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RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION THE YEAR 2008

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RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION†
THE YEAR 2008

by

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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 2008 — 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. 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. The outline focuses primarily on topics of broad general interest (to the three of us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services. Please read this outline at your own risk; we take no responsibility for any misinformation in it, whether occasioned by our advancing ages or our increasing indifference as to whether we get any particular item right. Any mistakes in this outline are Marty's responsibility; any political bias or offensive language is Ira's; and any useful information is Dan's.

†We are deeply indebted to Professor Larry Zelenak, Duke University School of Law, for his assistance in synopsizing the provisions of the Earnings Assistance and Relief Tax Act of 2008, the Heartland, Habitat, Harvest, and Horticulture Act of 2008, and the Housing Assistance Tax Act of 2008. All of his work was axiomatically perfect, and he is not to blame for any inaccuracies that we introduced in rewriting it and for any of our offensive commentary (including headlines and footnotes).

I. ACCOUNTING

A. Accounting Methods

1. **Accountant's persistent omission of a step in the computation of the LIFO value of inventories required a change of accounting method to correct. On appeal, held that the Commissioner's interpretation of the applicable regulation is "entitled to controlling weight."** *Huffman v. Commissioner*, 518 F.3d 357 (6th Cir. 4/4/08), *aff'g* 126 T.C. 322 (2006). Generally, corrections to the taxpayer's inventory accounting method constitute a change of accounting method. Furthermore, correction of a systematic erroneous method of calculating inventories on a recurring basis, without a change in the overall inventory method, constitutes a change of accounting method rather than the correction of a computational error. The Tax Court (Judge Halpern) held that correction to an inventory method employed by the accountant for S corporation automobile dealerships that reached an erroneous result over a 10- to 20-year period by omitting a computational step required by Reg. § 1.472-8, related to the link-chain, dollar-value method of pricing LIFO inventories, constituted an accounting method change that requires a § 481 adjustment, and was not simply the correction of a mistake in arithmetic. This was an accounting method change because the original method caused understatements and overstatements in the LIFO value of inventories but did not result in the permanent omission of gross income.

- The Sixth Circuit (Judge Rogers) affirmed the holding of the Tax Court. Reg. § 1.446-1(e)(2)(ii)(a) provides that "[a] change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan;" Reg. § 1.446-1(e)(2)(ii)(c) specifically provides that "a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting;" and Reg. § 1.446-1(e)(2)(ii)(a) provides that a "material item" is "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." According to Judge Rogers "[t]he essential characteristic of a "material item" is that it determines the timing of income or deductions." (Quoting *Knight-Ridder Newspapers, Inc. v. United States*, 743 F.2d 781, 798 (11th Cir. 1984).) "In this case, the change from the accountant's erroneous method to the proper dollar-value, link-chain method does just that."

- Judge Rogers added that his conclusion was bolstered by the fact that the case involved interpretation of a regulation — whether the correction of a specific accounting error constitutes a "change in method of accounting," as that phrase is defined in the regulations. He reasoned that in "dealing with the interpretation of rules of inclusion and exclusion that are 'creatures' of the Treasury Department's own making," the IRS's interpretation of

the regulation is “controlling” where the interpretation reflects a “fair and considered judgment” and is not “plainly erroneous or inconsistent with the regulation.” The Commissioner’s interpretation of what constituted a “change in method of accounting” (and therefore not ‘mathematical’ or ‘computational’ error) is [not] ‘plainly erroneous or inconsistent with the regulation,’ and the Commissioner’s interpretation is accordingly entitled to controlling weight.”

2. Judge Haines writes a treatise on defective claims to automatic consent to change an accounting method. Capital One Financial Corp. v. Commissioner, 130 T.C. No. 11 (5/22/08). Following the enactment in 1997 of § 1272(a)(6)(C)(ii), which provides that credit card late-fee receipts create or increase original issue discount rather than constituting an income item when they accrued under the all events test, the taxpayer claimed to have received the IRS’s consent to change its accounting method, pursuant to an automatic consent procedure, by filing Form 3115 with its 1998 tax return. However, the taxpayer did not change its accounting method for 1998 and 1999. In the Tax Court, the taxpayer sought to retroactively change its method for 1998 and 1999. Judge Haines, held that § 446(e) prohibited the taxpayer from retroactively changing its treatment of income from credit card late-fees for years 1998 and 1999 from the current-inclusion method to the method under § 1272(a)(6)(C)(iii) that requires late-fee receipts to create or increase original issue discount, even though the OID method was mandatory under the statute, because the taxpayer did not file a Form 3115 to notify the IRS of the change of accounting method with its 1997 return. Because the Form 3115 was not timely filed and did not specifically mention “late fees,” automatic consent had not been granted. “[A] taxpayer forced to change its method of accounting under section 448 must still file a Form 3115 with its return for the year of change. [Reg. § 1.448-1(h)(2)] If the Form 3115 is not filed timely, a taxpayer forced off the cash method must comply with the requirements of [Reg. § 1.446-1(e)(3)] in order to secure the consent of the Commissioner. Reg. § 1.448-1(h)(4). Pursuant to [Reg. § 1.446-1(e)(3)], a taxpayer requesting to change its method of accounting is required to file a Form 3115 during the year in which it intends to make the change.”

3. New and improved automatic consent procedures for changes of accounting methods. Rev. Proc. 2008-52, 2008-36 I.R.B. 587 (8/19/08). 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 modified and clarified, is clarified, modified, amplified, and superseded.

4. A little more help for the housing industry buried in more important proposed changes to changes in methods of accounting for long-term contracts. REG-120844-07, Rules for Home Construction Contracts,

73 F.R. 45180 (8/4/08). Currently, a taxpayer that uses the percentage-of-completion method or the exempt-contract percentage of completion method, that elects the 10-percent method or special alternative minimum taxable income method, or that adopts or elects a cost allocation method of accounting (or changes to another method of accounting with the IRS's consent) must apply the method(s) consistently for all similarly classified contracts until the taxpayer obtains consent under § 446 to change to another method of accounting. Prop. Reg. § 1.460-4(g) would provide that taxpayer-initiated change in method of accounting will be permitted only on a cut-off basis, i.e., for contracts entered into on or after the year of change, only for changes from a permissible percentage of completion to another permissible percentage of completion method for long-term contracts for which percentage of completion is required and for changes from a cost allocation method of accounting that complies with the cost allocation rules of Reg. § 1.460-5 to another cost allocation method of accounting that complies with those rules. All other taxpayer-initiated changes in method of accounting under § 460 would be made with a § 481(a) adjustment. Prop. Reg. §§ 1.460-6(c)(3)(vii) and 1.460-6(d)(2)(iv) would provide that in determining the hypothetical underpayment or overpayment of tax for any year as part of the look-back computation, § 481(a) adjustments would be taken into account in the tax year or years they are reported. The taxpayer would use amounts reported under its old method for the years the old method was used and would use amounts reported under its new method for the years the new method was used, netted against the amount of any § 481(a) adjustments under Prop. Reg. § 1.460-6(c)(3)(vii) and Prop. Reg. § 1.460-6(d)(2)(iv). As a result, a look-back computation would not be required upon contract completion simply because the taxpayer changed its method of accounting. But, a look-back computation would be required upon contract completion if actual costs or the contract price differ from the estimated amounts notwithstanding the fact that a change in method of accounting occurred. Prop. Reg. § 1.460-3(b)(2) would expand what is considered a townhouse or rowhouse, for purposes of the home construction contract exemption in § 460(e) to include an individual condominium unit, and expand the types of contracts eligible for the home construction contract exemption by providing that a contract for the construction of common improvements is considered a contract for the construction of improvements to real property directly related to the dwelling unit(s) and located on the site of such dwelling unit(s), even if the contract is not for the construction of any dwelling unit. The amendments to the regulations will be effective when finalized.

5. You've got to be really, really busy trading to be in the trade or business of being a stock trader. Holsinger v. Commissioner, T.C. Memo. 2008-191 (8/11/08). The taxpayer was not eligible for mark-to-market treatment of securities under § 475(f) because he was not a "trader" in

securities. Whether a person is a “trader” rather than an investor depends on a number of nonexclusive factors: (1) the taxpayer’s intent, (2) the nature of the income to be derived from the activity, and (3) the frequency, extent, and regularity of the taxpayer’s securities transactions. “For a taxpayer to be a trader the trading activity must be substantial, which means frequent, regular, and continuous enough to constitute a trade or business.” Activities constitute a trade or business where (1) “[t]he taxpayer’s trading is substantial, *and* (2) the taxpayer seeks to catch the swings in the daily market movements and to profit from these short-term changes rather than to profit from the long-term holding of investments.” [emphasis added] In the relevant years, 2001 and 2002, the taxpayer executed approximately 289 trades in 2001 on 63 days and 372 trades on 110 days, respectively. Judge Vasquez found it “doubtful whether the trades were conducted with the frequency, continuity, and regularity indicative of a business.” Judge Vasquez found further that the taxpayer did not seek to catch the swings in the daily market movements. He rarely bought and sold on the same day, and a significant amount of his holdings was held for more than 31 days. Accordingly, he was an investor, not a trader.

6. Hindsight is poor sight when looking for § 9100 relief. *Acar v. Commissioner*, 545 F.3d 727 (9th Cir. 9/23/08). The taxpayer was a financial planner and part-time securities trader. He attempted to make a § 475(f) mark-to-market election for 1999 and 2000 in 2002 by submitting amended returns. The election was untimely under Rev. Proc. 99-17, 1999-1 C.B. 503 and the IRS refused to grant relief under Reg. § 301.9100-3(c). The court upheld the IRS’s denial of § 9100 relief because he had used hindsight in making the late election and thus pursuant to Reg. § 301.9100-3(b)(3)(iii) did not satisfy the “good faith requirement. The court of appeals distinguished the Tax Court’s decision in *Vines v. Commissioner*, 126 T.C. 279 (2006), granting § 9100 relief for a late § 475(f) election on the ground that in *Vines*, unlike in the instant case, there had been no trading between the time the election should have been made and the time it was made, and thus *Vines* obtained no hindsight advantage.

B. Inventories

There were no significant developments regarding this topic during 2008.

C. Installment Method

There were no significant developments regarding this topic during 2008.

D. Year of Inclusion or Deduction

1. **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 a 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 of 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.

2. **Auto parts remanufacturer can’t anticipate return of “cores” and accrue only price net of future rebates.** Bigler v. Commissioner, T.C. Memo. 2008-133 (5/19/08). The taxpayer’s S corporation (BBB) remanufactured automobile alternators and starters and sold the remanufactured parts to retailers. For each remanufactured part purchased, the customers were entitled to return a core for a credit equal to a core price listed on the invoice. Because there was no time limit on returning a core, at the close of the year BBB did not know how many cores would be returned, and when the cores would be returned. BBB essentially accrued only the invoiced amounts net of the anticipated credit for return of the cores. The Tax Court (Judge Vasquez) agreed with the IRS that BBB was required to accrue the gross amount of the invoiced price of the parts. “After the sale the amount stated was fixed, and BBB had the right to collect the entire amount stated on the invoice. The fact that BBB might have to credit the customer at some point in the future does not mean that income has not accrued. Thus the all events test was satisfied for the entire amount of the invoice.”

• In an earlier case involving remanufactured auto parts, Judge Chiechi wrote a treatise on taxpayer’s impermissible use of LIFO inventory. Consolidated Manufacturing, Inc. v. Commissioner, 111 T.C. 1 (1998), *aff’d in part, rev’d in part*, 249 F.3d 1231 (10th Cir. 2001).

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. **Share the company's name and credit with "friends," then pay tax on the friends' income.** Industrial Electrical and Instrumentation, Inc. v. Commissioner, T.C. Memo. 2008-84 (4/3/08). The taxpayer corporation's principal shareholder and officer qualified the company to perform electrical contracting services in the State of Florida. Through various arrangements Stewart and Lance Penny, who could not obtain the requisite contractor's license, became minority shareholders of the taxpayer and performed services in the name of the taxpayer company. The Pennys obtained supplies on the company credit and employed workers in the company name. However, numerous checks for services and contracts performed by the Pennys were not recorded on the company's books, but cashed directly by the Pennys. These amounts were not reported as income on the company's return. The Tax Court (Judge Vasquez) found that this arrangement was undertaken with the company's support. The company had knowingly made its credit and license available to the Pennys to enable them to perform work. Thus, the court concluded that the amounts paid to the Pennys represented income to the company. The court also sustained fraud penalties for the understatement of income.

2. **The IRS changes position on the tax treatment of rebates.** Rev. Rul. 2005-28, 2005-1 C.B. 997 (4/25/05). This ruling holds that a payment made by a seller to a purchaser, the purpose and intent of which is to reach an agreed-upon net selling price, is treated as an adjustment to the sales price rather than a deduction item. Therefore, Medicaid rebates incurred by a pharmaceutical manufacturer are purchase price adjustments that are subtracted from gross receipts in determining gross income.

- Rev. Rul. 76-96, 1976-1 C.B. 23, which held that an automobile manufacturer's rebates paid to retail customers are deductible as ordinary and necessary business expenses under § 162, is suspended in part because the issue is being reconsidered by the IRS.

a. **Medicaid rebates paid by pharmaceutical company reduce gross receipts.** Rev. Rul. 2008-26, 2008-21 I.R.B. 985 (5/9/08), *clarifying and superseding* Rev. Rul. 2005-28, 2005-1 C.B. 997. Under the Medicaid reimbursement program pharmaceutical manufacturers pay a rebate to state Medicaid agencies to reduce the cost of prescription medicine purchased through state programs. The IRS ruled that these payments are a reduction of sales price that reduces gross receipts rather than ordinary business expenses, but the ruling notes that "This holding is limited to Medicaid Rebates that a

pharmaceutical manufacturer pays pursuant to the Medicaid Rebate Program established by the Act.”

- The ruling also noted:

Whether a rebate of the type described in Rev. Rul. 76-96 is an ordinary and necessary business expense or, alternatively, is an adjustment to the sales price in calculating gross receipts, is an issue under reconsideration. Therefore, pending the Service’s reconsideration of the issue and publication of subsequent guidance, the Service will not apply, and taxpayers may not rely on, the conclusion of Rev. Rul. 76-96 that rebates made by the manufacturer are ordinary and necessary business expenses deductible under § 162.

3. **“Taxation * * * is eternally lively; it concerns nine-tenths of us more directly than either smallpox or golf, and has just as much drama in it; moreover, it has been mellowed and made gay by as many gaudy, preposterous theories.”** — H.L. Mencken, **“The Dismal Science,”** *Smart Set*, June 1922, at 42. Monk v. Commissioner, T.C. Memo. 2008-64 (3/17/08). For many years, the taxpayer had reported his interest in a Baltimore bar, called Chuck’s Place, as a sole proprietorship on his tax returns. His name was on the bar’s liquor license, his name on the bar’s checking account, and he was recognized by Maryland as the bar’s lottery agent. During the course of an audit, the taxpayer’s accountant ascertained that the true economic relationship between the taxpayer and the operator of the bar was a lease that provided for a set monthly rent and an allocation of maintenance and repair expenses; the taxpayer did not share in profits or bear any risk of operating losses. The reason the arrangement was structured as it appeared to be was that the bar operator, an old friend of the taxpayer’s believed that his 40-year-old felony conviction would prevent a liquor license and state lottery agency from being issued to him, so the taxpayer filed the paperwork for him.

- The Tax Court (Judge Haines) held that an arrangement that was in substance a valid oral lease of real property to the true operator of the bar business and should be treated as such, even though the taxpayer appeared to be the owner of the business on all of the relevant documentation. “[W]here there is written documentation which contradicts the reality of a situation, we disregard the documents to properly tax the person actually earning the income. ... [I]n a labor-intensive business with no employees, there is a strong suggestion that the individuals performing the labor own the business.” (quoting *Malone v. Commissioner*, T.C. Memo. 2005-69 (2005)).

- The court observed, “[t]hough we assert no expertise in Maryland administrative law, it seems unlikely that either Monk or Maney will benefit from the position on the true ownership of Chuck’s Place that

they have taken in this case when Maryland authorities learn of it, further bolstering their credibility on this point.”

- Judge Haines demonstrated his wit and literacy by including the quotation from Mencken in the opening paragraph of his opinion.

4. The Housing Assistance Tax Act of 2008, § 3022(a)(1), removes from treatment as tax preferences for alternative minimum tax purposes interest from exempt facility bonds where 95% or more of the proceeds of the issue are used to provide qualified residential rental projects, qualified mortgage bonds, and qualified veterans’ mortgage bonds. Tax exempt interest on these instruments also is removed from corporate AMT adjustments in determining adjusted current earnings.

- A rental project is qualified under § 142(d) if either 20 percent or more of the project’s units are occupied by persons whose gross income is 50 percent or less of the area median gross income, or 40 percent or more of the units are occupied by persons whose income is 60 percent or less of the area median gross income.

- A bond qualifies as a qualified mortgage bond under § 143(a) if it is part of an issue all of the proceeds of which are used to finance owner-occupied residences for first-time home owners with a purchase price not exceeding 90 percent of the average area purchase price.

- A bond is a qualified veterans’ mortgage bond under § 143(b) if it is part of an issue 95 percent of which is used to provide residences for veterans.

5. Pate v. Commissioner, T.C. Memo. 2008-272 (12/9/08). The Tax Court (Judge Cohen) disregarded the taxpayer’s purported joint venture and S corporation as having no economic substance and held the taxpayer liable to report income from working as an “independent contractor” on the taxpayer’s individual return. The taxpayer was also responsible for employment taxes. Further, the court refused to treat the taxpayer’s cattle operation as having a profit motive.

B. Deductible Expenses versus Capitalization

1. At long last, the long-promised tangible property proposed regulations are out. REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 71 F.R. 48590 (8/21/06). The Treasury Department published comprehensive proposed regulations dealing with the capitalization of amounts paid or incurred to acquire or produce real or personal property, including transaction costs, and

to distinguish repairs from improvements subject to capitalization. The proposed regulations excepted from capitalization expenditures for property that had a useful life of one year or less, but did not have any *de minimis* rule (although the preamble stated that the absence of a *de minimis* rule would not change the current practice of permitting agreements between taxpayers and IRS examining agents not to select assets with minimal cost for review). The proposed regulations adopted a “unit-of-property” concept for purposes of distinguishing repairs from improvements. Amounts paid that materially increase the value of a unit of property must be capitalized, as must be amounts paid that substantially prolong economic useful life. The proposed regulations included a repair allowance system that would permit expenditures on each class of property up to a specified percentage of cost to be deducted as repairs, with any excess required to be capitalized; the percentage is to be determined based on the principle that a taxpayer will spend 50 percent of cost on repairs over the MACRS recovery period.

a. The old proposed rules capitalized too much – at least according to commentators. New regulations are proposed for the acquisition, production, or improvement of tangible personal property. REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 73 F.R. 12838 (3/10/08). New proposed regulations withdraw and replace the 2006 proposed regulations under § 263 regarding the acquisition, production or improvement of tangible personal property [REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 71 F.R. 48590 (8/21/06)]. The new proposed regulations retain many of the provisions of the 2006 proposed regulations, including the proposed format changes in which § 1.263(a)-1 provides general rules for capital expenditures, § 1.263(a)-2 provides rules for amounts paid for the acquisition or production of tangible property, and § 1.263(a)-3 provides rules for amounts paid for the improvement of tangible property. However, these new proposed regulations provide many additional rules. The new proposed regulations define material and supplies to treat as deductible (1) the cost of any property with a useful life that does not exceed one year and (2) any item that cost not more than \$100. They add a book-conformity *de minimis* rule, a safe-harbor for routine maintenance, and an optional simplified method for regulated taxpayers. The proposed regulations modify the provisions in the first version regarding a unit of property and restorations. The new proposed regulations do not provide for a detailed repair allowance rule, but do provide for future I.R.B. guidance regarding industry-specific repair allowance methods.

- *Acquisition and Production Costs.*

These proposed regulations [Reg. § 1.263(a)-2] would expressly provide that a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property (as determined under Prop. Reg. § 1.263(a)-3(d)(2)), including leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures.” Amounts paid to create intangible interests in land would be treated as capital expenditures. The preamble specifically invites comments on this provision. Transaction costs to facilitate the acquisition of property also are expressly required to be capitalized, even if the property is not acquired. [Reg. § 1.263(a)-2(d)(3)] Amounts paid to defend or protect title to property must be capitalized.

- *Selling Expenses.*

The proposed regulations [Prop. Reg. § 1.263(a)-1(d)] provide for the capitalization of selling expenses as an offset against sales proceeds (except in the case of dealers).

- *Investigation Costs.*

Although expenditures to produce or acquire tangible property, including expenses incurred to facilitate the acquisition, must be capitalized, the proposed regulations would provide an exception for pre-decisional investigative costs with respect to the acquisition of real property, similar to the provisions applicable to investigating the acquisition of intangible property that are treated as deductible business expansion costs.

- *Employee Compensation and Overhead.*

Except as required by § 263A, employee compensation and overhead are not treated as transaction costs facilitating the acquisition of property, unless the taxpayer elects to so treat them. [Prop. Reg. § 1.263(a)-2(d)(3)(D)].

- *Materials and Supplies.*

As under current provisions, Prop. Reg. § 1.162-3 would allow a deduction for non-incidentals materials and supplies in the year the property is consumed, and allow a deduction for incidental material and supplies in the year the expenditure is incurred. Materials and supplies include tangible property that is (i) not a unit of property or acquired as part of a unit of property, or (ii) tangible property that is a unit of property with (a) an economic useful life to the taxpayer of not more than 12-months, or (b) that costs not more than \$100 (an embedded *de minimis* rule). Taxpayers would be allowed an election to capitalize the cost of each item of material or supply. The *de minimis* rule also applies to property produced by the taxpayer, but items used in the production of other property remain subject to the uniform capitalization rules of § 263A. Prop. Reg. § 1.263A-1(b)(14). Rotable spare parts (parts installed temporarily in a unit of property) would be treated as used, and therefore deductible, in the year the part is disposed of.

- *Financial Accounting De Minimis Rules.*

The proposed regulations [Prop. Reg. § 1.263(a)-2(d)(4)] would allow a taxpayer to deduct expenditures to acquire or produce property (other than property produced for resale) if the taxpayer expenses the cost on a certified audited

financial statement (or certain financial statements filed with regulatory agencies) pursuant to an accounting procedure adopted by the taxpayer that treats as expenses amounts paid for property costing less than a specified dollar amount, as long as the aggregate amount deducted does not materially distort the taxpayer's income for purposes of § 446. A safe-harbor would provide that the deductions will not distort income if the amounts deducted under the second de minimis rule, plus deductions for materials and supplies, i.e., amounts deducted under the first de minimis rule, are do not exceed the lesser of 0.1 percent of the taxpayer's gross receipts or 2 percent of the taxpayer's total depreciation and amortization expense reflected in its financial statement.

- *Unit of Property.* Prop. Reg. § 1.263(a)-3(d)(2). The unit of property concept is central to the proposed regulations' requirement that improvements to a unit of property must be capitalized. The unit of property standards in the 2008 proposed regulations differ substantially from the standards in the 2006 proposed regulations. A building and its structural components (as defined in Reg. § 1.48-1(e)(2)) would be treated as a unit of property. However, fixtures attached to a building that pursuant to a cost segregation study are depreciated as tangible personal property, rather than real property, are separate units of property. For property other than buildings, all the components that are functionally interdependent comprise a single unit of property. Components of property are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component. However, a component that is recorded on the taxpayer's books as having a different economic useful life or which is in a different class of property for MACRS depreciation would be treated as separate unit of property. Thus, for example, all of the component parts of a railroad locomotive constitute a single unit of property, as does a truck trailer and its tires (unless the taxpayer's financial statements treat them as separate property). A special rule applies to "plant property," which is a functionally integrated collection of equipment and machinery used to perform an industrial process; each component (or group of components) that performs a discrete and major function or operation within the functionally interdependent machinery or equipment constitutes a separate unit of property.

- *Capitalize Improvements.* Expenditures to improve a unit of property must be capitalized. Prop. Reg. § 1.263(a)-3(d)(1). Amounts expended for repairs and maintenance of tangible property would be deductible if they are not required to be capitalized under Prop. Reg. § 1.263(a)-3. Prop. Reg. § 1.162-4. Expenditures that improve tangible property, and that are required to be capitalized, include expenditures that:

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

- (2) Restore a unit of property; or

(3) Adapt the unit of property to a new or different use.

- *Betterment.* Prop. Reg. § 1.263(a)-3(f).

An expenditure would result in a betterment of a unit of property if it (1) ameliorates a material condition or defect that existed prior to acquisition of the property or arose during production of the property, (2) results in a material addition to a unit of property, or (3) results in a material increase in capacity. Determination of whether an expenditure results in a betterment is factual and requires a comparison of the condition of the property immediately prior to the circumstance necessitating the expenditure (or the condition of property the last time the taxpayer corrected for normal wear and tear) with the condition of the property after the expenditure.

- *Restoration.* Prop. Reg. § 1.263(a)-3(g).

An expenditure would be capitalized as a restoration if it (1) replaces a component for which the taxpayer has deducted a loss, (2) replaces a component the adjusted basis of which has been accounted for in realizing gain or loss on a sale or exchange of the component, (3) repairs damage for which the taxpayer has deducted a casualty loss under § 165, (4) returns the property to its ordinary operating condition after the property as fallen into a state of disrepair and is no longer functional, (5) results in rebuilding the property to a like-new condition at the end of its economic useful life (*not* MACRS recovery period) to the taxpayer, or (6) is for the replacement of a major component or structural part of the unit of property. Replacement of a major component or structural part occurs if the cost is more than 50 percent of the replacement cost of the property or the replacement compromises more than 50 percent of the physical structure of the property and the replacement does not occur during the MACRS recovery period for the property.

- *New Use.* Prop. Reg. § 1.263(a)-3(h). A

unit of property would be treated as adapted to a new or different use if the adaptation is not consistent with the taxpayer's "intended ordinary use of the unit of property at the time originally placed in service by the taxpayer."

- *Rehabilitation doctrine is no more.*

Prop. Reg. § 1.263(a)-3(d)(4) would eliminate the judicially created rehabilitation doctrine by providing that, "Repairs and maintenance that do not directly benefit or are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement." But the proposed regulations provide that if otherwise deductible repairs benefit or are incurred by reason of an improvement, the cost of the repairs must be capitalized under § 263A.

- *Routine Maintenance Safe Harbor.*

Prop. Reg. § 1.263(a)-3(e) would provide a safe harbor from the capitalization requirement for "the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition." The safe harbor would apply to activities

that the taxpayer reasonably expects to perform more than once during the class life of the property, as determined under the MACRS alternative depreciation schedule of § 168(g). Routine maintenance includes maintenance with respect to and the use of rotatable spare parts. Routine maintenance excludes activities that follow a basis recovery event similar to the items that are described as restorations.

- *Repairs.* Prop. Reg. § 1.162-4 would allow as a deductible repair any costs that are not required to be capitalized under Prop. Reg. § 1.263(a)-3.

- *Repair Allowance.* The 2006 proposed regulations would have provided a comprehensive elective repair allowance rule under which all amounts paid for materials and labor during the taxable year to repair, maintain, or improve tangible property for which depreciation is computed under § 168 would be deductible under § 162 to the extent they did not exceed the “repair allowance amount,” determined separately for each MACRS property class. The new proposed regulations do not provide any such rule, but Prop. Reg. § 1.263(a)-3(j) permits taxpayers to use a repair allowance method that would be subsequently published in either the Federal Register or the Internal Revenue Bulletin, suggesting that such rules will be forthcoming.

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

2. Lease termination expenses are deductible and not capitalized into the basis of an acquired building. *ABC Beverage Corp. v. United States*, 577 F.Supp.2d 935 (W.D. Mich. 8/27/08). After settlement of a dispute over past due rent and the purchase price under a purchase option in the lease contract, the taxpayer acquired a property it was leasing from the landlord. In a refund claim, the taxpayer asserted that \$6.25 million of its \$11 million payment was deductible as a lease termination payment, and it capitalized \$2.75 million into the basis of the building. (The taxpayer’s calculation was based on what it considered the minimum purchase price under the option agreement.) The IRS asserted that under § 167(c)(2) the entire payment was allocated to acquisition of the fee interest, and that no part of the acquisition cost is therefore available as a deduction for termination of the lease. Following what it considered to be the law of the circuit, the court followed *Cleveland Allerton Hotel, Inc. v. IRS*, 166 F.2d 805 (6th Cir. 1948) and allowed the deduction. The court held that § 167(c)(2), which provides that upon acquisition of a property subject to a lease no basis is allocated to the lease, did not apply in the case of an acquisition of a property by the tenant. In that case the leasehold interest and the fee interest are merged. The District Court rejected the reasoning of the Tax

Court's contrary holding in *Union Carbide Foreign Sales Corp. v. Commissioner*, 115 T.C. 423 (2000).

• Note that Cleveland Allerton Hotel was decided before § 167(c)(2), or any analogous provision, was added to the Code.

3. Not all the “green in” the Emergency Economic Stabilization Act of 2008 is federal money The **Emergency Economic Stabilization Act of 2008**, Division C, § 318, extends the deduction allowed by § 198 for environmental remediation expenses (which might otherwise be capital expenditures) to expenditures through 2009. To qualify, a site must be certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance; sites that are identified on the national priorities list under CERCLA do not qualify.

a. The Act, § 322 also extends the incentives for investment in the District of Columbia to expenditures in 2009.

4. Legal fees incurred resisting states' attorney general challenges to the privatization of Blue Shield are capital expenses. Wellpoint, Inc. v. Commissioner, T.C. Memo. 2008-236 (10/27/08). The taxpayer provides health insurance coverage through operating subsidiaries that are licensees of the Blue Cross and Blue Shield Association and are a result of mergers with Blue Cross and Blue Shield organizations that were once characterized as tax-exempt charitable entities. Several state attorneys general brought *cy-pres* or charitable trust actions against the taxpayer claiming assets of the charitable organizations that were impressed with charitable trusts. The taxpayer made payments of nearly \$200 million to settle these actions. The court (Judge Kroupa) held the taxpayer's legal fees and settlement payments were incurred in a dispute over the equitable ownership of assets allegedly impressed with charitable trust obligations, and that the fees and payments were thus required to be capitalized. The court rejected the taxpayer's argument that the payments were incurred to protect its business practices.

5. West Covina Motors, Inc. v. Commissioner, T.C. Memo. 2008-237 (10/27/08). Taxpayer was required to capitalize legal fees paid on behalf of its related party lessor in protecting the taxpayer's interest in leased property on which the taxpayer's auto dealership was located. The taxpayer's related party lessor declared bankruptcy and the bank holding the mortgage on the leased property threatened to remove the taxpayer. The court (Judge Kroupa) held that the fees were incurred in defense of title and not subject to an exception that allows deduction of legal fees paid to benefit another where adverse

consequences to the taxpayer's business are direct and proximate. The court also required capitalization of legal fees incurred in the acquisition of the assets of another auto dealership consisting largely of inventory. The court also upheld accuracy-related substantial underpayment penalties.

6. 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.

C. Reasonable Compensation

1. The IRS takes a swipe at deducting generous executive severance packages. Rev. Rul. 2008-13, 2008-10 I.R.B. 518 (2/21/08). Section 162(m)(1) limits the deduction for compensation paid to a covered employee [as defined in § 162(m)(3)] by a public company to \$1 million

unless under § 162(m)(4)(C) the compensation is based on meeting performance goals. Reg. § 1.162-27(e)(2)(v) provides that compensation does not fail to be qualified performance-based compensation merely because the plan allows the compensation to be payable upon death, disability, or change of ownership or control. The IRS ruled that compensation is not excepted from the \$1 million deduction limitation as “remuneration payable solely on account of attainment of one or more performance goals” under § 162(m)(4)(C) if in addition to providing for payment upon attainment of a performance goal, the plan or agreement also provides that the compensation will be paid, without regard to whether the performance goal has been attained, if either: (1) the employee’s employment is involuntarily terminated by the corporation without cause or the employee terminates his or her employment for good reason, or (2) the employee retires. Neither termination without “cause” or for “good reason” nor retirement is listed as a permissible payment event under Reg. § 1.162-27(e)(2)(v). Involuntary termination without “cause” or voluntary termination for “good reason” (e.g., a reduction in title or base salary) might result from the employees failure to meet performance goals. Thus the compensation is not “remuneration payable solely on account of the attainment of one or more performance.”

• This ruling is not effective for existing arrangements or for performance periods beginning on or before 1/1/09.

2. Interim CEO is not “an outside director.” Rev. Rul. 2008-32, 2008-27 I.R.B. 6 (6/16/08). Section 162(m)(4)(C) allows deductible compensation in excess of the \$1,000,000 limitation of § 162(m) if the compensation is based on performance goals and approved by a compensation committee of the board of directors that is made up of two or more outside directors. The IRS ruled that that a member of the board of directors who served as interim CEO during a search for the permanent CEO is not qualified to serve as an outside director on the compensation committee.

3. The price of a bail-out includes limitations on compensation. Emergency Economic Stabilization Act of 2008, Act § 301(a), adding § 162(m)(5). The limit on deductible compensation is reduced to \$500,000 for the CEO and CFO, plus the three highest paid employees of an employer for the tax year in which more than \$300 million of troubled assets are acquired under the “troubled assets relief program” (TARP”) under the bail-out act. The limitation includes deferred deductions for compensation to a covered executive for services during an applicable employer taxable year. Note that the limitation is not limited to corporations, but covers any employer who sells troubled assets under TARP.

a. And the rip-cord is pulled on golden parachutes that are replaced by a tarp. The Emergency Economic

Stabilization Act of 2008, Act § 301(b), added new § 280G(e). The deduction disallowance and 20 percent excise tax imposed on golden parachute payments (compensation contingent on a take-over exceeding three times an executive's average compensation in the preceding five years) has been extended to severance payments by reason of involuntary discharge from an employer participating in the troubled assets relief program.

b. Notice 2008-94, 2008-44 I.R.B. 1070 (10/14/08), provides detailed guidance and definitions regarding the application of new §§ 162(m) and 280G(e), enacted as part of the **Emergency Economic Stabilization Act of 2008**, to limit deductions on compensation paid to executives of employers accepting bail-out funds. Taxpayers may rely on the guidance in the notice until further guidance is issued. Any future guidance that is more restrictive will be prospective only.

D. Miscellaneous Deductions

1. The IRS responds to high gasoline prices. Announcement 2008-63, 2008-28 I.R.B. 114 (6/24/08), *modifying* Rev. Proc. 2007-70. 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.

