FLORIDA TAX REVIEW

Volume 13 | *2013* | *Number 10*

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION: THE YEAR 2012

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This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – 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 the three of us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services. Please read this outline at your own risk; we take no responsibility for any misinformation in it, whether occasioned by our advancing ages or our increasing indifference as to whether we get any particular item right. Any mistakes in this outline are Marty's responsibility; any political bias or offensive language is Ira's; and Dan is just irresponsible.

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I. ACCOUNTING

A. Accounting Methods

1. Rev. Proc. 2012-39, 2012-41 I.R.B. 470 (9/4/12). The IRS announced a change in its policy on automatic accounting method changes in corporate reorganizations. Taxpayers that engage in a tax-free reorganization or liquidation under § 381(a) after 8/31/11 will be allowed to make automatic accounting method changes in the tax year they engage in the transaction. This revenue procedure clarifies and modifies (i) Rev. Proc. 2011-14, 2011-1 C.B. 330; and (ii) Rev. Proc. 97-27, 1997-1 C.B. 680, *as amplified and modified by* Rev. Proc. 2002-19, 2002-1 C.B. 696, *as amplified and clarified by* Rev. Proc. 2002-54, 2002-2 C.B. 432, *as modified by* Rev. Proc. 2007-67, 2007-2 C.B. 1072, *as clarified and modified by* Rev. Proc. 2009-39, 2009-2 C.B. 371, and *as clarified and modified by* Rev. Proc. 2011-14.

B. Inventories

There were no significant developments regarding this topic during 2012.

C. Installment Method

There were no significant developments regarding this topic during 2012.

D. Year of Inclusion or Deduction

1. "One potato, two potato, three potato, four …." To have spudded or not to have spudded, that is the question. Caltex Oil Venture v. Commissioner, 138 T.C. 18 (1/12/12). The taxpayer, which was on the accrual method, entered into a turnkey contract under which it paid $5,172,666 by cash and note in December 1999 for the drilling of two oil and gas wells. Some site preparation required under the contract occurred in 1999, but drilling was not commenced within ninety days after the end of 1999. The taxpayer deducted the full amount as intangible drilling and development costs (IDC) under § 263(c) in 1999 and the IRS disallowed the deduction on the ground that the economic performance requirement of § 461(h) was not satisfied. The Tax Court (Judge Gustafson) held that for purposes of the special rules in § 461(i)(2)(A), which provide ninety days leeway after the close of the year for economic performance to occur with respect to drilling oil and gas wells, "drilling of the well commences" when there is "actual penetration" of the ground surface in the act of drilling for purposes of spudding a well. Mere site preparation is insufficient. He emphasized that the title of the provision refers to "spudding," which Webster's Third New International Dictionary 2212 (2002) defines as "to begin to drill (an oil well) by alternately raising and releasing a spudding bit with the drilling rig." Thus, the taxpayer did not qualify under the special rule. Furthermore, the 3-1/2-month rule of Reg. § 1.461-4(d)(6)(ii), which allows a taxpayer to treat a liability as having been economically performed at the time of payment if that taxpayer "reasonably expect[ed] the . . . [provider of services] to provide the services ... within 3 ½ months after the date of payment," did not apply "because, in the case of an undifferentiated, non-severable contract, the 3-1/2-month rule contemplates that all of the services called for must be provided within 3-1/2 months of payment." Moreover, even if the 3-1/2-month rule applied to treat some of the services due under the contract as having been economically performed in 1999, the deductions allowed under the 3-1/2-month rule were limited to payments of cash or cash equivalents and did not include payments made by notes. Finally, Judge Gustafson held that a trial was warranted on how much of the IDC was actually incurred in 1999 and could be deducted under the general economic performance rule of § 461(h).

2. You'll learn more about insurance company taxation than income tax accounting reading this case. Massachusetts Mutual Life Insurance Co. v. United States, 103 Fed. Cl. 111 (Fed. Cl. 1/30/12). The Court of Federal Claims (Judge Horn) held that the taxpayer, an accrual method mutual life insurance company could deduct guaranteed minimum policyholder dividends in the year that the board of directors passed a resolution to pay the dividends during the following year. All events fixing liability had occurred and the obligation to pay out at least a minimum amount established both the fact of liability and that the liability could be determined with reasonable accuracy. Pursuant to § 461(h)(3) and Reg. § 1.461-5 because policyholder dividends were in the nature of return of premium, and they qualified under Reg. § 1.461-4(g)(3) as "rebates or refunds," and thereby satisfied both the matching requirement and the recurring item exceptions to the economic performance rule. Further, the court rejected the government's argument that the economic substance doctrine applied to prevent the taxpayer from accounting for dividends in guarantee years; the taxpayer "did not engage in a typical transaction with an investment followed by a deduction. Instead, as plaintiff notes, plaintiff's payment of policyholder dividends was not designed to generate a tax benefit, rather 'the payment of policyholder dividends is central to Plaintiff's business and that of the mutual life insurance industry as a whole,' and to the benefit of the policyholder."

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. The dentist's income is taxable to the dentist, just like his lawyer's income is taxable to the lawyer. Walker v. Commissioner, T.C. Memo. 2012-5 (1/9/12). The taxpayer dentist practiced through an LLC, owned 1 percent by the taxpayer and 99 percent by a partnership that included the dentist's children. The arrangement was patterned on entities created by Scott and Darren Cole to avoid income and employment on their law practice and rejected in *Cole v. Commissioner*, 637 F.3d 767 (7th Cir. 2011). The Tax Court (Judge Cohen) held that the arrangement represented an anticipatory assignment of income that was taxable to the taxpayer. The only distinction between the taxpayer and the taxpayers in *Cole* was the practice of dentistry versus law, a distinction that did not make a difference.

2. Assignment of income principles are alive and well, sort of. Owen v. Commissioner, T.C. Memo. 2012-21 (1/19/12). The taxpayers, John and Laura Owen incorporated a personal services company, J&L Owen, Inc., in which they were the sole shareholders. In 1997, John Owen and two others formed two companies, Family First Insurance Services companies (FFIS) and FFEAP, which sold insurance related and financial products. John was both an officer/employee and an independent contractor salesman. Laura was employed by FFIS as an executive. In 2002, John sold his 50 percent interest in the two companies for $7.5 million, $3.8 million of which was paid in the form of a cashier's check. The taxpayer reported $1.9 million on the sale of FFIS as capital gain and attempted to roll over $1.9 million of gain on the sale of FFEAP into a jewelry business under § 1045 (rollover of an investment of one small business corporation into another small business corporation). In each of January and December 2003 the purchaser paid an additional $1.5 million into the Owen family trust. The taxpayers' accountant mistakenly omitted the second payment from the taxpayers' 2003 return. An employment agreement retained John as President of FFIS and vice-president of FFEAP. Various compensation and incentive payments pursuant to the agreement and amendments signed by John in his role as president of FFIS were made to J&L Owen, Inc. In 2002 J&L Owen, Inc. reported $910,454 of wages to John and $225,000 to Laura on Forms W-2, which wages were deducted by the corporation. The Tax Court (Judge Wherry) held that payments to John for his sales activity in his capacity as an independent contractor for the insurance companies were under the control of J&L Owen, Inc., and were thus income of the corporation. The court indicated that, as an independent contractor, an individual has control over earned income, which includes the right to choose to do business as a corporation. After a factual inquiry into the nature of other payments, the court held that payments to John for consulting and sales promotion activities were made in his capacity as an officer of the insurance companies and therefore not subject to assignment to the personal service corporation. The court rejected the taxpayers' assertion that they over-reported their income for 2002 in the amount reported as compensation from the personal services corporation, stating that the taxpayers failed to meet their burden of showing that they did not receive the amounts reported on W-2s from the personal services corporation. (The IRS also conceded that amounts includable in the taxpayers' income for 2002 under assignment of income principles had been included in the W-2s from the personal services corporation.) The court also noted that while a taxpayer may conduct business in whatever form the taxpayer chooses, the taxpayer must also accept the result.

- With respect to the capital gain the taxpayer attempted to roll over under § 1045, the court held that the jewelry business into which the taxpayer invested proceeds from the sale of FFEAP was not an active trade or business and thus not a qualified small business for § 1045 purposes.

- The court imposed § 6662 accuracy related penalties, holding that the taxpayer did not reasonably rely on the tax advice of the accounting firm that structured the various transactions.

3. F. Lee Bailey defends himself in the Tax Court, as they say about the client of the (disbarred) lawyer who represents himself . . . . Bailey v. Commissioner, T.C. Memo. 2012-96 (4/2/12). To facilitate an incarcerated marijuana dealer's forfeiture plan, F. Lee Bailey entered into an unwritten agreement with the Justice Department to deposit \$5.9 million of Biochem Pharma stock in his investment account at Credit Suisse Bank that was provided by the client. The purpose of the arrangement was to facilitate repatriation and forfeiture of the client's assets to the U.S. Government as part of a deal to reduce the client's sentence. Mr. Bailey sold some of the stock and borrowed \$3 million from Credit Suisse posting the stock as security. Mr. Bailey used the proceeds to make payments on behalf of his client and deposited a portion of the proceeds in personal accounts. When the drug dealer client replaced Mr. Bailey with a different lawyer, the U.S. District Court ordered Mr. Bailey to return the stock to the court. Unfortunately, he was unable to do so because the bank refused to release the collateral until the loan was paid. As a consequence, Mr. Bailey was held in contempt by the District Court and incarcerated for a period of 44 days. After Mr. Bailey was able to raise capital to repay the Credit Suisse loan and transfer the stock, he was released. Mr. Bailey was reimbursed for out-of-pocket expenses that he paid on behalf of the client but was not paid any fee for his services. In a deficiency notice the IRS asserted that Mr. Bailey had unfettered dominion and control over the stock and therefore recognized as income the full value of the stock at the time it was deposited in his Credit Suisse account. Alternatively, the IRS asserted that if the full value of the stock was not includable in Mr. Bailey's income, at least the value of the stock that he used as collateral for the $3 million loan represented gross income. In a 143-page opinion addressing multiple issues, the Tax Court (Judge Gustafson) held that, based on findings in Mr. Bailey's litigation over the right to retain the stock (*Bailey v. United States*, 54 Fed. Cl. 459 (2002)), to which collateral estoppel applied, Mr. Bailey held the Biochem Pharma stock in trust for the U.S. Government. Mr. Bailey was not therefore taxable on the stock's value. However, the court also held that Bailey realized income of approximately $425,000 when he transferred proceeds from sale of some Biochem Pharma stock to his personal accounts in a departure from his fiduciary role. The court also rejected the IRS's assertion that Bailey realized income on the use of $12 million of the appreciated Biochem Pharma stock as collateral for the $3 million loan from Credit Suisse. The IRS argued that Bailey had misappropriated the value of the stock used as collateral for the loan. The court found that Bailey was personally liable for repayment of the Credit Suisse loan and that the loan was a bona fide indebtedness for which there was a consensual recognition of Mr. Bailey's obligation to repay. Thus, the receipt of the loan proceeds was not includible in income.

- The court rejected Bailey's argument that due process barred the government from including in his income $1.6 million in fees that were attached by the government and used to satisfy a portion of the indebtedness to Credit Suisse in order to release the Biochem Pharma stock from the Credit Suisse security, holding that payments made to a third party on behalf of the taxpayer are nonetheless included in income.
- The court rejected Bailey's argument that the burden of proof with regard to substantiation of expenses shifted to the government after he had notified the government that he was disposing of records stored in an aircraft hangar and provided access to those records to auditing agents prior to their destruction. The court observed that taxpayers are required to maintain records, there is no provision that imposes a recordkeeping requirement on the IRS, and the fact that he offered to let the IRS review and copy records before discarding them does not absolve Bailey of the recordkeeping requirement nor shift the burden of proof.
- The court held that Bailey's yacht renovation and rental activity was not an activity engaged in for profit, but that an aircraft renovation activity was a profit seeking activity.
- Finally, Bailey was found liable for negligence penalties.

4. The IRS cuts an illegal drug dealer a break not warranted on the face of the statute. Olive v. Commissioner, 139 T.C. No. 2 (8/2/12). The taxpayer operated a medical marijuana business that sold medical marijuana at retail under the California Compassionate Use Act of 1996. The Tax Court (Judge Kroupa) upheld the IRS's determination that the taxpayer underreported his gross receipts and that § 280E precluded his deduction of business related expenses. The IRS conceded that § 280E did not bar a deduction from gross receipts for costs of goods sold but argued that the taxpayer's ledger entries were inadequate substantiation and that as a factual matter cost of goods sold should be zero. Judge Kroupa sustained the IRS's position that the journal entries were unreliable, but applied *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930) to find, based on expert witness testimony, that the cost of goods sold was approximately 75 percent of the gross receipts and adjusted that amount to account for marijuana that was given away to customers and staff. Judge Kroupa rejected the taxpayer's argument that the expenses should be deductible based on *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007), in which the Tax Court held that the corporation's care-giving activities for terminally ill patients were a separate trade or business from its medical marijuana delivery and that expenses allocable to the care-giving activity were deductible as ordinary and necessary business expenses. In the instant case, unlike in *Californians Helping to Alleviate Medical Problems*, based on the facts and circumstances there were not two separate and distinct activities. In this case the taxpayer operated a single business of dispensing medical marijuana, with all other services being provided as part of that business.

- Judge Kroupa upheld accuracy-related penalties on the deficiency resulting from unsubstantiated expenses, but not with respect to expenses that were substantiated but disallowed under § 280E, reasoning that the application of § 280E to the medical marijuana industry was decided after the years at issue.

- A straightforward reading of § 280E and the last sentence of § 263A(a)(2) in concert clearly denies the recovery of cost of goods sold for the marijuana in this case. Prior to the enactment of the last sentence of § 263A(a)(2), however, § 280E alone did not deny drug dealers tax-free recovery of the cost of goods sold. *See, e.g., Franklin v. Commissioner*, T.C. Memo. 93-184. In *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007), the IRS, based on that outdated case law conceded — erroneously in our opinion — that § 280E did not operate to deny as matter of law the cost of goods sold to a taxpayer that purchased and resold marijuana. That mistake was repeated in this case.

5. Abracadabra: A creditor's bad debt does not necessarily create debtor's COD income. Abarca v. Commissioner, T.C.

Memo. 2012-245 (8/27/12). The Tax Court (Judge Goeke) held that no cancellation of debt income was realized by a taxpayer where the only evidence that the debt was discharged was a letter stating that the loan had been "charged off," but also stated that the taxpayer "still remain[ed] obligated for the repayment of the debt," and no Form 1099-C was introduced into evidence.

6. The fabled Plotkin diamond always comes with a curse — Mr. Plotkin. Plotkin v. Commissioner, 110 A.F.T.R.2d 2012-6752 (11th Cir. 11/27/12). Taxpayer received an economics degree from the University of Pennsylvania's Wharton School, class of 1963, and a law degree from St. Louis University, class of 1972, before he purchased a controlling interest in a nursing home empire from the father of his ex-wife in 1980. As the result of a complex series of financial machinations and fund diversions through his girlfriend(s) during the years 1991, 1992, and 1993, he was convicted on three counts of willfully making and subscribing false income tax returns under § 7206(1) in 1999 and sentenced to five years of probation. The Commissioner determined that he failed to report in excess of $1.5 million of Schedule C self-employment income during the years 1991 through 1995. In this unpublished per curiam opinion, the Eleventh Circuit affirmed a Tax Court decision upholding the Commissioner's determination, finding taxpayer's argument that he received non-taxable partnership distributions not supported by the facts because taxpayer deliberately chose not to be a partner in the entity from which he received financial benefits.

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. 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 (3/10/08)), 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)). The temporary 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 temporary regulations also revise rules under § 168 regarding disposition and maintenance of general asset accounts for MACRS property. In general, the regulations adopt the provisions of the 2008 proposed regulations, but with multiple modifications. Temp. Reg. § 1.263(a)-2T provides rules for amounts paid for the acquisition or production of tangible property, and § 1.263(a)-3T provides rules for amounts paid for the improvement of tangible property. However, these new proposed regulations provide many additional rules. The temporary 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 cost not more than $100. They add a book-conformity de minimis rule, a safe-harbor for routine maintenance, and an optional simplified method for regulated taxpayers. The temporary 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 regulations do not provide for a detailed repair allowance rule, but do provide for future I.R.B. guidance regarding industry-specific repair allowance methods.

- *Acquisition and Production Costs*. Temp. 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 Temp. Reg. § 1.263(a)-3T(d)(2)), 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. Amounts paid for work performed on a unit of property prior to the date the property is placed in service must also be capitalized. Temp. Reg. § 1.263(a)-2T(d)(1). Transaction costs to facilitate the acquisition of property are expressly required to be capitalized, Temp. Reg. § 1.263(a)-2T(f), but facilitative expenditures do not include employee compensation or overhead unless the taxpayer elects to capitalize such expenditures. Expenditures to defend or protect title must be capitalized. Temp. Reg. § 1.263(a)-2T(e).

- *Selling Expenses.* Temp. Reg. § 1.263(a)-1T(d) 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, Temp. Reg. § 1.162-3T 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, and (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 $100 (an embedded de minimis rule). Temp. Reg. § 1.162-3T(c). Taxpayers may elect to capitalize the cost of each item of material or supply. Items used in the production of other property remain subject to the uniform capitalization rules of § 263A. Temp. Reg. § 1.263A-1T(b). On sale or disposition, materials and supplies are not treated as capital assets. Temp. Reg. § 1.162-3T(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 rotable spare parts is deductible in the year of the disposition of the part. Temp. Reg. § 1.162-3T(a)(3). Temp. Reg. § 1.162-3T(e) provides an elective optional method of accounting for the treatment of rotable 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.* Temp. Reg. § 1.263(a)-2(g) allows a taxpayer to deduct expenditures to acquire or produce property (other than 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 property costing less than a specified dollar amount, as long as the amounts deducted under the de minims rule do 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 temporary regulations remove a provision in the 2008 proposed regulations that the aggregate amount deducted do not materially distort the taxpayer's income for purposes of § 446.) Property subject to the de minimis rule cannot be treated on sale or other disposition as a capital or § 1231 asset. A taxpayer may elect to apply the de minimis rule of Temp. Reg. § 1.263(a)-2T(g) to materials and supplies, including rotable spare parts, which are then not treated as materials or supplies under Temp. Reg. § 1.162-3T. Temp. Reg. § 1.162-3T(f).

- *Unit of Property*. Temp. Reg. § 1.263(a)-3T(e). The unit of property concept is central to the proposed regulations' requirement that improvements to a unit of property must be capitalized.

- Temp. Reg. § 1.263(a)-3T(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.[1] However, the improvement rules must be 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.

- Temp. Reg. § 1.263(a)-3T(e)(2) 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 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.

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1. 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 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.

- *Capitalization of Improvements.* Expenditures to improve a unit of property must be capitalized. Temp. Reg. § 1.263(a)-3T(d). Amounts expended for repairs and maintenance of tangible property are deductible if they are not required to be capitalized under Temp. Reg. § 1.263(a)-3T. Temp. Reg. § 1.162-4T. Expenditures that improve tangible property and that are required to be capitalized include expenditures that:
  - ºResult in a "betterment" to a unit of property (replacing the term "material increase in value" used in the original proposal);
  - ºRestore a unit of property; or
  - ºAdapt the unit of property to a new or different use.

Temp. Reg. § 1.263(a)-3T(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 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 § 168(i)(6); Temp. Reg. § 1.168(i)-8T(c)(4)(ii)(E).)

- *Betterment.* Temp. Reg. § 1.263(a)-3T(h). An expenditure results in a betterment of a unit of property if it (1) ameliorates a material condition or defect that existed prior to acquisition of the property or arose during production of the property, (2) results in a material addition to a unit of property, or (3) results in a material increase in capacity. 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.
- *Restoration.* Temp. Reg. § 1.263(a)-3T(i). An expenditure is 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. Whether there is 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. (The 50 percent of replacement cost test of the proposed regulations was eliminated.) 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.* Temp. Reg. § 1.263(a)-3T(j). A unit of property is treated as adapted to a new or different use if the adaptation is not consistent with the taxpayer's "intended ordinary use of the unit of property at the time originally placed in service by the taxpayer." An expenditure to adapt a component of a building to a new use must be capitalized as an expenditure to adapt the unit of property consisting of the building and its structural components to a new use.

- *Rehabilitation doctrine is no more.* Temp. Reg. § 1.263(a)-3T(f)(3) eliminates the judicially created rehabilitation doctrine by providing that, "[I]ndirect costs that do not directly benefit and 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." But the regulations provide that if otherwise deductible repairs benefit or are incurred by reason of an improvement, the cost of the repairs must be capitalized under § 263A.

- *Routine Maintenance Safe Harbor.* Temp. Reg. § 1.263(a)-3T(g) provides a safe harbor from the capitalization requirement for "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." 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 rotable spare parts. Routine maintenance excludes activities that follow a basis recovery event similar to the items that are described as restorations.

- *Repairs.* 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.

- *Repair Allowance.* The regulations do not provide for a repair allowance, but Temp. Reg. § 1.263(a)-3T(*l*) permits taxpayers to use a repair allowance method that is authorized by published guidance in the Federal Register or the Internal Revenue Bulletin, suggesting that such rules will be forthcoming.

• *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.

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 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). 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. This announcement amends — really!!?? Announcement 2013-7, 2013-3 I.R.B. 308 (1/14/13). An announcement amending regulations — 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 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.

2. Just because state law requires you to make the payment doesn't mean it's an ordinary and necessary business expense. Zweifel v. Commissioner, T.C. Memo. 2012-93 (3/28/12). Citing *Sebring v. Commissioner*, 93 T.C. 220, 227 (1989); *Firetag v. Commissioner*, T.C. Memo. 1999-355, *aff'd without published opinion*, 232 F.3d. 887 (4th Cir. 2000); and *Rankin v. Commissioner*, T.C. Memo. 1996-350, *aff'd*, 138 F.3d 1286 (9th Cir. 1998), the Tax Court (Judge Paris) held that payments to a "build up fund account" into which a bail bondsman is required under state law to make deposits to reimburse insurers for losses on bail bonds underwritten by the bail bondsman are not deductible in the year of the contribution to the account, because the expense for which the account was created has not yet arisen.

- As a condition of doing business, taxpayer bail bond agent was required by state law to maintain a "build-up fund" of 1 percent of bonds executed as an agent of National Surety Services (the underwriter) for the purpose of establishing an indemnity to protect the insuring company from loss through the posting of bonds by the agent. The taxpayer had legal title to the funds, was taxable on interest, and was entitled to return of the funds on termination of the contract with the insurer and discharge of remaining open bonds. Judge Paris rejected the taxpayer's argument that the payments were in the nature of insurance premiums paid to financially protect the taxpayer. The court indicated that the payments are specific payments tied to an individual bond and are not a general contract to protect against unforeseen losses. The court held that the payments are deductible when amounts are paid out of the build-up fund to the insurer.

- The court sustained penalties for failure to timely file and indicated with respect to negligence penalties that, although the taxpayer presented "well-thought-out arguments" to distinguish prior case law with respect to the claimed deductions, the taxpayer's failure to timely file indicates that the taxpayer did not act in good faith or with reasonable cause.

3. Avoided interest attributable to associated property taken out of service requires capitalization under *Chevron*-tested regulations that barely survive. Dominion Resources, Inc. v. United States, 97 Fed. Cl. 239 (2/25/11). The taxpayer, an electric utility, removed boilers from service to replace burners. Reg. § 1.263A-11(e)(1)(ii)(B) requires that the capitalized cost of improvements under § 263A include both direct expenditures and the capitalized cost of interest (under the avoided cost rules) attributable to the basis of property temporarily removed from service in order to complete the improvements. The court (Judge Lettow) rejected the taxpayer's arguments that (1) the associated property rule of Reg. § 1.263A-11(e)(1)(ii)(B) is invalid as inconsistent with § 263A, and (2) it was adopted in contravention of the requirements of the Administrative Procedure Act. Under the test of *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc*., 467 U.S. 837 (1984), the taxpayer argued that the regulation was inconsistent with § 263A(f)(2)(A)(ii), which provides that for purposes of determining production period interest "with respect to any property . . . interest on any . . . indebtedness [not directly attributable to production expenditures] shall be assigned to such property to the extent that the taxpayer's interest costs could have been reduced if production expenditures . . . had not been incurred." The taxpayer asserted that "property" for this purpose under the statutory language can include only the improvement itself, which is separately depreciable, and cannot, therefore be expanded to include associated property as provided in the regulation. The taxpayer also argued that the production costs were incurred with respect to the replacement burners, and not with respect to the boilers themselves. While the court was not completely happy with the IRS's argument that the property can be separated for depreciation purposes while considered as a unit for purposes of the interest allocation, the court concluded that the statute was sufficiently ambiguous under the first prong of the *Chevron* test that the regulation could be tested under the second prong of *Chevron*, which asks whether the regulation is a permissible construction of the statute. Here the court indicated that, "It is stretching the statute quite far to say that the associated-property rule 'is a reasonable interpretation of the enacted text' [of section 263A]." The court added that the IRS's rationales "are not very satisfying." The court then concluded, however, that "it is not this court's province to be making such policy choices. In this very close case, the court cannot say that Treasury overstepped the latitude granted by the statute to adopt regulations prescribing the calculation of interest to be capitalized in connection with an improvement to existing property used by the taxpayer to produce income" and held that the regulation therefore survived the taxpayer's challenge. With respect to the taxpayer's challenge under the Administrative Procedure Act, the court again found that "it is a stretch to conclude that Treasury 'cogently explain[ed] why it has exercised its discretion in a given manner,'" but added that "[t]he 'path' that Treasury was taking in the rulemaking proceedings can be 'discerned,' albeit somewhat murkily" and upheld the regulation. Finally, the court rejected retroactive application of a de minimis rule of Reg. § 1.263A-11(e)(2) to the taxpayer, and denied the IRS's counterclaim for capitalization of additional interest.

- No pretzel in existence has as many twists and bends as does this opinion.

a. But the regulation does not survive *Chevron* analysis on appeal. Dominion Resources, Inc. v. United States, 681 F.3d 1313 (Fed. Cir. 5/31/12). The Court of Appeals for the Federal Circuit (in an opinion by Judge Rader) reversed the Court of Federal Claims decision upholding Reg. § 1.263A-11(e)(1)(ii)(B), which requires that the capitalized cost of improvements under § 263A include both direct expenditures and the capitalized cost of interest (under the avoided cost rules) attributable to the basis of property temporarily removed from service in order to complete the improvements, by invalidating the regulation under step two of the *Chevron* analysis. The majority of the Federal Circuit panel held that "the regulation is unreasonable in defining 'production expenditures' to include the adjusted basis of the entire unit," because "[t]he regulation directly contradicts the avoided-cost rule that Congress intended the statute to implement." The opinion illustrated the problem with the following example.

> For example, let's say an owner purchased real property for $100,000 by a loan with a 3% interest rate. A few years later, she made an improvement that cost $5,000. If she had used that $5,000 toward the debt instead of the improvement, she would have avoided accruing $150 in interest ($5,000 multiplied by 3%). The avoided-cost rule requires her to capitalize that $150 in interest. The Treasury regulation, however, requires her to capitalize $3,150 in interest ($100,000 + $5,000 then multiplied by 3%). That result makes no sense, because there is no way that she could have avoided accruing $3,150 in interest by not making the improvement, as she did not expend or incur an amount equal to $105,000 when making the improvement.

- The court went on to point out that "[t]he only way that an amount equal to the adjusted basis could potentially satisfy the avoided-cost method is by assuming that the property owner would have sold the unit and used the sale proceeds to pay down the debt." Based on this analysis the Court of Appeals concluded that the Court of Federal Claims erred by concluding that the regulation reflected a "policy choice" by the agency and was thus permissible.

- The majority also invalidated the regulation, as did the concurring opinion of Judge Clevenger, on the basis that it violated the requirement imposed by the Supreme Court in *Motor Vehicle Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983), that the agency must provide a reasoned explanation for adopting a regulation. *"State Farm* requires that the Treasury 'articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choice made.'" Neither the preamble to the proposed regulations nor the preamble to the final regulations (nor Notice 88-99, 1988-2 C.B. 422) provided any rationale for adopting the rule in the regulations; there was "no explanation for the way that use of an adjusted basis implements the avoided-cost rule."

4. Proposed regulations restrict negative numbers in allocating indirect costs under the complicated "simplified methods rules." REG-126770-06, Allocation of Costs Under the Simplified Methods, 77 F.R. 54482 (9/5/12). Section 263A requires capitalization of all direct and indirect costs into goods produced during the year and inventory, so-called § 471 costs that must be included in inventory. Section 263A costs may be allocated on a facts and circumstances basis, or the taxpayer may use the simplified resale or simplified production methods provided in Reg. §§ 1.263A-2(b) and 1.263A-3(d) to allocate costs to eligible property produced or held for resale in lieu of a facts-and-circumstances allocation method. Under the simplified method a pool of additional capitalized § 263A costs (indirect costs not otherwise includible in inventory under the taxpayer's method of accounting) may be allocated among ending inventory and costs of goods sold based on an "absorption ratio" of such costs to the taxpayer's total § 471 inventory costs. In some circumstances the simplified method will produce negative amounts that cause distortions in inventory accounting, generally when a taxpayer capitalized a cost as an inventory cost that is greater than the amount required to be capitalized for tax purposes. Proposed Reg. § 1.263A-2(b) would, with certain exceptions, prevent taxpayers from using negative amounts in determining additional § 263A costs. Producers with average annual gross receipts of less than $10,000,000 would be allowed to continue to include negative amounts in additional § 263A costs. Retailers who use the simplified resale method would be permitted to remove inventory costs that are not required to be capitalized for tax purposes from ending inventory by treating them as negative additional § 263A costs.

- The proposed regulations include a modified simplified production method that would allow producers to separately determine the allocation of preproduction related additional § 263A costs using a preproduction cost absorption ratio applied to capitalized inventory costs for raw materials.

- As a sop for simplification, the proposed regulations would redefine a taxpayer's "additional § 263A costs" for purposes of the simplified methods as costs, other than interest, that a taxpayer capitalized to its inventory in its financial statements. The definition would provide, however, that a taxpayer must include all direct costs in its § 471 costs regardless of the taxpayer's treatment of the costs in its financial statements.

5. 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. Reg. §§ 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?

C. Reasonable Compensation

1. Non-limit limitations on excessive compensation to corporate officers. REG-137125-08, Certain Employee Remuneration in Excess of $1,000,000 Under Internal Revenue Code Section 162(m), 76 F.R. 37034 (6/24/11). Section 162(m) limits deductions for compensation to top corporate officers of publicly traded corporations to $1 million with an exception to performance-based compensation attributable to stock options and stock appreciation rights. Proposed regulation § 1.162-27(e)(2)(iv) would require that performance-based compensation plans designate the maximum number of shares with respect to which options or rights may be granted to an individual employee during a specified period. The preamble to the proposed regulations indicates that the IRS rejects assertions that specifying a limit is not necessary because such plans require shareholder approval as contrary to its interpretation of legislative history as requiring an objective formula for determining the maximum amount of compensation an employee could receive if the employee's performance goal is met.

a. Performance-based compensation is based in part on performance. Rev. Rul. 2012-19, 2012-28 I.R.B. 16 (6/25/12). The limitation of § 162(m) on deduction of employee compensation to an applicable employee by a publically held company to $1,000,000 does not apply to performance-based compensation. The IRS rules that a corporate plan to pay dividends and dividend equivalents on restricted stock granted to an employee that vests on meeting performance goals is performance based compensation. However, dividends and dividend equivalents payable on restricted stock regardless of whether the employee meets performance goals does not qualify as performance-based compensation. The ruling cites Reg. § 1.162-27(e)(2), which provides that performance-based compensation must be paid solely on account of preestablished performance goals based on an objective standard, on a grant-by-grant basis.

2. Every time a reasonable compensation case is appealable to the Seventh Circuit, it seems that whoever the judge is, after doing the *Exacto* bit to satisfy Judge Posner, he or she adds something like, "and in any event it wasn't deductible because it wasn't intended to be compensation." Mulcahy, Pauritsch, Salvador & Co. v. Commissioner, T.C. Memo. 2011-74 (3/31/11). The taxpayer, an accounting and consulting firm operating as a C corporation, made payments to three related entities owned by the three named principals of the corporation that essentially resulted in zeroing out the taxpayer's income for the year. The related entities performed no services for the taxpayer, and at trial the taxpayer claimed that the payments were deductible as compensation to the named principals, who did perform services for the taxpayer. The court (Judge Morrison) held that even if the payments were viewed as compensation to the named principals, the payments were not deductible. Applying the "hypothetical independent investor" test of *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999), because the case was appealable to the Seventh Circuit, Judge Morrison found that the rate of return on the firm's equity was "too low to create a presumption that the amounts claimed as 'consulting fees' were reasonable compensation for the [principals'] services." Because the taxpayer presented no other relevant evidence that the payments were reasonable in amount, the deduction was disallowed. Judge Morrison added that besides being reasonable in amount, to be deductible the payment must be intended to be compensation, and the payments in question were not intended to be compensation.

> [The firm] intended for the payments to the related entities to distribute profits, not to compensate for services. . . . Salvador chose the amount to pay each year so that the payments distributed all (or nearly all) accumulated profit for the year. He did this for tax planning purposes. Each [principal's] percentage of the payments to the related entities was tied to hours worked, but the firm's intent in making the payments was to eliminate all taxable income. The firm did not intend to compensate for services.

- Accuracy related penalties were upheld, with Judge Morrison taking special note of the fact that the taxpayer was an accounting firm.

a. And Judge Posner agrees adding "[t]hat an *accounting* firm should so screw up its taxes is the most remarkable feature of the case." Mulcahy, Pauritsch, Salvador & Co. v. Commissioner, 680 F.3d 867 (7th Cir. 5/17/12). The Seventh Circuit (Judge Posner) affirmed the Tax Court, holding that the consulting fee payments to the three related entities owned by the three named principals of the C corporation, did not constitute deductible compensation but, instead, constituted a return on invested capital, i.e., dividends. This is because the taxpayer corporation was not "a pane of glass" between the billings of a typical small professional services firm and the salaries of its professionals where the amount of capital invested is negligible. Here, the taxpayer corporation had 40 employees in multiple branches, so the amount of invested capital was relatively large, and the consulting fees constituted a return on that invested capital. Judge Posner noted that treating the consulting fees as salary expenses, which reduced the firm's return to equity to zero even though the firm was "doing fine," flunked the independent-investor test.

- During the course of the opinion, Judge Posner managed to chide taxpayer's lawyers for "appear[ing] not to understand the difference between compensation for services and compensation for capital." He also chided taxpayer's expert witness for using "firm income per partner" of comparable accounting firms without "divid[ing] firm income per partner into salary and dividend components," which rendered his testimony "irrelevant."
- Judge Posner noted his "puzzlement" that the firm did not organize as a pass-through entity, but noted that it had to accept the consequences of its entity choice, "that in this case include[d] a large tax deficiency and a hefty penalty."
- See *Pediatric Surgical Assocs., P.C. v. Commissioner*, T.C. Memo. 2001-81 (relating to the non-deductibility of compensation paid to shareholder employees derived from earnings resulting from the efforts of non-shareholder professionals).
- Shades of *Charles McCandless Tile Service v. United States*, 191 Ct. Cl. 108, 422 F.2d 1336 (Ct. Cl. 1970). It held that 15 percent of profits (before stockholders' salaries) should be considered as a dividend, and should reduce the deduction for salaries paid accordingly. That case aroused a great deal of interest when it first came out, and led to all sorts of closely held corporations paying out dividends of about $1,000 per year to establish a history of paying dividends.

D. Miscellaneous Deductions

1. 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. Standard mileage rates for 2012. Notice 2012-1, 2012-2 I.R.B. 260 (12/9/11). The standard mileage rate for rolling the tires after 1/1/12 remains at 55.5 cents (23 cents representing depreciation). The mileage rate for charitable service is 14 cents, and for medical care or moving expenses the rate is slightly down to 23 cents. The maximum standard automobile cost for computing the allowance under a fixed and variable rate (FAVR) plan is $28,000 for automobiles and $29,300 for trucks and vans.

b. Add one cent per mile for 2013 (except for charitable service). Notice 2012-72, 2012-50 I.R.B. 613 (11/21/12). The standard mileage rate for business miles in 2013 goes up to 56.5 cents per mile (with 23 cents representing depreciation), and the medical/moving rate goes up to 24 cents per mile. The charitable mileage rate remains fixed by § 170(i) at 14 cents.

c. The IRS announces per diem rates for travel away from home. Notice 2012-63, 2012-42 I.R.B. 496 (9/26/12). Per diem reimbursement rates in lieu of substantiated expenses under Rev. Proc. 2011-47, 2011-42 I.R.B. 520, effective for travel after 10/1/12, are unchanged from 2011. One revision, however, removes transportation expenses between points, lodging and meals, and mailing expense for travel vouchers from incidental expenses, so that these items may be separately reimbursed for travelers using the per diem method. Per diem rates are as follows:

- The special meals and incidental rates for the transportation industry are $59 within CONUS and $64 OCONUS.
- Incidental expense deduction for any location is $5 per day (the IRS believes in cheap tippers).
- Rates for travel within CONUS are $242 per day for high cost localities (listed in the notice) and $163 for all others. The portion allowed for meals is $65 in a high-cost locality and $52 for others.

d. Rev. Rul. 2012-27, 2012-41 I.R.B. 435 (10/4/12). The IRS has provided standard industry fare level cents-per-mile and terminal charges for the second half of 2012 for determining the value of non-commercial flights on employer provided aircraft. Under Reg. § 1.61-21(g) the value of a non-commercial flight is determined by multiplying the standard industry fare cents-per-mile rate by the applicable aircraft multiple and adding the applicable terminal charge.

2. The Empire strikes back against the "Millennium Plan." Goyak v. Commissioner, T.C. Memo. 2012-13 (1/11/12). The individual husband and wife taxpayers' wholly owned corporation, Goyak & Associates, contributed $1.4 million to a purported § 419A(F)(6) employee welfare benefit plan, known as the "Millennium Plan," of which the taxpayer husband was the sole beneficiary with respect to Goyak & Associates, and Goyak & Associates claimed a § 162 deduction. The Tax Court (Judge Goeke) held that the amount was a constructive dividend to Mr. Goyak, rather than a deductible ordinary and necessary business expense. The covered employee, i.e., Mr. Goyak, in the plan was able to (1) freely void his participation in the plan and have the life insurance policy maintained by the plan distributed to him, or (2) receive life benefits at a time of his choosing by "timing" a severance event. A 20 percent § 6662 accuracy-related penalty was upheld.

3. Reimbursement insurance is really a deposit. F.W. Services, Inc. v. Commissioner, 459 Fed. Appx. 389 (5th Cir. 1/25/12). The taxpayer, a temporary personnel agency, purchased insurance policies to cover workers compensation and employer's liability. The policies required the taxpayer to reimburse the insurer up to $500,000 for each claim. To provide evidence of financial responsibility to the insurer, the taxpayer entered into a second "insurance" contract to cover the reimbursement obligation. The second contract provided for an estimated premium of $3.9 million. The actual premium would be determined at the end of the policy year and provided for an increase or decrease in the amount owed depending upon experience. The taxpayer claimed a § 162 deduction for the full premium. Upholding the Tax Court, the Circuit Court agreed with the IRS position that the premium paid was a non-deductible deposit on the taxpayer's potential reimbursement liability under the first policy. The court added that funds set aside for future reimbursement did not constitute insurance as there was no shift in the risk of loss.

4. Family commune farm provides deductible meals and medical care to its members. Stahl v. United States, 861 F. Supp. 2d 1226 (E.D. Wash. 3/20/12), *on remand from* 626 F.3d 520 (9th Cir. 2010). The Stahl family (consisting of eight siblings and spouses plus children numbering 65 people) maintains a Hutterite colony engaged in farming on

30,000 acres selling potatoes and dairy products. As participants in a § 501(d) nonprofit apostolic corporation, each member pays personal income tax on the member's pro rata share of the corporation's income, determined after allowable deductions. In a claim for refund the taxpayers asserted that their share of the corporate income should be reduced by deductions for the cost of meals and payments for a health plan maintained by the corporation. On remand from the Ninth Circuit determination that the taxpayers were employees of the corporation, the District Court upheld the taxpayers' assertion that the corporate income of the colony is reduced by deductions for meals and the health plan. The court noted that it was necessary within the meaning of § 162 to maintain employees on the farm around the clock to maintain the dairy herd and found that food and medical care represented compensation to the employee family members who performed the work of the farm. The court stated that it was appropriate to treat the food and medical care as a form of "other compensation" deductible within the meaning of § 162(a)(1). The court also held that the medical insurance purchased by the corporation was a health plan within the meaning of Reg. § 1.106-1, excludable from income of the employee and deductible under Reg. § 1.162-10. The court rejected the IRS's argument that the food and health care were not deductible as personal expenses.

5. Don Draper likely would have tried to take advantage of this rule had it been around when he was renting hotel rooms in NYC. REG–137589–07, Local Lodging Expenses, 77 F.R. 24657 (4/25/12). Prop. Reg. § 1.162-31 would allow a deduction for local lodging, i.e., lodging while the taxpayer is not away from home, in carrying on a taxpayer's trade or business (whether or not as an employee) under a "facts and circumstances" test. One factor is whether the taxpayer incurs the expense because of a bona fide condition or requirement of employment imposed by the taxpayer's employer. (For employees the question usually is whether the employer-paid lodging is a working condition fringe benefit.) The proposed regulations provide a safe harbor for local lodging at business meetings and conferences. The examples indicate that there must be a bona fide business reason for the overnight stay, and, if provided by an employer, there must be a substantial noncompensatory reason. The regulations will be effective upon final publication, but pending finalization, taxpayers may rely on the proposed regulations.

- We foresee a deluge of future Tax Court cases involving deductions claimed for nights (or mid-day stays) at a host of no-tell motels.

6. Flying is entertainment, at least in the corporate aircraft. T.D. 9597, 77 F.R. 45480 (8/1/12), *corrected*, 77 F.R. 50373 (8/21/12). The Treasury Department has promulgated final regulations revising Reg. § 1.61-21(g)(14) and adding Reg. §§ 1.274-9 and 1.274-10, in addressing the disallowance of expenses under § 274(a) incurred in the use of taxpayer owned aircraft for entertainment. Under the regulations both fixed and variable expenses, including depreciation and interest expense, attributable to the use of taxpayer owned aircraft for entertainment are disallowed. Expenses are allocated on the basis of occupied seat miles or hours for entertainment travel relative to total seat miles or hours of aircraft use, or on a flight-by-flight basis. Expenses attributable to deadhead flights returning empty from an entertainment flight are included in the calculation. The Treasury Department rejected suggestions that expenses be determined on the basis of the primary purpose of a specific flight. Depreciation for the purpose of determining entertainment expenses may be calculated on a straight-line basis regardless of the depreciation method used by the taxpayer for other purposes. Aircraft with similar cost profiles that have the same type and number of engines can be aggregated in determining expenses allocable to use of the aircraft for entertainment. The regulations do not permit aggregation of the costs of all aircraft operated by the taxpayer. Expenses incurred for entertainment flights of specified employees (officers, directors, 10 percent owners) are excepted from disallowance under § 274(e)(2) only to the extent included in income as compensation by the recipient. Expenses in excess of the amounts included in income are disallowed. Also, expenses incurred to provide entertainment flights in taxpayer owned business aircraft to meet security concerns (which are excludable from the recipient's income as a fringe benefit) remain disallowed as deductions under § 274(a). The loss disallowance rules do not apply to expenses incurred by a commercial airline providing entertainment flights to "specified individuals" on a regularly scheduled flight on which 90 percent of the seats are offered for sale to the general public to the extent the entertainment flight is includable in the gross income of the specified individual.

7. The one who eats the food may not get the haircut: Proposed regulations allocate the § 274(n) limitations with respect to reimbursed meals. REG-101812-07, Reimbursed Entertainment Expenses, 77 F.R. 45520 (8/1/12). Section 274(n) limits otherwise allowable deductions for meals and entertainment to 50 percent of the expense. In the case of reimbursed meal or entertainment expenses that are not treated as income to the payor, § 274(e)(3) applies the limitation to the person claiming a deduction for the reimbursement. In *Transport Labor Contract/Leasing, Inc. v. Commissioner,* 461 F.3d 1030 (8th Cir. 2006), the court held that in a three-party reimbursement arrangement the § 274 limitation applied to the client who reimbursed an employee leasing company for meal expenses paid by the leasing company employer to contract truck drivers who were leased to a trucking company. The Eighth Circuit's opinion defined reimbursement arrangements by reference to definitions of an employer's accountable plan under § 62(a)(2)(A) and Reg. § 1.62-2. The proposed regulations would provide an independent definition of a reimbursement or expense allowance arrangement independent of the rules of § 62(a)(2)(A) and (c). Prop. Reg. § 1.274-2(f)(2)(iv)(a)(D) would define a reimbursement arrangement as one under which an employee or independent contractor receives an advance, allowance, or reimbursement from an employer, client, or contractor for expenses incurred by the recipient. A reimbursement plan involving payments to an independent contractor would have to be memorialized in a written agreement that identifies the party subject to the § 274 limitations.

- In the case of an employer, the limitations of § 274 apply to the employer's deduction of reimbursed expenses, except to the extent that the employer treats the reimbursement or other payment as compensation paid to the employee and wages for withholding purposes.

- In case of reimbursements to an independent contractor, the limitations apply to the independent contractor to the extent that the independent contractor does not account to the client or customer for meals and entertainment expenses under the substantiation rules of § 274(d). Where the independent contractor accounts for meal and entertainment expenses, the limitations are applicable to the client or customer. The person responsible for the § 274 limitations can be specified in a written agreement between the parties.

- The preamble to the proposed regulations and proposed examples indicate that in a multiple party arrangement each relationship will be treated as a two-party relationship subject to the independent contractor rules, which thus would impose the § 274 limitations upon the party that reimburses expenses substantiated to it by another party. Again, persons in multiparty reimbursement arrangements would be permitted to specify by agreement which party is subject to the § 274 limitations.

8. Cincinnati is one big metropolitan area. Saunders v. Commissioner, T.C. Memo. 2012-200 (7/17/12). The taxpayer worked for a single employer, had no principal place of business, and travelled directly from home to temporary work sites located between 74 and 96 miles away. The taxpayer lived in Manchester, Ohio [more than 70 miles away from Cincinnati], and indicated that his "main area" was Cincinnati. The Tax Court (Judge Thornton) refused to allow the taxpayer's claimed deductions for travel away from home as expenses incurred for travel outside the metropolitan area where the taxpayer lives and normally works. The court noted that the term "metropolitan area" is ill defined, but concluded under the facts and circumstances that the taxpayer failed to establish that any of the temporary worksites to which the taxpayer travelled were outside of the Cincinnati metropolitan area; the two worksites identified in the opinion were 20 and 31 miles away from downtown Cincinnati, but were located within the Cincinnati-Middletown, OH-KY-IN Metropolitan Statistical Area as defined in OMB Bulletin No. 08-01 (Nov. 20, 2007).

9. The Tax Court strikes a blow to the travel expense of two-earner couples. Noz v. Commissioner, T.C. Memo 2012-272 (9/24/12). The court (Judge Morrison) disallowed travel expense deductions to married taxpayers who worked as university professors, one in New York, one in Stockholm. Although the married taxpayers collaborated with each other on articles and books, the court held, "On the basis of the frequency of travel, the personal relationship between the petitioners, and the petitioners' failure to offer any evidence, beyond broad generalities, of how the trips advanced any stated business purpose, we find that the New York-Stockholm trips were motivated primarily by personal concerns."

10. Selling insurance is a service business not allowed a cost of goods sold, even to a former IRS agent. Perry v. Commissioner, T.C. Memo. 2012-237 (8/16/12). Along with denying unsubstantiated travel and business expenses (including $3,000 to an airline employee to be designated her "travel companion" for discounted airfare), the Tax Court (Judge Kroupa) held that the taxpayer's business of selling insurance was not the sale of a material product to which direct cost may be allocated to reduce gross receipts as cost of goods sold.

11. IRS tries to put a lid on wages recharacterized as reimbursements. Rev. Rul. 2012-25, 2012-37 I.R.B. 337 (9/10/12). The IRS ruled that certain employer arrangements that substitute reimbursement for tools, travel, supplies and the like under a purported "accountable plan" for compensation for services do not meet the business connection requirement of § 62(c) and therefore fail as accountable plans. The IRS noted that such plans are intended to avoid the two-percent limitation on deduction of employee business expenses and payment of employment taxes on wages that are recharacterized as reimbursements. Citing Reg. § 1.62-2(d), the ruling indicates with three factual situations that the business connection requirement is not met where hourly compensation is reduced and replaced with a reimbursement arrangement that pays the same gross amount to the employee regardless of whether the employee incurs deductible business expenses. The ruling states that the fact that the employee actually incurs a deductible expense in connection with employment does not cure the wage recharacterization. Second, a plan that pays the same amount of reimbursement to employees who have not actually incurred deductible expenses in connection with the employer's business fails the business connection requirement. In situation 4 of the ruling, the IRS indicates that a plan that reduces hourly compensation, but only reimburses employees who incur expenses in connection with the employer's business and who are required to substantiate expenses, qualifies as a reimbursement plan notwithstanding substitution for the reimbursement plan for a portion of the hourly compensation.

12. 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 to its sister, both of which were owned by two University of Texas El Paso engineering professors who used the LLCs for consulting and metal fabrication activities. 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.

13. Friends from the Cheers bar don't provide business bad debt deductions until all hope is gone. Alioto v. Commissioner, 699 F.3d 948 (6th Cir. 11/7/12). After the taxpayer hired John Ratzenberger (famous for his role in Cheers) he entered into a business venture with Ratzenberger to use celebrity talent in short form media to be sold as internet advertising. The taxpayer contended that he expected to be fully reimbursed for advances of his own money to the venture. Affirming the Tax Court (T.C. Memo. 2011-151), the Sixth Circuit (Judge Moore) denied business bad debt deductions because the taxpayer failed to meet his burden of proof that his losses were no longer subject to a reasonable prospect of recovery. The court rejected the taxpayer's testimony that he had received an e-mail from Ratzenberger's agent notifying the taxpayer that no further reimbursement would be forthcoming as insufficient proof, nor did the court accept the fact that the taxpayer filed bankruptcy as evidence that the debt was not recoverable. The court also denied the taxpayer's claim for a theft loss on the ground that there was no proof that Ratzenberger's actions amounted to larceny under Massachusetts law.

14. The CEO and sole shareholder of a janitorial corporation used cocaine as a chick magnet, but can the corporation deduct the cleanup costs? Held, the price paid for the cocaine overdose death of the boss's girlfriend is not a deductible corporate business expense. Cavanaugh v. Commissioner, T.C. Memo. 2012-324 (11/26/12). James Cavanaugh the CEO and sole shareholder of Jani-King International took a holiday trip to the Cavanaugh's villa in St. Maarten with his 27 year-old girlfriend, a body guard, and another female Jani-King employee. Unfortunately the girlfriend died from an overdose of cocaine. The girlfriend's mother sued the individuals and the corporation for wrongful death. The taxpayer's S corporation paid the full amount of the settlement, including a $250,000 reimbursement to Cavanaugh and claimed a business expense deduction. The Tax Court (Judge Holmes) began its opinion in this case submitted under Tax Court Rule 122[2] as follows:

> Twenty-seven-year-old Colony Anne (Claire) Robinson left Texas in November 2002 for a Thanksgiving vacation in the Caribbean with her boyfriend, his bodyguard, and another employee of the company that he had spent decades building.
>
> She did not return home alive.
>
> The coroner's report showed a massive amount of illegal drugs in her body and concluded that they were the likely cause of her death. Robinson's mother sued the boyfriend and his company for wrongful death. The parties settled. The company paid most of the $2.3 million settlement directly; the boyfriend contributed $250,000, which the company then reimbursed.

- Siding with the IRS, Judge Holmes looked to the origin of the claim, which the court held to be applicable to the corporation's payment in settlement of the wrongful death claim. The court concluded that although the claim related to the conduct of the three corporate employees, the conduct was not related to the corporate business, i.e., its profit-seeking activities. The court also rejected the taxpayer's theory that the bodyguard supplied cocaine in the course of his employment as a bodyguard and enabler for the CEO. Further, the court rejected the taxpayer's argument that reimbursement of the taxpayer's contribution to the settlement was contractually required under a corporate indemnity agreement. In addition, the court found that the payment was not deductible under the theory that it was

2. **RULE 122. SUBMISSION WITHOUT TRIAL**

(a) General: Any case not requiring a trial for the submission of evidence (as, for example, where sufficient facts have been admitted, stipulated, established by deposition, or included in the record in some other way) may be submitted at any time after joinder of issue (see Rule 38) by motion of the parties filed with the Court. The parties need not wait for the case to be calendared for trial and need not appear in Court.

