IRS would apply the provisions in the proposed revenue procedure instead of Rev. Proc. 2003-61 in evaluating claims for equitable relief. But if a taxpayer would have received more favorable treatment under one or more of the factors provided in Rev. Proc. 2003-61 and so advised the IRS, the IRS would apply those factors from Rev. Proc. 2003-61, until the new revenue procedure was finalized.

## H. Miscellaneous

1. **This case is just like *Loving v. Virginia*, 388 U.S. 1 (1967), except that, instead of freeing interracial same sex couples from discriminatory marriage laws, it is about freeing marginal tax return preparers from discriminatory competence testing.** *Loving v. IRS*, 917 F. Supp. 2d 67 (D.D.C. 1/18/13). The District Court (Obama appointee Judge Boasberg) enjoined the IRS from regulating otherwise unregulated “tax-return preparers” because they are not “representatives” and do not “practice” before the IRS and are not covered under 31 U.S.C. § 330(a) (authorizing the regulation of “the practice of representatives of persons before the [IRS]”). The regulation of tax-return preparers under Circular 230, including registration, payment of fees, passing a qualifying exam, and completing continuing education courses annually, fails the *Chevron* step one test because preparation of tax returns does not require that a “representative demonstrate ... (D) competency to advise and assist persons in presenting their cases,” 31 U.S.C. § 330(a)(2)(D), on the ground that “[a]t the time of filing, the taxpayer has no dispute with the IRS; there is no ‘case’ to present.” Judge Boasberg also noted that the “unstructured independence by the IRS [under Circular 230] would trample *the specific and tightly controlled penalty scheme in Title 26*” (emphasis added).

- Note that there is neither privilege nor work product protection for communications to a tax return preparer, which arises only when there is a realistic possibility of “controversy.”

a. **The injunction is modified, but not stayed.** *Loving v. IRS*, 920 F. Supp. 2d 108 (D.D.C. 2/1/13). On the IRS’s motion to stay the injunction, Judge Boasberg – while refusing to stay the injunction – modified it to make clear that its requirements were less burdensome than the IRS claimed. The requirement that each tax return preparer obtain a PTIN (and pay related fees) is authorized under § 6109(a)(4), so it may continue, except that the “IRS may no longer condition PTIN eligibility on being ‘authorized to practice’ under 31 U.S.C. section 330.” Therefore, “the requirements that tax return preparers (who are not attorneys, CPAs, enrolled agents, or enrolled actuaries) must pay fees unrelated to the PTIN, pass a qualifying exam, and complete annual continuing-education requirements” continue to be enjoined.

b. **Government’s motion for a stay pending appeal was denied summarily.** *Loving v. IRS*, 111 A.F.T.R.2d 2013-1384 (D.C. Cir. 3/27/13). The IRS appealed these two opinions and orders to the Circuit Court for the District of Columbia Circuit, 2/20/13. That court

refused to stay the District Court's injunction on the ground that the IRS failed to satisfy "the stringent requirements for a stay pending appeal."

**c. And the D.C. Circuit affirms the freedom of marginal tax return preparers to ply their trade free from discriminatory competence testing.** Loving v. I.R.S., \_\_\_ Fed \_\_\_, 2014 WL 519224 (D.C. Cir. 2/11/14).

**2. Ryan loses its constitutional challenge to Circular 230's contingent fee rule.** Ryan, LLC v. Lew, 934 F. Supp. 2d 159 (D. D.C. 3/29/13). The plaintiffs challenged § 10.27 of Circular 230 that generally limits the use of contingent fee arrangements in connection with the preparation and filing of refund claims with the IRS. More specifically, they mounted three distinct attacks against Circular 230: (1) Ryan, LLC and Mr. Ryan argued that Circular 230 violates their rights under the Petition Clause of the First Amendment (Count I); (2) Mr. Ryan argued that Circular 230 violates his Fifth Amendment Due Process Rights (Count II); and (3) Mr. Ridgely brought suit under the Administrative Procedure Act ("APA"), 5 U.S.C. §§ 701, *et seq.*, arguing that the IRS exceeded its statutory authority in promulgating Circular 230 (Count III). Plaintiffs sought a declaratory judgment that Circular 230's restrictions of contingent fee arrangements in the context of "ordinary refund claims" is unconstitutional and exceeds the scope of the IRS's authorizing statute, and they sought a permanent injunction barring the enforcement of Circular 230's restrictions on the use of contingent fee arrangements for "ordinary refund claims." The District Court (Judge Wilkins) dismissed Counts I and II on the grounds that: Count I failed to state a claim upon which relief may be granted, and Mr. Ryan lacked standing under Count II to pursue a Due Process claim so that claim lacked jurisdiction.