2. Captive insurance subsidiary of one corporation doesn't provide insurance, but the captive subsidiary of an affiliated group does. Rev. Rul. 2008-8, 2008-5 I.R.B. 340 (1/15/08). Under the facts of situation 1 of this ruling "Protected Cell Company" (a form of entity known as a protected cell company, a segregated account company, or segregated portfolio company) is formed by a sponsor, a domestic corporation, in jurisdiction A to provide insurance against professional liability risks. The sponsor owns the common stock of the Protected Cell Company. Protected Cell Company establishes multiple accounts, or cells, each of which has its own name and is identified with a specific participant, but which are not treated as separate entities. The capital of Protected Cell X is provided by X, which holds preferred stock in cell X. Cell X

only insures X's risks and collects premiums from X. In situation 2, Y Corporation holds the preferred stock in Cell Y, to insure professional liability of Y's twelve subsidiaries, which operate independently on a decentralized basis. The IRS ruled that there is no risk distribution, between X and its wholly owned protected cell and thus the payments to the protected cell are not deductible insurance premiums. In the Y cell situation, because risks and premiums are pooled among the various subsidiaries the arrangement does involve distribution of risk among the subsidiaries and the premiums are treated as deductible insurance premiums.

a. Compare, Rev. Rul. 2005-40, 2005-2 C.B. 4 (6/17/05). This revenue ruling concluded that the elements of risk shifting and risk distribution must be present for an arrangement to be considered insurance for federal income tax purposes, citing *Helvering v. Le Gierse*, 312 U.S. 531 (1941). Four situations are set forth. The first three situations were held to be "not insurance" and they involved an unrelated person receiving premiums to insure the risk of a single taxpayer that operated a large fleet of automotive vehicles in the courier transport business, including (in Situation 3) 12 single-member LLCs of approximately equal size owned by the same person which are classified as disregarded entities. In situation 4, each of those LLCs elected to be classified as an association, and the arrangement was considered to be "insurance."

3. The Third Circuit cans Alcoa's claim of right doctrine benefits. *Alcoa, Inc. v. United States*, 509 F.3d 173 (3d Cir. 11/28/07). Alcoa's production of aluminum products produced substantial waste. Under heightened environmental clean-up standards enacted in the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), and others, Alcoa was forced to incur substantial environmental remediation expense to clean up several of its manufacturing sites. Alcoa deducted these expenses in 1993 then filed a \$12 million claim for refund in the District Court. Alcoa cleverly argued that its 1993 expenses should have been included in its cost of goods sold in manufacturing operations for the years 1940-1987. Its reduced cost of goods sold for those years had generated excess income, received under a claim of right, which it was forced to return in the form of the deductible environmental remediation expenses incurred in 1993. Alcoa then claimed under § 1341 that, rather than taking the deduction in 1993 for the expense, it was entitled to a return of the taxes paid in 1940-1987 on its increased gross income resulting from the under-inclusion of disposal costs in its cost of goods sold. The Third Circuit concluded that Alcoa's obligation to return gross income in the form of increased remediation expenses "did not arise from the same *circumstances, terms, and conditions* as the initial failure to spend additional funds on environmental clean-up. Rather, the obligations were created by *new*

circumstances, terms, and conditions, namely, by an intervening change in environmental legislation.” Thus, there is no nexus between the income asserted to have been received under a claim of right, and the expenditure claimed as a refund of that income. The Court ultimately concluded that the § 1341 benefits were not available “because Alcoa’s expenditure of funds in 1993 was not the restoration of particular moneys to the rightful owner and did not arise from the same circumstances, terms, and conditions as Alcoa’s original acquisition of the income.”

a. Mitigation proves slippery for Pennzoil as well. Pennzoil-Quaker Co. v. United States, 511 F.3d 1365 (Fed. Cir. 1/8/08), *rev’g* 62 Fed. Cl. 689 (2004). Quaker State, later acquired by Pennzoil, was sued by suppliers in a class action for price fixing resulting in a large settlement payment to the suppliers. Pennzoil originally claimed the settlement payments as a deduction on its 1995 and 1996 tax returns, which was not challenged by the IRS. On amended returns, Pennzoil claimed a refund of taxes paid in prior years under § 1341 on the theory that it received overstated gross income in the earlier years because the lower prices paid to suppliers understated its cost of goods sold, which income was restored by virtue of the settlement payment. The Court of Federal Claims, 62 Fed. Cl. 689 (2004), allowed the refunds, but the Federal Circuit reversed and held for the government. The Circuit Court held that the settlement payments failed the “same circumstances test” because the earlier income and the settlement payments were not complementary in terms of the theory of deductibility, the taxpayer’s tax treatment, and the underlying transactions. In the prior years the taxpayer’s treatment of the original payments to suppliers as cost of goods sold was not an item included in income. The court thus concluded that, “There is thus a disconnect between the purported item included in gross income (understatement of COGS) and the item restored (a negotiated lump sum payment to settle a lawsuit). This problem is intractable: COGS cannot be deducted, and settlement payments are not included in gross income.” The court also concluded that there was no restoration of an item previously included in gross income to the same party on account of the same transaction or series of transactions. Finally, the court concluded alternatively that the inventory exception of § 1341(b)(2) precludes § 1341 relief for a refunded item that was included in gross income because of a sale of inventory.

b. And yet another circuit slaps down a taxpayer’s claim for the application of § 1341. Texaco v. United States, 528 F.3d 703 (9th Cir. 6/13/08). Between 1973 and 1981, Texaco sold crude oil and refined petroleum products at prices that exceeded the price ceilings set by federal petroleum price regulations. As a result of subsequent Department of Energy administrative proceedings, Texaco was required to pay \$1,250,000,000 plus interest. Texaco claimed a refund based on the application of § 1341, in lieu

of simply deducting the amount paid on its tax return for the year of the payment. The court (Judge Callahan) held that § 1341 was not available, because § 1341(b)(2) specifically provides that the relief provision does not apply to refunds and allowances with respect to inventory sold in prior years.

- Although the court found that the plain meaning of § 1341(b)(2) precluded Texaco's claim to its benefits, the court added that if there was some ambiguity it would have deferred to the IRS's position in Rev. Rul. 2004-17, 2004-1 C.B. 516, which, although it involved different facts (the ruling held that § 1341 does not apply to environmental remediation expenditures arising from prior years' manufacturing operations), includes the statement: "Section 1341(b)(2) provides that § 1341(a) does not apply to any deduction allowable with respect to an item included in gross income by reason of the sale or other disposition of the taxpayer's stock in trade (or other property of a kind that would have been included in the taxpayer's inventory if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business." The court noted that the Ninth Circuit accords revenue rulings *Skidmore* deference, under which agency rulings "while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance." [*Skidmore v. Swift Co.*, 323 U.S. 134, 140 (1944)].

4. Notice 2008-40, 2008-14 I.R.B. 725 (3/11/08). This notice provides guidance to supplement Notice 2006-52, 2006-1 C.B. 1175, with respect to certification of the installation in commercial buildings of energy efficient equipment for purposes of the § 179D deduction. The notice addresses allocation of the deduction in the case of government buildings, describes the requirements for approved software for calculating energy use and cost, and provides requirements for the interim energy efficient lighting rule of Notice 2006-52.

a. **The Emergency Economic Stabilization Act of 2008** [Division B], the **Energy Improvement and Extension Act**, § 303, extends the § 179D current deduction for installation of certain energy efficient property in a commercial building to property placed in service before 1/1/14.

5. **IRS determines who gets run over by the disallowed portion of leased driver's meal expenses.** Rev. Rul. 2008-23, 2008-18 I.R.B. 852 (4/14/08). In *Transport Labor Contract/Leasing, Inc. v. Commissioner*, 461 F.3d 1030 (8th Cir. 2006), the court held that a leasing company that provided employee truck drivers to clients was not subject to the § 274(n) 50 percent limitation on deduction of expense for meals because the leasing company had a reimbursement arrangement with its clients under § 274(e)(3) that exempted the

leasing company from the limitation. § 274(n)(2). The ruling provides three situations to explain who gets the § 274(n) haircut.

- Situation 1: The limitation applies to the leasing company where the driver accounts to it for meals and incidental expenses and the leasing company sends a lump-sum bill to the client.

- Situation 2: The limitation applies to the client where the driver accounts to the leasing company for meal and incidental expenses, the leasing company pays the driver, receives payment on a lump sum bill from the client, but then accounts to the client for the meal and incidental expenses by forwarding the driver's substantiation, which is accepted by the client who also acknowledges that the substantiated meal and incidental expenses are paid under a reimbursement arrangement with the leasing company and are subject to the § 274(n) limitation.

- Situation 3: The limitation applies to the client where the driver submits substantiation to the client who forwards copies to the leasing company. The leasing company pays the driver, including reimbursed meals and incidentals, and sends the client a bill that indicates reimbursed meals referring to the driver's substantiation submitted to the client. The client acknowledges that its payments to the leasing company equal to the reimbursement of the driver's meals and incidental expenses is paid under a reimbursement arrangement with the leasing company and is subject to the § 274(n) limitation.

- Undoubtedly the most important fact in situations 2 and 3 that shifts the burden of the § 274 limitation is the client's acknowledgement that the limitation applies to limit its deduction. Thus, the ruling seems to permit employee leasing companies to negotiate application of the limitation, leaving the issue open only with respect to the uninformed.

6. Does the Treasury Department care that local taxpayers might not approve of it making it easier for government employees to have tax-free "take-home" cars? REG-106897-08, Qualified Nonpersonal Use Vehicles, 73 F.R. 32500 (6/9/08). The Treasury has published Prop. Reg. §§ 1.132-5 and 1.274-5. A qualified nonpersonal use vehicle, defined in § 274(i) as a vehicle because of its nature is not likely to be used for personal purposes beyond a de minimis amount, is not subject to the substantiation requirements of § 274(d), and the use of a qualified nonpersonal use vehicle is treated as a working condition fringe. The proposed regulations would treat a clearly marked public safety vehicle used by a government worker as a qualified nonpersonal use vehicle even though, unlike the existing regulations, the user is not employed by a police or fire department.

7. Frozen on the ship, and frozen out of half of his meal deductions. Kurtz v. Commissioner, 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.” Judge Cohen ruled 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.

8. 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(a), (c) requires substantiation for the deduction.

9. Wouldn’t it just have been easier to cut rates in October 2004? No. Was it because that’s what the French-looking Vietnam War veteran was proposing? No, it was a replacement for the FSC/ETI export subsidies. Section 102 of the **American Jobs Creation Act of 2004** added new Code § 199, which provides a magical 9 percent deduction of a percentage of taxable income attributable to domestic manufacturing activities.

a. Proposed regulations. REG-105847-05, Income Attributable to Domestic Production Activities: Deduction, 70 F.R. 67220 (11/4/05). The Treasury has published massive [224 pages] proposed regulations [§§ 1.199-1 through -8] relating to the deduction for U.S. manufacturing income under § 199. The “shrinking back” concept of taking the deduction for only the value of the beans in a cup of brewed coffee, or for the value of the U.S.-manufactured shoelaces on a pair of foreign-manufactured sneakers is much discussed.

b. Finally, final regulations! Final § 199 regulations are out and are 247 pages long, but that is only 137 pages in Lexis and 55 pages in the Federal Register. T.D. 9263, Income Attributable to Domestic Production Activities, 71 F.R. 31268 (6/1/06). You have to be addlepat if you expect a summary.

c. Only a masochist would bother to read these regulations unless billable hours were involved. T.D. 9381, TIPRA Amendments to Section 199, 73 F.R. 8798 (2/15/08), *corrected*, 73 F.R. 16518

(3/28/08). The IRS has promulgated a raft of amendments of the already incomprehensible § 199 regulations.

d. Emergency Economic Stabilization Act of 2008, Act § 502(b), treats compensation to actors, production personnel, directors and producers for film-making services in the U.S. as W-2 compensation for purposes of the § 199 deduction.

e. Emergency Economic Stabilization Act of 2008 [Division B], Act § 401, would freeze the § 199 domestic manufacturing deduction for oil and gas producers at 6 percent, rather than increasing to 9 percent in 2010 as scheduled under current law.

10. “No man’s life, liberty or property is safe while the legislature is in session.” But the legislators’ “away from home” deductions are safe. REG-119518-07, Travel Expenses of State Legislators, 73 F.R. 16797 (3/31/08). Prop. Reg. § 1.162-24 incorporates the holdings of Rev. Rul. 82-33, 1982-1 C.B. 28, which will be obsolete when the proposed regulations are finalized. Further, Prop. Reg. § 1.162-24 would provide that a taxpayer becomes a state legislator on the day the taxpayer is sworn into office and ceases to be a state legislator on the day following the day on which the taxpayer’s term in office ends. A legislature is in session when the members of the legislature are expected to attend and participate as an assembled body of the legislature. Legislative days include a day on which the legislator’s attendance at a meeting of a committee of the legislature is formally recorded.

11. The tax Code comes to the rescue of endangered species. The **Heartland, Habitat, Harvest, and Horticulture Act of 2008**, amended § 175 applies to extend current deductibility to expenses incurred after 12/31/08 by farmers to achieve site-specific management actions pursuant to the Endangered Species Act of 1973.

12. Some folks in the heartland might not like this provision. Section 461(j), added by the **Heartland, Habitat, Harvest, and Horticulture Act of 2008** and effective for years beginning after 12/31/09, limits the deductibility of farming losses in any year in which the taxpayer receives either (1) a direct or counter-cyclical payment under Title I of the Food, Conservation, and Energy Act of 2008 (or any payment in lieu of such a payment), or (2) any Commodity Credit Corporation (CCC) loan. The allowable farm loss is limited to the greater of (1) \$300,000 (\$150,000 in the case of a married taxpayer filing a separate return) or (2) the taxpayer’s total net farm income for the five preceding taxable years. Disallowed losses may be carried

forward indefinitely. For partnerships and S corporations, § 461(j) applies at the partner or shareholder level.

13. Rev. Proc. 2008-59, 2008-41 I.R.B. 857 (9/25/08). This revenue procedure updates per-diem rates that may be claimed without substantiation for travel after October 1, 2008. Allowable per diem rates are at www.gsa.gov.

14. Yearout Mechanical & Engineering, Inc. v. Commissioner, T.C. Memo. 2008-217 (9/24/08). The taxpayer was a construction company that expanded into high-tech buildings during boom years in Albuquerque, New Mexico. Due to its financial position and the difficulty of reliably obtaining rental equipment, the taxpayer entered into rental equipment leases with its shareholders. The Tax Court (Judge Gale) rejected the Commissioner's assertion that rental payments under long-term lease contracts, which also contained actual use provisions, were excessive and allowed the taxpayer's deductions for the rental payments. The court found that the unique nature of equipment required for "clean room" construction and the general business climate in which the taxpayer operated established a business reason for the unique leasing arrangements.

15. **Since we are not willing to pay school teachers a living wage, let's give them a tax break worth less than \$2 a week at their tax brackets. The Emergency Economic Stabilization Act of 2008** [Division C], Act § 203, extended through 2009 the § 62(a)(2)(D) above-the-line deduction for up to \$250 paid by an eligible educator for books, supplies, computer equipment (including software), other equipment, and supplementary materials used by the eligible educator in the classroom.

E. Depreciation & Amortization

1. Using the tax code for subsidies where direct action has failed: First-year depreciation recovery for specified Gulf Opportunity Zone extension property. Notice 2007-36, 2007-17 I.R.B. 1000 (3/29/07). This notice provides guidance with respect to the 50 percent original first year depreciation deduction provided under § 1400N(d). A 50 percent first year depreciation allowance is provided for property placed in service in the so-called GO Zone. **The Tax Relief and Health Care Act of 2006**, § 120, adding Code § 1400N(d)(6), extends the placed in service date for GO Zone extension property to 12/31/10. GO Zone extension property is property the substantial use of which is on one or more portions of the GO Zone (listed in the notice) and which is either nonresidential real property or residential rental property, or

personal property that is used in such real property and is installed within 90 days of the date the building is placed in service. Otherwise, property eligible for the 50 percent first year depreciation must have been placed in service by 12/31/07, or 12/31/08, for qualified nonresidential real property and residential rental property. The notice also explains the requirement that original use of the property must commence with the taxpayer.

a. GO Zone depreciation recapture, or not, for like-kind exchanges and involuntary conversions. Notice 2008-25, 2008-9 I.R.B. 484 (2/11/08). Section 1400N(d)(5) requires recapture of tax benefits for GO Zone property that ceases to be GO Zone property. If GO Zone property is transferred by a taxpayer in a like-kind exchange or as a result of an involuntary conversion and the replacement property is GO Zone property in the taxpayer's hands, there is no recapture. If GO Zone property is transferred by a taxpayer in a like-kind exchange or as a result of an involuntary conversion and the replacement property is not GO Zone property in the taxpayer's hands and is not substantially used in the GO Zone or in the active conduct of a trade or business by the taxpayer in the GO Zone, there is recapture. If GO Zone property is transferred by a taxpayer in a like-kind exchange or as a result of an involuntary conversion and the replacement property is not GO Zone property in the taxpayer's hands but is substantially used in the GO Zone and in the active conduct of a trade or business by the taxpayer in the GO Zone, there is no recapture. But, if the replacement property subsequently ceases to be substantially used in the GO Zone or in the active conduct of a trade or business by the taxpayer in the GO Zone, there is recapture.

b. The Housing Assistance Tax Act of 2008, § 3082(b), extends the date for commencing construction of self-produced property eligible for GO Zone depreciation. Formerly the 50 percent depreciation allowance was available for Gulf Opportunity Zone property only if the taxpayer began construction of the property before January 1, 2008. The 2008 act deletes the January 1, 2008 date, but retains all other deadlines.

2. Rev. Proc. 2008-22, 2008-12 I.R.B. 658 (3/13/08). For cars subject to the limitations of § 280F placed in service in 2008, to which the 50-percent additional first year depreciation does not apply, the limit is \$2,960 for the first year, \$4,800 for the second year, \$2,850 for the third year, and \$1,775 for each succeeding year; for trucks and vans placed in service in 2008 the limit is \$3,160 for the first year, \$5,100 for the second year, \$3,050 for the third year, and \$1,875 for each succeeding year; for cars placed in service in 2008, to which the 50-percent additional first year depreciation applies, the limit is \$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 trucks and vans placed in service in

2008, to which 50-percent additional first year depreciation applies, the limit is \$11,160 for the first year, \$5,100 for the second year, \$3,050 for the third year, and \$1,875 for each succeeding year.

3. 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 (watch for the 2009 version of this outline).

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.
- (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.

4. Automatic deemed election for fifteen-year amortization of start-up expenditures. T.D. 9411, Elections Regarding Start-up Expenditures, Corporation Organizational Expenditures, and Partnership Organizational Expenses, 73 F.R. 38910 (7/8/08). The Treasury has promulgated Temporary Regulations regarding elections to amortize start up expenditures under § 195, corporate organizational expenses under

§ 248, and partnership organizational expenses under § 709. The Temporary Regulations reflect changes in the **American Jobs Creation Act of 2004** increasing the amortization period from 60 months to 15 years. In addition, under Temp. Reg. § 1.195-1T, a taxpayer is deemed to have elected to amortize start-up expenditures for the taxable year in which the active trade or business to which the expenditures relate begins, but may forgo the deemed election “by clearly electing to capitalize its start-up expenditures on a timely filed Federal income tax return (including extensions) for the taxable year in which the active trade or business to which the expenditures relate begins.” Either way, the election is irrevocable and applies to all start-up expenditures related to the active trade or business. A change in the characterization of an item as a start-up expenditure is a change in an accounting method, subject to § 446 consent of the IRS and § 481 adjustments, if the taxpayer treated the item consistently for two or more taxable years. Similar rules apply to corporate and partnership organizational expenses. Temp. Reg. §§ 1.248-1T, 1.709-1T.

5. Folks in the Bluegrass region of the heartland like this provision. The **Heartland, Habitat, Harvest, and Horticulture Act of 2008** provides that for 2009 through 2013, a three-year § 168 cost recovery period applies to a race horse that is two years old or younger at the time that it is placed in service.

6. Farm machinery is treated as five-year recovery property. **Emergency Economic Stabilization Act of 2008**, Act § 505(a), amended § 168(e)(3)(B). Farm machinery, the original use of which commences with the taxpayer, and which is placed in service in 2009, is treated as five-year recovery property for MACRS. The provision does not apply to a grain bin, ginning equipment, fences or other land improvements.

a. There is something for NASCAR fans. The **Emergency Economic Stabilization Act of 2008**, Act § 317, extends seven-year recovery for motorsports facilities defined in § 168(i)(15) to property placed in service in 2009.

b. And for film lovers. The **Emergency Economic Stabilization Act of 2008**, Act § 502(b), extends the expensing option of § 181 for qualified film and television production to costs incurred in production commencing before January 1, 2010. In the case of production costs exceeding \$15 million (\$20 million for production in low income communities or in areas of distress [will this result in more episodes of *The Wire*]), the first \$15 million (or \$20 million) of production costs may be expensed.

7. Emergency Economic Stabilization Act of 2008, Act § 305(a), amending § 168(e)(3)(E), extends fifteen-year amortization for qualified leasehold improvement property (improvements constituting § 1250 property made more than three years after a nonresidential building is placed in service) and qualified restaurant property (more than 50% of square footage devoted to food preparation and seating) placed in service before January 1, 2010.

8. Emergency Economic Stabilization Act of 2008, Division B, § 308, adds § 168(m) to provide a 50 percent first year depreciation allowance of the adjusted basis of qualified reuse and recycling property acquired after August 31, 2008, which is reuse and recycling property with at least a five year useful life the original use of which commences with the taxpayer. The allowance is available under the AMT.

9. The Emergency Economic Stabilization Act of 2008 extended through 2009 § 179E permits, which allows a taxpayer to elect to treat 50 percent of the cost of any “qualified advanced mine safety equipment” as a current expense.

10. On Boxing Day, the IRS privately provides for the creation of depreciable interests in land. PLR 200852013 (12/26/08). In this private letter ruling three sellers separately owned interests in a building with residential and commercial units, a parking structure and a surface parking lot. The sellers sold a remainder interest to an unrelated buyer, and a term interest in the land, buildings and other improvements and fixtures to the taxpayer. The sellers, the remainder interest holder, and the taxpayer are unrelated. Citing Reg. § 1.167(a)-1(b), *Gordon v. Commissioner*, 85 T.C. 309, 322-323 (1985), and *Lomas Santa Fe, Inc. v. Commissioner*, 74 T.C. 662, 683 (1980), *aff'd*, 693 F.2d 71 (9th Cir. 1982), the IRS held that the taxpayer may claim depreciation deductions for the cost allocated to the term interest in land over the term of the interest. The taxpayer is allowed to claim capital recovery for the buildings and parking structure under the rules of § 168.

F. Credits

1. T.D. 9401, Alternative Simplified Credit Under Section 41(c)(5), 73 FR 34185 (6/17/08). Treasury issued Temp. Regs. §§ 1.41-6T, -8T, and -9T, which contain rules for calculating § 41 research credits under the alternative simplified research credit provided by § 41(c)(5) enacted in the **Tax Relief and Health Care Act of 2006**. Although the research credit expired after 2007, if past history is any indication of future behavior, Congress will re-extend

the credit – in all likelihood retroactively. The 2006 Act added a third, “simplified”, method for calculating the credit. Under § 41(c)(5) the credit may be determined as equal to 12 percent of qualified research expenditures as exceeds 50 percent of the average qualified research expenditures for the previous three years, or 6 percent of qualified research expenditures if the taxpayer does not have qualified research expenditures in each of the previous three years.

2. 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 March 31, 2008, 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 January 1, 2006 and minimum tax credits attributable to adjusted minimum tax for years after January 1, 2006. 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, 2008-44 I.R.B. 1082 (10/14/08). 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).

3. The **Housing Assistance Tax Act of 2008**, § 3022(b), provides that for housing placed in service after 12/31/07, the low-income housing tax credit of § 42 and the rehabilitation credit of § 47 will offset alternative minimum tax liability. Before the amendment, these credits, along with general business credits, were limited to an amount not in excess of the taxpayer's regular tax liability over the tentative minimum tax. Sections 38(b)(4)(B)(ii) and (v) are amended to treat the tentative minimum tax as zero for purposes of determining the allowable low-income housing and rehabilitation credits.

4. We guess that the intent of this one is to bring food prices down. The **Heartland, Habitat, Harvest, and Horticulture Act of 2008** reduces the § 40 alcohol fuels credit amount for ethanol production from 51 cents per gallon to 45 cents per gallon for 2009 and 2010, subject to a delayed effective date if ethanol production and importation do not reach 7,500,000,000 gallons in 2008.

5. How many tax professionals know what "lignocellulosic" and "hemicellulosic" matter are? Section 40(b)(6), added by the **Heartland, Habitat, Harvest, and Horticulture Act of 2008**, adds the cellulosic biofuel producer credit as a new component of the §40 alcohol fuels credit. Generally, the amount of the credit is \$1.01 for each gallon of qualified production after 12/31/08 and before 1/1/13. If a cellulosic biofuel is alcohol, the amount of the credit is reduced by the amount of credit allowable under other parts of §40. Cellulosic biofuel is liquid fuel which is derived from any renewable lignocellulosic or hemicellulosic matter; examples of such matter include dedicated energy crops, wood, plants, grasses, animal wastes, and municipal solid waste.

a. The **Emergency Economic Stabilization Act of 2008** [Division B], the **Energy Improvement and Extension Act**, § 201, amends § 168(l)(3), which provides a 50 percent first year allowance for qualified cellulosic biomass ethanol plant property to provide a definition of cellulosic biofuel to include, “any liquid fuel which is produced from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis.” This definition replaces “cellulosic biomass ethanol.”

6. **Helping reservists by helping their employers. Why not just have Uncle Sam increase their pay while on active duty?** Section 45P, added as part of the general business credit by the **Heroes Earnings Assistance and Relief Tax Act of 2008**, creates a new credit for a “small business employer” (defined as an employer with an average of less than 50 employees on business days during the year) that pursuant to a written plan provides “eligible differential wage payments” to every “qualified employee” (defined as a person who has been employed by the taxpayer for the 91-day period immediately preceding the period for which the differential wage payment is made). “Differential wage payments” are defined (by cross-reference to § 3401(h)(2)) as payments made while a qualified employee of the employer is on active duty with the United States military for a period of more than 30 days, which represent all or some of the wages that the employee would have received from the employer if the employee were performing services for the employer. Credit-eligible differential wage payments are limited to \$20,000 per employee per year. The credit amount is 20 percent of credit-eligible payments. Section 280C(a) provides that the employer is not entitled to a business expense deduction for the portion of its wage expense that is equal to the amount of its credit under §45P. The credit is not available with respect to payments made after 12/31/09.

7. **The tax Code is enlisted to fight terrorists trying to make fertilizer bombs.** Section 45O, added as part of the general business credit by the **Heartland, Habitat, Harvest, and Horticulture Act of 2008**, provides a credit equal to 30 percent of “qualified chemical security expenditures” (including expenditures on employee security training, and on a wide range of security devices) incurred by an “eligible agricultural business.” The amount of the credit (*not* the amount of credit-eligible expenditures) with respect to any one facility is limited to \$100,000 (with the ceiling reduced by the total amount of credits allowed with respect to that facility over the five preceding years), and the total annual credit per taxpayer per year (again, *not* total credit-eligible expenditures) is limited to \$2,000,000. “Eligible agricultural businesses” are those that sell pesticides or certain fertilizers at retail to farmers and ranchers, and those which manufacture, formulate, distribute or aerially apply pesticides or certain fertilizers. The taxpayer’s deductible business expense

must be reduced by the amount of the credit claimed under §45O. The credit is not available with respect to expenditures paid or incurred after 12/31/12.

8. Credits for saving the spotted owl, or is it to increase the amount of timber that the Forest Service can sell off at bargain prices? Sections 54A and 54B, added by the **Heartland, Habitat, Harvest, and Horticulture Act of 2008**, create a credit for holders of qualified forestry conservation bonds (QFCBs). A QFCB is a bond issued by a State or a §501(c)(3) organization to finance a “qualified forestry conservation project” (which is defined as the acquisition of land adjacent to United States Forest Service land, subject to the requirement that at least half of the acquired land must be transferred to the Forest Service at no net cost, and several other requirements). The national limitation on QFCBs is \$500 million, with allocations among qualified projects to be determined by the Treasury Department. All the available project proceeds of a QFCB must be used within the three-year period beginning on the date of issuance, except that unspent proceeds may be used within 90 days from the end of the three-year period to redeem bonds. The holder of a QFCB is entitled to a credit determined by multiplying the face amount of the holder’s bond by the credit rate of the bond, with the credit rate having been determined by the Treasury Department at issuance; the credit rate is to be the rate necessary to permit the issuance of QFCBs without discount and without interest cost to the issuer. A recipient of the credit must include the amount of the credit in gross income as interest.

9. The low-income housing credit gets better temporarily. The **Housing Assistance Tax Act of 2008** made numerous changes in the low-income housing credit. (1) To qualify for the 70-percent credit base [new housing that is not federally subsidized], rehabilitation expenditures must equal or exceed the greater of (1) 20 percent of the adjusted basis of the building being rehabilitated, or (2) \$6,000 (indexed for post-2008 inflation) per low-income unit in the building being rehabilitated. (2) The 70-percent credit increases to a 91-percent credit base, and the 30-percent credit base [housing that is either existing or federally subsidized] increases to a 39-percent credit base, in the case of buildings (a) located in specified types of high-cost areas, and (b) designated by a State Housing credit agency as requiring the larger credit in order to be financially feasible. (3) For buildings placed in service after 7/30/08, neither (a) direct or indirect federal loans bearing interest rates below the AFR, nor (b) certain assistance provided under the HOME Investment Partnerships Act or the Native American Housing Assistance and Self Determination Act of 1996, are treated as federal subsidies that reduce the credit from 70 percent to 30 percent; tax exemption of bond interest under § 103 continues to reduce the credit percentage. (4) For non-federally subsidized buildings placed in service after 7/30/08 and before 12/31/13, the actual credit

percentage will not be less than 9 percent. (5) The annual per-resident credit allocated to each state housing credit agency is temporarily increased to \$2.20 for calendar years 2008 and 2009. (6) The election post a bond to avoid recapture has been replaced by an extension of the statute of limitations until three years after the taxpayer notifies the IRS of any noncompliance with the low-income housing credit rules resulting from a disposition.

10. Notice 2008-68, 2008-34 I.R.B. 418 (8/21/08). The notice provides guidance on the fuel cell credit and microturbine credit. The notice covers technical requirements for claiming the credit computation issues, and extension of the credit to a lessor.

11. The **Emergency Economic Stabilization Act of 2008** [Division B], the **Energy Improvement and Extension Act**, § 306, amends § 168(e)(3)(D) to treat qualified smart electric meters and a smart grid system, as defined in § 168(i)(18) and (19), as ten-year property, but limits the depreciation method in § 168(b)(2)(C) to 150 percent declining balance.

12. The “temporary” research credit that never sunsets is extended again. The **Emergency Economic Stabilization Act of 2008**, [Division C] § 301, extended the § 41 credit for increased research activities for amounts paid or incurred through December 31, 2009. The Act also increased the § 41(c)(5) alternative simplified credit to 14 percent for years ending after December 31, 2008, and amended § 41(c) to provide that the an election to claim the § 41(c)(4) alternative incremental credit shall not apply to years beginning after December 31, 2008.

13. **Indian credit.** The **Emergency Economic Stabilization Act of 2008** [Division C], § 314, extended the § 45A Indian Employment Credit for taxable years beginning on or before December 31, 2009.

14. **Marketing credit.** The **Emergency Economic Stabilization Act of 2008** extended the § 45D New Markets Tax Credit through 2009, permitting up to 3.5 billion in qualified equity investments for that calendar year.

15. **Schoolhouse credit.** The **Emergency Economic Stabilization Act of 2008** provides that the § 1397E Qualified Zone Academy Bond Credit does not apply to any bond issued after October 3, 2008, but added new § 54E, which provides a virtually identical credit for, and authorizes issuance of, up to \$400 million of new qualified zone academy bonds issued after October 3, 2008 and before 2010.

16. Katrina Employee credit. The **Emergency Economic Stabilization Act of 2008** extended the Work Opportunity Credit through Aug. 28, 2009 for certain employees hired in the core disaster area of Hurricane Katrina. The credit for Katrina employees hired to a new place of employment outside of the core disaster area was not extended.

17. Historic New Orleans credit. The **Emergency Economic Stabilization Act of 2008** extended §1400N(h) through December 31, 2009. Section 1400N(h), was added by the Gulf Opportunity Zone Act of 2005, to increase the 10 percent credit § 47 rehabilitation to 13 percent, and the 20 percent credit to 26 percent, for qualified expenditures incurred on or after August 28, 2005, and before January 1, 2009, with respect to structures and buildings located within the Katrina-related Gulf Opportunity Zone.

18. The Emergency Economic Stabilization Act of 2008 [Division C] contains other credit provisions:

a. Section 302, extends the § 45D credit for equity investment in qualified active low-income community business.

b. Section 316, extends the Railroad Track Maintenance Credit of § 45G to expenditures made in 2009 and allows the credit for AMT purposes.

c. Section 320 extends the rehabilitation credit through 2009.

G. Natural Resources Deductions & Credits

1. Safer mines credit. The **Emergency Economic Stabilization Act of 2008**, Act § 310, extended through 2009 the \$10,000 § 45N credit for expenses incurred in training “qualified mine rescue team employees.”

2. Safer Mines deduction. **Emergency Economic Stabilization Act of 2008**, Act § 311, extends the § 179E 50 percent expensing provision for mine safety equipment to include equipment placed in service before January 1, 2010.

3. The Emergency Economic Stabilization Act of 2008 [Division B], the **Energy Improvement and Extension Act**, § 209, extends the 50 percent expensing allowance by two years for qualified refinery property to

property placed in service before 1/1/11. The definition of a qualified refinery in § 179C(d) is expanded to the refining of fuel directly from shale or tar sands.

4. The Emergency Economic Stabilization Act of 2008

[Division B], the **Energy Improvement and Extension Act**, extends several credits and adds a few new twists.

- Section 101 extends the § 45 credit for wind and refined coal facilities for property placed in service before 1/1/10. The credit is extended for certain other facilities to include property placed in service in 2009 and 2010.

- The energy credit contains special rules for energy produced from refined coal. Section 101(b) changes the definitions of qualified refined coal to eliminate the requirement of § 45(c)(7)(A)(i)(IV) that the fair market value of refined coal be increased by 50 percent over the value of feedstock coal, and increases the requirement of § 45(c)(7)(B) for emissions reduction from 20 percent to 40 percent. Section 108 of the Act amends the § 45(c)(7)(A) definition of refined coal to include fuel produced from coal that is sold with a reasonable expectation that the fuel will be used to produce steam, is certified as resulting in a qualified emission reduction, and is produced in a manner that results in a 50 percent increase in value over feedstock coal or is steel industry fuel. Steel industry fuel is produced by liquefying coal waste sludge and distributing it on coal that is used for the manufacture of coke.

- Section 101(c) changes the definitions of trash facilities, biomass facilities, and facilities for hydropower production of § 45(c) and (d).

- Section 102 adds facilities for production of electricity from waves, tides and ocean currents.

- Section 103 extends the solar energy credit to include property placed in service in periods ending before 1/1/17, for fuel cell property and microturbine property in periods ending after 12/31/16.

- Section 103(b) allows the § 46 energy credit as an offset against the AMT, adding § 38(c)(4)(B)(v).

- Section 103(c) expands the § 48 energy credit to include power systems that combine power generation with steam generation for heat.

- Section 103(d) increases the credit limitation of § 48(c) for qualified fuel cell property from \$500 for each 0.5 kilowatt capacity to \$1500.

- Section 103(f)(2) allows the § 48 energy credit as an offset against the AMT, adding § 38(c)(4)(B)(v).

- Section 104(a) adds qualified small wind energy property to the 30 percent energy credit of § 48.

- Section 105 adds geothermal heat pump to the list of energy property available for the § 48 energy credit.