(b) Burden of Proof: The fact of submission of a case, under paragraph (a) of this Rule, does not alter the burden of proof, or the requirements otherwise applicable with respect to adducing proof, or the effect of failure of proof.

made to protect the corporation's business reputation because there was no evidence that underlay that theory.

15. Puerto Rico may not be a state, but it's part of the U.S.A. for § 199 domestic production purposes. The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 318, extends inclusion of manufacturing and production activities in Puerto Rico as domestic production activities for purposes of the § 199 domestic production activities deduction for the first eight years of a taxpayer beginning after 12/31/05 and before 1/1/14. Previously § 199 applied to the first six years of a taxpayer beginning after 12/31/05 and before 1/1/12.

16. Extended power to empowerment zones. The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 327, extends designations of empowerment zones through 12/31/13. The designations, which were set to expire on 12/31/11, extends a 20 percent wage credit under § 1396, additional $35,000 of first year expensing under §179, tax-exempt bond financing under § 1394, and capital gains deferral on replacement of qualified assets under § 1397B.

E. Depreciation & Amortization

1. 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 an agreed upon price for machinery and equipment. Subsequently, after a cost segregation study, the taxpayer attempted to change its method of accounting to separate out components of the plants 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.

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, 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.
- *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) & (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) & (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 deprecate 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 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).

e. This announcement amends regulations — really!!?? Announcement 2013-7, 2013-3 I.R.B. 308 (1/14/13). An announcement amending regulations — 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 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.

3. More trouble for cost segregation studies in an opinion from a self-described "high plains drifter" (in which Judge Holmes does to the taxpayer something like what The Stranger did to Callie Travers). Should the determination be made by comparison with a typical apartment building, or should it be made by comparison with a generic shell building? AmeriSouth XXXII, Ltd. v. Commissioner, T.C. Memo. 2012-67 (3/12/12). The Tax Court (Judge Holmes) rejected the taxpayer's attempt to use a cost segregation study to break down an apartment building and office complex into numerous components subject to MACRS cost recovery other than the 27.5 year straight line recovery attributable to residential real estate, in the process describing himself as a lone rider over the "llano estacado." The court described the property as "apartment buildings with over a thousand pieces of tangible personal property that just happen to be attached." Following a renovation, the taxpayer's cost segregation study broke down the property into several categories including site preparation and earthwork; water-distribution system; sanitary-sewer system; gas line; site electric; special HVAC; special plumbing; special electric; finish carpentry; millwork; interior windows and mirrors; and special painting. The court rejected the IRS's argument that the taxpayer did not own a depreciable interest in the water and electric utility lines and gas distribution systems crossing the property in utility owned easements, but agreed with the IRS that the taxpayer did not have a depreciable ownership interest in the sewer lines on the property. The court rejected the taxpayer's assertion that site preparation costs were segregated depreciable assets subject to 15 year recovery saying that the taxpayer failed to overcome the presumption that the IRS correctly determined that the site preparation costs were non-depreciable improvements to land. The taxpayer failed to provide evidence that some of the costs were attributable to depreciable sidewalks, parking and driveways. After a lengthy analysis of rulings and case law, the court concluded that costs of installing water, gas, and electrical distribution systems between utility mains and the numerous buildings in the apartment complex constituted structural components of the buildings and thus were not subject to shorter MACRS recovery. Turning to the building itself, Judge Holmes rejected the taxpayer's argument that the baseline for distinguishing structural components of the building from tangible personal property was an unfinished building shell suitable for being finished for a variety of purposes, instead agreeing with the IRS that the baseline was a typical apartment building. Applying this standard, Judge

Homes found that the only tangible personal property was the garbage disposals, dryer-dedicated venting having no connection to the general ventilation system, 220 amp power outlets dedicated to stoves, and 110 amp power outlets dedicated to refrigerators. All of the following were structural components of the buildings: venting connected to apartment stove hoods and HVAC systems, connecting plumbing, sinks, plastic wash tubs, laundry room drains, and gas lines (excepting individual gas line connectors to dryers and stoves), recessed lights, paddle fans with recessed lights, and wall outlets, finish carpentry (shelves, paneling, molding and the like), interior windows and mirrors, and special painting. In reaching all of these conclusions, the court refused to apply the holding in *Hospital Corp. of America v. Commissioner*, 109 T.C 21 (1997), which allowed segregation of certain rapidly depreciable tangible personal property that was not an inherently permanent structural component from the structural components of the hospital buildings in question in that case.

- Some have suggested that the precedential value of this decision might be limited because of the procedural aspects described by the court as follows:

> AmeriSouth sold Garden House about the time the case was tried, and stopped responding to communications from the Court, the Commissioner, and even its own counsel. We suspended briefing in an attempt to figure out what was going on and ended up ordering AmeriSouth to show cause why its attorneys should not be allowed to withdraw from its case. Without any response to the Court, we granted the attorneys' motion to withdraw and so AmeriSouth has been left representing itself. The Court then ordered AmeriSouth to file a posttrial brief, which it never did.
>
> Because the Court ordered a posttrial brief and AmeriSouth didn't file one, we could dismiss this case entirely. …. Despite AmeriSouth's lack of response and mysterious disappearance, however, we will not do so. We will, though, deem any factual matters not otherwise contested to be conceded.

- On the other hand, it is a decided Tax Court case, and according to rumor, this case presages further Tax Court interest in the cost segregation studies area.

4. Shockwave's shocking mechanical defects fail to hook GO Zone bonus depreciation. Blakeney v. Commissioner, T.C. Memo. 2012-289 (10/15/12). In February 2006 the taxpayer took possession of a new $3.9 million charter fishing yacht, Shockwave, to be based in

Orange Beach, Alabama, a city within the Gulf Opportunity Zone. Unfortunately multiple mechanical difficulties forced the boat to be tied up for repairs in the Caribbean until October 2006 when it was delivered to Orange Beach. Unfortunately, the fishing season ended in September so that the etaxpayer was not able to charter the boat in Orange Beach during the remainder of 2006. The taxpayer did, however, manage to charter the boat in the Caribbean for 43 days between repairs. The 50 percent bonus depreciation deduction of § 1400N is available for property placed in service after 8/28/05, substantially all of the use of which in the active conduct of a trade or business is in the Gulf Opportunity Zone. The court (Judge Vasquez) held that the 74 days during which the boat was available for charter in Orange Beach constituted use within the GO zone, even though the boat was not hired for charter during that period. The court also held that the boat was not available for use during the time it was laid up for repairs. However, the court treated the 43 days of charter service in the Caribbean as use outside of the GO zone and held that the 63 percent use (74/117) within the GO zone was not substantially all under § 1400N(d)(2)(A)(ii). The court indicated that it was not necessary to address whether the 80 percent use requirement of Notice 2006-77, 2006-2 C.B. 590, was entitled to deference under *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

5. First year bonus depreciation extended for one year by the 2012 Taxpayer Relief (and not so grand compromise) Tax Act. The first year bonus depreciation of 50 percent of adjusted basis of property with a MACRS recovery period of 20 years or less is extended to property placed in service before 1/1/14 and to certain transportation property placed in service before 1/1/15. The 50 percent allowance is available for depreciable machinery and equipment and most other tangible personal property, and is available for computer software and certain leasehold improvements, the first use of which began with the taxpayer. The 2012 Act also extends the provisions in § 168(e)(3)(E) treating qualified leasehold improvement property and qualified restaurant property as 15 year property, also eligible for the first year bonus depreciation.

6. Section 179 limits are extended again — is this becoming permanent like research credits? The 2012 Taxpayer Relief Act, § 315(a) retroactively extended, the Code § 179 first year expensing for tax years beginning in 2012 and 2013 in an amount not to exceed $500,000 with a phase-out amount beginning at $2,000,000. For tax years beginning after 2014 the maximum deduction drops to $25,000 with the phase-out beginning at $200,000 (at least until the business community again makes sufficient campaign contributions to extend the higher numbers into later years).

a. The sunny side of inflation. Rev. Proc. 2011-52, 2011-45 I.R.B. 701, § 3.20 (11/7/11). As adjusted for inflation and before extension by the 2012 Act, as provided in § 179(b)(6), the 2012 ceiling for expensing machinery and equipment and certain other § 1231 property was $139,000, and the phase-out threshold was $560,000. The retroactive application of the 2012 extension to tax years beginning in 2012 provided a windfall to taxpayers who exceeded the 2012 thresholds.

b. Section 179 is applied to computer software for another year. The 2012 Taxpayer Relief Act, extends for another year eligibility as qualified Code § 179 property to off-the-shelf computer software placed in service before 2014.

7. Mine safety equipment eligible for 50 percent expensing. The 2012 Act, § 316, extends the election under § 179E to expense 50 percent of mine safety equipment to apply to property placed in service on or before 12/31/2013.

8. 2012 depreciation tables for business autos, light trucks, and vans are to be increased by the 2012 Tax Relief Act with an additional $8,000 of first year recovery. Rev. Proc. 2012-23, 2012-14 I.R.B. 712 (3/2/12). The IRS published depreciation tables with the depreciation limits for business use of small vehicles:

Passenger Automobiles with § 168(k) first year recovery,

1st Tax Year	*$11,160*
2nd Tax Year	*$5,100*
3rd Tax Year	*$3,050*
Each Succeeding Year	*$1,875*

Trucks and Vans with § 168(k) first year recovery,

1st Tax Year	*$11,360*
2nd Tax Year	*$5,300*
3rd Tax Year	*$3,150*
Each Succeeding Year	*$1,875*

Section 168(k), as extended by the 2012 Act to property placed in service by 12/31/13, provides an additional $8,000 first year recovery

Passenger Automobiles not eligible for § 168(k) first year recovery,

1st Tax Year	*$3,160*
2nd Tax Year	*$5,100*
3rd Tax Year	*$3,050*
Each Succeeding Year	*$1,875*

Trucks and Vans not eligible for § 168(k) first year recovery,

1st Tax Year	*$3,360*
2nd Tax Year	*$5,300*
3rd Tax Year	*$3,150*
Each Succeeding Year	*$1,875*

- The revenue procedure also has tables for leased vehicles.

9. The IRS identifies property eligible for 100 percent depreciation, including the unintended consequences for business autos. Rev. Proc. 2011-26, 2011-16 I.R.B. 664 (3/29/11). 2010 tax acts extended the placed-in-service date for property to be eligible for the § 168(k)(1) 50 percent first year depreciation allowance to property placed in service before 2013 (2014 in the case of certain property described in § 168(k)(2)(B) and (C)) and adopted § 168(k)(5) to allow a 100 percent depreciation deduction for qualified property acquired after 9/8/10 and before 1/1/12, and placed in service before 1/1/12. The revenue procedure sets out several rules for the application of these provisions.

- Reg. § 1.168(k)-1(b)(4)(iii)(C)(1) and (2) provide that if the larger part of self-constructed property commences before the applicable dates for the 50 percent depreciation deduction, components self-constructed after the effective date are also ineligible for the accelerated deduction. If the construction of the larger part of self-constructed property begins before 9/9/10, but the qualified property otherwise qualifies for the 50 percent depreciation deduction, self-constructed components after 9/9/10, that are qualified property may be subject to an election to claim 100 percent depreciation deductions with respect to the component.

- Section 168(k)(2)(D)(iii) provides an election not to claim first year depreciation with respect to a "class of property" placed in service during the taxable year. Reg. § 1.168(k)-1(e)(2)(i) applies the election to each class of property described in § 168(e). The revenue procedure allows an election to claim 50 percent first year depreciation rather than 100 percent depreciation for a class of property.

a. The passenger automobile anomaly. The additional first year depreciation allowance is limited to $8,000 for passenger automobiles and light trucks subject to the § 280F limitations ($3,060, $4,900, $2,950 in years one through three respectively, and $1,775 in years four through six). Thus the first year depreciation allowance in year one is $11,060 ($3,060 plus $8,000). This allowance is treated as the 100 percent depreciation deduction. Under § 280F(a)(1)(B)(i), unrecovered passenger automobile basis is treated as a deductible expense (up to $1,775) in each year after the sixth year. Unless the taxpayer elects to forego 100 percent depreciation recovery with respect to a passenger automobile, the taxpayer would be treated as claiming 100 percent depreciation in year one, with no further deductions allowable in years two through six. The revenue procedure provides a safe harbor method of accounting that the taxpayer is deemed to apply by deducting depreciation of the passenger automobile for the first taxable year succeeding the placed-in-service year. In effect, the revenue procedure continues to treat passenger automobile and light truck depreciation as if the first year deduction were 50 percent depreciation.

b. The 2012 Act extends the eligibility to property placed in service before 1/1/14.

10. Not all self-created intangibles are nonamortizable. Fitch v. Commissioner, T.C. Memo. 2012-358 (12/26/12). The taxpayer sold his CPA practice to another accountant for $900,000 after suffering severe medical problems that led to brain surgery. Approximately 4-1/2 months after the sale, the purchaser suffered a seizure and was hospitalized. Five days later, the purchaser sold the practice back to the taxpayer for $900,000. The taxpayer claimed § 197 amortization deductions with respect to the cost of intangibles reflected in the $900,000 repurchase price, and the IRS denied the deductions. The IRS position was based on alternative arguments that (1) "'the alleged sales agreements petitioners submitted are untrustworthy and the alleged sales did not take place,'" (2) that the original transaction was rescinded, and (3) that the taxpayer reacquired self-created intangibles in a series of related transactions. The Tax

Court (Judge Vasquez) found that in light of the circumstances leading to each transaction, the two sales and purchase transactions were unrelated and genuine. Furthermore, the second transaction was not a mere rescission. Thus, the exception to the prohibition on amortization of certain self-created intangibles in Reg. § 1.197-2(d)(2)(iii)(C), which allows amortization if a taxpayer disposes of a self-created intangible and subsequently reacquires the intangible from a seller (in whose hands the intangible is amortizable) in an unrelated transaction, applied.

11. Tax incentives for "first peoples" — accelerated depreciation for property on Indian Reservations is extended. The 2012 Tax Relief Act, extends the shortened recovery periods of § 168(j) to property placed in service on Indian reservations before 12/31/13.

F. Credits

1. Save energy, save taxes. Notice 2012-26, 2012-17 I.R.B. 847 (3/28/12). Perpetually extended § 179D (through 2014 in the last iteration) allows a deduction of up to $1.80 per square foot for the cost of installing energy saving components if the total energy and power costs of a building are reduced by more than 50 percent compared to a reference building. A partial deduction is allowed for energy systems that do not meet the 50 percent threshold but satisfy a specified lowered requirement. The notice revises the percentage reductions figures of prior notices for the partial deduction for heating, cooling, ventilation, and hot water systems from 16 to 15 percent, from 16 to 25 percent for interior lighting, and from 16 to 10 percent for reductions attributable to the building envelope. Thus, the required percentage reductions in energy consumption for the partial deduction that are provided in the notice are 15 percent for HVAC systems, 25 percent for lighting, and 10 percent for the building envelope.

2. The Tax Court just says "no" to R&D credits claimed with 20/20 hindsight provided by alliantgroup. Shami v. Commissioner, T.C. Memo. 2012-78 (3/21/12). The taxpayer's S corporation hired alliantgroup to conduct § 41 research tax credit studies covering the years in question. The research and development department staff ranged from 18 to 27 and included chemists, technicians, and a vice president of research and development who supervised the department. The alliantgroup concluded that the corporation was entitled to claim the § 41 research credit based in part on wages paid to two individuals who were, respectively, its chairman of the board, chief executive officer, president, and secretary (Shami), and its executive vice president and the sole member of its sales and marketing committee (McCall), neither of whom had formal education or training in any physical or biological science or engineering. The only issue in the case involved credits based on wages paid to the two executives. The taxpayers "failed to provide any documentation that establishe[d] how much time, if any, Mr. Shami or Mr. McCall spent performing research and development services during the relevant years," but argued that the court "must estimate the amount of wages allocable to qualified services if [it found] either Mr. Shami or Mr. McCall performed qualified services." The Tax Court (Judge Kroupa) rejected the taxpayer's argument, on the basis that the *Cohan* rule (*Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930)) applies only if there is a reasonable basis on which the court can make an estimate, and that in this case the taxpayer failed to satisfy the court that there was sufficient evidence to estimate the appropriate allocation of wages between qualified services and nonqualified services. Judge Kroupa found *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009), which did apply the *Cohan* rule in determining the § 41 research credit, to be inapposite, stating that in *McFerrin* "the Court of Appeals for the Fifth Circuit did not overrule, or even address, the basic requirement under *Cohan* that a court must have a reasonable basis upon which to make an estimate."

3. You can't consume your supplies in research and sell them too. Union Carbide Corp. v. Commissioner, 697 F.3d 104 (2d Cir. 9/7/12) Affirming the Tax Court, T.C. Memo. 2009-50, the Second Circuit (Judge Pooler) held that raw materials used in three discontinued research products that were ultimately converted to products sold by the taxpayer were not eligible for inclusion as part of qualified research expenditures for the 20 percent research credit of § 41(a). The court specifically held that the costs of supplies used during research projects that would have been used in the course of the taxpayer's manufacturing process regardless of the research do not qualify under §§ 41(b)(2)(A)(ii) and 41(h)(1)(B) as "an amount paid or incurred for supplies used in the conduct of qualified research." The court, not willing to make "a fortress out of the dictionary," determined that the phrase "used in the conduct of qualified research" encompassed only supplies purchased for the purpose of conducting research, although supplies consumed in the normal manufacturing process were necessary to the research focused on more efficient methods of converting the raw materials to finished product. The court also noted that any ambiguity in the statute could be resolved by giving deference to the agency interpretation of the statute "even if that interpretation appears in a legal brief." The court found that the IRS's interpretation of the statute was consistent with the purpose of the research credit. In a concurring opinion Judge Pooler observed that if Congress had intended the supplies at issue to be creditable, it would have so provided in precise terms on a subject of industry lobbying.

4. Gross receipts are not defined by the narrow definition of Black's Law Dictionary, the regulations provide better guidance. Hewlett-Packard Company v. Commissioner, 139 T.C. No. 8 (9/24/12). For the tax years at issue the taxpayer elected the alternative incremental research credit (AIRC) method of computing the § 41 research credit, which provided a credit equal to the sum of: (i) 2.65% (1.65% for 1999) of so much of the qualified research expenditures (QRE) from the tax year as exceeded 1% of annual adjusted gross receipts (AAGR), but did not exceed 1.5% of those AAGR; (ii) 3.2% (2.2% for 1999) of so much of the QRE from the tax year as exceeded 1.5% of AAGR, but did not exceed 2% of those AAGR; and (iii) 3.75% (2.75% for 1999) of so much of the QRE from the tax year as exceeded 2% of AAGR. In 1999 Treasury proposed regulations to provide that adjusted gross receipts for this purpose include in addition to sales receipts (as adjusted for returns and allowances) other sources of gross income such as interest, dividends and rents. The final regulations adopted the provision but with an effective date for tax years beginning after the date of the final regulations, 1/3/01. For its tax years 1999 through 2001 the taxpayer calculated its credit on the basis of adjusted gross receipts that did not include income other than sales income. The Tax Court (Judge Goeke) concluded that the final regulations were a proper interpretation of the statutory language and legislative intent and that the Treasury's logic in embracing a definition of gross receipts as articulated in the preamble to the proposed regulations applies to taxable years preceding the effective date of the regulations. Thus the court adopted a definition of gross receipts that includes the total amount derived by a taxpayer from all activities and sources. The court rejected the taxpayer's argument that by adopting § 41(c)(4) (excluding "returns and allowances" from gross receipts), Congress indicated an intent to limit the concept of gross receipts for § 41 purposes to sales receipts. The court also refused to adopt a narrow "common law meaning" of gross receipts from Black's Law Dictionary as undermined by numerous statutory authorities using the term. Further, the court indicated that the maximum "*expressio unius est exclusio alterius*" applies to indicate that congressional enumeration of specific exceptions to gross receipts means that other exceptions are not to be implied.

5. Business tax credits extended and liberalized by the 2012 Taxpayer Relief (and not so grand compromise) Tax Act. The business tax credits extended include:

a. Research credit of § 41 for 20 percent of research expenditures over a base amount, 20 percent of basic research payments to universities and 20 percent of qualified energy research by an energy consortium is retroactively extended for two years to cover research expenditures incurred before 1/1/14. The new law also provides that the acquirer of a trade or business, or of a substantial portion of a business unit, may include certain qualified research expenditures of the predecessor and must include the gross receipts of the predecessor in calculating credits available to the acquirer. For controlled corporations, under § 41(f) all of the members are treated as a single taxpayer and the research credit and the credit allowable to each member is to be determined in proportion to its share of research expenditures.

b. Railroad track maintenance. The 2012 Act, § 306, extends the 50 percent credit of § 45G for qualified railroad track maintenance expenditures of up to $3500 per mile incurred by a qualified railroad owner to tax years beginning before 1/1/14.

c. Mine Rescue Training. The 2012 Act, § 307, extends the 20 percent credit of § 45N for costs of training qualified mine rescue employees to taxable years beginning before 12/31/13.

G. Natural Resources Deductions & Credits

1. Business energy related tax credits extended by the 2012 Taxpayer Relief (and not so grand compromise) Tax Act. The tax credits extended include:

a. Alternative vehicle fuel property. Section 402 of the Act extends the Code § 30C alternative fuel vehicle refueling property 30 percent credit, limited to $30,000 for depreciable property and $1,000 for other property, to property placed in service before 1/1/14.

b. Electric vehicles. Section 403 of the Act extends the Code § 30D credit for two or three wheel electric vehicles of $2,500 to $5,000 depending on battery power to vehicles acquired before 1/1/14.

c. Plant gas. Section 404 of the Act extends the per gallon credit for alcohol used as fuel to production before 1/1/14, and provides rules for using algae as qualified feedstock for fuel produced after 1/2/13 [the date of enactment]. In addition, § 410(b) of the Act extends the additional 50 percent depreciation allowance of Code § 168(l)(2) for biofuel plant property placed in service before 1/1/14.

d. Biodiesel, i.e., the timing of the Iowa primary; even Al Gore has given up on ethanol. Section 405 of the Act extends the Code § 40A $1.00 per gallon credit for biodiesel mixtures to fuel sold or used before 1/1/14.

e. Indian coal. Section 406 of the Act extends the $2 per ton additional renewable energy credit under § 45(e)(10) for coal produced at an Indian coal production facility and sold by the taxpayer during an eight year period beginning on 1/1/06.

f. Energy efficient homes. Section 407 of the Act extends the Code § 45L credit to contractors of $2,000 (or $1,000 in the case of certain manufactured homes) that are certified as energy efficient to homes acquired from the contractor for use as a residence on or before 12/31/13.

g. Refrigerators, dishwashers and washing machines. Section 409 of the Act retroactively extends for two years the credit under Code § 45M to energy efficient appliances manufactured in 2012 and 2013.

h. Transmission line sales. Section 411 of the Act extends the Code § 451(i) eight year amortization of gain recognized on sales of transmission lines by a qualified vertically integrated electric utility to an independent transmission company to sales before 1/1/14.

i. Alternative fuel excise tax credit. Section 412 of the Act retroactively extends through 2013 the excise tax credits of Code § 6426 for alternative fuels and fuels mixtures.

H. Loss Transactions, Bad Debts, and NOLs

1. Unless you think you have a CERT — no it's neither a breath nor a candy mint — or a CERIL, don't punish yourself by reading these proposed regulations just for fun. REG–140668–07, Regulations Regarding the Application of Section 172(h) Including Consolidated Groups, 77 F.R. 57452 (9/17/12). The corporate equity reduction transaction (CERT) rules of § 172(b)(1)(E) and (h) were enacted in 1989 to limit a corporation's ability to obtain tax refunds as the result of the carryback of NOLs that were attributable to interest deductions allocable to leveraged buyout transactions. Sections 72(b)(1)(E) and (h) limit the carryback of the portion of an NOL that constitutes a "corporate equity reduction interest loss" (CERIL) of an "applicable corporation" in any "loss limitation year." Prop. Reg. §§ 172(h)-0 through -5 provide general rules addressing whether a CERT has occurred, the computation of a CERIL, and the treatment of successor corporations.

2. ATNOLD is not a breath mint to relieve your AMT problems. Metro One Telecommunications Inc. v. Commissioner, 135 T.C. 573 (12/15/10). In computing AMTI, § 56(a)(4) allows a corporation to claim an AMT NOL in lieu of a regular NOL deduction allowed under § 72. The taxpayer claimed an AMT NOL deduction for 2002 based on a carryback of an AMT NOL from 2004. Analyzing a very complicated statutory pattern, Judge Paris held that § 56(a)(1) does not allow for an AMT NOL carryover to a prior year.

a. On appeal, the Ninth Circuit affirms and holds that a "carryover" is a "carryforward," but not a "carryback." Metro One Telecommunications, Inc. v. Commissioner, 704 F.3d 1057 (9th Cir. 12/19/12). For tax years 2002 through 2009 the Relief Rule of § 56(d)(1) allowed taxpayers to offset 100 percent of AMTI by an alternative tax net operating loss deduction (ATNOLD) which consisted of NOLs that were (1) "carryovers" to the 2001 and 2002 tax years or (2) carried back from 2001 or 2002 tax years to a prior year. The Ninth Circuit (Judge N.R. Smith) ruled that Metro One was precluded from carrying back net operating losses from 2004 to offset 100 percent of 2002 AMTI, but was limited to offsetting 90 percent of the 2002 AMT under former § 56(d)(1)A)(i)(II). The court indicated that the "plain meaning" of the term "carryovers" in the Relief Rule prevents taxpayers from using NOLs that are carried back from a later tax year. The use of the term "carryover" in § 172 is synonymous with "carryforward."

I. At-Risk and Passive Activity Losses

1. Ya gotta keep time records. Vandegrift v. Commissioner, T.C. Memo. 2012-14 (1/12/12). The taxpayer, who was employed as a salesman, invested in nine rental properties. Six of the properties were rented. The taxpayer acquired three properties for rental after renovations were completed, but sold the properties before they were rented. The Tax Court (Judge Goeke) held that the taxpayer failed to establish that he was a real estate professional under § 469(c)(7), because the taxpayer was unable to provide contemporaneous verification of the time he devoted to the real estate activity. The court also held that the taxpayer's rental real estate activity was a passive trade or business that included all nine properties. Thus, the taxpayer was permitted to offset losses from the rental properties against the capital gain recognized on the sale of three properties. The court rejected the IRS's argument that since the three properties that produced short-term capital gain were never rented the gain could not be offset by the losses.

2. Yeah, it's true – Ya really do gotta keep records of hours worked. Iversen v. Commissioner, T.C. Memo. 2012-19 (1/18/12). The Tax Court (Judge Swift) held that the taxpayer failed to prove he had satisfied the 500 hour participation test of Reg. § 1.469-5T(a)(1) in the operation of a Rocky Mountain cattle ranch that was principally run by a resident manager. Evidence of eleven trips (along with his children) to the ranch (which had a 20,000 square foot lodge) in a private plane funded by the taxpayer's successful medical supplies business and telephone conversations with the ranch manager did not convince the court that the taxpayer was a material participant. In addition, the court concluded that much of the taxpayer's activities were in the capacity of an investor, which do not qualify as participation under Reg. § 1.469-5T(f)(2)(ii)(A) and (B). The court did not sustain accuracy related penalties on the ground that the taxpayer reasonably relied on his accountant to prepare the returns.

3. Self-rent to the taxpayer's business was not passive income. Samarasinghe v. Commissioner, T.C. Memo. 2012-23 (1/19/12). Applying Reg. § 1.469-2(f)(6), the Tax Court (Judge Marvel) held that income from the taxpayer's rental of a building owned by the taxpayer, which was used in the taxpayer's medical practice was not passive activity income that could be offset with the taxpayer's losses from passive activities. The court also held that, under New Jersey state law, the original lease for the medical building entered into in 1980 was not subject to the transitional rule of Reg. § 1.469-2(f)(6), which is not applicable to binding contracts entered into before 1988. The court determined that the original lease had been ignored by the parties and not followed in the 2004 through 2009 time period at issue in the case. The court refused to impose § 6662 penalties because it found that the taxpayers reasonably relied on their tax advisor with respect to the treatment of the lease payments.

4. When good at-risk notes go bad there are tax consequences to the maker. Zeluck v. Commissioner, T.C. Memo. 2012-98 (4/3/12). In 2001, the taxpayer invested in an oil and gas partnership, investing $310,000 – $110,000 of cash and $200,000 in the form of a subscription recourse promissory note. He was initially at risk for $310,000, because the debt obligation was "genuine" through 2002, but by 2003, when the partnership terminated, his at-risk amount had been reduced to zero as a result of receiving passed-through losses and distributions totaling $310,000. After he had reduced his at-risk amount to zero, upon the termination of the partnership in 2003 his liability for the $200,000 note became "nongenuine." No principal payments had been made to the partnership and there was no evidence that the note was transferred or distributed to anyone upon dissolution of the partnership. After the termination of the partnership, there was no person or entity to which the taxpayer was liable for payment on the subscription note. He never received any written notification of the balance due on the subscription note, made no inquiry regarding the balance due, and has made no arrangements to pay the balance due. No demand for payment was made by any party as a result of the subscription notes, even after the due date. The taxpayer never signed an extension of the subscription note or otherwise pushed back the maturity date. As a result of the note becoming nongenuine, under § 465(b)(2) the taxpayer's at-risk amount was reduced to negative $200,000 in 2003. Thus, the Tax Court (Judge Goeke) decided that the taxpayer recognized a $200,000 gain for 2003 pursuant to § 465(e).

- The 20 percent accuracy-related penalty under § 6662(a), imposed for taxpayer's negligence in failing to reduce his amount at risk, was upheld by the court.

5. The Tax Court shines some light on passive solar energy installations. Wilson v. Commissioner, T.C. Memo. 2012-101 (4/10/12); Uyemura v. Commissioner, T.C. Memo. 2012-102 (4/10/12); Lum v. Commissioner, T.C. Memo. 2012-103 (4/10/12). In three nearly identical opinions the Tax Court (Judge Cohen) held that losses from a micro-utility activity involving purchase and rental of solar equipment were passive activity losses. The taxpayers each purchased photovoltaic systems from a company doing business in Hawaii as Mercury Solar. Under the program, the taxpayer also acquired an investment solar system that was installed at the residence of a ratepayer, who paid a monthly fee to purchase the energy produced by the investment system. Each taxpayer acquired a single investment system that was installed in the residence of the "ratepayer." The system was installed at the ratepayer's residence by Mercury Solar. The taxpayer contracted with another company to collect the monthly payments on behalf of the taxpayer as the equipment owner. The collection company maintained records and made payments on the taxpayers' loans to acquire the equipment. The court rejected the taxpayers' assertions that they qualified as material participants as the persons engaged in substantially all of the participation in the activity and held that that the taxpayers failed to meet their burden of proving that they participated in the activity for more than 100 hours, which was not less than the participation of any other individual. See Temp. Reg. § 1.469-5T(b)(2). The court noted that the participation of Mercury Solar and the collection company were also substantial. In the absence of material participation by the taxpayers in the three cases, the court did not need to consider whether the activity was a rental activity. In addition to disallowing deductions for losses under § 469, in *Uyemura* and *Lum* the court disallowed the taxpayers' claims for the § 48 business energy credit not subject to the passive activity loss limitation because the taxpayers had no tax liability with respect to the micro-utility and because no § 38 general business credits are allowable with respect to property for which a § 179 election to expense business assets is made.

6. The taxpayer loses, but not as badly as he would have had the IRS properly argued the case. Veriha v. Commissioner, 139 T.C. No. 3 (8/8/12). The taxpayer was the sole owner of JVT, a C corporation that conduced a trucking business in which he actively participated. JVT leased the tractors and trailers used in its business from TRI, an S corporation in which the taxpayer owned 99 percent of the stock, and JRV, a single-member LLC wholly owned by the taxpayer and thus a disregarded entity. Each lease of a tractor or trailer was governed by a separate contract. During the year in issue, TRI realized net income and JRV realized a net loss. The taxpayer treated the net income from TRI as passive income and treated the net loss from JRV as a passive loss. The IRS determined that pursuant to Reg. § 1.469-2(f)(6) — the self-rental recharacterization rule — each tractor and each trailer should be considered a separate "item of property" and that the income the taxpayer received from TRI should be recharacterized as nonpassive income, while the net loss realized by JRV remained a passive activity loss. Reg. § 1.469-2(f)(6) provides as follows: "An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if the property— (i) Is rented for use in a trade or business activity . . . in which the taxpayer materially participates . . . ." The Tax Court (Judge Wells) rejected the taxpayer's argument that all of the tractors and trailers collectively were one "item of property," and looking to *Webster's Third New International Dictionary* 1203 (2002) for the definition of the term "item" held that for purposes of applying Reg. § 1.469-2(f)(6), each individual tractor or trailer was an "item of property," and the income received from TRI was subject to recharacterization. However, because the IRS had not contested the taxpayer's netting of gains and losses within TRI, only TRI's net income was recharacterized as nonpassive income that could not be offset by losses from JRV.

- Judge Wells noted that the result was more favorable to the taxpayer than the result would have been if the IRS had taken the position — which was consistent with Judge Well's analysis of the meaning of the regulations — that the income from each tractor or trailer within TRI and JRV should have been recharacterized as nonpassive.

7. Cell tower rentals escape the self-rental rule. Dirico v. Commissioner, 139 T.C. No. 16 (11/13/12). The taxpayer's wholly owned S corporation was engaged in the business of operating specialized mobile radio services (SMR, a precursor to cellular services) which included numerous antenna towers. The taxpayer individually leased towers to the S corporation, which in turn leased space on the towers to cellular companies. The S corporation reported all of its income from its combined activities as ordinary business income. The IRS recharacterized the taxpayer's rental income from profitable tower leases as non-passive activity income under the self-rental rule of Reg. § 1.469-2(f)(6), which applies to rental income from property rented for use in a trade or business in which the taxpayer is a material participant. (The IRS characterized losses from unprofitable leases as passive.) The Tax Court (Judge Halpern) rejected the IRS argument that the S corporation rented cell tower space to third parties as part of its SMR business. The court concluded that the minimal services provided by the S corporation to third-party lessees such as painting the towers, making sure the lights worked, and removing snow, meant that the leasing of towers and land to unrelated parties was a rental activity within the meaning of § 469(j)(8) and Temp. Reg. § 1.469-1T(e)(3)(i). The rental activity complemented, but was not part of the SMR business. The court also rejected the IRS argument that the S corporation's grouping of the rental income with ordinary business income was proper and binding on the taxpayer even though the taxpayer had the same proportionate ownership in the S corporation business and the rental property under Reg. § 1.469-4(d)(1)(i)(C). The court indicated that no portion of the S corporation's use of the towers in its SMR business was rental and thus its rental of towers to third parties produced only rental income. Thus, the corporation's use of the towers for rental did not produce trade or business income supporting application of the self-rental to the taxpayer that could properly be combined into a single economic activity. Because the taxpayer derived his rental income from the S corporation as a lessor to the corporation, and not as its shareholder, the court held that the erroneous grouping of activities by the corporation was not binding on the taxpayer under the last sentence of Reg. § 1.469-4(d)(5)(i) ("A shareholder *** may not treat activities grouped together by a section 469 entity as separate activities"). The court concluded that while Reg. § 1.469-4(e)(1) "prohibits only the regrouping of activities by "the taxpayer" (in this case, [the corporation]) and, therefore, constitutes a limitation on the manner in which the taxpayer (i.e., [the corporation]) reports its income for purposes of section 469. It does not affect petitioner's reporting of [the corporation's] rental payments to him."

- The IRS also classified land rental income as non-passive under Temp. Reg. § 1.469-2T(f)(3), which provides that if less than 30 percent of the unadjusted basis of rental property is subject to depreciation under § 167 net passive activity income from the property will be treated as non-passive income. The regulation converts rental income from raw land to non-passive income. The court agreed with the IRS that under Reg. § 1.469-4(d)(2) an activity involving the rental of real property and an activity involving the rental personal property cannot be combined into a single activity.

Thus, the unadjusted basis of the towers and land could not be combined with the basis of raw land for purposes of the 30-percent rule.

- The court further rejected the taxpayer's argument that the IRS assertion of the 30-percent rule should be rejected because it was first raised on brief. While the court agreed that the IRS's raising the argument was not timely, causing an element of surprise, the court found that the taxpayer was not prejudiced by the argument since all of the evidence necessary to resolve the issue was presented at trial.

8. Ill bank president is not a real estate professional. Harnett v. Commissioner, T.C. Memo. 2011-191 (8/11/11). The taxpayer founded a savings and loan association to provide financing to customers of his real estate development company. In 2003 the taxpayer suffered a heart attack and other health problems. He resigned as CEO of the bank in 2005, but continued to work as a consultant to the bank and served as chairman of the board. After 2003 the taxpayer had stopped renting his real estate properties and had begun trying to sell them. The real estate was managed partly by the taxpayer's son, his wife, and his former bank secretary. The court (Judge Thornton) found that the taxpayer's unsubstantiated testimony did not meet the burden of proof required to establish that the taxpayer had performed more than 750 hours of service during the tax years at issue and thus failed to qualify as a real estate professional for purposes of § 469(c)(7). The taxpayer's real estate losses were, therefore, passive activity losses not deductible against active income sources. The court found that the taxpayer's statement that he spent most of his time on real estate activities and only 10 hours a month at the bank strained credibility since "for most of this period he was both chairman of the board and CEO of the bank, with wide-ranging responsibilities and six-figure compensation" and added that the court saw no reason to think that managing the taxpayer's dormant real estate holdings required him to spend anywhere near 750 hours each year.

a. Affirmed per curiam. Harrnett v. Commissioner, 110 A.F.T.R.2d 2012-6628 (11th Cir. 11/14/12) (unpublished opinion.)

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. Section 1221(a)(1) says "to customers in the ordinary course of business" (emphasis added), not "to a customer." Bennett v. Commissioner, T.C. Memo. 2012-193 (7/12/12). The taxpayer was a "serial entrepreneur" who constructed a single residence for purposes of resale at profit, but which he sold at a substantial loss after five years. The

Tax Court (Judge Wherry) upheld the IRS's determination that the residence was a capital asset, not property held for sale to customers in the ordinary course of business described in § 1221(a)(1), thereby denying ordinary loss treatment and subjecting the loss to § 1211 limitations. The taxpayer was not a real estate broker, had never before (or after) dealt in real estate, and did not have a contract to sell the property in place when he commenced construction. He did not meet the burden of showing that the real estate activity was a trade or business rather than an investment.

2. The taxpayer lost his claim that a qui tam relator's reward for ratting out HCA for Medicare fraud was a capital asset, while in the meanwhile the alleged mastermind of the HCA Medicare fraud scheme won the Florida gubernatorial race. Alderson v. United States, 686 F.3d 791 (9th Cir. 7/18/12). The taxpayer was a qui tam relator who filed a refund claim based on the argument that his share of the government's recovery (16 percent of $631 million) from the Hospital Corporation of America, Inc. (and several medical providers related to HCA) for Medicare fraud was capital gain rather than ordinary income. When Alderson, who was the CFO of an HCA related corporation (Quorum), was asked to prepare two sets of books, one for the hospital's financial auditors and one to serve as the basis for the hospital's Medicare cost reports, he refused to prepare separate books and was fired. Using information obtained during discovery in his wrongful termination suit, Alderson filed a qui tam suit against Quorum, HCA, and affiliated companies under the False Claims Act (31 U.S.C. §§ 3729 et seq.). Alderson made available to the United States the documents he had received during discovery, and eventually the government intervened in the suit. The Ninth Circuit (Judge Fletcher) affirmed the District Court's holding for the government. First, the court rejected the taxpayer's claim that he "'exchanged his documents, information and know-how[ ] and . . . received cash, thus consummating a sale or exchange . . .,'" reasoning that the taxpayer "did not 'sell' or 'exchange' his information." His right to a relator's share for pursuing his qui tam suit that was conferred by the FCA was subject to a statutory precondition that he share his information with the government. Second, the information regarding HCA and its affiliates was not the taxpayer's "property." The taxpayer had no legal right to exclude others from use of the information, the information was known to other officials in the companies, and the taxpayer had no right to prevent those officials from providing the information to others. The court also rejected the taxpayer's argument that his relator's share, which he argued appreciated in value from the time he filed his suit until he received payment, was the relevant capital asset. The taxpayer had no "underlying investment of capital," and the increase in value "did not 'reflect an accretion in value over cost to [the] underlying asset.'" The taxpayer "was not an investor who bought and held an asset that increased in value during the holding period," but "worked intensively . . . to increase the likelihood that his qui tam suit would be successful." Finally, the court summarily dismissed the taxpayer's argument that the increase in value of the claim was a capital asset under § 1234A, on the grounds that § 1234A only applies with respect to assets that are capital assets to start with.

3. Be still open transaction doctrine! Let's fight over the proper basis apportionment method. Dorrance v. United States, 877 F. Supp. 2d 827 (D. Ariz. 7/9/12). The taxpayers, who originally had purchased life insurance from a mutual life insurance company, received stock when the life insurance company demutualized; they retained the life insurance policies. The Form 1099-B that the taxpayers received, consistent with IRS policy, listed the basis in the stock as zero. When the taxpayers sold the stock, they reported it as having a zero basis and filed a refund claim seeking summary judgment based on the argument that the open transaction doctrine applied to the demutualization and that the basis in the life insurance policies resulting from the payment of premiums should be allocated to the stock with the result that all of the proceeds from the stock sale were a return of capital and they thus owed no tax. The government sought summary judgment on the theory that no part of the insurance premiums was paid to acquire the mutual rights under the policy, and that the entire premium was paid to purchase the policy, with the result that the stock received in exchange for the mutual rights had a zero basis. The District Court denied both motions, holding, first, that the open transaction doctrine did not apply, rejecting the Court of Federal Claims decision in *Fisher v. United States*, 82 Fed. Cl. 780 (Fed. Cl. 2008), which accepted the taxpayer's argument that the open transaction doctrine applied, allowing the taxpayer to treat all of the premium payments he had made during the course of the policy as capital investment where the taxpayer received a cash payment in exchange for his mutual rights during the demutualization of a life insurance company. The court noted that if the taxpayer was "allowed to use the open transaction doctrine in the context of stock received during demutualization, he 'is getting a windfall, because all of the basis may be allocated to the assets that will be sold, while the asset that does not require basis has had its basis reduced.'" The court also rejected the government's position, finding that the value of both the mutual rights and the policy itself at the time of demutualization could be determined. However, neither party had presented evidence from which the court could equitably apportion the premiums paid before demutualization as basis in the mutual rights and basis in the policies themselves. The court instructed the parties to bring forward arguments for choosing between two different valuation methods: (1) compare the cost of the policies to the cost of comparable policies issued by non-mutual insurance companies at the time of issuance; or (2) comparing the market value of the policy and the stock at the time of demutualization, and applying that ratio to the premium payments.

4. Should the name of the promoter of this tax scam have been "Devious," instead of "Derivium?" Calloway v. Commissioner, 135 T.C. 26 (7/8/10) (reviewed). In 2001 the taxpayer entered into an agreement with Derivium Capital LLC pursuant to which he transferred 990 shares of IBM common stock to Derivium under its 90-percent-stock-loan program. The terms of the agreement characterized the transaction as a loan, with the IBM stock pledged as collateral. (Derivium was not registered with the New York Stock Exchange or the National Association of Securities Dealers/Financial Industry Regulatory Authority.) The purported loan was nonrecourse; interest accrued but was not payable until maturity; all dividends were applied against interest due; prepayment during the 3-year term of the purported loan was prohibited. The terms of the agreement allowed Derivium to sell the stock and retain the proceeds, which it did immediately upon receipt, receiving $103,918.18. The taxpayer received $93,586.23 from Derivium, the amount of the payment being determined, and payment being made, only after Derivium had sold the stock. Upon maturity of the "loan," the taxpayer had the option of (1) paying the balance due and having an equivalent amount of IBM stock returned to him, (2) renewing the purported loan for an additional term, or (3) satisfying the "loan" by surrendering any right to receive IBM stock. At maturity in August 2004 the balance due was $124,429.09, which was $40,924.57 more than the then $83,318.40 value of the IBM stock. (Derivium had credited against the accrued interest the amount of dividends that would have been received had the stock not been sold, but the taxpayer never received a Form-1099-DIV or included any dividends in income.) The taxpayer elected to satisfy his purported loan by surrendering any right to receive IBM stock. The taxpayer never made any payments toward either principal or interest on the purported loan. Citing *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), and *Gregory v. Helvering*, 293 U.S. 465 (1935), for the proposition that substance controls over form, the Tax Court, in a reviewed opinion by Judge Ruwe (with no dissents but with Judges Halpern, Wherry, and Holmes concurring in result only), held that the 2001 transaction between taxpayer and Derivium was a sale, not a loan, under the test factors set forth in *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981). The taxpayer had transferred all the benefits and burdens of ownership of the stock to Derivium. Legal and equitable title, as well as possession and control of the stock were transferred in exchange for $93,586.23 with no obligation to repay that amount. "At best [the taxpayer] had an option to purchase an equivalent number of IBM shares after 3 years at a price equivalent to $93,586.23 plus 'interest.'" The transaction was not a true loan because "[f]or a transaction to be a bona fide loan the parties must have actually intended to establish a debtor-creditor relationship at the time the funds were advanced." There was no such intent. After the 2001 transaction the taxpayer never treated the transaction as a loan; in 2004 he did not report either a sale of the stock or cancellation of debt income, positions which were inconsistent with treating the transaction as a loan. Because Derivium was not acting as a broker, the court also rejected the taxpayer's argument that the transaction was analogous to the securities lending arrangement in Rev. Rul. 57-451, 1957-2 C.B. 295, which held that no sale occurred when the owner of stock deposited shares with a broker who could lend the securities until such time as the shareholder received from the broker property other than identical securities. Nor was the transaction equivalent to a securities lending arrangement under § 1058, because the agreement did not meet the requirements of that provision, which under *Samueli v. Commissioner*, 132 T.C. 37 (2009), requires that the transferor of the stock retain "all of the benefits and burdens of ownership of the transferred securities" and the right to "be able to terminate the loan agreement upon demand." Because the taxpayer could not regain possession of the stock for three years, his opportunity for gain was diminished.

- Section 6662 accuracy-related penalties were sustained.

- Judge Halpern's concurring opinion emphasized that the *Grodt & McKay* test, while appropriate for determining whether there had been a sale of property that was not fungible, was not useful in the determination of whether there had been a sale of fungible property, such as corporate stock. It was enough for him that the taxpayer "gave Derivium the right and authority to sell the IBM common stock in question for its own account, which Derivium in fact did."

- Judge Holmes's concurring opinion emphasized that the majority's test for a sale was too broad and could be applied to treat too wide a range of collateralized nonrecourse loan arrangements as sales. He concluded that the majority erred in treating the taxpayer's transfer of the stock to Derivium and Derivium's subsequent sale of the stock as one integrated transaction, because Derivium had represented to its customers that it would hold the stock and never told them of the quick sale. Instead, he would have treated Derivium's sale of the stock as the event triggering recognition by the taxpayer, under the *Tufts* principle that "when a nonrecourse liability is discharged by sale of collateral, the borrower must recognize income at that point — the amount realized is the amount of nonrecourse liability discharged as a result of the sale," since Reg. § 1.1001-2(a)(4)(i) provides that "the sale . . . of property that secures a nonrecourse liability discharges the transferor from the liability." He recognized that under his analysis, "the tax consequences to Calloway would be remarkably similar to those flowing from the result reached by the majority."

- The Tax Court majority opinion noted in a footnote that other cases involving Derivium transactions are pending in the Tax Court. From 1998 to 2002 Derivium engaged in approximately 1,700 similar transactions involving approximately $1 billion. The Government estimated the total tax loss associated with Derivium's scheme to be approximately $235 million.
- *Nagy v. United States*, 104 A.F.T.R.2d 2009-7789, 2010-1 U.S.T.C. ¶ 50,177 (D. S.C. 2009), *and United States v. Cathcart*, 104 A.F.T.R.2d 2009-6625, 2009-2 U.S.T.C. ¶ 50,658 (N.D. Calif. 2009) held, in § 6700 penalty cases, that the 90-percent stock- loan-program transactions offered by Derivium were sales of securities, not bona fide loans.
- District Court had enjoined Derivium Capital USA from promoting its 90 percent loan program. United States v. Cathcart, 105 A.F.T.R.2d 2010-1293 (N.D. Calif. 3/5/10).

a. And the Eleventh Circuit teaches even more about how to distinguish sales from loans in affirming the Tax Court. Calloway v. Commissioner, 691 F.3d 1315 (11th Cir. 8/23/12). In an opinion by Judge Ripple, the Eleventh Circuit affirmed the Tax Court's decision, essentially following the rationale of the Tax Court's majority opinion. Like the Tax Court, the Court of Appeals considered the *Grodt & McKay* factors to determine whether there had been a transfer of the benefits and burdens of ownership, which would thereby constitute a "sale," while pointing out that "'[N]one of these factors is necessarily controlling; the incidence of ownership, rather, depends upon all the facts and circumstances,'" citing *H.J. Heinz Co. & Subsidiaries v. United States*, 76 Fed. Cl. 570, 582 (2007). The Court of Appeals also considered the somewhat overlapping factors applied by the Tax Court in *Dunne v. Commissioner*, T.C. Memo 2008-63 specifically with respect to ownership of stock:

> (1) Whether the person has legal title or a contractual right to obtain legal title in the future;
> (2) whether the person has the right to receive consideration from the transferee of the stock;
> (3) whether the person enjoys the economic benefits and burdens of being a shareholder;
> (4) whether the person has the power to control the company;
> (5) whether the person has the right to attend shareholder meetings;
> (6) whether the person has the ability to vote the shares;
> (7) whether the stock certificates are in the person's possession or are being held in escrow for the benefit of that person;
> (8) whether the corporation lists the person as a shareholder on its tax returns;

(9) whether the person lists himself as a shareholder on his individual tax return;
(10) whether the person has been compensated for the amount of income taxes due by reason of the person's shareholder status;
(11) whether the person has access to the corporate books; and
(12) whether the person shows by his overt acts that he believes he is the owner of the stock.

- Applying the *Grodt & McKay* factors, as "refined" by *Dunne*, the court concluded that the most relevant factors "firmly" established that the transaction was a sale. Notwithstanding their labels, the agreements as a whole made it clear that during the period of time covered by the "loan," Derivium owned the stock. The court looked to its precedents under which "'the characteristics typically associated with "stock" are that it grants 'the right to receive dividends contingent upon an apportionment of profits'; is negotiable; grants 'the ability to be pledged or hypothecated'; 'confer[s][ ] voting rights in proportion to the number of shares owned'; and has 'the capacity to appreciate in value.'" When the taxpayer transferred the stock to Derivium pursuant to the agreements, "he ceded these rights of stock ownership to Derivium." Other *Grodt & McKay* benefits and burdens test factors also led to the conclusion that the transaction was a sale. The agreements granted "Derivium the right to possess the stock, the equity in the stock, and the right to receive the profits from either holding or disposing of the stock;" that the loan was nonrecourse assured that the risk of loss was shifted entirely to Derivium.

- The Court of Appeals rejected the approach taken by Judge Halpern in his concurring opinion, concluding that "Judge Halpern's approach risk[ed] transforming, for income tax purposes, all interests secured by stock into sales of stock." It also rejected the approach taken by Judge Holmes in his concurring opinion, concluding that "Judge Holmes's test could result in understatements of income when taxpayers have absolutely no way to determine that a taxable event has occurred."

b. Devious Derivium strikes again. Raifman v. Commissioner, T.C. Memo. 2012-228 (8/7/12). The taxpayer transferred stock to Derivium under its infamous "90% Stock Loan" program. Following *Calloway v. Commissioner*, 135 T.C. 26 (2010), the Tax Court (Judge Wells) granted the IRS's motion for summary judgment that the transactions were sales and not loans, but denied the IRS's motion for summary judgment on the taxpayer's claim for a theft loss deduction, concluding that genuine issues of material fact remained regarding whether the taxpayer was entitled to a theft loss deduction for the amount of the value of the options they purchased from Derivium. The taxpayer's affidavit alleged that Derivium misrepresented the nature of the transaction because Derivium never engaged in a plausible hedging strategy, but rather appeared to be massively betting that the price of all of its clients' stocks would fall, "hedged" only by a Ponzi scheme, and that the taxpayer relied on Derivium's misrepresentations when he entered into the 90% Stock Loan program by which he was defrauded. The instant case is distinguishable from prior Derivium cases in that none of the prior cases considered the taxpayer's attempt to exercise the rights to a return of the collateral after the maturity dates.

