

FLORIDA TAX REVIEW

Volume 12

2012

Number 5

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION: THE YEAR 2011

Martin J. McMahon, Jr.^{*}

Ira B. Shepard^{**}

Daniel L. Simmons^{***}

This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide Dan and Marty the opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to 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 any useful information is Dan's.

^{*} Stephen C. O'Connell Professor of Law, University of Florida Fredric G. Levin College of Law.

^{**} Professor Emeritus, University of Houston Law Center.

^{***} Professor of Law Emeritus, University of California Davis School of Law.

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I. ACCOUNTING

A. Accounting Methods

1. New and improved automatic consent procedures for changes of accounting methods. Rev. Proc. 2011-14, 2011-4 I.R.B. 330

(1/11/11). This revenue procedure provides automatic consent procedures for a wide variety of accounting method changes. Rev. Proc. 97-27 *clarified and modified*; Rev. Procs. 2001-10, 2002-28, 2004-34, and 2006-56 *modified*; Rev. Procs. 2008-52 and 2009-39 *superseded in part*.

a. Rev. Proc. 2011-14 has since been modified by Rev. Proc. 2011-27, 2011-18 I.R.B. 740 (4/4/11), Rev. Proc. 2011-28, 2011-18 I.R.B. 743 (4/4/11), and Rev. Proc. 2011-43, 2011-37 I.R.B. 326 (8/19/11).

2. Judge Haines writes a treatise on defective claims to automatic consent to change an accounting method. Capital One Financial Corp. v. Commissioner, 130 T.C. 147 (5/22/08). Following the enactment in 1997 of § 1272(a)(6)(C)(ii), which provides that credit card late-fee receipts create or increase original issue discount rather than constituting an income item when they accrued under the all events test, the taxpayer claimed to have received the IRS's consent to change its accounting method, pursuant to an automatic consent procedure, by filing Form 3115 with its 1998 tax return. However, the taxpayer did not change its accounting method for 1998 and 1999. In the Tax Court, the taxpayer sought to retroactively change its method for 1998 and 1999. Judge Haines held that § 446(e) prohibited the taxpayer from retroactively changing its treatment of income from credit card late-fees for years 1998 and 1999 from the current-inclusion method to the method under § 1272(a)(6)(C)(iii) that requires late-fee receipts to create or increase original issue discount, even though the OID method was mandatory under the statute, because the taxpayer did not file a Form 3115 to notify the IRS of the change of accounting method with its 1997 return. Because the Form 3115 was not timely filed and did not specifically mention "late fees," automatic consent had not been granted. Judge Haines stated:

[A] taxpayer forced to change its method of accounting under section 448 must still file a Form 3115 with its return for the year of change. [Reg. § 1.448-1(h)(2)] If the Form 3115 is not filed timely, a taxpayer forced off the cash method must comply with the requirements of [Reg. § 1.446-1(e)(3)] in order to secure the consent of the Commissioner. Reg. § 1.448-1(h)(4). Pursuant to [Reg. § 1.446-1(e)(3)], a taxpayer requesting to change its method of accounting is required to file a Form 3115 during the year in which it intends to make the change.

a. **The taxpayer won the substantive issue, but foot-faulted on seeking a change in method of accounting, so most of**

the deficiency is upheld. But in future years, it's "ooh la la" for the taxpayer! Capital One Financial Corp. v. Commissioner, 133 T.C. 136 (9/21/09). This case involved two issues and over \$280 million – \$175 million for one year alone – (apart from penalties). The first issue was the time that third-party credit card issuers are required to recognize credit card income known as interchange. Interchange is the difference between the amount charged on a credit card and the lesser amount remitted to the merchant by the issuing bank. Interchange resembles interest in that it is expressed as a percentage of the amount lent, usually with an additional nominal fee, although it is not time-sensitive and does not vary as interest rates fluctuate. The government argued that interchange income was credit card fee income that was recognized under the all events test at the time the interchange accrued – when the cardholder's credit card purchase was settled through either the Visa or MasterCard system – while the taxpayer argued that the interchange income was original issue discount (OID) that was properly recognized under § 1272(a)(6)(C)(iii), which was added to the Code in 1997, over the anticipated life of the pool of credit card loans to which the interchange related. The Tax Court (Judge Haines) agreed with the taxpayer and held that the interchange income was OID. Interchange is not a fee for any service other than the lending of money. However, because the taxpayer failed to follow proper procedures to change its accounting methods, the OID method was not available for credit card receivables creating or increasing OID in 1998 or 1999. With certain modifications, the method used by the taxpayer to compute the OID income (using a model developed by KPMG) was reasonable.

- A second issue was whether the taxpayer could currently deduct the estimated cost of future redemptions of "miles" it issued to cardholders that could be redeemed for airline tickets, the cost of which would be paid by the taxpayer. The court held that under § 461(h) and Reg. § 1.461-4, those expenses could not be deducted currently, but instead were deductible only to the extent that the amounts were fixed and known under the all events test and for which economic performance had occurred.

b. And Judge Wilkinson of the Fourth Circuit likes Judge Haines's approach to change of accounting method rules, but avoids writing a treatise. Capital One Financial Corp. v. Commissioner, 659 F.3d 316 (4th Cir. 10/21/11). The Fourth Circuit, in an opinion by Judge Wilkinson, affirmed both Tax Court decisions. Addressing the OID change of accounting method issue first, the Court of Appeals rejected the taxpayer's argument that because it was changing from an improper method of accounting to a proper method of accounting, it was not required to obtain the IRS's consent to the change of accounting method. It also rejected the taxpayer's argument that an uncodified provision of the 1997 legislation changing the OID rules, which provided that requests to

change to the new OID method would be subject to automatic consent, obviated the need to obtain consent. The court reasoned that an uncodified provision cannot override § 446(e), which “requires that taxpayers receive consent before a change in accounting method ‘except as otherwise expressly provided in this chapter.’” Finally, the court rejected the taxpayer’s arguments that (1) automatic consent changes do not require the filing of a Form 3115, and (2) a Form 3115 filed with the tax return suffices.

- Turning to the issue of whether the taxpayer could currently deduct the estimated cost of future redemptions of “miles” it issued to cardholders, the Court of Appeals affirmed on the grounds that the expenses did not meet the all events test: “When a single mile is awarded for each dollar charged on the card, it remains unknown when the cardholder will earn the 18,000 miles necessary to qualify for an airline ticket. It also remains uncertain when, if ever, the cardholders will redeem their outstanding accumulated miles. Therefore, the amount and timing of Capital One’s liabilities with respect to airline tickets for MilesOne cardholders are not fixed until customers redeem their miles.” The court rejected the taxpayer’s argument that Reg. § 1.451-4, allowing a current deduction for coupons issued in connection with was applicable, holding that credit card lending is not a “sale” of goods.

B. Inventories

There were no significant developments regarding this topic during 2011.

C. Installment Method

There were no significant developments regarding this topic during 2011.

D. Year of Inclusion or Deduction

1. **The long arm of § 267(a)(2).** Bosamia v. Commissioner, T.C. Memo. 2010-218 (10/7/10). Section 267(a)(2) applies to the determination of the cost of goods sold when an accrual method taxpayer purchases from a related cash method taxpayer property that will be included in the purchaser’s inventory. Thus, because the costs were not paid within two and one-half months after the close of the purchaser’s taxable year, the amounts could not be included in COGS. Furthermore, because the adjustment was a change of accounting method, § 481 applied to eliminate from the COGS amounts previously included in costs of goods sold with respect to amounts that remained unpaid in the current year for goods purchased in years beyond the statute of limitations.

a. **Affirmed by the Fifth Circuit.** Bosamia v. Commissioner, 661 F.3d 250 (5th Cir. 10/24/11). In this case presenting a question of first impression, the Fifth Circuit (Judge Garza) held that when the IRS requires a taxpayer to postpone a deduction from gross income under § 267(a)(2), that disallowance constitutes a change in a taxpayer's method of accounting under § 481. An accrual method S corporation purchased music as inventory from a related cash method S corporation during the years 1998-2002, and treated the \$877,581 amounts accrued as costs of goods sold when its liability became fixed. However, the purchasing S corporation failed to pay for the music purchases made during those years, which had been closed by the statute of limitations before the IRS audit of the 2004 year. Indeed, the purchasing corporation has not yet to date made those payments, and the selling S corporation has not included those amounts in income. In its audit of the purchasing S corporation for the year 2004, the IRS disallowed \$23,351 of erroneously accrued liabilities for music purchased during that year, but not paid for during that year or in the first 2½ months of 2005. The issue was whether the IRS could include the amounts accrued during the closed years 1998-2002 in income under § 481 as resulting from a change of accounting method. An amendment made to § 267(a)(2) in 1984 changed the result of failure to make timely payment from a complete denial of the deduction to a postponement of the deduction until the year of actual payment.

- The court held that the 2004 IRS audit change in the purchasing S corporation's treatment of a "material item," i.e., its cost of goods sold, constituted a change in its method of accounting pursuant to Reg. § 1.446-1(e)(2)(ii)(a). It further held that, even though § 267(a)(2) could preclude any deduction if the payment were never made, that would be the result had the payments been properly accounted for on the cash basis in the years 1998-2002. The court was also unimpressed with the absence of precedent because the IRS's "reasonable" position in its interpretation of the Code and Regulations would have been sustained even had it represented a change of position by the IRS.

2. **The IRS retreats on group liabilities! How far will it go?** Rev. Rul. 2011-29, 2011-49 I.R.B. 824 (11/9/11). This Revenue Ruling holds that an accrual method employer can establish the "fact of the liability" under § 461 for bonuses payable to a group of employees even though the employer does not know the identity of any particular bonus recipient and the amount payable to that recipient until after the end of the taxable year. Rev. Rul. 76-345, 1976-2 C.B. 134, in which the IRS announced that it would not follow *Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969), was revoked. A change in a taxpayer's treatment of bonuses to conform to this revenue ruling is a change of

accounting method that must be made in accordance with §§ 446 and 481, the regulations thereunder, and the applicable administrative procedures. See section 19.01(2) of the APPENDIX of Rev. Proc. 2011-14, 2011-4 I.R.B. 330.

- The logic of this revenue ruling should extend beyond bonuses to other types of “group” liabilities where the group and the aggregate amount owed, but not necessarily the exact identity and payment to each recipient, can be identified.

3. Simplifying OID! Is that oxymoronic? Notice 2011-99, 2011-50 I.R.B. 847 (11/28/11). This Notice provides a proposed revenue procedure that will allow taxpayers to use a simplified proportional method of accounting for OID on pools of credit card receivables under § 1272(a)(6). The proportional method allocates to an accrual period an amount of unaccrued OID that is proportional to the amount of pool principal that is paid by cardholders during the period.

4. Is the IRS reining in the recurring item exception to the “economic performance” rules? Rev. Rul. 2012-1, 2012-2 I.R.B. 255 (12/13/11). This ruling clarifies the treatment for accrual method taxpayers of liabilities under the recurring item exception to the economic performance requirement under § 461(h)(3) by addressing the application of the “not material” and “better matching” requirements of the recurring item exception to a lease and a related property service contract having one-year terms beginning on July 1 that runs over two taxable calendar years, with the entire amount being prepaid, where the taxpayer reasonably expects that it will enter into similar leases and service contracts on a recurring basis in the future. To apply the recurring item exception, the taxpayer must show either that (1) the liability is immaterial or (2) accruing the full liability in the year incurred results in better matching of expenses to related income. Because the taxpayer accrued the liabilities over more than one taxable year for financial statement purposes, the liabilities were material, so the first alternative was not met. Because the taxpayer used the leased property to generate income over the period of lease, accrual of the full amount of the liabilities in a year before economic performance did not result in better matching. Thus, the taxpayer cannot use the recurring item exception. The ruling distinguishes contracts for the provision of services from insurance and warranty contracts and applies the recurring item exception differently. A change in a taxpayer’s method of accounting to conform to the revenue ruling is an accounting method change to which §§ 446 and 481 apply. Rev. Proc. 2011-14, 2011-4 I.R.B. 330, is modified and amplified to provide automatic consent.

5. “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. No. 2 (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).

II. BUSINESS INCOME AND DEDUCTIONS

1. This claim of a tax-free contribution to capital goes down in flames. AT&T, Inc. v. United States, 629 F.3d 505 (5th Cir. 1/3/11), *aff’g* 104 A.F.T.R.2d 2009-6036 (W.D. Tex. 7/16/09). The Court of Appeals (Judge Dennis) affirmed a District Court decision holding that payments from the Federal government for universal telephone access were includible in income and were not excluded under § 118 as contributions to capital. The payments were part of state and federally mandated programs

funded by fees collected from telecommunications carriers based on revenues. Under those programs, payments are made to carriers with high cost obligations to provide universal access to telephone services. The District Court followed the decision in *United States v. Coastal Utilities, Inc.*, 514 F.3d 1184 (11th Cir. 2008). The court traced the history of the exclusion for contributions to the capital of a corporation, ending with the five characteristics of a nonshareholder contribution to capital set forth in *United States v. Chicago, Burlington & Quincy Railroad Co.*, 412 U.S. 401 (1973).

[1] It certainly must become a permanent part of the transferee's working capital structure. [2] It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. [3] It must be bargained for. [4] The asset transferred foreseeably must result in benefit to the transferee in an amount commensurate with its value. And [5] the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

• From the Supreme Court jurisprudence, the court derived "three principles."

(1) Whether a payment to a corporation by a non-shareholder is income or a capital contribution is controlled by the intention or motive of the transferor. (2) When the transferor is a governmental entity, its intent may be manifested by the laws or regulations that authorize and effectuate its payment to the corporation. (3) Also, a court can determine that a transfer was not a capital contribution if it does not possess each of the first four, and ordinarily the fifth, characteristics of capital contributions that the Supreme Court distilled from its jurisprudence in *CB&Q*.

• Applying these principles to the facts of the case, the court concluded that, "either by construing the controlling statutes and regulations or by applying the *CB&Q* five-factor test, the governmental entities in making universal service payments to AT&T did not intend to make capital contributions to AT&T; and thus, that the payments were income to AT&T." Under the statutes authorizing the payments, the administrative implementation in regulations, the payments "were not intended to be capital contributions to AT&T, but to be supplements to AT&T's gross income to enable it to provide universal service programs while meeting competition" The payments "were compensation to AT&T for the specific and quantifiable services it performed for high-cost and lower-income users as well as for developing and maintaining universal service" Furthermore, the

payments did not become “a permanent part of AT&T’s working capital structure, as is demanded by the first *CB&Q* requirement.”

a. And the beat goes on. Sprint Nextel Corporation v. United States, 779 F. Supp. 2d 1184 (D. Kan. 3/4/11). Payments from the FCC high cost program to make available communications services in high cost areas were not excluded nonshareholder contributions to capital.

2. A give on § 118 for corporations, but the IRS carefully limits it to corporations. Rev. Proc. 2011-30, 2011-21 I.R.B. 802 (4/14/11). The IRS will not challenge a corporate taxpayer’s treatment of an award from the Department of Energy under various programs for clean coal energy and carbon recapture, CCPI - Round 3, ICCS, or FutureGen 2.0, as a nonshareholder contribution to the capital of the corporation under § 118(a) of the Code if the corporate taxpayer properly reduces the basis of its property under § 362(c)(2) and the regulations.

3. Transparent insolvency for disregarded entities. REG-154159-09, Guidance Under Section 108(a) Concerning the Exclusion of Section 61(a)(12) Discharge of Indebtedness Income of a Grantor Trust or a Disregarded Entity, 76 F.R. 20593 (4/13/11). Prop. Reg. § 1.108-9 would provide that, for purposes of applying § 108(a)(1)(A) and (B), the bankruptcy and insolvency exclusions, to discharge of indebtedness income of a grantor trust or a disregarded entity, the term taxpayer, as used in § 108(a)(1) and (d)(1) through (3), refers to the owner(s) of the grantor trust or disregarded entity.

4. Mr. Wood’s stealing from his employer for the benefit of Woodie’s Market, Inc. is income to Wood. Wood v. Commissioner, T.C. Memo. 2011-190 (8/10/11). Mr. Wood embezzled funds from the overhead door company where he was general manager and used the money for personal expenses and operating money for Woodie’s Market, Inc., owned and operated by Wood and his wife. The court (Judge Goeke) rejected the taxpayer’s assertion that because checks were written on the overhead door company account to Woodie’s Market the income was taxable to the Market rather than taxpayer personally. The court concluded that because the taxpayer had control over the funds and determined their use, the embezzled money was includable in the taxpayer’s gross income. The court pointed out that the taxpayer confused how the money was spent with how the money was acquired. The court also rejected the taxpayer’s argument that the embezzled funds were a contribution to capital of the Market. Using stolen funds as a contribution to capital did not relieve the taxpayers of their liability to report the income.

5. Negotiated allocations characterizing damages received pursuant to a settlement have to be based on fact to be respected. Healthpoint, Ltd v. Commissioner, T.C. Memo. 2011-241 (10/3/11). In two different cases Healthpoint sued Ethex for false advertising, unfair competition, and trademark dilution under the Lanham Act and unfair competition, misappropriation, business disparagement under state law, and theft of trade secrets, in connection with Ethex's marketing of a generic drug substitute for one of Healthpoint's trademarked drugs. In one case (Ethex I) the jury awarded Healthpoint (1) actual damages of \$5,000,000, (2) disgorgement of Ethex's profits from false advertising and unfair competition of \$1,640,000, (3) punitive damages of \$3,174,515, and (4) Lanham Act enhanced damages of \$6,349,030. The other case (Ethex II) was not tried. Pending appeals, Healthpoint and Ethex settled both cases — Ethex I for \$12 million and Ethex II for \$4.5 million. Subsequently, Ethex and Healthpoint signed the settlement agreement resolving both cases. After intense negotiations, the damages were allocated under the settlement agreement as follows: (1) Ethex I: (a) damage to goodwill and reputation, \$10,450,000; (b) lost profits/disgorgement of profits, \$1,350,000; (2) Ethex II: (a) damage to goodwill and reputation, \$4,050,000, (b) lost profits/disgorgement of profits, \$450,000. Healthpoint reported \$14.5 million in long-term capital gain and \$1.8 million in ordinary income. On audit, the IRS determined that all proceeds of the settlement were ordinary income to Healthpoint (and applied a § 6662(a) penalty), but in the Tax Court, the IRS conceded that the Lanham Act enhanced damages of \$6,349,030 awarded by the jury for loss of goodwill were taxable as long-term capital gain. The taxpayer argued that the allocation of damages in the settlement agreement should be respected, but the Tax Court (Judge Cohen) held otherwise because the allocation of damages in the settlement agreement was not negotiated on the basis of adverse interests. The court held that “in the light of the circumstances of the settlement and the verdict in Ethex I, the allocations made by the jury should be applied to the settlement of Ethex I for tax purposes.” With respect to Ethex II, in which the issues were very similar, the court found that the taxpayer had not met its burden to show that the allocations according to the settlement agreement in Ethex II should be respected. Accordingly, the amounts paid to settle Ethex II were allocated in the same proportions and classifications as those in Ethex I, on the basis of the jury verdict. The court also upheld accuracy related penalties under § 6662 because, while Healthpoint relied on the advice of tax counsel to oversee the settlement agreement, there was no proof that tax counsel offered an opinion on the propriety of the allocations in the settlement agreement or that tax counsel participated in the negotiation of the allocation.

6. Offshore employee leasing arrangement produces constructive income and fraud penalties. Browning v. Commissioner, T.C.

Memo. 2011-261 (11/3/11). The taxpayer was the principal shareholder and CEO of a Vermont-based manufacturing corporation. The taxpayer leased his services to an Irish corporation, which in turn subleased the taxpayer's services to a U.S. employee leasing company, which then leased the services to the taxpayer's manufacturing company. For tax years 1995-2000 the manufacturing company paid the equivalent of the taxpayer's salary to the U.S. leasing company. The U.S. leasing company paid a portion of the payment to the taxpayer as wages, which the taxpayer reported. After deducting an amount for employment taxes, the U.S. leasing company remitted the remainder of the payment to the Irish corporation, which deposited the payment in a deferred compensation account for the taxpayer. The retirement account was opened in a Bahamas bank by a subsidiary of the Irish corporation. From 1998 the taxpayer obtained a credit card from a Bahamas bank that was supported by an account in the bank that was funded from the retirement account. The credit card was used by the taxpayer for personal expenses. The court (Judge Halpern) found that the taxpayer exercised unrestricted access to the Bahamas retirement account by means of the credit card and easily concluded that the evidence convincingly supported the IRS assertion that the taxpayer was in constructive receipt of income directed through the employee leasing arrangement. For the years after 1998, the court concluded that the taxpayer fraudulently intended to evade tax based on the taxpayer's use of the credit cards and concealment of the existence of the Bahamas bank accounts by answering "no" to the return question asking whether the taxpayer had signature authority over a foreign financial account. Because of the fraud, the statute of limitations remained open for years after 1998. However, the court did not extend its fraud finding to years 1995-1997 because the Bahamas account was not created before 1998. The court also imposed fraud penalties under § 6663 for the years 1998-2000.

7. A theory that is becoming more attractive to a couple of us is rejected. The one of us who is over 72 is old enough to know better. West v. Commissioner, T.C. Memo. 2011-272 (11/16/11). The court (Judge Paris) found that the taxpayer failed to meet the burden of proof required to overcome the IRS assertion of a deficiency on the basis of the taxpayer's belief that he did not have to report gross income because he was over the age of 72.

8. The dentist's income is taxable to the dentist, just like his lawyer's income is taxable 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.2d 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.

9. 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 Own 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.

B. Deductible Expenses versus Capitalization

1. Those fancy Pyrex® and Oneida® branded kitchen products are made by Robinson Knife Manufacturing, which is required to capitalize license fees. Robinson Knife Manufacturing Co. v. Commissioner, T.C. Memo. 2009-9 (1/14/09). The taxpayer designs and produces kitchen tools for sale to large retail chains. To enhance its marketing, the taxpayer paid license fees to Corning for use of the Pyrex trademark and Oneida for use of the Oneida trademark on kitchen tools designed and produced by the taxpayer. The taxpayer's production of kitchen tools bearing the licensed trademarks was subject to review and quality control by Corning or Oneida. The IRS asserted that the taxpayer's licensing fees were subject to capitalization into inventory under § 263A under Reg. § 1.263A-1(e)(3)(ii)(u), which expressly includes licensing and franchise fees as indirect costs that must be allocated to produced property. Agreeing with the IRS, the court (Judge Marvel) rejected the taxpayer's argument that the licensing fees, incurred to enhance the marketability of its produced products, were deductible as marketing, selling, or advertising costs excluded from the capitalization requirements by Reg. § 1.263A-1(e)(3)(iii)(A). The court noted that the design approval and quality control elements of the licensing agreements benefited the taxpayer in the development and production of kitchen tools marketed with the licensed trademarks. The court rejected the taxpayer's argument that Rev. Rul. 2000-4, 2000-1 C.B. 331, which allowed a current deduction for costs incurred in obtaining ISO 9000 certification as an assurance of quality processes in providing goods and services, was applicable to the quality control element of the license agreements. The court noted that although the trademarks permitted the taxpayer to produce kitchen tools that were more marketable than the taxpayer's other products, the royalties directly benefited and/or were incurred by reason of the taxpayer's production activities. The court also upheld the IRS's application of the simplified production method of Reg. § 1.263A-2(b) to allocate the license fees between cost of goods sold and

ending inventory as consistent with the taxpayer's use of the simplified production method for allocating other indirect costs.

a. But the Second Circuit disagrees.

Robinson Knife Manufacturing Co. v. Commissioner, 600 F.3d 121 (2d Cir. 3/16/10). Like the Tax Court, the Court of Appeals rejected Robinson's arguments that the royalty payments were deductible as marketing, selling, advertising or distribution costs under Reg. § 1.263-1(e)(3)(iii)(A), or that the royalty payments were deductible as not having been incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced under Reg. § 1.263A-1(e)(3)(ii)(U). The Court of Appeals concluded, however, that "royalty payments which are (1) calculated as a percentage of sales revenue from certain inventory, and (2) incurred only upon sale of such inventory, are not required to be capitalized under the § 263A regulations." The court held that the royalties were neither incurred in, nor directly benefited, the performance of production activities under Reg. § 1.263A-1(e)(3)(i). Unlike license agreements, the court concluded that Robinson could have manufactured the products, and did, without paying the royalty costs. The royalties were not, therefore, incurred by reason of the production process. The court also concluded that since the royalties were incurred for kitchen tools that have been sold, "it is necessarily true that the royalty costs and the income from sale of the inventory items are incurred simultaneously." The court noted further that had Robinson's licensing agreements provided for non-sales based royalties, then capitalization would have been required.

b. Proposed regulations make you wonder why the IRS ever litigated *Robinson Knife*. REG-149335-08, Sales-Based Royalties and Vendor Allowances, 75 F.R. 78940 (12/17/10). The IRS has proposed regulations under § 263A that generally provide the taxpayer-favorable result reached by the Second Circuit in *Robinson Knife*. The proposed regulations provide that sales-based royalties must be capitalized, but also provide that sales-based royalties required to be capitalized are allocable only to property that a taxpayer has sold, rather to closing inventory. The preamble asserts that the Second Circuit in *Robinson Knife* misconstrued the nature of costs required to be capitalized and that the costs of securing rights to use intellectual property directly benefits, or are incurred by reason of, production processes requiring that the costs be capitalized even if payable only on the basis of the number or units sold or as a percentage of revenue. Nonetheless, the proposed regulations are consistent with the holding of *Robinson Knife* where they provide that sales based royalties are related only to units that are sold during the taxable year. Thus,

Prop. Reg. § 1.263A-3(d)(3)(i)(C)(3) would provide that sales based costs would not be included in ending inventory under § 471.

- However, in light of the generous treatment of sales-based royalties, the proposed § 263A regulations, along with proposed amendments to Reg. § 1.471-3(e), require that sales-based vendor allowances [which are rebates or discounts from a vendor as a result of selling the vendor's merchandise] must be taken into account as an adjustment to the cost of merchandise sold, effectively requiring that such allowances be included in gross income immediately, and should not be taken into account in ending inventory.

- The formulas allocating additional indirect costs to ending inventory under the simplified production and resale methods would be modified to remove capitalized sales based royalties and vendor allowances allocable to property that has been sold.

c. But the IRS still disagrees with the Second Circuit. AOD 2011-01, 2011-9 I.R.B. 526 (2/9/11), *corrected by* Ann. 2011-32, 2011-22 I.R.B. 836 (5/31/11). The IRS disagrees with the Second Circuit analysis stating that the court “confused the timing with the purpose of the payments.” The IRS opines that Robinson incurred the royalty expenses first to produce then to sell the trade-marked items, adding that in order to sell the items it first had to produce them.

2. Starting-up is cheaper. The Small Business Jobs Act of 2010 increases the amount of deductible § 195 start-up expenses for investigating or creating an active trade or business from \$5,000 to \$10,000 for expenses incurred in a year beginning in 2010. The phase out amount is also increased from \$50,000 to \$60,000.

a. Start-up and organization expenses final regulations are adopted. T.D. 9542, Elections Regarding Start-up Expenditures, Corporation Organizational Expenditures, and Partnership Organizational Expenses, 76 F.R. 50887 (8/17/11). Sections 195 (start-up expenditures in an active trade or business), 248 (corporate organization expenditures), and 709 (partnership organization expenditures), each provide for an election to deduct such expenditures in the year business begins to the extent of the lesser of the amount of the expenditures or \$5,000 reduced by the amount that the expenditures exceed \$50,000. Under the election, the remaining expenses are amortizable over 180 months beginning with the month that business commences. The finalized regulations, Reg. §§ 1.195-1, 1.248-1, and 1.709-1, following temporary and proposed regulations, provide that a taxpayer is deemed to make the election to amortize start-up or organization expenses for the year in which the active business, corporate business, or partnership business to which the expenditure relates begins.

The regulations provide that a taxpayer may choose to forego the election by affirmatively electing to capitalize the expenditures on a timely filed return for the year in which the business begins. The final regulations are effective on the date of filing in the Federal Register, but may be applied by taxpayers to expenditures incurred after 10/22/04, provided the period for assessing a deficiency for the year the election is deemed made is still open.

3. Subsidizing Oscar hopefuls. 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 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 Reg. §§ 1.181-0, 1.181-1, 76 F.R. 64879 (10/19/11). The temporary 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.

4. 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 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 counterclaim for capitalization of additional interest.

- No pretzel in existence has as many twists and bends as does this opinion. For background, see *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (1/11/11), at XI.A., below.

5. Amounts paid that are contingent on successfully closing a transaction could be 70 percent deductible and 30 percent capitalizable. Rev. Proc. 2011-29, 2011-18 I.R.B. 746 (4/8/11). Reg. § 1.263(a)-5 requires a taxpayer to capitalize any amount paid to facilitate a business acquisition, which includes any amount paid to investigate or pursue the acquisition. An amount contingent on successfully closing a transaction is presumed to facilitate the transaction. The revenue procedure indicates that the IRS will not challenge the allocation of success based fees if the taxpayer treats 70 percent of the fee as an amount that does not facilitate the transaction, capitalizes the remaining 30 percent of the fee as an amount that does facilitate the transaction, and attaches a statement to the return for the year indicating that the taxpayer is electing the safe harbor.

- The IRS seems to be giving up a lot in order to avoid these types of controversies.

6. Housing construction on unimproved lots is production. Gardner v. Commissioner, T.C. Memo. 2011-137 (6/20/11). The taxpayer was a self-employed contractor who built single and multiple family housing on unimproved land that he purchased. The Tax Court (Judge Halpern) held that the taxpayer was required to capitalize engineering costs and taxes incurred in connection with a 34 acre parcel that the taxpayer prepared for subdivision then sold. The court concluded that the parcel was held for production, and § 263A requires capitalization of pre-production costs with respect to property held for construction or improvement. See § 263A(g)(1) and Reg. § 1.263A-2(a)(3)(ii). However, because no physical production had occurred during the year, the rule of § 263A(f), requiring capitalization of production period interest, did not apply to require capitalization of interest, so the interest was deductible. The court also held that the sale of three subdivided/duplex lots resulted in short-term capital gain. The court found that, although the taxpayer regularly purchased undeveloped land for development and sale, the taxpayer held some properties with the intent of developing the property and holding it for rent rather than for sale to customers.

7. 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 (3/7/08)), which were in turn based on a 2006 proposal that was substantially modified by the 2008 proposed regulations (REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 71 F.R. 48590 (8/21/06)). 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 rotatable 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 rotatable and temporary spare parts under which (1) the taxpayer deducts the amount paid for the part in the year the part is first installed on a unit of property, (2) in each year the part is removed from a unit of property the taxpayer includes the fair market value of the part in gross income, (3) includes in the basis of the part the value taken into income plus amounts paid to remove the part, (4) includes in the basis of the part any amounts expended to maintain the part, (5) then deducts the basis and any cost incurred to reinstall the part in a unit of property, and finally (6) deducts the basis of the part on final disposition.

- *Financial Accounting De Minimis Rules.* 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 minimis 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 material and supplies, including rotatable 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 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

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.

components) that performs a discrete and major function or operation within the functionally interdependent machinery or equipment constitutes a separate unit of property. Determinations of a unit of property with respect to network assets are based on the taxpayer's facts and circumstances unless otherwise provided in published guidance. Network assets include property such as railroad tracks, oil, gas, water and sewage pipelines, power transmission lines, and cable and telephone lines that are owned or leased by taxpayers in those industries.

- *Capitalization of Improvements.*

Expenditures to improve a unit of property must be capitalized. 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:

(1) Result in a "betterment" to a unit of property (replacing the term "material increase in value" used in the original proposal);

(2) Restore a unit of property; or

(3) Adapt 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 as 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 or are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement." 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 rotatable 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.

C. Reasonable Compensation

1. **Every time a reasonable compensation case is appealable to the Seventh Circuit, it seems that whoever the judge is, after doing the *Exacto Spring* 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.

2. 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 deduction 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 regulations § 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.

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 announced. Notice 2010-88, 2010-51 I.R.B. 882 (12/3/10). Standard mileage rates for

2011 are: (1) 51 cents per mile for business miles driven [up from 50 cents]; (2) 19 cents per mile driven for medical or moving purposes [up from 16.5 cents]; and (3) 14 cents per mile driven in service of charitable organizations [unchanged because the rate is statutory, § 170(i)].

b. Mileage rates are back up for second half of 2011. Ann. 2011-40, 2011-29 I.R.B. 56 (6/23/11). The IRS has announced that the standard optional mileage rates for computing the deductible costs of operating an automobile for business will increase from 7/1/11 through 12/31/11 to 55.5 cents per mile. The standard rate for purposes of medical and moving expenses is 23.5 cents per mile. The statutory rate for charitable deductions purposes is 14 cents per mile.

c. And remain almost the same for (part of?) 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.

2. Have you documented that your own cell phone is used for business rather than personal purposes? Tash v. Commissioner, T.C. Memo. 2008-120 (4/29/08). Among the many deductions claimed by a lawyer that Judge Haines disallowed was the deduction claimed for his cellular telephone, because “[t]he record did not indicate whether petitioner used his cellular telephone for business and/or personal calls.” Inasmuch as cell phones are listed property, Reg. § 1.274-5(c) and (f) require substantiation for the deduction.

a. How do you steer the car? It might or might not be OK to drive while talking on your cell phone, but it is imperative to take notes in your log book while chatting on the phone. Alami v. Commissioner, T.C. Memo. 2009-42 (2/23/09). Judge Vasquez denied the taxpayer’s claimed business deductions for cellular telephone service because the taxpayer failed to establish the amount of time he used his cell phone for business and personal purposes. A cellular phone is “listed property” that is subject to the strict substantiation requirements of § 274(d) pursuant to § 280F(d)(4)(A)(v), and a taxpayer must establish the amount of business use and the amount of total use for the property to substantiate the amount of expenses for listed property. An alternative ground for denying the deduction was that the taxpayer’s employer did not require that he have a cell phone.

- Query whether there are employer reporting obligations with respect to cell phones furnished to employees who fail to keep records?

b. But, simplified methods for reporting cell phone use are under consideration. Notice 2009-46, 2009-23 I.R.B. 1068 (6/8/09). IRS is considering methods to simplify treatment of employer-provided cell phones, including a (1) "minimal personal use method" (if the employee accounts to the employer that he has a personal cell phone for use during business hours); and (2) a safe harbor method under which an employer would treat 75 percent of each employee's use of the cell phone as business usage.

- In a letter to Representative Skelton, INFO 2009-0141 (7/8/09), the IRS advised that it is seeking clarifying legislation from Congress. 2009 TNT 216-62.

c. And the Prez says to Congress "delist" cell phones. President Obama's Fiscal Year 2011 Budget calls for Congress to amend § 280F to remove cellular telephones from the category of listed property, thereby "effectively removing the requirement of strict substantiation and the limitation on depreciation deductions." Department of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals 26 (February 2010). The substantiation requirements are "burdensome for employers"; it is difficult to document the cost of cell phone calls, and "the cost of accounting for personal use often exceeds the amount of any resulting income." The proposal specifically contemplates that "a cell phone (or other similar telecommunications equipment) provided primarily for business purposes would be excluded from gross income."

d. Finally, there is no longer a need to keep a log book on the front seat of your car. Section 2043 of the Small Business Jobs Act of 2010 removed "cellular telephones and similar telecommunications equipment" from the definition of "listed property" contained in § 280F(d)(4) for taxable years beginning after 12/31/09. This, in turn, eliminates the § 274(d) substantiation requirement for business cell phone use.

e. "Hanging on the [cellular] telephone." Notice 2011-72, 2011-38 I.R.B. 407. (9/15/11). After 12/31/09, a cellular telephone provided to an employee for a substantial noncompensatory purpose is a working condition fringe benefit. The employer's need to contact the employee at all times for work-related emergencies, the employer's requirement that the employee be available to

speak with clients at times when the employee is away from the office, and the employee's need to speak with clients located in other time zones at times outside of the employee's normal work day are possible substantial noncompensatory business reasons. A cell phone provided to promote the morale or good will of an employee, to attract a prospective employee or as a means of furnishing additional compensation to an employee is not provided primarily for noncompensatory business purposes. If the provision of the phone qualifies as a working condition fringe benefit, the value of any personal use of an employer-provided cell phone can be excluded from income as a de minimis fringe benefit.

3. The cost of figuring out what kind of work you're going to do isn't deductible. Forrest v. Commissioner, T.C. Memo. 2011-4 (1/4/11). The court (Judge Wherry) held that expenses incurred in a "fledgling effort" solo law practice by a lawyer who reported no income from her law practice, but which were incurred to make contacts and network in an effort to "figure out what kind of work ... [the taxpayer] was going to do," were nondeductible start-up expenses under § 195.

4. Appropriately-named television news anchor was denied a deduction for her wardrobe, etc. Hamper v. Commissioner, T.C. Summary Opinion 2011-17 (2/24/11). The court (Special Trial Judge Dean) denied a television news anchor's deduction of clothing costs and upkeep because the clothing in question was suitable for everyday wear and held that taxpayer's claimed business deductions were personal expenses. Accuracy-related penalties were upheld.

5. Let the judicial interpretation of § 199 begin! Gibson & Associates, Inc. v. Commissioner, 136 T.C. 195 (2/24/11). Section 199 allows a corporate taxpayer to deduct a percentage (equal to 3 percent for the year in question) of its "qualified production activities income." The starting point for the computation is "domestic production gross receipts." Section 199(c)(4)(A)(ii) provides that domestic production gross receipts include a taxpayer's gross receipts from the construction of real property performed in the United States if the taxpayer is engaged in the active conduct of a construction business and the gross receipts are derived in the ordinary course of that business, but § 199 does not define the phrase "construction of real property." The taxpayer is an engineering and heavy construction company that primarily erects or rehabilitates streets, bridges, airport runways, and other related real property. Its rehabilitation services relate mainly to real property that is substantially dilapidated or damaged from a casualty. The taxpayer also repairs and maintains real property. The taxpayer treated all of its receipts as "domestic production gross receipts" eligible for the § 199 deduction, but the IRS disallowed the deduction on the

ground that none of its receipts qualified. The Tax Court (Judge Paris) held that the receipts derived from the erection or substantial renovation of real property (that operated and performed a discrete function in and of itself) were domestic production gross receipts to the extent that the taxpayer's activities with respect to each property (1) materially increased the value of the real property, (2) substantially prolonged the useful life of the real property, and/or (3) adapted the real property to a different or new use. Many of the taxpayer's activities met this test. However, the gross receipts from the taxpayer's real property repair business that were unrelated to its primary business and which did not materially increase the value of the real property, substantially prolong its useful life, and/or adapt the real property to a different or new use did not qualify. The case was highly factual.

6. Hard Rock Cafes are unified but not substantiated. Morton v. United States, 98 Fed. Cl. 596 (4/27/11). The taxpayer is one of the co-founders of the Hard Rock Café chain, which is operated through a series of S corporations in which the taxpayer was the sole or majority investor. In addition the taxpayer owned the real property underlying Hard Rock cafes, which was leased to the S corporations. The taxpayer travelled in a Gulfstream III aircraft, which he exchanged for a Gulfstream IV through a qualified intermediary. The aircraft was used both for business and personal travel. While the pilot logs for the aircraft recorded the date, time of the trips, destinations, and the number of passengers, the logs did not record the identity of passengers or the purpose of the trips. The court accepted the taxpayer's argument that the taxpayer's unified business enterprise permitted deductions for the aircraft use that furthered the business purpose of the taxpayer's various entities other than the entity to which the aircraft was registered. *Deputy v. du Pont*, 308 U.S. 488 (1940), and *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943), held that the taxpayer and his corporations must be treated as separate entities for determining business expenses under § 162. The court concluded that, "Undisputed facts support the conclusion that Plaintiff's entities were intertwined and formed a unified business enterprise that operated for profit-making purposes." However, the court deferred ruling on the summary judgment motion on the deductibility of the expenses and depreciation pending indicating that its ruling would be dependent upon substantiation of business use of the aircraft.

- The court also held that a mistaken disbursement of cash to the taxpayer's corporation on the exchange of the Gulfstream III rather than to the qualified intermediary, when the money was immediately returned to the intermediary should not defeat like-kind exchange treatment under § 1031 because the error was quickly rectified.

- However, the court also deferred ruling on the § 1031 exchange pending a determination of the business use of the aircraft.

7. Folks never give up trying to claim they are away from home when the job is really permanent. Scroggins v. Commissioner, T.C. Memo 2011-103 (5/18/11). The court (Judge Wherry) held that the taxpayer who maintained a residence in Georgia but worked in California, was not entitled to away from home deductions for California expenses. The taxpayer was employed exclusively in California, and he knew that he would be away from Georgia for a very long time. The taxpayer's employment as a medical technician was highly specialized as a type of work not available in Georgia. Finally, the taxpayer had no business reason for maintaining a home in Georgia.

