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RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION: THE YEAR 2009

by

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RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION: THE YEAR 2009

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This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – unless one of us decides to go nuts and spend several pages writing it 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 and all of the many mistakes in this outline are Marty's responsibility; any political bias or offensive language is Ira's; and any useful information is Dan's.

One of us has recently become a grandfather, and he has become totally indifferent to any of his other responsibilities,

Virginia June Oakes McMahon

and another of us has been a grandfather for over 18 months but still won't acknowledge that he's old enough to have a grandchild or accept any other responsibility.

Lazar "Lalo" James Joseph Simmons Saadia

I. ACCOUNTING

A. Accounting Methods

1. New and improved automatic consent procedures for changes of accounting methods. Rev. Proc. 2008-52, 2008-2 C.B. 587 (8/18/08). This revenue procedure provides automatic consent procedures for a wide variety of accounting method changes. Rev. Proc. 2002-9, 2002-1 C.B. 327, as previously modified and clarified, is clarified, modified, amplified, and superseded.

(a) Automatic consent updated. Rev. Proc. 2009-39, 2009-38 I.R.B. 371 (8/27/09). The IRS has updated the procedures for obtaining automatic consent and advance consent to change accounting methods. A taxpayer who complies with applicable provisions of this revenue procedure has the IRS's consent to change an accounting method. The extensive list of changes is in the Appendix. Rev. Proc. 97-27, 1997-1 C.B. 680, is modified and clarified, and Rev. Proc. 2008-52, 2008-2 CB 587 is amplified, clarified, and modified.

- Normally, when automatic consent is sought from the IRS, there is no acknowledgment of the request.

2. Is the Public Company Accounting Oversight Board in the intensive care unit? Free Enterprise Fund v. PCAOB, 537 F.3d 667 (D.C. Cir. 8/22/08) (2-1), *cert. granted*, 129 S. Ct. 2378 (5/18/09). Judge Rogers held that the Article II Appointments Clause was not violated by having members of the PCAOB appointed by the SEC commissioners, nor was the separation of powers doctrine violated by the for-cause limitation on removal of PCAOB members.

- Judge Kavanaugh dissented strongly, stating:

> The two constitutional flaws in the PCAOB statute are not matters of mere etiquette or protocol. By restricting the President's authority over the Board, the Act renders this Executive Branch agency unaccountable and divorced from Presidential control to a degree not previously countenanced in our constitutional structure. This was not inadvertent; Members of Congress designed the PCAOB to have "massive power, unchecked power." 148 CONG. REC. at S6334 (statement of Sen. Gramm). Our constitutional structure is premised, however, on the notion that such unaccountable power is inconsistent with individual liberty. "The purpose of the separation and equilibration of powers in general, and of the unitary Executive in particular, was

not merely to assure effective government but to preserve individual freedom." *Morrison*, 487 U.S. at 727 (Scalia, J., dissenting); *see also Clinton v. City of New York*, 524 U.S. 417, 450 (1998) (Kennedy, J., concurring) ("Liberty is always at stake when one or more of the branches seek to transgress the separation of powers."). The Framers of our Constitution took great care to ensure that power in our system was separated into three Branches, not concentrated in the Legislative Branch; that there were checks and balances among the three Branches; and that one individual would be ultimately responsible and accountable for the exercise of executive power. The PCAOB contravenes those bedrock constitutional principles, as well as long-standing Supreme Court precedents, and it is therefore unconstitutional.

B. Inventories

There were no significant developments regarding this topic during 2009.

C. Installment Method

There were no significant developments regarding this topic during 2009.

D. Year of Inclusion or Deduction

1. God didn't answer this Trinity's prayers. Trinity Industries, Inc. v. Commissioner, 132 T.C. No. 2 (1/28/09). The taxpayer, which was on the accrual method, built barges for customers, and part of the payment of the purchase price was contractually deferred until 18 months after delivery of each barge. The customers later claimed there were defects in other barges purchased previously and asserted common law rights to offset their claimed damages against the deferred payments. The taxpayer included only the payments actually received and excluded the uncollected deferred payments. The Tax Court (Judge Thornton) held that the full contract price was includable in the year the barges were delivered, and the amount could not be reduced by the amount withheld by the purchasers under their asserted right to offset claimed damages. The court reasoned that the offset claims affected only the timing of the taxpayer's receipt of the sales proceeds, not its right to receive the proceeds. The taxpayer subsequently received the withheld amounts when, pursuant to a settlement agreement, they were applied in compromise of the purchasers' claims for

damages. Furthermore, § 461(f) did not apply to allow the taxpayer to deduct the withheld amounts in the year of the sale because the withheld amounts were not "transferred" by the taxpayer, as required by § 461(f), and even if they were constructively "transferred" as asserted by the taxpayer – an argument that the court did not accept – the transfer did not occur in the year the barges were delivered, but in a later year.

2. Thirty-five percent is not substantial here, even though it might be elsewhere in the Code. Nelson v. Commissioner, 130 T.C. 70 (2/28/08). Section 451(d) permits a cash method farmer who normally reports income from the sale of his crops in the year following crop production to elect to defer treating as income crop insurance proceeds received in a year until the following year. The taxpayers, who routinely reported only 65 percent of income realized from the sale of crops in the year of sale and 35 percent the following year (which the IRS stipulated was an acceptable accounting method), were not permitted to defer reporting 100 percent the proceeds of crop insurance until the following year. The Court (Judge Swift) applied Rev. Rul. 74-145, 1974-1 C.B. 113, which allowed deferred recognition of crop insurance proceeds under § 451(d) to a farmer who, under his normal method of accounting for crop income, deferred to the following year not all but more than 50 percent of his crop income, a percentage which the ruling referred to as a "substantial portion" of the farmer's annual crop income, and concluded that because the taxpayers did not normally defer a substantial portion of their crop income — 35 percent not being "substantial" for this purpose — § 451(d) was inapplicable.

(a) Affirmed, 568 F.3d 662 (8th Cir. 6/10/09). The Court of Appeals also followed Rev. Rul. 74-145, stating as follows: "The legislative history, however, indicates Congress intended § 451(d) to ameliorate the effects of forcing farmers to report two years of income in a single tax year. Because of Congress' clearly expressed intent, the IRS's revenue ruling reasonably concludes only farmers who customarily defer all or a substantial portion of their crop income to the tax year following production were intended to benefit from a § 451(d) deferment of insurance proceeds." The court also rejected the taxpayers' alternative argument that they satisfied the substantial portion test because they deferred more than fifty percent of aggregate annual crop income. Reg. § 1.451-6(a)(2) requires a farmer who receives crop insurance proceeds from two or more damaged crops, and elects to defer insurance proceeds under § 451(d), to defer all insurance proceeds attributable to crops constituting a single trade or business. On the basis of this provision, the taxpayers claimed that the substantial portion test applies to the entire farming operation, not to a single crop. The court held that Reg. § 1.451-6(a)(2) did not apply because it only applies "[i]n the case of a taxpayer who receives insurance proceeds as a

result of the destruction of, or damage to, two or more specific crops ...” and the insurance proceeds in the instant case related only to one crop.

3. Is whether a purported sale is bona fide really a fact question for the jury rather than a question of law? “Yes,” says the Fourth Circuit. Volvo Cars of North America, LLC v. United States, 571 F.3d 373 (4th Cir. 7/9/09). Volvo sold excess parts inventory to a purchaser who would store the parts for up to 15 years in its own warehouses. Under the original 1981 contract, Volvo not only retained the right to repurchase the inventory at 90% of standard cost, but in addition, the purchaser was required to notify Volvo prior to any planned disposition of Volvo parts inventory to third parties, giving Volvo an opportunity to repurchase that inventory before was sold it to others. Either party had the right to cancel the arrangement unilaterally upon 60 days written notice. An amended 1983 agreement eliminated the right to prior notice before the inventory was sold to a third party. The IRS challenged Volvo’s loss deductions on the parts sales, asserting that the sales were not *bona fide.* Volvo conceded that under the test of *Paccar, Inc. v. Commissioner*, 85 T.C. 754 (1985), *aff’d,* 849 F.2d 393 (9th Cir. 1988), the sales pursuant to the first contract [1981 and 1982 sales] were not *bona fide*, but argued that all of the sales in 1983 and thereafter were governed by the 1983 contract and that they were *bona fide* sales. In the refund suit, the District Court instructed the jury on the four relevant factors set forth by the Tax Court in *Paccar*, and submitted two questions to the jury: (1) whether there was a *bona fide* sale of inventory physically transferred before execution of the 1983 contract; and (2) whether there was a *bona fide* sale of inventory physically transferred after execution of the 1983 contract. The jury returned a verdict in Volvo’s favor. However, the District Court entered a judgment notwithstanding the verdict in favor of the government with respect to transfers of inventory made prior to execution of the amended contract, concluding as a matter of law that the amended contract did not address inventory previously transferred to the warehouser. On appeal, the Fourth Circuit (Judge Niemeyer) vacated the District Court’s judgment notwithstanding the verdict. He found that the jury had been properly instructed regarding the relevant law and could have reasonably concluded that the 1983 contract replaced the 1980 contract and covered not only inventory to be transferred after execution of the 1983 contract but also inventory that had been transferred under the 1980 contract and was still in the purchaser’s warehouses or had been purchased by third parties.

- The four relevant factors set forth by the Tax Court in *Paccar* are : (1) Who determined what items were taken into inventory; (2) who determined when to scrap existing inventory; (3) who determined when to sell inventory; and (4) who decided whether to alter inventory.

4. 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. No. 8 (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.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. This looks pretty good, but at first a few serious questions were lurking. The **2009 ARRA**, § 1231(a), added Code § 108(i), which defers and then ratably includes income arising from business indebtedness discharged by the reacquisition of a debt instrument. This new provision allows a taxpayer to irrevocably elect to include cancellation of

debt income realized in 2009 and 2010 ratably over five tax years, rather than in the year the discharge occurs, if the debt was issued in connection with the conduct of a trade or business or by a corporation. For partnerships and S corporations, the election is made by the partnership or corporation, not by the individual partners or shareholders. I.R.C. § 108(i)(5)(B)(iii). Under the § 108(i) election, income from a debt cancellation in 2009 is recognized beginning in the fifth taxable year following the debt cancellation: the income is recognized ratably in each of 2014 through 2018. Income from a debt cancellation in 2010 is recognized beginning in the fourth taxable year following the debt cancellation: the income is recognized ratably in each of 2014 through 2018. If a taxpayer elects to defer debt cancellation income under § 108(i), the § 108(a) exclusions for bankruptcy, insolvency, qualified farm indebtedness, and qualified real property business indebtedness do not apply to the year of the election or any subsequent year. I.R.C. § 108(i)(5)(C). Thus, the election cannot be used to move the year of inclusion to a year in which it is expected that one of the exceptions will apply. Once the election is made, inclusion is inevitable; the statute requires acceleration of inclusion to the taxpayer's final return in the event of the intervening death of an individual or liquidation or termination of the business of an entity. I.R.C. § 108(i)(5)(D). The acceleration rule also applies in the event of the sale or exchange or redemption of an interest in a partnership or S corporation by a partner or shareholder.

- Although the statute speaks in terms of cancellation of debt income arising from "reacquisition" of a "debt instrument," the statutory definitions of "reacquisition" and "an applicable debt instrument," respectively, are broad enough that the provision applies to most situations in which the debt is cancelled. Section 108(i)(3)(B) broadly defines "debt instrument" to include a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness within the meaning of §1275(a). Section 108(i)(4)(B) defines "acquisition" to include: (1) an acquisition of the debt instrument for cash; (2) the exchange of the debt instrument for another debt instrument, including an exchange resulting from a modification of the debt instrument (which includes a reduction of the principal amount of the debt); (3) the exchange of the debt instrument for corporate stock or a partnership interest; (4) the contribution of the debt instrument to capital; and (5) the complete forgiveness of the indebtedness by the holder of the debt instrument.

- However, the statutory definition of "acquisition" appears to omit the cancellation of a debt in connection with a property transfer, for example, a deed in lieu of foreclosure, although the legislative history contains some indication that this type of debt cancellation is included.

- Query when and to what extent real estate ownership qualifies as a trade or business.

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

2. This arbitration award is income rather than a return of capital. Who does he think he is, Richard Hatch? Bachmann v. Commissioner, T.C. Memo. 2009-51 (3/11/09). The taxpayer received an arbitration award of $1,369,729 against his employer, Salomon Smith Barney, Inc., based on the taxpayer's claim that Smith Barney had failed to compensate him for the use of the taxpayer's idea to create trust preferred stock. The trust preferred stock arrangement involved the issuance by a group of banks of debt to a trust which in turn issued preferred securities to investors for cash. The court (Judge Morrison) rejected the taxpayer's claim that the arbitration award was a return of capital. The court indicated that the taxpayer failed to prove that he had any basis in the idea. In addition, the court opined that the payment from Smith Barney for the taxpayer's business idea was nothing more than a payment for services. The court further rejected the taxpayer's reasonable cause and good faith arguments to impose substantial understatement penalties under § 6662.

3. Another claim of a "contribution to capital" exclusion goes down the drain. AT&T, Inc. v. United States, 103 A.F.T.R.2d 2009-2072 (W.D. Tex. 5/4/09). Magistrate Judge Nowak recommended summary judgment treating payments from the Federal government for universal telephone access as includible in income and not as contributions to capital under § 118. The decision follows *United States v. Coastal Utilities*, *Inc.*, 514 F.3d 1184 (11th Cir. 2008).

(a) The recommendation was accepted by the District Court. AT&T, Inc. v. United States, 104 A.F.T.R.2d 2009-6036 (W.D. Tex. 7/16/09).

4. Tax-free dollars to fight gypsy moths and southern pine beetles. Rev. Rul. 2009-23, 2009-32 I.R.B. 177 (7/27/09). The Forest Health Protection Program administered by the US Forest Service will be treated for purposes of § 126 is substantially similar, within the meaning of § 126(a)(9), to the type of programs described in § 126(a)(1) through (8). Cost sharing payments received by nonindustrial private forest landowners to establish an acceptable integrated pest management strategy that will prevent, retard, control, or suppress gypsy moth infestations, southern pine beetle infestations, spruce budworm infestations, or other major insect infestations are eligible for exclusion from gross income to the extent permitted by § 126. The extent of the exclusion is determined under § 126(b) and Reg. § 16A.126-1.

B. Deductible Expenses versus Capitalization

1. Who says § 1060 prevents allocating basis in excess of fair market to tangible assets? Not Judge Kroupa of the Tax Court. West Covina Motors, Inc. v. Commissioner, T.C. Memo. 2009-291(12/16/09). The taxpayer purchased the assets of another corporation and paid various legal and other transactional fees in connection with the acquisition. Most, but not all, of the fees were related to a seller-financing arrangement for the purchased assets. The parties stipulated that the taxpayer paid $6,050,601 for specific assets, including (1) $250,001 for fixed assets, (2) $3.5 million for goodwill, and (3) $2,300,600 for the inventory of used vehicles, parts, and miscellaneous items, as well as acquiring $6,258,074 worth of new and demonstrator vehicle inventory that was subject to a $6,421,047 floor plan line of credit. Those legal and transactional fees that were attributable to inventory financing and physical inventory were allocated to the inventory to be taken into account in determining cost of goods sold. The IRS argued that because the acquisition was an "applicable asset acquisition" to which § 1060 applied, the remaining legal fees, which were not specifically related to any particular asset, were required to be allocated to goodwill and going concern value under § 1060 because the fair-market-value limitations of § 1060 precluded an allocation to any other assets. In a stunning decision, Judge Kroupa rejected the IRS's position and held that even though the acquisition was an "applicable asset acquisition" as defined in § 1060, where the parties, i.e., the taxpayer and the IRS, have stipulated "the cost of each asset ... section 1060 does not apply." Accordingly, she agreed with the taxpayer that the legal fees should be allocated proportionately among all of the acquired assets to increase their

bases – 2.03% to fixed assets, 18.69% to used vehicles and parts inventory, 50.84% to new and demonstrator vehicles, and 28.44% to goodwill.

- Former Temp. Reg. § 1.1060-1T(e), which was the controlling regulation for the year for the transaction, specifically stated: "Allocation not to exceed fair market value. The amount of consideration allocated to an asset (other than Class IV assets) [defined therein as 'intangible assets in the nature of goodwill and going concern value'] shall not exceed the fair market value of that asset on the purchase date." Although Judge Kroupa's opinion cited that provision, she somewhat mysteriously stated that "[the Commissioner] cites no authority requiring legal fees to be allocated under the fair-market-value limitations of section 1060 where the parties have stipulated the cost of each asset, and we find none." We, on the other hand, believe that former Temp. Reg. § 1.1060-1T(e) does precisely what Judge Kroupa believed that no authority required. Former Temp. Reg. § 1.1060-1T(e) was mirrored in former Temp. Reg. § 1.338(b)-2T(c)(1), and that provision continues to apply in current Reg. § 1.338-6(c)(1). In addition, current Reg. § 1.338-6(a)(2)(ii) specifically provides that "[t]ransaction costs are not taken into account in allocating ADSP or AGUB to assets in the deemed sale (except indirectly through their effect on the total ADSP or AGUB to be allocated)." Even more to the point, current Reg. § 1.1060-1(c)(3) now clearly specifically precludes the result in *West Covina Motors* from occurring:

> The seller and purchaser each adjusts the amount allocated to an individual asset to take into account the specific identifiable costs incurred in transferring that asset in connection with the applicable asset acquisition (e.g., real estate transfer costs or security interest perfection costs). Costs so allocated increase, or decrease, as appropriate, the total consideration that is allocated under the residual method. No adjustment is made to the amount allocated to an individual asset for general costs associated with the applicable asset acquisition as a whole or with groups of assets included therein (e.g., non-specific appraisal fees or accounting fees). These latter amounts are taken into account only indirectly through their effect on the total consideration to be allocated.

- Although current Reg. § 1.1060-1(c)(3) post-dates the transaction in *West Covina Motors*, and thus was not technically controlling, it is merely a more specific statement of the rule in current Reg. § 1.338-6(a)(2)(ii), which in turn merely clarifies current Reg. § 1.338-6(c)(1), which is identical to former Temp. Reg. § 1.338(b)-2T(c)(1), which mirrored former Temp. Reg. § 1.1060-1T(e), which should have been controlling in *West Covina*.

- The bottom line: Don't take the holding in this case too seriously. Its reasoning is suspect.

2. Those fancy Pyrex® and Oneida® branded kitchen products are made by Robinson Knife Manufacturing, which is required to capitalize license fees. Robinson Knife Manufacturing Company, Inc. 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.

3. The increased cost of double-wides is affirmed. Load, Inc. v. Commissioner, 559 F.3d 909 (9th Cir. 3/4/09), *aff'g* T.C. Memo. 2007-51 (3/6/07). The taxpayer sells manufactured homes purchased from the manufacturer by placing models for sale and demonstration on leased lots, where they are sold by independent salespersons. The court adopted the Tax Court holding and opinion that costs attributable to placement of model manufactured homes on leased retail sales lots were includible in inventory under § 263A. The costs were not on-site storage

costs under Reg. § 1.263A-1(e)(3)(iii)(I) because transfers to independent resellers prevented the taxpayer from being considered as selling exclusively to retail customers.

4. The IRS discovers internet retail sales. Notice 2009-25, 2009-15 I.R.B. 758 (4/13/09). Under Reg. § 1.263A-3(c)(5) storage costs attributable to off-site storage of inventory must be capitalized, but storage costs attributable to the operation of an on-site storage facility are currently deductible. An on-site storage facility is defined as a facility that is physically attached to a retail sales facility, which is a facility where the taxpayer sells merchandise exclusively to retail customers in on-site sales. A facility that functions both as storage for an on-site retail facility and as storage for off-site sales is classified as a dual function storage facility with respect to which costs must be allocated between storage for the on-site retail sales and off-site sales, generally on the basis of gross sales. The IRS has recognized that the nature of retail sales has changed in that retailers may both sell merchandise on-site to walk-in customers and make sales over the internet or by facsimile orders from the same facility. The current regulations create problems by requiring these retailers to treat storage facilities attached to a retail sales facility as a dual function storage facility. The notice solicits comments about changed retail business practices resulting from technological advances and existing trends that affect the application of the existing regulations along with information about contemporary business models. The notice also solicits comments regarding changes in the regulations to reflect current business practices. Comments were requested before 7/13/09.

5. Merger termination fee to defend business from hostile takeover is deductible and not a capital expense. Santa Fe Pacific Gold Co. v. Commissioner, 132 T.C. No. 12 (4/27/09). As part of a strategy to thwart a hostile takeover attempt by Newmont USA Ltd., a larger mining company, Santa Fe entered into a merger agreement with the Homestake Mining Company. The Homestake merger agreement contained a termination clause, which required Santa Fe to pay Homestake $65 million in the event the merger was terminated by either party. Following announcement of the Homestake merger agreement, several lawsuits were filed alleging that the Santa Fe board breached its fiduciary duties to shareholders for failing to negotiate further with Newmont and that the Homestake merger agreement was entered into to protect the interests of Santa Fe's board and management. After negotiations and increased offers from both Newmont and Homestake, the Santa Fe board accepted Newmont's stock-for-stock merger offer and paid the termination fee to Homestake. Santa Fe deducted the termination fee. The IRS asserted that the fee was a capital expenditure incurred to provide a long term benefit to Santa

Fe. The Tax Court (Judge Goeke) concluded that the termination fee was deductible under § 162 and alternatively that the fee was incurred by Santa Fe to abandon the merger transaction with Homestake and was therefore deductible as an abandonment loss under § 165. The court rejected the IRS argument that the fee was incurred as part of an integrated transaction in which the termination fee was paid to extricate Santa Fe from one contract in order to enter into a more favorable contract and thus was not attributable to an abandoned transaction.

- Under Reg. § 1.263(a)-5(c)(8), which was promulgated after the events in question and thus was not controlling in this particular case, the amount in question would have to be capitalized as a termination payment or as an amount paid to facilitate a second transaction that was mutually exclusive with the first.

6. Intelligently pursuing wealth is not a trade or business. Woody v. Commissioner, T.C. Memo. 2009-93 (4/30/09). Throughout 2004 the taxpayer investigated and took steps to establish a real estate business, including taking a course on real estate investing from the Wealth Intelligence Academy. The taxpayer purchased an unoccupied rental property on 12/30/04, which was not rented until after 2004. The court (Judge Gustafson) suggested that the taxpayer was not engaged in a trade or business in 2004 before the rental property was actually held out for rent in a subsequent year. In any event, the court held that all of the expenses incurred before the taxpayer acquired property on 12/30/04, were start-up expenses subject to § 195. In addition, the court held that the taxpayer's education expense was incurred to prepare for a new trade or business and therefore not deductible under § 162.

7. Leasehold improvements treated as a substitute for rent are currently deductible; the transaction did not lack economic substance even though the lessor was a tax indifferent party. Remember, § 109 has a parenthetical. Hopkins Partners v. Commissioner, T.C. Memo. 2009-107 (5/19/09). Hopkins Partners operated the Sheraton Cleveland Airport Hotel under a lease agreement with the City of Cleveland. The agreement provided that the hotel and related parking facilitates were the property of the city. The partnership negotiated a modification to the lease agreement under which the cost of improvements to the hotel and parking facilities by the partnership above a specified level would result in reductions in the amount of rental payments otherwise due under the lease. Improvements in any particular year that exceeded the rent otherwise due under the lease were capitalized and depreciated, and were carried forward to be credited against rent in future years. In a year in which previous years' improvements were credited against rent, Hopkins Partners deducted the value of the credited improvements, but also treated them as being sold for

the credited amount and reported gain to the extent the credited amount exceeded the adjusted basis of the improvements. The court (Judge Wells) noted that, under Reg. § 1.162-11(b), the cost of improvements by a lessee to leased property generally are recoverable through depreciation deductions. The court found an exception, however, in Reg. § 1.61-8(c), which requires a lessor to recognize as rental income the cost of improvements placed on real property as a substitute for rent. The court indicated that because the regulation is "clear" that improvements in lieu of rent are treated as "rent" to the lessor, the cost of improvements in lieu of rent are currently deductible by the lessee under § 162(a)(3). The court held that whether improvements are in lieu of rent depended upon the intent of the parties. The court found that the language of the lease agreement treating the cost of improvements as a rent credit, and the testimony of the parties established an intent to treat the cost of improvements as rent. The fact that the lessor was a tax indifferent party did not change the result. The court rejected the IRS's argument that the cost of improvements treated as rent must be limited in duration. The court also held that the immediate transfer of improvements to the city in exchange for rent were not illusory transactions, notwithstanding the fact that the partnership retained control over the improvements. The court also rejected the IRS's contentions that the rent credit agreement lacked economic substance, that the deduction for the improvements failed to clearly reflect income under § 446, and that the deduction was an accounting method change under § 446(e) that required adjustments under § 481.

- The potential problems relating to such arrangements include level rent payments under § 467 and the economic performance rules under § 461(h). However, in *Hopkins Partners* itself, the terms of the particular arrangement appear to have been carefully and properly structured to avoid running afoul of either § 467 or § 461(h).

8. In the scrum of foreign corporate takeovers, these management costs must be capitalized. Canterbury Holdings, LLC v. Commissioner, T.C. Memo. 2009-175 (7/27/09). Taxpayers were partners in an LLC, which in turn formed a New Zealand corporation called Canterbury Holdings to acquire New Zealand publicly held shares of LWR Industries. Ltd. LWR was a 104-year-old garment manufacturing company that owned Canterbury brand rugby shirts. Canterbury Holdings entered into a management agreement with the 2/3 owner of LWR, from which it had an option to purchase LWR stock, to manage LWR during the takeover. At a point, the U.S. LLC (in which the taxpayers were members) made direct payments to the former LWR stock holder which it claimed as deductible management expenses. The court (Judge Holmes) rejected the taxpayer's assertion that the expenses were incurred to protect the LLC's reputation and credit in its trade or business of acquiring, managing and turning around distressed companies. Instead, the court held that the expenditure was

incurred to protect the LLC's investment in its New Zealand subsidiary and was thus a capital expense. The court noted that the only purpose of the LLC was the single acquisition of LWR and the only purpose of the expenditure was to protect the value of its investment in LWR stock. The court also rejected the taxpayers' argument that the payments to its New Zealand holding company were payments of the management fee through its agent. The court refused to allow the LLC to ignore its own organizational choices. The court also disallowed deductions for claimed interest expenses paid by the LLC on obligations of the New Zealand holding company. However, the court refused to impose accuracy related penalties, finding that the taxpayers reasonably relied on the advice of experienced CPAs in claiming the deductions.

C. Reasonable Compensation

1. A provision in ARRA specifically permitted the AIG bonus payments. ARRA § 7001 (in Title VII – Limits on Executive Compensation) amends § 111 of EESA of 2008. EESA of 2008 § 111(b)(3)(D)(iii) specifically exempts from the prohibition "any bonus payment required to be paid pursuant to a written employment contract executed on or before February 11, 2009." Senator Dodd (D-CT) – after weaseling around for a while – admitted that he added this exemption to the statute at the request of the Treasury Department.

(a) In 2009, the Ides of March fell during an Orwellian "Hate Week" against AIG, culminating a House-passed 90 percent tax rate on AIG bonus recipients. H.R. 1586, "To impose an additional tax on bonuses received from certain TARP recipients," was introduced on 3/18/09 by House Ways & Means Committee Chair Charles Rangel (D-NY) and passed by the House on the following day by a vote of 328 to 93. No legislative action has yet occurred in the Senate; this can only be attributed to a temporary reprieve from the mid-March madness.

2. Tax Court distinguishes *Exacto Spring* in case appealable to Seventh Circuit. Menard, Inc. v. Commissioner, T.C. Memo. 2004-207 (9/16/04), *reconsideration denied*, T.C. Memo. 2005-3 (1/6/05). In this decision, appealable to the Seventh Circuit and presumably governed by the "hypothetical independent investor" test of *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (1999), the Tax Court (Judge Marvel) nevertheless applied the traditional factor of compensation for CEOs of comparable publicly-traded corporations to disallow deduction of $13 million of the $20 million of compensation (which included 5 percent of pre-tax profits) paid to the John R. Menard, the CEO and owner of 89 percent of taxpayer's stock rather than applying solely the hypothetical independent

investor test. The court focused on language in Treas. Reg. § 1.162-7(b)(3), which was not discussed in *Exacto Spring*, and which provides as follows:

> In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.

(a) On reconsideration, Judge Marvel made clear that two prongs are required, i.e., (1) that the amounts paid be intended as compensation and (2) that they be reasonable in amount. T.C. Memo. 2005-3 (1/6/05). In denying taxpayer's motion for reconsideration, Judge Marvel reiterated – as an alternative ground for her decision – that the taxpayer did not intend that its payment be for services in light of (1) it never having paid dividends, (2) the CEO's contractual obligation to repay any portion of the compensation found to be excessive, and (3) the failure of the board of directors to make any effort to evaluate whether the compensation was excessive.

(b) Judge Posner is bullish on Menard, Inc., bearish on the Tax Court. No compensation is unreasonable for Judge Posner as long as shareholders are happy – even if it's all in the family. By the way, was it only by chance that Judge Posner was on the panel for this case? Menard, Inc. v. Commissioner, 560 F.3d 620 (7th Cir. 3/10/09). In an opinion by Judge Posner, the Seventh Circuit reversed the Tax Court's decision, T.C. Memo. 2004-207 (9/16/04), *reconsideration denied*, T.C. Memo. 2005-3 (1/6/05), and held that all of the compensation paid to Menard was reasonable. In 1998, the tax year at issue, the taxpayer was the third-largest home improvement retailer in the United States, following Home Depot and Lowes. The founder and CEO of the taxpayer, John Menard, held all of the company's voting shares and 56 percent of the nonvoting shares. The remaining shares were held by family members. Menard was paid a base compensation of $157,000, a profit share participation of $3 million, plus a bonus equivalent to five percent of the taxpayer's before tax net income that amounted to over $17 million. The compensation plan had been adopted by the company in 1973. In 1998 the taxpayer earned a return to shareholders of 18.8 percent. Judge Posner's opinion reflects displeasure that the Tax Court (Judge Marvel) applied its traditional multi-factor test rather than the Seventh Circuit's "hypothetical independent investor" test of *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (1999). In *Exacto Spring,* the Seventh Circuit created a presumption that "when ... the investors in his company are obtaining a far higher return than they had any reason to expect, [the owner/employee's]

salary is presumptively reasonable." The court added that the presumption could be rebutted by evidence that the company's success was attributable to extraneous factors or that the company intended to pay a dividend rather than salary. Judge Posner's opinion found fault with the Tax Court's reasoning in numerous respects.

- First, he found that although a comparison of the compensation of the shareholder/employee in question with the compensation of executives of other companies is "helpful only the comparison takes into account the details of the compensation package of each of the compared executives, and not just the bottom-line salary." He concluded that the Tax Court failed to conduct such an analysis and because "the Tax Court acknowledged that the presumption of reasonableness had been established but thought it rebutted by evidence that corporations in the same business as Menards paid their CEOs substantially less than Menards paid its CEO." He faulted the Tax Court for its "failure to consider the severance packages, retirement plans, or perks of the CEOs with whom it compared Menard (although it did take account of their stock options), even though such extras can make an enormous difference to an executive's compensation." Thus, the fact that the CEO of Home Depot was paid a mere $2.8 million, and the CEO of Lowes was paid $6.1 million (both of which were larger companies), did not suggest that the more than $20 million compensation paid to Menard was unreasonable. Menard's compensation was subject to different risk, and the Tax Court did not consider the severance packages, retirement packages available to the CEO's of Home Depot and Lowes, although the Tax Court did consider stock options. According to the court, the CEO of Home Depot hired two years after the tax year in issue, was paid $124 million in salary, exclusive of stock options, for the six years he held the post and received a severance payment of $210 million (including stock options) when he was fired in 2007.[1]
- Second, and pointedly relevant to *Exacto Spring Corp*. as law of the circuit, Judge Posner emphasized that there was "no suggestion that any of the shareholders were disappointed that the company obtained a rate of return of 'only' 18.8 percent."[2] Furthermore, the company's success was not due to windfall factors. "The Tax Court did

1. To at least one of us, Judge Posner appears not to be bothered by the fact that he was taking into consideration facts that not only were not in the record, but which did not occur not only after the year in question, but after the trial. One can only surmise that Judge Posner's "fact findings" were based on reading newspapers or surfing the Internet.

2. Two of us note that Judge Posner glossed over the fact that John Menard, held all of the company's voting shares and 56 percent of the nonvoting shares, with all of the remaining shares being held by family members.

not consider the possibility, which the evidence supports, that Menard really does do it all himself."

- Third, Judge Posner criticized the Tax Court's conclusion that Menard's compensation, in addition to being excessive, was *intended* as a dividend, based on (1) his agreement to reimburse the corporation if the deduction for the bonus were disallowed by the IRS, and (2) a bonus of 5 percent of corporate earnings year in and year out "looked" more like a dividend than like salary. Judge Posner concluded that (1) it was prudent, even though not in Menard's personal financial interest, for the corporation to require him to reimburse it if the IRS successfully disallowed the deduction, and (2) "5 percent of net corporate income [does not] look at all like a dividend." The court also noted that it was prudent for the taxpayer to require as part of the bonus plan that Menard return the bonus if the taxpayer's compensation deduction were challenged by the IRS.
- Fourth, Judge Posner addressed the Tax Court's concern that the board of directors that approved the 5 percent bonus was controlled by Menard. Judge Posner reasoned that since it could not be otherwise, because Menard was the only shareholder who is entitled to vote for members of the board of directors, the "logic of the Tax Court's position is that a one-man corporation cannot pay its CEO (if he is that one man) any salary!" He went on sarcastically to state that:

> The Tax Court's opinion strangely remarks that because Mr. Menard owns the company he has all the incentive he needs to work hard, without the spur of a salary. In other words, reasonable compensation for Mr. Menard might be zero. How generous of the Tax Court nevertheless to allow Menard to deduct $7.1 million from its 1998 income for salary for Menard![3]

- Fifth, Judge Posner criticized what he considered to be the Tax Court's main focus on whether Menard's compensation exceeded that of comparable CEOs, i.e., whether it was objectively excessive, and thus functionally, even though not intentionally a dividend rather than a bonus, instead of focusing on whether the corporation was acting in good faith in paying $17.5 million as a bonus rather than as a dividend.

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3. Some, but not necessarily all, of us marvel at Judge Posner's restrained judicial temperament.

> For compensation purposes, the shareholder-employee should be treated like all other employees. If an incentive bonus would be appropriate for a nonshareholder-employee, there is no reason why a shareholder-employee should not be allowed to participate in the same manner. In essence, the shareholder-employee is treated as two distinct individuals for tax purposes: an independent investor and an employee." *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1328 (5th Cir. 1987) ... .

- Additionally, the fact that the next-highest paid employee of the taxpayer received a salary of $468,000 was rejected as a factor because the "Tax Court did not consider the possibility, which the evidence supports, that Menard really does do it all himself." The fact that the taxpayer paid no dividends was not influential because many corporations choose to retain earnings rather than distribute dividends. The court stated that a bonus based on five percent of profits doesn't look like a dividend, which is normally calculated as an amount per share rather than a percentage of earnings.

- It shouldn't take a court to make decisions on whether compensation is reasonable. They should be left up to Pay Czar Kenneth Feinberg.

D. Miscellaneous Deductions

1. The IRS responds to high gasoline prices. Announcement 2008-63, 2008-28 I.R.B. 114 (6/23/08), *modifying* Rev. Proc. 2007-70, 2007-2 C.B. 1162. The IRS announced that the business mileage rate for the second half of 2008 will be 58.5 cents per mile – an increase of 8 cents per mile – and that the medical/moving rate will also increase by 8 cents per mile to 27 cents per mile. The statutory rate for charitable mileage under § 170(i) remains at 14 cents per mile.

(a) But gas prices abruptly declined in fall 2008. Rev. Proc. 2008-72, 2008-50 I.R.B. 1286 (11/24/08). The business mileage rate for 2009 will be 55 cents per mile – a decrease of 3.5 cents per mile – and that the medical/moving rate will decrease by three cents to 24 cents per mile. The statutory rate for charitable mileage under § 170(i) remains at 14 cents per mile.

(b) Mileage rates for 2010. Rev. Proc. 2009-54, 2009-51 I.R.B. 930 (12/03/09). Mileage rates for business travel after January 1, 2010 drop to 50 cents per mile, remain at 14 cents for charitable use, and drop to 16.5 cents for medical or moving use.

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: (1) a "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 would be 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 form 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 Administrations 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."

3. Throw another log on the fire! Loss of contemporaneous § 274(d) mileage log in a fire doesn't cause loss of mileage deductions too. Freeman v. Commissioner, T.C. Memo. 2009-213 (9/16/09). Judge Gustafson allowed the taxpayer a deduction, at mileage rates, for business use of his automobile on the basis of the taxpayer's credible testimony regarding the route he drove in connection with his auto parts delivery business. The taxpayer had maintained and at one time possessed adequate documentation, in the form of a daily log, to comply with § 274(d), but his failure to produce that daily log was the result of an accidental fire that destroyed his house and the logbook. Reg. § 1.274-5T(c)(5) allows a taxpayer to "substantiate a deduction by reasonable reconstruction of his expenditures or use" when records are lost through circumstances beyond the taxpayer's control, including a fire.

4. Change of bankruptcy from Chapter 11 to Chapter 7 is not a realization event. Ferguson v. Commissioner, 568 F.3d 498 (5th Cir. 5/12/09). The court rejected the taxpayer's argument that involuntary conversion of the taxpayer's Chapter 11 bankruptcy to Chapter 7 constituted abandonment in that year of farm property within the bankruptcy estate. The taxpayer did not realize loss from abandonment of bankruptcy estate property until the following year when the property was sold at a foreclosure sale.

5. These pay-phone tax shelters work about as well as pay phones do. Doherty v. Commissioner, T.C. Memo. 2009-99 (5/14/09). The Tax Court (Judge Marvel) denied claimed deductions for depreciation, legal fees, and other expenses related to the taxpayer's investment in pay phones and ATMs through a program run by Alpha Telcom, Inc. The court found that other than bare legal title the taxpayer did not possess any of the incidents of ownership regarding pay phones and ATMs.

(a) Ditto. Snyder v. Commissioner, T.C. Memo. 2009-97 (5/14/09). Same date, same judge, same issue, same result.

6. Frozen on the ship, and frozen out of half of his meal deductions. Kurtz v. Commissioner, 575 F.3d 1275 (11th Cir.

7/23/09), *aff'g* T.C. Memo. 2008-111 (4/22/08). Section 274(n)(2)(E) exempts from the 50 percent limitation on deductions for meal expenses any expenses for food or beverages "required by any Federal law to be provided to crew members of a commercial vessel." The Eleventh Circuit affirmed Tax Court Judge Cohen's holding that § 274(n)(2)(E) did not apply to meal expenses incurred by the taxpayer as an independent contractor on the crew of a commercial fishing boat in the Bering Sea, because federal law does not require commercial fishing boats to provide meals to crew members. Accordingly, only 50 percent of the taxpayer's shipboard meal expenses were deductible.

7. Revised per diem rates for lodging, meal, and incidental expenses. Rev. Proc. 2009-47, 2009-42 I.R.B 524 (9/30/09). The IRS has provided updated rules for employer provided per diem allowances that do not require substantiation, and which may be used by self-employed persons and employees who are not reimbursed for travel expenses. Per diem rates for travel within the U.S. are the rates for government travel set forth in 41 C.F.R. ch. 301, appx. A. Travelers may use the rates in effect for the first nine months of 2009 for all travel within 2009, or may use the updated rates for travel between October 1 and December 31, 2009. Rates for travel outside the continental United States (including Alaska and Hawaii) are published by the Secretary of Defense and the Secretary of State and are updated monthly. The rates are available at www.gsa.gov. A traveler may use per diem allowances for meals and incidental expenses along with actual lodging expenses. The revenue procedure also provides fixed high-low per diem rates of $258 for a high cost locality, with a list provided, and $163 for travel to any other locality.

8. Holding herself out as a contract attorney did not establish a trade or business. Forrest v. Commissioner, T.C. Memo. 2009-228 (10/5/09). Before 1988 the taxpayer worked as a contract attorney performing work for other attorneys. She then went to work for the California Department of Corporations, but was terminated from that position in 2000. She worked as a contract attorney in 2000, but not in 2001 and 2002. In 2003 the taxpayer attempted again to work as a contract attorney, incurring expenses, before she was reinstated with the Department of Corporations in 2003. The court (Judge Vasquez) held that the taxpayer's activities were not sufficiently regular or continuous to qualify as a trade or business. The court also concluded that, even if the taxpayer's prior activities were sufficient to qualify as a trade or business, there was insufficient continuity into her activities in 2003 to constitute a continuation of her previous trade or business. The court also noted that the taxpayer's attendance at a four day ABA meeting and attempts to solicit contract work were not regular and continuous business activates, that she did not negotiate

or perform contract attorney services during the year, and that her efforts were terminated when she resumed employment with the Department of Corporations.

9. The IRS rescues OID interest deductions for borrowers that recognize COD income under the Cottage Savings Regs as a result of loan modifications that don't reduce principal. Notice 2010-11, 2010-4 I.R.B. 326 (12/24/09). Pursuant to § 163(e)(5)(f)(iii), the IRS has extended through 12/31/10 the suspension of the application of § 163(e)(5), which partially disallows interest deductions with respect to certain applicable high yield discount obligations (AHYDOs), for "qualified obligations." An obligation is a "qualified obligation" only if: (1) the AHYDO is issued after December 31, 2009, and on or before December 31, 2010, in exchange (including an exchange resulting from a modification of the debt instrument) for an obligation that is not an AHYDO; (2) the issuer (or obligor) of the AHYDO is the same as the issuer (or obligor) of the obligation exchanged for the AHYDO; (3) the AHYDO does not pay interest that would be treated as contingent interest for purposes of § 871(h)(4) (without regard to § 871(h)(4)(D)); (4) the AHYDO is not issued to a related person (within the meaning of § 108(e)(4)); (5) the issue price of the AHYDO is determined under §§ 1273(b)(1), 1273(b)(2), 1273(b)(3), or 1274(b)(3), whichever is applicable, and the regulations thereunder; and (6) the AHYDO would not otherwise be an AHYDO if its issue price were increased by the amount of any discharge of indebtedness income realized by the issuer (or obligor) upon the exchange.

E. Depreciation & Amortization

1. The **Economic Stimulus Act of 2008, P.L. 110-185**, reinstated the first year 50 percent depreciation allowance of § 168(k) for property placed in service in 2008.

(a) The IRS says that the old regulations still apply. I.R. 2008-58 (4/11/08). The IRS has indicated that Reg. § 1.168(k)-1, promulgated under the earlier provision, will apply to bonus depreciation claimed for 2008. The IRS promises new guidance regarding additional issues raised under the current provision and covering increased first year deductions under § 179.

(b) Stimulating deductions. Rev. Proc. 2008-54, 2008-38 I.R.B. 722 (8/29/08). This revenue procedure provides guidance regarding amendments in the **Economic Stimulus Act of 2008** to § 168(k) allowing a 50 percent additional first year depreciation for certain new property acquired and placed in service during 2008 and to § 179 increasing

the dollar limitations for expensing depreciable property for taxable years beginning in 2008. Specifically, the revenue procedure clarifies:

> (1) How the Stimulus § 179 deduction interacts with the increased § 179 amounts provided under § 1400N(e) for certain § 179 GO Zone property;
> (2) How the Stimulus additional first year depreciation deduction interacts with the GO Zone additional first year depreciation deduction for GO Zone property;
> (3) How the Stimulus § 179 deduction interacts with the increased § 179 amounts applicable to the Kansas disaster area; and
> (4) How the Stimulus additional first year depreciation deduction interacts with the 50 percent additional first year depreciation deduction applicable to the Kansas disaster area.