5. This case disproves the old adage "you can't lose for trying." Sollberger v. Commissioner, 691 F.3d 1119 (9th Cir. 8/16/12). The taxpayer entered into an agreement with Optech pursuant to which he transferred floating rate notes (FRNs) worth approximately $1 million to Optech in return for a nonrecourse loan of 90 percent of the value of the FRNs. Under the agreement Optech had the right to receive all dividends and interest on the FRNs, and the right to sell the FRNs during the loan term without Sollberger's consent. Optech did not hold the FRNs as collateral for the loan, but immediately sold the FRNs and transferred 90 percent of the proceeds to the taxpayer. The taxpayer treated the transaction as a loan rather than as a sale. The Ninth Circuit (Judge Smith) affirmed the Tax Court's holding (T.C. Memo. 2011-78) that the transaction was a sale. The court stated:

> Although the transaction took the form of a loan, Sollberger transferred the FRNs to Optech, and gave Optech the right to sell the FRNs (which Optech promptly exercised), to transfer the registration of the FRNs into its own name, and to keep all interest due from the FRNs. Sollberger would not be personally liable if he did not make payments on the loan since it was nonrecourse. . . . Nonrecourse financing, which is sometimes viewed as an "indicator of a sham transaction," *Sacks v. Comm'r*, 69 F.3d 982, 988 (9th Cir. 1995), placed Sollberger more in the position of a seller than a debtor. Nowhere in the Master Agreement or the Loan Schedule did Sollberger promise to repay the money "lent" to him. Instead, Optech merely agreed to return the FRNs if Sollberger repaid the loan at the end of the seven-year loan term, thereby giving Sollberger the option of repurchasing the FRNs in seven years, but not requiring him to do so. Thus, the transaction was more akin to an option contract, whereunder the FRNs were sold, but the seller retained a call option to reacquire them after seven years, if he elected to do so, than a true loan. . . .
>
> Sollberger's and Optech's conduct also confirms our conclusion that the transaction was, in substance, a sale. Although interest accrued on the loan, Sollberger stopped receiving account statements and making interest payments

> after the first quarter of 2005, less than one year into the seven-year loan term. Thus, neither Sollberger nor Optech maintained the appearance that a genuine debt existed for long. The total amount that Sollberger paid to Optech was *de minimis* compared to the size of the loan. The FRNs were also sold before Sollberger received the loan from Optech, which suggests that Optech funded the majority of the "loan amount" with the proceeds received from the sale of the FRNs. The apparent lack of any ability or intention by Optech to hold the FRNs as collateral to secure repayment of the loan further buttresses our conclusion that the transaction was merely a sale in the false garb of a loan.

- The court also rejected the taxpayer's argument that the transaction came within the § 1058 safe harbor for securities lending transactions because the requirements of that section clearly had not been met.

6. The Cap Gemini exchange cases:

a. Gain is recognized on an exchange even if the taxpayer didn't yet have what she got and she might not have gotten to keep it. United States v. Culp, 99 A.F.T.R.2d 2007-618 (M.D. Tenn. 12/29/06). The government was granted summary judgment in an erroneous refund suit. The taxpayer exchanged her partnership interest in Ernst & Young for stock of a corporation acquiring E&Y's consulting business, in a transaction that was not a statutory nonrecognition event; however, the stock was held in escrow to enforce a forfeiture provision if the seller-taxpayer failed to perform certain services as an employee of the acquiring corporation. The court held that the open transaction doctrine was not applicable. If a taxpayer exchanges one property for a different property, the gain realized on the exchange must be recognized in the year the exchange occurs, even though the property received in the exchange is forfeitable if contractual provisions or representations in the contract for exchange are not subsequently satisfied and even though the property received in the exchange is held in escrow to assure enforcement of the forfeitability provisions.

b. The Seventh Circuit affirmed taxable exchange treatment for an E&Y consulting partner in a Capgemini exchange. United States v. Fletcher, 562 F.3d 839 (7th Cir. 4/10/09), *aff'g* 101 A.F.T.R.2d 2008-588 (N.D. Ill. 1/15/08). In this 2000 exchange of taxpayer's partnership interest in E&Y for restricted stock of Capgemini, the Seventh Circuit (Judge Easterbrook) affirmed the summary judgment award to the government in this erroneous refund suit, and in the process

"Fletcherized"[3] the E&Y consulting partner involved because she initially took the position of the parties to the transaction that all of the Capgemini shares received vested in the year 2000 [the year of the exchange], but after the stock declined in value took the position that she received income in 2000 only to the extent of cash she received in that year and the remainder of her income was recognized in 2003 [when the stock was worth less than one-fifth of its 2000 value].

- Judge Easterbrook did not appreciate the argument that she signed the "consulting partner transaction agreement" [which provided for taxable gain in 2000] only because she was afraid she would be fired if she did not do so. Both the district court and the Seventh Circuit held that under either *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), or the alternative "strong proof" test, taxpayer was bound by the agreement she signed. he stated that:

> Fletcher argues that she didn't "really" agree to the structure that Ernst & Young and Cap Gemini (and most of her partners) wanted in 2000. If she had voted no and refused to sign, she maintains, she would have been excluded from the economic benefits and might have been fired. If this is so, then she had a difficult choice to make; it does not relieve her of the choice's consequences. Hard choices may be gut-wrenching, but they are choices nonetheless. Even naïve people baffled by the fine print in contracts are held to their terms; a sophisticated business consultant who agrees to a multi-million-dollar transaction is not entitled to demand the deal's benefits while avoiding its detriments. The argument that Fletcher can avoid the terms as a matter of contract law is frivolous. All that matters now are the tax consequences of the contracts she signed.

- Judge Easterbrook concluded:

> The more likely it is that the conditions will be satisfied, and all restrictions lifted, the more sensible it is to treat all of the stock as constructively received when deposited in the account. To see this, suppose that the parties had wanted to defer the recognition of income and had put $2.5 million in each partner's account, with the condition that the whole amount would be forfeited if the temperature in Barrow, Alaska, exceeded 80 [degrees] F on January 1, 2005. Would the remote possibility of an Arctic heat wave enable the partners to defer paying taxes? Surely not. See

3. Horace Fletcher (1849–1919), a health food faddist, argued that food should be chewed thirty-two times before being swallowed. "Nature will castigate those who don't masticate."

> *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008). If, on the other hand, the parties agreed that the ex-partners would receive $ 2.5 million only if the temperature in Barrow on January 1, 2005, exceeded 80 [degrees] F, then none of the partners would constructively receive income in 2000; everything would depend on events in 2005.
>
> The sort of contingencies that could lead to forfeitures were within the ex-partners' control. That implies taxability in 2000, for control is a form of constructive possession. And the agreement to discount the stock by only 5% tells us that the parties deemed forfeitures unlikely. Fletcher's acknowledgment that the risk of forfeiture was small shows that the conditions of constructive receipt in 2000 have been satisfied.
>
> Thus although we agree with Fletcher that the ex-partners are entitled to contest the tax treatment called for by the 2000 contracts, we hold that the shares are taxable in 2000 at their value on the date of deposit to the accounts at Merrill Lynch. Income was constructively received in that year not because the contract said that everyone would report it so to the IRS, but because the parties were *right* to think that this transaction's actual provisions made the income attributable to 2000. That the price of Capgemini stock dropped in 2001 and later does not entitle the parties to defer the recognition of income. Fletcher must repay the refund (and amend her returns for later years to reflect receipt of the income in 2000).

c. Ex-post recharacterization is not an option for taxpayers. United States v. Bergbauer, 602 F.3d 569 (4th Cir. 4/16/10). The Fourth Circuit affirmed a summary judgment for the government in an erroneous refund suit. The taxpayer exchanged her partnership interest in Ernst & Young for stock of Cap Gemini, a corporation acquiring E&Y's consulting business, in a transaction that was not a statutory nonrecognition event; however, the stock was held in escrow to enforce a forfeiture provision if the seller-taxpayer failed to perform certain services as an employee of the acquiring corporation. The taxpayer initially reported that all of the Cap Gemini shares received vested in the year 2000 (the year of the exchange), but after the stock declined in value took the position that income was realized in 2000 only to the extent of cash received in that year and the remainder of the income was recognized in 2003 (when the stock was worth less than one-fifth of its 2000 value). The court held that if a taxpayer exchanges one property for a different property, the gain realized on the exchange must be recognized in the year the exchange occurs, even though the property received in the exchange is forfeitable if contractual provisions or representations in the contract for exchange are not subsequently satisfied and even though the property received in the exchange is held in escrow to assure enforcement of the forfeitability provisions. Furthermore, the court refused to accept the taxpayer's argument that the transaction could be recast into a form different than that which it had taken.

> To put it plainly, we have bound taxpayers to "the 'form' of their transaction" when they attempt to recharacterize an otherwise valid agreement bargained for in good faith. [citation omitted] We have also refused to entertain arguments "that the 'substance' of their transaction triggers different tax consequences." [citation omitted] This precept not only maintains the vital public policy of enforcing otherwise valid contracts, but also assures the reliability of agreed tax consequences to the public fisc. . . .
>
> There is no "disparity" in allowing "the Commissioner alone to pierce formal" agreements as "taxpayers have it within their own control to choose in the first place whatever arrangements they care to make." [citation omitted]

- Earlier cases that reached the same result for other taxpayers involved in the same transaction include *United States v. Fletcher*, 562 F.3d 839 (7th Cir. 4/10/09); *United States v. Culp*, 99 A.F.T.R.2d 2007-618, 2007-1 U.S.T.C. ¶50,399 (M.D. Tenn. 12/29/06); and *United States v. Nackel*, 105 A.F.T.R.2d 2010-474 (C.D. Cal. 10/20/09).

d. Judge Dyk stuck his finger into the Cap Gemini pie and pulled out a constructive receipt plum. Hartman v. United States, 694 F.3d 96 (Fed. Cir. 9/10/12). This Cap Gemini case was decided in favor of the government, as were all of the other Cap Gemini cases. The Federal Circuit (Judge Dyk) rejected the government's argument that taxpayer was bound under *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), by his agreement to recognize for federal income tax purposes in the year 2000 all the shares of Cap Gemini that were placed in escrow for him in that year because *Danielson* was limited to situations where "a taxpayer challenges express allocations of monetary consideration." Instead, Judge Dyk found that taxpayer was in constructive receipt of all the Cap Gemini stock that was received for him in exchange for his E&Y partnership interest even though the stock was placed into an escrow account and he could not receive the stock until subsequent years — subject to the risk of forfeiture should he sooner voluntarily terminate his employment with Cap Gemini.

7. Extended tax-free capital gains for "small" C corporation stock. Who is going to rush out and form a C corporation to grab this benefit? The 2012 Taxpayer Relief (and not so grand compromise) Tax Act extends help to qualified small business stock. Gain realized on a sale or exchange of qualified small business stock under § 1202, which was acquired after the date of enactment of the 2010 Small Business Act [9/27/10] and before 1/1/11 [subsequently extended to "before 1/1/12"], was subject to 100 percent exclusion from gross income. The 2012 Act, § 324(b), extends the 100 percent exclusion to stock acquired before 1/1/12 to before 1/1/14. Gain attributable to qualified small business stock acquired between 9/27/10 and 1/1/14 is not treated as an AMT preference item. The exclusion is applicable to noncorporate shareholders who acquire stock at original issue and hold the stock for a minimum of five years. Under the former 50 percent and 75 percent exclusions, included gain was subject to tax at the 28 percent capital gains rates. The amount of excluded gain attributable to any one corporation is limited to the greater of ten times the taxpayer's basis in a corporation's stock sold during the taxable year or $10 million reduced by gain attributable to the corporation stock excluded in prior years. Qualified small business stock is stock issued by a C corporation engaged in the active conduct of a trade or business with gross assets (cash plus adjusted basis of assets) not in excess of $50 million.

8. Application of the step transaction doctrine obviates the need to apply a statutory anti-abuse rule. G.D. Parker, Inc. v. Commissioner, T.C. Memo. 2012-327 (11/27/12). A Panamanian corporation (Vicmar) owned a minority interest in a Peruvian telecommunications corporation (Tele2000). The stock had a built-in loss of over $12 million. In March 2004, BellSouth, the owner, though a subsidiary of the majority interest, agreed to sell its stock of Tele2000 to Telefonica (a Spanish corporation). Telefonica's announced plan was to purchase 100 percent of Tele2000. During the period between March 2004 and December 21, 2004, Vicmar took steps to transfer its stock of Tele2000 to the taxpayer, G.D. Parker, Inc. On December 16, the parties, including the taxpayer, entered into a share transfer and settlement agreement, and the sale was finalized on December 21, 2004. The taxpayer was made a party to the share transfer agreement at the last minute after the sole shareholder of Vicmar represented to Bell South and Telefonica that the taxpayer was the owner of the Tele2000 shares. Before the last-minute representation, BellSouth's representative was unaware of the taxpayer's existence. Applying the end result version of the step transaction doctrine, the Tax Court (Judge Haines) held that Vicmar, the Panamanian corporation, not the taxpayer U.S. corporation, was the true seller of the stock and disallowed the taxpayer's loss deduction.

> [I]t is clear from the record that, from the start, the acquisition of the Tele2000 shares by petitioner and the

> subsequent sale to Telefonica were really steps of a single transaction intended to be taken for the purpose of reaching the ultimate result. Those steps constituted part of a prearranged plan to have Telefonica obtain the Tele2000 shares while having the capital loss shifted to petitioner. Had Telefonica acquired the shares directly from Vilanova, this shift in the capital loss would not have occurred, and petitioner would have been obligated to report a capital gain rather than a capital loss that it could carry back to prior years. Petitioner may not avoid this result by employing mere formalisms thinly disguised to mask its true intentions. . . . Hence under the end-result test petitioner's ownership of the Tele2000 shares must be ignored, with Telefonica being viewed as having acquired the shares from Vilanova.

- The IRS also argued that § 362(e), which would have reduced the taxpayer's basis in the stock to fair market value, applied, but Judge Haines concluded that there was no need to reach a decision with respect to § 362(e) because under the step transaction doctrine there was no transfer of the stock from Vicmar to the taxpayer for income tax purposes.

9. The taxpayer passed the benefits and burdens of ownership to his wholly owned corporation, so he sold the property and recognized a gain. Gaggero v. Commissioner, T.C. Memo. 2012-331 (11/29/12). In the early 1990s, the taxpayer bought, for $3 million, and moved into a rundown beach house in Malibu that was renovated into a splendid mansion while he lived in it as his primary residence. Before renovations began, in 1991 he entered into a Land Contract Purchase and Sale Agreement and a Development Contract (BCC), a real estate development corporation that was wholly owned by the taxpayer. The essence of the deal was that BCC would provide the development services and BCC would receive an equal share in any increase in the property's value between the time the contract was signed and the time the property was sold to a third party, even though the taxpayer would pay most of the costs of the project. BBC would receive its interest if it completed its work. The project was completed in 1997 and the residence was sold for $9.6 million. The taxpayer reported a receipt of $6.6 million, but claimed that pursuant to former § 1034 none of it was recognizable because he purchased a new residence for $6.7 million. BBC reported ordinary income of $3 million. The IRS contended that the taxpayer never sold any interest in the residence to BBC and that he realized $9 million on its sale and should have reported a $2.9 million gain. The Tax Court (Judge Holmes) engaged in an extensive factual inquiry of whether the benefits and burdens of ownership in a partial interest in the residence had passed to BBC prior to the sale to the ultimate purchaser, and concluded that because benefits and burdens of ownership had been transferred, a partial ownership had passed from the taxpayer to BBC prior to the sale to the ultimate purchaser. That the taxpayer continued to maintain the property as his primary residence did not alter that fact. Accordingly, a sale had occurred. However, the sale from the taxpayer to BBC occurred in 1997, when BBC's interest vested, and the amount realized on that sale was $3 million; the remaining $6.6 million was realized by the taxpayer on the sale of the remaining interest. Since he realized $9.6 million of the sale of his residence and purchased a replacement residence for only $6.7 million, he should have recognized a gain of $2.9 million. However, the court did not uphold penalties, finding that the taxpayer relied in good faith on his tax advisor.

B. Interest, Dividends, and Other Current Income

1. The statute might read "State or local bond" but it means "State or local obligation." DeNaples v. Commissioner, 674 F.3d 172 (3d Cir. 3/19/12). The Third Circuit (Judge Fuentes) held that the § 103 exclusion for state and local bond interest applied to interest on an obligation issued by a state government that provided for deferred payments, with interest, to compensate the taxpayers for condemned land. Even though § 103 refers to "bond[s]," it applies to any "obligation" of a state that is incurred "under the borrowing power." However, it does not to apply when a government's obligation to pay interest arises by operation of law. In this case the state's obligation to pay interest arose from voluntary bargaining in which the state invoked its borrowing power.

2. What does "traded on an established securities market" mean in the Internet era? REG-131947-10, Property Traded on an Established Market, 76 F.R. 1101 (1/7/11). Under the OID rules, if a debt instrument is issued for stock or other debt instruments (or other property) that is traded on an established securities market (often referred to as "publicly traded"), the issue price of the debt instrument is the fair market value of the stock or other property. Similarly, if a debt instrument issued for property, such as another debt instrument, is traded on an established securities market, the issue price of the debt instrument is the fair market value of the debt instrument. See Reg. § 1.1273-2(c). Among other issues, a debt-for-debt exchange (including a significant modification of existing debt) in the context of a work-out may result in a reduced issue price for the new debt, which generally would produce (1) COD income for the issuer (i.e., debtor), (2) a loss to a holder (i.e., creditor) whose basis is greater than the issue price of the new debt, and (3) OID that must be accounted for by both the issuer and the holder of the new debt. The Treasury has published proposed regulations that are intended to simplify and clarify the determination of when property is traded on an established market. Prop. Reg. § 1.1273-2(f)(1) would identify four ways for property to be traded on an established market: (1) the property is publicly traded on an exchange (as defined), which is relatively unusual for debt instruments other than corporate bonds; (2) a sales price for the property is reasonably available — it appears in a medium that is made available to persons that regularly purchase or sell debt instruments, or persons that broker purchases or sales of debt instruments" ("a sale that is reported electronically at any time in the 31-day time period, such as in the Trade Reporting and Compliance Engine ("TRACE") database maintained by the Financial Industry Regulatory Authority, would cause the instrument to be publicly traded, as would other pricing services and trading platforms that report prices of executed sales on a general basis or to subscribers"); (3) if a firm price quote to buy or sell the property is available; or (4) a price quote (other than a firm quote) that meets certain standards set forth in the regulations is provided by a dealer, a broker, or a pricing service (an indicative quote). In all four cases, the time for determining whether the property is publicly traded is the 31-day period ending fifteen days after the issue date of the debt instrument. There would be an exception for "small debt issues — those below $50 million. The regulations will apply to debt instruments that have an issue date on or after the promulgation of final regulations.

a. Finalized with some important changes. T.D. 9599, Property Traded on an Established Market, 77 F.R. 56533 (9/13/12). Final Reg. § 1.1273-2(f)(1) substantially follows the framework of the proposed regulations but provides only three rules for determining that property is traded on an established market. Reg. § 1.1273-2(f)(1) provides that property is traded on an established market if at any time in the 31-day time period ending 15 days after the issue date of a debt instrument: (1) a sales price for the property is reasonably available — it appears in a medium that is made available to persons that regularly purchase or sell debt instruments, or persons that broker purchases or sales of debt instruments (a sale that is reported electronically such as in the Trade Reporting and Compliance Engine (TRACE) database maintained by the Financial Industry Regulatory Authority, would cause the instrument to be publicly traded, as would other pricing services and trading platforms that report prices of executed sales on a general basis or to subscribers); (2) a firm price quote to buy or sell the property is available; or (3) a price quote (other than a firm quote) that meets certain standards set forth in the regulations, is provided by a dealer, a broker, or a pricing service (an "indicative quote"). Very significantly, Reg. § 1.1273-2(f)(6) provides that a debt instrument will not be treated as traded on an established market if at the time the determination is made the outstanding stated principal amount of the issue that includes the debt instrument does not exceed $100 million (rather than $50 million as provided in the proposed regulations). The other significant change made in the final regulations is to require that the issue price be reported consistently by issuers and holders.

- The regulations generally apply to a debt instrument issued on or after 11/13/12.
- According to the preamble:

> The final regulations dispense with the category of exchange listed property because the small amount of debt that is listed rarely actually trades over the exchange. Moreover, although stock, commodities, and similar property are commonly listed on and traded over a board or exchange, such property typically will be the subject of frequent sales or quotes and would be covered in a separate category of publicly traded property. A debt instrument that is issued for stock, commodities, or similar exchange traded property is therefore tested under the rule for property where there is a sales price or quote within the 31-day period ending 15 days after the issue date of the debt instrument. Eliminating the category of property listed on an exchange also eliminates the need for the de minimis trading exception in the proposed regulations, which was intended to exclude property that is listed on an exchange but trades in a negligible quantity.

3. Ouch! He got nothing in pocket, but his realized income was $29,093.30. Brown v. Commissioner, 693 F.3d 765 (7th Cir. 9/11/12). The taxpayer owned an insurance policy on which he had borrowed money in excess of the cash surrender value. At the time that the policy was cancelled by the insurance company, the taxpayer had paid $44,205.00 in premiums, but the insurance company had applied $31,063.30 of policy dividends to the purchase of additional insurance above the $100,000 face value of the policy, and $4,869.94 of dividends had been applied to pay premiums and repay policy loans. The additional paid up life insurance had been surrendered for its cash value to repay policy loans prior to the cancellation of the base $100,000 policy. The Seventh Circuit (Judge Posner) affirmed a Tax Court decision holding that the taxpayer's investment in the contract had been reduced from $44,205.00 to $8,271.76 as a result of the application of $35,933.24 of dividends as described. Accordingly, because the cash surrender value of the policy, which was applied against policy loans when it was cancelled was $37,365.06, taxpayer realized income of $29,093.30 ($37,365.06 - $8,271.76).

4. Exempt financing for New York Liberty Zone bonds extended. The 2012 Taxpayer Relief Act, § 328, extends the issue date for exempt New York Liberty Bonds to bonds issued before January 1, 2014.

C. Profit-Seeking Individual Deductions

There were no significant developments regarding this topic during 2012.

D. Section 121

There were no significant developments regarding this topic during 2012.

E. Section 1031

1. Judge Goeke lets the taxpayer get away with a like-kind exchange claim where the replacement property was used as taxpayer's principal residence. Reesink v. Commissioner, T.C. Memo. 2012-118 (4/23/12). The taxpayer disposed of an undivided one-half interest in an apartment building (along with his estranged brother) and acquired a single family home (the Laurel Lane property), which was originally acquired as investment or rental property, but into which the taxpayer and his family moved, as their principal residence, eight months after the acquisition. According to the Tax Court (Judge Goeke), the only issue in the case relating to whether the acquisition and disposition of the two properties qualified as a like kind-exchange was whether the taxpayer held the acquired property "with investment intent at the time of the exchange." Based on a number of factors, including the taxpayer's efforts to rent the acquired property, that he did not sell his principal residence in another city until six months after the acquisition, and the testimony of the taxpayer's estranged brother that the taxpayer did not plan to relocate until his son was finished with high-school, which he was not at the time of the transaction, Judge Goeke held that the taxpayer had acquired the property for investment.

2. 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.

F. Section 1033

There were no significant developments regarding this topic during 2012.

G. Section 1035

There were no significant developments regarding this topic during 2012.

H. Miscellaneous

1. It takes a paper trail to prove that stock is "qualified small business stock," but a bribery attempt by taxpayer's representative [an enrolled agent] during the audit was not sufficient to support a fraud penalty. Holmes v. Commissioner, T.C. Memo. 2012-251 (8/30/12). Section 1045 provides for elective nonrecognition of capital gain on the sale of "qualified small business stock," as defined in § 1202, if the stock has been held for more than six months, and if the taxpayer purchases replacement qualified small business stock within 60 days of the date of the sale. The taxpayer's efforts to defer gain on the sale of stock in this case failed. The Tax Court (Judge Halpern) held that § 1045 did not apply because, among other reasons, the taxpayer failed to prove that (1) as required by § 1202(c)(1)(B), he acquired the stock at its original issue in exchange for money, or (2) as required by § 1202(d)(1)(A) and (B), the corporation's aggregate gross assets immediately after the stock issuance did not exceed $50 million. The taxpayer offered no documentary evidence, such as stock certificates or book entries from the corporation, indicating from whom he acquired the stock. Nor did the taxpayer introduce into evidence corporate balance sheets or other financial statements showing the amount of cash and property held by the corporation before and immediately after each date he acquired stock.

- Even though the taxpayer's return preparer/representative during the audit, an enrolled agent, attempted to bribe the Revenue Agent conducting the audit, behavior that Judge Halpern described as "highly inappropriate," such behavior was not sufficient to support imposition of a fraud penalty, because, among other facts, the record was "devoid of evidence indicating that Mr. Afshar's actions towards Agent Mahamoud, while highly inappropriate, were part of petitioner's scheme of tax evasion initiated at the time of filing the subject tax returns. As we have stated above, it seems more likely that Mr. Afshar's actions were a continuation of his attempt at mitigating the tax preparation errors."

- Compare: The taxpayer's conduct was not fraudulent, but maybe he wasn't an innocent babe in the woods either. The return was fraudulent even though the taxpayer did not know it. Allen v. Commissioner, 128 T.C. 37 (3/5/07). Judge Kroupa held that the statute of limitations for a fraudulent return is extended under § 6501(c)(1), even though it was solely the return preparer, rather than the taxpayer, who had the intent to evade tax. The taxpayer was a truck driver who filed timely returns for the years at issue. He gave his Form W-2, 401(k) statement, mortgage interest statement, and other relevant documents to his return preparer (Goosby) who prepared the returns and filed them. As prepared by Goosby, the returns claimed false and fraudulent itemized deductions for charitable contributions, meals and entertainment, and pager and computer expenses, as well as various other expenses. The taxpayer received complete copies of the returns for the years at issue after they had been filed, but he did not file any amended tax returns. Judge Kroupa reasoned as follows:

> We do not find it unduly burdensome for taxpayers to review their returns for items that are obviously false or incorrect. It is every taxpayer's obligation. Petitioner cannot hide behind an agent's fraudulent preparation of his returns and escape paying tax if the Government is unable to investigate fully the fraud within the limitations period.

- She further noted that the IRS was seeking to collect only the deficiency (and interest) from the taxpayer.

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. The IRS modifies guidance on reporting of employer-provided healthcare coverage despite the fact that the amounts reported have no relevance whatsoever to anyone's taxes. Notice 2012-9; 2012-4 I.R.B. 315 (1/3/12), *superseding* Notice 2011-28, 2011-16 I.R.B. 656. The IRS has issued interim guidance on informational reporting to employees of the cost of their group health insurance coverage under § 6051(a)(14). The notice includes the following statement: "This reporting to employees is for their information only. The reporting is intended to inform them of the cost of their health care coverage, and does not cause excludable employer-provided health care coverage to become taxable. Nothing in § 6051(a)(14), this notice, or the additional guidance that is contemplated under § 6051(a)(14), causes or will cause otherwise excludable employer-provided health care coverage to become taxable."

2. The IRS began ramping up for the Patient Protection and Affordable Care Act even before the Supreme Court upheld it. Notice 2012-17, 2012-9 I.R.B. 430 (2/9/12). The IRS (along with the Labor Department and Department of Health and Human Services) has issued guidance in Q-&-A format that is intended to identify likely direction and scope of future regulations and other published guidance addressing provisions of the Patient Protection and Affordable Care Act that become effective beginning in 2014. The guidance explains (1) automatic enrollment of new full-time employees where employer has more than 200 full-time employees; (2) employer shared responsibility and assessable payment; and, (3) 90-day limitation on waiting period.

3. The value of those corporate jets that some people want to tax. Rev. Rul. 2012-10, 2012-14 I.R.B. 614 (3/29/12). The IRS has announced the cents-per-mile and terminal charges for calculating the value of noncommercial flights on employer-provided aircraft as a fringe benefit for the period January 1 through June 30, 2012. The cents-per-mile is multiplied by the aircraft multiple (based on size) in Reg. § 1.61-21(g)(7), then increased by the terminal charge. The mileage rates are, up to 500 miles, $0.2455 per mile; 501-1500 miles, $0.1872 per mile; and over 1500 miles, $0.1800 per mile. The terminal charge is $44.88.

4. This one hits parents of special needs children the hardest. Wouldn't it just be easier to have a government-run national health care program? Then we could have rationing by queue. Notice 2012-40, 2012-26 I.R.B. 1046 (5/30/12). This Notice provides guidance on the limits in § 125(i) on salary reduction contributions to health flexible spending arrangements, effective for cafeteria plan years beginning after 12/31/12, and requests comments on possible modification to the "use-or-lose" rule in the proposed § 125 regulations. The Notice provides that the $2,500 limit does not apply for plan years that begin before 2013 and plans may adopt the required amendments to reflect the $2,500 limit at any time through the end of calendar year 2014. (Indexing of the $2,500 limit applies to plan years beginning after 12/31/13.) For plans providing a grace period (which may be up to two months and 15 days), unused salary reduction contributions to the health FSA for plan years beginning in 2012 or later that are carried over into the grace period for that plan year will not count against the $2,500 limit for the subsequent plan year.

5. Did the Tax Court really mean to deny a deduction for a taxable fringe benefit? DKD Enterprises, Inc. v. Commissioner, T.C. Memo. 2011-29 (1/31/11). The Tax Court (Judge Chiechi) upheld the IRS's denial of the corporation's deduction of the cost of medical insurance premiums for a policy covering its employee/sole shareholder because the corporation "failed to carry its burden of establishing that it had in effect during any of the years at issue a sickness, hospitalization, medical expense, or similar benefit plan for employees." For that same reason, the individual shareholder/employee was not entitled to exclude the amount of the premiums under either § 105 or § 106.

- Notably, the court did not expressly recharacterize the premium payment as a constructive dividend.

a. And the Eighth Circuit also seems to be smoking suspicious substances in analyzing this issue. DKD Enterprises, Inc. v. Commissioner, 685 F.3d 730 (8th Cir. 7/17/12). The Eighth Circuit, in an opinion by Judge Riley, affirmed "[b]ecause the tax court permissibly found DKD failed to prove the payments were made pursuant to a pre-determined plan for the benefit of employees." Although acknowledging that under Reg. § 1.105-5, "a plan may cover a single employee or limited class of employees; need not be in writing; and need not be enforceable by the employee," the court held that there was no "plan" because while the taxpayer "testified DKD 'paid [her] quarterly medical insurance,' paying approximately the same amount for her insurance in 2003, 2004, and 2005," she "did not testify these payments were made according to a pre-determined 'plan' intended to benefit employees."

- We wonder whether the court's reasoning indicates that it thought twelve consecutive payments for medical insurance were made by accident. "Plan" versus "accident;" are there any other alternatives?

6. **Premiums for corporate welfare benefit plans for principal owners fail the smell test, with penalties.** Curcio v. Commissioner, 689 F.3d 217 (2d Cir. 8/9/12). In consolidated cases involving three different subchapter S corporations, Judge Chin upheld the Tax Court's denial of deductions for premiums paid to maintain welfare benefit plans consisting of individual life insurance policies for selected employees, the so-called Benistar 419 plan, a multi-employer welfare benefit trust. The plan allowed the policy beneficiaries to withdraw the life insurance policies from the plan and obtain the net surrender value. In each case the court found that the life insurance policies were provided to key employees (shareholders) for the personal benefit of the employees (to fund a buy/sell agreement, to provide retirement planning, and to divert business profits). While the court acknowledged that contributions to a welfare benefit plan may be deductible, in these cases the court indicated that the Tax Court did not err in finding that the contributions were not helpful for the development of the taxpayers' businesses and were made instead for the personal benefit of the S corporation shareholders. The court observed that the plan was designed to benefit the owners and their families, not the respective business entities. In addition to upholding tax deficiencies representing increased pass-through income to the taxpayers, the court upheld § 6662(a) accuracy-related penalties, again indicating that the Tax Court did not err in concluding that the taxpayers were negligent and acted in disregard of the tax rules and regulations. The court further rejected the taxpayer's assertion that they relied on the advice of their accountants noting that there was little reason for the taxpayers to believe that their accountants were experts in the tax treatment of welfare benefit plan contributions or that the accountants had sufficiently researched the issue.

7. **Putin might be fighting American adoptions, but Congress likes adoptions.** The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 104, made permanent the Code § 137 exclusion for employer-provided adoption assistance. The maximum exclusion is $12,170 (adjusted for inflation), and the phase-out range is $182,520 to $222,520 (adjusted for inflation).

B. Qualified Deferred Compensation Plans

1. Rev. Proc. 2013-12, 2013-4 I.R.B. 313 (12/31/12), *modifying and superseding* Rev. Proc. 2008-50, 2008-2 C.B. 464. This revenue procedure updates the comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements of §§ 401(a), 403(a), 403(b), 408(k), or 408(p) of the Code, but that have not met these requirements for a period of time. This system, the Employee Plans Compliance Resolution System ("EPCRS"), permits Plan Sponsors to correct these failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis. The components of EPCRS are the Self-Correction Program ("SCP"), the Voluntary Correction Program ("VCP"), and the Audit Closing Agreement Program ("Audit CAP").

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

1. A sad story involving non-qualified stock options, with a different twist. McLaine v. Commissioner, 138 T.C. No. 10 (3/13/12). In this review of a CDP proceeding, the Tax Court, in a reviewed opinion by Judge Colvin, sustained the IRS's determination to proceed with a levy against the taxpayer to collect unpaid taxes resulting from his exercise of non-qualified stock options. The taxpayer argued that in the CDP proceeding the IRS wrongly denied him a § 31 credit for a third-party payment by a successor to his former employer of the taxes that should have been withheld from the stock proceeds but which the taxpayer claimed were paid in the year after the year in which he filed his tax return. Judge Colvin found that there was no evidence that any such payment occurred.

- Judge Halpern (joined by Judge Holmes) concurred, but would have held that as a matter of law, even if the successor company paid the non-withheld taxes associated with the option exercise in a later year, the taxpayer would not have been entitled to a § 31(a) credit for the payment. He wrote:

> I believe the law is clear that an employer's (or former employer's) payment to the Internal Revenue Service (IRS) of taxes that should have been, but were not, withheld in a prior year does not entitle the employee to a section 31(a) credit for that payment. Under those circumstances we have a duty not to mislead taxpayers by perpetuating a case . . . that may very well encourage needless litigation. Therefore, we should hold, in the alternative, that, as a matter of law, the VarTec payment alleged by petitioner, even if proven, would not entitle him to a section 31(a) credit therefor.

2. 20/20 hindsight doesn't change the value of stock purchased through stock options. Sheedy v. Commissioner, T.C. Memo. 2012-69 (3/14/12). In June 2006, the taxpayer exercised nonstatutory stock options in his employer, which six months later was bankrupt. The stock was not publicly traded but was bought and sold through an investment bank that maintained a trading desk with the ability to facilitate secondary trading among and between accredited investors and qualified institutional buyers; the investment bank did not set these prices but reported prices resulting from a bid-ask process in which it acted as the market maker. Between January 11, 2005, and February 22, 2007, the price per share ranged between $1.50 and $10.25. At the time the taxpayer exercised the options, and for several months thereafter, the investment bank sold several blocks of stock for $3 per share. The taxpayer received a W-2 showing $744,466.25 in gross income — the difference between the $750,000 fair market value of the stock (at $3 per share) on the exercise date and the $5,533.75 the taxpayer paid for the stock. Nevertheless, the taxpayer argued that the stock was worthless on the date of exercise and that he therefore realized no income. The Tax Court (Judge Laro) rejected that argument. Citing *First National Bank of Kenosha v. United States*, 763 F.2d 891, 894 (7th Cir. 1985) as controlling authority, the court held that "subsequent events should not be used to determine fair market value, except to the extent that they were reasonably foreseeable on the valuation date." On the record, the bankruptcy and the worthlessness of the stock were not reasonably foreseeable events on the exercise date. Following the principle that "price of stock in a liquid market is presumptively the one to use in judicial proceedings," the court accepted the IRS's valuation of $3 per share. The taxpayer was required to include $744,466.25 in gross income — the difference between the $750,000 fair market value of the stock on the exercise date and the $5,533.75 that he paid for the stock.

3. Tightening the meaning of "substantial risk of forfeiture." REG–141075–09, Property Transferred in Connection With the Performance of Services Under Section 83, 77 F.R. 31783 (5/30/12). The Treasury Department has proposed amendments to Reg. § 1.83-3 to clarify the meaning of "substantial risk of forfeiture." Under the proposed amendments, a substantial risk of forfeiture may be established only through a service condition or a condition related to the purpose of the transfer. When determining whether a substantial risk of forfeiture exists based on a condition related to the purpose of the transfer, both the likelihood that the forfeiture event will occur and the likelihood that the forfeiture will be enforced must be considered. In addition, the proposed amendments clarify that except as specifically provided in § 83(c)(3) and Reg. § 1.83–3(j) and (k), transfer restrictions do not create a substantial risk of forfeiture, including transfer restrictions which carry the potential for forfeiture or disgorgement of some or all of the property, or other penalties, if the restriction is violated. The proposed amendments would add two additional examples to Reg. § 1.83–3(c)(4) illustrating that a substantial risk of forfeiture is not created solely as a result of potential liability under Rule 10b–5 of the Securities Exchange Act of 1934 or a lock-up agreement. (This change incorporates the holding of Rev. Rul. 2005-48, 2005-2 C.B. 259, holding that if an employee exercises a nonstatutory option more than six months after grant, and thus outside the period covered by § 16 of the Securities Exchange Act of 1934, but is subject to restrictions on his ability to sell the stock obtained through exercise of the option under Rule 10b-5 under the Securities Exchange Act of 1934 and "lock-up" contractual provisions imposed by the employer in connection with a public offering, the employee is required to recognize income under § 83 at the time of the exercise of the option because full enjoyment of the shares is not conditioned on any obligation to provide future services.)

- The proposed amendments are proposed to apply to property transferred on or after 1/1/13. Taxpayers may rely on the proposed regulations for property transferred after 5/30/12.

4. The IRS provides help to avoid messing up your § 83(b) election, but you still have to remember to file it on time, i.e., within 30 days. Rev. Proc. 2012-29, 2012-28 I.R.B. 49 (6/27/12). This Revenue Procedure provides sample language that may be used, but is not required to be used, for making a § 83(b) election. It also provides several examples of the consequences of making a § 83(b) election.

D. Individual Retirement Accounts

1. The "use a C corporation to increase IRA contributions" scam is struck down. Repetto v. Commissioner, T.C. Memo. 2012-168 (6/14/12). The Tax Court (Judge Marvel) imposed the 6 percent excess contribution tax under § 4973 for a scheme established by the taxpayers' CPA. The taxpayers formed two corporations, most of the stock of which was held by the taxpayers' newly formed IRAs. One of the two corporations was intended to provide office and support services, and the other to provide marketing and business development services to the taxpayers' construction and rental property businesses operated through an S corporation and LLC. The court indicated that the preponderance of the evidence supported a finding that the service agreements and the payments to the Roth IRA owned corporations "were nothing more than a mechanism for transferring value to the IRA." The court stated that the service agreements did not change the identity of the person providing services to the construction businesses, the taxpayers continued to do the work as they had done before the arrangement was structured, and the taxpayers provided no written documentation of the services provided. The court's conclusion was bolstered by the language of the engagement letter with the CPA, which supported the finding that payment of dividends to the Roth IRAs was the primary goal of the support agreements. The court determined that the amount contributed to the Roth IRA and the amount of excess contributions should be determined based on the fair market value of the Roth IRA at year end. The court rejected the IRS approach that would have treated payments to the corporations as distributions to the taxpayers who subsequently contributed the amounts to the Roth IRAs.

- In the consolidated cases the court also held that amounts distributed by the taxpayers' S corporation were to be treated as wages rather than distributions.
- Amounts paid for medical plans that benefited the taxpayers by the IRA-owned C corporations were disallowed as deductions by the corporations because the employment relationship with Mrs. Repetto was a sham.
- The taxpayers were liable for a 5 percent penalty for failure to file Form 5329 reporting excess contributions to their IRAs and that the taxpayers' reliance on the tax professionals who promoted the scheme was not reasonable.
- The taxpayers were liable for the 20 percent penalty of § 6662A incurred for an understatement attributable to a reportable transaction. The transaction was substantially similar to the listed transaction described in Notice 2004-8, 2007-1 C.B. 333, promulgated before the taxpayers filed returns involving the transaction. In addition, the taxpayers were held liable for the increased 30 percent penalty of § 6662A(c) for failing to file a disclosure of their participation in a listed transaction. Again the court found that taxpayers did not reasonably rely on the advice of independent tax professionals.
- The court revised the IRS computation of the understatement subject to penalties by holding that understatements attributable to wages paid by the taxpayers' S corporation and the disallowance of medical expense deductions were not related to the listed transaction.

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? Not likely, unless it was left to the bigoted voters. 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*, 184 L. Ed. 2d 527 (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 § 7 of 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.

2. Net investment income tax of 3.8 percent.[4] 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

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4. We thank Professor Bruce McGovern, South Texas College of Law for contributing this description of § 1411 and the regulations thereunder.

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 there is a deemed basis adjustment that results in taking 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)-(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. Proposed regulations provide extensive guidance on the tax on net investment income. On 11/30/12, the Treasury Department issued proposed regulations regarding the § 1411 tax on net investment income. REG-130507-11, Net Investment Income Tax, 77 F.R. 72612 (12/05/12). The proposed regulations generally are proposed to be effective for tax years beginning after 12/31/13. The Treasury Department intends to issue final regulations during 2013. 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 the effective date of the final regulations.

- *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. The proposed regulations provide that, 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. Prop. Reg. § 1.1411-1(a).

- *Application to estates and trusts.* The proposed regulations provide as a general rule that 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. Prop. 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). It also does not apply to trusts that are exempt from taxes imposed by subtitle A of the Code. Prop. Reg. § 1.1411-3(b)(2)-(4). This is true even if the trust is subject to tax on its unrelated business taxable income. The proposed 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. Prop. Reg. § 1.1411-3(b)(5). Special computational rules apply to electing small business trusts and charitable remainder trusts. Prop. Reg. § 1.1411-3(c)(2). 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. The proposed regulations provide detailed rules regarding the calculation of an estate or trust's undistributed net investment income. Prop. Reg. § 1.1411-3(c)(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.

- *Net investment income.* 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 proposed regulations provide taxpayers 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. Prop. Reg. § 1.469-11(b)(3)(iv). Net investment income, which is investment income reduced by the deductions properly allocable to that 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. Prop. 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. 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. The proposed regulations provide detailed guidance on determining the net investment income arising from the disposition of interests in partnerships or S corporations. Prop. Reg. § 1.1411-7.

- *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 proposed 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. Prop. 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 proposed regulations allow a taxpayer to elect to treat the income inclusions required by § 951(a) and § 1293 as net investment income. Prop. Reg. § 1.1411-10(g). The election can be revoked only with the Service's consent. Although the proposed regulations do not address the issue, it appears that 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.

- See also, FAQs on the net investment income tax, released by the IRS on 11/29/12, 2012 TNT 232-47.

3. "Middle class" tax rates extended "permanently" by the 2012 Taxpayer Relief (and not so grand compromise) Tax Act, but the "rich" must pay more. These changes made by Act §§ 101 and 102 include:

- **Individual income tax rates.** The 10%, 15%, 25%, 28%, 33%, and 35% tax rates enacted in 2001 have been made permanent (including the expansion of the 15% bracket to mitigate the "marriage penalty"). However, the 39.6% rate from pre-2001 Act law has been restored for taxable incomes in excess of the following amounts: (1) $450,000 for married couples filing jointly and surviving spouses; (2) $425,000 for head-of-households; (3) $400,000 for single taxpayers; (4) $225,000 for married taxpayers filing separately. For tax years after 2013, these highest bracket threshold amounts are adjusted for inflation with 2012 as the base year. (For trusts and estates the brackets are 15%, 25%, 28%, 33% and, for income in excess of $11,950, 39.6%; there is no 35% rate bracket.)

- **Capital gains and dividends.** Taxing qualified dividends at the same rate as long-term capital gains has been made permanent, but the maximum rate has been increased. The maximum rates are as follows: 20% for income otherwise in the 39.6% bracket, 15% for income otherwise in the 25% or higher bracket (but below the 39.6%), and zero for income otherwise in the 10% or 15% bracket.

- **The above rates are in addition to the Affordable Care Act investment income tax.** Beginning in 2013, the 3.8% net investment income tax under Code § 1411 applies to taxpayers whose modified adjusted gross income exceeds (1) $250,000 for joint returns and surviving spouses; (2) $125,000 for separate returns, and (3) $200,000 for all other taxpayers. Thus, for qualified dividends and most capital gains, the overall rate for taxpayers in the 39.6% rate bracket will be 23.8%. For taxpayers who are subject to a 25%-or-greater rate on ordinary income, but whose income is below the 39.6% rate threshold and are subject to the net investment income tax, the rate will be 18.8%.

B. Miscellaneous Income

1. The Treasury Department uses regulations to reverse a principle established in a Supreme Court decision that the government won. Do *Mayo* doubters think that the Treasury exceeds its powers when it issues regulations giving away government victories in the Supreme Court? T.D. 9573, Damages Received on Account of Personal Physical Injuries or Physical Sickness, 77 F.R. 3106 (1/23/12). The Treasury Department has finalized proposed amendments (REG-127270-06, Damages Received on Account of Personal Physical Injuries or Physical Sickness, 74 F.R. 47152 (9/15/09)) to Reg. § 1.104-1(c) under § 104(a)(2) to reflect amendments to § 104 and certain judicial decisions. The amended regulations provide that the § 104(a)(2) exclusion applies to personal physical injuries or physical sickness. Emotional distress is not considered to be a physical injury or physical sickness. However, the regulations provide that damages for emotional distress attributable to a physical injury or physical sickness are excludable under § 104(a)(2). The regulations do not address loss of consortium or emotional distress from witnessing physical injury to another person. Under the amended regulations, the term "damages" means an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution. Notably, the amended regulations eliminate the requirement in the prior regulations that to be excludable under § 104(a)(2) the damages must have been "based upon tort or tort type rights." Thus, damages for physical injuries may qualify for exclusion under § 104(a)(2) even though the injury giving rise to the damages is not defined as a tort under state or common law. The reason for the change was the Treasury Department's concern that the Supreme Court's interpretation of the tort type rights test in *United States v. Burke*, 504 U.S. 229 (1992), limiting the § 104(a)(2) exclusion to damages for personal injuries for which the full range of tort-type remedies is available, could preclude an exclusion under § 104(a)(2) for redress of physical personal injuries under a "no-fault" statute that does not provide traditional tort-type remedies.

- Taxpayers may apply the amended regulations to amounts paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after 9/13/95 and received after 8/20/96.

2. 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.

3. It pays really big tax benefits to run your own church and give yourself two parsonage allowances. Driscoll v. Commissioner, 135 T.C. 557 (12/14/10) (reviewed, 4-4-6). The taxpayer (Phillip Driscoll) received a parsonage allowance from Mighty Horn Ministries, Inc., later known as Phil Driscoll Ministries, Inc., that was applied to the acquisition and maintenance of not only a principal residence but also a second home — a vacation residence. The IRS disallowed a § 107 exclusion for the portion of the parsonage allowance received with respect to the second home — for four years amounts totaled over $400,000 — on the grounds that § 107(a) refers to "a home" and that the legislative history limited the § 107 exclusion to only one home. The Tax Court majority, in an opinion by Judge Chiechi (in which four judges joined), with four concurrences, rejected the IRS's argument, stating "[w]e find nothing in section 107, its legislative history, or the regulations under section 107, which, as respondent points out, all use the phrase 'a home,' that allows, let alone requires, respondent, or us, to rewrite that phrase in section 107." The opinion pointed to § 7701(p)(1) [(m)(1) for the years at issue)], which refers to the definition in 1 U.S.C. § 1 that provides that in interpreting the United States Code, the singular includes the plural, unless the context indicates otherwise.

- Judge Gustafson, joined by five other judges, dissented, on the grounds that exclusions should be interpreted narrowly, and "[T]he chance that Congress in 1954 thought it was permitting the exclusion of multiple parsonage allowances seems remote."

a. Reversed and remanded. A home means only one home. Commissioner v. Driscoll, 669 F.3d 1309 (11th Cir. 2/8/12). In a *per curiam* opinion, the Eleventh Circuit held that the rental allowance taxpayers received for their second house was not excluded from income under § 107(2) because the proposition that singular terms also include their plural terms, contained in the Dictionary Act, 1 U.S.C. 1, does not apply if "'the context indicates otherwise'" and the use of "home" in § 107(2) "has decidedly singular connotations."

4. "Home" means where the taxpayer actually resides, not just any old house the taxpayer owns. Stromme v. Commissioner, 138 T.C. No. 9 (3/13/12). Section 131 provides an exclusion for certain amounts paid by a state or local government (or a "qualified foster care placement agency") to a "foster care provider for caring for a qualified foster individual in the foster care provider's home," or which is a "difficulty of care payment." The taxpayers cared for several developmentally disabled adults at a home they owned and in which they worked, but in which they did not reside and received several hundred thousand dollars from the local government. The Tax Court (Judge Colvin) held that § 131 did not apply to exclude payments from the local government to provide foster care, because § 131 applies only if the care is provided in the home in which the taxpayer actually resides.

5. Who ever heard of a local real property tax appraisal that was anywhere near accurate? Shepherd v. Commissioner, T.C. Memo. 2012-212 (7/24/12). The taxpayers compromised a consumer credit card debt for $4,412 less than the balance and claimed that pursuant to § 108(a)(1)(B) none of the COD income should be recognized because they were insolvent. The IRS and taxpayers agreed on the amount of the taxpayers' debts and the value of all of their property with three exceptions: (1) the value of their principal residence, (2) the value of a beach house, and (3) whether a pension was an asset to be included in the determination of insolvency. The Tax Court (Judge Ruwe) held that taxpayers were not able to demonstrate insolvency because they failed to establish the value of the residences. Local tax assessments introduced by the taxpayers were insufficient evidence of value because "a value placed upon property for local taxation purposes is not determinative of fair market value of the property for Federal income tax purposes in the absence of evidence of the method used in arriving at that valuation." Appraisals introduced into evidence were based on "comparable" sales more than two years after the date of discharge, and thus were not probative of the value of the homes at the time of the debt cancellation. The portion of the pension that could have been withdrawn (or borrowed), but not the excess thereof, was included in the value of assets, because "the word 'assets' as used in the definition of the term 'insolvent' for section 108(d)(3) includes 'assets exempt from the claims of creditors under applicable State law'" citing *Carlson v. Commissioner,* 116 T.C. 87, 105 (2001). The taxpayers were not insolvent, and the COD income was includible in income.

6. If you take the Fifth in front of a Senate investigating committee, you may become a martyr, but if you take the Fifth in front of the Tax Court, you lose. A Cicero, Illinois politician fraudulently underreported income by omitting conversion of $350,000 campaign funds to personal use, but that's small potatoes compared to the more than $10 million insurance fraud scheme for which she spent time in the federal slammer. There may well be a falcon mixed up in here as well, but no sign of it appears in the Tax Court opinion. Loren-Maltese v. Commissioner, T.C. Memo. 2012-214 (7/30/12). The taxpayer, Betty Loren-Maltese, was the President of Cicero, Illinois — "a suburb of Chicago that sits on its western hip like a well-holstered gun, and that has a colorful history that reaches back into the 1920s when Al Capone took refuge there" — and the Republican Committeeman of Cicero Township in 1994. She also served as Cicero's deputy liquor commissioner, a position to which she was appointed by her husband, a "prominent Cicero politician who confessed to being a mob bookmaker and pleaded guilty to a federal gambling charge," when the previous deputy liquor commissioner resigned during an FBI investigation into his practice of taking bribes and skimming money off liquor-license renewal fees. In 2002, Loren-Maltese was convicted of conspiracy to defraud Cicero through a pattern of racketeering via multiple acts of bribery, money laundering, mail and wire fraud, official misconduct, and interstate transportation of stolen property. The conviction ended her political career, and she was sentenced to eight years in prison. The government tried her separately on criminal tax fraud charges, but the trial ended in a hung jury, and the government decided not to try her again. In the instant case, the IRS asserted a deficiency for unreported income and civil fraud penalties based on Loren-Maltese's purchase of a 1993 classic black Cadillac Allante convertible for her personal use and her investment in a luxury golf course and clubhouse with checks totaling more than $350,000 drawn on her "Committeeman Fund" account. (For the year in question, Illinois law allowed public officials, who like Loren-Maltese, were also political-party officials, to raise money from donors in their capacity as party officials, in amounts that they could keep secret. The evidence established that Cicero's town attorney explained to Loren-Maltese that she could supplement her salary by taking money from the Committeeman Fund to buy something for herself or to make an investment for her own personal benefit, but the money would be personal income to her and she would owe tax on it in the year that she took it.) The Tax Court (Judge Holmes) found that both items should have been included in Loren-Maltese's income and that her failure to do so was due to fraud. Importantly, Loren-Maltese was mostly silent during her trial, relying on her attorney's advice to take shelter under the Fifth Amendment. Judge Holmes found that Loren-Maltese's valid invocation of the Fifth Amendment nevertheless allowed the court to draw a negative inference from her refusal to answer question where the IRS produced some additional supporting evidence. Similarly, he drew inferences from Loren-Maltese's silence where, under the circumstances, it would have been natural for her to object.