8. Day trading is a losing proposition, but it's not a trade or business. Kay v. Commissioner, T.C. Memo 2011-159 (7/6/11). As the sole owner of a ball bearing manufacturing operation the taxpayer reported wages of \$36,400, \$43,600, and \$52,000 in tax years 2000, 2001, and 2002. The taxpayer's S corporation reported net income of \$657,683, \$385,270, and \$278,213 in those years. The taxpayer also claimed losses of \$2,052,637, \$399,740 and \$278,297 from sales of stocks in his day trading activities. In the years 2000, 2001, and 2002, the taxpayer executed 313, 172 and 84 trades respectively. The taxpayer rarely purchased and sold stocks on the same day. During the years at issue, the taxpayer conducted trading activity on 29 percent, 7 percent, and 8 percent of the available trading days. The Tax Court (Judge Cohen) held that, although the taxpayer's trading was substantial, the taxpayer's activities were not sufficiently frequent to be treated as a trade or business. The court noted that the taxpayer's S corporation was his primary source of income and rejected the taxpayer's claim that he spent the majority of his time in his trading activities. Thus the taxpayer's losses were capital losses, the deductions of which were limited to \$3,000 per year. The court also sustained penalties under § 6662.

9. Deductible legal fees incurred in defending internet shoe sales. Ramig v. Commissioner, T.C. Memo. 2011-147 (6/27/11). The taxpayer incurred legal expenses successfully defending an investor suit against a failed internet shoe store in which the taxpayer was the CEO and an investor. The Tax Court (Judge Morrison) agreed with the taxpayer's assertion that because he was sued personally, the legal claims originated out of the taxpayer's services for the company as an employee and allowed deductions under § 162. The court disallowed claimed bad debt deductions for advances that the taxpayer made to the company when it was unable to obtain external financing, holding that the advances were equity.

10. The girlfriend's house is not a primary place of business. Bogue v. Commissioner, TC Memo. 2011-164 (7/11/11). The taxpayer shared a home with his fiancée from which he travelled to various construction job worksites. The taxpayer stored tools at the residence, made business related phone calls, and used a computer to search for materials, but did not establish an exclusively used home office. The Tax Court (Judge Wells) denied deductions for travel between the residence and the worksites holding that under the judicial exception for travel expenses between a home and worksites requires that the residence constitute a principal place of business at which the taxpayer maintains a home office that meets the requirement of § 280A(c)(1) that the home office be used regularly and exclusively as the taxpayer's principal place of business. The court also denied deductions for travel from the taxpayer's residence in Cherry Hill, New Jersey to worksites in the Philadelphia area as travel to temporary distant worksites.

11. What's a freeway flyer adjunct professor who teaches online courses? Why an employee, of course. Schramm v. Commissioner, T.C. Memo. 2011-212 (8/30/11). The taxpayer was an adjunct professor at Nova Southern University (NSU) who taught online economics courses under separate contracts entered into for each course. NSU provided the syllabus for each course and specified the material that was to be covered. NSU filed forms W-2 for the taxpayer treating him as an employee. The court (Judge Ruwe) agreed with the IRS that the taxpayer was an employee and denied deductions for business expenses reported by the taxpayer on schedule C as an independent contractor. The court found an employment relationship under multiple factors, noting that even though the taxpayer's position as an adjunct professor allows an independent approach in teaching his classes, NSU had authority to exercise control in a manner that rendered the taxpayer an employee, the taxpayer's own investment in tools or facilities was insubstantial, the remuneration received by the taxpayer was not subject to fluctuation as independent profit or loss, the taxpayer did not demonstrate that he would be entitled to breach of contract damages if the relationship were terminated, the taxpayer was engaged in NSU's regular business, the taxpayer maintained a continuing relationship with NSU over a period of years, and NSU considered the relationship to be an employer-employee relationship. The court indicated that the fact that NSU did not provide employment benefits, indicating an independent contractor status, carried little weight in the overall analysis.

12. Farm spouse's medical reimbursement plan may be deductible if she is a common law employee. Shellito v. Commissioner, 437 Fed. Appx. 665 (10th Cir. 8/24/11). The taxpayer conducted a farming operation in all of which he claimed a sole proprietary interest. The

taxpayer's wife worked on the farm since 1982 assisting in planting and harvesting, operation of tractors, caring for livestock, repairing fences and equipment, handling books and records, and other tasks. The taxpayer claimed that he made all of the business and operating decisions without input or consent from his wife, whose work he directed. He did not regard his wife as a business partner and listed her occupation on their joint return as housewife. In 2001 the taxpayer adopted a medical reimbursement plan for employees and entered into an employment agreement with his wife that indicated that she was a hired farm hand to do farm work as the taxpayer directed. The Tax Court, T.C. Memo. 2010-41, sustained the IRS disallowance of the taxpayer's deductions on the couple's joint return for expenses of the medical reimbursement plan holding that the taxpayer's wife was not an employee because she was not compensated concluding that the wife was an equal owner of all funds paid into her individual account from the couple's joint checking account, that payment of her medical expenses was simply an assumption of her husband's liability under Kansas state law, and that the form of the transaction did not in substance give rise to a true employment relationship. In reversing the Tax Court, the Tenth Circuit reviewed numerous Tax Court memorandum and summary opinions to point out that the IRS position on a spouse as employee has been inconsistent. The court also referred to Rev. Rul. 71-588, 1971-2 C.B. 91, which provides that, "Amounts reimbursed under an accident and health plan covering all bona fide employees, including the owner's wife, and their families are not includable in the employee's gross income and are deductible by the owner as business expenses." The court rejected the IRS argument that the medical reimbursement should be disregarded because they convert a legal obligation to support into a deductible expense as not supported by any case law. The court also rejected the Tax Court's conclusion that the payments were not deductible because they were made from the couple's joint checking account noting that such a requirement would only add another structural layer to the holding of Rev. Rul. 71-588 providing for spousal employment. The court also noted that there was no proof that the funds in the joint checking account were equally owned by the spouses. The appellate court also rejected the Tax Court's "substance over form" holding by indicating that the Tax Court was incorrect in concluding that the taxpayer's wife worked for no compensation. Ultimately, the appellate court remanded the case for findings on the issue of whether the wife was an employee under the common law agency doctrine.

13. It's how you spend the loan proceeds, not what you pledge to secure the loan that determines deductibility of interest. Sherrer v. Commissioner, T.C. Memo. 2011-198 (8/15/11). Under Temp. Reg. § 1.163-8T(c), the actual use of loan proceeds is generally determinative of the classification of the interest paid on the loan. Except in

the case of qualified residence interest subject to § 163(h)(3), the absence or presence of a security interest is not relevant. Applying this rule, the Tax Court (Judge Carluzzo) held that interest paid by the taxpayer on loans secured by business property was not deductible as interest on trade or business indebtedness, because taxpayer failed to show that proceeds of the loans were used for business purposes. The interest on the loans was treated as nondeductible personal interest.

14. Home may be a tax home. Lyseng v. Commissioner, T.C. Memo. 2011-226 (9/21/11). The taxpayer was a contract laborer performing maintenance work on nuclear plants and other utilities. The taxpayer worked temporarily at job sites that required travel away from the taxpayer's residence in Northern Minnesota where he lived with his father and fiancé. Petitioner's jobs lasted less than one year, and most lasted only a few months. Petitioner sought work through his union located in his city of residence. The Tax Court (Judge Swift) indicated that "the taxpayer's home may be the tax home if, (1) The taxpayer incurs duplicate living expenses while traveling and maintaining the home; (2) the taxpayer has personal and historical connections to the home; and (3) the taxpayer has a business justification for maintaining the home," citing *Hantzis v. Commissioner*, 638 F.2d 248, 255 (1st Cir. 1981). The court concluded that because the taxpayer's jobs were temporary he had no principal place of work, the taxpayer incurred duplicated expenses, and his home historically had been around the city of his residence. Thus, the court ruled that the taxpayer was entitled to claim deductions for his travel away from his place of residence. The court allowed some and denied some of the taxpayer's claimed deductions based on an evaluation of the substantiation provided by the taxpayer in accord with the strict requirements of § 274(d).

15. Researching tax dodges doesn't qualify for the R&D credit. The Heritage Organization, LLC v. Commissioner, T.C. Memo. 2011-246 (10/19/11). Heritage was an LLC owned by four members consisting of Holdings, Inc. and three limited partnerships. Heritage was operated by Gary Kornman, the sole owner of Holdings, which in turn was a five percent member of Heritage, and William Ralph Canada. Heritage was engaged in producing and managing life insurance for high net worth individuals and became involved in tax and estate planning for clients. Heritage maintained a subsidiary responsible for identifying and researching potential clients and referring them to Kornman and Canada who worked to complete life insurance transactions. Heritage's research subsidiary also conducted legal and tax research regarding corporate and trust structures to minimize taxes, including Son of Boss transactions. Kornman controlled eleven dormant corporations, each of which was transferred to a trust created by Kornman and Canada. Heritage lent \$1 million to each corporation which

was used by the corporation to engage in a short sale of U.S. Treasury notes through individual brokerage accounts that were in turn transferred to a trading partnership. In January 2000 each corporation closed its short sales at a loss and transferred funds back to Heritage in partial payment of the loans, leaving an outstanding balance of \$275,000 in each corporation. In December 2000, the Heritage secretary, who also was an officer in each corporation, sent checks to herself from each corporation in the amount of \$550,000. The checks were ultimately rejected and payment was effected through a wire transfer in January 2001. While checks sent by a cash method taxpayer are generally deductible in the year the checks are distributed, the court (Judge Paris) ruled that since the checks were ultimately settled by the subsequent wire transfer in 2001, the expenditures were attributable to Heritage's 2001 tax year. In addition, the court rejected the taxpayer's claim that the \$6,050,000 represented by the payments to the eleven corporations was deductible as a § 174 research and experimental expense based on the taxpayer's assertion that the expenses were incurred to "develop" a set of shelf corporations with embedded losses. The court indicated that the expenditure was not for research in the experimental or laboratory sense and was not incurred to eliminate uncertainty concerning the development of a product. The court also rejected the taxpayer's argument that the expenditure was deductible under § 162 as an ordinary and necessary business expense. The court concluded that the payoff to the eleven corporations was to meet the losses incurred by the corporations on their short sales and that Heritage had not shown that it was obligated to repay the corporations for losses from investment activity. The court further indicated that under the TEFRA rules the disallowed deduction was a partnership item thereby increasing the distributive share of each partner's partnership income. Finally, the court sustained negligence penalties under § 6662.

16. Apparently the Tax Court is unaware that under No Child Left Behind teachers' pay is determined with reference to their students' performance. *Farias v. Commissioner*, T.C. Memo. 2011-248 (10/24/11). The taxpayer was an elementary school teacher whose classes included health, nutrition, and fitness. The school provided teachers with basic classroom supplies, and purchases of anything beyond basic supplies were left to the teacher's discretion. Teachers were not reimbursed for any items purchased for the classroom. The taxpayer claimed deductions for the cost of "candy and sugar" provided to students as incentives, although her documentation was not perfect. She also testified that she purchased a U.S. savings bond that was presented to a student in recognition of community service provided to the school. Judge Cohen upheld the disallowance of all of the claimed expenses. "There is no evidence that the school required the purchase of the candy or the savings bond for petitioner's students. These

expenses were not necessary to petitioner's job; and no matter how well intentioned, gifts to students are not deductible as business expenses."

17. Unsubstantiated expenses are not allowed as deductions, but the business had to have some expenses even after walking away. Bell v. Commissioner, T.C. Memo. 2011-296 (12/22/11). In a return for his 1996 tax year, filed ten years late, the pro se taxpayer claimed expenses from his landscaping business. The IRS assessed a deficiency for understated income and disallowed the expenses. The taxpayer asserted that he lost all of his records because, "It has been all destroyed due to the [criminal] case that I was dealing with in '96. I had a choice of walking away or doing jail time, and I chose to walk away." The court (Judge Wherry), following the rule of *Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930), indicated that "it is inconceivable that he did not pay some expenses operating the landscaping business. We believe petitioner had to have paid expenses such as for the rental of machinery, for repairs and maintenance of his equipment, and incidental expenses such as gas for lawnmowers and related equipment." The court thus allowed \$3,283 of the approximately \$36,000 claimed by the taxpayer. The court also rejected the taxpayer's assertion the wage income shown on his 1996 return, prepared by Beverly A. Arrington, was fabricated by her, and imposed penalties under § 6651(a)(1) for failure to file a timely return and § 6662(a) accuracy-related penalties.

18. A partner's unreimbursed reimbursable expenses incurred on behalf of the partnership are not deductible on his own return. McLauchlan v. Commissioner, T.C. Memo. 2011-289 (12/19/11). The taxpayer was a partner in a law firm and he paid various expenses, such as advertising, home office, automobile, travel, meals, entertainment, cell phone, professional organizations, continuing legal education, state bar membership, supplies, interest, banking fees and legal support services in connection with his law practice. The partnership reimbursed him for over \$60,000 of the expenses in each year in question, but he claimed more than \$100,000 of additional expense on Schedule C in each year. The Tax Court (Judge Kroupa) articulated the principal issue as whether a partner can deduct unreimbursed expenses incurred in furtherance of the partnership's business. She then articulated the relevant legal principle as prohibiting a partner from deducting on his own return expenses of the partnership, even if the expenses were incurred by the partner in furtherance of partnership business, unless there is an agreement among partners, or a routine practice equal to an agreement, that requires a partner to use his or her own funds to pay a partnership expense, citing *Cropland Chem. Corp. v. Commissioner*, 75 T.C. 288, 295 (1980), *aff'd without published opinion*, 665 F.2d 1050 (7th Cir. 1981). In the instant case, the partnership agreement required petitioner to pay "indirect partnership expenses" that were

unreimbursable, but there was no routine practice that required petitioner to pay any other partnership expenses. Thus, expenses at issue were deductible only if they were unreimbursable indirect partnership expenses that were actually incurred. Turning to the facts, Judge Kroupa found that all of the claimed expenses were either reimbursable under the partnership agreement or not properly substantiated. Accordingly, all of the claimed deductions were disallowed and § 6662 accuracy related penalties were upheld.

19. 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.

20. Reimbursement insurance is really a deposit. F.W. Services, Inc. v. Commissioner, 109 A.F.T.R. 2d 2012-676 (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.

E. Depreciation & Amortization

1. Section 179 limits are extended again – is this becoming permanent like research credits? The Compromise Tax Relief

Act of 2010, § 402, provides for Code § 179 first year expensing for tax years beginning in 2012 in an amount not to exceed \$125,000 with a phase-out amount beginning at \$500,000. For tax years beginning after 2012 the maximum deduction drops to \$25,000 with the phase-out beginning at \$200,000 (at least until the business community 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 as provided in § 179(b)(6), the 2012 ceiling for expensing machinery and equipment and certain other § 1231 property is \$139,000, and the phase-out threshold is \$560,000.

b. Section 179 is applied to computer software for another year. The Compromise Tax Relief Act of 2010, § 402, extends eligibility as qualified Code § 179 property to off-the-shelf computer software placed in service before 2013.

2. That light-weight crossover SUV might get caught by § 280F, but that ridiculously expensive heavyweight SUV is fully deductible under § 168(k). Rev. Proc. 2011-21, 2011-12 I.R.B. 560 (3/18/11), *amplifying and modifying* Rev. Proc. 2010-18, 1010-9 I.R.B. 427. For automobiles placed in service in 2011 that qualify as § 168(k) property, the § 280F ceilings on depreciation deductions are \$11,060 for the first year, \$4,900 for the second year, \$2,950 for the third year, and \$1,775 for each succeeding year. For light trucks or vans placed in service in 2011 that qualify as § 168(k) property, the limits are \$11,260 for the first year, \$5,200 for the second year, \$3,150 for the third year, and \$1,875 for each succeeding year. For automobiles placed in service in 2011 that do not qualify as § 168(k) property, the limits are \$3,060 for the first year, \$4,900 for the second year, \$2,950 for the third year, and \$1,775 for each succeeding year. For light trucks or vans placed in service in 2011 that do not qualify as § 168(k) property, the limits are \$3,260 for the first year, \$5,200 for the second year, \$3,150 for the third year, and \$1,875 for each succeeding year.

a. 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.

- **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.

3. Antenna support structures and leased digital equipment have longer lives than the taxpayer would like. Broz v. Commissioner, 137 T.C. 25 (7/7/11). The Tax Court (Judge Kroupa) held that cellular antennas, equipment shelters, and related land improvements were depreciable over 15 years in asset class 48.14 (Telephone Distribution Plant), rather than over seven years in asset class 48.32 (High Frequency Radio and Microwave Systems). The court also agreed with the IRS that cell phone site equipment including base station radio and switching equipment is classified as ten year property under asset class 48.12 (Telephone Central

Office Equipment) rather than as five year property under asset class 48.121 (Computer-based Telephone Central Office Switching Equipment). The court concluded that the primary difference between asset classes 48.12 and 48.121 is that the latter category includes equipment that functions as a computer. The digital cellular equipment within the base station functioned as a radio rather than as a computer.

4. Ouch! Fifteen year recovery period for a one-year lived asset. Covenant not to compete from a minority S corporation shareholder is a § 197 intangible. Recovery Group, Inc. v. Commissioner, T.C. Memo. 2010-76 (4/15/10). The taxpayer S corporation paid a retiring 23 percent shareholder/employee \$400,000 for a one-year covenant not to compete. The taxpayer asserted that the acquisition of a 23 percent interest was not “entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof” as provided in § 197(d)(1)(E), and claimed a full year’s deduction for the amount paid. The court (Judge Gustafson) upon a careful analysis of the statutory phrase concluded that the covenant was part of an acquisition of an interest in a trade or business, that the interest was “substantial,” and that in any event the term “thereof” in the statutory language does not modify “an interest,” which, therefore, need not be substantial.

a. And the First Circuit says “Eat your peas” to the taxpayer. Recovery Group, Inc. v. Commissioner, 652 F.3d 122 (1st Cir. 7/26/11). In an opinion by Judge Torruella, the Court of Appeals for the First Circuit affirmed the Tax Court decision holding that a covenant not to compete entered into in connection with the redemption of a portion of the stock of a corporation that is engaged in a trade or business is considered a § 197 intangible as defined in § 197(d)(1)(E), regardless of whether the portion of stock acquired constitutes at least a “substantial portion” of such corporation’s total stock. The court expressly rejected the taxpayer’s argument that “the term section ‘197 intangible’ means ... any covenant not to compete ... entered into in connection with an acquisition ... of [(1)] [the entire] interest in a trade or business or [(2)] [a] substantial portion [of an interest in a trade or business],” based on the legislative history of the statutory provision. The court reasoned that the purpose of § 197 was to reduce controversies regarding the allocation of purchase price between goodwill and covenant not to compete, and that since goodwill reasonably could be conveyed only if a substantial portion of the assets of a business were transferred, in the context of asset acquisitions, “Congress made [§ 197(d)(1)(E)] applicable only where the covenant not to compete was entered into in connection with the acquisition of at least a substantial portion of assets constituting a trade or business.” The court then explained

how entering into a covenant not to compete in connection with a stock sale and purchase differed

In the context of stock acquisitions, however, the uncertainty — and consequently the possibility for much litigation between taxpayers and the IRS — caused by the inherent difficulty in valuing goodwill and going concern is generally present even where the purchased stock does not constitute a substantial portion of the corporation's total stock. This is due to the fact that goodwill and going concern generally constitute an essential component of the value of each share of corporate stock, as each share of stock reflects a proportionate allotment of the value of the corporation's goodwill and going concern. ...

If [§ 197(d)(1)(E)] had not applied to a covenant not to compete entered into in connection with the acquisition of a corporation's stock, a buyer of such stock would have had a very significant incentive to allocate to the cost of the covenant what was in fact stock purchase price, because the ostensible cost of the covenant would presumably be amortized and deducted over its usually short useful life, while amounts allocated to the stock's purchase price would not be deductible and would simply form part of the buyer's basis in the stock, presumably to be recovered only after the buyer subsequently disposed of such stock and a capital gain/loss was computed on such disposition.

- According to the court, this analysis explains why “Congress chose different tax treatments for (1) covenants executed in connection with the acquisition of at least a substantial portion of assets constituting a trade or business, as opposed to (2) covenants executed in connection with the acquisition of less than a substantial portion of assets constituting a trade or business.”

5. 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. 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.

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

- *Accounting for MACRS property.*

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

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

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

8T(d). Recognized loss on other dispositions is the excess of the adjusted depreciable basis of the asset over fair market value. Identification of the asset disposed of from a multiple asset account, and its basis, is generally determined from the taxpayer's records. Temp. Reg. § 1.168(i)-8T(e) & (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 depreciate assets in the general asset account as if no disposition occurred. Temp. Reg. § 1.168(i)-1T(e)(2). However, consistent with existing regulations, the temporary regulations allow a taxpayer to elect to terminate general asset account treatment on disposition of an asset in a qualifying disposition, in which case gain or loss is recognized under the rules of Temp. Reg. § 1.168(i)-8T. The list of qualifying disposition 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).

F. Credits

1. Simplified research credit elections regulations are final. T.D. 9528, Alternative Simplified Credit under Section 41(c)(5), 76 F.R. 33994 (6/10/11). Section 41(c)(5) provides a “simplified” research credit of 14 percent of so much of qualified research expenditure as exceeds 50 percent of the average qualified research expenditures for the three preceding taxable year, or, if the taxpayer has no qualified research expenditures in prior years, the simplified credit is 6 percent of qualified research expenditures for the year. (The regular credit under § 41(a)(1) is 20 percent of qualified expenditures over a base.) Temporary regulations are finalized as Reg. § 1.41-9 to require an election for the alternative simplified credit to be made with the return filed for the year to which the election applies. The election may not be made on an amended return, nor will the IRS grant an extension of time to file the election. While the election may not be revoked absent the consent of the IRS, consent is deemed to have been requested and granted if the taxpayer files a Form 6765 calculating the credit under regular methods and attaches the revocation to a timely filed (including extensions) original return for the year to which the revocation applies. The final regulations allow taxpayers to prorate short tax years by the number of days in the year.

a. Can the incomprehensively complicated be “simplified”? T.D. 9539, Election of Reduced Research Credit Under Section 280C(c)(3), 76 F.R. 44800 (8/27/11). These regulations, Reg. § 1.280C-4, “simplify” how taxpayers make the election to claim the “reduced research credit” under § 280C(c)(3).

2. New markets credit is revised to help markets other than real estate. REG-101826-11, New Markets Tax Credit Non-Real Estate Investments, 76 F.R. 32882 (6/7/11). Section 45D allows a new markets tax credit for an equity investment at original issue in a community development entity (CDE), an entity that invests in qualified low income community projects. In order to encourage investments in projects other than real estate development proposed regulations would reduce the requirement that returns on investments by a CDE be re-invested in community development projects during a seven year credit period. The proposed regulation would allow a CDE to reinvest capital from non-real estate businesses in unrelated certified community development financial

institutions that are CDEs under § 45D(c)(2)(B) at various points during the seven-year credit period. The proposed regulations would allow an increasingly aggregate amount to be invested in certified community development financial institutions in the latter part of the seven year period.

a. Final regulations define an entity serving targeted populations for the new markets tax credit. T.D. 9560, Targeted Populations Under Section 45D(e), 76 Fed. Reg. 75774 (12/5/11). Section 45D provides a 5 percent credit each year for three years, then 6 percent for subsequent three years for equity investment in a qualified community development entity. A qualified entity is a domestic corporation or partnership with a primary mission to serve or provide investment capital for low-income communities or persons that maintains accountability to the community with representation on its governing board and which certified by Treasury as being a qualified community development entity. Qualified investment includes investment in a qualified active low-income community business, a business for which at least 50 percent of total gross income is derived from the active conduct of a qualified low income community business (including rental real estate) and a substantial portion of its property and services are within a low-income community. Sections 1400M and 1400N include The maximum amount of investment qualified for the credit is an amount allocated to the community development entity from a pool that is limited to \$3.5 billion for 2011, with nothing specified thereafter. § 45(f)(2). Following the proposed regulations and guidance contained in Notice 2006-60, 2006-2 C.B. 82, the final regulations, § 1.45D-1, provide that an entity will not qualify as an active low-income community business unless at least 50 percent of the entity's total gross income for any taxable year is derived from sales, rentals, services, or other transactions with individuals who are low income persons, at least 40 percent of the entity's employees are low-income persons, or at least 50 percent of the entity is owned by individuals who are low income persons. The regulations provide that an entity may determine the status of an individual as low income using any reasonable method including U.S. Census Bureau measures, HUD rules or income from Form 1040. Also, income derived from transactions with low income persons includes both payments made directly by low-income persons plus money and the fair market value of contributions of property or services provided to the entity primarily for the benefit of low income persons (provided that the contributor not receive a direct benefit). An entity whose sole business is rental real property will be treated as satisfying the 50 percent gross income requirement if the entity is treated as being located in a low-income community.

G. Natural Resources Deductions & Credits

1. **Actually passing gas is required for the alternative fuels credit.** Collins v. Commissioner, T.C. Memo. 2011-37 (2/9/11). On the recommendation of his return preparer, Mr. Tax of America, the taxpayer invested in Gas Recovery Partners to claim a credit under § 29 (now § 45K) for alternative fuel produced from landfills in Puerto Rico and Ohio. The court (Judge Paris) denied the credit because neither petitioners nor the person they dealt with or the partnership they paid had an interest in a fuel-producing source and no fuel was produced. Accordingly, the court found it unnecessary to explore the complexities of the credit provision. The court also denied the taxpayer's claimed expense deductions under §§ 162 and 212 finding that the taxpayer had not engaged in the activity primarily for profit. The court denied a § 165 theft loss deduction for payments made to the partnership finding that there was no evidence that the taxpayer discovered the losses during the years at issue.

H. Loss Transactions, Bad Debts, and NOLs

1. **He lost at the track, but showed in the Tax Court.** Mayo v. Commissioner, 136 T.C. 81 (1/25/11), *acq.* AOD 2011-006 (12/21/11), 2012-3 I.R.B. (unnumbered) (1/17/12). In a reviewed opinion, the Tax Court (Judge Gale) applied § 165(d) to limit the allowable gambling losses of a taxpayer who the IRS conceded was in the "trade or business of gambling on horse races." The court rejected the taxpayer's argument that under the reasoning of the Supreme Court in *Commissioner v. Groetzinger*, 480 U.S. 23 (1987), which held that § 162 expenses of a professional gambler were deductible in computing AGI (rather than as itemized deductions), the § 165(d) limitation on the deduction of wagering losses to wagering income should not apply to a professional gambler. In this respect, the court reaffirmed its holding in *Offutt v. Commissioner*, 16 T.C. 1214 (1951), which reached the same result under the 1939 Code predecessor to § 165(d). The taxpayer's \$11,297 net wagering loss was disallowed. However, with respect to the taxpayer's trade or business expenses, the court overruled its opinion in *Offutt*, which had treated such expenses as additional disallowed losses, and held that the taxpayer's trade or business incurred in connection with his gambling activities (which did not include the amounts actually wagered). Accordingly, the taxpayer was allowed to deduct under § 162(a) the \$10,968 of business expenses incurred in carrying on his gambling business.

2. **Character of income versus character of deductions for venture capital fund managers: Capital gain income and ordinary deductions, or "Heads the taxpayer wins, tails the government**

loses.” *Dagres v. Commissioner*, 136 T.C. 263 (3/28/11). The Tax Court (Judge Gustafson) held that a \$5 million loan from a venture capital fund manager to a business associate who provided leads on companies in which the venture capital funds (organized as limited partnerships) might invest was proximately related to the taxpayer’s trade or business of managing venture capital funds (which was conducted as the managing member of LLCs that were the general partners of the funds, with actual management conducted through an S Corporation owned by the partners (LLC members) of the general partner). Although the venture capital funds’ sole activity was investing, the taxpayer’s activities in managing the funds on behalf of the investors (even though he had a hefty carry — raking-in over \$40 million for the year in issue), rose to the level of a trade or business. Judge Gustafson reasoned that “[t]he General Partner L.L.C.s were thus different from an investor (whose nonbusiness activity involves buying and selling securities for his own account) and were more like a broker (whose business is to buy and sell securities as inventory for commissions).” He rejected the IRS’s argument that the fact that the general partner managing LLCs were one percent partners rendered their activity investment rather than a trade or business. Significantly, the court observed as follows:

It may be anomalous that, with the IRS’s concurrence, a venture capitalist may treat its receipt of “carry” as a nontaxable event, see Rev. Proc. 93-27, sec. 4.01, 1993-2 C.B. 343, 344, and may then report its eventual income as capital gain, see Rev. Proc. 2001-43, sec. 4.01, 2001-2 C.B. 191, 192; 23 but that treatment is not challenged here. Accordingly, even though this profit interest is compensation for personal services, it is deemed to remain passthrough income with the same character in the hands of the recipient (the General Partner L.L.C.) as in the hands of the partnership (the Venture Fund L.P.) — i.e., primarily capital gains from investment. See secs. 701, 702; 26 C.F.R. secs. 1.701-1, 1.702-1, Income Tax Regs. We do not agree with the IRS that the character of this income proves that the General Partner L.L.C.s were investors and were not in a trade or business... .

• Because the managing LLCs were in the trade or business of managing investments, that trade or business was imputed to the taxpayer in his capacity as a member manager of the LLCs. See Rev. Rul. 98-15, 1998-1 C.B. 718. Because the taxpayer’s income from his management activities was more than twenty times his return from the capital investment, he satisfied the test set forth in *United States v. Generes*, 405 U.S. 93 (1972). Thus, the taxpayer was allowed a business bad debt deduction under § 166(a) for the amount of the loan (\$3,635,218) that was unpaid and uncollectible.

- The court failed to consider the potential application of § 1271, which would have resulted in the taxpayer's loss being a capital loss. Section 1271(a), which has applied to debts issued by individuals since 1997, in relevant part provides as follows: "Amounts received by the holder on retirement of any debt instrument shall be considered as amounts received in exchange therefor." Because the debt was retired at less than its principal amount, rather than being wholly worthless, as long as the debt owed to Dagres was a capital asset, which it should have been, § 1271 would mandate capital loss treatment. *McClain v. Commissioner*, 311 U.S. 527 (1941), held where a creditor received less than all of the principal of a debt obligation upon the retirement of the debt by the obligor, the predecessor of § 1271 applied to provide capital loss treatment, rather than a bad debt deduction being allowed under the predecessor of § 166, even though if the creditor had received nothing, he would have had a bad debt deduction. Interestingly, however, *McClain* has not been cited in any cases or revenue rulings in over thirty years. (The *McClain* principle has not been applied to taxpayers engaged in the trade or business of making loans by virtue of § 1221(a)(4), see *Burbank Liquidating Corp. v. Commissioner*, 39 T.C. 999 (1963), *acq. sub. nom.* United Associates Inc., 1965-1 C.B. 5, *modified on other grounds*, 335 F.2d 125 (9th Cir. 1964), but that is another story.)

- In addition, the *Dagres* opinion does not discuss Rev. Rul. 2008-39, 2008-2 C.B. 252, which in determining whether investment advisory expenses incurred with respect to an investor upper tier partnership that invested in lower tier partnerships that were traders were deductible under § 212 or under § 162, applied an "on behalf of standard," to determine that the upper tier management fees were § 212 expenses, because they were not incurred "on behalf of" the lower tier partnership, for which management fees were § 162 expenses.

3. A bad investment in an abusive shelter is a theft loss, but the taxpayer has to prove no possibility of recovery. *Vincentini v. Commissioner*, T.C. Memo 2008-271 (12/8/08), *aff'd*, 429 Fed. Appx. 560 (6th Cir. 7/12/11). The taxpayer in 1999 invested in an international tax fraud scheme on the basis of listening to audio tapes produced by Keith Anderson, founder of Anderson Ark and attending an Anderson Ark conference in Costa Rica. In a petition challenging the IRS assessment of a deficiency for 1999 denying losses claimed from the taxpayer's Anderson Ark investment, the taxpayer claimed a theft and casualty loss from the investments in 2001 or 2002 that could be carried back to taxpayer's 1999 taxable year. In 2002 the Anderson Ark promoters were convicted of money laundering and/or conspiracy to commit money laundering by the District Court for the Eastern District of California (*United States v. Anderson*, 391 F.3d 970, 974 (9th Cir. 2004)). In 2004 the same defendants were convicted in the Washington District Court on charges of conspiracy to commit wire and mail fraud and to

defraud the United States. The judgment of the Washington District Court ordered the Anderson Ark defendants to provide restitution to Anderson Ark investors, including the taxpayer. The Tax Court (Judge Marvel) held that since the Government in the Anderson Ark criminal cases took the position that the taxpayer was a victim of fraud and was entitled to restitution, judicial estoppel prevented the Government from asserting in the Tax Court that the taxpayer did not suffer a theft loss. However, the court also held that the taxpayer failed to establish that it was reasonably certain at the end of 2001 that the taxpayer would not recover his loss from Anderson Ark. Thus, the casualty loss deduction was denied. In addition, the taxpayer was assessed penalties under § 6662 with respect to losses claimed from the Anderson Ark investment. The court rejected the taxpayer's assertion of reasonable reliance on the advice of a tax professional noting that, reliance on the advice of an accountant who was referred to the taxpayer by the promoter was not reasonable reliance.

a. Affirmed on appeal. Vincentini v. Commissioner, 429 Fed. Appx. 560 (6th Cir. 7/12/11). The Court of Appeals found that in examining the evidence the Tax Court could properly conclude that Vincentini did not meet his burden of proving that at the end of 2002 there was no possibility of recovery. The court was not persuaded by Vincentini's assertion that the Tax Court overlooked the facts that in 2002 the Anderson Ark defendants were convicted in California and facing lengthy imprisonment, and that they were represented by appointed council, as providing proof that there was no reasonable possibility of recovery. The court also affirmed the § 6662 penalties noting that Vincentini put his faith in a "biased professional, affiliated with the organization promoting the investments" and that he "either errantly omitted important investigatory steps or chose to ignore the telltale signs of an investment that was too good to be true."

4. A NOL not used is a NOL absorbed. Hall v. United States, 99 Fed. Cl. 617 (8/9/11). Section 172(b) provides that net operating losses *shall* be carried back to each of the two taxable years preceding the taxable year of the loss, then forward to each of the next twenty taxable years following the year of the loss. For taxable years beginning before 8/6/97, the carryover was back three years and forward fifteen years. Section 172(b)(2) mandates that the entire amount of the loss be carried back to the appropriate years. Section 172(b)(3) allows an election to waive the carryback in a timely filed return for the year in which a loss was incurred. In a refund action based on amended returns, the taxpayer attempted to offset 2003 income with losses going back to 1988. In granting summary judgment to the government, the court stressed that the carryback provision is mandatory unless waived in a timely filed return. Thus, portions

of the taxpayer's NOLs were consumed in prior carryback years when the taxpayer had operating income. The court also rejected the taxpayer's argument that the mandatory provisions of § 172 were discriminatory against a group of smaller and less wealthy entities and individuals.

5. IRS expands its rescue of Bernie Madoff's Ponzi scheme victims to include death. Rev. Proc. 2011-58, 2011-50 I.R.B. 849 (11/28/11). In Rev. Proc. 2009-20, 2009-1 C.B. 749, the IRS provided a safe harbor under which qualified investors are allowed to treat a lost investment in a Ponzi scheme as a theft loss deduction. Among the condition in the safe harbor is a requirement that the perpetrator of the scheme be charged with criminal theft. Inconveniently, the IRS notes that the lead figure in some of these cases has avoided indictment by dying. Thus, the requirement of Rev. Proc. 2009-20 is amended to provide for indictment, information, or state complaint charging theft that has not been withdrawn for reasons other than the death of the lead figure.

I. At-Risk and Passive Activity Losses

1. After winning cases on the failure of attempted aggregation elections, the IRS makes relief available to real estate professionals who fail to make timely aggregation elections. Rev. Proc. 2011-34, 2011-24 I.R.B. 875 (5/27/11). Real estate professionals may make elections under Reg. § 1.469-9(g) to treat all interests in rental real estate as a single rental real estate activity for making the determination as to whether those professionals materially participate in that activity; if there is material participation, losses from that activity are not treated as passive activity losses. This election is normally made by filing a statement with the taxpayer's original income tax return for the taxable year. Under this revenue procedure, relief for late elections is available provided that (i) the taxpayer failed to file the election with an original tax return in the year the election was to take effect as required by Reg. § 1.469-9(g), (ii) the taxpayer has filed all returns for years subsequent to the year for which an election is made consistent with having made a timely election to aggregate properties, (iii) the taxpayer had timely filed each return affected by the election if it had been made (or filed within six months of the due date excluding extensions), and (iv) the taxpayer had reasonable cause for its failure to file under Reg. § 1.469-9(g). Application for relief is to be made in a statement as required by Reg. § 1.469-9(g)(3) attached to an amended return for the most recent tax year. The statement requires a declaration under penalty of perjury by a person with personal knowledge that "the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." The application for relief is not treated as a request for a private letter ruling, and thus does not require a user fee.

2. 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 ten 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.

3. This taxpayer piloted ships over the bar of the passive activity loss limitations. Miller v. Commissioner, T.C. Memo. 2011-219 (9/18/11). Taxpayer was a San Francisco Bay Bar Pilot, which means that he piloted commercial ships in and out of San Francisco Bay over the shallow bar that blocks entrance to the Bay as a partner in the San Francisco Bay Bar Pilots Association. In addition taxpayer served as the contractor on the construction of rental real estate which he and his wife also managed. The taxpayer convinced the court (Judge Kroupa) that he spent more time in real estate activities ["in which he materially participate[d]"] than he did in piloting ships, and that he met the 750 hour requirement [by "performing services ... in real property trades or businesses in which [he] materially participate[d]"] under § 469(c)(7) to qualify as a real estate professional entitled to claim real estate losses without limitation to passive activity income under § 469. However, the taxpayer failed to elect under § 469(c)(7)(A) to treat all of his real estate activities as a single activity. The court found that the taxpayer was a material participant in only two of his six real estate properties having participated more than 100 hours in each activity, which was more than any other participant. The taxpayer failed to establish that he met the 100 hour requirement or that his participation was more than other participants in four properties. The court rejected the IRS imposition of § 6662 accuracy related penalties.

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

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

- Second, for purposes of determining the taxpayer's at-risk amount with respect to Alpine, in what was described as an issue of first impression, the court held that the RFB stock pledged for the loans represented pledged property used in the business not eligible to be treated as an amount at-risk by virtue of § 465(b)(2)(A). Since Alpine was formed to expand RFB's cellular networks, the pledged RFB stock was related to Alpine's business. Thus, because the shareholder did not guarantee the loans to Alpine, the shareholder was not economically or actually at-risk with respect to his involvement with Alpine.

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

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

5. A song and a dance doesn’t make the law practice a professional real estate business, but renting your building to the law practice is active. Langille v. Commissioner, T.C. Memo. 2010-49 (3/18/10). The taxpayer Deanna Langille, formerly known as Deanna Birdsong, worked long hours in her law practice and devoted somewhat less of her time to her rental real estate activities. Unfortunately for the taxpayer she resigned from her law practice in lieu of disciplinary proceedings implemented for misappropriation of funds from her firm’s client trust accounts. To make matters worse, after an unsuccessful negotiation for the sale of her law practice, the potential buyer reported to the IRS that the taxpayer maintained two sets of books for the practice, which resulted in a criminal investigation and a guilty plea to one count of a tax fraud indictment. In the civil tax matter the Tax Court (Judge Gustafson) found that the taxpayer willfully failed to report income from her law practice and residential real estate rental activities (from which she had no profit). The taxpayer was unable to establish the number of hours she worked on her residential real estate activities and thus was unable to establish herself as a real estate professional under the 50 percent of all personal services requirement of § 469(c)(7)(B)(i) or that she satisfied the 750 hour requirement of § 469(c)(7)(B)(ii). In addition, the court held that income from the taxpayer’s rental of office space to her law practice in which she was a material participant was not passive activity income under Reg. § 1.469-2(f)(6).

a. The Eleventh Circuit sings the same tune but without making a recording. Langille v. Commissioner, 447 Fed. Appx. 130 (11th Cir. 11/22/11). In an unpublished per curiam opinion, the court affirmed the Tax Court in spite of the court’s statement that it construes briefs of pro se litigants liberally.

6. Limited liability doesn’t necessarily mean limited partner. REG-109369-10, Passive Activity Losses and Credits Limited, 76 F.R. 72875 (11/28/11). The Treasury has published proposed amendments to Reg. § 1.469-5, dealing with the definition of an “interest in a limited partnership as a limited partner” for purposes of determining whether a taxpayer materially participates in an activity under § 469. Prop. Reg.

§ 1.469-5(e) would eliminate the current reliance (in Temp. Reg. § 1.469-5T(e)(3)) on limited liability for determining whether an interest is an interest in a limited partnership as a limited partner under § 469(h)(2) and replace it with an approach that relies on the individual partner's right to participate in the management of the entity. Specifically, Prop. Reg. § 1.469-5(e)(3) would provide that "an interest in an entity shall be treated as an interest in a limited partnership as a limited partner if ... [t]he holder of such interest does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement." A right to manage includes authority to bind the entity. Furthermore, an individual who holds a limited partnership interest would not be treated as holding a limited partnership interest if the individual also holds an interest in the partnership that is not a limited partnership interest as defined in Prop. Reg. § 1.469-5(e)(3). The regulations will be effective upon promulgation of final regulations

a. But you really don't have to wait to claim the benefit of this concession. Limited Liability Partnership and Limited Liability Company membership interests are not presumptively limited partnership interests under the passive activity loss rules. Garnett v. Commissioner, 132 T.C. 368 (6/30/09). The taxpayers held a number of direct and indirect interests in limited liability partnerships and LLCs that were engaged in agribusiness. Section 469(h)(2) provides that a limited partnership interest will not be treated as an interest with respect to which a taxpayer is a material participant, except as provided in regulations. Temp. Reg. § 1.469-5T(e)(2) provides that a limited partner materially participates in a partnership activity only if (1) the taxpayer devotes more than 500 hours to the activity in the year, (2) the taxpayer materially participates in the activity for five of the preceding ten taxable years, or (3) the activity is a personal service activity in which the taxpayer materially participated for any three preceding years. Temp. Reg. § 1.469-5T(e)(2)(1), (5), (6). Temp. Reg. § 1.469-5T(e)(3) defines a limited partnership interest as an interest designated as a limited partner interest in a partnership agreement or an interest for which the partner has limited liability. Temp. Reg. § 1.469-5T(e)(3)(ii) has an exception from the material participation rule for an interest of a limited partner who also holds a general partnership interest. The court (Judge Thornton) concluded that in the case of an interest in a limited liability partnership or a limited liability company, both of which the court described as different from a limited partnership, the interests are not to be treated as limited partnership interests under § 469(h)(2). Holders of such interests are not barred by state law from materially participating in the affairs of the entity and thus hold their interests as general partners within the meaning of the temporary regulations. Thus, whether or not the taxpayer is a material participant requires a full factual inquiry and an LLC member can

satisfy the material participation requirement under any of the seven tests in Temp. Reg. § 1.469-5T(a).

b. The Court of Federal Claims agrees.