- With respect to an issue he didn't address,

Judge Wilkins stated:

In pressing for the dismissal of Plaintiffs' claim, the Government first argues that the Petition Clause does not protect "a taxpayer's right to file an administrative claim for refund" with the IRS. (Defs.' Reply at 7). The Court finds this proposition dubious. Not only has the Supreme Court explicitly held that Petition Clause guarantees citizens the ability to seek relief with courts, but it has also made clear that these protections extend to "other forums established by the government for the resolution of legal disputes." *Borough of Duryea*, 131 S. Ct. at 2494. The Court has also explained that "[t]he same philosophy governs the approach of citizens or groups of them to administrative agencies

(which are both creatures of the legislature, and arms of the executive) and to courts, the third branch of Government.” *Cal. Motor Transport Co. v. Trucking Unlimited*, 404 U.S. 508, 510 (1972) (“Certainly the right to petition extends to all departments of the Government. The right of access to the courts is indeed but one aspect of the right of petition.”). Insofar as the Internal Revenue Service is an administrative agency established by the Government, the Court believes that the Petition Clause would protect citizens’ rights to file claims with the IRS, as Plaintiffs suggest. On balance, however, the Court need not directly pass on this issue because, even assuming that the right to file a refund claim with the IRS does fall within the ambit of the Petition Clause’s protections, Plaintiffs fail to allege any constitutionally cognizable violation or impingement of such a right.

**3. New nationwide rollout of fast track settlement (“FTS”) program for small businesses and self-employed individuals (“SB/SE”) means settlement opportunities for taxpayers.** IR-2013-88, 2013 TNT 216-10 (11/6/13). FTS uses alternative dispute resolution techniques to help taxpayers save time, so audit issues can usually be resolved within 60 days – and, taxpayers who choose this option do not forfeit their appeal rights if the FTS process is unsuccessful. Normally, the Appeals representative acts as mediator between the taxpayer and representatives from SB/SE’s Examination Division.

- Any time the IRS initiates a new program, those administering the program want to see it work. Therefore, taxpayers who utilize the program in its early days have settlement opportunities unavailable elsewhere. Compare “decisions in aid of jurisdiction” in the Court of Federal Claims.

## **XI. WITHHOLDING AND EXCISE TAXES**

### **A. Employment Taxes**

**1. Tax refunds in a bad economy set up another deference conflict among the circuits.** *In Re Quality Stores, Inc.*, 693 F.3d 605 (6th Cir. 9/7/12), *cert. granted*, 134 S. Ct. 49 (10/1/13). In November 2001 Quality Stores closed 63 stores and 9 distribution centers and terminated the employment of all employees in the course of Chapter 11 bankruptcy cases. Quality Stores adopted plans providing severance pay to terminated employees. The company reported the severance pay as wages for

withholding and employment tax purposes then filed claims for refund of FICA and FUTA taxes claiming that the severance pay represented supplemental unemployment compensation benefits (SUBs) that are not wages for employment tax purposes. Disagreeing with the contrary holding by the Federal Circuit in *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008), the Sixth Circuit held that the SUBs were exempt from employment taxes. The court examined the language and legislative history of § 3402(o)(1), which provides that SUB payments “shall be treated *as if it were a payment of wages*” for withholding purposes, to conclude that by treating SUB payments as wages for withholding, Congress recognized that SUB payments were not otherwise subject to withholding because they did not constitute “wages.” Then, under *Rowan Cos. v. United States*, 452 U.S. 247, 255 (1981), the court concluded that the term “wages” must carry the same meaning for withholding and employment tax purposes. Thus, if SUBs are not wages under the withholding provision (because they must be treated as wages by statutory directive), the SUBs are not wages for employment tax purposes. The court also rejected the IRS’s position in Rev. Rul. 90-72, 1990-2 C.B. 211, that to be excluded from employment taxes SUBs must be part of a plan that is designed to supplement the receipt of state unemployment compensation. The court declined to follow the Federal Circuit’s holding in *CSX Corp.*, which adopted the eight part test of Rev. Rul. 90-72, stating that, “We decline to imbue the IRS revenue rulings and private letter rulings with greater significance than the congressional intent expressed in the applicable statutes and legislative histories.” The court also stated that it could not conclude that the opinion in *Mayo Foundation for Medical Education & Research v. United States*, 131 S. Ct. 704 (2011), eroded the holding of *Rowan Cos. v. United States*, which compelled the court to interpret the meaning of “wages” the same for withholding and employment tax purposes.