- Section 106 expands the credit for residential energy efficient property by extending the credit to 12/31/16, eliminating the \$2,000 limitation for solar electric property expenditures, adding a 30 percent credit for small wind energy property limited to \$500 for each half kilowatt of capacity not to exceed \$4,000, adding geothermal heat pump property to the list of eligible expenditures (limited to \$2,000), and allows the credit against the alternative minimum tax.

- Section 111 expands the investment credit under § 48 for qualifying advanced coal projects. The credit is allowed for projects certified by the IRS in consultation with DOE under a competitive bidding process. Amended § 48A(d)(3)(A) expands the amount of available credits from \$1.3 billion to \$2.55 billion. Section 48A(a)(3) is added to provide a 30 percent credit for projects described in § 48(d)(3)(B), which include greenhouse gas capture capability, increased by-product utilization, applicants who have a partnership with an educational institution, and other benefits. The IRS is also directed in § 48A(d)(3)(B) to direct specified amounts to particular types of projects. Section 48A(e)(1) is amended to direct the IRS to give priority to projects that capture and sequester carbon dioxide emissions.

- Section 112 increases the coal gasification credit of § 48B from 20 percent to 30 percent and expands the total amount of available credits to \$3.5 billion. Section 48B(f) is added to provide for recapture of the credit for any project that fails to meet the carbon dioxide separation and sequestration requirements of § 48B(d)(1).

- Section 115 adds a new credit to § 38 business credits for carbon dioxide sequestration. Section 48Q provides a credit of \$20 per metric ton of qualified carbon dioxide which is captured by the taxpayer and disposed of in secure geological storage and \$10 per ton of captured carbon dioxide that is used as a tertiary injectant in a qualified enhanced oil or natural gas recovery project.

- **And the scientists are to tell us whether any of this works to reduce hot air.** Section 117 requires the Secretary of the Treasury to enter into an agreement with the National Academy of Sciences to undertake an audit of the Code to determine which provisions have the greatest affect on carbon dioxide and other greenhouse gas emissions.

- Section 202 increases the § 40A credit for biofuel from 50 cents to \$1 for each gallon of biofuel used in the production of a qualified biodiesel mixture. The credit is extended to biofuel used in the production of aviation jet fuel. (Southwest may find a new use for its peanuts, gas production.) The credit is not available for fuel produced using feedstock that is not biomass.

- Section 203 restricts the fuels credits under §§ 40 (alcohol), 40A (biodiesel), 6426 (excise tax), by excluding fuels produced outside of the United States for use outside of the United States.

- Section 210 extends exclusion from the 100 percent of income limitation on percentage depletion that is provided for production from marginal properties for one year to include production in a tax year beginning before 12/31/09.

- Section 304 extends the energy efficient home credit of § 45L through 2009.

- Section 305 extends the § 45M credit (part of the § 38 investment credit) for production of energy efficient dishwashers, clothes washers, and refrigerators to products manufactured in 2009, with different dates for different products.

5. Notice 2008-72, 2008-43 I.R.B. 998 (10/27/08). The § 43 enhanced oil recovery credit for taxable years beginning in the 2007 calendar year is phased out completely, because the reference price for the 2006 calendar year (\$66.52) exceeds \$28 multiplied by the inflation adjustment factor for the 2006 calendar year (\$41.06) by \$25.45.

6. Notice 2008-89, 2008-43 I.R.B. 999 (10/27/08). The applicable percentage under § 613A to be used in determining percentage depletion for marginal oil and gas properties for the 2007 calendar year is 15 percent.

H. Loss Transactions, Bad Debts, and NOLs

1. Bynum v. Commissioner, T.C. Memo. 2008-14 (1/28/08). The Tax Court (Judge Foley) held that cash payments by an individual for start-up expenses and routine business expenses of his controlled corporation were capital contributions and not deductible as business bad debts. The taxpayer had no debtor-creditor relationship with his incorporated businesses and there was no enforceable obligation of the corporations to make fixed payments of principal or interest.

2. **Proposed regulations that threatened the ordinary loss treatment of bank loans are withdrawn.** REG-109367-06, Section 1221(a)(4) Capital Asset Exclusion for Accounts and Notes Receivable, 73 F.R. 21861 (4/22/08). Prop. Reg. § 1.1221-1(e) (2006), REG-109367-06, Section 1221(a)(4) Capital Asset Exclusion for Accounts and Notes Receivable, 71 F.R. 44600 (8/7/06), would have provided that notes or receivables would be treated as capital assets outside of the § 1224(a)(4) exclusion if the notes were acquired

for more than a de minimis consideration in addition to services or inventory property. Commentators raised concern with respect the ordinary loss treatment of devalued notes issued for mortgage loans, contrary to the position in cases such as *Burbank Liquidating Corp. v. Commissioner*, 39 T.C. 999 (1963), *acq. sub nom. United Assocs., Inc.*, 1965-1 C.B. 3, *aff'd in part and rev'd in part on other grounds*, 335 F.2d 125 (9th Cir. 1964). In withdrawing the proposed regulations the IRS announced that it would not challenge reporting positions consistent with existing case law treating bank loans as ordinary loss assets.

3. When Congress gives the IRS authority to promulgate procedures, the deadlines stick. *Tualatin Valley Builders Supply, Inc. v. United States*, 522 F.3d 937 (9th Cir. 4/10/08). The Job Creation and Worker Assistance Act of 2002, enacted on 3/9/02, amended § 172 to allow a five year carryback of net operating losses for 2001 and 2002 tax years. The Act authorized the IRS to prescribe procedures to claim adjustments with respect to returns filed for 2001. In Rev. Proc. 2002-40, 2002-1 C.B. 1096, the IRS provided that taxpayers were required to change their 2001 reporting positions before 10/31/02. The court denied the taxpayer's claim for refund based on amended returns filed on 1/7/03, attempting to apply the 5-year carryback allowed in the 2002 Act rather than the 2-year carryback of the taxpayer's 2001 NOLs originally reported and allowed. The court held that the specific grant of authority provided in § 172(j) authorized the revenue procedure, which was entitled to deference under *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

4. 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 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. The court 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."

- A debt owed to the taxpayer by a bankrupt corporation, that possibly was insolvent and which had agreed to sell all of its operating assets, was not worthless where the stock was still trading for \$3 per share and the corporation still owned numerous technologies, patents, office space, a research facility, and land and continued to employ a team of engineers. “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.

5. Ordinary gain and loss on sale of Fannie Mae and Freddie Mac Preferred Stock. The **Emergency Economic Stabilization Act of 2008**, Act § 301, contains an off-code provision allows an applicable financial institution to treat losses on the sale of Fannie Mae or Freddie Mac preferred stock held on September 6, 2008, as ordinary losses. The EESA allows the Secretary to treat transferred basis stock as held on the requisite date. Applicable financial institutions are defined in § 582(c)(2) and include banks, savings banks, a small business investment company, and a business development corporation. The EESA also allows depository institutions to treat losses as ordinary.

a. Benefits extended to partners and subsidiaries. Rev. Proc. 2008-64, 2008-47 I.R.B. 272 (10/30/08). The ordinary loss treatment is extended to the distributive share of loss of a qualified financial institution partner in a partnership that held qualified Fannie Mae or Freddie Mac preferred stock on 9/6/08, and sold the stock after that date, and to the sale of a partnership interest by a qualified financial institution if 95% of the partnership’s assets consisted of qualified preferred stock or cash equivalents. A qualified financial institution that receives a distribution of qualified preferred stock from a partnership 95% of whose partnership’s assets consisted of qualified preferred stock or cash equivalents, is treated as holding the qualified preferred stock on 9/6/08. Sales of qualified preferred stock of subsidiaries of a qualified financial institution are treated as ordinary gain or loss. Qualified preferred stock held by a qualified financial institution whose basis is determined from the basis of the person who transferred the stock and who held the stock on 9/6/08, is also treated as having held the stock on 9/6/08.

6. Jojoba partnership investment may have been worthless from the outset, but not enough to claim a loss deduction. Helbig v. Commissioner, T.C. Memo. 2008-243 (10/29/08). The taxpayer invested in Contra Costa Jojoba Research Partners, an investment in jojoba beans promoted by Charles B. Toepfer. Deductions from the partnership investment were denied for 1983, 1984, and 1985 in *Utah Jojoba I Research v. Commissioner*, T.C. Memo. 1998-6, to which the taxpayer had agreed to be bound. The court (Judge Wherry) denied taxpayer's additional claim that the investment was worthless from the outset giving rise to loss deductions in 1983-1985. The court noted that the taxpayer continued to pursue the investment through 1993.

• The court also upheld negligence penalties under § 6653(a) and substantial understatement penalties under § 6661.

a. Heller v. Commissioner, T.C. Memo. 2008-232 (10/20/08). The court upheld negligence penalties under § 6653 and substantial understatement penalties under § 6661 on investors in the Contra Costa jojoba bean shelter. The court held that the Hellers had been negligent in their failure to consult a tax expert before taking the large deductions from Contra Costa's research and development efforts.

7. Worthless stock is not theft, even though it may feel like it. Electronic Picture Solutions, Inc. v. Commissioner, T.C. Memo 2008-212 (9/8/08). The corporate taxpayer purchased publicly traded Novatek stock through a California broker. The SEC filed a civil complaint alleging massive fraud on Novatek investors. The taxpayer claimed a theft loss under § 165(a) (instead of a capital loss for worthless securities). In denying the deduction the court (Judge Thornton) observed that under California law that a purchaser of securities on the open market cannot support a claim of theft because there is no privity between the perpetrator and the victim.

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

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

I. At-Risk and Passive Activity Losses

1. This deficit restoration obligation was not at-risk.

Hubert Enterprises v. Commissioner, T.C. Memo. 2008-46 (2/28/08), *on remand from* 230 Fed. Appx. 526 (6th Cir. 4/27/07). The taxpayer held 99 of 100 units of a Wyoming LLC that purchased equipment financed with recourse debt. The taxpayer amended the LLC agreement to provide a requirement for restoration of a deficit capital account on liquidation of the LLC in order to pay creditors and restore the positive balance of a member's capital account. Relying on the ultimate liability standard of *Emershaw v. Commissioner*, 949 F.2d 841 (6th Cir. 1991), the Tax Court (Judge Laro) held that the taxpayer had no personal liability because repayment of any deficit was contingent on liquidation of the LLC and no creditor had a right to force a liquidation under state law.

2. Due process does not protect this tax attorney's pre-1986 real estate investments from the passive activity loss rules. Ziegler v. Commissioner, 282 Fed.Appx. 869 (2d Cir. 6/26/08).

The Second Circuit, in a summary opinion, affirmed the Tax Court's decision (T.C. Memo. 2007-166 (6/27/07)), rejecting Stephen Ziegler's argument that application of the passive activity loss rules to investment real estate purchased in 1984, two years before the effective date of § 469, was a retroactive application of the law constituting a taking under the due process clause of the Fifth Amendment. The Tax Court had observed that tax legislation is not a promise and that the taxpayer has no vested right in the Internal Revenue Code. The Circuit Court added that application of § 469 is not an unconstitutional taking under the Fifth Amendment because the taxpayer did not have a property right to the tax benefits affected by enactment of § 469.

3. Let's consider changing the requirements for grouping activities under § 469. Notice 2008-64, 2008-31 I.R.B. 268 (8/4/08). Reg. § 1.469-4(c)(1) provides rules for grouping trade or business activities and rental activities into a single activity for purposes of applying the passive activity loss limitations of § 469. Grouping several activities into a single activity might be an advantage if the taxpayer can establish him or herself as a material participant in the group of activities. On the other hand, since disposition of an activity permits deduction of unused losses from the activity, a large grouping may be disadvantageous. The IRS is seeking comments on a proposal to require taxpayers to provide a written statement indicating whether one or more trade or business activities are grouped as a single activity or as separate activities. The statement would be required to be filed with a return for the first taxable year in which a grouping is made, in any year the taxpayer adds new activities to a grouping, whenever a taxpayer disposes of an activity from an existing grouping, or when it is determined that existing groupings are inappropriate under the regulations. Statements would be required to be filed only in years when there are changes in a taxpayer's grouping of activities. Failure to file the required statements would cause each of the taxpayer's activities to be treated as a separate activity. Comments are requested by 11/4/08. The proposal would be effective on the date that final guidance is published.

4. A closing agreement does not override the passive activity loss rules. *Shelton v. United States*, 102 A.F.T.R.2d 2008-6287 (Fed. Cl. 9/23/08). The taxpayers entered into a closing agreement in a partnership audit that provided that, "Any losses disallowed under this agreement are suspended under I.R.C. § 465. Such suspended losses may be used to offset the taxpayers' pro rata share of any income earned by the partnership and/or other income in accordance with the operation of I.R.C. § 465." The taxpayer asserted that the closing agreement allowed deduction of suspended loss in a year that at-risk amounts are increased, regardless of the passive activity loss limitation of § 469. The Claims Court (Judge Miller) held on summary judgment that § 469 always applies after the limitation of § 465 is overcome and that any absence of a reference to § 469 in the closing agreement does not eliminate its application.

III. INVESTMENT GAIN

A. Capital Gain and Loss

1. The ever-expanding deemed sale or exchange concept limits ordinary loss deductions. REG-101001-05, Abandonment of Stock and Other Securities, 72 F.R. 41468 (7/30/07). Prop. Reg. § 1.165-5(i) would provide that a security that has been abandoned is treated as a wholly

worthless security. To abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for it. Thus, if the abandoned security (other than a security in an affiliated corporation subject to § 165(g)(3)) is a capital asset, the resulting loss is a capital loss incurred on the last day of the taxable year. All the facts and circumstances determine whether the transaction is properly characterized as an abandonment or other type of transaction, such as an actual sale or exchange, contribution to capital, dividend, or gift. These proposed regulations will be effective after the date of publication of final regulations.

a. Finalized in the blink of an eye. T.D. 9386, Abandonment of Stock or Other Securities, 73 F.R. 13124 (3/12/08). The proposed regulations were adopted as final regulations, without change, and are effective for any abandonment of stock or other securities after 3/12/08.

2. Despite repeated tries, insurance agency termination payments continue to be denied capital gains treatment. Trantina v. United States, 512 F.3d 567 (9th Cir. 1/9/08). The taxpayer was a State Farm insurance agent, who sold policies exclusively for State Farm as an independent contractor, operating his own agency, developing clients, hiring employees, and paying expenses. Upon retirement, the taxpayer returned all of State Farm's property to it, but transferred no identifiable assets of his own, and he received a "termination payment." The insurance policies he had written were assigned to a successor agent. The taxpayer argued that he realized a capital gain on the transfer to State Farm of his insurance agency agreement [the "Corporate Agreement"]. The Ninth Circuit (Judge Bybee) denied the taxpayer capital gain treatment with respect to the termination payment. He transferred no assets that owned.

A precondition to realizing a long-term capital gain is the ownership of a capital asset. Yet under the express terms of Trantina's Corporate Agreement with State Farm, Trantina simply had no property that could be sold or exchanged. ... To quote the district court, "[t]he suggestion that the Corporate Agreement is itself an asset, when it declares that all assets pertaining to Plaintiffs' insurance agency belong to State Farm, is paradoxical." Trantina, 381 F. Supp. 2d at 1106. It is likewise paradoxical to suggest that the Corporate Agreement was an asset when the agreement itself stated that it could not be sold or otherwise exchanged. ...

Instead, the better view of the termination payments is that they were made pursuant to, not in exchange for, the Corporate Agreement.

The entire termination payment was ordinary income. The facts and analysis were substantially similar to those in *Baker v. Commissioner*, 338 F.3d 789 (7th Cir. 2003).

3. Taxpayer could not prove he sold personal goodwill when the payment was characterized as being for a noncompete agreement. *Muskat v. United States*, 101 A.F.T.R.2d 2008-1606 (D. N.H. 4/2/08). The District Court denied taxpayer's claim for refund on the ground that \$1,000,000 paid to corporate CEO and 37% shareholder as payment under a non-competition agreement was in fact payment for personal goodwill. The taxpayer's age and lack of interest in competing were not enough to convince the court that the non-competition provision in the agreement was in effect a purchase of goodwill.

4. The Tax Court makes it a little bit more difficult to claim that it's shareholder goodwill, not corporate goodwill, that was sold. *Solomon v. Commissioner*, T.C. Memo. 2008-102 (4/16/08). A corporation (Solomon Colors), of which the taxpayers (father and son) were dominant shareholders, sold one of its lines of business to a competitor. In connection with the sale, the shareholder-employees entered into covenants not to compete. Conflicting provisions in the documentation of the transaction variously described certain payments received by the shareholders as consideration for their ownership interest in the customer list for the line of business and as consideration for their entering into covenants not to compete. The court (Judge Laro) rejected the IRS's argument that the corporation had distributed an undivided interest in the customer list to the shareholders as a dividend immediately prior to the sale, which would have resulted in corporate level gain under § 311(a) as well as dividend income – then taxable at ordinary income rates — to the shareholders. He also rejected the taxpayer's argument that, like in *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998), the payments were consideration for the sale of goodwill owned by the shareholders (which would have been taxed as capital gains). *Martin Ice Cream* was distinguished because the court found that the value of Solomon Colors was not attributable to the quality of service and customer relationships developed by the shareholders. Because the corporation's business was processing, manufacturing, and sale of a product, rather than the provision of services, it did not depend entirely on the goodwill of its employee-shareholders for its success. Furthermore, unlike in *Martin Ice Cream*, the shareholders in Solomon were not named as the sellers of any asset but were included in the sale in their individual capacities solely to effect the covenants not to compete. Finally, that the shareholders were not required to enter into employment or consulting agreements made it unlikely that the buyer was purchasing their personal goodwill. Accordingly, Judge Laro

found the payments to be entirely consideration for the shareholders' covenants not to compete.

5. 🎵“Well, there’s thirteen hundred and fifty two guitar pickers in Nashville.”🎵 T.D. 9379, Time and Manner for Electing Capital Asset Treatment for Certain Self-Created Musical Works, 73 F.R. 7464 (2/8/08); REG-153589-06, Time and Manner for Electing Capital Asset Treatment for Certain Self-Created Musical Works, 73 F.R. 7503 (2/8/08). Temp. Reg. § 1.1221-3T provides procedures regarding time and manner for making an election to treat the sale or exchange of a musical composition or copyright in a musical work created by the taxpayer (or received by the taxpayer from the work’s creator in a transferred basis transaction) as the sale or exchange of a capital asset pursuant to § 1221(b)(3). The election must be made on the tax return filed on or before the due date (including extensions) of the return for the taxable year of the sale or exchange. An election is revocable with the IRS’s consent.

6. You have to tell the creditor who holds pledged stock to sell the high-basis stock first. Rendall v. Commissioner, 535 F.3d 1221 (10th Cir. 8/5/08). The debtor taxpayer recognized gain upon a sale by a creditor of stock the taxpayer had pledged to secure the debt. The IRS properly applied the FIFO principle in Reg. § 1.1012-1(c)(2) to determine the taxpayer’s gain upon the sale by the creditor of only a portion of the stock the taxpayer had pledged to secure the debt, because no designation had been made as required to identify another block as the stock that was sold.

7. New rules for determining basis in securities. **Emergency Economic Stabilization Act of 2008** [Division B], Act § 403, amends § 1012 to create new rules for determining the basis of securities acquired after December 31, 2010. 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 from 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. **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 (stock acquired in a reorganization where basis can't be identified). 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. The applicable date for stocks is January 1, 2011, for stocks under the average basis method, January 1, 2012, and of any other security, January 1, 2013 or such later date as specified by the Treasury Department. 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.

8. Taxpayer took the position that he was exchanging appreciated stock for a private annuity contract, while the IRS asserted that he was instead simply exercising his puts. The IRS lost, but would have prevailed had proposed regulations applied. *Katz v. Commissioner*, T.C. Memo. 2008-269 (12/3/08). Taxpayer received publicly held UICI stock when his student-loan business was acquired. Thereafter, he engaged in an equity swap transaction with Merrill Lynch to hedge some of that stock by purchasing 200,000 common stock put options at \$23.09 per share and selling 200,000 common stock call options at \$26.93 per share. These options were European-style options which could be exercised only on 2/3/00. This had the effect of collaring the taxpayer's UICI stock value between those two share prices. Pursuant to an arrangement facilitated by Merrill Lynch on the morning of 2/3/00, taxpayer exchanged the equity swap [i.e., 200,000 shares of UICI stock and the put options] for a single lump-sum private variable annuity from a successful Canadian businessman's wholly-owned Bahamian corporation (SJA). Five days later, Merrill Lynch settled the sale of the UICI stock and (after some typical Merrill Lynchish fumbling around) deposited most of the \$4.6 million proceeds in SJA's account. The Tax Court (Judge Foley) held that pursuant to Rev. Rul. 69-74, 1969-1 C.B. 43, when a taxpayer exchanges appreciated property for a private annuity, the "gain should be reported ratably over the period of years measured by the annuitant's life expectancy and only from that portion of the annual proceeds which is includible in gross income by application of section 72."

- The Commissioner argued that the equity swap was exercised before the purchase of the private annuity, which would result in taxpayer being taxed immediately on the gain. Judge Foley held that stipulations entered into in this case negated the Commissioner's position that the substance of the transaction [i.e., realization of the gain before the purchase of the annuity] trumped the form of the transaction [i.e., transfer of the equity swap to SJA in exchange for the annuity].

- Note that the result set forth in Rev. Rul. 69-74 would be reversed when proposed regulations [which will treat taxpayers who exchange property for an annuity as if they had sold the property] become final. REG-141901-05, Exchanges of Property for an Annuity, 71 F.R. 61441 (10/18/06). The Treasury has published proposed regulations that provide a single set of rules for the taxation of an exchange of property for an annuity contract. Essentially, the proposed rules will treat the transaction as if the property was sold for cash equal to the value of the annuity contract [as determined under § 7520] and the proceeds were used to buy an annuity contract; however, taxpayers may continue to structure transactions as § 453(b) installment sales. These proposed regulations do not change existing Reg. § 1.1011-2 for charitable gift annuities, but will change prior law on exchanges of appreciated property for private annuities to the extent it permitted open transaction treatment or ratable recognition as the annuities were paid. The effective date is 10/18/06, with a delayed effective date of 4/18/07 for non-abusive transactions. These proposed regulations would bring the current treatment of exchanges of appreciated property for private annuities into line with the tax treatment of exchanges for commercial annuities. Before these regulations are applicable, the law generally postponed tax on the exchange based on the assumption that the value of a private annuity contract could not be determined for federal income tax purposes.

B. Interest

There were no significant developments regarding this topic during 2008.

C. Section 121

1. **Here's a little tax-based financial help for the CIA that's not hidden as a \$600 toilet seat.** The **Heroes Earnings Assistance and Relief Tax Act of 2008** modified the two-out-of-five years principal residence rule in § 121 in several respects. First, with respect to the § 121(d)(9) suspension of the five year period for CIA and NSA personnel who are moved to a new duty station, the requirement that the new duty station is outside the United States was removed. Second the provision was made permanent. New § 121(d)(12) extends the benefit of the suspension of the running of the five-year period to Peace Corps volunteers and to Peace Corps employees on "qualified official extended duty."

2. **Ouch, the Realtors® in vacation resort areas aren't going to like this new rule. Will the real estate lobby have enough clout to get it retroactively revoked?** The **Housing Assistance Tax Act of 2008** added

§ 121(b)(4), which provides that gain on the sale of a personal residence is not excluded from gross income to the extent the gain is allocated to periods of “nonqualified use” of the residence. In general, periods of nonqualified use include any periods in which the property is not used as the principal residence of the taxpayer or the taxpayer’s spouse or former spouse. There are exceptions: (1) use prior to 1/1/09 is not nonqualified use; (2) use after the last date that the taxpayer or the taxpayer’s spouse used the property as a principal residence is not nonqualified use; (3) use while the taxpayer or the taxpayer’s spouse is serving (for up to an aggregate period of ten years) on qualified official extended duty (as defined in § 121(d)(9) [military, CIA or NSA]) is not nonqualified use; (4) use during any other period of temporary absence (for up to an aggregate period of two years) is not nonqualified use, if the absence is due to change of employment, health conditions, or other unforeseen circumstances specified by regulations.

- The amount of gain not excluded by reason of § 121(b)(4) is determined by allocating gain to periods of nonqualified use based on the ratio of aggregate periods of nonqualified use to the total time the taxpayer owned the property. If any portion of a taxpayer’s gain on the sale of a principal residence is attributable to post-5/6/97 depreciation (and thus not eligible for exclusion under § 121 by reason of § 121(d)(6)), that gain is not taken into account in determining the allocation of gain to periods of nonqualified use.

- *Rental Property Example:* Suppose a taxpayer buys a property on January 1, 2009, for \$500,000, and uses it as a rental property for one year, claiming \$15,000 of depreciation deductions (reducing the property’s basis to \$485,000). On January 1, 2010, the taxpayer converts the property to his personal residence. On January 1, 2013, the taxpayer ceases to use the property as his personal residence. On January 1, 2014, the taxpayer sells the property for \$600,000. Pursuant to § 121(d)(6), the \$15,000 of gain attributable to the depreciation deductions is not excluded from gross income. The remaining \$100,000 of gain is excluded, except to the extent it is attributable to periods of nonqualified use. The first year of rental use is a period of nonqualified use, but the year after the taxpayer moves out is not. The one-year period of nonqualified use is twenty percent of the taxpayer’s five-year period of ownership, so twenty percent (\$20,000) of the \$100,000 is allocated to the period of nonqualified use and thus is not eligible for exclusion under § 121. The other \$80,000 is excluded from gross income.

- *Vacation Home Example:* In addition to denying nonrecognition to gain attributable to periods the residence was held for rental, § 121(b)(4) denies the exclusion for gains attributable to the period the residence was a secondary residence or vacation home. To illustrate, suppose a taxpayer again buys a property on January 1, 2009, for \$500,000, and uses it solely as a vacation home for 12 years. On January 1, 2021, the taxpayer converts the property to his principal residence. On January 1, 2024, the taxpayer sells the

property for \$800,000. The twelve years of vacation use is a period of nonqualified use that is eighty percent of the taxpayer's fifteen-year period of ownership, so eighty percent (\$240,000) of the \$300,000 is allocated to the period of nonqualified use and thus is not eligible for exclusion under § 121. The other \$60,000 is excluded from gross income.

D. Section 1031

1. Have you heard about how you can do § 1031 like-kind exchanges of vacation homes? Don't drink that Kool-Aid! And renting it out for a few weeks just before the exchange does not work. Moore v. Commissioner, T.C. Memo. 2007-134 (5/30/07). The taxpayer exchanged land with a mobile home, which the taxpayer used as a vacation residence, for another vacation property, and claimed the transaction qualified for nonrecognition under § 1031 because both vacation properties were acquired and held with the expectation that they would appreciate and thus were "investment" property. The court (Judge Halpern) held that the exchange did not qualify. The mere expectation that property will appreciate does not establish investment intent if the taxpayer uses the property as a residence. There was no evidence that taxpayer made either property available for rent or held either property primarily for sale at a profit.

a. The IRS provides a safe harbor for vacation home swappers, but it is a small – very small – crack in the wall denying § 1031 nonrecognition to exchanges of vacation homes. Rev. Proc. 2008-16, 2008-10 I.R.B. 547 (2/15/08). This revenue procedure provides safe-harbor guidance regarding whether a residential property that the taxpayer held or intends to hold for mixed uses, e.g., personal vacation use and rental / investment purposes qualifies as property held for productive use in a trade or business or for investment under § 1031. Under the revenue procedure, the relinquished property qualifies if: (1) the property was owned by the taxpayer for at least 24 months immediately before the exchange, and (2) within that period, in each of the two 12-month periods immediately preceding the exchange, (a) the taxpayer rented the property to another person or persons at a fair rental for 14 days or more, and (b) the taxpayer's personal use of the property did not exceed the greater of 14 days or 10 percent of the number of days during each 12-month period that the dwelling unit was rented at a fair rental. (For this purpose, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day) and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day).) The replacement property qualifies if (1) the property is owned by the taxpayer for at least 24 months immediately after the exchange, and within that period, in each of the two 12-month periods

immediately after the exchange (a) the taxpayer rents the property to another person or persons at a fair rental for 14 days or more, and (b) the taxpayer's personal use of the property does not exceed the greater of 14 days or 10 percent of the number of days during each 12-month period that the property is rented at a fair rental. (For this purpose, the first 12-month period immediately after the exchange begins on the day after the exchange takes place and the second 12-month period begins on the day after the first 12-month period ends.) Personal use of a dwelling unit occurs on any day on which a taxpayer is deemed to have used the dwelling unit for personal purposes under § 280A(d)(2) (taking into account § 280A(d)(3) but not § 280A(d)(4)).

2. Clarifying the treatment of exchange accommodation loans. T.D. 9413, Escrow Accounts, Trusts, and Other Funds Used During Deferred Exchanges of Like-Kind Property, 73 F.R. 39614 (7/10/08). The Treasury promulgated final regulations under § 468B providing rules regarding the taxation of income earned on escrow accounts, trusts, and other funds used during deferred like-kind exchanges of property and under § 7872 regarding below-market loans to facilitators of like-kind exchanges. The regulations affect taxpayers that engage in deferred like-kind exchanges and escrow holders, trustees, qualified intermediaries, and others that hold funds during deferred like-kind exchanges. Exchange funds generally are treated as loaned by a taxpayer to the exchange facilitator, and the facilitator takes into account all items of income, deduction, and credit with respect to the funds. There is an exception if the agreement provides that earnings from the exchange funds are payable to the taxpayer. Special rules apply when an intermediary commingles exchange funds with other funds. A loan to an exchange facilitator is treated as a compensation-related demand loan under § 7872(c)(1)(B). The regulations generally are effective 10/08/08.

3. We didn't realize that the mutual ditch, reservoir, or irrigation company lobby had this kind of clout! Section 1031(i), added by the **Heartland, Habitat, Harvest, and Horticulture Act of 2008**, provides that the general disqualification under §1031(a)(2) of exchanges of stock does not apply with respect to certain shares in mutual ditch, reservoir, or irrigation companies.

4. Is it a reverse like-like exchange? Is it a deferred like-kind exchange? It's both! ILM 200836024 (5/12/08). The IRS Chief Counsel's office concluded that a taxpayer may engage in a "reverse" like-kind exchange under Rev. Proc. 2000-37, 2002-2 C.B. 308, and a deferred forward like-kind exchange described in Reg. § 1.1031(k)-1 using the same relinquished property in both exchanges. This is useful where the surrendered property is more valuable than either replacement property.

E. Section 1033

There were no significant developments regarding this topic during 2008.

F. Section 1035

1. Rev. Proc. 2008-24, 2008-13 I.R.B. 684 (3/18/08) The direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract, regardless of whether the two annuity contracts are issued by the same or different companies, is a tax-free exchange under § 1035 if either (a) no amounts are withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange (the date of the transfer); or (b) the taxpayer demonstrates that one of the conditions described by § 72(q)(2)(A), (B), (C), (E), (F), (G), (H) or (J), or any similar life event (such as divorce or loss of employment), occurred between the date of the transfer, and the date of the withdrawal or surrender. A transfer that is not treated as a tax-free exchange under § 1035 will be treated as a distribution, taxable under § 72(e), followed by a payment for the second contract.

G. Miscellaneous

1. **Tax protection for lenders to over-exuberant short-sellers.** Rev. Proc. 2008-63, 2008-42 I.R.B. 946 (9/26/08). Section 1058 provides nonrecognition to a person whose stock or securities is lent to another person to effect a short sale of that stock or securities. Technically, the transaction is a transfer of stock or securities in exchange for a contractual right to receive back identical stock or securities, together with any dividends, interest, or other payments receivable with respect to the stock or securities during the period between the initial transfer and the transfer back or replacement securities, which otherwise is a realization and recognition event. This revenue procedure provides that if a securities loan under § 1058 is terminated because of the bankruptcy of the borrower or an affiliate and the lender applies the collateral to the purchase of identical securities as soon as is commercially practicable (but in no event more than 30 days following the default), the IRS will treat the purchase as an exchange to which § 1058(a) applies.

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. **The cafeteria line is better for a military reservist who is called to active duty.** Section 125(h), added by the **Heroes Earnings Assistance and Relief Tax Act of 2008**, provides an exception to the cafeteria plan requirement of forfeiture of unused benefits at the year's end for a "qualified reservist distribution." A cafeteria plan or a health flexible spending arrangement (FSA) is not disqualified if it permits a distribution to a participant of some or all of his FSA balance if the participant is a military reservist who is called to active duty for a period of at least 180 days (or for an indefinite period).

2. **Employer housing in Alice Springs, Australia doesn't qualify for exclusion from gross income.** Middleton v. Commissioner, T.C. Memo. 2008-150 (6/11/08). The taxpayer was employed by TRW, Inc. to work at the Joint Defense Space Research Facility/Joint Defense Space Communication System (joint defense facility), located at the Pine Gap Air Force base near Alice Springs. As a condition of employment the taxpayer was required to live in employer provided housing in Alice Springs. The housing was in a residential neighborhood. No work was performed for TRW in the housing. Following its prior decision on similar facts in Hargrove v. Commissioner, T.C. Memo. 2006-159, the Tax Court (Judge Chiechi) held that the value of the housing is not eligible for exclusion from gross income under § 119. The court also rejected the taxpayer's claim that the housing was an excludible allowance under § 912, which excludes foreign area allowances provided to certain civilian officers and employees of the U.S. government.

3. **Some transit systems need additional time to modify their technology to "get smart."** Notice 2008-74, 2008-38 I.R.B. 718 (9/3/08). The IRS has delayed the effective date of Revenue Ruling 2006-57, 2006-2 C.B. 911, which provides guidance to employers on the use of smartcards, debit or credit cards, or other electronic media to provide qualified transportation fringes under §§ 132(a)(5) and 132(f), from 1/1/09 (See Notice 2007-76, 2007-40 I.R.B. 735) until 1/1/10. "Nevertheless, employers and employees may rely on Revenue Ruling 2006-57 with respect to transactions occurring prior to January 1, 2010."

4. **Six more months to try to get away with buying beer and cigs at the pharmacy with health FSA and HRA debit cards.** Notice 2008-104, 2008-51 I.R.B. 1298 (12/5/08). Notice 2007-2, 2007-1 C.B. 254, provided that after 12/31/08, health FSA and HRA debit cards could not be used at stores with the Drug Stores and Pharmacies merchant category code unless: (1) the store participates in the inventory information approval system in Notice

2006-69, 2006-2 C.B. 107, or (2) 90 percent of the individual store's gross receipts during the prior taxable year were from items that qualify as expenses for medical care under § 213(d) (including nonprescription medications as described in Rev. Rul. 2003-102, 2003-2 C.B. 559). This notice extends the deadline in Notice 2007-2 by six months. After 6/30/09, health FSA and HRA debit cards may not be used at stores with the Drug Stores and Pharmacies merchant category code unless the requirements are satisfied.