• The IRS and the Treasury Department also intend to amend Reg. § 1.179-5(c) to permit taxpayers to make a § 179 election without IRS consent on an amended return for taxable years beginning after 2007.

(c) And 50 percent bonus depreciation continues. The **2009 ARRA**, § 1201, extended the Code § 168(k) 50 percent additional first year depreciation allowance to qualified property placed in service before 1/1/10. (Aircraft and "long-production-period property" qualify if placed in service before 1/1/11.)

(d) And more guidance for extension property. Rev. Proc. 2009-33, 2009-29 I.R.B. 150 (7/1/09). The revenue procedure provides guidance regarding the election out of additional depreciation, which increases general business credits, for 2009 extension property. The additional first year depreciation is available for 2009 property if the taxpayer had previously elected out for property placed in service in previous years.

2. Now that's a whole lotta expens'n goin' on! For taxable years beginning in 2008 and 2009, the **2009 ARRA**, § 1202, increases the I.R.C. § 179 maximum deductible amount to $250,000 and provides a phase-out threshold of $800,000. The maximum amount allowed to be deducted under § 179 is increased by another $35,000 for (a) qualified enterprise zone property, I.R.C. § 1397(a)(1), and (b) qualified renewal community property acquired and placed in service after 2001 and before 2010. I.R.C. § 1400J. In addition, for both qualified enterprise zone property and qualified renewal community property, only fifty percent of the cost of property in excess of the threshold for the phase-out is taken into account. I.R.C. § 1397(a)(2). Code § 179(e) increases the maximum amount allowed to be deducted under § 179 by $100,000, and increases the phase-out

threshold by $600,000, for qualified disaster assistance property placed in service after 2007 (with respect to disasters declared after that date) and before 2010. The increased expensing and ceiling limits under the **2009 ARRA** also affect the special expensing rules for enterprise zone property, renewal property, and for qualified disaster assistance property. Thus, the maximum § 179 deduction for qualified enterprise zone and renewal property is $285,000 for 2008 and 2009 ($250,000 + $35,000). For qualified disaster assistance property in 2008 and 2009 the maximum deduction is $350,000 ($250,000 +$100,000), and the phase-out threshold is $1,400,000 ($800,000 + $600,000).

3. "Luxury" car depreciation. Rev. Proc. 2009-24, 2009-17 I.R.B. 885 (4/9/09). For automobiles placed in service in 2009 that do not qualify as § 168(k) property, the limits on depreciation deductions are $2,960 for the placed in service year, $4,800 for the second tax year, $2,850 for the third tax year, and $1,775 for each succeeding year; for automobiles that qualify as § 168(k) property, the limits are $10,960 for the first year, $4,800 for the second year, $2,850 for the third year, and $1,775 for each succeeding year. For light trucks or vans that are not § 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 that qualify as § 168(k) property, the limits 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.

4. Converting corn to ethanol is waste reduction and resource recovery, not a chemical process. Notice 2009-64, 2009-36 I.R.B. 307 (8/24/09). The notice contains a proposed revenue ruling to classify tangible assets used to convert corn into fuel grade ethanol as belonging to asset class 49.5 of Rev. Proc. 87-56, 1987-2 C.B. 674, ten year property with a seven year MACRS recovery period. The IRS concludes that such assets are not properly assigned to asset class 28, manufacture of chemicals and allied products, which has a 9.5 year class life and five year MACRS recovery period.

F. Credits

1. Corporate taxpayers need spreadsheet net present value analysis to figure out this election. The **Housing Assistance Tax Act of 2008**, § 3081, provides for an increase in available § 38 credits for increased research activity in lieu of the § 168(k) 50 percent first year allowance for property placed in service in 2008. For property placed in service after 3/1/08, a corporation may elect to forego the additional deduction under § 168(k) and increase the research credit or minimum tax

credit limitation of §§ 38(c) and 53(c) (AMT credits are limited to the excess of regular tax over tentative tax) by 20 percent of the bonus depreciation amount. The increase in credits may provide refundable credits against regular tax liability. For eligible property the bonus depreciation amount is the amount of increased depreciation deductions available under § 168(k). The bonus depreciation amount is limited to the lesser of $30 million or six percent of the sum of research credit carryforwards from years beginning after 1/1/06 and minimum tax credits attributable to adjusted minimum tax for years after 1/1/06. Depreciation for eligible property for both regular tax and AMT purposes is computed under the straight line method. This provision is included in a section of the act entitled "Revenue Provisions."

- This amendment allows corporate (but *not* individual) taxpayers to elect to accelerate the AMT credit and the research credit in lieu of claiming bonus depreciation.

(a) Jesus Chrysler? And the Pork takes a drive in a new car – powered by corn. The **Housing Assistance Tax Act of 2008**, § 3081, also provides that "an applicable partnership" may elect to be treated as making a deemed tax payment in the amount of the least of (1) the bonus depreciation that would be allowed if an election were in effect for the partnership, (2) the amount of the partnership's research credit for the year, or (3) $30 million (reduced by any deemed payment for a prior taxable year). An applicable partnership is "a domestic partnership that was formed on August 3, 2007, and will produce in excess of 675,000 automobiles during the period beginning on January 1, 2008, and ending on June 30, 2008." There must be a lot of qualified partnerships out there. ☺

(b) And it's all explained by the IRS. Rev. Proc. 2008-65, 2008-2 C.B. 1082 (10/10/08). Section 168(k)(4) allows an election to treat the 50 percent bonus depreciation amount (over regular depreciation) as an increase in the limitation of § 38(c) on the general business credit or as an increase in the § 53(c) limitation on the amount of credit against regular tax liability for lower tentative minimum tax (refundable). The increases are allowed to corporations and the Chrysler LLC (not identified by name in the revenue procedure). The election is available for qualified property placed in service between 3/31/08 and 1/1/10. The revenue procedure defines eligible property under the various provisions of the Housing and Economic Recovery Act of 2008, provides rules for making the election, determining the bonus depreciation amounts, and allocating the bonus depreciation amount between the limitations of §§ 38(c) and 53(c).

(c) The IRS supplements the explanation. Rev. Proc. 2009-16, 2009-6 I.R.B. 449 (1/23/09). The revenue procedure

contains rules for electing under § 168(k)(4) to claim an increase in the business tax credit limitation and the AMT credit limitation in lieu of claiming 50 percent first year depreciation allowances under § 168(k), and provides rules for allocating the increases among members of a controlled group and to corporate partners of a partnership allowed to make the election (Chrysler). The revenue procedure clarifies that an S corporation may make the election, but points out that any business or AMT credit limitation increases that result are applied at the corporate level, and not at the shareholder level. This means that the credit limitation increase will only affect credits allowed against tax due on recognized built-in gains under § 1374.

(d) One more year! ARRA § 2001 amended Code § 168(k)(4) to extend this election for one year to property placed in service in 2009.

2. A credit for Vinny Gambini hiring disconnected "yutes." The **2009 ARRA**, § 1221, added two new categories of eligible employees for 2009 and 2010 under the existing Code § 51 Work Opportunity Tax Credit: unemployed veterans and "disconnected youths." To qualify as an unemployed veteran, the employee (1) must have been discharged from active duty in the military (after serving at least 180 days or being discharged for a service-connected disability) during the five-year period ending on the hiring date, and (2) must have received unemployment compensation for at least four weeks during the one-year period ending on the hiring date. A disconnected youth is an individual certified by the designated local agency who is (1) at least age 16 but not yet age 25 on the hiring date, (2) not regularly attending any secondary, technical, or post-secondary school during the six-month period preceding the hiring date, (3) not regularly employed during the six-month period preceding the hiring date, and (4) not readily employable by reason of lacking a sufficient number of skills.

(a) Disconnected yutes defined. Notice 2009-28, 2009-24 I.R.B. 1082 (5/28/2009). **2009 ARRA** amended § 51 to add two new targeted groups for purposes of the § 51 work opportunity credit: unemployed veterans and disconnected youths who begin work for an employer during 2009 or 2010. This provides guidance on the definition of "disconnected youth." It also provides transition relief for employers who hire unemployed veterans or disconnected youths after 12/31/08, and before 7/17/09.

3. Will this myriad of new credits lead to an electric outlet on every parking meter, even outside of the Arctic portions of the

U.S.? Section 30D, added to the Code by the Energy Improvement and Extension Act of 2008, was amended by § 1141(a) of the 2009 ARRA, to provide a plug-in electric drive motor vehicle credit. The statute defines a credit-eligible "new qualified plug-in electric drive motor vehicle" as a motor vehicle, the original use of which is by the taxpayer, that (1) draws propulsion using a traction battery with a capacity of at least 4 kilowatt hours, (2) recharges its battery with an external source of energy, (3) meets certain environmental standards, (4) is acquired by the taxpayer for use or lease (rather than for resale), and (5) is made by a manufacturer. The amount of the credit is $2,500 for each qualifying vehicle placed in service by a taxpayer during a taxable year, with an increase of $417 in the credit amount for each kilowatt hour of traction battery capacity in excess of 4 kilowatt hours. However, for vehicles acquired before January 1, 2010, the total amount of the credit for any one vehicle cannot exceed $7,500 if the vehicle weighs 10,000 pounds or less, cannot exceed $10,000 if the vehicle weighs more than 10,000 pounds but not more than 14,000 pounds, cannot exceed $12,500 if the vehicle weighs more than 14,000 pounds but not more than 26,000 pounds, and cannot exceed $15,000 if the vehicle weighs more than 26,000 pounds. For vehicles acquired after December 31, 2009, only vehicles with a gross vehicle rating of less than 14,000 pounds qualify, and the credit cannot exceed $7,500. Once the total number of qualified plug-in electric drive vehicles sold for use in the United States after December 31, 2009, reaches 200,000, the credit will be phased out, with the phase-out period beginning in the second calendar quarter following the calendar quarter in which the 200,000th sale occurs. During the first two calendar quarters of the phase-out period, the credit is 50 percent of the otherwise allowable amount; in the third and fourth calendar quarters, the credit is 25 percent of the otherwise allowable amount; and no credit is allowable after the end of the fourth calendar quarter.

- A taxpayer electing to claim the credit must reduce its basis in the vehicle by the amount of the credit. (Section 30D(f)(6) permits the taxpayer to elect not to claim the credit.) Any deduction or credit otherwise allowable with respect to the purchase of the vehicle must be reduced by the amount of the credit claimed. The statute directs the Treasury to promulgate regulations providing for the recapture of the credit with respect to any vehicle which ceases to be credit-eligible property (including the case of a lease period shorter than a vehicle's economic life). In the case of a qualifying vehicle used in the taxpayer's trade or business, the credit is part of the general business credit. In the case of qualifying personal use vehicle, the credit is treated as a personal credit, and is allowed against both the regular income tax and the AMT. The credit applies to taxable years beginning after 12/31/08, but will not be available for vehicles purchased after 12/31/14.

- If the vehicle is placed in service by a tax-exempt entity, the person selling the vehicle to the tax-exempt entity may

claim the credit, but only if the seller discloses to the entity the amount of the credit. § 30D(f)(3).

(a) And just to make things simpler, a second, alternative credit for plug-in electric vehicles. The **2009 ARRA**, § 1142(a), significantly revised the § 30 renewable electricity production credit, which now applies only to "plug-in" vehicles. The revisions apply to vehicles acquired after 2/17/09. Revised § 30 allows an elective credit equal to 10 percent of the cost of any qualified plug-in electric vehicle placed in service in a trade or business or for personal use up to a maximum per-vehicle credit of $2,500. The statute defines a credit-eligible "qualified plug-in electric drive motor vehicle" as a motor vehicle, the original use of which is by the taxpayer, that (1) is propelled to a significant extent by an electric motor that draws power from a battery with a capacity of at least 4 kilowatt hours (2.5 kilowatt hours in the case of a 2- or 3- wheeled vehicle), (2) recharges its battery with an external source of energy, (3) has a gross vehicle rating of less than 14,000 pounds, (4) is acquired by the taxpayer for use or lease (rather than for resale), (5) is made by a manufacturer, and (6) and is either (i) a "low speed vehicle within the meaning of section 571.3 of title 49, Code of Federal Regulations" as in effect on 2/17/09 or (ii) is a 2- or 3-wheel vehicle. A taxpayer electing to claim the credit must reduce its basis in the vehicle by the amount of the credit. (Section 30(e)(6) permits the taxpayer to elect not to claim the credit.) Any deduction or credit otherwise allowable with respect to the purchase of the vehicle must be reduced by the amount of the credit claimed. The statute directs the Treasury to promulgate regulations providing for the recapture of the credit with respect to any vehicle which ceases to be credit-eligible property. In the case of a qualifying vehicle used in the taxpayer's trade or business, the credit is part of the general business credit. In the case of qualifying personal use vehicle, the credit is treated as a personal credit, and is allowed against both the regular income tax and the AMT. The credit will not be available for vehicles purchased after 12/31/11. Furthermore, for any vehicle acquired after 2/17/09 and before 1/1/10, the § 30 credit is not available if a credit is allowed under § 30D.

(b) Credit for figuring out how to plug in an old car. The **2009 ARRA**, § 1143(b), amended § 30B to extend the alternative motor vehicle credit to a "plug-in conversion." The plug-in conversion credit is an amount equal to 10 percent of the first $40,000 of cost to convert a vehicle to "qualified plug-in electric drive vehicle," as defined in § 30D. The plug-in conversion credit is allowed in addition to any other credits allowed with respect to the vehicle. The credit applies only to conversions placed in service after 2/17/09 and before 1/1/12. In addition,

new § 30B(g)(2) permits the § 30B alternative motor vehicle credit to be claimed against the alternative minimum tax for years after 2008.

4. And some tax credit help for homebuilders. Section 45L, which previously had been scheduled to expire at the end of 2008, provides a credit, in the amount of either $2,000 or $1,000, to an eligible contractor (including the producer of a manufactured home) who constructs and sells an energy efficient home to a person who will use the home as a residence. The **2009 ARRA** extended the life of the § 45L credit through 2009.

5. Pick, choose, and apply a combination of proposed and final regulations. FedEx Corp. v. United States, 103 A.F.T.R.2d 2009-2722 (W.D. Tenn. 6/9/09). Federal Express claimed $11.6 million of § 41 research credits for years 1997-2007 for a business software development project initiated in 1996 and abandoned as not technologically feasible in 2001. The discovery test of § 41(d)(1)(B) requires that to be eligible for the credit qualified research must be undertaken for the purpose of discovering information which is technological in nature, is useful in the development of a new or improved business component, and the activities must be experimental in nature. Reg. § 1.41-4(a)(3) of regulations finalized in 2001, but applicable to expenditures for internal use software incurred after 1985, defined the discovery test as requiring that "research be undertaken to 'obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.'" Under § 41(d)(4)(E), internal use software is qualified for the research credit only to the extent provided in regulations. Reg. § 1.41-4(c)(6)(vi) provided that internal use software is qualified for the research credit if the software is innovative, development requires significant economic risk, and the software is not commercially available. Regulations proposed in 2001 and finalized in 2003, applicable to taxable years ending after 12/26/01, revised the discovery test to apply to research that, "is intended to eliminate certain uncertainty concerning the development or improvement of a business component." The preamble to the 2001 proposed regulations stated that the IRS generally will not challenge return positions consistent with the proposed regulations. (66 F.R. 66362.) The 2003 finalized regulations did not adopt the internal use software test, marking that section of the regulations as reserved. In Ann. 2004-9, 2004-6 I.R.B. 441, the Service indicated that taxpayers could continue to rely on the internal use software test of the 2001 regulations, but if they did so, they were also subject to the discovery test of those provisions. Granting summary judgment, the court (Judge Mays) accepted Federal Express's assertion that it could rely on the broadened discovery test of the 2003 regulations and the internal use software test of the 2001 regulations. The court rejected the IRS

argument that the taxpayer cannot "cut and paste" portions of the 2001 and 2003 regulations to produce a favorable result. The court concluded that deference to administrative regulations under *Chevron U.S.A. Inc., v. Natural Res. Def. Council*, 467 U.S. 837 (1984), requires that taxpayers be permitted to rely on promulgated regulations. The Treasury statements in the preamble to the 2003 regulations that indicate that those provisions better reflect legislative history, precludes the IRS from forcing the taxpayer to apply the earlier and modified provision. The IRS announcement as an interpretation of regulations did not merit *Chevron* deference over the promulgated regulations. The taxpayer was allowed to rely on the internal use software provisions of the 2001 regulations as those provisions were the only regulatory provisions in existence with respect to the taxpayer's expenditures.

6. With "a little song, a little dance," the Fifth Circuit holds that the *Cohan* rule permits courts to estimate qualified research expenditures. United States v. McFerrin, 570 F.3d 672 (5th Cir. 6/9/09). Through a clerical error, the IRS granted the taxpayer's claim for a refund that was based on § 41 research credits previously unclaimed on taxpayer's return, but claimed on an amended return prepared by Alliantgroup. In the IRS suit to recover the refund the burden of proof fell on the IRS. Reversing the District Court, the Fifth Circuit held that under the rule of *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), if the taxpayer can demonstrate that his activities were qualified research, then the trial court can estimate the expenses associated with those activities. In addition, the court held that the District Court erred in not reviewing the claimed research activities under the 2003 final regulations defining "discovery." The taxpayer's claim for refund was based on language of regulations proposed in 2001, the preamble to which indicated that taxpayers could rely on the test of the proposed regulations. The case was remanded to the District Court for reconsideration under the 2003 regulations.

- As noted below, former IRS Commissioner Mark Everson has joined Alliantgroup as vice chair.

7. Can the incomprehensively complicated be "simplified?" REG-130200-08, Election of Reduced Research Credit under Section 208C(c)(3), 74 F.R. 34523 (7/16/09). These proposed regulations would "simplify" how taxpayers make the election to claim the "reduced research credit" under § 280C(c)(3).

8. There is no research credit for foreign research, but foreign gross receipts do count in calculating the amount of the allowable credit. Deere & Company v. Commissioner, 133 T.C. No. 11 (10/22/09). As in effect for the year at issue, § 41(c)(4) provided that the

§ 41(a) increasing research credit was equal to the sum of 2.65 percent of so much as of the qualifying research expenses for the taxable year as exceeded one percent of the average annual gross receipts of the taxpayer for the 4 taxable years preceding the credit year, 3.2 percent of the amount of qualifying research expenditures that exceed 1.5 percent of the average gross receipts, and 3.75 percent of the qualifying research expenditures that exceed 2 percent of the average gross receipts for the four year period. The Tax Court (Judge Chiechi) rejected the taxpayer's assertion that average gross receipts under this provision is calculated by excluding the annual gross receipts from foreign branches. The court concluded that nothing in the structure of § 41 nor the legislative history indicates that Congress did not intend to include foreign gross receipts in the § 41(c)(4) calculation. The court indicated that if Congress had intended to exclude foreign gross receipts, it would have so mandated. The court also concluded that including the foreign gross receipts is not inconsistent with the focus of the research credit on increases in domestic research activities.

9. Property sold to customers is "supplies!" Huh? TG Missouri Corporation v. Commissioner**,** 133 T.C. No. 13 (11/12/09). The § 41 research credit includes in qualified research expenses the cost of "supplies used in the course of qualified research." Under § 41(b)(2)(C) supplies include tangible personal property, but do not include property subject to the allowance for depreciation. The taxpayer manufactures automobile parts for customers. In the course of designing and producing new parts the taxpayer designs and engineers production molds that it purchases from a third-party tool maker. Once the production molds are ready for the production of parts for the customer the taxpayer sells the molds to the customer. However, the taxpayer retains possession of the molds as it produces parts for the customer. The IRS asserted that the molds are property of a character subject to the allowance for depreciation regardless of whether the molds are depreciable property in the taxpayer's hands. The Tax Court (Judge Marvel) accepted the taxpayer's interpretation of § 41(b)(2)(C) that the exclusion from supplies applies to property that is subject to the allowance for depreciation in the hands of the taxpayer. The court examined language in § 174(c) to conclude that for both purposes the exclusion applicable to depreciable property is applicable to property that is accounted for by the taxpayer as depreciable property. By virtue of its sale of the molds to customers, taxpayer did not retain an economic interest in the molds entitling it to claim depreciation deductions, notwithstanding the taxpayer's continued possession of the molds. The court also looked to §§ 1239 and 453 to conclude that references in the Code to depreciable property are not limited to the extrinsic nature of the property alone, but depend upon the property being depreciable in the hands of the holder.

G. Natural Resources Deductions & Credits

1. And they call the wind Maria. The **2009 ARRA**, § 1302(a), added to the 30 percent energy credit (investment credit) under Code § 46, wind facilities eligible for the § 45 renewable electricity production credit placed in service in 2009 through 2012, and any other facility eligible for the § 45 renewable electricity production credit placed in service in 2009 through 2013 (except small irrigation power facilities, refined coal production facilities, and Indian coal production facilities). If the § 48(a) energy credit is claimed for any such facility, the § 45 renewable electricity production credit cannot be claimed. The Act also added to the § 46 credit the § 48C qualifying advanced energy credit.

- The one of us who's from Texas thinks that wind power is capable of completely replacing oil as an energy source if only the wind industry would deploy its back-up gerbils on calm days.

2. Another green energy credit. The **2009 ARRA**, § 1302(b), added the § 48C "qualifying advanced energy project" credit as part of the § 46 investment credit. The credit amount is 30 percent of the investment, measured by basis, in eligible property placed in service in a qualified advanced energy manufacturing project after 2/17/09. A qualified advanced energy manufacturing project is defined as a project that re-equips, expands, or establishes a manufacturing facility for the production of (1) property designed to be used to produce energy from the sun, wind, or geothermal deposits or other renewable resources, (2) fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric motor vehicles, electric grids to support the transmission of intermittent sources of renewable energy, including storage of that energy, (3) property designed to manufacture equipment for use for carbon capture or sequestration, (4) property designed to refine or blend renewable fuels to produce energy conservation technologies (including energy-conserving lighting technologies and smart grid technologies), (5) new § 30D qualified plug-in electric drive motor vehicles, (6) § 30(d) qualified plug-in electric vehicles or components that are designed specifically for use with these vehicles, including electric motors, generators, and power control units, or (7) other advanced energy property designed to reduce green house gas emissions. Only (1) depreciable tangible personal property, and (2) "other tangible property (not including a building or its structural components)" — presumably meaning fixtures — used in a qualified advanced energy manufacturing project qualify for the credit. Property used in the refining or blending of any transportation fuel, other than renewable fuels, does not qualify. Although the accompanying committee report states that the basis of qualified property must be reduced by the amount of credit, the statute does not so provide; presumably a technical correction will be necessary to

implement any requirement of a basis reduction. If a credit is allowed under § 48C, no credit is allowed for the expenditure under §§ 48, 48A, or 48B. Section 48C(b)(3) limits the credit to qualified advanced energy manufacturing projects certified as eligible by the Treasury Department, after consultation with the Secretary of Energy. The maximum amount of credits that may be certified is $2.3 billion. The statute sets time frames for applying for certification and certain procedures and criteria that the Treasury Department should apply in determining whether any particular project should be certified. The Treasury Department is required to review projects for which credits have been allocated, and may reallocate credits under certain circumstances.

H. Loss Transactions, Bad Debts, and NOLs

1. Duh! Stock that is still trading is not worthless yet. Rendall v. Commissioner, 535 F.3d 1221 (10th Cir. 8/5/08), *aff'g* T.C. Memo. 2006-174. The taxpayer lent $2 million to a publicly traded company that he had founded. The loan was secured by stock of the company held as security by the lender, Merrill Lynch. The loan proceeds were used to partially fund construction of a plant in Canada to extract crude oil from oil shale. In 1997 the corporation declared bankruptcy in Canada and the United States. Merrill Lynch sold a portion of the taxpayer's pledged stock to satisfy the debt. The company arranged to sell most of its assets, but retained rights to certain of its patented technologies. At the close of the 1997 tax year the company stock was traded over-the-counter for $3 per share. At that time the corporation still owned numerous technologies, patents, office space, a research facility, and land and continued to employ a team of engineers. The Court of Appeals affirmed the Tax Court holding denying a deduction in 1997 for worthless debt. The court agreed with the Tax Court's conclusion that at the end of 1997 the taxpayer had not met the standard for treating the debt as worthless, which it described as "fixed by identifiable events that form the basis of reasonable grounds for abandoning any hope of recovery."

- "'Where a debtor company continues to operate as a going concern the courts have often concluded that its debts are not worthless for tax purposes despite the fact that it is technically insolvent.'" (quoting *Roth Steel Tube Co. v. Commissioner*, 620 F.2d 1176, 1182 (6th Cir. 1980)).
- The court also rejected the taxpayer's claim that it realized no gain on the disposition of its pledged stock. The taxpayer argued that Merrill Lynch sold the stock without permission and that any income should be taxed to Merrill Lynch which obtained the stock by theft. The court also upheld the Tax Court's allocation of basis to the sold shares on a FIFO basis.

(a) But optimism doesn't always pay when selecting the year to claim a worthless stock loss. Bilthouse v. United States, 553 F.3d 513 (7th Cir. 1/15/09), *aff'g* 100 A.F.T.R.2d 2007-6191 (N.D. Ill. 9/28/07). The taxpayers were passive investors (they did not materially participate) in an S corporation that had passed-through losses that were suspended. The taxpayers asserted that cancellation of indebtedness income realized by the insolvent S corporation in 1997 increased the taxpayers' stock basis and that the stock became worthless in 1997, thereby allowing the taxpayers to treat the worthlessness as a disposition, permitting deduction of the passive activity losses. The taxpayers filed a refund claim based on the theory that the stock became worthless in 1997, and that the worthlessness was a complete taxable disposition under § 469(g) that allowed the losses to be claimed. The Court of Appeals affirmed the District Court's denial of the refund claim on the ground that the stock had become worthless in 1995, not 1997, as claimed by the taxpayer, and that 1995 thus was the year of the disposition. As of 1995, the stock of the corporation had no liquidating value. Although it was pursuing a lawsuit from which the shareholders claimed that the corporation expected a large financial recovery that would have allowed it to stay in business, the record did not demonstrate that the lawsuit represented a reasonable possibility that the corporation would remain in business after 1995, because there was no evidence proving any basis for why anyone thought the lawsuit would be successful. The suit was settled in 1997 with no damages being awarded to the corporation. The court stated "a taxpayer relying on the potential value of a company to put off the year of worthlessness must provide objective evidence of this value; merely asserting his self-serving hopes will not do."

2. Carry me back to those long ago days of yore, when there were profits to be offset by today's NOL. The **2009 ARRA**, § 1211(b), amended Code § 172 to permit an "eligible small business" to elect to extend the carryback period for a net operating loss arising in 2008 to any number of years greater than two or fewer than six – i.e., the elected carryback period may be five, four, or three years. (Absent an election the normal two year carryback rule still applies.) An "eligible small business" is defined in § 172(b)(1)(H)(iv) (through cross references to § 172(b)(1)(F)) as a corporation, partnership, or sole proprietorship with average annual gross receipts of $15 million or less. An election under § 172(b)(1)(H) must be made by the due date (including extensions) for filing the taxpayer's return for the year the net operating loss arose (i.e., 2008). If the taxpayer is on a fiscal year, the election can be made with respect to either the taxable ending in 2008 or the taxable year beginning in 2008, but not with respect to both taxable years. § 172(b)(1)(H)(ii),(iii). The election is irrevocable.

(a) And here's instructions on how to get back to those days of yore. Rev. Proc. 2009-19, 2009-14 IRB 747 (3/16/09). This revenue procedure provides guidance under § 1211 of **2009 ARRA**, which amended § 172(b)(1)(H) to allow a taxpayer that is an eligible small business to elect a 3-, 4-, or 5-year NOL carryback for a taxable year ending after 2007.

(b) Rev. Proc. 2009-19 was modified and superseded by Rev. Proc. 2009-26. Rev. Proc. 2009-26, 2009-19 I.R.B. 935 (4/25/09). This revenue procedure was issued because many eligible small businesses inadvertently failed to make valid elections that complied with Rev. Proc. 2009-19.

(c) Now the carryback is available to larger businesses as well. Section 13 of the Worker, Homeownership, and Business Assistance Act of 2009 (WHABA) amends § 172 to permit larger businesses to make the **2009 ARRA** 2008 and 2009 NOL carryback election of up to five years. The election applies with respect to NOLs incurred in either 2008 or 2009, but not both years. In addition, 2008 or 2009 NOLs can be used to offset only fifty percent of the taxable income earned in the fifth prior taxable year. This 50 percent limit does not apply to carrybacks of 2008 losses by "eligible small businesses." In addition, an "eligible small business" may take advantage of the extended carryback rules with respect to both 2008 and 2009 losses, rather than the losses of only one of those years. Generally, the extended NOL carry back election is not available for TARP recipients or corporations that, at any time during 2008 or 2009 were a member of an affiliated group including a TARP recipient.

- This provision also increases the use of NOLs to offset a corporation's alternative minimum taxable income by the NOLs the taxpayer elects to carry back up to five taxable years and removes the 90 percent AMT limit.

(d) More instructions. Rev. Proc. 2009-52, 2009-49 I.R.B. 744 (11/20/09). This revenue ruling provides guidance regarding procedures for making the election and its effect. The revenue procedure explains which business can elect the net operating loss carry back periods provided by WHABA.

3. "Take your submarine sandwich shop and shove it" earns a loss deduction for the franchise fee. Alami v. Commissioner, T.C. Memo. 2009-42 (2/23/09). Judge Vasquez held that the taxpayer had established abandonment of Quiznos restaurant franchise (basis $25,000), and an associated corporate charter (basis $750). The taxpayer continually expressed intent to abandon the franchise by repeatedly expressing to

Quiznos representatives his desire to have the franchise fee refunded because he no longer sought to open a Quiznos restaurant, he did not contribute the additional money needed to open a Quiznos restaurant or select a location within the 1-year limit in the initial franchise agreement, and he filed a complaint with the state attorney general when Quiznos failed to respond to repeated requests for a refund. There was no evidence that the taxpayer took any steps to use the corporation for purposes other than running a Quiznos franchise; rather, at trial the taxpayer was not even aware whether the corporation remained in existence.

4. The IRS comes to rescue the loss deductions of Bernie Madoff's Ponzi scheme victims. Rev. Rul. 2009-9, 2009-14 I.R.B. 735 (3/17/09). This revenue ruling, issued in response to the Bernie Madoff Ponzi scheme scandal, comprehensively addresses the tax treatment of losses to investors from criminally fraudulent Ponzi investment schemes. As for the *proper treatment*, the IRS ruled as follows:

(1) A loss from a Ponzi scheme is a loss from a criminal fraud or embezzlement in a transaction entered in profit that is a theft loss, not a capital loss, under § 165;

(2) The loss is deductible under § 165(c)(2), not § 165(c)(3). (Rev. Rul. 71-381 is obsoleted to the extent that it holds that a theft loss incurred in a transaction entered into for profit is deductible under § 165(c)(3) rather than § 165(c)(2).);

(3) The loss is an itemized deduction, but is not subject to the limitation on personal losses in § 165(h), or the limitations on itemized deductions in §§ 67 and 68;

(4) The theft loss is deductible in the year it is discovered, to the extent that the loss is not covered by a claim for reimbursement, with respect to which there is a reasonable prospect of recovery;

(5) The amount of a theft loss is the amount invested in the arrangement, less amounts withdrawn, if any, reduced by reimbursements or recoveries, and reduced by claims as to which there is a reasonable prospect of recovery. *Where an amount is reported to the investor as income prior to discovery of the arrangement and the investor includes that amount in gross income and reinvests this amount in the arrangement, the amount of the theft loss is increased by the purportedly reinvested amount*; and

(6) A theft loss in a transaction entered into for profit may create or increase a net operating loss under § 172 that can be carried back up to 3 years and forward up to 20 years; the three-year carryback for a theft loss is permitted under § 172(b)(1)(F). The investor can also qualify as an eligible small business under § 172(b)(1)(F)(iii) and § 172(b)(1)(H)(iv), and if the investor qualifies, under § 172(b)(1)(H)(iv), the investor may elect either a 3-, 4-, or 5-year net operating loss carryback for an applicable 2008 net operating loss.

- The ruling also holds that certain relief provisions do not apply:

(1) A theft loss in a transaction entered into for profit does not qualify for § 1341 treatment; and

(2) A theft loss in a transaction entered into for profit does not qualify for the application of the mitigation rules in §§ 1311-1314 to adjust tax liability in years that are otherwise barred by the period of limitations on filing a refund claim.

(a) And a safe-harbor to ease the burden of calculating potential recoveries that affect the amount and proper year for the deduction. Rev. Proc. 2009-20, 2009-14 I.R.B. 749 (3/17/09). This revenue procedure provides an optional safe harbor under which qualified investors (as defined in the revenue procedure) may treat a Ponzi scheme loss as a theft loss deduction. Its purpose is to alleviate the problems that arise because highly factual determinations regarding Ponzi schemes that are required by Rev. Rul. 2009-9, which describes the proper treatment regarding claiming Ponzi scheme theft losses. The revenue procedure requires many qualifying conditions, and it does not include a person that invested solely in a fund or other entity that invested in the specified fraudulent arrangement (although it can apply to the fund or entity itself). Among the qualifying conditions are that the lead figure (1) must have been either (a) charged by indictment or information with a crime that would have been theft if convicted, or (b) subject to a state or criminal complaint alleging such a crime, and (2) either (a) the complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or (b) a receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen. If the myriad of qualifying conditions is satisfied, the safe harbor deduction amount is computed under the following formula:

(1) Multiply the amount of the "qualified investment" by —

(a) 95 percent, for a qualified investor that does not pursue any potential third-party recovery; or

(b) 75 percent, for a qualified investor that is pursuing or intends to pursue any potential third-party recovery;

(2) Subtract from this product the sum of any actual recovery and any potential insurance and/or Securities Investor Protection recovery.

- Generally speaking, the amount of the "qualified investment" equals the sum of (1) the amount invested (money and the basis of property) in the arrangement, and (2) amounts previously included in gross income by investor that were purportedly reinvested, minus any amounts withdrawn. The safe harbor "discovery year' for claiming the

deduction is the investor's taxable year in which the indictment, information, or complaint is filed.

- The amount of the deduction so determined is not further reduced by potential direct recovery or potential third-party recovery. However, the investor may have income or an additional deduction in a subsequent year depending on the actual amount of the loss that is eventually recovered. Special procedures must be followed in completing the investor's tax return to flag that the investor is claiming a safe-harbor theft loss under the revenue procedure. The taxpayer must sign and attach to the return a statement agreeing: (1) not to deduct in the discovery year an amount in excess of the deduction permitted under the revenue procedure; (2) not to file returns or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year; (3) not to apply § 1341 with respect to the theft loss deduction allowed by the revenue procedure; and (4) not to apply the doctrine of equitable recoupment or the mitigation provisions in §§ 1311-1314 with respect to income from the investment arrangement that was reported in taxable years that are otherwise barred by the period of limitations.

- A taxpayer that does not elect to use the safe harbor provided by the revenue procedure is subject to all of the generally applicable provisions governing the deductibility of losses under § 165, including proof that a theft occurred, proof of the year of discovery, and proof that there is no reasonable prospect of recovery. A taxpayer that does not apply the safe harbor and files or amends income tax returns for years prior to the discovery year to exclude amounts reported as income from the investment arrangement must establish that those amounts were actually or constructively received (or accrued by a taxpayer using an accrual method of accounting).

(b) But life is tough outside the safe-harbor rule. Vincentini v. Commissioner, T.C. Memo. 2009-255 (11/9/09). Judge Marvel held that the taxpayer could not deduct any portion of a $511,500 theft loss incurred in fraudulent investment scheme because he failed to prove that he had no reasonable prospect of recovery. The taxpayer offered no evidence regarding (1) whether he had received or would receive any restitution, (2) the status of any restitution payments, (3) the availability of funds from the substantial forfeitures ordered by the state court, (4) whether the perpetrators were judgment proof or had insufficient assets to satisfy the restitution orders, (5) that the forfeitures did not occur as ordered, or (6) that it was otherwise improbable that he would receive restitution pursuant to the restitution orders.

5. Why not just give all losses a ten year carryback? In re Harvard Industries, Inc. 568 F.3d 444 (3d Cir. 6/17/09). Section 172(b)(1)(C) provides for a ten year carryback of specified liability losses,

which are defined in § 172(f) as product liability losses that arise out of physical or emotional injury or loss of use of property on account of a defect in products produced by the taxpayer, and liability that arose out of state or federal law, or out of any tort committed by the taxpayer. In a bankruptcy proceeding the taxpayer claimed Federal tax refunds based on carrybacks of specified liability losses. The taxpayer produced defective lock nuts for use in aircraft engines. No one was actually injured as a result of the defects, but the taxpayer suffered losses in actions by distributors who could not sell the defective lock nuts. The court concluded that "loss of property" could refer to the loss of the defective product itself so that losses attributable to settlements with distributors who could not sell the defective product qualified under the definition of specified liability losses. The court also held that losses incurred in making payments to its pension plan as required by the PBGC were losses incurred under Federal law because of the minimum funding requirements of ERISA. Finally, the court affirmed lower court rulings that retrospective workers compensation insurance premiums, including the portion of the premiums representing the insurance company's administrative costs, represented specified liability losses as they arose under state workers compensation laws.

I. At-Risk and Passive Activity Losses

1. You don't need a real estate broker's license from the state to be a real estate broker for purposes of § 469. Agarwal v. Commissioner, T.C. Summ. Op. 2009-29 (3/2/09). The taxpayer, who worked full-time as a licensed real estate agent, but was not a licensed real estate broker, deducted losses from a real estate rental activity in which she materially participated against her compensation income. Under § 469(c)(7), if more than one-half of the personal services performed by the taxpayer during the year are performed in one or more real property trades or businesses in which the taxpayer materially participates and the taxpayer performs more than 750 hours of services in such activities, then any real property rental activity in which the taxpayer materially participates is not treated as a *per se* passive activity, and losses are fully deductible against the taxpayer's income from all sources. Section 469(c)(7)(C) defines a real property trade or business as any real property development, redevelopment, construction, acquisition, conversion, rental, management, leasing, or brokerage business. Special Trial Judge Dean held that for purposes of § 469(c)(7), the "business" of a real estate broker includes, but is not limited to: (1) selling, exchanging, purchasing, renting, or leasing real property; (2) offering to do those activities; (3) negotiating the terms of a real estate contract; (4) listing of real property for sale, lease, or exchange; or (5) procuring prospective sellers, purchasers, lessors, or lessees. Under this standard, a licensed real estate agent qualifies as a real estate broker for

purposes of § 469(c)(7), even if the agent is not a licensed real estate broker under state law.

2. Rock, hammer, warehouse – these activities are not an economic unit. Senra v. Commissioner, T.C. Memo. 2009-79 (4/15/09). The taxpayer owned a warehouse through a disregarded LLC, which leased the warehouse to a C corporation, 86.75 percent of which was owned by the taxpayer and which employed the taxpayer. The taxpayer deducted losses from the rental activity against his salary from the C corporation, claiming that the warehouse leasing and employment by the C corporation was a single activity under Reg. § 1.469-4. The Tax Court (Judge Chabot) held that the warehouse activity could not be grouped with the C corporation activity. Reg. § 1.469-4(d)(5)(ii) permits an activity that a taxpayer conducts through a C corporation to be grouped with another activity only for the purposes of determining whether the taxpayer materially or significantly participates in the other activity. Otherwise, an activity conducted through a C corporation may not be grouped with another activity. Thus, the warehouse activity losses could not be deducted against the salary from the C corporation. The court also noted that although the taxpayers may have undertaken their activities with a different structure that would have permitted use of the losses, they are bound by the form of the business they adopted.

3. 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. No. 19 (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) 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 participated in the activity for five of the preceding ten taxable years, or (6) the activity is a personal service activity in which the taxpayer materially participated for any three preceding years. 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 partner 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 describes 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 in Temp. Reg. § 1.469-5T(a).

(a) 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 that is a different state law entity that is treated as a partnership for tax purposes. 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."

(b) Ditto. *Hegarty v. Commissioner*, T.C. Summ. Op. 2009-153 (10/6/09), is to the same effect.

4. Deciding on whether to uphold the Commissioner's rejection of this horse lover's losses is like pulling teeth. Cunningham v. Commissioner, T.C. Memo. 2009-194 (8/31/09). The taxpayer, a New York dentist, claimed losses from five partnership horse activities in California on returns prepared by a tax return preparer. The court (Judge Cohen) found that the taxpayer had no knowledge of whether or not the horse activities occurred as represented in the partnership returns. He relied on representations by the return preparer in deducting the partnership losses against their other income. The taxpayer's suggestion that the court

Google the return preparer to ascertain that the taxpayer was mislead by a charlatan and that paying the tax would result in financial hardship did not impress Judge Cohen, and the deficiency was upheld. The court also rejected the taxpayer's argument that he had reasonable cause for failing to file a timely return and imposed penalties under § 6651(a)(1).

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. Stimulating stock investments in small business corporations. The **2009 ARRA**, § 1241(a), amended Code § 1202 to provide special rules for qualified small business stock acquired in 2009 and 2010, regardless of when the stock is sold. For such stock, seventy-five percent of the gain (rather than fifty percent) is excluded under § 1202(a), and the special rules of § 1202(a)(2) for stock in a qualified empowerment zone business do not apply.

2. Gain is recognized on an exchange even if the taxpayer didn't yet have what she got and she might not have gotten to keep it. United States v. Culp, 99 A.F.T.R.2d 2007-618, 2007-1 U.S.T.C. ¶50,399 (M.D. Tenn. 12/29/06). The government was granted summary judgment in an erroneous refund suit. The taxpayer exchanged her partnership interest in Ernst & Young for stock of a corporation acquiring E&Y's consulting business, in a transaction that was not a statutory nonrecognition event; however, the stock was held in escrow to enforce a forfeiture provision if the seller-taxpayer failed to perform certain services as an employee of the acquiring corporation. The court held that the open transaction doctrine was not applicable. If a taxpayer exchanges one property for a different property, the gain realized on the exchange must be recognized in the year the exchange occurs, even though the property received in the exchange is forfeitable if contractual provisions or representations in the contract for exchange are not subsequently satisfied and even though the property received in the exchange is held in escrow to assure enforcement of the forfeitability provisions.

(a) The Seventh Circuit affirmed taxable exchange treatment for an E&Y consulting partner in a Capgemini exchange. United States v. Fletcher, 562 F.3d 839 (7th Cir. 4/10/09), *aff'g* 101 A.F.T.R.2d 2008-588, 2008-1 U.S.T.C. ¶50,149 (N.D. Ohio 1/15/08). In this 2000 exchange of taxpayer's partnership interest in E&Y for restricted stock of Capgemini, the Seventh Circuit (Judge Easterbrook) affirmed the summary judgment award to the government in this erroneous refund suit,

and in the process "Fletcherized"[4] the E&Y consulting partner involved because she took inconsistent positions. The taxpayer initially took the position that all of the Capgemini shares received vested in the year 2000 (the year of the exchange), but after the stock declined in value took the position that she received income in 2000 only to the extent of cash she received in that year and the remainder of her income was recognized in 2003 (when the stock was worth less than one-fifth of its 2000 value).

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

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

- Judge Easterbrook concluded:

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

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

Investors, LLC v. United States, 515 F.3d 749 (7th Cir. 2008). If, on the other hand, the parties agreed that the ex-partners would receive $ 2.5 million only if the temperature in Barrow on January 1, 2005, exceeded 80° F, then none of the partners would constructively receive income in 2000; everything would depend on events in 2005.