**2. Proposed regulations define employment tax liabilities of agents designated by an employer to pay employment taxes.** REG-102966-10. Designation of Payor as Agent to Perform Acts Required of an Employer, 78 F.R. 6056 (1/29/13). Proposed regulations under § 3405 would provide rules regarding obligations for all employment tax under an agreement between an employer and a third party payor that is designated as an agent to perform the acts of the employer. The proposed regulations would provide that all provisions of the law, including penalties, are applicable to the payor, and that the employer for which the payor is designated as agent also remains liable for all provisions of the employment tax. The preamble indicates that consistent with the IRS position on administering the § 6672 trust fund penalty, the employment tax liability of an employer will be collected only once whether from the payor or the employer. The agency designation does not apply to (1) a payor that is itself

the common law employer of a person performing services for a client, (2) a payor that has legal control over the payment of wages under § 3401(d)(1) (and is thus the liable employer), and (2) a payor who is a payroll service provider that reports employment taxes under the employer's EIN.

**3. Advances to keep employees are wages.** The Vancouver Clinic, Inc. v. United States, 111 A.F.T.R.2d 2013-1571 (W.D. Wash. 4/9/13). The clinic provided "advances" to newly hired physicians that were subject to repayment if the physician did not continue to work for the clinic for a period of five years. The advances were not reported on Form W-2. Instead, the clinic reported on Form 1099 the subsequent forgiveness of the advances. The court granted summary judgment to the IRS on the clinic's suit for refund after paying employment taxes assessed by the IRS. The court rejected the clinic's assertion that the advances were loans principally on the finding that at the time the arrangements were entered into neither the clinic nor the physicians intended that the advances would be repaid. The court characterized the repayment obligation as liquidated damages payable by the physicians on breach of a contractual obligation to remain at the clinic for five years compelling the conclusion that the advances were compensation for services and thus subject to employment taxes and wage withholding.

**4. "The self-employment tax provisions are construed broadly in favor of treating income as earnings from self-employment." Old McDonald had a farm and on his farm he collected federal subsidies that were self-employment income.** Morehouse v. Commissioner, 140 T.C. No. 16 (6/18/13). In a reviewed opinion (15-0-0), the Tax Court (Judge Marvel) overruled its prior decision in Wuebker v. Commissioner, 110 T.C. 431 (1998), *rev'd*, 205 F.3d 897 (6th Cir. 2000), and held that payments under the U.S. Department of Agriculture (USDA) Conservation Reserve Program (CRP) are self-employment income subject to self-employment taxes. The taxpayer owned farm land in South Dakota, which he had rented to tenant farmers. The taxpayer entered into a CRP contract with the USDA under which in exchange for annual payments the taxpayer agreed to (1) maintain already established grass and legume cover for the life of the contract; (2) "[e]stablish perennial vegetative cover on land temporarily removed from agricultural production", including pubescent or intermediate wheatgrass, alfalfa, and sweet clover; and (3) engage in "pest control and pesticide management" for the life of the contract. The taxpayer hired a former tenant farmer to carry out most of the work, but the taxpayer supervised the operation, purchased materials needed to implement the conservation plans, gathered documentation necessary to the CRP payments, arranged for individuals to hunt on some of the properties, and visited the properties several times during the tax years involved. The court held that

these activities were sufficient to constitute a trade or business carried on by the taxpayer the income from which was subject to self-employment taxes under § 1402(a)(1). The court indicated that regardless of whether the taxpayer's activities qualified as farming, the taxpayer was directly and through his agent "engaged in the business of participating in the CRP and that he enrolled, maintained, and managed multiple properties subject to CRP contracts with the primary intent of making a profit."