5. Qualifying for disability insurance is not dispositive in determining whether an individual is disabled for purposes of the 10-percent additional tax under § 72(t). *Kowsh v. Commissioner*, T.C. Memo. 2008-204 (8/28/08). The taxpayer took early distributions from a qualified retirement account and did not file a tax return. He did not have an easy life in the period leading up to the distributions. His wife died from cancer at age 53 in June 2001, leaving him to care for their two teenage children and her aged mother. He worked at Deutsche Bank near the World Trade Center and lost a number of friends and neighbors in the 9/11 attacks, including several friends who had attended his wife's funeral. By February 2002, his depression, and sleep apnea that caused him to have narcoleptic episodes, left him unable to work. Although the taxpayer received both short-term and long-term disability payments from a disability insurance policy with a private insurer, his doctor was unwilling to provide any certification that he was disabled, and at trial he provided no evidence that he applied for or received Social Security disability benefits. In addition, to finding him liable for the deficiency, interest, and failure to file and failure to pay penalties, he was held to be liable for the § 72(t) 10-percent additional tax for a premature distribution.

6. Qualified transportation includes bicycles. **Emergency Economic Stabilization Act of 2008** [Division B], Act § 211, adds to the qualified transportation fringe benefit excluded from income under § 132(f), a qualified bicycle commuting benefit. The provision excludes from income an employer reimbursement during the 15 month period beginning on the first day of the taxable year of up to \$20 per month of bicycle commuting for the purchase, improvements, repair and storage of a bicycle. A qualified bicycle commuting month is any month during which an employee regularly uses the bicycle for a substantial portion of travel between the employee's residence and work place and does not receive the benefit of any other qualified transportation fringe benefit. The bicycle benefit is not subject to the cash alternative escape from constructive receipt of § 132(f)(4).

B. Qualified Deferred Compensation Plans

There were no significant developments regarding this topic during 2008.

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

1. Section 409A added a new layer of rules for nonqualified deferred compensation. Section 885 of the **American Jobs Creation Act of 2004** added new § 409A, which modifies the taxation of nonqualified deferred compensation plans for amounts deferred after 2004. Section 409A has changed the tax law governing nonqualified deferred compensation by making it more difficult to avoid current inclusion in gross income of unfunded deferred compensation. Nevertheless, § 409A has not completely supplanted prior law. The fundamental principles of prior law continue in force but have been modified in certain respects.

a. Did you know that § 409A will apply for the 2008-2009 school year to teachers who elect to receive their salaries over a 12-month period instead of being paid only during the nine-month school year? Remember, this results from an anti-Enron provision in the 2004 Act. IRS [or, should it be Congress], give us a break! IR-2007-142 (8/7/07). School districts that offer annualization elections to teachers may have to make some changes in their procedures in the future, but the IRS announced that the new deferred compensation rules will not be applied to annualization elections for school years beginning before 1/1/08.

(1) Notice 2008-62, 2008-29 I.R.B. 130 (7/1/08). The IRS has announced its intent to propose regulations under § 457(f), which would exclude from coverage under §§ 457(f) and 409A of most arrangements involving public school employees who provide services during a 9- or 10-month school year and elect to be paid ratably over 12 months.

b. Notice 2008-113, 2008-51 I.R.B. 1305 (12/22/08) This Notice provides procedures to obtain relief from the full application of the income inclusion and additional taxes requirements of § 409A with respect to certain operational failures to comply with the requirements of § 409A.

2. Emergency Economic Stabilization Act of 2008 [Division C], Act § 504(c), provides that up to \$100,000 of amounts received by

a taxpayer engaged in the fishing business from the settlement of Exxon Valdez litigation can be contributed to retirement accounts in the year of receipt.

D. Individual Retirement Accounts

1. Penalty-free premature IRA distributions for active duty reservists. The **Heroes Earnings Assistance and Relief Tax Act of 2008** made permanent § 72(t)(2)(G), which, exempts from the 10 percent penalty tax for premature IRA distributions certain distributions to reservists called to active duty for at least 179 days. This exemption originally was scheduled to expire after 2007.

2. Limited unlimited contributions of military death benefits to Roth IRAs for survivors of reservists. The **Heroes Earnings Assistance and Relief Tax Act of 2008** amended § 408A(e) to permit an individual who receives a military death gratuity payment (excluded from gross income by § 134) or a Servicemembers' Group Life Insurance payment (excluded from gross income by § 101) to contribute the payment to a Roth IRA without regard to the otherwise applicable annual contribution limit and the income phase-out of the contribution limit.

3. Congress encourages retirees to drain their ravaged IRAs to benefit charities. The **Emergency Economic Stabilization Act of 2008** extended through 2009 Code § 408(d)(8), which permits tax-free distributions up to \$100,000 directly to charities that are publicly supported under § 509(a)(1) and (2) (but not § 509(a)(3)) from IRAs owned by individuals over 70½ years of age. These direct distributions to charities would be applied towards satisfying the § 401(a)(9) required minimum distribution amounts.

4. 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.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

There were no significant developments regarding this topic during 2008.

B. Miscellaneous Income

1. Forgiven accrued but unpaid interest on a consumer loan is COD income. Hahn v. Commissioner, T.C. Memo. 2007-75 (4/2/07). The Tax Court (Judge Wells) held that discharge of indebtedness income can be realized under the *Kirby Lumber Co.* “freeing of assets” rationale even though the debtor did not receive any cash or other property when he incurred the liability. When a creditor writes off accrued but unpaid interest owed by a cash method debtor, discharge of indebtedness income is realized, unless the interest would have been deductible if it had been paid and thus excludable under § 108(e)(2), because “[t]he right to use money represents a valuable property interest.” Taxpayer’s motion for summary judgment was denied because whether the interest expenses incurred in a horse breeding activity was deductible as a trade or business expense was a question of fact on which a trial was necessary.

a. More bad tax news for over-burdened consumer credit card debtors who beat the bank. They don’t beat the IRS! Payne v. Commissioner, T.C. Memo. 2008-66 (3/18/08). Compromise of credit card debt, including interest, incurred for personal living expenses results in realization of COD income for a cash method taxpayer. Section 108(e)(5) is inapplicable where the only relationship between the debtor and creditor is the debtor-creditor relationship and there was no property sale and purchase giving rise to the debt.

2. Congress provides tax relief for sub-prime mortgage borrowers. The **Mortgage Forgiveness Debt Relief Act of 2007** added new § 108(a)(1)(E), which excludes from gross income the discharge of “qualified principal residence indebtedness” (QPRI) that takes place on or after 1/1/07 and before 1/1/10. The provision is, of course, a legislative response to the subprime mortgage loan crisis. QPRI is defined as acquisition indebtedness, a loan on a taxpayer’s principal residence, as defined in § 163(h)(3)(B), except that for purposes of § 108(a)(1)(E) the ceilings are \$2,000,000 (for married couples filing joint returns) and \$1,000,000 (for other taxpayers). QPRI does not include (1) indebtedness on a home that is not the taxpayer’s principal residence, or (2) home equity indebtedness. The exclusion is not available if the discharge is not on account of either (1) a decline in the value of the home or (2) the financial condition of the taxpayer. The taxpayer’s basis in the principal residence must be reduced by the amount excluded under § 108(a)(1)(E). If only a portion of the cancelled debt is QPRI, the exclusion applies only to the extent the amount discharged exceeds the non-QPRI portion of the loan. If a taxpayer qualifies for both the QPRI exclusion and the insolvency exclusion of § 108(a)(1)(B), the QPRI exclusion applies unless the taxpayer elects the application of the insolvency exclusion.

a. Anticipating the tax consequences of the next wave of ARMs and teaser-rate home mortgages that reset interest rates. The **Emergency Economic Stabilization Act of 2008** extended § 108(a)(1)(E), excluding from gross income discharge of COD that is qualified principal residence indebtedness (QPRI) through December 31, 2012. The provision, which was added in the Mortgage Forgiveness Debt Act of 2007, had been scheduled to expire after December 31, 2009.

3. Ouch! Sanford v. Commissioner, T.C. Memo. 2008-158 (6/23/08). Damages received as a result of an EEOC proceeding based on claims of work-related sexual harassment were not excluded under § 104(a)(2). The damage award was not on account of personal physical injuries or sickness.

4. Section 134(b)(6), added by the **Heroes Earnings Assistance and Relief Tax Act of 2008**, provides that an excludable qualified military benefit includes “any bonus payment by a State or political subdivision thereof to any member or former member of the uniformed services of the United States or any dependent of such member only by reason of such member’s service in [a] combat zone.”

5. Police arrest procedures did not result in “physical injury.” Stadnyk v. Commissioner, T.C. Memo. 2008-289 (12/22/08). The Tax Court (Judge Goeke) held that damages received on account of false imprisonment were not excludable under § 104(a)(2), even though the taxpayer was detained, handcuffed and searched, because she suffered no physical harm. The damages received in the settlement compensated the taxpayer for “the ordeal ... suffered as a result of her arrest, detention, and indictment” as the result of her bank erroneously stamping a check “NSF” when it had been stopped for “dissatisfied purchase.” The damages were “stated in terms of recovery for nonphysical personal injuries: Emotional distress, mortification, humiliation, mental anguish, and damage to reputation.” Judge Goeke also rejected summarily the taxpayer’s claim that damages received for personal injuries are not gross income within the meaning of § 61(a) and that “section 104(a)(2) conflicts with section 61(a) and violates the Sixteenth Amendment to the extent that it taxes compensatory damages received for personal injuries.”

• The court did not impose taxpayer penalties because taxpayers had received “disinterested advice” that the damages were not includable in income. The advice came from taxpayer’s lawyer, the bank’s lawyer and the mediator who negotiated the settlement. In holding a § 6662 penalty inappropriate, Judge Goeke stated,

Petitioners received unsolicited advice from three separate and independent individuals that the settlement would not be taxed. At least two of those individuals were disinterested parties with

no relationship with petitioners. This advice confirmed petitioners' previous understanding of the taxation of settlement awards. Although none of those individuals had specialized knowledge in tax law, they were experienced in personal injury lawsuits and settlements. Petitioners acted reasonably and in good faith when following their advice and preparing their own return as they have done for over 40 years.

C. Profit-Seeking Individual Deductions

1. **When will trust investment advisory fees get up off the § 67 floor?** Rudkin Testamentary Trust v. Commissioner, 124 T.C. 304 (6/27/05) (reviewed, 18-0), *aff'd*, 467 F.3d 149 (2d Cir. 10/18/06) (2-0), *aff'd sub nom. Knight v. Commissioner*, 128 S. Ct. 782 (1/16/08). The Tax Court (Judge Wherry) held that amounts paid for investment management advice by trusts set up by a family involved in the founding of the Pepperidge Farm food products company (which was sold to Campbell Soup Company in the 1960s) are not subject to the § 67(e) exception to the § 67(a) floor of 2 percent of AGI (which limits the deductibility of employee business expenses and miscellaneous itemized deductions to amounts exceeding that floor). In reaching this result, the court determined that these expenses did not qualify for the exception in § 67(e)(1), under which costs paid or incurred in connection with the administration of a trust that wouldn't have been incurred if the property weren't held in the trust are allowed as deductions in arriving at adjusted gross income. The Tax Court explained that the statutory text of § 67(e)(1) creates an exception allowing for deduction of trust expenditures without regard to the 2 percent floor where two requirements are satisfied: (1) the costs are paid or incurred in connection with administration of the trust and (2) the costs would not have been incurred if the property were not held in trust.

- **The Tax Court previously held that a trust's investment advice costs were subject to the 2 percent floor.** *O'Neill Trust v. Commissioner*, 98 T.C. 227 (1992). However, the Sixth Circuit reversed the Tax Court and held that investment counseling fees paid by the trust to aid the trustees in discharging their fiduciary duty to the trust beneficiaries were not subject to the 2 percent floor under the § 67(e)(1) exception. (994 F.2d 302 (6th Cir. 1993)). Subsequently, the Sixth Circuit approach was rejected by the IRS (*nonacq*, 1994-2 C.B. 1); the Federal Circuit (*Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001)); and the Fourth Circuit (*Scott v. United States*, 328 F.3d 132 (4th Cir. 2003)). In reaching their decisions, the Federal and Fourth Circuits emphasized the importance of not interpreting the statute so as to render superfluous any portion of it. They said that if courts were to hold that a trust's investment-advice fees were fully deductible, the second requirement of § 67(e)(1)

would have been rendered meaningless. The Sixth Circuit's rationale was stated as follows:

The Tax Court reasoned that “[i]ndividual investors routinely incur costs for investment advice as an integral part of their investment activities.” Nevertheless, they are not required to consult advisors and suffer no penalties or potential liability if they act negligently for themselves.

Therefore, fiduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust. (994 F.2d at 304).

a. The Second Circuit affirmed Rudkin Trust and gave a third interpretation of “an unambiguous statute.” 467 F.3d 149 (2d Cir. 10/18/06) (2-0). Judge Sotomayor held that § 67(e) was unambiguous and permitted a full deduction only for those types of trust expenses that an individual could not possibly incur.

b. The Treasury tried to preempt the Supreme Court with proposed regulations. REG-128224-06, Section 67 Limitations on Estates or Trusts, 72 F.R. 41243 (7/27/07). Prop. Reg. § 1.67-4 would provide that costs incurred by estates or non-grantor trusts that are unique to an estate or trust are not subject to the 2 percent floor of § 67. Under Prop. Reg. § 1.67-4(b), a cost is unique to an estate or trust if an individual could not have incurred that cost in connection with property not held in an estate or trust. Any miscellaneous itemized deductions that do not meet this standard are subject to the 2 percent floor. Prop. Reg. § 1.67-4(c) prevents circumvention of the limitation by “bundling” investment advisory fees and trustees’ fees into a single fee. If an estate or non-grantor trust pays a single fee that includes both costs that are unique to estates and trusts and costs that are not, the fee must be allocated between the two types of costs. The regulations provide a non-exclusive list of services for which the cost is either exempt from or subject to the 2 percent floor. The regulations will apply to payments made after the date final regulations are published in Federal Register.

- Under the reasoning of *National Cable & Telecommunications Ass’n v. Brand X Internet Services*, 545 U.S. 967 (2005), a court’s interpretation of a statute trumps an agency’s subsequent regulation “under the doctrine of *stare decisis* only if the prior court holding ‘determined a statute’s clear meaning.’ ... [A] court’s prior interpretation of a statute ... overrides an agency’s interpretation only if the relevant court decision held the statute unambiguous.” Otherwise the validity of the regulation is determined under

Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).

c. The Supreme Court issued the writ of certiorari to resolve the conflict between the Second and Sixth Circuits, but decided to follow the Federal and Fourth Circuits. The Supreme Court affirmed Rudkin Trust sub nom. Knight v. Commissioner, 128 S. Ct. 782 (1/16/08) (9-0). The Court affirmed the Second Circuit in an opinion written by Chief Justice Roberts but rejected the Second Circuit test in favour of the test of whether individuals commonly employ investment advisors set forth in *Mellon Bank* and *Scott*. This holding leaves the final resolution to a factual inquiry and the results could differ in different cases.

d. Meanwhile, bundled fiduciary fees may be deducted in full. Notice 2008-32, 2008-11 I.R.B. 593 (2/27/08). This Notice provides interim guidance on the treatment of investment advisory costs subject to the 2 percent floor of § 67 that are bundled as part of a single fiduciary fee for years beginning before 1/1/08. It provides that the taxpayer may deduct the full amount of the bundled fiduciary fee without regard to the 2 percent floor.

e. Ditto for the year 2008, except for payments by the fiduciary to third parties for expenses subject to the 2-percent floor. Notice 2008-116, 2008-52 I.R.B. 1372 (12/29/08). This notice modifies and supersedes Notice 2008-32, 2008-11 I.R.B. 593, extending its relief. Taxpayers are not required to determine the portion of a bundled fiduciary fee that is subject to the § 67 2-percent floor for any taxable year beginning before January 1, 2009. The full amount of the bundled fiduciary fee is deductible; however, payments by the fiduciary to third parties for expenses subject to the 2-percent floor are readily identifiable and must be treated separately from the otherwise bundled fiduciary fee.

2. He lost in the casinos but won his bet that he'd beat the IRS in Tax Court with the help of an expert witness named Mark Nicely. Gagliardi v. Commissioner, T.C. Memo. 2008-10 (1/24/08). Gagliardi won the California lottery and was receiving annual payments of approximately \$666,500. After winning the lottery, Gagliardi spent most of his waking hours at casinos, averaging approximately 10 hours per day playing the slot machines. He was a compulsive gambler, who placed at a minimum four or five bets per minute, averaging \$9 per bet. For the years in question he reported wagering losses of up to \$500,000 more than his wagering winnings and deducted the excess losses against his lottery winnings. The IRS disallowed a substantial portion of his claimed deductions, but the Tax Court (Judge Vasquez) held for the taxpayer, finding that the evidence supported the conclusion that Gagliardi's

actual losses exceeded the amount he claimed. Although Gagliardi did not maintain a contemporaneous wagering log, he retained all his receipts and records related to his gambling winnings and losses, including but not limited to ATM receipts, copies of checks cashed at the casinos, bank and credit card statements reflecting withdrawals made at the casinos, and Forms W-2G he received from the casinos, all of which he provided to his tax return preparer. In addition, taxpayer's expert witness Mark Nicely, a casino gaming industry and math expert with an expertise in math and slot machines [who was the head of a department at a slot machine manufacturer responsible for the development of games and gaming math, testing equipment, working with regulators, and training employees on how to design games for casinos], credibly testified that the application of a formula to calculate the likelihood and extent of Gagliardi's gambling losses at slot machines during the years in issue indicated that Gagliardi's total net losses from slot machine play for the years at issue was greater than the total net gambling losses from slot machine play he claimed for the tax years at issue.

3. Those union dues helped the taxpayer prove his case. Balla v. Commissioner, T.C. Memo. 2008-18 (1/31/08). The taxpayer was a merchant seaman who incurred mileage, meals and incidental expenses incurred in connection with attending firefighting school, the tuition for which was paid by his union. Judge Cohen held that even though the taxpayer's employer did not require him to attend the school, he had adequately substantiated the business purpose of his travel expenses because (1) firefighting was related to his employment as a merchant sailor and engineer, and (2) payment of tuition for the course by his union supported characterization of the related travel expenses as ordinary business expenses. The taxpayer was allowed to deduct as unreimbursed employee business expenses the mileage, meals, and incidental expenses incurred in connection with attending the firefighting school, even though he never sought reimbursement for the mileage, meals and incidental expenses.

4. Section 212 deductions for a day trading seminar disallowed even though there wasn't any fun in the sun. Jones v. Commissioner, 131 T.C. No. 3 (7/28/08). The taxpayer was a day trader who incurred approximately \$6,000 of expenses to attend a 5-day one-on-one course called DayTradingCourse.com that consisted of 37 hours of instruction. He stayed in a modest hotel and did not participate in any recreational activities. The seminar was held in Cartersville, Georgia, approximately 750 miles from the taxpayer's home in Florida. The taxpayer conceded that he was not in the trade or business of day trading, but claimed the deduction under § 212. Judge Vasquez upheld the IRS's disallowance of the deduction under § 274(h)(7), which disallows any deduction under § 212 for "expenses allocable to a

convention, seminar, or similar meeting, including the costs of registration fees, travel, meals, and lodging, even if the personal benefits of the trip are secondary to the investment benefits.” Judge Vasquez cited Merriam-Webster’s Collegiate Dictionary (9th ed. 1985), which defines a seminar as a “meeting for giving and discussing information,” and concluded that the course was a seminar, or a similar meeting within the scope of § 274(h)(7).

5. Hammering employees whose deferred compensation comes from offshore, i.e., hedge fund managers. The **Emergency Economic Stabilization Act of 2008** added new Code § 457A, which provides that any nonqualified deferred compensation (as defined in § 409A) under a plan of a nonqualified entity must be included in gross income in the first year in which there is no substantial risk of forfeiture. Nonqualified entities include (1) a foreign corporation unless substantially all of its income is either: (a) effectively connected with the conduct of a U.S. trade or business, or (b) subject to a comprehensive foreign income tax, and (2) any partnership unless substantially all of its income is allocated to persons other than: (a) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, or (b) tax exempt organizations. If the amount of the deferred compensation is not determinable when the right to it vests, the deferred compensation will be included when it becomes determinable, but an interest charge at the deficiency rate plus one percent will be added with respect to the period between the year when the compensation was deferred, or vested if later, and the year it becomes includible. To the extent provided in regulations if compensation is determined solely by reference to the amount of gain recognized on the disposition of an investment asset, the compensation will be treated as subject to a substantial risk of forfeiture until the disposition.

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

1. Maybe the taxpayer/IRS auditor should have hired Michael Vick as a business consultant to bolster his case. How relevant should it be that he never named the dogs? Whitecavage v. Commissioner, T.C. Memo. 2008-203 (8/27/08). The taxpayer, who was a full-time IRS auditor, raised and raced greyhounds. He did not spend time with the dogs except for feeding and cleaning up after them mornings and evenings. He kept the pups at his kennel until they were a little over a year old and then sent them to racing kennels. When they were done racing, the dogs were either sent for adoption or euthanized. The taxpayer had no employees or business advisor and consistently lost money. The Tax Court (Judge Thornton) held that the taxpayer’s losses were limited by § 183.

Certain aspects of petitioner's activity, such as feeding, grooming, and cleaning up after the greyhounds, generally might not be considered pleasurable, even though they are not so different from the duties of any pet owner. Ultimately, however, it seems to us that petitioner's activity of breeding greyhounds for racing, although conducted by petitioner in a seemingly inhumane manner (for many years keeping numerous dogs confined in crates in his Yuma, Arizona, garage, while he worked a full-time job at the IRS, sending the pups off to "training" that almost a fourth of them would not survive, and ultimately casting off most of the others for possible adoption or destruction) involved recreational elements as are common to other forms of recreational gambling, with those elements being enhanced by such sense of sport or gamesmanship as might derive from having one's own dogs in the races. This factor weighs against petitioner.

E. Deductions and Credits for Personal Expenses

1. Congress encourages more sub-prime mortgage lending. The **Tax Relief and Health Care Act of 2006** added new § 163(h)(3)(E), providing an itemized deduction for the cost of mortgage insurance on a qualified personal residence. The deduction is phased-out ratably by 10 percent for each \$1,000 by which the taxpayer's AGI exceeds \$100,000. Thus, the deduction is unavailable for a taxpayer with an AGI in excess of \$110,000. As originally enacted, the provision was effective for amounts paid or accrued (and applicable to the period) after 12/31/06 and before 1/1/08 for mortgage contracts issued after 12/31/06.

a. And Congress extends the provision encouraging sub-prime mortgage borrowing. The **Mortgage Forgiveness Debt Relief Act of 2007** extended the 12/31/07 termination date for § 163(h)(3)(E) to 12/31/10.

2. The Heroes Earnings Assistance and Relief Tax Act of 2008 made permanent § 32(c)(2)(B)(vi), which permits a taxpayer to elect to treat combat pay excluded from gross income under § 112 as earned income for EITC purposes. The provision had been scheduled to expire after 2007.

3. The deduction for state and local property taxes is only semi-itemized for 2008. We bet this one becomes a permanent fixture in the annual extenders bill until it becomes permanent. Section 63(c)(1)(C),

added by the **Housing Assistance Tax Act of 2008**, adds the “real property tax deduction” as a component of the standard deduction, effective only for taxable years beginning in 2008. The amount of the deduction is the lesser of (1) the amount the taxpayer could claim as a state and local real property tax deduction under § 164(a)(1) if he itemized his deductions, or (2) \$500 (\$1,000 in the case of a joint return).

a. Congress extends another microscopic and complicating tax deduction. The **Emergency Economic Stabilization Act of 2008** extended through 2009 the Code § 63(c)(1)(C) above-the-line deduction for a limited amount of real property taxes. The amount of the deduction is the lesser of (1) the amount the taxpayer could claim as a state and local real property tax deduction under § 164(a)(1) if he itemized deductions, or (2) \$500 (\$1,000 in the case of a joint return). The provision originally was effective only for 2008.

4. This “relief” provision is an interest free loan from the government unless your tax bracket increased. Section 3082 of the **Housing Assistance Tax Act of 2008** (an uncodified provision) allows a taxpayer who claimed a casualty loss deduction with respect to his personal residence resulting from Hurricane Katrina, Hurricane Rita, or Hurricane Wilma, and who in a later year receives a federal grant as reimbursement for the loss, to elect to file an amended return for the earlier taxable year (eliminating the casualty loss deduction to the extent of the later reimbursement) in lieu of including the reimbursement in income in the later year.

5. Helping entry-level homebuyers invest in the bear housing market. Section 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.

6. Congress wants to encourage consumers — at least those in Texas and Florida and a few other states — to shop in these hard times. The **Emergency Economic Stabilization Act of 2008** extended through 2009 the § 164(b)(5) itemized deduction for state sales taxes (optionally in lieu of income taxes in those states that have both sales and income taxes).

7. Making children more affordable. The **Emergency Economic Stabilization Act of 2008** added Code § 24(d)(4), which provides that for 2008 (and only for 2008) the ceiling on the refundable child credit is 15 percent of the excess of earned income over \$8,500 rather than \$10,000 (indexed for post-2000 inflation). Because the 2008 inflation adjusted \$10,000 amount would have been \$12,050, this provision increases the by \$532.50 the refundable amount.

8. The Emergency Economic Stabilization Act of 2008

[Division B], the **Energy Improvement and Extension Act**, extends several credits and adds a few new twists.

- Section 205 adds a new credit, under § 30D, for qualified electric drive motor vehicles. The credit amount is \$2,500 plus \$417 for each kilowatt hour of traction battery capacity in excess of 4 kilowatt hours (the minimum required for obtaining the credit). The credit is limited to \$7,500 for vehicles weighing less than 10,000 pounds, \$10,000 for vehicles weighing between 10,000 and 14,000 pounds, \$12,500 for vehicles weighing between 14,000 and 26,000 pounds, and \$15,000 for those electric plug-in SUVs in excess of 26,000 pounds. The credit begins to phase out after the first 250,000 vehicles are sold.

- Section 302 extends the § 25C 10 percent credit (limited to \$500 in a lifetime) for nonbusiness energy saving property to property placed in service in 2009. The provision contains several changes to the definitions of qualified energy property.

9. There's no constitutional right to deduct the cost of sexless procreation by a healthy man. The expenses of obtaining eggs from anonymous egg donors, and of the gestational carriers in whom the eggs – after being fertilized with taxpayer's semen – were implanted, were not deductible. Magdalin v. Commissioner, T.C. Memo. 2008-293 (12/23/08). The court (Judge Wherry) held that the costs of taxpayer's fathering two children by use of two egg donors and two gestational carriers were not § 213 medical expenses because taxpayer was medically able to father children, and had previously fathered twins with his ex-wife, born through natural processes and without the use of in vitro fertilization. Because (1) there was no causal relationship between an underlying medical condition or defect – taxpayer's sperm count and motility were found to be within normal limits – and the taxpayer's expenses, and (2) the expenses at issue were not incurred for the purpose of affecting a structure or function of the taxpayer's body, the expenses were not "medical care" as defined in § 213(d). Judge Wherry rejected the taxpayer's argument that "it was his civil right to reproduce, that he should have the freedom to choose the method of reproduction, and that it is sex discrimination to allow women but not men to choose how they will reproduce."

- The court refused to address the question of whether the fees would have been deductible had taxpayer suffered from a medical condition, e.g., infertility, that left him unable to have children except by use of in vitro fertilization.

- In PLR 200318017 (1/9/03), the IRS ruled that a woman who was unable to conceive using her own eggs and received an implanted fertilized egg was entitled to deduct as medical expenses under § 213 her unreimbursed expenses for the egg donor fee, the agency

fee, the donor's medical and psychological testing, the insurance for post-procedure donor assistance, and the legal fees for preparation of the egg donor contract.

F. Divorce Tax Issues

1. Final regulations identify which divorced or separated parent can claim the dependency exemption. T.D. 9408, Dependent Child of Divorced or Separated Parents or Parents Who Live Apart, 73 F.R. 37797 (7/2/08). The Treasury has finalized proposed regulations [REG-149856-03, Dependent Child of Divorced or Separated Parents or Parents Who Live Apart, 72 F.R. 24192 (5/2/07)] interpreting § 152(e), as amended by the **2005 Act (GOZA)**, to provide that a child of parents who are divorced, separated, or living apart may be claimed as a qualifying child of the non-custodial parent if the child receives over one-half of his/her support from the parents, the child is in the custody of one or both parents during the calendar year, and the custodial parent signs a written declaration that the custodial parent will not claim the exemption (which must be attached to the non-custodial parent's return), or a pre-1985 instrument allocates the exemption and the non-custodial parent contributes at least \$600 for the support of the child during the year.

- Under Reg. §1.152-4:

(1) The custodial parent is the parent with whom the child spends the greatest number of nights during the taxable year. A child who is temporarily away is treated as spending the night with the parent with whom the child would have resided. If another person is entitled to custody for a night, the child is treated as spending the night with neither parent. If a child is temporarily absent from a parent's home for a night, the child is treated as residing with the parent with whom the child would have resided for the night, but if the child resides with neither parent for a night and it cannot be determined with which parent the child would have resided or if the child would not have resided with either parent for the night, the child is treated as not residing with either parent for that night. If because a parent works at night, a child resides for a greater number of days but not nights with that parent, that parent is treated as the custodial parent. On a school day, the child is treated as residing at the primary residence registered with the school.

(2) The required written declaration must contain an unconditional statement that the custodial parent will not claim the exemption for the specified year or years. A declaration is not unconditional if it conditions the custodial parent's release of the right to claim to the exemption on the noncustodial parent meeting a support obligation. The written declaration may be made on Form 8332, Release/Revocation of

Release of Claim to Exemption for Child by Custodial Parent, or a successor form designated by the IRS; any declaration not on the form designated by the IRS must conform to the substance of that form and must be a document executed for the sole purpose of serving as a written declaration under § 152(e)(2). The original document need not be attached to the tax return; a copy of the written declaration must be attached to the tax return for each year the noncustodial parent claims the exemption.

(3) The custodial parent may revoke a revocation by providing written notice to the non-custodial parent specifying the years of the revocation. A revocation will be effective in the first calendar year after the year in which the revoking parent provides notice to the other parent.

(4) Never-married parents who live apart are entitled to agree by written declaration to transfer the exemption to the non-custodial parent (following *King v. Commissioner*, 121 T.C. 245 (2003)).

a. A child who is not a dependent is a dependent for some purposes. Rev. Proc. 2008-48, 2008-36 I.R.B. 586 (8/18/08). If a child of parents who are divorced, legally separated, or living apart at all times for the last 6 months of the calendar year: (1) receives over one-half of the child's support from the parents, (2) is in the custody of one or both parents for more than one-half of the calendar year, and (3) is qualified as a qualifying child or qualifying relative of one of the parents, the child will be treated as a dependent of one or both parents for purposes of (1) the exclusions of § 105 for medical expense insurance reimbursements, (2) § 106 for employer provided health coverage, (3) the definition of covered employees under § 132(h)(2)(B) for purposes of certain excluded fringe benefits, (4) qualifying payments from Archer Medical Savings Accounts (§ 220(d)(2)), and (5) qualifying payments from Health Savings Accounts (§ 223(d)(2)), whether or not the custodial parent has released the claim for exemption with respect to the child under § 152(e)(2). (However, absent the filing of a release, only the custodial parent is entitled to claim a dependency exemption with respect to a child.)

b. Refining the definition of qualifying child and tightening (very modestly) eligibility for the child credit. The **Fostering Connections to Success and Increasing Adoptions Act**, § 501, amended the definition of a qualifying child to add requirements that a qualifying child must not have filed a joint return with a spouse (other than to claim a refund) [§ 152(c)(3)(A)] and must be younger than the claimant [§ 152(c)(1)(D)]. In addition, if the parents fail to claim their child as a dependent, another taxpayer must have a higher gross income than either of the parents in order to claim the child [§ 152(c)(4)(C)]. Finally, § 24(a) was amended to limit the child credit to

taxpayers eligible to claim the child as a dependent under § 151.

2. The IRS should be sanctioned for pursuing this case. If not, it sends the message that the IRS's lawyers can ignore easy to find unambiguous state law that determines the outcome of the case. Le v. Commissioner, T.C. Memo. 2008-183 (7/30/08). In a divorce proceeding, a Kansas court entered a temporary spousal maintenance order pursuant to which the taxpayer was required to pay his soon-to-be ex-wife \$12,000. The state court order specifically stated that “Said spousal maintenance shall be taxable income to [the soon-to-be ex-wife] and shall be deductible on [taxpayer’s] income tax return,” but it did not specifically provide the obligation to pay the lump sum (in satisfaction of past due temporary support) would be cancelled if the soon-to-be ex-wife died before the payment was made. The IRS claimed that the payment was not deductible as alimony because the obligation to make the payment did not terminate upon the death of the obligee. Judge Vasquez held for the taxpayer, finding that Kansas law provided that the obligation to make the payment would terminate upon the death of the soon-to-be ex-wife.

In Kansas “temporary maintenance ceases when the divorce action terminates”. In re Marriage of Vientos, 139 P.3d 152 (Kan. Ct. App. 2006). A divorce action is “purely personal and ends on the death of either spouse.” Wear v. Mizell, 946 P.2d 1363, 1367 (Kan. 1997). In cases where the payor spouse is in arrears on support payments but then later pays the amount in arrears, “the payment retains the characteristics of the original payments for which it is substituted”. Davis v. Commissioner, 41 T.C. 815, 820 (1964); see also Stroud v. Commissioner, T.C. Memo. 1993-317.

The \$12,000 of spousal support was temporary maintenance. Accordingly, under Kansas law the liability to make such payments would have ceased on either petitioner’s or Ms. Le’s death because the divorce proceeding would have automatically terminated, ending the operation of the temporary orders.

• We ask: For gosh sakes, couldn’t the Chief Counsel’s office have figured this out without a trial?

3. Only till death do the payments continue. Johanson v. Commissioner, 541 F.3d 973 (9th Cir. 9/3/08). Where state [California] law unambiguously provides for spousal support payments to terminate upon the death of a payee spouse, a payment may be found not to qualify as alimony if under state law a written agreement can waive that termination requirement and the agreement in question does so. If the agreement is ambiguous, extrinsic evidence is admissible to determine the intent of the parties. On the facts, the

payee spouse failed to prove that payments would not terminate upon her death, and the payments were thus alimony.

4. So what's this otherwise mundane reviewed case really about? *Mitchell v. Commissioner*, 131 T.C. No. 15 (12/15/08) (reviewed 13-2-0). In what at first blush appears to be a mundane case, the Tax Court in a reviewed opinion by Judge Goeke held that amounts paid to the taxpayer from her former spouse's military retirement pay, pursuant to a QDRO based on community property rights, were includible in the payee spouse's gross income.

- The real issue, which the majority ducked, but on which Judge Holmes wrote a comprehensive concurring opinion (with which Judge Halpern agreed) was whether the case should have been decided on the merits, as the majority so decided it, or whether the taxpayer ought to have been collaterally estopped as argued by the Commissioner. The taxpayer had previously litigated and lost the identical issue for an earlier year in an S case. Judge Holmes's exhaustive analysis concluded that collateral estoppel principles should attach to issues previously litigated in an S case if collateral estoppel would have attached if the earlier case had been a regular case.