Thompson v. United States, 87 Fed. Cl. 728 (7/20/09). The court (Judge Block) granted summary judgment treating the taxpayer member/manager of an LLC as a material participant. The taxpayer's degree of participation was stipulated and the only question was whether § 469(h)(2) precluded treating the taxpayer as a material participant in a Texas LLC. The court noted that § 469(h)(2) treats limited partners differently because of an assumption that limited partners do not materially participate in their limited partnerships. In an LLC, on the other hand, all members have limited liability but members may participate in management. The court noted that Temp. Reg. § 1.469-5T(e)(3) treats a partnership interest as a limited partner interest if the holder has limited liability "under the law of the State in which the partnership is organized." The court held that the quoted language applies only to an entity that is a partnership under state law, which does not include an LLC, which, although treated as a partnership for tax purposes, is a different type of entity under state law. The taxpayer was both a member and manager of the LLC. Unlike a limited partner, a member manager does not lose limited liability by participation in the management of the LLC. The court also recognized that shareholders of an S corporation have limited liability as shareholders, but participate in management, and are not subject to being automatically treated as passive participants. The taxpayer, therefore, was able to demonstrate his material participation in the activity by using all seven of the Temp. Reg. § 1.469-5T(a) tests.

c. Ditto. Newell v. Commissioner, T.C.

Memo. 2010-23 (2/16/10). Relying on Garnett v. Commissioner, *supra*, Judge Marvel held that the interest of a managing member of a California LLC was not a limited partnership interest for purposes of Reg. § 1.469-5T(c)(1). Taxpayer's losses were not passive activity losses because the IRS conceded that the taxpayer met the "significant participation" test of Temp. Reg. § 1.469-5T(a)(4).

d. The IRS acquiesces. AOD 2010-02, 2010-

14 I.R.B. 515 (4/5/10). The IRS acquiesces in the result in Thompson.

7. Ya gotta keep records of hours worked.

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.

8. Yeah, it's true — Ya really do gotta keep records of hours worked. Iverson 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.

9. 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.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. The IRS begins to gear up on basis reporting.

REG-101896-09, Basis Reporting by Securities Brokers and Basis Determination for Stock, 74 F.R. 67010 (12/17/09). These proposed regulations relate to reporting sales of securities by brokers (Prop. Reg. § 1.6045-1) and determining the basis of securities (Prop. Reg. § 1.1012-1). The proposed regulations reflect changes in the law made by the Energy Improvement and Extension Act of 2008 that require brokers when reporting the sale of securities to the IRS to include the customer's adjusted basis in the sold securities and to classify any gain or loss as long-term or short-term. The proposed regulations under § 1012 alter how taxpayers compute basis when averaging the basis of shares acquired at different prices and expand the ability of taxpayers to compute basis by averaging with respect to RIC shares and shares specifically held in a dividend reinvestment plan. Brokers must furnish information statements to customers by February 15th. The proposed regulations provide for the implementation of new reporting requirements imposed upon persons that transfer custody of stock and upon issuers of stock regarding organizational actions that affect the basis of the issued stock. It also contains proposed regulations reflecting changes in the law that alter how brokers report short sales of securities.

a. Final regulations on basis reporting and basis determination. T.D. 9504, Basis Reporting by Securities Brokers and Basis Determination for Stock, 2010-47 I.R.B. 670 (11/22/10). These regulations adopt, with only minor changes, the regulations proposed in December 2009. They permit the use of the average basis method by regulated investment companies and dividend reinvestment plans. Brokers must use either the specific identification method or the FIFO method for securities sold from any particular account.

- To minimize the possibility of identification foot-faults, the creation of different accounts to hold securities acquired at different times is recommended.

- The final regulations also permit election of the FIFO method if the securities in any account consist predominantly of dogs.

b. Interim guidance. Notice 2011-56, 2011-29 I.R.B. 54 (6/22/11). This notice provides interim guidance under § 1012 on issues relating to the basis of stock pending the anticipated publication of superseding regulations. These regulations will provide that a taxpayer may revoke the broker's average cost method for RIC or DRP stock by notifying

the broker to change to the cost basis method before the earlier of one year or the first disposition of stock. Different methods may be used on an account-by-account basis.

2. When does a debt instrument that has in effect become a proprietary interest because the debtor is insolvent remain a debt instrument? REG–106750–10, Modifications of Debt Instruments, 75 F.R. 31736 (6/4/10). The Treasury Department has proposed amendments to Reg. § 1.1001-3, which deals with when a modification of a debt instrument results in an exchange for purposes of § 1001 (gain or loss realization by creditor) and § 61(a)(12) (realization of COD income by debtor). Under Reg. § 1.1001-3(e)(5), a modification of a debt instrument that results in an instrument or property right that is not debt for tax purposes is a significant modification. An analysis of all of the factors relevant to a debt determination of the modified instrument at the time of an alteration or modification is required. However, Prop. Reg. § 1.1001-3(f)(7) would clarify that any deterioration in the financial condition of the issuer between the date the debt instrument was issued and the date it was altered or modified, insofar as it relates to the issuer's ability to repay the debt instrument, will not be taken into account in determining whether the instrument has been converted to another type of interest unless there is a substitution of a new obligor or the addition or deletion of a co-obligor. Thus, any decrease in the fair market value of a debt instrument (whether or not publicly traded) is not taken into account to the extent that the decrease in fair market value is attributable to the deterioration in the financial condition of the issuer, rather than to a modification of the terms of the instrument, but only for purposes of determining the nature of the instrument. According to the preamble, “[c]onsistent with this rule in the proposed regulations, if a debt instrument is significantly modified and the issue price of the modified debt instrument is determined under Reg. § 1.1273-2(b) or (c) (relating to a fair market value issue price for publicly traded debt), then any increased yield on the modified debt instrument attributable to this issue price generally is not taken into account to determine whether the modified debt instrument is debt or some other property right for Federal income tax purposes. However, any portion of the increased yield that is not attributable to deterioration in the financial condition of the issuer, such as a change in market interest rates, is taken into account.”

- The provisions of Prop. Reg. § 1.1001-3(f)(7) will be effective upon finalization, but taxpayers may rely on paragraph (f)(7) of this section for alterations of the terms of a debt instrument occurring before that date. See Prop. Reg. § 1.1001-3(h)(2).

a. Finalized with only very minor clarifications. T.D. 9513, Modifications of Debt Instruments, 76 Fed. Reg.

1603 (1/7/11). The proposed amendments to Reg. § 1001-3 have been finalized with only a clarifying change. The final regulations add language to the general rule of Reg. § 1.1001-3(b) that makes it clear that the rules of Reg. § 1.1001-3(f)(7) apply to determine whether the modified instrument received in an exchange will be classified as debt for Federal income tax purposes. According to the preamble, “unless there is a substitution of a new obligor or the addition or deletion of a co-obligor, all relevant factors (for example, creditor rights or subordination) other than any deterioration in the financial condition of the issuer are taken into account in determining whether a modified instrument is properly classified as debt for Federal income tax purposes.”

3. The return of tax-free basis step-up (or down) at death — with a very interesting twist for George Steinbrenner and others who followed the same tax planning technique. The Compromise Tax Act, § 301(a), reinstated the § 1014 fair-market-value-at-death basis rule for taxable years after 2010. For estates of decedents dying in 2010, Act § 301(c) provides a special rule that allows the executor to elect between (1) applying the rules enacted in 2001, i.e., no estate tax for 2010 coupled with the § 1022 carryover basis rules, or (2) paying an estate tax (applying the rates and exemptions provided in Act § 302 for years after 2009) and applying the § 1014 fair-market-value-at-death basis rules.

a. Here is how to elect to not pay the estate tax for someone who died in 2010. Nice of them to tell a bit less than three months before the form is due. Notice 2011-66, 2011-35 I.R.B. 184 (8/5/11). This notice provides guidance regarding the time and manner in which the executor of the estate of a decedent who died in 2010 elects to have the estate tax not apply and to have the carryover basis rules in § 1022 apply to property transferred as a result of the decedent’s death. It also addresses some issues arising in the application of § 1022. To elect out of the estate tax and into § 1022 carryover basis, the executor must file a Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent, on or before 11/15/11. (If no executor has been appointed, any person in actual or constructive possession of property acquired from the decedent may file a Form 8939 for the property he or she actually or constructively possesses.) Prior filings purporting to make the § 1022 Election must be replaced with a timely filed Form 8939. The election is irrevocable except as provided in the Notice. The allocation of any basis increase under § 1022 must be made on the Form 8939. An allocation of the spousal basis increase may be made on an amended Form 8939 filed after 11/15/11 under certain limited conditions. Executors may apply for § 9100 relief to (1) revoke an election, (2) seek additional time to allocate a basis increase, or (3) seek additional time to file Form 8939. The Notice cautions,

however, that: “Taxpayers should be aware, however, that, in this context, the amount of time that has elapsed since the decedent’s death may constitute a lack of reasonableness and good faith and/or prejudice to the interests of the government (for example, the use of hindsight to achieve a more favorable tax result and/or the lack of records available to establish what property was or was not owned by the decedent at death), which would prevent the grant of the requested relief.”

b. And here are the rules for figuring out that nasty carryover basis if you opt out of the estate tax. This Rev. Proc. is long enough and complicated enough to have been a set of regulations, but they probably couldn’t have gotten regulations out before the due date of the Form on which you tell them the amount of the carryover basis. Rev. Proc. 2011-41, 2011-35 I.R.B. 188 (8/5/11). This very long and detailed Revenue Procedure – detailed enough to be worthy of regulations if the issue were permanent – provides safe harbor guidance regarding the determination of the basis of property under § 1022. It is generally incapable of being concisely summarized, except to say that it describes the types of property and types transfers of property to which § 1022 does and does not apply. It also describes the types of property for which no allocation of an otherwise permitted basis increase is allowed, and the methods for allocating allowable basis increase among permitted property. No basis increase may be allocated in a manner that increases the basis to increases in value occurring after the decedent’s death. The decedent’s depreciation deductions for § 1245 property are taken into account by the transferee in computing § 1245 recapture. The Revenue Procedure reiterates that under § 1040, the satisfaction of a pecuniary bequest with property having a fair market value in excess of basis results in gain recognition, noting that this rule does not apply to satisfaction of a pecuniary bequest with an item of IRD. The Revenue Procedure is effective 8/29/11.

4. The key to the philosopher’s stone, which transmutes ordinary income into capital gain. T.D. 9514, Time and Manner for Electing Capital Asset Treatment for Certain Self-Created Musical Works, 76 F.R. 6553 (2/7/11). The Treasury has finalized Reg. § 1.1221-3, which deals with the election to treat gain or loss from the sale or exchange of taxpayer-created musical compositions or copyrights in musical works as gain or loss from the sale or exchange of a capital asset. It also covers taxpayers whose basis is determined by reference to the basis of such property in the hands of the taxpayer whose personal efforts created the property.

- This levels the playing field between creators of musical works and creators of patented inventions.

5. 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. The regulations will apply to debt instruments that have an issue date on or after the promulgation of final regulations.

6. This case is a poster child for the argument that § 1221 ought to list what are capital assets rather than listing what are not capital assets.² *Tempel v. Commissioner*, 136 T.C. 341 (4/5/11). On

2. See Martin J. McMahon, Jr., *Reinstating a Capital Gains Preference and Tax Expenditure Analysis*, 48 TAX NOTES 1437 (September 10, 1990).

December 17, 2004, the taxpayers donated a qualified conservation easement to a qualified organization and qualified for \$260,000 of conservation easement income tax credits, which were transferrable, from the State of Colorado. They incurred \$11,574.74 of expenses in connection with the donation that primarily consisted of various professional fees. Under complex Colorado statutory provisions (which are not fully explained in the opinion) only \$50,000 of the credits was currently refundable to the taxpayers, and then only in a year in which Colorado had a budget surplus; the excess could be carried over for twenty years. However, Colorado law permitted the sale of excess credits to third parties, who could use them to offset their tax liabilities. In December of 2004, the taxpayers sold \$40,500 of their state tax credits to an unrelated third party for net proceeds of \$30,375. Later in December of 2004, they sold an additional \$69,500 of their credits to another unrelated third party for net proceeds of \$52,125. They reported \$77,603 of short-term capital gains from the sale of their State tax credits, reflecting total sales proceeds of \$82,500 and a basis of \$4,897 in those credits. They computed their basis in the State tax credits by allocating the \$11,574.74 of expenses they incurred to make the donation to the portion of the credits they sold (i.e., \$110,000 of credits sold / \$260,000 of total credits x \$11,574.74 = \$4,897). The IRS took the position that the sales resulted in ordinary income and that the credits had no basis. The Tax Court (Judge Wherry) rejected the IRS argument that the credits were not capital assets, but agreed with the IRS that the credits had a zero basis. Thus the taxpayers recognized an \$82,500 short-term capital gain.

- The IRS relied on the “substitute for ordinary income” doctrine, which excludes a wide variety of property rights from capital asset status. Judge Wherry rejected the IRS’s argument that the credits were analogous to contract rights to receive ordinary income, which under Tax Court precedent, e.g., *Gladden v. Commissioner*, 112 T.C. 209 (1999), *rev’d on a different issue*, 262 F.3d 851 (9th Cir. 2001), are not capital assets. Judge Wherry likewise rejected the application of the more general “substitute for ordinary income” doctrine. The IRS’s position was that the sales proceeds were a substitute for the up-to-\$50,000 tax refund that a Colorado taxpayer could receive in a year the State had a budget surplus. Judge Wherry noted that there had been no opportunity for a refund from the State either during 2004 (the year the taxpayers sold their credits) or in 2006 through 2010, and that there was no evidence and the IRS did not assert that the taxpayers had sold credits they otherwise could have used to receive a refund. Thus, he concluded that the sales proceeds were not a substitute for a tax refund.

- He also rejected the IRS’s argument that a taxpayer who sells a credit, rather than claiming the credit against his own tax liability has the “economic equivalent of ordinary income” because as a result the taxpayer’s itemized deduction for state income taxes is greater than it

would have been had the taxpayer retained and used the credits. Ultimately, he reasoned as follows:

It is also apparent that the transferred State tax credits never represented a right to receive income from the state. Instead, they merely represented the right to reduce a taxpayer's State tax liability. It is without question that a government's decision to tax one taxpayer at a lower rate than another taxpayer is not income to the taxpayer who pays lower taxes. A lesser tax detriment to a taxpayer is not an accession to wealth and therefore does not give rise to income.

It follows that the taxpayer who is able to claim a deduction or credit has no more income by virtue of having that right than the taxpayer who is unable to make such a claim. Had petitioners used all of their credits to offset their State tax liability, rather than selling them, it appears that respondent would agree there would have been no income to petitioners. Using a tax credit to offset a tax liability is not an accession to wealth.

Petitioners never possessed a right to income from the receipt of the credits. They did not sell a right either to earned income or to earn income. Consequently, the sale proceeds are not a substitute for rights to ordinary income.

- In a Pyrrhic victory for the IRS on the basis issue, Judge Wherry held that taxpayers' expenses to create the easement were not the purchase price of the State tax credits under § 1012, but if anything, they were deductible under § 212(3) (which was a question not before the court). Furthermore, allocating basis to the credits would be inconsistent with the basis allocation rules in § 170(e)(2) and Reg. § 1.170A-14(b)(3)(iii), which allocate the donor's entire basis in the property between the conservation easement and the retained interest according to the ratio that the fair market value of the easement bears to the total pre-easement fair market value of the property.

- Judge Wherry rejected the taxpayers' claim, raised in a cross motion for summary judgment, that the holding period of the credits was the same as the holding period of the property the easement burdened. The taxpayers had no property rights in the credits until the donation of the easement was complete and the credits had been granted by the state.

- The taxpayer in this case recognized capital gain treatment with respect to an asset that had never appreciated over the time they held it. That is not the type of situation that should receive preferential treatment. In *Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130, 134 (1960), the Supreme Court said:

This Court has long held that the term “capital asset” is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation and the entire gain in one year.

- The court cited *Gillette Motor Transport, Inc.* and quoted part of the above passage, but gave it no real weight.

a. Just because a case is wrongly decided doesn’t mean it’s not binding precedent. *McNeil v. Commissioner*, T.C. Memo 2011-109 (5/23/11). In a case involving facts substantially the same as the facts in *Tempel v. Commissioner*, 136 T.C. 341 (4/5/11), the Tax Court (Judge Cohen) followed *Tempel* and allowed the taxpayer’s claimed short-term capital gain treatment for the proceeds from the sale of state tax credits.

7. Judge Goeke protects the Lays from IRS overreach following the Enron bankruptcy. *Estate of Lay v. Commissioner*, T.C. Memo. 2011-208 (8/19/11). In the summer of 2001, when Kenneth Lay was asked by the board of directors to re-take the position of CEO of Enron (which he had resigned in February 2001) upon the unexpected resignation of his successor, Jeffrey Skilling, the Enron board’s compensation committee decided that the best way to compensate him and ensure his remaining at Enron was for Enron to purchase two single premium annuities owned by Mr. Lay and his wife for their \$10 million cost. The purchase would both provide liquidity to the Lays and provide a retention device to Enron because the annuities could be earned back by the Lays if Mr. Lay remained as CEO for 4.25 years. The Lays provided the original annuity contracts and transfer documents to Enron on 9/21/01, but instead of providing the original documents to the insurance company, as required by the annuity contracts, Enron faxed them. Enron did not include the \$10 million on the original Form W-2 it sent to Mr. Lay, but in 2004, after an employment tax audit, sent Mr. Lay an amended form W-2 for 2001 that included the \$10 million as compensation. Judge Goeke held, “[w]e do not find this after-the-fact event relevant to the case before us.”

- The IRS took the position that the Lays did not sell the annuity contracts and that the \$10 million was an employee cash bonus includable in income for the 2001 year. Judge Goeke found that the Lays completed their requirements to transfer the annuities and that the risks and rewards of the annuity contracts were transferred to Enron on 9/21/01.

- The IRS also took the position that the purchase price of the annuities was in excess of the \$4.691 million the Lays

would have received from the insurance company if they liquidated but less than the \$11.2 million that compensation consultant Towers Perrin valued the annuities. Judge Goeke held that, based on *Commissioner v. Brown*, 380 U.S. 563 (1965), the purchase price was within a reasonable range and held that a sale had taken place.

- Judge Goeke also held that no compensation income was realized by virtue of the contractual provision under which Lay could earn back the annuity contracts if he worked for Enron for 4.25 years. The annuity contracts were not transferred or set aside and insulated from creditor's claims; Lay had no right to them and they were subject to forfeiture. The contracts were not constructively received and would not be so received until Lay had completed 4.25 years of service (or upon an earlier termination that triggered a transfer to him under the terms of the agreement).

8. Pizza is the eighth deadly sin, and the ninth is stealing the sausage process, even if the damages are taxable. Freda v. Commissioner, T.C. Memo. 2009-191 (8/25/09). The taxpayer was the shareholder of C&F Packing Co., an S corporation that supplied Pizza Hut with pre-cooked sausage prepared with the taxpayer's patented process. C&F also entered into license and royalty agreements to provide its trade secrets to other Pizza Hut suppliers. After discovering that Pizza Hut disclosed the process to an unlicensed supplier (IBP) who also sold pre-cooked sausage to Pizza Hut, C&F recovered damages from Pizza Hut for misappropriation of trade secrets. The Tax Court (Judge Chiechi) held that the damages were received as compensation for lost profits, and thus were taxable as ordinary income. The court applied the principle that "the tax treatment of the amount at issue 'depends upon the nature of the claim and the actual basis of recovery,'" quoting *Sager Glove Co. v. Commissioner*, 36 T.C. 1173, 1180 (1961), *aff'd*, 311 F.2d 210 (7th Cir. 1962). The court rejected the taxpayer's argument that the damages were for injury to or destruction of the trade secret, a capital asset.

a. Affirmed. Freda v. Commissioner, 656 F.3d 570 (7th Cir. 8/26/11). The Court of Appeals (Judge Tindler) first noted that "trade secret misappropriation, aside from signaling that a capital asset may be in some way implicated, does not tell us very much about the actual nature of C&F's original claim, which can take many forms." It then went on to hold that the Tax Court's finding that "Pizza Hut paid the amount at issue to [the taxpayer] for 'lost profits, lost opportunities, operating losses and expenditures,'" which tracks the language of the relief requested in the complaint and "ha[d] some support in the trial testimony," was not clearly erroneous. In the civil suit, the taxpayer-plaintiff "sought profits and other types of monetary recovery that may properly be taxed as ordinary income

from the get-go rather than focusing on the damage to or destruction of its capital asset.”

The factual allegations incorporated into C&F’s misappropriation claim highlight vast reductions to C&F’s margins, ... C&F’s financial losses, ..., the disproportionate impact Pizza Hut’s conduct had on C&F’s total sales, ... and C&F’s inability to “exploit” its C&F process The shareholders did not offer the tax court evidence which undercut the Commissioner’s reasonable conclusion that the damages C&F alleged were the main attraction rather than mere placeholders; their sole attempt to do so was (properly) rejected on hearsay grounds. They likewise failed to make any effort to explain why they voluntarily treated some of the money they received for a virtually identical claim (trade secret misappropriation against IBP) as ordinary income if all such claims necessarily net capital gains [*sic*]. Based on the record before it, the tax court did not err in upholding the Commissioner’s presumptively correct determination that the settlement was not “in lieu of” a replacement of capital.

- Finally, the court noted that “the settlement agreement gives no indication that Pizza Hut believed it was compensating C&F for the sale or even the use of its trade secrets. ... Without at least some hallmarks of a sale, C&F’s transfer to Pizza Hut of its trade secrets should not be considered one for tax purposes.”

- Judge Manion dissented and would have reversed, on the ground that the Tax Court was “wrong because it misread the complaint.” Judge Manion read the complaint, which after describing the elements of its trade secret misappropriation claim against Pizza Hut, C&F alleged that “[a]s a result, C&F has been damaged, and has suffered, among other things, lost profits, lost opportunities, operating losses and expenditures,” as including the lost opportunity to negotiate a transfer of the secret process to another pizza giant after Pizza Hut cut C&F off. He concluded that the Tax Court improperly over-emphasized the phrase “lost profits.” According to Judge Manion’s analysis, the nature of the claim that C&F was bringing against Pizza Hut was that Pizza Hut had wrongfully acquired and then disclosed a trade secret to C&F’s competitor, IBP, and that this damaged C&F’s property interest in the trade secret; the phrase “lost profits” was part of a non-exclusive list describing ways C&F had been injured by Pizza Hut’s trade secret misappropriation. But this phrase “lost profits” did not negate the fact that C&F’s trade secret had been severely damaged and that C&F was also seeking compensation for this damage.

9. Getting rip off by Bernie Ebbers wasn’t a theft loss. Schroerlucke v. United States, 100 Fed. Cl. 584 (9/21/11). In an opinion

that was far longer than necessary to employ a well-established principle to resolve the case, the court held that the loss of value of stock, purchased pursuant to employee stock options, in WorldCom (from \$79.4375/share to \$0.91/share) caused by Bernie Ebbers/WorldCom's fraudulent accounting practices was not a theft loss. There was no theft under relevant state law, which is prerequisite to § 165 theft loss.

10. ♪♪“Lipstick on your collar told a tale on you.”♪♪
Anschutz Co. v. Commissioner, 135 T.C. 78 (7/22/10). An S corporation, through a Q-Sub (TAC) entered into transactions with Donaldson, Lufkin & Jenrette Securities (DLJ) involving appreciated stock that it owned. The agreements were memorialized by a master stock purchase agreement (MSPA) that included “Prepaid Variable Forward Contracts” (PVFCs) and share-lending agreements (SLAs) with respect to the shares subject to the PVFCs. The PVFCs required DLJ to make an upfront payment to TAC in exchange for a promise by TAC to deliver a variable number of shares to DLJ in ten years. The amount of the payment was 75 percent of the fair market value of the shares subject to the PVFCs. If the stock subject to the PVFCs appreciated over the term of the contract, TAC was entitled to retain 50 percent of the appreciation, and the remainder accrued to DLJ. TAC pledged the shares of stock at issue in the PVFCs as collateral for the upfront payment and to guarantee TAC's performance under the PVFC. The pledged shares were delivered to a trustee. Before each stock transaction DLJ executed short sales of that stock in the open market. After TAC lent shares to DLJ pursuant to the SLAs, DLJ used the shares to close out the short sales. TAC received upfront payments under the PVFCs totaling \$350,968,652 and \$23,398,050 in prepaid lending fees under the SLAs.

- The taxpayer claimed that TAC executed two separate transactions – PVFCs and SLAs – and neither constituted a current sale for tax purposes, relying, in part, on § 1058. The Tax Court (Judge Goeke) agreed with the IRS that the shares subject to the PVFCs and lent pursuant to the SLAs were sold for income tax purposes. The transaction consisted of two integrated legs, one of which called for share lending, but the two legs were clearly related and interdependent. Analyzing the MSPA as a whole, in exchange for valuable consideration TAC transferred to DLJ the benefits and burdens of ownership, including (1) legal title to the shares; (2) all risk of loss; (3) a major portion of the opportunity for gain; (4) the right to vote the stock; and (5) possession of the stock. Although the SLAs provided that TAC could terminate share loans and recall the shares, in reality any share recalls were really TAC borrowing shares from DLJ. Because DLJ closed out its original short sales with the lent shares, the shares later transferred to TAC were in substance DLJ borrowing shares from third parties and delivering them to TAC. Gain was recognized with respect to the upfront cash payments received in the transactions. The taxpayer's reliance on § 1058 was rejected

because the taxpayer's argument relied on the premise that the PVFCs were separate from the SLAs. The MSPA violated the requirement of § 1058(b)(3) that the agreement not limit the lender's risk of loss or opportunity for gain, because the agreements eliminated TAC's risk of loss with regard to the lent shares.

- On the bright side ☺, Judge Goeke rejected the IRS's alternative argument that the transactions were also either a constructive short sale by TAC under § 1259(c)(1)(A) or a constructive forward contract sale under § 1259(c)(1)(C). TAC did not enter into any short sale because DLJ was acting as a principal and not as an agent in making the short sales. The transactions were not constructive forward contract sales because they were not forward contracts as defined in § 1259(d)(1) in that they did not provide for delivery of a substantially fixed amount of property for a substantially fixed price.

- The transaction in *Anschutz Co.* occurred before the issuance of Rev. Rul. 2003-7, 2003-1 C.B. 363, in January 2003. That ruling offered a roadmap to avoidance of gain recognition although a collar around unrealized appreciation was achieved.

a. **“Not only did DLJ effectively obtain and dispose of the actual shares pledged by TAC, TAC received significant value for those shares and simultaneously lost nearly all of the incidents of ownership of those shares.”** *Anschutz Co. v. Commissioner*, 664 F.3d 313 (10th Cir. 12/27/11). In affirming the Tax Court's decision, the Court of Appeals applied the principles from *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981) – “the term ‘sale’ is given its ordinary meaning and is generally defined as a transfer of property for money or a promise to pay money” – and relied on factors listed in *H.J. Heinz Co. and Subsidiaries v. United States*, 76 Fed. Cl. 570, 581 (2007): “(1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damages to the property; and (8) which party receives the profits from the operation and sale of the property.” The court continued that with respect to stock transactions in particular, the following factors are also considered relevant to this determination: “(i) whether the purchaser bears the risk of loss and opportunity for gain; (ii) which party receives the right to any current income from the property; (iii) whether legal title has passed; and (iv) whether an equity interest was acquired in the property.” Looking at the transactional documents, the Court of Appeals concluded that the transaction “effectively afforded DLJ all incidents of ownership in the pledged and borrowed shares,

including the right to transfer them.” Given the specifics of the underlying agreements, the court did not assign much weight to the fact the parties treated the transactions as executory contracts for the sale of shares to DLJ, rather than current sales of the shares. As for the third factor, DLJ obtained an equity interest in the shares because it had the right to do as it saw fit with them. TAC received (a) upfront cash equal to 75 percent of the pledged stock’s then-existing market value, (b) a 5 percent prepaid tranche fee, (c) the potential of benefitting to a limited degree if the pledged stock increased in value over the life of the transactions, and (d) the complete elimination of any risk of loss. The fourth, fifth, and seventh factors were easily satisfied on the facts. (The sixth factor was not relevant.) Looking at the eighth factor, the court noted that “TAC had significantly less ... price reward from the ... shares [at issue] by executing [the transactions] than it would have [had] by simply holding onto the shares and selling them after ten years.” In addition, the court noted that TAC effectively transferred the voting rights, had only limited rights to received dividends or dividend equivalent payments, and “DLJ the right to possess, and ultimately dispose of, the shares.”

- The court rejected the taxpayer’s argument that the taxpayer’s transaction was “substantially identical” to the one in Revenue Ruling 2003-7, 2003-1 C.B. 363, and that, consequently, “the transactions at issue should not be treated as current sales of TAC’s shares to DLJ.” Unlike Revenue Ruling 2003-7, which involved only a variable prepaid forward contract, the transaction in the instant case also included a master stock purchase agreement and share lending agreement. The result was that that “DLJ obtained possession, and most of the incidents of ownership, of TAC’s pledged shares. TAC, in turn, obtained cash payments and an elimination of any risk of loss in the pledged stock’s value at the end of the term of the transactions.”

- Finally, the court rejected the taxpayer’s argument that the transaction was protected by the so-called “safe harbor” § 1058. To qualify as a loan of securities under § 1058, the loan agreement must (1) provide for the return to the lender of identical securities, (2) require payments to the lender equal to all interest, dividends, and other distributions on the securities during the period of the loan, and (3) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred. Section 1058 did not apply because the transactions did not satisfy the requirements of § 1058(b)(2) and (3): The transactions at issue did not ensure that TAC would receive amounts equivalent to all interest, dividends, and other distributions to which TAC was otherwise entitled on the pledged stock, and the transactions effectively reduced TAC’s risk of loss and opportunity for gain on the pledged shares.

b. No ring-around-the-collar here: This collar just plain clean works. Rev. Rul. 2003-7, 2003-1 C.B. 363

(11/16/03). The IRS ruled that a shareholder has neither sold stock currently nor caused a constructive sale of stock under § 1259 where he (1) receives a fixed amount of cash, (2) simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date [but which does provide a “collar” on the number of shares of stock to be delivered, in effect providing a “collar” on the ultimate sale price], (3) pledges the maximum number of shares for which delivery could be required, (4) has the unrestricted right to deliver the pledged shares or to substitute cash or other shares on the delivery date, and (5) is not economically compelled to deliver the pledged shares.

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

B. Interest, Dividends, and Other Current Income

1. Quasi-substitutes for dividends ain’t qualified dividends – pay up at ordinary rates. *Rodriguez v. Commissioner*, 137 T.C. No. 14 (12/7/11). The Tax Court agreed with the IRS’s conclusion in Notice 2004-70, 2004-2 C.B. 724, that amounts of a controlled foreign corporation’s income that are includable by the shareholders as ordinary income under §§ 951(a)(1)(B) and 956, because the CFC’s earnings and profits were invested in U.S. property, were not qualified dividend income subject to the § 1(h)(11) preferential tax rate. Because there was no distribution, and neither the Code nor the regulations provides a special rule treating a § 951 inclusion as a dividend for purposes of § 1(h)(11), there was no dividend. “[T]o say that section 951 treats a CFC’s investments in U.S. property ‘much like’ a constructive dividend is a far cry from saying that such amounts actually constitute dividends. In fact, the statutory structure and operating rules in the Code, particularly as they have evolved over time, strongly suggest that these amounts do not constitute dividends under the Code.” There are important distinctions between dividends and § 951 inclusions: (1) while dividend distributions reduce the earnings and profits of the distributing corporation, § 951 inclusions do not; and (2) while a dividend does not result in an increase to the shareholder’s stock basis, a § 951 inclusion does.

C. Profit-Seeking Individual Deductions

1. The IRS still can't figure out *Knight*. Notice 2010-32, 2010-1 C.B. 594 (4/1/10). This notice provides that pending further guidance, taxpayers are not required to determine the portion of a "bundled fiduciary fee" that is subject to the § 67 two-percent of AGI floor on miscellaneous itemized deductions for any taxable year beginning before 1/1/10. Taxpayers may deduct the full amount of the bundled fiduciary fee; payments by the fiduciary to third parties for expenses subject to the two-percent floor must be treated separately. It modifies and supersedes Notice 2008-116, 2008-1 C.B. 593, which provided similar relief for years beginning before 1/1/09.

a. And we don't have to until final regulations are published. Notice 2011-37, 2011-20 I.R.B. 785 (4/13/11). This notice extends the interim guidance provided in Notice 2010-32, 2010-1 C.B. 594 (4/1/10), to taxable years that begin before the date final regulations under Temp. Reg. § 1.67-4 are published.

b. Proposed regulations are published. REG-128224-06, Section 67 Limitations on Estates or Trusts, 76 F.R. 55322 (9/7/11). These proposed regulations would add Reg. § 1.67-4, to define whether some costs incurred by an estate or non-grantor trust would have been "commonly or customarily ... incurred by a hypothetical individual owning the same property" Fees for investment advice would be covered by the 2-percent floor but incremental costs of investment advice incurred because the advice is rendered to a trust or estate are not subject to the floor. Bundled fees may be allocated by "[a]ny reasonable method"

2. The taxpayer fought an almost spot-on example in the regulations and, unsurprisingly, lost on summary judgment. Ellington v. Commissioner, T.C. Memo. 2011-193 (8/11/11). The taxpayers borrowed over \$1.5 million from Merrill Lynch to purchase a residence. The loan was secured by the residence and nearly 9,000 shares of Intel stock worth approximately \$650,000. The taxpayer's subsequently refinanced the Merrill Lynch loan with another lender, and the refinanced loan was secured only by the residence. The taxpayers deducted a portion of the interest on the Merrill Lynch loan as investment interest (because of the statutory ceiling on the amount of the home mortgage for which interest is deductible). The taxpayers argued that a portion of the interest accrued on the Merrill Lynch loan was allocable to the Intel stock because the loan was partly secured by the Intel stock. The Tax Court (Judge Kroupa) rejected the argument, applying the tracing rules in Temp. Reg. § 1.163-8T(c)(1) to conclude that the entire loan was attributable to the purchase of the residence. Under the

regulations, debt and interest are allocated to expenditures according to the use of the debt proceeds, and Merrill Lynch had disbursed all of the loan proceeds directly to the sellers from whom the taxpayers had purchased the residence. Judge Kroupa cited Reg. § 1.163-8T(c)(1), Example, which provides that a taxpayer who finances the purchase of a personal-use automobile with a loan secured by corporate stock held for investment incurs personal interest expense, not investment interest expense.

D. Section 121

There were no significant developments regarding this topic during 2011.

E. Section 1031

There were no significant developments regarding this topic during 2011.

F. Section 1033

There were no significant developments regarding this topic during 2011.

G. Section 1035

1. Instructions for qualifying for a tax-free annuity swap. Rev. Proc. 2011-38, 2011-30 I.R.B. 66 (6/28/11). The direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract (regardless of whether the two annuity contracts are issued by the same or different companies) is a tax-free exchange under § 1035 if no amount, other than an amount received as an annuity for a period of ten or more years or during one or more lives, is withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 180 months beginning on the date on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange (the date of the transfer). A transfer that is not treated as a tax-free exchange under § 1035 will be examined under general tax principles to determine if it will be treated as a distribution, taxable under § 72(e), followed by a payment for the second contract, or as boot in an otherwise tax-free exchange. This Revenue Procedure is effective for transfers completed after 10/23/11. Rev. Proc. 2008-24, 2008-1 C.B. 684, which is modified and superseded, controls transfers before 10/24/11.

H. Miscellaneous

There were no significant developments regarding this topic during 2011.

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. **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.

2. **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."

B. Qualified Deferred Compensation Plans

There were no significant developments regarding this topic during 2011.

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

1. What's the FMV of a life insurance policy?

Schwab v. Commissioner, 136 T.C. 120 (2/7/11). The Tax Court (Judge Holmes) held that “the amount actually distributed” and therefore includable in gross income under §§ 402(b) and 72 where a variable universal life insurance policy was received as a distribution upon termination of a § 419 nonqualified employee-benefit plan was not the “stated value” determined by the insurance company. Rather the amount distributed was the fair market value of the contract, including paid up insurance, but reflecting surrender charges and other limiting conditions imposed on the beneficiary by the insurance contract. Section 6662 penalties did not apply because the understatement of income, i.e., the amount distributed, was less than \$5,000, and taxpayers were not careless, reckless, or in intentional disregard of rules or regulations.

2. Getting paid in volatile stock that you cannot sell for a while due to lapsing restrictions is a tax unhealthy behavior.

Gudmundsson v. United States, 634 F.3d 212 (2d Cir. 2/11/11). In 1999, the taxpayer received 73,105 unregistered shares of stock in his employer pursuant to an incentive compensation plan. The stock was worth approximately \$1.3 million. The stock was not subject to forfeiture, but the taxpayer's ability to transfer the stock was subject to three lapse restrictions. First, pursuant to SEC Rule 144, the stock could not be sold on a public exchange until July 1, 2000, although it could be sold privately or pledged. Second, pursuant to contract with the employer, prior to July 1, 2000, the stock could be sold only to certain “permitted transferees,” a group which included family members and relatives. Third, the sale of the stock was limited by the employer's insider trading policy, which required compliance with certain waiting periods and consent procedures prior to trading the stock. By the time the stock was freely marketable on July 1, 2000, its value had fallen dramatically. The Court of Appeals held that the \$1.3 million value of the stock in 1999 was properly includable in that year under § 83, because it was not subject to a substantial risk of forfeiture. None of the limitations on trading the stock could result in its forfeiture. Because all of the restrictions were lapse restrictions, none were taken into account in valuing the stock.

3. At least one kind of forfeiture must have “an objectively reasonable chance of success,” even if most do not.

Strom v. United States, 641 F.3d 1051 (9th Cir. 4/6/11). Section 83(c)(3) specifically provides that property will be treated as subject to a substantial risk of forfeiture as long as the sale of the property at a profit “could” subject the

individual to suit under § 16(b) of the Securities Exchange Act. The Ninth Circuit held that § 83(c)(3) applies to defer inclusion only if the taxpayer shows that a § 16(b) suit premised on a sale of the property “would have had an objectively reasonable chance of success.” After extensive analysis of the treatment of stock options under the Exchange Act, as applied to the facts, the Court of Appeals reversed the District Court’s judgment for the taxpayer and held that § 83(c)(3) did not apply to defer inclusion. However, it remanded the case to the district court for a determination of whether deferral was allowed under Reg. § 1.83-3(k), which provides that “property is subject to substantial risk of forfeiture and is not transferable so long as the property is subject to a restriction on transfer to comply with the ‘Pooling-of-Interests Accounting’ rules set forth in Accounting Series Release Numbered 130 and ... 135.” The record was not fully developed regarding the existence and terms of any such restrictions.

D. Individual Retirement Accounts

There were no significant developments regarding this topic during 2011.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

There were no significant developments regarding this topic during 2011.

B. Miscellaneous Income

1. A Blackwater mercenary cannot exclude combat zone pay. Holmes v. Commissioner, T.C. Memo. 2011-26 (1/31/11). The Tax Court (Judge Goeke) held that income received by a private contractor performing military duties in Iraq during the Iraq war was not excludable under § 112. Section 112 applies only to members of the U.S. armed services and not to civilian employees of military contractors.

2. The IRS uses taxpayer’s net losses at the casino to prove unreported gross income from other sources. Pan v. Commissioner, T.C. Memo. 2011-40 (2/14/11). Judge Vasquez upheld the IRS’s reconstruction of unreported gross income determined in part based on currency transactions reports filed by Foxwoods gambling casino. The non-gambling gross income was determined to be at least equal to the taxpayer’s net cash expenditures (chip purchases minus the sum of chip redemptions and complementary expenses) at the casino.

3. No sympathy for veterans here. Robinson v. Commissioner, T.C. Memo. 2011-59 (3/10/11). The Tax Court (Judge Wells) held that a pension received from the United States to a retired U.S. Postal Service worker, whose retirement was due to delayed effect of injuries received while serving in the military in Vietnam, was not excludable under § 104(a)(4). The cause of the disability was irrelevant when determining eligibility for the pension. Thus the disability payments the taxpayer received were not paid as compensation for personal injuries or sickness incurred in military service, which is a requirement for § 104(a)(4).