The sort of contingencies that could lead to forfeitures were within the ex-partners' control. That implies taxability in 2000, for control is a form of constructive possession. And the agreement to discount the stock by only 5% tells us that the parties deemed forfeitures unlikely. Fletcher's acknowledgment that the risk of forfeiture was small shows that the conditions of constructive receipt in 2000 have been satisfied.

Thus although we agree with Fletcher that the ex-partners are entitled to contest the tax treatment called for by the 2000 contracts, we hold that the shares are taxable in 2000 at their value on the date of deposit to the accounts at Merrill Lynch. Income was constructively received in that year not because the contract said that everyone would report it so to the IRS, but because the parties were *right* to think that this transaction's actual provisions made the income attributable to 2000. That the price of Capgemini stock dropped in 2001 and later does not entitle the parties to defer the recognition of income. Fletcher must repay the refund (and amend her returns for later years to reflect receipt of the income in 2000).

3. The IRS gives insureds a partial pass on the "substitute for ordinary income" limitation on capital gains treatment when they sell their life insurance policies. Rev. Rul. 2009-13, 2009-21 I.R.B. 1029 (5/1/09). This revenue ruling addresses the amount and character of income recognized with respect to the disposition by the insured of a life insurance policy in three different factual situations. First, upon the surrender by the owner of a life insurance contract to the issuer for its cash surrender value, the amount of income recognized is the amount received minus the investment in contract, and the income is ordinary income. Second, if a life insurance contract is sold to unrelated person who would not suffer loss if beneficiary died, the amount of income realized is the amount received on sale minus the adjusted basis in contract. The adjusted basis is the total premiums adjusted to properly reflect "cost of insurance," which is excluded from the contract's basis in determining the gain realized on the sale. The portion of the gain reflecting inside build-up immediately prior to the sale is

ordinary income, but any excess amount is capital gain, which is long term if the contract has been held for more than one year. Third, if a term-life contract with no cash surrender value is sold to an unrelated person who would not suffer a loss if beneficiary died, the amount of income recognized is the excess of the amount realized over the adjusted basis of contract; because the cost of insurance each month is presumed to equal to monthly premium paid, there is no inside build-up under contract, and thus the entire amount recognized is long-term capital gain.

(a) Let the life insurance gambling tax shelter wave begin. The IRS gives a third-party purchaser of life insurance who buys the insured's contract a full pass on the "substitute for ordinary income" limitation on capital gains treatment when he sells the life insurance policy instead of waiting for ordinary gain on the payout. Rev. Rul. 2009-14, 2009-21 I.R.B. 1031 (5/1/09). This revenue ruling deals with the treatment in three different situations of a cash method taxpayer who purchases a life insurance contract from the insured. In all three situations, the contract was a level premium fifteen-year term life insurance contract without cash surrender value. The purchaser had no insurable interest or relationship to the insured. At the time of purchase, the remaining term of the contract was 7 years, 6 months, and 15 days. The monthly premium for the contract was $500, due and payable on the first day of each month. The purchaser named itself beneficiary under the contract immediately after acquiring the contract.

- In the first situation, the purchaser paid the insured $20,000 for the contract, paid premiums totaling $9,000 to keep the contract in force, and received $100,000 under the life insurance contract upon the insured's death. The ruling concludes that although the life insurance contract was not property described in § 1221(a)(1)-(8), and thus was a capital asset in the purchaser's hands, "neither the surrender of a life insurance or annuity contract nor the receipt of a death benefit from the issuer under the terms of the contract produces a capital gain." Accordingly, the $71,000 income recognized by the purchaser upon the receipt of the death benefit was ordinary income.
- In the second situation, prior to the insured's death the purchaser sold the life insurance contract to another person for $30,000, after paying the insured $20,000 for the contract and premiums totaling $9,000. The ruling held that the $9,000 of premiums paid by the purchaser to keep the contract in force were capital expenditures, which were added to the original $20,000 basis in the contract. The purchaser recognized a $1,000 gain, which was a capital gain because the life insurance contract was not property described in § 1221(a)(1)-(8), and thus was a capital asset.
- The third situation was the same as the first situation, except the purchaser was a foreign corporation that was not

engaged in any U.S. trade or business. The purchaser again recognized $71,000 of income upon the receipt of death benefits. This income is "fixed or determinable annual or periodical" income subject to U.S. under § 881(a)(1), see Reg. § 1.1441-2(b); Rev. Rul. 64-51, 1964-1 C.B. 322; Rev. Rul. 2004-75, 2004-2 C.B. 109.

(b) Gross income without cash upon surrender of life insurance policy with outstanding policy loans. Barr v. Commissioner, T.C. Memo. 2009-250 (11/3/09). When an insurance company withholds from the cash surrender value of a life insurance policy upon its surrender amounts necessary to repay policy loans, the withheld amount is constructively realized by the owner of the policy and is included in the amount taxable under § 72(e).

4. Small-time, one-time real estate developer gets capital gain treatment. Rice v. Commissioner, T.C. Memo. 2009-142 (6/16/09). The taxpayers purchased a 14.4 acre parcel of land on which to build their "dream home." They originally planned to keep the entire property and build a single home for them and their children. When Mrs. Rice became concerned about being too "isolated," they subdivided a portion of the property and sold eight lots (only six suitable for construction) to six different buyers, over nine years, reserving one lot for their daughter and keeping the remaining land for their residence, on which they built a home with 8,000 square feet of interior space and 4,000 square feet of garages and porches. They had never before (or subsequently) engaged in real estate development and sales activities, and both had full-time jobs. Judge Kroupa held that the taxpayers realized capital gains, not ordinary income on the sales of the three lots sold during the year at issue. The total number of lots sold in all years was small, and the substantiality and frequency of sales is among the most important factors in determining whether sales were to customers in the ordinary course of business. The lots were sold primarily to friends, friends of friends, and relatives. Other than posting a sign outside the subdivision, petitioners did not advertise or promote the sale of lots. Their efforts were "more characteristic of those of investors than of dealers." Finally, although the taxpayers made significant improvements to develop and sell the lots, many of those improvements would have been necessary merely to build their own residence.

5. 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 supplied Pizza Hut with pre-cooked sausage prepared with the taxpayer's patented process. The taxpayer 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 who also sold pre-cooked sausage to Pizza Hut, the taxpayer recovered damages from Pizza Hut for misappropriation of trade secrets. The court (Judge Chiechi) held that the damages were received as compensation for lost profits, and thus were taxable as ordinary income. The court rejected the taxpayer's argument that the damages were for injury to or destruction of the trade secret, a capital asset.

6. New rules for determining basis in securities. The **Emergency Economic Stabilization Act of 2008** [Division B], Act § 403, amends § 1012 to create new rules for determining the basis of securities acquired after 12/31/10. The FIFO or other conventions for determining the basis of securities when sold must be applied on an account-by-account basis. Thus, with respect to a taxpayer who holds the same stock in more than one account, determining the basis of sold securities from any account will be determined solely with regard to the basis of securities in that account. In addition, § 1012(d) provides for averaging the basis of stock acquired in a dividend reinvestment plan. Stock in a dividend reinvestment plan is treated as held in a separate account for purposes of determining basis.

(a) No more fooling the IRS about basis. The **Emergency Economic Stabilization Act of 2008** [Division B], § 403, adding § 6045(g), requires brokers to report the customer's basis in a "covered security" and whether gain or loss is long-term or short-term, in addition to the existing requirement that the broker report gross sales proceeds. In general, the customer's basis is to be reported on a first-in first-out method, unless an average basis method is permissible. Covered securities include securities acquired through an account with the broker or transferred to the broker from another account on or after an applicable date. January 1, 2011, is the applicable date for stocks. January 1, 2012, is the applicable date for stocks under the average basis method. January 1, 2013, or such later date as is specified by the IRS, is the applicable date for any other security. Under § 6045A, a taxpayer transferring securities to a broker will be required to report information required by regulations necessary to permit the broker to meet its reporting requirements. Section 6045B requires the issuer of any security to report information describing any organizational action that affects the basis of the security.

(b) And the IRS begins to gear up. 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.

B. Interest, Dividends, and other Current Income

1. Billions and billions of new private activity tax-free bonds. Code § 1400U-2, added by § 1401(a) of the **2009 ARRA**, creates a new category of tax-exempt private activity bonds, which are termed "recovery zone facility bonds." Generally speaking recovery zone facility bonds are subject to the rules that apply to qualified private activity bonds, except that they are not subject to the aggregate annual State private activity bond volume limits in § 146 and the § 147(d) restrictions on acquisition of existing property does not apply. Under § 1400U-1, $15 billion in recovery zone facility bonds can be issued during 2009 and 2010. Each state will receive a share of the national allocation based on that state's job losses in 2008 as a percentage of national job losses in 2008, although each state will receive a minimum allocation of each of these bonds that is not less than 0.9 percent of the total bonds to be issued. These allocations will be, in turn, sub-allocated to local municipalities in proportion to job losses within the state. Municipalities receiving an allocation of these bonds can use the proceeds of the bonds to invest in infrastructure, job training, education, and economic development in areas within the boundaries of the State, city or county. To be designated as an economic recovery zone an area must have significant poverty, unemployment, general distress, or home foreclosures, or be an area for which a designation as an empowerment zone or renewal community is in effect. To qualify as a recovery zone facility bond, 95 percent or more of the net proceeds of the bond issue must be used for "recovery zone property" and the issue must be designated by the issuer as a recovery zone facility bond. "Recovery zone property" is any depreciable property to which § 168 applies (or would apply but for § 179): (1) that was purchased by the taxpayer after the designation of the recovery zone took effect; (2) the original use of which in the recovery zone commences with the

taxpayer; and (3) substantially all of the use of which is used in the active conduct of a qualified business by the taxpayer in the recovery zone. A "qualified business" is any trade or business except residential rental property or the operation of a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or liquor store. Apparently, bars and nightclubs qualify.

(a) Tribal Development Bonds. Code § 7871, added by § 1402(a) of the **2009 ARRA**, allows Indian tribal governments to issue "tribal economic development bonds," the interest on which is tax exempt under Code § 103. Tribal economic development bonds issued by an Indian tribal government are treated as if such bonds were issued by a State, except that § 146 (relating to State volume limitations) does not apply. A tribal economic development bond is any bond issued by an Indian tribal government (1) the interest on which would be tax-exempt if issued by a State or local government, and (2) that is designated by the Indian tribal government as a tribal economic development bond. The aggregate face amount of bonds that may be designated by any Indian tribal government cannot exceed the amount of national tribal economic development bond limitation allocated to such government. There is a national ceiling of $2 billion, which will be allocated by the Treasury Department, in consultation with the Department of the Interior. Tribal economic development bonds cannot be used to finance any portion of a casino or any facility located outside of the Indian reservation.

2. Build America Bonds. Code § 54AA, added by § 1531 of the **2009 ARRA**, provides a credit for holders of "build America" bonds on any interest payment date. The amount of the credit is 35 percent of the interest payable, and the credit can be claimed against the alternative minimum tax; unused credits can be carried over. A build America bond is any state or local obligation (other than a private activity bond), the interest received on which would otherwise be tax-exempt under § 103, which is issued before 2011 and which the issuer elects to be treated as a build America bond. Interest on build America bonds must be included in gross income, and the amount of the credit must be included as well. §§ 54AA(f)(2), 54A(f). The issuer of a "qualified build America bond" can elect to claim a refundable credit equal to 35 percent of the interest payable in lieu of the holder being entitled to the credit. To be a qualified build America bond, one hundred percent of the available project proceeds, less a reasonably required reserve (as defined in § 150(a)(3)), must be used for capital expenditures. For build America bonds that are "designated recovery zone economic development bonds," the credit rate for the issuer is 45 percent. I.R.C. §§ 1400U-2(a)(1); 6431(g). New § 1400U-2 creates tax credit

bonds for investments in economic recovery zones. New § 1400U-1 authorizes $10 billion in recovery zone economic development bonds that can be issued during 2009 and 2010. To be designated as an economic recovery zone the area must have significant poverty, unemployment, general distress, or home foreclosures, or be any area for which a designation as an empowerment zone or renewal community is in effect. Each state will receive a share of the national allocation based on that state's job losses in 2008 as a percentage of national job losses in 2008, although each state will receive a minimum allocation of each of these bonds that is not less than 0.9 percent of the total bonds to be issued. These allocations will be, in turn, sub-allocated to local municipalities in proportion to job losses within the state. Municipalities that receive an allocation of these bonds can use the proceeds of the bonds to invest in infrastructure, job training, education, and economic development in areas within the boundaries of the State, city or county (as the case may be) that have significant poverty, unemployment or home foreclosures.

3. Credits for lenders who buy bonds to build schools. Code § 54F, added by § 1521(a) of the **2009 ARRA**, creates another new category of new category of tax-credit bonds for purposes of the § 54A credit: qualified school construction bonds. A taxpayer holding a qualified school construction bond on a credit allowance date is entitled to a tax credit at a rate (determined by the Treasury Department) that is the percentage rate that would permit issuance of such bonds without either discount or interest cost to the issuer. The amount of the tax credit is determined by multiplying the bond's credit rate by the face amount of the bond. The credit accrues quarterly, is includible in gross income as if it were an interest payment on the bond, and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits may be carried forward to succeeding taxable years. Credits may be separated from the ownership of the underlying bond in a manner similar to the manner in which interest coupons can be stripped from interest-bearing bonds. To qualify, a school construction bond must meet three requirements: (1) 100 percent of the available project proceeds of the bond issue is used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a bond-financed facility is to be constructed; (2) the bond must be issued by a State or local government within which such school is located; and (3) the issuer must designate such bond as a qualified school construction bond. The maturity of qualified school construction bonds is the term that the Treasury Department determines will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified school

construction bonds are issued. There is a national limitation on qualified school construction bonds of $11 billion for each of 2009 and 2010. The statute provides elaborate rules for allocating the allowable dollar volume of bonds among the states, the District of Columbia, United States possessions, Indian tribal government schools, and large local educational agencies. Qualified school construction bonds generally are subject to the arbitrage limitations of § 148, with a number of modifications. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified school construction bonds are issued.

C. Profit-Seeking Individual Deductions

1. Judge Posner says that the distinction between a temporary and indefinite work location is untenable: "work can be, and usually is, both temporary and indefinite." But the taxpayer gets bumped anyway. Wilbert v. Commissioner, 553 F.3d 544 (7th Cir. 1/21/09), *aff'g* T.C. Memo. 2007-152 (6/14/07). The taxpayer was a mechanic for Northwest Airlines, who was laid off at his work location in Minneapolis. He exercised seniority rights to bump a mechanic in Chicago, but he worked there for only a few days before being bumped by a more senior mechanic. Subsequently, he bumped a mechanic in Anchorage, and worked there for three weeks before being himself bumped. He then bumped a mechanic at LaGuardia Airport, but worked there for only a week before he was bumped again. Three weeks later the airline hired him back, outside the bumping system, to fill an interim position (maximum nine months) in Anchorage. He occupied that position for several months before being laid off again. He never had a realistic prospect of returning to work for Northwest in Minneapolis. He kept his home in Minneapolis, where his wife continued to live. Because he was working too far from home to be able to live there, he incurred living expenses of almost $20,000 that he would not have incurred had he remained in Minneapolis. The Tax Court denied the deduction, reasoning that because of the indefinite nature of the employment at the alternative locations, the taxpayer was not temporarily away from home. Although the Court of Appeals affirmed, the appellate court's reasoning (Judge Posner) differed from that of the Tax Court. According to Judge Posner, "[t]he problem with the Tax Court's distinction is that work can be,

and usually is, both temporary and indefinite ... ." Rather, Judge Posner looked to the principles of *Commissioner v. Flowers*, 326 U.S. 465 (1946), and *Hantzis v. Commissioner*, 638 F.2d 248 (1st Cir. 1981), that deny the deduction for travel expenses unless the taxpayer has a business rather than a personal reason to be living in two places if he decides not to move. He compared Wilbert's situation to the common case of the construction worker who works at different sites throughout the country, never certain how long each stint will last and reluctant therefore to relocate his home, who is nevertheless denied a deduction. See *Yeats v. Commissioner*, 873 F.2d 1159 (8th Cir. 1989).

(a) Ditto, sorta. Alami v. Commissioner, T.C. Memo. 2009-42 (2/23/09). This case presented substantially the same factual situation as *Wilbert*, and the Tax Court reached the same conclusion on the same grounds as it did in *Wilbert*.

- Apparently the Tax Court is no more impressed by Judge Posner's reasoning than he is impressed by the Tax Court's reasoning.

2. Dang that AMT. Gralia v. Commissioner, T.C. Memo. 2009-219 (9/21/09). The taxpayer diverted funds from an S corporation in which another shareholder held a minority interest, and by which both shareholders were employed. When the minority shareholder sued him, the taxpayer settled the suit by paying substantial damages. Judge Halpern held that the damage payments, as well as the taxpayer's attorney's fees to defend the suit, were deductible only as either § 212 expenses or employee business expenses under § 162, and thus were miscellaneous itemized deductions. Because the taxpayer was in the AMT, no tax savings resulted from the deductions.

D. Section 121

There were no significant developments regarding this topic during 2009.

E. Section 1031

1. Don Quixote [a/k/a David Aughtry] tilted at the windmill and deflected only the penalty, not the deficiency. Ocmulgee Fields, Inc. v. Commissioner, 132 T.C. No. 6 (3/31/09). This opinion by Judge Halpern applied § 1031(f) to deny tax-free like-kind exchange treatment in the following situation: (1) The taxpayer transferred appreciated real property (Wesleyan Station) to a qualified intermediary; (2) an unrelated third party purchased the Wesleyan Station property from the qualified

intermediary for cash; (3) a partnership related to the taxpayer sold like-kind property (Barnes & Noble Corner) to the qualified intermediary for cash; and (4) the qualified intermediary transferred the like-kind Barnes & Noble Corner property to the taxpayer. But for the application of § 1031(f)(4), the exchange with the qualified intermediary would have qualified for § 1031 nonrecognition. The taxpayer, who wanted the replacement property to be in the same general geographic area, i.e., middle Georgia, as the surrendered property, argued that the reason for the acquisition of replacement property from a related person was that it was unable to locate a suitable replacement property within the time limits imposed on deferred like-kind exchanges by § 1031(a)(3) and Reg. § 1.1031(k)-1(b). (We note, however, that a careful reading of the facts reveals that the taxpayer entered into the agreement to acquire the replacement property only five days after the relinquished property was sold and actually closed the purchase before the 45-day identification period had even lapsed.) As argued by the Commissioner, Judge Halpern held that § 1031(f)(4) required recognition because the taxpayer had "structured" the transaction "to avoid the purposes" of the rule of § 1031(f) denying non recognition for an exchange to a related person if the transferee sells the property within two years. Based on the legislative history, he concluded that the "basis shifting" that resulted from the transaction "suppl[ied] the principal purpose of tax avoidance." The basis shift effected an approximately $1.8 million reduction in taxable gain, because if the related party had acquired Wesleyan Station from the taxpayer in a like-kind exchange for Barnes & Noble Corner, the related party's substituted basis in Wesleyan Station, which in the taxpayer's hands was only around $716,164, would have been $2,554,901 (equal to the related person's basis in Barnes & Noble Corner). In addition, if § 1031 applied, the gain on the sale of Wesleyan Station would have been taxed at only 15 percent, the applicable rate for capital gains taxed to the partners of the related partnership, instead of the 34 percent rate that would have applied had the taxpayer sold the property. Judge Halpern further found the case to be substantially similar to *Teruya Bros., Ltd. v. Commissioner*, 124 T.C. 45 (2005), in which the taxpayer transferred properties to a qualified intermediary, who sold them to unrelated third parties and used the proceeds to purchase like-kind replacement property from a related party. In *Teruya Bros*., Judge Thornton held that the transactions were economically equivalent to direct exchanges between the taxpayer and related party, followed by the related party's sale of the properties to unrelated third parties, and that they were structured to avoid the purposes of § 1031(f). The taxpayer argued that unlike the taxpayer in *Teruya Bros*., it did not have a prearranged plan to use property from a related person to complete a like-kind exchange, but Judge Halpern found that the presence of the prearranged plan in *Teruya Bros*. was not a critical element of the holding in that case. Nevertheless, the taxpayer avoided the § 6662 negligence penalty because

(1) the return reporting the transaction as a § 1031 like-kind exchange was prepared by an accountant with extensive experience in representing real estate developers, (2) the accountant was aware of all relevant facts, and (3) when the taxpayer filed its return, the Tax Court had not yet decided *Teruya Bros*., and while Rev. Rul. 2002-83, 2002-2 C.B. 927 (presaging the result in *Teruya Bros*.) had been issued, Judge Halpern did "not think that the ruling left the result free from doubt."

(a) "[I]t appears that these transactions took their peculiar structure for no purpose except to avoid § 1031(f)." Teruya Bros., Ltd. v. Commissioner, 580 F.3d 1038 (9th Cir. 9/8/09), *aff'g* 124 T.C. 45 (2005). The taxpayer transferred properties to a qualified intermediary, who sold them to unrelated third parties and used the proceeds to purchase like-kind replacement property from a related party. In the Tax Court, Judge Thornton held that the transactions were economically equivalent to direct exchanges between the taxpayer and related party, followed by the related party's sale of the properties to unrelated third parties, and that they were structured to avoid the purposes of § 1031(f). He further held that taxpayer failed to prove that avoidance was not one of the principal purposes of the transactions under the § 1031(f)(4) exception. The taxpayer argued that even though more gain was recognized by the related party on some of the properties, the only tax consequences of the gain recognition were reduction of the related party's net operating loss – as opposed to current taxation for taxpayer. The Ninth Circuit affirmed the Tax Court's decision, stating, "it appears that these transactions took their peculiar structure for no purpose except to avoid § 1031(f);" "Teruya could have achieved the same property dispositions through far simpler means."

F. Section 1033

There were no significant developments regarding this topic during 2009.

G. Section 1035

There were no significant developments regarding this topic during 2009.

H. Miscellaneous

There were no significant developments regarding this topic during 2009.

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. **Economists say that everything happens on the fringes. Using fringe benefits to stimulate public transportation.** The **2009 ARRA**, § 1151(a), amended Code § 132(f) to provide that the $175 ceiling (as adjusted for inflation) on tax-free parking benefits also applies to transit passes and qualified commuter highway vehicle use for months beginning after February 2009 and before 1/1/11. The 2009 amount for the $175 ceiling on tax free parking benefits, as adjusted for inflation, is $230 per month.

2. **Involuntarily terminated employees will receive assistance with their COBRA premiums for a while.** The **2009 ARRA** § 3001 (in Title III – Premium Assistance for COBRA Benefits) provides premium assistance for COBRA benefits to the extent of 65 percent of the otherwise applicable COBRA premium. Eligibility for this benefit is more restrictive than eligibility for COBRA, with elimination of the premium subsidy for high-income individuals as well as for those eligible for another form of medical coverage, e.g., retiree medical. The DOL has provided a model notice to individuals pursuant to ARRA § 3001.

- The premium subsidy is only provided with respect to involuntary terminations that occur on or after 9/1/08 and before 1/1/10.

(a) **And for a while longer.** H.R. 3326, § 1010, extends the COBRA subsidy period from nine months to 15 months and extends the subsidy to terminations occurring in the first two months of 2010. Notification requirements are provided for individuals who may have previously lost assistance but became eligible for the extended subsidy period.

B. Qualified Deferred Compensation Plans

1. **Section 72(t) has no catchall hardship exception.** Dollander v. Commissioner, T.C. Memo. 2009-187 (8/19/09). There is no general exception to the § 72(t) penalty tax for premature withdrawals from a qualified retirement plan based on the need to withdraw funds due to general "financial hardship."

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

1. My employer cheated on me (and a lot of others) but it's still income. Gourley v. United States, 104 A.F.T.R.2d 2009-6119 (Fed. Cl. 8/26/09). The taxpayer, a WorldCom employee, exercised nonqualified stock options for 90,300 shares of WorldCom stock valued at $42,125 per share on January 28, 2000. The value of the stock was reflected in a W-2 issued to the taxpayer by WorldCom. The taxpayer disposed of the stock during 2000 and 2001. On June 25, 2002, WorldCom announced a major restatement of its financials admitting that because of fraudulent accounting practices it incurred undisclosed losses from 2000 to 2001. The taxpayer thus claimed in a refund action that the stock he received in January 2000 was worth only $12.52 per share and that the W-2 issued by WorldCom was grossly inflated. The court rejected the refund action pointing out that the known fair market value of the WorldCom stock on the date of the taxpayer's exercise formed the basis of the taxpayer's gross income. The court pointed out that the market price based on imperfect information is nonetheless the prevailing market price.

D. Individual Retirement Accounts

1. Us weary 70½+ geriatrics do not have to take RMDs for the 2009 year. WRERA, § 201, amends Code § 401(a)(9) to suspend required minimum distributions ("RMDs") from 401(k) plans, IRAs and similar retirement accounts for 2009. RMDs for the year 2008 were not affected, including RMDs for 2008 that are permitted to be made in 2009 by reason of an individual's required beginning date being 4/1/09.

2. A distribution not itself subject to the § 72(t) penalty tax does not trigger a modification of an existing series of substantially equal periodic payments. Benz v. Commissioner, 132 T.C. No. 15 (5/11/09). Section 72(t)(2)(A)(iv) provides an exception from the 10 percent penalty tax on premature IRA distributions for distributions that are part of a series of substantially equal periodic payments made for the life of the owner of an IRA (or the joint lives of the owner and a designated beneficiary). However, if the series of substantially equal periodic payments is modified within 5 years of the date of the first distribution (other than by reason of death or disability), or before the employee has attained age 59-1/2, the 10 percent penalty tax is imposed retroactively on prior distributions made before the taxpayer attains age 59-1/2, plus interest. Within five years of making an election to receive distributions from her IRA in a series of substantially equal periodic payments before attaining age 59-1/2, the taxpayer withdrew additional amounts to pay qualified higher education

expenses as defined in § 72(t)(7) relating to her son's college expenses. The Tax Court (Judge Goeke) held that a distribution that satisfies the statutory exception to the penalty tax on premature withdrawals under § 72(t)(2)(E) for payment of higher education expenses is not a modification of a series of substantially equal periodic payments. Such a withdrawal does not trigger the § 72(t) penalty tax where the taxpayer receives the distribution within 5 years after the taxpayer begins receiving distributions under a series of substantially equal periodic payments.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

There were no significant developments regarding this topic during 2009, but there might be in 2010.

B. Miscellaneous Income

1. **Helping the unemployed.** The **2009 ARRA**, 1107(a), amended Code § 85 to provide an exclusion for up to $2,400 of unemployment compensation received by an individual in 2009.

2. **Judge Gale rescues a taxpayer who was trying to rely on the wrong exclusionary rule.** Watts v. Commissioner, T.C. Memo. 2009-103 (5/18/09). The taxpayer was injured in an automobile accident with an uninsured motorist, but her insurance company denied coverage under one of the two policies issued to the taxpayer and her husband, relying on anti-stacking provisions in the contracts. Eventually, as a result of the settlement of a class action suit against her automobile insurance company, she received a damage award. Both the taxpayer and the IRS argued the case on the basis of the applicability of § 104(a)(2). Judge Gale held that because the damage award was not received with respect to "tort or type rights," it was not excludable under § 104(a)(2). However, notwithstanding the taxpayer's apparent failure to raise the argument, the damages were excludable under § 104(a)(3) as an amount received through accident or health insurance for personal injuries or sickness. To be eligible to receive damages the taxpayer was required to have been (1) insured under multiple insurance policies purchased from the same company with uninsured motorist coverage, (2) injured through the fault of an uninsured motorist, and (3) denied payment under one of the policies while receiving payment under another. These prerequisites establish that the taxpayer received the settlement payment "through" accident insurance, or under such a policy, for purposes of § 104(a)(3). Judge Gale rejected the IRS's argument that because the class action lawsuit involved numerous claims beyond those premised on personal

injury (e.g., breach of contract, breach of covenant of good faith and fair dealing, fraud, etc.) and sought compensatory damages, treble damages, punitive damages, and interest, and because the settlement agreement did not expressly allocate any portion of the payment to personal injury and the taxpayer executed a general release of all claims, the taxpayer did not receive the payment "for" personal injury. The determining factor in his decision was that the taxpayer's eligibility to receive a portion of the settlement fund depended upon her showing that she had not been fully compensated for her injuries.

- Note that under Prop. Reg. § 1.104-1(c), infra, Item 5, published after this decision, the damages received in a suit like this one might be excludable under § 104(a)(2).

3. Even if the cop's CPA might have acted stupidly, the cop wasn't penalized for an erroneous exclusion of a damage award. Longoria v Commissioner, T.C. Memo. 2009-162 (7/2/09). Judge Gustafson held that no portion of a $156,667 settlement award in an employment discrimination suit by a Puerto Rican New Jersey state trooper was excludable under § 104(a)(2), even though the taxpayer suffered physical injuries as a result of acts of discrimination, because the complaint in the discrimination suit did not allege that he had suffered any physical injuries as a result of discrimination during his employment. No penalties were assessed, however, because the taxpayer reasonably relied on the erroneous advice of a CPA in excluding the award from gross income.

4. Tax free mortgage principal paydowns. Rev. Rul. 2009-19, 2009-28 I.R.B. 111 (6/23/09). The Federal government's Homeowner Affordability and Stability Plan helps homeowners who have defaulted, or are at risk of default, on their mortgages by providing certain incentive payments to lenders/investors on the behalf of homeowner's that make timely payments on modified loans that reduce the principal balance on the homeowner's mortgage loan. This revenue ruling holds that the payments are excludable from the homeowner's income under the general welfare exclusion.

5. Treasury proposes to reverse a principle established in a Supreme Court decision that the government won. REG-127270-06, Damages Received on Account of Personal Physical Injuries or Physical Sickness, 74 F.R. 47152 (9/15/09). The Treasury has published proposed regulations (Prop. Reg. § 1.104-1(c)) under § 104(a)(2) to reflect amendments to § 104 enacted since the current regulations were promulgated and certain judicial decisions. The proposed regulations provide that the § 104(a)(2) exclusion applies to personal *physical* injuries or *physical* sickness. Emotional distress is not considered a physical injury or physical

sickness. However, the proposed regulations provide that damages for emotional distress attributable to a physical injury or physical sickness are excludable under § 104(a)(2). Under the proposed 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 proposed regulations eliminate the requirement in the current regulations that to be excludable under § 104(a)(2) the damages must be "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 proposed regulations to amounts paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995 and received after August 20, 1996.

6. Some bad tax news for over-burdened consumer credit card debtors who beat the bank. They don't beat the IRS! Forgiven accrued but unpaid interest on a consumer loan is COD income. Payne v. Commissioner, T.C. Memo. 2008-66 (3/18/08). Judge Haynes held that the compromise of credit card debt, including interest, incurred for personal living expenses resulted in recognition of COD income for a cash method taxpayer. The § 108(e)(5) exception for cancellation of purchase money debt did not apply because the only relationship between the debtor and creditor was the debtor-creditor relationship and there was no property sale and purchase between the creditor and debtor that gave rise to the debt.

(a) The result must have been so obvious that the Tax Court was affirmed per curiam. Payne v. Commissioner, 104 A.F.T.R.2d 2009-7783 (8th Cir. 12/22/09).

7. The out of pocket cost of compromising consumer debt does not reduce the amount of COD income. Melvin v. Commissioner, T.C. Memo. 2009-199 (9/8/09). The taxpayers owed Chase Manhattan Bank $13,084 on a consumer credit card, and Chase agreed to accept $4,579 to settle the debt. The taxpayers paid a third party (Arbitronix) 25 percent of the $8,505 savings, or $2,126 to negotiate the compromise. The

Tax Court (Judge Halpern) held that the taxpayers recognized COD income in the full amount of the cancelled debt. The "[taxpayers] received goods and services (and cash advances) on credit; when Chase relieved them of their corresponding obligation to pay, petitioners without question received an 'accession to income.'" The court rejected the taxpayer's argument that under § 61(a)(12) itself only the net benefit of the debt cancellation was includable in gross income — that is they should have been allowed to offset their "phantom income" with the "loss" they suffered when they paid the fee. Judge Halpern held that § 61(a)(12) "manifestly does not provide for any kind of deduction." The taxpayers did not argue for a deduction under § 162 because they acknowledged that the amount was not paid with respect to a business, and they did not argue for a § 212 deduction because they were in the AMT.

- One of our colleagues who specializes in consumer law commented, "What a rip-off. If the people had called Chase themselves they probably could have gotten an even better deal than the third party did, and saved 25 percent."

8. The IRS was not entitled to rely on a naked Form 1099-C to show cancellation of indebtedness income occurred in a particular year. Linkugel v. Commissioner, T.C. Summ. Op. 2009-180 (12/1/09). The taxpayer's house was foreclosed upon in 2000, and the mortgagee secured a deficiency judgment in the amount of $35,247, which it made no effort to collect. Citigroup acquired the mortgagee in late 2000 and also engaged in no efforts to collect upon the judgment. In 2007, a Citigroup subsidiary issued a Form 1099-C in the deficiency amount for the 2006 taxable year. The taxpayer failed to include the cancellation of indebtedness income on his 2006 return, and IRS determined a deficiency. The taxpayer asserted that the COI income occurred in an earlier year. Special Trial Judge Armen held that taxpayer was entitled to a shift in the burden of proof under § 6201(d), which required the IRS to present other evidence to support the incidence of the cancellation of debt income in 2006. The IRS failed to meet its burden of production.

- The court relied on *Portillo v. Commissioner*, 932 F.2d 1128 (5th Cir. 1991), which was codified as § 6201(d) in the 1996 second Taxpayer Bill of Rights.

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

1. Mucking stalls for 60 horses helps avoid the hobby loss limitations. Helmick v. Commissioner, T.C. Memo. 2009-220 (9/22/09). The taxpayers conducted a horse breeding activity involving 40-60 horses on property on which they lived. They incurred substantial losses

for eleven consecutive years and never made a profit. Their other income was a modest salary. Judge Gustafson allowed the claimed losses, and stated:

> Although their intention to make the activity eventually profitable was objectively unreasonable, it was their genuine subjective intention. By the time of the years in issue, the Helmicks had invested so much time and effort in this failing activity that they could see no way out except to somehow make the thing work. No other possible purpose explains their willingness to persist in an activity that had become so frustrating and unpleasant.

D. Deductions and Credits for Personal Expenses

1. Helping entry-level homebuyers invest in the bear housing market. Code § 36, added by the **Housing Assistance Tax Act of 2008**, provides a refundable credit for a "first-time homebuyer" who purchases a principal residence on or after 4/9/08, and before 1/1/09. The amount of the credit is the lesser of 10 percent of the purchase price or $7,500 ($3,750 in the case of a married individual filing a separate return). If two or more unmarried persons purchase a principal residence together, the total amount of the credit will be allocated among them as prescribed by the IRS. The credit is phased out over the modified adjusted income range of $75,000 to $95,000 ($150,000 to $170,000 in the case of a joint return). A person qualifies as a "first-time homebuyer" if neither the person nor the person's spouse (if any) owned a principal residence at any time during the three-year period ending on the date of purchase of the credit-generating residence. The credit is not available if the taxpayer purchased the property from a related person or acquired it by gift, or if the taxpayer's basis in the property is determined under § 1014. (Persons are related for this purpose if they are related for purposes of § 267 or § 707, except that the family of an individual under § 267(c)(4) is limited for this purpose to his spouse, ancestors, and lineal descendants.) The credit is also not available: (1) if a credit under § 1400C (relating to first-time homebuyers in the District of Columbia) has ever been allowable to the taxpayer; (2) if the taxpayer's financing is from tax-exempt mortgage revenue bonds; (3) if the taxpayer is a nonresident alien; or (4) if the taxpayer disposes of the residence or ceases to use it as his principal residence before the close of the taxable year.

- The amount of the credit is recaptured ratably over the 15-year period beginning with the second taxable year following the taxable year in which the credit-generating purchase was made. For example, if a taxpayer properly claimed a credit of $7,500 for a purchase in 2008, the recapture amount would be $500 in 2010, with another $500 recapture amount in each of the next 14 years. Thus, the credit actually

functions as an interest-free loan from the government to the taxpayer. If, prior to the end of the 15-year recapture period, a taxpayer disposes of the credit-generating residence or ceases to use it as his principal residence, the recapture of any previously unrecaptured credit is accelerated. In the case of a sale of the principal residence to an unrelated person, the recapture amount is limited to the amount of gain (if any) on the sale. There is no recapture (either regular or accelerated) after the death of a taxpayer, and there is no accelerated recapture following an involuntary conversion of a residence if the taxpayer acquires a new principal residence within the next two years. If a credit-generating residence is transferred between spouses or incident to a divorce, in a transaction subject to § 1041, any remaining recapture obligation is imposed solely on the transferee.

- Although the credit is ordinarily allowed with respect to the year in which the credit-generating purchase occurred, a taxpayer purchasing a home in 2009 (before July 1) may elect to treat the purchase as having been made in 2008, for the purpose of claiming the credit on his 2008 tax return. If the election is made, the first year of the recapture period will be 2010, rather than 2011.

(a) The homebuyer credit started out as an interest-free loan, but now it's outright free money from the federal government. Section 1006 of the **2009 ARRA** amended Code § 36(h) to extend the life of the first-time homebuyer credit through November 30, 2009, and to increase the amount of the credit to $8,000 for 2009. It also amended § 36(f) to eliminate the recapture of the credit for a home purchased in 2009, unless the home is sold or ceases to be the taxpayer's principal residence within 36 months of the date of purchase.

(b) Extended and modified in the Worker, Homeownership, and Business Act of 2009. Section 11 of the WHABA of 2009 amends Code § 36 to extend the credit for homes purchased through 5/1/10 (7/1/10, if subject to a binding contract on 5/1/10). Extension and Modification of First-Time Homebuyer Credit (§ 36)

- An individual (and, if married, the individual's spouse) who has maintained the same principal residence for any five-consecutive year period during the eight-year period ending on the date of the purchase of a subsequent principal residence is treated as a first-time homebuyer. The maximum allowable credit for such taxpayers is $6,500. This provision applies to residences purchased after 11/30/09.
- There are, of course, income limitations for the credit, with phaseouts between $225,000 and $245,000 of AGI, as well as a purchase price limit of $800,000.

(c) We guess DOMA doesn't apply to domiciles. Notice 2009-12, 2009-6 I.R.B. 446 (1/15/09). This notice explains how to allocate the § 36 first-time homebuyer credit between unmarried co-purchasers of a principal residence. Any reasonable method is allowed when two unmarried individuals purchase a first home as tenants in common. Under some circumstances a full $7,500 credit can be obtained even where one buyer would not qualify for any amount of credit under the phaseout rules, if both contribute to purchase and both are first-time buyers.

2. A little help for the auto industry, but it's probably not enough. Section 1008(b) of the **2009 ARRA** added Code § 164(b)(6) to allow taxpayers who do not elect to deduct state and local general sales taxes under § 164(b)(5) to deduct state and local sales and excise taxes paid on the purchase of new cars, light trucks, motorcycles, and recreational vehicles in 2009. The deduction is available only with respect to the first $49,500 of the purchase price, is phased out for taxpayers with adjusted gross incomes (with certain modifications) in excess of $125,000 ($250,000 in the case of a joint return), and is fully phased out when adjusted gross income (as modified) exceeds $135,000 ($270,000 in the case of a joint return). The deduction is allowed as a deduction in computing adjusted gross income and thus is allowable whether or not the taxpayer itemizes deductions.

3. Pennies from heaven: the "making work pay" credit. Code § 36A, added by § 1001(a) of the **2009 ARRA**, provides individuals a refundable tax credit for 2009, and only for 2009, equal to 6.2% of earned income. The maximum credit is $400 for a single individual and $800 for married taxpayers filing a joint return. The credit amount is reduced (but not below zero) by two percent of taxpayer's adjusted gross income (with certain limited modifications relating to foreign income) in excess of $75,000 for single taxpayers, or in excess of $150,000 for married couples filing jointly. A taxpayer who is claimed as a dependent by another taxpayer is ineligible for the credit. The credit can be claimed through a reduction in income tax withholding or by claiming the credit on a tax return.

(a) All Social Security recipients are entitled to this payment, i.e., there is no income ceiling on it! Section 2201 of the **2009 ARRA** (in the title called Assistance for Unemployed Workers and Struggling Families) provides for a one-time $250 payment to adults who were entitled to receive social security, etc. payments in any of the months of November 2008, December 2008, or January 2009. This payment will reduce the "making work pay" credit.

4. "Go forth and propagate." More kids, more EITC. Section 1001(a) of the **2009 ARRA** added Code § 32(b)(3) to increase the EITC credit rate for taxpayers with three or more children to 45 percent of earned income up to $12,570 for taxable years 2009 and 2010. The Act also amended Code § 32(b)(2)(B) for 2009 and 2010 to increase the phase-out threshold for joint returns to $5,000 more than the phase-out threshold for single returns (subject to an inflation adjustment in 2010).

(a) Viva Viagra! More stimulating of propagation. Section 1004 of the **2009 ARRA** amended Code § 24(d) to allow the child tax credit to be refundable to the extent of 15 percent of the taxpayer's earned income in excess $3,000 for 2009 and 2010.

5. QEEIs to your house are the key to a credit. Section 25C, added to the Code by the **Energy Tax Incentives Act of 2005** and amended significantly by § 1121 of the **2009 ARRA**, provides a nonrefundable credit for certain expenditures to improve the energy efficiency of a taxpayer's principal residence. As amended, the credit is available for property placed in service in 2006, 2007, or 2009 (but not for property placed in service in 2008). In the case of "qualified energy efficiency improvements" (QEEIs), the credit equals 30 percent of the cost of the improvements (10 percent for years before 2009). A QEEI is any energy efficient building component (i.e., insulation, exterior windows and doors, certain coated metal roofs, and asphalt roofs with cooling granules) satisfying criteria established by the 2000 International Energy Conservation Code, if the original use of the component commences with the taxpayer and the component is expected to remain in use for at least five years. The other category of credit-eligible costs is "residential energy property expenditures" (REPEs). REPEs are expenditures for the following types of property, if they are installed in the taxpayer's principal residence and satisfy energy efficiency standards to be promulgated by the Treasury Department pursuant to detailed statutory instructions: (1) main air circulating fans; (2) natural gas, propane or oil furnace or hot water boilers; and (3) "energy efficient building properties" (electric heat pump water heaters; electric heat pumps; geothermal heat pumps; certain air conditioners; water heaters using natural gas, propane, or oil; and stoves burning biomass fuel). (The §25C credit is not available for geothermal heat pumps placed in service in 2009. Instead, a credit is available under §25D.) For REPEs the credit amount is established by schedule: the first $50 of the cost of a main air circulating fan, the first $150 of the cost of a natural gas, propane, or oil furnace or hot water boiler, and the first $300 of the cost of any item of energy-efficient building property. For years prior to 2008, there was a lifetime limit of $500 on the aggregate credits a taxpayer could claim under § 25C, of which no more than $200 could be based on expenditures for windows. Section 1121(a) of the

2009 ARRA amended § 25C(b) to eliminate the lifetime limit and replace it with an aggregate limit of $1,500 for 2009 and 2010.