G. Education

1. A tax subsidy for newly-minted public interest lawyers. Rev. Rul. 2008-34, 2008-28 I.R.B. 76 (6/20/08). Section 108(f) excludes from gross income cancellation of indebtedness income that would otherwise be realized when a student loan is canceled pursuant to its terms as a result of the former student working for a specified period of time in certain professions for one of a broad class of employers. This ruling held that a law school loan, that refinanced original student loans, made under a "Loan Repayment Assistance Program" (LRAP) was a "student loan" and satisfied the requirements of § 108(f). The specific facts dealt with an LRAP under which to qualify the law school graduate was required to work in a law-related public service position for, or under the direction of, a tax-exempt charitable organization or a governmental unit, including a position in (1) a public interest or community service organization, (2) a legal aid office or clinic, (3) a prosecutor's office, (4) a public defender's office, or (5) a state, local, or federal government office. The amount of the LRAP loan was based on the graduate's outstanding student loan debt and annual income. After the graduate worked for the required period in a qualifying position, the law school forgives all or part of the loan.

- Professor Ellen Aprill of Loyola, Los Angeles cautions that "because the tax-free status of loan forgiveness under § 108(f) pursuant to the College Cost Reduction and Access Act of 2007 may be available for some borrowers, uncertain for others, and unavailable for yet others,

supporters of this recent legislation have identified the need for and are seeking legislation extending § 108(f).”

- Is this a way to encourage law school graduates to go to work for the IRS?

2. Section 530(d)(9), added by the **Heroes Earnings Assistance and Relief Tax Act of 2008**, allows an individual who receives a military death gratuity payment (excluded from gross income by §134 or a Servicemembers’ Group Life Insurance payment (excluded from gross income by §101), to contribute the payment to a Coverdell Educational Savings Account without regard to the otherwise applicable annual contribution limit and the income phase-out of the contribution limit.

3. **Congress extends the [paltry] deduction for college tuition, and adds ridiculous complexity.** The **Emergency Economic Stabilization Act of 2008** extended through 2009 Code § 222, which allows an above-the-line deduction for up to \$4,000 of qualified tuition and expenses for higher education for a taxpayer with AGI of \$65,000 or less (\$130,000 or less for a joint return), or up to \$2,000 for a taxpayer with AGI greater than \$65,000 (\$130,000) but not greater than \$80,000 (\$160,000) through 2008. The provision, which was added in 2004 had been scheduled to expire after December 31, 2007. In addition, the Act amended § 222 to disallow the qualified tuition deduction to any taxpayer for 2008 and 2009 if in the absence of the alternative minimum tax the taxpayer would have a lower tax liability for that year if he elected the Hope or Lifetime Learning credit with respect to an eligible individual instead of the qualified tuition deduction.

- We have no idea how to explain this new limitation. We would need to plug the numbers into Turbo Tax and just believe the answer it spit out.

H. Alternative Minimum Tax

1. **Making the world safe from the AMT, one year at a time.** The **Tax Increase Prevention Act of 2007** provided another one-year “patch” for the AMT. The 2007 exemption amounts are \$44,350 for unmarried taxpayers and \$66,250 for married taxpayers filing joint returns, and \$33,125 for married taxpayers filing separately. The Act also extended to 2007 the special rule in §26(a)(2) allowing the otherwise nonrefundable personal credits to offset the AMT (after taking into account the foreign tax credit).

a. **Congress, save us from the AMT! Amen, again only for a year at a time.** The **Emergency Economic Stabilization Act**

of 2008 provided yet another one-year patch for the AMT.

- The exemption amount for 2008 is increased to \$46,200 for unmarried taxpayers and to \$69,950 for married taxpayers filing joint returns (\$34,975 for married taxpayers filing separately). (Because of the inflation adjustments in § 59(j) the lower ceiling on the AMT kiddie tax exemption amount for 2008 will be the sum of the child's earned income plus \$6,400.)

- The rule allowing nonrefundable credits (e.g., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, and the D.C. homebuyer's credit) to offset the AMT also was extended to 2008.

- The refundable credit rules also were modified. First, the refundable credit includes the § 53(f)(2) AMT credit for 2008 and 2009 of 50 percent of the aggregate amount of the interest and penalties paid by the taxpayer before October 3, 2008 as a result of failure to report AMT liability resulting from application of the § 56(b)(3) treatment of ISOs requiring taxation under § 83 for AMT purposes. Second, the \$5,000 minimum allowable credit was eliminated. Third, as amended, § 53(e) provides a refundable credit amount for a tax year in an amount (not in excess of the long-term unused minimum tax credit for the tax year) equal to the greater of (1) 50% of the long-term unused minimum tax credit for the tax year (instead of 20 percent under prior law), or (2) the AMT refundable credit amount (if any) for the taxpayer's preceding tax year (determined without regard to the increased AMT refundable credit amount allowed under § 53(f)(2)). [The change of 20% to 50% means that the long-term unused minimum tax credit can be claimed over a two-year period rather than a five-year period.] Fourth, the AGI phase-out was eliminated.

- New §53(f)(1) abates any underpayment of tax outstanding on October 3, 2008 that is attributable to the application of the § 56(b)(3), requiring taxation of ISOs under § 83 for AMT purposes, for any taxable year ending before January 1, 2008, as well as any interest or penalty with respect to such underpayment. Any outstanding AMT liability that has been abated under § 53(f)(1) cannot be taken into account in computing the AMT credit.

2. More instances of the AMT wandering from its original, i.e., 1969, roots; more preferences creep into the AMT. The **Housing Assistance Tax Act of 2008** amended § 57(a)(5)(C) to provide that tax-exempt interest on a bond issued after 7/30/08, is not a tax preference item if the bond is (1) an exempt facility bond issued as part of an issue at least 95 percent of the net proceeds of which are used to provide qualified residential rental projects, (2) a qualified mortgage bond, or (3) a qualified veterans'

mortgage bond. As amended by Act § 38(c)(4)(B) allows the low-income housing credit [§ 42] and the rehabilitation credit [§ 47] to be claimed against the AMT.

VI. CORPORATIONS

A. Entity and Formation

1. **Congress gave the IRS the power to overrule the statute and the IRS accepted the invitation.** T.D. 9397, Assumption of Liabilities, 73 F.R. 26321 (5/9/08). Section 358(h) requires that the basis of the stock received in a § 351 transaction be reduced (but not below the fair market value) by the amount of any § 357(c)(3) liability that was assumed by the corporation, but § 358(h)(3) provides that, except as provided in regulations, § 358(h) does not apply if, as part of the exchange (1) “the trade or business with which the liability is associated is transferred to the person assuming the liability,” or (2) “substantially all of the assets with which the liability is associated are transferred to the person assuming the liability.” Reg. § 1.358-5, replacing Temp. Reg. § 1.358-5T, narrows the statutory exception by providing that the exception for a transfer of “substantially all of the assets with which the liability is associated” to the corporation assuming the liability is inoperative. Thus, the exception in § 358(h)(3) actually applies if, and only if, the trade or business with which the liability is associated is transferred to the corporation assuming the debt, for example, the specific fact pattern in Rev. Rul. 95-74, 1995-2 C.B. 36. The exception in § 358(h)(3) does not apply to selective transfers of assets that may bear some relationship to the liability, but that do not represent the full scope of the trade or business with which the liability is associated.

B. Distributions and Redemptions

1. **We think the taxpayer should seek attorney’s fees after winning this one. The IRS’s constructive dividend claim was off the wall.** Beckley v. Commissioner, 130 T.C. No. 18 (6/30/08). The taxpayer’s wife made a loan to a corporation (CT) in which he was a 50 percent shareholder. CT used the borrowed funds to develop a working model of Web-based video conferencing software. Subsequently, CT however, had financial problems and was dissolved, and the working model was transferred to a new corporation (VDN) in which the taxpayer was a shareholder (the precise ownership percentage not being a matter of record – taxpayer claimed he owned only 1 percent of VDN’s stock, while the IRS claimed he owned 50 percent). VDN made payments to the taxpayer’s wife, a portion of which was reported as taxable interest income and the balance of which was treated as a repayment of

the principal she lent to CT. The IRS accepted the taxpayer's wife's reporting, but treated 50 percent of the payments she received as taxable constructive dividends to the taxpayer from VDN. Before the Tax Court, the IRS argued "that VDN's payments to [the taxpayer's wife] were made to satisfy only [his] personal moral obligations," because VDN did not execute a written loan agreement and that, therefore, under the statute of frauds [Oregon] VDN was not liable for the debt. Judge Swift rejected the IRS's argument, concluding that "the existence of an oral agreement . . . may cause an Oregon court to enforce an oral agreement if unjust enrichment would occur if the oral agreement were not enforced," and, in any event, "VDN's conduct in actually making payments to Virginia, which related to Virginia's loan to CT and to CT's transfer of the working model to VDN, establish the loan repayment character of the payments and the principal and interest nature thereof."

2. Section 162(k)'s bite is as loud as its bark. Ralston Purina Co. v. Commissioner, 131 T.C. No. 4 (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 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. & Subs. 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.

• This is the same result reached in *Conopco, Inc. v. United States*, 100 A.F.T.R.2d 2007-5296 (D. N.J. 7/18/07).

3. The Tax Court is bearish on Merrill Lynch. Merrill Lynch & Co. v. Commissioner, 120 T.C. 12 (1/15/03). In 1986 and 1987 Merrill Lynch structured several transactions to sell certain assets of first-tier and second-tier subsidiaries and not only eliminate any tax on the gains, but to create losses. To take advantage of the interaction of the consolidated return regulations and § 304 [before the promulgation of Reg. § 1.1502-80(b), rendering § 304 inoperative in consolidated returns], Merrill Lynch caused the subsidiaries holding the assets to drop the assets to be retained into new lower level subsidiaries [in § 351 transactions], following which the new subsidiaries were sold cross chain to other Merrill Lynch subsidiaries. The sales proceeds were then distributed to its parent by the subsidiary to be sold, and that subsidiary was then sold. The plan was that the cross-chain sale would be recharacterized as a dividend under § 304, which would result in a basis increase under Reg. §§ 1.1502-32 and -33 [as then in effect] in the stock of the subsidiaries to be sold. The IRS did not contest that § 304 applied, but responded that the “distributions” coupled with the sales of the subsidiaries outside the group were part of a firm and fixed plan by the subsidiaries that were sold outside the group to dispose of the stock of the lower tier subsidiaries that had been sold cross chain. Therefore, even after applying § 304 the distributions were treated as amounts received in a redemption under § 302(b)(3) [applying *Zenz v. Quinlivan*, 213 F.2d 913 (6th Cir. 1954)]. The Tax Court (Judge Marvel) held that under the principles of *Niedermeyer v. Commissioner*, 62 T.C. 280 (1974), a firm and fixed plan existed with respect to every such sale and held for the IRS.

The record establishes that on the dates of the cross-chain sales, petitioner had agreed upon, and had begun to implement, a firm and fixed plan to completely terminate the target corporations’ ownership interests in the issuing corporations (the subsidiaries whose stock was sold cross-chain). The plan was carefully structured to achieve very favorable tax basis adjustments resulting from the interplay of section 304 and the consolidated return regulations, and the steps of the plan were described in detail in written summaries prepared for meetings of Merrill Parent’s board of directors. As described in those written summaries, the cross-chain sales of the issuing corporations’ stock and the sales of the target corporations were part of the same seamless web of corporate activity intended by petitioner to culminate in the sale of the target corporations outside the consolidated group.

a. As is the Second Circuit, which affirmed the Tax Court. 386 F.3d 464 (2d Cir. 9/28/04). On appeal Merrill Lynch argued for the first time that the proceeds of the cross-chain sales should be treated as § 301 dividends, even if the actual and constructive ownership interest in the subsidiary

corporation that was sold was completely terminated, because Merrill Lynch retained a constructive ownership interest in the purchased subsidiaries for purposes of § 302(b)(3). The Second Circuit remanded the case for consideration of this issue.

b. Now the Tax Court is bearish on Bank of America (as well as on Ken Gideon and Marty Ginsburg). 131 T.C. No. 19 (12/30/08). On remand, the taxpayer argued that because its ownership interest in the issuing corporations was not completely terminated within the meaning of § 302(b)(3), it properly reported sales proceeds as dividends. The taxpayer's argument went as follows: (1) Immediately before the cross-chain sales, the acquiring corporation was a wholly owned subsidiary; (2) under the § 318 attribution rules, ownership of the issuing corporations was also attributed to its ownership of their parent; and (3) after the sale of the subsidiaries' former parent [the seller in the cross-chain sale], the taxpayer continued constructively to own 100 percent of the stock of the issuing corporations through its ownership of the acquiring corporations. The Tax Court (Judge Marvel) rejected the taxpayer's argument and agreed with the Commissioner that the rules in §§ 302 and 304 "apply only to the shareholder who, in exchange for stock, actually receives the proceeds of a cross-chain sale. The position that the section 302(b) tests may be applied to a shareholder who indirectly or constructively holds stock but has neither transferred any stock nor received the proceeds of the stock sale cannot be reconciled with the language and structure of section 304(a)(1)." The subsidiary-parent that was sold by the taxpayer was the only "person" who transferred any stock to the acquiring subsidiary corporations in the cross-chain sales, and it was the only shareholder that received property from the acquiring corporations in exchange for stock in the issuing corporations. Consequently, it was the only shareholder whose interest in the issuing corporations should be tested under § 302(b)(3). Because its interest in the issuing corporations was completely terminated upon its sale outside of the affiliated group, the redemption was a distribution in exchange for stock.

C. Liquidations

There were no significant developments regarding this topic during 2008.

D. S Corporations

1. Proposed regulations implementing the ever-easing standards for qualifying as an S. REG-143326-05, S Corporation Guidance Under **AJCA of 2004** and **GOZA of 2005**, 72 F.R. 55132 (9/28/07). The

Treasury has published proposed amendments to various regulations under Subchapter S, including, among others, Prop. Regs. §§ 1.1361-1(e) [number of shareholders]; 1.1361-1(h) [special rules relating to trusts eligible to be shareholders]; 1.1361-1(m) [ESBTs]; 1.1361-4 [inadvertent terminations and inadvertently invalid elections]; and 1.1366-2 [limitations on deduction of passed-through losses].

- **The entire state of Arkansas counts as one shareholder.** Section 403(b) of **GOZA** amended § 1361(c)(1)(B)(iii) to apply the test for qualifying members of a family with a common ancestor not more than six generations removed to the latest of (1) The date the S election is made, (2) the earliest date an individual who is a “member of the family” holds stock in the S corporation, or (3) October 22, 2004. Prop. Reg. § 1.1361-1(e)(3) clarifies that the “six generation” test is applied only at the date specified in § 1361(c)(1)(B)(iii) and thereafter has no continuing significance in limiting the number of generations of a family that may hold stock and be treated as a single shareholder.

- Section 234 of **AJCA** amended § 1361(e)(2) to provide that in determining an ESBT’s potential current beneficiaries for any period (PCBs), powers of appointment are disregarded if not exercised by the end of that period. Also, the period during which an ESBT may safely dispose of S corporation stock after an ineligible shareholder becomes a PCB was increased from 60 days to one year. Prop. Reg. § 1.1361-1(m)(2)(vi) reflects these changes. All members of a class of unnamed charities permitted to receive distributions under a discretionary distribution power held by a fiduciary that is not a power of appointment, will be considered, collectively, to be a single PCB for purposes of determining the number of permissible shareholders, unless the power is actually exercised, in which case each charity that actually receives distributions will also be a PCB. A power to add beneficiaries, whether or not charitable, to a class of current permissible beneficiaries is generally a power of appointment and thus will be disregarded to the extent it is not exercised. Fiduciary powers to spray trust distributions to a class of current beneficiaries or possible current beneficiaries are *not* “powers of appointment,” and thus every member of the class remains a PCB, whether or not receiving a distribution.

- Proposed amendments to Reg. § 1.1362-4 implement 1996 amendments to § 1362(f), which provide relief for corporations with inadvertently invalid S corporation elections [in addition to the relief previously available for inadvertent terminations of valid S corporation elections]. Section 238 of **AJCA** amended § 1362(f) to provide that QSubs are eligible for relief for an inadvertent invalid QSub election or termination under the same standards applied to an inadvertent invalid S corporation election or termination. The proposed regulations would make conforming changes to Reg. § 1.1362-4.

- Section 235 of **AJCA** amended § 1366(d)(2) to provide that if the stock of an S corporation is transferred between spouses or incident to divorce under § 1041(a), any loss or deduction with respect

to the transferred stock that could not be taken into account by the transferring shareholder in the year of the transfer because of the basis limitation in § 1366(d)(1) is treated as incurred by the corporation in the succeeding taxable year with regard to the transferee. Proposed amendments to Reg. § 1.1366-2(a)(5) would implement this exception to the general rule of nontransferability of losses and deductions. Losses and deductions carried over to the year of transfer that are not used by the transferor spouse in that year will be prorated between the transferor spouse and the transferee spouse based on their stock ownership at the beginning of the succeeding taxable year.

a. Finalized before you could say “Jack Robinson.” T.D. 9422, S Corporation Guidance Under **AJCA of 2004** and **GOZA of 2005**, 73 F.R. 47526 (8/13/08). The proposed regulations were finalized, with only ministerial changes. They are effective 8/14/08, with various specific applicability dates. Notice 2005-97, 2005-2 C.B. 1164, was obsoleted.

2. Short-term beneficial treatment for charitable contributions through an S corporation teaches why you shouldn’t make future charitable contributions of appreciated property through an S corporation unless the law changes. Rev. Rul. 2008-16, 2008-11 I.R.B. 585 (3/17/08). If an S corporation made a charitable contribution of appreciated property during a taxable year beginning after 12/31/05, and before 1/1/08, the shareholder’s deduction may not exceed the sum of: (1) the shareholder’s pro rata share of the fair market value of the contributed property over the contributed property’s adjusted tax basis, and (2) the amount of the § 1366(d) loss limitation amount that is allocable to the contributed property’s adjusted basis under Reg. § 1.1366-2(a)(4). Any disallowed portion of the contribution retains its character and is carried over.

- The **Tax Technical Corrections Act of 2007** added § 1366(d)(4), which provides, in effect, that the basis limitation rule of § 1366(d)(1) does not apply to the amount of deductible appreciation in the contributed property in taxable years beginning after 12/31/05, and before 1/1/08.

- The **Pension Protection Act of 2006** amended § 1367(a)(2) to provide that the decrease in shareholder basis under § 1367(a)(2)(B) by reason of a charitable contribution of property is the amount equal to the shareholder’s pro rata share of the adjusted basis of such property in taxable years beginning after 12/31/05, and before 1/1/08.

- The **Emergency Economic Stabilization Act of 2008** extend through 2009 the application of § 1366(d)(4).

- Absent further statutory change, charitable contributions made by S corporations in subsequent taxable years are subject to the law in existence prior to these amendments [i.e., stock basis will be reduced by the full amount of the deduction]. The IRS and Treasury Department

are considering issuing guidance on the treatment of charitable contributions made by S corporations in subsequent taxable years.

3. F reorganizations of S corporations. Rev. Rul. 2008-18, 2008-13 I.R.B. 674 (3/7/08). When an S corporation undergoes § 368(a)(1)(F) reorganization [through a § 351 contribution of the S corporation stock to a holding company or through a downstream merger into a newly formed second tier subsidiary] in which an operating S corporation becomes a QSub of a newly formed holding company that qualifies to be an S corporation, the newly formed parent succeeds to the original S corporation's election and does not have to make a new S election. See Rev. Rul. 64-250, 1964-2 C.B. 333. Effective 1/1/09, the new parent must obtain its own EIN rather than succeed to the QSub's EIN. However, for S corporations that have previously undergone a § 368(a)(1)(F) reorganization in a manner described in the ruling transaction to create the holding company, where the parent took the QSub's EIN, the parent should continue to use that EIN and the QSub will have to get a new EIN when it is treated as a separate corporation. Rev. Rul. 64-250, 1964-2 C.B. 333 is amplified.

4. Revenge for *Gitlitz*? REG-102822-08, Section 108 Reduction of Tax Attributes for S Corporations, 73 F.R. 45656 (8/6/08). 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); § 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), Prop. Reg. § 1.108-7(d) would treat 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 proposed regulations will be effective when finalized.

5. Section 101(j) meets § 1368(e). Rev. Rul. 2008-42, 2008-30 I.R.B. 175 (7/1/08). Premiums paid by an S corporation on an employer-owned life insurance contract, of which the S corporation is directly or indirectly a beneficiary, do not reduce the S corporation's AAA. The benefits received by reason of the death of the insured from an employer-owned life

insurance contract that is not taxed under § 101(j), because it meets one of the exceptions under § 101(j)(2), do not increase the S corporation's AAA.

6. Proposed regulations restrict the use of open account debt to increase basis and deduct losses. REG-144859-04, Section 1367 Regarding Open Account Debt, 72 F.R. 18417 (4/12/07). Prop. Reg. § 1.1367-2(a), (c)(2), (d), & (e), Ex.6, would limit open account debt from an S corporation to a shareholder to debt not evidenced by written instruments for which the principal amount of aggregate advances, net of repayments, does not exceed \$10,000 at the close of any day during the S corporation's taxable year. The proposed regulations will reverse the result in *Brooks v. Commissioner*, T.C. Memo. 2005-204 (8/25/05), which allowed an S corporation shareholder to borrow money from a bank, advance the funds to the shareholder's S corporation which increased basis and allowed loss deductions, receive payment of the debt in the subsequent taxable year, repay the bank, then at the end of the year again borrow funds to avoid gain on release from the low basis debt and deduct further losses. Thus the taxpayer was able to create endless deferral of gain. The preamble to the proposed regulations indicates that the purpose of the open account debt provisions is administrative simplicity. Whenever advances not evidenced by written instruments exceed \$10,000, the indebtedness will be treated as a separate indebtedness for which payments and advances are separately determined for purposes of basis and gain recognition on repayment.

a. Regulations are now final, with relaxing modifications. T.D. 9428, Section 1367 Regarding Open Account Debt, 73 F.R. 62199 (10/20/08). The final regulations adopt a \$25,000 aggregate principal threshold amount per shareholder for open account debt. Generally, this determination is to be made at the end of the taxable year – with exceptions for dispositions of shareholder debt and termination of a shareholder's interest (for which the determination is to be made immediately before the event).

7. *Gitlitz* by analogy? “Not,” says the Tax Court. Nathel v. Commissioner, 131 T.C. No. 17 (12/17/08). Prior to 2001, the taxpayer had claimed losses passed-through from an S corporation in an amount that exceeded his stock basis but which were properly allowable under § 1366(d)(1)(B) because there were outstanding loans to the corporation from the taxpayer-shareholder. The taxpayer's basis in the loans to the corporation was reduced under § 1367(d)(2)(A) to \$112,547. In 2001 the corporation paid \$649,775 on the loan, which exceeded the taxpayer's \$112,547 basis in the loan by \$537,228. Later in 2001, pursuant to a restructuring of the ownership of the S corporation and two other corporations owned by the taxpayer, his brother, and a third party (which left the taxpayer with no ownership in the corporation), the taxpayer made a capital contribution of \$537,228 to the S corporation, which equaled the

amount by which the loan repayment exceeded the taxpayer's basis in the debt. The consideration for the contribution was the assumption by another shareholder of the taxpayer's obligation on guarantees of loans from banks to the corporation. In calculating the gain realized upon receipt of the loan repayment, the taxpayer treated the capital contribution as income under § 1366(a)(1) to the S corporation, although excludable income under § 118, and therefore as restoring or increasing under § 1367(b)(2)(B) his bases in the outstanding loans before repayment (rather than increasing his stock basis), thus eliminating any gain. Relying on *Gitlitz v. Commissioner*, 531 U.S. 206, 216 (2001), the taxpayer argued that because § 118 excludes capital contributions from the gross income of an S corporation, capital contributions are "permanently excludible" and are thus "tax-exempt income" under Reg. § 1.1366-1(a)(2)(viii), and that as such it is included as an item of the S corporation's income to for purposes of § 1366(a)(1) and the resulting § 1367 basis adjustments. The Tax Court (Judge Swift) rejected the taxpayer's argument and upheld the deficiency.

By attempting to treat petitioners' capital contributions to [the corporation] as income to [the corporation], [taxpayers] in effect seek to undermine three cardinal and longstanding principles of the tax law: First, that a shareholder's contributions to the capital of a corporation increase the basis of the shareholder's stock in the corporation; ... sec. 1.118-1, Income Tax Regs.; second, that equity (i.e., a shareholder's contribution to the capital of a corporation) and debt (i.e., a shareholder's loan to the corporation) are distinguishable and are treated differently by both the Code and the courts ... ; and third, that contributions to the capital of a corporation do not constitute income to the corporation; sec. 118; ... sec. 1.118-1, Income Tax Regs.

We do not believe that the *Gitlitz* holding or the provisions of subchapter S, namely sections 1366(a)(1), 1367(a)(1)(A), and 1367(b)(2)(B), should be interpreted to override these three longstanding principles of tax law.

- Reg. § 1.118-1 provides that "if a corporation requires additional funds for conducting its business and obtains such funds through *** payments by its shareholders *** such amounts do not constitute income." Thus, shareholder capital contributions are not treated as items of income to an S corporation under § 1366(a)(1) and are not taken into account in calculating the "net increase" under § 1367(b)(2)(B) for the purpose of restoring or increasing a shareholder's tax basis in loans a shareholder made to an S corporation. Such capital contributions are not "tax-exempt income" under § 1366(a)(1) nor under Reg. § 1.1366-1(a)(2)(viii) and do not restore or increase the bases in shareholder loans under § 1367(b)(2)(B).

8. 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-exempt obligations 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.

E. Reorganizations

1. Making post-reorganization intra-group restructurings even easier. T.D. 9361, Corporate Reorganizations; Transfers of Assets or Stock Following a Reorganization, 72 F.R. 60552 (10/25/07), *making final* REG-130863-04, Corporate Reorganizations; Transfers of Assets or Stock Following a Reorganization, 69 F.R. 51209 (8/18/04). The Treasury has finalized regulations dealing with (1) the continuity of business enterprise requirement (Reg. § 1.368-1(d)) and (2) the definition of a "party to a reorganization" requirement (Reg. § 1.368-2(f)) to liberalize the rules regarding permissible post-acquisition restructurings of acquiring corporations in a controlled group of corporations. In addition to post-acquisition drops of assets to lower-tier subsidiaries, certain post-acquisition distributions by an acquisition subsidiary that is member of the acquiring corporation's group to a corporation that controls the acquiring corporation of either the target corporation's stock (following a § 368(a)(1)(B) or § 368(a)(2)(E) reorganization) or assets (following a § 368(a)(1)(A), § 368(a)(1)(C), or § 368(a)(2)(E) reorganization), and certain cross chain transfers, subsequent to the acquisition, do not disqualify the acquisition from reorganization treatment, even though there is no statutory provision expressly providing that such distributions do not affect the validity of reorganization treatment, provided that the distribution would not result in the distributing corporation being treated as liquidated for income tax purposes. The regulations thus permit the acquiring corporation to significantly rearrange ownership of the target corporation's assets or stock, as the case may be, among

the members of its qualified group (based on § 368(c) control) without disqualifying the reorganization. Furthermore, the final regulations (Reg. § 1.368-1(d)(4)(ii)), unlike the proposed regulations, permit qualified group members to aggregate their direct stock ownership of a corporation, in a manner similar to aggregation under § 1504(a), in determining whether they have the requisite § 368(c) control of such corporation (provided that the issuing corporation has § 368(c) control in at least one other corporation).

a. Less than six months later the new regulations require clarification. T.D. 9396, Corporate Reorganizations; Amendment to Transfers of Assets or Stock Following a Reorganization, 73 F.R. 26322 (5/9/08). Reg. § 1.368-2(k), dealing with drop downs and push-ups following reorganizations, which was finalized in October, 2007, has been amended in several respects: (1) The amended regulations clarify that a transfer to the former shareholders of the target corporation (other than the acquiring corporation) is not a safe harbor push-up to the extent it constitutes consideration by the shareholders for their proprietary interests in the target, because it “calls into question” whether the transaction satisfies the continuity of interest requirement, as well as statutory limitations on permissible consideration (such as the “solely for voting stock” requirement in § 368(a)(1)(B) or (C)); however, the safe harbor applies to transfers to the former shareholders that are not consideration for their proprietary interests in the target, for example a pro-rata dividend distribution following the acquisition. (2) The safe harbor is available for an upstream reorganization, e.g., a merger of an eighty percent controlled subsidiary into its parent, followed by a drop-down of the acquired assets. The preamble refers to Rev. Rul. 69-617, 1969-2 C.B. 57, as an example of this principle. (3) The safe harbor does not apply to a transfer to the issuing corporation or a person related to the issuing corporation by the former shareholders of the target corporation (other than a former shareholder that is also the acquiring corporation) of consideration initially received in the potential reorganization. (4) A transfer to a shareholder is always a push-up described in paragraph (k)(1)(I) even if it also meets the description of a drop-down described in paragraph (k)(1)(ii), e.g., a transfer to a subsidiary that also is a shareholder. (5) The drop-down/sideways safe harbor does not apply if the target or acquisition subsidiary terminates its corporate existence for Federal income tax purposes in connection with the transfer.

2. The step-transaction doctrine applies to cause a push-up to defeat tax-free reorganization treatment, but it does not apply to treat the push-up as an asset purchase. Rev. Rul. 2008-25, 2008-21 I.R.B. 986 (5/27/08). A reverse triangular merger that otherwise would qualify as a tax free reorganization under § 368(a)(2)(E), but which could not qualify as a tax-free reorganization either under § 368(a)(1)(C) because of the mix of

consideration or under § 368(a)(1)(D) because the shareholders of the target did not own sufficient stock of the issuer, followed by an liquidation of the newly acquired subsidiary pursuant to an “integrated plan,” will be treated as a qualified stock purchase of the target corporation’s stock, followed by a § 332 liquidation. Because the acquired corporation was liquidated, Reg. § 1.368-2(k) does not apply and the first step does not qualify as a § 368(a)(2)(E) tax-free reorganization, because after the acquisition, the target does not hold substantially all of its properties.

- Note that nonrecognition at the corporate level and the basis of the target’s assets are unaffected by this ruling. The only effect is that shareholders of the target recognize all of their gain or loss.

3. Did the IRS strike out by swinging for a home run?

Fisher v. United States, 82 Fed. Cl. 780 (Fed. Cl. 8/6/08). The taxpayer (a trust) owned a life-insurance policy issued by a mutual insurance company with respect to which it had paid over \$190,000 in premiums. The insurance company converted to a stock company and the taxpayer received 3,892 shares of stock in exchange for its voting and liquidation rights. Pursuant to the demutualization plan, it elected to take cash in lieu of the shares and the insurance company sold the shares on the open market for \$31,759.00, which was paid to the taxpayer. The IRS had issued a private letter ruling to the insurance company stating that the receipt of the shares would be tax free under § 354, but that under § 358 the shares would take a zero basis because that was the basis of the policyholder’s voting and liquidation rights. The taxpayer reported \$31,759.00, unreduced by any basis adjustment, on its federal income tax return for 2000, and then sought a refund, claiming that the entire basis of the insurance policy could be offset against the stock sale proceeds under the open transaction doctrine. Judge Allegra rejected the IRS’s position and agreed with the taxpayer. He reasoned that under Reg. § 1.61-6(a), the basis of the mutual insurance policy should have been apportioned between the stock received in the demutualization and the continuing insurance policy, but that because it was “impractical or impossible” to allocate the basis of the mutual insurance policy between the insurance benefits and voting and liquidation rights, because they were not alienable apart from the insurance policy, the open transaction doctrine applied. He cited *Inaja Land Co. v. Commissioner*, 9 T.C. 727 (1947), *acq.*, 1948-1 C.B. 2, as his rationale of applying open transaction treatment to the payment.

- Judge Allegra rejected the IRS’s argument that the payment represented a “windfall,” stating, “The ‘windfall’ tag, therefore, lacks evidentiary adhesive and does not stick.”

- We wonder if the IRS might have blown this one by going for a home run and trying to assign a zero basis to the stock on the ground that zero was the basis of the voting and liquidation rights appurtenant to the mutual insurance policy in exchange for which the stock was received. It

should have argued that the basis of the mutual insurance policy should have been apportioned between the stock and the continuing insurance policy, although the exact statutory provision to cite for that proposition is not entirely clear.

4. Proposed regulations with respect to transfers of property with no net value. The transfer of something worth nothing (or less than nothing) on a net basis is not a transfer of property for purposes of subchapter C. REG-163314-03, Transactions Involving the Transfer of No Net Value, 70 F.R. 11903 (3/10/05). These proposed regulations deal with the net value requirement for tax-free transactions under subchapter C, and provide that exchanges under §§ 351, 332 and 368 do not qualify for tax-free treatment where there is no net value in the property transferred or received, with exceptions for E, F and some D reorganizations. The proposed regulations also provide guidance on the treatment of creditors of an insolvent corporation will be treated as proprietors to determine whether continuity of interest is preserved.

a. This new rule is certain to be applied a lot in the next few years. Continuity of interest is satisfied when the target corporation's creditors get stock in the acquirer. T.D. 9434, Creditor Continuity of Interest, 73 F.R. 75566 (12/12/08). In 2005 the Treasury Department published proposed regulations describing the circumstances in which a corporation's creditors will be treated as holding a proprietary interest in a target corporation immediately before a potential reorganization. REG-163314-03, Proposed Rules, Transactions Involving the Transfer of No Net Value, 70 F.R. 11903-01 (3/10/05). These regulations have been finalized with only minor modifications and clarifications, and they apply for continuity of interest purposes both within and outside of bankruptcy proceedings. The regulations adopt the holding in *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), that a transfer of assets pursuant to which creditors of a bankrupt concern became the controlling stockholders of a new corporation provided the requisite continuity of interest for a reorganization. The preamble notes extending the reorganization rules to reorganizations of insolvent corporations outside of bankruptcy is consistent with Congress's intent to facilitate the rehabilitation of troubled corporations. Reg. § 1.368-1(e)(6) describes the circumstances in which creditors of a corporation generally, and which creditors in particular, will be treated as holding a proprietary interest in a target corporation immediately before a potential reorganization. In general, the regulation adopts the standard for reorganizations under § 368(a)(1)(G) recommended in the Senate Finance Committee Report to the Bankruptcy Tax Act of 1980. Claims of the most senior class of creditors that receive a proprietary interest in the issuing corporation and claims of all equal classes of creditors (the senior claims) and all junior claims represent proprietary interests in the target corporation. The value of proprietary interests in the target

corporation represented by the senior claims is calculated with reference to the average treatment for all senior claims. The value of a senior claim's proprietary interest in the target is determined by multiplying the fair market value of the creditor's claim by a fraction, the numerator of which is the fair market value of the proprietary interests in the issuing corporation that are received in the aggregate in exchange for the senior claims, and the denominator of which is the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in the issuing corporation) received in the aggregate in exchange for such claims. The value of the proprietary interest in the target corporation represented by a junior claim is the fair market value of the junior claim. Thus, there is 100 percent continuity of interest if each senior claim is satisfied with the same ratio of stock to nonstock consideration and no junior claim is satisfied with nonstock consideration. Where only one class of creditors receives stock, more than a de minimis amount of acquiring corporation stock must be exchanged for the creditors' proprietary interests relative to the total consideration received by the insolvent target corporation, its shareholders, and its creditors, before the stock will be counted for purposes of continuity of interest.