4. Qui tam relator's award is a taxable "reward." Campbell v. Commissioner, 658 F.3d 1255 (11th Cir. 9/28/11), *aff'g* 134 T.C. 20 (1/21/10). The taxpayer recovered a gross award of \$8.75 million as a relator in a qui tam action on behalf of the United States government against a military contractor and paid \$3.5 million of attorney's fees, which amount was retained by the taxpayer's attorney to whom the \$8.75 million had been remitted; the taxpayer received only \$5.25 million from his attorney. The Eleventh Circuit affirmed the Tax Court's decision (Judge Wells) holding that the entire gross award of \$8.75 million was includable in gross income, and the \$3.5 million of attorney's fees was deductible as a miscellaneous itemized deduction. The Court of Appeals reasoned that the \$8.75 million was in the nature of a "reward." The Court of Appeals also upheld the § 6662(b) substantial understatement penalty; even though the taxpayer filed a Form 8275, there was neither reasonable cause nor substantial authority supporting the omission from gross income.

- "Qui tam" is an abbreviation of the Latin phrase "qui tam pro domino rege quam pro se ipso in hac parte sequitor," which means "who pursues this action on our Lord the King's behalf as well as his own."

- The tax year involved in this case (2003) pre-dates the effective date of 2004 amendments to § 62(a), which now permits attorney's fees in a False Claims Act case to be an above-the-line deduction.

5. 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.

6. 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.

7. 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, 7-6). The taxpayer (Phillip Driscoll) received a parsonage allowance from Mighty Horn Ministries, Inc., later known as Phil Driscoll Ministries, Inc., as the Ministries, 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, 109 A.F.T.R.2d 2012-832 (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.”

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

1. They did everything right except make money. Blackwell v. Commissioner, T.C. Memo. 2011-188 (8/8/11). The taxpayer husband worked full time as a senior officer of a number of motorcycle, snowmobile, ATV, and personal watercraft manufacturing companies. The wife taxpayer was involved in the couple’s horse breeding and training activity. During the relevant years in which the couple conducted the horse activity, his salary income ranged from approximately \$371,000 to over \$1,200,000. The wife typically spent 15-20 hours a week on the horse activity and the husband typically spent two to five hours a week on the horse activity. Over the years they acquired and sold over twenty horses. Over a seven year period the activity lost over \$500,000. Judge Swift held that they conducted the horse activity for a profit motive and that § 183 did not apply to limit their deductions. Before starting the activity, they took over seven years learning about horse breeding and management before

attempting to start the operation. They were not “absentee, aloof, or recreational horse owners.” The wife “managed and worked diligently and daily on the horse activity, doing essentially all of the horse maintenance herself.” The taxpayers “consulted expert horsemen, hired expert horse trainers to assist in training the horses, advertised, showed the horses, and paid significant stud fees to have their mares bred with stallions which they regarded as having good bloodlines.” They made adjustments to their business plan, maintained reasonably good books and records for the activity, and, after seven years of losses, terminated the activity. “The time, effort, and financial resources [the taxpayers] personally put into and invested in their ... horse activity are not indicative of a hobby; rather, they are indicative of a for-profit activity.”

D. Deductions and Credits for Personal Expenses

1. Singing ♪ “I’m a Yankee Doodle Dandy” supports some of the claimed deductions for which no records were available. *Zilberberg v. Commissioner*, T.C. Memo. 2011-005 (1/5/11). Judge Wherry applied the *Cohan* rule [*Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930)] with respect to deductible personal expenses. The taxpayer was allowing \$3,000 of a claimed \$5,000 § 217 moving expense deduction, even though he had inadequate records, because he established that he had moved for employment purposes and that he had incurred some expenses. He was also allowed \$15,500 of a claimed \$36,250 § 165(c)(3) casualty loss deduction with respect to his residence, where his records were destroyed in the hurricane that gave rise to the casualty.

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

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

Preventive Services Under the Patient Protection and Affordable care Act, 76 F.R. 46677 (8/3/11), promulgates identical proposed regulations. The effective date is 8/1/12.

3. Is this a casualty loss in limbo? Alphonso v. Commissioner, 136 T.C. 247 (3/16/11). The taxpayer owned stock in a N.Y. cooperative housing corporation from which she rented an apartment as her personal residence. When a retaining wall on the grounds of the apartment complex collapsed, the corporation levied an assessment for the cost of repairs, and the taxpayer paid \$26,390, with respect to which she claimed a casualty loss deduction of \$23,188 (reflecting computational limitations in § 163(h)). The IRS disallowed the deduction, and the Tax Court (Judge Chiechi) upheld the disallowance. Judge Chiechi reasoned that under the relevant state law and controlling legal instruments, the taxpayer had no property interest in the retaining wall, which was part of the common grounds – nothing in the lease, the corporation charter and by-laws, or any other governing documents indicated that the taxpayer possessed a leasehold interest, an easement, or any other property interest in the common grounds. Finally, Judge Chiechi rejected the taxpayer’s argument that § 216, which allows cooperative apartment owners to deduct their shares of the real estate taxes and mortgage interest paid by the cooperative corporation, should be extended by judicial interpretation to casualty losses. Although Judge Chiechi rejected the IRS’s argument that the absence of a reference to casualty losses in § 216 conclusively determined that it did not apply to casualty losses, after examining the legislative history she concluded that Congress intended § 216 to apply only to interest and real estate taxes.

4. A pang of tax pain. Pang v. Commissioner, T.C. Memo. 2011-55 (3/9/11). The Tax Court (Judge Gustafson) upheld the disallowance by the IRS of the taxpayer’s claim of a § 165(c)(3) casualty loss deduction for damages paid to the plaintiff in a wrongful death suit against the taxpayer, citing Whitney v. Commissioner, 13 T.C. 897 (1949). To be a casualty loss the taxpayer’s own property must be damaged or stolen, which did not occur in this case.

5. The IRS tries to defy national middle-income income housing policy and be too stingy with the first time homebuyer credit and, as a result, gets slapped down by the Tax Court. Woods v. Commissioner, 137 T.C. 159 (10/27/11). The taxpayer entered into a contract for deed to purchase a house in 2008, took possession of the house in 2008, and claimed the § 36 first-time homebuyer credit for 2008. The house required renovations before being ready for occupancy, and the intended to use the credit proceeds to pay for the necessary renovations. He received a refund for the credit in 2009 and began renovations. The IRS subsequently

denied the credit on the grounds that the taxpayer was not entitled to the credit because (1) the taxpayer took possession of the house under a contract for deed and therefore had not “purchased” the house, and (2) even if the “purchase” requirement was satisfied the house was not the taxpayer’s “principal residence” in 2008 for purposes of § 36. The Tax Court (Judge Haines) held for the taxpayer (who represented himself pro se). First, under state (Texas) property law, the contract for deed conferred equitable title to the house on the taxpayer, and therefore he had “purchased” the house. Second § 36 requires a prospective analysis, asking whether a taxpayer will occupy a house as a principal residence. Because the taxpayer established that he intended to occupy the house as his principal residence as soon as the necessary renovations were complete, he was entitled to the first-time homebuyer tax credit for 2008.

6. 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. No. 4 (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 taxpayer’s 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 is 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.

E. Divorce Tax Issues

1. He was on the hook for the mortgage even if she died, so paying the mortgage wasn’t alimony. Moore v. Commissioner, T.C. Memo. 2011-200 (8/16/11). Judge Vasquez held that the payment by the husband of the mortgage debt on the martial home pursuant to the

divorce instrument was not deductible as alimony. Because neither the divorce instrument nor state law provided that the husband's obligation to pay the debt would be terminated by the wife's death, the condition in § 71(b)(1)(D) had not been met.

F. Education

There were no significant developments regarding this topic during 2011.

G. Alternative Minimum Tax

There were no significant developments regarding this topic during 2011.

VI. CORPORATIONS

A. Entity and Formation

1. **Did the Tax Court hint that *Moline Properties* might trump the economic substance doctrine, or did it merely conclude that a corporation that passes muster under *Moline Properties* has "economic substance?"** Weekend Warrior Trailers, Inc. v. Commissioner, T.C. Memo. 2011-105 (5/19/11). The sole shareholder of the taxpayer corporation, which manufactured travel trailers, established a sibling corporation (Leading Edge) to provide design and management services, to be performed by the taxpayer's shareholder as an employee of Leading Edge (while he also continued to serve as a managerial employee of the taxpayer), for the taxpayer's manufacturing operations. Leading Edge elected to be an S corporation. The taxpayer also transferred its employees to Leading Edge, which then leased the employees to the taxpayer. The shareholder then sold almost all of the stock of Leading Edge to an ESOP, of which he was the sole beneficiary. The taxpayer made substantial payments (millions of dollars) to Leading Edge for management services. When § 409(p) was amended to eliminate the tax benefits of the structure, in June 2004 Leading Edge repurchased its shares from the ESOP. The IRS disallowed the taxpayer's management fee deductions for 2002 through 2004 on the grounds that (1) Leading Edge "should be disregarded for Federal income tax purposes as Leading Edge Design, Inc. lacked both economic substance and economic purpose and was formed for the primary purpose of obtaining tax benefits", and (2) "Transactions entered into between Leading Edge Design, Inc. and Weekend Warrior Trailers, Inc. should be disregarded for Federal Income tax purposes because they lacked economic substance and economic purpose and were entered into for the primary purpose of obtaining tax

benefits.” At trial the IRS also argued that the sale of the Leading Edge stock to the ESOP had no business purpose. Applying the *Moline Properties* doctrine (*Moline Properties v. Commissioner*, 319 U.S. 436 (1943)), Judge Marvel held for the taxpayer, stating as follows:

Even if a corporation was not formed for a valid business purpose, it nevertheless must be respected for tax purposes if it actually engaged in business activity. See *Moline Props., Inc. v. Commissioner*, 319 U.S. at 438-439; *Bass v. Commissioner*, [50 T.C. 595, 602 (1968)]. The prongs of the test under *Moline Props.* are alternative prongs. See *Moline Props., Inc. v. Commissioner*, supra at 438-439; *Bass v. Commissioner*, supra at 602; see also *Rogers v. Commissioner*, T.C. Memo. 1975-289 (“*Moline* establishes a two-pronged test, the first part of which is business purpose, and the second, business activity. *** Business purpose or business activity are alternative requirements.”). Accordingly, the issue turns on whether Leading Edge engaged in business activity. Whether a corporation is carrying on sufficient business activity to require its recognition as a separate entity is a question of fact. *Bass v. Commissioner*, supra at 602 (status of a corporation respected when testimony established that “the corporation was managed as a viable concern, and not as simply a lifeless facade.”)

- Judge Marvel then concluded that, on the record, Leading Edge was not a “lifeless facade.” Nevertheless, the taxpayer’s scheme failed because Judge Marvel went on to hold that the evidence did not prove that the management fees paid by Weekend Warrior to Leading Edge were necessary or reasonable.

- - B. Distributions and Redemptions**

There were no significant developments regarding this topic during 2011.

- - C. Liquidations**

There were no significant developments regarding this topic during 2011.

- - D. S Corporations**

- - - 1. Despite wildly disproportionate distributions, with no evidence of corrective distributions, the corporation was still an**

S corporation. Miller v. Commissioner, T.C. Memo., 2011-189 (8/9/11). The taxpayer reported that he had gifted 95 percent of the stock of his S corporation, having a basis of \$823,450, to his son in 2002, leaving the taxpayer with a basis of only \$43,339 in his remaining stock. For 2003 the corporation's original tax return allocated 5 percent of its \$366,162 of income (\$18,308) to the taxpayer and 95 percent to the son. In 2003 the corporation distributed \$619,551 to the taxpayer and \$385,692 to the taxpayer's son. After audit, the IRS determined that the taxpayer had received distributions of \$548,664 that exceeded his basis in the stock. The parties stipulated that the corporation was an S corporation, despite the disproportionate distributions. Judge Cohen rejected the taxpayer's argument that because of the disproportionate distributions, the events should be recharacterized to treat the effective date of the transfer of stock from the taxpayer to his son as occurring after the disproportionate distributions. Accordingly, the deficiency was upheld.

2. 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 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. Santa Clara Valley Housing Group, Inc. v. United States, 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.

E. Mergers, Acquisitions and Reorganizations

1. This case decided under old case law might come out differently if decided under new regulations. Ralphs Grocery Co. v. Commissioner, T.C. Memo. 2011-25 (1/27/11). This case involved the validity of a joint § 338(h)(10) election with respect to the transfer of the stock of a subsidiary in the course of a chapter 11 bankruptcy proceedings of its parent corporations, in which the stock of the subsidiary was eventually distributed to parent corporation's creditors. The question was whether the transfer was a sale and purchase, as argued by the taxpayer, or a tax-free reorganization, as argued by the IRS. The Tax Court (Judge Chiechi) held that the § 338(h)(10) election was valid, because the acquisition of stock was a purchase as defined in § 338(h)(3) and a qualified stock purchase under § 338(d)(3), and rejecting the IRS's claim that it was a reorganization. The IRS's argument was based on the fact that the consideration received by the

transferor corporations was stock of the transferee corporation, and that although the stock received was transferred to creditors, under *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), the creditors were equity holders of the parent corporations for continuity-of-interest purposes. Judge Chiechi found the continuity of interest requirement not to have been satisfied, distinguishing *Alabama Asphaltic*. Judge Chiechi found that *Alabama Asphaltic* and its progeny differed from the instant case because in those cases the creditors had instituted involuntary bankruptcy proceedings or took other “proactive” steps to “take ‘effective command’” over the corporation’s assets. In this case, however, the chapter 11 proceeding was voluntary, and “none of the ... creditors took any proactive steps to enforce or protect their respective rights to payment ... of their respective debts.” Thus, the acquisition of Ralphs’ stock was a purchase as defined in § 338(h)(3) and a qualified stock purchase under § 338(d)(3), and consequently the § 338(h)(10) election was valid.

- Note that if this transaction had occurred in a later year in which Reg. § 1.368-1(e)(6) would have controlled (on and after 12/12/08), the determination of whether the continuity of interest requirement for a reorganization was satisfied, and the result might have differed. To treat the creditors as holders of a proprietary interest for continuity of interest purposes, Reg. § 1.368-1(e)(6) does not require that the creditors have instituted involuntary bankruptcy proceedings or have taken other “proactive” steps to “take ‘effective command’” over the corporation’s assets. Reg. § 1.368-1(e)(6) simply provides that “[a] claim of the most senior class of creditors receiving a proprietary interest in the issuing corporation and a claim of any equal class of creditors will be treated as a proprietary interest” None of us has had the patience to wade through the pages and pages of fact findings in the case to try to figure out what the result actually might have been had the current regulations applied.

2. The Ninth Circuit finds basis in rights created from the collapse of the savings and loan industry in the 1970s: the hell with § 362(b). *Washington Mutual Inc. v. United States*, 636 F.3d 1207 (9th Cir. 3/3/11). The taxpayer, as the successor corporation to Home Savings of America, filed a refund action claiming amortization deductions for certain rights, and loss deductions for abandonment of branching rights, created in a § 368(a)(1)(G) reorganization by the Federal Savings and Loan Insurance Corporation (FSLIC) in which Home Savings acquired three failed savings and loan associations in a transaction structured. The District Court granted summary judgment to the IRS, concluding that Home Savings had no basis in the rights. The Ninth Circuit reversed and remanded, disagreeing with the District Court’s conclusion regarding basis. As part of the acquisition of the three failed thrifts in a supervisory merger transaction structured as a type G reorganization, FSLIC entered into an “Assistance Agreement” with Home

Savings that included, among other things, approval for Home Savings to establish branches in Florida and Missouri as if Home Savings maintained its home office in those states, and approval of the purchase method of accounting under which Home Savings was permitted to apply a percentage of acquired intangible assets in its deposit base and for amortization of the remainder over forty years. The Ninth Circuit accepted the taxpayer's argument and concluded that the excess of liabilities of the acquired thrifts over the value of assets represented a cost that was consideration for the rights represented in the assistance agreement in the integrated transaction, and concluded that allowing the taxpayer a cost basis was not inconsistent with characterizing the transaction as a § 368(a)(1)(G) reorganization, notwithstanding the transferred basis rule of § 362(b). The Court rejected the IRS's assertion that "recognizing Home Savings a cost basis in the Rights based on the assumption of FSLIC's liabilities requires characterizing some of the acquired thrifts' liabilities as FSLIC's liabilities, because Home Savings did not pay FSLIC or the Bank Board separate consideration for the Rights." The District Court concurred with the IRS position holding that the excess liabilities of the acquired thrifts were the same as FSLIC's insurance liabilities which remained liabilities of FSLIC. The Ninth Circuit reasoned that Home Savings received a generous incentive package, the cost of which was the excess of the failing thrifts liabilities over the value of their assets. A concurring opinion argued that the acquired rights had a fair market value basis as acquired directly from FSLIC in exchange for taking over the liabilities of the failed thrifts. The Ninth Circuit remanded the case to the District Court to determine the proper amortization amounts for the intangibles and the amount of abandonment loss for the branch rights.

3. The IRS tells corporations how to determine transferred basis when they don't know who the transferors were. Rev. Proc. 2011-35, 2011-25 I.R.B. 890 (6/1/11), *amplified and modified by* Rev. Proc. 2011-42, 2011-37 I.R.B. 318 (8/19/11). The IRS has published revised procedures that update, revise, and replace the survey methodology of Rev. Proc. 81-70, 1981-2 C.B. 729, for corporations to determine the basis of the stock of a target corporation acquired in a tax free reorganization in which the acquirer takes a transferred basis, i.e., in § 368(a)(1)(B) reorganizations and § 368(a)(2)(E) reorganizations that could have qualified as a § 368(a)(1)(B) reorganization (if the acquirer elects a transferred basis). These new procedures in part reflect the fact that shares are often held by nominees under confidentiality agreements not to disclose true ownership. The revenue procedure provides safe harbors to determine the basis of shares acquired from various categories of transferring shareholders, including reporting shareholders, registered non-reporting shareholders, and nominees. The revenue procedure describes methodologies for determining the basis of acquired shares. The acquiring corporation may follow procedures for

surveying all surrendering target shareholders, use a statistical sampling when a full survey is not feasible, or use one of two statistical sampling techniques when specified criteria are met. An acquiring corporation may use a different methodology as agreed between the IRS and the acquiring corporation. However, if the acquiring corporation has actual knowledge of a surrendering shareholder's basis in acquired stock, that basis must be used for the acquired shares.

a. Tracking the basis of nonexistent stock ain't easy. T.D. 9558, Corporate Reorganizations; Allocation of Basis in "All Cash D" Reorganizations, 76 FR 71878 (11/21/11). Temp. Reg. § 1.358-2T deals with stock basis in all cash type D reorganizations under Reg. § 1.368-2(l). If an actual shareholder of the acquiring corporation is deemed to receive a nominal share of stock of the issuing corporation described in Reg. § 1.368-2(l), that shareholder must, after allocating and adjusting the basis of the nominal share in accordance with the rules of Reg. § 1.358-1, and after adjusting the basis in the nominal share for any transfers described in Reg. § 1.358-1, designate the share of stock of the acquiring corporation to which the basis, if any, of the nominal share will attach. Under these rules, the ability to designate the share of stock of the acquiring corporation to which the basis of the surrendered stock or securities of the target will attach applies only to a shareholder that actually owns shares in the issuing corporation. Thus, for example, if in an all cash D reorganization, Y Corporation, a first tier subsidiary of P Corporation, acquires the assets of T Corporation, a second tier subsidiary of P Corporation, owned by X Corporation, a first tier subsidiary of P Corporation, X Corporation cannot designate any share of Y Corporation stock to which the basis, if any, of the nominal share of Y Corporation stock will attach; and P Corporation cannot designate a share of Y Corporation stock to which basis will attach because P Corporation's basis in the nominal share of Y Corporation stock (deemed to have been distributed to it by X Corporation) is zero (its fair market value).

4. 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 with 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, 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.”

5. “[A]doption of these exceptions [to § 382(g)] is appropriate because these transactions do not introduce new capital into the loss corporation and because direct or indirect ownership of the loss corporation becomes less concentrated, thus diminishing the opportunity for loss trafficking.” REG-149625-10, Application of the Segregation Rules to Small Shareholders, 76 F.R. 72362 (11/23/11). The Treasury Department has published proposed amendments to Reg. § 1.382-3

that would reduce the complexity of applying § 382 in tracking transactions involving small amounts of stock of a loss corporation. Reg. § 1.382-3 currently provides that all shareholders who do not individually own five percent of a loss corporation are grouped together and treated as a single “public group” five-percent shareholder. However, current Temp. Reg. § 1.382-2T segregates into two or more public groups any public group of less than five percent stockholders that can be separately identified as having acquired their stock in a particular transaction. The proposed regulations would provide that the segregation rule does not apply to transfers of a loss corporation’s stock to non-five-percent shareholders by five-percent shareholders, or entities that directly or indirectly own at least five percent of a loss corporation whose owners (excluding those who are five percent shareholders of a loss corporation) own, in the aggregate, five percent or more of a loss corporation. The proposed regulations also would provide that the segregation rules do not apply to transfers of ownership interests in five-percent entities to shareholders who are not themselves five-percent shareholders. The proposed regulations also provide a special exception under which a loss corporation may annually redeem ten percent of the value of its stock, or 10 percent of the shares of a particular class of stock, without triggering the segregation rules and the creation of new 5 percent groups. Under the proposed regulations, transactions that under the current rules result in the creation of a new public group, and thus a possible owner shift, simply will be folded into the existing public groups, thereby reducing the chance of an ownership change.

6. 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.** Frank Sawyer Trust of May 1992 v. Commissioner, T.C. Memo. 2011-290 (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 Taxco 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"

7. When to measure the value of consideration to determine whether continuity of interest exists: It is the business day before the day on which the binding contract is entered into. Continuity of interest regulations revised, finally! T.D. 9565, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest, 76 F.R. 78540 (12/19/11). The Treasury Department finalized, with only minor

changes, Prop. Reg. § 1.368-1(e)(2), REG-146247-06, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest, 72 F.R. 13058 (3/20/07), which were identical to Temp. Reg. § 1.368-1(e)(2), which had expired on 3/19/10. Reg. § 1.368-1(e)(2)(i) provides that for purposes of determining whether shareholders received a sufficient proprietary interest in the acquiring corporation, the value of consideration received in a reorganization is determined as of the last business day before the contract is binding, if the contract provides for fixed consideration. Under Reg. § 1.368-1(e)(2)(iii)(A), a contract provides for fixed consideration if it specifies the number of shares of the acquiring corporation, the amount of money, and the other property (identified by value or by description) that is to be exchanged for the stock of the target corporation. With an Orwellian flourish, Reg. § 1.368-1(e)(2)(iii)(C)(1) states that “a contract that provides for contingent consideration will be treated as providing for fixed consideration if it would satisfy the requirements of paragraph (e)(2)(iii)(A) of this section without the contingent adjustment provision.” Reg. § 1.368-1(e)(2)(iii)(C)(2) adds that contingent consideration will not be fixed consideration if the adjustments prevent the target shareholders from being subject to the economic benefits and burdens of ownership of the acquiring corporation stock as of the last business day before a binding contract. Thus, adjustments that reflect changes in the value of the stock or assets of the acquiring corporation at a later date will prevent the contract from being treated as providing for fixed consideration. The preamble to the Temporary Regulations, T.D. 9316, 72 F.R. 12974 (2007), suggested that the contingent consideration provision allows adjustments to the consideration that do not decrease the ratio of the value of the shares of the acquiring corporation to the value of money or other property delivered to the target shareholders relative to the ratio of the value of the target stock to the value of the money or other property that would be delivered to the target shareholders if none of the contingent consideration were delivered.

- Under Temp Reg. § 1.368-1(e)(2)(iii)(B), if the target corporation’s shareholders may elect to receive either stock or money, the contract provides for fixed consideration if the determination of the number of shares of issuing corporation stock to be provided to the target corporation shareholder is based on the value of the issuing corporation stock on the last business day before the first date there is a binding contract. The preamble to the Temporary Regulations indicates that the IRS and Treasury Department believe that if shareholders have an election to receive stock of the acquiring corporation at an exchange rate based on the value of the acquiring corporation stock on the date of a binding contract, the target shareholders are at risk for the economic benefits and burdens of ownership of the acquiring corporation stock as of the contract date. Thus, the preamble concludes that it is appropriate to value the stock of the acquiring corporation as of the signing date for purposes of testing continuity of interest.

Reg. § 1.368-1(e)(2)(v), Ex. (9) provides an example of the application of the shareholder election.

- Reg. § 1.368-1(e)(2)(ii)(A) provides that a binding contract is an instrument enforceable under applicable law. However, the presence of a condition outside of the control of the parties, such as a requirement for regulatory approval, will not prevent an instrument from being treated as a binding contract. Reg. § 1.368-1(e)(2)(ii)(C) provides rules pursuant to which a tender offer can be considered to be a binding contract, even though it is not enforceable against the offerees, if certain conditions are met. The regulations also provide for modifications of a binding contract. If the contract is modified to change the amount or type of consideration that the target shareholders would receive, the date of the modification becomes a new signing date for purposes of testing for continuity of interest. Reg. § 1.368-1(e)(2)(ii)(B)(1). However, if in a transaction that provides for adequate continuity of interest, the contract is modified to increase the amount of stock of the acquiring corporation to be delivered to the target shareholders, or to decrease the amount of cash or value of other property, then the modification will not be treated as a modification of the binding contract. Reg. § 1.368-1(e)(2)(ii)(B)(2). Similarly, in a transaction that does not qualify as a reorganization for failure to meet the continuity of interest requirement, a modification that reduces the number of shares of stock to be received by the target shareholders, or increases the amount of money or value of property, will not be treated as a modification of the binding contract so that the consideration will continue to be valued as of the signing date. Reg. § 1.368-1(e)(2)(ii)(B)(3). Reg. § 1.368-1(e)(2)(iii)(D) provides that stock that is escrowed to secure customary pre-closing covenants and representations and warranties is not treated as contingent consideration, which would render the safe harbor unavailable. However, escrowed consideration that is forfeited, is not taken into account in determining whether the continuity of interest requirement has been met. Reg. § 1.368-1(e)(2)(iv), Ex. 2.

- Notice 2010-25, 2010-1 C.B. 527 (3/17/10), provided that, until the issuance of new regulations, taxpayers could choose (subject to strict consistency rules) to apply the proposed regulations after the expiration of the Temporary Regulations. The ability of taxpayers to elect to apply the rules of the proposed regulations, as provided in the Notice, is incorporated into Reg. § 1.368-1(e)(9)(ii).

a. Still work left to be done. Isn't that always true? REG-124627-11, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest, 76 F.R. 78591 (12/19/11). The Treasury Department has published Prop. Reg. § 1.368-1(e)(2)(vi), under which application of the signing date principles for determining whether continuity of interest is satisfied would be expanded. The proposed regulations would also permit the use of an average value for issuing

corporation stock, in lieu of the value of issuing corporation stock on the closing date, in certain circumstances. An average value could “be used if it is based on issuing corporation stock values occurring after the signing date and before the closing date, and the binding contract utilizes the average price, so computed, in determining the number of shares of each class of stock of the issuing corporation, the amount of money, and the other property to be exchanged for all the proprietary interests in the target corporation, or to be exchanged for each proprietary interest in the target corporation.” This rule applies signing date rule “principles,” because “the target shareholders become subject to the fortunes of the issuer’s stock across the range of dates being averaged.”

- The proposed regulations would apply to transactions occurring on or after they are finalized, unless the transaction was completed pursuant to a binding agreement that was in effect immediately before the date such final regulations are published and all times afterwards.

F. Corporate Divisions

1. “Hot stock” cools off in a DSAG. T.D. 9548, Guidance Regarding the Treatment of Stock of a Controlled Corporation Under Section 355(a)(3)(B), 76 F.R. 65110 (10/20/11). The Treasury has promulgated amendments to Reg. § 1.355-2(g) and (i) to replace Temporary Regulations promulgated in T.D. 9435, Guidance Regarding the Treatment of Stock of a Controlled Corporation Under Section 355(a)(3)(B), 73 F.R. 75946 (12/25/08), and proposed in REG-150670-07, Guidance Regarding the Treatment of Stock of a Controlled Corporation Under Section 355(a)(3)(B), 73 F.R. 75979 (12/15/08). The final regulations adopt the substantive rules of the temporary regulations without change. Reg. § 1.355-2(g), deals with the “hot stock” rule of § 355(a)(3)(B) to conform to the 2006 amendments of § 355(b)(3), creating the “SAG” rules, which treat a corporation’s SAG [separate affiliated group] as a single corporation for purposes of determining whether the active trade or business requirements of § 355 have been met. Section 355(a)(3)(B) provides that stock of a controlled corporation that has been acquired by the distributing corporation in a taxable transaction within the five year period preceding distribution to stockholders otherwise qualifying under § 355 will be treated as boot taxable to the stockholders. Generally speaking, the temporary regulations provide that the hot stock of § 355(a)(3)(B) rule does not apply to any acquisition of stock of controlled where controlled is a DSAG [separate affiliated group of the distributing corporation] member at any time after the acquisition (but prior to the distribution of controlled). Transfers of controlled stock owned by DSAG members immediately before and immediately after the transfer are disregarded and are not treated as acquisitions for purposes of the hot

stock rule. (Prop. Reg. § 1.355-3(b)(1)(ii) would apply a similar rule for purposes of the active trade or business requirement.) The temporary regulations also incorporate the exception of former Reg. § 1.355-2(g), which provides that the hot stock rule does not apply to acquisitions of controlled stock by distributing from a member of the affiliated group (as defined in Reg. § 1.355-3(b)(4)(iv)) of which distributing was a member. The final regulations generally apply to distributions occurring after 10/20/11. (The Temporary Regulations generally apply to distributions occurring after 12/15/08, but there are a number of transition rules. Taxpayers also may elect to apply the regulations to distributions made after 5/17/06.)

G. Affiliated Corporations and Consolidated Returns

1. We can always use some new consolidated return regs — they're still too easy to understand. T.D. 9515, Guidance Under Section 1502; Amendment of Matching Rule for Certain Gains on Member Stock, 76 F.R. 11956 (3/4/11). The Treasury has promulgated final amendments to Reg. § 1.1502-13 that provide for the redetermination of intercompany gain as excluded from gross income in certain transactions involving stock transfers between members of a consolidated group. Under the regulations, intercompany gain with respect to member stock may be permanently excluded from gross income following certain stock basis elimination transactions, for example, tax-free spin-offs and § 332 liquidations. The rule in the regulations applies only if: (1) the group has not and will not derive any Federal income tax benefit from the intercompany transaction; and (2) the excluded gain will not be treated as tax-exempt income for purposes of the investment adjustment regulations. The excluded gain is not treated as tax exempt income for purposes of § 1.1502-32 and does not increase earnings and profits.

• The Treasury also has revised Temp. Reg. § 1.1502-13T (as promulgated in 2009) to take into account the above-described amendments to the final regulations and repromulgated it in the revised form without substantive change. Generally speaking, these regulations provide that an intergroup liquidation- reincorporation that also could be treated (under step-transaction, substance over form, or recast) as a tax-free reorganization (asset transfer for stock followed by liquidation) will be treated as a reorganization.

2. Section 382 alone is complicated; the consolidated return rules alone are complicated. When the time comes to apply § 382 to consolidated returns, only rocket scientists need apply. REG-133002-10, Redetermination of the Consolidated Net Unrealized Built-In Gain and Loss, 76 F.R. 65634 (10/24/11). The Treasury and IRS

have published proposed amendments to Reg. § 1.1502-91(g), which provides rules for determining whether an acquired loss group has a net unrealized built-in gain (NUBIG) or a net unrealized built-in loss (NUBIL) for purposes of applying § 382 in the consolidated return context. Under the current regulations, Reg. § 1.1502-91(g)(1) provides that the determination of whether a loss group has a consolidated NUBIG or NUBIL is based on the aggregate amount of the separately determined NUBIGs and NUBILs of each member included in the loss group. Under this rule, unrealized gain or loss with respect to the stock of a member of the loss group (an included subsidiary) is disregarded in determining the separately determined NUBIG or NUBIL. The proposed amendments would modify the current regulations to take into account the unduplicated gain or loss on stock of included subsidiaries, but only to the extent that such gain or loss is taken into account by the group during the recognition period. This will generally be the case only if, within the recognition period, such stock is sold to a nonmember or becomes worthless, or a member takes an intercompany item into account with respect to such stock.

H. Miscellaneous Corporate Issues

There were no significant developments regarding this topic during 2011.

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. Creation of two wholly owned corporations as LLC members didn't avoid disregarded entity status. Robucci v. Commissioner, T.C. Memo. 2011-19 (1/24/11). The taxpayer converted his psychiatric practice from a sole proprietorship into an LLC. The members of the LLC consisted of the taxpayer and two corporations, both of which were wholly owned by the taxpayer. The taxpayer owned 95 percent of the LLC interests, 85 percent as a limited partner based on the value of transferred intangibles and 10 percent as a general partner based on the taxpayer's provision of medical services. One of the corporations, Westsphere, entered into an expense reimbursement plan with the LLC under which the corporation agreed to provide health insurance for LLC employees and reimburse them for expenses of diagnostic medical procedures at specified medical facilities. The second corporation was to provide financial management services to the LLC. The taxpayer had little understanding of the purpose of the corporations that were created on the advice of his CPA. The taxpayer's Medicare and Medicaid billings (a small portion of his practice) were done as an individual practitioner. The corporations did not

independently undertake business activities. The court (Judge Halpern) held that neither corporation was formed with a purpose equivalent to business activity under the test of *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943), nor did either corporation undertake business activity. The court disregarded both entities. As a consequence, the taxpayer's LLC was a single member entity disregarded for federal tax purposes. Net income of the LLC, including amounts paid to the corporations, was taxable to the taxpayer. The court also upheld accuracy related penalties under § 6662(a), holding that the taxpayer's reliance on the advice of his CPA to produce employment tax savings that were too good to be true was not reasonable. The court indicated that the taxpayer failed to exercise ordinary business care by failing to question an arrangement that purported to minimize his taxes "while effecting virtually no change in the conduct of his medical practice."

2. 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.

3. Foreign tax credit shelter fails to deliver because the investment was a loan rather than a partnership. Pritired 1, LLC v. United States, 108 A.F.T.R.2d 2011-6605 (D. Iowa 9/30/11). The District Court granted summary judgment to the IRS on a partnership refund claim for deficiencies imposed on denial of \$21 million of foreign tax credits. Pritired, the taxpayer LLC, was formed as a partnership by Principal Life Insurance Company (a subsidiary of Principal Financial Group) and Citibank. Pritired invested \$300 million in a French equivalent of an LLC along with two French Banks. Pritired received \$9 million of class B shares of the French LLC plus \$291 million of "perpetual certificates" structured to provide a LIBOR based return. The interest payments were offset with LIBOR based swaps that the court described as equivalent to providing an interest rate less French taxes. The court found that the only return available to Pritired was the value of foreign tax credits. The French banks contributed \$930 million to the French LLC in exchange for \$455 million of class A stock and \$455 million of one percent convertible notes. The \$1.2 billion was invested in low return securities. The foreign tax credits on the \$1.2 billion investment returns were allocated by the French LLC to Pritired. The French banks treated the transaction as a debt. Pritired asserted that through the swap mechanism its investment in the class B shares and the perpetual certificates constituted an equity investment in the French LLC that was a partnership. The court described the transaction as follows:

Through this transaction, the French banks were able to borrow three hundred million dollars at below market rates. The American companies received a very high return on an almost risk free investment. Only one thing could make such a transaction so favorable to everyone involved. United States taxpayers made it work.

- The court applied traditional debt/equity concepts to conclude that the transaction represented a loan to the French banks rather than an equity investment. Based on the attributes of debt specified in Notice 94-47, 1994-1 C.B. 357, the court ultimately found that the class B shares and the perpetual certificates had more debt-like attributes than

equity-like attributes. The court then concluded that “as a practical matter” the transaction was structured to be a loan rather than an equity investment treated as partnership, citing *TIFD III-E, Inc. v. United States (Castle Harbour)*, 459 F.3d 220, 236 (2d Cir. 2006). The court also concluded that the transaction lacked economic substance. Although the transaction was designed to appear as a partnership equity investment, it was primarily structured to generate foreign tax credits. The court applied the anti-abuse rule of Reg. § 1.701-2 to disregard the partnership and disallow the foreign tax credits claimed by the U.S. taxpayers for French taxes purportedly paid by the French LLC. Given these holdings, the court found it unnecessary to address the IRS’s additional argument that allocation of the French taxes to the Pritired lacked substantial economic effect under Reg. § 1.704-2(b)(2).

4. 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, *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 Investering*s 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-written³ 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 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

3. 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.”

decision in *Castle Harbour III* is the very first case ever 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 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)(2)(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 Treas. Reg. § 1.6662-4(d)(2)(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 that District Court as having found that the banks incurred “real risk” that might require them to restore a 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."

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

1. Tax law firm misses on its own special allocation.

Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137 (2/9/11). The taxpayer law firm practiced tax law in a Kansas limited liability partnership. The partnership consisted of the three lawyers in the firm plus a subchapter S corporation wholly owned by an ESOP whose beneficiaries were the three attorney partners. For the partnership's 2004 tax year the partnership allocated 87.557 percent of the law firm's net business income to the S corporation partner. K-1s filed for the 2004 year showed each attorney partner with a 30 percent profit and loss interest and a 10 percent profit and loss interest for the S corporation. Capital interests were reported as 33.3 percent for each attorney partner. The taxpayer could not produce a written

partnership agreement for the 2004 tax year. The firm amended its partnership agreement in 2005 to eliminate the S corporation partner and allocate partnership income among the three attorneys under a formula that reflected income from the individual clients of each attorney, which was accepted by the IRS. The court (Judge Jacobs) held that the taxpayer failed to meet its burden to establish the allocation of income in the face of the missing partnership agreement for 2004. The court did not accept the taxpayer's assertion that the amended 2005 agreement provided evidence of the 2004 provisions. As a consequence, the court determined the partners' share of 2004 partnership income taking into account the facts and circumstances to identify the partners' distributive shares. The court affirmed the IRS reallocation of income in accord with the partners' capital and profits interests absent the special allocation. See another issue in this case at XI.A., below.

2. 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?

3. State rehabilitation tax credits for sale, or not. Virginia Historic Tax Credit Fund 2001 LP v. Commissioner, T.C. Memo. 2009-295 (12/21/09). The Virginia Historic Rehabilitation Credit Program contains an allocation provision that allows a developer partnership to allocate state rehabilitation tax credits to partners in proportion to their ownership interests in the partnership or as the partners mutually agree. The taxpayer partnership was a state tax credit partner in partnerships developing historic rehabilitation projects in Virginia. The taxpayer limited partnership, as a state tax credit partner, held a small percentage ownership interest in Virginia rehabilitation projects but was allocated most of the rehabilitation tax credits that the developer partnership could otherwise not use. The taxpayer partnership also purchased state tax credits under a one-time transfer provision. The taxpayer in turn received capital contributions from 282 investor limited partners (either directly or through a lower-tier LLC or LP). The pooled capital was invested in various developer rehabilitation partnerships. The Virginia State Rehabilitation credits were allocated to the investor partners. In general each investor was allocated \$1 of state tax credit for each \$0.74 invested. The investors were “bought out after the partnerships accomplished their purpose.”

- The court (Judge Kroupa) rejected the IRS’s alternative assertions that the partnership derived income from the sale of state tax credits to the investors who were not partners, or if the investors were to be recognized as partners in the tax credit partnerships, the transactions constituted disguised sales of the state tax credits under § 707(a)(2)(B). The court was impressed by several elements of the transactions in determining that the investors created a community of interest in profits and losses by joining together for a business purpose: the parties agreed to form a partnership, they

acted as partners, the parties pooled resources in that the investors' contributed capital and the general partners contributed capital and services, and that the partners had a business purpose in terms of deriving a net economic benefit from state income tax savings (which was not a federal tax savings). The court further held that the substance of the transactions was the formation of a partnership rather than the sale and purchase of the state tax credits in part because the transaction was compelled by the form of investment specified by the Virginia program that encouraged the use of partnerships as a vehicle for attracting capital into historic rehabilitation. Rather than treating the investors as purchasers of state tax credits, the court concluded that the investors' funds were pooled to facilitate investments in developer partnerships and that the investors remained as participants in the partnerships until the developer partnerships completed rehabilitation projects.

- The court also found that the investors bore a risk that the developer partnerships would fail to generate rehabilitation credits. The court rejected the IRS's § 707(a)(2)(B) argument for similar reasons. The court concluded that the substance of the transactions reflects valid contributions and allocations rather than sales based upon the court's findings that the investors made capital contributions in furtherance of the partnership's purpose to invest in developer partnerships engaged in historic rehabilitation and to receive state tax credits, the partnerships were able to participate because of the investors' pooled capital, the state tax credits were allocated to the investors consistent with the allocation provisions of the Virginia program, and that the investors were subject to the entrepreneurial risks of the partnerships operations. See Reg. § 1.707-3(b)(1). Finally, the court held that since the partnership did not have unreported income from the sale of state tax credits, the three year statute of limitation barred assessment and was not subject to extension to six years under § 6229(c)(2) because of an omission of 25 percent of gross income.