6. Enlisting the tax Code to help stop funding both sides in the war on terror: Credit for generating power at home. Code § 25D, added by the Energy Tax Incentives Act of 2005, and modified by the Tax Relief and Health Care Act of 2006 and by the Energy Improvement and Extension Act of 2008, provides a nonrefundable credit for certain expenditures on residential energy-efficient property. Qualifying property is of five types: (1) solar electric property (which uses solar energy to generate electricity); (2) solar water heating property; (3) fuel cell property (which converts a fuel into electricity using electrochemical means); (4) small wind energy property (which uses a wind turbine to generate electricity for a residence); and (5) geothermal heat pump property (which uses the ground or ground water to heat or cool a residence). The property must be installed in a dwelling unit located in the United States and used by the taxpayer as a residence (principal residence, in the case of fuel cell property). Expenditures allocable to a swimming pool or hot tub are not eligible for the credit. The credit equals 30 percent of qualifying expenditures. For years prior to 2009, the credit was subject to annual ceilings (on the credit amount, not on credit-eligible expenditures) of $2,000 for solar electric property, $2,000 for solar water heating property, $500 per half kilowatt of capacity of fuel cell property, $500 per half kilowatt capacity (but not more than $4,000 in total) of small wind energy property, and $2,000 for geothermal heat pump property.

(a) As amended by § 1122(a)(1) of the **2009 ARRA**, § 25D(b) provides that, for taxable years beginning after 12/31/08, there are no ceilings except the $500 ceiling on fuel cell property. The credit may be claimed against the AMT as well as the regular income tax, and unused credit amounts may be carried forward. The credit is available only for property placed in service before 2017.

7. This CCA on deductible home mortgage interest will break a lot of hearts in California – almost as many as the voters broke in November 2008. CCA 200911007 (11/24/08; released 3/13/09). This CCA addressed the amount of interest that was deductible as "qualified residence interest" under § 163(h)(3)(A) when a residence encumbered by a purchase money mortgage of more than $1 million is co-owned by two unmarried taxpayers both of whom are obligated on the mortgage and for both of whom the residence is the principal residence. The CCA holds that the $1 million ceiling on "acquisition indebtedness," as defined in § 163(h)(3)(B), applies on a residence-by-residence basis as well as on a taxpayer-by-taxpayer basis. Its reasoning is as follows.

> Under § 163(h)(3)(B)(i), acquisition indebtedness is defined, in relevant part, as indebtedness incurred in acquiring a qualified residence of the taxpayer – not as indebtedness incurred in acquiring taxpayer's *portion* of a qualified residence. The entire amount of indebtedness incurred in acquiring the qualified residence constitutes "acquisition indebtedness" under § 163(h)(3)(A)(i). In this case, the amount of indebtedness incurred in acquiring [the residence] exceeds $1,000,000. However, under § 163(h)(3)(B)(ii), the amount *treated* as acquisition indebtedness for purposes of the qualified residence interest deduction is limited to $1,000,000 of total, "aggregate" acquisition indebtedness. This is evident from the parenthetical in § 163(h)(3)(B)(ii).

- The CCA addressed only the tax consequences of one of the co-owners — the one who originally had owned the property in fee simple and was solely obligated on the mortgage and who subsequently conveyed an undivided ownership interest to a second person who also became obligated on the mortgage. The CCA concluded that the interest deductible by the taxpayer in question was to be determined by multiplying the amount of interest the taxpayer paid by a fraction: $1,000,000 divided by the amount of mortgage. Thus, for example, if the amount of the mortgage were $1,500,000 and the taxpayer paid $75,000 of interest, the amount of the taxpayer's interest deduction would be $50,000, i.e., $75,000 x ($1,000,000 ÷ $1,500,000).
- Some practitioners and tax professors had asserted prior to the issuance of this CCA that they assumed that unmarried co-owners could each deduct mortgage interest on $1 million of acquisition indebtedness, thus permitting deduction of interest on a $2 million mortgage on a home they owned in common. At least two of us believe that the reasoning and conclusion of the CCA limiting to $1 million the amount of "acquisition indebtedness" that can be taken into account collectively by all of the owners of the residence likely is correct; the third of us lives in California (but probably agrees anyway). A careful reading of the statutory language indicates that because § 163(h)(3)(B)(ii) omits any reference to a "taxpayer," it limits to $1 million the aggregate amount of "acquisition indebtedness" that maybe taken into account in determining the amount of "qualified residence interest" with respect to all of the taxpayers that might reside in that residential unit. If it does not do so, and each taxpayer who resides in the residence who is an owner and is obligated on the "acquisition indebtedness" mortgage should be entitled to deduct interest paid on up to $1 million of acquisition indebtedness, then on a joint return each of the husband and wife, who are separate and distinct taxpayers (see, e.g. *Frahm v. Commissioner*, T.C. Memo. 2007-351), would be entitled to deduct interest on up to $1 million of "acquisition indebtedness." But the statute clearly does not contemplate that result, as evidenced by the

limitation on the deduction to the interest on $500,000 of acquisition indebtedness by married taxpayers who file separately. The parenthetical indicates, even though it does not expressly state, that a husband and wife who each own a one-half interest in the residence and are jointly and severally liable on the mortgage can deduct interest on up to only $1 million of acquisition indebtedness. An interpretation of the statute that applies the $1 million ceiling on "acquisition indebtedness," as defined in § 163(h)(3)(B), on both a residence-by-residence basis, and on a taxpayer-by-taxpayer basis avoids this "marriage penalty" that would otherwise arise.

8. The IRS recedes from Tax Court victories on the scope of "home equity indebtedness." ILM 200940030 (8/7/09). Home mortgage indebtedness in excess of $1,000,000 may qualify as home equity indebtedness under § 163(h)(3)(C). The position taken in the memo is inconsistent with *Pau v. Commissioner*, T.C. Memo. 1997-43, and *Catalano v. Commissioner*, T.C. Memo. 2000-82, but is consistent with the instructions in IRS Pub. 936, Home Mortgage Interest Deduction.

- Shouldn't this position be stated in a published revenue ruling since Tax Court decisions are the law and instructions in IRS Publications are not the law?

9. Taxpayer whose blood contained 0.09 percent alcohol was not drunk enough to be grossly negligent. At least he drove more than 400 yards before crashing. Rohrs v. Commissioner, T.C. Summ. Op. 2009-190 (12/10/09). The Tax Court (Judge Gerber) held that a taxpayer who totaled his 2½-month-old $40,000 pickup truck was entitled to a $33,629 casualty loss deduction because driving with a blood alcohol content of 0.09 percent is not "willful negligence" for purposes of Reg. § 1.165-7(a)(3). The court held that taxpayer took care to secure transportation to and from a party he attended, and believed he was not impaired when he drove to his parents' house and failed to successfully negotiate a turn resulting in his truck sliding off an embankment and rolling over. The court saw no reason to rely on public policy to deny the loss deduction, and the court held that taxpayer was not liable for the § 6662(a) accuracy-related penalty.

E. Divorce Tax Issues

There were no significant developments regarding this topic during 2009.

F. Education

1. Stimulating increases in college tuition. Section 1004(a) of the **2009 ARRA** added Code § 25A(i) to increase the Hope Scholarship Credit for 2009 and 2010 to the sum of (1) 100 percent of the first $2,000 of tuition, fees and course materials, and (2) 25 percent of the next $2,000, paid during the taxable year. The maximum credit is $2,500. The temporarily increased credit has been named the "American Opportunity Tax Credit." In addition to increasing the amount of the credit, the **2009 ARRA** extends the availability of the credit to the first four years of post-secondary education (in lieu of the prior two-year rule), and adds "course materials" to the expenses eligible for the credit (previously only tuition and fees had been eligible). Thus, for 2009 and 2010, the credit can be claimed with respect to a student with respect to whom the credit already had been claimed for two years. The revised credit can be claimed against the alternative minimum tax. Forty percent of the allowable credit is refundable, unless the taxpayer is a child subject to the § 1(g) "kiddie tax." The American Opportunity Tax Credit is phased out for taxpayers with adjusted gross income in excess of $80,000 ($160,000 for married couples filing jointly) under the same formula as the Hope Scholarship Credit.

2. A little stimulus for Apple, HP, Dell, Microsoft, etc. Section 1005(a) of the **2009 ARRA** amended Code § 529(e)(3)(A) to include as qualified expenses, amounts paid or incurred in 2009 or 2010 for computer technology or equipment (including internet access and related services) used by the beneficiary during the time the beneficiary is enrolled at an eligible institution. Expenses for computer software designed for sports, games, or hobbies do not qualify "unless the software is predominantly educational in nature" – whatever that might mean.

G. Alternative Minimum Tax

1. Whittling away yet more at the original purpose of the AMT: Why not just rename it the "special tax on blue state taxpayers with kids?" Code § 57(a)(5)(vi), added by § 1503(a) of the 2009 ARRA, provides that interest on private activity bonds issued in 2009 and 2010 will not be treated as a tax preference item for AMT purposes; if the bond is issued in one of those years the interest will be tax-exempt for purposes of the AMT (as well as for regular tax purposes) even though the interest is received after 2010.

VI. CORPORATIONS

A. Entity and Formation

1. To check the box, 75 days is extended to 3 years and 75 days. Rev. Proc. 2009-41, 2009-39 I.R.B. 439 (9/3/09). Reg. § 301.7701-3(c)(1) provides that an election by an unincorporated entity to be taxed as an association is effective on a date specified in the election on Form 8832, or on the date the form is filed if no date is specified. The effective date cannot be more than 75 days before or twelve months after the date on which the Form 8832 is filed. Under Reg. § 301.7701-3(d)(1), an election affecting a foreign entity is relevant when its classification affects the tax liability of any person for federal tax or information purposes. The revenue procedure extends the provisions for relief provided in Rev. Proc. 2002-59, 2002-2 C.B. 615, to include both an election with respect to newly electing entities and a change in an existing election. This revenue procedure provides for an application to an IRS service center for relief from failure to timely file the form 8832 for up to three years and 75 days after the effective date of the election. Relief is available if the entity can establish reasonable cause for its failure to timely file its Form 8832, the application includes a completed Form 8832, and all tax returns affected by the election have been filed consistently with the elected status. The revenue procedure also provides that relief may be sought by an entity not eligible for relief under the terms of the revenue procedure by filing a request for a letter ruling that includes a statement that all required tax and information returns have been timely filed as if the entity classification election had been in effect on the effective date requested.

B. Distributions and Redemptions

1. Section 162(k)'s bite is as loud as its bark. Ralston Purina Co. v. Commissioner, 131 T.C. 29 (9/10/08). Ralston Purina claimed a deduction under § 404(k) for payments made to its ESOP in redemption of Ralston Purina preferred stock owned by the ESOP to fund distributions to employees terminating participation in the ESOP. The Commissioner argued the redemption payments were not deductible under either § 404(k)(1) or (5), or alternatively that the deduction was barred by §162(k). The Tax Court, in a unanimous reviewed opinion by Judge Nims, held that because Ralston Purina's payments were "in connection with the redemption of its own stock," § 162(k) applied to disallow the deduction. The Tax Court refused to follow the contrary opinion on almost identical facts in *Boise Cascade Corp. v. United States*, 329 F.3d 751 (9th Cir. 2003). In *Boise Cascade* the Ninth Circuit interpreted the phrase "in connection with" to include only expenses that have their origin in a stock redemption transaction, excluding expenses

that have their origin in a "separate, although related, transaction." The Tax Court previously had rejected the Ninth Circuit's narrow interpretation of the phrase "in connection with" in *Fort Howard Corp. v. Commissioner*, 103 T.C. 345 (1994), and did so again in *Ralston Purina*. The court rejected Ralston Purina's argument that because the payments were an applicable dividend under § 404(k), the transaction was excepted from the application of § 162(k) under § 162(k)(2)(A)(ii). The Tax Court reasoned that the entire transaction potentially deductible as an applicable dividend under § 404(k) — payment from the corporation to the ESOP and the distribution to the ESOP participants — must also pass muster under § 162(k), and that the 'otherwise allowable' deduction was disallowed because the payment was 'in connection with' a repurchase of stock.

(a) And the Third Circuit agrees with the Tax Court, not with the Ninth Circuit. Conopco, Inc. v. United States, 572 F.3d 162 (3d Cir. 7/13/09), *aff'g* 100 A.F.T.R.2d 2007-5296 (D. N.J. 7/18/07). The court held that assuming that Conopco's payments were applicable dividends under § 404(k)(1) — an issue that it did not reach — "where a corporation makes payment to an ESOP trust in redemption of its stock, the otherwise allowable § 404(k)(1) deduction for an applicable dividend inevitably involves an 'amount paid or incurred by a corporation in connection with the reacquisition of its stock' and is therefore barred by § 162(k)(1)."

(b) The dog food corporation precedent wasn't the people's food corporation's best friend. General Mills v. United States, 554 F.3d 727 (8th Cir. 1/26/09). General Mills claimed a deduction under § 404(k) for payments made to its ESOP in redemption of General Mills stock owned by the ESOP to fund distributions to employees terminating participation in the ESOP. In a very brief opinion, the court (Judge Benton) held that §162(k) barred the deduction for the "applicable dividend" otherwise allowable under § 404(k). The court followed the Tax Court's decision in *Ralston Purina Co. v. Commissioner*, 131 T.C. 29 (9/10/08), and refused to follow the contrary opinion in *Boise Cascade Corp. v. United States*, 329 F.3d 751 (9th Cir. 2003), because it disagreed with the reasoning of *Boise Cascade*.

2. Every share of stock is a separate item of property and the results of (almost) every Subchapter C transaction should be determined with respect to the consideration received in regard to each share. REG-143686-07, The Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities, 74 F.R. 3509 (1/21/09). The Treasury and IRS have published proposed regulations under §§ 301, 302, 304, 351, 354, 356, 358,

368, 861, 1001, and 1016 regarding the recovery of stock basis in (1) § 301 distributions and transactions that are treated as § 301 distributions, and (2) sale and exchange transactions to which § 302(a) applies (including certain aspects of reorganization exchanges). The proposed regulations also provide the method for determining gain realized under § 356 and make a number of clarifying, but nonsubstantive, modifications to the rules for determining stock basis under § 358 resulting from a reorganization. The core principal underlying the rules is that each share of stock is a separate unit of property that can be sold or exchanged and the results of a transaction should be determined with respect to the consideration received in regard to each share.

- *Section 301 distributions* — A § 301 distribution is received on a pro rata, share-by-share basis with respect to the class of stock upon which the distribution is made. Prop. Reg. § 1.301-2. A distribution that is not a dividend under §§ 301(c)(1) and 316 can result in gain with respect to some shares of a class while other shares have unrecovered basis. (This is consistent with the holding in *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971).)

- *Dividend equivalent redemptions* — The same basis recovery rules that apply to §301 distributions apply to redemptions that do not qualify under § 302(a) and (b) ("dividend-equivalent redemptions") and § 304 transactions that are taxed under § 301. Prop. Reg. §§ 1.302-5(a), 1.304-2. A dividend equivalent redemption results in a pro rata, share-by-share distribution to all shares of the redeemed class held by the redeemed shareholder immediately before the redemption. The term "redeemed class" means all of the shares of that class held by the redeemed shareholder. Only the basis of shares of the redeemed class may be reduced before gain is realized. Dividend equivalent redemptions can produce gain with respect to some shares while other shares have unrecovered basis.

- *Basis adjustments in dividend equivalent redemptions if less than all of the shares of a single class held by the taxpayer are redeemed* — If less than all of the shares of a class of stock held by the taxpayer are redeemed, the redeemed shareholder is treated as exchanging in a tax-free reorganization all of the shares in the class owned before the redemption for the number of shares held after the redemption transaction. Prop. Reg. § 1.302-5(2). Reg. § 1.358-2 applies to preserve the basis of the shares in the shareholder's remaining shares. Thus, a dividend equivalent redemption is generally treated in the same manner, and its results are the same as, a § 301 distribution in which no shares were cancelled.

- *Example* — A owns all 100 shares of the common stock (the only class) of X Corporation. At different times, A acquired 50 shares for $100 (block 1) and 50 shares for $200 (block 2). The corporation, which has no earnings and profits, redeems all of A's block 2

shares for $300. Under §§ 302(d) and 301, the redemption proceeds are treated as a recovery of basis. The distribution of property is applied on a pro rata, share-by-share basis with respect to each of the shares in the redeemed class owned by A before the redemption. Thus, A recognizes a $50 capital gain on block 1 ($150-100) under § 301(c)(3) and has $50 of basis remaining in block 2 ($150-200). To reflect the actual number of shares held by A after the redemption, A's shares in the redeemed class, including the shares actually surrendered, will be treated as exchanged in a recapitalization under section 368(a)(1)(E). A's basis in the 50 recapitalized shares is determined under Reg. §1.358-2. Thus, A has 25 shares with a zero basis (attributable to block 1) and 25 shares with a basis of $50 (attributable to block 2).

- *Basis recovery in dividend equivalent redemptions in which the taxpayer surrenders all of its shares in a single class* — If all of the shares of a single class held by a shareholder are redeemed in a dividend equivalent redemption, under Prop. Reg. § 1.302-5(a)(3), the unrecovered basis is treated as a deferred loss that can be used by the shareholder when (1) the conditions of §§ 302(b)(1), (2), or (3) are satisfied, or (2) when all the shares of the issuing corporation (or its successor) become worthless under § 165(g). The current rules in Reg. § 1.302-2(c) that permit unrecovered basis in the redeemed shares to shift to other shares would be revoked.
- *Dividend equivalent reorganization exchanges* — If boot is received in a reorganization that qualifies under § 368, the proposed regulations provide that the overall reorganization exchange is taken into account in determining whether a particular exchange in which boot is received is dividend equivalent. For example, if a shareholder exchanges one class of stock for stock and boot and exchanges another class of stock solely for boot, the effect of the overall exchange is considered in determining whether each particular exchange is dividend equivalent. If the boot received in the exchange is a dividend equivalent, an exchange of a class of stock solely for boot is an exchange to which § 302(d), and thus § 301, rather than § 356(a)(2), applies. However, the boot is treated as received pro rata, on a share-by-share basis, with respect to each share in the class. If both stock and boot are received with respect to a surrendered class (or classes) of stock and the boot is dividend equivalent, all of the consideration received in the exchange is treated as received pro rata (by value) with respect to all surrendered shares in the class. Prop. Reg. §§ 1.354-1(d); 1.356-1(b). However, economically reasonable designations between classes of stock or securities (as opposed to within a class) generally will be recognized.
- *Redemptions given sale or exchange treatment by § 302* — The proposed regulations do not change the rule that in a § 302(a) redemption, a shareholder who owns shares of stock with different bases can decide whether to surrender high basis shares, low basis shares or any combination thereof, as permitted by Reg. §1.1012-1(c). The acquiring

corporation takes a cost basis in the stock of the issuing corporation that it acquires under § 1012. If § 304 applies and the sale of issuer stock is treated as a sale or exchange, rather than as a § 301 distribution, the basis and the holding period of the common stock of the acquiring corporation that is treated as redeemed will be the same as the basis and holding period of the stock of the issuing corporation actually surrendered.

- *Reorganization exchanges resulting in sale or exchange treatment* — If boot received in a reorganization is not a dividend equivalent, § 302(a) applies to the extent shares are exchanged solely for boot. A shareholder can elect to surrender high basis shares, low basis shares or any combination thereof in a non-dividend equivalent redemption, a shareholder engaging in a reorganization exchange in which the boot is not dividend equivalent can designate the shares with respect to which the boot was received and the amount of boot received with respect to each share, provided that the terms of the exchange are economically reasonable. Prop. Reg. § 1.354-1(d)(1). If solely boot is received with respect to a share, the shareholder will recognize gain or loss with respect to that share pursuant to § 302(a), and § 356(a)(1) will not apply. Nor will § 356(c) deny the loss. Prop. Reg. § 1.354-1(d)(2).

- *Section 351 exchanges* — Prop. Reg. § 1.351-2(b) would provide that the amount of gain recognized under § 351(b) as a result of the receipt of boot, is determined by allocating the fair market value of each category of consideration received by a transferor among the transferred properties in proportion to each property's relative fair market value. This is the approach of Rev. Rul. 68-55, 1968-1 C.B. 140. Prop. Reg. § 1.358-2(g) provides as a general rule that in a § 351 exchange, the aggregate basis of the property transferred (as adjusted for gain and boot) is allocated among all of the shares of stock received in proportion to the fair market values of each share of stock. However, under Prop. Reg. § 1.358-2(g), if a shareholder transfers stock and other property, the separate bases will be preserved in the § 358 basis of the stock received in the exchange, provided that no liabilities are assumed in the exchange.

3. Does this case mean an "accidental" benefit conferred on a corporate shareholder is not a constructive dividend? Cox Enterprises, Inc. v. Commissioner, T.C. Memo. 2009-134 (6/9/09). A member of Cox Enterprises' affiliated group transferred the assets of a television station to a partnership in exchange for a majority interest in the partnership. Two family partnerships, the partners of which were family members of three trusts that together held a 98 percent majority interest in Cox Enterprises contributed cash to the partnership and received minority interests. The IRS asserted that under § 311(b), the Cox Enterprises group recognized income on the constructive transfer to the trusts of a portion of the partnership interest it received in exchange for the assets, because the

partnership interest received by the Cox Enterprises group member that transferred the assets was worth $60.5 million less than the value of the transferred assets. The Commissioner's theory was that the Cox Enterprises group had constructively distributed a dividend of an economic portion of its partnership interest to the shareholder trusts by transferring to family partnerships "for the benefit of" the shareholder trusts. On the taxpayer's motion for summary judgment, for purposes of the motion, the $60.5 million disparity was between the value of the assets and the value of the partnership interest it received in return was admitted. Judge Halpern found that the undisputed facts established that Cox Enterprises' primary purpose was not to provide an economic benefit to the family partnerships and, derivatively, to the shareholder trusts. In summarizing the applicable case law, he quoted *Gilbert v. Commissioner*, 74 T.C. 60, 64 (1980): "'[T]ransfers between related corporations can result in constructive dividends to their common shareholder if they were made primarily for his benefit and if he received a direct or tangible benefit.' If the benefit to the shareholder is 'indirect or derivative in nature, there is no constructive dividend.'" Applying this legal standard to his factual conclusion, there was not a constructive dividend to the shareholder trusts, even though an economic benefit was conferred on the beneficiaries of the shareholder trusts. Judge Halpern found the transfer of the television station to the partnership had a business purpose and that because a gratuitous transfer of assets would have violated the board of directors' fiduciary duty, a purpose to make a gratuitous transfer could not be assumed to exist merely due to the value disparity. Accordingly, no gain was recognized under § 311(b). Judge Halpern rejected the Commissioner's argument that to find a constructive dividend "it is only necessary to establish that appreciated assets left the corporate solution … , for the benefit of its Shareholder Trusts, to establish that there has been a distribution with respect to [the] Shareholder Trusts' stock to which section 311 applies."

4. Reducing E&P for nondeductible expenses. Rev. Rul. 2009-25, 2009-38 I.R.B. 365 (9/4/09). Interest paid by a corporation on a loan to purchase a life insurance policy on an individual for which a deduction has been disallowed under § 264(a)(4) reduces earnings and profits for the taxable year in which the interest would have been allowable as a deduction but for its disallowance under § 264(a)(4). It does not further reduce earnings and profits when the death benefit is received under the life insurance contract.

C. Liquidations

There were no significant developments regarding this topic during 2009.

D. S Corporations

1. Disregarded QSub is still a bank subject to reduced interest deductions for interest incurred to carry tax-exempt obligations. Vainisi v. Commissioner, 132 T.C. No. 1 (1/15/09). Sections 291(a)(3), (e)(1)(B), and 265(b)(3) disallow interest deductions of a financial institution incurred to carry tax-exempt obligations, but allow an 80 percent deduction for interest on tax-exempts acquired after 12/31/82, and before 8/7/86, and for certain qualified tax exempt obligations as defined in § 265(b)(3)(B). Section 1361 allows certain financial institutions to elect to be treated as an S corporation, and further allows an S corporation to treat a financial institution as a qualified S corporation subsidiary (QSub). Under § 1361(b)(3)(A), a QSub is not treated as a separate corporation except as provided in regulations. Reg. § 1.1361-4(a)(3) provides that in the case of a bank that is an S corporation or a QSub of an S corporation, any special rules applicable to banks will apply to an S corporation or a QSub that is bank. The court (Judge Foley) held that under these provisions the limitations of § 291(a)(3) are applicable to interest deductions claimed by a parent S corporation for interest expense generated by the S corporation's QSub bank. The court also held that Reg. § 1.1361-4(a)(3) is consistent with the enactment of § 1361(b)(3)(A) and its legislative history.

2. Suspending the built-in gains tax to goose the economy by encouraging disinvestment in business assets. Section 1251(a) of the **2009 ARRA** amended Code § 1374 to exempt an S corporation from the built-in gains tax for taxable years beginning in 2009 and 2010 if the seventh taxable year in the recognition period preceded the 2009 and 2010 tax years. This rule applies separately for property acquired from C corporations in carryover basis transactions.

3. Another failed attempt to end run the § 1366(d) basis limitation on passed-though losses. Kerzner v. Commissioner, T.C. Memo. 2009-76 (4/6/09). The taxpayers, who were equal partners in a partnership and equal shareholders of an S corporation, attempted to avoid the § 1366(d) limitation on passed-through losses from an S corporation by borrowing money from the partnership and re-lending the loan proceeds to the S corporation, which in turn paid equivalent amounts of rent back to the partnership. The Tax Court (Judge Nims) disallowed the pass-through losses, holding that the taxpayers did not acquire any basis in indebtedness from the S corporation from the transactions because they involved a circular flow of funds and there was no real expectation that they would ever repay the borrowed funds. Thus the taxpayers had not incurred any economic outlay.

4. Check and Elect! A formerly unincorporated entity can move directly to S corporation status. Rev. Rul. 2009-15, 2009-21 I.R.B. 1035 (5/8/09). When an unincorporated entity taxed as a partnership becomes a corporation for federal tax purposes, the corporation is eligible to elect to be taxed as an S corporation effective for its first taxable year as a corporation. Additionally, the corporation will not be deemed to have an intervening short taxable year in which it was a C corporation. These results occur whether: (1) the entity is an unincorporated entity classified as a partnership that both (a) elects under Reg. § 301.7701-3(c)(1)(i) to be treated as a corporation, and (b) elects under § 1362(a) to be taxed as an S corporation, with both elections effective on the same date; or (2) the entity is an unincorporated entity classified as a partnership that both (a) converts into a corporation under a state law formless conversion statute, and (b) elects under § 1362(a) to be taxed as an S corporation, with both elections effective on the same date.

5. Roth IRA is not an eligible S corporation shareholder. Taproot Administrative Services, Inc. v. Commissioner, 133 T.C. No. 9 (9/29/09) (reviewed, 12-4). The taxpayer corporation's sole shareholder was a custodial Roth IRA account. Eligible S corporation shareholders as defined in § 1361 include individuals, estates, certain specifically designated trusts and certain exempt organizations. With an effective date after the year involved in this case, § 1361(c)(2)(A)(iv) was enacted to allow a bank whose stock is held by an IRA or Roth IRA to elect S corporation status. Reg. § 1.1361-1(e)(1) provides that a person for whom S corporation stock is held by a nominee, guardian, custodian or agent is deemed to be the S corporation shareholder. However, in Rev. Rul. 92-73, 1992-2 C.B. 224, the IRS ruled that a trust that qualifies as an IRA is not a permitted S corporation shareholder. Declaring the issue as one of first impression, and indicating that under *Skidmore* deference to revenue rulings depends upon their persuasiveness, the Tax Court (Judge Wherry) agreed with the IRS's rationale in the ruling that IRAs are not eligible S corporation shareholders because the beneficiary of the IRA is not taxed currently on the trust's share of corporate income unlike the beneficiary of a custodial account or the grantor of a grantor trust who is subject to tax on the pass-through corporate income. (The income of the corporation owned by a Roth IRA would never be subject to tax.)

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

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

6. Revenge for *Gitlitz*? T.D. 9469, Section 108 Reduction of Tax Attributes for S Corporations, 74 F.R. 56109 (10/30/09). The Treasury Department has promulgated final regulations proposed in REG-102822-08, Section 108 Reduction of Tax Attributes for S Corporations, 73 F.R. 45656 (8/5/08). Section 108(d)(7)(A) provides that if an S corporation excludes COD income under § 108(a), the excluded amount reduces the S corporation's tax attributes under § 108(b)(2); section 108(b)(4)(A) provides that the reduction occurs after the S corporation's items of income, loss, deduction and credit for the taxable year of the discharge pass through to its shareholders. Pursuant to § 108(d)(7)(B), Reg. § 1.108-7(d) treats any § 1366(d)(3) shareholder carryover losses from prior years and any passed through losses from the current year in excess of the shareholders' bases as a "deemed NOL" of the S corporation that would be reduced under § 108(b). Where an S corporation has more than one shareholder during the taxable year of the discharge, a shareholder's disallowed losses or deductions equal a pro rata share of the total losses and deductions allocated to the shareholder under § 1366(a) during the corporation's taxable year (including losses and deductions disallowed under § 1366(d)(1) for prior years that are treated as current year losses and deductions with respect to the shareholder under § 1366(d)(2)). The regulations provide that the deemed NOL allocated to a shareholder consists of a proportionate amount of each item of the shareholder's loss or deduction that was disallowed under § 1366(d)(1) in the year of the debt cancellation. The regulations were effective on 10/30/09.

E. Mergers, Acquisitions and Reorganizations

1. As the old saying goes, "There's no tax free basis step-up without a funeral." This "midco" tax shelter was rejected by the court. Enbridge Energy Co., Inc. v. United States, 553 F. Supp. 2d 716 (S.D. Tex. 3/31/08). In a transaction substantially similar to the transaction described in Notice 2001-16, 2001-1 C.B. 730, the taxpayer (Midcoast)

acquired the assets of a selling corporation (Bishop) through an intermediary (K-Pipe). Midcoast desired to acquire the Bishop assets with a cost basis, but Bishop's shareholder (Langley) was unwilling to engage in an asset sale, insisting on a stock sale and purchase. Midcoast's tax advisor, PWC, arranged for the formation of an intermediary, K-Pipe Merger, and the financing necessary for K-Pipe Merger to purchase the Bishop stock, with the loan to K-Pipe Merger being secured by Midcoast assets. After a downstream merger of K-Pipe Merger into Bishop, Bishop, which changed its name to K-Pipe Group, sold the Bishop assets to Midcoast. (K-Pipe purportedly offset the gain with built-in loss on assets contributed to it by its shareholder in a pre-§ 362(e) year.) Thereafter, K-Pipe engaged in no business activity and was merely a shell. On cross motions for summary judgment, the District Court (Judge Harmon) upheld the IRS's treatment of the transaction from Midcoast's perspective as a stock sale followed by a § 332 liquidation, which resulted in denying the step-up in basis on which Midcoast's claimed depreciation deductions were based. After disregarding K-Pipe because it had no substance other than as a vehicle to allow Midcoast to claim a cost basis in the Bishop assets in a stock sale transaction without a § 338 election, the court addressed what was the real substance of the transaction: a sale of stock or a sale of assets. Because Langley would not agree to a direct sale of Bishop's assets, "the only way in which Midcoast could have obtained the Bishop Assets was to purchase the Bishop Stock and liquidate." Assessment of the § 6662(d) substantial understatement penalty was upheld, and because the transaction was a "tax shelter," neither the substantial authority nor adequate disclosure exceptions applied. Alternatively, there was not substantial authority because the weight of authority in Supreme Court and Fifth Circuit cases was held to have required disregarding K-Pipe.

(a) Affirmed! Substance over form is alive and well in the Fifth Circuit. Enbridge Energy Co., Inc. v. United States, 104 A.F.T.R.2d 2009-7289 (5th Cir. 11/10/09). In a nonprecedential per curiam opinion, the Fifth Circuit applied the substance over form doctrine in affirming the District Court's decision upholding the IRS's treatment of a "midco" transaction arranged by the buyer as a stock purchase followed by a § 332 liquidation, which resulted in denying the step-up in basis on which the taxpayer's claimed depreciation deductions were based. Imposition of a 20 percent § 6662 penalty also was affirmed.

2. All cash (D) reorgs are now in the final regulations. T.D. 9475, Corporate Reorganizations; Distributions Under Sections 368(a)(1)(D) and 354(b)(1)(B), 74 F.R. 67053 (12/18/09). In 2006, the Treasury Department promulgated Temp. Reg. § 1.368-2T, providing that the distribution requirement under §§ 368(a)(1)(D) and 354(b)(1)(B) is

deemed to have been satisfied despite the fact that no stock and/or securities are actually issued in a transaction otherwise described in § 368(a)(1)(D) if the same person or persons, directly or indirectly, own all of the stock of the transferor and transferee corporations in identical proportions. T.D. 9303, 71 F.R. 75879 (12/19/06). To a limited extent, the attribution rules in § 318 are invoked to determine whether the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee. An individual and all members of his family that have a relationship described in § 318(a)(1) are treated as one individual; and stock owned by a corporation is attributed proportionally to the corporation's shareholder without regard to the 50 percent limitation in § 318(a)(2)(C). Ownership in absolutely identical proportions is not required. A *de minimis* variation in shareholder identity or proportionality of ownership in the transferor and transferee corporations is disregarded. The regulations give as an example of a *de minimis* variation a situation in which A, B, and C each own, respectively, 34%, 33%, and 33% of the transferor's stock and A, B, C, and D each own, respectively, 33%, 33%, 33% and 1% of the transferee's stock. Stock described in § 1504(a)(4) – nonvoting limited preferred stock that is not convertible – is disregarded for purposes of determining whether the same person or persons own all of the stock of the transferor and transferee corporations in identical proportions. When a transaction qualifies as a § 368(a)(1)(D) reorganization under the regulations, a nominal share of stock of the transferee corporation will be deemed to have been issued in addition to the actual consideration. That nominal share of stock is deemed to have been distributed by the transferor corporation to its shareholders and, in appropriate circumstances, further transferred to the extent necessary to reflect the actual ownership of the transferor and transferee corporations. Identical proposed regulations were simultaneously published. The proposed regulations have been finalized, with certain modifications, as Reg. § 1.368-1(e). First, if no consideration is received, or the value of the consideration received in the transaction is less than the fair market value of the transferor corporation's assets, the transferee corporation is treated as issuing stock with a value equal to the excess of the fair market value of the transferor corporation's assets over the value of the consideration actually received in the transaction. If the value of the consideration received in the transaction is equal to the fair market value of the transferor corporation's assets, the transferee corporation will be deemed to issue a nominal share of stock to the transferor corporation in addition to the actual consideration exchanged for the transferor corporation's assets. In addition, Reg. § 1.358-2(a)(2)(iii) has been amended to provide that in a reorganization in which the property received consists solely of non-qualifying property equal to the value of the assets transferred, as well as a nominal share described in the regulations, the shareholder or security holder may designate the share of stock of the transferee to which the basis, if any, of the stock or securities surrendered will attach.

- If an all-cash transaction subject to these regulations occurs between members of a consolidated group, the selling member (S) is treated as receiving the nominal share and additional stock of the buying member (B) under § 1.1502-13(f)(3), which it distributes to its shareholder member (M) in liquidation. Immediately after the sale, the B stock (with the exception of the nominal share which is still held by M) received by M is treated as redeemed in a distribution to which § 301 applies. M's basis in the B stock is reduced under Reg. § 1.1502-32(b)(3)(v), and under Reg. § 1.302-2(c), any remaining basis attaches to the nominal share.

F. Corporate Divisions

There were no significant developments regarding this topic during 2009.

G. Affiliated Corporations and Consolidated Returns

1. Are "new and more precise mechanics" synonymous with "ever-more complicated"? REG-107592-00, Consolidated Returns; Intercompany Obligations, 72 F.R. 55139 (9/28/07). The IRS has proposed amendments to Reg. § 1.1502-13(g) with respect to the treatment of obligations between members of a consolidated group. Reg. 1.1502-13(g) applies to three types of transactions: (1) transactions in which an obligation between a group member and a nonmember becomes an intercompany obligation – for example, the purchase by a consolidated group member of another member's debt from a nonmember creditor or the acquisition by a consolidated group member of stock of a nonmember creditor or debtor (inbound transactions); (2) transactions in which an intercompany obligation ceases to be an intercompany obligation – for example, the sale by a creditor member of another member's debt to a nonmember or the deconsolidation of either the debtor or creditor member (outbound transactions); and (3) transactions in which an intercompany obligation is assigned or extinguished within the consolidated group (intragroup transactions). The proposed regulations "adopt new and more precise mechanics" for the application of the deemed satisfaction-reissuance model to intragroup and outbound transactions. The following sequence of events to occur immediately before, and independently of, the actual transaction: (1) the debtor is deemed to satisfy the obligation for a cash amount equal to the obligation's fair market value; and (2) the debtor is deemed to immediately reissue the obligation to the original creditor for that same cash amount. The parties are then treated as engaging in the actual transaction but with the new obligation. With respect to inbound transactions, the IRS and the Treasury Department have concluded that the

mechanics of the deemed satisfaction-reissuance model and its application produce appropriate results and, therefore, no change has been proposed.

(a) Finalized with various clarifications! T.D. 9442, Consolidated Returns; Intercompany Obligations, 72 F.R. 55139 (1/5/09). The proposed regulations have been finalized without any significant change in the basic framework of the rules. Some of the anti-abuse rules have been modified. The final regulations also clarify that the routine modification exception applies to a deemed exchange of intercompany debt for intercompany debt that occurs under Reg. § 1.1001-3 as a result of an assumption transaction. The final regulations also clarify that an exception for certain § 351 nonrecognition exchanges is available for transactions in which a debtor's obligation is assumed. An exception also applies to exchanges to which both §§ 332 and 337(a) apply in which no amount is recognized by either the creditor or debtor member.

2. Modernizing the "controlled group" definition regulations. T.D. 9451, Guidance Necessary to Facilitate Business Election Filing; Finalization of Controlled Group Qualification Rules, 74 F.R. 25147 (5/27/09). This Treasury decision has finalized Prop. Reg. § 1.1563-1, REG-161919-05, 71 F.R. 76955 (12/22/06), with no substantive changes. Temp. Reg. § 1.1563-1T has been removed. Amendments to § 1563(a) in 2004 expanded the definition of a brother-sister controlled group to a group of corporations if five or fewer persons who are individuals, estates, or trusts own stock more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation. Prior to the 2004 amendments, the definition also required the same five or fewer taxpayers to own at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each corporation (the 80 percent requirement). The revised regulation reflects the elimination of the 80 percent requirement from the § 1563(a)(2) definition of a brother-sister controlled group. The regulations also clarify an S corporation is treated as a component member of a controlled group only to the extent that a particular tax, and thus a particular tax benefit item subject to § 1561(a), applies. In addition, as amended, the regulations refer generically to the tax benefit items listed in § 1561(a) rather than refer specifically to those items by listing and describing each one. Each component member of a controlled group must annually file a form (Form 1120, Schedule O) with its tax return indicating whether or not an apportionment plan is in effect, and any change is made to the group's apportionment of its § 1561(a) tax benefit items from the

previous year. The new regulations also provide ministerial changes to facilitate e-filing.

3. A controlled corporation is not a controlled corporation, except when it is controlled. REG-135005-07, Clarification of Controlled Group Qualification Rules, 74 F.R. 49829 (9/28/09). Section 1563(a) defines groups of controlled corporations based on ownership of voting control and value of stock in parent-subsidiary and brother-sister controlled groups (or a combination). Section 1563(b) excludes certain controlled corporations from being treated as component members, including, among others, a corporation that was a member of the group for less than half of the days of a testing period, foreign corporations that do not have effectively connected income. Section 1561(a) limits the component members of a controlled group to one application of certain benefits and limitations, such as one bite at the taxable income brackets of § 11. In addition, some provisions, such as § 41 which provides a credit for increased research expenditures, treat the members of a controlled group as a single corporation. Controlled group for these purposes is defined by reference to § 1563(a). Prop. Reg. § 1.1563-1(a)(ii) would provide that in determining whether two or more corporations are members of a controlled group under § 1563(a), an excluded member under § 1563(b)(2), while not a component member of a controlled group under § 1563(b)(1), nevertheless is a member of a controlled group under § 1563(a). This proposed regulation is intended to clarify that for purposes of Code provisions other than § 1561(a) that reference the definition of a controlled group under § 1563(a) for purposes of limiting tax benefits, all corporations meeting the ownership requirements are taken into account. The IRS indicates its belief that the provision is supported by clear statutory language.

- The preamble to the proposed regulation states that some taxpayers have taken the position that the limitation of § 41 and similar provisions is applicable only to component members of a controlled group.

4. More controlled group guidance. T.D. 9476, Apportionment of Tax Items Among the Members of a Controlled Group of Corporations, 74 F.R. 68530 (12/28/09). Reg. §§ 1.1561-1 through 1.1561-3 provide rules regarding the apportionment of tax benefit items among corporations that are (1) members of a consolidated group filing a life-nonlife income tax return (life insurance company included with a non-life insurance company) or (2) component members of a controlled group of corporations.

5. More help from the IRS for consolidated groups: Are they "too big to fail?" T.D. 9458, Modification to Consolidated Return

Regulation Permitting an Election To Treat a Liquidation of a Target, Followed by a Recontribution to a New Target, as a Cross-Chain Reorganization, 74 F.R. 45757 (9/4/09). Temp Reg. § 1.1502-13T(f)(5)(ii)(B) modifies the election under which a consolidated group can avoid immediately taking into account an intercompany item after the liquidation of member corporation that previously had been sold within the group. Under the regulations, if § 332 otherwise would apply to a target's liquidation into its parent and the parent transfers substantially all of targets assets to a new member, and if a direct transfer of substantially all of the target's assets to the new member corporation would qualify as a § 368(a) reorganization, *i.e.*, a cross-chain type (D) reorganization, then the liquidation and transfer of substantially all of the assets be disregarded and instead, the transaction will be treated as if target transferred substantially all of its assets to the new corporation exchange for the new corporation's stock and the assumption of T's liabilities in a § 368(a)(1)(D) reorganization. The result is that target's deferred items are not triggered. The temporary regulations generally apply to transactions that occur on or after 10/25/07. The text of the temporary regulations also is text of the proposed regulations. REG-139068-08, 74 F.R. 45789 (9/4/09).

H. Miscellaneous Corporate Issues

1. Who needs Congress to legislate billions of tax benefits via loss carryovers from failing banks that have undergone ownership changes? Notice 2008-83, 2008-42 I.R.B. 905 (10/1/08). Taxpayers which have acquired failing banks will not be limited by § 382(h) in their deductions for losses on loans or bad debts. Under this notice, these losses "shall not be treated as a built-in loss or a deduction that is attributable to periods before the [ownership] change date." This notice applies whether the acquirer is a private investor (including another bank) or is the Treasury.

(a) Congress tells Treasury and the IRS, "You can't do that, but we can grandfather what you did. So there, take this." Section 1261 of **2009 ARRA**, an uncodified provision, generally voided Notice 2008-83 for ownership changes occurring after 1/16/09. However, Notice 2008-83 will be applied to (1) any ownership change occurring on or before 1/16/09, and (2) any ownership change that occurs after 1/16/09, if the change (a) is pursuant to a written binding contract entered in to on or before 1/16/09, or (b) was described on or before that date in a public announcement or in a filing with the SEC required by reason of the ownership change.

2. Again, who needs Congress to permit continued use of loss carryovers of corporations whose toxic paper is acquired by

Treasury? Notice 2008-100, 2008-44 I.R.B. 1081 (10/15/08). This notice provides guidance on the application of § 382 to loss corporations whose financial instruments are acquired by Treasury as part of the Capital Purchase Program pursuant to EESA. Under this program, Treasury will acquire preferred stock and warrants from qualifying financial institutions. This notice specifies that Treasury will not be treated as a 5 percent shareholder for this purpose.