5. Some rules designed to trace basis in an era of paper stock certificates no longer work. Notice 2009-4, 2009-2 I.R.B. 251 (12/12/08). This notice explains the guidance that the IRS contemplates issuing regarding the determination of the transferred basis in stock that has been acquired in a § 368(a)(1)(B) reorganization. Rev. Proc. 81-70, 1981-2 C.B. 729, which provided guidelines for surveying surrendering shareholders to determine the basis of Target stock and sampling and estimation procedures to address administrative burdens and shareholder nonresponsiveness is outdated because at the time Rev. Proc. 81-70 was published, most stock was registered stock, but now stock of public companies is primarily held in street name, often with several tiers of nominee owners, each subject to confidentiality.

F. Corporate Divisions

1. "Hot stock" cools off in a DSAG. T.D. 9435, Guidance Regarding the Treatment of Stock of a Controlled Corporation Under Section 355(a)(3)(B), 73 F.R. 75946 (12/25/08). The Treasury has promulgated Temp. Reg. § 1.355-2T(g), dealing with the "hot stock" rule of § 355(a)(3)(B) to conform to the 2006 amendments of § 335(b)(3), creating the "SAG" rules, which treat a corporation's SAG [separate affiliated group] as a single corporation for purposes of determining whether the active trade or business requirements of § 355 have been met. Section 355(a)(3)(B) provides that stock of a controlled corporation that has been acquired by the distributing corporation in a taxable transaction within the five year period preceding distribution to

stockholders otherwise qualifying under § 355 will be treated as boot taxable to the stockholders. Generally speaking, the temporary regulations provide that the hot stock of § 355(a)(3)(B) rule does not apply to any acquisition of stock of controlled where controlled is a DSAG [separate affiliated group of the distributing corporation] member at any time after the acquisition (but prior to the distribution of controlled). Transfers of controlled stock owned by DSAG members immediately before and immediately after the transfer are disregarded and are not treated as acquisitions for purposes of the hot stock rule. (Prop. Reg. § 1.355-3(b)(1)(ii) would apply a similar rule for purposes of the ATB requirement.) The temporary regulations also incorporate the exception of former Reg. § 1.355-2(g), which provides that the hot stock rule does not apply to acquisitions of controlled stock by distributing from a member of the affiliated group (as defined in Reg. § 1.355-3(b)(4)(iv)) of which distributing was a member. The regulations generally apply to distributions occurring after December 15, 2008, but there are a number of transition rules. Taxpayers also may elect to apply the regulations to distributions made after May 17, 2006.

a. REG-150670-07, Guidance Regarding the Treatment of Stock of a Controlled Corporation Under Section 355(a)(3)(B), 73 F.R. 75979 (12/15/08). The Temporary Regulations are also published as proposed regulations.

G. Affiliated Corporations and Consolidated Returns

1. **Twenty-two years after the authorizing statute was enacted, the Treasury and IRS propose regulations to prevent triple taxation resulting from sales, exchanges and distributions of corporate stock resulting from *General Utilities* repeal.** REG-143544-04, Regulations Enabling Elections for Certain Transactions Under Section 336(e), 73 F.R. 49965 (8/25/08). The IRS has published proposed regulations under § 336(e). Section 336(e), enacted as part of the TRA 1986 repealing the *General Utilities* doctrine, authorizes regulations allowing a corporation that sells, exchanges, or distributes stock in another corporation (target) meeting the requirements of § 1504(a)(2) to elect to treat the disposition as a sale of all of target's underlying assets in lieu of treating it as sale, exchange, or distribution of stock, as under § 338(h)(10). The purpose of a § 336(e) election is to prevent creation of a triple layer of taxation — one at the controlled corporation level, one at the distributing corporation level and, ultimately, one at the shareholder level. Prop. Regs. §§ 1.336-0 through 1.336-5, when finalized, will provide the requirements and mechanics for, and consequences of, treating a stock sale, exchange, or distribution that would not otherwise be eligible for a § 338 election. Under the proposed regulations, the results of a § 336(e) election generally are the same (with certain exceptions) as those of a § 338(h)(10) election. The structure of the

proposed regulations resembles the § 338(h)(10) regulations regarding the allocation of consideration, application of the asset and stock consistency rules, treatment of minority shareholders, and the availability of the § 453 installment method, although certain definitions and concepts differ to reflect differences between § 336 and § 338(h)(10). Unlike under § 338(h)(10), however, a § 336(e) election is a unilateral election by the seller. A transaction that meets the definition of both a qualified stock disposition and a qualified stock purchase under § 338(d)(3) generally will be treated only as a qualified stock purchase and does not qualify for a § 336(e) election. Prop. Reg. § 1.336-1(b)(5)(ii).

- *General Rules.* A qualified stock disposition for which a § 336(e) election may be made is any transaction or series of transactions in which stock meeting the requirements of § 1504(a)(2) of a domestic corporation is either sold, exchanged, or distributed, or any combination thereof, by another domestic corporation in a disposition (as defined in Prop. Reg. § 1.336-1(b)(4)), during the 12-month disposition period (as defined in Prop. Reg. § 1.336-1(b)(5)). (All members of a consolidated group are treated as a single transferor. Prop. Reg. § 1.336-2(g)(2)). Stock transferred to a related party (determined after the transfer) is not considered in determining whether there has been a qualified stock disposition. Prop. Reg. §§ 1.336-1(b)(4)(i)(C) and 1.336-1(b)(5)(i). A section 336(e) election is available for qualifying dispositions of target stock to non-corporate transferees, as well as to corporate transferees. Prop. Reg. § 1.336-1(b)(2) However, the election is not available with respect to the stock of an S corporation. See Prop. Reg. § 1.336-1(b)(5).

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

- *Sales or Exchanges of Target Stock.* In general, if a seller sells or exchanges target stock in a qualified stock disposition, the treatment of old target, seller, and purchaser are similar to the treatment of old target (old T), S, and P under § 338(h)(10). If a § 336 election is made, the sale or exchange of target stock is disregarded. Instead, target (old target) is treated as selling all of its assets to an unrelated corporation in a single transaction at the close of the disposition date (the deemed asset disposition). Old target recognizes the deemed disposition tax consequences from the deemed asset disposition on the disposition date while it is a subsidiary of seller. Old target is then treated as

liquidating into seller which in most cases will be treated as a § 332 liquidation to which § 337 (or § 336) applies. Additionally, the deemed purchase of the assets of old target by new target constitutes a deemed purchase of any subsidiary stock owned by target, and a § 336(e) election may be made for the deemed purchase of the stock of a target subsidiary if it constitutes a qualified stock disposition. A § 336(e) election generally does not affect the tax consequences, e.g., stock basis, to a purchaser of target stock.

- *Distributions of Target Stock Not*

Subject to § 355. A § 336(e) election can be made for a taxable distribution of target stock (e.g., dividend, redemption, liquidation), but the election does not affect the tax treatment of the shareholders. Special rules assure that the tax consequences to a distributee are the same as if no § 336(e) election was made. If a distribution is a qualified stock disposition, the distributing corporation is treated as purchasing from new target (immediately after the deemed liquidation of old target) the amount of stock distributed and to have distributed the new target stock to its shareholders. The distributing corporation recognizes no gain or loss on the distribution (old target having recognized gain on the deemed asset sale). Prop. Reg. § 1.336-2(b)(1)(iv). If the distribution is a § 301 distribution, the portion that is a dividend may be affected by the difference between (1) the § 311 gain, and thus E&P, that would have been recognized on a stock distribution and (2) the gain, and thus E&P, that results from the deemed asset disposition and liquidation of target. See Prop. Reg. § 1.336-2(c). Because a distributing corporation cannot recognize loss on the distribution of stock in a § 301 or 302 distribution, losses cannot be recognized on the § 336(e) deemed asset disposition to the extent the qualified stock disposition was the result of a stock distribution; only a portion of the losses may be recognized. Only the portion of the loss on stock that was sold or exchanged, rather than distributed, may be recognized. Prop. Reg. §§ 1.336-2(b)(1)(i)(B)(2) and (3).

- *Section 355 Distributions.*

The proposed regulations would allow a corporation that would otherwise recognize gain with respect to a qualified stock disposition resulting, in whole or in part, from a disposition described in § 355(d)(2) or (e)(2) to make a § 336(e) election. However, to preserve the E&P allocation consequences of a § 355 distribution under Reg. § 1.312-10, the proposed regulations provide special rules. Old target is not deemed to liquidate into the distributing corporation, but is treated as acquiring all of its assets from an unrelated person and the distributing corporation is treated as distributing the stock of the controlled corporation (old target) to its shareholders. Prop. Reg. § 1.336-2(b)(2)(ii) and (iii). Because the controlled corporation (old target) is not treated as liquidated, it will retain its tax attributes despite the § 336(e) election. Furthermore, the controlled corporation will take into account the effects of the deemed asset disposition to adjust its E&P immediately before allocating E&P pursuant to Reg. § 1.312-10. Prop. Reg. § 1.336-2(b)(2)(vi). Losses from the deemed asset sale will be recognized only in relation to the amount

of stock sold or exchanged in the qualified stock disposition on or before the disposition date. Prop. Reg. §§ 1.336-2(b)(2)(i)(B)(2) and (3). However, if the controlled corporation (old target) has any subsidiaries for which a § 336(e) election is made, the general deemed asset disposition methodology shall apply. This prevents taxpayers from effectively electing whether the attributes of the lower tier subsidiary become those of target, by doing an actual sale of target subsidiary's assets followed by a liquidation of target subsidiary, or remain with target subsidiary, by making a § 336(e) election for target subsidiary.

- *Intragroup Transfers Prior to External Dispositions.* If target stock is transferred within an affiliated group and is then transferred outside the affiliated group, a § 336(e) election is not available for the intragroup transfer (because a qualified stock disposition may not be made between related sellers and purchasers). Even if a § 336(e) election is made for the transfer outside of the group, the affiliated group would recognize gain both on target's assets and the target stock. The proposed regulations do not solve this problem, but the preamble requests comments on how to address this issue, and related issues under § 355(f), which provides that § 355 does not apply to an intragroup distribution prior to a distribution subject to § 355(e)(2).

- *Aggregate Deemed Asset Disposition Price (ADADP) and Adjusted Grossed Up Basis (AGUB).* To calculate old target's gain under a § 336(e) election, the proposed regulations define a new term, "aggregate deemed asset disposition price" (ADADP). New target's asset basis is determined with reference to adjusted grossed up basis (AGUB), as used in § 338 and Reg. § 1.338-5. Under Prop. Reg. §§ 1.336-3 and 1.336-4, ADADP and AGUB are determined similarly to the way ADSP and AGUB are determined under the § 338 regulations. The proposed regulations account for the lack of an actual amount realized on a stock distribution by treating the grossed-up amount realized as including in the amount realized the fair market value of distributed target stock Prop. Reg. § 1.336-3(c)(1)(i)(B). In addition, because in the case of a § 336(e) election (unlike in the case of a § 338 election, where there is only one purchasing corporation and it is relatively easy to determine the purchaser's basis in nonrecently purchased stock in order to determine AGUB), there can be multiple purchasers or distributees who acquired target stock prior to the 12-month disposition period, the proposed regulations provide that "nonrecently disposed stock," which has a similar meaning to the term "nonrecently purchased stock" in § 338(b)(6)(B), includes only stock in a target corporation held by a purchaser (or a related person) who owns (with § 318(a) attribution, except § 318(a)(4)), at least 10 percent of the total voting power or value of the stock of target that is not recently disposed stock. Prop. Reg. § 1.336-1(b)(17).

- New target is treated as acquiring all of its assets from an unrelated person in a single transaction at the close of the disposition date, but before the deemed liquidation (or, in the case of a § 355 distribution, before the distribution) in exchange for an amount equal to the

AGUB. With certain modifications, Prop. Reg. § 1.336-4 generally resembles Reg. § 1.338-5 to determine target's AGUB for target. New target allocates AGUB among its assets in the same manner as in Regs. §§ 1.338-6 and 1.338-7. Prop. Reg. §§ 1.336-2(b)(1)(ii) and 1.336-2(b)(2)(ii).

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

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

- A taxpayer will be allowed to make a protective § 336(e) election if it is unsure whether a transaction constitutes a qualified stock disposition. A protective election will have no effect if the transaction does not constitute a qualified stock disposition, but it will otherwise be binding and irrevocable. Prop. Reg. § 1.336-2(j).

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

- *Effective date.* The regulations will apply to any qualified stock disposition for which the disposition date is on or after the date of publication of final regulations.

2. What hath Rite-Aid wrought? T.D. 9424, Unified Rule for Loss on Subsidiary Stock, 73 F.R. 53934-01 (9/17/08). The Treasury and IRS have finalized proposed regulations [REG-157711-02, Proposed Rules, Unified Rule for Loss on Subsidiary Stock, 72 F.R. 2964 (1/23/07)] that address the duplication of loss by consolidated groups and completely replace the former basis adjustment and loss suspension rules in former Reg. §§ 1.337(d)-2 and 1.1502-35. The final regulations generally follow the proposed regulations with certain modifications. New Reg. § 1.1502-36 provides “unified rules for loss on subsidiary stock” when a member transfers a share of subsidiary stock and, after taking into account the effects of all applicable rules, including those that would not be given effect until after the transfer, the share is a “loss share.” (The relevant effects may be attributable to lower-tier dispositions and worthlessness, as well as to the application of the unified loss rule.) See Reg. § 1.1502-36(a)(3)(I). A transfer of stock includes any event in which (1) gain or loss

would be recognized (apart from the rules in the proposed regulations), (2) the holder of a share and the subsidiary cease to be members of the same group, (3) a nonmember acquires an outstanding share from a member, or (4) the share is treated as worthless. The purpose of these rules is twofold, to prevent the consolidated return provisions from creating non-economic losses on the sale of subsidiary stock and to prevent members of the affiliated group filing the consolidated return from claiming more than one tax benefit from a single economic loss. Under the proposed regulations, any transfer of a loss share (defined as a share of stock of an affiliate having a basis in excess of fair market value), requires the application in sequence of three basis rules, even if the loss is deferred. However, if a member transfers a share of subsidiary stock to another member and any gain or loss on the transfer is deferred under § 1.1502-13, the unified loss rule, with appropriate adjustments, applies to the transfer when the intercompany item is taken into account.)

- First, a basis redetermination rule, under Reg. § 1.1502-36(b) is applied to deal with tax losses attributable to investment adjustment account allocations among different shares of stock under Reg. § 1.1502-32 that result in disproportionate reflection of gain or loss in a share's basis. Second, if any share is a loss share after application of the basis redetermination rule, a basis reduction rule is applied under Reg. § 1.1502-36(c) to deal with loss duplication attributable to investment adjustment account adjustments, but this reduction does not exceed the share's "disconformity amount." Third, if any duplicated losses remain after application of the basis reduction rule, under Reg. § 1.1502-36(d) an attribute reduction rule is applied to the corporation the stock of which was sold to prevent the duplication of a loss recognized on the transfer or preserved in the basis of the stock. If a chain of subsidiaries is transferred (rather than a single subsidiary) the order in which the rules are applied is modified. In this case, basis redetermination rule and basis reduction rule are applied sequentially working down the chain, and the attribute reduction rule is then applied starting with the lowest tier subsidiary and working up the chain.

- *The Basis Redetermination rule.* — Under the basis redetermination rule in Reg. § 1.1502-36(b), investment adjustments (exclusive of distributions) that were previously applied to members' bases in subsidiary stock are reallocated in a manner that, to the greatest extent possible, eliminates basis disparity on all shares. This rule affects both positive and negative adjustments, and thus addresses both noneconomic and duplicated losses. First, positive investment adjustments (except positive adjustments to preferred shares, which reflect only the right to receive distributions) up to the amount of the loss are eliminated from the bases of transferred loss shares. Second, to the extent of any remaining loss on the transferred shares, negative investment adjustments are removed from shares that are not transferred loss shares and are applied to reduce the loss on transferred loss shares. Third, the positive adjustments removed

from the transferred loss shares are allocated to increase basis of other shares only after the negative adjustments have been reallocated. Note that those three provisions do not affect the aggregate basis of the shares, and thus have no impact and do not apply if all of the shares of a subsidiary are sold; they are important only when some, but not all, shares are sold. A number of special limitations on basis reallocation also must be considered in various specific circumstances.

- *The Basis Reduction Rule.* — If, after applying the basis redetermination rule in step one, any transferred share is a loss share (even if the share only became a loss share as a result of the application of the basis redetermination rule), the basis of that share is subject to reduction. The basis reduction rule in Reg. § 1.1502-36(c) eliminates noneconomic losses that arise from the operation of the investment adjustment account rules. Under this rule, the basis of each transferred loss share is reduced (but not below its value) by the lesser of (1) the share's disconformity amount, or (2) the share's net positive adjustment.

- The "disconformity amount" with respect to a subsidiary's share is the excess of its basis over the share's allocable portion of the subsidiary's inside tax attributes (determined at the time of the transfer) other than credits. Every share within a single class of stock has an identical allocable portion. Between shares of different classes of stock, allocable portions are determined by taking into account the economic arrangements represented by the terms of the stock. "Net inside attributes" is the sum of the subsidiary's loss carryovers (except carryovers waived under Reg. § 1.1502-32(b)(4)), deferred deductions, cash, and asset basis (including the basis of lower tier subsidiary stock), minus the subsidiary's liabilities. The disconformity amount identifies the net amount of unrealized appreciation reflected in the basis of the share.

- A share's net positive adjustment is computed as the greater of (1) zero, or (2) the sum of all investment adjustments (excluding distributions) applied to the basis of the transferred loss share, including investment adjustments attributable to prior basis reallocations under the basis reallocation rule. The net positive adjustment identifies the extent to which a share's basis has been increased by the investment adjustment provisions for items of income, gain, deduction and loss (whether taxable or not) that have been taken into account by the group. Special rules apply when the subsidiary the stock of which is transferred itself holds stock of lower-tier subsidiary.

- *The Attribute Reduction Rule.* — If any transferred share remains a loss share after application of the basis reallocation and basis reduction rules, the loss on the transferred share is allowed. However, in this instance, the subsidiary's tax attributes (including the consolidated attributes, e.g., loss carryovers, attributable to the subsidiary) are reduced pursuant to Reg. § 1.1502-36(d). The attribute reduction rule addresses the duplication of loss by members of consolidated groups, and is designed to prevent the group from recognizing more than one tax loss with respect to a single economic loss,

regardless of whether the group disposes of the subsidiary stock before or after the subsidiary recognizes the loss with respect to its assets or operations.

- Under the attribute reduction rule, the subsidiary's attributes are reduced by the "attribute reduction amount," which equals the lesser of (1) the net stock loss, or (2) the aggregate inside loss. The "attribute reduction amount" reflects the total amount of unrecognized loss that is reflected in both the basis of the subsidiary stock and the subsidiary's attributes. "Net stock loss" is the amount by which the sum of the bases (after application of the basis reduction rule) of all of the shares in the subsidiary transferred by members of the group in the same transaction exceeds the value of those shares. The subsidiary's "aggregate inside loss" is the excess of its net inside attributes over the value of all of the shares in the subsidiary. (Net inside attributes generally has the same meaning as in the basis reduction rule, subject to special rules for lower-tier subsidiaries.) However, if the total attribute reduction amount is less than five percent of the aggregate value of the subsidiary shares that are transferred by members in the transaction, the attribute reduction rule does not apply to the transfer, unless the taxpayer elects to apply it.

- The attribute reduction amount is first applied to reduce or eliminate to the maximum extent possible items that represent actual realized losses, i.e., capital loss carryovers (Category A), operating loss carryovers (Category B), and deferred deductions (Category C), in that order unless the taxpayer elects a different allocation. Any excess attribute reduction amount is then applied to reduce the basis of assets (Category D) in the asset classes specified in Reg. § 1.338-6(b) other than Class I (cash and general deposit accounts, other than certificates of deposit held in depository institutions), but in the reverse order from the order specified in that section. Thus, the basis in any purchased goodwill is the first item reduced. However, the Category D attribute reduction is first allocated between the subsidiary's basis in any stock of lower-tier subsidiaries and the subsidiary's other assets (treating the non-stock Category D assets as one asset) in proportion to the subsidiary's basis in the stock of each lower-tier subsidiary and its basis in the Category D assets other than subsidiary stock. Only the portion of the attribute reduction amount not allocated to lower-tier subsidiary stock is applied under the reverse residual method. (Additional special rules apply to prevent excessive reduction of attributes when the subsidiary itself holds stock of a lower-tier subsidiary.) If the attribute reduction amount exceeds all of the attributes available for reduction, that excess amount generally has no effect. If, however, cash or other liquid assets are held to fund payment of a liability that has not yet been deducted but will be deductible in the future (e.g., a liability the deduction for which is subject to the economic performance rules of § 451(h)), loss could be duplicated later, when the liability is taken into account. To prevent such loss duplication, the excess attribute reduction amount will be held in suspense and applied to prevent the deduction or capitalization of later payments with respect to the liability.

- The regulations permit taxpayers to make a protective election to reattribute attributes (other than asset basis) and/or to reduce stock basis (and thereby reduce stock loss) in order to avoid attribute reduction. If an election is made and it is ultimately determined that the subsidiary has no attribute reduction amount the election will have no effect (or if the election is made for an amount that exceeds the finally determined attribute reduction amount, the election will have no effect to the extent of that excess). In addition, taxpayers may elect to reduce (or not reduce) stock basis, or to reattribute (or not reattribute) attributes, or some combination thereof, in any amount that does not exceed the subsidiary's attribute reduction amount.

- Finally, if the subsidiary ceases to be a member of the consolidated group as a result of the transfer, the common parent of the group can elect to reduce stock basis (thereby reducing an otherwise allowable loss on the sale of the stock), reattribute attributes, or apply some combination of basis reduction and attribute reattribution to alter the otherwise required attribute reduction.

- *Worthlessness.* — Reg. § 1.1502-36(d)(7) provides that, if a member treats stock of the subsidiary as worthless under § 165 (taking into account Reg. § 1.1502-80(c)) and the subsidiary continues as a member, or if a member recognizes a loss on subsidiary stock and on the following day the subsidiary is not a member and does not have a separate return year following the recognition of the loss, all Category A, Category B, and Category C attributes (i.e., capital loss carryovers, net operating loss carryovers, and deferred deductions) that have not otherwise been eliminated or reattributed, as well as any credit carryovers, are eliminated.

- *Built-in Loss in § 351 Transactions.* — New Reg. § 1.1502-80(h) makes § 362(e)(2) generally inapplicable to intercompany transactions. Thus only the consolidated return provisions address loss duplication in an intercompany § 351 transaction within the group. However, an anti-abuse rule provides for appropriate adjustments to be made to clearly reflect the income of the group if a taxpayer acts with a view to prevent the consolidated return provisions from properly addressing loss duplication.

- *Effective Date.* — The regulations generally apply to transfers on or after 9/17/08, unless the transfer is made pursuant to a binding agreement between unrelated parties (related party has the same meaning as in § 267(b)) that was in effect before 9/17/08 and at all times thereafter.

H. Miscellaneous Corporate Issues

1. **Taking from the big and contributing to the small does not produce excluded contributions to capital.** United States v. Coastal Utilities, Inc., 483 F. Supp. 2d 1232 (S.D. Ga. 3/28/07). Summary judgment was granted to the Government denying a utility's refund claim based on its assertion

that payments received from the Universal Service Administration Company and the State of Georgia Access Funds were contributions to capital excluded from gross income under § 118. The payments were part of state and federally mandated programs funded by fees collected from telecommunications carriers based on revenues. Payments are made to carriers with high cost obligations to provide universal access to telephone services. Based on undisputed facts, and following an in-depth analysis of the relevant authorities distinguishing non-shareholder contributions to capital from gross income, the District Court concluded that the purpose of the payments was to supplement income. The court focused on the mechanisms used to calculate the amount of universal support, which, although largely related to investment expenditures, took into account operation, maintenance, administrative, and other expenses that were unrelated to capital investment.

a. The IRS concludes the same by ruling. Rev. Rul. 2007-31, 2007-21 I.R.B. 1275 (4/27/07). The IRS ruled that universal service support payments received are not a non-shareholder contribution to capital under § 118(a).

b. And the Eleventh Circuit agrees too. Coastal Utilities is affirmed. United States v. Coastal Utilities, 514 F.3d 1184 (11th Cir. 1/23/08). The Eleventh Circuit adopted in full the district court's order.

2. State law is relevant in determining who is performing professional services, but lack of a state law license doesn't mean you're not performing professional services. Grutman-Mazler Engineering Inc v. Commissioner, T.C. Memo. 2008-140 (5/21/08). In determining whether a corporation a "qualified personal service corporation" as defined under § 448(d)(2), state law is relevant to determine whether an activity is within a qualifying field. Under the relevant state law [California] civil engineering includes submitting designs, plans, tentative tract maps, grading plans, and engineering reports to local governments and coordinating other professionals. A 40 percent shareholder who performed such services in a "planning division," who had an engineering degree but was not a licensed civil engineer, thus was performing "engineering service." Therefore, because the other conditions of § 448 were met – a 60 percent shareholder was a licensed engineer who performed engineering services for the corporation and oversaw its activities – the corporation's income was taxed at the flat 35 percent rate under § 11(b)(2), not at the graduated rates claimed by taxpayer.

3. Can't the IRS spell FANNIE MAE and FREDDIE MAC when \$5 trillion is at stake? Notice 2008-76, 2008-39 I.R.B. 768

(9/7/08). Sections 1117(a) and (b) of the **Housing and Economic Recovery Act of 2008**, Pub. L. No. 110-289 (2008), authorize the Treasury Department to purchase obligations and other securities issued by FANNIE MAE and FREDDIE MAC – described in the notice as “certain entities” to protect the names of the guilty parties – under the **Housing and Economic Recovery Act of 2008**. The IRS and Treasury will issue regulations under § 382(m) that will provide that notwithstanding any other provision of the Code or the regulations, for purposes of § 382, with respect to a corporation as to which there such an acquisition, the term “testing date” (as defined in Reg. § 1.382-2(a)(4)) will not include any date on or after the date on which the United States (or any agency or instrumentality thereof) acquires stock or an option to acquire stock in the corporation. The regulations will apply on or after September 7, 2008. Thus, the bailout of FANNIE MAE and FREDDIE MAC will not trigger an ownership change invoking the § 382 limitations on NOLs.

• Various media outlets attribute the substance of the provisions of the notice to Henry Paulson, who is reported to have ordered the IRS to issue the notice. See http://www.cfo.com/article.cfm/12079734/c_12079931?f=home_todayinfinance

4. Who needs Congress to legislate billions of tax benefits via loss carryovers from failing banks which 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.

5. 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.

6. 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

1. The **2007 Small Business Tax Act**, § 8215(a), added Code § 761(f), which provides that a husband and wife who operate a qualified joint venture may elect not to treat the joint venture as a partnership. A qualified joint venture is one conducted by a husband and wife both of whom are material participants and who file a joint return. Each spouse is required to report the spouse's share of income and expense items on a separate schedule C. Each spouse is individually assessed self-employment tax. I.R.C. § 1402(a)(17), as amended by the **2007 Small Business Tax Act**. Note that Rev. Proc 2002-69, 2002-2 C.B. 831, permitted a husband and wife to treat a wholly owned LLC held as community property as a disregarded entity.

a. **Chief Counsel clarifies employment tax rules.** Chief Counsel Advice 200816030 (4/18/08). Income of husband and wife from real estate rental and dividends, that is excluded from wages for self-employment tax purposes (§ 1402(a)), does not become subject to employment taxes by virtue of the making of an election under § 761(f) for treatment as a qualified joint venture.

2. I.R. 2008-110 (9/25/08). The IRS is considering the issue of guidance regarding technical termination of publicly traded partnerships under § 708(b) resulting in multiple taxable years of an affected partnership due to transfers of more than 50 percent of a partnership's capital and profits interests in a 12-month period.

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

1. **Final regulations test substantiality of partnership allocations by looking to the tax impact to the owners of look-through entities.** T.D. 9398, Partner's Distributive Share, 73 F.R. 28699 (5/19/08). Under § 704(b) partnership allocations provided in a partnership agreement are followed if the allocation has substantial economic effect. An allocation is substantial only if there is a reasonable possibility that the allocation will affect the dollar amounts to be received by the partners independent of the tax consequences of the allocation. Reg. § 1.704-1(b)(2)(iii)(a). The regulations

provide that an allocation is not substantial if the after-tax economic consequences to one partner are enhanced in present value terms while the after-tax economic consequences to other partners are not diminished. An allocation is not substantial if the economic consequence of the allocation is a shifting allocation (an allocation that merely shifts tax consequences without altering economic consequence) or a transitory allocation (an allocation that will be offset by another allocation so that net increases and decreases in partners' capital accounts will not differ substantially from what they would have been absent the allocation).

- The regulations clarify that the appropriate comparison is the after-tax consequences that result from an allocation with the after-tax consequences that would have resulted if the allocations were determined from the partners' interests in the partnership. Reg. § 1.704-1(b)(2)(iii)(a).

- The new regulations provide that in determining the economic detriment of an allocation to a look-through entity that is a partner, the effect of the allocation on the tax attributes of the owner of the look-through entity must be taken into account. Look-through entities include a partnership, S corporation, estate, trust, disregarded entity, and controlled foreign corporation that owns at least 10 percent of the capital or profits of the partnership. In addition, in the case of an allocation to a corporate partner that is a member of a consolidated group, the effect of the allocation on the tax attributes of members of the group is taken into account. Reg. § 1.704-1(d).

- The regulations contain a de minimis rule that the tax attributes of less than 10 percent partners, or partners to whom less than 10 percent of any item is allocated, need not be taken into account in determining substantiality. Reg. § 1.704-1(e).

- The new regulations also remove the presumption that if a partnership allocation does not have substantial economic effect, then with respect to the item the partners' interest in the partnership is per capita. The Treasury concluded that "because the per capita presumption failed to consider factors relevant to a determination of the manner in which the partners agreed to share the economic benefits or burdens corresponding to the allocation of partnership items, the correct result was reached in very few cases."

- The final regulations are effective as of May 19, 2008.

2. Proposed regulations would expand anti-abuse rules to look at the tax attributes of indirect owners to test allocations of built-in gain or loss. REG-100798-06, Contributed Property, 73 F.R. 28765 (5/19/08). Reg. § 1.704-3(a)(10) provides that an allocation with respect to contributed built-in gain or loss property under § 704(c) (or a reverse allocation in the case of a book-up) is not reasonable if the contribution of property and the allocation is

made with a view of shifting built-in gain or loss among partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. Proposed regulations would provide that in testing for a reduction in aggregate tax liability, the tax consequence to both direct and indirect partners would have to be considered. Indirect partners include the owners of an entity that is a partner and is a partnership, S corporation, estate, trust, or controlled foreign corporation that is a ten percent partner. Indirect partners include the members of a consolidated group in which the partner is a member.

- The proposed regulations would also provide in Prop. Reg. § 1.704-3(a)(1) that the use of allocation methods with respect to built-in gain or loss property only apply to contributions to a partnership that "are otherwise respected." The regulation would add that even though an allocation may comply with the literal language of Reg. § 1.704-3(b), (c), or (d) (traditional method, curative allocations, or remedial allocations), "the Commissioner can recast the contribution as appropriate to avoid tax results inconsistent with the intent of subchapter K." The proposed regulations would identify remedial allocations among related partners as one factor that may be considered.

- The proposed regulations would be effective on publication of final regulations in the Federal Register.

3. Sorting out § 162 from § 212 expenses in upper-tier and lower tier partnerships. Rev. Rul. 2008-39, 2008-31 I.R.B. 252 (7/4/08). This revenue ruling addressed the treatment of management fees paid by an upper-tier investment partnership (UTP) and by lower-tier trader partnerships (LTP) to their respective managers under §§ 162 and 212 where the upper tier partnership's activities consist solely of acquiring, holding, and disposing of interests in the lower tier trader partnerships and UTP's management fee is not paid or incurred by UTP on behalf of any LTP in connection with the trades or businesses of the LTPs. The ruling holds that UTP's management fee is not a § 162 deduction and cannot be taken into account in computing UTP's taxable income or loss described in § 702(a)(8). Rather, UTP's management fee is a § 212 expense and must be separately stated by UTP and separately taken into as a § 212 deduction by an individual limited partner. In contrast, the management fee paid by an LTP is a § 162 expense taken into account in computing the LTP's § 702(a)(8) bottom-line taxable income or loss. UTP's distributive share of LTP's bottom-line income or loss is taken into account in computing UTP's bottom-line income or loss, the distributive share of which an individual limited partner in UTP takes into account.

4. Partnership debt for equity swaps. Holy Asymmetry! The partners have COD income but the creditor doesn't have a loss deduction. REG-164370-05, Section 108(e)(8) Application to

Partnerships, 73. F.R. 64903 (10/31/08). As amended by the **American Jobs Creation Act of 2004**, § 108(e)(8) provides that for purposes of determining COD income of a partnership, if debtor partnership transfers a capital or profits interest to a creditor in satisfaction of either recourse or nonrecourse partnership debt the partnership is treated as having satisfied the debt with an amount of money equal to the fair market value of the interest. Any COD income recognized under § 108(e)(8) passes through to the partners immediately before the discharge. Prop. Reg. § 1.108-8 would provide that for purposes of § 108(e)(8), the fair market value of a partnership interest received by the creditor is the liquidation value of that debt-for-equity interest, if: (1) the debtor partnership maintains capital accounts in accordance with Reg. § 1.704-1(b)(2)(iv), (2) the creditor, debtor partnership, and its partners treat the fair market value of the debt as equaling the liquidation value of the partnership interest for purposes of determining the tax consequences of the debt-for-equity exchange, (3) the debt-for-equity exchange is an arm's-length transaction, and (4) subsequent to the exchange, neither the partnership redeems nor any person related to the partnership purchases the creditor's partnership interest as part of a plan that has as a principal purpose the avoidance of COD income by the partnership. If these conditions are not satisfied, all of the facts and circumstances are considered in determining the fair market value of the debt-for-equity interest for purposes of applying § 108(e)(8). Prop. Reg. § 1.721-1(d) would provide nonrecognition of loss in a debt-for-partnership interest exchange in which the liquidation value of the partnership interest is less than the outstanding principal balance of the debt. The creditor's basis in the partnership is determined under § 722. However, the proposed regulations provide that § 721 does not apply to the transfer of a partnership interest to a creditor in satisfaction of a partnership's indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount). In addition, the proposed regulations do not supersede the gain recognition rules of § 453B regarding dispositions of installment obligations. The proposed regulations will be effective when final regulations are published in the Federal Register.

C. Distributions and Transactions Between the Partnership and Partners

There were no significant developments regarding this topic during 2008.

D. Sales of Partnership Interests, Liquidations and Mergers

There were no significant developments regarding this topic during 2008.

E. Inside Basis Adjustments

There were no significant developments regarding this topic during 2008.

F. Partnership Audit Rules

1. Individual partners' reasonable reliance defenses to penalties is not part of TEFRA partnership proceeding. Stobie Creek Investments, LLC v. United States, 101 A.F.T.R.2d 2008-1151 (Fed. Cl. 3/10/08). The court (Judge Miller) rejected the motion of non-managing members of a family LLC to assert jurisdiction to hear individual defenses to accuracy related penalties based on asserted reasonable reliance on the advice of the managing investment advisor member of the LLC. The court held that TEFRA establishes a two-tier process under which the court in the partnership proceeding has jurisdiction to consider whether the partnership itself has a reasonable cause defense to asserted penalties, but not whether individual partners can assert a reasonable cause defense. Citing §§ 6230(c)(1) and 6231(a)(2)(B), the court indicated that individual partners may challenge an erroneous computational adjustment and may raise individual defenses to penalties in a refund action.