- The court indicated that the analysis in a proposed revenue ruling published in Notice 2006-108, 2006-2 C.B. 118, that would have treated CRP payments as self-employment income, while not controlling, was nevertheless well-grounded and consistent with the court's holding in the case.

- The court also held that the CRP payments were not rental income excluded from self-employment tax by § 1402(a)(1). Although the payments were described as rental in the contract, the court found that the payments were not received in exchange for use or occupancy of the land by the USDA.

**5. S corporation distributions to sole shareholder sole employee were wages.** Glass Blocks Unlimited v. Commissioner, T.C. Memo. 2013-180 (8/7/13). The IRS classified an S corporation as the employer of Frederick Blodgett, who was its sole shareholder and president. Blodgett advanced funds to the corporation to cover operating expenses during years of financial difficulty. In each of 2007 and 2008 the corporation distributed \$31,000 to Blodgett as repayment of loans. The corporation paid no salary to its shareholder/employee. The Tax Court (Judge Halpern) sustained the IRS's deficiency for employment taxes payable on the distributions. The S corporation did not object to the IRS's characterization of the shareholder as an employee and thus the court held that, "[b]ecause Mr. Blodgett was petitioner's employee for the periods at issue and performed substantial services for it yet it did not pay him a salary, its distributions to him are deemed wages and thus are subject to Federal employment taxes." The court rejected the taxpayer's argument that the advances from the shareholder were loans citing the absence of notes or other instruments, the taxpayer's failure to treat the transfers as loans, and the absence of any interest payments. The court also rejected for lack of evidence the S corporation's assertion that treating the distributions as wages would result in unreasonable compensation to the shareholder. Finally, the court sustained penalties under §§ 6651(a) and 6656 for failure to file employment tax forms and make required deposits.

**a. This lengthy summary opinion determines reasonable compensation for an S corporation shareholder.** Sean McAlary Ltd. v. Commissioner, T.C. Summary Opinion 2013-62 (8/12/13). McAlary was the sole shareholder and employee of a moderately

sized real estate brokerage operated as an S corporation. McAlary and the corporation entered into a compensation contract providing for a \$24,000 annual salary. Most of the corporation's gross receipts were attributable to commissions generated by McAlary. The corporation did not issue a W-2 to McAlary nor claim deductions for salary paid to him. The corporation did, however, distribute \$240,000 to McAlary. The IRS expert determined, based on a statistical evaluation of similar sized real estate brokerages that McAlary should earn \$48.44 per hour and assessed employment taxes on an annual compensation of \$100,755, which reduced the corporation's profit margin to slightly in excess of the industry average and represented 19.4 percent of the corporation's gross receipts, again close to industry averages. The court (Special Trial Judge Guy) rejected the contract between the corporation and McAlary as controlling because McAlary sat on both sides of the table during the negotiation. The court also was not persuaded by the IRS expert's statistical analysis noting that reasonable compensation depended on the facts and circumstances identified through a multifactor analysis. Ultimately the court concluded that \$40 per hour was reasonable compensation and assessed employment taxes on the basis of \$83,200. The court also sustained additions to tax under §§ 6651(a)(1) and 6656 for failure to file and pay employment taxes. The court rejected the taxpayer's assertion of reasonable reliance on a tax professional, indicating that the taxpayer failed to present evidence that he investigated the background or qualifications of his return preparer/advisor to confirm that the advisor was a competent professional.

**6. The minister of his own church under a vow of poverty must still file the right forms.** Rogers v. Commissioner, T.C. Memo. 2013-177 (8/1/13). The taxpayer performed ministerial duties for a church he formed. As compensation the church paid the taxpayer's home mortgage (although the taxpayer deducted home mortgage interest against other income), personal credit card bills, and utility payments. The Tax Court (Judge Paris) held that the payments were income includible under § 61 and wages subject to employment tax. The taxpayer was ineligible to claim exemption from employment taxes under § 1402(c)(4) due to his failure to timely file the mandatory exemption certificate required by § 1402(e)(3). The taxpayer was also not allowed to exclude mortgage payments as a rental allowance under § 107 because of the absence of an employment agreement designating payment of a rental allowance as remuneration for services. Finally the court rejected the taxpayer's argument that the payments were not includible under the taxpayer's vow of poverty.