(a) Notice 2009-14, 2009-7 I.R.B. 516 (1/30/09). This Notice amplifies and supersedes Notice 2008-100, 2008-44 I.R.B. 1081, regarding the (non)application of § 382 to corporations the stock or options of which are acquired by the Treasury Department under the Troubled Asset Relief Program. This guidance is optional for taxpayer use, and is focused on treatment of debt, preferred stock, common stock, warrants, and redemption of stock held by the Treasury Department. Any capital contributions made by the Treasury pursuant to TARP programs will not be considered to have been made as part of a plan the principal purpose of which was to avoid or increase any § 382 limitation.

(b) Section 1262 of the **2009 ARRA** added new Code § 382(n), which provides that the § 382 limitations on NOLs do not apply to certain ownership changes under a restructuring plan which (1) is required under a loan agreement or a commitment for a line of credit entered into with the Treasury Department under the Emergency Economic Stabilization Act of 2008, and (2) is intended to result in a rationalization of the costs, capitalization, and capacity with regard to the manufacturing workforce of, and suppliers to, the taxpayer and its subsidiaries. This waiver of § 382 does not apply, however, to an ownership change if, immediately after the ownership change, any person (other than a VEBA under § 501(c)(9)) owns either fifty percent or more of the total combined voting power or value of the stock of the old loss corporation. Related persons (as defined in §§ 267(b) or 707(b)) and persons who are members of a group acting in concert (§ 382(n)(3)(B)) are treated as a single person. The waiver of § 382 does not apply to a subsequent ownership change, unless that ownership change also is described in the preceding sentence. Section 382(n) is effective for ownership changes occurring after 2/17/09.

(c) Notice 2009-38, 2009-18 I.R.B. 901 (4/14/09). This notice amplifies and supersedes Notice 2009-14 to provide guidance to corporate issuers with respect to Treasury's acquisition of instruments pursuant to the following EESA programs: (1) the Capital Purchase Program for publicly-traded issuers (Public CPP); (2) the Capital Purchase Program for private issuers (Private CPP); (3) the Capital Purchase Program for S corporations (S Corp CPP); (4) the Targeted Investment

Program (TARP TIP); (5) the Asset Guarantee Program; (6) the Systemically Significant Failing Institutions Program; (7) the Automotive Industry Financing Program; and (8) the Capital Assistance Program for publicly-traded issuers (TARP CAP).

3. **Help! Stop me before I give away any more money without congressional action.** Notice 2008-101, 2008-44 I.R.B. 1082 (10/15/08). This notice specifies that TARP funds received by banks for "troubled assets" will not be treated as "the provision of Federal financial assistance" within the meaning of § 597. That Code section requires that "Federal financial assistance shall be properly taken into account by the institution from which the assets were acquired."

VII. PARTNERSHIPS

A. Formation and Taxable Years

There were no significant developments regarding this topic during 2009.

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

1. **Rip Van Winkle awakened. After 23 years Treasury has proposed regulations under § 706(d).** REG-144689-04, Determination of Distributive Share When a Partner's Interest Changes, 74 F.R. 17119 (4/14/09). Section 706(d)(1), originally enacted in 1976 and amended in 1984, provides that in any taxable year in which there is a change in a partner's interest, each partner's distributive share of partnership items must be determined under a method prescribed by regulations to take into account the partners' varying interests during the year. Pre-1976 regulations, Reg. § 1.706-(1)(c)(2), mandated the use of the interim closing of the books method, unless the partnership elected a proration method. The proposed regulations would adopt these rules under the current statutory provision, with significant modifications. The proposed regulations continue to mandate the interim closing of the books method, whenever a partner's interest is changed, including a partner's retirement or sale of the partner's entire interest in the partnership, unless the partnership by agreement among the partners elects to use the proration method. Prop. Reg. § 1.706-4(a)(1). For purposes of determining allocations to partners whose interests vary during the taxable year, the proposed regulations would require the partnership to allocate partnership items under its method of accounting for the full taxable year to segments of the taxable year representing discrete periods during which partners' interests vary. Prop. Reg. § 1.706-4(a)(2).

Segments rule.—Under the interim closing of the books method, Prop. Reg. § 1.704-4(c)(2) would allow the partnership to allocate items to a segment of the taxable year ending either on the calendar day a partner's interest changes, or to adopt a semi-monthly convention under which a change in a partner's interest during the first fifteen days of a month would require the partnership to close its books as of the last day of the preceding month, and a change in a partner's interest after the fifteenth day of the month would require the partnership to close its books on the fifteenth day of the month of the change. Prop. Reg. § 1.706-4(e). Under the proration method, the partnership's items for the entire year would be prorated over the full taxable year and allocated among the partners based on their respective percentage interests during each segment of the taxable year. Prop. Reg. § 1. 706-4(d)(1). A segment would end on the calendar day on which a partner's interest changes. Prop. Reg. § 1.706-4(d)(2) &(e)(1).

Prohibition on prorating "extraordinary items.—Prop. Reg. § 1.706-4(d)(3) contains special rules under the proration method that would prevent a prorated allocation of "extraordinary" items, which is a problem under the current regulations for a partner who disposes of the partner's entire interest by liquidation or sale. The proposed regulations would require an allocation of extraordinary items that, in general, arise on a disposition of partnership property to the partners in proportion to their interests at the beginning of the calendar day on which the extraordinary item is taken into account. Extraordinary items include, among others, gain or loss on the disposition or abandonment of capital assets, trade or business property, property excluded from capital gains treatment under § 1221(a)(1), (3), (4), or (5) if substantially all of the assets in a particular category are disposed of in one transaction, discharge of indebtedness, and items from the settlement of tort or third-party liability.

Other stuff.— Although the proposed regulations would apply to a change in a partner's interest attributable to a disposition of a partners entire interest or a partial interest, the proposed regulations would not apply to changes in allocations of partnership items among contemporaneous partners that satisfy the allocation rules of § 704(b), provided that a reallocation is not attributable to a capital contribution to the partnership or a distribution of money or property that is a return of capital. The proposed regulations would also provide safe harbors for changes in the interests of partners in a service partnership under a reasonable method that complies with § 704(b) for taking into account varying interests during the year, and for publically traded units of a publically traded partnership that uses a semi-monthly convention.

Effective date.—The proposed regulations would be applicable to partnership taxable years beginning after the date of publication of final regulations, but not before taxable years beginning after 12/30/09.

2. If you lose it once, you can't claim it again. LeBlanc v. United States, 104 A.F.T.R.2d 2009-7611 (Fed. Cl. 12/4/09). The taxpayers invested as limited partners in an agriculture limited partnership that produced farming expense deductions in its first year of operation. In a TEFRA audit proceeding, the partnership agreed to the disallowance of a portion of the deductions from transactions lacking economic substance. In a separate Tax Court proceeding, while the partnership proceeding was still pending, the taxpayers agreed to a settlement disallowing the same deductions on the partners' return. Several years later the taxpayers claimed a loss deduction from abandonment of the partnership interest in a refund suit. The taxpayers claimed that as a result of the settlements with the IRS they retained a substantial basis in their partnership interest which resulted in a loss on abandonment of the partnership interest. First, the court rejected the IRS assertion that it lacked subject matter jurisdiction because disallowance of the partners' losses was determined in the partnership proceeding. The court concluded that allowance of an abandonment loss deduction is an affected item subject to determination in a partner's refund action. The court stated that the partnership prong, allowance of an item, must be determined in the partnership proceeding; then the second prong, the impact of the affected item on the partners' individual tax liabilities, may be determined in a subsequent partner level proceeding. The court thus held that the sham transaction nature of the investment was determined in the partnership level proceeding, and that determination was not affected by the taxpayers' partner level settlement agreement, but that the court had jurisdiction to determine the partners' remaining bases for purposes of claiming their § 165 abandonment losses. The taxpayers asserted that their bases were reduced to zero, and no lower, by losses in the first year of the investment, but that additions to basis in subsequent years, not offset by the first year reductions to basis below zero, created a positive basis in the year of abandonment. The court held that calculation of basis under § 705 is cumulative and reflects a partner's entire period of ownership. Thus income and loss in the current year and prior years is summed in making the calculation. The statutory direction that basis cannot fall below zero does not mean that the history of profits and losses over the history of the partnership is permanently set to zero. Further, the basis at the end of one year set at zero does not preclude a calculation of basis at any other time that includes all preceding distributed income and losses. The court also pointed out that the taxpayers' claim would allow them to recover as abandonment losses the loss deductions previously disallowed in the partnership proceeding.

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.]

C. Distributions and Transactions Between the Partnership and Partners

1. Careful capital accounts and tax accounts are necessary to avoid recognition of gain. Robertson v. Commissioner, T.C. Memo. 2009-91 (4/29/09). The taxpayers (husband and wife) were 51 and 49 percent partners in an automobile engine repair and restoration business operated as an LLC. The LLC incurred debt to finance land and building acquisitions and operating expenses. The partnership returns were prepared late by a tax return preparer who was under investigation by the IRS. The returns were filed late. The preparer died after the returns were filed and the preparer's landlord disposed of the preparer's records, including the records of the taxpayers' LLC. With respect to a sale of the partnership assets, followed by distributions of money, the IRS asserted deficiencies claiming that the taxpayers had no basis in their partnership interests to offset distributions in one year, and that proceeds on the sale of partnership assets in a second year resulted in capital gain. The court (Judge Goeke) determined that the taxpayers failed to establish their partnership basis with adequate records, although the court indicated that the taxpayers' testimony was honest.

- The court also held that reliance on the return preparer for timely filings did not relieve the taxpayers of their obligations to timely file returns and imposed late filing penalties under § 6651(a)(1). However, the court found that the taxpayers reasonably relied on the preparer to accurately report their income and rejected proposed negligence penalties under § 6662.

2. Layers within the partnership mixing bowl need comment. Notice 2009-70, 2009-34 I.R.B. 255 (8/12/09). Sections 704(c)(1)(B) and 737 require recognition of built-in pre-contribution gain with respect to property contributed to a partnership on a distribution of

contributed property to a non-contributing partner, or other property to the contributing partner, within seven years of the contribution. Regulations proposed in 2007 (Prop. Regs. §§ 1.704-4(c)(4) and 1.737-2(b), REG-143397-06, Partner's Distributive Share, 72 F.R. 46932 (8/22/07)), provided that in an assets-over partnership merger, the seven-year clock begins anew with respect to built-in gain or loss with respect to property transferred from a merged partnership to the continuing partnership (the surviving partnership whose members own 50% or more of the partnership interests), but the clock dates back to the date of initial contribution with respect to pre-merger gains and losses, creating layers of old and new built-in gains and losses. The proposed regulations adopted the position of Notice 2005-15, 2005-1 C.B. 527, which was withdrawn after complaints that the Notice was inconsistent with existing regulations. Commentators raised numerous questions regarding application of the proposed regulations and the examples, including problems with respect to application of the proposed regulations to tiered partnerships. The IRS has again asked for comments on the proposed regulations, addressing, among other things, whether additional events allowing revaluation of partnership property should be included in Reg. § 1.704-1(b)(2)(iv)(f), how to provide for partnership allocation of depreciation and other items among different layers, and how to deal with specified issues in tiered partnerships. Comments were requested by 2/22/10.

3. Forfeitable for decades and thus not guaranteed payments as annually accrued, but 100 percent a guaranteed payment when received. Wallis v. Commissioner, T.C. Memo. 2009-243 (10/27/09). The taxpayer (a tax lawyer) retired as a equity partner in Holland & Knight, and among other amounts received $240,000 in twelve $20,000 payments over four taxable years. The $240,000 represented accumulated amounts that had been awarded to him as an equity partner over many years, but which were neither currently distributable as awarded nor recorded in the partner's capital account; rather, the amounts, which were determined annually without regard to partnership income, were payable over a period of time after the partner reached age 68, but were forfeitable if the partner left the firm before that date. The Tax Court (Judge Cohen) held that the payments were a guaranteed payment under § 707(c) and § 736(a), taxable as ordinary income, and were not received as distributions under § 731.

D. Sales of Partnership Interests, Liquidations and Mergers

1. Too many factors — proposed regulations on disguised sale of a partnership interest are withdrawn. Ann. 2009-4, 2009-8 I.R.B. 597 (2/23/09). The IRS has withdrawn Prop. Reg. § 1.707-7 (2004), REG-149519-03, Section 707 Regarding Disguised Sales, Generally, 69 F.R. 68838 (11/26/04). Section 707(a)(2)(B) provides that that a

contribution by a partner in connection with a related distribution will under regulations be treated as a disguised sale. Regulations proposed in 2004 would have expanded that concept to provide that a transfer of money or property, including an assumption of liabilities, to a partnership by a "purchasing partner" in connection with a related distribution to a "selling partner" would be treated as a purchase and sale of a partnership interest rather than a contribution and distribution. The latter transaction results in lesser or no recognition by the selling partner. The proposed regulation would have applied a multiple factor test to identify a disguised sale of a partnership interest. The Tax Court in *Colonnade Condominium, Inc. v. Commissioner*, 91 T.C. 793 (1988), adopted a more elegant approach based on an examination of whether there is an adjustment in partnership capital accounts reflecting a contribution and distribution, or whether there is simply a shift in the ownership of unchanged partnership capital. The announcement indicates only that the Treasury Department and the IRS have considered written comments regarding the proposed regulation and will continue to study the matter and may issue guidance in the future. In the meantime, determinations whether a contribution and related distribution constitute a sale of a partnership interest will be based on case law and the legislative history to § 707(a)(2)(B).

E. Inside Basis Adjustments

1. Intervenor is not allowed to demand that an FPAA be remanded to the IRS for an explanation of its views. Austin Investment Fund LLC v. United States, 103 A.F.T.R.2d 2009-607 (Fed. Cl. 1/6/09). In a refund action filed by an LLC through its tax matters partner, LLC members sought to intervene with a motion to remand the case back to the IRS for an explanation of the IRS position to support the adjustments made in the FPAA. The court denied the motion pointing out that in cases seeking readjustment of partnership items in an FPAA the court makes a de novo determination of all partnership items. Rewriting the FPAA to include a statement of reasons would be unnecessary. In addition, the court indicated that the intervenors cited no authority for their claim that the FPAA was required to be re-written to comply with the Administrative Procedures Act.

F. Partnership Audit Rules

1. Treasury Regulations defining defenses to penalties that may be raised in partnership proceeding are valid. New Millennium Trading, L.L.C. v. Commissioner, 131 T.C. No. 18 (12/22/08). In a TEFRA partnership proceeding, the determination of all partnership items is binding on the partners and may not be re-determined in another proceeding. Section 6221 provides for determination of penalties at the

partnership level and the court may consider reasonable cause defenses of the partnership. Section 6230(c)(1)(C) provides that a partner may contest the imposition of penalties in a claim for refund, which includes under § 6230(c)(4) the assertion of partner-level defenses to the penalties. Temp. Reg. §§ 301.6221-1T(c) and (d) provides that partner level defenses to penalties imposed at the partner level, including the reasonable cause exception of § 6664(c), can only be determined through separate refund actions. On summary judgment, the Tax Court (Judge Goeke) rejected an individual partner's argument that the temporary regulations cannot be applied to deprive the Tax Court of jurisdiction to consider the partner's reasonable cause defense to penalties, and upheld the validity of the regulations. The court observed that nothing in §§ 6221 or 6226(f) grants jurisdiction to consider partner-level defenses and that the partner's remedy under § 6230(c)(4) is to assert partner-level defenses in a refund claim. The court also opined that the regulations do not misinterpret the requirement of § 6664(c)(1) that no penalty may be imposed under §§ 6662 or 6663 if it was shown that there was reasonable cause. The court reached this conclusion by applying the deference rule of *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), and noting that the Court of Appeals to which the case is appealable, the D.C. Circuit, has indicated that Treasury regulations are to be given *Chevron* deference.

(a) Different judge, same result. Tigers Eye Trading, LLC v. Commissioner, T.C. Memo. 2009-121 (5/27/09). In another Son-of-Boss tax shelter proceeding, the court (Judge Beghe) treated accuracy-related penalty defenses as affected items determinable only in an individual partnership proceeding and upheld the validity of Temp. Reg. §§ 301.6221-1T(c) and (d). The court also rejected the IRS motions *in limine* to declare the shelter opinion of Curtis, Mallet-Prevost, Colt & Mosle LLP to be an opinion by a shelter promoter on which the partner could not rely for penalty protection holding that the issue was to be determined in the partnership proceeding. In addition, the court granted the IRS motion to reject the expert report of Stuart Smith on the grounds that the report consisted of legal discussion and argument.

- In a lengthy afterword, Judge Beghe questioned the wisdom of dividing partner and partnership items into separate proceedings in these tax shelter cases and observes that the division creates complex logistical problems at great cost to judicial economy and attorney resources. Judge Beghe also notes that the IRS and Treasury have proposed regulations that would allow the IRS to convert partnership items to nonpartnership items and allow a single proceeding – but only for listed transactions.

2. William Strunk Jr. & E.B. White, *The Elements of Style*, helps identify the statute of limitations as a partnership item. Keener v. United States, 551 F.3d 1358 (Fed. Cir. 1/8/09). The taxpayers invested in tax shelters promoted by AMCOR in the mid-1980s. In a partnership audit procedure, following issuance of an FPAA, the partnership entered into a settlement agreement with the IRS that allowed a percentage of ordinary deductions, but provided that the IRS could assert additional tax liability against individual partners plus interest. Subsequently the IRS assessed additional tax plus penalties against the taxpayers, which they paid in full. In their refund claim the taxpayers asserted that the statute of limitations had expired on the IRS' assessment of tax. The Federal Circuit (Judge Prost) affirmed the holding of the Court of Federal Claims that it lacked jurisdiction to determine the refund claims because application of the statute of limitations is a partnership item as defined in § 6231(a) subject to determination in the TEFRA proceeding. Section 6231(a) defines a partnership item as "any item required to be taken into account for the partnership's taxable year under any provision of subtitle A." The taxpayer argued that the statute of limitations, provided for under subtitle F, is not a partnership item under this definition. Referring to *The Elements of Style*, the court concluded that the restrictive phrase "subtitle A" modifies the words that immediately precede it, "taxable year," and not the words "partnership item." In citing Strunk & White, the court followed *Prati v. United States*, 81 Fed. Cl. 422 (2008). The court added that Reg. § 301.6631(a)(3)-1(b), which includes as a partnership item any determination of the amount, timing, and characterization of items, is a reasonable interpretation of the statutory ambiguity that is entitled to deference under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). The court also rejected the taxpayer's claim for refund of additional interest penalties imposed on tax motivated transactions, holding that a determination that characterizes a partnership transaction as a sham is a partnership item.

3. Reverse TEFRA: Partnership items from listed transactions are to be treated as nonpartnership items. REG-138326-07, Tax Avoidance Transactions, 74 F.R. 7205 (2/13/09). The TEFRA audit rules originally were enacted to allow the IRS to address issues in the large tax shelter partnerships of the 1970s with a single partnership level proceeding rather than multiple proceedings involving the same issue against numerous partners. Many of the recent abusive tax shelter transactions are structured to provide tax benefits to a single individual through a labyrinth of partnerships and trusts. Proposed regulations §§ 301.6231(c)-3 and 301.6231-9 would permit the IRS to notify a taxpayer that a partnership item attributable to a listed transaction from an identified partnership will be treated as a nonpartnership item, and thus not subject to the TEFRA partnership audit rules. The proposed regulations would only apply to

transactions that are identified as a listed transaction under Reg. § 1.6011-4(b)(2) prior to the date the IRS notifies the taxpayer that the taxpayer's partnership items related to the listed transaction will be treated as a nonpartnership item. The IRS would determine whether an item would be treated as a nonpartnership item on a partnership-by-partnership and partner-by-partner basis. The determination may include an item that passes through more than one partnership. In the case of an indirect partner who holds an interest in a listed transaction through a lower-tier partnership, the notification may identify only the lower-tier partnership. The determination would not apply to items from partnerships not attributable to a listed transaction, which will remain partnership items. Items attributable to listed transactions would remain partnership items unless the IRS notifies the taxpayer that the item will be treated as a nonpartnership item. Notification will apply to all partnership items from identified partnerships for all taxable years that ended before the date of the notice and all items attributable to that partnership that are related to a listed transaction. When finalized, the proposed regulations would apply to any taxable period ending on or after 2/13/09, the date of publication of the proposed regulations.

4. More woes for investors in Hoyt partnerships. River City Ranches v. Commissioner, 103 A.F.T.R.2d 2009-1088 (9th Cir. 2/26/09), *aff'g* T.C. Memo. 2007-171 (7/2/07). The Ninth Circuit affirmed the Tax Court's holding that that the six year statute of limitations under § 6229(c)(1) was applicable because the partnership return (prepared by Hoyt) contained a false or fraudulent item, and that the sheep breeding partnerships at issue were sham partnerships lacking economic substance, which justified increased interest penalties under § 6621(c). The Tax Court had also held that an asserted conflict of interest between the tax matters partner and the other partners did not invalidate waiver of the statute of limitations by the tax matters partner.

5. Thou shalt not allow a jury trial to challenge an FPAA assessment. RCL Properties, Inc. v. United States, 103 A.F.T.R.2d 2009-1784 (D. Colo. 4/14/09). The partnership's tax matters partner deposited an assessed deficiency as required by § 6226(e) and filed a civil action for recovery of the tax. The taxpayer filed a motion requesting a jury trial. The court (Judge Babcock) noted that under 28 U.S.C. § 2402, civil actions against the United States must be tried without a jury. An exception in 28 U.S.C. § 1346(a)(1) allows jury trials in cases for the recovery of any "internal revenue tax." However, § 6226(e)(3) provides that a deposit for jurisdictional purposes is not treated as the payment of tax. Jurisdiction in § 6226 action is provided under 28 U.S.C. § 1346(e), and is thus not within the exception allowing jury trials of 28 U.S.C. § 1346(a)(1).

6. Release from debt to restore negative capital account is a partnership item. Bassing v. United States, 563 F.3d 1280 (Fed. Cir. 4/16/09). Affirming the Court of Federal Claims, the court (Judge Bryson) held that the release of one partner's obligation to restore a capital account deficit is a partnership item. The taxpayer was one of two general partners and also held limited partner interests in a real estate development partnership. The partnership agreement required the taxpayer to restore his capital account deficit. The partnership entered into agreements with its principal creditor to settle outstanding liabilities and liquidate. At the same time the partnership entered into an agreement with the taxpayer, who was insolvent, to discharge the taxpayer's deficit restoration obligation. The taxpayer reported the discharge as short-term capital gain on a deemed sale of his partnership interest. Subsequently the taxpayer filed an amended return treating the forgiveness of his deficit restoration obligation as cancellation of indebtedness income that was excluded under § 108(a)(1)(B) because of his insolvency. The court held that the taxpayer's refund action filed in the Court of Federal Claims was barred by § 7422(h), which prohibits refund actions attributable to partnership items as defined in § 6231(a)(3). The court reasoned that a capital account deficit is determined under the partnership capital account maintenance rules, based on partnership accounting rules. See Reg. § 301.6231(a)(3)-1(b). The release of a debt to restore a negative capital account is also a partnership item because the enforceability of the item is also determined under the partnership capital account maintenance rules so that release of the debt would be treated as cancellation of debt for the partnership. Reg. § 301.6231(a)(3)-1(a). The court rejected the taxpayer's argument that the tax treatment of the discharge of the deficit restoration obligation was an individual, non-partner issue that has no impact on the partnership or other partners. The purpose of the TEFRA audit rules is served by consistent treatment of capital account deficits for both co-general partners.

7. 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 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 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, 105 A.F.T.R.2d 2010-333 (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 Court of Appeals concluded that the partners' bases were affected items, not partnership items, and that the Tax Court did not have jurisdiction to determine the partners' bases in the partnership proceeding. The court rejected the IRS argument that the Tax Court had jurisdiction in the partnership proceeding to determine the partners' outside basis as an affected

item whose elements are mainly determined from partnership items. The court held that resolution of the affected item requires a separate determination at the partner level even though the affected item could easily be determined in the partnership proceeding. Finally, the Court of Appeals held that accuracy related penalties under § 6662(a) could not be determined without a determination of the partners' outside basis in a partner level proceeding and vacated and remanded the Tax Court's determination of penalty issues.

8. Tax matters partner need not have anything personally at stake. Gateway Hotel Partners, LLC v. Commissioner, T.C. Memo. 2009-128 (6/4/09). Over the IRS objection, the taxpayer partnership was permitted to substitute as a tax matters partner a new partner who was not a partner during the years subject to TEFRA partnership audit. The court (Judge Goeke) concluded that the fact that the tax matters partner's tax liability will not be affected by the proceeding does not disqualify the substitution. The court observed that, "[t]he tax matters partner's importance derives from his role as a fiduciary serving on behalf of the other partners, and 'His personal interest, if any, is beside the point.'" (Quoting from *Computer Programs Lambda, Ltd. v. Commissioner*, 89 T.C. 198, 205 (1987).)

9. A Notice of Deficiency relating to partner-level loss limitation rules need not wait for a FPAA. Meruelo v. Commissioner, 132 T.C. No. 18 (6/9/09). Judge Vasquez held that the application to a partner of the loss limitation rules of §§ 704(d) and 465 are affected items that require a partner-level determination. A notice of deficiency to a partner based on the application of the loss limitation rules of §§ 704(d) and 465 was not issued prematurely and was valid, even though IRS had neither issued a notice of final partnership administrative adjustment for the partnership nor accepted the partnership's return as filed for the year. The Tax Court had jurisdiction over the petition.

(a) But a notice of deficiency is not proper while the partnership case is still pending. Bausch & Lomb Inc. v. Commissioner, T.C. Memo. 2009-112 (5/21/09). The court (Judge Kroupa) granted a motion by the IRS to dismiss a deficiency notice for lack of jurisdiction. The IRS issued a deficiency notice to the parent of an affiliated group disallowing losses claimed from a limited partnership investment and imposing accuracy related penalties. The deficiencies arose from partnership items and affected items reflected in a FPAA in a partnership level proceeding that was not yet concluded. The court rejected the taxpayer's argument that its basis in the partnership must be determined in the year of a contribution of a note to the partnership, which is not the year at issue in the

FPAA, and therefore the basis is not a partnership item or affected item in the year subject to the partnership proceeding. The court concluded that the partner's basis in contributed property is a partnership item subject to determination in the partnership proceeding.

10. The assessment of a deficiency doesn't have to be on the computer tape if it's manually processed. Williams v. Commissioner, T.C. Memo. 2009-158 (6/30/09). The statute of limitations under § 6229(a) for assessment of a deficiency attributable to a partnership item or an affected item is three years after the later of the date on which a partnership return is filed, the last day for filing the partnership return. If an FPAA is mailed to the tax matters partner the limitations period is suspended for the time in which a court action may be brought, or if a court action is brought, until the court action becomes final plus one year thereafter. The taxpayer asserted that assessment statute expiration dates (ASED) had expired and that the computerized account transcripts did not indicate the assessment until after the ASED. The court (Judge Cohen) concluded that testimony from IRS personnel was credible to establish that the assessments were issued manually and that the computer coding lagged the actual issue of the assessment. In addition, since the assessment was dated by August 15, within the AESD, the fact that the notice of assessment was only postmarked on August 21 (after the AESD) did not invalidate the assessment.

11. Reasonable cause defense to the gross valuation misstatement penalty is not a partnership item, and by the way, Son-of-Boss transactions lack economic substance as a matter of law. Clearmeadow Investments, LLC v. United States, 87 Fed. Cl. 509 (6/17/09). Granting summary judgment to the government, the court held that the reasonable cause defense of § 6664(c)(1) to § 6662 accuracy related and substantial misstatement penalties is a partner level defense not subject to the Federal Claims Court's jurisdiction in a TEFRA partnership proceeding. The court rejected the taxpayers' argument that its jurisdiction to consider partnership level penalties under § 6662 empowers the court to address reasonable cause defenses asserted by a partner. Notwithstanding contrary language in *Klamath Strategic Investment Fund ex rel. St. Croix Ventures v. United States*, 103 A.F.T.R. 2d 2009-2220 (5th Cir. 5/19/09), the court pointed out that Reg. § 301.6221-1(d) and Temp. Reg. § 301.6221-1T(c)-(d) specifically describe the reasonable cause defense as a partner level defense that may not be asserted in a partnership proceeding. The court also rejected the taxpayer's argument that although Reg. § 1.752-6 applied retroactively to reduce basis by the amount of contingent liability in the Son-of-Boss transaction, the entity used by the taxpayers was not a partnership but a "multi-member disregarded entity." (The taxpayers were fortunate that the

court did not impose a frivolous argument penalty on this.) The court imposed a 40 percent § 6662 penalty.

- The taxpayers – whether providently or not – conceded both the retroactivity of Reg. § 1.752-6 and the lack of economic substance in their transaction.

12. Partnership audit rules extend the statute of limitations. Curr-Spec Partners L.P. v. Commissioner, 2009-2 U.S.T.C. ¶50,578, 104 A.F.T.R.2d 2009-5249 (5th Cir. 8/11/09). Section 6501(a) provides a three-year statute of limitations for assessing tax deficiencies. Section 6229(a) provides that the period for assessing a deficiency attributable to a partnership item does not expire until three years after the later of the date a partnership return or the due date for the partnership return. The IRS issued an FPAA disallowing claimed partnership losses four years after the partnership return was filed, and assessed deficiencies against the partners for years into which the losses were carried forward. The assessment to individual losses disallowing the loss carryforwards were within the three-year statute of limitations applicable to the partners' returns. The Fifth Circuit affirmed the Tax Court holding that § 6229(a) does not establish an independent three-year statute of limitations with respect to partnership items, but merely extends the limitations period of § 6501(a). Thus, assessment of a deficiency against partner's whose individual return remains open is not barred by any limitation period in § 6229(a).

(a) The Tax Court agrees. LVI Investors, LLC v. Commissioner, T.C. Memo 2009-254 (11/9/2009). The court (Judge Nims) followed its holding in *Curr-Spec Partners* as affirmed by the Fifth Circuit. Section 6501(a) provides a three year assessment period after an individual's return is filed. Section 6229(a) provides that the period for assessing any tax attributable to a partnership item or an affected item expires three years after the latter of the due date of the partnership return or the date the partnership return was filed.. The court held that § 6229 does not override § 6501 and instead sets a minimum limitations period that may extend the § 6501(a) period.

13. Basis in a closed year is a partnership item that may be redetermined in an FPAA for an open year. Wilmington Partners L.P. v. Commissioner, T.C. Memo. 2009-193 (8/26/09). The IRS issued an FPAA for the partnership's 1993 year that was closed without adjustment. In an FPAA issued for 1999, the IRS determined that the partnership's basis in a reset note contributed in 1993 was zero. The court (Judge Kroupa) held that nothing in TEFRA prevents the court from considering events in a closed year to determine the proper adjustments for a docketed year. The court also held that the basis of the contributed note was a partnership item in the

closed year of contribution, and remained a partnership item in each subsequent year. The court rejected the taxpayer's argument that the fact that § 6228(a)(5) expressly empowers the court to look back at non-docketed items as an offset to an administrative adjustment requested by a tax matters partner under § 6227, does not bar the court from looking at the facts of a non-docketed year in another matter.

14. Filing a refund claim before paying the $150 million, rather than paying first, filing second, left the taxpayer out the $150 million on procedural grounds. Ackerman v. Commissioner, 104 A.F.T.R.2d 2009-5830 (D. D.C. 8/18/09). Following a TEFRA partnership proceeding, the IRS notified the taxpayers of the resulting adjustments to their tax liability — over $150 million. Within the required sixty days of receiving the notices, the taxpayers filed administrative refund requests to which the IRS never responded. Subsequently they filed the refund suit. However, the taxpayers did not pay the deficiency until after the administrative refund request was filed. The government argued that § 6230(c) requires that the taxes be paid in full before the administrative refund request is filed, while the taxpayers argued that under § 6230(c) — unlike under § 7422, which governs refund claims generally — it is not necessary to pay the taxes in full before the administrative refund request is filed, but merely before the suit is filed. The court held that, as argued by the government, for the court to have jurisdiction, the taxes must be paid in full before the administrative refund request is filed. The court found the long line of cases imposing the "pay first" rule under § 7422 to be controlling. The court further held that even though accuracy related penalties resulting from the partnership adjustments were partner-level items, § 6230(c) — and not § 6511— nevertheless controlled the period for filing a refund claim. Thus, the taxpayer's refund claim was untimely because it was not filed within 60 days. The suit was dismissed.

15. Be careful what you stipulate to. LKF X Investments, LLC v. Commissioner, T.C. Memo. 2009-192 (8/25/09). The IRS issued a notice of final administrative adjustment (FPAA) to the taxpayer partnership asserting that a LLC taxed as a partnership that was used to invest in market-linked deposit transactions (another form of abusive shelter using contingent offsetting payments to generate losses) should be disregarded for tax purposes and that the investors had zero basis in their partnership interest. In the partnership proceeding the parties contested the Tax Court's jurisdiction to consider disregard of the partnership and the partners' bases as partnership items and stipulated that if the court determined that it had jurisdiction the parties would not contest the determinations made in the FPAA other than whether the valuation misstatement penalty imposed under § 6662 applies to any underpayment

resulting from the adjustments in the FPAA. The court (Judge Marvel) granted summary judgment to the IRS holding that a determination whether a partnership is a sham, lacks economic substance, or otherwise should be disregarded is a partnership item, following its prior decision in *Petaluma FX Partners, LLC v. Commissioner*, 131 T.C. 84 (2008). The court also held that when a partnership is disregarded for Federal income tax purposes, the court has jurisdiction in the TEFRA proceeding to determine that the partners have zero outside basis. The court added that when the taxpayer stipulates that it would not contest an issue other than on jurisdictional grounds, the court will treat the issue as conceded. Finally, the court also held that where the partnership is disregarded and the partners' outside basis is zero the court had jurisdiction to determine as partnership items the applicability of accuracy related and valuation misstatement penalties under § 6662. The court rejected that taxpayer's assertion that the valuation misstatement penalty in inapplicable because it was attributable to disregard of the partnership rather than an erroneous valuation.

16. In a Son-of-Boss litigation the Tax Court has jurisdiction to determine partner level deficiencies related to affected items. Hiding the loss through additional pass-throughs justifies taxpayer-level determinations. Desmet v. Commissioner, 581 F.3d 297 (6th Cir. 9/17/09). The taxpayers formed a partnership in a Son-of-Boss transaction, then transferred their partnership interests to an S corporation. In the TEFRA partnership proceeding, which became final, the IRS determined that the partnership's basis in distributed property was zero. Rather than directly assessing tax against the taxpayers as computational adjustments resulting from the FPAA under § 6230(a)(1), the IRS sent notices of deficiency related to affected items that require partner level determinations under § 6230(a)(2). The taxpayers asserted that the IRS was required to assess the tax directly because no additional partner level determinations were necessary and that the statute of limitations had run on the assessment of individual deficiencies. Affirming the Tax Court, the Sixth Circuit concluded that the partnership proceeding determined only that the partnership was required to reduce its basis on account of its contingent obligation to close the short sale leg of the Son-of-Boss transaction. The partnership proceeding did not address the taxpayers' claimed losses through their S corporation. The S corporation's loss was not addressed in the FPAA. The S corporation's loss arose from the sale of distributed stock, which could not be determined from the FPAA. Thus, the court held that the IRS was empowered to bring individual level proceedings to resolve issues regarding the losses passed-through from the S corporation. The court also rejected the taxpayers' assertion that the procedure allows duplicative proceedings contrary to the purpose of the TEFRA partnership provisions.

17. Go figure the deposit and come back. Russian Recovery Fund Ltd. v. United States, 105 A.F.T.R.2d 2010-310 (Fed. Cl. 12/14/09). Section 6226(a) requires that in order to petition for a readjustment of a partnership item in the Court of Federal Claims, the petitioning partner must provide a deposit of the amount by which the tax liability of the petitioning partner would be increased if the treatment of partnership items on the partner's return were consistent with the FPAA. Reg. § 301.6226(e)-1(a)(1) requires that if the petitioning partners is itself a partnership, the deposit must include the potential liability of each indirect partner. In an arrangement with losses flowing to partners through multiple partnerships, the court holds that the deposit must be calculated by any downstream partner to include losses flowing through the chain of partnerships, and not just losses passing through a single filing partnership. The filing partner's $50,000 actual deposit was increased to a required deposit of $8 million under this interpretation. Rather than dismiss the case, however, the court allowed the taxpayer to show that she made a good faith effort to calculate the required deposit.

G. Miscellaneous

1. Just because the K-1 says you're the partner doesn't necessary mean you're really the partner. Windheim v. Commissioner, T.C. Memo. 2009-136 (6/10/09). A Canadian resident who received legal title to a partnership interest from his father (now deceased) was held not to be the beneficial owner of the partnership interest for federal tax purposes. The taxpayer was involved in disputes with his mother and sister over control of family assets. The partnership issued K-1s in the taxpayer's name in care of his mother. A Canadian trial court had held that disbursements by Toronto Dominion Bank of partnership distributions to the taxpayer's mother were negligent, but that decision was reversed by a higher court holding that the bank was not liable to the taxpayer. A New York court had awarded the taxpayer's mother a constructive trust over the partnership proceeds. The Tax Court (Judge Goeke) held that the taxpayer had no economic benefit from the partnership interest and was thus not a partner subject to tax on partnership income.

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings — The Saga Starts a Long, Long Time Ago, But New Mysteries Continue to Unravel.

1. Notice 2000-44. Baby BOSS is a fraud too! Notice 2000-44, 2000-2 CB. 255 (8/13/00). "Artificial" capital losses generated by Baby BOSS transactions will not be allowed. (Note that Notice 99-59, 1999-

2 C.B. 761, advised taxpayers that losses from "BOSS" product transactions are not properly deductible.)

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

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

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

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

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

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

- The temporary regulations purport to be effective for transactions occurring after 10/18/99 and before 6/24/03. The cases which held them to be retroactively effective include: *Cemco Investors, LLC v. United States*, 99 A.F.T.R.2d 2007-1882 (N.D. Ill. 2007), *aff'd*, 515 F.3d 749 (7th Cir. 2008); and *Maguire Partners – Master Investments, LLC v. United States,* 103 A.F.T.R.2d 2009-763, 2009-1 U.S.T.C. ¶50,215 (C.D. Calif. 2/4/09). The cases which held them not to be retroactively effective include: *Klamath Strategic Investment Fund, LLC v. United States*, 440 F. Supp. 2d 608 (E.D. Tex. 2006), a*ff'd in part, vacated in part, and remanded*, 568 F.3d 537 (5th Cir. 5/21/09); *Sala v. United States*, 552 F. Supp. 2d 1167 (D. Colo. 2008); *Stobie Creek Investments, LLC v. United States*, 82 Fed. Cl. 636 (Fed. Cl. 2008); and *Murfam Farms LLC v. United States*, 88 Fed. Cl. 516 (Fed. Cl. 7/30/09).

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

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

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

(c) Affirmed in part, vacated in part, and remanded, 568 F.3d 537 (5th Cir. 5/21/09). In ruling unfavorably on the

taxpayers' cross-appeal of the holding that the transaction lacked economic substance, the Fifth Circuit (Judge Garza) followed the majority rule, which "is that a lack of economic substance is sufficient to invalidate the transaction regardless of whether the taxpayer has motives other than tax avoidance." He stated, "[T]hus, if a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations."

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

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

4. ***Maguire Partners.*** Maguire Partners – Master Investments, LLC v. United States, 103 A.F.T.R.2d 2009-763 (C.D. Calif. 2/4/09). Two individuals, through various entities, in late 2001 entered into call options spreads, i.e., they sold short call options to AIG via an Arthur Andersen tax strategy and purchased offsetting long call options and promissory notes from the same company; the options were European options, with an Asian-style feature, in that they were to be exercised on a particular date based upon the average value of a REIT basket over a 90-day period. The partnerships received the long options and notes and assumed the short options. In finding for the government, the court (Judge Walter) held that the evidence demonstrated that the transactions did not have economic substance because the individuals received no economic benefit, other than an increase in basis, from the transactions. The court also held that the evidence demonstrated that the individuals were motivated by the increased basis and not by any purported hedging benefit. The court held that, under both the step transaction doctrine and the substance-over-form doctrine, the individuals' actual cost basis was the original amount of their investment – not the increased basis reported by the partnerships, because they had no

downside exposure, and only an extremely remote possibility of receiving a return. Judge Thomas further held that the obligation created by the short option is a liability for purposes of § 752, or alternatively, it had to be taken into account under Reg. § 1.752-6 which applies retroactively. He further found that the individuals had been placed on notice by Notice 2000-44, issued in August 2000.

- The court also held that the partnerships made a gross valuation misstatement under § 6662, citing in support the fact that one of the individual's partnerships reported an increase in its capital account equal to 67 times the actual economic outlay that the individual paid for the transaction.

(a) The court amended its earlier opinion to hold that the partnerships were not liable for the gross valuation misstatement penalties, but were liable for negligence penalties instead. Maguire Partners – Master Investments, LLC v. United States, 104 A.F.T.R.2d 2009-7839 (C.D. Calif. 12/11/09). The court focused its discussion of penalties on the "negligence or disregard of rules or regulations" under 6662(a) and (b)(1) and did not mention the valuation misstatement issue.

5. *Samueli.* A Twenty First Securities tax shelter bites the dust. Samueli v. Commissioner, 132 T.C. No. 4 (3/16/09). 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 on a margin loan (the broker was entitled to hold the securities as collateral for the margin loan) and then "lent" the securities to the broker. The standard form agreement allowed the taxpayer to terminate the transaction and receive identical securities from the broker 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 the broker 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 the broker a variable rate fee for use of the $1.64 billion cash collateral. In December, 2002, the taxpayer paid the broker $7.8 million of "interest" on the $1.64 billion cash collateral, which was relent to the taxpayer (secured by the securities, which had increased in value). The transaction terminated on January 15, 2003 and the broker 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 the broker $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 the broker 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 the broker 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) If at first you don't succeed, try again on procedural grounds; however, an amended return is not an Administrative Adjustment Request. Samueli v. Commissioner, 132 T.C. No. 16 (5/18/09). The taxpayers were ten percent partners in a tax shelter partnership. Partnership level deductions claimed by the taxpayers were disallowed in Samueli v. Commissioner, 132 T.C. No. 4 (3/16/09), a partnership level determination. The taxpayers asserted that deficiencies assessed against them were not partnership items because of amended returns filed by the taxpayers for the year at issue. Section 6227 allows a partner to

file an Administrative Adjustment Request (AAR) on behalf of the partner, which allows a separate determination of an item as a non-partner item. The court (Judge Kroupa) held that the taxpayer's amended return was not an Administrative Adjustment Request. The request must follow the form required in Reg. § 301.6627(d)-1, which requires that a taxpayer file a partner AAR on a form prescribed – Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR) – and in accordance with the form's instructions, which require the taxpayer to explain in detail on the form the reasons for the AAR reported on the form. The taxpayer is required to file the original form with the taxpayer's amended income tax return and a copy of the form with the service center where the partnership files its tax return. The court rejected the taxpayer's argument that because the amended return contained all of the information required on Form 8082 for an AAR, it constituted an AAR. The taxpayer's claim was dismissed for lack of jurisdiction.