2. The statute of limitations tolls for these bean farmers. Christopher v. Commissioner, T.C. Memo. 2008-80 (4/2/08). Taxpayers reported partnership losses from an investment in Contra Costa Jojoba Research Partners in their 1983 and 1985 tax years. The IRS sent notices of final partnership administrative adjustment (FPPA) on May 30, 1989, and a petition was filed by the tax matters partner on July 13, 1989. The issuance of an FPPA suspends the three-year statute of limitations during the period a petition for judicial review may be brought, and until one-year following final decision. I.R.C. § 6229(d)(1) & (2). The Tax Court entered a decision against the partnership in April 2005, which was not appealed and became final in July 2005. Thus, the statute of limitations expired in July 2006, one-year and 90 days after the partnership level decision. An individual partner cannot challenge the timeliness of the FPPA issued to the partnership. Notices of deficiency issued to the taxpayers on April 17, 2006, were within the statute of limitations. The taxpayers were also held responsible for negligence penalties. Reliance on assurances of the tax shelter promoter, without further investigation, was rejected as reasonable reliance on the advice of professionals. The taxpayers were also subject to substantial understatement penalties related to the partnership deductions.

3. The partner was a party to a proceeding he didn't know about. Kimball v. Commissioner, T.C. Memo. 2008-78 (4/1/08). Taxpayer disputed liabilities for additional interest in tax motivated transactions in a Collection Due Process hearing. The Tax Court (Judge Haines) held that since the taxpayers had not received a notice of deficiency or other opportunity to dispute the tax for the interest increase the Tax Court would review the case de novo. However, the court held that the taxpayers were liable for the increased interest. Even if the tax matters partner failed to notify the taxpayer partner of the partnership proceedings (although the court was satisfied that the taxpayer was notified), the partner is a party to those proceedings, which remain applicable to the partner. Enhanced interest under § 6621(c) is a partnership level item so the Tax Court has limited jurisdiction to reconsider the item outside of the partnership level proceeding. See River City Ranches #1 Ltd. v. Commissioner, 401 F.3d 1136 (9th Cir. 2005). The determination in the partnership proceeding that the transaction lacked economic substance was sufficient to establish that the transaction was tax motivated and thus the enhanced interest was appropriate. The taxpayer was also assessed a failure to pay penalty for delayed payment of the deficiency.

4. Another reason to not just sit back and let the TMP handle the TEFRA audit. Prati v. United States, 81 Fed. Cl. 422 (4/16/08, reconsideration denied, 82 Fed. Cl. 373 (7/1/08)). Section 7422(h) bars partners who did not participate in a TEFRA partnership audit proceeding, but signed Forms 870-AD in connection with that proceeding, from pursuing refund claims challenging timeliness of assessments arising from the TEFRA partnership audit proceeding that were made more than three years after the partnership filed its tax return. (Note that § 6229(d) suspends that statute of limitations upon issuance of a FPAA.) Pursuant to § 6229(a), the statute of limitations on adjustments to partnership items is itself a partnership item (the statute of limitations on an affected item is partner specific). A determination of the timeliness of the assessment would affect the assessment for all partners and thus is a partnership-level determination, not an affected item determination.

5. Proof of mailing suffices. Proof of actual receipt is not necessary. McClaskey v. Commissioner, T.C. Memo. 2008-147 (6/9/08). Proof of mailing of notice of beginning of partnership administrative proceeding (NBAP) and final partnership administrative adjustment (FPPA) is sufficient to prevent a partner from treating an item as requiring partner level determination under § 6223(e)(2). Proof of the actual receipt of the mailing is not required.

6. Uncontested FPAA does not act as *res judicata* to consideration of a partnership tax deficiency in a bankruptcy proceeding. Central Valley AG Enterprises v. United States, 531 F.3d 750 (9th Cir. 6/25/08).

The Bankruptcy Code, 11 U.S.C. § 505(a), allows a bankruptcy court to determine the amount or legality of a tax unless the tax had been contested and adjudicated before a “judicial or administrative tribunal of competent jurisdiction” before commencement of the bankruptcy case. The taxpayer, Central Valley, wholly owned a subsidiary that invested in the tax shelter partnership. Central Valley thus was an “indirect partner” under the TEFRA audit rules. I.R.C. § 6231(a)(2), (9), (10). An FPAA issued to a tax shelter limited partnership was not contested by the tax matters partner or other partners. After the FPAA had become final, Central Valley filed a bankruptcy proceeding. The court concluded that since the FPAA was never challenged in a court of competent jurisdiction, 11 U.S.C. § 505(a) permits the bankruptcy court to adjudicate Central Valley’s tax liability attributable to the partnership item. The court held that the appeals conference more closely resembles a settlement conference than a hearing before an administrative tribunal that would preclude bankruptcy court jurisdiction.

7. The \$9,500 deposited was only \$2.9 million short; that’s a reasonable mistake. Kislev Partners v. United States, 84 Fed.Cl. 385 (Fed. Cl. 8/13/08). The taxpayer, a non-tax matters partner, filed an action seeking review of a final partnership administrative adjustment for Kislev Partners, which claimed \$140 million of losses in an abusive tax shelter known as a distressed asset/debt transaction (DAD). In order to invoke jurisdiction in the Court of Federal Claims, a filing partner is required under § 6226(e)(1) to make a deposit of the amount by which the taxpayer’s tax liability would be increased if the partner’s return were filed consistent with the treatment of partnership items in the FPAA. In this case the taxpayer made a deposit of \$9,500 reflecting the taxpayer’s potential tax liability for the year in which the claimed losses were passed through from the partnership. The taxpayer did not calculate the deposit based on the taxpayer’s liability for years to which he carried over the losses. The correct amount of the deposit, including claimed tax reductions in the carryover years was \$2,905,046, exclusive of penalties and interest. The court held that the deposit amount is to be calculated over multiple taxable years. However, the court was satisfied that the taxpayer made a good faith effort to determine the deposit under the statute and denied the government’s motion to dismiss, as long as the taxpayer has made the additional deposit within 60 days of the date of the opinion.

8. Former Chief Counsel Will Nelson wins one for a non-tax matters partner against the tax matters partner. Imprimis Investors, LLC v. United States, 83 Fed.Cl. 46 (Fed. Cl. 8/7/08). The tax matters partner filed an action challenging an FPAA. The tax matters partner asserted that the tax allocations made on the partnership return should be upheld over the reported inconsistent position taken on its return by the other partner. The Court of

Federal Claims (Judge Horn) granted summary judgment to the intervening partner interpreting the allocation provisions of the LLC agreement to include allocations of long-term capital gain income to the intervening partner, and increasing allocations of ordinary income to the tax matters partner.

9. The wrong form letter gives these partners two-bites at litigating their Son-of-BOSS shelter. JT USA LP v. Commissioner, 131 T.C. No. 7 (10/6/08). The taxpayers (“the Gregorys”) sold their business producing motocross and paintball accessories for a large capital gain. The business was in a family partnership in which the taxpayer husband and wife held both direct and indirect partnership interests (interests as members of an LLC that was a member of the partnership being audited). The Gregorys were indirect partners, through both an S Corporation and a partnership, in a Son-of-Boss partnership. Just before the statute of limitations expired, The IRS issued a notice of final partnership administrative adjustment (FPAA) to partnership and its partners without ever having provided to the partners a § 6223(a) notice that a partnership level proceeding was commencing. The IRS also sent a form letter notifying the partnership that under § 6223(e)(2) the partners could elect into the TEFRA partnership proceedings. The form letter was the wrong form letter, but the Gregorys responded and elected out as indirect partners but asked to have the “partnership items of the Direct Partner treated as partnership items.” Because there was no advance notice of an audit, but the received notice before the time to challenge the adjustments proposed by the FPAA had run, the default rule of § 6223(e)(3), not § 6223(e)(2), applied, and any partner entitled to receive notice had the right to opt out and not the right to opt in. By the time the partnership engaged in the Son-of-Boss transaction to which the FPAA proposed adjustments related, the Gregorys’ only interest was held as indirect partners. Thus, if the election had been valid, the Gregorys would not be subject to any deficiency proceedings because any items that become nonpartnership items under § 6223(e) are subject to the standard deficiency procedures of §§ 6211 through 6216, see § 6230(a)(2)(A)(ii), and the IRS has one year from the time a partner’s partnership items become nonpartnership items to send a notice of deficiency to that partner, see §§ 6229(f)(1), and the § 6503(a) election was made more than one year before the Tax Court proceeding. The Tax Court (Judge Holmes) held that the Gregorys were allowed to make separate elections as direct and indirect partners and that their elections to opt out as indirect partners were valid. The Gregorys’ elections to “opt in” in their capacity as direct partners had no effect because the default rule dictates the same result under § 6223(e)(3); a partner is bound by the TEFRA proceedings unless a proper election is made to opt out.

10. Who’s the partner is not a partnership item. Sands v. United States, 84 Fed.Cl. 209 (Fed. Cl. 10/9/08). Robert Sands, one of four

equal partners in a limited partnership, transferred partnership interests to four charitable remainder unitrusts. The partnership sold stock and claimed substantial losses. In an FPAA issued to the partnership the IRS reduced the partnership's asserted basis in the sold stock which resulted in a partnership capital gain. The IRS also sought to allocate the recognized gain to Sands by claiming that the transfers of partnership interest to the charitable remainder trusts were economic shams. The court (Judge Hewitt) held that the identity of a partner is not a partnership item subject to determination in a TEFRA partnership proceeding. The court dismissed Sands as the filing partner in the proceeding and substituted the charitable remainder trusts. Nonetheless, the court refused to refund Sand's deposit as a filing partner.

11. Whether it's a partnership is a partnership item.

Petaluma FX Partners, LLC v. Commissioner, 131 T.C. No. 9 (10/23/08). Petaluma was formed to invest in foreign currency options trading. The investor partners contributed offsetting long and short foreign currency options on 10/10/00. The investor partners increased their partnership bases for the premiums of the long options, but did not offset basis to reflect a reduction of liabilities for the short options. The investors withdrew from the partnership on 12/12/00, claiming a high basis in distributed property. The property was sold for a loss on 12/26/00. In the FPAA issued to the partnerships, the IRS claimed that the partnership should be disregarded, and that even if the investors formed a partnership, the partnership had no business purpose other than tax avoidance and lacked economic substance. In granting summary judgment to the IRS, the court (Judge Geoke) held that whether a partnership exists, and whether the partnership has a business purpose or lacks economic substance, are partnership items as described in Reg. § 301.6231(a)(3)-1(a) over which the court has jurisdiction in a partnership proceeding. The court noted that because determination whether a partnership is a sham or lacks economic substance underlies all of the partnership's purported tax items, the determination fits "squarely" within the regulations identification of partnership items.

- The court rejected the partnership's argument that because sham treatment requires an examination of all of the facts and circumstances, including the intent of individual partners, the determination must be made at the partner level. Since the partnership indicated that it would not contest the determination on other than the jurisdictional grounds, the court issued summary judgment for the IRS that the partnership was disregarded.

- The determination of the partners' outside basis in this case was also treated as a partnership item because, once the partnership was disregarded, no partner-level determinations were necessary. The court also held that it had jurisdiction to determine accuracy related penalties attributable to the determination that the partnership should be disregarded.

- Finally, the court rejected the taxpayer's attempt to challenge valuation understatement penalties on the merits because of the taxpayers' stipulations in the case, but indicated that the taxpayers could challenge the penalties in a refund action.

12. Natty Bumpo wouldn't have signed that extension agreement. Leatherstocking 1983 Partnership v. Commissioner, 102 A.F.T.R.2d 2008-6695 (2d Cir. 10/20/08) (per curiam), *rev'g* T.C. Memo. 2006-164 (8/14/06). The Second Circuit held that – inasmuch as the IRS knew that the tax matters partner had been placed under criminal investigation – the tax matters partner was laboring under a conflict of interest and could not provide the IRS with consents that bound the underlying partners and partnership. This was so even though the IRS had not misled the partners about the extent of the criminal conduct of the tax matters partner.

13. 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, 842-843 (1984), and noting that the Court of Appeals to which the case is appealable [the D.C. Circuit] has indicated that IRS regulations are to be given *Chevron* deference.

14. Strunk and White, *The Elements of Style*, help identify the statute of limitations as a partnership item. Keener v. United States, 103 A.F.T.R. 2d 2009 364 (Fed. Cir. 1/8/09). The taxpayers invested in tax shelters promoted by AMCOR in the mid-1980's. 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 may 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's assessment of tax. The court affirmed the finding 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 taxpayers 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." (Following *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 taxpayers' 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.

G. Miscellaneous

1. Partnership interest incurred in the business of trading securities is treated as investment interest to a noncorporate limited partner. Rev. Rul. 2008-12, 2008-10 I.R.B. 520 (2/19/08). The IRS ruled that a limited partner in a partnership engaged in the trade or business of trading securities is subject to the investment interest limitation of § 163(d) on the partner's distributive share of the partnership's interest deduction. Section 163(d)(5)(A)(ii) provides that the term "property held for investment" includes any interest held by a taxpayer in an activity involving the conduct of a trade or business that is not a passive activity and with respect to which the taxpayer does not materially participate. Reg. § 1.469-1T(e)(6) provides that trading personal property for the account of owners of an interest in the activity (without regard to whether or not the activity is a trade or business) is not a passive activity. Thus,

partnership interest of a partner who is not a material participant is investment interest described in § 163(d)(3). As such it is subject to the § 163(d) limitation on the deduction of investment interest.

a. But the interest is deductible above the line.

Rev. Rul. 2008-38, 2008-31 I.R.B. 249 (7/3/08). This revenue ruling addressed two issues. First, with respect to an individual limited partner who does not materially participate, interest paid or accrued on indebtedness allocable to investment-type property [see § 163(d)(5)(A)(ii)] by a partnership engaged solely in the trade or business of trading securities for its own account and not for customers is, after the application of the § 163(d)(1) limitation, a deduction described in § 62(a)(1) that is taken into account in determining AGI. Second, if an individual has both (1) investment interest expense described above, and (2) investment interest expense attributable to indebtedness allocable to investment property held in an activity that is excluded from the definition of a passive activity by § 469(e)(1) [see § 163(d)(5)(A)(i)], e.g. investment assets owned by the same partnership, and (3) the individual partner's aggregate investment interest expense is greater than his net investment income, the taxpayer must allocate net investment income between the two categories of investment interest expense. A reasonable method of allocation is an allocation proportionate to the relative amounts of interest expense within each category.

b. The interest expense is reported on Schedule

E. Announcement 2008-65, 2008-31 I.R.B. 279 (7/4/08). The limited partner described in Rev. Rul. 2008-12 should include the allowable amount of his distributive share of the trading partnership's interest expense described in § 163(d)(5)(A)(ii) on Schedule E (identified in Part II, Line 28, column (a), as "investment interest," followed by the name of the trading partnership that paid or incurred the interest expense, and the amount of such interest expense should be entered in column (h)) in computing ordinary business income or loss.

2. Not "*E pluribus unum*" but "Many out of one."

Private Letter Ruling 200803004 (1/18/08). This PLR ruled that each series of a series LLC (organized under Delaware law) is treated as a separate tax entity and its own tax status will be determined independently of the other series, based upon its own characteristics and elections. Some of the series were disregarded entities, some were partnerships, and others were corporations (RICs on the facts).

3. Publicly traded partnerships that are treated as partnerships are to include partnerships in the business of marketing carbon dioxide or transporting alternative fuels. The Emergency Economic Stabilization Act of 2008 [Division B], the Energy Improvement and

Extension Act, §§ 116 and 208, amending § 7704(d)(1)(E). Publicly traded partnerships that derive income from investment, activities, real estate and natural resources are excepted from the requirement that a publicly traded partnership be taxed as an association. The definition of qualifying income is expanded to include income derived from the marketing of industrial source carbon dioxide and income derived from the transportation and storage of alternative fuels (biodiesel, alcohol, etc.).

4. LMSB asserts that the § 118 exclusion does not apply to partnerships. LMSB-04-1007-069, 2007 TNT 202-16 (10/18/07), *reaffirming* LMSB-04-1106-016 (10/28/06). The § 118 exclusion from income for nonshareholder contributions to the capital of a corporation does not apply to partnerships. The directive contains the following admonition, “This Directive is not an official pronouncement of law, and cannot be used, cited, or relied upon as such.”

a. LMSB reiterates this position in a coordinated issue paper for all industries. LMSB-04-1008-051, 2008 TNT 225-14 (11/18/08). The IRS has advised that a partnership or any other non-corporate entity cannot use § 118(a) or any common-law “contribution-to-capital” doctrine to exclude from gross income amounts received from persons other than an owner of the entity.

- This is a Tier 1 issue for litigation purposes, and it arises because of the prevalence of tax increment financing by municipalities.

VIII. TAX SHELTERS

A. Tax Shelter Cases

1. Notice 2000-44. Baby BOSS is a fraud too! Notice 2000-44, 2000-36 I.R.B. 255 (8/11/00). “Artificial” capital losses generated by baby BOSS transactions will not be allowed. (Note that Notice 99-59, 1999-52 I.R.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 to be deductible. T.C. Memo 1988- 570, in which the government won a summary judgment that commodities straddles were shams despite not having offered evidence of the taxpayers’ offsetting gains. The notice also cites Reg. §1.702-2 [the partnership anti-abuse rules]. The government also is reexamining the partnership basis rules.

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

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

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.

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), on appeal to the Fifth Circuit (9/19/07). 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.

4. Cemco. There is a partnership liability in a short sale: Another shelter falls on summary judgment for the IRS with penalties, and a FPAA to one is as good as an FPAA to the other. This case differs from Klamath because the transaction was entered into following the 8/11/00 release of Notice 2000-44 (which made it a listed transaction). Cemco Investors, LLC v. United States, 99 A.F.T.R.2d 2007-1882 (N.D. Ill. 3/27/07), *aff'd*, 515 F.3d 749 (7th Cir. 2/7/08), cert. denied, 129 S.Ct. 131 (10/6/08). In this tax shelter scheme, Cemco Investment Trust (CIT), a grantor trust, entered into two foreign exchange digital option transactions on December 2, 2000, with Deutsche Bank. CIT simultaneously purchased a \$3.6 million digital foreign currency option (the long position) and sold a digital foreign currency option for \$3.564 million (the short position). On the following day CIT assigned the options to Cemco Investment Partners (CIP), a general partnership. A few days later, CIP purchased €55,947 for \$50,000. CIP then entered into a termination agreement with respect to both of the option contracts. On December 21, CIP was liquidated with a transfer of the €55,947 and \$45,847 to CIT. The transfer occurred by moving assets from CIP's account at Deutsche Bank to CIT's account. On December 26, CIT transferred the euros to Cemco LLC. On December 29, Cemco sold the majority of the euros for \$51,324 (a non-functional currency treated as property). Cemco and CIP consisted of two partners, Steven Kaplan and Forest Charter Holdings, Ltd. Forest was a shell company to orchestrate the transactions. Forest's sole shareholder and president, Paul Daugerdas, was the trustee of CIT. Kaplin and Forest were the CIT beneficiaries.

- Cemco claimed a \$3.53 million loss on the sale of the euros. CIP claimed a \$3.6 million basis in the long currency position, and that the contingent obligation of the short position is not treated as a liability for § 752 purposes, which would otherwise have reduced basis on termination of the contracts. (See *Helmer v. Commissioner*, T.C. Memo. 1975-160.) Cemco asserted that while CIP had a total tax basis of \$3.6 million, its only assets were the euros and cash in its possession. Thus, the basis of the euros distributed in liquidation would be \$3.6 million less the \$47,847 cash, producing a loss on the sale of euros. The District Court held that Notice 2000-44, 2000-2 C.B. 255, which was issued on 9/5/00 [predating the transaction], and Reg. § 1.752-1(a)(4)(ii), issued in June 2003, established that the contingent obligation represented by the short sale would be treated as a liability to prevent the creation of artificial basis in transactions designed to create artificial tax losses by overstating basis. Thus, Cemco's losses were disallowed.

- Cemco's major claim was that that the FPPA should have been issued to CIP, which was the partnership that executed the transactions and thereby generated the basis figure with respect to property distributed to Cemco. Agreeing with the Government, the District Court held that, although the basis of the Euros was a partnership item of CIP, Cemco was also required to correctly determine the basis of the euros contributed to it and could not merely carry over the basis as determined by either CIT or CIP. Thus, the FPPA issued to Cemco was not premised on CIP's errors.

- The summary judgment also affirmed imposition of the § 6662(a) accuracy related penalty, increased to 40% under § 6662(e) for a gross valuation misstatement.

a. Affirmed, with very strong support for the authority of the IRS to issue retroactive regulations. 515 F.3d 749 (7th Cir. 2/7/08). Judge Easterbrook upheld the retroactive application of Temp. Reg. § 1.752-6T to reduce the basis of the partnership interest by the contingent obligation. He reasoned that § 309(d)(2) of the 2000 Act specifically provided that the basis reduction regulations for partnerships authorized by that act could be retroactive to October 18, 1999, and “[t]hat’s the power the Commissioner used when promulgating Treas. Reg. § 1.752-6.” Judge Easterbrook rejected what he read as the holding of the district court in *Klamath* [440 F. Supp. 2d 608] – that although a retroactive application of the regulation could have been grounded on the 2000 Act, the IRS had not properly availed itself of that power.

- Judge Easterbrook reasoned:

But if the IRS was not using that authority, why in the world does the regulation reach back to October 18, 1999? Retroactivity requires justification; to make a rule retroactive is to invoke one of the available justifications; and the choice of date tells us that the justification is the one supplied by the

2000 Act (in conjunction with §7805(b)(6)). A regulation's legal effect does not depend on reiterating the obvious. So Treas. Reg. §1.752-6 applies to this deal and prevents Cemco's investors from claiming a loss.

Judge Easterbook added that Cemco was "scarcely in a position to complain – not only because this tax shelter was constructed after the warning in Notice 2000-44, but also because all the regulation does is instantiate the pre-existing norm that transactions with no economic substance don't reduce people's taxes." Finally, Judge Easterbook rejected Cemco's procedural argument that an FPPA should have been issued to CIP. Such an action was not required because Cemco never had been partner of CIP, and thus its basis in the euros was not a partnership item of CIP, even if the basis of the euros in the hands of CIT, which contributed them to Cemco was the same as in the hands of CIP.

- Note that unlike Judge Easterbrook, we read the holding of *Klamath* to be that the retroactive application of Temp. Reg. § 1.752-6T was invalid under the Fifth Circuit precedent in *Snap-Drape Inc. v. Commissioner*, 98 F.3d 194, 202 (5th Cir. 1996), because the retroactivity to a transaction before the date of Notice 2000-44 was an abuse of discretion.

5. Jade Trading. The Court of Federal Claims follows Coltec on the economic substance issue. *Jade Trading LLC v. United States*, 80 Fed. Cl. 11 (12/21/07). The Court of Federal Claims (Judge Williams) held that, although they literally complied with the Code, digital options spread transactions lacked economic substance. She relied upon *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), to reach that conclusion. Judge Williams stated,

In sum, this transaction's fictional loss, inability to realize a profit, lack of investment character, meaningless inclusion in a partnership, and disproportionate tax advantage as compared to the amount invested and potential return, compel a conclusion that the spread transaction objectively lacked economic substance.

- The 20 percent and 40 percent penalties were applied although the § 6664 reasonable cause exception issue was postponed to possible partner-level proceedings.

a. Reconsideration denied. 81 Fed.Cl. 173 (3/20/08). The taxpayer argued that the negligence penalty should not have been applied at to the partnership, because the inaccurate reporting occurred on the individual partner's tax returns, not on Jade's. Judge Williams responded as follows:

The Code dictates that the Court assess the applicability of the negligence penalty with respect to the partnership in the context of this partnership proceeding. First, section 6621, “Tax Treatment Determined at Partnership Level,” directs that the tax treatment of any “partnership item” and the applicability of any penalty which “relates to” an adjustment to a “partnership item” shall be determined at the partnership level. ... The negligence penalty clearly related to the inflated basis the spread transaction in the partnership generated on the [partner’s] individual returns

Although typically accuracy-related penalties are applied at the partnership level based upon the *partnership return’s* inaccurate reporting, it would be inappropriate to eliminate the penalty here solely because there are no numerical inaccuracies on Jade’s partnership tax return. Applying the negligence penalty to the partnership here is particularly appropriate because it was only the construct of forming the partnership and contributing the spread to the partnership that permitted the tax losses to be realized. Had the Ervin LLCs simply done the spread transactions on their own without contributing them to Jade there would have been no substantial losses. As the Court recognized: “packaging the investment in the partnership vehicle was an absolute necessity for securing the tax benefits.” Jade, 80 Fed. Cl. at 14.

... [S]ections 6621, 6226(f) and 6662(b) and (c), read together permit the Court to determine whether an underpayment on an individual partner’s tax return is “attributable to” negligence that “relates to” partnership items. In doing so, the Court is free to analyze the conduct at the partnership level which generated the losses. (emphasis in original)

6. COLM. This decision might have a “colming” effect on the IRS. *COLM Producer, Inc. v. United States*, 460 F. Supp. 2d 713 (N.D. Tex. 10/16/06). The court (Judge Godbey) upheld the disallowance of a loss of about \$102.7 million on the sale of a limited partnership interest in December 1999. The partnership interest was funded by the Ettman Family Trust with \$2 million plus the contribution of the \$102.5 million proceeds of the short sale of \$100 million (face value) of U.S. Treasury Notes subject to the obligation to replace the borrowed T-notes. The partnership interest was then sold to an unrelated third party for \$1.8 million. Judge Godbey held that the obligation to

replace the borrowed T-notes [on the closing of the short sale] should have been treated as a liability under § 752. Although contingent liabilities were not included as liabilities under § 752, the obligation to close the short sale was a “liability” based upon his reading of the Black’s Law Dictionary definition [“the quality or state of being legally obligated or accountable” or, “a financial or pecuniary obligation”]; he reinforced his conclusion by citing Rev. Rul. 95-26, 1995-1 C.B. 131, and *Salina Partnership LP v. Commissioner*, T.C. Memo. 2000-352.

a. **Affirmed *sub. nom.* Kornman & Associates Inc. Short sale obligations in Son-of-Boss transaction are indebtedness under § 752(b).** *Kornman & Associates Inc. v. United States*, 527 F.3d 443 (5th Cir. 5/12/08). This variant of the Son-of-Boss shelter involved the taxpayer entering into a short-sale of Treasury notes, followed by contribution of the \$102.5 million of cash proceeds and the obligation to replace the borrowed Treasury notes to a partnership. The taxpayer then sold the partnership interest for a \$1.8 million promissory note from the buyer claiming a basis of \$102.5 million and a capital loss. The taxpayer claimed that relief from the obligation to replace the Treasury bills was a contingent liability based on closing the short sale and therefore not release of indebtedness includible in amount realized on sale of the partnership interest under § 752(b). The Fifth Circuit affirmed summary judgment for the government holding that the obligation to close a short sale is a liability for purposes of § 752. (See Reg. § 1.752-1(a)(4)(i), effective May 26, 2005).

- The court followed Rev. Rul. 88-77, 1988-2 C.B. 128; Rev. Rul. 95-26, 1995-1 C.B. 131; and Rev. Rul. 95-45, 1995-1 C.B. 53, in holding that short sale obligations are taken into account in computing basis. The court held that the revenue rulings are not entitled to deference under *Chevron USA, Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984), but, although not controlling, the rulings are entitled to some deference depending on the power to persuade. *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).

- The court also held that the open transaction treatment applied to short sales under § 1233 applies to recognition of capital gains and losses and has no role in determining basis under § 752.

7. ***Marriott International. Short sale obligations are treated as liabilities under § 752.*** *Marriott International Resorts, L.P. v. United States*, 83 Fed.Cl. 291 (Fed. Cl. 8/28/08). The taxpayer, Marriott Resorts was a limited partnership consisting of Marriott International JBS Corporation (JBS), the general partner, and Marriott Ownership Resorts, Inc. (MORI), the limited partner. JBS was the general partner of MORI. The limited partner in MORI was Marriott International Capital Corporation. MORI sold timeshare units in resort properties and subsequently transferred the buyer’s promissory notes to TIAA.

MORI entered into a short sale of five-year Treasury notes and invested the proceeds of the short sale in repurchase obligations (Repos) yielding a fixed return. MORI contributed the repurchase obligations and some mortgage notes to the taxpayer partnership for a 99 percent limited partnership interest. The partnership assumed MORI's obligation on the short sale. (This is similar to a Son of BOSS transaction but predates the retroactive effective date of Reg. § 1.752-6.) The partnership closed the short sales by using funds from the repurchase obligations to acquire Treasury securities. MORI then transferred its partnership interest to Marriott International Capital Corporation, which caused a termination and re-formation of the partnership under § 708(b). All of the parties claimed a basis in partnership interests and partnership assets from the cost of the repurchase obligations unreduced by the obligation under the short sale, and used this basis to claim losses on the ultimate disposition of partnership assets (done through a grantor trust). The partnership claimed a loss on the sale of the contributed mortgage notes. The Claims Court (Judge Lettow) held on summary judgment that the obligation under the short sale was a liability for purposes of § 752(b) that reduced the partnership's basis in its assets, and thereby eliminated the claimed losses. The court followed the result in *Salina Partnership v. Commissioner*, T.C. Memo 2000-352, and rejected arguments based on holdings in *La Rue v. Commissioner*, 90 T.C. 465 (1988); *Long v. Commissioner*, 71 T.C. 1 (1978); and *Helmer v. Commissioner*, T.C. Memo 1975-160. Citing Rev. Rul. 88-77, 1988-2 C.B. 128, the court noted that the taxpayer was on notice that the IRS would assert that symmetry is required under § 752 on the transfer of property that creates basis and offsetting contingent obligations that should reduce basis.

8. *Sala*. Interest is suspended under § 6404(g) because of the absence of fraud. *Sala v. United States*, 552 F.Supp.2d 1157 (D. Colo. 5/1/07). If an individual files a timely return (including extensions) and the IRS has not sent the taxpayer a notice of additional liability (e.g., a math error notice of deficiency), including an explanation of the basis for the liability, within one year following the later of (1) the due date of the return (*without* regard to extension), or (2) the date on which the taxpayer filed the return, § 6404(g)(1) suspends the accrual of interest for the period beginning one year after the due date (or filing, if applicable) of the return. Interest resumes running twenty-one days after the IRS sends a notice to the taxpayer. Section 6404(g) does not apply at all if an underpayment is due to fraud. In this case, the district court held that the fraud exception to § 6404(g) does not apply to a deficiency from a tax shelter transaction ["Baby BOSS"] that lacked economic substance, unless the government shows that the taxpayer engaged in some act of concealment or misrepresentation. Even though the taxpayer entered into the transaction knowing that it was a listed transaction [Notice 2000-44], and knowing that it would not be registered with the IRS in order to conceal his participation,

because taxpayer relied on a “more likely than not opinion” by R.J. Ruble that the tax results of the transaction would be upheld, the taxpayer acted in good faith and the government could not prove that the taxpayer had fraudulent intent. Summary judgment was entered for the taxpayer.

a. Was it a “qualified amended return”? Sala v. United States, 99 A.F.T.R.2d 2007-3011 (D. Colo. 5/30/07). On plaintiff’s motion for partial summary judgment, Judge Babcock held that the amended 2000 return filed by Sala on 11/18/03 was possibly not a “qualified amended return” because the date that the IRS notified KPMG that it was under a § 6700 examination was 10/17/03. The resolution of this issue depended upon the scope of the § 6700 examination at the time the amended return was filed, and an issue of fact existed that precluded summary judgment. The court refused to stay the case pending the availability of testimony from Sala’s KPMG accountant, Tracie Henderson, and from R.J. Ruble, both of whom indicated they would invoke their Fifth Amendment rights, because the delay would be substantial and would prejudice Sala.

b. Sala v. United States, 100 A.F.T.R.2d 2007-5097 (D. Colo. 7/3/07). Judge Babcock reiterated his holding that there is an issue of fact as to whether the 11/18/03 amended return was a qualified amended return.

c. District Court holds for the taxpayer on the merits in an options transaction for which R.J. Ruble provided the tax opinion. Sala v. United States, 552 F. Supp. 2d 1167 (D. Colo. 4/22/08). The District Court (Judge Babcock) held that taxpayer was entitled to a \$60 million ordinary loss on 24 long and short currency options entered into in November 2000 as part of a Deerhurst Program, in which the options were contributed to a partnership. The basis of that partnership interest was increased by the cost of the long options but was not reduced by the contingent liability on the short options under Helmer v. Commissioner, T.C. Memo. 1975-160 (1975). This was based upon Judge Babcock’s finding of fact that the long and short options were separate instruments for tax purposes. The court found that the regulations issued in 2003, Reg. § 1.752-6, retroactive to October 1999, which contained an “exception to the exception” for transactions described in Notice 2000-44, exceeded Treasury’s authority. Judge Babcock held that the regulations were not legislative because the “exception to the exception” was not comparable to the rules for corporations described in § 358(h). Judge Babcock concluded that the corporate rules were only “to prevent acceleration or duplication of losses,” which were not involved in the transactions described in Notice 2000-44. He refused to follow Cemco Investors, LLC v. United States, 515 F.3d 749 (7th Cir. 2008).

- Judge Babcock analyzed the complex transaction under the step transaction doctrine and found the doctrine inapplicable.
- He found the losses deductible under § 165(c)(2) because they were incurred in a transaction entered into for profit, which was to be determined at the time taxpayer entered into the transaction, and not in hindsight. In this, Judge Babcock credited Sala's testimony that "he expected his investment in Deerhurst to be profitable above and beyond the expected tax loss"
- He found the taxpayer was "an extremely cautious investor who invested a great deal of time and energy carefully researching and choosing his investments" and that he had a business purpose other than tax avoidance for structuring his investment as he did.
- Judge Babcock further held that Sala's amended return filed on 11/18/03 was a "qualified amended return" because KPMG had not been contacted regarding Deerhurst prior to that date, although it had been previously contacted regarding transactions similar to Deerhurst.

d. Government motion on 6/10/08 for new trial based upon affidavit given in connection with decision not to prosecute investment manager. Andrew J. Krieger, a key witness for the taxpayer, stated in an affidavit dated 5/22/08 that a portion of the testimony he gave at deposition was false, in that there was no "test period" for an "investment program" but merely an effort to obtain tax savings. 2008 TNT 114-15. The motion was opposed by the taxpayer because Krieger gave his affidavit only after the government granted him immunity from prosecution by executing a non-prosecution cooperation agreement in connection with a criminal investigation unrelated to this case, i.e., the Coplan criminal case pending in the Southern District of New York. 2008 TNT 130-62, 7/1/08.

e. Government motion for new trial denied. 251 F.R.D. 614, 102 A.F.T.R.2d 2008-5292 (7/18/08). Judge Babcock denied the motion, holding that the evidence submitted by the government was not new. He stated, "Rather than implying diligence, the timing of this "new" evidence instead implies a deliberate attempt on the part of the Government to further delay and derail this case for tactical gain."