- One of the taxpayer's lawyers is a former student of Professor McMahon in the University of Florida College of Law Graduate Tax Program. [PAID ADVERTISEMENT.]

a. The Fourth Circuit reversed *Virginia Historic* and found that there was, indeed, a sale — albeit one that was disguised. *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 3/29/11). On appeal, the Fourth Circuit (Judge Duncan) reversed the Tax Court opinion and found that the alleged capital contributions were disguised sales under § 707(a)(2)(B) and Reg. § 1.707-3 and should have been reported by the funds as income. The court did not decide whether “bona fide” partnerships existed, but held that the IRS properly recharacterized the transactions as sales based upon § 707, which “prevents the use of the partnership provisions to render nontaxable what would in substance have been a taxable exchange if it had not been ‘run

through' the partnership." As it was strengthened in 1984, § 707(a) provides that "[i]f a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall . . . be considered as occurring between the partnership and one who is not a partner." Under § 707(a)(2)(B), non-partnership-capacity transactions include the situation where:

- (i) there is a direct or indirect transfer of money or other property by a partner to a partnership,
- (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and
- (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property.

- There is a cross-reference in Reg. § 1.707(b)-6(a) to Reg. § 1.707-3, which requires an evaluation of all the facts and circumstances to determine whether the transfer of money or other consideration would not have been made *but for* the transfer of property; and in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. Transfers made within two years of one another are presumed to be sales. Reg. § 1.707-3(b)(2) lists ten factors to be considered, five of which were relevant to this case. They are:

- (i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;
- (ii) That the transferor has a legally enforceable right to the subsequent transfer;
- (iii) That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured; ***
- (ix) That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and
- (x) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

- The court further held that the tax credits in question were property, looking to the substance of state law and not to labels given by, or conclusions drawn from these labels.

- It further held that any entrepreneurial risks to the investors were “both speculative and circumscribed,” continuing “that the only risk here was that faced by any advance purchaser who pays for an item with a promise of later delivery.” This conclusion was based upon the investors being promised a fixed rate of return, they did not expect any allocations of partnership income, gains or losses, and they were promised refunds if the tax credits were not delivered.

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

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

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

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

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

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

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

5. Partnership debt for equity swaps. Holy Asymmetry! The partners have COD income but the creditor doesn't have a loss deduction. REG-164370-05, Section 108(e)(8) Application to Partnerships, 73 F.R. 64903 (10/31/08). As amended by the American Jobs Creation Act of 2004, § 108(e)(8) provides that for purposes of determining COD income of a partnership, if a debtor partnership transfers a capital or profits interest to a creditor in satisfaction of either recourse or nonrecourse partnership debt the partnership is treated as having satisfied the debt with an amount of money equal to the fair market value of the interest. Any COD income recognized under § 108(e)(8) passes through to the partners immediately before the discharge. Prop. Reg. § 1.108-8 would provide that for purposes of § 108(e)(8), the fair market value of a partnership interest received by the creditor is the liquidation value of that debt-for-equity interest, if: (1) the debtor partnership maintains capital accounts in accordance with Reg. § 1.704-1(b)(2)(iv), (2) the creditor, the debtor partnership, and its partners treat the fair market value of the debt as equaling the liquidation value of the partnership interest for purposes of determining the tax consequences of the debt-for-equity exchange, (3) the debt-for-equity exchange is an arm's-length transaction, and (4) subsequent to the exchange, neither the partnership redeems, nor any person related to the partnership purchases, the creditor's partnership interest as part of a plan that has as a principal purpose the avoidance of COD income by the partnership. If these

conditions are not satisfied, all of the facts and circumstances are considered in determining the fair market value of the debt-for-equity interest for purposes of applying § 108(e)(8). Prop. Reg. § 1.721-1(d) would provide nonrecognition of loss in a debt-for-partnership interest exchange in which the liquidation value of the partnership interest is less than the outstanding principal balance of the debt. The creditor's basis in the partnership is determined under § 722. However, the proposed regulations provide that § 721 does not apply to the transfer of a partnership interest to a creditor in satisfaction of a partnership's indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount). In addition, the proposed regulations do not supersede the gain recognition rules of § 453B regarding dispositions of installment obligations. The proposed regulations will be effective when final regulations are published in the Federal Register.

a. Finalized, with some modifications, but learn to live with the asymmetry. T.D. 9557, Application of Section 108(e)(8) to Indebtedness Satisfied by a Partnership Interest, 76 F.R. 71255 (11/17/11). The final regulations generally are the same as the proposed regulations, with certain modifications.

(1) First, Reg. § 1.108-8(b)(2)(i)(B) requires as a condition to the liquidation value safe harbor that a partnership apply a consistent valuation methodology to all equity issued in any debt-for-equity exchange that is part of the same overall transaction. This prevents selective exploitation of the discrepancy between liquidation value and fair market value.

(2) Second, Reg. § 1.108-8(b)(2)(i)(C) clarifies that the arm's length transaction requirement for the liquidation value safe harbor is available to a transaction involving related parties as long as the debt-for-equity exchange has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests.

(3) Third, for the anti-abuse provision [condition (4) in the proposed regulations, *supra*] "related" party is defined by cross-references to §§ 267(b) and 707(b); Reg. § 1.108-8(b)(2)(i)(D).

(4) Fourth, the liquidation value of an interest in an upper-tier partnership is determined by taking into account the liquidation value of any lower-tier partnership interest; Reg. § 1.108-8(b)(2)(ii).

(5) Fifth, Reg. § 1.108-8(b)(1) provides that if the fair market value of the debt-for-equity interest does not equal the fair market value of the indebtedness exchanged, then general tax law principles shall apply to account for the difference. The preamble notes that, if appropriate, § 707(a)(2)(A) can be applied.

(6) Sixth, Reg. § 1.721-1(d)(2) provides that § 721 does not apply to a debt-for-equity exchange to the extent the partnership interest is exchanged for the partnership's indebtedness for unpaid rent, royalties, or interest on the

partnership's indebtedness (including accrued OID) that accrued on or after the beginning of the creditor's holding period for the indebtedness.

(7) Seventh, the final regulations provide that COD income arising from a discharge of a partnership or partner nonrecourse indebtedness is treated as a first-tier item for minimum gain chargeback purposes under Regs. §§ 1.704-2(f)(6), 1.704-2(j)(2)(i)(A) and 1.704-2(j)(2)(ii)(A); Reg. § 1.704-2(f)(6).

C. Distributions and Transactions Between the Partnership and Partners

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.

D. Sales of Partnership Interests, Liquidations and Mergers

There were no significant developments regarding this topic during 2011.

E. Inside Basis Adjustments

There were no significant developments regarding this topic during 2011.

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 had 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. § 301.6223-1T(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, “Logically, 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 Appeals Court 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, Petaluma FX Partners, LLC v. Commissioner, 591 F.3d 649 (D.C. Cir. 2010); RJT Invs. X v. Commissioner, 491 F.3d 732 (8th Cir. 2007), 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.

2. The Tax Court finds jurisdiction to address § 6662 penalties in this Son-of-Boss TEFRA partnership proceeding. Taxpayer's reasonable cause defense was rejected because advisors were promoters and the opinion was sloppy. 106 Ltd. v. Commissioner, 136 T.C. 67 (1/10/11). The taxpayer's tax matters partner responded to Ann. 2004-46, 2004-1 C.B. 964, and filed an amended return removing losses attributable to a Son-of-Boss transaction promoted by Joe Garza. The IRS issued an FPAA to the partnership that adjusted partnership items and asserted penalties. In prior proceedings the Tax Court issued orders granting summary judgment to the IRS on the substantive partnership issues and the presence of a gross valuation misstatement. In this proceeding the court (Judge Holmes) held that the Tax Court had jurisdiction to determine

whether the partnership had a reasonable cause defense based on reliance on opinion of counsel, but that the reliance itself was not reasonable. The court concluded that the decision in *Petaluma FX Partners v. Commissioner*, 591 F.3d 649 (D.C. Cir. 2010) holding the Tax Court did not have jurisdiction in a partnership proceeding to determine the partners' outside basis or whether penalties were applicable to the outside basis issues did not bar jurisdiction to adjudicate a reasonable cause defense where outside basis is not at issue. Following *Am. Boat Co., LLC v. United States*, 583 F.3d 471, 480 (7th Cir. 2009), and similar authorities, the court held that it had jurisdiction in a partnership proceeding to consider entity level defenses to the accuracy-related penalty. Nonetheless, the court rejected the reasonable cause defense finding that the partnership could not in good faith rely on advisors who were promoters of the transaction. In addition, the court found that the tax-matters partner entered into a "tax strategy" with the intent to "lose money," which combined with the sloppy opinion and the tax-matters partner's unusual experience demonstrated a lack of good faith reliance.

3. Son of Jade Trading finds that penalties based on a partner's basis are a partner item. *Jade Trading, LLC v. United States*, 98 Fed. Cl. 453 (4/29/11). In affirming the Court of Federal Claims' determination that the taxpayers' Son of Boss transaction lacked economic substance the Court of Appeals for the Federal Circuit remanded the case for a determination as to whether penalties could be imposed without relying on individual partners' outside basis, which is not a partnership item. *Jade Trading, LLC v. United States*, 598 F.3d 1372, 1381 (Fed. Cir. 2010). Section 6226(f) confers jurisdiction in a partnership proceeding to determine penalties that relate to an adjustment of a partnership item. Partnership item is defined in § 6231(a)(3) as an item required to be taken into account under any provision of subtitle A to the extent that regulations provide that the item is more appropriately determined at the partnership level. In the Son of Boss transactions, various options contracts are structured to permit a distribution of property (usually foreign currency) with an artificially high basis determined from the outside basis of a liquidated partnership interest. Tax deficiencies resulted from denying losses claimed using the partners' outside basis transferred to distributed assets. Relying on *Petaluma FX Partners, LLC v. Commissioner*, 591 F.3d 649 (D.C. Cir. 2010), the court pointed out that, even though the partnership proceeding determined that the partnership was a sham, which is a partnership item, the resulting effect on the partner's outside basis remains a partner item not within the jurisdiction of the partnership proceeding. The court rejected the IRS argument that the determination that the partnership was a sham and that the option spread transaction lacked economic substance was converted into a finding that something other than the partners' outside bases justified penalties as the partnership level. The court also rejected the IRS attempt to recharacterize

the litigation as denying deductions on the partnership's misstatement of a partnership item based on the partner's contributions of options rather than as basing adjustments on the partners' bases.

4. If you pay without a statutory notice, you can't get a refund. *Bush v. United States*, 599 F.3d 1352 (Fed. Cir. 3/31/10). During the pendency of a partnership level proceeding, the taxpayers entered into closing agreements with the IRS with respect to their § 465 at-risk amounts in the partnership. The closing agreements did not waive the right to a deficiency notice. Subsequently, the IRS issued Notices of Adjustment, without issuing any deficiency notices, based on the application of the agreed upon at-risk amount in the closing agreements. The taxpayers paid the assessed taxes and sought a refund. A deficiency notice is not required if a tax liability issue has been resolved in a partnership-level proceeding. In that case any additional tax due is assessed as a computational adjustment, § 6230(a)(1), which § 6231(a)(6) defines for this purpose as the "change in the tax liability of a partner which properly reflects the treatment under this subchapter of a partnership item." But a deficiency notice is required if the additional tax asserted by the IRS to be due does not involve such a "computational adjustment." Thus, a deficiency notice is required if the deficiency is attributable to "affected items which require partner level determinations." I.R.C. § 6230(a)(2)(A)(i). The court (Judge Dyk) held for the government, concluding that on the facts of the case, the IRS's failure to issue a deficiency notice was harmless error. After first concluding that § 6213(a) "does not broadly provide for a refund of amounts paid by the taxpayer after assessment or provide for a refund where the taxpayer voluntarily pays the assessment before collection proceedings are initiated," the court continued as follows:

The IRS did not issue a demand for payment (which is a predicate to collection, see I.R.C. § 6303) or initiate collection proceedings. The taxpayers do not ... seek repayment of funds improperly collected. Rather, the taxpayers paid the assessments and then sued for a refund, alleging that they are entitled to a refund simply because the IRS failed to issue the requisite notice, without regard to whether the tax was in fact owed, and without any showing that the taxpayers were prejudiced by litigating the tax issue in the refund proceedings rather than in the Tax Court. Nothing in the language of the statute confers such a refund right on the taxpayer, and the failure in the statute to provide for a refund under such circumstances strongly suggests that no such automatic refund was intended.

• Finally, the court explained that despite the taxpayers not having received a deficiency notice, had they not

voluntarily paid the tax, they could have had their day in Tax Court simply by not paying and seeking collection due process relief under § 6330 when the IRS subsequently took actions to collect the assessed taxes.

a. And the full court upholds the IRS, but for different reasons. Bush v. United States, 655 F.3d 1323 (Fed. Cir. 8/24/11). After vacating its prior decision and rehearing the case en banc, the Federal Circuit again ruled for the Government. The court held that under § 6231(a)(6) a computational adjustment may be made for any changes in a partner's tax liability that arise from the partnership proceeding regardless of whether the TEFRA proceeding makes changes to the treatment of partnership items from the partnership returns. Thus, the fact that the partnership proceeding was settled with a closing agreement permits subsequent computational adjustments to the partners without requiring a notice of deficiency. The court also held that because of the settlement, redetermining the partners' at-risk amounts did not require partner level factual determinations that would treat the adjustments as affected items requiring a partner-level notice of deficiency.

5. Son-of-Boss sham partnership determination, partner's basis, and liability for penalties are not affected items over which the Tax Court has jurisdiction in a partner proceeding. Thompson v. Commissioner, 137 T.C. No. 17 (12/27/11) (reviewed). The taxpayer invested in a Son-of-Boss transaction through a partnership. In a final partnership proceeding affirmed by the Eighth Circuit, the court determined that the partnership was a sham, that there was no basis in a partnership interest, and that the partnership was subject to a 40 percent accuracy penalty. *RJT Invs. X, LLC v. Commissioner*, 491 F.3d 732 (8th Cir. 2007). The IRS thereafter issued an affected item notice of deficiency to the taxpayer for the deficiency attributable to the partnership action and to collect the penalty. On the following day, the IRS directly assessed the deficiency and the penalty amount as a computational item based on the partnership proceeding, not requiring a notice of deficiency. The taxpayer filed a petition with the Tax Court to set aside the deficiency. The IRS responded that the notice of deficiency was invalid and that the Tax Court lacked jurisdiction in the case on the ground that no valid statutory notice of deficiency had been sent to the taxpayers. The Tax Court (Judge Wherry) held for the IRS with two dissents. The court held that assessing the deficiency based on the final partnership proceeding did not require any partner level determinations and thus was not subject to deficiency procedures. The court rejected the taxpayer's argument that under *Petaluma FX Partners, LLC v. Commissioner*, 591 F.3d 649 (D.C. Cir. 2010), *aff'g. in part, rev'g in part, and remanding in part* 131 T.C. 84 (2008), an accuracy related penalty does not relate to adjustment of a partnership item and can be

assessed only in a partner proceeding. The court held that the accuracy related penalty can be directly assessed and is not subject to deficiency procedures, notwithstanding the need for partner-level determinations. The court also held that the fact that the IRS's direct assessment contained errors that required correction resulting in a reduction of the deficiency did not make the assessment a determination that required a notice of deficiency under § 6212(a). The majority determined that all of the four items in the notice of deficiency followed directly from the treatment of the partnership as having no profit motive and were thus computational. Judge Goeke dissented on the question of subject matter jurisdiction asserting that, even though the taxpayer and the IRS resolved the factual issues presented in the notice of deficiency, the determination of partner level losses requires a partner-level determination subject to a notice of deficiency. Judge Holmes argued that the multiple adjustments asserted in the notice of deficiency involved partner-level determinations that went beyond the adjustments that directly resulted from the partnership level proceeding, including the taxpayer's claimed loss on liquidation of the partnership, which Judge Holmes concluded was an item one-step removed from the partnership level determination. Judge Holmes' dissent expressed a concern that the rejection of jurisdiction will require a case-by-case assessment of whether a computational adjustment will involve a partner level determination.

6. Who settled with whom and when? Mathia v. Commissioner, 109 A.F.T.R.2d 2012-375 (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.

G. Miscellaneous

There were no significant developments regarding this topic during 2011.

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. **Another corporate tax shelter investor with a “never say die” attitude toward litigating hopeless cases. God bless their willingness to pay attorney’s fees for cases that can’t be won.** Wells Fargo & Co. v. United States, 641 F.3d 1319 (Fed. Cir. 4/15/11). Wells Fargo was denied the tax benefits it sought from another package of fairly generic SILO transactions with tax-exempt entities involving transportation and technology equipment. The Court of Claims had “found that the claimed tax deductions are for depreciation on property Wells Fargo never expected to own or operate, interest on debt that existed only on a balance sheet, and write-offs for the costs of transactions that amounted to nothing more than tax deduction arbitrage.” Accordingly, the Federal Circuit affirmed the Court of Federal Claims’ determination that transactions did not pass muster under the substance over form doctrine. Judge Bryson’s opinion noted:

The only flow of funds between the parties to the transaction was the initial lump sum given to the tax-exempt entity as compensation for its participation in the transaction. From the tax-exempt entity’s point of view, the transaction effectively ended as soon as it began. The benefits to Wells Fargo continued to flow throughout the term of the sublease, however, in the form of deferred tax payments. The third-party lender and its affiliate were also compensated for their participation, as were the creators and promoters of the transactions. These transactions were win-win situations for all of the parties involved because free money—in the form of previously unavailable tax benefits utilized by Wells Fargo—was divided among all parties. The money was not entirely “free,” of course, because it was in effect transferred to Wells Fargo from the public fisc.

2. **A Twenty First Securities tax shelter bites the dust.** Samueli v. Commissioner, 132 T.C. 37 (2009). The taxpayer entered into a tax shelter transaction planned by Twenty First Securities (of *Compaq* fame), a simplified (☺) explanation of which is as follows. In October 2001, the taxpayer purchased fixed-income securities (Freddie Mac principal strips) from a broker (Refco) on a margin loan (Refco was entitled to hold

the securities as collateral for the margin loan) and then “lent” the securities to Refco. The standard form agreement allowed the taxpayer to terminate the transaction and receive identical securities from Refco by giving notices on any business day, but an addendum overrode that provision and provided that the “loan” of the securities would terminate on January 15, 2003, or at the taxpayer’s election on July 1 or December 2, 2002. The taxpayer purchased the securities for \$1.64 billion, but immediately “lent” the securities to Refco and received cash “collateral” of \$1.64 billion, which he used to repay the margin loan. The loan contracts provided that the taxpayer was entitled to receive all interest, dividends, and other distributions attributable to the securities, but that the taxpayer was obligated to pay Refco a variable rate fee for use of the \$1.64 billion cash collateral. In December 2002, the taxpayer paid Refco \$7.8 million of “interest” on the \$1.64 billion cash collateral, which was re-lent to the taxpayer (secured by the securities, which had increased in value). The transaction terminated on January 15, 2003 and Refco was obligated to pay the taxpayer \$1.69 billion to purchase the securities in lieu of transferring them to the taxpayer. The taxpayer was simultaneously obligated to pay Refco \$1.68 billion, which reflected repayment of the \$1.64 billion cash collateral, plus accrued but unpaid variable rate fees, but the amounts were offset and Refco paid the taxpayer \$13.6 million. The taxpayer reported a \$50 million long term capital gain and deducted \$33 million of interest (cash collateral fees). Judge Kroupa held that the purported loan transaction did not satisfy the requirements of § 1058. To qualify as a loan of securities under § 1058, the loan agreement must (1) provide for the return to the lender of identical securities; (2) require payments to the lender equal to all interest, dividends, and other distributions on the securities during the period of the loan, and (3) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred. If any of these conditions is not satisfied, the purported loan will be treated as a realization event. Because the taxpayer could demand return of the securities only on three specified dates, and not at any time during the term of the loan, he could not sell the securities to realize a gain at any and all times that the possibility for a profitable sale arose. Thus, the taxpayer’s opportunity for gain with respect to the transferred securities transferred was reduced. Judge Kroupa rejected the taxpayer’s argument that because the taxpayer had not surrendered all opportunity to realize a gain with respect to the securities that the third condition prerequisite to qualifying for loan treatment under § 1058 had been satisfied. The statutory test for disqualification does not require complete elimination of the benefits of ownership, but merely a reduction. As a result, the “loan” of the securities in 2001 was treated as a sale on which no gain was realized (because the basis and amount realized were identical), and the “repayment” of the securities to the taxpayer in 2003 was treated as a repurchase followed by a resale to Refco on which a \$13.5 million short term capital gain was realized.

Furthermore, the taxpayer was not entitled to deduct the cash collateral fees paid as interest in connection with the purported securities lending arrangement because no debt existed. The cash transferred in 2001 represented the proceeds of the first sale and not collateral for a securities loan. Thus, no “cash collateral” was outstanding during the relevant years on which the claimed collateral fees could accrue.

a. On appeal, every argument in the taxpayer’s kitchen sink goes down the drain. Samueli v. Commissioner, 658 F.3d 992 (9th Cir. 9/15/11). In an opinion by Judge Tashima, the Ninth Circuit affirmed the Tax Court. The first sentence was worded in a manner that left no suspense: “This case requires us to decide whether a purported securities loan with a fixed term of at least 250 days and possibly as long as 450 days, entered into not for the purpose of providing the borrower with access to the lent securities, but instead for the purpose of avoiding taxable income for the lender, qualifies for nonrecognition treatment as a securities loan pursuant to § 1058” The core reasoning of the Court of Appeals was the same as the Tax Court’s.

The plain language of §1058(b)(3), with the gloss provided by elementary economic analysis, supports the Tax Court’s conclusion on this point. Taxpayers relinquished all control over the Securities to Refco for all but two days in a term of approximately 450 days. During this period, Taxpayers could not have taken advantage of a short-lived spike in the market value of the Securities, because they had no right to call the Securities back from Refco and sell them at that increased price until several months later. Common sense compels the conclusion that this reduced the opportunity for gain that a normal owner of the Securities would have enjoyed.

- The court rejected the taxpayer’s argument, which it labeled as “superficially appealing” that “their inability to secure the return of the Securities on demand did not affect their ability to recognize gain because the Securities were ‘zero-coupon bonds whose value [did] not widely fluctuate with windfall profits at some momentary period,’” because “when one owns \$1.6 billion of a particular security, even a small fluctuation in value can produce a significant opportunity, in absolute terms, for profit.” Furthermore, “Refco’s option to purchase the Securities at the LIBOR-based prices still affected Taxpayers’ ability to realize the market price of the Securities on the dates when they had the option of getting them back from Refco.”

- The court noted, however, that its conclusion that the transaction at issue reduced the taxpayers’ opportunity for gain “does *not* necessarily imply a conclusion that a securities loan must be

terminable upon demand to satisfy the requirements of § 1058(b)(3),” but declined to address the issue further, noting that additional guidance from the IRS and Treasury should deal with the issue.

- The court also rejected the taxpayer’s argument that § 1058 is merely a safe harbor and even if the transaction did not qualify under § 1058, it nevertheless was a loan under general tax principles. Although the taxpayer’s purchase of the securities funded by a margin loan had a non-tax business purpose, “[t]he sole motivation for adding the purported securities loan to the transaction was tax avoidance. ... Unlike a typical securities lending arrangement, this transaction was designed around minimizing Taxpayers’ tax bill rather than around Refco’s need to have the Securities available to deliver to its customers.”

- The court also rejected the taxpayer’s argument that § 1058 was irrelevant and the transaction was in substance the “liquidation” of a contract right to receive the securities from Refco, which would result in long term capital gain because the contract right was held for more than one year.

3. Low value, high substitute basis tax shelter falls on the absence of a partnership and a lack of economic substance.

Rovakat, LLC. v. Commissioner, T.C. Memo. 2011-25 (9/20/11). This is a TEFRA partnership proceeding against a cookie-cutter tax shelter arrangement created by Lance O. Valdez who did business as a tax attorney and financial advisor. In this particular case, the taxpayer, Rovakat, was an LLC taxed as a partnership formed by International Capital Partners LP (ICP), a Cayman Islands partnership controlled by Valdez, and International Strategic Partners (ISP), a Delaware LLC, which was owned 99.6 percent by Mr. Hovnanian who acted as the tax matters partner for Rovakat, and the remaining interest was owned by ICP and another Valdez-controlled entity. In a series of transactions through partners in ICP, Rovakat acquired as a contribution from ICP 50,000 Swiss Francs with a fair market value of \$34,185 in which ICP then Rovakat claimed a basis of \$5.8 million. One month later, Mr. Hovnanian purchased 90 percent of ICP’s interest in Rovakat for \$30,776. The next day Rovakat sold the Francs for \$30,776, and claimed a loss of \$5,769,532. The court (Judge Laro) ruled for the IRS disallowing the losses after a trial that involved seven lay and three expert witnesses, 700 stipulated facts and over 600 exhibits, finding that—

- ICP, one of the Rovakat partners was not itself a partnership so that ICP’s acquisition of the Francs provided it with a cost basis rather than a high transferred basis. Thus, in turn, Rovakat’s basis in the Francs was only the cost basis of ICP. The court found that the ICP partners did not intend to join together to carry on a trade or business, but only to acquire tax basis in “what was otherwise a worthless shell entity.”

- The transaction lacked economic substance under what the court described as the integrated two-part analysis of the economic substance doctrine, holding on consideration of multiple factors that the various transactions had no practical economic effect apart from tax savings, and that the taxpayer did not participate in the transaction for a valid non-tax business purpose.

- The court also held that Rovakat omitted \$650,000 of gross income attributable to fees for consulting that were not offset by claimed deductions, and that this income was self-employment income subject to self-employment tax.

- To make victory complete, the court upheld § 6662 penalties indicating that the partnership's reliance on tax opinions from De Castro, West, Chodorow, Glickfield & Nass, Inc. and Sidley, Austin, Brown, and Wood LLP, was not reasonable reliance. As to the former, the court indicated that Mr. Hovnanian had no personal contact with the attorneys who wrote the opinion, and that the opinion contained material misstatements of fact. The Sidley Austin opinion was obtained by Valdez and ICP and made no reference to Hovnanian or Rovakat.

4. Another LILO tax shelter bites the dust. Can anyone really be surprised? *Altria Group v. United States*, 658 F.3d 276 (2d Cir. 9/27/11). Altria claimed \$24,337,623 in depreciation, interest, and transaction cost deductions relating to nine leveraged LILO transactions with tax-indifferent entities. "In each transaction, Altria leased a strategic asset from a tax-indifferent entity; immediately leased back the asset for a shorter sublease term; and provided the tax-indifferent entity a multimillion dollar 'accommodation fee' for entering the transaction and a fully-funded purchase option to terminate Altria's residual interest at the end of the sublease term." The district court, in a jury trial, held that Altria was not entitled to the claimed tax deductions. "Applying the substance over form doctrine, the jury rejected Altria's contention that it retained a genuine ownership or leasehold interest in the assets and therefore was entitled to the tax deductions." Altria appealed on the grounds that the court's jury instructions were incorrect as a matter of law, and that the court erred by not entering judgment for it as a matter of law. The court of appeals affirmed, for all the usual reasons in LILO transactions.

5. Culbertson — Oh yeah!, but Canal — No thanks! *Southgate Master Fund LLC v. United States*, 659 F.3d 466 (5th Cir. 9/30/11). The Fifth Circuit affirmed a District Court decision upholding the disallowance of artificial loss deductions generated by a complex multi-party Chinese non-performing loan (NPL) investment transaction. The taxpayer invested approximately \$19.4 million in a transaction, structured through the purchase of a partnership interest in a partnership that held the NPLs, which

purported to produce tax losses of approximately \$210 million. [Note: Under current § 704(c)(1)(B), the transaction would have failed on a technical analysis.] To pass the losses through without running afoul of the § 704(d) limitation, the taxpayer purported to contribute securities with a basis of over \$180 million to the partnership. Although the acquisition of the NPLs had economic substance under the Fifth Circuit precedent in *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537 (5th Cir. 2009), Southgate was a “sham” partnership under a *Culbertson* analysis (*Commissioner v. Culbertson*, 337 U.S. 733 (1949)). The parties did not join together with a business purpose to share profits. Applying a “substance over form” analysis, the court concluded that the acquisition of the portfolio of NPLs was a direct acquisition by the purported partners. Nevertheless, the Court of Appeals affirmed the District Court’s holding that no § 6662 accuracy related penalties should be imposed. There was no error in the District Court’s finding that the taxpayer reasonably relied on “more likely than not” opinions from his tax advisors, who had structured the deal.

6. Given the government’s winning percentage in tax shelter cases, is continued litigation of tax shelter cases really just self-help welfare for tax controversy attorneys? *WFC Holdings Corp. v. United States*, 108 A.F.T.R.2d 2011-6531 (D. Minn. 9/30/11). A tax shelter so complicated that we cannot understand from the opinion how it purported to work bit the dust because it was “devoid of economic substance.” We think it was based on a variation of the kind of structure involved in *Coltec Industries v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1261 (2007).

7. 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.

B. Identified “tax avoidance transactions”

1. Now let me get this straight. I followed the Code and Regs meticulously, claimed my loss deduction, but it was disallowed because I really had no possibility of actually making money on the deal and all I was looking for was a nice tax loss, and even though I’ve got this letter from my lawyer saying the deduction is 100 percent legal, I’m still looking at a 40 percent penalty on the deficiency. But my neighbor who deducted the cost of his kid’s college education as a business

expense, which every kindergartner knows you can't do, doesn't have to pay any penalty because he's dumb and his dumb, but probably honest, CPA said it was OK. Say What!? Well, we don't have to "know it when we see it" because Congress has defined it for us. The 2010 Health Care Reconciliation Act added new Code § 7701(o), codifying the economic substance doctrine, which has been applied by the courts for several decades as a judicial interpretive doctrine to disallow tax benefits otherwise available under a literal reading of the Code and regulations.

- **Background** — Codification of the economic substance doctrine has been on the legislative agenda many times since early in the first decade of this century, or for the past ten years (for those of us still hung up on Y2K). The move for codification was motivated in part by the insistence of not a few tax practitioners that the economic substance doctrine simply was not actually a legitimate element of the tax doctrine, notwithstanding its application by the courts in many cases over several decades. This argument was based on the assertion that the Supreme Court had never actually applied the economic substance doctrine to deny a taxpayer any tax benefits, ignoring the Supreme Court's decision in *Knetsch v. United States*, 364 U.S. 361 (1960), and instead focusing on the Supreme Court's subsequent decisions in *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991), and *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), in which a transaction that on the facts showed the total lack of "economic substance" was upheld. Congressional concern was intensified by the decision of the Court of Federal Claims in *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (2004), *vacated and remanded*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (2007), which questioned the continuing viability of the doctrine, stating that "the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers." See STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT," 144 (JCX-18-10 3/21/10). However, in that case the trial court found that the particular transaction at issue in the case did not lack economic substance, and thus the trial court did not actually rule on its validity, and on appeal, the Court of Appeals for the Federal Circuit vacated the Court of Federal Claims decision and, reiterating the validity of the economic substance doctrine and, in the opinion of some, expanding it greatly, held that transaction in question lacked economic substance. Although the economic substance doctrine has been articulated in a number of different manners by different courts over the years, its purpose is aptly described by the Court of Appeals for the Federal Circuit in *Coltec Industries v. United States*, *supra*.

The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to

prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute.

- The modern articulation of the doctrine traces its roots back to *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), where the Court upheld the taxpayer's treatment of an early version of a SILO, stating as follows:

[W]here, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

- This passage – which sets forth a statement as to what was sufficient for economic substance, but which was subsequently interpreted to be a statement as to what was necessary for economic substance⁴ – has led courts to two different formulations of the economic substance doctrine. One, the so-called “conjunctive test” requires that a transaction have *both* (1) economic substance and (2) a non-tax business purpose in order to be respected for tax purposes. See, e.g., *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009); *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993); *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1990); *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161 (2009); *Coltec, supra*. Under the other formulation, the so called “disjunctive test,” represented principally by *IES Industries v. United States*, 253 F.3d 350, 358 (8th Cir. 2001), and *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985), a transaction would be respected for tax purposes if it had *either* (1) economic substance and (2) a non-tax business purpose. Yet a third articulation appeared in *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999), where the court concluded that “these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a ‘rigid two-step analysis,’ but rather represent related factors both of which inform the analysis of whether the

4. Ira believes that the interpretation contains an error in logic which takes a statement from the *Frank Lyon* case as to what is “sufficient” for economic substance and construes it as a statement as to what is “necessary” for economic substance. Marty and Dan do not so believe, or think that the alleged error is irrelevant.

transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.” The courts also have differed with respect to the nature of the non-tax economic benefit a taxpayer is required to establish to demonstrate that a transaction has economic substance. Some courts required a potential economic profit. See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967). Other courts have applied the economic substance doctrine to disallow tax benefits where – even though the taxpayer was exposed to risk and the transaction had a profit potential – compared to the tax benefits, the economic risks and profit potential were insignificant. *Sheldon v. Commissioner*, 94 T.C. 738 (1990); *Goldstein, supra*. Yet other courts have asked whether a stated business benefit – for example, cost reduction, as opposed to profit-seeking – of a particular transaction was actually obtained through the transaction in question. See *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (2007). Finally, notwithstanding that several courts have rejected the bootstrap argument that an improved financial accounting result — derived from tax benefits increasing after-tax profitability — served the valid business purpose requirement, see, e.g., *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762, *aff’d*, 326 F.3d 737 (6th Cir. 2003); *Wells Fargo & Company v. United States*, 91 Fed. Cl. 35 (2010), taxpayers continued to press such claims.

- ***The Codified Economic Substance***

Doctrine — The codification of the economic substance doctrine in new § 7701(o) clarifies and standardizes some applications of the economic substance doctrine when it is applied, but does not establish any rules for determining when the doctrine should be applied. According to the legislative history, “the provision [I.R.C. § 7701(o)(5)(C)] does not change present law standards in determining when to utilize an economic substance analysis.” See STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE “RECONCILIATION ACT OF 2010,” AS AMENDED, IN COMBINATION WITH THE “PATIENT PROTECTION AND AFFORDABLE CARE ACT,” 152 (JCX-18-10 3/21/10). Thus, “the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.” *Id.*, at 153. Codification of the economic substance doctrine was not intended to alter or supplant any other judicial interpretive doctrines, such as the business purpose, substance over form, and step transaction doctrines, any similar rule in the Code, regulations, or guidance thereunder; § 7701(o) is intended merely (merely?) to supplement all the other rules. *Id.*, at 155.

- ***Conjunctive analysis of objective***

and subjective prongs — One of the most important aspects of new § 7701(o) is that it requires a *conjunctive* analysis under which a transaction has economic substance only if (1) the transaction changes the taxpayer’s economic position

in a meaningful way apart from Federal income tax effects *and* (2) the taxpayer has a substantial business purpose, apart from Federal income tax effects, for entering into such transaction. (The second prong of most versions of the codified economic substance doctrine introduced in earlier Congresses added “and the transaction is a reasonable means of accomplishing such purpose.” See, e.g., H.R. 2345, 110th Cong, 1st Sess. (2007); H.R. 2, 108th Cong., 1st Sess. (2003). It is not clear what difference in application was intended by adoption of the different final statutory language.) This conjunctive test resolves the split between the Circuits (and between the Tax Court and certain Circuits) by rejecting the view of those courts that find the economic substance doctrine to have been satisfied if there is either (1) a change in taxpayer’s economic position *or* (2) a nontax business purpose, see, e.g., *Rice’s Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *IES Industries, Inc. v. United States*, 253 F.3d 350, 353 (8th Cir. 2001). Section 7701(o)(5)(D) allows the economic substance doctrine to be applied to a single transaction or to a series of transactions. The Staff of the Joint Committee Report indicates that the provision “does not alter the court’s ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine,” and gives as an example the courts’ ability “to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.”

- ***Claim of Profit Potential*** — Section 7701(o)(2) does not require that the taxpayer establish profit potential in order to prove that a transaction results in a meaningful change in the taxpayer’s economic position or that the taxpayer has a substantial non-Federal-income-tax purpose. Nor does it specify a threshold required return if the taxpayer relies on the profit potential to try to establish economic substance. (In this respect the enacted version differs from earlier proposals that would have required the reasonably expected pre-tax profit from the transaction to exceed a risk-free rate of return. See, e.g., H.R. 2345, 110th Cong, 1st Sess. (2007); H.R. 2, 108th Cong., 1st Sess. (2003).) But if the taxpayer does rely on a profit potential claim, then the profit potential requires a present value analysis:

The potential for profit of a transaction shall be taken into account in determining whether the requirements of [the § 7701(o) test for economic substance] are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

- Thus the analysis of profit potential by the Court of Federal Claims in *Consolidated Edison Co. of New York v. United States*, 90 Fed. Cl. 228 (2009), which appears not to have thoroughly taken into account present value analysis, would not stand muster under the

new provision. In all events, transaction costs must be taken into account in determining pre-tax profits, and the statute authorizes regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases. Any State or local income tax effect that is related to a Federal income tax effect is treated in the same manner as a Federal income tax effect. Thus, state tax savings that piggy-back on Federal income tax savings cannot provide either a profit potential or a business purpose. Similarly, a financial accounting benefit cannot satisfy the business purpose requirement if the financial accounting benefit originates in a reduction of Federal income tax.

- ***Don't worry, be happy! [?]*** —

Section 7701(o)(5)(B) specifically provides that the statutory modifications and clarifications apply to an individual only with respect to “transactions entered into in connection with a trade or business or an activity engaged in for the production of income.” (We wonder what else anybody would have thought they might apply to?) The home mortgage interest deduction? Charitable contributions of appreciated property? How about a Son of Boss transaction where there is no possibility for profit?) More importantly, according to STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE “RECONCILIATION ACT OF 2010,” AS AMENDED, IN COMBINATION WITH THE “PATIENT PROTECTION AND AFFORDABLE CARE ACT,” 152-153 (JCX-18-10 3/21/10), “[t]he provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.” The list of transactions and decisions intended to be immunized for the application of the economic substance doctrine includes:

(1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.

- Leasing transactions will continue to be scrutinized based on all of the facts and circumstances.

- ***Jettisoned along the way*** — Many earlier versions of the codification of economic substance doctrine, some of which were adopted by the House, also provided special rules for applying what was essentially a *per se* lack of economic substance in transactions with tax indifferent parties that involved financing, and artificial income and basis shifting. See, e.g., H.R. 2345, 110th Cong, 1st Sess. (2007); H.R. 2, 108th Cong., 1st Sess. (2003). These rules did not make it into the enacted version.

Special statutory rules for determining the profitability of leasing transactions also did not find their way into the final statutory enactment.

• ***Penalties, oh what penalties!*** —

New §§ 6662(b)(6), in conjunction with new § 6664(c)(2), imposes a *strict liability* 20 percent penalty for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, within the meaning of new § 7701(o), “or failing to meet the requirements of any similar rule of law.” (Does that extend to substance versus form in a SILO? How about business purpose in a purported tax-free reorganization?) The penalty is increased to 40 percent if the taxpayer does not adequately disclose the relevant facts on the original return or an amended return filed before the taxpayer has been contacted for audit — an amended return filed after the initial contact cannot cure original sin. I.R.C. § 6664(i). Because the § 6664(c) “reasonable cause” exception is unavailable, outside (or in-house) analysis and opinions of counsel or other tax advisors will not insulate a taxpayer from the penalty if a transaction is found to lack economic substance. Likewise, new § 6664(d)(2) precludes a reasonable cause defense to imposition of the § 6662A reportable transaction understatement penalty for a transaction that lacks economic substance. (Section 6662A(e)(2) has been amended to provide that the § 6662A penalty with respect to a reportable transaction understatement does not apply to a transaction that lacks economic substance if a 40 percent penalty is imposed under § 6662(i)). A similar no-fault penalty regime applies to excessive erroneous refund claims that are denied on the ground that the transaction on which the refund claim was based lacked economic substance. § 6676(c). However, under the “every dark cloud has a silver lining” maxim, the §§ 6662(b)(6) and 6664(c)(2) penalty regime does not apply to any portion of an underpayment on which the § 6663 fraud penalty is imposed.

• ***Effective date*** — Section 7701(o)

and the revised penalty rules applies to transactions entered into after the date of enactment and to underpayments, understatements, and refunds and credits attributable to transactions entered into after 3/30/10.

a. Better than a sharp stick in the eye, but not much better. The IRS is catching conjunctivitis, weighing in on the conjunctive test. Notice 2010-62, 2010-2 C.B. 411 (9/13/10). The IRS indicates that it will rely on relevant case law in applying the two-pronged conjunctive test for economic substance. Thus, both in determining whether a transactions meets both of the requirements of the conjunctive test, the IRS will apply cases under the common law economic substance doctrine to determine whether tax benefits are allowable because a transaction satisfies the economic substance prong of the economic substance doctrine and to determine whether a transaction has a sufficient nontax purpose to satisfy the requirement that the tax benefits of a transaction are not allowable because

the taxpayer lacks a business purpose. The IRS adds that it will challenge taxpayers who seek to rely on case law that a transaction will be treated as having economic substance merely because it satisfies either of the tests. The IRS also indicates that it anticipates that the law of economic substance will continue to evolve and that it “does not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.”