7. It looks like-the home mortgage crisis continues, so the mortgage COD exclusion continues. The 2012 Taxpayer Relief Act, § 202, extends the exclusion from income of discharged principal residence indebtedness under § 108(a)(1)(E) to indebtedness discharged before 1/1/14.

8. Excludible mass transit and parking fringe benefits are brought to sweet harmony. For 2012, employees were allowed to exclude $240 per month for parking but only $125 for employer-provided mass-transit and vanpool benefits. Congress came to the rescue in the 2012 Taxpayer Relief Act to provide the same benefit (indexed to $245) through 2013. Congress did not explain how the benefit will apply retroactively in 2012. Perhaps the IRS can figure it out.

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

1. This space cadet didn't get a secret decoder ring. He might have succeeded had he had limited himself to saying "to the Moon!" <u>Barker v. Commissioner</u>, T.C. Memo. 2012-77 (3/20/12). The Tax Court (Judge Goeke) sustained the IRS's disallowance of deductions claimed by the taxpayer, an experienced NASA scientist, relating to planning the exploration of Mars, including "ways to actually live off the land once people have arrived on Mars as opposed to taking all supplies along on the flight." Judge Goeke held that the taxpayer was not engaged in an active trade or business because under the factors in Reg. § 1.183-2(b), the taxpayer did not conduct his activities with the intention of earning a profit. Furthermore, his nascent business had not yet begun to function as a going concern; at most he was merely researching or investigating a potential business, which is insufficient to demonstrate that a taxpayer is engaged in a trade or business.

2. Only a doctor could think he could win this case. <u>Verrett v. Commissioner</u>, T.C. Memo. 2012-223 (8/2/12). The taxpayer was a physician who had an annual salary as such of approximately $120,000 in each of the three years at issue. He claimed losses from a construction business run from his home for which he had no license and had never showed a profit in 17 years. Most of his services during the years at issue involved uncompensated projects for his family and his church. Obviously, the losses were disallowed under § 183.

D. Deductions and Credits for Personal Expenses

1. Only in the IRC can "first-time" mean not within the past three years, but these taxpayers still weren't "property virgins." Foster v. Commissioner, 138 T.C. 51 (1/30/12). The taxpayers bought a home on July 28, 2009 and claimed the temporary, then-in-effect § 36 first-time homebuyer credit. They had listed their previously-owned house for sale in February 2006 and spent "considerable time" at one of their parents' house; the taxpayers sold their old house on June 6, 2007 and rented an apartment that month. The Tax Court (Judge Foley) held that the taxpayers did not qualify for the credit. Under § 36(c)(1), a "first-time homebuyer" is any individual who has not owned a principal residence for three years prior to the date of purchase of a new principal residence. Thus, the taxpayers could have qualified if they had not owned a principal residence after July 27, 2006, and before July 28, 2009 (i.e., the period three years prior to the purchase of their new house). Although the taxpayers owned the old house until June 6, 2007, they argued that they ceased using it as their principal residence in February 2006. Judge Foley found that the taxpayers' original home remained their principal residence through at least July, 2006 — a date within the three years preceding the purchase of the new home — because until it was sold the original home was fully furnished, and taxpayers maintained utility services, frequently stayed overnight, hosted family holiday gatherings, kept personal belongings, accessed the Internet, and received bills and correspondence at that home, as well as listing it as the address for renewing a driver's license and filing federal income tax returns.

2. Two unmarried male cohabitants holding residences in joint ownership were not entitled to double the § 163(h)(3) limits, but were instead restricted to mortgage interest deductions on only $1.1 million of loans. Sophy v. Commissioner, 138 T.C. No. 8 (3/5/12). The Tax Court (Judge Cohen) decided that the $1.1 million § 163(h)(3) limitations on qualified residence indebtedness should be applied on both a per taxpayer and a per-residence basis with respect to residence owners who are not married to each other, rather than solely on the per-taxpayer basis argued for by the unmarried taxpayers who jointly owned the residence in question on which the purchase money mortgage exceeded $1.1 million.

Thus, each of the two taxpayers was limited to deducting interest on only $500,000 of acquisition debt on their two residences and $50,000 of home equity indebtedness on their principal residence. The decision was based upon congressional intent, as shown by the statute's repeated use of phrases "with respect to any qualified residence" and "with respect to such residence," which would have been superfluous had Congress intended that the limitations be applied on a per-taxpayer basis.

3. Married filing separately status can put a big dent in the home mortgage interest deduction. Bronstein v. Commissioner, 138 T.C. No. 21 (5/17/12). The taxpayer, who was married, purchased a residence as joint tenants with rights of survivorship together with her father-in-law. The taxpayer and her husband resided in the home, and her father-in-law did not. The amount of the mortgage exceeded $1.3 million, and the taxpayer made all of the payments on the mortgage. The taxpayer, who filed separately, deducted interest on $1.1 million of the mortgage. The Tax Court (Judge Goeke) applied § 163(h)(3)(B)(ii), which provides that a married individual filing a separate return is limited to a deduction for interest paid on $500,000 of home acquisition indebtedness, and § 163(h)(3)(C)(ii), which provides that a married individual filing a separate return is limited to a deduction for interest paid on $50,000 of home equity indebtedness, which limits the taxpayer's total deduction to interest on $550,000 of mortgage debt. Section 6662 accuracy-related penalties were upheld, even though the taxpayer claimed to have relied on her tax advisor in taking her return position, because "she . . . made no attempt to establish that the reliance was reasonable."

- Interestingly, the same tax advisor who prepared her return also represented her in the Tax Court litigation.

4. No dependency or child credits for nonresident, noncitizen children. Carlebach v. Commissioner, 139 T.C. No. 1 (7/19/12). This case involved whether the taxpayers were allowed § 151 dependency exemption deductions and § 21 and § 24 child-related credits, which require that the children satisfy the same statutory test, for non-resident, non-citizen children. One of the married taxpayers was a U.S. citizen and the other an Israeli, and they lived in Israel; the children were born in, and lived in Israel. The Tax Court (Judge Halpern) applied § 152(b)(3)(A), which provides that "[t]he term 'dependent' does not include an individual who is not a citizen or national of the United States unless such individual is a resident of the United States or a country contiguous to the United States," and Reg. § 1.152-2(a)(1), which provides that "to qualify as a dependent an individual must be a citizen or resident of the United States . . . at some time during the calendar year in which the taxable year of the taxpayer begins" to deny the deductions and credits. He rejected the taxpayers' argument that because the children were citizens in the year (2007) in which returns were filed, they qualified as dependents for the years at issue (2004 through 2006). He also rejected the taxpayers' argument that the children had "derivative citizenship" under 8 U.S.C. § 1433, because such citizenship is not automatic, but requires an application and naturalization, which had not occurred during the years in question. Finally, he rejected the taxpayers argument that because § 152(b)(3)(A) does not require citizenship during the year in question, Reg. § 1.152-2(a)(1), which does require citizenship during the year in question, was invalid. The regulation was a reasonable interpretation of § 152(b)(3)(A), which he interpreted "in the context of subtitle A of the Internal Revenue Code, which deals with income taxes, and in which the concept of an annual accounting system is deeply embedded." Section 6662 accuracy related penalties were upheld.

5. An incomplete effort to collect on a homeowner's insurance policy is all that's necessary to secure a casualty loss deduction. Ambrose v. United States, 106 Fed. Cl. 152 (8/3/12). The taxpayers' home was destroyed in a fire, and the next day they filed a timely claim with their homeowner's insurance company. However, they failed to file a timely "proof of loss" as required by the insurance policy; they sued the insurance company in state court and lost. The IRS applied § 165(h)(5)(E) to deny the taxpayer's claim for a casualty loss deduction. Section 165(h)(5)(E) provides that "[a]ny loss of an individual described in subsection (c)(3) to the extent covered by insurance shall be taken into account under this section only if the individual files a timely insurance claim with respect to such loss." The Court of Federal Claims (Judge Allegra) upheld the taxpayers' refund claim, allowing the casualty loss deduction, on the ground that § 165(h)(5)(E) does not apply to a taxpayer who files a timely claim but whose claim is rejected by the insurance company when the taxpayer fails to timely file a "proof of loss" as required by the insurance policy. Reading from Webster's Dictionary to divine the meaning of the terms "file" and "claim" in § 165(h)(5)(E), Judge Alegra concluded that there is a "distinction between the filing of a claim, i.e. the 'deliver[y] . . . to the proper officer' of a 'demand for something due or believed to be due' and the subsequent submission of proof of the validity of that claim," and that in enacting § 165(h)(5)(E), Congress intended to require only the former. He rejected the government's argument that "an insurance 'claim' [includes fulfilling] all of the conditions on recovery found in a given policy."

6. If you don't plead the right theory, you lose — even though had you pled the correct theory, you might have won. Halata v. Commissioner, T.C. Memo. 2012-351 (12/19/12). In 2007, the taxpayer was suckered into paying $180,000 in a scam "bank guarantee transaction" that promised a return of $2.5 million, with the first installment to be received only a few weeks after the payment was made. The "opportunity" was presented through one Montgomery, a California lawyer, who provided the taxpayer with documents memorializing the transaction. No funds ever were received. The taxpayer hired a lawyer to attempt to recover the funds. Montgomery insisted that the purported bank-guaranty transaction was a legitimate transaction, but that he was merely a facilitator of the transaction, received no money, and had no information about how the transaction worked or the identities and roles of the parties to the transaction. In 2009, the taxpayer's lawyer advised her that a suit against Montgomery likely would be fruitless. The taxpayer did not claim a theft deduction on her 2007 tax return and did not file a 2008 tax return. The IRS audited her for 2007 and 2008 and proposed deficiencies. In the Tax Court, the taxpayer argued that she suffered a theft loss in 2007 and 2008 that would offset her otherwise unreported income. The Tax Court (Judge Morrison) agreed with the taxpayer that a theft had occurred under the relevant state law and that Montgomery most likely was the thief, but denied a deduction for the year before the court because the loss was not sustained until 2009. Based on all of the facts, prior to 2009, she had a reasonable prospect of recovery. Furthermore, the taxpayer never filed a pleading asserting her theory that there was a net-operating loss for 2009 that should be carried back to prior years.

7. One P&S, one loan, one property — all residence. Norman v. Commissioner, T.C. Memo. 2012-360 (12/27/12). The taxpayers purchased a principal residence on 8.875 acres of land for $1.8 million. The land was zoned for 1/4 acre lots, and the taxpayers hired a civil engineering firm to study the feasibility of development. However, the purchase contract did not allocate the price between the residence with a limited amount of acres and remaining acreage, and the taxpayers obtained a single mortgage of $1,860,000. The land was never subdivided. The taxpayers deducted all of the interest on the mortgage, but the IRS allowed only the interest on $1.1 million as qualified home mortgage interest, rejecting the taxpayer's claim that they paid $1 million was for the dwelling unit plus three acres and $800,000 for "investment property" consisting of the other 6.875 acres. The Tax Court (Judge Thornton) upheld the deficiency, largely on the grounds that the purchase contract did not allocate the price between the residence and the acreage that was purportedly investment property and the acquisition was financed with a single loan, which included not only the purchase price, but also a line of credit for renovations to the house.

8. The validity and effect of an admittedly executed Form 8332 is beyond question. George v. Commissioner, 139 T.C. No. 19

(12/19/12). The taxpayer, who was the custodial spouse following a divorce, in compliance with a state court order, executed a Form 8332 (Release of Claim to Exemption for Child of Divorced or Separated Parents), which stated that "I agree not to claim an exemption for" her daughter as a dependent for the years at issue. However, the taxpayer believed that the state court order was improper, because she thought that court lacked jurisdiction to issue such an order and because any such order should have taken into account her former husband's past arrears in child support before enabling him to obtain the dependency exemption. As a result, she nevertheless claimed a dependency exemption and a child tax credit for the child. The taxpayer's former spouse also claimed the child as a dependent for those years and attached the executed Form 8332 to his tax returns. The Tax Court (Judge Gustafson), held that the taxpayer was not entitled to the dependency exemption. The executed Form 8332 was not rendered invalid by any error in the state court order requiring it or by the fact that the taxpayer signed the Form 8332 under the compulsion of that state court order. The release of the claim to the exemption was valid. Likewise the child credit was disallowed.

9. If an ex-spouse disobeys a court order to sign Form 8332, the noncustodial spouse still loses. What's a guy gotta do? Armstrong v. Commissioner, 139 T.C. No. 18 (12/19/12). The taxpayer and his wife divorced, and his ex-wife had custody of their son. A state court order provided that the taxpayer would be entitled to the dependency exemption and explicitly required his ex-wife to execute in his favor a Form 8332, "Release of Claim to Exemption for Child of Divorced or Separated Parents") provided that the taxpayer met child support obligations. The taxpayer met his child support obligations, but his ex-wife failed to provide the executed Form 8332. The IRS disallowed the taxpayer's claimed dependency exemption, even though he appended to his tax return the court order and provided the IRS evidence that he had met his support obligations. In a reviewed opinion (12-3) by Judge Gustafson, the Tax Court upheld the denial of the exemption. The state court order, even though countersigned by the taxpayer's ex-wife was not a substitute for a Form 8332 because it failed to unconditionally declare that the ex-wife "will not claim such child as a dependent" for the year at issue. That defect is not cured by the noncustodial parent's proof that he has fulfilled support conditions beyond those in the statute. Likewise the child credit was disallowed.

- Judge Holmes wrote a very, very lengthy dissent, in which Judges Halpern and Vasquez joined. The essence of the dissent was that the statutory requirement to "attach" the waiver to the tax return properly requires only that it be "associated with" or "connected to by attribution" to the return. Thus, all relevant documents should be considered to be "attached" to a taxpayer's return, without regard to the point in time those documents are provided to the IRS.

10. Miscellaneous not-so-permanent extensions through 2013. The 2012 Taxpayer Relief (and not so grand compromise) Tax Act extends multiple expiring individual deductions, but only through 2013, so Congress can be sure it has some work to do next year. These include extenders for:

a. Teachers. Section 201 of the Act extends the § 62(a)(D) above-the-line deduction for up to $250 of classroom related expenditures of elementary and secondary school teachers for expenses incurred in taxable years beginning in 2012 and 2013.

And who says that the Federal government doesn't abundantly support quality education for children?

b. Mortgage insurance. Section 204 of the Act extends the Code § 164(b)(5) deduction as qualified residence interest provided for mortgage insurance premiums incurred in connection with acquisition indebtedness for a qualified residence that are paid or accrued before 1/1/14.

c. State and local taxes: A not-so-permanent extension of the election to deduct state sales taxes. Section 205 extends the Code § 164(b)(5) election to deduct state and local sales and use taxes in lieu of state and local income taxes to tax years beginning before 1/1/14.

- **Thank you!** Professor Shepard (Texas) and Professor McMahon (Florida) thank Congress and the President for their solicitude on this issue. For Professor Simmons (California), this provision is irrelevant.

11. Standard deduction marriage penalty relief is now permanent. The 2012 Taxpayer Relief (and not so grand compromise) Tax Act made permanent the provisions in Code § 63 providing a basic standard deduction for a married couple filing a joint return double the basic standard deduction for single individuals. The basic standard deduction for married taxpayers filing separately is the same as the basic standard deduction for single taxpayers.

12. PEP and PEASE zombie-like arise from the grave.

a. PEP. The 2012 Taxpayer Relief (and not so grand compromise) Tax Act permanently revived the phase-out of personal exemptions for high-income taxpayers for years beginning after 2012. The phase-out kicks in the following AGI levels: (1) $300,000 for joint returns or surviving spouses; (2) $150,000; and for married taxpayers filing separately; (3) $275,000 for heads of household; and (4) $250,000 for single taxpayers. After 2013, the threshold amounts are adjusted for inflation. The amount of the phase-out, as previously, is 2% of the exemption amount for each $2,500 ($1,500 for married taxpayers filing separate returns), or portion thereof, by which AGI exceeds the phase-out threshold.

b. PEASE The Act also permanently revived for years beginning after 2012 the limitation on itemized deductions. Like PEP, the phase-out begins at the following AGI levels: (1) $300,000 for joint returns filers or surviving spouses; (2) $150,000; and for married taxpayers filing separately; (3) $275,000 for heads of household; and (4) $250,000 for single taxpayers. After 2013, the threshold amounts are adjusted for inflation. The amount of the phase-out, as previously, is 3% of the excess of certain itemized deductions over the threshold amount, but not by more than 80% of the itemized deductions subject to the limitation. (As previously, the limitation does not apply to medical expenses, investment interest, casualty and theft losses, and wagering losses.)

13. Making children permanently cheaper. The Taxpayer Relief (and not so grand compromise) Tax Act extended permanently the increase of the § 24 child credit for taxpayers having children under age 17 to $1,000. (No inflation adjustment has been added.) The refundability of the credit to the extent of 15% of the taxpayer's earned income in excess of $3,000 (unindexed) has been extended only through 2017.

14. Send the kids to day care, get a tax break. The Taxpayer Relief (and not so grand compromise) Tax Act extended permanently the increases to the § 21 dependent care credit in the EGTRRA 2001. The credit is 35% of up to $3,000 of eligible expenses (maximum $1,050) for one qualifying dependent, and 35% of up to $6,000 of eligible expenses (maximum $2,100) for two or more qualifying dependents. The 35% credit rate is reduced, but not below 20%, by one percentage point for each $2,000 (or fraction thereof) of AGI above $15,000.

15. It's tax-smart to adopt rather than to procreate. The Taxpayer Relief (and not so grand compromise) Tax Act extended permanently the EGTRRA Code § 23 credit for adoption expenses, but not the changes in the credit in the Patient Protection and Affordable Health Care Act. As a result: (1) the maximum per-child credit is $10,000 (inflation adjusted) for all adoptions; (2) the credit begins to phase-out at a modified AGI of $150,000 (inflation adjusted); (3) for special needs adoptions, the credit is $10,000 regardless of actual expenses; and (4) the credit is allowed against the AMT. The credit remains nonrefundable. For 2013 the maximum credit is expected to be approximately $12,770 and the phase-out is expected to begin at approximately $189,710, after inflation adjustments.

16. EITC 2001 simplification and expansion is made permanent and 2009 expansion is extended five years. The Taxpayer Relief (and not so grand compromise) Tax Act made permanent the 2001 simplifying revisions to the Code § 32 earned income tax credit, as amended by the 2003 Jobs and Growth Tax Relief Reconciliation Act and the 2004 Working Families Tax Relief Act, and also extended the 2009 increases in the earned income credit for taxpayers with three or more qualifying children through 2017. Through 2017, the phase-out threshold for married taxpayers filing joint returns will be $5,000 (inflation adjusted) higher than for other taxpayers, and starting in 2018 the phase-out threshold for married taxpayers filing joint returns will be $5,000 (inflation adjusted) higher than for other taxpayers.

E. Divorce Tax Issues

1. The test for whether it's "alimony" is objective, not subjective. Rood v. Commissioner, T.C. Memo. 2012-122 (4/25/12). The taxpayer was obligated under Florida law to pay his former spouse a "lump sum alimony" award of $300,000 payable over 60 months in $5,000 payments. The Tax Court (Judge Goeke) held that the payments were not deductible as "alimony" because under Florida law the taxpayer's obligation did not terminate upon his former wife's death. The court declined to consider extrinsic evidence in determining the nature of the payments: "The intent of the parties is irrelevant in determining whether such an obligation would terminate at death." Even though the purpose of the requirement of § 71(b)(1)(D) that the payment terminate upon death is to prevent deductions of amounts that are attributable to support of the payee, the relevant inquiry is entirely objective; the intent of the parties regarding the purpose of the payments is irrelevant.

2. A QDRO can't lend tax-free disability payment status to a substitute payee. Fernandez v. Commissioner, 138 T.C. No. 20 (5/14/12). The Tax Court (Judge Wherry) held that § 104(a)(1) does not apply to exclude disability payments paid to the disabled worker's former spouse pursuant to a § 414(p) qualified domestic relations order (QDRO).

> Section 402(a) provides that amounts distributed from employee trusts are taxable to the distributee "Except as

> otherwise provided in this section", and section 72 provides that "Except as otherwise provided in this chapter gross income includes any amount received as an annuity *** under an *** endowment, or life insurance contract." Nowhere in section 402(a) or section 72 is section 104(a) mentioned. Section 402(e)(1)(A) explicitly provides: "For purposes of subsection (a) [of section 402] and section 72, an alternate payee who is the spouse or former spouse of the participant shall be treated as the distributee of any distribution or payment made to the alternate payee under a qualified domestic relations order." If Congress had included section 104 in this portion of the statute, the result in this case might be different. However, without congressional approval we decline to expand the reach of section 402(e)(1)(A) beyond the sections specifically referred to in its text.

3. Counting to six distinguishes child support from alimony. Schilling v. Commissioner, T.C. Memo. 2012-256 (9/5/12). The Tax Court (Judge Swift) applied § 71(c) and Temp. Reg. § 1.71-1T(c), Q&A 18, to hold that the amount by which payments received pursuant to a divorce decree were reduced on dates that corresponded to taxpayer's children attaining age 18 or starting college were child support. However, an amount by which payments were reduced to zero on a fourth date, in the sixth post-separation year was treated as alimony. Although the complete termination of payments occurred within six months of one child's twenty-first birthday, which ordinarily would be treated as related to a contingency relating to a child under § 71(c)(2)(B), Temp. Reg. § 1.71-1T(c), Q&A 18, expressly provides that complete cessation of support payments during the sixth post-separation year does not qualify as a contingency relating to a child.

F. Education

1. Congress encourages universities to raise tuition even more in the next five years. The Taxpayer Relief (and not so grand compromise) Tax Act extended the 2009 expansion of the Code § 25A American Opportunity Tax Credit (formerly known as the Hope Scholarship credit) through 2017.

a. Doubling down on encouraging universities to raise tuition even more in the next five years. Section 207 of the Taxpayer Relief (and not so grand compromise) Tax Act reinstates and extends the above-the-line deduction of higher education expenses provided in Code § 222(d) for expenses incurred in taxable years 2012 and 2013. Previously § 222(d) applied only to expenses incurred before 12/31/11.

2. Helping banks keep student loan interest rates higher. The 2012 Tax Act made permanent the EGTRRA changes to the Code § 221 above-the-line deduction for qualified higher education student loan interest.

3. Helping banks market education IRAs. The 2012 Tax Act made permanent the many EGTRRA changes to the Coverdell education savings account ("Coverdell ESA," or "CESA," formerly called an "education IRA") rules (§§ 25A, 530). The 2001 changes that have been extended permanently are extensive and since they have been in place for twelve years, we won't bore you with them.

4. Encouraging employers to pay for employee's education. The 2012 Tax Act made permanent the Code § 127 tax-free fringe benefit for up to $5,250 annually for amounts paid or expenses incurred by the employer in providing educational assistance to employees under an educational assistance program (including graduate courses).

G. Alternative Minimum Tax

1. Finally — permanent AMT relief!!! The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 104, has provided permanent AMT relief. Beginning in 2012, the AMT exemption amount has been increased to: (1) $78,750 for married couples filing jointly and surviving spouses; (2) $39,375 for married individuals filing separate returns; and (3) $50,600 for single taxpayers. These amounts are subject to automatic adjustment for inflation after 2012 using 2011 as the base year. The AMT exemption is phased out by an amount equal to 25% of the amount by which AMT exceeds the following thresholds: (1) $150,000 for married couples filing jointly and surviving spouses; (2) $75,000 for married individuals filing separate returns; and (3) $112,500 for single taxpayers. The phase-out thresholds are likewise subject to inflation adjustments. (The 2012 Act did not change the $22,500 exemption amount for estates and trusts.) The 2012 Act also provides permanent 0%, 15%, and 20% (for taxpayers otherwise in the 39.6% bracket for ordinary income) AMT rates for long-term capital gains and qualified dividends. The rule under Code § 26(a)(2) allowing various nonrefundable personal credits to offset AMT has been made permanent. Finally, by an amendment to Code § 26, the § 24 refundable child credit offset of AMT has been made permanent.

VI. CORPORATIONS

A. Entity and Formation

There were no significant developments regarding this topic during 2012.

B. Distributions and Redemptions

1. The cat's out of the bag! DKD Enterprises, Inc. v. Commissioner, 685 F.3d 730 (8th Cir. 7/17/12), *aff'g* T.C. Memo. 2011-29 (1/31/11). The Eighth Circuit, in an opinion by Judge Riley, held that expenses incurred by a corporation to operate a cattery, the deductions for which were disallowed because the cattery was not operated with a genuine profit-seeking motive, constituted constructive dividends to the corporation's sole shareholder because the corporation operated the cattery "for the personal pleasure of . . . its sole stockholder, and that during each of those years that activity was incident to [her] personal hobby." Because the corporation did not have "a legitimate business purpose to operate the cattery," the expenditures to operate constituted a constructive dividend "even though this activity conferred no tangible economic benefit on [the shareholder]."

2. Is section 306 like the human appendix — a vestige of something that might have once served a purpose? The 2012 Taxpayer Relief (and not so grand compromise) Tax Act made permanent the treatment as qualified dividend income of ordinary income realized under Code § 306. The only effect of § 306 now is to affect basis recovery.

C. Liquidations

1. Adios collapsible corporations. But how will tax professors be able to torture their students now? The 2012 Taxpayer Relief (and not so grand compromise) Tax Act permanently repealed the infamous Code § 341.

D. S Corporations

1. Poison pill warrants issued in an S corporation tax shelter scheme turn truly poisonous to S corporation status. Santa Clara Valley Housing Group, Inc. v. United States, 108 A.F.T.R.2d 2011-6361 (N.D. Cal. 9/21/11). The stock of Santa Clara Valley Housing Group, Inc. (SCVHG) originally was held by a husband and wife and their children.

To implement a KPMG tax shelter product known as the S Corporation Charitable Contribution strategy (SC2), SCVHG recapitalized itself so as to have 100 shares of voting stock and 900 shares of nonvoting stock. SCVHG also issued to each shareholder a warrant to purchase ten shares of nonvoting stock for each share of voting stock (which was tax-free under § 305(a)). The warrants were issued solely to protect the original shareholders' interest in SCVHG while they engaged in the SC2 strategy. (The warrants protected against the possibility that the donee charity would refuse to sell its stock back to the original shareholders after the agreed-upon length of time, because if the warrants were exercised, the warrants would dilute the stock held by the charity to such an extent that the original shareholders would end up owning approximately 90 percent of the outstanding shares.) Thereafter, the shareholders transferred all of the nonvoting stock to the City of Los Angeles Safety Members Pension Plan (CLASMPP), a tax-exempt entity as a "donation," with the understanding that CLASMPP would sell the shares back after a certain period of time. While CLASMPP held the stock, SCVHG reported over $114 million of income, of which more than $100 million was passed through to CLASMPP, but CLASMPP received distributions of only $202,500, representing .02 percent of the income allocated to CLASMPP. After four years, CLASMPP sold the 900 shares of stock back to the original shareholders for $1,645,002, and the warrants were cancelled. The IRS concluded that the transaction was an abusive tax shelter. The IRS concluded that under Reg. § 1.1361-1(*l*)(4)(ii) the warrants constituted a second class of stock in SCVHG and SCVHG's status as an S corporation was terminated and issued a deficiency notice based upon treating SCVHG as a C corporation. The District Court agreed with the IRS. The warrants "constitute equity," and were intended to prevent CLASMPP "from enjoying the rights of distribution or liquidation that ordinarily would come with ownership of the majority of a successful company's shares." Thus the warrants were a second class stock and SCVHG's S corporation status was terminated. However, the warrants were not a second class of stock under Reg. § 1.1361-1(*l*)(4)(iii), which provides that options are a second class if, under the facts and circumstances, (1) the option is substantially certain to be exercised and (2) has an exercise price substantially below the fair market value of the underlying stock on the date the option is issued. In this case it was never intended that the options be exercised; they were a "poison pill."

a. Reconsidered. <u>Santa Clara Valley Housing Group, Inc. v. United States</u>, 109 A.F.T.R.2d 2012-554 (N.D. Cal. 1/18/12). On reconsideration of its summary judgment, the court determined that there is a triable issue of fact whether the warrants are protected from being treated as a second class of stock under the safe harbor of Reg. § 1.1361-1(f)(4)(iii)(C), which provides that a call option will not be treated as a second class of stock if the strike price is at least 90 percent of the fair market value of the underlying stock on the date the option is issued, transferred to an ineligible shareholder, or materially modified. The regulation also directs that a good faith determination of value will be respected unless it can be shown that the valuation was substantially in error and the determination was not made with reasonable diligence. The court indicated that there is conflicting evidence regarding the value of the stock at the time the warrants were issued.

2. QSub status is a property right of the QSub. In re The Majestic Star Casino, LLC, 109 A.F.T.R.2d 2012-698 (Bankr. D. Del. 1/24/12). A debtor QSub, but not its parent S corporation, was in bankruptcy. The court held that the parent corporation's post-bankruptcy petition revocation of its S corporation status, which under § 1361(b)(3)(C) automatically terminated the debtor-subsidiary's QSub status, converting it into a C corporation, was an avoidable 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 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."

- *In re Prudential Lines, Inc*., 107 B.R. 832 (Bankr. S.D.N.Y. 1989), *aff'd*, 928 F.2d 565 (2d Cir. 1991), followed.

3. Roth IRA is not an eligible S corporation shareholder. Taproot Administrative Services, Inc. v. Commissioner, 133 T.C. 202 (9/29/09) (reviewed, 12-4). The taxpayer corporation's sole shareholder was a custodial Roth IRA account. Eligible S corporation shareholders as defined in § 1361 include individuals, estates, certain specifically designated trusts and certain exempt organizations. With an effective date after the year involved in this case, § 1361(c)(2)(A)(vi) was enacted to allow a bank whose stock is held by an IRA or Roth IRA to elect S corporation status. Reg. § 1.1361-1(e)(1) provides that a person for whom S corporation stock is held by a nominee, guardian, custodian, or agent is deemed to be the S corporation shareholder. However, in Rev. Rul. 92-73, 1992-2 C.B. 224, the IRS ruled that a trust that qualifies as an IRA is not a permitted S corporation shareholder. Declaring the issue as one of first impression, and indicating that under *Skidmore* deference to revenue rulings depends upon their persuasiveness, the Tax Court (Judge Wherry) agreed with the IRS's rationale in the ruling that IRAs are not eligible S corporation shareholders because the beneficiary of the IRA is not taxed currently on the trust's share of corporate income unlike the beneficiary of a custodial account or the grantor of a grantor trust who is subject to tax on the pass-through corporate income. (The income of the corporation owned by a Roth IRA would never be subject to tax.)

- Judge Holmes dissented in a beautifully-reasoned opinion which made the point that an IRA account is owned by a custodian for the benefit of an individual, who is to be treated as the shareholder, and any unwarranted tax benefits would not accrue because the income of the IRA would be taxed under § 511 as UBIT. His opinion concluded:

> This case is a reminder that tax law does not cascade into the real world through a single channel. It meanders instead through a vast delta, and any general principles tugged along by its current are just as likely to sink in the braided and re-braided rivulets of specific Code provisions and the murk of regulations as they are to survive and be useful in deciding real cases. Taproot thinks it found a course through the confluence of the subchapter S and IRA rules that it could successfully navigate. Its route would be new, but the stakes are not that great, and the sky will remain standing if we had just read and applied the regulation as it is.

a. Yes, it would be too good to be true, so a Roth IRA isn't an eligible shareholder. Taproot Administrative Services, Inc. v. Commissioner, 679 F.3d 1109 (9th Cir. 3/21/12). The Court of Appeals affirmed the Tax Court's holding that a Roth IRA is not an eligible shareholder for an S corporation, and that the taxpayer corporation thus was a C corporation. Although the Court of Appeals "adopt[ed] the Tax Court's reasoning," it concluded that "the analysis requires further elaboration," because the Tax Court's focus "fail[ed] ... to squarely address Taproot's alternative argument for eligibility as the legal owner of the individual shares of stock comprising the IRA." The taxpayer argued that "both forms of IRAs – trusts and custodial accounts – lack the essential attributes of a separate tax-paying entity and consequently should be treated as legally indistinguishable from their individual owners." But the Court of Appeals concluded that the reasoning behind Revenue Ruling 92-73, 1992-2 C.B. 224, "unequivocally supports the opposite result." Furthermore, the legislative history of subchapter S favors limited eligibility, and "[a]ccording to the legislative history of the ESOP eligibility amendment, ... Congress did not envision IRAs as permissible shareholders at the time of enactment." The court also rejected the taxpayer's argument that the language of Reg. § 1.1361-1(e), which provides guidance regarding determining the number of shareholders of a corporation statute, stating that "[t]he person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder ... directly authorizes ownership of S corporation stock by IRAs and Roth IRAs created as custodial accounts." Rather, the court agreed with the IRS's argument that "the language of the regulation requires consideration of who ultimately bears the tax responsibility from its application," and concluded that "[a]pplying this logic, custodial IRAs and Roth IRAs are different in kind and therefore distinguishable from other custodial accounts, such as those involving minors or disabled individuals." The court emphasized that "[t]o adopt the position Taproot urges, this Court must conclude that Congress consciously crafted a legislative scheme enabling shareholders to employ Roth IRAs to perpetually avoid any taxation on S corporation profits. The legislative history and regulatory record foreclose this conclusion."

4. 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.

5. An S corporation is not an individual, even if an IRS employee said so. Trugman v. Commissioner, 138 T.C. No. 22 (5/21/12). The taxpayers moved from California to Nevada to avoid state income taxes. They acquired a principal residence in Henderson, Nevada through their wholly owned S corporation, which held rental properties in Missouri, Texas, and California. The taxpayers claimed the $8,000 first time homebuyer's credit under now-expired § 36, which was available to an "individual" who had no present ownership interest in a principal residence during the three year period ending on the date of the purchase. The Tax Court (Judge Kroupa), in a case of first impression, held that a corporation is not an individual for purposes of § 36, and election of subchapter S status does not change that characterization. The pass-through nature of the credit did not alter the fact that the corporation purchased the property. The court pointed out that individuals can have a principal residence, but a corporation has a principal place of business. The court also was unsympathetic to the taxpayer's request for leniency on the grounds that an IRS representative advised them that they could claim the credit if the residence was purchased through an S corporation. The court pointed out that the Commissioner is not bound by the erroneous legal advice of IRS employees.

- Even though an S corporation is taxed like an individual (with four enumerated exceptions) under § 1363(b), an S corporation is still not an individual.

6. Paper is substance. Corporate resolutions and ledger entries create an "economic outlay." — No kidding, they really do, says Judge Ruwe. Maguire v. Commissioner, T.C. Memo. 2012-160 (6/6/12). The taxpayers in these consolidated cases owned two S corporations with related businesses — one was an auto dealership, and the other a finance company that purchased customer notes from the auto dealership. The finance company operated at a profit and the dealership operated at a loss. Apart from the transactions at issue, the taxpayers did not have sufficient basis in the dealership to deduct losses, but had substantial basis in the finance company. The finance company owned substantial accounts receivable due from the dealership. At the end of each year, through journal entries, the finance company distributed accounts receivable to the taxpayers, who in turn contributed them to the related dealership to increase the basis in the dealership sufficiently to avoid the § 1366(d) limitation on the deduction of passed through losses. The IRS disallowed the claimed loss deductions on the grounds that the transactions did not increase the taxpayers' basis in the dealership because the taxpayers had not made an "an economic outlay." The IRS argued that the corporate "resolutions and adjusting journal entries made to the books of the related companies were devoid of any economic reality and did not alter the economic positions of the parties." The Tax Court (Judge Ruwe) rejected the IRS's position and held for the taxpayer, finding that the "distributions and contributions did have real consequences that altered the positions of petitioners individually and those of their businesses." Thus, the transactions did result in the taxpayer making the required "economic outlay."

> [T]he distributions and contributions created actual economic consequences for the parties, because the accounts receivable had real value in that they were legitimate debts that Auto Acceptance owed to CNAC and thus were legitimate assets of CNAC. Petitioners' contribution of the accounts receivable resulted in their being poorer in a material sense in that the accounts receivable were no longer collectible by them individually.

- Judge Ruwe added that he saw "no reason why shareholders in two related S corporations should be prohibited from taking distributions of assets from one of their S corporations and investing those assets into another of their S corporations, in order to increase their bases in the latter. The effect is to decrease the shareholders' bases in the S corporation making the distribution, thereby reducing the shareholders' potential future tax-free distributions from the distributing S corporation, while increasing the shareholders' bases in the S corporation to which the contribution is made." Furthermore, "[t]he fact that the two S corporations have a synergistic business relationship and are owned by the same shareholders should make no difference so long as the underlying distributions and contributions actually occurred."

- But for the fact that the shareholders' ownership of the two corporations was not congruent, this issue could have been avoided by having the two operating corporations organized as subsidiary QSubs of an S corporation holding company.

7. The Treasury Department proposes major surgery on the rules for determining an S corporation shareholder's basis limitation for passed-through losses under § 1366(d). REG-134042-07, Basis of Indebtedness of S Corporations to Their Shareholders, 77 F.R. 34884 (6/12/12). The Treasury Department has proposed amendments to Reg. § 1.1366-2 that would deal with determination of an S corporation shareholder's basis in any debt of the S corporation, which principally affects the limitation on the pass-through of losses under § 1366(d). The proposed regulations expressly provide that the basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis (as defined in Reg. § 1.1011-1 and as provided in § 1367(b)(2)) in any "bona fide indebtedness of the S corporation that runs directly to the shareholder." Whether indebtedness is "bona fide indebtedness" to a shareholder is determined under general tax principles and depends on "all of the facts and circumstances." Prop. Reg. § 1.1366-2(a)(2)(i). Furthermore, the proposed regulations expressly provide that:

> A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness for which the shareholder has acted as guarantor or in a similar capacity, based on the facts and circumstances, the shareholder may increase its basis of indebtedness to the extent of that payment.

- The preamble states that "[u]nder these proposed regulations, an incorporated pocketbook transaction [see, e.g., *Yates v. Commissioner*, T.C. Memo. 2001-280; *Culnen v. Commissioner*, T.C. Memo. 2000-139] increases basis of indebtedness only where the transaction creates a bona fide creditor-debtor relationship between the shareholder and the borrowing S corporation."

- Prop. Reg. § 1.1366-2(a)(2)(ii), Example (3) in the proposed regulation blesses a basis increase resulting from a back-to-back loan in which one S corporation lends money to the shareholder who in turn lends the loan proceeds to a second S corporation, if the loan to the second S corporation "constitutes bona fide indebtedness" from the borrower S corporation to the shareholder. Example (4) in the proposed regulation blesses a basis increase resulting from a distribution of a note from one S corporation (S2) to another S corporation (S1) if after the distribution S2 is indebted to the shareholder and "the note constitutes bona fide indebtedness" from S2 to the shareholder.

- The proposed regulations do not attempt to clarify the meaning of "bona fide indebtedness," or provide any examples of relevant facts and circumstances, but rely on "general Federal tax principles." This may portend that the voluminous debt versus equity jurisprudence might replace the "actual economic outlay" by the shareholder test for creating basis of indebtedness, applied in cases such as *Maloof v. Commissioner*, 456 F.3d 645 (6th Cir. 2006); *Spencer v. Commissioner*, 110 T.C. 62, 78-79 (1998), *aff'd without published opinion*, 194 F.3d 1324 (11th Cir. 1999); *Hitchins v. Commissioner*, 103 T.C. 711 (1994); and *Perry v. Commissioner*, 54 T.C. 1293 (1970). The preamble refers to *Knetsch v. United States*, 364 U.S. 361 (1960) (disallowing interest deductions for lack of actual indebtedness); *Geftman v. Commissioner*, 154 F.3d 61 (3d Cir. 1998); *Estate of Mixon v. U.S.*, 464 F.2d 394 (5th Cir. 1972); and *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367 (1973), as relevant authorities.

- The proposed regulations do not address how to determine the basis of the shareholder's stock in the S corporation. Rev. Rul. 81-187, 1981-2 C.B. 167, provides that a shareholder of an S corporation does not increase basis in stock for purposes of § 1366(d)(1)(A) by contributing the shareholder's own unsecured demand promissory note to the corporation. In the preamble, the Treasury Department and the IRS have requested comments concerning the propriety of basis calculations in the S corporation and partnership context, similar to the one currently in Reg. § 1.704-1(b)(2)(iv)(d)(2), which provides that a partner's capital account is increased with respect to non-readily tradable partner notes only (i) when there is a taxable disposition of such note by the partnership, or (ii) when the partner makes principal payments on such note.

- The proposed regulations will apply to loan transactions entered into on or after the date of publication of final regulations.

8. Shareholder consent to an S election constitutes consideration paid to the S corporation for cash distributions. — Say What! In re Kenrob Information Technology Solutions, Inc., 110 A.F.T.R.2d 2012-5190 (Bankr. E.D. Va. 7/10/12). Kenrob was an S corporation in bankruptcy. Pursuant to a long-standing pre-existing agreement between the corporation and the shareholders, the corporation had paid directly to the IRS the personal income taxes attributable to the shareholders' passed-through income. The trustee asserted that the payments were fraudulent conveyance because they were made without consideration by the corporation. The Bankruptcy court rejected the trustee's argument, holding that the consideration received by the corporation was the shareholders' "election" — the court should have said "consent" to have the corporation be taxed as an S corporation — as long as the corporation paid the resulting personal income tax liability. The benefit to the corporation was the § 11 taxes that it would not have had to pay had it not made the S election.

9. The lifetime of built-in gain gets shorter every year. The Small Business Jobs Act of 2010 shortened the holding period under § 1374 for recognizing unrealized built-in gain on conversion from a C corporation to an S corporation to five years preceding the corporation's tax year beginning in 2011. Before the change the holding period was ten years for sales or exchanges in tax years beginning before 2009, and seven years for tax years beginning in 2009 or 2010.

a. And again. The 2012 Taxpayer Relief Act, § 326(a)(2), extends the Code § 1374 five-year holding period reduction to five years for recognized built-in gain in 2012 and 2013.

10. S corporation charitable contributions favored with reduced basis deductions. The 2012 Taxpayer Relief Act, § 325, extended Code § 1367(a)(2), enacted in 2006, which provides that shareholders of an S corporation reduce stock basis by the adjusted basis of property contributed to a charity, even though the full fair market value of the contributed property is passed through to the shareholder as a charitable contribution. Prior law applied to contributions made in tax years beginning before 1/1/12. The two-year extension applies to contributions made in tax years beginning before 1/1/14.

E. Mergers, Acquisitions and Reorganizations

1. Corporate shareholders knew what MidCoast's midco deal was all about. Transferee liability imposed. Feldman v. Commissioner, T.C. Memo. 2011-297 (12/27/11). The Tax Court (Judge

Swift) upheld transferee liability against the shareholders of a corporation who sold the stock of the corporation engaged in a purported stock sale to a midco (the infamous MidCoast) to avoid recognition of gain from earlier sale of the corporation's assets. The transaction was structured as a stock redemption for cash after the asset sale, with the remainder of the stock being sold in the same taxable year of the corporation to a midco that purported to shelter the gains with losses from purported distressed debt tax shelter transactions. The purported stock sale "lack[ed] both business purpose and economic substance" and was disregarded for federal income tax purposes. "The substance of the transaction was a liquidation [of the corporation] and a fee payment to MidCoast for its role in facilitating the sham." The court specifically noted that the taxpayers took no actions to ensure that the corporate income tax liability triggered by the asset sale would be paid, and that it remained unpaid.

a. A different Tax Court judge sees a somewhat differently structured MidCoast deal as immune from transferee liability. <u>Frank Sawyer Trust of May 1992 v. Commissioner</u>, 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 Taxi 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 (12/27/11), supra, 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 . . . ."

b. And yet another shareholder escapes transferee liability after yet another MidCoast midco transaction. Slone v. Commissioner, T.C. Memo. 2012-57 (3/1/12). The taxpayer's family-owned corporation sold all of its assets for cash, resulting in a gain of over $38 million and an estimated combined federal and state income tax liability of over $15 million. None of the proceeds had been distributed at the time Fortrend and MidCoast made an unsolicited offer to purchase the stock of the corporation, which ultimately was accepted, at a purchase price of $35,753,000, plus assumption of the corporation's federal and state income taxes owed as of the closing date. Not unsurprisingly, the taxes were never paid and the IRS asserted transferee liability against the shareholders. Because the asset sale and stock sale were independent of each other and the shareholders "had no reason to believe that Fortrend's methods were illegal or inappropriate, . . . [n]either the substance over form doctrine nor any related doctrines appl[ied] to recast the stock sale as a liquidating distribution." Thus, because the IRS's transferee liability theory was grounded on recasting the stock sale as a liquidation, the IRS lost.

c. And the IRS loses yet again on similar facts but with different "bad guys." Salus Mundi Foundation v. Commissioner, T.C. Memo. 2012-61 (3/6/12). Judge Goeke found that the case was similar to *Frank Sawyer Trust* and *Sloane*, *supra*, and unlike *Feldman*, *supra*. Actually, the facts here were even better for the taxpayer — the stock sale preceded the asset sale to the unrelated schemer, so there was no corporate tax liability at the time the stock was sold.

d. And the IRS's batting average continues to sag. Starnes v. Commissioner, 680 F.3d 417 (4th Cir. 5/31/12), *aff'g* T.C. Memo. 2011-63. The Fourth Circuit refused to apply transferee liability under § 6901 against the shareholders of a corporation (Tarcon) who sold the stock of a corporation to MidCoast after an asset sale, even though the corporation had nothing but cash, which pursuant to the contractual provisions was transferred to Midcoast by wire transfer contemporaneously with the closing of the stock sale and purchase, even though the purchase price was substantially less than the cash holdings of the corporation. The Court of Appeals held that under *Commissioner v. Stern*, 357 U.S. 39 (1958), whether a "person is the 'transferee' of a taxpayer's assets, the 'existence and extent' of that transferee's liability for unpaid taxes the taxpayer owed prior to the transfer is determined by state law, not federal law." (It failed to consider the impact of the Federal Debt Collection Act, which postdates Stern.) The court also held that *Stern* forecloses the application of federal tax law principles to recast of the actual transactions under federal law before applying state law to the set of transactions: "An alleged transferee's substantive liability for another taxpayer's unpaid taxes is purely a question of state law, without an antecedent federal-law recasting of the disputed transactions."

- A cogent dissent by Judge Wynn would have imposed transferee liability.

- Judge Wynn would have followed *BB&T Corp. v. United States*, 523 F.3d 461, 472 (4th Cir. 2008) – "[i]n applying the doctrine of substance over form, we 'look to the objective economic realities of a transaction rather than to the particular form the parties employed'" (quoting *Frank Lyon*, 435 U.S. at 573 (alteration omitted)) to recast the transaction because "the 'objective economic realities' establish that the former shareholders effectively wound up Tarcon and received liquidating distributions of its cash as a result of the stock sale to MidCoast." Judge Wynn reasoned that the sale to MidCoast was not a true sale of stock. Rather, the "substance" of the transaction was merely a cash-for-cash swap and because cash is fungible, the transaction in substance was a receipt by the former shareholders of distributions of Tarcon's cash. Finally, because the stock sales agreement did not require that Tarcon get anything in return for its cash, this transfer was clearly fraudulent under the relevant state law.

2. The Treasury proposes what is essentially elective location of e&p following asset-acquisition reorganizations. REG–141268–11, Allocation of Earnings and Profits in Tax-Free Transfers From One Corporation to Another, 77 F.R. 22515 (4/16/12). The Treasury Department has published proposed amendments to Reg. § 1.312-11(a) that would provide that in a transfer described in § 381 – which applies to tax-free § 368 asset-acquisitions and § 332 liquidations – only the acquiring corporation, as defined in Reg. § 1.381(a)–1(b)(2), succeeds to the earnings and profits of the distributor or transferor corporation unless the second transfer also is described in § 381(a). Thus, if following an asset-acquisition reorganization all of the target's assets are dropped to a subsidiary of the acquiring corporation, the earnings and profits move to the subsidiary; but if the acquiring corporation retains any assets, then it retains all of the earnings and profits. Amended Reg. § 1.312-11(a) will not apply if Reg. § 1.312-10 applies in the case of a § 355 distribution.

3. This District Court decision, if followed, makes it much much more difficult ever to have personal goodwill as an employee-shareholder. Howard v. United States, 106 A.F.T.R.2d 2010-5533 (E.D. Wash. 7/30/10). The taxpayer was a dentist who practiced through a solely owned (before taking into account community property law) professional corporation until the practice was sold to a third party. He had an employment agreement with the corporation including a noncompetition clause that survived for three years after the termination of his stock ownership. The purchase and sale agreement allocated $47,100 to the corporation's assets, $549,900 for the taxpayer-shareholder's personal goodwill, and $16,000 in consideration of his covenant not to compete with the purchaser. The corporation did not "dissolve" until the end of the year following the sale. The taxpayer reported $320,358 as long-term capital gain income resulting from the sale of goodwill (the opinion does not explain how the remainder of the sales price was reported, but the IRS recharacterized the goodwill as a corporate asset and treated the amount received by the taxpayer from the sale to the third party as a dividend from the taxpayer's professional service corporation. Because the sale occurred in 2002, when dividends were taxed at higher rate than capital gains, a deficiency resulted. The government's position was based on three main reasons: (1) the goodwill was a corporate asset because the taxpayer was a corporate employee with a covenant not to compete for three years after he no longer owned any stock; (2) the corporation earned the income, and correspondingly earned the goodwill; and (3) attributing the goodwill to the taxpayer-shareholder did not comport with the economic reality of his relationship with the corporation. After reviewing the principles of *Norwalk v. Commissioner*, T.C. Memo. 1998-279, and *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998), the court held that because the taxpayer was the corporation's employee with a covenant not to compete with it, any goodwill generated during that time period was the corporation's goodwill. The court also rested its holding that the goodwill was a corporate asset on its conclusions that the income associated with the practice was earned by the corporation and the covenant not to compete, which extended for three years after the taxpayer no longer owned stock in the corporation, rendered any personal goodwill "likely [of] little value."

- See *Solomon v. Commissioner*, T.C. Memo. 2008-102, for an extended discussion of the issues underlying an attempted sale of individual goodwill.

a. Affirmed — "Dr. Howard has offered no compelling reason why he should be let out of the corporate structure he chose for his dental practice." 448 Fed. Appx. 752 (9th Cir. 8/29/11). The

Ninth Circuit affirmed the district court in an opinion that contains an elegantly concise summary of the current state of the law.

> Goodwill "is the sum total of those imponderable qualities which attract the custom of a business, — what brings patronage to the business." *Grace Brothers v. Comm'r*, 173 F.2d 170, 175-76 (9th Cir. 1949). For purposes of federal income taxation, the goodwill of a professional practice may attach to both the professional as well as the practice. *See, e.g., Schilbach v. Comm'r*, 62 T.C.M. (CCH) 1201 (1991). Where the success of the venture depends entirely upon the personal relationships of the practitioner, the practice does not generally accumulate goodwill. *See Martin Ice Cream Co. v. Comm'r*, 110 T.C. 189 at 207–08 (1998). The professional may, however, transfer his or her goodwill to the practice by entering into an employment contract or covenant not to compete with the business. *See, e.g., Norwalk v. Comm'r*, 76 T.C.M. (CCH) 208, *7 (1998) (finding that there is no corporate goodwill where "the business of a corporation is dependent upon its key employees, *unless* they enter into a covenant not to compete with the corporation or other agreement whereby their personal relationships with clients become property of the corporation") (emphasis added); *Martin Ice Cream Co.*, 110 T.C. at 207-08 (finding that "personal relationships ... are not corporate assets when the employee has *no* employment contract [or covenant not to compete] with the corporation") (emphasis added); *Macdonald v. Comm'r*, 3 T.C. 720, 727 (1944) (finding "no authority which holds that an individual's personal ability is part of the assets of a corporation ... where ... the corporation does *not* have a right by contract or otherwise to the future services of that individual") (emphasis added). In determining whether goodwill has been transferred to a professional practice, we are especially mindful that "each case depends upon particular facts. And in arriving at a particular conclusion ... we ... take into consideration all the circumstances ... [of] the case and draw from them such legitimate inferences as the occasion warrants." *Grace Brothers v. Comm'r*, 173 F.2d 170, 176 (9th Cir. 1949).