6. *New Phoenix*. Not so heavenly BLISS. A Son-of-Boss transaction by any other name still stinks. New Phoenix Sunrise Corporation v. Commissioner**,** 132 T.C. No. 9 (4/9/09). In this Paul Daugerdas, Jenkens & Gilchrist structured deal named BLISS (Basis Leveraged Investment Swap Spread), New Phoenix Sunrise Corporation (Phoenix) purchased two pairs of digital option contracts in a transaction designed to eliminate $10 million of capital gain realized on an asset sale by a corporate subsidiary included on the taxpayer's consolidated return. The long portion of the options was purchased from Deutsche Bank AG for an initial payment of $10.631 million plus two additional payments of $63 million each. The short option was sold to Deutsche Bank for an initial payment of $10.369 million and two additional payments of $63.066 million. Only the $138,750 difference between the purchase and sales prices changed hands. The digital options called for offsetting payments based on the USD/JPL price with a variance in the options of only 0.00002 (2 Pips). Phoenix contributed the purchased and sold options to a general partnership for a 99% interest. The 1% partner was a dominant shareholder in Phoenix. Phoenix claimed a basis in its partnership interest in the amount of the cost of the purchased long option. Phoenix also claimed that its liability on the short position of the sold option was a contingent liability that did not reduce its basis in the partnership. Thereafter, the partnership acquired shares of Cisco stock for $149,958. After the options expired, the partnership distributed the Cisco stock to Phoenix. Phoenix claimed a § 732 basis in the Cisco stock equal to its partnership interest basis and a $10 million loss on its subsequent sale of the Cisco stock. In an exceedingly well-written opinion, the court (Judge Goeke), rejected the claimed loss on several grounds:

- The taxpayer did not suffer a real economic loss. "The loss claimed as a result of the stepped-up basis in the Cisco stock was purely fictional."
- The BLISS transaction had no realistic possibility of earning a profit. Deutche Bank's control as the calculation agent for the option contracts empowered it to assure that the market rate chosen for the closing of the options would never trigger the so-called "sweet spot" under which the investor would earn substantial profits.
- The transaction lacked economic substance. The court stated:

> Absent the benefit of the claimed tax loss, there was nothing but a cash flow that was negative for all relevant periods—the "hallmark of an economic sham" as the Court of Appeals for the Sixth Circuit has held. *Dow Chem. Co. v. United States*, 435 F.3d at 602 (quoting *Am. Elec. Power Co. v. United States*, 326 F.3d 737, 742 (6th Cir. 2003). Such a deal lacks economic substance. Id. Because we find that the transaction at issue lacked economic substance, we do not consider Mr. Wray's and Capital's profit motive in entering into the transaction. Id. at 605 ... . Pursuant to the aforementioned cases, the BLISS transaction must be ignored for Federal income tax purposes. Accordingly, the overstated loss claimed as a result of the sale of the CISCO stock is disregarded, as is the flowthrough loss from Olentangy Partners.

- The court disallowed a $500,000 deduction for fees paid to Jenkens & Gilchrist for the tax opinion and structuring the transaction. The fees were not incurred in the production of any income against which a deduction is allowable.
- The court also sustained a 40 percent gross valuation penalty under § 6662(e) and (h), holding that the undervaluation penalty is applicable to overstated basis. The court also indicated that the § 6662(d) substantial understatement of tax and the § 6662(c) negligence penalties were applicable. The court rejected the taxpayer's argument that it reasonably relied on the Jenkens & Gilchrist tax shelter opinion. Because the penalties are not additive, only the gross valuation penalty was imposed.

7. *Murfam Farms*. Retroactive application of the partnership contingent liability regulation rejected again. Murfam Farms L.L.C. v. United States, 88 Fed. Cl. 516 (Fed. Cl. 7/30/09). The court (Judge Damich) granted the taxpayers' motion for partial summary judgment in a COBRA tax shelter case (COBRA is a Son-of-Boss digital options shelter under another name) declaring that Temp. Reg. § 1.752-6T may not be

applied retroactively. The court held that retroactive application of the temporary regulation was barred by the prohibition of § 7805(b)(1) on retroactive application of regulations because it was not issued pursuant to a congressional grant of authority. The court further opined that the retroactive application of the regulation was not authorized by § 309(c) of the 2000 Act because the abuse it sought to prevent was not the same type of abuse that § 358(h) was designed to prevent, i.e., it "was not to combat the inflation of basis – artificial or otherwise – rather, to preclude the acceleration and/or duplication of losses."

8. *Castle Harbour.* The Second Circuit 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*, 104 A.F.T.R.2d 2009-6746 (D. Conn. 10/7/09), *as amended*, 2009 U.S. Dist. LEXIS 98884 (D. Conn. 10/23/09) ("Castle Harbour").

(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.

- 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.

- 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.

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

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

Investerings and *Saba* findings on appeal that there was no partnership. Now the Second Circuit has adopted the lack-of-partnership argument.

(c) *Castle Harbour III*: 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. 104 A.F.T.R.2d 2009-6746 (D. Conn. 10/7/09), *as amended*, 2009 U.S. Dist. LEXIS 98884 (D. Conn. 10/23/09). In a carefully-written[5] opinion, Judge Underhill held that, while the Second Circuit opinion decided that the partnership did not meet the *Culbertson* totality-of-the-circumstances test ("whether ... the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise"), it did not address the § 704(e)(1) issue. He held that the Dutch banks satisfied 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).

- Some of the authors observe that 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 decision in *Castle Harbour III* is the very

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5. One of us thinks the opinion is "carefully-written." Dan and Marty, the only two of us who teach and regularly write about partnership taxation, do not so think. Ira, who has never taught a course in partnership taxation, appreciates the innovative logic underlying the opinion.

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. (emphasis supplied)

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

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

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

- Stay tuned for further proceedings on appeal to the Second Circuit, where the same panel that heard *Castle Harbour II* will hear *Castle Harbour IV*.

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

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

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

10. Another Son-of-Boss-type shelter bites the dust in the Tax Court and not even the Thighmaster can trim the tax bill. Palm Canyon X Investments, LLC, et al. v. Commissioner, T.C. Memo 2009-288 (12/15/09). In a lengthy opinion the court (Judge Marvel) held that a Son-of-Boss investment in offsetting digital option contracts was to be disregarded under the economic substance doctrine. Taxpayers Alan and Suzanne Hamel ran a retail business that included the extremely successful "Thighmaster," which featured Suzanne Hamel, a/k/a the actress Suzanne Somers, in its advertising. They incorporated Alan Hamel Investments (AHI), which in turn was the sole member of Palm Canyon, an LLC. Palm Canyon entered into a long digital option contact for a premium of $5 million an offsetting short option for which the counterparty paid a premium of $4.945 million, resulting in a net premium outlay of $55,000. An investment company formed by one of the promoters acquired a membership interest in the LLC, thereby allowing the LLC to be treated as a partnership. AHI claimed a basis

in the LLC in the amount of the premium paid for the long position without reduction for the contingent liability represented by the short position assumed by the partnership. On the subsequent liquidation of the partnership, AHI claimed a high basis in a Canadian dollars position that was sold for a loss. The contracts were entered into through John Ivsan, a tax attorney with Cantley & Sedacca, LLP, who directed them to the Dallas branch of Deutsche Bank to implement the strategy, which created a $5 million ordinary loss. The court avoided the technical issues, and assumed that the transaction satisfied the literal language of § 752 and that under *Helmer v. Commissioner*, T.C. Memo 1975-160, AHI's partnership basis was not reduced by the contingent short option liability. The court also avoided the issue of retroactive application of Temp. Reg. § 1.752-6, which would have required AHI to reduce its basis by the LLC's potential payment on the short option. Nonetheless, the court concluded that the transaction failed to satisfy the subjective prong of the economic substance test because the Hamels entered into the transaction for the sole purpose of avoiding federal income tax, and failed the objective prong because the taxpayers' failed to demonstrate that the transactions had any reasonable prospect of earning a profit. The court noted that because of the marketing agent's ability to determine the spot market exchange rate on the option date, the marketing agent could assure that the option contracts would not hit the "sweet spot" that would make the transaction profitable. The court imposed accuracy related penalties concluding that the transaction qualified as a tax shelter and that the Hamels could not reasonably rely on the tax opinion of Pryor, Cashman, Sherman & Flynn, LLP, which was part of the promoter team and therefore had a conflict of interest in issuing the opinion.

11. Government misconduct amounting to fraud does not require a showing of prejudice to justify relief. Tax shelter investors entitled to the same deal received by the taxpayers who cooperated with the government. <u>Dixon v. Commissioner</u>, 316 F.3d 1041 (9th Cir. 1/17/03), *remanding* T.C. Memo. 2000-116 and T.C. Memo. 1999-101. The Ninth Circuit reversed the Tax Court finding that misconduct by IRS attorneys during the trial of test cases (secretly allowing the deduction of attorney's fees in exchange for taxpayer cooperation) constituted harmless error. The tax shelter was one designed and administered by Honolulu businessman Henry Kersting, in which participants purchased stock with loans from entities financed by two layers of promissory notes, resulting in their being able to claim interest deductions on their individual returns. Judge Hawkins held that the taxpayers demonstrated fraud and that a demonstration of prejudice was unnecessary. The Tax Court was directed to enter judgment in favor of taxpayers on terms equivalent to the secret settlement agreements entered into with the test case taxpayers who cooperated with the government.

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

(b) On remand to the Tax Court, it really hits the fan for the Commissioner – and deservedly so. The misconduct of the government lawyers involved and the Commissioner's failure to fully disclose the misconduct to all taxpayers who had been bound by the outcome of the Kersting project test cases infested the stipulated decisions in all of the hundreds of cases settled in accordance with the outcome of the test cases. Hartman v. Commissioner, T.C. Memo. 2008-124 (5/1/08). In a 137-page opinion, the Tax Court (Judge Beghe) held that all of the hundreds of Kersting tax shelter cases in which stipulated decisions had been entered and which had became final many years ago had to be re-opened and the taxpayers' accounts had to be adjusted administratively in accordance with the settlements received by the taxpayers in the test cases.

(c) The Tax Court awards attorney's fees to Porter & Hedges under § 6673, the tests for which are different from those for attorney's fees under § 7430. Dixon v. Commissioner, 132 T.C. No. 5 (3/23/09). In awarding fees of $1.1 million to Porter & Hedges for the services and expenses of its lawyers, Henry Binder and John Irvine, who represented the taxpayers during the remand proceedings following the 2003 Ninth Circuit decision without charge other than the costs, expenses, and fees that the court might require the IRS to pay pursuant to § 6673(a)(2), the Tax Court (Judge Beghe) in a masterful opinion held that – unlike § 7430 fees which are limited to reimbursement of the fees paid by taxpayers plus fees which the taxpayers have incurred, i.e., for which they were personally liable – under § 6673 a party who has "multiplied the proceedings ... unreasonably and vexatiously" has injured not only the opposing party but also the court and counsel and is liable for fees without such limitation "other than the requirement that the fees to be paid have been 'reasonably incurred' because of such conduct." Judge Beghe found applicable to the § 6673 sanctioning statute the broader definition of "incurred" in Black's Law Dictionary, which means "liabilities cast upon one by act or operation of law, as distinguished from contract." He concluded that interest on the fee amount was applicable because "in augmenting the award of fees and expenses with interest equivalents, we do no more than mimic DeCastro's fee arrangement with the Thompsons."

- Henry Binder died of cancer on December 15, 2006. One of the authors recalls that Henry Binder was consumed by this case, even during the worst moments of his final illness.

12. Transactions underlying a tax shelter are just done for grins in the real world; you can take that to the bank, man! Hoosier homer judge grants injunctive relief to tax-indifferent party to a tax shelter contract without requiring the plaintiff to disgorge the $20 million it pocketed for entering into the tax shelter in the first place. Hoosier Energy Rural Electric Cooperative, Inc. v. John Hancock Life Insurance Co., 588 F. Supp. 2d 919 (S.D. Ind. 11/25/08). Hoosier Energy Rural Electric Cooperative ("Hoosier Energy") was the tax indifferent party in a sale-in/lease-out transaction of one of its generating plants for which it received $20 million for its participation. Professor Joseph Bankman of Stanford Law School furnished an expert opinion in affidavit form that this type of sale-in/lease-out transaction was an abusive tax shelter, leading the court to find that the "deal was an attempt to create an appearance of a sale but without any real economic substance." Pursuant to the documentation of the arrangement, Hoosier Energy was required to maintain specified adequate security for its obligation to make future lease payments, i.e., provide a credit default swap from a party with at least an AA rating – failing which, it was required to make the agreed-upon termination payment of $120 million to a third-party which was obligated to pay the amount to John Hancock Life Insurance Co. ("John Hancock"). Hoosier Energy maintained this security in the form of a guarantee from AIG and it did timely make each of its lease payments. Upon the falling of AIG's credit rating below the contractually-required standard, Hoosier Energy sought unsuccessfully to secure an equivalent guarantee. On Hoosier Energy's request, Chief Judge Hamilton granted an injunction against enforcement of Hoosier Energy's obligation to make the $120 million termination payment to the third party on the ground that the arrangement was entered into solely for tax benefits and was somehow unenforceable against Hoover.

- Chief Judge Hamilton did state that Hoosier Energy might at some time in the future be required to give back the $20 million, but that there was no hurry about that.
- Professor Bankman's affidavit stated that the transaction was similar to that in *AWG Leasing Trust v. United States*, 592 F. Supp. 2d 953 (N.D. Ohio 5/28/08).

(a) In a later proceeding, Judge Hamilton pretends to require Hoosier Energy to give John Hancock adequate security to cover the possibility that his 11/25/08 injunction was incorrectly issued. Hoosier Energy Rural Electric Cooperative, Inc. v. John Hancock Life Insurance Co., 2008 WL 5216027 (S.D. Ind. 12/11/08). Judge

Hamilton, in addition to a $2 million cash bond, required Hoosier Energy "to post its own [i.e., meaningless] undertaking to pay John Hancock up to an additional $130 million in damages it might suffer from an improper injunction."

(b) Affirmed on "temporary commercial impracticability" grounds, but not because the transaction was an abusive tax shelter. 582 F.3d 721 (7th Cir. 9/17/09). Judge Easterbrook held that John Hancock's taxes are a matter for it to resolve with the IRS, and that "does not affect Hoosier Energy's contractual duties." He further stated that "temporary commercial impracticability" becomes a pumpkin at year end. On remand, the District Court increased the bond substantially. 2009 U.S. Dist. LEXIS 93186 (S.D. Ind. 10/5/09).

13. The Supreme Court enhances the sanctity of arbitration agreements. <u>Arthur Andersen LLP v. Carlisle</u>, 129 S. Ct. 1896 (5/4/09), *rev'g* <u>Carlisle v. Curtis, Mallet-Prevost, Colt & Mosle, LLP</u>, 521 F.3d 597 (6th Cir. 4/9/08). The respondents in this case invested in a Son-of-Boss type transaction called a "leveraged option strategy." The investors entered into an investment-management agreement with Bricolage Capital, LLC, which contained a mandatory arbitration provision. Only Bricolage Capital was a signatory to the agreement with the arbitration provision. The investors filed an action for fraud and malpractice against Arthur Andersen and Curtis, Mallet-Prevost, Colt & Mosle, LLP (who provided the tax opinion). The parties moved for a stay of the District Court action under the provisions of the arbitration agreement. The Federal Arbitration Act, 9 U.S.C. § 3, provides for a stay of any action in federal court that is "referable to arbitration under an agreement in writing." 9 U.S.C. § 16(a)(1)(A) allows an immediate appeal from an order denying a stay. The District Court denied the stay. On appeal, the Sixth Circuit held that it had no jurisdiction to hear the appeal. The Supreme Court (Justice Scalia) reversed and remanded the case for further proceedings.

- The Court concluded that the Court of Appeals conflated questions of the applicability of 9 U.S.C. §§ 3 and 16(a) with the substantive merits of the question whether non-signatories to a written arbitration agreement possessed contract rights to arbitration under the agreement. "The jurisdictional statute here unambiguously makes the underlying merits irrelevant, for even utter frivolousness of the underlying request requires for a § 3 stay cannot turn a denial into something other than 'an order ... refusing a stay of any action under section 3.'"
- The Court further concluded that, in order not to award the "petitioners a remarkably hollow victory," state law is applicable to determine whether non-signatories to the arbitration agreement

may enforce the agreement and thereby obtain a stay of proceedings pursuant to the written arbitration agreement.

- The dissenting justices (Justice Souter joined by Chief Justice Roberts and Justice Stevens) argued that 9 U.S.C. § 3 offers a stay only to signatories of an arbitration agreement because "it would therefore seem strange to assume that Congress meant to grant the right to appeal a § 3 stay denial to anyone as peripheral to the core agreement as a nonsignatory ... ."

- This opinion highlights the likelihood that the resolution of questions regarding professional responsibility in tort law of law firms, accounting firms and the banks involved in the promotion of the recent crop of abusive tax shelters will be shielded from public disclosure by confidential arbitration proceedings and only known to the parties involved.

B. Identified "tax avoidance transactions."

1. A safe cove (not big enough to be a harbor) for some taxpayers in the tax shelter war. Notice 2008-111, 2008-51 I.R.B. 1299 (12/1/08). This notice clarified Notice 2001-16, 2001-1 C.B. 730, and superseded Notice 2008-20, 2008-6 I.R.B. 406, regarding Intermediary Transaction Tax Shelters. A transaction is treated as an Intermediary Transaction with respect to a particular person only if that person engages in the transaction pursuant to a plan, the transaction contains the four objective components indicative of an Intermediary Transaction, and no safe harbor exception applies to that person.

C. Disclosure and Settlement

There were no significant developments regarding this topic during 2009.

D. Tax Shelter Penalties, Etc.

1. The E&Y deal. IR-2003-84, 2003 TNT 128-1 (7/2/03). The IRS announced that it settled Ernst & Young's potential liability under the tax shelter registration and list maintenance penalty provisions for a nondeductible payment of $15 million.

(a) These "value ideas" did produce extraordinary results for E&Y tax partners, but not the results they expected. United States v. Coplan, 2007 TNT 105-1. Two current and two former partners of Ernst & Young, Robert Coplan, Martin Nissenbaum, Richard Shapiro, and Brian Vaughn – all members of its VIPER (Value Ideas Produce Extraordinary Results) group – were indicted on 5/30/07 in the

Southern District of New York for crimes relating to tax shelters promoted by E&Y. The shelters included CDS ("Contingent Deferred Swap"); COBRA ("Currency Options Bring Reward Alternatives"); CDS Add-On; and PICO ("Personal Investment Corporation").

(b) More defendants. 2008 TNT 35-23 (2/21/08). The indictment was expanded to add David L. Smith, Private Capital Management, and Charles Bolton to the list of alleged co-conspirators. Smith is alleged to have introduced the CDS strategy to E&Y and is further alleged to have licensed the CDS transactions to Bolton and a group of Bolton companies who implemented the transactions.

(c) The four indicted members of E&Y's VIPER group were convicted by a jury following a ten-week trial in the Southern District of New York on 5/7/09. The convictions were for conspiracy relating to four tax shelters, tax evasion relating to clients who used a tax shelter transaction known as "CDS Add-On," obstructing the IRS, and making false statements to the IRS. Department of Justice Press Release (5/7/09). 2009 TNT 88-122. They were sentenced to prison terms, but released on bail pending appeal.

- The DOJ release further noted that Bolton pleaded guilty on 1/22/09 and Smith has not been apprehended. It further noted that Peter Cinquegrani, a former Arnold & Porter partner who provided opinion letters on E&Y tax shelters pleaded guilty to conspiracy to commit tax fraud on 9/11/08, and Bell Six, a former E&Y employee who later went to work for entities that implemented shelters for E&Y pleaded guilty to conspiracy to commit tax fraud on 6/14/07.

2. Jerry Cohen outsmarts the government and mitigates taxpayer penalties. Alpha I LP v. United States, 84 Fed. Cl. 622 (11/25/08), *motion for reconsideration denied*, 86 Fed. Cl. 126 (3/16/09). The IRS issued FPAAs that adjusted the partners' capital gains and losses based on five theories: (1) § 752; (2) Reg. § 1.752-6 (the "retroactive regulation"); (3) the transaction or entities were a sham or lacked economic substance; (4) Reg. § 1.701-2 (the partnership anti-abuse regulation); and (5) "none of the transactions of the Partnership increases the amount considered at-risk for an activity under § 465(b)(1)." The partners "conceded the adjustments on the ground that none of the transactions of the partnerships increased the amount considered at-risk for any activity under § 465(b)(1) and that the at-risk rules would disallow losses and require the partnerships and their partners to recognize gain on the transactions as set forth in the FPAAs." In addition, the IRS asserted that the § 6662 substantial valuation misstatement penalty should apply, but the taxpayers did not concede that issue. Rather, the taxpayers argued that valuation misstatement penalties

were inapplicable as a matter of law because "any underpayment of tax was not 'attributable to' a valuation misstatement, but instead would be attributable to plaintiffs' concession that [the IRS's] adjustments were correct under [§ 465(b)(1)]." The court (Judge Hewitt) agreed with the taxpayers and held that where adjustments are made on grounds unrelated to valuation, valuation penalties do not apply. The court also rejected the IRS's argument the court lacked jurisdiction to accept the taxpayer's concession because "there are not any partnership level determinations to be made with respect to § 465." The court found that the "concession obviate[d] the need to conduct a trial on valuation issues and therefore achieve[d] the very efficiencies and economies that the elimination of penalties sought to encourage. ... To go behind the concession and attempt to assign to it a specific ground would be to engage in an activity that the elimination of penalties is intended to prevent." The court also refused to accept the government's argument that it should consider on the merits the government's alternative grounds for the adjustments that were based on valuation, i.e., basis, misstatements, solely for the purposes of determining the applicability of penalties. The court agreed with the taxpayers' argument "that forcing a 'trial on alternative grounds for adjustments plaintiffs have already conceded violates the purpose and policy behind the valuation misstatement penalties and is simply a waste of the Court's and the parties' resources.'"

(a) Taxpayers are not precluded from asserting defenses, but they are bound by their stipulations. Alpha I LP v. United States, 89 Fed. Cl. 347 (Fed. Cl. 8/26/09). Taxpayers are limited to asserting defenses based on the ground under which they made their concessions to avoid valuation penalties. A trial on penalties will not encompass valuation misstatement penalties because the court has already held that valuation misstatement penalties are inapplicable. Plaintiffs are not judicially estopped from asserting defenses based on § 465.

3. Another IRS weapon in the tax shelter war. REG-160872-04, Section 6707 and the Failure To Furnish Information Regarding Reportable Transactions, 73 F.R. 78254 (12/22/08). Prop. Reg. § 301.6707-1 would reflect the amendments to § 6707 in The **American Jobs Creation Act of 2004**. A § 6707 penalty may be assessed against each material advisor required to file a return under § 6111 who fails to file a timely return as required under Reg. § 301.6111-3(e) or files a return with false or incomplete information. If more than one material advisor is responsible for filing a return under § 6111 with respect to the same reportable transaction, a separate penalty under § 6707 may be assessed against each material advisor who fails to timely file a return or files a return with false or incomplete information. Incomplete information means a Form 8918, "Material Advisor

Disclosure Statement" (or successor form), filed with the IRS that does not provide the information required under Reg. § 301.6111-3(d). Failure to timely file or the submission of false or incomplete information is intentional if (1) the material advisor knew of the obligation to file a return, and knowingly did not timely file a return, or (2) filed a return knowing that it was false or incomplete. The proposed regulations provide factors that the IRS should take into account during the determination whether to rescind all or a portion of a § 6707 penalty. The list of factors generally follows Rev. Proc. 2007-21, 2007-1 C.B. 613. The regulations will apply to returns the due date of which is after the final regulations are published in the Federal Register.

4. The Tax Court does have jurisdiction to determine whether partnership transactions were tax-motivated for penalty purposes. Keller v. Commissioner, 568 F.3d 710 (9th Cir. 6/3/09), *rev'g* T.C. Memo 2006-166. The case concerned the outstanding tax liabilities of 16 partners who invested in cattle partnerships that were sold to investors as "The 1,000 lb Tax Shelter." These partnerships were part of a large series of cattle- and sheep-breeding partnerships organized, promoted and operated by Walter J. Hoyt III from the 1970s through the 1990s, and which have been the subject of extensive litigation over the years. The IRS had offered a variety of settlement offers to the partners in the partnerships at issue. When the IRS sent notices of intent to levy, the partners requested collection due process hearings and submitted offers in compromise to settle their outstanding tax liabilities. The IRS rejected the partners' offers in compromise and, in collection due process hearings, imposed interest under former § 6621(c) (which imposed a higher interest rate for substantial underpayments that resulted from tax-motivated transactions). In the ensuing litigation, the Tax Court held that the IRS did not abuse its discretion in rejecting the offers in compromise. The court also held that it did not itself have jurisdiction to determine whether the partnerships' transactions were tax-motivated for purposes of former § 6621(c).

- The Tax Court (Judge Goeke) based its jurisdiction decision on the fact that the question of whether the transactions were tax-motivated is a partnership item that must be determined in partnership-level proceedings. Here, the individual partners were the parties to the various cases being litigated, not the partnerships, so the court held that in these proceedings it did not have jurisdiction to decide the partnership-level issue. The effect of this decision was to leave the Service's imposition of higher interest rates under former § 6621(c) in place.

- The Ninth Circuit (Judge Rymer) agreed with the Tax Court that the determination of whether transactions are tax-motivated is a partnership item to be determined at partnership-level proceedings. This rule was formulated by the Ninth Circuit in *River City*

Ranches #1 Ltd., 401 F.3d 1136 (9th Cir. 2005). However, the partnership proceedings in this case were completed and judgment became final before the *River City Ranches* decision announced this rule.

- The Tax Court has jurisdiction in a collection due process proceeding to decide issues relating to liability that the taxpayer has not had an opportunity to contest (§ 6330(c)(2)(B)). Therefore, according to the Ninth Circuit, in a collection due process proceeding of a partner in a partnership, the Tax Court has jurisdiction to review the record of a partnership-level proceeding to make a determination about a partnership level issue affecting the partner's liability that the partner did not have an opportunity to contest. In this case, the Ninth Circuit believed that the record from the partnership proceedings was sufficient to allow the Tax Court to determine whether the partnership transactions were tax-motivated. The Ninth Circuit then performed the review of the partnership proceedings itself and determined that the partnership transactions were tax-motivated.

5. **Say it ain't so, BDO.** The U.S. Attorney for the Southern District of New York announced on 6/3/09 that Charles W. Bee, Jr., a former Vice-Chairman and board member at BDO Seidman, pleaded guilty to a three-count felony information charging him with conspiracy to defraud the United States in connection with tax shelter transactions involving clients of his firm and of the law firm Jenkens & Gilchrist (J&G); tax evasion in connection with a multimillion-dollar tax shelter that Bee helped sell to a client of his firm; and to giving material false deposition testimony regarding his firm's tax shelter practice.

6. **"Everyone's doing it" is not a legal principle**. 3K Investment Partners v. Commissioner, 133 T.C. No. 6 (9/3/09). In a partnership proceeding to determine whether the partnership reasonably relied on tax opinions in a Son-of-Boss tax shelter investment in order to avoid § 6662 accuracy related penalties, the partnership sought discovery of all of the Son-of-Boss tax shelter opinions and a list of firms providing opinions in order to bolster its argument that reliance on opinions of Jenkens & Gilchrist was reasonable. In denying the discovery motion, the court (Judge Thornton) observed that, "Petitioner's argument appears to be a variant of the refrain, familiar to parents of teenagers, that 'Everyone's doing it.' For the same reason that this does not constitute reasonable cause for teenagers, it would not constitute reasonable cause for petitioner." The court held that the partnership must establish reasonableness based on the facts of its own case. The court also rejected the partnership's argument that the undisclosed opinions, which the court described as involving only a small subset of tax advisors, disclosed a general consensus of tax advisors supported good faith reliance. The court also ruled that the undisclosed tax

opinions in the possession of the IRS represented confidential taxpayer information protected from disclosure under § 6103(a).

7. The Seventh Circuit jumps ship on penalties as partnership items. It affirmed a District Court holding that no accuracy-related penalties applied in a Son-of-Boss case because taxpayers were entitled to rely on tax opinions. American Boat Company, LLC v. United States, 583 F.3d 471 (7th Cir. 10/1/09). David Jump transferred Mississippi river towboats to American Boat L.L.C. after an accident in which barges broke loose from a tow boat and nearly caused a disaster by floating into a casino moored in St. Louis. In a series of Son-of-Boss transactions, American Boat used Treasury note short sales to increase the basis of its tow boats and claim higher depreciation deductions. In a District Court proceeding brought by the partnership the trial court held that the Son-of-Boss transactions were shams, but upheld the partnership's assertion of a reasonable cause defense under § 6664(c) to accuracy related penalties as a partnership item. The government appealed the penalty issue.

- The court stated that the vast majority of courts have held that a partnership may assert a reasonable cause defense as a partnership item on its own behalf based on the conduct of its managing or general partner. The court also noted that a partner may not raise the partner's own reasonable cause defense in a partnership proceeding, but rejected the IRS argument that a reasonable cause defense is limited. The court concluded that a partnership may raise a reasonable cause defense on facts and circumstances common to all partners and which relies on neither an individual partner's tax return nor his unique conduct. The court further concluded that, while it was a close case, the appellate court was not able to conclude that the District Court committed clear error in finding that American Boat, through David Jump, reasonably relied on the tax opinion of Erwin Mayer and Jenkens & Gilchrist in reporting the Son-of-Boss transaction.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

There were no significant developments regarding this topic during 2009.

B. Charitable Giving

1. One of Timothy McVeigh's lawyers loses again, but the consequences are not as severe this time. Jones v. Commissioner, 129 T.C. 146 (11/1/07). Leslie Steven Jones, one of Timothy McVeigh's lawyers in the criminal proceeding stemming from the Oklahoma City

Federal Building bombing, donated to the University of Texas copies of documents received by him from the government in the course of his representation of Timothy McVeigh and claimed a charitable contribution deduction for the appraised value. Judge Cohen upheld the IRS's disallowance of any deduction on the ground that under the relevant state law (Oklahoma), the materials were not attorney work product and not being attorney work product, the client, not the lawyer, was the owner of the materials in the case file. Because the taxpayer "was not the legal owner of the materials, he was not legally capable of divesting himself of the burdens and benefits of ownership or effecting a valid gift of the materials." Alternatively, even if the material in the file was attorney work product, it constituted "letters, memoranda, and similar property" prepared by the taxpayer's personal efforts, which by virtue of § 1221(a)(3)(A) was an ordinary income asset, and thus under § 170(e)(1)(A) the deduction was limited to basis, which was zero.

(a) Affirmed, but on subtly different reasoning. Jones v. Commissioner, 560 F.3d 1196 (10th Cir. 3/27/09). The Tenth Circuit affirmed the Tax Court's decision on the ground that the discovery material was not a capital asset, but did not address whether the taxpayer owned the discovery material under Oklahoma law. However, the rationale of the Court of Appeals for determining that the discovery material was not a capital asset differed from that of the Tax Court. The Tax Court held that the discovery material constituted "letters, memoranda, or similar property created by the taxpayer's own efforts" excluded from the definition of capital asset pursuant under § 1221(a)(3)(A). According to the Court of Appeals, however, the record clearly demonstrated that the discovery material for which Jones claimed a charitable contribution deduction was not created by his own personal efforts, and thus § 1221(a)(3)(A) did not apply to it. Rather, the Court of Appeals held that the discovery material, which was first compiled by the government to assist in its investigation and copies of which were made, organized, and categorized by the government and delivered to the taxpayer for the benefit of Jones and his client, was not a capital asset because it constituted letters, memoranda, or similar property "prepared or produced" for the taxpayer within the meaning of § 1221(a)(3)(B). "[T]he discovery material was provided to Taxpayer only because of his position as lead counsel for McVeigh, and it was the type of material typically produced for defense counsel in the course of a criminal trial."

2. Tax benefits flow from promising not to build an office building between the first green and second tee. Golf course perpetual easements gave rise to charitable contribution deductions. Kiva Dunes Conservation, LLC v. Commissioner, T.C. Memo. 2009-145

(6/22/09). The Tax Court (Judge Wells) held that the owner of a golf course was entitled to a charitable contribution deduction for its grant to the North American Land Trust of a perpetual conservation easement covering a golf course that it owned. He further rejected the asserted § 6662 accuracy-related penalty because the adjustment he made to value was "approximately 10 percent."

3. The easement has to have some real effect to give rise to a charitable contribution deduction. Herman v. Commissioner, T.C. Memo. 2009-205 (9/14/09). Judge Gustafson held that a contribution to a charitable organization of an easement burdening developable air rights over a certified historic structure owned by another person did not qualify for a charitable contribution deduction under § 170(h). The easement did not preclude the taxpayer, the structure's owner, or any subsequent purchaser of the property from altering or demolishing the structure. Thus, the conservation easement did not preserve an "historically important land area" or a "certified historic structure" within the meaning of § 170(h)(4)(A)(iv).

4. 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 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 purposes 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 taxpayer to a higher level of enforcement than that provided by local law.

X. TAX PROCEDURE

A. Interest, Penalties and Prosecutions

1. Increased penalty for failure to file on time. For returns required to be filed after December 31, 2008, the Heroes Earnings Assistance and Relief Tax Act of 2008 increases the minimum penalty failure to file a return on time to the lesser of $135 or 100 percent of the tax required to be shown on the return.

(a) Watch out for this one when not filing partnership tax returns for years beginning in 2008! The revenue offset to a tax reduction. P.L. 110-141, "An Act to exclude from gross income payments from the Hokie Spirit Memorial Fund to the victims of the tragic event at Virginia Polytechnic Institute & State University" was signed by President Bush on 12/17/08. Section 2 of that Act is an off-Code provision that adds $1 to the § 6698(b)(1) "Failure to File a Partnership Return" penalty. The $1 addition does not apply to S Corporation returns. The $1 increase only applies to a taxable year beginning in 2008.

(b) Increased penalties for failing to timely file partnership and S corporation returns. Section 16 of the Worker, Homeownership, and Business Act of 2009 (WHABA) amends §§ 6698 and 6699 to increase the penalty for failing to file a partnership or S corporation tax return from $89 to $195.

2. No free trade agreement for SSNs. T.D. 9437, Amendments to the Section 7216 Regulations – Disclosure or Use of Information by Preparers of Returns, 73 F.R. 76216 (12/16/08). This Treasury Decision amends Reg. § 301.7216-3(b)(4) to permit disclosure by a tax return preparer of a taxpayer's SSN to another tax return preparer located outside the United States only with the taxpayer's consent. The amended regulation applies to disclosures of tax return information occurring on or after 1/1/09.

(a) But there is some freedom for preparers to use taxpayer return information to increase their own profitability. T.D. 9478, Amendments to the Section 7216 Regulations – Disclosure or Use of Information by Preparers of Returns, 75 F.R. 48 (12/29/09). Temp. Reg. § 301.7216-2T(n) allows return preparers to compile, maintain, and use a list containing solely the names, addresses, e-mail addresses, phone numbers, taxpayer entity classification, and income tax return form numbers of taxpayers whose tax returns the tax return preparer has prepared, if the list is used only to contact the taxpayers on the list either (1) to provide tax, general business, or economic information for educational purposes, or (2) for soliciting additional tax return preparation services. Temp. Reg. § 301.7216-2T(p) allows return preparers to disclose return information without penalty for the purpose of a quality or peer review, but only to the extent necessary to accomplish the review. The information also may be used to perform a conflict of interest check. Identical proposed regulations were published simultaneously. REG-131028-09, Amendments to the Section 7216 Regulations – Disclosure or Use of Information by Preparers of Returns, 75 F.R. 94 (12/29/09).

(1) Rev. Rul. 2010-5, 2010-4 I.R.B. 312 (12/30/09). This revenue ruling provides further guidance and allows disclosure of return information to a return preparer's malpractice insurance carrier to the extent necessary to obtain insurance or to defend against claims; to defend claims, the tax return itself may be disclosed and it may be disclosed to attorneys engaged to defend against the claim.

(2) Rev. Rul. 2010-4, 2010-4 I.R.B. 309 (12/30/09). This revenue ruling provides further guidance and details circumstances that justify use of lists to contact clients and allowing disclosure of information to a third-party provider who prepares the mailings.

3. It is not criminal tax fraud if you intended to cheat but after the fact discover a rationale that might disprove the existence of any deficiency. Justice Souter emphasizes that transactions should be treated in accordance with their substance, regardless of the intent of their participants. Boulware v. United States, 552 U.S. 421 (3/3/08) (9-0). Michael Boulware was convicted on nine counts of tax evasion and filing a false income tax return, stemming from his diversion of funds from Hawaiian Isles Enterprises (HIE), a closely held corporation of which he was the president, founder, and controlling (though not sole) shareholder. The Supreme Court emphasized the necessity of a tax deficiency as an essential element of tax evasion under § 7201 in reversing the taxpayer's conviction. *Boulware* involved a shareholder of a closely held corporation who failed to report millions of dollars from the corporation. "[H]e siphoned off this money primarily by writing checks to employees and friends and having them return the cash to him, by diverting payments by HIE customers, by submitting fraudulent invoices to HIE, and by laundering HIE money through companies in the Kingdom of Tonga and Hong Kong." The funds were used to support his "lavish lifestyle," and were treated as distributions of property to him from the corporation. Boulware sought to introduce evidence that HIE had no earnings and profits in the relevant taxable years, and because the amount diverted did not exceed his basis for his stock, there was no dividend under §§ 301(c)(1) and 316, and the entire amount was a return-of-capital treatment under § 301(b)(2). Boulware's argument was that because the return of capital was nontaxable, the Government could not establish the tax deficiency required as an element of criminal tax fraud. The trial court refused to admit the proffered evidence, and the Ninth Circuit affirmed, reasoning that the return of capital theory could be advanced only if at the time the occurred the corporation intended it to be a return of capital, following its prior decision in *United States v. Miller*, 545 F.2d 1204 (9th Cir. 1976). The Supreme Court (Justice Souter) vacated the conviction. The Court concluded:

> There is no criminal tax evasion without a tax deficiency, ... and there is no deficiency owing to a distribution (received with respect to a corporation's stock) if a corporation has no earnings and profits and the value distributed does not exceed the taxpayer-shareholder's basis for his stock.

- With respect to the intent question the Court reasoned as follows:

> *Miller's* view that a criminal defendant may not treat a distribution as a return of capital without evidence of a corresponding contemporaneous intent sits uncomfortably not only with the tax law's economic realism, but with the particular wording of §§ 301 and 316(a), as well. As those sections are written, the tax consequences of a "distribution by a corporation with respect to its stock" depend, not on anyone's purpose to return capital or to get it back, but on facts wholly independent of intent: whether the corporation had earnings and profits, and the amount of the taxpayer's basis for his stock.

- The Court stated the test to be "that economic substance remains the right touchstone for characterizing funds received when a shareholder diverts them before they can be recorded on the corporation's books," and that they "may be seen as dividends or capital distributions for purposes of §§ 301 and 316(a)." He analyzed the treatment of distributions received with respect to a corporation's stock under § 301(a) and concluded that an exception for criminal cases was improper, and concluded:

> The implausibility of a statutory reading that either creates a tax limbo or forces resort to an atextual stopgap is all the clearer from the Ninth Circuit's discussion in this case of its own understanding of the consequences of *Miller's* rule: the court openly acknowledged that "imposing an intent requirement creates a disconnect between civil and criminal liability," 470 F.3d at 934. In construing distribution rules that draw no distinction in terms of criminal or civil consequences, the disparity of treatment assumed by the Court of Appeals counts heavily against its contemporaneous intent construction (quite apart from the Circuit's understanding that its interpretation entails criminal liability for evasion without any showing of a tax deficiency).

- The Court declined to address the government's alternative argument that diversion was an unlawful act akin to embezzlement, rather than a distribution with respect to the corporation's stock, which would result in §§ 301 and 316 being irrelevant and give rise to

deficiency for failure to report the proceeds of a theft, because that question had not been considered by the Court of Appeals.

(a) *Boulware* on remand. It was a Pyrrhic victory before the Supreme Court. He's still going to get room and board from the federal government for a few years. The Ninth Circuit still refuses to permit the use of the "return of capital" theory. United States v. Boulware, 558 F.3d 971 (9th Cir. 3/9/09). In ruling to affirm Boulware's conviction, the court (Judge Thomas) held that the proffer of expert testimony to establish the theory that corporate distributions were legally non-taxable because the corporation had no earnings and profits was properly rejected because the expert testimony constituted a legal opinion and it was within the discretion of the trial judge to exclude it. Judge Thomas went on to hold that in order to be non-taxable the distribution had to be made with respect to the corporation's stock and there was no affirmative evidence "that any nexus existed between the distribution and Boulware's stock ownership." "[A]t the very least a taxpayer must tender some evidence of nexus between the corporate distribution and stock ownership, or show that there were no other alternate explanations, in order to proceed with a return of capital theory at trial." Boulware did neither, and thus the District Court did not err in declining to allow him to present his theory to the jury.

- He further held there was no evidence that Boulware's stock basis equaled or exceeded the $10 million of corporate distributions to Boulware.

(b) And on the merits in the tax case, Boulware's corporations lose deductions. HIE Holdings, Inc. v. Commissioner, T.C. Memo. 2009-130 (6/8/09). Based on a voluminous trial record, the Tax Court (Judge Laro) denied losses and deductions to corporations controlled by Boulware and owned in part by his former secretary/mistress in trust for one of their children. The court denied net operating losses arising from NOL carryovers, disallowed claimed bad debt deductions, denied deductions for claimed professional fees (related to Boulware's criminal defense and civil proceedings by the former mistress), and upheld constructive dividend treatment for distributions to Boulware because professional fees were paid by his constructive withdrawals from the corporations. The court found that the professional fees treated as constructive dividends did not exceed the E&P available for the year.

4. Apparently it's OK to lie on irrelevant attachments to an amended return. United States v. Adams, 314 Fed. Appx. 633 (5th Cir. 2/17/09). The taxpayer was convicted under § 7206(1) on two counts of filing a false return. One count was based on the theory that in signing a Form 1040X amended return, by virtue of the jurat, the taxpayer

falsely swore to truth of an attached copy of his original Schedule C, which contained income omissions. (The government did not seek an indictment for making false statements on the original Form 1040, because the applicable statute of limitations had run.) The Court of Appeals reversed the conviction on this count. The jurat on the Form 1040X states that the taxpayer has "examined this amended return, including accompanying schedules and statements, and to the best of my knowledge and belief, this amended return is true, correct, and complete." By specifying that the signer's examination extends to the amended return and all attachments while limiting the signer's assurance of truth, correctness, and completeness to just the amended return, the jurat's language makes a clear distinction between that which the taxpayer examined and that which he swore was true. In the case of an original return, this distinction is insignificant because accompanying schedules and statements are generally considered integral parts of the return to which the jurat applies. In this case, however, the court concluded that the original Schedule C, which constituted an integral part of his 1999 Form 1040, was not an integral part of the Form 1040X. The purpose of the amended return was to report additional gross income from the sale of the business, not the operation of the business, and the Form 1040X instructs taxpayers to "[a]ttach only the supporting forms and schedules for the items changed."

5. It's no defense to a criminal failure to pay charge that you squandered the money and couldn't have paid it if you wanted to. United States v. Easterday, 539 F.3d 1176 (9th Cir. 8/22/08). The defendant was convicted under § 7202 for willful failure to pay over withheld employee payroll and income taxes. He had requested "an 'ability to pay instruction' in order to contend to the jury that his failure to pay over the taxes he owed was not 'willful,' because he had spent the money on other business expenses and therefore could not pay it to the government when it was due," but the District Court refused to give the instruction. The Ninth Circuit affirmed, overruling its prior decision to the contrary in *United States v. Poll*, 521 F.2d 329 (9th Cir. 1975), on the ground that the subsequent Supreme Court decision in *United States v. Pomponio*, 429 U.S. 10 (1976), by implication repudiated any requirement of proving ability to pay as an element of the crime of willful failure to pay. Possession of sufficient funds to pay the tax is not an element of the crime of under § 7202 (or § 7203). A conviction will be sustained without any showing of the taxpayer's ability to pay and a taxpayer is not entitled to a jury instruction that to support a conviction the government must prove that the taxpayer could have paid the tax.