- The Notice also indicates that, except for reportable transactions, disclosure for purposes of the additional penalty of § 6621(i) will be adequate if the taxpayer adequately discloses on a timely filed original return, or a qualified amended return the relevant facts affecting the tax treatment of the transaction. A disclosure that would be deemed adequate under § 6662(d)(2)(B) will be treated as adequate for purposes of § 6662(i). The disclosure should be made on a Form 8275 or 8275-R.

b. In the absence of helpful IRS guidance, LB&I steps up with something to lean on for the meanwhile. Taxpayers must be notified at the outset of the process. LB&I-4-0711-015. Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties (7/15/11). The Large Business and International Division of the IRS has issued guidance regarding the process that an examiner must follow in determining whether to seek approval of the Director of Field Operations (DFO) to apply the § 7701(o) economic substance doctrine. “An examiner should notify a taxpayer that the examiner is considering whether to apply the economic substance doctrine to a particular transaction as soon as possible, but not later than when the examiner begins the analysis in the steps described below.” There are three steps in the analysis.

- *Three step analysis:* (1) First, an examiner should evaluate whether the circumstances in the case are those under which application of the economic substance doctrine to a transaction is likely not appropriate. (2) Second, an examiner should evaluate whether the circumstances in the case are those under which application of the doctrine to the transaction may be appropriate. (3) Third, if an examiner determines that the application of the doctrine may be appropriate, the examiner must make a series of inquiries before seeking approval to apply the doctrine.

- Facts and circumstances indicating that the economic substance doctrine should **not** be applied:

- (1) The transaction is not promoted/developed/administered by tax department or outside advisors;
- (2) The transaction is not highly structured;
- (3) The transaction contains no unnecessary steps;

- (4) The transaction that generates targeted tax incentives is, in form and substance, consistent with congressional intent in providing the incentives;
- (5) The transaction is at arm's length with unrelated third parties;
- (6) The transaction creates a meaningful economic change on a present value basis (pre-tax);
- (7) The taxpayer's potential for gain or loss is not artificially limited;
- (8) The transaction does not accelerate a loss or duplicate a deduction;
- (9) The transaction does not generate a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset);
- (10) The taxpayer does not hold offsetting positions that largely reduce or eliminate the economic risk of the transaction;
- (11) The transaction does not involve a tax-indifferent counter-party that recognizes substantial income;
- (12) The transaction does not result in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years;
- (13) The transaction has credible business purpose apart from federal tax benefits;
- (14) The transaction has meaningful potential for profit apart from tax benefits;
- (15) The transaction has significant risk of loss;
- (16) Tax benefit is not artificially generated by the transaction;
- (17) The transaction is not pre-packaged;
- (18) The transaction is not outside the taxpayer's ordinary business operations.

• Facts and circumstances indicating that the economic substance doctrine **should be** applied:

- (1) The transaction is promoted/developed/administered by tax department or outside advisors;
- (2) The transaction is highly structured;
- (3) The transaction includes unnecessary steps;
- (4) The transaction is not at arm's length with unrelated third parties;
- (5) The transaction creates no meaningful economic change on a present value basis (pre-tax)
- (6) The taxpayer's potential for gain or loss is artificially limited;
- (7) The transaction accelerates a loss or duplicates a deduction;
- (8) The transaction generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset);
- (9) The taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction;

- (10) The transaction involves a tax-indifferent counter-party that recognizes substantial income;
- (11) The transaction results in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years;
- (12) The transaction has no credible business purpose apart from federal tax benefits;
- (13) The transaction has no meaningful potential for profit apart from tax benefits;
- (14) The transaction has no significant risk of loss;
- (15) Tax benefit is artificially generated by the transaction;
- (16) The transaction is pre-packaged;
- (17) The transaction is outside the taxpayer's ordinary business operations.

- The seven required subsequent

inquiries:

(1) Is the transaction a statutory or regulatory election? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(2) Is the transaction subject to a detailed statutory or regulatory scheme? If so, and the transaction complies with this scheme, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(3) Does precedent exist (judicial or administrative) that either rejects the application of the economic substance doctrine to the type of transaction or a substantially similar transaction or upholds the transaction and makes no reference to the doctrine when considering the transaction? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(4) Does the transaction involve tax credits (e.g., low income housing credit, alternative energy credits) that are designed by Congress to encourage certain transactions that would not be undertaken but for the credits? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(5) Does another judicial doctrine (e.g., substance over form or step transaction) more appropriately address the noncompliance that is being examined? If so, those doctrines should be applied and not the economic substance doctrine. To determine whether another judicial doctrine is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.

(6) Does recharacterizing a transaction (e.g., recharacterizing debt as equity, recharacterizing someone as an agent of another, recharacterizing a partnership interest as another kind of interest, or recharacterizing a collection of financial products as another kind of interest) more appropriately address the noncompliance that is being examined? If so, recharacterization should be applied and not the economic substance doctrine. To determine whether recharacterization is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.

(7) In considering all the arguments available to challenge a claimed tax result, is the application of the doctrine among the strongest arguments available? If not, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

- *Approval Process.* If an examiner completes the inquiries described above and concludes that it is appropriate to seek approval for the application of the economic substance doctrine, the examiner, in consultation with his or her manager and territory manager, should describe the analysis in writing for the appropriate Director of Field Operations, whose approval is required.

- *Penalties Limitation.* Until further guidance is issued, the penalties provided in §§ 6662(b)(6) and (i) and 6676 are limited to the application of the economic substance doctrine and may not be imposed due to the application of any other “similar rule of law” or judicial doctrine (e.g., step transaction doctrine, substance over form or sham transaction).

- *Really!?* The final sentence of the directive reads as follows: “This LB&I Directive is not an official pronouncement of law, and cannot be used, cited, or relied upon as such.”

c. **“I’m not sure how important it is to have formal guidance — this is what’s supposed to be issued. It sets forth the procedures that exam, counsel, [and] managers need to follow . . . who’s the formal guidance supposed to benefit?”** Mark Silverman, 2011 TNT 137-1. Deborah Butler states that taxpayers may not rely on this guidance.

C. Disclosure and Settlement

There were no significant developments regarding this topic during 2011.

D. Tax Shelter Penalties, etc.

1. If it's "too good to be true," it ain't true. Gustashaw v. Commissioner, T.C. Memo. 2011-195 (8/11/11). In an opinion by Judge Halpern, the Tax Court upheld accuracy related penalties of over \$1,000,000 against an investor in a CARDS tax shelter, with respect to which the investor had an opinion from Brown & Wood. Judge Halpern concluded as follows:

A reasonable and ordinarily prudent person would have considered as "too good to be true" a carryover deduction generated from a previously claimed \$9,938,324 tax loss when he did not suffer an associated economic loss and invested only \$800,000 in the transaction. As such, he would have conducted a thorough investigation before claiming the deduction on his tax return. ...

[The taxpayer] did not attempt to understand the mechanics of the CARDS transaction, executed the transaction documents without reading them and without an attorney's review, and, although aware of the transaction's untested tax ramifications, declined to seek a ruling from the IRS. Further, he did not question the claimed carryover loss amount even though he knew that he did not suffer an associated economic loss.

• Furthermore, Judge Halpern held that the taxpayer's reliance of the Brown & Wood opinion was "unreasonable" because he should have known that Brown & Wood had an inherent conflict of interest; the promoter of CARDS both referred Brown & Wood to the taxpayer and supplied him with a model tax opinion letter describing a CARDS transaction that was not unique to the taxpayer's situation. There was no evidence that the taxpayer had an engagement letter with Brown & Wood, spoke to any attorney at the law firm, or directly compensated Brown & Wood for a tax opinion letter. The taxpayer "could not have reasonably believed that Brown & Wood was an independent adviser."

2. Tax professionals compensated at hourly rates were "independent advisers," but § 6662 penalties were nevertheless imposed because the Son of BOSS transaction was "too good to be true." Candyce Martin 1999 Irrevocable Trust v. United States, 108 A.F.T.R.2d 2011-6693 (N.D. Cal. 10/8/11). Trusts for the San Francisco Chronicle heirs and the heirs themselves entered into digital option Son-of-Boss transactions to shield more than \$300 million of capital gain from taxation arising from the sale of their stock in Chronicle Publishing Company in 2000. Judge Hamilton held that the transactions failed for federal income tax purposes because (1) the obligations on the short options constituted liabilities for

purposes of § 752; (2) the transactions lacked economic substance; and (3) the transactions were not entered into for profit so losses were nondeductible under § 165.

• The trustee of the trusts [Peter Folger] and the leading Martin family member [Francis Martin] engaged San Francisco tax lawyer Richard Sideman – a Harvard Law School graduate, with a Masters in Tax from NYU, who had previously advised the family on gift tax and trust reformation issues – to advise the trusts and heirs as to the tax and non-tax consequences of their Chronicle Publishing stock sale. Sideman did a great deal of investigation by getting advice from large accounting firms, investment banks, economists, and R.J. Ruble, which resulted in proposed transactions and proposed opinion letters undergoing numerous changes. Finally, the transactions proposed by JP Morgan and implemented by PWC, with R.J. Ruble opinion letters were decided upon; Sideman “greenlight[ed],” i.e., approved, the transactions. In upholding § 6662 penalties and denying taxpayers’ “reasonable cause and good faith defense,” Judge Hamilton stated:

[M]ere reliance on the advice of a professional tax advisor “does not necessarily demonstrate reasonable cause and good faith.” *Id.* A taxpayer’s claim of reliance upon professional advice as support for this defense is to be evaluated under an objective standard. ...

While the record is clear that Mr. Folger and the Martin family relied heavily on Mr. Sideman, the record is not clear as to the extent that they relied directly on the advice of Dr. Rubinstein and Mr. Ruble, if at all. It was Mr. Sideman who appears to have relied on the advice of Dr. Rubinstein and Mr. Ruble in advising Mr. Folger and the Martin family.

... [A]ny reliance on Dr. Rubinstein’s advice would not be reasonable because his conclusions were not based on all pertinent facts and circumstances as required for reasonable cause.

... Mr. Sideman testified that he saw his role as that of overseeing the transaction “in a broad way [and] hiring or engaging at my recommendation the most qualified people that I knew who could provide the actual expertise about the transaction and about its financial implications.” ... Mr. Sideman characterized himself as a tax controversy lawyer, unfamiliar with economic judgments involving financial matters to advise the Martin family directly on the issue whether the tax proposal by Arthur Andersen, and the subsequent proposal by PWC, would have an economic reality or economic benefit. Mr. Sideman testified that he relied on the advice of PWC, Dr. Rubinstein and Mr. Ruble

to examine the business purpose of the proposed transaction.

...

While the evidence at trial establishes that Mr. Folger and the Martin family relied on Mr. Sideman's advice, the trial evidence lacks clarity as to exactly what advice Mr. Sideman gave them, other than approving or "greenlighting" the transaction based on the advice he received from the other professionals. The weaknesses noted above in the Ruble and Rubinstein opinions, as well as other aspects of the transaction, should have put at least Mr. Sideman, if not the taxpayers, on notice that the transaction was a questionable tax avoidance scheme lacking economic substance. However, the question before the court is not whether Mr. Sideman's reliance on professional advice was reasonable, but whether Mr. Folger and the Martin family's reliance on Mr. Sideman's and the other professionals' advice was reasonable. As previously noted, it is not clear to what extent the taxpayers themselves relied on any advice other than Mr. Sideman's. Nor was it established that Mr. Sideman ever specifically advised them that the transaction was bona fide or legal. All the evidence clearly establishes is that Mr. Sideman approved the transaction.

- Judge Hamilton rejected government contentions that the taxpayers could not rely on PWC and Sideman because they had an inherent conflict of interest, stating that advisers compensated at an hourly rate were not conflicted.

- However, the court found that taxpayers did not rely reasonably on Sideman's advice, concluding:

The government has not provided a clear argument or any authority for whether Mr. Sideman's unreasonable reliance on the professionals he hired should be imputed to the taxpayers. This was a highly sophisticated transaction, one for which a taxpayer would reasonably be expected to hire a tax lawyer. The court is not prepared to find that having retained a tax lawyer who "greenlights" a complicated transaction as having a business purpose, a taxpayer necessarily acts unreasonably by relying on that advice. See *United States v. Boyle*, 469 U.S. 241, 250-51, 105 S. Ct. 687, 83 L. Ed. 2d 622 (1985) (when an accountant or attorney advises a taxpayer on a matter of tax law, it is reasonable for the taxpayer to rely on that advice, "even when such advice turned out to have been mistaken"). Even assuming, however, that the taxpayers acted reasonably in relying on their tax lawyer's advice to proceed with the

transaction, to be entitled to the reasonable cause and good faith defense, the taxpayers must also prove that they acted in good faith. Good faith is not synonymous with objective reasonableness. Even if the concept of business purpose was too complicated for the taxpayers to assess and apprehend, the court finds that Mr. Folger and the Martin family have not demonstrated good faith under the circumstances and in light of the underlying purposes of entering into the transaction.

First, Mr. Folger and the Martin family should have known that the transaction resulting in a \$315.7 million tax basis for a \$0.9 million offsetting options transaction was “too good to be true.” *Stobie Creek*, 608 F.3d at 1383. Furthermore, they knew that the purpose of the transaction was to boost the basis to generate a large capital loss to offset the capital gains from the CPC sale. Finally, they proceeded with the transaction even after the issuance of Notice 2000-44, entitled “Tax Avoidance Using Artificially High Basis,” which alerted them that the basis created by the options transaction would likely be disallowed. Although they were advised by Mr. Sideman that the transaction had a legitimate business purpose, Mr. Folger and the Martin family entered into this transaction with the knowledge that it would generate an artificially high capital loss. Given the level of education and business experience shared by Mr. Folger and the Martin family, they should have known that the absence of a tax liability on a sizeable capital gain did not reflect the economic reality of the transaction. The underpayment of tax was not, therefore, the result of “an honest misunderstanding of fact or law.” Treas. Reg. § 1.6664-4(b)(1). Because Mr. Folger, with the consent of the Martin family, did not act in good faith, the court finds that the accuracy-related penalty was appropriately applied here.

3. Conceding that a 2001 transaction lacked economic substance avoided the § 6662(h) 40-percent gross valuation misstatement penalty, but this particular ploy won’t work as well for years to which the § 6662(b)(6) strict liability penalty applies. Bergman v. Commissioner, 137 T.C. 136 (10/11/11). The taxpayers, the husband taxpayer being a partner in KPMG, participated in two SOS (Short Option Strategy) transactions promoted by KPMG that was the same as or substantially similar to a tax avoidance transaction described in Notice 2000-44, 2000-2 C.B. 255. The IRS served KPMG with a summons concerning transactions described in Notice 2000-44, seeking among other things, a list

of clients that had engaged in such transactions. KPMG provided a list that included the taxpayer's 2000 transaction but not the 2001 transaction. After filing original returns claiming the deductions from the SOS transactions, subsequent to the IRS issuing the summons to KPMG, the taxpayers filed amended returns that eliminated the losses. The IRS argued that the summons terminated the period for the taxpayers to file a qualified amended return under Reg. § 1.6664-2(c)(3), and the taxpayers conceded they were liable for a 20-percent accuracy-related penalty under § 6662(a) if they failed to file a qualified amended return, but that their amended returns were a qualified amended returns. In addition, the IRS also asserted that the taxpayers were liable for a 40-percent gross valuation misstatement under § 6662(h) if the amended returns were not qualified amended returns. This required the court (Judge Kroupa) to decide whether the IRS must impose a promoter penalty under § 6700 (relating to abusive tax shelters) to terminate the time to file a qualified amended return under Reg. § 1.6664-2(c)(3)(ii). The taxpayers argued that the IRS failed to establish that KPMG was liable for a promoter penalty under § 6700 and therefore the time to file a qualified amended return never terminated. With regard to the first issue, Judge Kroupa held that the period to file a qualified amended return terminated before the taxpayers filed the amended return. The taxpayers "could reasonably conclude that [the IRS] would discover their 2000 transaction once KPMG was served the Notice 2000-44 summons. Accordingly, disclosure after the Notice 2000-44 summons was served on KPMG would not have been voluntary." The amended return petitioners filed was not a QAR since it was filed after respondent issued KPMG the Notice 2000-44 summons. As a result, for penalty purposes, the additional tax stated on the amended return was not includable in the amount of tax shown on the original return, and the taxpayers had an underpayment of tax for 2001 equal to the additional tax reported on the amended return. But with regard to the second issue, she held that the taxpayers' underpayment was not attributable to a gross valuation misstatement and they thus were not liable for the gross valuation penalty. *McCrary v. Commissioner*, 92 T.C. 827 (1989), held that where the IRS asserts a ground unrelated to value or basis of property for totally disallowing a deduction or credit and a taxpayer concedes the deduction or credit on that ground, any underpayment resulting from the concession is not attributable to a gross valuation misstatement; that holding was extended in *Rogers v. Commissioner*, T.C. Memo. 1990-619, to situations where the taxpayer does not state the specific ground for the concession as long as the IRS has asserted some ground other than value or basis for totally disallowing the relevant deduction or credit. In this case the taxpayers conceded that the transactions lacked economic substance, and thus had conceded "on grounds other than regarding the value or basis of the property" that they were not entitled to deduct any portion of the losses at issue."

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. **An agency's interpretation of its regulation is controlling unless the interpretation is "plainly erroneous or inconsistent with the regulation."** *Polm Family Foundation v. United States*, 644 F.3d 406 (D.C. Cir. 5/6/11). The issue in this declaratory judgment case was whether the Polm Family Foundation was a private foundation under § 509 or a § 509(a)(3)(A) supporting organization, treated as a public charity, the IRS having conceded that it was a § 501(c)(3) organization. Among the requirements to qualify under § 509(a)(3)(II) is that the organization demonstrate that it is "organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified [publicly supported] organizations." The Foundation's articles of incorporation designated as supported organizations "the class of organizations ... which support, promote and/ or perform public health and/or Christian objectives, including but not limited to Christian evangelism, edification and stewardship." Reg. § 1.509(a)-4(d)(2)(i)(b) does not require a specific listing of the name each publicly supported organization, but Reg. § 1.509(a)-4(d)(3) indicates that the articles of incorporation must require that it be operated to support or benefit one or more beneficiary organizations which are designated by class or purpose. The IRS argued that the exception to specific designation applies only if the class of beneficiary organizations is "readily identifiable," and the court accepted the IRS's argument that the class of beneficiary organizations was not "readily identifiable," citing Example (1) in Reg. § 1.509(a)-4(d)(2)(iii) ("institutions of higher learning in the State of Y") and Rev. Rul. 81-43, 1981-1 C.B. 350 ("[tax-exempt public charities] located in the [city of] Z area"). The court found that "unlike the examples contained in the regulation and the revenue ruling, [the Foundation's] designation does not make its beneficiary organizations readily identifiable. There is no geographic limit. There is no limit by type of publicly supported organization (such as churches or seminaries). In light of the broad purposes mentioned in Foundation's articles of incorporation, we agree with the government that it would be difficult, if not impossible, to determine whether the Foundation will receive oversight from a readily identifiable class of publicly supported organizations."

• Very significantly, in its analysis, the court stated as follows:

An agency's interpretation of its regulation is controlling unless the interpretation is "plainly erroneous or inconsistent with the regulation." *Auer v. Robbins*, 519 U.S. 452, 461

(1997). This is so even if the interpretation appears for the first time in a legal brief. *Chase Bank USA, N.A. v. McCoy*, 131 S. Ct. 871, 880–81 (2011); *Bigelow v. Dep't of Def.*, 217 F.3d 875, 878 (D.C. Cir. 2000). “Because the interpretation the [IRS] presents in its brief is consistent with the regulatory text,” *Chase Bank*, 131 S. Ct at 880, we have no basis for rejecting it in favor of some other version.

2. Your client put it off for three years, so why not put it off until year-end 2012: Organizations which lost their tax-exempt status may seek reinstatement until 12/31/12. IR-2011-63 (6/8/11). This information release provides guidance to help reinstate currently-existing organizations among the 275,000 which lost their tax-exempt status for failure to file required annual reports for three consecutive years. Notice 2011-43, 2011-25 I.R.B. 882; Notice 2011-44, 2011-25 I.R.B. 883; and Rev. Proc. 2011-36, 2011-25 I.R.B. 915, provide full details.

3. Even the Tax Court is anti-union. National Education Association v. Commissioner, 137 T.C. 123 (9/28/11). National Education Association (NEA) is a tax-exempt labor organization described in § 501(c)(5). It published two magazines at an expense of about \$7 million that it distributed to dues-paying members and to a few non-member paying subscribers. NEA’s literature stated that members received the magazines as a benefit of membership and stated an amount of dues that paid for the magazines. Members who declined the magazines did not pay a smaller amount of dues. NEA made most but not all of the content of the magazines available for free over the Internet to the general public. NEA published paid advertising in the magazines from which it earned annual net income of approximately \$1 million. NEA reported negligible circulation income, resulting in a substantial claimed loss on its circulation activity; NEA used that loss to fully offset its taxable advertising profit. Thus, NEA reported that it owed no unrelated business income tax (UBIT). The IRS allocated a portion of NEA’s membership dues to circulation income, which resulted in NEA having circulation income substantially in excess of the advertising income, resulting in the advertising income being UBIT. Reg. § 1.512(a)-1(f)(3)(iii) provides that “[w]here the right to receive an exempt organization periodical is associated with membership or similar status in such organization for which dues, fees or other charges are received (hereinafter referred to as ‘membership receipts’), circulation income includes the portion of such membership receipts allocable to the periodical (hereinafter referred to as ‘allocable membership receipts’).” The NEA argued that its members did not have ‘the right to receive’ the magazines because it was under no obligation to continue publishing and because its members as well as the general public could access the magazines for free on the Internet. On these

grounds, the NEA argued that it thus had virtually no circulation income, but had substantial excess readership costs that it could deduct from its advertising income, reducing that income to zero. The IRS argued that NEA members had the right to receive the magazines because a portion of the NEA's members' dues was paid for magazines. As a result, the NEA had substantial circulation income that more than covered the cost of producing the magazines; thus it had no excess readership costs, and accordingly had unrelated business taxable income from its paid advertising. The Tax Court (Judge Gustafson) upheld the deficiency, finding that the NEA members, in fact, had a right to receive the publications. Under its bylaws it could not "halt publication of the magazines at its whim," its contracts with advertisers limited its right to halt publication, as did relevant postal regulations. Furthermore, the enrollment forms used by State affiliates, through which all NEA members joined, separately listed the portion of the dues allocable to the publication subscriptions and promised delivery of the publications. Finally, the court concluded that the alternative free availability of a publication to members did not nullify their right to receive the publication resulting from payment of dues.

• As a preliminary matter the court rejected the IRS's argument that "the principle that an agency's interpretation of its own regulation is controlling unless it is 'plainly erroneous or inconsistent with the regulation'" applied in this case. The court concluded that "[d]eference here to the agency's interpretation is difficult, second, because the IRS is unable to show that the agency has in fact stated a position on the interpretation of 'right to receive.'"

B. Charitable Giving

1. **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 taxpayer’s 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. Another facade conservation easement deduction on mortgaged property bites the dust, with an alternative ground of uselessness. *1982 East, LLC v. Commissioner*, T.C. Memo. 2011-84 (4/12/11). *Kaufman* was followed to deny the claimed charitable contribution deduction for a facade conservation easement burdening mortgaged property where the lender had a “‘prior claim’” to all condemnation and insurance proceeds “‘in preference’ to [the donee] ‘until’ that mortgage was satisfied and discharged. ... [A]t any point before the mortgage was repaid, the possibility existed for [the lender] First Republic Bank to deprive [the donee] of value that should have otherwise been dedicated to the conservation purpose.”

- **Alternatively**, the deduction was disallowed because the building with respect to which the easement was granted was in the New York City Metropolitan Museum Historic District, and

local law protected the building against alteration and the easement provided no additional protection.

2. A possibly faulty conservation easement deduction saved by local preservation laws. Simmons v. Commissioner, T.C. Memo. 2009-208 (9/15/09). Judge Wherry held that facade conservation easements validly supported a charitable contribution deduction, even though they allowed the easement holder to consent to changes to the properties, because any rehabilitative work or new construction on the facades was required to comply with the requirements of all applicable Federal, State, and local government laws and regulations. Reg. § 1.170A-14(d)(5) allows a donation to satisfy the conservation purpose's test even if future development is allowed, as long as that future development is subject to local, State, and Federal laws and regulations. That the properties were already subject to local preservation laws did not prevent any charitable contribution deductions, because even though the easements were duplicative in some respects, the easements subjected the taxpayer to a higher level of enforcement than that provided by local law.

a. Affirmed. 646 F.3d 6 (D.C. Cir. 6/21/11). The Court of Appeals (Judge Ginsburg) agreed with the Tax Court that even though the deeds did not spell out precisely what would happen upon the dissolution of the donee, District of Columbia law provides the easements would be transferred to another organization that engaged in "activities substantially similar to those of" the grantee. The court reasoned that the clauses permitting changes or abandonment upon the donee's consent had "no discrete effect upon the perpetuity of the easements" because "[a]ny 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." The deduction could not be disallowed based upon the remote possibility the donee would abandon the easements. Finally, the court rejected the government's argument that the deduction should be disallowed because the taxpayer did not obtain qualified appraisals meeting the requirements of Reg. § 1.170A-13(c)(3)(ii); the Tax Court did not clearly err in concluding that the appraisals sufficiently identified the method and basis for the valuations.

3. 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).

4. “Too good to be true” turns out not to be true at all. Gundanna v. Commissioner, 136 T.C. 151 (2/14/11). In 1998, the taxpayer transferred over \$250,000 of appreciated stock to the xélan Foundation, a § 501(c) (3) organization that was not a private foundation. The stock was held “as ‘a donor advised fund’ or ‘family public charity’ (Foundation account), by means of which a donor’s donations would be segregated for investment and future distribution as the donor might recommend.” The taxpayer claimed a charitable contribution deduction; he did not include in income any gain from the sales of the stocks that had been transferred to the Foundation and which Foundation had sold in 1998, or any dividends or interest generated by the assets in petitioner’s Foundation account. Pursuant to the taxpayer’s requests, the Foundation made distributions from his Foundation account of several thousand dollars to the Shiva Vishnu Temple in each of the years 1999 through 2002. In addition, in 2001 and 2002, at the taxpayer’s request, \$70,299 was distributed from his Foundation account to the University of Pennsylvania in connection with the Foundation’s student loan program, as a loan to the taxpayer’s son to cover the cost of his tuition, room, and board. In 2003, approximately \$19,500 was distributed to the taxpayer to pay his legal fees in connection with an audit that proposed disallowance of the charitable contribution deduction claimed for 1998. During the course of the audit, the taxpayer repaid the principal of his son’s student loans, but the Foundation waived accrued interest. The Tax Court (Judge Gale) upheld the IRS’s disallowance of the charitable contribution deduction on the ground that the taxpayer retained dominion and control over the property transferred to the Foundation and held in his Foundation account. This conclusion was based “principally on the basis of the use of funds in petitioner’s Foundation account for student loans to his son.” The taxpayer’s “understanding, at the time he transferred the stocks to his Foundation account in 1998, that the account’s assets could be used to make student loans to his children, and the Foundation’s perfunctory acquiescence in making such loans in subsequent years, provide substantial support for the conclusion that petitioner neither intended, nor in fact did, cede dominion and control over the property transferred to the Foundation in 1998.” Judge Gale also found “that the promotion of another Foundation account feature – petitioner’s ability to arrange for distributions of account funds to compensate himself or family members for performance of ‘good works’ – also support[ed] the conclusion that petitioner maintained control of the assets in his Foundation account.” Alternatively, Judge Gale held that the substantiation requirements of § 170(f)(8)(A) had not been satisfied because, despite the Foundation providing the taxpayer with a contemporaneous written acknowledgment stating that no goods or services had been provided, under Reg. § 1.170A-13(f)(6) goods or services that the taxpayer expects to receive in the future must be taken into account, and when the taxpayer transferred the stock to the Foundation he expected to receive goods or

services in the form of student loans to his children. In addition to upholding disallowance of the charitable contribution deduction, Judge Gale held that because the taxpayer retained dominion and control over the funds, he was taxable on the capital gains and other income earned by the fund. Finally, and not surprisingly, § 6662 accuracy related penalties for negligence and substantial underpayment were upheld.

[P]etitioners were negligent because petitioner failed to make a reasonable attempt to ascertain the correctness of a deduction which would seem to a reasonable or prudent person to be “too good to be true” under the circumstances. A reasonable or prudent person would have perceived as “too good to be true” a deduction for a supposed charitable contribution where the amounts deducted could be used to fund student loans for his own children.

• Judge Gale rejected the taxpayer’s argument that because the Foundation was listed in Publication 78, he had substantial authority for the deduction.

5. Another claimed conservation easement sinks in quicksand. Boltar, L.L.C. v. Commissioner, 136 T.C. 326 (4/5/11). In a conservation easement charitable contribution deduction case, the Tax Court (Judge Cohen), sustained the IRS’s motion to exclude the taxpayer’s expert’s valuation report because the taxpayer’s expert failed to apply the correct standards required by Reg. § 1.170A-14(h)(3)(i). He did not determine the value of the donated easement by the “before and after” valuation method, did not value contiguous parcels owned by the taxpayer and encumbered by conservation easements, and assumed development potential (for a 174 unit condominium) that actually was not feasible on the property. As a result, the deduction was disallowed and the deficiency upheld.

6. The boilerplate can kill ya! Schrimsher v. Commissioner, T.C. Memo. 2011-71 (3/28/11). The taxpayers granted a facade easement with respect to property in Huntsville, Alabama, commonly known as the “Times Building,” to the Alabama Historical Commission. They claimed a charitable contribution deduction, listing on the Form 8283 the appraised fair market value of the facade easement as \$705,000. The “Appraisal Summary” on the Form 8283 omitted various items of required information, and it was not signed or dated by the donor, the appraiser, or any representative of the donee; a written appraisal of the facade easement was not attached. The agreement facade easement stated:

[F]or and in consideration of the sum of TEN DOLLARS, plus other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Grantor [taxpayer] does hereby irrevocably GRANT, BARGAIN,

SELL, AND CONVEY unto the Grantee [the commission], its successors and assigns, a preservation and conservation easement to have and hold in perpetuity

- The agreement also provided as follows: “This agreement sets forth the entire agreement of the parties with respect to the Easement and supercedes all prior discussions, negotiations, understanding, or agreements relating to the Easement, all of which are merged herein.” The Tax Court (Judge Thornton) granted summary judgment upholding the disallowance of the deduction because there was no other written acknowledgment of the gift, the agreement failed the requirements of § 170(f)(8)(B)(iii) because it did not include a description and good faith estimate of the “other good and valuable consideration.”

7. A touch of *Cohan* [?], with a cap, for the Cat Woman’s unreimbursed charitable volunteer expenses. Van Dusen v. Commissioner, 136 T.C. 515 (6/2/11). The taxpayer claimed charitable contribution deductions for out-of-pocket expenses incurred in caring for “foster cats” as a volunteer on behalf of Fix Our Ferals, a § 501(c)(3) organization. The Tax Court (Judge Morrison) applied the “substantial compliance doctrine” to allow a deduction for expenses incurred by a volunteer providing services to a charitable organization, even though the taxpayer’s records did not strictly meet the specific requirements of Reg. § 170A-13(a)(1). The taxpayer’s documents were “legitimate substitutes for canceled checks,” because they contained all of the information that would have been on a canceled check — the name of the payee, the date of the payment, and the amount of the payment. Although the regulation requiring substantiation records to reflect the name of the donee was not written with unreimbursed volunteer expenses in mind, because the amounts expended exceeded \$250 and the taxpayer failed to satisfy requirements of § 170(f)(8)(a) and Reg. § 1.170A-13(f)(1) for substantiation in the form of a contemporaneous written acknowledgment from the charitable organization, the deductible amount for each separate expenditure was limited to \$250.

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

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

it was received by taxpayer after his 2004 federal income tax return was filed.

9. 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 Foundation*, 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.

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 and 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 remains 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, Dec. 14, 2011. 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. 🎵 “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 will be available on the IRS website in February 2012.

2. Since the same penalty statute applies, the principle of this estate tax penalty case should also apply to late payment of income taxes. *Baccei v. United States*, 632 F.3d 1140 (9th Cir. 2/16/11). In *United States v. Boyle*, 469 U.S. 241 (1985), which involved a § 6651(a)(1) penalty for failure to timely file an estate tax return, the Supreme Court held that reliance on an accountant, lawyer, or other agent to file the return is not “reasonable cause” for late filing. In another estate tax case, The Ninth Circuit (Judge Burgess) extended this principle to the § 6651(b) penalty to timely pay a tax, holding that the taxpayer’s reliance on an accountant, lawyer, or other tax advisor to seek an extension of time to pay the estate tax was not “reasonable cause” for the late payment.

3. The Tax Court won’t waste time or paper on frivolous arguments! Or will it? *Wnuck v. Commissioner*, 136 T.C. 498 (5/31/11). The IRS determined a deficiency based on the taxpayer’s unreported wages. At the trial the taxpayer admitted, “I exchanged my skilled labor and knowledge for pay.” In a bench opinion the Tax Court sustained the deficiency, ruling that the taxpayer’s arguments were frivolous, imposed a \$1,000 § 6673(a) penalty, and warned the taxpayer that if he repeated his frivolous positions he faced the risk of a larger penalty. On the

taxpayer's motion for reconsideration on the grounds that the court had not adequately addressed his arguments, Judge Gustafson wrote a magisterial full opinion, denying the motion for reconsideration and holding that the taxpayer was not entitled to a court opinion addressing his frivolous arguments. While the opinion did not directly answer the substance of the frivolous arguments, it did show why the arguments were frivolous. It also increased the penalty to \$5,000, and warned taxpayer that further frivolous arguments would subject him to a penalty of up to \$25,000.

- Judge Gustafson stated at the outset:

If one is genuinely seeking the truth, if he focuses on what is relevant, and if he confines himself to good sense and logic, then the number of serious arguments he can make on a given point is limited. However, if one is already committed to a position regardless of its truth, if he is willing to say anything, if he is willing to ignore relevance, good sense, and logic, and if he is simply looking for subjects and predicates to put together into sentences in ostensible support of a given point, then the number of frivolous arguments that he can make on that point is effectively limitless. When each frivolous argument is answered, there is always another, as long as there are words to be uttered. Such arguments are without number. Consequently, a Court that decides cases brought by persons willing to make frivolous arguments – such as “tax protesters” or “tax defiers” [fn. 2] – would by definition never be finished with the task of answering those frivolous arguments.

- That notable footnote [fn. 2]

explained as follows:

Persons who make frivolous anti-tax arguments have sometimes been called “tax protesters”. Section 3707 of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206, 112 Stat. 778, provided that “The officers and employees of the Internal Revenue Service *** shall not designate taxpayers as illegal tax protesters”, because Congress was “concerned that taxpayers may be stigmatized”, S. Rept. 105-174, at 105 (1998), 1998-3 C.B. 537, 641. This prohibition applies only to IRS employees and not to the courts; and we use here the alternative term “tax defier” for a reason having nothing to do with any supposed stigma attached to being a “zero returns” or who otherwise try to shirk their civic responsibility, evade their fair share of the tax burden, waste tax enforcement resources, and clog the courts with pointless lawsuits are simply scoff-laws. They enjoy the benefits of American

security and stability while refusing to shoulder their portion of the burden. They are not protesters but are defiers.

4. Mistakes that were the result of “confusion, inattention to detail, or pure laziness” of a tax advisor who was the vice president of taxes were not attributable to “reasonable cause,” but when the same tax advisor acted as an independent consultant between stints as a corporate employee and made those same mistakes, the taxpayers’ reliance was in good faith. Huh! Seven W. Enterprises, Inc. v. Commissioner, 136 T.C. 539 (6/7/11). The IRS asserted § 6662 accuracy related penalties for 2000 through 2003 with respect to the underpayment of the personal holding company tax. For certain years during that period, William Mues, a CPA, prepared the 2000 and 2001 tax returns for one of the taxpayer corporations and the 2001 return for another of the taxpayer corporations as an independent consultant. In 2002, the taxpayer corporations’ group hired Mues as vice president of taxes, and in that capacity he prepared and signed, on behalf of one of the taxpayer corporations its 2001, 2002, and 2003 tax returns and the 2002, 2003, and 2004 tax returns of another of the taxpayer corporations. The taxpayers contended that they had reasonable cause for their underpayments and acted in good faith and that they reasonably relied on Mues’s advice in 2000 when he served as a consultant and in 2001 through 2004 when he served as vice president of taxes. The Tax Court (Judge Foley) held that even though Mues had been an employee of the taxpayer corporations from 1990 until January 2001 and during that time period executed various tax documents on behalf of the taxpayer corporations, at the time he signed the tax returns as an independent consultant, he was acting as an independent consultant and not as an employee. Because he was an “experienced and knowledgeable tax professional, with all of the relevant information necessary to prepare the return” the taxpayer relied in good faith on Mues to accurately and correctly prepare the 2000 return, even though he made several mistakes in applying the personal holding company tax rules. However, with respect to the 2001 through 2004 returns, the taxpayer corporations did not satisfy the good faith reliance test. For those years, Mues was a corporate employee acting on behalf of the corporations, not an independent advisor. Because he was not a person “other than the taxpayer” the “good faith reliance” defense to the penalties was not available. Furthermore, the taxpayers did not have “reasonable cause” for the understatements. “It is unclear whether [taxpayers’] myriad of mistakes was the result of confusion, inattention to detail, or pure laziness, but we are convinced that petitioners and Mues failed to exercise the requisite due care. ... [The taxpayers’] repeated audit adjustments relating to multiple IRS audits coupled with Mues’ experience, expertise, and education further bolster [the] conclusion that [the taxpayers]

failed to exercise ordinary business care and prudence as to the disputed items.”

5. Yes, it’s my return but can’t I rely on my CPA’s transcription and arithmetic skills? Held: Reliance on a return preparer who omits a \$3.4 million gain on a transaction in which the taxpayer personally participated and for which he received a Form-1099 was not good faith reasonable reliance. *Woodsum v. Commissioner*, 136 T.C. 585 (6/13/11). In 2006 the taxpayers realized a \$3.4 million gain on “swap” transaction in which one of the taxpayers, who was a managing director of a private equity investment firm, was personally involved. The taxpayers received a Form 1099-MISC, Miscellaneous Income, that reported the payment. The taxpayers retained a firm with a lawyer and a certified public accountant to prepare their 2006 income tax return and gave the firm all the over 160 information returns they had received from third-party payors, including the Form 1099-MISC reporting the \$3.4 million gain. The taxpayers’ 115-page return that the firm prepared reported \$29.2 million of AGI, but omitted the \$3.4 million from the swap transaction. The taxpayers briefly reviewed the return on the due date but did not compare or match the items of income reported on the Form 1040 and its schedules with the information returns that the third-party payors had provided before they signed and filed the return. When the IRS asserted a deficiency for the \$3.4 million gain and § 6662 substantial understatement penalty, the taxpayers conceded the deficiency with respect to the gain but contested the penalty on the grounds of “reasonable cause” and good faith reliance on their tax return preparer. The Tax Court (Judge Gustafson) upheld the penalty. Even though he “assumed” that the taxpayers were unaware of the omission when they signed and filed the return, they “failed to make sure that all their income items were reported on the return that [the return preparer] had prepared. The court reasoned that “to constitute ‘advice’ within the definition of [Reg. § 1.6662-4(c)(2)] the communication must reflect the adviser’s ‘analysis or conclusion.’” The taxpayer must show that he relied on the advisor’s “judgment.” The taxpayers did not rely on the preparer’s judgment, because “[n]o ‘special training’ was required for Mr. Woodsum to know that the law required him to include on that return an item of income that he had received and that Deutsche Bank had reported on Form 1099.” Furthermore, even though Reg. § 1.6664-4(b)(1) provides that “[a]n isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith,” assuming that the omission was an innocent oversight by the return preparer, the taxpayers’ review of the return was not reasonable under the circumstances. Although a taxpayer is not required to duplicate the work of his return preparer, and an omission of an income item in a return prepared by a third party is not necessarily fatal to a finding of reasonable cause and good faith on the taxpayer’s part if the taxpayer conducts a review

of his third-party prepared return with the intent of ensuring that all income items are included, that effort must be reasonable under the circumstances. In this case, the taxpayers failed to demonstrate that they made a reasonable effort to review the return. The taxpayer had personally ordered the transaction that gave rise to the income and had received a Form 1099–MISC reporting that income. The amount should have appeared on Schedule D as a distinct item, but it was omitted. The taxpayers’ “‘review’ of the defective return was of an unknown duration and that it consisted of the preparer turning the pages of the return and discussing various items.” The \$3.4 million understatement “was substantial not only in absolute terms but also in relative terms (i.e., it equaled about 10 percent of petitioners’ adjusted gross income). A review undertaken to ‘make sure all income items are included’ ... or even a review undertaken only to make sure that the *major* income items had been included—should, absent a reasonable explanation to the contrary, have revealed an omission so straightforward and substantial.” Finally, the court concluded as follows:

Mr. Woodsum terminated the swap ahead of its set termination date because his watchful eye noted that it was not performing satisfactorily as an investment. That is, when his own receiving of income was in question, Mr. Woodsum was evidently alert and careful. But when he was signing his tax return and reporting his tax liability, his routine was so casual that a half-million-dollar understatement of that liability could slip between the cracks. We cannot hold that this understatement was attributable to reasonable cause and good faith.