- Looking at the facts as found by the District Court, the Ninth Circuit concluded that "while the relationships that Dr. Howard developed with his patients may be accurately described as personal, the economic value of those relationships did not belong to him, because he had conveyed control of them to the Howard Corporation." Furthermore, the court rejected the taxpayer's argument that the purchase and sale agreement impliedly terminated both the employment contract and the non-competition agreement, thereby transferring the accumulated goodwill of the practice back to Dr. Howard, the court added that even if it accepted that argument, "such a release would constitute a dividend payment, the value of which would be equivalent to the price paid for the goodwill of the dental practice."

b. Has Judge Holmes breathed new vitality into *Martin Ice Cream*? H&M, Inc. v. Commissioner, T.C. Memo. 2012-290 (10/15/12). H&M, Inc. conducted a small town insurance agency business for many years. In the years before it sold its business it paid Schmeets, its principal employee/sole shareholder, an annual salary of approximately $29,000. In an integrated transaction, a bank bought H&M, Inc.'s insurance business for $20,000 and entered into an employment agreement with Schmeets pursuant to which he was paid total compensation of over $600,000 over a six-year period for continuing to run the insurance business on behalf of the bank that purchased the insurance agency. Schmeets kept H&M, Inc. alive and converted its business to (unsuccessfully) exploiting patents developed by its sole shareholder. The IRS asserted a deficiency against H&M, Inc. based on the "substance over form" theory that a significant portion of the compensation paid to Schmeets by the bank under the employment agreement actually was a payment to H&M, Inc. for the sale of the insurance business, and that H&M, Inc. thus realized significant capital gains and interest income over the period the compensation was paid to Schmeets. The IRS's argued that all of the compensation that was fixed in amount actually was part of the purchase price and that only the portion of the compensation that varied (the greater of $50,000 or 45% of "net adjusted income" for the year) was actually compensation. The Tax Court (Judge Holmes) rejected the IRS's argument completely. Applying *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998), and *MacDonald v. Commissioner,* 3 T.C. 720 (1944), Judge Holmes concluded that payments by a purchaser of a corporate business to a controlling shareholder for that shareholder's customer relationships were not taxable to the corporation "where the business of a corporation depends on the personal relationships of a key individual [i.e., the controlling shareholder], unless he transfers his goodwill to the corporation by entering into a covenant not to compete or other agreement so that his relationships become property of the corporation." Judge Holmes found the instant case to be like *MacDonald* and *Martin Ice Cream Co.* The insurance business was "'extremely personal,' and the development of [the] business before the sale was due to Schmeets's ability to form relationships with customers and keep big insurance companies interested in a small insurance market."

Furthermore, the compensation paid to Schmeets was reasonable, and there were no other intangibles to be accounted for in the purchase price.

- The IRS won on a whole raft of run-of-the-mill other issues, typically found in closely held corporations, none of which are particularly interesting.

F. Corporate Divisions

There were no significant developments regarding this topic during 2012.

G. Affiliated Corporations and Consolidated Returns

1. The ELA was triggered in a closed year. LPCiminelli Interests, Inc. v. United States, 110 A.F.T.R.2d 2012-6631 (W.D.N.Y. 11/13/12). The IRS asserted a deficiency against the taxpayer's consolidated group on the grounds that an inactive subsidiary realized COD income in 2004. The taxpayer paid the deficiency and sought a refund. In the refund proceedings, the government conceded that COD issue but asserted that pursuant to Reg. § 1.1504-19, the taxpayer recognized gain from the subsidiary's excess loss account (ELA) upon the worthlessness of the subsidiary's stock in 2004. The taxpayer proved that between 1999 and the end of 2003, the subsidiary's assets declined from more than $8.2 million to $4,128, and that under the pre-2008 version of Reg. § 1.1504-19, the subsidiary's stock was worthless by the end of 2003 — a year beyond the statute of limitations — because the subsidiary had disposed of substantially all of its assets. Accordingly, the court held that the income was not realized in 2004. The government further asserted that even if the subsidiary had disposed of substantially all of its assets prior to 2004, the ELA was properly included in 2004 under the "anti-avoidance rule" of Reg. § 1.1502-19(e), which provides: "If any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section." The government's theory was based on the argument that the taxpayer "acted with the purpose of avoiding the regulations by not reporting [the subsidiary] as an inactive subsidiary prior filing its consolidated return for tax year 2004, and by failing to file an amended return for the year (or years) during which the income from [the subsidiary's] ELA was actually realized." The court rejected this argument for two reasons. First, the taxpayer had fully disclosed the facts to the IRS during the audit and had offered to extend the statute of limitations for 2001-2003 on the issue, and while the limitations periods from 2001–2003 were open, the IRS examined the matter and chose not to assess tax based on any realized ELA income. Second, there is no obligation to file an amended return.

H. Miscellaneous Corporate Issues

1. Have you thought about the personal holding company or accumulated earnings taxes recently? Bet not! The 2012 Taxpayer Relief (and not so grand compromise) Tax Act permanently increased from 15% and set at 20% the § 531 accumulated earnings tax and the § 541 personal holding company tax.

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. The *Castle Harbour* saga. Will it ever end? The Second Circuit twice reverses a taxpayer victory in a self-liquidating partnership note transaction, in which the lion's share of income was allocated to a tax-indifferent party, on the ground that the tax-indifferent Dutch banks were not really equity partners. TIFD III-E, Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 11/1/04), *rev'd*, 459 F.3d 220 (2d Cir. 8/3/06), *on remand*, 660 F. Supp. 2d 367 (D. Conn. 10/7/09), *as amended*, 2009 U.S. Dist. LEXIS 98884 (D. Conn. 10/23/09), *rev'd*, 666 F.3d 836 (2d Cir. 1/24/12).

a. *Castle Harbour I*: District Court holds for the taxpayer. The court found that the creation of Castle Harbour, a Nevada LLC, by General Electric Capital Corp. subsidiaries was not designed solely to avoid taxes, but to spread the risk of their investment in fully-depreciated commercial airplanes used in their leasing operations. GECC subsidiaries put the following assets into Castle Harbour: $530 million worth of fully-depreciated aircraft subject to a $258 million non-recourse debt; $22 million of rents receivable; $296 million of cash; and all the stock of another GECC subsidiary that had a value of $0. Two tax-indifferent Dutch Banks invested $117.5 million in Castle Harbour. Under the LLC agreement, the tax-indifferent partner was allocated 98 percent of the book income and 98 percent of the tax income.

- The book income was net of depreciation, and the tax income did not take depreciation into account (because the airplanes were fully depreciated for tax purposes). Depreciation deductions for book purposes were on the order of 60 percent of the rental income for any given year.

- Scheduled distributions in excess of book income would have resulted in the liquidation of the investment of the Dutch banks in eight years, with the Dutch banks receiving a return of approximately nine percent, with some "economically substantial" upside and some downside risk. Castle Harbour was terminated after five years because of a threatened change in U.S. tax law, but during that period about $310 million of income was shifted to the Dutch banks for a tax saving to the GECC subsidiaries of about $62 million.
- Query whether § 704(b) was properly applied to this transaction?
- This appears to be a lease-stripping transaction in which the income from the lease was assigned to foreign entities while the benefits of ownership were left with a domestic entity.
- The court (Judge Underhill) held that satisfaction of the mechanical rules of the regulations under § 704(b) transcended both an intent to avoid tax and the avoidance of significant tax through agreed upon partnership allocations. In this partnership, 2 percent of both operating and taxable income was allocated to GECC, a United States partner, and 98 percent of both book and taxable income was allocated to partners who were Dutch banks. The Dutch banks were foreign partners who were not liable for United States taxes and thus were indifferent to the U.S. tax consequences of their participation in the partnership. Because the partnership had very large book depreciation deductions and no tax depreciation, most of the partnership's taxable operating income, which was substantially in excess of book taxable income, was allocated to the tax-indifferent foreign partners, even though a large portion of the cash receipts reflected in that income was devoted to repaying the principal of loans secured by property that GECC had contributed to the partnership. The overall partnership transaction saved GECC approximately $62 million in income taxes, and the court found that "it appears likely that one of GECC's principal motivations in entering into this transaction — though certainly not its only motivation — was to avoid that substantial tax burden." The court understood the effects of the allocations and concluded that "by allocating 98% of the income from fully tax-depreciated aircraft to the Dutch Banks, GECC avoided an enormous tax burden, while shifting very little book income." Put another way, by allocating income less depreciation to tax-neutral parties, GECC was able to "re-depreciate" the assets for tax purposes. The tax-neutrals absorbed the tax consequences of all the income allocated to them, but actually received only the income in excess of book depreciation. Nevertheless, the court upheld the allocations. "The tax benefits of the . . . transaction were the result of the allocation of large amounts of book income to a tax-neutral entity, offset by a large depreciation expense, with a corresponding allocation of a large amount of taxable income, but no corresponding allocation

of depreciation deductions. This resulted in an enormous tax savings, but the simple allocation of a large percentage of income violates no rule. The government does not – and cannot – dispute that partners may allocate their partnership's income as they choose. Neither does the government dispute that the taxable income allocated to the Dutch Banks could not be offset by the allocation of non-existent depreciation deductions to the banks. And . . . the bare allocation of a large interest in income does not violate the overall tax effect rule."

- Judge Underhill concluded:

> The government is understandably concerned that the Castle Harbour transaction deprived the public fisc of some $62 million in tax revenue. Moreover, it appears likely that one of GECC's principal motivations in entering into this transaction — though certainly not its only motivation — was to avoid that substantial tax burden. Nevertheless, the Castle Harbour transaction was an economically real transaction, undertaken, at least in part, for a non-tax business purpose; the transaction resulted in the creation of a true partnership with all participants holding valid partnership interests; and the income was allocated among the partners in accordance with the Internal Revenue Code and Treasury Regulations. In short, the transaction, though it sheltered a great deal of income from taxes, was legally permissible. Under such circumstances, the I.R.S. should address its concerns to those who write the tax laws.

b. *Castle Harbour II*: Second Circuit reverses. 459 F.3d 220 (2d Cir. 8/3/06). The Second Circuit, in an opinion by Judge Leval, held that the Dutch banks were not partners because their risks and rewards were closer to those of creditors than partners. He used the facts-and-circumstances test of *Commissioner v. Culbertson*, 337 U.S. 733 (1949), to determine whether the banks' interest was more in the nature of debt or equity and found that their interest was overwhelmingly in the nature of a secured lender's interest, "which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits."

- In *ACM* (Colgate), Judge Laro wrote a 100+ page analysis to find that there was no economic substance to the arrangement. The next contingent payment installment sale case in the Tax Court was *ASA Investerings* (Allied Signal), in which Judge Foley wrote a much shorter opinion finding that the Dutch bank was not a partner; the D.C. Circuit affirmed on Judge Foley's holding that the Dutch bank was not a partner. The IRS began to pick up this lack-of-partnership argument and began to use it on examinations. Later, the Tax Court (Judge Nims) used the economic substance argument in *Saba* (Brunswick), which the DC Circuit remanded based on *ASA Investerings* to give taxpayer the opportunity to argue that there was a valid partnership, which it could not do, as Judge Nims found on remand. Even later, the D.C. Circuit reversed the District Court's *Boca* (Wyeth or American Home Products) case based upon this lack-of-partnership argument – even though Cravath planned *Boca* carefully so that if the Dutch bank was knocked out, there would still be a partnership – based upon its *ASA Investerings* and *Saba* findings on appeal that there was no partnership. Now the Second Circuit has adopted the lack-of-partnership argument.

c. *Castle Harbour III*. Judge Underhill still likes GE. On remand in *Castle Harbour*, the District Court found a valid partnership to have existed under § 704(e) because the heading does not alter the clear language of a statute. A valid family partnership is found in the absence of a family. Additionally, in his contingent penalty findings, Judge Underhill stated that his 2004 taxpayer-favorable decision *ipso facto* means that the taxpayer's reporting position was based upon substantial authority. 660 F. Supp. 2d 367 (D. Conn. 10/7/09), *as amended*, 2009 U.S. Dist. LEXIS 98884 (D. Conn. 10/23/09). In a carefully-written[5] opinion, Judge Underhill held that, while the Second Circuit opinion decided that the partnership did not meet the *Culbertson* totality-of-the-circumstances test ("whether . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise"), it did not address the § 704(e)(1) issue. He held that the Dutch banks did satisfy the requirements of that paragraph, which reads:

> (e) Family partnerships.
>
> (1) Recognition of interest created by purchase or gift. – A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

- In so holding, he relied upon well-settled law that the title of a statute cannot limit the plain meaning of the text, and that the title is of use only when it sheds light on some ambiguous word or phrase. *See also* I.R.C. § 7806(b).

- It is worth noting that although *Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1971), *aff'g* 54 T.C. 40 (1970), which

5. We do not all share the opinion that the opinion is "carefully-written," but Ira thinks so. Ira's college classmate [Judge] Pierre Leval characterized the District Court's analysis as "thorough and thoughtful."

Judge Underhill relied upon extensively to reach his conclusion, held that the application of § 704(e)(1) was not limited to the context of family partnerships, *Evans* involved the question who, between two different persons — the original partner or an assignee of the original partner's economic interest—was the partner who should be taxed on a distributive share of the partnership's income. Although in the family context § 704(e) frequently has been applied to determine whether a partnership exists in the first place, Judge Underhill's decision in *Castle Harbour III* is the first case to "discover" that § 704(e)(1) applies to determine whether an arrangement between two (or more) otherwise unrelated business entities or unrelated individuals constituted a partnership.

- It has sometimes been adduced that the fact that a court of applicable jurisdiction subsequently upholds the tax treatment of a transaction should be a strong argument for the proposition that such tax treatment was based upon substantial authority. With respect to whether the applicability of penalties should he be reversed on appeal, Judge Underhill stated:

> To a large extent, my holding in *Castle Harbour I* in favor of the taxpayer demonstrates the substantial authority for the partnership's tax treatment of the Dutch Banks, as does my discussion above of the Dutch Banks' interest in Castle Harbour under section 704(e)(1). In addition, the government's arguments against the substantial authority defense are unavailing.

- Judge Underhill also sought to place the application of the penalty provisions in a temporal context when he stated:

> The government argues that *Culbertson* and Second Circuit cases like *Slifka* and *Dyer* that interpreted *Culbertson* cannot provide substantial authority for the partnership's tax position because the Second Circuit held in *Castle Harbour II* that the Dutch Banks were not partners under *Culbertson*. The government, however, has not pointed to any Second Circuit case or other authority, prior to 1997 and 1998 when the Castle Harbour partners took the tax positions at issue, where the parties' good faith intention or valid business purpose in forming a partnership was not sufficient to support a conclusion of partnership status for tax purposes.

- In the context of the previous two bullet points, it is worth noting that Judge Underhill's observations in the immediately preceding bullet point appears to be consistent with Reg. § 1.6662-4(d)(3)(iv)(C), which provides that whether a position was supported by substantial authority must be determined with reference to authorities in existence at the time. But Judge Underhill's observations in the second preceding bullet point appear to be inconsistent with both Reg. § 1.6662-

4(d)(3)(iv)(C) and observations in the immediately preceding bullet. However, we are not all in agreement with what Judge Underhill intended the observations in the second preceding bullet point to mean.

d. *Castle Harbour IV*: The Second Circuit smacks down the District Court again in an opinion that leaves you wondering why it ever remanded the case in the first place. 666 F.3d 836 (2d Cir. 1/24/12). In another opinion by Judge Leval, the Second Circuit again reversed Judge Underhill and held that the enactment of § 704(e)(1), which recognizes as a partner one who owns a "capital interest in a partnership," did not "change[] the law so that a holding of debt (or of an interest overwhelmingly in the nature of debt) could qualify as a partnership interest."

> Notwithstanding that they tend to favor the government's position, the governing statute and regulation leave some ambiguity as to whether the holder of partnership debt (or an interest overwhelmingly in the nature of debt) shall be recognized as a partner. Therefore, we may consult the legislative history to see whether it sheds light on their interpretation. . . . The reports of the House and the Senate accompanying the passage of § 704(e) make clear that the provision did not intend to broaden the character of interests in partnerships that qualify for treatment as a partnership interest to include partnership debt.
>
> The purpose of the statute was to address an altogether different question. The concern of § 704(e)(1) was whether it matters, for the determination of whether a person is a partner for tax purposes, that the person's purported partnership interest arose through an intrafamily transfer. The section was passed to reject court opinions that refused to recognize for tax purposes transfers of partnership interests because the transfers were effectuated by intrafamilial gift, as opposed to arm's length purchase. Its focus is not on the nature of the investment in a partnership, but rather on who should be recognized for tax purposes as the owner of the interest.

- The Second Circuit went on to describe the District Court as having found that the banks incurred "real risk" that might require them to restore negative capital accounts, and thus having concluded "that the banks' interest was therefore an 'interest in the assets of the partnership' distributable to them upon liquidation." The Second Circuit then described the District Court's finding that the banks' interest qualified as a capital interest as having been "premised entirely on the significance it accorded to the possibility that the banks would be required to bear 1% of partnership losses exceeding $7 million, or 100% of partnership losses exceeding $541 million." But the Second Circuit disagreed, holding that there was a mere appearance of risk, rather than any real risk, which did not justify treating the banks' interest as a capital, or equity, interest, noting that it had reached the same conclusion in its earlier opinion. The Second Circuit then suggested that "[t]he district court was perhaps reading § 704(e)(1) to mean that the addition to a debt interest of any possibility that the holder's ultimate entitlement will vary, based on the debtor's performance, from pure reimbursement plus a previously fixed rate of return will qualify that interest as a partnership interest, no matter how economically insignificant the potential deviation and how improbable its occurrence." The Second Circuit "disagree[d] with any such reading of the statute. No such interpretation is compelled by the plain language of § 704(e)(1). And the fact that the statute was intended to serve an altogether different purpose is confirmed by the legislative reports." The Second Circuit continued:

> In explaining our conclusion that the banks' interest was not a genuine equity interest, we repeatedly emphasized that, as a practical matter, the structure of the partnership agreement confined the banks' return to the Applicable Rate regardless of the performance of Castle Harbour. . . .
>
> The banks' interest was therefore necessarily not a "capital interest" . . . . Because the banks' interest was for all practical purposes a fixed obligation, requiring reimbursement of their investment at a set rate of return in all but the most unlikely of scenarios, their interest rather represented a *liability* of the partnership. . . . Accordingly, for the same reasons that the evidence compels the conclusion that the banks' interest was not bona fide equity participation, it also compels the conclusion that their interest was not a capital interest within the meaning of § 704(e)(1).

- Turning to the § 6662 penalty issue, the Second Circuit again trashed Judge Underhill's opinion and reversed, reinstating the penalties, stating that Judge Underhill had "mistakenly concluded that several of our decisions supported treatment of the banks as partners in Castle Harbour."

2. Frack the corporate tax for this waste removal partnership. Ltr. Rul. 201227002 (3/1/12, *released* 7/6/12). The IRS concluded in this private letter ruling that income from the removal, treatment, recycling and disposal of waste products from fracturing processes in oil and gas production is qualifying gross income under § 7704(d)(1)(E), permitting a publicly traded partnership to avoid being taxed as an association under § 7704.

3. 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) 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% preferred return on its contributions to HBH. Referring to *Virginia Historic Tax Credit Fund,* the Third Circuit treated the 3% 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.

4. Deathbed estate planning with intended contributions creates a Texas style family limited partnership. Keller v. United States, 637 F.3d 238 (5th Cir. 9/25/12). On May 10, the decedent met in her hospital bed with advisors to structure estate planning AB trusts as partners with an LLC in a family limited partnership. The decedent executed partnership agreements and indicated that she intended to fund the partnership with community property bonds. The decedent also wrote a check to the partnership which was never cashed. The decedent died on May 15. After attending a CLE conference, the taxpayer's advisors re-thought the estate's estate tax payment and claimed a $147 million refund of estate taxes on the basis of a valuation discount attributable to the assets in the family limited partnership. The IRS asserted that the partnership was never funded. The court, affirming findings by the District Court, held that under "[w]ell-established principles of Texas law" the decedent's intent to make an asset partnership property caused the bonds to be equitably owned by the partnership. Thus the estate was entitled to the valuation discount for the partnership property.

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

1. De minimis partners become substantial under proposed regulations. REG-109564-10, Partner's Distributive Share, 76 F.R. 66012 (10/25/11). The economic effect of a partnership allocation is not substantial under Reg. § 1.704-1(b)(2)(iii)(*a*) if, at the time the allocation (or allocations) becomes part of the partnership agreement: (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. Reg. § 1.704-1(b)(2)(iii)(*e*) provides that the tax attributes of a de minimis partner (a partner who owns less than 10 percent of partnership capital or profits) need not be taken into account in applying the substantiality tests. The proposed regulation would remove the de minimis partner rule "in order to prevent unintended tax consequences." The preamble to the proposed regulation indicates that the de minimis partner rule was "not intended to allow partnerships to entirely avoid the application of the substantiality regulations if the partnership is owned by partners each of whom owns less than 10 percent of the capital or profits, and who are allocated less than 10 percent of each partnership item of income, gain, loss, deduction, and credit." The regulations will be effective when finalized.

a. De minimis partners are still partners under the substantiality test. T.D. 9607, Partner's Distributive Share, 77 F.R. 76380 (12/28/12). Reg. § 1.704-1(b)(2)(iii)(e) is amended to remove the de minimis rule that provided that in determining whether the economic effect of a partnership allocation is substantial under Reg. § 1.704-1(b)(2)(iii) the tax consequences to a less than 10 percent partner could be ignored. The final regulation is applicable to allocations that become part of a partnership agreement after 12/28/12, and is applicable for all partnership taxable years beginning on or after 12/28/12, regardless of when an allocation became part of the partnership agreement.

2. Only in tax law could insolvency result from debts you don't really have to repay. Rev. Rul. 2012-14, 2012-24 I.R.B. 1012 (5/25/12). Section 108(a)(1)(B) excludes COD from gross income if the cancellation occurs when the taxpayer is insolvent; § 108(a)(3) limits the amount of COD income excluded by § 108 to the amount by which the taxpayer is insolvent. Rev. Rul. 92-53, 1992-2 C.B. 48, provides that the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt ("excess nonrecourse debt") is treated as a liability in determining insolvency for purposes of § 108 to the extent that the excess nonrecourse debt is discharged. Revenue Ruling 2012-14 holds that for purposes of measuring a partner's insolvency under § 108(d)(3), each partner treats as a liability an amount of the partnership's discharged "excess nonrecourse debt" that is based upon the allocation of COD income to such partner under § 704(b) and the regulations thereunder.

3. Retention of an economic interest is not a liquidation. Brennan v. Commissioner, T.C. Memo. 2012-209 (7/23/12). Ashland and Brennan were members of the Cutler & Company LLC, which managed asset portfolios for high-income individuals. (Another Cutler case is discussed under the partnership audit rules at VII.F.7., below.) Ashland was the CEO of Cutler. Cutler was restructured in 2002 because of "turmoil" among the members. Cutler sold certain institutional accounts under an agreement entered into in 2002, with payments made in 2003 and 2004. Sales proceeds were used to satisfy Cutler liabilities and obligations. At the time of the sale Brennan ceased to be a member of Cutler, but continued to hold "an economic interest" which conferred a continuing interest in income and loss items. Ashland reported capital gain from the sale in 2003, but none in 2004. Brennan reported no capital gain from the Cutler sale. The IRS asserted inconsistent deficiencies against both Ashland and Brennan in order to avoid a whipsaw, asserting that Ashland was responsible for reporting all of the capital gains recognized in 2003 and 2004 and that Brennan was responsible for reporting his 45 percent distributive share of the capital gains. The Tax Court (Judge Kroupa) rejected Brennan's claim that his partnership interest terminated in 2002, holding that a retiring partner remains a partner for tax purposes until the partner's interest has been completely liquidated. Thus, the court held that Brennan was responsible for reporting his share of partnership capital gain derived in 2003 and 2004. Ashland was responsible for reporting her share of the capital gain as set forth in the 2002 restructuring agreement.

4. Family farm is a partnership. Holdner v. Commissioner, T.C. Memo. 2010-175 (8/4/10). When his son Randal expressed little interest in going to college, William Holder, an accountant, invested in developing a small family farm for his son to operate with an agreement to divide the profits with an undefined equity interest in the property. As the farming operation expanding, father and son took title to property as tenants in common. On his returns, William reported one-half of the income and claimed deductions for all operating expenses. The Tax Court (Judge Marvel) held that the arrangement was a partnership, rejecting the taxpayer's arguments that they each operated as independent sole proprietors. Judge Marvel noted that both William and Randal contributed properties and labor to the venture, which conducted business activities. She also found that the taxpayers failed to rebut a presumption that the partners shared equal capital interests in the partnership that applied to all items of income and expenditure, and that differing capital contributions did not justify an allocation of all expenditures to William. The court sustained an accuracy related penalty under § 6662 finding that William failed to make a reasonable attempt to ascertain the correctness of his reporting positions.

a. Not clearly erroneous says the Ninth Circuit. Holdner v. Commissioner, 483 Fed. Appx. 383 (9th Cir. 10/12/12). Affirming the Tax Court in an unpublished opinion, the Ninth Circuit upheld Judge Marvel's conclusion that the farming operation was a 50-50 partnership, as opposed to a mere co-ownership of property. It also rejected the taxpayer's argument that the Notice of Deficiency was not adequate because it failed to inform the taxpayer of what would be relevant at trial.

C. Distributions and Transactions Between the Partnership and Partners

There were no significant developments regarding this topic during 2012.

D. Sales of Partnership Interests, Liquidations and Mergers

There were no significant developments regarding this topic during 2012.

E. Inside Basis Adjustments

There were no significant developments regarding this topic during 2012.

F. Partnership Audit Rules

1. Partner's outside basis in a tax-shelter partnership is a partner item. Napoliello v. Commissioner, T.C. Memo. 2009-104 (5/18/09). The taxpayer invested in a Son-of-Boss transaction involving digital foreign currency items. The IRS issued an FPAA to the taxpayer as a notice partner. In the uncontested partnership proceeding, it was determined that the partnership was a sham that lacked economic substance, that transactions entered into by the partnership should be treated as transacted directly by the partners, and that purported losses claimed on disposition of distributed property with an enhanced basis should be disallowed. The IRS assessed a deficiency against the taxpayer based on the partnership items. The Tax Court previously held in *Petaluma FX Partners, LLC v. Commissioner*, 131 T.C. 84 (2008), that the determination of whether a partnership was a sham that will be disregarded for Federal tax purposes is a partnership item. In the instant case, the court (Judge Kroupa) agreed with the IRS that the partner's basis in distributed securities from the sham partnership is an affected item subject to determination in the partnership proceeding, and not subject to re-determination in the partner-level deficiency proceeding. Because the amount of any loss with respect to the partner's disposition of securities distributed from the partnership required a factual determination at the partner level, the court held that it had jurisdiction in the partner deficiency proceeding to proceed under normal deficiency procedures. The court thus proceeded to determine that the taxpayer's claimed loss on the sale of the distributed securities was disallowed, that the taxpayer's basis in the securities was their direct cost rather than an exchange basis from the partnership interest, and that the taxpayer was not allowed to deduct transaction costs attributable to the investment. The Tax Court also held that the FPAA gave the taxpayer fair notice of the IRS claims.

a. Part of the Tax Court's holding in *Petaluma FX* Partners retains its vitality, but not the part the Tax Court relied upon in *Napoliello*. Petaluma FX Partners, LLC v. Commissioner, 591 F.3d 649 (D.C. Cir. 1/12/10). The Tax Court in this Son-of-Boss tax shelter case determined that it had jurisdiction in a TEFRA partnership proceeding to determine that the partnership lacked economic substance and was a sham. Since the partnership was disregarded, the Tax Court concluded that it had jurisdiction to determine that the partners' outside basis in the partnership was zero. The Tax Court reasoned that a partner could not have a basis in a partnership interest that did not exist. (131 T.C. 84 (2008)) The Court of Appeals agreed that the Tax Court had jurisdiction in the partnership proceeding to determine that the partnership was a sham. Temp. Reg. § 301.6233-1T(a) expressly provides that "[a]ny final partnership administrative adjustment or judicial determination ... may include a determination that the entity is not a partnership for such taxable year." The Court of Appeals held that the regulation was explicitly authorized by § 6233. A partnership item is defined in § 6231(a)(3) as an item required to be taken into account in determining the partnership's income under Subtitle A of the Code that is identified in regulations as an item more appropriately taken into account at the partnership level. The court indicated that, "[l]ogically, it makes perfect sense to determine whether a partnership is a sham at the partnership level. A partnership cannot be a sham with respect to one partner, but valid with respect to another." However, the Court of Appeals concluded that the partners' bases were affected items, not partnership items, and that the Tax Court did not have jurisdiction to determine the partners' bases in the partnership proceeding. The court rejected the IRS argument that the Tax Court had jurisdiction in the partnership proceeding to determine the partners' outside basis as an affected item whose elements are mainly determined from partnership items. The court held that resolution of the affected item requires a separate determination at the partner level even though the affected item could easily be determined in the partnership proceeding. Finally, the Court of Appeals held that accuracy related penalties under § 6662(a) could not be determined without a determination of the partners' outside basis in a partner level proceeding and vacated and remanded the Tax Court's determination of penalty issues.

b. On remand, the Tax Court disavowed jurisdiction over penalties in the partnership-level proceeding. Petaluma FX Partners, LLC v. Commissioner, 135 T.C. 581 (12/15/10). The court (Judge Goeke) held that in light of the Court of Appeals holding that determination of adjustments attributable to the partner's outside basis is an affected item properly addressed in individual partner level proceedings, any § 6662 penalties must also be determined at the partner-level proceeding and that the Tax Court had no jurisdiction to assess the penalties. The court rejected the IRS argument that the penalties proceeded from the partner-level determination that the partnership was a sham, thereby providing jurisdiction for the Tax Court to determine the negligence penalty. The Tax Court held that if a penalty "does not relate directly to a numerical adjustment to a partnership item, it is beyond our jurisdiction. In this case there are no such adjustments to which a penalty can apply." Judge Halpern dissented, asserting that the Tax Court could reconsider the penalty on grounds other than the partners' outside bases under the court's initial findings that the partnership was a sham and did not provide the basis increase claimed by the partners. A dissent by Judge Marvel (joined by three others) argued that the Tax Court has jurisdiction to determine the imposition of a penalty for negligence related to adjustment of a partnership item in the partnership level proceeding, but the amount of the individual penalty depends upon a computation at the partner level.

c. Partner's outside basis in a tax-shelter partnership is a partner item. Napoliello v. Commissioner, 655 F.3d 1060 (9th Cir. 8/23/11). The taxpayer invested in a Son-of-Boss transaction involving digital foreign currency items. The IRS issued an FPAA to the taxpayer as a notice partner. In the uncontested partnership proceeding it was determined that the partnership was a sham that lacked economic substance, that transactions entered into by the partnership should be treated as transacted directly by the partners, and that purported losses claimed on disposition of distributed property with an enhanced basis should be disallowed. The IRS assessed a deficiency against the taxpayer based on the partnership items. Upholding the Tax Court, the Ninth Circuit joined the D.C and Eighth Circuits, in *Petaluma FX Partners, LLC v. Commissioner*, 591 F.3d 649 (D.C. Cir. 2010), and *RJT Invs. X v. Commissioner*, 491 F.3d 732 (8th Cir. 2007), respectively, holding that the determination of whether a partnership was a sham that will be disregarded for Federal tax purposes is a partnership item. The Ninth Circuit also agreed with the Tax Court that the partner's basis in distributed securities from the sham partnership is an affected item subject to determination in the partnership proceeding, and not subject to re-determination in the partner-level deficiency proceeding. Because the amount of any loss with respect to the partner's disposition of securities distributed from the partnership required a factual determination at the partner level, the court held that the Tax Court had jurisdiction in the partner deficiency proceeding to proceed under normal deficiency procedures. Thus, the Tax Court could determine that the taxpayer's claimed loss on the sale of the distributed securities was disallowed, that the taxpayer's basis in the securities was their direct cost rather than an exchange basis from the partnership interest, and that the taxpayer was not allowed to deduct transaction costs attributable to the investment.

d. Disregarded tax-shelter partnership is still a partnership for purposes of the TEFRA audit rules. Tigers Eye Trading LLC v. Commissioner, 138 T.C. 67 (2/13/12) (reviewed, court opinion joined by fiver judges, three judges concurred and four dissented). In this Son-of-BOSS tax shelter matter, the parties stipulated that the tax shelter partnership should be disregarded, the basis of distributed property should be reduced to zero, and upheld accuracy related penalties. The partnership filed a motion to revise the stipulated decision after the D.C. Circuit's decision in *Petaluma FX Partners, LLC v. Commissioner*, 591 F.3d 649 (D.C. Cir. 2010), which held that a partner's outside basis is not a partnership item subject to the court's jurisdiction in a partnership-level proceeding and thus not subject to a penalty determination in the partnership proceeding. In an opinion joined by only Judges Colvin, Halpern (who also wrote a separate concurring opinion), Cohen, and Goeke, the Tax Court (Judge Beghe) held that it has jurisdiction in a partnership-level proceeding against an entity that filed a partnership return to determine whether the entity should be disregarded as a partnership and to determine all items of the entity that would be partnership items if the entity had been a partnership, citing §§ 6233 and 6226(f) and Temp. Reg. § 301.6226(f)-1T. Under § 6233, if a partnership return is filed for a taxable year but it is determined that no partnership exists, the TEFRA procedures apply to the partnership, partnership items, and to persons holding an interest in the entity. The court specifically noted that a holding that an entity does not exist under Temp. Reg. § 301.6233-1T(a) "will serve as a basis for a computational adjustment reflecting the disallowance of any loss or credit claimed by a purported partner with respect to that entity." The court indicated that *Petaluma FX Partners* was decided on the basis of a government concession that outside basis was not a partnership item. The court held that under *Mayo Foundation for Med. Educ. & Research v. United States*, 131 S. Ct. 704 (2011), decided after *Petaluma FX Partners,* it was required to defer to the regulations. The court then interpreted the basis rules of subchapter K and Reg. § 301.6231(a)(3)-1(a) to require that determination of outside basis is a partnership item:

> Determination of the partners' outside bases in their interests in a partnership that is recognized for Federal

> income tax purposes requires complex determinations of not only the amounts of partnership items that are elements of outside basis but also the partners' shares of those amounts, which are also partnership items. Those complex determinations must be made in the partnership proceeding, and most often there are no other factors to be determined at the partner level.

- With respect to its jurisdiction to assess penalties, unlike the D.C. Circuit in *Petaluma FX Partners,* the court indicated that, based on its holding that the partners' outside bases were subject to determination in the partnership-level proceeding, the court had jurisdiction to impose the 40-percent basis misstatement penalty at the partnership level.
- Judge Wherry wrote a concurring opinion. Judges Gale and Paris concurred in the result only, without opinions. Judge Marvel wrote a dissent, which was joined in part by Judges Thornton and Kroupa. Judge Foley dissented without opinion, and Judges Vasquez, Gustafson, and Morrison did not participate.
- Since this case is appealable to the D.C. Circuit, the Tax Court's lengthy opinion is not likely to be the last word.

e. Partnership items are in the eye of the beholder. Petaluma FX Partners, LLC v. Commissioner, T.C. Memo. 2012-142 (5/17/12). On its own motion, the D.C. Circuit again remanded this case back to the Tax Court to reassess the Tax Court's holding in *Petaluma III* (135 T.C. 581) that it lacked jurisdiction to determine the partner's outside basis in the partnership proceeding because it is an affected item in light of the court's majority decision in *Tigers Eye Trading LLC v. Commissioner*, 138 T.C. 67 (2/13/12), that it had jurisdiction in the partnership level proceeding to determine the partner's outside bases and assess penalties. Petaluma FX Partners, LLC v. Commissioner, 109 A.F.T.R. 2d 2012-2238 (D.C. Cir. 2/27/12). The Court of Appeals cited the lone dissent by Judge Holmes where he stated that "[o]ur decision today overrules *Petaluma III*". In its supplemental memorandum decision, the Tax Court (Judge Goeke) indicated that the decision on remand in *Petaluma* was based on the "narrow" instruction on remand from the D.C. Circuit which established the law of the case and further stated that its decision on remand was "thoroughly imbued with the legal reasoning and logic provided by the D.C. Circuit in its earlier decision." The court also stated that the language from Judge Holmes's dissent in *Tigers Eye* that was cited in the D.C. Circuit's remand does not represent the position of the court and indicated that no part of the opinion in *Tigers Eye* "purported to explicitly alter or overrule the decision in this case or to revise the language of the Court's Opinion in *Petaluma III*."

2. Who settled with whom and when? Mathia v. Commissioner, 669 F.3d 1080 (10th Cir. 1/5/12). The taxpayer's deceased husband was a partner in a Swanton Coal partnership that the IRS challenged with an FPAA. In 1991 the law firm representing the tax matters partner entered into a settlement agreement in principle, but which required further negotiation with the IRS to determine the settlement amount. In 1995 the IRS sent a stipulation of settlement agreement to the partnership that was signed by the partnership but not by the IRS. An identical agreement was signed by both parties in 2001 and entered as a final judgment by the Tax Court. Within the one year allowed from the date of final judgment under § 6225(a), the IRS issued a deficiency assessment against the taxpayer, who asserted that the earlier settlements represented a settlement with individual partners that reclassified the claimed partnership losses as nonpartnership items under § 6231(b)(1)(C), which then required an assessment within one year of the settlement. The court held that even if the 1991 agreement in principle and the subsequent settlement were binding agreements, the agreements dealt only with partnership items and not settlement agreements with individual partners. Thus, the taxpayer was not dismissed from the partnership level proceeding, and the assessment within one year of the final Tax Court judgment was timely.

3. Keep those addresses up to date. International Strategic Partners, LLC v. Commissioner, 455 Fed. Appx. 91 (2d Cir. 1/19/12). By summary order, the Second Circuit affirmed the Tax Court's dismissal of a petition filed more than 150 days after the IRS mailed an FPAA. The court held that the IRS met the § 6223(a) notice requirements by mailing the notices to the LLC at the address shown on its tax return and to the partners at the addresses shown on accompanying Schedules K-1. The IRS was not required to do more when the LLC failed to provide the IRS with additional information. The taxpayer is responsible for updating contact information under § 6223(c)(2) and Reg. § 301-6223(c)-1.

4. The TEFRA audit rules create a mess with tiered partnerships. Rawls Trading, L.P. v. Commissioner, 138 T.C No. 12 (3/26/12). The ultimate taxpayer, Jerry Rawls, entered into Son-o-BOSS transactions using a tiered partnership structure. The proceeds of short sales of Treasury notes were contributed to lower-tier partnerships by various trust entities (referred to by the court as source partnerships). In turn, the partnership interests in the lower-tier partnerships with inflated basis were contributed to middle partnerships (referred to by the court as interim partnerships). The interim partnership passed through losses generated by transactions using the inflated basis of the source partnerships. The "contrived losses" eventually inured to the tax benefit of Rawls. The IRS issued FPAA's to both the source and interim partnerships. The court (Judge Vasquez) ultimately concluded that since any determination of a deficiency in the interim partnership required resolution of the FPAA issued to the source partnership, such a deficiency was based on a computational adjustment to the interim partnership as a partner, or on resolution of an affected item. In either case, the court held that it lacked jurisdiction to consider the FPAA issued to the interim partnership and dismissed the FPAA. The court rejected the IRS request to stay the proceeding with respect to the interim partnership as premature until the issues in the source partnership proceeding were resolved. The court indicated that since it had no jurisdiction to consider the FPAA issued to the interim partnership, it had no jurisdiction to stay the proceeding. The court also addressed the IRS's assertion that it would be barred from issuing a second FPAA to the interim partnership by the no-second-notice rule of § 6223(f) by pointing out that the court's jurisdiction is conferred by statute and that it had no option to grant the stay. The court suggested, however, that to the extent that adjudication of the shelter issues in the FPAA issued to the source partnership results in a computational adjustment, the IRS could make a direct assessment against Rawls as an indirect partner (§ 6231(a)(2)) without the need for an FPAA against the interim partnership.

5. TEFRA audit rules bar Tax Court consideration of a guaranteed payment of a small partnership with a pass-through member. Brennan v. Commissioner, T.C. Memo. 2012-187 (7/9/12). In consolidated cases, the Tax Court (Judge Kroupa) determined that it lacked jurisdiction under the TEFRA audit rules to determine whether the taxpayers were entitled to flow-through losses attributable to guaranteed payments. The involved parties were members of the Cutler & Company LLC, which managed asset portfolios for high-income individuals. Ashland was the CEO of Cutler. Ashland and Brennan transferred their Cutler interests to a general partnership, Airport Plaza (AP), which was to dissolve under its own terms at the end of 2001. The Cutler operating agreement in 2002 identifies AP as a Cutler member. Cutler was restructured in 2002 because of "turmoil" among the members. AP's 2002 partnership return claimed a partnership loss for 2002 attributable to a guaranteed payments to Brennan of $4,785,616 and Joseph Furey, a former Cutler member, of $485,000. Ashland claimed her share of the loss from AP on her 2002 return. In a petition contesting the IRS disallowance of the loss, Ashland asserted in an amended petition to the court that the guaranteed payments were in fact made by Cutler and that Ashland was entitled to a pass-through loss from Cutler for the payments. The Cutler 2002 partnership return, signed by Ashland as CEO, reported the payments as guaranteed payments to Brennan and Furey. The court agreed with the IRS that Cutler was a TEFRA partnership so that the status of guaranteed payments by Cutler was a partnership item, determinable only in a TEFRA proceeding. A petition for administrative adjustment of Cutler's 2002 return was barred by the statute of limitations. The court rejected the taxpayer's assertion that Cutler was a small partnership (fewer than ten members) because the small partnership exception does not apply under § 6231(a)(9) to a partnership that has a pass-through entity as a member. The court did not allow Ashland to disregard her chosen form of operating AP as a partnership and reporting partnership returns. In addition the court found that AP was treated a member of Cutler in spite of Ashland's argument that Cutler membership interests were never formally transferred to AP because of stipulations by Ashland to the contrary and the Cutler operating agreement unambiguously including AP as a member.

6. A Notice of Deficiency relating to the partner level loss limitation rules need not wait for an FPAA. Meruelo v. Commissioner, 691 F.3d 1108 (9th Cir. 8/16/12, as amend3ed 11/14/12). The taxpayer reported losses from a single-member LLC (disregarded entity) that was a partner in Intervest, which reported losses from foreign currency transactions. Neither the Intervest returns nor the taxpayer's individual returns identified the status of the disregarded LLC. Although the IRS was investigating Intervest for fraud, and there was a related grand jury proceeding, the IRS did not notify Intervest that it would begin an audit, nor did it issue an FPAA for the year at issue. The IRS issued a notice of deficiency to the taxpayers shortly before the three-year statute of limitations would have expired with respect to their individual returns. Affirming the Tax Court, 132 T.C. 355 (2009), the Court of Appeals (Judge N.R. Smith) held that even though application to a partner of the loss limitation rules of §§ 704(d) and 465 are affected items that require a partner-level determination, a notice of deficiency to a partner based on the application of the loss limitation rules of §§ 704(d) and 465 was not issued prematurely and was valid. The Tax Court had jurisdiction over the petition. While the TEFRA audit rules require completion of partnership proceedings when a partnership item or a related item is involved before issuing a notice of deficiency to partners, the court held that TEFRA does not limit the issuance of a notice of deficiency when no partnership proceeding is pending and no notice of deficiency has been sent. The court also stated that although § 6225(a) provides that "'no assessment of a deficiency attributable to any partnership item may be made . . . before' 150 days after the date a notice of FPAA is mailed or a proceeding in Tax Court has been finalized[,]" [a]ssessment of a deficiency is not equivalent to providing notice of a deficiency." The court also rejected the taxpayer's argument that the notice of deficiency was improper when issued because the IRS was considering a criminal investigation that might have found fraud. The court held that the IRS's contemplation of initiating future proceedings is irrelevant and that requiring the IRS to prove that it had no interest in future partnership-level proceedings would serve no purpose.

7. Asset management joint venture is not a partnership, so take that ordinary income. Rigas v United States, 107 A.F.T.R.2d 2011-2046 (S.D. Tex. 5/2/11). Hydrocarbon Capital, LLC, which held a number of oil and gas industry financial assets, entered into a loan management and servicing agreement (specifically stating the arrangement was not a partnership) with Odyssey Energy Capital I, LP, formed by five individual limited partners with an LLC general partner. The management agreement provided for a performance fee representing 20 percent of profits after provisions for disposition of income realized on the asset portfolio designed to recoup Hydrocarbon's expenses, the capital value of the portfolio, and a 10 percent preferred return. In a claim for refund, the taxpayer, one of Odyssey's limited partners, claimed pass-through capital gain treatment on gains from disposition of the managed assets. The District Court (Judge Ellison) agreed with the IRS determination that the income to the Odyssey partners was ordinary income as a service fee rather than pass-through partnership income from a joint venture with Hydrocarbon. The court indicated that notwithstanding the unambiguous text of the management agreement eschewing partnership status, it may still look to the conduct of the parties to determine whether the arrangement was a partnership. The court indicated that the Odyssey partners contributed both capital and services to the relationship with Hydrocarbon, and the arrangement provided for a profit sharing and some risk of loss for the Odyssey partners, which supported treating the arrangement as a partnership. Odyssey maintained significant management responsibility for the Hydrocarbon assets, but it did not have authority to withdraw funds from Hydrocarbon bank accounts, it could not increase Hydrocarbon's capital commitment to a particular asset, it could not enter into binding agreements in Hydrocarbon's name, and it could not dispose of an asset without Hydrocarbon's written approval. Odyssey did not share control over bank accounts that corresponded to companies in the asset portfolio, nor could it disburse funds from the accounts, and thus lacked control over the assets and income of the venture. Finally, the court pointed to the fact that neither Hydrocarbon nor Odyssey filed tax returns treating the arrangement as a partnership. Thus, the court found that the IRS established by a preponderance of the evidence that a partnership did not exist.

- The court also held that it had jurisdiction to consider the taxpayer's refund claim under TEFRA as a partner item based on its holding that the taxpayers' amended returns qualified as a partner Administrative Adjustment Request as being in substantial compliance with the requirements of Reg. § 301.6227(d)-1, notwithstanding the absence of a timely filed form 8802 as required by the regulations.

a. The Fifth Circuit reverses the District Court but the taxpayer still loses. This case proves that the TEFRA audit rules are ridiculously complicated and result in a Catch-22. Rigas v. United States, 486 Fed. Appx. 491 (5th Cir. 8/21/12). The taxpayer was one of five limited partners in Odyssey Energy Capital I, LP (Odyssey), which entered into a loan management and servicing agreement with Hydrocarbon Capital, LLC. The agreement provided for a performance fee representing 20 percent of profits after provisions for disposition of income realized on the asset portfolio designed to recoup Hydrocarbon's expenses, the capital value of the portfolio and a 10 percent preferred return. The agreement specifically stated that the arrangement was not a partnership. In 2004 Hydrocarbon recognized approximately $110 million of gain on disposition of assets and paid a performance fee to Odyssey of approximately $20 million. Odyssey originally reported the $20 million as a management fee constituting ordinary income, and the Odyssey partners reported their share of the ordinary income on individual returns. Subsequently Odyssey filed an amended return claiming it was in a partnership with Hydrocarbon and its $20 million share of proceeds was capital gain. The partners filed amended individual returns claiming refunds. Apparently the IRS allowed refunds to four partners, but denied Rigas's claim. In Rigas's refund suit, the District Court held that there was no partnership between Odyssey and Hydrocarbon and the fees paid to Odyssey were properly treated as ordinary income. *Rigas v United States*, 107 A.F.T.R.2d 2011-2046 (S.D. Tex. 5/2/11). The District Court also held that it had jurisdiction to consider the taxpayers' refund claims under TEFRA as a partner item based on its holding that the taxpayers' amended returns qualified as a partner Administrative Adjustment Request as being in substantial compliance with the requirements of Reg. § 301.6227(d)-1, notwithstanding the absence of a timely filed Form 8802 as required by the regulations. With a complicated meander through the limitations on filing refund actions by partners under TEFRA, the Fifth Circuit in a lengthy per curiam opinion reversed the District Court's holding that it had jurisdiction to hear the refund action, denied the taxpayer's claim that he was entitled to consideration of whether the partnership item was capital gain, held that the District Court had jurisdiction to determine whether the taxpayer was given inconsistent settlement treatment, but alas concluded that there was no settlement.

- Section 7422(h) bars jurisdiction to consider a refund claim by a partner attributable to partnership items except as provided in §§ 6228(b) or 6230(c). Section 6228(b) allows a refund suit attributable to partnership items if the IRS responds to a partner's Administrative Adjustment Request (AAR), filed as provided in § 6227(d), by mailing a notice indicating that partnership items will be treated as non-partnership items, or if the IRS fails to allow the AAR and no notice is mailed. Section 6230(c) provides for claims arising from erroneous computations and was not at issue in the case. The Court of Appeals rejected the District Court holding that the taxpayer's filing an amended return was substantial compliance with the AAR requirement. The court held that the requirement of Reg. § 301.6627(d)-1 that the taxpayer file a specific form (Form 8082) is a procedural requirement that may be met with substantial compliance, but that the requirement that the taxpayer provide a detailed explanation of the claim is a substantive requirement that must be satisfied so that the IRS can properly decide whether to allow the AAR. The court held that Rigas' amended return failed to meet the substantive requirements because it had not been filed in the Service Center where the partnership return had been filed, and it did not provide a detailed explanation of the claim for refund.

- The court held that a partner's claim to settlement terms consistent with the terms of a settlement between the IRS and another partner under § 6224(c)(2) is an item that depends upon whether the particular partner has been properly offered consistent settlement terms and is, therefore, not a partnership item. Thus, the court has jurisdiction to consider a refund claim on that basis. However, the court concluded that as a matter of law the IRS's payments of refunds to the other Odyssey partners were not settlement agreements under § 6224 because there was no partnership-level administrative proceeding.
- Finally, the court rejected the taxpayers alternate claim that since the character of the income was adjusted at the partnership level in the partnership amended return, the taxpayer is entitled to tax treatment consistent with the treatment of the partnership item. The court held that the District Court lacked jurisdiction to consider a refund claim on this basis under § 7422(h) because when the taxpayer "claim that the Performance Fee was recharacterized as capital gains instead of ordinary income at the partnership level and that they are entitled to a refund based on a similar characterization at the partner level, their claim is attributable to a partnership item." The court noted in support of its finding that the item is a partnership item that characterization of the performance fee at the partnership level affects both the partnership's reporting and the reporting of the other partners.

G. Miscellaneous

1. Electronic K-1s. Rev. Proc. 2012-17, 2012-10 I.RB. 453 (2/13/12). The IRS has provided procedures for furnishing Schedule K-1s to persons to whom a partnership is required to provide the form in an electronic format. The Rev. Proc. notes that the recipient entitled to a K-1 must affirmatively consent to receive the form in electronically, and that the consent may be conveyed electronically.

2. Hiding abusive shelter transactions behind disregarded entities makes the indirect partner an unidentified partner for statute of limitations purposes. Gaughf Properties, L.P. v. Commissioner, 139 T.C. No. 7 (9/10/12). The taxpayers invested in KPMG/Jenkens & 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 John Doe summons issued to Jenkens & 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 Jenkens & Gilchrist and KPMG's John Doe summons 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 (1) because of 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.

VII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. Yet another investor in a KPMG OPIS tax shelter gets devoured by the economic substance doctrine. Blum v. Commissioner, T.C. Memo. 2012-16 (1/17/12).The taxpayer's bogus $45 million loss claimed from a KPMG OPIS tax shelter was disallowed. The taxpayers did not contest that their loss was "fictional." Section 6662 accuracy-related penalties for gross valuation misstatements and negligence were upheld.

2. 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.