**7. Squeezing blood from a turnip? The taxpayer is enjoined to pay taxes and follow the law.** United States v. Petrie & Sons,



Inc., 112 A.F.T.R.2d 2013-5760 (E.D. Wash. 8/7/13). On findings that the taxpayer failed to file employment tax returns, pay employment taxes, lacked sufficient assets to satisfy outstanding tax liabilities of more than \$750,000, the IRS was likely to prevail on the merits, and would suffer irreparable harm in the absence of preliminary relief, the taxpayer was enjoined from hindering tax law enforcement and specifically to withhold from employee wages as required by law, deposit withholdings in a bank within 72 hours, and was further enjoined from making any other payments or property transfers until it made payments to the IRS. In addition, the taxpayer was ordered to inform employees with check writing authority of the injunction and each such employee was required to provide a written acknowledgment to the IRS.

- We have not seen such an action in the years we've been doing this outline and we wonder whether an injunction to follow the law will change the taxpayer's behavior (especially the one of us who is related to a deceased tax protestor).

**8. Employed and self-employed at the same time. This status exists for all U.S. citizens working for foreign consulates in the United States.** Rosenfeld v. Commissioner, T.C. Memo 2011-110 (5/23/11), *aff'd*, 112 A.F.T.R.2d 2013-5638 (9th Cir. 8/8/13) (unpublished opinion). The taxpayer, who maintained a consulting business advising clients on marketing, accepted a three year full-time appointment with the British Consulate General (BCG) to perform services similar to those provided by the taxpayer to private clients. The Tax Court (Judge Dean) held that the taxpayer was an employee of the consulate for withholding purposes and not entitled to separately report income from the engagement on a Schedule C. The court found employee status based on the facts that the taxpayer worked under the control of the BCG, the taxpayer received a fixed salary for his services, and the taxpayer's services furthered BCG's goals. The court described as "neutral" the facts that, although BCG provided an office (whether or not the taxpayer used the office was irrelevant) the taxpayer incurred many costs associated with his work, the taxpayer's three year contract was not defined as long term, and either party could terminate the relationship without cause. The court also rejected the taxpayer's arguments that he was self-employed because the parties defined the relationship as an independent contractor relationship that specifically provided that the BCG would not withhold taxes, and the taxpayer received no employee benefits and concluded that the taxpayer was a common law employee of BCG.

**9. Husband and wife in a community property state are liable for self-employment tax on their separate activities.** Fitch v. Commissioner, T.C. Memo. 2013-244 (10/28/13). Donald and Barbara Fitch

were married taxpayers in California, a community property state. Donald worked as a CPA and reported net losses from his accounting practice on a schedule C. Barbara worked as a real estate agent and reported her income on a separate schedule C. In a rule 151 computation from a prior Tax Court case, *Fitch v. Commissioner*, T.C. Memo. 2012-358, the IRS separately calculated self-employment tax liability for Donald as zero, and calculated positive self-employment tax liability for Barbara based on her real estate business income. In a supplemental opinion, the Tax Court (Judge Vasquez) agreed with the IRS that the taxpayers were not permitted to net the individual self-employment income to determine the combined self-employment tax due on their joint return. Section 1402(a)(5)(A) provides that in a community property state income derived from a trade or business that is community property is treated as the gross income (and deductions) of the spouse carrying on the trade or business. The provision adds that if the trade or business is jointly operated, the gross income and deductions are treated as the gross income and deductions of each spouse on the basis of their respective shares of gross income and deductions. The court found that the real estate business was conducted by Barbara alone and that Donald was not a participant in the business. The court also rejected the taxpayers' assertion that under Reg. § 1.1402(a)-8(a) gross income from a business in a community property state is treated as the income of the husband, pointing out that the regulation pre-dates the 2004 enactment of § 1402(a)(5)(A) and had not been updated to reflect the revised statutory language.