- If this CPA cannot copy and cannot add, he is nevertheless not subject to preparer penalties because this was an isolated mistake. The one of us who uses a CPA to prepare his tax returns is outraged that a taxpayer who employs a CPA to prepare his income tax return cannot rely on the CPA’s transcription and arithmetic skills.

6. Canal opinion redux? Paschall v. Commissioner, 137 T.C. 8 (7/5/11). Through a series of convoluted preplanned transactions designed by Grant Thornton that the Tax Court found to lack economic substance, the taxpayer in essence moved approximately \$1.3 million from a traditional IRA to a Roth IRA, without paying any taxes. The IRS asserted that he had made excess contributions to a Roth IRA. The taxpayer had filed timely Forms 1040 for the years in issue, but failed to file Forms 5329 reporting the excess contributions for the years in issue. More than three years after the due date for the Forms 1040 for the years in issue, the IRS proposed § 4973 excise tax assessments. The taxpayer asserted that the statute of limitations had run, but the Tax Court (Judge Wherry) held that the filing of the Forms 1040 did not start the statute of limitations running for

purposes of the § 4973 excise tax in the absence of accompanying Forms 5329. Section 6651(a)(1) failure to file a required return penalties were sustained. The taxpayer did not demonstrate reasonable cause and “good faith” to mitigate the penalties. The taxpayer paid his advisors a flat fee of \$120,000, which was payable only if the transaction was completed, and relied solely on the advice of the advisors promoting the transaction; the tax advisors were not independent. Furthermore, “Paschall should have realized that the deal was too good to be true.”

Mr. Paschall had doubts, repeatedly asking whether the Roth restructure was legal. Despite these doubts, he never asked for an opinion letter or sought the advice of an independent adviser, including Mr. Jaeger, who was preparing his tax returns at the time he met Mr. Stover. This was even after he received a letter warning him that there might be problems with the Roth restructure and that his name was being turned over to the IRS.

a. Different taxpayer, same scam, same tax advisors, same result, this time citing and quoting *Canal*. Swanson v. Commissioner, T.C. Memo. 2011-156 (7/5/11). This case involved a transaction substantially similar to *Paschall*, *supra*, if not essentially identical. The taxpayer conceded the substantive excise tax penalty issue and contested only the penalty issue, which he lost. The court (Judge Wherry) rejected the taxpayer’s claim reasonable cause defense to the § 6662 penalties. The taxpayer claimed reliance on his tax advisors, who participated in structuring the transaction. In rejecting the taxpayer’s argument, Judge Wherry quoted from *Canal Corp. v. Commissioner*, 135 T.C. 199, 218 (2010): “Courts have repeatedly held that it is unreasonable for a taxpayer to rely on a tax adviser actively involved in planning the transaction and tainted by an inherent conflict of interest.” Judge Wherry found that “at a minimum” the tax advisors on whom the taxpayer relied “had a conflict of interest and were not independent” because they “set up the various entities and coordinated the deal ‘from start to finish’.” They “were paid ‘a flat fee for implementing *** [the Roth restructure] and wouldn’t have been compensated at all if *** [Mr. Swanson] decided not to go through with it.’ Therefore [the taxpayers] cannot argue that their reliance on [the tax advisors] establishes reasonable cause and good faith.”

7. “Same taxpayer” really does mean the same taxpayer. Energy East Corp v. United States, 645 F.3d 1358 (6/20/11). Section 6621(d) deals with overlapping periods of underpayment and overpayment by the “same taxpayer” by imposing a net interest rate of zero on the equivalent underpayment and overpayment for the period of the overlap. Energy East Corporation filed a refund claim, seeking to offset the

amount it underpaid in 1999 with amounts two of its subsidiaries overpaid from 1995–97, even though consolidation did not occur until 2000 and 2002. The Court of Appeals for the Federal Circuit (Judge Gajarsa) held that § 6621(d) did not apply in this situation. The parent and the subsidiaries were not the same taxpayer in the pre-consolidation years that the underpayments and overpayments were made. The court rejected the taxpayer’s argument that § 6621(d) merely requires the taxpayers to be the same only as of the time the netting claim was filed. The court rejected the taxpayer’s alternative argument that § 6621(d) allows interest netting when two or more corporations file consolidated returns for years during which interest accrues.

a. But a particular corporation is the “same taxpayer” after it joins a consolidated group as it was before it joined the consolidated group, even though *Energy East* is law of the Circuit. Magma Power Co. v. United States, 101 Fed. Cl. 562 (10/28/11). Prior to 2/24/95, Magma Power was not part of a consolidated group. In 2000 Magma Power was assessed a deficiency for 1993, which it paid in 2002 and 2003. In 2004 and 2005, the IRS determined that the consolidated group of which Magma Power was a member overpaid its taxes for the years 1995-1998 and paid a refund. A portion of the refund for those years was attributable to an original overstatement of Magma Power’s contribution to consolidated taxable income. The Court of Federal Claims (Judge Baskir) held that for purposes of applying the interest netting rule of § 6621(d), Magma Power was the “same taxpayer” with respect to its underpayment for 1993, before it joined a consolidated group and with respect to the consolidated group’s overpayments for the period of 1995 through 1998. The court rejected the government’s argument that the “plain meaning” of § 6621(d) “contemplates a complete identity between the entities reflected on the tax returns in question, regardless of which specific taxpayers are responsible for underpayments and overpayments,” reasoning – correctly in our opinion – that the group is not a “taxpayer” under the Code. The court distinguished *Energy East Corp v. United States*, 645 F.3d 1358 (Fed. Cir. 6/20/11), *supra*, because the overpayments and underpayments in that case related to different corporations and were with respect to pre-consolidation years.

8. Does he go to “Club Fed” or do “hard time”? United States v. Cooper, 645 F.3d 1104 (10th Cir. 8/15/11). The Tenth Circuit upheld the criminal conviction for wire fraud under 18 U.S.C. § 1343 and mail fraud under 18 U.S.C. § 1341 of an individual who was the founder, president, and CEO of Renaissance, The Tax People, Inc., a corporation that marketed and sold tax materials — the “Tax Relief System” — and a bundle of services — Platinum Tax Advantage — aimed at home based businesses. The package included a scheme to enable anyone associated with

Renaissance to avoid paying taxes on their W-2 income through the use of the “W-4 Exemption Increase Estimator” and fraudulently claimed deductions, including the cost of vacations, “wages/allowance paid to children,” commuting miles, and “unreasonable percentage use of the home for business purposes.”

- Somehow the jury had acquitted him of aiding and abetting in the preparation of fraudulent returns under § 7602(2).

9. Enjoy being enjoined. United States v. Stover, 650 F.3d 1099 (8th Cir. 8/16/11). The Eighth Circuit upheld a permanent injunction under § 7408 against an accountant barring him from promoting his “Parallel C,” “ESOP/S,” or “Roth/S” fraudulent tax evasion schemes.

10. The IRS must speak quickly or lose interest. T.D. 9545, Interest and Penalty Suspension Provisions Under Section 6404(g) of the Internal Revenue Code, 76 F.R. 52259 (8/22/11). The Treasury Department has promulgated Reg. § 301-6404-4, providing specific rules dealing with the suspension of interest, penalties, additions to tax, or additional amounts under § 6404(g), which suspends the accrual of interest for the period beginning one year (or eighteen months, if applicable) after the due date (or filing, if applicable) of the return if the return is timely filed and the IRS has not sent the taxpayer a notice of additional liability (e.g., a math error notice of deficiency), including an explanation of the basis for the liability, within one year following the later of (1) the due date of the return (*without* regard to extension) or (2) the date on which the taxpayer filed the return. (Interest resumes running twenty-one days after the IRS sends a notice to the taxpayer.) Among other things, the regulations provide (1) that a notice may be provided in person, to the taxpayer’s representative, or by mail (if notice is sent to taxpayer’s last known address under principles of § 6212(b); certified or registered mail is not required; (2) if a taxpayer files an amended return showing an increase in tax liability, the date on which the return was filed will be the filing date; if an amended return shows a decrease in tax liability, interest will not be suspended if the IRS proposes to adjust the items on the amended return.

11. If you’re the guy who doesn’t remit the wage withholding taxes to the IRS, you can’t claim a credit for taxes withheld, and you might be hit with a fraud penalty to boot. May v. Commissioner, 137 T.C. 147 (10/24/11). The taxpayer was the CEO and president, as well as a shareholder of his employer. The employer corporation withheld taxes from paychecks, but did not remit the taxes to the government. The taxpayer nevertheless claimed credit of the withheld taxes on his own return. Following the taxpayer’s conviction for criminal tax fraud, the IRS asserted a deficiency, and the taxpayer filed a Tax Court petition. The Tax Court (Judge

Goeke) held, first, that the Tax Court has jurisdiction over fraud penalties in a case involving a deficiency based on overstated withholding credits, citing *Rice v. Commissioner*, T.C. Memo. 1999-65. The Tax Court had jurisdiction over the case as involving a “deficiency” because an “underpayment” includes a taxpayer’s overstated credits for withholding under *Feller v. Commissioner*, 135 T.C. 497 (2010). The court rejected the taxpayer’s argument that under Reg. § 1.31-1 which provides that “[i]f the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer.” Instead, following *United States v. Blanchard*, 618 F.3d 562 (6th Cir. 2010), it concluded that “the proper test to determine whether actual withholding at the source occurred should consider whether the funds functionally left the control of a taxpayer. Such a test should not be strictly constrained by the multiple identities one person may have when acting in both a personal and a corporate capacity.” On the facts, “[b]ecause Mr. May was responsible for the nonremittance and fully controlled the corporate finances,” the court concluded that “that the funds never left Mr. May’s functional control and were therefore not ‘actually withheld at the source’ from his wages.” Furthermore, the IRS carried its burden of proof on the fraud issue and the 75-percent fraud penalty was justified with respect to the underpayments resulting from overstated withholding credits.

12. The Treasury explains the penalty for failing to rat yourself out regarding reportable transactions. T.D. 9550, Section 6707A and the Failure To Include on Any Return or Statement Any Information Required To Be Disclosed Under Section 6011 With Respect to a Reportable Transaction, 76 F.R. 55256 (9/7/11). Reg. § 301.6707A-1 provides that a taxpayer may incur a separate penalty under § 6707A with respect to each reportable transaction that the taxpayer was required, but failed, to disclose within the time and in the form and manner required under Reg. § 1.6011-4(d) and (e) or as stated in other published guidance. A taxpayer who is required to disclose a reportable transaction on a Form 8886 (or successor form) filed with a return, amended return, or application for tentative refund and who also is required to disclose the transaction on a Form 8886 (or successor form) with the Office of Tax Shelter Analysis (OTSA), is subject to only a single § 6707A penalty for failure to make either one or both of those disclosures. The regulations define “reportable transaction” and “listed transaction” by reference to the regulations under § 6011.

13. 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 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 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.”

(6) “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.”

(7) “... 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!

B. Discovery: Summonses and FOIA

1. Appraiser’s work papers are not protected by privilege when the appraisal is part of the tax return. United States v. Richey, 632 F.3d 559 (9th Cir. 1/21/11). The Court of Appeals held that the work papers of an appraiser hired by the taxpayer’s lawyer to provide a valuation for a conservation easement contributed to charity were not protected by attorney-client privilege. The appraisal was required by Reg. § 1.170A-13(c)(1) and was attached to the taxpayer’s tax return. “[A]ny communication related to the preparation and drafting of the appraisal for submission to the IRS was not made for the purpose of providing legal advice, but, instead, for the purpose of determining the value of the Easement.” Similarly, the file was not protected by the work product

doctrine, because the materials were not prepared “in anticipation of litigation.” Unless an appraisal had been attached to the return, the taxpayers would not have been entitled to any deduction at all. “Had the IRS never sought to examine the Taxpayers’ 2003 and 2004 federal income tax returns, the Taxpayers would still have been required to attach the appraisal to their 2002 federal income tax return. Nor is there evidence in the record that Richey would have prepared the appraisal work file differently in the absence of prospective litigation.”

- Query whether FIN 48 workpapers would be protected by work product privilege when a Schedule 1120-UTP prepared using those workpapers is part of a tax return? Note also the possibility of disclosure to the IRS by a whistleblower.

2. You can’t use the third party summons notice requirement as a heads-up to clean out the bank account. Viewtech, Inc. v. United States, 653 F.3d 1102 (9th Cir. 8/10/11). Section 7609(c)(1)(D)(i) exempts from the third-party summons notice requirement any summons issued in aid of collection of an assessment of tax against the person with respect to whose liability the summons is issued. In construing the application of this provision in *Ip v. United States*, 205 F.3d 1168 (9th Cir. 2000), the Ninth Circuit reasoned that “giving taxpayers notice in certain circumstances would seriously impede the IRS’s ability to collect taxes,” as would giving notice to fiduciaries or transferees of the taxpayer. It therefore concluded that the clause (i) exception should be given a limited reading to avoid vitiating the legislative purpose. In the instant case the court applied the § 7609(c)(1)(D)(i) to a summons issued to a bank with respect to a corporation in which the taxpayer owned 100 percent of the stock in one year and 97 percent of the stock in another year, and of which he was an officer. “This close legal relationship is sufficient to give [the taxpayer] the requisite interest in the Viewtech bank account such that Viewtech is disqualified from receiving notice under the clause (i) exception.” Because the corporation was not entitled to notice, it had no standing to seek to quash the summons.

3. You can’t hide your foreign bank account records behind the Fifth Amendment. M.H. v. United States, 648 F.3d 1067 (9th Cir. 8/19/11). 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.

C. Litigation Costs

1. Here’s a case of nonliteral interpretation of the Code that was taxpayer favorable. We didn’t know that courts can waive sovereign immunity without a clear statutory rule. Reynoso v. United States, 108 A.F.T.R.2d 2011-5654 (N.D. Cal. 8/8/11). In this refund case the taxpayer recovered over 80 percent of the refund sought, and the court awarded attorney’s fees under § 7430 because the government’s position was not substantially justified. The court also awarded attorney’s fees with respect to the taxpayer’s administrative refund claim, rejecting the government’s argument that because § 7430(c)(7) defines the term “position of the United States” with respect to administrative proceedings as the position taken “as of the earlier of: (i) the date of the receipt by the taxpayer of the notice of decision of the Office of Appeals, or (ii) the date of the notice of deficiency,” and in the refund claim the taxpayer never received a notice of decision from the IRS Office of Appeals or a notice of deficiency, the government has not taken a “position” with respect to taxpayer’s case at the administrative level. Without dealing with any technical interpretation of the statutory language, the court simply concluded that the IRS had taken an administrative position:

The IRS’s failure to respond to Plaintiff’s repeated requests for his refund and for the return of the unapplied portion of the cash bond was tantamount to a denial of those requests. The government cannot insulate itself from paying attorney’s fees by simply ignoring a refund request instead of issuing a formal denial. The Court thus rejects the government’s contention that it did not take a “position” prior to litigation in this case. Plaintiff is therefore entitled to costs and fees incurred at the administrative level.

D. Statutory Notice of Deficiency

1. Did the malefactor escape on a technicality or did the IRS chase the wrong guy as the malefactor? Shockley v. Commissioner, T.C. Memo. 2011-96 (5/2/11). The IRS sought to impose transferee liability (for corporate income taxes) on Shockley (an officer/shareholder who sold corporate stock in a Midco transaction) and

Shockley filed a Tax Court petition seeking dismissal of the proceeding for lack of jurisdiction because the statute of limitations had run. The Tax Court (Judge Cohen) ruled in favor of Shockley. At the time the IRS sent to the transferor corporation (and Shockley) the deficiency notice with respect to the asserted corporate tax liability, the IRS knew that it had not been sent to the transferor's last known address. In response to that deficiency notice Shockley, who was a former corporate officer of the transferor, had filed petition seeking dismissal of the proceeding for lack of jurisdiction because of the absence of proper notice. Because the Tax Court previously had held that the deficiency notice with respect to which the petition was filed was invalid, in the instant case it held that the period of limitations was not suspended. Thus, the notice determining that Shockley was subject to transferee liability was invalid because it was beyond the period of limitations. Because the statute of limitations was not suspended by the earlier invalid notice and the petition in response to that notice, the period of limitations on transferee liability under § 6901(c) – one year after the expiration of the period of limitation for assessment against the transferor – had expired.

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) six-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 includable 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, *cert. granted*, 132 S. Ct. 71 (9/27/11). 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 an 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 (9/24/09). 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] 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 (9/24/09). 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.

- The Supreme Court's decision in *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (1/11/11), holding that Treasury Regulations are entitled to deference under *Chevron*, *U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), will play a major role in who wins this shoot-out.

o. And 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). 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), *cert. granted*, 132 S. Ct. 71 (9/27/11). 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 De Moss 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*,—F.3d —, No. 09-2353) 2011 WL 361495, *7 (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 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.

[The Supreme Court expressly found the predecessor statute ambiguous, and turned to the legislative history to resolve the question. ... (“[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.”

[The 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 were 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.

- The opinion of the Court of Appeals for the Federal Circuit does not directly address the question raised in *Home Concrete & Supply Company, LLC v. United States*, 634 F.3d 249 (4th Cir. 3/11/11) cert. granted, 132 S. Ct. 71 (9/27/11), which held that Reg. § 301.6501(e)-1(a)(1)(ii) was not applicable because according to the terms of the regulation it applies only to taxable years with respect to which the statute of limitations remained open on and after Sept. 24, 2009, and the three-year statute of limitations had expired before that date. Again, this is an argument, and a holding, that we simply cannot understand, other than as the taxpayer’s and court’s expression of gut feelings that it is “dirty pool” for the Commissioner to put his thumb on the regulatory scale to affect an issue pending before a court, even though in *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (1/11/11), the Supreme Court appears to have expressly blessed such a tactic, albeit in litigation over an different issue.

s. **Did anyone really expect the Tax Court to roll over and play dead just because the IRS promulgates regulations that say it wins?** *Carpenter Family Investments v. Commissioner*, 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 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 Found. For Med. Educ. & 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. 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) and 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 § 65019e) does not apply to basis overstatements and that Reg. § 301.6501(e)-1 is invalid.

• The court noted that “The 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), 132 S. Ct. 71 (9/27/11). It declined invitations from the government to consider cases from the Fifth and Seventh Circuits.

2. “It takes real chutzpah for Donnelley to demand a refund under these circumstances.” – J. Harvie Wilkinson III. That sentence seems uncharacteristic from a good ol’ Virginia boy, but his birth certificate shows he was born in New York City. R.H. Donnelley Corp. v. United States, 641 F.3d 70 (4th Cir. 3/31/11). The taxpayer filed a timely refund claim with respect to 1991 and 1992 resulting from carrying back approximately \$11 million of excess credits from 1994. In response the IRS conducted an audit and disallowed a large deduction for 1994 and calculated a \$43 million deficiency for 1994, which was not assessed because 1994 was a closed year, the taxpayer having filed its refund claim two days before the statute of limitations expired. Based on this recalculation, the IRS determined that all of the credits had been used in 1994, and none could be carried back. The Court of Appeals (Judge Wilkinson) upheld the IRS's determination, applying the rule of *Lewis v. Reynolds*, 284 U.S. 281 (1932). The court observed as follows.

... Donnelley was not content merely to escape from its tax liability in the first instance. It filed a refund claim two days before the statute of limitations for the assessment of 1994 taxes expired, presumably counting on the fact that the IRS could not investigate any underpayment in time to collect it. That refund claim depended on credits that could be carried back only because Donnelley had misreported its taxes in the first place. It is true that the statute of limitations may protect Donnelley from additional collection, but it does not give Donnelley license to claim a second windfall in the form of a refund. To claim otherwise is almost beyond belief.

- The court then concluded by stating:

No one is entitled a refund who has not actually overpaid his taxes. This axiomatic observation, made first by the Supreme Court in *Lewis* and recognized by this circuit in *Estate of Michael* [*v. Lulo*, 173 F.3d 503 (4th Cir. 1999)], defeats this taxpayer's claim. Here, Donnelley has not overpaid its taxes, and we will not allow it to reap where it has not sown.

a. Although the government can assert underpayments beyond the period of limitations as a defense in refund suits, taxpayers cannot assert overpayments beyond the period of limitations on refunds as a set off against a deficiency. Brady v. Commissioner, 136 T.C. 422 (4/28/11). In reviewing a CDP determination, the Tax Court (Judge Ruwe) held that alleged overpayments in prior years for which the taxpayer had filed timely refund claims, which were denied and with respect to which the taxpayer had failed to file a timely refund suit, could not be taken into account to reduce his liability for the year in question.

3. Mitigation of limitations permitted where taxpayer was inconsistent. Anthony v. Commissioner, T.C. Summ. Op. 2011-50 (4/18/11). The Tax Court (Judge Swift) held that a taxpayer who erroneously overstated the amount of her Schedule C closing inventory in the 2004 open year was behaving inconsistently when she asserted that the overstated amount could nevertheless be used as her opening inventory amount in the 2005 year, which had been closed by the statute of limitations. The IRS permitted her to correct the overstatement for 2004 as part of a stipulated decision entered on 12/31/09. In a classic mitigation of limitations scenario under §§ 1311-1314, the deficiency asserted by the IRS on 1/7/10 based on the corrected opening inventory amount for the otherwise closed 2005 year was upheld.

4. A durable power of attorney is a good thing, right? Not when § 6511(h) is in play. *Platt v. United States*, 99 Fed. Cl. 634 (8/19/11). The taxpayer, who suffered from dementia and not able herself to manage her financial affairs, filed a refund claim more than three years after paying the tax. Section 6511(h) tolls the statute of limitations on filing refund claims for any period that the taxpayer is unable to manage his financial affairs by reason of a medically determined physical or mental impairment that will result in death or that has lasted or can be expected to last at least twelve months. The statute is not tolled, however, if another person is authorized to manage the taxpayer's financial affairs. The court held that the taxpayer was not entitled to § 6511(h) relief, because her son had authority under a durable power of attorney to act on her behalf on financial matters.

F. Liens and Collections

1. The IRS has an obligation to cooperate with taxpayers too. *Azzari v. Commissioner*, 136 T.C. 178 (2/24/11). In a CDP proceeding the taxpayer requested the IRS to subordinate its tax lien for unpaid employment taxes to the third-party lender that was lending the taxpayer funds to pay current employment taxes and to enter into an installment agreement with respect to the back taxes. In reviewing the IRS's determination not to grant CDP relief, the Tax Court (Judge Wells) held that the Appeals Office had abused its discretion because it had misinterpreted § 6323(c) and the regulations thereunder (governing the priority of liens in certain commercial financing arrangements). "Although the Commissioner's Appeals Office has discretion under § 6325(d) to determine whether it is in the Government's interest to subordinate a Federal tax lien, it appears that Mr. Lee's refusal to consider petitioner's request to subordinate the lien was based on an error of law. To the extent it was based upon an error of law, his determination constitutes an abuse of discretion." Furthermore, the refusal to consider the taxpayer's request for an installment agreement also was an abuse of discretion. Although the IRS's refusal to consider an installment agreement when the taxpayer is not satisfying current obligations is not generally an abuse of discretion, in this case the IRS's refusal to subordinate its tax lien contributed to the taxpayer falling behind on current employment tax payments, and the taxpayer was denied a chance to become current.

2. Day trading is dissipation of assets. Well, duh! *Tucker v. Commissioner*, T.C. Memo. 2011-67 (3/22/11). The taxpayer was a day trader, who at a time he owed the IRS \$39,000, lost \$22,645 in his day trading activities. In calculating the reasonable collection potential for purposes of evaluating the taxpayer's offer in compromise, the Office of Appeals considered his day trading to constitute asset dissipation that

warranted rejection of his OIC. The Tax Court (Judge Gustafson) upheld the IRS's determination in a CDP hearing to reject the taxpayer's OIC.

3. The IRS loses a “battle of the forms.” Thornberry v. Commissioner, 136 T.C. 356 (4/19/11). The taxpayers' request for a CDP hearing, though it was a “boilerplate form” copied from an internet website, might have set forth legitimate issues, among those that were not legitimate. The IRS's response with a “boilerplate form” that did not address those issues was inappropriate. The letter from the Appeals Office stating that the taxpayers' request for a collection due process hearing would be disregarded because the request was frivolous and intended only to delay or impede the collection of tax constituted a “determination” subject to review by the Tax Court. The court (Judge Dawson) ordered the taxpayers to identify specific issues and the grounds that they wished to raise before issuing any further orders.

4. What's a little non-*ex parte* among friends? Hoyle v. Commissioner, 136 T.C. 463 (5/23/11). The Tax Court held that neither the ABA Model Code of Judicial Conduct nor a state law Code of Judicial Conduct was relevant to communications between personnel of the IRS Office of Chief Counsel and an Appeals Division officer conducting a CDP hearing. Rev. Proc. 2000-43, 2000-2 C.B. 404, is the relevant authority in nondocketed cases and Chief Counsel Notice CC-2007-006 is the relevant authority in docketed cases, including, as in the instant case, a CDP remand from the Tax Court. Much of the communication in this case was merely ministerial. Furthermore, “[a] request by a hearing officer for legal advice in connection with the remanded CDP case may be handled by the Counsel attorney who is handling the docketed Tax Court case, so long as that attorney did not give legal advice to an originating function (e.g., Collection) concerning the same issue in the same case.” The Counsel attorney provided legal advice on specific issues, such as whether the taxpayer could challenge the underlying liability if he had received a notice of deficiency. The Counsel attorney's review of the Appeals Officer's draft supplemental notice of determination was meant to ensure that the supplemental notice of determination on remand complied with the Tax Court's order, and was not an impermissible *ex parte* communication. Thus, there was no prohibited *ex parte* contact.

5. OICs must be realistic; the taxpayer must feel the pain. Johnson v. Commissioner, 136 T.C. 475 (5/31/11). The IRS did not abuse its discretion in rejecting the taxpayer's offer in compromise of an amount that was based solely on the proceeds available from a single asset, which ignored future disposable income. Reasonable collection potential included some amount of future disposable income.

6. “When in doubt, the bank wins.” – Even against the IRS this time. Bloomfield Bank v. United States, 644 F.3d 521 (7th Cir. 5/1/11). Reversing a District Court decision, the Court of Appeals (Judge Posner), held that a mortgage that assigns future rental income to the mortgagee creates a security interest that takes priority over a federal tax lien. The rental income from the property is not a distinct form of property; it is merely proceeds of owning a rented property, as are the sales proceeds.

7. The divorce bought the taxpayer a second bite at a CDP hearing. Churchill v. Commissioner, T.C. Memo. 2011-182 (8/1/11). The Tax Court (Judge Holmes) held that it has authority to remand a CDP determination, even though the IRS did not abuse its discretion, where there has been a material change in a taxpayer’s factual circumstances between the time of the hearing and the time of the Tax Court review. The taxpayer’s divorce after the CDP hearing with respect to an offer in compromise was such a change in circumstances.

8. The taxpayer won on the evidentiary issue, but that was all. Kreit Mechanical Associates, Inc. v. Commissioner, 137 T.C. 123 (10/3/11). The taxpayer sought review of the IRS’s CDP determination following the rejection of the taxpayer’s offer in compromise. The IRS’s determination was based on its conclusion that the entire amount due was collectible after it found that a 75-percent discount of taxpayer’s accounts receivable was inappropriate in valuing its assets. Applying the *Golsen* rule (*Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff’d*, 445 F.2d 985 (10th Cir. 1971), following Ninth Circuit precedent (*Keller v. Commissioner*, 568 F.3d 710, 718 (9th Cir. 2009)), the Tax Court (Judge Wherry) limited the review of the administrative determination to the administrative record. However, under an exception to the administrative record rule in the Ninth Circuit by which “[t]he extra-record inquiry is limited to determining whether the agency has considered all relevant factors and has explained its decision,” *Friends of the Payette v. Horseshoe Bend Hydroelectric Co.*, 988 F.2d 989, 997 (9th Cir. 1993), as a preliminary matter, Judge Wherry allowed into evidence, over the IRS’s objection, a report by an expert witness (a former IRS revenue officer and settlement officer, with over thirty years of experience) for the taxpayer that “opine[d] on other factors that [the expert witness] believed the settlement officer should have taken into account when evaluating [taxpayer’s] offer-in-compromise and ability to make payments, because “the report is helpful to the Court in understanding respondent’s administrative procedures and options and assists the Court in comprehending the evidence.” Having done so, the court quickly concluded that the IRS had not abused its discretion.

9. Ya gotta tell the court ya want a speedy trial. Thompson v. United States, 106 A.F.T.R.2d 2010-6464 (N.D. Ill. 9/29/10). The failure of the district court to review a jeopardy assessment within twenty days, as required by § 7429(b)(2) is not alone grounds for entering judgment for the taxpayer. The taxpayer bears the responsibility for informing the district court of the statutory time deadline. The taxpayer failed to do so.

a. The Seventh Circuit echoes the District Court: Ya gotta tell the court ya want a speedy trial. Thompson v. United States, 448 Fed. Appx. 878 (7th Cir. 11/3/11), *aff'g* 106 A.F.T.R.2d 2010-6464 (N.D. Ill. 9/29/10). The failure of the district court to review a jeopardy assessment within twenty days, as required by § 7429(b)(2) is not alone grounds for entering judgment for the taxpayer. The twenty-day provision is “‘only a strong admonition for the judiciary to act expeditiously’ rather than ‘a limitation on the lower courts’ jurisdiction...’”; the levy should not be voiding unless the plaintiff has shown extraordinary diligence in informing the court that the case is ready for a prompt ruling. The taxpayer bears the responsibility for informing the district court of the statutory time deadline. The taxpayer failed to do so.

10. IRS mails wrong form, but provides required information. Just as in the NBA, no harm, no foul. Conway v. Commissioner, 137 T.C. No. 16 (12/19/11). If the IRS fails to comply with the requirement of § 6303(a) that within sixty days of the assessment it notify the taxpayer and demand payment, the IRS may be barred from collecting through nonjudicial procedures. In this CDP case involving trust fund taxes owed by a failed airline, the Tax Court (Judge Paris) followed *Hughes v. United States*, 953 F.2d 531 (9th Cir. 1992), holding that the form on which a notice of assessment and demand for payment is made is irrelevant as long as it provides the taxpayer with all of the information required by § 6303. In the case at bar, with respect to one taxpayer [the failed airline’s CFO] a levy notice constituted adequate notice under § 6303 because it went beyond the typical notice of intent to levy by including a demand for immediate payment of the specific amounts of the taxes owed, listed by period, within sixty days of the assessment, even though no earlier adequate notice had been provided.

• However, with respect to another taxpayer [the failed airline’s CEO], a lien notice that merely reflected that unpaid taxes were owed, but which did not state the amounts, types, or periods of the unpaid taxes, was not adequate notice under § 6303(a). The court rejected the IRS’s argument that the taxpayer’s multiple communications with IRS Appeals before the assessments regarding the amounts of the unpaid taxes had provided him with constructive notice.

11. Bankruptcy doesn't prevent the IRS from collecting tax shelter based deficiencies. In re Vaughn, 463 B.R. 531 (Bankr. Colo. 12/28/11). The taxpayer's tax debts arising from disallowed "BLIPS" tax shelter losses were excepted from discharge under the 11 U.S.C. § 523(a)(1)(C) fraudulent return and/or willful evasion provisions. Fraudulent return evidence included facts that despite taxpayer's business experience and savvy, he disregarded numerous red flags about the BLIPS transaction, relied on the promoter's advice, and entered into the transaction without obtaining a truly independent opinion as to its potential and its tax implications.

G. Innocent Spouse

1. That regulation ain't got no equity and it ain't got no empathy, so it's invalid. The Tax Court majority responds to "the sound of [congressional] silence." Lantz v. Commissioner, 132 T.C. 131 (4/7/09) (reviewed, 12-4). The taxpayer sought equitable relief from joint income tax liability under § 6015(f), but the IRS denied relief on the ground that she had not requested relief within two years from the IRS's first collection action, as required by Reg. § 1.6015-5(b)(1). Consequently, the IRS did not reach the substantive issues of the claim. In a reviewed opinion by Judge Goeke, joined by eleven judges, with four dissents, the Tax Court held Reg. § 1.6015-5(b)(1) to be invalid as applied to § 6015(f) relief. (Following the *Golsen* rule, the Tax Court applied *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), because the Seventh Circuit held in *Bankers Life & Cas. Co. v. United States*, 142 F.3d 973, 979 (7th Cir. 1998), that regulations issued under general or specific authority of the IRS to promulgate necessary rules are entitled to *Chevron* deference; Reg. § 1.6015-5 was issued under both a general grant of authority under § 7805 and a specific grant of authority in § 6015(h).) The court focused on the explicit inclusion of a two-year deadline in both § 6015(b) and § 6015(c), in contrast to the absence of any deadline in § 6015(f), to find that the regulation was not a reasonable interpretation of the statute under the *Chevron* standard.

"It is generally presumed that Congress acts intentionally and purposely' when it 'includes particular language in one section of a statute but omits it in another'". ... We find that by explicitly creating a 2-year limitation in subsections (b) and (c) but not subsection (f), Congress has "spoken" by its audible silence. Because the regulation imposes a limitation that Congress explicitly incorporated into subsections (b) and (c) but omitted from subsection (f), it fails the first prong of *Chevron*. ...

Had Congress intended a 2-year period of limitations for equitable relief, then of course it could have easily included in subsection (f) what it included in subsections (b) and (c). However, Congress imposed no deadline, yet the Secretary prescribed a period of limitations identical to the limitations Congress imposed under section 6015(b) and (c).

- As a result, the IRS abused its discretion in failing to consider all facts and circumstances in the taxpayer's case. Further proceedings are required to fully determine the taxpayer's liability.

a. You don't have to actually know the IRS denied § 6015(b) relief for the statute of limitations on seeking review to have expired, but you can always turn to § 6015(f), which for now appears to have an open-ended period for review. Mannella v. Commissioner, 132 T.C. 196 (4/13/09), *rev'd*, 631 F.3d 115 (3d Cir 1/19/11). The IRS sent the taxpayer a notice of intent to levy and notice of the right to a § 6330 CDP hearing on 6/4/04. On 11/1/06, more than two years later, the taxpayer requested § 6015 relief from joint and several liability, which the IRS denied on the grounds that the request was untimely. The taxpayer claimed that she did not receive her notice of intent to levy because her former husband received the notices, signed the certified mail receipts, and failed to deliver, or inform her of, the notices. Judge Haines held that actual receipt of the notice of intent to levy or of the notice of the right to request relief from joint and several liability is not required for the two-year period in which to request relief under §§ 6015(b) and (c) to begin. The taxpayer's request for relief under §§ 6015(b) and (c) was not timely. However, the taxpayer's claim for relief under § 6015(f), was timely because *Lantz v. Commissioner*, 132 T.C. 131 (4/7/09), held that Reg. § 1.6015-5(b)(1), requiring a request for relief within two years from the IRS's first collection action, is invalid as applied to § 6015(f) relief.

b. But the IRS will fight this one to the bitter end! CC-2010-005, Designation for Litigation: Validity of Two-Year Deadline for Section 6015(f) Claims Under Treas. Reg. § 1.6015-5(b)(1) (3/12/10). This Chief Counsel Notice states that because the issue of the validity of the two-year deadline in Reg. § 1.6015-5(b)(1) for filing a claim for § 6015(f) relief, which was held to be an invalid regulation in *Lantz v. Commissioner*, 132 T.C. 131 (2009), has been designated for litigation by the Office of Chief Counsel, the IRS will continue to deny claims for relief under § 6015(f) as untimely and will not settle or concede this issue. However, depending on the facts of the case, the merits of the § 6015(f) claim might be conceded.

c. **And the IRS's bitter-end fight to validate the regulation ended up in the Seventh Circuit, where Judge Posner denied the existence of "audible silence."** *Lantz v. Commissioner*, 607 F.3d 479 (7th Cir. 6/8/10) (*Lantz II*). The taxpayer was described as "a financially unsophisticated woman whose husband, a dentist, was arrested for Medicare fraud in 2000, convicted and imprisoned. They had been married for only six years when he was arrested and there is no suggestion that she was aware of, let alone complicit in, his fraud." She received a packet that included a notice of a proposed levy on her in 2003, but did not respond because her estranged husband told her "he'd deal with the matter." He asked the IRS to send the application form for seeking innocent-spouse relief, explaining that his wife was an "innocent spouse," but he died before filing it. In 2006, the IRS applied the taxpayer's \$3,230 income tax refund for 2005 to her joint and several liability for 1999 of more than \$1.3 million. "Unemployed and impecunious, she applied for innocent-spouse relief but the IRS turned her down because she'd missed the two year-deadline" The Seventh Circuit (Judge Posner), sustained the regulation and agreed with the IRS's denial of relief, stating, "... any statute of limitations will cut off some, and often a great many, meritorious claims."

• Judge Posner denied the existence of "audible silence" in the following words:

But even if our review of statutory interpretations by the Tax Court were deferential, we would not accept "audible silence" as a reliable guide to congressional meaning. "Audible silence," like Milton's "darkness visible" or the Zen *koan* "the sound of one hand clapping," requires rather than guides interpretation. Lantz's brief translates "audible silence" as "plain language," and adds (mysticism must be catching) that "Congress intended the plain language of the language used in the statute."

• In sustaining the regulation Judge Posner reasoned as follows;

Agencies ... are not bashful about making up their own deadlines[,] ... and because it is as likely that Congress knows this as that it knows that courts like to borrow a statute of limitations when Congress doesn't specify one, the fact that Congress designated a deadline in two provisions of the same statute and not in a third is not a compelling argument that Congress meant to preclude the Treasury Department from imposing a deadline applicable to cases governed by that third provision"; if there is no deadline in subsection (f), the two-year deadlines in subsections (b) and (c) will be set largely at naught because the substantive

criteria of those sections are virtually the same as those of (f). ...

We must also not overlook the introductory phrase in subsection (f) — “under procedures prescribed by the [Treasury Department]”—or the further delegation in 26 U.S.C. § 6015(h) to the Treasury to “prescribe such regulations as are necessary to carry out the provisions of” section 6015. In related contexts such a delegation has been held to authorize an agency to establish deadlines for applications for discretionary relief.

• The opinion concludes with the hope that the IRS would grant taxpayer relief under § 6343 from its levy on taxpayer by declaring the taxes “currently not collectible” as follows:

Ironically, the Service declared the taxes owed by Lantz’s husband – the crooked dentist – “currently not collectible.” She is entitled *a fortiori* to such relief, and there is no deadline for seeking it. We can at least hope that the IRS knows better than to try to squeeze water out of a stone.⁵

d. And the Tax Court responds with a big “raspberry” to Judge Posner. Hall v Commissioner, 135 T.C. 374 (9/22/10). In a reviewed opinion by Judge Goeke, in which seven judges joined, the Tax Court adhered to its position in *Lantz*, supra, that Reg. § 1.6015-5(b)(1) imposing a two-year statute of limitations on claims for relief under § 6015(f) is invalid, notwithstanding the reversal of its decision in *Lantz* by the Seventh Circuit. Five judges dissented.

e. The Third Circuit likes the way Judge Posner thinks and gives a big “raspberry” to the Tax Court. Mannella v. Commissioner, 631 F.3d 115 (3d Cir. 1/19/11), *rev’g* 132 T.C. 196 (4/13/09). In a 2-1 decision written by Judge Greenberg, the Third Circuit reversed the Tax Court and upheld the two-year statute of limitations on taxpayers seeking § 6015(f) equitable relief provided in Reg. § 1.6015-5(b)(1). According to Judge Greenberg’s opinion, “[w]e cannot say that section 6015, in terms, requires that we embrace any particular view of Congress’s intent with respect to a subsection (f) filing deadline,” and “the absence of a statutory filing deadline in subsection (f) similar to those in subsections (b) and (c) does not require us to conclude that the Secretary cannot impose a two-year deadline by regulation.” In the course of applying step one of its *Chevron* analysis, the court stated “[w]e agree with the Court of Appeals for the Seventh Circuit that this silence is not made audible by the presence of deadlines in subsections (b) and (c).” Turning to step two of its *Chevron*

5. *But cf.*, Exodus 17:1-7 and Numbers 20:1-13.

analysis, the court acknowledged that the taxpayer's argument that the legislative history of § 66(c), which provides relief similar to § 6015(e) relief for taxpayers in community property states who do not file a joint return and which was enacted at the same time as § 6015(f), suggested that there should not be a rigid statute of limitations on seeking § 6015(f) equitable relief, "lends some support to [the taxpayer's] position," but concluded that "it fails to overcome the deference that we must give to Treasury Regulation § 1.6015-5(b)(1) under *Chevron* and it does not clearly demonstrate that Congress intended that requests for relief under subsection 6015(f) not be subject to a two-year filing deadline." Additionally, the court likewise rejected the taxpayer's argument that "the inclusion of deadline periods in subsections (b) and (c) but omission of such a period in subsection (f) "demonstrates Congressional intent that requests for equitable relief not be subject to a bright-line time limitation, but rather allow the taxpayer to request relief during the 10-year collection period of 26 U.S.C. § 6502." However, the Court of Appeals remanded the case to the Tax Court to determine whether the statute of limitations in Reg. § 1.6015-5(b)(1) is subject to equitable tolling and, if so, whether the taxpayer met the standards for equitable tolling.