(a) Petition for rehearing en banc denied. United States v. Easterday, 564 F.3d 1004 (9th Cir. 4/27/09). In denying the

taxpayer's petition for a rehearing en banc (2-1), Judge Schroeder amended the original opinion, but reached the same conclusion. In the amended option, the court rejected the taxpayer's argument that as long as *United States v. Poll*, 521 F.2d 329 (9th Cir. 1975), a panel opinion, had not been overruled by an en banc panel of the court, a panel of the Ninth Circuit was bound to follow *Poll* as law of the circuit. The dissent by Judge Smith would have upheld the taxpayer's argument that one panel of the Ninth Circuit cannot overrule a decision of an earlier panel, even though Judge Smith agreed that *Poll* was wrongly decided.

6. He was convicted of criminal tax fraud, but in the civil case, the IRS couldn't prove that any of the over $200,000 deficiency was due to fraud, so Judge Holmes "estimates" $500 of the deficiency due to fraud in order to avoid inconsistency. Barrow v. Commissioner, T.C. Memo. 2008-264 (11/25/08). Because the IRS issued the deficiency notice more than three years after the return filing date, the deficiency notice was timely only if the understatement of tax was fraudulent. The taxpayer had been convicted of criminal tax fraud with respect to taxable years 1985, 1987, and 1988. In the criminal trial, the government's primary theory was that Barrow had cheated on his taxes by not reporting on his individual returns fees that two health care organizations paid to him as the chairman of the board and a trustee. In the civil action, however, the government's theory was that Barrow's unreported income was income diverted from the incorporated accounting firm that he headed (because the government also was seeking a deficiency against the accounting firm). The government argued that Barrow was collaterally estopped from arguing that the understatement was not fraudulent. The Tax Court (Judge Holmes) upheld that the taxpayer's argument that because the government's theory with respect to the unreported fees was different in the civil action from in the criminal action, the issues in that regard were not identical — a requirement for collateral estoppel to apply — with respect to the two actions, but that Barrow nevertheless was collaterally estopped from arguing that the understatement was not fraudulent because they were "relatively minor items of unreported income or incorrect expenses whose consequences for Barrow's tax liability are unaffected by the switch in government theories between the cases." Because in the criminal trial, the government established willful tax evasion beyond a reasonable doubt, but the jury was not required to return a verdict detailing which items of income had not reported or which claimed expenses had not been paid, collateral estoppel applied with respect to the entire claimed deficiency. However, on the merits, Judge Holmes found that even though in the criminal case the government proved beyond a reasonable doubt that some part of Barrow's underpayments for 1987 and 1988 were due to fraud, in the civil case the Commissioner failed to prove that any particular underpayments were

actually due to fraud. Recognizing that "it would be inconsistent to hold no part of the underpayment due to fraud," Judge Holmes "estimate[d] that $500 in 1987 and 1988 was due to fraud for purposes of applying the fraud penalty." But because no part of any underpayments for 1984 or 1986 (the accounting firm's 1988 and 1989 deficiencies) was due to fraud, the Commissioner's determination for those years was not sustained.

7. **Hip, hip, hypocrisy!** Treasury Press Release on the swearing-in of a new Secretary of the Treasury, http://www.ustreas.gov/news/index1.html (1/26/09). This appointment requires IRS employees to feel ashamed – but undeterred – when they propose penalties or criminal prosecutions with respect to an amount of tax owed that does not exceed $48,268. See, also, http://www.ustreas.gov/press/releases/tg01.htm.

(a) H.R. 735, the **Rangel Rule Bill of 2009**, was introduced on 1/28/09 by Representative John Carter (R-TX). It would permit taxpayers to immunize themselves from penalties and interest when they file a return to pay back taxes.

8. **Small businesses that underpay estimated taxes are the backbone of the American economy.** Section 1212 of the **2009 ARRA** amended § 6654(d) to reduce the 100 percent of the prior year's taxes safe-harbor to 90 percent of the prior year's taxes for an individual whose adjusted gross income for the prior year was less than $500,000, if more than 50 percent of the gross income on the prior year's tax return was from a small business (generally defined as a business with fewer than 500 employees).

9. **IRS gets addicted to announcing amnesty for offshore tax cheats.** IRS News Release IR-2003-05, 2003 TNT 10-11 (1/14/03). An Offshore Voluntary Compliance Initiative provided that "eligible taxpayers," who used offshore payment cards or other offshore financial arrangements to hide their income, may avoid civil fraud and information return penalties (but not failure to pay tax or accuracy-related penalties) if they come forward and pay up by 4/15/03 and provide full details on those who promoted or solicited the offshore scheme. Promoters and solicitors are not eligible. The information release contains the following example:

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

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

(b) **Liechtenstein!** IR-2008-26 (2/26/08). The IRS announced that it was initiating enforcement action involving more than 100 U.S. taxpayers in connection with accounts in Liechtenstein. According to a story in the 2/19/08 Wall Street Journal, (a) Heinrich Kieber, a former employee of Liechtenstein's largest bank, LGT Group, has offered confidential client data to tax authorities on several continents over the past 18 months, and (b) the German government paid roughly €4.2 million ($6.4 million) to an unnamed individual for the same type of information.

(c) **UBS settles with the Justice Department for $780 million.** On 2/18/09, the Swiss bank UBS agreed to pay $780 million under a deferred prosecution agreement over the bank's offshore services to U.S. taxpayers. It also agreed to hand over the names and account information of some of these taxpayers; however, there were indications that only 250 client names out of 19,000 account holders were being disclosed. 2009 TNT 31-1.

(d) **The 2009 version is much less of an amnesty than the 2003 version.** On 3/26/09, the IRS announced several programs relating to penalties on voluntarily disclosed offshore accounts. They have a 3/23/09 effective date, and are good for six months. Several internal memoranda explain how the IRS intends to process voluntary disclosure claims made regarding offshore accounts. 2009 TNT 57-2.

(1) These memoranda include one on examinations of offshore transactions, 2009 TNT 57-32; one on the routing of voluntary disclosure cases, 2009 TNT 57-33; and one authorizing a new penalty structure for voluntary disclosures, 2009 TNT 57-34.

(2) IR-2009-84 (9/21/09). The filing deadline for the voluntary disclosure was extended to 10/15/09, and the IRS announced there would be no further extensions.

(e) **The instructions for the new FBAR are FUBAR.** IR-2009-58 and Announcement 2009-51, 2009-25 I.R.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.

(3) Notice 2009-62, 2009-35 I.R.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.

10. Sentence was unreasonably lenient, said Third Circuit. United States v. Tomko, 498 F.3d 157 (3d Cir. 8/20/07). A sentence of one year of home confinement in "the very mansion built through the tax evasion scheme at issue," a $250,000 fine, three years probation, and 250 hours of community service for evading taxes of $228,557, was vacated as unreasonably lenient. The case was remanded for resentencing.

(a) However, the court en banc affirmed the District Court's sentence. United States v. Tomko, 562 F.3d 558 (3d Cir. 4/17/09) (8-5). The majority opinion (Judge Smith) held that the District Court's variation from the 18 U.S.C. § 3553(a) U.S. Sentencing Guidelines' recommendations, which included between twelve and eighteen months' imprisonment, after consideration of all relevant factors was entitled to "due

deference" despite the fact that some judges in the majority would have imposed prison time on a plumbing contractor who directed numerous subcontractors who were building his multimillion dollar home to falsify information on billing invoices so the invoices would show work done at one of his corporation's many job sites instead of at his home, resulting in a tax deficiency of $228,557. Defendant's work for Habitat For Humanity's Pittsburgh affiliate and his willingness to work for its New Orleans affiliate post-Katrina – despite its beginning after his indictment – appears to have influenced the District Court's downward departure.

- Judge Fisher's dissent focused on the greater apparent pervasiveness of defendant's scheme, including his repeated statements that his vacation home in Maryland was "a gift from Uncle Sam," and found that the District Court "exceeded the lower outer limit of the range of appropriate choices it had the discretion to make, and in doing so abused that discretion" because virtually all other "typical tax evader[s]" possessed the same type of mitigating factors relied upon by the District Court.

11. Tax Court jurisdiction to review an otherwise unreviewable assessable penalty can't piggyback on a related deficiency proceeding. Smith v. Commissioner, 133 T.C. No. 18 (12/21/09). Section 6707A, added to the Code by the American Jobs Creation Act of 2004, imposes a penalty for a taxpayer's failure to include with his return required information with respect to a reportable transaction. The IRS assessed a § 6707A penalty against the taxpayer and issued a deficiency notice to his wholly owned corporation with respect to the transaction to which the § 6707A penalty applied. The taxpayer filed a timely petition with the Tax Court, but Judge Kroupa held that a penalty imposed under § 6707A is not reviewable by the Tax Court, even in a deficiency proceeding. Although the IRS issued a deficiency notice, the notice did not determine the § 6707A penalty. The § 6707A penalty was properly independently assessed without the IRS issuing a deficiency notice, and the penalty was thus not within the Tax Court's deficiency jurisdiction. The taxpayer's only redress is though a refund proceeding.

12. There's no prepayment judicial review for the failure to pay penalty. Burke v. Commissioner, T.C. Memo. 2009-282 (12/8/09). The § 6651(a)(3) addition to tax for failure to pay is not subject to deficiency procedures, but may be collected administratively if it not paid upon notice and demand.

B. Discovery: Summonses and FOIA

1. District Court finds tax accrual workpapers protected by the "work product privilege" and denies the IRS petition

for summons enforcement. United States v. Textron Inc., 507 F. Supp. 2d 138 (D. R.I. 8/28/07). Textron engaged in six SILO transactions in 2001 before SILOs became listed transactions in 2005. Under IRS procedures, engaging in more than one listed transaction means that the IRS will request the entire tax accrual workpapers file. Textron produced all requested documents with respect to the SILO transactions but refused to turn over its entire workpaper file. Judge Torres held that the tax accrual workpapers were prepared "because of" anticipated litigation with the IRS. He refused to follow contrary authority from the Fifth Circuit in *United States v. El Paso Company*, 682 F.2d 530 (1982), which used the more stringent primary purpose test for determining whether documents were prepared "in anticipation of litigation." He also held that work product protection was not lost when the tax accrual workpapers were provided to Ernst & Young for its audit of the company because the AICPA Code § 301 on confidential client information made it very unlikely that the accounting firm would provide them to the IRS.

(a) This split decision has been taken to the banc. United States v. Textron Inc., 507 F. Supp. 2d 138 (D. R.I. 8/28/07), *affirmed in part, vacated in part and remanded*, 553 F.3d 87 (1st Cir. 1/21/09) (2-1), *taxpayer's petition for rehearing denied*, (3/24/09), *government's petition for en banc rehearing granted*, (3/25/09). The majority opinion (Judge Torruella) affirmed the holding that Textron's tax accrual workpapers were protected by the work product doctrine on the ground that the First Circuit law is that "dual purpose" documents created because of the prospect of litigation are protected even though they were also prepared for a business purpose, i.e., E&Y's audit of Textron. It distinguished *United States v. El Paso Company*, 682 F.2d 530 (5th Cir. 1982), as being part of an existing split between the circuits in the definition of "the anticipation of litigation."

- The majority remanded the case for the District Court to consider the questions of whether Textron waived work-product protection by showing its tax accrual workpapers to E&Y and whether E&Y's workpapers were within the "control" of Textron.

- Judge Boudin dissented on the ground that the proper test should be whether the tax accrual workpapers were prepared "in the ordinary course of business" or were otherwise independently required, and their preparation would not be chilled by lack of protection because they are required by "the financial statement obligations and accounting rules." He based his opinion on the need for such documents "[i]n the wake of Enron and other corporate scandals ... ." He later stated,

> And, while it may seem one-sided to give the government Textron's blue print to weaknesses in Textron's tax returns, the return is massive — constituting more than 4000 pages;

> the government has an important interest in collecting taxes that are owed; and its inquiries into work papers were focused on a specific type of transaction that had been shown to be open to abuse. So context should be kept in mind before shedding too many tears for Textron.

- The government's petition for rehearing en banc was granted.

(b) Reversed by a divided First Circuit in an en banc rehearing. The First follows the Fifth to *El Paso*. United States v. Textron Inc., 577 F.3d 21 (1st Cir. 8/13/09) (3-2). The majority (Judge Boudin) held that the work product privilege protects only work done for litigation purposes (the "prepared for" test or the "primary purpose" test), and abandoned the prior First Circuit "because of" test, encompassing work done in preparing financial statements that also is prepared in contemplation of litigation. The majority followed *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982),

- Judge Boudin concluded:

> Textron apparently thinks it is "unfair" for the government to have access to its spreadsheets, but tax collection is not a game. Underpaying taxes threatens the essential public interest in revenue collection. If a blueprint to Textron's possible improper deductions can be found in Textron's files, it is properly available to the government *unless* privileged. Virtually all discovery against a party *aims* at securing information that may assist an opponent in uncovering the truth. Unprivileged IRS information is equally subject to discovery.
>
> The practical problems confronting the IRS in discovering under-reporting of corporate taxes, which is likely endemic, are serious. Textron's return is massive — constituting more than 4,000 pages — and the IRS requested the work papers only after finding a specific type of transaction that had been shown to be abused by taxpayers. It is because the collection of revenues is essential to government that administrative discovery, along with many other comparatively unusual tools, are furnished to the IRS.
>
> As Bentham explained, all privileges limit access to the truth in aid of other objectives, 8 Wigmore, *Evidence* § 2291 (McNaughton Rev. 1961), but virtually all privileges are restricted — either (as here) by definition or (in many cases) through explicit exceptions — by countervailing limitations. The Fifth Amendment privilege against self-

> incrimination is qualified, among other doctrines, by the required records exception, and the attorney client privilege, along with other limitations, by the crime-fraud exception.
>
> To sum up, the work product privilege is aimed at protecting work done for litigation, not in preparing financial statements. Textron's work papers were prepared to support financial filings and gain auditor approval; the compulsion of the securities laws and auditing requirements assure that they will be carefully prepared, in their present form, even though not protected; and IRS access serves the legitimate, and important, function of detecting and disallowing abusive tax shelters. (*footnote and internal citations omitted*)

2. The work product privilege claim didn't work, but the § 7525 privilege claim did. Valero Energy Corp. v. United States, 100 A.F.T.R.2d 2007-6473 (N.D. Ill. 8/23/07). Valero sought to quash summonses issued by the IRS to Valero's tax advisor, Arthur Andersen, relating to certain branch transactions, foreign currency transactions, dual consolidated losses, overall foreign losses, and hedge positions in connection with fluctuation risks. The court (Judge Kennelly) rejected Valero's claim that the documents were protected by the work product doctrine. He found that the documents were "best categorized as having been prepared during the ordinary course of business, with the possibility of future litigation being secondary at most." He concluded that "Valero confuse[d] the possibility of litigation with the requirement that to be protected, a document must have been prepared *because* of anticipated litigation. The fact that Valero hired Arthur Andersen with an eye toward the complex nature of the transaction, and the possibility that the IRS might investigate, does not support a contention that Arthur Andersen prepared its materials because Valero or Andersen anticipated actual litigation." (Under Seventh Circuit precedent, the work product doctrine applies only when "the document can fairly be said to have been prepared or obtained *because* of the prospect of litigation." *Logan v. Commercial Union Ins. Co.*, 96 F.3d 971, 976–77 (7th Cir. 1996) (emphasis in original).) However, the documents were protected under the § 7525 tax practitioner's privilege as 'confidential tax advice.' Even though it had the effect of avoiding federal income taxes, the tax shelter exception in § 7525(b) did not apply for two reasons. First, "the transactions in question did not involve the *promotion* of tax shelters;" nothing in the record indicated that Arthur Andersen had anything to do with "promotion" of participation in a tax shelter. Second, the tax shelter exception only applies to a transaction in which tax avoidance is a "significant purpose," and not where tax avoidance is merely "one of the purposes" of the transaction. Nothing in the record indicated the purpose of the transactions. (Under Seventh Circuit precedent, *United States v. BDO Seidman, LLP*, 492 F.3d

806 (7th Cir. 2007), "the burden rests on the opponent of the privilege to prove preliminary facts that would support a finding that the claimed privilege falls within an exception.")

(a) Oops, no, the § 7525 privilege did not apply, because the transactions involved promotion of tax shelters. Valero Energy Corp. v. United States, 102 A.F.T.R.2d 2008-5916 (N.D. Ill. 8/1/08), *on reconsideration*, 102 A.F.T.R.2d 2008-5929 (N.D. Ill. 8/26/08). On the government's motion for entry of a further order of an IRS summons issued to Valero's tax advisors, Arthur Andersen, LLP, and after an in camera inspection of the requested documents, Judge Kennelly held that the government "met its burden of showing a foundation in fact that the transactions involved a tax shelter" so the lion's share of the documents were not privileged. The court refused to construe the word "promotion" in § 7252(b) narrowly, and held that "promotion" includes participation in the organization or sale of a tax shelter.

(b) Affirmed. "Nothing ... limits tax shelters to cookie-cutter products peddled by shady practitioners or distinguishes tax shelters from individualized tax advice." Valero Energy Corp. v. United States, 102 A.F.T.R.2d 2008-5916 (N.D. Ill. 8/1/08), *on reconsideration*, 102 A.F.T.R.2d 2008-5929 (N.D. Ill. 8/26/08), *aff'd*, 569 F.3d 626 (7th Cir. 6/17/09). The Seventh Circuit, in an opinion by Judge Evans, affirmed the District Court's order enforcing the summons, noting that "our review of the District Court's ruling is deferential, and we will reverse only if it is clearly erroneous. Findings regarding privilege are fact-intensive, case-specific questions that fall within the District Court's expertise, and, under these circumstances, 'a light appellate touch is best.'" First, the Court of Appeals described many of the documents as "the type of information generally gathered to facilitate the filing of a tax return," which is "accounting advice ... not covered by the privilege, ... whether or not the information made it on the tax returns." Other documents dealt with "inventory methods, compensation packages, or general structure, and analyzed how they affect tax computations." The court concluded that the documents were discoverable, even though they "'contain[ed] some legal analysis,' because it comes part and parcel with accounting advice, and is therefore also open to the government." Finally, the court held that "[n]othing in [the § 6662(d)(2)(C)(ii) definition of a 'tax shelter'] limits tax shelters to cookie-cutter products peddled by shady practitioners or distinguishes tax shelters from individualized tax advice. Instead, the language is broad and encompasses any plan or arrangement whose significant purpose is to avoid or evade federal taxes."

3. Law firm was not entitled to materials under FOIA because they might help its clients to circumvent the law. Mayer Brown LLP v. Internal Revenue Service, 562 F.3d 1190 (D.C. Cir. 4/17/09). The D.C. Circuit (Judge Brown) upheld the denial of Mayer Brown's FOIA request for various information relating to the IRS's LILO settlement practices. FOIA Exemption 7(E), 5 U.S.C. § 552(b)(7)(E), shields information if "disclosure could reasonably be expected to risk circumvention of the law," and revelation of the IRS's settlement practices would risk circumvention of the law, including the Internal Revenue Code.

> [E]nforcement of the tax laws, a largely self-policed obligation, depends heavily on the personal probity of taxpayers and the deterrent effect of severe and certain sanctions. And, as a slew of high profile cases have recently demonstrated, compliance will often be delayed until enforcement (or unfavorable exposure) is imminent. ...
>
> [C]ompanies using LILO schemes would love to have information about the IRS's objectives of settlement, assessment of litigation hazards, and acceptable ranges for settlement. Why? Because this information would inform their cost-benefit analysis about the advantages of evading the law. Constructing a phony tax shelter may only be worthwhile if the IRS's acceptable settlement range is below 80% of the tax liability. Once armed with (hypothetical) information that the IRS's acceptable settlements are between 60% and 75%, a questionable tax scheme becomes viable. Even a failure may be a win. And, once also armed with information about which cases the IRS does not like to litigate, the illegal tax shelter can be designed to minimize the chances of litigation or the likelihood of sanctions.

4. The IRS has the burden of showing that the exception to the FATP privilege for corporate tax shelter promotion communications applies. Countryside Limited Partnership v. Commissioner, 132 T.C. No. 17 (6/8/09). When the IRS moved to compel production of certain meeting notes prepared by one of the taxpayer's accountant-advisors, the taxpayer claimed that the documents were protected from disclosure by the attorney client privilege and the § 7525 federally authorized tax practitioner (FATP) privilege. The meeting notes "constitute[d] a cumulative chronicle of communications, in part confidential, from clients, including Countryside Limited Partnership ... , to their attorneys for legal advice or to Timothy Egan ... , whom [the court] found to be an FATP, for tax advice, or from those individuals back to their clients." The Tax Court (Judge Halpern) held that the taxpayer has the

burden of proving the preliminary facts necessary to establish the § 7525 privilege. The Commissioner can negate the privilege claim by proving that the requested documents are written communications in connection with the promotion of corporate tax shelters and that the exception in § 7525(b) thus applies. On the facts, Judge Halpern found that because the meeting notes in question were not themselves communicated to anyone but were merely written summaries of oral communications, they were not a written communication that could satisfy that element of the § 7525(b) exception. The documents in question also were not within the § 7525(b) exception because the Commissioner failed to show that the accountant had "promoted" a corporate tax shelter. Section 7525 does not define "promotion," but the legislative history quoted in the opinion provides, "[t]he Conferees do not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client. Accordingly, the Conferees do not anticipate that the tax shelter limitation will adversely affect such routine relationships." H. Conf. Rept. 105-599, at 269 (1998), 1998-3 C.B. 747, 1023. Judge Halpern found Eagan's relationship to the taxpayer to be a "routine" relationship that did not involve promotion of a tax shelter.

> Mr. Egan has had a long, close relationship with the Winn organization, preparing returns, assisting with tax planning when asked, answering questions when asked, and responding to notices and inquiries from Federal and State tax officials. His advice with respect to the partnership redemptions and associated transactions under review in these cases was furnished (as was similar advice with respect to similar transactions) as part of a long-standing, ongoing, and, hence, routine relationship with the Winn organization. Mr. Egan provided tax advice to the Winn organization when requested to do so, and his advice here followed the same regular course of procedure as did his other tax advice, including tax advice related to partnership redemptions. His employer, PWC, had no stake in the outcome of the transactions under review in this case other than in the continued retention of the Winn organization as a client. It did not receive a fixed fee or a fee based on a percentage of some claimed tax saving. It was paid by the hour pursuant to a rate schedule for Mr. Egan's time in rendering his advice, just as it was for the other services outside of return preparation that he rendered to the Winn organization.

5. A stern warning against unwarranted blanket claims of privilege. Eulich v. United States, 104 A.F.T.R.2d 2009-6337 (N.D. Tex. 9/4/09). In connection with an audit, the IRS summonsed certain

documents relating to a Bahamian trust, and the taxpayer asserted attorney client privilege and work product doctrine protection for 'voluminous documents" that were submitted for *in camera* review. The court (Judge Lindsay) determined that hundreds — we lost count at over 400 — of documents were privileged in whole or in part, and that hundreds — we again lost count at over 400 — of documents were not privileged in whole or in part. The Judge Lindsay concluded as follows:

> This review has placed an undue, and in many instances unjustified, burden on the court and its staff. It has stretched scarce judicial resources in a way never contemplated by the court. In many instances, the court does not believe that the claim of privilege was met seq.ade in good faith. *Petitioner is put on notice that the court will not tolerate such blanket claims of privilege and will impose sanctions as appropriate if such conduct recurs.* (Emphasis in original.)

C. Litigation Costs

1. A contingent attorney's fee has been incurred even if it's not owed. Morrison v. Commissioner, 565 F.3d 658 (9th Cir. 5/13/09). The Ninth Circuit reversed a Tax Court decision, T.C. Memo 2006-103, which held that a taxpayer had not "incurred" attorney's fees reimbursable under § 7430 when the fees were advanced by a corporation owned by the taxpayer under an agreement providing that the taxpayer would reimburse the corporation if he was able to recover them under § 7430. It should be self evident that when a third person, e.g., a corporation of which the taxpayer is a shareholder, who has no direct interest in the litigation pays attorney's fees on behalf of a taxpayer, the taxpayer has "incurred" the fees as long as the taxpayer has an absolute obligation to repay the third person, regardless of whether he successfully moves for an attorney's fees award under § 7430. Going a step further, the Ninth Circuit held that when such a third person pays attorney's fees on behalf of a taxpayer, the taxpayer has "incurred" the fees if he has only a contingent obligation to pay the fees in the event that he is able to recover them under § 7430. Because the nature of the agreement between the taxpayer and the corporation that advanced the attorney's fees was unclear from the record, the Ninth Circuit remanded the case to the Tax Court to apply the definition it adopted of "incurred," after determining the precise nature of the fee agreement, if any, between the taxpayer and the corporation.

2. Clarifying guidance on collecting attorney's fees from the IRS. REG-111833-99, Regulations Under I.R.C. Section 7430 Relating to Awards of Administrative Costs and Attorneys Fees, 74 F.R. 61589 (11/25/09). The Treasury Department has published proposed

regulations relating to awards of administrative costs and attorneys fees under § 7430 to conform to the amendments made in the Taxpayer Relief Act of 1997 and the IRS Restructuring and Reform Act of 1998. Among the changes reflected in the proposed regulations are the following. (1) A taxpayer has ninety days after the date the IRS mails to the taxpayer a final decision determining tax, interest or penalty, to file an application with the IRS to recover administrative costs. (2) A taxpayer has ninety days after the date the IRS mails to the taxpayer, by certified or registered mail, a final adverse decision regarding an award of administrative costs, to file a petition with the Tax Court. (3) Individuals filing joint returns should be treated as separate taxpayers for purposes of determining net worth. (4) Trusts are subject to the net worth requirements. (5) Clarifying changes address the calculation of net worth. (6) Several amendments to § 7430 in the IRS Restructuring and Reform Act of 1998 are reflected in the proposed regulations: (a) the hourly rate limitation is increased to $125; (b) difficulty of the issues presented and local availability of tax experts may be considered to increase an attorney's hourly rate; (c) a court should consider whether the IRS has lost cases with substantially similar issues in other circuit courts of appeal in deciding whether the IRS's position was substantially justified; (d) if an individual who is authorized to practice before the Tax Court or the IRS is representing the taxpayer on a pro bono basis, the taxpayer may petition for an award of reasonable attorneys fees in excess of the amounts that the taxpayer paid or incurred, as long as the fee award is ultimately paid to the individual or the individual's employer; (e) the period for recovery of reasonable administrative costs is extended to include costs incurred after the date on which the first letter of proposed deficiency ("30-day letter") is mailed to the taxpayer, but the taxpayer may be eligible to recover reasonable administrative costs from the date of the 30-day letter only if at least one issue (other than recovery of administrative costs) remains in dispute as of the date that the IRS takes a position in the administrative proceeding.

D. Statutory Notice of Deficiency

There were no significant developments regarding this topic during 2009.

E. Statute of Limitations

1. The taxpayer might have been confused by inconsistent letters from the IRS, but that's no excuse. Leonard v. United States, 85 Fed. Cl. 435 (1/30/09). A letter sent to the taxpayer on Feb. 29, stating that a formal disallowance of a refund claim that will start the statute of limitations on filing a refund suit would be issued in the following week,

did not toll the period of limitations that had been commenced by a letter sent on Feb. 6, stating that the refund claim had been disallowed and that a suit for refund could be commenced within two years of the date of the Feb. 6 letter.

2. The tax return really does have to rat you out to avoid the six year statute of limitations if the understatement exceeds 20 percent. Benson v. Commissioner, 560 F.3d 1133 (9th Cir. 3/31/09), *aff'g* T.C. Memo. 2006-55 (3/27/06). Items on the tax returns of brother-sister corporations reflecting payments between them, which on the facts were found to be constructive dividends to their common shareholder, did not constitute adequate disclosure with respect to the shareholder's return to prevent the § 6501(e)(1)(A) six-year statute from being applicable.

3. 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), Overstated basis resulted 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 ground that the language at issue in the instant case was the same as the statutory language interpreted in *Colony.* The court noted, however, that "The 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). In a TEFRA partnership tax shelter case, the Court of Federal Claims (Judge Allegra) held that the § 6501(e) 6-year statute of limitations does not apply to basis overstatements, citing *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958). Section 6501(e), rather than § 6229(c)(2) as in *Bakersfield Energy Partners, LP*, applied because in earlier proceedings in the instant case (71 Fed. Cl. 324 (2006)), the court had held that § 6229 did not create an independent statute of limitations, but instead only provides a minimum period for assessment for partnership items that could extend the § 6501 statute of limitations, and because the FPAA was sent within this six-year statute of limitations under § 6229(d) the statute of limitations with respect to the partners was suspended.

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

(e) And a different judge of the Court of Federal Claims agrees with the District Court in Florida and disagrees with the prior Court of Federal Claims opinion by the judge in *Grapevine Imports*. Salman Ranch Ltd. v. United States, 79 Fed. Cl. 189 (11/09/07). The court (Judge Miller) refused to follow *Bakersfield Energy Partners* and *Grapevine Imports* and held that the § 6501(e) 6-year statute of .imitations 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 and 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). 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. No. 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). 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, "in 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). 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.

4. Proposed Regulations provide an instruction manual on how to start running the otherwise endless statute of limitations on previously unreported listed transactions. Notice of Proposed Rulemaking, Period of Limitations on Assessment for Listed Transactions Not Disclosed Under Section 6011, REG-160871-04, 74 F.R. 55127 (10/7/09). The Treasury has published proposed regulations § 301.6501(c)-1(g) under § 6501(c)(10), which extends the statute of limitations when a taxpayer fails to disclose a listed transaction; the statute of limitations does not expire until one year after the earlier of (1) the date on which the taxpayer furnishes the required information, or (2) the date a material advisor (as defined in § 6111) satisfies the list maintenance requirements of § 6112 with respect to a request by the IRS. The proposed regulations specify the methods for subsequent disclosure of listed transaction that was not properly disclosed under § 6011. The extended statute of limitations applies only to the tax relating to the listed transaction, but the proposed regulations provide that tax with respect to the listed transaction includes, but is not limited to, adjustments made to the tax consequences claimed on the return plus interest, additions to tax, additional amounts, and penalties that are related to the listed transaction or adjustments made to the tax consequences, as well as any item to the extent the item is affected by the listed transaction even if it is unrelated to the listed transaction.

5. A listed transaction is a listed transaction, is a listed transaction, period. A partner's statute of limitations can be

determined in a TEFRA partnership level proceeding. Blak Investments v. Commissioner, 133 T.C. No. 19 (12/23/09) (reviewed, 12-3). The taxpayers engaged in a Son-of-Boss type transaction in December 2001 and January 2002 that first became a reportable transaction on 2/28/03, when Reg. § 1.6011-4 was promulgated. As of that date, they had already filed their 2001 return, but they had not yet filed their 2002 return. Reg. § 1.6011-4(e)(2) required them to attach a statement to their 2002 return disclosing the listed transaction, but when they filed their 2002 return on October 15, 2003, they failed to include the required statement. The IRS issued an FPAA on October 13, 2006, challenging the transactions as shams. Section 6501(c)(10) was added by the American Jobs Creation Act of 2004 applicable to tax years "with respect to which the period for assessing a deficiency did not expire before" 10/22/04, and the statute of limitations with respect to the taxpayers' transactions was open on that date. Section 6707A, including the definition of listed transactions in § 6707A(c), imposes penalties on failure to provide required information on reportable transactions on returns due after 10/22/04. Temp. Reg. § 1.6011-4T (and Prop. Reg. § 1.6011-4), requiring disclosure of defined listed transactions were first published in 2000. In a reviewed opinion by Judge Haines, the majority first held that although the Tax Court's jurisdiction in a partnership proceeding generally is limited to determining "partnership items," an exception extends jurisdiction over whether the period of limitations has expired as to individual partners presents, because the expiration of the period of limitations can depend on facts that are peculiar to the individual partners, citing *Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner*, 114 T.C. 533 (2000), *appeal dismissed and remanded,* 249 F.3d 175 (3d Cir. 2001), and *Curr-Spec Partners, LP v. Commissioner*, T.C. Memo. 2007-289, *affd,* 579 F.3d 391(5th Cir. 2009). The majority rejected the taxpayers' argument that there are two types of listed transactions, those entered into before, and those entered into after, 10/22/04, and that extension of the period for assessment under § 6501(c)(10) only applied to transactions for which a return was due after that date. The court concluded that the extension of the statute of limitations under § 6501(c)(10) is effective for tax years for which the period of limitations had not expired on 10/22/04, and that the enactment of the penalty provisions in § 6707A has no bearing on the application of § 6501(c)(10). "[I]t is of no consequence that the transaction in question became a reportable transaction after the transaction had already occurred. The legislative history expressly contemplated such a result." The court also held that Temp. Reg. § 1.6011-4T was valid and required disclosure of the taxpayers' transactions on their 2001 and 2002 returns. The court rejected the taxpayers' arguments that the temporary regulation violated Executive Order 12866, which requires Office of Management and Budget review of proposed significant regulatory actions, or that the temporary regulation violated the notice and comment requirements of the Administrative

Procedure Act. Thus, the statute of limitations remained open on the taxpayers' transactions under § 6501(c)(10) until one year after the required disclosure was provided.

- Judge Halpern (joined by Judges Foley and Holmes) dissented on the grounds that the Tax Court does not have the authority in a partnership-level proceeding to decide whether the statute of limitations bars the assessment of a resulting computational adjustment. The dissenters assert that the application of the statute of limitations to the subsequent assessment against the partners is neither a partnership item nor an affirmative defense to the FPAA.

F. Liens and Collections

1. Even though she tells us she's a Blues fan, Judge Marvel says the Queen of the Blues has a legal obligation to honestly report and pay her income tax liability each year. Is this what killed her? Taylor v. Commissioner, T.C. Memo. 2009-27 (2/5/09). The taxpayer, the late Koko Taylor – the "Queen of the Blues," failed to pay estimated taxes or remit full payment with her tax returns for several years. The IRS rejected her subsequent offer in compromise, which she grounded on "economic hardship," because it found no hardship or reasonable cause for failure to pay, and following a collection due process hearing issued a determination that a levy should proceed. The Queen of the Blues appealed to the Tax Court, but Judge Marvel upheld the IRS's determination.

> Both petitioner and respondent repeatedly commented on petitioner's stature as a beloved and well-known professional singer as support for their respective positions in these consolidated cases. We disagree with both parties insofar as they contend that a taxpayer's celebrity status is somehow relevant to what this Court must do in deciding whether the Commissioner's collection action may proceed. Every taxpayer, no matter how famous or notorious, has a legal obligation to honestly report and pay his or her income tax liability each year and is entitled to fair enforcement of Federal tax laws. A taxpayer like petitioner whose business income is generated by performances must carefully comply with estimated tax requirements. The record establishes that petitioner had outstanding tax liabilities for 1998, 2000, and 2001 because she did not make required estimated tax payments when due and that respondent did not abuse his discretion in determining that the filing of an NFTL was appropriate and that respondent may proceed to collect petitioner's outstanding tax liabilities

> by levy. Respondent gave petitioner ample opportunity to rectify her failure to pay estimated tax when due and considered petitioner's collection alternatives in accordance with applicable administrative and legal requirements.

2. Plaintiff asks the Court of Federal Claims to order the government to return to him an erroneous refund that it recovered through an administrative levy, even though he never filed an administrative refund claim, and amazingly at first the court is willing to listen to the argument. Pennoni v. United States, 79 Fed. Cl. 552 (12/4/07). After the taxpayer failed to file a federal income tax return for tax year 1998, the IRS sent him a Proposed Individual Income Tax Assessment, claiming that he owed $17,764. Although the IRS eventually agreed that the taxpayer was owed a refund in the amount of $2,801, it sent him a refund check in the amount of $80,166. The IRS recognized its mistake after the taxpayer cashed the check, and it sent the taxpayer a Notice of Balance Due and ultimately placed a levy on his bank account and garnished his wages. The taxpayer sued the government, seeking an order requiring it to repay amounts it took from his bank account and wages, plus costs, and the government filed a motion to dismiss the action, claiming that the court lacked jurisdiction because the taxpayer did not file an administrative claim for a refund before he filed suit. The court found that the taxpayer did not have to file an administrative claim before he filed suit because he was not seeking a tax refund. Instead, he was suing the government for illegal exaction, and the suit was timely under the six-year statute of limitations pertaining to lawsuits filed under the Tucker Act, so the government's motion to dismiss was denied.

(a) On second thought, the IRS might not have to follow administrative procedures to "reassess" liability for an erroneous refund, but the taxpayer has to follow administrative procedures before filing suit to recover money to which he was never entitled. Pennoni v. United States, 86 Fed. Cl. 351 (2/26/09). The Court of Federal Claims (Judge Firestone) applied the principles of *United States v. Clintwood Elkhorn Mining,* 553 U.S. 1 (2008), which held that the requirements of § 7422 are to be strictly construed, to hold that § 7422(a) requires that administrative remedies be pursued before a taxpayer files suit seeking recovery of amounts that the IRS has collected by administrative levy, without following deficiency or assessment procedures, to recoup an erroneous refund. The court concluded that "even if the plaintiff is correct in its characterization that the IRS improperly used its levy powers to collect a non-tax debt created by the erroneous refund, rather than to collect an unpaid tax liability, this case nonetheless clearly falls within the 'any sum' language of section 7422(a). By its terms, section 7422(a) extends beyond suits for

'the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected,' to suits for the recovery of 'any sum alleged to have been excessive or in any manner wrongfully collected.'"

- The taxpayer is a tax lawyer who did not dispute that he received and negotiated the check, and that it was an erroneous refund!

(b) **Ditto!** Strategic Housing Finance Corporation of Travis County v. United States, 86 Fed. Cl. 518 (2/27/09). Judge Scott interpreted the requirements of § 7422(a) in the same manner as Judge Firestone did in *Pennoni* and denied a nonprofit housing finance corporation/tax-exempt bond issuer's refund claim, for which there had no administrative claim filed, seeking to recover an IRS-accelerated arbitrage rebate overpayment made under protest. The plaintiff characterized the suit as one for an "illegal exaction" or "illegal taking."

3. **A victory for the taxpayer on CDP procedures turns Pyrrhic when the Tax Court reaches the merits.** Mason v. Commissioner, 132 T.C. No. 14 (5/6/09). The taxpayer sought review of a CDP hearing with respect to § 6672 penalties assessed against her as a responsible person for failure to collect and pay over withholding taxes of a corporation. She had not been permitted to contest liability at the CDP hearing, even though prior to the CDP hearing the taxpayer had not received a notice of the IRS's intent to assess § 6672 penalties. The Tax Court (Judge Gerber) held that because the taxpayer had not received a notice of intent to assess a trust fund recovery penalty, she had not had an opportunity to dispute that tax liability under § 6330(c)(2)(B). Because the taxpayer did not have an opportunity to dispute the underlying tax liability at any time during the administrative proceedings and had raised the issue at the CDP hearing, the Tax Court reviewed the liability de novo. However, a notice of intent to assess § 6672 penalties is valid for purposes of assessing the penalties, even though the taxpayer has not received the notice. Thus, the penalties were validly assessed. On the facts, the taxpayer was a "responsible person" who willfully failed to pay over withholding taxes and was liable for the trust fund penalties. The IRS's determination to uphold the lien filing was not an abuse of discretion.

4. **Even the certainly dead face the certainty of taxation.** Estate of Brandon v. Commissioner, 133 T.C. No. 4 (8/27/09). Judge Foley held that a tax lien that is filed after the taxpayer's death with respect to taxes assessed prior to the taxpayer's death is valid, even though at the time the lien was filed ownership of the property had passed to the taxpayer's estate. Under § 6321 a tax lien arises when the assessment is made and under § 6322 continues to be enforceable until it is satisfied or it

becomes unenforceable by a lapse of time, and the IRS complied with the lien notice and filing requirements.

5. **Taxpayer's poverty trumps a proposed levy.** Vinatieri v. Commissioner, 133 T.C. No. 16 (12/21/09). The taxpayer submitted a settlement offer for delinquent taxes, but the IRS determined to levy on the taxpayer's wages and car. Even though the IRS concluded that the levy would create an economic hardship, the settlement officer determined collection alternatives to the levy, including an installment agreement, an offer-in-compromise, and reporting the account as currently not collectible, were not available because the taxpayer had not filed returns for several years. In a review of a § 6330 CDP hearing, Judge Dawson held that it was unreasonable and an abuse of discretion for the IRS to proceed to levy on the taxpayer's wages and car, because a levy would have left the taxpayer impoverished. Section 6343(a)(1) requires that the IRS must release a levy upon all, or part of, a taxpayer's property if it determines that the levy creates an economic hardship due to the taxpayer's financial condition. Reg. § 301.6343-1(b)(4) provides that a levy creates an economic hardship due to the financial condition of an individual taxpayer and must be released "if satisfaction of the levy in whole or in part will cause an individual taxpayer to be unable to pay his or her reasonable basic living expenses." Because the taxpayer had demonstrated that a levy would render her unable to pay her reasonable basic living expenses, the IRS was barred from levying. Judge Dawson rejected the IRS's argument that because the taxpayer was not in compliance with the filing requirements for all required tax returns, its determination to levy was not unreasonable.

- The requirement that taxpayer be currently in compliance with his or her obligations to the IRS under its "currently not collectible" ("CNC") program does not apply to relief under § 6343.

6. **"I would gladly pay you Tuesday for a hamburger today."** T.D. 9473, Agreements for Payment of Tax Liabilities in Installments, 74 F.R. 61525 (11/25/09). The Treasury Department has promulgated final Reg. § 301.6159-1, dealing with rules governing the acceptance and rejection by the IRS of proposed installment agreements, the terms of installment agreements, modification or termination by the IRS, and appeal procedures when the IRS rejects or terminates an installment agreement. Among the provisions is a requirement that the IRS review partial payment installment agreements every two years to determine whether the financial condition of the taxpayer changed enough to warrant an increase in the payments. The IRS may terminate an installment agreement if the taxpayer provides materially inaccurate or incomplete information in connection with a requested financial update. The IRS will generally notify

the taxpayer in writing at least 30 days prior to terminating an installment agreement and describe the reason for the termination, after which the taxpayer may provide information showing that the IRS's reason is incorrect. Appeals procedures are provided. The IRS cannot levy during the time an installment agreement is pending, unless an installment agreement request was made solely to delay collection. The statute of limitations on collection under § 6502 of the Code is suspended for the period that a proposed installment agreement is pending, plus 30 days following a rejection, and during any appeal.

7. Nuanced differences in the statutory subsections result in different periods for suspending the statute of limitations on collections. Severo v. Commissioner, 586 F.3d 1213 (9th Cir. 11/20/09), *aff'g* 129 T.C. 160 (11/15/07). Section 6503(h) suspends the running of the period of limitations on collection from the date of the taxpayer's bankruptcy petition was filed to the date six months after the bankruptcy court issues a discharge order. The more limited suspension of the period of limitations in § 6503(b), which applies to judicial proceedings generally when the taxpayer's assets are under control of a court, does not apply in bankruptcy situations.