**10.** T.D.9649, Section 3504 Agent Employment Tax Liability, 78 F.R. 75471 (12/12/13). Final regulations include Federal Unemployment Tax Act (FUTA) withholding taxes within the scope of current regulatory authority that allows employers to meet their FICA tax obligations for domestic in-home services through an agent as provided in § 3401. The agent files a single return for multiple employers using the agent's employer identification number.

**a.** Rev. Proc. 2013-39, 2013-52 I.R.B. 830 (12/12/13). The IRS has described and updated procedures for filing Form 2678 for an employer of a provider of domestic in-home services to designate an agent under Reg. § 31.3504-1(a) to file employment taxes.

## B. Self-employment Taxes

There were no significant developments regarding this topic during 2013.

## C. Excise Taxes

**1. The price of a tan goes up even in disregard of the hazard from which the owner is protected.** T.D. 9596, Disregarded Entities and the Indoor Tanning Services Excise Tax, 77 F.R. 37806 (6/25/12). Temp. and Prop. Reg. § 1.1361-4T(a)(8)(iii) adds the 10 percent excise tax on indoor tanning services of § 5000B to the list of excise taxes for which disregarded entities (QSub or single owner business entity) are treated as separate entities.

**a. The price of skin cancer is increased by the excise tax on tanning services.** T.D. 9621, Indoor Tanning Services; Excise Tax, 78 F.R. 34874 (6/11/13). Final Regulations § 49.5000B-1 are promulgated for collection of the 10 percent excise tax on indoor tanning facilities under § 5000B enacted as part of the Affordable Health Care Act. The tax is imposed on amounts paid for indoor tanning services. The final regulations generally adopt provisions in the proposed and temporary regulations. The regulations include an exemption for Qualified Physical Fitness Facilities, the predominant business or activity of which is to serve as a physical fitness facility that does not charge separately for indoor tanning services available at the facility. For other purveyors of indoor tanning, the tax applies to amounts actually paid for indoor tanning services that are provided at a reduced rate. The tax does not apply to services that are obtained by redemption of points through a loyalty program. Where tanning services are bundled with other goods and services, the final regulations set out a formula to determine the amount reasonably attributable to indoor tanning services. With respect to gift cards, the tax is imposed when the card is redeemed specifically to pay for indoor tanning services and not when the card is purchased. The tax is also imposed on prepaid monthly membership and enrollment fees regardless of the services actually provided.

**2. The medical devices excise tax sticks to the manufacturer.** Chemence Medical Products, Inc. v. Medline Industries, Inc., 112 A.F.T.R.2d 2013-7245 (N.D. Ga. 12/5/13). In a declaratory relief action, the court held that the 2.3 percent tax on medical devices imposed under § 4191(a), enacted as part of the Affordable Care Act, falls on the manufacturer rather than the distributor. Before enactment of the ACA, Chemence Medical Products entered into a contract to supply adhesives to Medline, a distributor of medical supplies. Chemence sought declaratory

relief that it could pass the tax onto the supplier as a price increase, notwithstanding the fact that price increases were limited under the agreement between Chemence and Medline. The court found that the language of § 4191 and Reg. § 48.4191-1(c) are clear that the incidence of the tax falls on the manufacturer when the manufacturer is taxable. The court rejected arguments by the manufacturer that language in the statute imposing the tax at the highest wholesale price, imposing the tax on distributors when the manufacturer, producer, or importer is “untaxable”, or that pass-through provisions in the statute indicate the ultimate burden of the tax should fall on the entity that bears the tax permit shifting the tax from the manufacturer. The court also found that provisions in the sales agreement prohibited Chemence from passing the tax to Medline as a price increase.

## **XII. TAX LEGISLATION**

### **A. Enacted**

**1. For this he needs an Act of Congress?** H.R. 3458, the **Fallen Firefighters Assistance Tax Clarification Act of 2013**, P.L. 113-63 was signed by President Obama on 12/20/13. This Act exempts from income payments from public charities under §§ 509(a)(1) and (2) to firefighters [formerly, firemen] injured in a 12/24/12 ambush, or to the spouses or dependents of firefighters who were killed, when responding to a fire in Webster, NY. Payments between 12/24/12 and 1/19/14 will qualify for the exemption.