3. Just another generic tax shelter that lacks economic substance — Taxpayer, "you lose." Reddam v. Commissioner, T.C. Memo. 2012-106 (4/11/12). The taxpayer invested in an OPIS tax shelter peddled by KPMG. The Tax Court (Judge Goeke) found that the "'pretax profit' potential of the transaction was so remote as to render disingenuous any suggestion that the transaction was economically viable."

> [The taxpayer] knew little to nothing about the details of the OPIS transaction. The extent of his knowledge was limited to an understanding that the OPIS transaction was a "formula or a recipe" that would provide him with a substantial capital loss. Despite the fact that petitioner and his closest advisers were ignorant as to the function and design of the investment, petitioner never investigated the transaction further, relying instead on the opinion letters provided by or on behalf of KPMG. Petitioner's lack of due diligence in researching the OPIS transaction indicates that he knew he was purchasing a tax loss rather than entering into a legitimate investment.

- Accordingly, the losses claimed by the taxpayer were denied on the grounds that the transaction lacked economic substance. Amazingly, the opinion makes no reference to accuracy related penalties — did the IRS forget to assess penalties?

4. You better hope that your H-P computer works better than H-P's tax planning strategies. Hewlett-Packard Co. v. Commissioner, T.C. Memo. 2012-135 (5/14/12). In a complicated transaction designed by AIG-Financial Products to generate foreign tax credits, Hewlett-Packard purchased a preferred stock interest in a foreign entity called Foppingadreef (FOP) that was to engage in a U.S.-dollar linked Netherlands guilder stepped coupon contingent note transaction which took advantage of asymmetric treatment of contingent interest in the U.S. and the Netherlands. The common stock of FOP was held by the Dutch bank, ABN, which also provided capital to FOP through transactions structured as a loan to an AIG subsidiary which in turn transferred the Dutch guilder proceeds to FOP along with an obligation on the part of FOP to pay contingent interest back to ABN. Hewlett Packard treated FOP as a controlled foreign corporation through its ownership of the preferred stock and warrants to acquire additional stock and claimed foreign tax credits for Dutch taxes. The transaction was structured to terminate in 2003 through the exercise of put options to transfer Hewlett-Packard's stock interest back to ABN for a price that resulted in a loss to Hewlett-Packard. The Tax Court (Judge Goeke), applying the multiple factors used to distinguish debt from equity, found that the structure of the transaction resulted in a fixed repayment of Hewlett-Packard's investment on a fixed date and treated the investment as a loan rather than an equity interest in FOP, thereby disallowing claimed foreign tax credits. The court also disallowed Hewlett-Packard's claimed § 165 loss on the difference between its initial investment and the price it received on the termination date. The court agreed with the IRS's assertion that Hewlett-Packard's claimed $15.5 million loss on termination of the transaction was in effect a fee paid to AIG in order to participate in a tax shelter. The court held that fees spent for the generation of artificial tax losses are not deductible as payments incurred in a transaction that lacked economic substance citing *Enrici v. Commissioner*, 813 F.2d 293, 296 (9th Cir. 1987), and *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161, 186 (2009), *aff'd* 408 Fed. Appx. 908 (6th Cir. 2010). The court also noted that Hewlett-Packard failed to meet its burden of proof regarding the proper timing of the deduction.

5. "A [contingent liability section 351] transaction that would let [the taxpayer] deduct an approximately $38 million tax loss on the sale of $11,000 in securities which had just recently been purchased for the same amount ... would clearly appear to be too good to be true," said Judge Marvel in a decision rendered nine years after the trial. At long last, this is the first case to apply § 351(g). Gerdau MacSteel, Inc. v. Commissioner, 139 T.C. No. 5 (8/30/12). To shelter capital gains of over $41 million recognized on the sale of two subsidiary corporations in 1997, the taxpayer (Quanex), which was the parent in a consolidated group, entered into a tax shelter transaction devised and recommended by Deloitte & Touche that was intended to create an artificial short-term capital loss of approximately $38 million to offset the capital gains, called the "Double Deducting Environmental and Other Contingent Liabilities" (DDCL). The loss was to be created in a series of transactions involving Quanex's liabilities under for its medical plan benefits (MPBs). In simplified form, the transaction involved the following steps using two of Quanex's inactive subsidiaries (QS and QHMC): (1) Quanex caused QHMC to be recapitalized to have multiple classes of stock, including Class B and Class C voting preferred stock, (a) each with "an assumed $100 issue price," (b) cumulative dividends of 9.5%, payable quarterly, providing Quanex or QHMC with rights to call the preferred stock after five years and providing the Class C shareholders with rights to put the preferred stock after seven years, and (c) providing for a liquidation value for the Class C stock in amount equal to the greater of $125 or an amount equal to the lesser of a percent of any cumulative cost savings in MPBs or of QHMC's book net equity; (2) Quanex transferred $38,000,000 to QS, which assumed Quanex's contingent liability to pay MPBs under Quanex's benefits plan which were treated as being in the amount of $37,989,000; (3) QS transferred $38 million to QHMC, which in turn assumed the liability to pay Quanex's MPBs, in exchange for newly issued Class C stock; and (4) QS sold its Class C preferred stock to a former employee of a Q subsidiary for $11,000. The taxpayer took the position that the transfers of $38 million and the assumptions of liability were § 351 nonrecognition transactions and that pursuant to § 358(a)(2) and Rev. Rul. 95-74, 1995-2 C.B. 36, QS's basis in the QHMC stock was $38 million unreduced by the $37,989,000 of MPBs that were not deductible until paid. The taxpayer claimed a $37,989,000 loss recognized on the sale of the Class C stock that was used to offset the capital gains on the sales of the other subsidiaries. The Tax Court (Judge Marvel) found as facts that the transactions were structured in such a way that it was highly likely when the Class C stock was issued that the Class C stock would be redeemed within the five- and seven-year periods and that the redemption payment would be $125 per share. Judge Marvel further found that after the transactions, Quanex continued to process claims for MPBs, and its handling of the claims transferred to QHMC was the same as the handling of claims with respect to individuals whose MPBs were not transferred to QHMC. QHMC's reimbursements to Quanex for claims were made through intercompany entries recorded on Quanex's books as a receivable due from QHMC and on QHMC's books as a payable. QHMC lent the $38 million to an affiliated corporation, and QHMC eventually reimbursed Quanex for the MPBs when QHMC received payments on the loan. Based on the fact finding, Judge Marvel disallowed the loss deduction on two grounds.

- First, she held that because the Class C stock "'does not participate in corporate growth to any significant extent' within the meaning of I.R.C. sec. 351(g)(3)(A)," it was nonqualifed preferred stock (NQPS) as defined in § 351(g). The taxpayer and IRS had stipulated that if the Class C stock was found to be NQPS the claimed loss was not allowable. (The opinion does not explain the reason that the claimed loss was not allowable if the Class C stock was NQPS; however, § 351(g)(1)(A) provides that when NQPS is the only stock received, § 351(a) [and § 358] shall not apply to the transaction, and pursuant to §§ 1001 and 1012, the basis of the stock is equal to its fair market value.)

- The loss also was also disallowed under the economic substance doctrine, as was a § 162 deduction for $352,251 of fees incurred to effect the transactions. Judge Marvel found no business reason for assumption by QHMC of the MPB liabilities, the sale of the Class C stock, or any other aspect of the transactions; the transactions were all entirely tax motivated, for the purpose of generating an artificial loss. The court also upheld a § 6662(a) 20 percent accuracy penalty (and alternatively a substantial understatement penalty).

> [A] transaction that would let petitioners deduct an approximately $38 million tax loss on the sale of $11,000 in securities which had just recently been purchased for the same amount, and that this result, to a savvy, experienced businessman ... would clearly appear to be too good to be true.

- Thus, the reasonable cause exception of § 6664(c) was not available despite subsequent trial court decisions (later reversed on appeal) upholding tax plans similar to this one. But applying the *Golsen* rule, the court followed the Fifth Circuit's precedents in *Heasly v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), *rev'g* T.C. Memo. 1988-408, and *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988), *aff'g* 89 T.C. 912 (1987), in declining to sustain a 40 percent penalty asserted by the IRS, because the grounds underlying the court's disallowance of the capital loss deduction were not directly related to the taxpayer's valuation of the Class C stock or to the reporting of the proper basis therein.

6. Even though this D&T DDCL worked for a few years, double deductions are a "No No!" Thrifty Oil Co. v. Commissioner, 139 T.C. No. 6 (8/30/12). Thrifty was the common parent of a consolidated group for the relevant years (fiscal years ending 9/30/96 through 9/30/02), but only the years ending in 2000 through 2002 were at issue. During the fiscal year ending in 1996, Thrifty had generated and claimed a capital loss by causing a subsidiary (GW) to transfer a $29,100,000 note from another subsidiary (B) to yet another preexisting subsidiary (EM), which had assumed contingent environmental liabilities in transaction in exchange for 90 shares EM stock; this was done upon the advice of Deloitte & Touche. The taxpayer took the position that the transfer of the $29,100,000 note and the assumption of the $29,070,000 of contingent environmental remediation liabilities was a § 351 nonrecognition transaction and that pursuant to § 358(a)(2) and Rev. Rul. 95-74, 1995-2 C.B. 36, GW's basis in the EM stock was the $29,100,000 face value of the B note, without reducing the stock basis by the $29,070,000 of contingent environmental remediation liabilities EM assumed, which were not deductible until paid. Three days later (9/30/96), GW sold its EM stock for $25,200 and claimed a capital loss of $29,074,800. The taxpayer deducted a total of $18,347,205 of the capital loss on its 1996 through 1999 tax returns, years which were beyond the statute of limitations at the time the dispute in the case arose. The taxpayer claimed deductions for the remaining $10,727,595 of the capital loss on its 2000 through 2002 income tax returns, and those carryforwards were disallowed by the IRS. The sale of the 90 shares of EM stock had not broken EM's affiliation with the consolidated group, and in the years 2000 through 2002, the Thrifty group claimed § 162 deductions for $11,109,962 of environmental remediation expenses that were accruable in those years. The IRS disallowed the deductions. After stipulations — the taxpayer conceded the capital loss issue and the IRS conceded the deduction for environmental remediation expenses that had not previously been deducted in closed years as capital losses, as well as any penalties — the only issue for the court was the deductibility of the $11,109,962 of environmental remediation expenses from 2000 through 2002. The Tax Court (Judge Wherry) applied *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934), and its progeny to disallow the deductions as "double deductions" that had been previously claimed as capital losses in the closed years 1996 through 1999. The court reasoned that under its applicable precedents and the applicable precedents in the Ninth Circuit, to which the case was appealable, "[i]f the deductions represent the same economic loss to [the taxpayer] and [the taxpayer] cannot point to a specific provision demonstrating Congress' [*sic*] intent to allow the double deductions, then the claimed environmental remediation expense deductions must be disallowed." Factually, there was a "double deduction" because "the capital loss arose not as a result of how basis was calculated but as a result of the contingent environmental remediation liabilities being taken into account in calculating the amount realized (or fair market value) but not in calculating basis." Furthermore, § 162, a general deduction provision, does not reflect a "clear declaration of intent" to allow a double deduction. Moreover, under Ninth Circuit precedent in *Stewart v. United States*, 739 F.2d 411 (9th Cir. 1984), as well as cases from other courts, it was immaterial to the application of *Charles Ilfeld Co.* whether the earlier deduction was proper or erroneous but not timely challenged by the IRS.

7. District Court upholds BLIPS tax shelter on taxpayer's partial summary judgment motion. Klamath Strategic Investment Fund, LLC v. United States, 440 F. Supp. 2d 608 (E.D. Tex. 7/20/06). The court (Judge Ward) held that the premium portion of the loans received from the bank in connection with the funding of the instruments contributed to a partnership was a contingent obligation, and not a fixed and determined liability for purposes of § 752. The transaction was entered into prior to the release of Notice 2000-44, 2000-2 C.B. 255, which related to Son-of-BOSS transactions. Judge Ward held that a regulation to the contrary, Reg. § 1.752-6 (*see* T.D. 9062), was not effective retroactively, and was therefore invalid as applied to these transactions. Judge Ward held that there was clear authority existing at the time of the transaction that the premium portion of the loan did not reduce taxpayer's basis in the partnership.

a. *Klamath* on the merits: It does not work because it lacks economic substance, but no penalties. The authorities discussed in the Holland & Hart and Olson Lemons opinions provide "substantial authority." Klamath Strategic Investment Fund, LLC v. United States, 472 F. Supp. 2d 885 (E.D. Tex. 1/31/07). The transactions lacked economic substance because the loans would not be used to provide leverage for foreign currency transactions, but no penalties were applicable because taxpayers passed on a 1999 investment, they thought they were investing in foreign currencies, and the tax opinions they received that relied on relevant authorities set forth in the court's earlier opinion provided "substantial authority" for the taxpayers' treatment of their basis in their partnerships.

b. On government motions, Judge Ward refuses to vacate partial summary judgment decision on the retroactivity of the regulations under § 752, and he permits the deduction of operational expenses — despite his earlier finding that the transactions lacked economic substance — because the taxpayers had profit motives. Klamath Strategic Investment Fund, LLC v. United States, 99 A.F.T.R.2d 2007-2001 (E.D. Tex. 4/3/07). First, Judge Ward held that even though the loans lacked economic substance, they still existed, and thus the partial summary judgment on the non-retroactivity of the regulations under § 752 was not premised on invalid factual assumptions. Second, he held that the existence of profit motive for deduction of operational expenses was based on the purposes of Nix and Patterson — and not on the motives of Presidio, the managing partner of the partnership.

c. Affirmed in part, vacated in part, and remanded, Klamath Strategic Investment Fund, LLC v. United States, 568 F.3d 537 (5th Cir. 5/21/09). In ruling unfavorably on the taxpayers' cross-appeal of the holding that the transaction lacked economic substance, the Fifth Circuit (Judge Garza) followed the majority rule, which "is that a lack of economic substance is sufficient to invalidate the transaction regardless of whether the taxpayer has motives other than tax avoidance." He stated, "[t]hus, if a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations."

- In ruling unfavorably on the government's appeal of the non-imposition of penalties, Judge Garza stated:

> The district court found that Patterson and Nix sought legal advice from qualified accountants and tax attorneys concerning the legal implications of their investments and the resulting tax deductions. They hired attorneys to write a detailed tax opinion, providing the attorneys with access to all relevant transactional documents. This tax opinion concluded that the tax treatment at issue complied with reasonable interpretations of the tax laws. At trial, the Partnerships' tax expert [Stuart Smith] concluded that the opinion complied with standards established by Treasury Circular 230, which addresses conduct of practitioners who provide tax opinions. Overall, the district court found that the Partnerships proved by a preponderance of the evidence that they relied in good faith on the advice of qualified accountants and tax lawyers.

d. A small lagniappe to the taxpayers in a tax shelter. Klamath Strategic Investment Fund, LLC v. United States, 110 A.F.T.R.2d 2012-6021 (E.D. Tex. 9/24/12). On appeal, the Fifth Circuit Court of Appeals disallowed losses generated by a BLIPS tax shelter investment which was held to lack economic substance. *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009). The Court of Appeals remanded the case to the District Court to determine whether partnership operational expenses of $903,000 and fees for investment advice to the partner investors were deductible under § 212. Based on findings by the trial court, the Court of Appeals indicated that although the transaction lacked economic substance, the profit motive of the individual investors would permit the deduction of their economic outlays if the investors effectively controlled the partnership activities so that their profit motive would be attributable to the partnership. (The managing partners were held to have lacked the necessary profit motive to support the deductions.) The District Court (Judge Gilstrap) found that the partnerships were formed to effect an investment strategy selected by the investors, the managing partners were the managing partners "only because [the investors] made it so," the managing partners were confined to the investment strategy directed by the investors "who could shut down the whole process by withdrawing from the partnerships they had created." The court thus held that the investors were the parties having effective control over the partnerships. The court also held that $250,000 of investment fees paid to investment advisors who provided guidance with respect to the partnerships' foreign currency investments were deductible. The court concluded from its reading of the Court of Appeals remand that it had jurisdiction to order the refund in the partnership proceeding notwithstanding the fact that the expenses were not paid or incurred by the partnerships.

B. Identified "tax avoidance transactions"

There were no significant developments regarding this topic during 2012.

C. Disclosure and Settlement

1. Not all losses are tax shelter losses. Rev. Proc. 2013-11, 2013-2 I.R.B. 269 (12/06/12). This revenue procedure provides that certain losses are not taken into account in determining whether a transaction is a reportable transaction for purposes of the disclosure rules under Reg. § 1.6011-4(b)(5). However, these transactions may be reportable transactions for purposes of the disclosure rules under Reg. § 1.6011-4(b)(2), (b)(3), (b)(4), (b)(6), or (b)(7). Among the losses not subject to § 6011 are losses (1) with respect to the sale or exchange of property where the basis was determined with respect to *cash* paid by the taxpayer, or under §§ 358, 1014, 1015, or 1031(d); (2) from fire, storm, shipwreck, or other casualty, or from theft, as those terms are defined for purposes of § 165(c)(3); (3) from compulsory or involuntary conversions as described in § 1231(a)(3)(A)(ii) and (a)(4)(B); (4) to which § 475(a) or § 1256(a) applies; (5) arising from hedging transactions described in § 1221(b), if the taxpayer properly identifies the transaction as a hedging transaction, or from a mixed straddle account under Reg. § 1.1092(b)-4T; (6) attributable to the abandonment of depreciable tangible property that was used by the taxpayer in a trade or business and that has a basis determined in clause (1), *supra*; (7) arising from the bulk sale of inventory if the basis of the inventory is determined under § 263A; and (8) that are equal to, and determined solely by reference to, a payment of cash by the taxpayer.

D. Tax Shelter Penalties, etc.

There were no significant developments regarding this topic during 2012.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. The exclusivity of a gated parking lot for the neighborhood beach club has a tax price. Ocean Pines Association, Inc. v. Commissioner, 135 T.C. 276 (8/30/10). The taxpayer was a homeowners association that was tax-exempt under § 501(c)(4) as a not-for-profit organized to promote community welfare. In addition to enforcing zoning and providing roads and recreational facilities within Ocean Pines, funded by members' dues (but which were open to both members and nonmembers), it operated a beach club and parking lots eight miles from the area (Ocean Pines) in which its members lived. The primary beach club facilities (e.g., pool, locker room, etc.) and parking lots were accessible only to the association's members and their guests, but the snack bar, restaurant, and beach itself were open to the public. The taxpayer charged its members a separate fee for parking permits, and maintained a parking permit system and guards. It also leased the parking lots to third-party businesses at night and in the off season. The taxpayer did not report any of the income as subject to the unrelated business income tax (UBIT). The IRS issued a deficiency notice determining that the net income from the parking lots and beach club facilities was subject to UBIT, because their operation was not substantially related to the promotion of community welfare. The Tax Court (Judge Morrison) upheld the deficiency. The court concluded that the operation of the beach club and the parking lots did not promote community welfare because they were not accessible to nonmembers, i.e., the general public. Therefore, unless an exception applied, the income was subject to UBIT. Finally, the court held that the § 512(b)(3)(A)(i) exception for rents from real property did not apply because Reg. § 1.512(b)-1(c)(5) provides that income from the operation of a parking lot is not rent from real property.

a. Affirmed — Parking lots and a beach club that benefit only those who own property in a private community and their guests that provide "a private refuge for those who would live apart," do not promote social welfare. Ocean Pines Association, Inc. v. Commissioner, 672 F.3d 284 (4th Cir. 3/2/12). The Fourth Circuit (in an opinion by Judge Motz) affirmed the Tax Court's decision in favor of the government. The Court of Appeals made three key points. First, "facilities that do not permit access to the general public – like the parking lots and beach club – simply do not promote 'social welfare.'" Second, the court rejected the taxpayer's argument that "'social welfare' must be interpreted through the lens of the Association's charter, *which aims to promote the community welfare of the Association's members rather than that of the general public*," holding that "[n]otwithstanding the Association's charter, the purpose that constitutes the basis of the Association's exemption under § 501(c)(4) is its promotion of 'social welfare' *as defined by the statute and regulations*." (emphasis added by the court) Third, the court rejected the taxpayer's argument that "Congress's purpose in enacting the unrelated business income tax was to avoid unfair competition with private enterprise, and that a rule requiring a business operated by a 501(c)(4) organization to be open to the general public in order to avoid taxation would frustrate that purpose." Rather, the court held that "[t]he plain language of the statute and regulations speak with . . . clarity ... . [T]he only question . . . is whether the parking lots and beach club are 'substantially related' to the Association's tax-exempt purpose," which they were not. Thus, the income was subject to UBIT.

2. Proposed regulations on program-related investments. REG-144267-11, Examples of Program-Related Investments, 77 F.R. 23429 (4/19/12). The proposed regulations add nine examples depicting a wider range of investments that qualify as program-related investments. The new examples demonstrate that a program-related investment may accomplish a variety of charitable purposes, such as advancing science, combating environmental deterioration, and promoting the arts. Several examples also show that an investment funding activities in one or more foreign countries, including investments that alleviate the impact of a natural disaster or that fund educational programs for poor individuals, may further the accomplishment of charitable purposes and qualify as a program-related investment.

B. Charitable Giving

1. 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).

2. Both their house and their claimed charitable contribution deduction went up in smoke. Rolfs v. Commissioner, 135 T.C. 471 (11/4/10). The taxpayers donated a home, but not the underlying land, to the local volunteer fire department to be burned down in a training exercise. The fire department could not use the house for any purpose other than destruction by fire in training exercises. The taxpayers claimed a charitable contribution deduction of $76,000 based on a "before and after" valuation, comparing the value of the parcel with the building intact and the value of the parcel after demolition of the building; they complied with all record keeping and substantiation requirements. The Tax Court (Judge Gale) upheld the IRS's denial of the deduction. First, based on expert testimony, he found that the taxpayers received a quid-pro-quo in the amount of $10,000, which was the value of the demolition services provided to them by the donee fire department. Second, he found that the building, with ownership severed from the land and burdened by the condition that it be removed, i.e., in this case demolished, had no value. The lack of value was established by the expert testimony of home movers, who testified that considering the costs of removal to another site, the modest nature of the home, and the value of nearby land, no one would purchase the home for more than a nominal amount, between $100 and $1,000, sufficient to render the contract enforceable. Applying the principles of *Hernandez v. Commissioner*, 490 U.S. 680 (1989), and *United States v. American Bar Endowment*, 477 U.S. 105 (1986), Judge Gale held that because the consideration received by the taxpayers exceeded the value of the transferred property, there was no charitable contribution. He rejected application of the "before and after" valuation method, because that method did not take into account the restrictions that would have affected the marketability of the structure severed from the land.

a. While the Tax Court opinion is very fact specific, the Court of Appeals affirmance looks to establish a broader principle. Rolfs v. Commissioner, 668 F.3d 888 (7th Cir. 2/8/12). In an opinion by Judge Hamilton, the Seventh Circuit affirmed the Tax Court's decision. The Seventh Circuit concluded that "proper consideration of the economic effect of the condition that the house be destroyed reduces the fair market value of the gift so much that no net value is ever likely to be available for a deduction, and certainly not here." The appellate court reasoned that "the fair market valuation of donated property must take into account conditions on the donation that affect the market value of the donated property," and that the Tax Court properly rejected the before-and-after method for valuing a donation of property conditioned on the destruction of the property. The valuation must take into account any reduction in fair market value that results from the condition. Moving and salvage, under which the house had no actual value, were analogous situations reasonably approximated the actual facts. The before-and-after valuation method proffered by the taxpayer was not appropriate, because the facts were not analogous to conservation easements, where that method typically is used; in this case the donation destroyed the residential value rather than transferring it.

b. Another burning house charitable contribution deduction goes up in smoke. Patel v. Commissioner, 138 T.C. No. 23 (6/27/12). In 2006 the taxpayers purchased residential property with the intention to demolish the house and construct a new one on the site. Shortly after purchasing the property, the taxpayers obtained a demolition permit and executed documents granting the local fire department the right to conduct training exercises on the property and to destroy the house by burning during the exercises. Soon thereafter live fire training exercises were conducted, and the house was destroyed. The taxpayers claimed a noncash charitable contribution of $339,504 for the donation of the house to the fire department, but the IRS disallowed the deduction on the ground that the donation was a contribution of a partial interest in property, a deduction for which is denied by § 170(f)(3). In a reviewed opinion by Judge Dawson, the Tax Court granted summary judgment for the IRS and upheld the denial of the deduction. The court reasoned that under the controlling (Virginia) state law, the taxpayers had merely granted the fire department a license to conduct training exercises on the property and to destroy the building, which did not convey any interest in the building to the fire department. In doing so, they conveyed only a partial interest in the land. Section 170(f)(3) thus denies any charitable contribution deduction for the donation of the use of the property regardless of the value of that use. However, the taxpayers acted with reasonable cause and in good faith and were not liable for any accuracy-related penalty under §§ 6662(a) or (h), because at the time they filed their return, *Scharf v. Commissioner*, T.C. Memo. 1973-265, which held that a charitable contribution deduction was available for the donation of a building to a volunteer fire department for demolition in firefighter training exercises, was the only relevant case law.

- An appendix explained that a license does not convey an interest in the property under the common law in any state or the District of Columbia.
- Judges Colvin, Cohen, Vasquez, Thornton, Marvel, Gustafson, and Morrison joined in the opinion of the court. Judge Paris concurred in the result only.
- Judge Gale, in an opinion joined by Judges Halpern, Foley, Goeke, Wherry, Kroupa, and Holmes, dissented. The dissent reasoned that the taxpayers had not merely granted a license, but "by virtue of the fire department's severance and destruction of the house, petitioners in substance ceded all substantial property interests they held in the structure to the department." Citing *Rolfs v. Commissioner*, 668 F.3d at 888 (7th Cir. 2012), *aff'g* 135 T.C. 471 (2010), in which Judge Gale wrote the Tax Court opinion, the dissent noted that to be entitled to a charitable contribution deduction, the taxpayers "must show that the value of the house, taking into account the conditions on its donation, exceeded the value of the benefit they received from the fire department in the form of demolition services." Thus the dissenters would have denied the motion for summary judgment and proceeded to trial on that fact question.
- Judge Kerrigan dissented but did not join in Judge Gale's dissent or write separately.

3. Mining is not the highest and best use for land that no one actually wants to mine. Esgar Corp. v. Commissioner, T.C. Memo. 2012-35 (2/6/12). The taxpayers granted conservation easements in certain land that was zoned irrigated, agricultural, and which had historically been used as irrigated and unirrigated farmland. The land was not permitted for any mining, but absent the donations it was likely that the necessary permits to mine (gravel) could have been obtained. The terms of the conservation easements provided the donee organization perpetual rights to preserve the natural and open space conditions and protect the wildlife, ecological, and environmental values and water quality characteristics of the property. The conservation easements specifically prohibited the mining or extraction of sand, gravel, rock, or any other mineral. The taxpayers valued the easement donation under the "before and after method," treating the highest and best use before the donation as gravel mining. The Tax Court (Judge Wherry) held that the before highest and best use was agricultural, not mining.

> Where . . . an asserted highest and best use differs from current use, the use must be reasonably probable and

> have real market value. . . . "Any suggested use higher than current use requires both 'closeness in time' and 'reasonable probability'". *Hilborn v. Commissioner*, [85 T.C. 677, 689 (1985)]. Any proposed uses that "depend upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable" are to be excluded from consideration. *Olson v. United States*, 292 U.S. 246, 257 (1934).
>
> Where the asserted highest and best use of property is the extraction of minerals, the presence of the mineral in a commercially exploitable amount and the existence of a market "that would justify its extraction in the reasonably foreseeable future" must be shown. *United States v. 69.1 Acres of Land*, [942 F.2d 290, 292 (4th Cir. 1991)]. "There must be some objective support for the future demand, including volume and duration. Mere physical adaptability to a use does not establish a market."

- Based on detailed examination of the facts and expert witness reports, the evidence did not prove that a hypothetical willing buyer in the year of the donation would have considered the land as the site for construction of a gravel mine. "While it would have been physically possible to mine the properties in 2004 (or in the future), there was no unfilled demand and there was no unmet market." Instead, Judge Wherry found that there were comparable sales upon which a before valuation of the contribution could be based. However, Judge Wherry declined to uphold the § 6662(b)(3) substantial valuation penalty asserted by the IRS because he found that the taxpayers relied in good faith on the appraisers and the accounting firm they hired as advisors.

4. Judge Wells analyzed in detail the expert testimony concerning four donated conservation easements in the Columbus, Georgia area. Butler v. Commissioner, T.C. Memo. 2012-72 (3/19/12). Taxpayers claimed about $10 million of charitable contribution deductions for four donated easements on large tracts of rural land located in the direction of the expansion of the city of Columbus, Georgia. The Tax Court (Judge Wells) allowed deductions totaling about $6.5 million. He analyzed in detail the reports and testimony of the appraisers for both taxpayers and the IRS in a lengthy opinion, including a consideration of the various appraisal methods used, particularly the discounted cash flow method, the comparable sales method and the so-called "comparable easements" method. It also deals with the difference between the last two methods, the latter of which arrives at a percentage diminution in value caused by the donated easement.

- As an initial matter, the Tax Court (Judge Wells) concluded that the taxpayer had produced credible evidence as required by § 7491(a) with respect to the factual issues regarding whether their conservation easements satisfied the requirements of § 170(h), thus shifting the burden of proof to the IRS. The purposes of the easements were to provide a significant wildlife resource for the region and enhance the natural aesthetics of the area; the site offered forage, nesting habitat, and shelter; the public would be benefitted by cleaner air and water, plentiful game for hunting, and natural beauty in the area. Among the uses prohibited by the conservation easements were mineral exploitation, "commercial or industrial facilities (other than those necessary in the operation or uses of the Property expressly permitted by the Easement), dumping, billboards, commercial towers, and mobile homes or recreational vehicles." The conservation deeds did not permit the general public to access the properties. The conservation deeds reserved numerous rights for the taxpayer. The taxpayer (or future owners) could partition one of the properties into smaller tracts averaging 36 acres, each of which would include a 2-acre building site on which a home and a garage could be constructed and could build on one two-acre building site on the other property. Roads or driveways could be constructed to access the buildings. The taxpayer (or future landowners) could operate small-scale farms and could use agrichemicals to eliminate "noxious weeds" subject only to the exhortation that they "minimiz[e] the impact upon non-noxious foliage and vegetation." They could construct dams to create ponds for recreation or irrigation, and they could construct docks, gazebos, and "related recreational structures." They could clear timber for agricultural uses, clear brush and remove trees for "aesthetic" purposes, and plant nonnative species of trees or other plants. The conservation deeds also permitted a wide variety of other uses provided that those uses do not result in "demonstrable degradation to the Conservation Values," including the construction of fences, the construction of other roads besides those that access the building sites, the construction of an unlimited number of barns and sheds for agricultural or recreational use on any portion of the property (not just the two-acre building sites), and commercial timber harvesting pursuant to an approved timber management plan. The donee had the right to determine whether such uses would result in degradation to the conservation values. Judge Wells held that these reserved rights were not inconsistent with the conservation purpose and allowed the deduction. Even if fully exercised, the rights would not destroy the habitats and high-quality ecosystems on the property.
- Judge Wells refused to uphold substantial understatement penalties because taxpayers throughout the process had had "reasonable cause and acted in good faith" by relying on their long-term attorney and accountant. The attorney also helped taxpayers in selecting Conservation Advisors, L.L.C., a real estate firm specializing in conservation conveyances, which in turn helped them select qualified and experienced

appraisers who "had access to sufficient information to value the conservation easements."

5. 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. No. 16 (4/3/12). In 2003, the taxpayer contributed a conservation easement 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.

6. 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.

a. **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.

b. **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. Commissioner, 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."[6] 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.

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.

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6. 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.

- 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."

7. But 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) has 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 (2012), that the unlikelihood of default is irrelevant.

8. If the donee messes up on the written acknowledgement, your only recourse is to have the chaplain punch your Tare Sugar chit [Tango Sierra chit, if you were in the military after the 1950s] because Judge Cohen won't help you. Durden v. Commissioner, T.C. Memo. 2012-140 (5/17/12). A letter from taxpayers' church, dated 1/10/08, acknowledged numerous contributions during 2007, mostly in amounts of $250 or more, totaling $22,517; however the letter lacked a statement that no goods or services were provided to taxpayers in exchange for their contributions. A second letter from the church contained that statement but was dated 6/21/09 — after the IRS sent a notice of deficiency disallowing most of the claimed charitable contribution deductions. The Tax Court (Judge Cohen) held that the second letter was untimely and the first letter was insufficient, so the taxpayers' charitable contributions of $250 or more were disallowed under § 170(f)(8).

- Unless there are damning facts not reflected in the opinion, shouldn't there have been a better way for the IRS to have handled this matter?

9. You can't be your own appraiser, even if you might be qualified! "A taxpayer relies on his private interpretation of a tax form at his own risk." Mohamed v. Commissioner, T.C. Memo. 2012-152 (5/29/12). The taxpayer, a real-estate broker and certified real-estate appraiser, donated five real estate properties worth millions of dollars to a charitable trust. The taxpayer prepared his own tax return, including the Form 8283, Noncash Charitable Contributions, claiming charitable contribution deductions of over $3,000,000, even though the properties were worth over $15,000,000. The taxpayer left blank the Declaration of Appraiser because it stated, "I declare that I am not the donor, the donee, a party to the transaction," and he recognized that he was the donor (and the donee, since he was trustee of the Trust), but he did sign the Donee Acknowledgment saying that the Trust was a qualified organization under § 170(c) and that the Trust had actually received the claimed donations. The taxpayer also attached two statements to the tax return. The first was captioned "Statement of Explanation for Entry on Line 6 of Schedule A," and gave the addresses of the properties, more detailed descriptions of their size and improvements, and values for the properties. The second one, titled "Appraised Market Values," elaborated on the appraisal. He signed the second document, and under his signature indicated that his title was "Real Estate Broker/Appraiser." In the course of an audit over valuation, the taxpayer hired an independent appraiser whose valuations were relatively consistent with the taxpayer's valuations, but the IRS thereupon asserted that no deduction was allowable for failure to comply with the Reg. § 1.170A-13(c) substantiation requirements, which among other things require a "qualified appraisal," which under the regulations cannot be the donor or taxpayer claiming the deduction or the donee of the property. The taxpayer thus was not a qualified appraiser, and his attachments to the tax return did not qualify as the required appraisal summary that must be attached to the return because they failed to include information about several of the required categories on Forms 8283 and the attached statements. The Tax

Court (Judge Holmes) granted summary judgment to the IRS, upholding the validity of the regulations — no surprise — and finding that the taxpayer had failed to satisfy the "substantial compliance" doctrine, because "[t]he cases make clear that substantial compliance requires a qualified appraisal," but excuses certain other minor deviations from the regulations requirements. Lastly, Judge Holmes rejected the taxpayer's "last-ditch effort" to save the deductions by arguing that Form 8283 for the years in question did not indicate that a taxpayer had to get an independent appraisal for contributions worth more than $5,000 and presented conflicting messages about what could be filled out by the taxpayer and what required an appraiser's signature. "We can't hold the form's failings against the Commissioner here, because 'the authoritative sources of Federal tax law are in the statutes, regulations, and judicial decisions and not in such informal publications.'"

10. According to Judge Wells, you can write your own acknowledgment of the donee's receipt of your charitable contribution. <u>Averyt v. Commissioner</u>, T.C. Memo. 2012-198 (7/16/12). The Tax Court (Judge Wells) held that a conservation easement deed reciting that the easement had been conveyed for "no consideration" satisfied the requirements of § 170(f)(8), even though the letter from the donee organization acknowledging the contribution did not satisfy § 170(f)(8) because it failed to state that no goods or services were received in exchange for the contribution. The letter recited that the taxpayer's sons had received "pens and pencils," which it was stipulated never had been received, but the letter nevertheless did not qualify, even though the pens and pencils would have had only nominal value, because the letters did not comply with the requirements of Rev. Proc. 90-12, § 2.05, 1990-1 C.B. 471, 472 (because the contribution was not pursuant to a fund-raising campaign).

- Section 170(f)(8)(B) provides that the contemporaneous written acknowledgment must include the following information: (i) The amount of cash and a description (but not value) of any property other than cash contributed; (ii) Whether the donee organization provided any goods or services in consideration, in whole or in part, for any property described in clause (i); (iii) A description and good faith estimate of the value of any goods or services referred to in clause (ii). Section 170(f)(8)(C) defines a "contemporaneous" acknowledgment as one received on or before the earlier of: (i) the date on which the taxpayer files a return for the year when the contribution was made; or (ii) the due date for that return, including any extensions.

11. Another case allowing the taxpayer to write the receipt. You just have to remember to get it countersigned by the donee. <u>RP Golf, LLC v. Commissioner</u>, T.C. Memo. 2012-282 (10/3/12). The Tax

Court (Judge Paris) held that a conservation deed signed by donee trust's representative, as well as by donor, satisfied the § 170(f)(8) written acknowledgment requirement. The deed provided detailed description of property and easement, and was contemporaneous with donation. The deed "stated that the conservation easement was an unconditional gift, recited no consideration received in exchange for it, and stipulated that it constituted the entire agreement between the parties with respect to the contribution of the conservation easement." Accordingly, the "deed, taken as a whole, stated that no goods or services were received in exchange for the contribution."

12. Maybe it's time for the IRS to stop trying to deny conservation easement deductions due to imaginary foot faults. Irby v. Commissioner, 139 T.C. No. 14 (10/25/12). The Tax Court (Judge Jacobs) allowed a charitable contribution deduction for the contribution to a qualified organization, via a bargain sale, of conservation easements that placed on the use of property a variety of limitations that served to protect the relatively natural habitat for fish, wildlife, and plants and to preserve open space and agricultural resources. Although the donee was required to reimburse the government agencies that funded the bargain purchase price in the event it received proceeds if the land to which the easements related was condemned and the easements were extinguished, the conservation purpose for the easements was protected in perpetuity. The donee would have received its full share of the condemnation proceeds vis-a-vis the donor taxpayers, and there was no risk that the donors would reap a windfall in the event of condemnation. While the donee was required to reimburse the funding governments, the requirement of Reg. § 1.170A-14(g)(6)(i) that all of the extinguishment proceeds would be used by donee in a manner consistent with the conservation purposes of the original contribution was met because the reimbursement under the terms of the conservation deeds would enhance the ability of the funding governmental agencies to conserve and protect more land, since the reimbursed funds would be used for that purpose. Judge Jacobs rejected the IRS's argument that the deduction should be denied on the ground that the taxpayer's appraisal report was not a "qualified appraisal" because the report did not include explicit statements that the appraisal was prepared for income tax purposes.

> [T]he appraisal report in this case included all of the required information either in the appraisal or in the appraisal summaries attached to petitioners' respective returns—it included a discussion of the purpose of the transaction (i.e., that the purpose of the appraisal was to value the donation of a conservation easement pursuant to the terms of section 170(h)) . . . ; it stated that fair market valuation was to be used in determining the value of the property; and Form 8283 was properly filed with petitioners'

> respective returns. The IRS has not provided to the public a specific form for the tax purpose statement, and respondent has not proffered any instance where a suboptimal tax purpose statement, by itself, invalidated an otherwise qualified appraisal.

- Finally, Judge Jacobs rebuffed the IRS's argument that the deduction should be disallowed on the ground that the taxpayers did not obtain contemporaneous written acknowledgments from the donee indicating the amount of goods or services that received for the contribution. He concluded that collectively (1) the option agreement between the donors and the donee, (2) the Forms 8283 attached to the taxpayers' tax returns, (3) letters from the donee to the donors states that it was a qualified § 170(h) organization and would receive and hold the conservation deeds with respect to the parcels, (4) the settlement statements prepared by the title company in the transaction, which list the amounts paid as part of the bargain sale, and (5) the conservation deeds, which stated the source of funding for the bargain purchase, described the donated property, and listed the responsibilities and rights that the donors and donees had regarding the enforcement of the easement — all of which were prepared before the taxpayers income tax returns were filed — contained sufficient information to constitute a contemporaneous written acknowledgment despite the absence of any statement that no services were received by the donors (because goods were received by the donors in their bargain sales).

13. Contributions to a disregarded entity owned by a charity. Notice 2012-52, 2012-35 I.R.B. 317 (7/31/12). This Notice holds that the IRS will treat a contribution to a disregarded single member LLC that is wholly owned and controlled by a U.S. charity as a charitable contribution to a branch or division of the U.S. charity.

14. No Mardi Gras beads from the Tax Court for this taxpayer. Whitehouse Hotel Limited Partnership v. Commissioner, 131 T.C. 112 (10/30/08). The Tax Court (Judge Halpern) held that, as a precondition to using the replacement cost approach to valuing real estate, the taxpayer must show that the property is unusual in nature and other methods of valuation, such as comparable sales or income capitalization, are not applicable. The income approach to valuation is favored only where comparable market sales are absent. On the facts, the value of the contribution of a conservation facade easement for an historic structure on the edge of the French Quarter in New Orleans was overstated. The accuracy-related penalty for gross overvaluation was proper because there was no good faith investigation into the value.

a. Regardless of which valuation method is used, it still must relate to the property's "highest and best use." Whitehouse Hotel Limited Partnership v. Commissioner, 615 F.3d 321 (5th Cir. 8/10/10). In an opinion by Judge Barksdale, the Fifth Circuit vacated the Tax Court's decision and remanded the case for a determination of the easement's value, although it rejected the taxpayer's arguments that the IRS's expert was unqualified and that his report was unreliable and should not have been admitted. But the Court of Appeals agreed with the taxpayers' argument that the Tax Court "miscomprehended the highest and best use" of the building subjected to the conservation easement, and thereby undervalued the easement.

> In sum, the tax court erred in declining to consider the Maison Blanche and Kress buildings' highest and best use in the light of both the reasonable and probable condominium regime and the reasonable and probable combination of those buildings into a single functional unit, both of which foreclosed the realistic possibility, for valuation purposes, that the Kress and Maison Blanche buildings could come under separate ownership. This combination affected the buildings' fair market value.

- As result the court did not reach the Tax Court's holding that the income and replacement-cost methods of valuation were inapplicable and directed the tax court to consider those methods, in addition to comparable sales method on remand. Because the holding on the valuation was vacated, the Tax Court's holding that the gross overvaluation penalty also was vacated.

b. Judge Halpern reconsiders the whole case in light of the Fifth Circuit decision and increases the allowable deduction by only $65,415, from $1,792,301 to $1,857,716. Whitehouse Hotel Limited Partnership v. Commissioner, 139 T.C. No. 13 (10/23/12). On remand, Judge Halpern elaborated at length on the proper valuation method to be used to value the building under the "before and after" method, and once again accepted the IRS's argument that the value of the property should be determined using a comparable-sales method. The comparable-sales method applied by Judge Halpern was based on the sales of buildings suitable for conversion into hotels based primarily on local sales data, rejecting the taxpayer's argument that non-local sales data should be taken into account. He again rejected both the taxpayer's reproduction-cost method and income method to valuation. Judge Halpern explained that "[t]he reproduction cost of an historic building usually bears little relationship to its present economic value. Such cost is usually far in excess of the cost of construction of a similarly sized modern structure, and may reflect the price of materials and workmanship that are no longer readily available." Because reconstruction of the Maison Blanche Building, if destroyed, would not have been a reasonable business venture, there was no probative correlation between the taxpayer's expert's estimate of the reproduction cost of the Maison Blanche Building and the fair market value of the property. Judge Halpern rejected the income valuation method because in this case, where there was no ongoing business, it was based on too many contingencies, was inadequately developed, and thus was too speculative, particularly where the value could be established by comparable sales. He did not reject the income method of valuation as a matter of law. He stated: "We have no difficulty with the process. Where we have difficulty is with petitioner's call to trust on their face [the taxpayer's expert's] judgments as to values to be input to his model." Judge Halpern also again found that the easement conveyance did not deprive the partnership or any subsequent owner of the ability to add stories to the top of the Kress Building or blocking views of the Maison Blanche facade. However, in light of the Fifth Circuit's directive, Judge Halpern determined the value of the facade conservation easement based on the before- and after-restriction values of the combined Maison Blanche and Kress Building property. He concluded that the value of the easement was approximately $1.86 million, rather than $1.79 million as determined in his first opinion. Responding to the Fifth Circuit's determination that he had misapprehended the properties highest and best use, Judge Halpern reasoned that "although the highest and best use of property may determine a ceiling on how much a willing buyer would pay for the property, it does not necessarily determine a floor on how little a willing seller would accept. . . . [T]he hypothetical willing buyer and the hypothetical willing seller who populate our standard definition of fair market value will not invariably conclude their negotiation over price at a price reflecting the value of the property at its highest and best use." He turned to auction price theory to conclude that in determining the fair market value of the property, which is the relevant benchmark, "the equilibrium price at which the willing buyer and the willing seller would meet would be somewhere between the value of the property taking into account its most productive use (i.e., its highest and best use) and the value of the property taking into account its second most profitable use." Accordingly, he rejected the taxpayer's argument that the valuation should be based on the use of the buildings as the shell of a luxury hotel, there being no scarcity of buildings in New Orleans suitable for development as luxury hotels. "Only if there were sufficient scarcity would the partnership . . . capture a piece of the economic return to luxury hotel development of the building's shell." Finally, based on the $1.86 million value, the claimed value of the exceeded 400 percent of the actual value and the § 6662(h) gross valuation misstatement penalty applied. The § 6664(c) reasonable cause and good-faith exceptions did not apply, because

Whitehouse failed to make a good-faith investigation of the value of the easement and did not reasonably rely on an appraisal.

15. **Congress wants old folks to give their IRAs to charity.** The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 208(b)(2), retroactively extends the allowance of Code § 408(d)(8) that permits taxpayers 70½ years or older to take a $100,000 IRA distribution and contribute it to charity without recognizing income and without affecting the charitable contribution limitation of § 170 to contributed distributions made in tax years before 1/1/14. In addition, taxpayers may elect to treat distributions made in January 2013 as made on 12/31/12. Taxpayers are also allowed to elect to treat any distribution in December 2012 as a qualified charitable distribution if the distribution was transferred in cash to a charitable organization by 1/31/13.

16. **Let's go green for a few more years**; **contributions of conservation easements.** The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 206, extended through 2013 the provisions of Code § 170 allowing a deduction for a qualified conservation contribution made by an individual or corporate farmer or rancher in tax years beginning after 12/31/05 of up to 100% of the taxpayer's taxable income. The limits under Code § 170(e) are 50% of the taxpayer's charitable conservation base over other allowable charitable contributions, 100% for farmers and ranchers, with a fifteen year carryforward.

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. **The instructions for the new FBAR are FUBAR.** IR-2009-58 and Announcement 2009-51, 2009-1 C.B. 1105 (6/5/09). The IRS announced that for the Reports of Foreign Bank and Financial Accounts (FBARs) due on 6/30/09, filers of Form TD F 90-22.1 (Rev. 10-2008) need not comply with the new instruction relating to the definition of a United States Person, i.e.:

> **United States Person.** The term "United States person" means a citizen or resident of the United States, or a person in and doing business in the United States. See 31 C.F.R. 103.11(z) for a complete definition of 'person.' The United States includes the states, territories and possessions of the United States. See the definition of United States at 31 C.F.R. 103.11(nn) for a complete definition of United States. A foreign subsidiary of a United States person is not required to file this report, although its United States parent

> corporation may be required to do so. A branch of a foreign entity that is doing business in the United States is required to file this report even if not separately incorporated under U.S. law.

- Instead, for this year, taxpayers and others can rely on the definition of a United States person included in the instruction to the prior form (7-2000):

> **United States Person.** The term "United States person" means: (1) a citizen or resident of the United States; (2) a domestic partnership; (3) a domestic corporation; or (4) a domestic estate or trust.

a. Notice 2009-62, 2009-2 C.B. 260 (8/7/09). By this notice, the IRS extended the filing deadline until 6/30/10 to report foreign financial accounts on Form TD F 90-22.1 for persons with signature authority over (but no financial interest in) a foreign financial account and persons with signature authority over, or financial interests in, a foreign commingled fund.

b. Still clear as mud: New definitions and instructions. RIN 1506-AB08, Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations – Reports of Foreign Financial Accounts, 75 F.R. 8844 (2/26/10). This proposed rule would include a definition of "United States person" and definitions of "bank account," "securities account," and "other financial account," as well as of "foreign country." It also includes draft instructions to Form TD F 90-22.1 (FBAR).

(1) Notice 2010-23, 2010-1 C.B. 441 (2/26/10). Provided administrative relief to certain person who may be required to file an FBAR for the 2009 and earlier calendar years by extending the filing deadline until 6/30/11 for persons with signature authority, but no financial interest in, a foreign financial account for which an FBAR would have otherwise been due on 6/30/10. It also provides relief with respect to mutual funds.

(2) Announcement 2010-16, 2010-1C.B. 450 (2/26/10). The IRS suspended, for persons who are not U.S. citizens, U.S. residents, or domestic entities, the requirement to file an FBAR for the 2009 and earlier calendar years.

c. Second (or, is it the third?) special voluntary disclosure initiative available through 8/31/11. IR-2011-14 (2/8/11). The 2011 Offshore Voluntary Disclosure Initiative is similar to the 2009 Offshore Voluntary Disclosure Program with a 25-percent penalty and an 8-year look-back requirement (both slightly-increased from 2009). There are lower penalties in some limited situations (5 percent), and where offshore accounts do not surpass $75,000 (12.5 percent). All original and amended tax returns must be filed and payment of all taxes, interest, and penalties must be made by the 8/31/11 deadline.

- Subsequent Q&As offer the possibility of a 90-day extension to complete the voluntary disclosure where total compliance had not been made by the deadline despite good faith attempts. See Q&A 25.1.

d. Additional relief for persons with signature authority. Notice 2011-54, 2011-29 I.R.B. 53 (6/16/11). Provides additional relief to persons whose requirement to file Form TD-F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), for calendar year 2009 or earlier calendar years was based solely upon signature authority. Their deadline is now 11/1/11. The deadline for reporting signature authority over, or a financial interest in, foreign financial accounts for the 2010 calendar year was 6/30/11.

- Reporting problems occur for former employees, as well as with respect to foreign accounts that give signature authority to “all officers.“

e. Complying with FATCA may cause tax return preparers to become confused. IR-2011-117 (12/14/11). An information return on Form 8938 must be filed by individuals with more than the threshold amount for foreign financial assets. It will serve as a check on foreign financial institutions providing Form 1099 with respect to income from such assets.

f. And the proposed FATCA regulations place an unwanted burden on foreign financial institutions to the point that many of them refuse to open accounts for U.S. citizens. REG-121647-10, Regulations Relating to Information Reporting by Foreign Financial Institutions and Withholding on Certain Payments to Foreign Financial Institutions and Other Foreign Entities, 77 F.R. 9022 (2/15/12). The Treasury Department has published proposed regulations under §§ 1471 through 1474, regarding information reporting by foreign financial institutions (FFIs) with respect to U.S. accounts and withholding on certain payments to FFIs and other foreign entities. These regulations affect persons making certain U.S.-related payments to FFIs and other foreign entities and payments by FFIs to other persons.

g. ♪♫ “This is a song that doesn’t end. / It goes on and on, my friend ….” ♫♪ Third (or fourth) voluntary disclosure program is announced. IR-2012-5 (1/9/12). The IRS has announced the reopening of the offshore voluntary disclosure program (OVDP) following the closure of the 2011 and 2009 programs. There is no set deadline within which to apply, but the program could be changed or terminated at any time. The penalty structure for the program will be similar to the 2011 program except the highest penalty will be 27.5 percent instead of 25 percent. Details are available on the IRS website.

2. A careful reading of this criminal tax fraud case should put the fear of God, or at least of the CID and DOJ, in the hearts of many tax shelter investors. United States v. Rozin, 664 F.3d 1052 (6th Cir. 1/6/12). The Sixth Circuit, in an opinion by Judge Rogers, upheld the defendant's conviction for criminal tax fraud. The defendant had claimed business and individual tax deductions for the cost of so-called "loss of income" (LOI) insurance policies, although the insurance aspect of the policies was questionable, and the policies allegedly permitted the defendant to reclaim or maintain control of the amount paid as premiums. The LOI policies insured against loss of income due to certain circumstances, including corporate downsizing, changes in technology, or employee layoffs arising within one year from the date the policy was issued, but did not cover the following: death; disability; voluntary termination; self-inflicted injuries; proven criminal acts; negligent or willful misconduct; substance abuse; dishonesty or fraud; insubordination, incompetence, or inefficiency; conflict of interest; or breach of employment contract. In conjunction with the LOI insurance policy, the defendant also purchased from the same "return of premium" (ROP) riders. If no claim was filed on the LOI policy, under the rider the LOI premium would be invested for the policy owner and would be distributed to the owner after ten years or at age sixty-five. According to the promotional materials, the LOI premium payments (but not the rider) were deductible. In convicting the defendant of tax evasion and conspiracy to defraud the IRS, the District Court noted:

> (1) the lack of a "true business purpose for purchasing the various LOI policies," (2) the "dubious nature" of the policies, including the high premium to coverage ratio, as well as the practice of backdating, (3) Rozin's access to and control over the funds, (4) Rozin's descriptions of the policies to [friends to whom he recommended the scheme] as "tax-savings product[s]," and (5) the differences between the policies Rozin bought and those that were advertised in [the insurance broker's] promotional materials.