- Judge Ambro dissented. He agreed with the majority, and disagreed with the Tax Court, on the question of whether Congress had spoken directly on the issue of the time frame in which the taxpayer must seek § 6015(f) relief, but would have invalidated Reg. § 1.6015-5(b)(1) in step two of the *Chevron* analysis on the ground that in promulgating the regulation, "the IRS has not advanced any reasoning for its decision to impose a two-year limitations period on taxpayers seeking relief under subsection (f), leaving us no basis to conduct the analysis mandated by *Chevron* step two." He reasoned that "it is ... a necessary corollary of the deference owed to agencies—that courts may not supplement deficient agency reasoning," and did not find Judge Posner's reasoning in *Lantz v. Commissioner*, 607 F.3d 479 (7th Cir. 6/8/10), to be convincing.

f. Stand by your *Lantz*. *Pullins v. Commissioner*, 136 T.C. 432 (5/5/11). The Tax Court (Judge Gustafson) reaffirmed that it would continue to follow its decision in *Lantz v. Commissioner*, 132 T.C. 131 (2009), *rev'd*, 607 F.3d 479 (7th Cir. 2010), that the two-year deadline for seeking equitable relief from joint and several liability under § 6015(f) imposed by Reg. § 1.6015-5(b)(1) is invalid, notwithstanding the contrary decisions by the U.S. Courts of Appeals for the Seventh Circuit in *Lantz II* and for the Third Circuit in *Mannella v. Commissioner*, 631 F.3d 115, *rev'g*, 132 T.C. 196 (2009). On the facts, relief was granted. Three factors supported denying relief – (1) the taxpayer's failure to prove economic hardship, (2) her lack of a reasonable expectation that her husband would pay the liabilities when she signed the returns, and

(3) her failure to timely file her returns and pay her taxes since the years in issue. Four factors favored granting relief – (1) the taxpayer’s divorce from her husband, (2) his legal obligation pursuant to the divorce decree to pay the tax liabilities, (3) her lack of significant benefit from the nonpayment, and (4) her poor health. A fifth factor, her lack of knowledge of her husband’s unreported income, favored relief as to the deficiency for one particular year. Judge Gustafson found “especially weighty” “the fact that the divorce court – with the family’s circumstances set out before it in greater detail than was possible in our tax case – determined that [the taxpayer’s husband] should pay the taxes, placed proceeds in his hands sufficient to do so, and allocated resources to Ms. Pullins on the assumption that he would do so and she would not have to.”

g. But *Lantz* doesn’t allow a mulligan if the tax payer has already litigated denial of relief in another forum. Haag v. Commissioner, T.C. Memo. 2011-87 (4/19/11). The taxpayer had sought § 6015 relief in a District Court proceeding in which the government sought to reduce unpaid assessments to judgment, and relief was denied on the ground that her claim was not timely. That decision was affirmed on appeal. In the instant Tax Court proceeding, the taxpayer sought § 6015(f) relief for the same years, claiming that because *Lantz* invalidated the two-year deadline for seeking equitable relief from joint and several liability under § 6015(f) imposed by Reg. § 1.6015-5(b)(1) changed the law, her claim was not barred. The Tax Court (Judge Gustafson) held that res judicata barred the taxpayer’s claim; her claim for relief was an issue in the prior litigation, even though the merits were not reached, and she meaningfully participated. “[A] change in the law after a matter has been litigated does not change the claim-preclusive effect of the earlier decision.”

h. Another taxpayer loss. Jones v. Commissioner, 642 F.3d 459 (4th Cir. 6/13/11). Holds that Reg. § 1.6015-5(b)(1), which mandates a two-year limitations period for persons seeking equitable innocent spouse relief under § 6015(f), is valid. Judge Niemeyer used a *Chevron* analysis to follow the Seventh and Third Circuit precedents in *Lantz II* and *Mannella*.

i. And the IRS demonstrates that it has a heart by throwing in the towel even though it was consistently winning in the Courts of Appeals. Notice 2011-70, 2011-32 I.R.B. 135 (7/25/11). The IRS announced that it will no longer enforce Reg. § 1.6015-5(b)(1) limiting to two years after the date of the IRS’s first collection activity the period in which it would consider requests for equitable relief under § 6015(f). Under the new procedures, the IRS will consider requests for relief under § 6015(f) as long as the period of limitation on collection of

taxes provided by § 6502 remains open for the tax years at issue, and if the relief sought involves a refund of tax, the period of limitation on credits or refunds provided in § 6511 will govern whether the IRS will consider the request for relief for purposes of determining whether a credit or refund may be available. The relief from the truncated period of limitations is retroactive. For requests for § 6015(f) that have already been submitted and are under consideration, the IRS will consider the request for equitable relief even if the request was submitted more than two years after the first collection activity was taken if the applicable period of limitation under § 6502 or § 6511 was open when the request for equitable relief was filed. Individuals whose requests for equitable relief under § 6015(f) were denied by the IRS solely for untimeliness and were not litigated may reapply for § 6015(f) relief, and the original Form 8857 will be treated as a claim for refund for purposes of the period of limitation on refunds. For case in litigation, the IRS will concede the timeliness issue consistent with the position announced in the notice. For cases that were litigated and in which (1) the validity of the two-year deadline to request equitable relief was at issue, (2) the decision in the case is final, and (3) the IRS stipulated in the court proceeding that the individual's request for equitable relief would have been granted if the request had been timely, the IRS will not seek to collect from the individual any portion of the underlying liability for which equitable relief would have been granted.

j. 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.

2. The Tax Court strikes a blow for greater employment opportunities for tax lawyers. Harbin v. Commissioner, 137 T.C. 93 (9/26/11). The taxpayer sought § 6015(b) relief for taxes attributable to his former wife's gambling activities. The amount of the liability had been determined in a prior proceeding in which the issue of § 6015 relief had not been raised by the attorney who had jointly represented both spouses in both the tax proceeding and their contemporaneous divorce. Section 6015(g)(2) bars a spouse who has meaningfully participated in a court proceeding involving the taxable year in issue from subsequently electing innocent spouse relief under § 6015(b) or apportioned liability under § 6015(c). Judge Kroupa held that § 6015(b) did not bar the taxpayer from seeking § 6015(b) relief because, due to his attorney's conflict of interest in the prior proceeding, the taxpayer had not materially participated in the earlier proceeding. The taxpayer and his wife's "financial interests and interests in the allocation of liability for the deficiencies at issue were adverse in the prior deficiency case [and the attorney's] joint representation ... in the prior deficiency case created a conflict of interest." The taxpayer's wife had exercised control over the prior proceeding and all communication between the IRS and the taxpayer and his wife had been through the attorney. The attorney had not explained the conflict or sought a waiver. Nor had the attorney informed the taxpayer of the opportunity to seek § 6015 relief. The taxpayer had a "viable claim" for § 6015 relief, but the opportunity to raise that claim "was obscured and obstructed" by the attorney's joint representation. After holding that the bar of § 6015(g)(2) did not apply, Judge Kroupa went on to grant § 6015(b) relief on the facts, because the IRS had stipulated that § 6015(b) relief was warranted if the § 6015(g)(2) bar did not apply.

3. 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. No. 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. Congress discovers that corporations as well as unincorporated businesses might cheat less if payors rat them out to the IRS. The 2010 Health Care Act amended § 6041 to extend to payments to corporations the information reporting requirement for all payments by a business to any single payee (other than a payee that is a tax exempt corporation) aggregating \$600 or more in a calendar year for amounts paid in consideration for property or services. However, the expanded rule does not override other specific Code provisions that except payments from reporting, for example, securities or broker transactions as defined under § 6045(a) and the regulations thereunder. The new rule is effective for payments made after 12/31/11.

a. This provision was repealed one year later, before it went into effect. On 4/14/11, President Obama signed legislation to repeal the burdensome 1099 reporting requirements enacted under health care legislation [PPACA].

2. IRS releases recommendations that paid tax return preparers would be required to register. IR-2010-1, 2010 TNT 2-1 (1/4/10). The IRS released a list of recommendations that would require that individuals who sign a tax return as a paid preparer pay a user fee to register online with the IRS and obtain a preparer tax identification number [PTIN]. All preparers – except attorneys, CPAs and enrolled agents – would have to

pass competency exams and complete 15 hours of annual CPE in federal tax law topics. The IRS proposes to expand Circular 230 to cover all signing and nonsigning return preparers. Registered preparers would be listed on a publicly-searchable data base and would be required to have PTINs in 2011.

a. We wish we had Karen's confidence in Accenture. The IRS Office of Professional Responsibility is not at all concerned with the task of registering paid tax preparers. That is because Accenture will be the vendor to establish a system for on-line registration, with a target date of 9/1/10. Accenture will undoubtedly bring to this task the same thoughtful foresight and judgment it used when it selected Tiger Woods as its leading spokesperson. 2010 TNT 85-24 (5/4/10). The IRS announced that Accenture National Security Services, LLC, will be the vendor to establish a system for on-line registration of paid tax return preparers. "The vendor will develop and maintain the registration application system and address related questions." Karen Hawkins, Director of the IRS Office of Professional Responsibility recently stated that she was not worried about registration of paid preparers because Accenture would take care of it completely.

b. Some of us learned about the concept of "fee simple" in school but these will not be "simple fees"; instead there will be multiple fees – some of which will be raked off by Accenture. REG-139343-08, User Fees Relating to Enrollment and Preparer Tax Identification Numbers, 75 F.R. 43110 (7/23/10). Registration for an identifying number, together with a \$50 fee will be required for all tax return preparers who prepare all, or substantially all, of a return or claim for refund of tax after 12/31/10. Accenture may charge a "reasonable fee" that is independent of the \$50 user fee.

- The IRS later confirmed that the user fee for the first year of registration will be \$64.25; the excess \$14.25 will permit Accenture to "wet its beak."

c. The IRS issued proposed regulations which would regulate tax return preparers and establish a new class of practitioner – a "registered tax return preparer" – whose qualifications obviously exceed those of any other class of practitioner. REG-138637-07, Regulations Governing Practice Before the Internal Revenue Service, 75 F.R. 51713 (8/19/10). These proposed regulations would amend Circular 230 to apply to all paid return preparers and identify exactly which preparers have a registration obligation. They would also change the general Circular standard of contact from "more likely than not" to "reasonable basis" [*sic*].

Specifically, the proposed regulations establish "registered tax return preparers," as a new class of practitioners.

Sections 10.3 through 10.6 of the proposed regulations describe the process for becoming a registered tax return preparer and the limitations on a registered tax return preparer's practice before the IRS. In general, practice by registered tax return preparers is limited to preparing tax returns, claims for refund, and other documents for submission to the IRS. A registered tax return preparer may prepare all or substantially all of a tax return or claim for refund, and sign a tax return or claim for refund, commensurate with the registered tax return preparer's level of competence as demonstrated by written examination. The proposed regulations also revise section 10.30 regarding solicitation, section 10.36 regarding procedures to ensure compliance, and section 10.51 regarding incompetence and disreputable conduct.

Proposed regulations under section 6109 of the Code (REG-134235-08) published in the Federal Register (75 FR 14539) on March 26, 2010, also implement certain recommendations in the Report. The proposed regulations under section 6109 provide that, for returns or claims for refund filed after December 31, 2010, the identifying number of a tax return preparer is the individual's preparer tax identification number (PTIN) or such other number prescribed by the IRS in forms, instructions, or other appropriate guidance. The proposed regulations under section 6109 provide that the IRS is authorized to require through other guidance (as well as in forms and instructions) that tax return preparers apply for a PTIN or other prescribed identifying number, the regular renewal of PTINs or other prescribed identifying number, and the payment of user fees.

- Just as "registered" mail is "better" than "certified" mail, a "registered tax return preparer" – whose duties focus solely on the preparation of tax returns – seems to be "better" than a "certified public accountant" – whose duties are numerous and varied. Additionally, the "registered" practitioner gets his authority from the U.S. Government's Internal Revenue Service while the "certified" practitioner gets his authority merely from one of the states.

d. Proposed amendments to Circular 230.

REG-138637-07, Rules Governing Practice Before the Internal Revenue Service, 2010-2 C.B. 581 (8/19/10). These proposed regulations contain standards with respect to tax returns under § 10.34, as well as new rules governing the oversight of tax return preparers under §§ 10.3 through 10.6. There are also proposed revisions to § 10.30 regarding solicitation, § 10.36

regarding procedures to ensure compliance, and § 10.51 regarding incompetence and disreputable conduct.

e. Final § 6109 regulations. T.D. 9501, Furnishing Identifying Number of Tax Return Preparer, 75 F.R. 60309 (9/28/10). Final regulations amending § 1.6109-2 explaining how the IRS will define those required to obtain a PTIN as a return preparer, with four examples.

f. David Williams is to be given “broad responsibility.” IR-2010-107 (10/26/10). In a speech to the AICPA Fall Meeting, IRS Commissioner Shulman announced the creation of a Return Preparer Office under David R. Williams at the IRS itself, which office is to have “broad responsibility” for the return preparer initiative. The office will complement the work of the IRS Office of Professional Responsibility under Karen Hawkins.

g. Register those staff members as “supervised preparers”! Notice 2011-6, 2011-1 C.B. 315 (12/30/10). This notice provides guidance on the new regulations § 1.6901-2 governing tax return preparers, including the exemption from continuing education requirements and competency exams for non-signing supervised staff members employed and supervised by an attorney, CPA or enrolled agent; however, these “supervised preparers” must obtain PTINs and pass the mandatory tax compliance and suitability checks [and pay the \$64.25 annual fee]. The notice also contains a list of forms that do not require that their preparer have a PTIN, as well as interim rules that permit individuals to obtain provisional PTINs before the first offering of competency examinations; the provisional PTINs may be renewed until the end of 2013.

h. Relief for IRS delays. Notice 2011-11, 2011-7 I.R.B. 497 (1/26/11). This notice temporarily allows certain tax return preparers who have made a good faith effort to obtain a PTIN to prepare tax returns for compensation even though they have not received a PTIN. Any tax return preparer who receives (1) a notice from the IRS that it was unable to process his online PTIN application or (2) an acknowledgment of receipt of the paper PTIN application will be allowed to prepare and file tax returns or claims for refund for compensation after the tax return preparer complies with all instructions provided in the notification or acknowledgment letter. This relief applies only for the 2011 tax return filing season.

i. Final amendments to Circular 230. T.D. 9527, Regulations Governing Practice Before the Internal Revenue Service,

76 F.R. 32286 (5/31/11). These regulations adopt, with some changes, proposed regulations (REG-138637-07), see d., above. Attorneys and CPAs are not affected by the amendments to Circular 230 §§ 10.3, 10.4, 10.5, 10.7 and 10.9, which relate to rules regarding registered tax return preparers. Section 10.30(a) (regarding advertising and solicitation restrictions) provides: “An example of an acceptable description for registered tax return preparers is ‘designated as a registered tax return preparer by the Internal Revenue Service.’”

- **Section 10.34 standards for signing tax returns as preparer.** With respect to the standards for tax returns and documents, etc., § 10.34(a)(1)(i) provides that a practitioner may not willfully, recklessly, or through gross incompetence, sign a tax return or claim for refund that the practitioner knows or reasonably should know contains a position that: (A) lacks a reasonable basis; (B) is an unreasonable position as described in section 6694(a)(2) (including the related regulations and other published guidance); or (C) is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in section 6694(b)(2) (including the related regulations and other published guidance).

- **Section 10.36 standards for supervisory responsibility.** There is supervisory responsibility under § 10.36(b) for overseeing a firm’s practice of preparing tax returns, claims for refunds and other documents filed with the IRS. The firm must take reasonable steps to ensure that the firm has adequate procedures in effect for purposes of complying with Circular 230.

- It appears that references to the Office of Professional Responsibility were present in the proposed regulations and missing from the final regulations. Query: Does this mean that attorneys, CPAs and Enrolled Agents would be subject to discipline from the IRS Return Preparer Office, and not from the OPR, for improprieties in connection with the preparation of returns?

- These regulations were effective on 8/2/11.

j. There are no registered tax return preparers – yet. Notice 2011-45, 2011-25 I.R.B. 886 (5/31/11). Because the conditions for becoming a registered tax return preparer are not yet able to be satisfied by any individual – neither the competency examination nor the suitability check are not yet available – no individual may represent that he is a registered tax return preparer. In addition, Circular 230 § 10.30 will be amended to require that any individual who represents himself or herself to be a registered tax return preparer in any paid advertising must include the following statement: “The IRS does not endorse any particular individual tax return preparer. For more information on tax return preparers go to IRS.gov.”

k. It is only a rumor that the IRS Return Preparer Office has put out an RFP for DNA matching services. REG-116284-11, User Fees Relating to the Registered Tax Return Preparer Competency Examination and Fingerprinting Participants in the Preparer Tax Identification Number, Acceptance Agent, and Authorized E-File Provider Programs, 76 F.R. 59329 (9/26/11). These proposed regulations would set fees going to the IRS of (1) \$27 for taking the registered tax return preparer competency examination testing and (2) \$33 for being fingerprinted. These fees are in addition to the unspecified fees that will be paid to the private vendors that administer the examinations and take fingerprints.

l. Notice 2011-80, 2011-43 I.R.B. 591 (9/21/11). This notice provides guidance for the issuance of provisional PTINs and their annual renewal on a calendar year basis. It also states that the IRS will not require individuals to be fingerprinted prior to obtaining a PTIN until at least 4/18/12. Attorneys, CPAs, enrolled agents, enrolled retirement plan agents and enrolled actuaries will not be required to be fingerprinted “at this time.”

m. REG-140280-09, Tax Return Preparer Penalties Under Section 6695, 76 F.R. 62689 (10/11/11). Proposed regulations under § 6695(g), Prop. Reg. § 1.6695-2, relating to tax return preparer due diligence requirements for determining under earned income credit eligibility. When made final, the regulations will require the completion and submission of Form 8867 with each tax return or claim for refund claiming the EIC.

3. This whistleblower gets a chance to let the Tax Court decide whether or not he was whistling in the dark. Cooper v. Commissioner, 135 T.C. 70 (7/8/10). The Tax Court (Judge Kroupa) held that it has jurisdiction under § 7623(b)(4) to review the denial of a claim for a whistleblower award. The court rejected IRS’s argument that the Tax Court’s jurisdiction is limited to appeals of a determination of the amount of the award.

a. The whistleblower was whistling in the dark. Cooper v. Commissioner, 136 T.C. 597 (6/20/11). Cooper had provided information to the IRS regarding an alleged underpayment of tax and sought a whistleblower award. The IRS determined not to pursue the matter and denied any award. Cooper sought review in the Tax Court. In an earlier proceeding, Cooper v. Commissioner, 135 T.C. 70 (2010), the Tax court determined that it had jurisdiction to review a denial of any award. In the instant case, the Tax Court (Judge Kroupa) held that § 7623(b) does not

confer on the Tax Court jurisdiction to redetermine the tax liability of the taxpayer with respect to whom a claimant is seeking a whistleblower reward.

- The Senate Finance Committee's version of § 7623 would have permitted the whistleblower's lawyer to participate in the audit of the taxpayer.

b. Was this whistleblower whistling in the dark? Kasper v. Commissioner, 137 T.C. 37 (7/12/11). In an opinion by Judge Haines, the Tax Court reaffirmed its earlier holding in Cooper v. Commissioner, 136 T.C. 597 (2011), that a letter from the IRS rejecting a whistleblower claim constitutes a determination, for which review may be sought in the Tax Court. The court further held that the 30-day period for seeking review commences upon mailing or personal delivery of the letter, and that the IRS must demonstrate either mailing or delivery to the whistleblower's last known address.

c. The whistleblower made no noise, and keeps his (?) identity secret. Whistleblower 14106-10W v. Commissioner, 137 T.C. No. 15 (12/9/11). 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.

4. How much is that little tax cheat in the window? REG-131151-10, 76 F.R. 2852 (1/18/11), Rewards and Awards for Information Relating to Violations of Internal Revenue Laws. The Treasury has published proposed amendments to Reg. § 301.7623-1 that clarify the definitions of proceeds of amounts collected and collected proceeds for purposes of § 7623.

a. Large whistleblower award announced.

An attorney, Egan Young of Egan Young Attorneys at Law in Blue Bell, PA – not to be confused with Blue Ball, PA, see *Ginzburg v. United States*, 383 U.S. 463, 467 (1966) – claimed that one of his clients, a CPA, was awarded more than \$4.5 million for alerting the IRS of a Fortune 500 financial services company's \$20 million unreported tax liability. 2011 TNT 69-4 (4/11/11).

- Query whether a CPA is subject to professional discipline if he reports a client to the IRS?

5. Just because there are no longer any District Directors doesn't mean the IRS can't fulfill functions that the regulations still assign to District Directors. Grunsted v. Commissioner, 136 T.C. 455 (5/11/11). The taxpayer, against whom frivolous return penalties had been assessed, argued that because Reg. § 301.6203-1 provides for assessment officers to be appointed by district directors, and there are no longer any district directors, therefore no assessment officers have been properly appointed and thus frivolous return penalties could not be validly assessed against him. The Tax Court was unimpressed by this argument. Judge Kroupa held that provisions of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206, 112 Stat. 685, which required the IRS to substantially modify its regional and district organization, keeps in effect regulations that refer to officers whose positions no longer exist, e.g., District Directors. The Act also provides that nothing in the reorganization plan impairs any right or remedy of the IRS to recover any penalty claimed to have been collected without authority.

6. Take your time, relax. T.D. 9531, Extension of Time for Filing Returns, 76 F.R. 36996 (6/24/11). Final regulations §§ 1.6081-2 and 1.6081-6 provide for an automatic five-month extension of time to file returns for partnerships, estates and trusts. The IRS rejected extending the extension to six-months because of hardships in completing returns that would be created for individual taxpayers with six-month extension. Reg. § 1.6081-2(a)(2) allows a six-month automatic extension for electing large partnerships, which are required by § 6031(b) to provide K-1s to beneficial interest holders by March 15 in any event.

7. The burden is shifted to the IRS only if you cooperate. McNeill v. Commissioner, T.C. Memo. 2011-150 (6/28/11), *aff'd per curiam*, 451 Fed. Appx. 622 (1/10/12). If the taxpayer asserts a reasonable dispute with any item shown on an information return on which a proposed deficiency is based, and the taxpayer has fully cooperated with the IRS with respect to the production of witnesses, documents, and other information, § 6201(d) requires the IRS to produce additional reasonable and

probative evidence of the deficiency. In this case, in which the taxpayer filed a “zero” return and did not cooperate with the IRS, Judge Laro held that § 6201(d) did not apply. The IRS could rely on information returns and the burden of proof remained on the taxpayer.

8. Even if they thought God was on their side, the AIA still kept them out of Paradise. Christian Coalition of Florida, Inc. v. United States, 662 F.3d 1182 (11th Cir. 11/15/11). The Eleventh Circuit held that the § 7421 Anti-Injunction Act barred further proceedings in a case originally filed as a refund suit by an organization claiming tax exemption under § 501(c)(4). After the suit had been filed the IRS refunded the taxes in full because the statute of limitations on collection had run before the taxes had been assessed. The District Court granted the government’s motion to dismiss the suit as moot. Section 7428 authorizes declaratory judgment actions only for organizations seeking exemption under § 501(c)(3). Thus, the plaintiff’s suit was barred by the AIA.

9. New Tax Court proposed rules (12/28/11). The United States Tax Court has proposed amendments to its Rules of Practice and Procedure. Comments in writing are 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.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. **The Supremes spread *Mayo* all over the Code. *National Muffler is dead: long live Chevron.* Mayo Foundation for Medical Education and Research v. United States, 131 S. Ct. 704 (1/11/11). In a unanimous decision, written by Chief Justice Roberts, the Supreme Court affirmed the Court of Appeals in what undoubtedly will be one of the most far reaching tax decisions ever rendered by the Court. The Court applied the two part test of *Chevron, U.S.A., Inc. v. Natural Resources. Defense Council, Inc.*, 467 U.S. 837 (1984), to test the validity of the regulation and upheld it. Under *Chevron*, the first question is whether Congress has directly spoken to the precise question at issue. If the statute has “directly addressed the precise question at issue” the regulation must follow the unambiguously expressed intent of Congress. If the statute is silent or ambiguous with respect to the specific issue, the second question is whether the agency’s answer is based on a permissible construction of the statute. In this second step, according to the Supreme Court, a court “may not disturb an agency rule unless it is ‘arbitrary or capricious in substance, or manifestly contrary to the statute.’” Thus, a court may not substitute its own construction for the reasonable interpretation of an agency. In *Mayo*, the Supreme Court held that “[t]he principles underlying our decision in *Chevron* apply with full force in the tax context.” In applying *Chevron*, the Court unambiguously overruled its prior decision in *National Muffler Dealers Association v. United States*, 440 US 472, 477 (1979), rendering the *National Muffler* standards irrelevant in all future cases. Under *National Muffler* the inquiry was as follows:**

In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose. A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner’s interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.

- In overruling *National Muffler*, the Court unequivocally stated that “an agency’s interpretation of an ambiguous statute does not turn on such considerations.” The Court specifically stated that “[a]gency inconsistency is not a basis for declining to analyze the agency’s interpretation under the *Chevron* framework.” Quoting its earlier decision in *Bob Jones University v. United States*, 461 U.S. 574, 596 (1983), the Court stated, “[I]n an area as complex as the tax system, the agency Congress vests with administrative responsibility must be able to exercise its authority to meet changing conditions and new problems.” The Court also rejected the taxpayer’s argument that a regulation, like the one question, promulgated under the general authority of § 7805(a) was entitled to less deference than one “‘issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision,’” and in so doing overruled its prior decisions in *Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981), and *United States v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982), which had so held, stating that the court’s inquiry does not turn on whether Congress’s delegation of authority was general or specific. Furthermore, the Court held that “it is immaterial to our analysis that a ‘regulation was prompted by litigation,’” noting that in *United Dominion Industries, Inc. v. United States*, 532 U.S. 822 (2001), it had “expressly invited the Treasury Department to ‘amend its regulations’ if troubled by the consequences of our resolution of the case.” Thus, the Supreme Court has unambiguously stated that as long as a regulation can withstand *Chevron* analysis, a Treasury Regulation can reverse case law. Finally, however, in upholding the validity of the regulation, the Court emphasized that the regulation was promulgated after notice and comment, thus leaving open the possibility that *Mayo/Chevron* deference might not apply to a Temporary Regulation issued without notice and comment.

2. 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.

3. Tax law firm misses on its own special allocation.

Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137 (2/9/11). The taxpayer law firm practiced tax law in a Kansas limited liability partnership. The partnership consisted of the three lawyers in the firm plus a subchapter S corporation wholly owned by an ESOP whose beneficiaries were the three attorney partners. The court (Judge Jacobs) held that the individual partners' share of partnership income was subject to self-employment tax. The court also rejected the partnership's argument that the partners of the limited liability partnership were limited partners subject to the § 1402(a)(13) exclusion from self-employment tax the income of a limited partner. The court opined that the purpose of § 1402(a)(13) "was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage." The court concluded that legislative history did not support a holding that the exclusion applied to partners who performed services for the partnership in their capacity as partners. Thus, the court held that distributive shares arising from legal services performed in the partners' capacity as partners in the law firm were subject to self-employment tax.

4. 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). 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.

5. Employed and self-employed at the same time.

Rosenfeld v. Commissioner, T.C. Memo 2011-110 (5/23/11). The taxpayer, who maintained a consulting business advising clients on marketing, accepted a three year full-time appointment with the British Consulate General (BCG) to perform services similar to those provided by the taxpayer to private clients. The court (Judge Dean) held that the taxpayer was an employee of the consulate for withholding purposes and not entitled to separately report income from the engagement on a schedule C. The court found employee status based on the facts that the taxpayer worked under the control of the BCG, the taxpayer received a fixed salary for his services, and the taxpayer's services furthered BCG's goals. The court described as "neutral" the facts that, although BCG provided an office (whether or not the taxpayer used the office was irrelevant) the taxpayer incurred many costs associated with his work, the taxpayer's three year contract was not defined as long term, and that the either party could terminate the relationship without cause. The court also rejected the taxpayer's arguments that he was self-employed because the parties defined the relationship as an independent contractor relationship that specifically provided that the BCG would not withhold taxes, and the taxpayer received no employee benefits and concluded that the taxpayer was a common law employee of BCG.

6. Part time professor as an independent contractor. Robinson v. Commissioner, T.C. Memo 2011-99 (5/5/11). The taxpayer, a full time criminal justice professor at Rowan University, taught vocational classes at Temple University in its Criminal Justice Training Program. From 1985-1996 Temple treated the taxpayer as an independent contractor thereafter reported the taxpayer's compensation as an employee. The court (Judge Wells) focused largely on the control test for employment status and found that the degree of control exercised by Temple over the taxpayer as a vocational instructor was less than the control normally exercised over an adjunct professor. The court noted that the taxpayer prepared the curricula for the courses he taught, mostly covering topics mandated by the State police commission that paid Temple. The court added that the only control Temple exercised over taxpayer's work updating curricula was to set deadlines and convey the general topics he was to cover. The court also noted that Temple did not provide the taxpayer an office or other space in which to write and update curricula, taxpayer's opportunity for profit and loss depended on how many courses he was hired to teach and was not dependent on the level of enrollment in each course (a risk borne by Temple), and that the record suggested that the taxpayer was hired for individual jobs thereby being asked to perform discrete tasks under varying

payment terms. The court further cited that fact that teaching police training courses was not part of Temple's regular business of teaching for-credit courses to regularly enrolled students. The remaining factors considered by the court included that the taxpayer's relationship with Temple fluctuated over time rather than constituting a permanent position, the taxpayer was paid an hourly wage for teaching but a flat fee for writing curricula suggesting both an employee relationship and an independent contractor relationship, that Temple treated the taxpayer as an employee for reporting purposes, but provided no employment benefits. Considering all of the factors, the court found the taxpayer was an independent contractor. The court also denied multiple deductions claimed by both the taxpayer and the taxpayer's spouse on schedules C and A for lack of substantiation and imposed § 6662 penalties.

7. Litigious attorney liable for employment taxes, no matter how many courts he tries. Western Management, Inc. v. United States, 101 Fed. Cl. 105 (9/9/11). Attorney Kovacevich practiced through his wholly owned and operated corporation as an independent contractor. Taxpayer withdrew funds from the corporation as needed. In addition the corporation paid multiple personal expenses for the taxpayer and his wife. On instructions from the taxpayer, the corporation's accountant treated disbursements to the taxpayer as loans and did not file forms 1099 for any of the payments. In a 2003 decision (T.C. Memo. 2003-162, *aff'd*, 176 Fed. Appx. 778 (9th Cir. 2006)) the Tax Court held that Kovacevich was an employee and the corporation was liable for employment taxes, plus § 6662 penalties for the 1994 and 1995 tax years. The IRS subsequently prevailed against the taxpayer in a collection action in which the taxpayer asserted that checks credited against previous employment tax liabilities (also litigated in the Court of Federal Claims) should be applied to the 1994 and 1995 deficiencies. (T.C. Memo. 2009-160.) Kovacevich and the corporation filed a claim for refund of payments made by Kovacevich on the corporation's employment tax liabilities. The court granted summary judgment for the IRS, holding that the taxpayer could not re-litigate the prior Tax Court holdings that the taxpayer was an employee of the corporation. In addition, the court granted summary judgment to the Government, holding that Kovacevich was personally liable for the corporation's employment taxes, plus penalties and interest because the taxpayer operated the corporation as his alter-ego. Finally, the court held that the taxpayer's wife was also liable for the taxes and penalties under Washington community property law. There is a moral here.

8. Voluntarily reclassify workers and pay less tax for last year. Ann. 2011-64, 2011-41 I.R.B. 503 (9/21/11). The IRS announced a voluntary classification settlement program that permits

accepted applicants to agree to re-classify independent contractors as employees and pay reduced taxes for the prior year. The program augments the existing classification settlement program that allows eligible taxpayers under examination for worker classification issues. The program is available to taxpayers that currently and consistently classify workers as nonemployees and who filed all required Forms 1099 for the previous three years. The program is not available to taxpayers currently under audit for worker classification issues. A taxpayer accepted in to the program who agrees to prospectively treat workers as employees for future tax periods will be able to pay 10 percent of the employment tax liability that might have been due on compensation paid to workers in the most recent taxable year and will not be subject to penalties or interest on the liability. The taxpayer will not be subject to an employer tax audit with respect to worker classification for prior years. In addition, the taxpayer must agree to three year extension of the statute of limitations with respect to employment taxes for the first, second, and third calendar years beginning after the date on which the taxpayer has agreed under the program to treat workers as employees. The voluntary program is significantly more generous than the current classification settlement program.

9. Disregarded entities are regarded for employment tax purposes, except when they are disregarded. T.D. 9554, Extending Religious and Family Member FICA and FUTA Exceptions to Disregarded Entities, 76 F.R. 67363 (11/1/11). Several cases, sustaining the check the box regulations under *Chevron* deference, held that the sole owner of a disregarded entity was liable for the disregarded entity's employment taxes. See, e.g., *Litriello v. United States*, 484 F.3d 372 (6th Cir. 2007), and *McNamee v. Dept. of the Treasury*, 488 F.3d 100 (2d Cir. 2007). In the face of these litigation successes, Treasury adopted Reg. § 301.7701-2(c)(2)(iv) to provide that a disregarded entity is treated as a corporation for employment tax purposes and related reporting requirements, thereby shifting the liability away from the owner. However, treating the entity as a corporate employer would eviscerate provisions that exempt certain employment among family members and employment among religious persons who believe that Social Security taxes are contrary to the teachings of the religion or sect. Thus, temporary and proposed regulations, §§ 31.3121(b)(3)-1T(d) and 31.3306(c)(5)-1T(d) provide that a disregarded entity treated as a corporation for employment tax purposes will not be treated as a corporation for purposes of §§ 3121(b)(3) and 3306(c)(5), which provide an exemption from employment taxes for certain services performed by and for parents, children and spouses. Temporary and proposed regulations § 31.3127-1T(c) provide that a disregarded entity will not be treated as a corporation for purposes of § 3127, which provides an exception from FICA taxes where both the employer and employee are members of a religion that opposes participation

in Social Security. Under each of these provisions, for purposes of applying the exemptions only, the owner of the disregarded entity will be treated as the employer. Further, temporary and proposed regulation § 301.7701-2T(c)(2)(iv)(A) is amended to clarify that the owner of a disregarded entity remains subject to the backup withholding requirements of § 3406. The changes are effective for wages paid after 12/31/08, the effective date of Reg. § 301.7701-2(c)(2)(iv).

10. The economy may be bad, but wages are going up. Social Security News Release (10/19/11). The Social Security Administration announced that the Social Security wage base will increase in 2012 to \$110,100, up from the wage base of \$106,800. The \$3,300 increase is due to an increase in average total wages.

a. But good for the cost of nannies. The Social Security Administration announced online that the exclusion for wages paid for domestic service in the employer's home goes up to \$1,800 from \$1,700 for 2012.

11. "I'll gladly pay you Tuesday for a hamburger today." T.D. 9566, Employer's Annual Federal Tax Return and Modifications to the Deposit Rules, 76 F.R. 77672 (12/14/11). Treasury has published proposed and temporary regulations providing for annual, rather than quarterly, deposits of employment taxes for employers who have estimated employment tax liability for wage withholding, social security and Medicare of \$1,000 or less. When notified by the IRS, employers who qualify are required to file the annual Form 944 rather than the quarterly Form unless the employer opts out of annual reporting under the procedures of Rev. Proc. 2009-51, 2009-45 I.R.B. 625.

12. 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.

B. Self-employment Taxes

There were no significant developments regarding this topic during 2011.

C. Excise Taxes

1. Telephone excise tax trouble for the government ahead. Cohen v. United States, 578 F.3d 1 (D.C. Cir. 8/7/09) (2-1). In this telephone excise case, Judge Janice Rogers Brown's majority opinion held that the telephone excise tax challenge litigation violated neither (1) the Anti-Injunction Act, 26 U.S.C. § 7421(a), which provides that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed" nor (2) the Declaratory Judgment Act, 28 U.S.C. § 2201(a), which allows for declaratory relief but specifically excludes federal taxes from its reach, because (a) the standalone Administrative Procedure Act, 5 U.S.C. § 702, claim in the instant case is "the anomalous case where the wrongful assessment is not disputed and the litigants do not seek a refund," and (b) the Declaratory Judgment Act is coextensive with the Anti-Injunction Act (citing circuit precedent). Judge Brown began her opinion:

Comic-strip writer Bob Thaves [creator of *Frank and Ernest* (1972)] famously quipped, "A fool and his money are soon parted. It takes creative tax laws for the rest." In this case it took the Internal Revenue Service's ("IRS" or "the Service") aggressive interpretation of the tax code to part millions of Americans with billions of dollars in excise tax collections. Even this remarkable feat did not end the IRS's creativity. When it finally conceded defeat on the legal front, the IRS got really inventive and developed a refund scheme under which almost half the funds remained unclaimed. Now the IRS seeks to avoid judicial review by insisting the notice [Notice 2006-50] it issued, acknowledging its error and announcing the refund process, is not a binding rule but only a general policy statement.

• Judge Brown stated that the IRS position was "just mean," and that it "places taxpayers in a virtual house of mirrors." She continued, "Despite the obvious infirmities of [the IRS position], the IRS still has the chutzpah to chide taxpayers for failing to intuit that neither

the agency's express instructions nor the warning on its forms should be taken seriously.”

- Judge Brown concluded, however, that “[a]ppellant Neiland Cohen filed his refund claim prematurely and, “[we] thus, affirm the District Court’s dismissal of his refund claim.” The case was remanded to the District Court for its consideration of the merits.

- Judge Kavanaugh dissented, stating that the appellant could simply have followed the procedures of Notice 2006-50.

- The D.C. Circuit granted rehearing en banc, 3/11/10.

a. A case warning that tax professionals continue to ignore administrative law at their (clients’(?)) peril. The panel holding was upheld on rehearing en banc. Cohen v. United States, , 650 F.3d 717 (D.C. Cir. 7/1/11) (6-3). In upholding its original panel decision to remand the case to the District Court for its consideration of the merits, Judge Brown wrote the majority opinion that held the suit was not precluded by either the Anti-Injunction Act or the Declaratory Judgment Act. Judge Kavanaugh’s dissent emphasized that this suit was merely a prelude to a class action suit seeking monetary relief from the government, and that there was an adequate remedy in individual refund suits following claims for refund under the procedures of Notice 2006-50 in which all claims under the Administrative Procedure Act could be asserted.

- **“Enough, already!” The IRS cries, “Uncle.”** Notice 2006-50, 2006-1 C.B. 1141 (5/26/06), *revoking* Notice 2005-79, 2005-2 C.B. 952. The IRS announced that it will stop assessing the § 4251 telephone excise tax on long distance services, and that it will provide for refunds of taxes paid on services billed after 2/28/03 and before 8/1/06. These refunds are to be requested on 2006 Federal income tax returns, the right to which will be preserved by the IRS scheduling overassessments under § 6407. Individuals are eligible to receive a safe harbor amount, which has not yet been determined. Interest received on the refunds will have to be reported as 2007 income.

2. Disregarded entities are regarded as corporations for excise taxes. T.D. 9553, Disregarded Entities; Excise Taxes and Employment Taxes, 76 F.R. 66181 (10/26/11). The Treasury has finalized temporary regulations issued in 2009 that provide that a disregarded entity is treated as an entity separate from its owner for purposes of Federal tax liabilities of the entity for any period that it was not a disregarded entity, Federal tax liabilities of any other entity for which the disregarded entity is liable, and refunds or credits of federal tax. Reg. § 301.7701-2(c)(2)(iv)(B)

provides that a disregarded entity is treated as a corporation for purposes of employment tax and income tax withholding, and Reg. § 301.7701-2(c)(2)(v)(B) provides that a disregarded entity is treated as a corporation for purposes of excise taxes described in Reg. § 301.7701-2(c)(2)(v)(A). The preamble to the regulation states that the “final regulations retain the rule that excise taxes imposed on amounts paid for covered services (such as air transportation) apply to amounts paid between state law entities for such services (unless a statutory exception applies).” Thus, for example, payments by the owner for air transportation to a disregarded entity are subject to excise taxes under § 4261.

XII. TAX LEGISLATION

A. Enacted

1. H.R. 3590, the **Patient Protection and Affordable Care Act** (“PPACA” – pronounced “pee-pac-a”), 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, which also “delivered the opinion of the court in part” 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. Department of Health & Human Services, 648 F.3d 1235 (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.

2. H.R. 4, the **Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011**, was approved by the Senate on 4/5/11 following passage by the House. The bill would repeal the requirement that businesses submit a Form 1099 for payments made to a single vendor for goods and services totaling more than \$600 annually. The bill would be paid for by raising the amount of a healthcare tax credit that can be recaptured from taxpayers in cases of overpayment. President Obama called for repeal of the 1099 provision in his State of the Union speech, and might actually sign the bill if it is brought to his attention between vacation trips. He did, indeed, sign it into law on 4/14/11.

3. The **America Invents Act of 2011**, P.L. 112-29, was signed by President Obama on 9/16/11. Section 14 of the Act provides that "any strategy for reducing, avoiding, or deferring tax liability, whether known or unknown at the time of the invention or application for patent, shall be deemed insufficient to differentiate a claimed invention from the prior art." This provision does not apply to computer tax return preparation products. It will not affect patents already issued.

4. The **Three Percent Withholding Repeal and Job Creation Act**, P.L. 112-56, was signed by President Obama on 11/21/11.

5. The Temporary Payroll Tax Cut Continuation Act of 2011, P.L. 112-78, was signed by President Obama on 12/23/11.

B. Pending

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).