8. Ever-expanding Tax Court jurisdiction over CDP appeals. Michael v. Commissioner, 133 T.C. No. 10 (10/8/09). Judge Goeke held that a settlement of the government's counterclaim in a prior refund suit for § 6694 penalties does not preclude Tax Court jurisdiction to review a § 6330 CDP determination with respect to collection of the settlement amount. The District Court's dismissal of the refund action with prejudice on the basis of the settlement agreement does not render the administrative statutory collection remedies unavailable. Nor does the District Court's retention of jurisdiction for a 60-day enforcement period preclude the IRS from pursuing statutory collection remedies, such as a levy. Thus, the Tax Court had jurisdiction to review the IRS's determination to sustain the levy and to determine whether respondent may collect the unpaid penalties by levy.

G. Innocent Spouse

1. The Tax Court sticks to its position that it has broad discretion in reviewing denial of innocent spouse relief. Porter v. Commissioner, 130 T.C. 115 (5/15/08) (reviewed, 2 judges dissenting). Judge Haines held that the Tax Court continues to follow its holding in *Ewing v. Commissioner*, 122 T.C. 32 (2004), *vacated on unrelated jurisdictional grounds*, 439 F.3d 1009 (9th Cir. 2006), that (1) its determination whether the IRS abused its discretion in denying innocent

spouse relief under § 6015(f) is made in a trial de novo, and (2) it may consider evidence introduced at trial which was not included in the administrative record. He rejected the IRS's argument that pursuant to the Eighth Circuit's decision in *Robinette v. Commissioner*, 439 F.3d 455 (8th Cir. 2006), *rev'g* 123 T.C. 85 (2004), the Tax Court's review is limited to the administrative record. Judge Haines distinguished *Robinette* as involving review of a § 6330 CDP determination: "Whereas section 6015 provides that we 'determine' whether the taxpayer is entitled to relief, section 6330(d) provides for judicial review of the Commissioner's determination by allowing the taxpayer to 'appeal such determination to the Tax Court' and vesting the Tax Court with 'jurisdiction with respect to such matter.' As discussed above, the use of the word 'determine' suggests that we conduct a trial de novo."

(a) And the Tax Court applies a de novo standard of review — The IRS gets cut no slack. Porter v. Commissioner, 132 T.C. No. 11 (4/23/09). This opinion dealt with issues not addressed in *Porter v. Commissioner*, 130 T.C. 115 (2008), which held that in determining whether the IRS abused its discretion in denying innocent spouse relief under § 6015(f) the Tax Court conducts a trial de novo, and may consider evidence introduced at trial which was not included in the administrative record. In this reviewed opinion by Judge Haines, in which eight other judges joined, supported by a concurring opinion of two other judges, the Tax Court held that it applies de novo standard of review as well as de novo scope of review. *Jonson v. Commissioner*, 118 T.C. 106 (2002), *aff'd*, 353 F3d 1181 (10th Cir. 2003), and *Butler v. Commissioner*, 114 T.C. 276 (2000), which applied an abuse of discretion standard of review are no longer controlling. Applying this standard of review, equitable relief was granted on the facts. Six judges dissented from the opinion with respect to the standard of review and two judges who concurred with respect to the standard of review dissented on the merits.

(b) And the Eleventh Circuit agrees with the Tax Court that it's more powerful than the IRS's administrative record. Commissioner v. Neal, 557 F.3d 1262 (11th Cir. 2/10/09) (2-1). In an opinion by Judge Wilson, the Eleventh Circuit held that the Tax Court properly considered facts that were not in the administrative record in determining in a trial de novo that the IRS abused its discretion in denying innocent spouse relief under § 6015(f). He concluded that Commissioner had not shown that the Tax Court's reasoning to that effect in *Ewing v. Commissioner*, 122 T.C. 32 (2004), *vacated on other grounds*, 439 F.3d 1009 (9th Cir. 2006), and *Porter v. Commissioner*, 130 T.C. 115 (2008) was in error, and he rejected the Commissioner's argument that the Administrative Procedure Act required that the Tax Court's review be limited to the

administrative record. Section 6015(e), providing for Tax Court jurisdiction to review the IRS's denial of innocent spouse relief in a stand-alone petition cannot be read in isolation from the remainder of rules governing Tax Court review of deficiency "determinations," which differ from "appeals" from the IRS's decision.

> [Section] 6015 is "part and parcel" of the statutory framework for Tax Court review of IRS deficiency determinations. ... It is from this framework that the "[Tax Court's] de novo review procedures emanate." ... Accordingly, when Congress chose to use the same statutory language in § 6015 as it used in establishing the longstanding trial de novo procedure for deficiency actions, "it did so in full awareness of [the Tax Court's] long history of de novo review," ... and did not intend to impose a different procedure. Thus, per § 559, "the APA does not disturb or supersede [the Tax] Court's longstanding de novo judicial review procedures for cases involving spousal relief under section 6015." ...

- The Court noted that the legislative history of the APA confirms it does not supersede the Tax Court's adjudication procedures, quoting the relevant language from the House report.
- Finally, the decision regarding the scope of review was not a Pyrrhic victory; the taxpayer won on the merits.
- **Judge Tjoflat [dis?]respectfully dissents.** Judge Tjoflat wrote a lengthy dissent concluding that the Administrative Procedure Act did apply to limit the Tax Court's review to the administrative record. He caustically concluded as follows:

> Today, the court has given the Tax Court the authority to second-guess the Commissioner at its whim, superimposed upon the farce that the Commissioner's determination is given discretionary weight. Under such a scheme, why should the Commissioner conduct his hearings in a careful and diligent manner? Why bother when the Commissioner knows that his review of the facts and law will be ignored? For that matter, why should taxpayers be required to fund and use the IRS appeals process since any conclusions made by those federal officials will dissipate in the Tax Court like whispers in the wind? I have found no satisfactory answers to these questions. Therefore, I respectfully dissent from the court's judgment.

2. Taxpayer is screwed out of substantive rights by Congress's failure to adequately deal with procedural issues. Pollock v.

Commissioner, 132 T.C. No. 3 (2/12/09). The taxpayer sought § 6015(f) nondeficiency stand-alone innocent spouse relief. In April 2007, the IRS denied the relief before § 6015(e) was amended to confer jurisdiction on the Tax Court to review denial of such relief. The taxpayer did not seek judicial review of the IRS determination. Subsequently, Congress amended § 6015 to confer jurisdiction on the Tax Court to hear § 6015(f) nondeficiency stand-alone cases, effective for tax liabilities "arising or remaining unpaid on or after [December 20, 2006]." When the IRS sought to collect the taxes in a lien-enforcement action, the District Court invoked the doctrine of equitable tolling to give the taxpayer 30 days to file a petition with the Tax Court to review the denial of innocent spouse relief. The taxpayer filed her petition within the time limit set by the District Court's order. The Tax Court (Judge Holmes), although showing sympathy for the taxpayer's plight, granted the Commissioner's motion to dismiss for lack of jurisdiction because the taxpayer filed her petition more than 90 days after the IRS had mailed the notice of determination to her. The § 6015(e)(1)(A) 90-day limit for filing a Tax Court petition for review of the IRS's denial of innocent spouse relief is jurisdictional and therefore does not allow for equitable tolling. Thus, even though the taxes remained unpaid on December 20, 2006, the Tax Court lacked jurisdiction because the petition for review had not been timely filed. The timely filing requirement applied even though on the last day for filing a petition, the Tax Court lacked jurisdiction to review the denial of innocent spouse relief.

3. 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. No. 8 (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. No. 10 (4/13/09). 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 of 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 2-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. No. 8 (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.

4. See no evil, hear no evil, but speak evil of ex-spouse – a perfect formula for § 6015 relief. Phemister v. Commissioner, T.C. Memo. 2009-201 (9/2/09). The taxpayer was entitled to relief from liability on a tax deficiency attributable to her ex-husband's medical practice under § 6015(b) where she had no meaningful involvement with the business and the adjustments resulted from his failure to substantiate claimed expenses. Although his business income supported the taxpayer, it was more than sufficient to have provided support without regard to the disallowed expenses. Thus, the disallowed expenses did not result in any meaningful financial benefit to the taxpayer. The taxpayer also was entitled to § 6015(f) equitable relief. She was divorced from her ex-husband, she had no meaningful involvement with the business, his adjustments resulted from his failure to substantiate claimed expenses; she did not know who kept her husband's books and records, and there was no evidence she reviewed any of his claimed deductions.

H. Miscellaneous

1. A criminal sentence for obstructing and impeding the administration of federal tax laws was vacated because a CPA's two "very good" defense counsel failed to retain an expert witness in tax law to determine the proper amount of tax loss. Baxter v. United States, 634 F. Supp. 2d 897 (N.D. Ill. 6/25/09). After plea negotiations, a CPA pleaded guilty to one count of violating § 7212(a) (obstructing and impeding the administration of federal tax laws) and in the plea agreement stated that "the offense involved a tax loss of more than $550,000 [i.e., $576,000]" but the government asserted that she was accountable for a tax loss of $5.1 million for sentencing purposes. The court rejected the $5.1 million amount after a 2005 hearing, but did not understand that the $576,000 amount was included in the rejected $5.1 million tax loss. In this 28 U.S.C. § 2255 proceeding to "vacate, set aside or correct sentence," Judge Holderman held that the defendant's two ["very good"] criminal defense lawyers provided constitutionally ineffective counsel "because they had failed to retain a tax expert to ascertain the correct amount of tax loss attributable to Baxter's criminal conduct and had failed to evaluate the correct tax ramifications of Baxter's criminal conduct for sentencing purposes."

2. Claims for a method for hedging risk in commodities trading are held not to concern patent-eligible subject matter. This leads to the possible conclusion that tax strategies are not patentable. However, the Federal Circuit did not overrule the *State Street* case and the Supreme Court has granted certiorari in this case. In re Bilski, 545 F.3d 943 (Fed. Cir. 10/30/08) (9-3), *cert. granted sub nom.*

Bilski v. Doll, 129 S. Ct. 2735 (6/1/09). The Federal Circuit (Judge Michel) affirmed a decision of the Board of Patent Appeals and Interferences that claims for a method for managing (hedging) the risks in commodities trading did not constitute a patent-eligible subject matter. The meaning of a patentable "process" under 35 U.S.C. § 101 ["Whoever invents or discovers any new and useful process, machine [etc.] ... may obtain a patent therefore ... .] includes only the transformation of a physical object or substance, or an electronic signal representative of a physical object or substance."

3. Politics as usual; but different politics now. A union suit no longer means underwear but whether it suits a union (such as the NTEU). IR-2009-19 (3/5/09). After conducting an extensive review of the private debt collection program, including the cost effectiveness of the effort, the IRS will not renew its contracts with two private debt collection agencies. The IRS determined that the work is best done by IRS employees who have more flexibility handling cases, which is particularly important with many taxpayers currently facing economic hardship.

4. The government gets a chance to establish a greater deficiency when the civil suit follows the criminal prosecution. McHan v. Commissioner, 558 F.3d 326 (4th Cir. 2/27/09). The IRS is not barred by collateral estoppel from asserting a deficiency in a civil proceeding that is based on the determination of a greater understatement of income than was determined to have been the amount of unreported income in a prior criminal proceeding against the taxpayer. Collateral estoppel does not apply "where the party against whom the doctrine is invoked had a heavier burden of persuasion on that issue in the first action than he does in the second."

5. The taxpayer has no legal remedy to restrain backup withholding. Zigmont v. Commissioner, T.C. Memo. 2009-48 (3/5/09). Special Trial Judge Armend held that the Tax Court lacks jurisdiction to enjoin the IRS (under § 6213(a)) from collecting amounts through § 3406 backup withholding. Backup withholding is not a deficiency. Nor is it a proposed lien or levy subject to CDP procedures that the Tax Court has jurisdiction to review under § 6330(e)(1).

6. Is there two-stop shopping to find out if the redetermined deficiency was discharged in a prior bankruptcy? Ferguson v. Commissioner, 568 F.3d 498 (5th Cir. 5/12/09), *aff'g* T.C. Memo. 2006-32 (2006). If subsequent to the taxpayer's discharge in bankruptcy the IRS issues a deficiency notice for a year prior to the discharge and the taxpayer properly invokes the Tax Court's jurisdiction for a redetermination of the deficiency, the Tax Court lacks jurisdiction to determine whether the taxpayer's liability was discharged in bankruptcy.

7. When they called, should he have said, "I gave at the office?" Commissioner of Internal Revenue Mark Everson announced his resignation to become head of the American Red Cross. 2007 TNT 76-1 (4/19/07). In his message to IRS employees, he said, "Together, we have rebalanced the organization, bringing to life the equation: *Service + Enforcement = Compliance*."

(a) Now, we can all look forward to seeing the IRS getting stiffed. Brown's successor as Acting Commissioner will be Deputy Commissioner for Operations Support Linda Stiff, who will assume the position of Deputy Commissioner for Services and Enforcement and, on Brown's departure, Acting Commissioner. 2007 TNT 146-2 (7/30/07).

(b) Apparently someone at the Red Cross under Mark Everson was also getting stiffed. It appears that Everson was really "giving at the office." Mark Everson resigned his Red Cross presidency on November 27, 2007 because the Red Cross Board learned that he "engaged in a personal relationship with a subordinate employee." All in all, it is a sad commentary on the IRS that Everson could not find anyone there with whom to have a "personal relationship."

(c) Is this a come-down? Mark Everson has joined Alliantgroup as vice chair. 2009 TNT 148-3 (8/5/09). "I couldn't be more pleased that Mark Everson has decided to join us," said Alliantgroup CEO Dhaval Jadav. "His service with the IRS and with the OMB gives him unmatched insight into building positive bridges between taxpayers, CPA firms, and the IRS."

8. Two bites at the apple for the IRS, because the apples are different varieties. Frank Sawyer Trust of May 1992 v. Commissioner, 133 T.C. No. 3 (8/24/09). The trust was the shareholder of four corporations that sold all of their assets for cash, resulting in large capital gains. Following the asset sales, the trust sold all of the stock of the corporations to a midco – actually named Midco – which purportedly sheltered the corporations' capital gains with losses from newly contributed high basis, low value assets, following which the assets of the corporations were stripped. Initially, the IRS asserted a deficiency against the trust on the theory that the corporations had been constructively liquidated while still owned by the trust and the trust had received the cash balances held by the corporations. A docketed Tax Court case on this issue was settled with the IRS conceding that there was no deficiency. Subsequently, all four corporations entered into closing agreements with the IRS under which substantial taxes were due with respect to the asset sales. At that time,

however, all four of the corporations were insolvent. The IRS asserted transferee liability against the trust, and the trust raised the defenses of res judicata and collateral estoppel. Judge Goeke held that neither res judicata nor collateral estoppel applied. The cause of action in the deficiency cases was different than the cause of action in the transferee liability case. The deficiency case dealt with the trust's fiduciary income tax liability on the sale of the stock in the corporations. That determination would not have required the trust to pay the unpaid tax liabilities of the corporations. The trust's liability as transferee differs from the trust's income tax liability. Collateral estoppel did not apply because no facts were determined in the earlier proceeding that concluded with the IRS's concession. Because the question whether there were liquidating distributions to the trust was not litigated and was not essential to the decisions in the deficiency actions, collateral estoppel did not bar the IRS from asserting in the transferee action that there were liquidating distributions from the corporations to the trust.

9. The taxpayer won the complex legal issue, inadvertently conceded the critical factual issue, and thus lost the case. Ron Lykins, Inc. v. Commissioner, 133 T.C. No. 5 (9/2/09). A deficiency asserted against the taxpayer corporation for 1999 and 2000 was resolved in a Tax Court case, *Ron Lykins, Inc. v. Commissioner*, T.C. Memo. 2006-35. The taxpayer incurred an NOL in 2001, and the taxpayer requested and received a tentative refund attributable to carrying back the NOL to 1999 and 2000 before the IRS issued the deficiency notice. The deficiency notice did not refer to the NOL carrybacks from 2001 or take into account the refunds in its computation of tax liability. Subsequently, the IRS disallowed the tentative NOL carrybacks and taxpayer raised the issue of the NOL carrybacks, but the Tax Court held that there was no deficiency without regard to the NOL carrybacks, neither party having put on evidence as to the NOL carrybacks. After initially allowing the tentative refund attributable to the NOL carrybacks, the IRS disallowed them and summarily assessed the amounts of the tentative refunds pursuant to § 6213(b)(3). The IRS gave notice of intent to levy and the taxpayer requested a CDP hearing. Following the CDP hearing the IRS issued a notice of determination to proceed with collection, and the taxpayer appealed. The taxpayer did not attempt to prove the merits of the 2001 NOL in either the CDP hearing or the Tax Court, but argued that under res judicata, the 2006 decision in the original deficiency case barred the IRS from asserting that it owed more taxes for 1999 and 2000. The Tax Court (Judge Gustafson) first found that collateral estoppel did not bar the taxpayer from raising the 2001 NOL carryback, because the merits of the 2001 NOL were not "actually litigated" in the prior deficiency case. More importantly, he held that even assuming that either party could have litigated the NOL in the prior deficiency case, res judicata did not bar either the taxpayer or the IRS from raising or disputing the 2001 NOL

carryback and its effect upon the 1999 and 2000 tax liabilities. The reason res judicata did not bar relitigation of the impact of the NOL carryback was that § 6511(d)(2)(B) explicitly permits the taxpayer to pay the summary assessments and pursue an overpayment remedy for NOL carrybacks without the bar of res judicata. On the other side of the coin, although § 6212(c)(1) generally bars the IRS from issuing a second notice of deficiency after a taxpayer has filed a Tax Court petition, § 6213(b)(1) and (3) expressly allow the IRS to determine an additional deficiency that results from a tentative carryback refund even if the IRS has previously issued a deficiency notice of for the carryback year and the taxpayer has filed a Tax Court petition. The court emphasized that it was not holding simply that § 6212(c)(1) by itself trumps res judicata, and that the IRS avoids res judicata whenever it is permitted by § 6212(c)(1) to determine an additional deficiency, but that §§ 6411, 6212(c)(1), and 6213(b)(3) create a unique procedure for tentative carryback refunds, because recapture of a tentatively allowed refund is not ordinarily the subject of a taxpayer's petition in a deficiency case. However, in the end the court held for the IRS, concluding that because the taxpayer failed to carry the burden of proving its loss in 2001 and establishing the validity of the carrybacks to 1999 and 2000, having conceded the issue by not raising it the CDP hearing, the proposed levy to collect the summary assessment would be upheld.

10. Electronic filing to be required beginning in 2011. Section 17 of WHABA mandates that the IRS require electronic filing by "specified tax return preparers" for all tax returns filed after 12/31/10. Specified tax return preparers are "all return preparers except those who neither prepare nor reasonably expect to prepare ten or more individual income tax returns [including returns for estates and trusts] in a calendar year."

11. Burton Kanter got in trouble again, and this time it followed him to the grave. Investment Research Associates, Ltd. v. Commissioner, T.C. Memo. 1999-407 (12/15/99). In a 600-page opinion, Burton Kanter was held liable for the § 6653 fraud penalty by reason of his being "the architect who planned and executed the elaborate scheme with respect to … kickback income payments ... ."

- **At first, he was unable to wriggle out, the way he did 25 years ago when he was acquitted by a jury. (**His partner was convicted and imprisoned. See *United States v. Baskes*, 649 F.2d 471 (7th Cir. 1980), *cert. denied,* 450 U.S. 1000 (1981).) The taxpayers subsequently moved to have access to the special trial judge's "reports, draft opinions, or similar documents" prepared under Tax Court Rule 183(b). They based their motion on conversations with two unnamed Tax Court judges that the original draft opinion from the special trial judge was changed by Judge

Dawson before he adopted it. (Kanter's attorney later revealed the names of the two judges, when asked at oral argument to the Seventh Circuit, as Tax Court Judge Julian Jacobs and Chief Special Trial Judge Peter J. Panuthos. See the text at footnote 1 of Judge Cudahy's dissent in the Seventh Circuit *Kanter Estate* opinion, below.) They were turned down because the Tax Court held that the documents related to its internal deliberative processes. See, Tax Court Order denying motion, 2001 TNT 23-31 (4/26/00) and (on reconsideration) 2001 TNT 23-30 (8/30/00).

(a) And the Tax Court's procedures are vindicated and taxpayer Ballard loses on appeal on the fraud issue in the Eleventh Circuit. Ballard v. Commissioner, 321 F.3d 1037 (11th Cir. 2/13/03), *aff'g* T.C. Memo. 1999-407. The Eleventh Circuit affirmed the Tax Court decision and rejected the taxpayers' argument that changes allegedly made to the original draft opinion from the special trial judge by Judge Dawson before he adopted it were improper. Judge Fay stated:

> Even assuming Dick's [taxpayers' lawyer's] affidavit to be true and affording Petitioners-Appellants all reasonable inferences, the process utilized in this case does not give rise to due process concern. While the procedures used in the Tax Court may be unique to that court, there is nothing unusual about judges conferring with one another about cases assigned to them. These conferences are an essential part of the judicial process when, by statute, more than one judge is charged with the responsibility of deciding the case. And, as a result of such conferences, judges sometimes change their original position or thoughts. Whether Special Trial Judge Couvillion prepared drafts of his report or subsequently changed his opinion entirely is without import insofar as our analysis of the alleged due process violation pertaining to the application of [Tax Court] Rule 183 is concerned. Despite the invitation, this court will simply not interfere with another court's deliberative process.
>
> The record reveals, and we accept as true, that the underlying report adopted by the Tax Court is Special Trial Judge Couvillion's. Petitioners-Appellants have not demonstrated that the Order of August 30, 2000 is inaccurate or suspect in any manner. Therefore, we conclude that the application of Rule 183 in this case did not violate Petitioners-Appellants' due process rights. Accordingly, we deny the request for relief and save for another day the more troubling question of what would have occurred had Special Trial Judge Couvillion not indicated that the report adopted

by the Tax Court accurately reflected his findings and opinion.

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

- Burton Kanter died on October 31, 2001.

(c) And the Tax Court's procedures are vindicated but taxpayer Lisle's Estate wins on appeal on the fraud issue in the Fifth Circuit. Estate of Lisle v. Commissioner, 341 F.3d 364 (5th Cir. 7/30/03), *aff'g in part and rev'g in part* T.C. Memo. 1999-407. The Fifth Circuit (Judge Higginbotham) followed the Eleventh and Seventh Circuit decisions upholding the nondisclosure of the special trial judge's original report by the Tax Court.

(d) Justice Ginsburg to Tax Court judges: "You Article I judges don't understand your own rules, so let *me* tell you what you meant when you adopted them in 1983." Ballard v. Commissioner, 544 U.S. 40 (3/7/05) (7-2), *reversing and remanding* 337 F.3d 833 (7th Cir. 7/24/03) and 321 F.3d 1037 (11th Cir. 2/13/03). Justice Ginsburg held that the Tax Court may neither exclude from the record on appeal nor conceal from the taxpayers the original draft reports of Special Trial Judges under Tax Court Rule 183(b) or under any statutory authority.

- Chief Justice Rehnquist's dissenting opinion, joined by Justice Thomas, states that the "Tax Court's compliance with its own Rules is a matter on which we should defer to the interpretation of that court."

(e) The Eleventh Circuit orders that the Special Trial Judge's report be added to the record. Ballard v. Commissioner, 2005-1 U.S.T.C. ¶ 50,393 (11th Cir. 5/17/05).

(f) Tax Court changes its rules. (9/20/05). The Tax Court adopted amendments to Tax Court Rules 182 and 183,

relating to Special Trial Judges' reports in cases other than small tax cases. The Special Trial Judge's recommended findings of fact and conclusions of law are to be served on the parties, who may file written objections and responses. After the case is assigned to a regular Judge, any changes made shall be reflected in the record and "[d]ue regard shall be given to the circumstance that the Special Trial Judge had the opportunity to evaluate the credibility of witnesses, and the finding of fact recommended by the Special Trial Judge shall be presumed to be correct."

(g) The Eleventh Circuit remands the case to the Tax Court – after reinstating the Special Trial Judge's report. Ballard v. Commissioner, 429 F.3d 1026 (11th Cir. 11/2/05) (per curiam). The case was remanded to the Tax Court with the following instructions: (1) the "collaborative report and opinion" is ordered stricken; (2) the original report of the special trial judge is ordered reinstated; (3) the Tax Court Chief Judge is instructed to assign this case to a previously-uninvolved regular Tax Court Judge; and (4) the Tax Court shall proceed to review this matter in accordance with the Supreme Court's dictates and with its newly-revised Rules 182 and 183, giving "due regard" to the credibility determinations of the special trial judge and presuming correct fact findings of the trial judge.

(h) And the Fifth Circuit remands it too. Estate of Lisle v. Commissioner, 431 F.3d 439 (5th Cir. 11/22/05) (per curiam). The case was remanded to the Tax Court with orders to: (1) strike the "collaborative report" that formed the basis of the Tax Court's ultimate decision; (2) reinstate Judge Couvillion's original report; (3) refer the case to a regular Tax Court judge who had no involvement in the preparation of the "collaborative report," who in dealing with the remaining issues of tax deficiency must give "due regard" to the credibility determinations of Judge Couvillion, presuming that his fact findings are correct unless manifestly unreasonable; and (4) adhere strictly hereafter to the amended Tax Court Rule in finalizing Tax Court opinions.

(i) On remand, in a 458-page opinion Judge Haines of the Tax Court pours out Kanter and Ballard. Estate of Kanter v. Commissioner, T.C. Memo. 2007-21 (2/1/07). The Tax Court (Judge Haines) found that certain of the Special Trial Judge's findings of fact were "manifestly unreasonable" because they were "internally inconsistent or so implausible that a reasonable fact finder would not believe [the recommended finding]" or they were "directly contradicted by documentary or objective evidence." Judge Haines therefore found that the Kanter-related entities were shams, that "Kanter, Ballard, and Lisle participated in a complex, well-disguised scheme to share kickback payments earned jointly

by Kanter, Ballard, and Lisle," and that they earned income during the years at issue which they failed to report.

- Judge Haines found that – based upon factors such as (1) failure to report substantial amounts of income, (2) concealment of the true nature of the income and the identity of the earners of the income, (3) use of sham, conduit, and nominee entities, (4) reporting Kanter's and Ballard's income on IRAs (and another entity's) tax returns, (5) commingling of Kanter's and Ballard's income with funds belonging to others, (6) phony loans, (7) false and misleading documents, and (8) failure to cooperate during the examination process by engaging in a "strategy of obfuscation and delay" – the Commissioner demonstrated by "clear and convincing evidence" that Kanter and Ballard filed false and fraudulent tax returns for each of the years at issue.
- Judge Haines held that the Tax Court is "obliged to review the recommended findings of fact and credibility determinations set forth in the STJ report under a 'manifestly unreasonable' standard of review, and ... may reject such findings of fact and credibility determinations only if, after reviewing the record in its entirety, [it] conclude[s] that the recommended finding of fact or testimony (1) is internally inconsistent or so implausible that a reasonable fact finder would not believe it, or (2) is not credible because it is directly contradicted by documentary or objective evidence." Furthermore, Judge Haines held that a special trial judge's credibility determinations may be rejected under the "manifestly unreasonable" standard of review without rehearing the disputed testimony.
- Judge Haines further found that the appropriate standard for determining whether the assignment of income doctrine should be applied had been appropriately articulated in *United States v. Newell*, 239 F.3d 917, 919-920, as follows:

> To shift the tax liability, the assignor [taxpayer] must relinquish his control over the activity that generates the income; the income must be the fruit of the contract or the property itself, and not of his ongoing income-producing activity. ... This means, in the case of a contract, that in order to shift the tax liability to the assignee the assignor either must assign the duty to perform along with the right to be paid or must have completed performance before he assigned the contract; otherwise it is he, not the contract, or the assignee, that is producing the contractual income – it is his income, and he is just shifting it to someone else in order to avoid paying income tax on it.

(j) And the beat goes on, with a judicial recognition that structural complexity is the norm for "a knowledgeable

tax attorney." Ballard v. Commissioner, 522 F.3d 1229 (11th Cir. 4/7/08). The Eleventh Circuit (Judge Fay) reversed, vacated and remanded T.C. Memo. 2007-21 (2/1/07) (Haines, J.), with instructions to "enter an order approving and adopting Judge Couvillion's original report as the opinion of the Tax Court." The reason assigned was that Judge Haines "did not presume Judge Couvillion's findings to be correct or give Judge Couvillion's credibility determinations their due deference," concluding that

> It is no surprise that a knowledgeable tax attorney would use numerous legal entities to accomplish different objectives. This does not make them illegitimate. Unfortunately such "maneuvering" is apparently encouraged by our present tax laws and code.

(k) "One for all and all for one." Estate of Lisle v. Commissioner, 541 F.3d 595 (5th Cir. 8/25/08) is to the same effect as *Ballard*.

(l) A former member of the University of Chicago Law School faculty, members of which took a pro-Kanter stand during the entire litigation because the School was getting big bucks from Kanter and/or his estate, decided the last appeal in this matter in favor of Burton Kanter's estate. Result: The late Burton Kanter = 1; the IRS = zero; the Tax Court = minus 1. Did we mention that the former faculty member was married to a current member of the faculty? Kanter v. Commissioner, 590 F.3d 410 (7th Cir. 12/1/09). The Seventh Circuit reversed, vacated and remanded T.C. Memo. 2007-21 (2/1/07), with instructions to "enter an order approving and adopting the STJ's report as the decision of the Tax Court." Judge Wood found that the STJ's findings were not "clearly erroneous" but "freely acknowledge[d] that a rational person could just as easily have come to the opposite conclusion on this record."

- On his federal income tax returns for the years 1979 through 1989, Burton Kanter reported that he had no income tax liability. That return position has been vindicated. So it goes.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. Wisdom from the Mount. Medical residents may be students for FICA taxes. United States v. Mount Sinai Medical Center of Florida, Inc., 486 F.3d 1248 (11th Cir. 5/18/07). Section 3121(b)(10) provides that employment taxes are not payable with respect to services performed in the employ of a college or university by a student who is enrolled and regularly attending classes. The government argued that

legislative history with respect to the repeal of an exemption for medical interns in 1965 (former § 3121(b)(13)) established as a matter of law that medical residents are subject to employment taxes. The Eleventh Circuit concluded that § 3121(b)(10) is unambiguous in its application to students and that the statute requires a factual determination whether the hospital is a "school, college, or university" and whether the residents are "students."

(a) This is no April fool. The Minnesota District Court also finds that medical residents at the University of Minnesota are students. Regents of the University of Minnesota v. United States, 101 A.F.T.R.2d 2008-1532 (D. Minn. 4/1/08). The university's summary judgment motion was granted by the District Court, which held that medical residents at the University of Minnesota are not subject to employment taxes under the student exclusion of § 3121(b)(10). The court reiterated its conclusion that the full-time employee exception in Reg. § 31.3121(b)(10)-2(d), as amended in 2004, is invalid.

(b) The District Court finds that the Mount Sinai Medical Center is a school and the residents are students. United States v. Mount Sinai Medical Center of Florida, Inc., 102 A.F.T.R.2d 2008-5373 (S.D. Fla. 7/28/08). After the decision in *Minnesota v. Apfel*, 151 F.3d 742 (8th Cir. 1998), Mount Sinai Medical Center obtained refunds for FICA taxes paid in 1996-1997. The United States filed suit against the Medical Center for erroneous refunds. Following the Eleventh Circuit's direction to make a factual determination whether the program qualifies for the § 3101(b)(10) exception, the District Court found that the Medical Center's residency programs were operated as a "school, college, or university," that residents were present for training in patient care, which was an intrinsic and mandatory component of the training, and that the residents were "students" who were regularly enrolled and attending classes. The court also found that the students' performance of patient care services was incident to their course of study.

(c) South Dakota medical residents are also students. Center for Family Medicine v. United States, 102 A.F.T.R.2d 2008-5623 (D. S. Dak. 8/6/08). Following *Minnesota v. Apfel*, 151 F.3d 742 (8th Cir. 1998), the South Dakota District Court held that medical residents in the Center for Family Medicine (CFM) and University of South Dakota School of Medicine Residency Program (USDSMRP) were eligible for the student exception to the definition of employment under § 3101(b)(10). The court rejected the government's assertion that CFM was not a school, college or university because CFM was affiliated with a non-profit hospital. The court found that CFM's work includes teaching its medical residents the skills required to practice in their chosen profession. The court also

concluded that the students were "enrolled" in the institution and that their attendance at noon conferences and medical rounds established that the students regularly attended classes. Tossing a small bone to the government, the court held that chief residents in the programs, who are essentially coordinators for the residency programs, were not students.

(d) Residents in Chicago are also students. University of Chicago Hospitals v. United States, 545 F.3d 564 (7th Cir. 9/23/08). The court affirmed the District Court's denial of the government's motion for summary judgment based on the government argument that medical residents are *per se* ineligible for the student exemption from employment taxes under § 3121(b)(10). The court indicates that a case-by-case analysis is required to determine whether medical residents qualify for the statutory exemption.

(e) And ditto for medical residents in Detroit. United States v. Detroit Medical Center, 557 F.3d 412 (6th Cir. 2/26/09). Reversing the District Court's summary judgment, the Sixth Circuit joins the lineup holding that medical residents at the seven Detroit area hospitals operated by the Detroit Medical Center in a joint program with Wayne State University, which provides graduate medical education, may be students entitled to exemption from employment taxes under § 3121(b)(10). The court remanded the case for further development of the record regarding the nature of the residents' relationship to the hospitals and the education program. The court indicated that further development of the record would not preclude deciding the matter on summary judgment. The Sixth Circuit also affirmed summary judgment that the stipends paid to medical residents were not scholarships or fellowships excludible from income under § 117. The court found both that the stipends were received in exchange for services and that the medical residents were not candidates for a degree as required for exclusion under the terms of § 117.

(f) And ditto again for Sloan-Kettering. United States v. Memorial Sloan-Kettering Cancer Center, 563 F.3d 19 (2d Cir. 3/25/09). Following similar decisions in the Sixth, Seventh, Eighth, and Eleventh Circuits, the Second Circuit Court of Appeal reversed summary judgment for the United States holding that the District Courts for the Northern and Southern Districts of New York erred in holding as a matter of law that medical residents at the Albany Medical Center and the hospitals of the Memorial Sloan-Kettering Cancer Center were not eligible for exclusion from employment taxes under § 3121(b)(10). The cases were remanded to the trial courts for factual determinations whether the residents were students and whether the hospitals were schools.

(g) But the tide turns for the Mayo Clinic. Mayo Foundation for Medical Education and Research v. United States, 568 F.3d 675 (8th Cir. 6/12/09). For purposes of the student exclusion from FICA taxes under § 3121(b)(10), Reg. § 31.3121(b)(10)-2(c) and (d), limit the definition of a school, college, or university to entities whose "primary function is the presentation of formal instruction." Reg. § 31.3121(b)(10)-2(d) provides that to qualify as a "student" rather than be classified as an employee, any services rendered must be "incident to and for the purpose of pursuing a course of study" at the institution for which the student provides the services. Furthermore, under the regulation, a person whose work schedule is 40 hours or more per week is a full-time employee rather than a student. The District Court, in granting refunds of employment taxes, declared the regulation invalid. Applying the deference standard of *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), the Eighth Circuit reversed and remanded the case for entry of judgment for the United States. The court concluded that application of the exemption only to students pursuing a course of study who are not full time employees is a reasonable interpretation of the statute. The court declined to consider whether the portion of the regulation limiting the definition of a school or college is valid because the medical residents were not students under the regulation in any event.

2. Ten ways to be a contractor – estate rebuffed in its attempt to collect damages and indemnification on its claim that decedent was an employee of multiple employers rather than an independent contractor. Estate of Suskovich v. Anthem Health Plans of Virginia, Inc. 553 F.3d 559 (7th Cir. 1/22/09). The decedent worked as a computer programmer for Wellpoint, a health insurance company and Trasys, an information technology company. The decedent's estate claimed damages from the companies for failure to treat the decedent as an employee and provide certain employee benefits, and claimed indemnification for employment taxes paid directly by the decedent. The court upheld the District Court's finding that the decedent was an independent contractor based on the District Court's application of the ten factor test for employment status of the *Restatement (Second) of Agency*. The court concluded, "[i]n fact, overwhelming evidence suggests that he considered himself an independent contractor, filed his tax returns as an independent contractor, and was compensated like an independent contractor. Accordingly, the District Court properly awarded summary judgment to WellPoint and Trasys on this issue."

3. The Tax Court follows the Sixth and Second Circuits to hold that pre-2009 employment tax liability of a disregarded LLC must be paid by the sole-member. Medical Practice Solutions, LLC

v. Commissioner, 132 T.C. No. 7 (3/31/09). Following the decisions in *Littriello v. United States*, 484 F.3d 372 (6th Cir. 2007), and *McNamee v. Dept. of the Treasury*, 488 F.3d 100 (2d Cir. 2007), both of which upheld the validity of the "check-the-box" regulations in the same context, applying *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), the Tax Court (Judge Cohen), held that the check-the-box regulations treating a single member entity that does not elect to be treated as a corporation as a disregarded entity, Reg. § 301.7701-3(b), are valid and as a result the sole member of a disregarded limited liability company is responsible for the LLC's unpaid employment taxes. After 1/1/09, under Reg. § 301.7701-2(c)(2)(iv), a disregarded entity is treated as a corporation for purposes of employment tax reporting and liability. The court rejected the taxpayer's argument that the amendment to the regulations, which reverses the prior rule, demonstrates that the prior regulation imposing employment tax liability on the sole-member of the disregarded entity was unreasonable. The court stated that, "In light of the emergence of limited liability companies and their hybrid nature, and the continuing silence of the Code on the proper tax treatment of such companies in the decade since the present regulations became effective, we cannot conclude that the above Treasury regulations, providing a flexible response to a novel business form, are arbitrary, capricious, or unreasonable."

4. Wage tax relief for reservists. Rev. Rul. 2009-11, 2009-18 I.R.B. 896 (4/16/09). Under § 3401(h), added by the Heroes Earnings Assistance and Relief Tax Act of 2008, differential wages paid to an employee on active duty in the military are treated as wages for purposes of income tax withholding. This revenue ruling explains that these are supplemental wages that are to be added to the employee's regular wages for the period for purposes of calculating wage withholding. However, differential wages paid to a person providing service to the military for an extended period of time are not wages subject to FICA and FUTA tax. See Rev. Rul. 69-136, 169-1 C.B. 252.

5. This isn't a valid "cash method" of accounting. Hi-Q Personnel, Inc. v. Commissioner, 132 T.C. No. 13 (5/4/09). The taxpayer corporation provided temporary workers for clients for fees related to the work performed. The taxpayer offered the workers a choice between being paid in cash or by check. The taxpayer reported workers paid by check as employees and paid applicable employment taxes. The taxpayer failed to pay employment taxes for workers paid in cash. The taxpayer's president, Luan Nguyen, pleaded guilty to Federal criminal charges for failing to pay employment taxes on $14,845,019 of wages paid to temporary workers. The court (Judge Halpern) agreed with the IRS that because of its president's plea agreement in the criminal matter, the taxpayer could not contest its liability

for employment taxes or fraud penalties under the doctrine of issue preclusion or collateral estoppel. The court concluded that the plea agreement was a judgment on the merits with respect to identical issues, and that the corporation's president and sole shareholder was in privity with it with respect to the obligation to pay employment taxes. The court also concluded Mr. Nguyen's guilty plea imputed his fraudulent intent to the corporation for purposes of fraud penalties.

6. Both back pay and front pay are subject to withholding. Josifovich v. Secure Computing Corp., 104 A.F.T.R. 2d 2009-5807 (D. N.J. 7/31/09). Josifovich entered into a settlement agreement with her former employer for unpaid commission income, violations of the New Jersey Conscientious Employee Protection Act and the New Jersey Law Against Discrimination. The settlement included back pay for prior work and front pay for compensation she would have received after the settlement date. The parties could not agree on whether the payments were subject to wage withholding and sought to resolve the issue in the District Court. The court recognized that payments for back wages were subject to wage withholding. The court also concluded that the front pay was based on contract and quasi-contract claims under the New Jersey statutes for wages that are thus subject to withholding. The court, which is in the Third Circuit, did not cite the Eighth Circuit opinion in *Newhouse v. McCormick & Co.*, 157 F.3d 582 (8th Cir. 1998), which held that front pay is not subject to wage withholding or FICA. The court also rejected Ms. Josifovich's claim that the damage award in the settlement should be grossed up to account for the withholding taxes.

7. FICA in paradise. Zhang v. United States, 89 Fed. Cl. 263 (9/22/09). Nonresident aliens, Chinese nationals who were temporary contract workers in the Commonwealth of the Northern Mariana Islands, were subject to FICA taxes. The Commonwealth is statutorily connected to Guam, which is a U.S. territory, through a covenant that causes the Commonwealth to be considered within the U.S. for FICA purposes. The court noted that the covenant mandates that, except for FICA tax proceeds, income and other tax revenues shall be remitted to the treasury of the Commonwealth instead of the U.S. Treasury.

B. Self-employment Taxes

There were no significant developments regarding this topic during 2009.

C. Excise Taxes

1. Refund claims for telephone excise taxes are subject to the three-year statute of limitations of § 6511(a). RadioShack Corp. v. United States, 566 F.3d 1358 (Fed. Cir. 5/26/09). RadioShack filed a refund action for erroneously collected telephone excise taxes in 1996. The IRS stopped collecting the tax in May 2006 and announced in Notice 2006-50, 2006-1 C.B. 1141, that it would accept claims for refund of taxes billed between February 28, 2003, and August 1, 2006, pursuant to claims for refund filed in accord with the Notice. The Court of Appeals affirmed the holding of the Federal Claims Court that the refund action is subject to the three-year statute of limitations of § 6511(a) and the court lacked jurisdiction to consider the refund claims. Claims for taxes paid in 2002 are still pending.

2. Northstar Trekking LLC v. United States, 637 F. Supp. 2d 676 (D. Ak. 5/4/09). The Alaska District Court (Judge Sedwick) held that a helicopter glacier tour company that operated Alaska glacier tours mostly for tour ship customers did not operate on a regular line and was thus exempt from the Air Transportation Excise Tax.

3. 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 (1) 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 (2) 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.

(a) "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.

4. The telephone excise tax may involve only one-way communication. IRS v. WorldCom, Inc., 104 A.F.T.R.2d 2009-5881 (S.D. N.Y. 8/7/09). WorldCom purchased central office based remote access (COBRA) services from local exchange carriers in order to receive information across analog dial-up connections and route the communication to its computer servers. Reversing the Bankruptcy Court's allowance of a refund of the telecommunications excise tax and remanding for further findings, the District Court overruled the Bankruptcy Court's interpretation of § 4252(a) as requiring capacity for two-way communication in order to impose the telecommunications excise tax. Section 4252(a) defines telephone service as "access to a local telephone system, and the privilege of telephonic quality communication with substantially all persons having telephone or radio telephone stations ... ." Distinguishing § 4252(b)(2), the court held that

the phrase “communication with” does not require communication to and from telephone stations. Thus, the essential in-bound nature of communication into the COBRA system may fall within the definition of § 4252(a).

XII. TAX LEGISLATION

A. Enacted

1. ARRA! Or, shall we call it Arrgh? The American Recovery & Reinvestment Act of 2009 (“2009 ARRA”), P.L. 1115, was signed by President Obama on 2/17/09. Title I of Division B of 2009 ARRA is called the American Recovery and Reinvestment Tax Act of 2009; title II of Division B is called Assistance for Unemployed Workers and Struggling Families.

2. H.R. 3548, the **Worker, Homeownership, and Business Act of 2009**, P.L. 111-92 (“WHABA”), was signed by President Obama on 11/6/09.

3. H.R. 3326, the **2010 Defense Appropriations Act**, P.L. 111-118, which contains the COBRA subsidy extension at § 1010, was signed by President Obama on 12/19/09.