The District Court held that "Rozin did not have a good faith reliance defense because he withheld relevant information and had reason to suspect the motives of the individuals on whom he supposedly relied." In upholding the conviction, the Court of Appeals made the following points:

(1) "Though peddled as 'insurance,' . . . the covered risks — corporate downsizing, employee layoffs, and technological obsolescence – were unlikely to happen to Rozin because he was an owner of a carpet company. Many of the most obvious causes of loss of income, such as death, disability, voluntary termination, and breach of contract, were not covered, and Rozin, Inc. was not under any immediate threat of bankruptcy." In addition, unlike other legitimate insurance policies, Rozin maintained control of the funds; when pitching the LOI policies to potential buyers, Rozin described them as "a way to lower your taxes" while also receiving "a large percentage of that money back."

(2) "[B]ackdating the LOI policies showed willfulness, because there was no reason for such backdating other than to claim the improper tax deductions."

(3) "When selling the LOI policies to friends, Rozin stated outright that about eighty-five percent of the money would 'come back and be held in a trust' that the individual would 'have control over.' Evidence that Rozin knew that he would have access to most of his money, while reaping the benefits of a large tax deduction, would permit a rational trier of fact to find that he willfully utilized the LOI policies in order to evade taxes."

(4) "Because Rozin either did not provide full information to those he supposedly relied upon, or he had reason to believe that the advice provided by these individuals was incorrect, the district court correctly held that Rozin could not mount a credible good faith reliance defense."

(5) "Because [the CPA who prepared the tax returns] was not aware of the full facts regarding the LOI policies, Rozin cannot claim that he relied on [his] advice in good faith."

(6) "Rozin did not rely on Cohen, let alone rely on Cohen in good faith. . . . Cohen also told Rozin that if the IRS did 'challenge the deduction,' the worst thing that Rozin would have to do would be to pay the taxes owed plus interest. Noting the possibility that the IRS could challenge the deduction should have raised a red flag for Rozin, giving him reason to suspect that the information Cohen provided him was incorrect. In addition . . . Cohen's motivations were at least suspect because he received commissions from the sale of the LOI policies."

- If those "factors" don't describe a lot of tax shelter investors to a "T," we don't know what does!

3. Hiding funds to try to cheat creditors isn't the same as hiding them to try to cheat the IRS, even if the effect is the same. Avenell v. Commissioner, T.C. Memo. 2012-32 (2/2/12). The taxpayer diverted funds from the corporation (Tacon) of which he was the president and a 96 percent shareholder. The primary issue in the case was not whether he was liable for income taxes on the diverted funds, but whether he was liable for the civil tax fraud penalty. The taxpayer, represented by Larry

Sherlock of the Chamberlain Hrdlicka firm, argued that he did not divert the funds with intent to evade tax but rather to hide the funds from a judgment creditor of the corporation. Even though part of the taxpayer's behavior included the use of a Cayman Island bank account, Judge Kroupa held that the IRS had failed to prove fraud by clear and convincing evidence. She reasoned that "he did not understand that Tacon was a separate entity and that Tacon's funds were different and separate from his own. . . . [S]pending company funds for personal use is not per se fraudulent. . . . [P]etitioner's actions stemmed from an intent to avoid judgment collection coupled with a lack of sophistication about and attention to legal obligations and financial details."

4. Inconsistent Forms 1099 from year to year for the same payment give rise to a "reasonable cause" defense to accuracy related penalties. Sewards v. Commissioner, 138 T.C. No. 15 (4/2/12). The taxpayer, who had been a policeman until he retired following a service related injury, was eligible for two types of retirement plans: (1) a service retirement based on his length of service (service retirement) and (2) a service-connected disability retirement based on his service-connected injuries (SCD retirement). Under the SCD plan, a policeman was eligible for a benefit equal to the greater of (1) one-half of final salary, or (2) the service retirement benefit. One-half of the taxpayer's salary was $7,046 annually while the service benefit was $12,861. The taxpayer originally received 2001 and 2002 Forms 1099-R indicating that his service retirement payments were fully taxable. After his SCD retirement became effective, he received amended 2001 and 2002 Forms 1099-R indicating that the taxable amount was not determined. He subsequently received 2003, 2004, and 2005 Forms 1099-R also indicating that the taxable amount was not determined. A letter dated December 20, 2006, notified the taxpayer that beginning in 2006 benefits equal to 50 percent of his final compensation would be reported as taxable, and he received a 2006 Form 1099-R indicating a portion of his SCD retirement payments was taxable, but the taxpayer did not report any of his benefits as taxable income. The Tax Court (Judge Foley) held that an amount equal to the minimum payment under the SCD retirement plan — one-half of final salary — was excludable under § 104(a)(1) as an amount received pursuant to a workmen's compensation act or a statute in the nature of a workmen's compensation act. But the remaining benefit was not excludable because it was determined by reference to the employee's age or length of service, citing Reg. § 1.104-1(b). However, Judge Foley declined to uphold the § 6662 accuracy-related penalties imposed by the IRS. He held that the taxpayer had reasonable cause because over the course of several years the Forms 1099 varied.

5. Filing a false return or aiding and abetting the filing of a false return by a lawful permanent resident alien carries a really stiff penalty. Bye-bye America! Kawashima v. Holder, 132 S. Ct. 1166 (2/21/12). In a 6-3 decision written by Justice Thomas, the Supreme Court held that a lawful permanent resident alien could be deported as a result of conviction of willfully making and subscribing a false (not necessarily fraudulent) tax return, which is a criminal offense under § 7206(1), or a conviction for aiding and assisting in the preparation of a false tax return, which is a criminal offense under § 7206(2). The convictions qualified as crimes involving fraud or deceit under 8 U.S.C. § 1101(a)(43)(M)(i) (Clause (i)) and thus were aggravated felonies for which the taxpayers could be deported under 8 U.S.C.§ 1227(a)(2)(A)(iii).

- Justice Ginsburg's dissenting opinion makes a great deal of sense.

6. The Steve Martin excuse[7] doesn't work in the Seventh Circuit. Failure to file for nearly twenty years isn't mere negligence. United States v. Collins, 685 F.3d 651 (7th Cir. 7/6/12). The defendant, who failed to file income tax returns for almost twenty years, was convicted of tax evasion. On appeal, he argued that the use of the Seventh Circuit pattern jury instructions for tax evasion was erroneous because they did not distinguish the crime of tax evasion from a "mere negligent failure to file a tax return." The Court of Appeals (Judge Sykes) affirmed, stating that "it's not remotely plausible to attribute a tax delinquency of almost two decades to mere negligence." A jury does not need to "be specifically instructed that 'willful' tax evasion requires more than a mere negligent failure to file a return."

7. The IRS tells you how to apologize for filing a frivolous return and get the penalty reduced, but only once. Rev. Proc. 2012-43, 2012-49 I.R.B. 643 (11/5/12). This revenue procedure describes the limited circumstances in which a person may be eligible for a one-time reduction of any unpaid § 6702 frivolous return penalty. If a person satisfies all eligibility criteria, including filing all tax returns and paying all outstanding taxes, penalties (other than under § 6702), and related interest, the IRS will reduce all unpaid § 6702 penalties assessed against that person to $500.

8. Instructions on how to rat yourself out. Rev. Proc. 2012-51, 2012-51 I.R.B. 719 (11/26/12). This revenue procedure updates Rev. Proc. 2012-15, 2012-7 I.R.B. 369 and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an

7. "I forgot."

item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and for the purpose of avoiding the tax return preparer penalty under § 6694(a), relating to understatements due to unreasonable positions). There have been no substantive changes. The revenue procedure does not apply with respect to any other penalty provisions, including § 6662(b)(1) accuracy-related penalties. If this revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275–R, as appropriate, attached to the return for the year or to a qualified amended return.

9. **Freedom for preparers to use taxpayer return information to increase their own profitability.** T.D. 9608, Disclosure or Use of Information by Preparers of Returns, 77 F.R. 76400 (12/28/12). The Treasury has finalized Prop. Reg. §§ 301.7216-2(n) through 301.7216-2(p) (REG-131028-09, Amendments to the Section 7216 Regulations — Disclosure or Use of Information by Preparers of Returns), replacing Temp. Reg. §§ 301.7216-2T(n) through 301.7216-2T(p). 75 F.R. 94 (1/04/10). Reg. § 301.7216-2(n) allows preparers to compile, maintain, and use a list containing solely the names, addresses, e-mail addresses, phone numbers, taxpayer entity classification, and income tax return form numbers of taxpayers whose tax returns the tax return preparer has prepared, if the list is used only to contact the taxpayers on the list either (1) to provide tax, general business, or economic information for educational purposes, or (2) for soliciting additional tax return preparation services. Reg. § 301.7216-2(o) allows return preparers to use tax return information, subject to limitations to produce a statistical compilation of data described in Reg. § 301.7216-1(b)(3)(i)(B) for a purpose relating directly to the internal management or support of the tax return preparer's tax return preparation business, or to bona fide research or public policy discussions concerning state or federal taxation; disclosure of the statistical compilation must be anonymous as to taxpayer identity, and may not disclose an aggregate figure containing data from fewer than ten tax returns. Reg. § 301.7216-2(p) allows return preparers to disclose return information without penalty for the purpose of a quality or peer review, but only to the extent necessary to accomplish the review. The information also may be used to perform a conflict of interest check.

B. Discovery: Summonses and FOIA

1. You can't hide your foreign bank account records behind the Fifth Amendment. In re M.H., 648 F.3d 1067 (9th Cir. 8/19/11), *cert. denied*, 133 S.Ct. 26 (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.

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). 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 his 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. Litigation Costs

1. Shades of the nineteenth century. A written opinion in a case with $71 dollars at stake. Dale v. Commissioner, T.C. Memo. 2012-146 (5/22/12). In a case in which the IRS conceded that the taxpayer was entitled to attorney's fees under § 7430, Judge Kroupa held that a taxpayer may not recover "costs for secretarial and clerical work performed by a secretary ($37.50), an assistant ($23) and a 'staff' member ($10.50) (collectively, fees at issue)" that were not subsumed in the attorney's hourly rate.

D. Statutory Notice of Deficiency

1. The Eleventh Circuit reverses the Tax Court by reading WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY. Shockley v. Commissioner, 686 F.3d 1228 (11th Cir. 7/11/12). The Court of Appeals for the Eleventh Circuit (Judge Hull) reversed a Tax Court decision, T.C. Memo. 2011-96, in which the Tax Court held that if it determines that the deficiency notice with respect to which the petition was filed is invalid, then the period of limitations is not suspended. The Court of Appeals reasoned that the proposition that limiting this holding to only petitions filed in response to a valid deficiency notice "cannot be found on the face of the suspension statute, nor can it be squared with the plain language of the statute."

> Here, the breadth of § 6503(a)(1)'s plain language indicates the 2005 petition qualifies as a "proceeding in respect of the [SCC] deficiency." First, the proceeding need only be "in respect of" the deficiency, not seeking "a redetermination of" the deficiency. The phrase "in respect of" is particularly comprehensive, with one dictionary ascribing a definition of "as to; as regards; insofar as concerns; [or] with respect to." *Webster's Third New International Dictionary* 1934 (1993); *cf. Kosak v. United States*, 465 U.S. 848, 854, 104 S. Ct. 1519, 1523 (1984) (describing the phrase "arising in respect of" in a section of the Federal Tort Claims Act, 28 U.S.C. § 2680(c), as "encompassing"). This choice of phrase is in contrast to a closely related statute, § 6213(a), where Congress selected the more specific phrase "redetermination of" the deficiency. In our view, the phrase "in respect of" in § 6503(a)(1)

requires only that the substance of the proceeding concern the deficiency.

- Presumably, the Tax Court will continue to follow its own precedent in future cases that are not appealable to the Eleventh Circuit.

E. Statute of Limitations

1. The courts hold that overstating basis is not the same as understating gross income, but the Treasury Department ultimately plays its trump card by promulgating regulations. Section 6501(e)(1) extends the normal three-year period of limitations to six years if the taxpayer omits from gross income an amount in excess of 25 percent of the gross income stated in the return. Section 6229(c)(2) provides a similar extension of the statute of limitations under § 6229(a) for assessments arising out of TEFRA partnership proceedings. A critical question is whether the six year statute of limitations applies if the taxpayer overstates basis and as a consequence understates gross income.

a. The Tax Court says overstating basis is not the same as understating gross income. Bakersfield Energy Partners, LP v. Commissioner, 128 T.C. 207 (6/14/07). The taxpayer overstated basis, resulting in an understatement of § 1231 gain. Looking to Supreme Court precedent under the statutory predecessor of § 6501(e) in the 1939 Code (*Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958)), from which the six-year statute of limitations in § 6229(c)(2) is derived and to which it is analogous, the Tax Court concluded that this understated gain was not an omission of "gross income" that would invoke the six-year statute of limitations under § 6229(c)(2) applicable to partnership audits.

b. The Ninth Circuit likes the way the Tax Court thinks: *Bakersfield Energy Partners* is affirmed. Bakersfield Energy Partners, LP v. Commissioner, 568 F.3d 767 (9th Cir. 6/17/09). The Ninth Circuit affirmed the Tax Court on the grounds that the language at issue in the instant case was the same as the statutory language interpreted in *Colony*. The court noted, however, that "[t]he IRS's interpretation of § 6501(e)(1)(A) is reasonable."

c. And a judge of the Court of Federal Claims agrees. Grapevine Imports, Ltd v. United States, 77 Fed. Cl. 505 (7/17/07), *rev'd*, 636 F.3d 1368 (Fed. Cir. 3/11/11). In a TEFRA partnership tax shelter case, the Court of Federal Claims (Judge Allegra) held that the § 6501(e) six-year statute of limitations does not apply to basis overstatements, citing *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958).

Section 6501(e), rather than § 6229(c)(2) as in *Bakersfield Energy Partners, LP*, applied because in earlier proceedings in the instant case (71 Fed. Cl. 324 (2006)), the court had held that § 6229 did not create an independent statute of limitations, but instead only provides a minimum period for assessment for partnership items that could extend the § 6501 statute of limitations, and because the FPAA was sent within this six-year statute of limitations under § 6229(d) the statute of limitations with respect to the partners was suspended.

d. But a District Court in Florida disagrees. Brandon Ridge Partners v. United States, 100 A.F.T.R.2d 2007-5347 (M.D. Fla. 7/30/07). The court refused to follow *Bakersfield Energy Partners* and *Grapevine Imports* and held that the § 6501(e) 6-year statute of limitations does apply to basis overstatements. The court reasoned that as a result of subsequent amendments to the relevant Code sections, the application of *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), is limited to situations described in § 6501(e)(1)(A)(i), which applies to trade or business sales of goods or services. ["In the case of a trade or business, the term 'gross income' means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services."] The court reasoned that to conclude otherwise would render § 6501(e)(1)(A)(i) superfluous. Because the transaction at issue was the partnership's sale of stock, which was not a business sale of goods or services, the gross receipts test did not apply. On the facts, the partners and partnership returns (and statements attached thereto), taken together "failed to adequately apprise the IRS of the true amount of gain on the sale of the ... stock." Thus, the partnership did not show that the extended limitations period was inapplicable.

e. And a different judge of the Court of Federal Claims agrees with the District Court in Florida and disagrees with the prior Court of Federal Claims opinion by a different judge in *Grapevine Imports*. Salman Ranch Ltd. v. United States, 79 Fed. Cl. 189 (11/9/07). The court (Judge Miller) refused to follow *Bakersfield Energy Partners* and *Grapevine Imports* and held that the § 6501(e) six-year statute of limitations does apply to basis overstatements. Judge Miller reasoned that an understatement of "gain" is an omission of gross income, and that omission can result from a basis overstatement as well as from an understatement of the amount realized. Like the *Brandon Ridge Partners* court, Judge Miller concluded that the application of *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), is limited to situations described in § 6501(e)(1)(A)(i), which applies to trade or business sales of goods or services. ("In the case of a trade or business, the term 'gross income' means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services.") Because the transaction at issue was the partnership's sale of a ranch, which was not a business sale of goods or services, the gross receipts test did not apply. On the facts, the partners' and partnership returns failed to adequately apprise the IRS of the amount of gain in a variant of the Son-of-Boss tax shelter. Accordingly, the partnership did not show that the extended limitations period was inapplicable. The amended order certified an interlocutory appeal and stayed the case pending further court order, because of the split of opinion between *Salman Ranch*, on the one hand, and *Bakersfield Energy Partners* and *Brandon Ridge Partners*, on the other hand.

f. And the pro-government opinion by Judge Miller is slapped down by the Federal Circuit. Salman Ranch Ltd. v. United States, 573 F.3d 1362 (Fed. Cir. 7/30/09). Following *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), the Federal Circuit (Judge Schall, 2-1) held that "omits from gross income an amount properly includible therein" in § 6501(e)(1)(A) does not include an overstatement of basis. Accordingly, the six-year statute of limitations on assessment did not apply – the normal three-year period of limitations applied. Judge Newman dissented.

g. But a second District Court sees it the government's way. Home Concrete & Supply, LLC v. United States, 599 F. Supp. 2d 678 (E.D.N.C. 10/21/08), *rev'd*, 634 F.3d 249 (4th Cir. 2/7/11), *aff'd*, 132 S. Ct. 1836 (4/25/12). The court held that §6501(e) extends the statute of limitations for deficiencies attributable to basis overstatements that result in omitted gross income exceeding 25 percent of the gross income reported on the return. The court refused to follow the Tax Court's decisions in *Bakersfield Energy Partners* and *Grapevine Imports*, because it concluded that those cases were erroneously decided.

h. A hiccup from Judge Goeke in the Tax Court: Overstated basis in an abusive tax shelter is a substantial omission from gross income that extends the statute of limitations. Highwood Partners v. Commissioner, 133 T.C. 1 (8/13/09). The taxpayers invested through partnerships in foreign currency digital options contracts designed to increase partnership basis and generate losses marketed by Jenkens & Gilchrist (Son-of-Boss and miscellaneous other names). After expiration of the three-year statute of limitations, the IRS issued an FPAA to the partnership based on the six-year statute of §6501(e)(1) applicable if there was a greater than 25 percent omission of gross income on each partner's or the partnership's return. The court (Judge Goeke) held that the digital options contracts produced § 988 exchange gain on foreign currency transactions, which, under the regulations, are required to be separately stated. The long and short positions of the options contracts were treated as separate transactions. Thus, failure to report the gain on the short position, not offset by losses on the accompanying stock sale, represented an omission of gross income. The court also rejected the taxpayer's argument that because the IRS asserted that the options transactions should be disregarded in full, there can be no omission of gross income from the disregarded short position. Finally, the court refused to apply the adequate disclosure safe harbor of § 6501(e)(1)(A)(ii) because the taxpayer's netting of the gain and loss from the long and short positions was intended to mislead and hide the existence of the gain and did not apprise the IRS of the existence of the gain.

i. But Judge Haines follows the Tax Court orthodoxy. Beard v. Commissioner, T.C. Memo. 2009-184 (8/11/09), *rev'd*, 633 F.3d 616 (7th Cir. 1/26/11). In a basis offset deal involving contributions of long and short positions in Treasury notes contributed to S corporations, the court (Judge Haines) granted summary judgment to the taxpayer holding that the basis overstatement attributable to the short sale was not a substantial omission of gross income. Because the transaction involved Treasury notes, there were no § 988 issues involved. This holding is consistent with *Bakersfield Energy Partners v. Commissioner*, 568 F.3d 767 (9th Cir. 6/17/09), and *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 7/30/09).

j. And the IRS loses again in the Tax Court. Intermountain Insurance Service of Vail v. Commissioner, T.C. Memo. 2009-195 (9/1/09). The court (Judge Wherry), again following *Bakersfield Energy Partners LP v. Commissioner*, 128 T.C. 207 (2007), granted summary judgment to the taxpayer holding that a basis overstatement is not a substantial omission from gross income that triggers the six-year extended statute of limitations under § 6229.

k. Finally, the IRS gets the upper hand with temporary regulations. T.D. 9466, Definition of Omission from Gross Income, 74 F.R. 49321 (9/28/09). Temp. Reg. §§ 301.6229(c)(2)-1T and 301.6501(e)-1T both provide that for purposes of determining whether there is a substantial omission of gross income, gross income as it relates to a trade or business includes the total amount received from the sale of goods or services, without reduction for the cost of goods sold; gross income otherwise has the same meaning as under § 61(a). The regulations add that, "[i]n the case of amounts received or accrued that relate to the disposition of property, and except as provided in paragraph (a)(1)(ii) of this section, gross income means the excess of the amount realized from the disposition of the property over the unrecovered cost or other basis of the property. Consequently, except as provided in paragraph (a)(1)(ii) of this section, an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income for purposes of section 6229(c)(2)."

l. But the IRS still suffers from a hangover in cases on which the extended statute had run before the effective date of the regulations. UTAM, Ltd v. Commissioner, T.C. Memo. 2009-253 (11/9/09), *rev'd*, 645 F.3d 415 (D.C. Cir. 6/21/11). Judge Kroupa followed *Bakersfield Energy Partners* to hold that the statute of limitations is not extended to six years pursuant to § 6229(c)(2) or § 6501(e)(1)(A) as a result of a basis overstatement that causes gross income to be understated by more than 25 percent.

- Although the date of the decision was after the effective date of Temp. Reg. §§ 301.6229(c)(2)-1T and 301.6501(e)-1T, the result was dictated by prior law effective when the FPAA was issued in 1999.

m. Judge Wherry shoves it up the Commissioner all the way to his "*Colon(-y)*" in a reviewed Tax Court decision that holds the Temporary Regulations invalid. Intermountain Insurance Service of Vail v. Commissioner, 134 T.C. 211 (5/6/10) (reviewed, 7-0-6), *supplementing* T.C. Memo. 2009-195 (9/1/09) (granting summary judgment to the taxpayer, holding that a basis overstatement is not a substantial omission from gross income that triggers the six year extended statute of limitations under § 6229), *rev'd*, 650 F.3d 691 (D.C. Cir. 6/21/11). On the IRS's motions to reconsider and vacate in light of Temp. Reg. §§ 301.6229(c)(2)-1T and 301.6501(e)-1T, the Tax Court (Judge Wherry) held that the Supreme Court's opinion in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), "'unambiguously forecloses the [IRS's] interpretation' . . . and displaces [the] temporary regulations." The first ground was that the temporary regulations were specifically limited their application to "taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009," and in this case that period was not open as of that date. The second ground was that the Supreme Court had held in *Colony* that the statute was unambiguous in light of its legislative history and foreclosed temporary regulations to the contrary.

- Judges Halpern and Holmes concurred in the result. They stated that they were not persuaded by either of the majority's analyses, but that the temporary regulations should be invalidated on procedural grounds for failure to comply with the Administrative Procedure Act's notice-and-comment requirement.

n. "Tax Court, we'll see ya at high noon in front of the courts of appeals," says the IRS. T.D. 9511, Definition of Omission From Gross Income, 75 F.R. 78897 (12/17/10). The IRS and Treasury have finalized amendments to Regs. §§ 301.6229(c)(2)-1 and 301.6501(e)-1, replacing Temp. Reg. §§ 301.6229(c)(2)-1T and 301.6501(e)-1T, T.D. 9466, Definition of Omission from Gross Income, 74 F.R. 49321 (9/28/09). The final regulations are identical to the Temporary Regulations in providing that for purposes of determining whether there is a substantial omission of gross income, gross income as it relates to a trade or business includes the total amount received from the sale of goods or services, without reduction for the cost of goods sold; gross income otherwise has the same meaning as under § 61(a).

- The IRS and Treasury declared in the preamble that they believed that the Tax Court's decision in *Intermountain Insurance Service of Vail v. Commissioner*, 134 T.C. 211 (5/6/10), invalidating the Temporary Regulations, was erroneous:

> The Treasury Department and the Internal Revenue Service disagree with Intermountain. The Supreme Court stated in Colony that the statutory phrase ''omits from gross income'' is ambiguous, meaning that it is susceptible to more than one reasonable interpretation. The interpretation adopted by the Supreme Court in *Colony* represented that court's interpretation of the phrase but not the only permissible interpretation of it. Under the authority of Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 982–83 (2005), the Treasury Department and the Internal Revenue Service are permitted to adopt another reasonable interpretation of ''omits from gross income,'' particularly as it is used in a new statutory setting.

- According to the preamble, the final regulations have been clarified to emphasize that they only apply to open tax years and do not reopen closed tax years. However, the preamble states:

> The Tax Court's majority in Intermountain erroneously interpreted the applicability provisions of the temporary and proposed regulations, which provided that the regulations applied to taxable years with respect to which "the applicable period for assessing tax did not expire before September 24, 2009." The Internal Revenue Service will continue to adhere to the position that "the applicable period" of limitations is not the "general" three-year limitations period. . . . Consistent with that position, the final regulations apply to taxable years with respect to which the

six-year period for assessing tax under section 6229(c)(2) or 6501(e)(1) was open on or after September 24, 2009.

o. And the government wins in the Seventh Circuit, without any help from the Temporary Regulations. Beard v. Commissioner, 633 F.3d 616 (7th Cir. 1/26/11), *rev'g* T.C. Memo 2009-184 (8/11/09). The Seventh Circuit, in an opinion by Judge Evans, reversed the Tax Court's decision that an overstatement of basis results in an omission of gross income that triggers the six year statute of limitations under § 6501(e)(1)(A). In a very carefully reasoned opinion, (*but see* the *Burks* case, below) the court concluded that the Supreme Court's decision in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958) was not controlling. The Seventh Circuit reasoned that *Colony* was both factually different – *Colony* involved an overstatement of the basis of lots held by a real estate developer for sale to customers in the ordinary course of business, while the instant case involved an overstatement of basis in a partnership interest in a Son-of-BOSS tax shelter transaction – and legally different because of changes between the 1939 Code § 275(c), which was interpreted in *Colony* and 1954 Code § 6501(e). The court held that "*Colony*'s holding is inherently qualified by the facts of the case before the Court, facts which differ from our case, where the Beards' omission was not in the course of trade or business." From the perspective of statutory interpretation, the court focused on the impact of the addition of § 6501(e)(1)(B)(ii) in the 1954 Code, which provides that "in determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item." Quoting *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968), the court stated "[w]e conclude that the enactment of subsection (ii) . . . of section 6501(e)(1)[(B)] makes it apparent that the six year statute is intended to apply where there is either a complete omission of an *item* of *income* of the requisite amount or misstating of the nature of an item of income which places the "commissioner ... at a special disadvantage in detecting errors." (emphasis supplied in original). Even though it distinguished *Colony* and concluded that it was "left without precedential authority," the court nevertheless concluded that because the language of § 6501(e)(1)(A) at issue in the case was identical to the language of § 275(c) interpreted in *Colony*, it was required to interpret § 6501(e)(1)(A) in light of *Colony*. However, it also reasoned that it must "bear in mind" that Congress did add subsections (i) and (ii) to § 6501(e)(1)(B) and that "the section as a whole should be read as a gestalt." In analyzing Colony, the court noted that the Supreme Court had found § 275(c) to be ambiguous, but was more persuaded by the taxpayer's argument that focused on the word "omits." The Seventh Circuit noted that what *Colony* "does not address in depth is 'gross income' which is defined generally in Section 61 of the Code as 'all income from whatever source derived,'" but which is not defined in § 6501(e) except for the special definition in § 6501(e)(1)(B)(i) that applies to trade or business income. The court then went on to hold:

> Using these definitions and applying standard rules of statutory construction to give equal weight to each term and avoid rendering parts of the language superfluous, we find that a plain reading of Section 6501(e)(1)(A) would include an inflation of basis as an omission of gross income in non-trade or business situations. . . . It seems to us that an improper inflation of basis is definitively a "leav[ing]out" from "any income from whatever source derived" of a quantitative "amount" properly includible. There is an amount — the difference between the inflated and actual basis — which has been left unmentioned on the face of the tax return as a candidate for inclusion in gross income.

- The court was reinforced in its conclusion by the existence of § 6501(e)(1)(B)(i), reasoning that "[i]f the omissions from gross income contemplated Section 6501(e)(1)(A) were only specific items such as receipts and accruals, then the special definition in subsection (i) would be, if not superfluous, certainly diminished. The addition of this subsection suggests that the definition of gross income for the purposes of Section 6501(e)(1)(A) is meant to encompass more than the types of specific items contemplated by the *Colony* holding." The Seventh Circuit considered *Bakersfield Energy Partners v. Commissioner*, 568 F.3d 767 (9th Cir. 6/17/09), and *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 7/30/09), to have been erroneously decided. Finally, the court addressed the parties' arguments regarding the impact of Temp. Reg. § 301.6501(e)-1T(a)(1)(a). Rather than ruling on the validity of the regulation, however, the court stated that because it did not find *Colony* controlling and reached its decision that the six-year statute of limitations applied on the face of the Code section, it would not reach the validity of the regulation. However, in dictum, the court stated that it would be inclined to grant deference to Temp. Reg. § 301.6501(e)-1T(a)(1)(a), even though it was issued without notice and comment, citing *Barnhart v. Walton*, 535 U.S. 212 (2002), for the proposition that "the absence of notice-and-comment procedures is not dispositive to the finding of *Chevron* deference."

p. But the Fourth Circuit relied on *Colony* to find for the taxpayer. Home Concrete & Supply, LLC v. United States, 634 F.3d 249 (4th Cir. 2/7/11), *aff'd*, 132 S. Ct. 1836 (4/25/12). The Fourth Circuit (Judge Wynn) held that *Colony* decided that 1954 Code § 6501(e)(1)(A) was unambiguous and that an overstated basis in property is not an omission from gross income that extends the limitations period. It further held that Reg. § 301.6501(e)-1(e) by its plain terms did not apply to the tax year in this case because the six-year limitations period had expired before the regulation was issued. Judge Wynn stated:

> Like the Ninth and Federal Circuits, we hold that the Supreme Court in *Colony* straightforwardly construed the phrase "omits from gross income," unhinged from any dependency on the taxpayer's identity as a trade or business selling goods or services. There is, therefore, no ground to conclude that the holding in *Colony* is limited to cases involving a trade or business selling goods or services. . . .
>
> Further, the Supreme Court's discussion of the legislative history behind former § 275(c) is equally compelling with regard to current § 6501(e)(1)(A). The language the Court construed in former § 275(c) — "omits from gross income an amount properly includable therein" — is identical to the language at issue in § 6501(e)(1)(A). Because there has been no material change between former § 275(c) and current § 6501(e)(1)(A), and no change at all to the most pertinent language, we are not free to construe an omission from gross income as something other than a failure to report "some income receipt or accrual." . . . Thus, we join the Ninth and Federal Circuits and conclude that *Colony* forecloses the argument that Home Concrete's overstated basis in its reporting of the short sale proceeds resulted in an omission from its reported gross income.

- Judge Wynn concluded that the regulation was "not entitled to deference."

q. As did the Fifth Circuit, which chided the Seventh Circuit for misinterpreting a Fifth Circuit case on which it relied in *Beard*. Burks v. United States, 633 F.3d 347 (5th Cir. 2/9/11). The Fifth Circuit (Judge DeMoss) also held that an overstatement of basis is not an omission from gross income for purposes of § 6501(e)(1)(A). Judge DeMoss disagreed with the Seventh Circuit's interpretation of *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968), as limiting *Colony*, stating that "the Seventh Circuit failed to note the distinct factual pattern presented in *Phinney*, where the taxpayers had misstated the very nature of the item so that the IRS would not have had any reasonable way of detecting the error on the tax return. That is not the case here."

- In its final footnote, the court stated:

> Although we hold that § 6501(e)(1)(A) is unambiguous and its meaning is controlled by the Supreme Court's decision in *Colony*, we note that even if the statute

was ambiguous and *Colony* was inapplicable, it is unclear whether the Regulations would be entitled to *Chevron* deference under *Mayo Foundation for Medical Research v. United States*, 131 S. Ct. 704, 711 (2011). *See, e.g.*, *Home Concrete & Supply, LLC v. United States*, [634 F.3d 249] (4th Cir. Feb. 7, 2011) (declining to afford the Regulations *Chevron* deference because the statute is unambiguous as recognized by the Supreme Court in *Colony*). In *Mayo*, the Court held that the principles underlying its decision in *Chevron* "apply with full force in the tax context" and applied *Chevron* to treasury regulations issued pursuant to 26 U.S.C. § 7805(a). *Id*. at 707. Significantly, in *Mayo* the Supreme Court was not faced with a situation where, during the pendency of the suit, the treasury promulgated determinative, retroactive regulations following prior adverse judicial decisions on the identical legal issue. "Deference to what appears to be nothing more than an agency's convenient litigating position" is "entirely inappropriate." *Bowen v. Georgetown Univ. Hosp*., 488 U.S. 204, 213 (1988). The Commissioner "may not take advantage of his power to promulgate retroactive regulations during the course of a litigation for the purpose of providing himself with a defense based on the presumption of validity accorded to such regulations." *Chock Full O' Nuts Corp. v. United States*, 453 F.2d 300, 303 (2d Cir. 1971).

Moreover, *Mayo* emphasized that the regulations at issue had been promulgated following notice and comment procedures, "a consideration identified . . . as a significant sign that a rule merits *Chevron* deference." 131 S. Ct. at 714. Legislative regulations are generally subject to notice and comment procedure pursuant to the Administrative Procedure Act. *See* 5 U.S.C. § 553(b)(A). Here, the government issued the Temporary Regulations without subjecting them to notice and comment procedures. This is a practice that the Treasury apparently employs regularly. *See* Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 76 GEO. WASH. L. REV. 1153, 1158-60 (2008) (noting that the treasury frequently issues purportedly binding temporary regulations open to notice and comment only after promulgation and often denies the applicability of the notice and comment procedure when issuing its regulations because that

> requirement does not apply to regulations that are not a significant regulatory action, while continuing to assert that the regulations are entitled to legislative regulation level deference before the courts). That the government allowed for notice and comment after the final Regulations were enacted is not an acceptable substitute for prepromulgation notice and comment. *See U.S. Steel Corp. v. U.S. EPA*, 595 F.2d 207, 214-15 (5th Cir. 1979).

r. Finally, a court that read *Colony* very very carefully and understands what *Colony* really said and what it really did not say. Grapevine Imports, Ltd. v. United States, 636 F.3d 1368 (Fed. Cir. 3/11/11), *rev'g* 77 Fed. Cl. 505 (2007). The Federal Circuit, in a unanimous panel opinion by Judge Prost, reversed the Court of Federal Claims holding that the six-year statute of limitations does not apply to an understatement of gross income attributable to a basis overstatement. The Court of Federal Claims had relied on the Supreme Court's decision in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958). However, the Court of Appeals for the Federal Circuit applied Reg. § 301.6229(c)(2)-1 and Reg. § 301.6501(e)-1, after first concluding that the Supreme Court's opinion in *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011), unambiguously held that a subsequently promulgated Treasury Regulation could overrule a prior judicial decision (including a Supreme Court decision), as long as the regulation was valid under the standards of *Chevron, USA, Inc. v. Natural Resources Defense Council, Inc*., 467 U.S. 837 (1984). Preliminarily the court found that the regulations, "state that *Colony* did not conclusively resolve the statutory interpretation issue, and that overstatement of basis (outside the trade or business context) can trigger the extended limitations period." A critical point in the court's reasoning was that the decision in *Colony* did not hold that the language in question, which is the language that § 6501(e)(1) has in common with § 275(c) of the 1939 Code that was at issue in *Colony*, was unambiguous.

> [T]he Supreme Court expressly found the predecessor statute ambiguous, and turned to the legislative history to resolve the question. [*Colony, Inc.*, 357 U.S. at 33] ("[I]t cannot be said that the language [of the statute] is unambiguous."). And while it is true that the Court later referred to the updated § 6501(e)(1)(A) as "unambiguous," it did not rely or elaborate on that statement, nor was the updated statute at issue in that case. . . . Further, in *Colony* the taxpayer was in the business of land sales, so § 6501(e)(1)(A)(i)'s test for income "in the case of a trade or business" expressly applied. That is not the case here. The ambiguity concerns what to do outside the trade and business context, and the

> only language in § 6501(e)(1)(A) applicable outside the trade or business context is the same language from the predecessor statute, "omits from gross income an amount." The Supreme Court previously noted that this term was ambiguous as to whether it encompassed an overstated basis. We therefore find *Colony* no bar to our finding that the text of the relevant statutes, standing alone, is ambiguous as to the disposition of this issue.

- Turning to *Chevron* step one analysis, the Court of Appeals concluded that §§ 6229(c)(2) and 6501(e) are ambiguous, and that the Treasury thus "is entitled to promulgate its own interpretation of these statutes, and to have that interpretation given deference by the courts so long as it is within the bounds of reason."

> [T]he Tax Code's use of the term "omits" suggests that the section is primarily addressed to the return where the taxpayer has "fail[ed] to include or mention" or "le[ft] out" some item rather than misrepresenting it (as by an overstatement of basis). . . . But without looking beyond the text itself, we cannot say that the statute forecloses the possibility that a taxpayer's overstated basis might constitute an omission from gross income.

- Turning to the second step of the *Chevron* analysis, which asks whether the regulations constitute "a reasonable policy choice for the agency to make," the court concluded that the regulations are reasonable, even though they depart from the judicial interpretation of *Colony* and *Salman Ranch, Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009). Next, the court rejected the taxpayer's arguments that the regulations were invalid because they were "retroactive," noting that in *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957), the Supreme Court confirmed that § 7805(b) authorizes retroactive regulations. The court also rejected an argument by the taxpayer – one which we confess not to understand – that the statute of limitation expired upon the entry of judgment by the Court of Federal Claims, notwithstanding rules tolling the period of limitations during a pending appeal. Finally, based on Supreme Court precedent, the court rejected the taxpayer's claim that the Treasury did not have the power to affect the outcome of the appeal by promulgating regulations after the trial court decision and before the appeal was heard.

s. Did anyone really expect the Tax Court to roll over and play dead just because the IRS promulgates regulations that say it wins? <u>Carpenter Family Investments, LLC v. Commissioner</u>, 136 T.C. 373 (4/25/11). In a reviewed opinion by Judge Wherry, in which only four other judges joined, but with a number of concurrences and no dissents, the Tax Court once again held that the six year statute of limitations under §§ 6501(e) and 6229(c)(2) do not apply to understatements of gross income attributable to basis overstatements. In doing so the court held that final Reg. §§ 301.6501(e)-1T and 301.6229(c)(2)-1T are invalid, just as it had held in *Intermountain Insurance Service of Vail v. Commissioner*, 134 T.C. 211 (5/6/10), that Temp. Reg. §§ 301.6501(e)-1T and 301.6229(c)(2)-1T were invalid. Noting that the case was appealable to the Ninth Circuit, in which *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767 (9th Cir. 6/17/09), is the controlling precedent, the Tax Court followed the line of reasoning previously applied by it, *Bakersfield Energy Partners*, and some other courts, that the Supreme Court's decision in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), was not limited to situations involving a trade or business and that it controlled the interpretation of § 6501(e)(1)(A). The court then turned to whether Reg. §§ 301.6501(e)-1T and 301.6229(c)(2)-1T were entitled to deference under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), and *Mayo Foundation for Medical Research v. United States*, 131 S. Ct. 704, 711 (1/11/11), and determined that they were not entitled to deference. In this context the court observed that *Mayo* "focuses exclusively on the statutory text at *Chevron* step one and suggests (by negative implication) a disfavor of using legislative history at that stage. We are not persuaded, however, that after *Mayo*, any judicial construction that examines legislative history is automatically relegated to a *Chevron* step two holding by that fact alone." In proceeding to analyze whether under the authority of *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967 (2005), the Treasury Department and the IRS have the power to promulgate regulations overturning prior court decision, the court appears first to have concluded that "only if an 'unwise judicial construction' represents a policy choice, must it yield to 'the wisdom of the agency's policy.'" In the end, however, the court appears also to have grounded its decision on what it perceived to be ambiguities in the preamble of T.D. 9511, which promulgated the regulations at issue and which the court infers did not strongly enough invoke a power under *Brand X* as the basis for promulgating the regulations. The final passage of its reasoning as follows:

> Even if we read the Supreme Court's recent *Mayo* opinion as a license to categorize most judicial constructions that discuss legislative history as *Chevron* step two decisions, respondent has yet to unabashedly accept the Court of Appeals for the Ninth Circuit's invitation and issue regulations that unequivocally repudiate the *Colony* holding. Unless and until he does so, his hands must remain tied.

- Judge Thornton's concurring opinion, with which Judges Cohen, Halpern, Holmes, and Paris agreed, would have decided the case solely on the grounds that the result "follows from the unambiguous terms of the statute," and there is no compelling reason for the Tax Court to abandon its precedents.

- Judges Halpern and Holmes joined in another concurring opinion discussing the scope and meaning of *Chevron* and *Brand X*.

t. And the Tenth Circuit also likes the way the IRS thinks. Salman Ranch, Ltd. v. Commissioner, 647 F.3d 929 (10th Cir. 5/31/11). In a case involving a different tax year for the taxpayer, the Federal Circuit held, (*see* e. and f., above) that the extended statute of limitations did not apply to this partnership for its 1999 year. Subsequently, in *Grapevine Imports, Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 3/11/11) (*see* r., above) the Federal Circuit overruled its pro-partnership decision in the 1999 *Salman Ranch* case. In this separate case for this partnership's 2001 and 2002 years, the Tax Court had held collateral estoppel required summary judgment be granted for the partnership. The Tenth Circuit (Judge Seymour) reversed and remanded, holding that collateral estoppel was inapplicable because of an intervening change in law, i.e., the final regulations (*see* n., above). Judge Seymour based his decision that the final regulations were entitled to *Chevron* deference based upon the Supreme Court's holdings in *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 713 (1/11/11), and refused to follow contrary authority among the cases discussed above.

u. And the government chalks up another victory in front of a panel that really understands the proposition for which *Colony* stands and the propositions for which it really does not stand [or, does it?]. Intermountain Insurance Service of Vail v. Commissioner, 650 F.3d 691 (D.C. Cir. 6/21/11). After a thorough examination of the history of § 275(c) of the 1939 Code, the pre-*Colony* litigation, the *Colony* decision itself, the enactment of § 6501(e), the relevant changes from § 275(c), and the recent cases on the issue, and the promulgation of Reg. §§ 301.6501(e)-1T(a)(iii) and 301.6229(c)(-1T)(a)(iii), the Court of Appeals for the District of Columbia, in an opinion by Judge Tatel, reversed the Tax Court and, with a healthy spread of *Mayo* upheld the regulations, and dismissed the taxpayer's [tautological, in our opinion] argument, which was accepted by the Tax Court (and a few other courts) that the regulations by the terms of their effective date were inapplicable to the transaction in question. The court's opinion carefully explains the source of the statutory ambiguity and why *Colony* did not state that the relevant language was unambiguous, rejecting the less well reasoned opinions of those courts that found *Colony* to have held that the statutory provision was unambiguous. Going a step further, the court concluded that *Colony* simply did not apply to either § 6501(e) or § 6229(c)(2), and that under *Chevron* it was an easy call to uphold the substance of the regulations, while under *Mayo* there were no procedural problems with the manner in which the regulations were promulgated. However, the Court of Appeals remanded the case to the Tax Court to consider Intermountain's alternative argument that Intermountain avoided triggering the extended statute of limitations by "*adequately disclos[ing]* to the IRS the basis amount it applied in connection with the transaction at issue."

v. Let's play that tune again. UTAM, Ltd v. Commissioner, 645 F.3d 415 (D.C. Cir. 6/21/11). The Court of Appeals for the District of Columbia, in a very brief opinion by Judge Randolph, reversed the Tax Court decision (*see* l., above) on the basis of the court's holding in Intermountain Insurance Service of Vail v. Commissioner, 650 F.3d 691 (D.C. Cir. 6/21/11). Although the Tax Court did not reach the issue of whether § 6229(c) suspends the individual partner's § 6501 limitations period when that period is open on the date the IRS mailed the FPAA, the Court of Appeals found that a remand on this issue would not serve a useful purpose. Under D.C. Circuit's opinion in *Andantech, L.L.C. v. Commissioner*, 331 F.3d 972 (D.C. Cir. 2003), the assessment period suspended by § 6229(d) is the partner's open assessment period under § 6501. Thus, the statute of limitations had not run.

w. The Fifth Circuit stands by its *Burks* holding, and the government is ready to talk to the Supreme Court. R and J Partners v. Commissioner, 441 Fed. Appx. 271 (5th Cir. 9/19/11). In a per curiam opinion, the Fifth Circuit followed *Burks v. United States*, 633 F.3d 347 (5th Cir. 2011), to hold that the six year statute of limitations of § 6501(e) does not apply to basis overstatements and that Reg. § 301.6501(e)-1 is invalid.

- The court noted that "[t]he Commissioner agrees that *Burks* controls the law in the circuit on that question and that the Tax Court correctly applied that law, but took this protective appeal in an effort to obtain a review by the Supreme Court." However, the Supreme Court did not grant certiorari in this case.

x. And now the Supremes will sing †♫♪ "Nothing But Heartaches" ♫♪! But will the song be dedicated to the taxpayer or the government? The Supreme Court granted certiorari to the Fourth Circuit in *Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. 2/7/11), *cert. granted*, 132 S. Ct. 71 (9/27/11). It declined invitations from the government to consider cases from the Fifth and Seventh Circuits.

y. Taxpayer wins in the Supreme Court, 4-1-4. United States v. Home Concrete and Supply, LLC, 132 S. Ct. 1836 (4/25/12). In an opinion by Justice Breyer, a former law professor in the administrative law area, the Supreme Court held that there is no extension of the three-year statute of limitations under § 6501(e)(1)(A) "when the taxpayer *overstates his basis* in the property that he has sold, thereby *understating the gain* that he received from its sale." Justice Breyer rested this conclusion on the precedential value of *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), which construed identical operative language in the 1939 Code counterpart to current § 6501(e)(1)(A), and concluded that the statute's scope is limited "to situations in which specific receipts or accruals of income are left out of the computation of gross income," and that the word "omits" (unlike, say, "reduces" or "understates") means "'[t]o leave out or unmentioned; not to insert, include, or name.'" He rebutted the government argument that because the *Colony* opinion stated "it cannot be said that the language is unambiguous," there is room for a regulation that is a "permissible construction," stating:

> We do not accept this argument. In our view, *Colony* has already interpreted the statute, and there is no longer any different construction that is consistent with *Colony* and available for adoption by the agency.

- The test stated in the plurality opinion – Justice Scalia did not join the Court's opinion on this point – was whether Congress delegated "gap-filling authority" to the agency. Justice Breyer's opinion stated that the *Colony* opinion, including its examination of the legislative history to the statute, concluded that Congress "had decided the question definitively, leaving no room for the agency to reach a contrary result."

- Justice Scalia's concurring opinion would have overruled the *National Cable & Telecommunications Assn. v. Brand X Internet Services*, 545 U.S. 967 (2005), holding that "a 'prior judicial construction,' unless reflecting an 'unambiguous' statute, does not trump a different agency construction of that statute."

- Four justices dissented in an opinion by Justice Kennedy on the ground that the 1954 Code amendments to the statute created inferences that would have permitted the Treasury to promulgate its contrary regulations. Justice Breyer dismissed this position in part by stating that to rely on one of these changes "is like hoping that a new batboy will change the outcome of the World Series."

- **Has the Court cut the hair of *Brand X* and *Mayo*?** In invalidating the regulations, the Court held that a regulation can validly trump a prior judicial interpretation of a statute only if the "statute's silence or ambiguity as to a particular issue means that Congress has not 'directly addressed the precise question at issue' (thus likely delegating gap-filling power to the agency)." The Court noted that in *Chevron* it stated that "[i]f a court, *employing traditional tools of statutory construction*, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect." This logic in logic in *Home Concrete* is somewhat tautological because it presumes that it is for agencies, through regulations — not courts, through judicial decisions — to fill gaps in the statute, but then states that if a court has already interpreted the statute in the absence of a regulation, then the court, per force, has ascertained congressional intent, and there is no gap in the statute remaining to be filled by regulations. Moreover, the Court's opinion is ambiguous with respect to which court's prior decision cannot be overturned by regulations — does this principle apply only to Supreme Court decisions, or dos it extend to lower courts decisions as well? Are Courts of Appeals decisions different than trial court decisions? What about Tax Court, or even District Court, decisions? Even more troubling is how this principle applies to splits between lower courts; for example, if the IRS prevails in the Tax Court but the decision is reversed on appeal, what are the limits on the Treasury Department's power to enshrine its Tax Court victory in regulations.

2. **Tolling is personal; it can't be inherited.** Murdock v. United States, 103 Fed. Cl. 389 (2/9/12). The trustee of a deceased taxpayer's trust filed tax returns for the deceased taxpayer for the years 2001-2006, for which the taxpayer, who had died on May 4, 2006, had not filed returns. The trustee did not discover that no returns had been filed until January 2009, and did not file the returns until September 2009. Taxes had been withheld by the government on pension payments. In an attempt to avoid the limitations of § 6511(b)(2), the trustee argued that the tolling of the period of limitations on refunds under § 6511 applied because the taxpayer's failure to file returns was "attributable to his advanced age, medical ailments, and alcoholism." The court (Judge Lettow) rejected the trustee's claim, holding that § 6511(h) tolls the period of limitations only during the taxpayer's lifetime; "if the financially disabled taxpayer is no longer alive, Subsection 6511(h) can no longer apply and the statutory clock must begin to run." Thus, the three year look-back period had expired in May 2009.

F. Liens and Collections

1. **You can't tell the filing period deadline without a scorecard.** Gray v. Commissioner, 138 T.C. No. 13 (3/28/12). The Tax Court (Judge Gale) followed *Raymond v. Commissioner*, 119 T.C. 191 (2002), holding that where a taxpayer raises § 6015 relief in a § 6330 CDP hearing, and the notice of determination included a determination that the taxpayer was not entitled to § 6015 relief, a Tax Court petition, filed more

than 30 days, but within 90 days, after the issuance of the notice of determination, was timely for purposes of conferring jurisdiction on the Tax Court to determine the appropriate § 6015 relief. However, *Barnes v. Commissioner*, 130 T.C. 248 (2008), held that a second request for § 6015(f) relief from an underpayment that was essentially duplicative of an earlier request for which a final determination had been issued did not confer jurisdiction on the Tax Court under § 6015(e)(1)(A). On the basis of the record developed in this case, the court was unable to determine whether the claim for § 6015 relief that the taxpayer raised at her CDP hearing is "sufficiently dissimilar" from the claim for which she received an earlier final determination, and further proceedings were necessary to determine whether jurisdiction exists. On a second issue, the court held that the petition was timely for purposes of conferring jurisdiction under § 6404(h)(1) to determine whether the IRS's determination not to abate interest, which was requested by the taxpayer in the CDP hearing, was an abuse of discretion. The notice and petition conferred jurisdiction under § 6404(h) that was independent of § 6330. Insofar as the petition sought review under § 6404(h) of the IRS's failure to abate interest, it was timely because it was filed within 180 days of the final determination not to abate interest.

2. Ca-ching! The IRS collects twice. Weber v. Commissioner, 138 T.C. No. 18 (5/7/12). In 2007 the taxpayer filed an income tax return for 2006 reporting an overpayment and elected to have it applied to his 2007 estimated income tax. However, the IRS had determined that the taxpayer was liable for a § 6672 penalty and instead applied the income tax overpayment to that penalty liability. In 2008 the trust fund tax liability was satisfied by third-party payments, and when thereafter the taxpayer filed his 2007 income tax return, he claimed a credit for the overpaid 2006 income tax, thereby reporting a 2007 income tax overpayment, and elected to have that asserted 2007 overpayment applied to his 2008 estimated income tax. The IRS adjusted the 2007 credits downward to eliminate the claimed 2006 income tax overpayment, thereby eliminating the overpayment for 2007, resulting in a balance due. This pattern was repeated when the taxpayer filed his 2008 income tax return in 2009, when he again claimed a credit for earlier overpaid income tax. When the taxpayer did not pay the balance due, the IRS issued a notice of proposed levy, and the taxpayer requested a CDP hearing. At the CDP hearing the taxpayer argued that the § 6672 penalty had been overpaid and that his income tax liability would be satisfied if that overpayment were applied to his income tax liability. The IRS rejected his argument and determined to proceed with the levy. The Tax Court (Judge Gustafson) held that the taxpayer was not entitled to apply the earlier income tax overpayment to his later income tax liability, because after application of the income tax overpayment to the

§ 6672 penalty liability, there was no 2006 overpayment available. Furthermore, in reviewing the CDP hearing, the Tax Court lacked jurisdiction to adjudicate the taxpayer's claim of a § 6672 penalty overpayment. Section 6330 — the statute conferring CDP jurisdiction on the Tax Court — has no provision conferring and delimiting any overpayment jurisdiction. Finally, the opinion described the many administrative problems that would arise from allowing a person against whom a § 6672 penalty had been assessed and collected to seek a credit (or refund) based on the assertion that the penalty had been "over-collected."

3. The whole is greater than the sum of the parts. Lewis v. Commissioner, T.C. Memo. 2012-138 (5/16/12). In this review of an IRS CDP determination to proceed with a levy, Judge Paris held that the IRS had abused its discretion. "While each individual defect on its own may be insufficient to support a holding that [the IRS] abused [its] discretion, the cumulative effect of such defects demonstrates that [the IRS] acted both arbitrarily and capriciously in rendering [its] determination." The IRS's argument sought "to quilt together a string of exceptions to account for [the] deviation from what one would consider a thorough review of [the taxpayer's] case. . . . Accordingly, the Court holds that the [IRS] abused [its] discretion in sustaining the proposed levy."

4. CDP hearings raising the issue of liability for tax at a CDP doesn't require antique common law pleading by the taxpayer. Fielder v. Commissioner, T.C. Memo. 2012-284 (10/4/12). The Tax Court (Judge Laro) rejected the IRS's argument that a taxpayer was precluded from challenging his liability for taxes in a CDP hearing because he did not raise the issue in the Form 12153 hearing request. Neither the statute nor Tax Court case law requires a taxpayer to raise the liability issue in the request for a CDP hearing. The statutory rule only limits the taxpayer's ability to contest the underlying tax liability at the CDP hearing if the taxpayer did not receive a notice of deficiency or otherwise had a prior opportunity to dispute the tax liability. The statute does not specify the time for raising the issue. The underlying liability should be considered if a taxpayer raises it at any time during a CDP hearing.

G. Innocent Spouse

1. 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 "where appropriate 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.

2. An IRS levy on a joint account doesn't trump a spouse's right to seek § 6015(g) relief. Minihan v. Commissioner, 138 T.C. 1 (1/11/12). At the time the taxpayer was seeking Tax Court review of the

IRS's denial of § 6015(g) relief, the IRS levied on a joint bank account owned by the taxpayer's husband and the taxpayer to satisfy the tax liability. At that time collection against the taxpayer was suspended pursuant to § 6015(e)(1)(B). Judge Gustafson held that because under state law the taxpayer owned one-half of the funds in the bank account, she was not precluded from seeking a refund of one-half of the funds in the account if she prevailed on the § 6015(f) relief issue. While a taxpayer who is relieved from joint and several liability under § 6015(f) in a Tax Court proceeding is not entitled to a refund under § 6015(g)(1), unless the taxpayer made an overpayment, if the taxpayer prevailed, the levy on her one-half of the bank account funds would constitute an overpayment as defined in § 6402(a). Although *United States v. Nat'l Bank of Commerce*, 472 U.S. 713 (1985), held that the IRS can lawfully levy on a joint bank account to satisfy one account holder's individual tax liability, that levy is conditional, and it does not extinguish a third party's rights in levied property. The court then concluded that the rights of an "innocent spouse" who claims a refund under § 6015(g)(1) survive post-levy in the same way that the rights of a § 7426 or § 6343(b) wrongful levy claimant survive. Accordingly, the IRS was denied summary judgment, and whether Mrs. Minihan deserved § 6015(f) relief was a matter for trial.

H. Miscellaneous

1. The whistleblower made no noise, and kept his (?) identity secret. Whistleblower 14106-10W v. Commissioner, 137 T.C. No. 15 (12/8/11). In a reviewed opinion by Judge Thornton, the Tax Court granted summary judgment for the IRS in this case in which a whistleblower appealed the IRS's denial of a reward. The IRS filed the affidavit of a Chief Counsel Attorney "declaring, on the basis of his review of respondent's administrative and legal files and on the basis of conversations with relevant IRS personnel, that the information petitioner provided resulted in respondent's taking no administrative or judicial action against X or collecting from X any amounts of tax, interest, or penalty," and the whistleblower did "not set forth, by affidavits or otherwise, any specific facts showing that there [was] a genuine issue for trial." The court granted the whistleblower's request for anonymity and redaction from the record of any identifying information because the potential harm from disclosing the whistleblower's identity as a confidential informant outweighed the public interest in knowing the whistleblower's identity in a case decided on summary judgment for the IRS denying an award. Because granting the request for anonymity and redaction adequately protected the whistleblower's privacy interests as a confidential informant, the motion to seal the record was denied.

a. Calculating collected proceeds in calculating whistleblower awards. T.D. 9580, Rewards and Awards for Information Relating to Violations of Internal Revenue Laws, 77 F.R. 10370 (2/22/12). The Treasury Department promulgated final regulations relating to the payment of rewards under § 7623(a) for detecting underpayments or violations of the internal revenue laws and whistleblower awards under § 7623(b) that amend Reg. § 301.7623-1. The amendments clarify the definitions of proceeds of amounts collected and collected proceeds and provide that the provisions of Reg. § 301.7623-1(a) concerning refund prevention claims are applicable to claims under § 7623(a) and (b). "[B]oth proceeds of amounts collected and collected proceeds include: Tax, penalties, interest, additions to tax, and additional amounts collected by reason of the information provided; amounts collected prior to receipt of the information if the information provided results in the denial of a claim for refund that otherwise would have been paid; and a reduction of an overpayment credit balance used to satisfy a tax liability incurred because of the information provided."

b. You could be the next one to strike it rich by ratting out your employer. IRS Summary Award Report, 9/11/12. The IRS Whistleblower Office recommended a payment of $104 million to former UBS banker Bradley Birkenfeld based on his 2009 claim under § 7623(b). The non-redacted portion of the recommendation read:

> Birkenfeld provided information on taxpayer behavior that the IRS had been unable to detect, provided exceptional cooperation, identified connections between parties to transactions (and the methods used by UBS AG), and the information led to substantial changes in UBS AG business practices and commitment to future compliance. The actions against UBS AG and the attendant publicity also contributed to other compliance programs. Each of these factors could support an increase in the award percentage above the statutory minimum. The comprehensive information provided by the whistleblower was exceptional in both its breadth and depth. While the IRS was aware of tax compliance issues related to secret bank accounts in Switzerland and elsewhere, the information provided by the whistleblower formed the basis for unprecedented actions against UBS AG, with collateral impact on other enforcement activities and a continuing impact on future compliance by UBS AG.

c. No relief for an uncompensated whistleblower when the IRS closes its ears to the whistle. Cohen v. Commissioner, 139 T.C. No. 12 (10/9/12). In a case of first impression, the Tax Court (Judge Kroupa) held that no relief is available to a whistleblower under § 7623(b) when the IRS denies a claim without initiating an administrative or judicial action or collecting proceeds. The taxpayer's argument that the IRS abused its discretion by not acting on his information was rejected.

d. More comprehensive Proposed Regulations on how to get rich ratting out tax cheats. REG–141066–09, Awards for Information Relating to Detecting Underpayments of Tax or Violations of the Internal Revenue Laws, 77 F.R. 74798 (12/18/12). The Treasury Department has published detailed comprehensive proposed regulations regarding whistleblower awards under section § 7623 to replace the current final regulations that are only slightly more than one year old. The proposed regulations provide guidance on eligibility and submitting information to the IRS and filing claims for award with the Whistleblower Office that are intended to clarify the process individuals should follow to be eligible to receive whistleblower awards; the proposed regulations in large part, track the existing regulations. A claimant must provide the name of the taxpayer and specific facts and documents to support the claim. The proposed regulations reaffirm the practice of Treasury and the IRS to safeguard the identity of whistleblowers whenever possible. The definitions of proceeds of amounts collected and collected proceeds in the proposed regulations build on the definitions in the existing regulations, but some definitions, such as "related actions," are new. The definition of "collected proceeds" restates the rule from those final regulations that collected proceeds include: tax, penalties, interest, additions to tax, and additional amounts collected because of the information provided; amounts collected prior to receipt of the information provided if the information results in the denial of a claim for refund that otherwise would have been paid; and a reduction of an overpayment credit balance used to satisfy a tax liability incurred because of the information provided. Prop. Reg. § 301.7623–3 describes the administrative proceedings applicable to claims whistleblower awards. Prop. Reg. § 301.7623-4 provides the framework and criteria that the Whistleblower Office will use in exercising its discretion to make awards. The proposed regulations are consistent with, and build on, the award determination provisions provided in the Internal Revenue Manual. The proposed regulations will be effective upon finalization.

2. New Tax Court proposed rules (12/28/11). In December of 2011, the United States Tax Court proposed amendments to its

Rules of Practice and Procedure. Comments in writing were due by 2/27/12. The proposals include:

(1) amending Rule 23 to: (a) reduce the number of copies required for papers filed with the Court, (b) delete the nonproportional font requirement for papers filed with the Court, and (c) revise the language regarding the Court's return of documents;

(2) deleting Rule 175, as the number of copies required for papers filed with the Court in small tax cases would be the same as in all other cases;

(3) amending Rule 26 to require electronic filing by most attorneys;

(4) amending Rules 70 and 143 to conform the Court's Rules to rule 26(a)(2)(B) of the Federal Rules of Civil Procedure, regarding the contents of expert witness reports, rule 26(b)(3) of the Federal Rules of Civil Procedure, regarding work product protections, and revisions to rule 26(b)(4) of the Federal Rules of Civil Procedure, limiting discovery of draft expert witness reports and trial preparation communications and materials;

(5) amending Rule 121, Summary Judgment, to conform the Rule with revisions to rule 56 of the Federal Rules of Civil Procedure;

(6) amending Rule 155 to clarify that computations may be filed in conjunction with dispositive orders;

(7) amending Rule 241, Commencement of Partnership Actions, so that its notice provisions are consistent with those of Reg. § 301.6223(g)-1(b)(3);

(8) adopting new Rule 345 to provide privacy protections in whistleblower cases;

(9) amending various Rules to make conforming changes; and

(10) providing new Form 18 in recognition of 28 U.S.C. sec. 1746, which allows an unsworn declaration to substitute for an affidavit.

a. The proposed rules were adopted effective 7/6/12.

3. Just because the case was an S case doesn't entitle the taxpayer to a mulligan. Or, in other words, if you don't want an adverse decision in an S case, which would be res judicata, hire John W. Davis to represent you in the S case. Koprowski v. Commissioner, 138 T.C. 54 (2/6/12). In a reviewed decision by Judge Gustafson, the Tax Court held (with no dissents) that res judicata attaches to final decisions in a small tax case and bars relitigation of a liability determined in such a case. In this case the taxpayer was not allowed to relitigate a clam for innocent spouse relief that could have been raised in earlier small case regarding the deficiency.

- In a concurring opinion, Judge Holmes noted that "the same result will certainly follow when the [Tax] Court finally addresses the question of whether decisions in S cases collaterally estop losing parties from relitigating the same issues in later cases."

4. Updating the "independence" of Appeals. Rev. Proc. 2012-18, 2012-10 I.R.B. 455 (2/15/12). This revenue procedure provides comprehensive guidance in narrative format regarding *ex parte* communications between Appeals and other IRS functions. Rev. Proc. 2000-43, 200-2 C.B. 404 was amplified, modified and superseded.

5. IRS provides "Fresh Start" penalty relief for the faltering self-employed and the unemployed. IR-2012-31 (3/7/12). Relief for the failure-to-pay penalty of 0.5 percent per month (up to a maximum of 25 percent) is provided for otherwise compliant taxpayers who are either wage earners who have been unemployed for at least 30 days during 2011 and 2012 (up to the 4/17/12 filing deadline) or self-employed people who experienced a 25 percent or greater reduction in business income due to the economy. The announcement also doubles the dollar threshold for tax balance due amount that qualifies for the streamlined installment agreement program from $25,000 to $50,000 and raises the term for such agreements from five years to six years; these programs can be set up on the IRS website without the filing of Form 433-A or Form 433-F financial statements.

a. The IRS announces more flexible offer-in-compromise terms. IR-2012-53 (5/21/12). The IRS announced an expansion of its "Fresh Start" initiative that would enable taxpayers to revise their tax problems in as little as two years (compared to the four or five years in the past). The changes include: (1) revising the calculation for the taxpayer's future income; (2) allowing taxpayers to repay their student loans; (3) allowing taxpayers to pay state and local delinquent taxes; and (4) expanding the Allowable Living Expense allowance category and amount.

6. No evidence of this, no evidence of that, no memory of anything — how in the world did this taxpayer expect to prove that it actually had filed a refund claim? Maine Medical Center v. United States, 675 F.3d 110 (1st Cir. 3/30/12). The issue in this case was whether an administrative refund claim had been timely filed. No one could locate a certified mail receipt or return receipt. No agent of the taxpayer had a specific memory of mailing the claim, and no one was aware of the identity of the postal service employee who would have dealt with the mailing of the claim. The IRS asserted that it has no record of ever receiving the claim. The First Circuit (Judge Stahl) held that Reg. § 301.7502-1(e), promulgated in 2011, forecloses the use of extrinsic evidence – not that there really could have been any such evidence after all of the things about which there was no evidence had been ascertained – as a means of proving a timely postmark. Thus there was no jurisdiction to hear a refund suit. The court acknowledged that in cases decided before the promulgation of Reg. § 301.7502-1(e), *see Anderson v. United States*, 966 F.2d 487 (9th Cir. 1992); Estate of *Wood v. Commissioner*, 909 F.2d. 1155 (8th Cir. 1990), other circuits had held that a taxpayer was entitled to prove via extrinsic evidence that its refund claim had a timely postmark, but described the holding in those cases as limited to allowing the extrinsic evidence to give rise to the common law presumption of delivery in a § 7502 context and were thus not applicable because there was no evidence that the IRS ever received the refund claim.

7. A zero return is a nothing. Waltner v. United States, 679 F.3d 1329 (Fed. Cir. 4/19/12). The Federal Circuit (Judge Prost) held that amended returns showing zeros for all income items and income taxes withheld were not a valid tax returns, and hence not valid administrative refund claims. Thus there was no jurisdiction to hear a refund suit.

8. The Constitution does not require Appeals Officers for CDP hearings to be appointed by the President. Tucker v. Commissioner, 676 F.3d 1129 (D.C. Cir. 4/20/12), *aff'g* 135 T.C. 114 (7/26/10). The taxpayer requested a CDP hearing after the IRS issued a notice of filing of a tax lien. After the settlement officer had upheld the tax lien notice, the taxpayer requested a remand for a hearing to be heard by an officer appointed by the President or the Secretary of the Treasury, in compliance with the Appointments Clause of U.S. Const., art. II, sec. 2, cl. 2. The Tax Court (Judge Gustafson) held that an "officer or employee" or an "appeals officer" under § 6320 or § 6330 is not an "inferior Officer of the United States" for purposes of the Appointments Clause. They are instead properly hired, pursuant to § 7804(a), under the authority of the Commissioner of Internal Revenue. The taxpayer's motion to remand was denied. In an opinion by Judge Williams, the Court of Appeals for the District of Columbia affirmed the Tax Court's decision. "[T]o be an 'Officer of the United States' covered by Article II, a person must 'exercis[e] significant authority pursuant to the laws of the United States.'" However, "Appeals employees' discretion is highly constrained. . . . [T]he significance and discretion involved in the decisions seem well below the level necessary to require an 'Officer.'"

9. Just as a taxpayer is not required to file an amended return, the IRS is not required to accept and process an amended return. Roberts v. Commissioner, T.C. Memo. 2012-144 (5/21/12). The taxpayer filed a return for 2007 reporting zero taxable income and $6,000 of withheld taxes. The IRS processed the return and applied the $6,000 overpayment to the taxpayer's unpaid 1983 tax liability. Subsequently, the taxpayer filed an amended return for 2007 reporting nearly $59,000 of taxable income, but the IRS did not process the amended return. Instead the IRS sent a deficiency notice with respect to the same amounts reported on the amended return, and did not credit the $6,000 withholding against the 2007 taxes. The taxpayer argued that was improper for the IRS to apply the overpayment claimed on his original 2007 return to a prior year tax liability, but the Tax Court (Judge Foley) was unimpressed by the argument.

> Petitioner further contends that respondent was required to treat his amended 2007 return as superseding the original 2007 return. We disagree. Taxpayers are permitted to submit amended returns, but the Commissioner is "not statutorily required to *** [accept an amended return], or to treat an amended return as superseding an original return." *Fayeghi v. Commissioner*, 211 F.3d 504, 507 (9th Cir. 2000), aff'g T.C. Memo. 1998-297.

10. You can remove those mindless disclaimers from your emails when these proposed regulations become final (but not before).[8] REG-13867-06, Regulations Governing Practice Before the

8. Chicago lawyer Sheldon I. Banoff suggests consideration of the following language at the end of emails until the proposed regulations become final:

> CIRCULAR 230 DISCLOSURE, NON-DISCLOSURE AND DISCLOSURE OF NON-DISCLOSURE: In accordance with Treasury Regulations Circular 230, any tax advice contained in this communication was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matter addressed herein (together, the "Prohibited Purposes"). In September 2012 Treasury proposed elimination of the requirement of the aforementioned Circular 230 disclosure, to be effective prospectively only (upon adoption in final form and publication of the revised Circular 230 in the Federal Register). Until that time, our emails shall continue to include the aforementioned Circular 230 disclosure. At such time as we are no longer required to include the aforementioned Circular 230 disclosure, we shall no longer do so; however, we recognize that those handful of you

Internal Revenue Service, 77 F.R. 57055 (9/17/12). In the course of a comprehensive revision of the requirements for tax opinions, these proposed Circular 230 regulations include the following:

- The rigid covered opinion rules in current § 10.35 (which require that the written opinion contain a description of the relevant facts, the application of the law to those facts, and the practitioner's conclusion with respect to the law and the facts) are removed; these rules are replaced with a single standard for all written tax advice under proposed § 10.37. This standard requires that the practitioner must: (i) base the written advice on reasonable factual and legal assumptions; (ii) reasonably consider all the relevant facts that the practitioner knows or should know; (iii) use reasonable efforts to identify and ascertain the facts relevant on each Federal tax

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who previously have bothered to read our Circular 230 disclosure will at that time wonder whether the elimination of our Circular 230 disclosure was due to oversight or, worse yet, that the email being sent by us to you is in fact "intended or written to be used," and can be used, for the Prohibited Purposes. Such inference is not intended (except in those extremely rare cases where it is intended, i.e., where you really would be entitled to so use our emails for the Prohibited Purposes). Therefore, effective as of the moment that the revised Treasury Regulations Circular 230 is published in the Federal Register, which should only happen in our lifetimes, the following disclosure shall become operative without any further action on our part: "Treasury Regulations Circular 230 was recently amended to eliminate the requirement that we disclose to you that any tax advice contained in this communication was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matter addressed herein (the "Prohibited Purposes"). Therefore, as of this moment you should not consider this email to be a Circular 230 disclosure. However, no inference is intended, and none should be taken, that our failure to make a Circular 230 disclosure to you from this moment forward shall entitle you to rely on any tax advice herein for any Prohibited Purpose. Further, in the event any person who is a member of, employed by or affiliated with this firm should continue to include a Circular 230 disclaimer on any email after the amendment of Circular 230 becomes effective, no negative inference should be taken that the emails of any others who are members of, employed by or affiliated with our firm whose emails do not contain the Circular 230 disclosure but which contain any tax advice can be used for the Prohibited Purposes, without the express written consent of an authorized representative of the firm."

matter; (iv) not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) if reliance on them would be unreasonable; and (v) not take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit. The determination of whether a practitioner has failed to comply with these requirements is based on all the facts and circumstances, not on whether each requirement is addressed in the written advice.

- Proposed § 10.35 provides that a practitioner must exercise competence when engaged in practice before the IRS (including providing written opinions), which includes the required knowledge, skill, thoroughness, and preparation necessary for the matter for which he is engaged. This complements the provision in § 10.51 that a practitioner can be sanctioned for incompetent conduct.
- Proposed § 10.36 conforms the "procedures to ensure compliance" with the removal of the covered opinion rules in current § 10.35, but expands these "procedures to ensure compliance" to include all of the provisions of Circular 230.
- Proposed § 10.1 provides that the Office of Professional Responsibility – as opposed to the IRS Return Preparer Office – would have exclusive responsibility for matters related to practitioner discipline.
- Proposed § 10.82 extends the expedited disciplinary procedures for immediate suspension, but limits it to practitioners who have engaged in a pattern of willful disreputable conduct by failing to make an annual Federal tax return during four of five tax years immediately before the institution of the expedited suspension proceeding, provided that the practitioner is also noncompliant at the time the notice of suspension is served.
- Proposed § 10.31 forbids practitioners from negotiating any taxpayer refunds, which specifically adds manipulation of any electronic refund process.

11. Not just any old express mail service cuts the mustard when you wait until the last minute to file a Tax Court petition. Scaggs v. Commissioner, T.C. Memo. 2012-258 (9/10/12). Tax Court Special Trial Judge Armen held that a Tax Court petition received more than 90 days after the date of a deficiency notice but which was sent via FedEx "Express Saver Third business day" within the 90-day period, was not timely filed. Notice 2004–83, 2004–2 C.B. 1030, which lists the private delivery serves that qualify for the same "mailbox" treatment as shipment via the U.S. Postal Service pursuant to § 7502(f), does not list FedEx "Express Saver Third business day."

12. If the statute requires Appeals to consult with Chief Counsel, it's not a prohibited *ex parte* communication. Hinerfeld v. Commissioner, 139 T.C. No. 10 (9/27/12). The taxpayer's proposed offer in compromise was rejected and he sought review in the Tax Court. Among the taxpayer's arguments was that the Appeals Officer had an improper ex parte consultation with Chief Counsel's Office, violating the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 1001(a)(4), 112 Stat. at 689, and Rev. Proc. 2000-43, 2000-2 C.B. 404, which provides guidelines in question and answer format that are designed to distinguish prohibited and permissible ex parte communications between Appeals and other IRS employees during an administrative appeal. The Tax Court (Judge Gale) rejected the taxpayer's argument. The Appeals Officer had consulted Chief Counsel's Office to seek an opinion as to whether the taxpayer had made a fraudulent conveyance. There was no evidence of improper communications, and review by Counsel was mandated by § 7122(b), which, when the IRS is to compromise any unpaid tax assessed of $50,000 or more, requires an opinion of the Chief Counsel to be filed with the IRS.

13. The IRS can't disclose knowingly false taxpayer information just because it could have disclosed true information. Aloe Vera of America, Inc. v. United States, 699 F.3d 1153 (9th Cir. 11/15/12). The statute of limitations under § 7431(d) on a claim for wrongful disclosure of a tax return begins to run when the taxpayer knows or reasonably should know of the government's allegedly unauthorized disclosures. On the facts of the case, the statute of limitations did not begin to run when the taxpayer became aware of a pending general investigation that would involve disclosures, but only later when they knew or should have known of the specific disclosures at issue. Under § 6103(k)(4), return information may be disclosed to a foreign government that has a tax treaty with the United States, if such information as is pertinent to carrying out the provisions of the treaty or preventing fraud or fiscal evasion in relation to the taxes which are the subject of the treaty. But the disclosure of knowingly false information to a foreign tax authority in a proposal for a simultaneous tax examination is not protected as "pertinent" information. There was a genuine issue of material fact as to whether the government knowingly disclosed false information, and the District Court's grant of summary judgment for the government was vacated and the issue remanded.

14. Prison tax returns. The 2012 Taxpayer Relief Act, § 209, expands the list of persons to whom false prisoner tax returns may be disclosed by the IRS under Code § 6103(k)(10) to include officers and employees of the Federal Bureau of Prisons, state agencies charged with prison administration, and contractors responsible for operating a Federal or state prison.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. Social Security is cheaper for 2011, but the deficits grow. The Compromise Tax Relief Act of 2010, § 601, reduces the employee portion of the Old-Age, Survivors, And Disability Insurance Tax (OASDI) from 6.2 percent to 4.2 percent for calendar year 2011.

- The 4.2 percent rate also applies to the railroad retirement tax.

a. Congress giveth a little and taketh some of it back. IR-2011-124 (12/23/11). This news release highlights the two month reduction in payroll withholding for social security taxes from 6.2 percent to 4.2 percent and the complimentary reduction in self-employment taxes for the first two months of 2012 under The Temporary Payroll Tax Cut Continuation Act of 2011. The news release indicates that employers should implement the new payroll rate as soon as possible, but in any event no later than March 31, 2012. The news release also highlights the recapture tax that is imposed on employees who receive more than $18,350 in wages during the two-month extension period in the amount of an additional 2 percent income tax on wages in excess of $18,350 received during the two-month extension.

b. The recapture tax was repealed. The Middle Class Tax Relief and Job Creation Act of 2012 repealed the two-percent recapture tax included in the December 2011 legislation that effectively capped at $18,350 the amount of wages eligible for the payroll tax cut. As a result, the now-repealed recapture tax does not apply

2. Attorneys are employees of their professional corporation law firm. Donald G. Cave a Prof. Law Corp. v. Commissioner, T.C. Memo 2011-48 (2/28/11), *aff'd*, 476 Fed. Appx. 424 (5th Cir. 3/22/12). The court (Judge Marvel) held that Donald Cave, the principal attorney for the taxpayer S corporation engaged in law practice, associates of the firm, and a law clerk were employees for employment tax purposes. Donald Cave was the corporation's president, made corporate decisions, and received a percentage of legal fees. The court held that Cave's management services in the capacity of the corporation's president were not provided as an independent contractor. Numerous factors supported employment status for associate attorneys, hired by Cave in his purported activity as an "an attorney incubator"; they were found to be sufficiently under the control of the corporation, the corporation provided facilities, while the associates' compensation was on a percentage basis, they bore no risk of loss, the relationship was "continuous, permanent, and exclusive," there was no evidence that the associate attorneys provided services to anyone else, and the associate attorneys provided everyday professional tasks in the corporation's business. The court also denied independent contractor status under the safe harbor of § 530 of the 1978 Revenue Act finding no reasonable basis for the corporation to have treated the attorneys as independent contractors. The corporation was also required to pay failure to deposit tax penalties under § 6656.

a. Affirmed on control and non-exposure to losses issues. Donald G. Cave, a Prof. Law Corp. v. Commissioner, 476 Fed. Appx. 424 (5th Cir. 3/22/12). The Fifth Circuit, in affirming the Tax Court, emphasized the factors of potential control by the firm of its associate attorneys and law clerk, as well as their non-exposure to losses. Judge Haynes concurred to note that, while the law clerk was "free" to do work for other attorneys outside the firm, "almost no evidence about [the clerk's] other work [was presented]," and continued, "we need not address here the tax treatment of a person who truly performs piece work for numerous business entities."

3. The forms are in the mail doesn't establish delivery. Martinez v. United States, 101 Fed. Cl. 686 (1/5/12). The taxpayer employed drivers as independent contractors in his sole-proprietorship trucking company. The taxpayer claimed relief from employment taxes for misclassified workers under § 530 of the Revenue Act of 1978, which requires that the taxpayer consistently treat workers as independent contractors and file appropriate tax returns. The taxpayer asserted that the required Forms 1099 were delivered to the IRS asserting that the timely delivery date can be established under the common-law mailbox rule, which provides that proof of timely mailing creates a presumption of delivery. The court noted that under § 7502(a) and (c) the only exceptions to requirements that returns be delivered are that a return will be deemed delivered on the date of the postmark, or on the date the mailing is registered [extended by regulation to certified mail]. The court added that even if the taxpayer could invoke a common-law mailbox rule, the evidence was not sufficient to prove a timely and proper mailing.

4. Employment tax liability depends upon which form you can use. LaFlamme v. Commissioner, T.C. Memo. 2012-36 (2/6/12). The taxpayer, a self-employed individual, deducted her contributions to her qualified defined benefit pension plan on her Schedule C, rather than on line 26 of her Form 1040 and claimed that her income from self-employment for purposes of employment tax liability was thereby reduced by the allowable § 162 deduction. Section 404(a)(8) allows a self-employed individual to deduct contributions to qualified plans under §§ 162 or 212. Section 1402 defines net income from self-employment subject to the self-employment tax of § 1401 as gross income "from any trade or business" less the deductions allowed by Subtitle A "which are attributable to such trade or business." The court (Judge Vasquez) agreed with the IRS that that the taxpayer's pension contribution is "not attributable to her trade or business." The court also indicated that the special rule of § 404(a)(8) does not apply outside of the context of that section. Thus, the taxpayer's pension contribution was not allowed as a deduction on her Schedule C in computing business income. The court declined to impose penalties under § 6662 finding that the taxpayer acted in good faith in the mistaken belief that she was entitled to deduct the pension contribution on her Schedule C.

5. S corporation "John Edwards gambit" dividends may be treated as wages. David E. Watson, P.C. v. United States, 714 F. Supp. 2d 954 (S.D. Iowa 5/27/10). Using a common tax reduction device, David Watson formed an S corporation that was a member of Watson's accounting firm. The S corporation contracted with the accounting firm to provide services. Watson was paid a salary of $24,000 as an employee of the S corporation, on which the S corporation paid employment taxes. The remainder of the S corporation income, approximately $200,000 per year, was distributed to Watson as a dividend, not subject to employee taxes. The IRS recharacterized the dividends as wages. The S corporation paid an assessment and brought a refund action. In a motion for summary judgment the S corporation asserted that its intent controls whether amounts paid are wages and that it intended to pay dividends in the amount of cash on hand after the payment of wages. Citing a long line of authorities in support of its position, the District Court held that the S corporation's "self-proclaimed intent" to pay salary does not limit the government's ability to recharacterize dividends as wages. The court indicated that whether amounts paid to Watson were remuneration for services is a question of fact.

- The court's opinion concluded with the following passage:

> In support of its Motion for Summary Judgment, Plaintiff points the Court to the following oft-cited statement of Judge Learned Hand:
>
> > Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes

> any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

> See Pl.'s Reply Br. at 5 n. 2 (quoting *Commissioner of Internal Revenue v. Newman*, 159 F.2d 848, 850-51 (2d Cir.1947) (L. Hand, J., dissenting)). While the Court agrees fully with Judge Learned Hand, it would remind Plaintiff of Justice Oliver Wendell Holmes' succinct, yet equally eloquent statement in *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*: "Taxes are what we pay for civilized society." 275 U.S. 87, 100 (1927) (Holmes, J., dissenting). Indeed, "the greatness of our nation is in no small part due to the willingness of our citizens to honestly and fairly participate in our tax collection system." *Manley v. Commissioner of Internal Revenue*, T.C. Memo 1983-558 (Sept. 12, 1983). Thus, while Plaintiff is free to structure its financial affairs in such a way as to avoid paying "more [taxes] than the law demands," Plaintiff is not free to structure its financial affairs in a way that avoids paying those taxes demanded by the law. In this case, the law demands that Plaintiff pay employment taxes on "all remuneration for employment," and there is clearly a genuine issue of material fact as to whether the funds paid to Watson, in actuality, qualify as such.

a. Since the judge gave the IRS everything it asked for, will the IRS go for the whole kit and caboodle the next time? David E. Watson, P.C. v. United States, 757 F. Supp. 2d 877 (S.D. Iowa 12/23/10). On the merits, Judge Pratt rejected the taxpayer's claim that the wages subject to employment tax were limited to the $24,000 salary formally paid to the sole shareholder/sole employee. In addition to the "salary" in each of the years in question, the corporation distributed approximately $175,000 of "profits," pursuant to a corporate resolution authorizing "payment to Watson of 'dividends in the amount of available cash on hand after payment of compensation and other expenses of the corporation.'" Citing *Joseph Radtke, S.C. v. United States*, 712 F. Supp. 143 (E.D. Wisc. 1989), *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990), and *Veterinary Surgical Consultants v. Commissioner*, 117 T.C. 141 (2001), as particularly persuasive, the court concluded that "characterization of funds disbursed by an S corporation to its employees or shareholders turns on an analysis of whether the 'payments at issue were made . . . as remuneration for services performed.'" After examining the facts, the court concluded that the reasonable amount of Watson's compensation for each of the years at issue was $91,044, increasing the $24,000 salary amount by the full amount of the $67,044 that the corporation claimed was a § 1368 distribution, thus upholding in full the government's position.

b. Reasonable compensation can go up as well as down. David E. Watson, P.C. v. United States, 668 F.3d 1008 (8th Cir. 2/21/12), *cert. denied*, 10/1/12. In affirming the District Court, the Court of Appeals agreed with the IRS that the factors used by courts to assess reasonable compensation in the context of deductions are applicable to determine whether payments are in fact remuneration for FICA purposes. The court indicated that "in light of all the facts and circumstances of the case, scrutinizing compensation for its reasonableness may guide a court in characterizing payments for FICA tax purposes." Assessing the facts, the Court of Appeals concluded that the District Court did not clearly err in treating additional payments to the taxpayers as remuneration for services. The court also rejected the taxpayer's argument that under *Pediatric Surgical Assocs., P.C. v. Commissioner*, T.C. Memo. 2001-81, the intent of the payor is controlling, noting that *Pediatric Surgical* did not involve a question of reasonableness.

6. The story line is just a rerun: NOLs do not reduce self-employment income. DeCrescenzo v. Commissioner, T.C. Memo. 2012-51 (2/27/12). The taxpayer was assessed deficiencies when he failed to file a return of income from self-employment as an accountant. The Tax Court (Judge Marvel) held – yet again — that § 1402(a)(4) prohibits a taxpayer from offsetting net earnings from self-employment with an NOL carryforward or carryback.

7. Tax-exempt employer is not subject to excise tax on qualified plan reversions. Research Corporation v. Commissioner, 138 T.C. 192 (2/29/12). Section 4980(a) imposes a 20 percent tax on the amount of any reversion to the employer from a qualified plan. However, § 4980(c)(1) excludes from the definition of a qualified plan, a plan "maintained by an employer if such employer has, at all times, been exempt from tax under subtitle A." Research Corporation received a reversion from its qualified plan in the amount of $4,411,395, but reported a taxable reversion under § 4980 of only $14,055 asserting that the reported amount reflected the portion of its income that was subject to the unrelated business income tax. In a case of first impression, the Tax Court (Judge Haines) rejected the IRS assertion that, because the tax-exempt corporation was subject to tax on unrelated business income, it was not at all times exempt from tax under subtitle A. The court cited the language of § 501(b), which provides that a § 501(c)(3) organization that is subject to the unrelated business income tax "shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes." Thus the court held that Research Corporation was to be treated as exempt from tax at all times for purposes of § 4980(c)(1). The court also concluded that Research Corporation overpaid its taxes on the portion that it treated as a reversion, but that the court lacked jurisdiction to order a refund.

8. Full-time resident horse farm workers don't have enough independence from the horse-mistress. Twin Rivers Farm, Inc. v. Commissioner, T.C. Memo. 2012-184 (7/2/12). The Tax Court (Judge Ruwe) denied the subchapter S corporation's petition for redetermination of the IRS's determination of employment status for two farm workers on the taxpayer's Tennessee horse farm. In spite of assertions by the taxpayer's sole shareholder that she did not exercise control over the two workers, the court noted that to maintain the requisite degree of control to establish employee status the principal need not directly control the worker; it is sufficient that the principal has the right to do so. The court indicated that by the nature of the work relationship, it was likely that the shareholder had the right to exercise control. The workers were using the taxpayer's equipment, caring for the corporation's principal assets, and living full time in a trailer on the taxpayer's property. The court pointed out that if the workers were not exercising their duties appropriately that the shareholder would certainly have intervened with direction. The court also pointed to the fact that the workers were receiving a regular weekly salary for their services and were long-term employees who resided on the farm. In addition, the taxpayer maintained workers compensation insurance and covered the workers' necessary job-related expenditures. The court also held the taxpayer liable for penalties under § 6651(a)(1) for failure to file the required Form 943 for employers of agricultural workers and penalties under § 6656 for failure to make timely employment tax deposits.

9. Skilled pieceworkers were employees even though the employer did not "stand over them" to control them. Atlantic Coast Masonry, Inc. v. Commissioner, T.C. Memo 2012-233 (8/13/12). In spite of the fact that construction masons and laborers were paid in cash by the taxpayer on a piece-work basis, the workers were held to be employees by Judge Jacobs. The Tax Court noted that the workers were skilled craftsmen who did not require direct supervision. Nonetheless, instruction from the taxpayer on the nature of the work and requirements for completion constituted control over the workers. "An employer need not 'stand over' the employee to control an employee." The court also indicated that the workers did not share in profits and losses notwithstanding the piece-work nature of the workers' compensation, and that the factor supported employee status. Section 530 relief was denied because the taxpayer failed to file Forms 1099 with respect to the workers. The taxpayer was also held liable for § 6651 penalties for failure to file required employment tax returns and § 6656 penalties for failure to pay required employment tax deposits. The court held that the taxpayer failed to demonstrate reasonable cause for the absence of filings.

10. 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). 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 the 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.

- Will the disagreement between the Federal and Sixth Circuits once again invite the Supreme Court to enter the deference fray?

11. The District Court for the Eastern District of New York gets the message. Recoveries in age discrimination suit are wages. Gerstenbluth v. Credit Suisse Securities (USA) LLC, 110 A.F.T.R.2d 2012-6238 (E.D.N.Y. 9/28/12). The District Court for the Eastern District of New York (Judge Seybert) granted summary judgment to defendants in a claim for refund against the employer and the IRS for employment taxes withheld by the employer on damages paid to the taxpayer in a successful claim for age discrimination. The court ruled that money paid to settle employment discrimination claims constitute wages where the money represents back pay or front pay. Although the settlement agreement with Credit Suisse did not explicitly describe the payment as wages, the court concluded that the payment represented wages based on the employer's characterization of the payment as wages in reporting the settlement as compensation on Form W-2.

a. As does the Northern District. Back and front pay in a Title VII wrongful discharge recovery are wages. Noel v. New York State Office of Mental Health Central New York Psychiatric Center, 697 F.3d 209 (2d Cir. 8/31/12). The plaintiff in a Title VII wrongful discharge case recovered damages for back and front pay in a jury trial. The State Office of the Controller withheld employment taxes from its payment of the judgment. The District Court for the Northern District of New York ordered the Controller to pay the full amount of the judgment. In an appeal filed by the Controller, joined by the Tax Division of the Justice Department as *amicus*, the Court of Appeals held that the front and back pay constituted wages subject to withholding. The court noted that both front and back pay constitute remuneration paid to compensate for what the employee would have earned had the employee not been a victim of discrimination. Thus, the court concluded that, "[t]hese amounts are 'wages' because they constitute 'remuneration' for services during an employee-employer relationship."

12. Funding health care by making the HI tax more progressive. Section 1401, as amended by the 2010 Health Care Act, increases the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages in excess of a threshold amount. The threshold amount is $250,000 of the combined wages of both spouses on a joint return ($125,000 for a married individual filing a separate return). The threshold is $200,000 for all other individuals. The employer must withhold the additional HI tax, but in determining the employer's withholding requirement and liability for the tax, only wages that the employee receives from the employer in excess of $200,000 for a year are taken into account, and the employer disregards the employee's spouse's wages. I.R.C. § 3102(f). The employee is liable for the additional 0.9 percent HI tax to the extent the tax is not withheld by the employer. Section 1402(b), as amended, imposes an additional tax of 0.9 percent on self-employment income above the same thresholds. The threshold amount is reduced (but not below zero) by the amount of wages taken into account in determining the FICA tax with respect to the taxpayer. No deduction under § 164(f) is allowed for the additional SECA tax, and the alternative deduction under § 1402(a)(12) is determined without regard to the additional SECA tax rate. The additional tax applies to wages received in taxable years after 12/31/12.

a. Proposed regulations relating to the Additional Medicare Tax. REG-130074-11, Rules Relating to Additional Medicare Tax, 77 F.R. 72268 (12/05/12). Proposed regulations under §§ 1401, 3101, and 3102, relating to Additional Hospital Insurance Tax on income above threshold amounts ("Additional Medicare Tax"), as added by the Affordable Care Act. Specifically, these proposed regulations provide guidance for employers and individuals relating to the implementation of Additional Medicare Tax. This document also contains proposed regulations relating to the requirement to file a return reporting Additional Medicare Tax, the employer process for making adjustments of underpayments and overpayments of Additional Medicare Tax, and the employer and employee processes for filing a claim for refund for an overpayment of Additional Medicare Tax.

- The changes to §§ 1401 and 3102 are effective for tax years beginning after 12/31/12, and taxpayers may rely on the proposed regulations for purposes of complying with these section until the effective date of the final regulations, which are expected to be made final during 2013 and will be applicable to tax years beginning after 12/31/13.
- FAQs to the Additional Medicare tax were released by the IRS on 11/30/12, 2012-TNT 232-48.

B. Self-employment Taxes

1. LLC guaranteed payments are subject to self-employment tax; the members are held to their reporting positions. Howell v. Commissioner, T.C. Memo. 2012-303 (11/1/12). Mr. Howell and Mr. Bruzee formed a limited liability company to develop medical technology. Mrs. Howell (the taxpayer), however was named as a 60 percent member of the LLC instead of Mr. Howell because she had a better credit rating and the parties intended to use her personal credit card for LLC expenditures. The LLC members were compensated with payments deducted by the LLC as guaranteed payments. Under § 1402(a)(13) a limited partner's distributive share of partnership income is excluded from wages for self-employment tax purposes except for guaranteed payments under § 707(c) for services rendered to the partnership. The Tax Court (Judge Marvel) rejected the taxpayer's argument that the payments were distributions of partnership share not subject to employment tax. The court held that the taxpayer was bound by the characterization of the payments on the partnership returns, which she signed, noting that taxpayers are free to organize their affairs as they choose, but that a taxpayer "may not enjoy the benefit of some other route he might have chosen to follow but did not." The court also observed that the taxpayer introduced no evidence to prove that the payments to Mrs. Howell were not in substance guaranteed payments. The court indicated that although Mrs. Howell's services were minimal in contrast to the management services of her husband pursuant to a contract signed by Mrs. Howell on behalf of the partnership, Mrs. Howell provided marketing advice, signed documents, entered into contracts on behalf of the LLC, and allowed the LLC to use her credit card and credit rating. The court thus found that Mrs. Howell was not merely a passive investor in the LLC. The guaranteed payments were not, therefore, excluded from wages.

2. Good preaching at home does not avoid self-employment tax for this carpenter. Good v. Commissioner, T.C. Memo 2012-323 (11/20/12). The taxpayer's claimed ministry for Prepare the Way Ministries, formed based on various books about churches and taxes, did not exempt the taxpayer's income from various services from self-employment tax under the minister exception of § 1402(c)(4). Taxpayer's receipts were also otherwise includible in gross income. The Tax Court (Judge Marvel) concluded that the taxpayer failed to provide any credible evidence that he was a minister of a church and held the taxpayer liable for fraud penalties.

3. Local police officers working off-duty security jobs are independent contractors. Specks v. Commissioner, T.C. Memo. 2012-343 (12/11/12). The taxpayer, a Houston police officer, provided off-duty security services in uniform for private companies. The private companies reported the remuneration on Forms 1099. The Tax Court (Judge Kroupa) determined that the taxpayer was an independent contractor subject to self-employment tax. The private parties did not train, supply, or equip the taxpayer in performing the security service, which was performed on an at-will basis. The court concluded that the absence of evidence of control over the taxpayer was to be given greater weight over other factors indicating employee status.

- The court sustained § 6662(a) accuracy-related penalties and indicated that the taxpayer failed to establish under

§ 664(c) reasonable reliance on a return preparer who was a competent professional with significant expertise and provided all of the relevant information.

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 is added to the list of excise taxes for which disregarded entities (QSub or single owner business entity) that are treated as separate entities.

2. Roll your own, inhale, and pay the tax. Section 100122 of the Transportation Act would amend Code § 5702(d) to add to the tobacco excise tax any person who for commercial purposes makes available to the consumer a machine that rolls cigarettes, cigars, or other tobacco products. Previously the tax only applied to manufacturers of cigarettes and cigars who actually rolled the product, but did not apply to consumers who rolled their own. This change would add to the tobacco excise tax establishments that provided access to commercial grade rolling equipment to consumers who purchased the tobacco and paper from the retailer and fed it into the machine provided by the retailer, obtaining cigarettes at much lower cost free of the excise tax.

3. The IRS rejects a (former) Court of Claims limitation on retroactive application of rulings. AOD 2012002 (9/12/12). The IRS announced its nonacquiescence in *International Business Machines Corp. v. United States*, 343 F.2d 914 (Ct. Cl. 1965), which held that the IRS could not apply a changed position on an excise tax issue prospectively from the date of revocation to a taxpayer whose erroneous favorable ruling was revoked, but retroactively as to another taxpayer. The Court of Claims in *IBM* held that it was an abuse of discretion to treat two competitors differently with respect to excise taxes on the same type of equipment.

4. Final regulations for the Medical Device Excise Tax. T.D. 9604, Taxable Medical Devices, 77 F.R. 72924 (12/7/12). Final Reg. §§ 48.4191-1 and -2 provide guidance on the excise tax imposed on the sale of certain medical devices, enacted by the Health Care and Education Reconciliation Act of 2010 in conjunction with the Patient Protection and Affordable Care Act. They define "taxable medical device" and provide for the imposition of the tax at a 2.3 percent rate on manufacturers, producers and importers making sales of such devices.

- The tax is applicable to sales on and after 1/1/13.

a. Notice 2012-77, 2012-52 I.R.B. 781 (12/5/12). The IRS has provided guidance regarding the § 4191 excise tax imposed on the sale of certain medical devises by domestic and foreign manufactures. The notice spells out a methodology for determining a constructive sales price applicable to manufacturers who sell through multiple distribution channels. The notice also exempts the sale price of domestically produced connivance kits for practitioners who install the medical device. Foreign produced convenience kits are subject to the excise tax only to the extent of the value of included taxable medical devices.

- FAQs to the excise tax were released by the IRS on 12/6/12, 2012-TNT 235-22.

XII. TAX LEGISLATION

A. Enacted

1. The **Patient Protection and Affordable Care Act** ("PPACA" – pronounced "pee-pac-a" or "Obamacare"), P.L.111-148, was signed by President Obama on 3/23/10, and H.R. 4872, the **Health Care and Education Reconciliation Act of 2010** ("2010 Health Care Act" or "2010 Reconciliation Act"), P.L. 111-152, was signed by President Obama on 3/30/10.

a. The 2010 Health Care Act is constitutional, but the "penalty" is not a "tax." Thomas More Law Center v. Obama, 651 F.3d 529 (6th Cir. 6/29/11) (2-1). The Sixth Circuit Court of Appeals, in an opinion by Judge Martin, upheld the constitutionality of the Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010), amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029. The majority opinion upheld the Act under the Commerce Clause. Judge Sutton's concurring opinion also concluded that the Act was constitutional under the Commerce Clause, but held that the Act was not an exercise of the taxing power – the penalty for not purchasing health insurance was not a tax. An opinion by Senior District Judge Graham, concurring in part and dissenting in part, also held that the Act was not an exercise of the taxing power but would have held the Act unconstitutional as beyond Congress's power to regulate commerce.

b. But, on the other hand, the Eleventh Circuit holds that the individual mandate is unconstitutional. Florida v.

U.S. Department of Health & Human Services, 648 F.3d 1235 (11th Cir. 8/12/11) (2-1). The Eleventh Circuit held that Congress exceeded its authority by requiring Americans to buy coverage, but also ruled that the rest of the wide-ranging law could remain in effect. The case stems from a challenge by twenty-six states which had argued the individual mandate, set to go into effect in 2014, was unconstitutional because Congress could not force Americans to buy health insurance or face the prospect of a penalty. The majority stated:

> This economic mandate represents a wholly novel and potentially unbounded assertion of congressional authority: the ability to compel Americans to purchase an expensive health insurance product they have elected not to buy, and to make them re-purchase that insurance product every month for their entire lives.

c. Does anyone really care what D.C. Circuit thinks when the issue is already up on certiorari? Seven-Sky v. Holder, 661 F.3d 1 (D.C. Cir. 11/8/11). The Court of Appeals for the District of Columbia (2-1) upheld the constitutionality of the minimum essential health care coverage requirement of § 1501 of the 2010 Patient Protection and Affordable Health Care Act, codified at Code § 5000A as an exercise of Congress's power under the Commerce clause. The suit was not barred by the Anti-Injunction Act because the suit involved a penalty unconnected to a tax liability. Judge Kavanaugh dissented as to jurisdiction because he would have held that the AIA barred the suit.

d. When President Obama said that the "individual mandate" was not a tax, Justices Kennedy, Scalia, Thomas, and Alito thought he was being serious, but the Chief Justice and Justices Ginsburg, Breyer, Sotomayor, and Kagan knew that, as usual, he was just fooling with us. National Federation of Independent Business v. Sebelius, 132 S. Ct. 2566 (6/28/12). On certiorari to the Eleventh Circuit, the Chief Justice delivered the opinion for the Court which held: (1) that the suit to declare the individual mandate unconstitutional was not barred by the Anti-Injunction Act because Congress indicated that it did not want it to be so barred (9-0); (2) that the individual mandate was unconstitutional as an exercise of congressional power under the Commerce Clause (5-4); and (3) that the individual mandate was valid as a tax – but not a direct tax – under the Taxing Clause (5-4). With respect to the Direct Tax Clause, the Chief Justice stated:

> A tax on going without health insurance does not fall within any recognized category of direct tax. It is not a capitation. Capitations are taxes paid by every person, "without regard to property, profession, or *any other*

> *circumstance*." *Hylton, supra*, at 175 (opinion of Chase, J.) (emphasis altered). The whole point of the shared responsibility payment is that it is triggered by specific circumstances — earning a certain amount of income but not obtaining health insurance. The payment is also plainly not a tax on the ownership of land or personal property. The shared responsibility payment is thus not a direct tax that must be apportioned among the several States.

- There was some more stuff about Congress lacking the power to force states to expand Medicaid upon pain of denial of all federal aid to states for Medicaid, which was decided 7-2.

2. The **Middle Class Tax Relief and Job Creation Act of 2012**, P.L. 112-96, was signed by President Obama on 2/22/12. The new law also repeals the two-percent recapture tax included in the December 2011 legislation that effectively capped at $18,350 the amount of wages eligible for the payroll tax cut. As a result, the now-repealed recapture tax does not apply.

3. The **Moving Ahead for Progress in the 21st Century Act** (the "Transportation Act"), P.L. 112-141, was signed by President Obama on 7/6/12. Section 100122 of the Transportation Act amends Code § 5702(d) to add to the tobacco excise tax any person who for commercial purposes makes available to the consumer a machine that rolls cigarettes, cigars, or other tobacco products.

4. The **American Jobs Act of 2011** was orally signed by President Obama on 9/8/11. It will reduce the unemployment rate to 4 percent, cause the oceans to recede and cure cancer. Lacking are a written bill (because the Congressional Budget Office perversely refuses to score speeches) and the trivial detail of congressional voting (rendered irrelevant by President Obama's multiple repetitions of the necessity of immediate passage of the yet-unwritten bill, which Congress perversely failed to do on 9/9/11).

a. His directing that this fiscal cliff bill be "signed" with an autopen, instead of signing it himself, confirms that Obama acted arrogantly throughout this entire process. The lion's share of the Act consists of so-called "Jimmy Johnson" provisions. The **American Taxpayer Relief Act of 2012** ("the 2012 Taxpayer Relief (and not so grand compromise) Act" or "the Act"), P.L. 112-240, was "signed" by President Obama's autopen on 1/2/13.

- According to a White House Press Secretary statement, it "makes permanent the temporary rates on taxable income at or below $400,000 for individual filers and $450,000 for married individuals filing jointly; permanently indexes the Alternative Minimum Tax exemption amount to the Consumer Price Index; extends emergency unemployment compensation benefits and Federal funding for extended benefits for unemployed workers for one year; continues current law Medicare payment rates for physicians' services furnished through December 31, 2013; extends farm bill policies and programs through September 30, 2013; and provides a postponement of the Budget Control Act's sequester for two months.