9. Stobie Creek. The Court of Federal Claims denied retroactive application of the regulations, but slammed the door on the digital options strategy on economic substance grounds and upholds penalties. *Stobie Creek Investments, LLC v. United States*, 82 Fed. Cl. 636 (Fed. Cl. 7/31/08). The Welles family recognized substantial capital gain on disposition of 50 percent of the family residential entry door business for \$455 million. Prior to sale the family transferred their stock holdings in the family

corporation, Therma-Tru, to a family investment partnership, Stobie Creek. The partnership, through single member LLCs, participated in the Jenkins & Gilchrist digital options strategy, to no avail according to the Court of Federal Claims. In an extraordinarily detailed and lengthy opinion, the court held:

- *Helmer v. Commissioner*, T.C. Memo. 1975-160, establishes that the contingent nature of the short sold position in foreign currency prevents a reduction in basis for a reduction in partnership liabilities on distribution of property from the partnership. Thus the potential liability on the open currency option did not reduce the taxpayers' basis in distributed Therma-Tru stock, whose basis was increased by the purchase price of the short options.

- Retroactive application of Reg. § 1.752-6 is not justified by § 309 of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 309, 114 Stat. 2763A-587, -638. That provision was aimed at corporate transactions and is focused on the use of contingent liabilities to accelerate or duplicate losses. The court opined that, "The transfers of the contingent liabilities in the cases at bar resulted in increasing each partner's outside basis, but did not cause any acceleration or duplication of losses."

- Judge Miller held that the long and short digital options were two options, not one as contended by the government.

- Judge Miller dismissed Notice 2000-44, which was issued in August 2000, after the transactions occurred but before they were reported by taxpayers in 2001, as follows:

[The government's] argument misunderstands the import of IRS notices. As a general proposition, IRS notices are press releases stating the IRS's position on a particular issue and informing the public of its intentions; such notices do not constitute legal authority. Whether [taxpayers] had "notice" that their transactions would be subject to scrutiny has no bearing on whether a Treasury regulation, seeking retroactively to effect a change in the law, can serve to disallow [taxpayers'] reporting position.

- Nonetheless, under *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), the partnership transaction in options lacked economic substance. The court indicated that in *Coltec*, "The Federal Circuit thus adopted a disjunctive test for determining whether a transaction should be disregarded as an economic sham: the doctrine should apply and a transaction should be disregarded either if the transaction lacks objective economic substance or if it is subjectively shaped solely by tax avoidance motivations." After an exhaustive analysis of conflicting expert opinions, the court found that, "the weight of the evidence overwhelms plaintiffs' claim that the transactions were investments motivated by a business purpose to return a profit." The court also interpreted *Coltec* as holding that, "if a transaction was shaped solely by a tax-avoidance purpose, the fact that the transaction may have some

objective economic reality cannot save it from being disregarded as an economic sham.” As to the taxpayers’ subjective purpose, the court found that, “Plaintiffs’ limited evidence of non-tax avoidance subjective motivation does not imbue the transactions with economic substance.”

- The court also applied the step transaction doctrine to deny the claimed tax benefits. The court stated, “Trial established that, under either the interdependence test or the end result test, the step transaction doctrine applies to plaintiffs’ transactions. Accordingly, the tax consequences must turn on the substance of the transaction and not on the form by which plaintiffs engaged in it. In disregarding the predetermined steps of the J&G strategy, Stobie Creek is unable to claim a basis increase in the Therma-Tru stock, and the capital gains must be taxed according to the reality of the transaction.”

- The court upheld accuracy and negligence penalties and rejected the taxpayers’ claims that they reasonably relied on the advice of counsel. The court concluded that because of the built-in conflict of interest of the lawyers promoting the transaction that was known to the taxpayers, reliance on the legal opinions was not reasonable.

10. *Countryside*. A major partnership razzle dazzle that defers real estate gains with liquidation distributions survived economic substance scrutiny by the Tax Court, but there is much more to come. Countryside Limited Partnership v. Commissioner, T.C. Memo. 2008-3 (1/2/08). The Tax Court (Judge Halpern) granted summary judgment to limited partners holding that distributions of non-marketable securities held by a disregarded LLC in liquidation of limited partners’ interests were respected as distributions of non-marketable securities that did not trigger recognition of gain under § 731. The partnership borrowed \$17 million (guaranteed by one of the distributee partners) which it used to acquire a 99 percent interest in two LLCs. The LLCs borrowed an additional \$3.4 million and purchased non-traded notes from AIG. The interest payable on the notes was less than the interest paid on the debt. The LLC interests were distributed to two limited partners in liquidation of their interests in 2000. The reduction in the liquidated partners’ share of partnership liability did not exceed the basis generated by the liabilities. The partnership sold its highly appreciated real estate in 2001. The proceeds of sale were used to repay the partnership’s liabilities. The AIG notes were redeemed in 2003. The Tax Court rejected the IRS’s claim that the economic substance of the transaction was a distribution of cash. The court was satisfied that, although the transaction was structured to avoid tax, in economic substance the transaction represented a conversion of the taxpayers’ investments in the partnership to investments in 10-year promissory notes, “two economically distinct forms of investment.” The issue of the partnership’s step-up in basis under § 734(b) as a result of the liquidation distributions remained at issue in a separate case addressing the partnership’s 2001 taxable year.

11. 7050 Ltd. Son-of-Boss deal fails because a few thousand C\$ were left behind in a bank account. 7050 Ltd. v. Commissioner, T.C. Memo 2008-112 (4/23/08). The Son-of-Boss transaction relies on a partnership liquidation distribution of property that takes an inflated exchanged basis under § 732(b). One of the issues in the government’s partial summary judgment motion in this Son-of-Boss tax shelter case was whether a distribution of property (foreign currency) from the partnership was a liquidating distribution, resulting in an exchanged basis for the property determined with reference to the partnership interest pursuant to § 732(b) (which the taxpayer partner claimed was determined with respect to a high basis option contributed to the partnership), or a current distribution, resulting in a transferred basis from the partnership pursuant to § 732(a). The Tax Court (Judge Holmes) granted summary judgment for the Commissioner, holding that liquidation of a partner’s interest on dissolution of a partnership requires a complete termination of all partnership activities, including the distribution to the partners of all the partnership’s assets. The presence of a few thousand Canadian dollars in an account belonging to the partnership, distributed in the next taxable year, caused a distribution of property to a partner in the prior year to be treated as a current distribution to the partner in which the distributee partner’s basis in the distributed property was the transferred partnership’s basis under § 732(a), rather than the higher exchanged basis from the partner’s outside partnership basis. Property distributed in complete liquidation of a partner’s interest takes the partner’s outside basis in the partnership interest under § 732(b). In addition, the court refused to grant summary judgment to the Commissioner on the issue of whether options originally contributed to the partnership had expired by the date of the contribution indicating that the issue depended on questions of fact that could not be settled on summary judgment. The Tax Court also reserved judgment on penalty issues pending resolution of whether Temp. Reg. § 301.6221-1T(c), treating reasonable reliance as a partner-level defense, is valid.

• This is a more appropriate way of attacking tax shelters than by the government relying on amorphous judicial doctrines and on whether a black muumuu wearer is “shocked, shocked” by the result of Congressional language plainly interpreted.

12. LILO. Hi-Lili, Hi-Lili, LILO! District court grants summary judgment to the government in a LILO transaction. BB&T Corp. v. United States, 99 A.F.T.R.2d 2007-376 (M.D. N.C. 1/4/07). The taxpayer, a financial services corporation, leased equipment from a wood pulp manufacturer [a head lease] and re-leased it back to the wood pulp manufacturer in a “lease-in/lease-out” (“LILO”) transaction and claimed substantial rent and other deductions. The court held that the form of the transaction should not be respected for tax purposes because taxpayer did not acquire a current leasehold

interest in the equipment and incurred no risk of loss. The reciprocal offsetting obligations were disregarded because, in substance, the taxpayer acquired only a future interest in the right to use and possess the equipment – and acquired that interest only if the owner-sublessee did not exercise its option to buy-out taxpayer’s interest in the head lease. The transaction did not substantially affect the wood pulp manufacturer’s rights to use and possess the property.

a. **Affirmed**, 523 F.3d 461 (4th Cir. 4/29/08). In this “typical” LILO transaction entered into in 1997 – the tax benefits of which were largely eliminated by regulations that became effective in 1999 [Reg. § 1.467-1 to -5] – the court (Judge Williams) found that the transaction was a financing arrangement, not a genuine lease and sublease, distinguishing *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

13. SILO. Same result in a SILO. *AWG Leasing Trust v. United States*, 101 A.F.T.R.2d 2008-2397 (N.D. Ohio 5/28/08). A LILO transaction evolved into a Sale-In-Lease-Out (SILO), which is essentially the same transaction but the head lease was longer term so that the initial acquisition was claimed to be treated as a sale and purchase by the taxpayer. Not so, says Judge Gwin of the U.S. District Court for the Northern District of Ohio. In this case the taxpayer acquired a German municipal incineration and power generation facility with a nonrecourse loan from German banks and leased the facility back to the seller with an option for the seller to purchase the plant. The court concluded that the “small, but guaranteed, pre-tax profit [was] sufficient to show that the transaction had some ‘practicable economic effects other than the creation of income tax losses’” and refused to disregard the transaction under the economic substance doctrine. However, finding that substance controls over form, the taxpayer was denied depreciation and amortization deductions on the grounds that the transaction was a financing arrangement, rather than a purchase of property, because the transaction was structured to avoid transfer of the substantive rights and liabilities associated with ownership. The court also denied interest deductions on the nonrecourse loan. The circular flow of funds involved with the loan proceeds in an escrow arrangement to fund the lease payments that were equal to obligations on the note meant that the loan was a sham. The court described the loan as a “‘loop debt’ in which the loan proceeds are used solely for the purpose of paying the purported debt.”

14. Enbridge. 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.

15. *Shell.* Judge Werlein holds that the transfers by Shell Western E&P Inc. to Shell Frontier Oil & Gas Inc. of assets that had declined in value, followed by sales of the subsidiary's stock to unrelated parties at a loss, were not part of a tax-motivated "shell game." The lesson to take from this case is that top management likes being kept in the dark; this is because the case turned on testimony believed by Judge Werlein that the VP of Tax "intentionally refrained from discussing the ... tax implications [of the transaction] with Shell's top management or [the CEO]." *Shell Petroleum Inc. v. United States*, 102 A.F.T.R.2d 2008-5085 (S.D. Tex. 7/3/08). In 1992 Shell Western transferred high-basis assets that had declined in value to a newly-created subsidiary, Shell Frontier. Following that, Shell Western sold so-called "Dutch auction rate preferred stock" for \$110 million to unrelated parties, which constituted more than 20 percent of the value of Shell Frontier stock. This sale created a loss of more than \$353 million. The high-basis property transferred to Shell Frontier was described by Judge Werlein as follows:

The term “frontier property” is commonly used by Shell to describe an asset that is not currently commercially competitive, but which has the potential to become commercially competitive if technological, political, economic, or other factors change.

• The idea of the transaction originated in Shell’s Tax Department. Judge Werlein described it as follows:

The Government makes much of the fact that the creation of Shell Frontier was proposed by Steve Stryker, Shell’s Vice President of Tax. The evidence is that Shell’s CEO Frank Richardson had set overarching goals for the company to improve its return on investment, to reduce costs, and to raise cash without incurring new debt. A variety of recommendations were made by executives and managers, from which at least seven major initiatives were adopted and executed by the company. Only one of these seven approved recommendations came from the tax department. When Stryker presented the proposal, however, he intentionally refrained from discussing the specific tax implications of the § 351 exchange with Shell’s top management or Richardson, who ultimately approved the Shell Frontier plan, in order to assure that the ultimate decision to form Shell Frontier would be made on non-tax business grounds. The testimony of Shell’s decision-makers is that Shell Frontier was formed to raise cash, preserve long-term properties, and increase management efficiency. These proffered business purposes are consistent with Shell’s contemporaneous overall strategy of improving its return on investment and increasing cash flow by investing strategically to increase production and by restructuring some of its assets. Indeed, a taxpayer’s restructuring of a going-concern is a recognized, valid business purpose. See United Parcel Serv. of Am., 254 F.3d at 1020 (holding a transaction that “simply altered the form of an existing, bona fide business” possessed an adequate business purpose). That the Shell Frontier idea originated with Shell’s tax department, which anticipated the beneficial tax consequences that might also be realized, does not undercut the testimony of Shell’s executives that their authorization of Shell Frontier’s formation, including the transfer of some of Shell Western’s non-producing assets, was based on their legitimate cash raising, asset preservation, and management objectives.

- In his opinion, Judge Werlein held that the transaction should be respected. He rejected arguments that the transaction lacked economic substance and refused to apply *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), to the § 351 transaction taken out of its context.

- The government argued that assets with no discounted net cash flow value did not constitute property and Judge Werlein responded as follows:

Under the Government's construction of the term, "property" does not include assets such as the Shell Western non-producing properties because, while not producing, they had no discounted net cash flow value. But the statute itself contains no such limitation. At least one court has implicitly construed § 351(a) not even to require that the transferred property have a fair market value in excess of zero. *See Abbrecht v. Comm'r*, T.C. Memo 1987-199, 53 T.C.M. (CCH) 611 (1987) (holding § 351 applied to debt exchanged for stock, although the value of the debt was not shown to have a fair market value greater than zero). ***

In sum, even if the Court were to accept the Government's unsupported view that real property is not "property" within the meaning of § 351 if it is lacking in value, the evidence establishes that the non-producing properties transferred by Shell Western to Shell Frontier did in fact have some value and unquestionably qualify as "property" entitled to non-recognition under § 351.

- Note that in 2004, § 362(e) was added to the Code, and, as stated in footnote 1 of the opinion,

Congress has since changed the law so that in Section 351 exchanges occurring after October 22, 2004, transfers of property with built-in losses require that either the transferee's basis in the transferred property, or, if the transferor so elects, the transferor's basis in the stock received, is reduced to fair market value. *See* Pub. L. 108-357, 118 Stat. 1596 (codified as amended at 26 U.S.C. § 362(e)(2) (2004)). Hence, as Shell points out, Shell Western's transfer to Shell Frontier of its producing and non-producing properties had occurred under the 2004 amendment, Shell Western still would have had the right to take the stock it received with a cost basis equal to that of the properties it transferred to Shell Frontier, just as Shell claims here. By making that election, however, under the 2004

amendment Shell Frontier's basis in the properties would be reduced to fair market value as of the date of exchange. Regardless, Shell Frontier's tax liability is not at issue in this case, and, of course, this case is governed by the pre-2004 statute.

16. 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. Dixon v. Commissioner, 316 F.3d 1044 (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.

- Three lawyers from the Houston area represented various taxpayers. They were Henry Binder of Porter & Hedges, Michael Louis Minns, and Joe Alfred Izen, Jr.

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 become 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.

17. 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., 2008 WL 5068649, Case No. 1:08-cv-1560-DFH-DML (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 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*, 101 A.F.T.R.2d 2008-2397 (N.D. Ohio 5/28/08), *supra*, VIII.A.13.

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. Identified “tax avoidance transactions.”

1. A new listed transaction: This time the IRS isn’t just TOI-ing. Notice 2008-34, 2008-12 I.R.B. 642 (2/27/08) This notice describes as a listed transaction certain transactions entered into in an attempt to avoid the effect of the amendments to §§ 704, 734 and 743 in The **American Jobs Creation Act of 2004** designed to prevent taxpayers from shifting a built-in loss from a tax indifferent party to a U.S. taxpayer through the use of a partnership. [The 2004 amendments to §§ 704, 734 and 743 generally (1) require that a built-in loss may be taken into account only by the contributing partner and not other partners, and (2) make the basis adjustment rules mandatory in cases with a substantial basis reduction or substantial built-in loss.] In the transaction, a tax indifferent party directly or indirectly contributes one or more distressed assets (for example, a creditor’s interest in debt) with a high basis and low fair market value to a trust or series of trusts and sub-trusts, and a U.S. taxpayer acquires an interest in the trust (and/or series of trusts and/or sub-trusts) for the purpose of shifting a built-in loss from the tax indifferent party to the U.S. taxpayer that has not incurred the economic loss. This transaction (referred to as a distressed asset trust or DAT transaction) and substantially similar transactions are listed transactions for purposes of Reg. § 1.6011-4(b)(2) and §§ 6111 and 6112.

2. 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 2008.

D. Tax Shelter Penalties, Etc.

1. These “value ideas” did produce extraordinary results for E&Y tax partners, but not the results they expected. United States v. Coplan. Two current and two former partners of Ernst & Young – 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”). 2007 TNT 105-1 (5/31/07).

a. 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.

2. Liechtenstein! IR-2008-26 (2/26/08). The IRS announced that it is 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.

3. The Court of Federal Claims isn’t particularly fussy about who the taxpayer relies on for bad tax advice. Allison v. United States, 80 Fed. Cl. 568 (2/27/08). In December 1982 the taxpayers invested in a limited partnership to place plastics recycling machines with businesses generating polystyrene scrap in order to recycle the scrap into a reusable form of resin pellets, for which they claimed the energy and investment tax credits. The case involved investors in the Masters Plastic Recycling Tax Shelters, which were found not to have economic substance in the test case, *Provizer v. Commissioner*, T.C. Memo.1992-177. This case decided by the Court of Federal Claims (Judge Wolski) related solely to negligence penalties imposed by the IRS under former § 6653(a). When the issue is whether a taxpayer was negligent in claiming deductions from a tax shelter that are ultimately disallowed for lack of economic substance, reliance on the advice of a professional investment adviser, who is neither a lawyer nor accountant that an investment can be expected to be

profitable, is reasonable, even if the adviser lacks knowledge and experience in the relevant industry, if the adviser investigated the investment in question.

4. The KPMG deal: the price of settling goes up dramatically. IR-2005-83 (8/29/05). The IRS and the Justice Department announced that KPMG LLP has admitted to criminal wrongdoing and agreed to pay \$456 million in fines, restitution, and penalties as part of an agreement to defer prosecution of the firm. Nineteen individuals, chiefly former KPMG partners including the former deputy chairman of the firm [Jeffrey Stein], as well as a New York lawyer [R.J. Ruble] were indicted in the Southern District of New York in relation to the “multi-billion dollar criminal tax fraud conspiracy.” Several of those indicted were partners in KPMG’s Washington National Tax group and several of those indicted were practice partners at KPMG.

a. Judge Kaplan refuses to find prosecutorial misconduct in the deferred prosecution agreement. United States v. Stein, 428 F. Supp. 2d 138 (S.D.N.Y. 4/4/06). Judge Kaplan denied a motion to dismiss based upon alleged prosecutorial misconduct by reason of the alleged manipulation of KPMG in the deferred prosecution agreement. This DPA required the firm “upon pain of corporate death, [to] espouse a government-approved version of [the] facts.” Judge Kaplan based his decision on the ethical provision applicable to all attorneys that prohibits them from coercing witnesses to give false testimony. He further held that nothing in the DPA pressures individual KPMG employees to testify in any particular way, but that the DPA merely requires the firm to disavow any assertion by an affiliated individual that is inconsistent with the DPA’s Statement of Facts.

b. In its post-Enron war against white collar crime, the Justice Department’s notion that what is fair against organized crime is also fair against white collar crime receives a [temporary?] setback. Judge Kaplan finds prosecutorial misconduct in the use of the Thompson Memorandum to prevent KPMG from continuing its customary practice of paying attorney’s fees for individuals caught up in controversy by reason of their affiliation with the firm. United States v. Stein, 435 F. Supp. 2d 330 (S.D.N.Y. 6/26/06), *as amended*, 7/14/06. The court held that the Justice Department’s Thompson Memorandum policy [continued from the Holder Memorandum] of basing a determination of whether a firm is “cooperating” with the government on its refusal (unless compelled by law) to advance legal fees for affiliated individuals unless they in turn fully cooperated with the government, as it was applied by the prosecutors in this case, was an unconstitutional interference with defendants’ ability to use resources that – absent the government’s misconduct – would be otherwise available to them for payment of attorneys’ fees. The resources in question were funds that would have

customarily been received by these defendants from KPMG to pay their attorneys.

- Judge Kaplan suggested that the constitutional violation could be rendered harmless if the defendants could successfully force KPMG to pay their legal expenses, and *sua sponte* instructed the clerk of the district court to open a civil docket number for an expected contract claim by the defendants against KPMG for payment of their defense costs. Judge Kaplan stated that the court would “entertain the claims pursuant to its ancillary jurisdiction over this case.” The defendants subsequently filed the anticipated complaints against KPMG.

- Judge Kaplan subsequently refused to eliminate from his opinion a statement that prosecutors in the case were “economical with the truth.” He also refused to eliminate from his opinion the names of the prosecutors involved. 2006 TNT 130-10.

c. Judge Kaplan indefinitely postponed the federal criminal trial against 16 former KPMG employees, an outside investment adviser, and a lawyer. *United States v. Stein*, 461 F. Supp. 2d 201 (S.D.N.Y. 11/13/06). Judge Kaplan reaffirmed his earlier holding that ancillary jurisdiction existed over the contractual fee dispute between the defendants and KPMG. He rejected KPMG’s argument that the defendant’s claims were foreclosed by written agreements, and found that enforcement of any applicable arbitration clause would be contrary to public policy, because it might interfere with the ability to ensure a speedy trial, could lead to a dismissal of meritorious criminal charges, would endanger the defendants’ rights to a fair trial, and might impose unnecessary costs on taxpayers if the defendants became indigent. Judge Kaplan cited fears that defendants may be unable to pay their lawyers in further postponing the trial.

d. *Stein v. KPMG, LLP*, 486 F.3d 753 (2d Cir. 5/23/07). The Second Circuit vacated the district court orders in *United States v. Stein* to the extent that they found jurisdiction over the complaint against KPMG and dismissed the defendants’ complaint against KPMG.

The prejudice to KPMG in having these claims resolved in a proceeding ancillary to a criminal prosecution in the Southern District of New York is clear. At stake are garden variety state law claims, albeit for large sums. KPMG believed that contractual disputes between it and the appellees would be resolved by arbitration. Instead, KPMG is faced with a federal trial of more than a dozen individuals’ multi-million dollar “implied-in-fact” contract claims. Moreover, because such a

proceeding is governed by no express statutory authority, the district court has indicated its intention to apply to this expedited undertaking an ad hoc mix of the criminal and civil rules of procedure determined on the fly, as it were. ...

First, “the interrelationship of the factual issues underlying the finding of constitutional violations and the asserted contract claims is marginal. ...

Second, while the ancillary proceeding is a major undertaking, its contribution to the efficient conclusion of the criminal proceeding is entirely speculative. ...

Third, even if there were constitutional violations and even if KPMG is contractually obligated to advance [defendants’] attorneys’ fees and costs, creating an ancillary proceeding to enforce that obligation was not the proper remedy. ...

Finally, on the present record, a proceeding ancillary to a criminal prosecution was not necessary either to avoid perceived deficiencies in ordinary civil contract actions to enforce the alleged advancement contracts or to remove some barrier to the [defendants’] bringing of such actions.

e. Indictment against 13 KPMG defendants dismissed because the government interfered with their Sixth Amendment right to secure counsel which would have been available to them absent government interference. United States v. Stein, 495 F. Supp. 2d 390 (S.D.N.Y. 7/16/07). Judge Kaplan dismissed the indictment as to 13 of the 16 defendants who had been affiliated with KPMG at the time of their alleged conduct because the U.S. Attorney’s Office interfered with their ability to receive payment of their attorneys’ fees from KPMG. The government announced its intention to appeal the dismissal of the 13 defendants, and Judge Kaplan indicated his intention to proceed with the trial of the remaining five defendants in October 2007. This trial was postponed until 2008.

f. Judge Kaplan’s dismissal of the indictment against 13 former KPMG partners was affirmed by the Second Circuit. United States v. Stein, 541 F.3d 130, (2d Cir. 8/28/08). In a resounding opinion, Chief Judge Jacobs agreed with Judge Kaplan’s analysis that the actions taken by KPMG to “condition[], cap[] and ultimately cease[]” to advance legal fees to defendants constituted “state action” which deprived defendants of their Sixth Amendment right to counsel because they were the result of the prosecutors’

(mis?)use of the Thompson Memorandum to overwhelmingly influence KPMG to not follow its past practice “to advance legal fees for employees facing regulatory, civil and criminal investigations without condition or cap” upon pain of a possible indictment of the firm.

g. The McNulty Memorandum is not much better than the Thompson Memorandum. The Thompson Memorandum [which was based upon the Holder Memorandum] was replaced on 12/12/06 by the McNulty Memorandum which requires threats to prosecute entities “unless” they do something [e.g., waive attorney client privilege] or “if” they do something [e.g., advance legal fees] to emanate from a higher level of the Justice Department.

- **The Filip Memorandum is close, but no cigar.** The McNulty Memorandum was, in turn, replaced on 8/28/08 with the Filip Memorandum, which purportedly removes the requirements that a firm must waive attorney-client privilege and work product protection in order to receive “cooperation credit.” Instead, that determination should be based on “whether the corporation has provided the facts about the events [which putatively constituted misconduct].” Also, “mere” participation in a joint defense agreement is to be permitted but such participation should not disable the firm from providing [all] relevant facts to the government. Payment of legal fees for employees is permissible unless such payment is “used in a manner that would otherwise constitute criminal obstruction of justice.”

- **Eric Holder has been nominated for the post of attorney general in the Obama Administration.** In the era of new politics, it is unlikely that he will receive even half as much scrutiny as did Joe the Plumber.¹ But see, Arlen Specter & Edwin Meese III, “Even Businessmen Deserve a Lawyer,” Wall Street Journal, 1/15/09 at A11.

5. Jerry Cohen outsmarts the government and mitigates taxpayer penalties. *Alpha I LP v. United States*, 102 A.F.T.R.2d 2008-7073 (Fed. Cl. 11/25/08). The IRS issued FPAAAs that adjusted the partners’ capital gains and losses based on five theories: “(1) Section 752; (2) Treas. Reg. § 1.752-6 (the ‘retroactive regulation’); (3) the transaction or entities were a sham or lacked economic substance; (4) Treas. 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 I.R.C. § 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 Section 465(b)(1) and that the at-risk rules would disallow losses and require the partnerships and their partners to recognize gain on the

1. Only Ira subscribes to this paragraph of the outline.

transactions as set forth in the FPAAAs.” 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 IRS’s argument that it should consider on the merits the IRS’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.”

6. 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, 2007-9 I.R.B. 613. The regulations will apply to returns the due date of which is after the final regulations are published in the Federal Register.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

There were no significant developments regarding this topic during 2008.

B. Charitable Giving

1. **The potential tax benefits of a charitable contribution “described as offering a ‘huge [tax] windfall’ of ‘150K,’” morphed into a 40% gross valuation misstatement penalty.** Bergquist v. Commissioner, 131 T.C. No. 2 (7/22/08). Prior to 2001, the taxpayers provided medical services to the Oregon Health & Science University Hospital (OHSU) through their medical professional corporation (UA). Following the announcement by OHSU that it would terminate its contracts with various medical professional corporations through which physicians provided services and form its own organization, the Oregon Health & Science University Hospital Medical Group (OHSUMG), which thereafter would employ the physicians, the taxpayers contributed most of the stock of UA to OHSUMG. The corporation [UA] had no assets other than accounts receivable and had never paid any dividends. After the consolidation was completed, UA would have no doctors and no patients, and UA would not operate other than to collect accounts receivable outstanding as of the date of the consolidation. According to the court’s fact findings, “OHSUMG’s executive management accepted the donation of UA stock as a professional courtesy to the UA stockholders. At the time of donation, OHSUMG’s management did not expect to derive any economic benefit from the donated UA stock. OHSUMG management did not expect to receive and in fact did not receive from UA any dividends or distributions.” OHSUMG advised the taxpayers that it was valuing the contribution at zero. Twenty six of twenty eight shareholders claimed charitable contributions deduction of \$401.79 per share, based on an appraisal. Judge Swift found that UA was not a going concern at the time of the contribution and allowed a deduction of \$37 per share for voting stock and \$35 per share for nonvoting stock, which had been conceded by the Commissioner based on its expert’s appraisal. The substantial valuation misstatement penalty of § 6662(e) and gross valuation misstatement penalty of § 6662(h) applied, depending, taxpayer-by-

taxpayer, on whether the deficiency exceed \$5,000. The taxpayers did not act in good faith:

From the beginning, the plan to donate UA stock on the brink of the January 1, 2002, consolidation was presented to UA stockholders as a way to reap a potential “150K” windfall. Petitioners are well educated and surely were cognizant of the imprudence of valuing the UA stock at such a high value given the likelihood that by 2002 UA would no longer be an operating entity. ... Petitioners were aware of the January 8, 2002, letter from OHSUMG’s president stating that OHSUMG had decided to book the donated stock at zero ... [A] taxpayer will not be considered to have reasonably relied in good faith on advice from an adviser if the advice is based on an ‘unreasonable’ assumption the “taxpayer knows, or has reason to know, is unlikely to be true”. This would appear to be particularly applicable where no adviser is sought out who is truly independent of the planned transaction.

2. Proposed regulations on contributions of used underwear, oh yeah and also substantiation requirements. REG-140029-07, Substantiation and Reporting Requirements for Cash and Noncash Charitable Contribution Deductions, 73 F.R. 45908 (8/7/08). The Treasury Department has published proposed regulations [Prop. Regs. §§ 1.170A-15 through 1.170A-18] regarding substantiation and reporting requirements for cash and noncash charitable contributions to reflect the enactment of provisions of the American Jobs Creation Act of 2004 [§ 170(f)(11) and (12)] and the Pension Protection Act of 2006 [§ 170(f)(16) and (17)].

- Prop. Reg. § 1.170A-15(a) would provide that the substantiation requirements of § 170(f)(17) regarding cash contributions could be met by a monthly bank statement and a photocopy or image obtained from the bank of the front of the check indicating the name of the donee and that a written communication from the charity sufficient to meet the requirement must show the name of the donee, the date of the contribution, and the amount of the contribution. The written communication may be electronic. A contribution made by payroll deduction can be substantiated by (1) a pay stub, Form W-2, or other document furnished by the employer that sets forth the amount withheld during the taxable year for payment to a donee, together with (2) a pledge card or other document prepared by or at the direction of the donee organization that shows the name of the donee organization. A receipt is not required for contribution to a charitable remainder trust of less than \$250 or for unreimbursed expenses of less than \$250 incurred incident to the rendition of services to a charitable organization, but taxpayers should maintain records of the gifts or expenses. Prop. Reg. § 1.170A-16(c) would provide that for claimed noncash

contributions of more than \$500 but not more than \$5,000, the donor must obtain a contemporaneous written acknowledgment required by § 170(f)(8) and Reg. § 1.170A-13(f) and must file a completed Form 8283 (Section A) with the return on which the deduction is claimed. For claimed contributions of more than \$5,000 but not more than \$500,000, the donor must obtain (a) a contemporaneous written acknowledgment required by § 170(f)(8) and Prop. Reg. § 1.170A-13(f), and (b) a qualified appraisal as defined in Prop. Reg. § 1.170A-17(a)(1) (prepared by a qualified appraiser, as defined in Prop. Reg. § 1.170A-17(b)(1)), and must file a completed Form 8283 (Section B), which requires very detailed information about the contribution and the property contributed, with the return on which the deduction is claimed.

- Prop. Reg. § 1.170A-17(a) elaborates on the § 170(f)(11)(E) definition of a qualified appraisal. A qualified appraisal is an appraisal document that is prepared by a qualified appraiser in accordance with generally accepted appraisal standards. Under the proposed regulations, generally accepted appraisal standards are the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation, see Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Public Law 101-73, 103 Stat. 183 (12 U.S.C. §§3331-3351). The fee for a qualified appraisal cannot be based to any extent on the appraised value of the property. A qualified appraisal must contain the following declaration by the appraiser: “I understand that my appraisal will be used in connection with a return or claim for refund. I also understand that, if a substantial or gross valuation misstatement of the value of the property claimed on the return or claim for refund results from my appraisal, I may be subject to a penalty under section 6695A of the Internal Revenue Code, as well as other applicable penalties. I affirm that I have not been barred from presenting evidence or testimony before the Department of the Treasury or the Internal Revenue Service pursuant to 31 U.S.C. section 330(c).” In addition to the statutory exceptions providing that a qualified appraisal is not required for (1) publicly traded securities, and (2) qualified vehicles, if certain conditions have been met, I.R.C. § 170(f)(11)(A)(ii), (3) Prop. Reg. § 1.170A-16(d)(2) provides exceptions for certain intellectual property (described in §170(e)(1)(B)(iii)), and (4) inventory and property held by the donor primarily for sale to customers in the ordinary course of the donor’s trade or business.

- Prop. Reg. § 1.170A-17(b) would provide a detailed definition of “qualified appraiser” including minimum educational requirements. Prop. Reg. § 1.170A-16(f)(6) would provide that to satisfy the “reasonable cause” exception to the noncash substantiation requirements, a donor must (1) submit with the return a detailed explanation of why the failure to comply was due to reasonable cause and not to willful neglect and (2) obtain (i) a contemporaneous written acknowledgment and (ii) a qualified appraisal, if applicable.

- Prop. Reg. § 1.170A-18 would provide more detailed rules regarding limitations under § 170(f)(16) for contributions of used underwear, as well as other clothing and household items. Food, paintings, antiques, and other objects of art, jewelry, gems, and collections are *not* household items.

3. The tax Code continues to try to green-up America.

The **Heartland, Habitat, Harvest, and Horticulture Act of 2008**, extended § 170(b)(1)(E) through 2009. Section 170(b)(1)(E) allows an individual (other than a qualified farmer or rancher) to claim a charitable contribution deduction for a qualified conservation contribution to the extent of the excess of 50 percent of the taxpayer's contribution base over the amount of all other allowable charitable contributions. For an individual who is a qualified farmer or rancher, qualified conservation contributions are allowed up to 100 percent of the excess of the contribution base over the sum of all other allowable charitable contributions. The ceiling for a privately held corporation that is a qualified farmer or rancher is 100 percent of the excess of the corporation's taxable income over the sum of all other allowable contributions. In all cases, any disallowed qualified conservation contributions may be carried forward for up to 15 years.

4. More computers and books for school children.

The **Emergency Economic Stabilization Act of 2008** extend through 2009 the application of Code § 170(e)(6), which permits a corporation to deduct an amount equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis, for a contribution of computer software, equipment, and peripherals to educational institutions for use in kindergarten through twelfth grade education. The equipment must be previously unused and not more than two years old. The Act also extends § 170(e)(3)(D) which provides a similar enhanced charitable contribution deduction for contributions of book inventory by C corporations.

5. Whitehouse Hotel Limited Partnership v.

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

6. Try again, but the kids' religious school education is still not deductible even if the IRS made a deal with the Scientologists. Sklar v. Commissioner, 549 F.3d 1252 (9th Cir. 12/12/08). The Ninth Circuit (Judge Wardlaw) followed its prior decision involving different taxable years (*Sklar v. Commissioner (Sklar I)*, 282 F.3d 610 (9th Cir. 2002)) and denied the taxpayers' claimed deductions of a portion of tuition and fees paid to Orthodox Jewish Day schools for the education of their children. The taxpayers argued that deduction of a portion of their tuition payments as charitable contributions for strictly religious services is allowed under the closing agreement with the Church of Scientology. After convincing the Supreme Court that fees for training and auditing sessions provided by the Church of Scientology were paid as a quid pro quo for services rather than deductible charitable contributions (*Hernandez v. Commissioner*, 490 U.S. 680 (1989)), the IRS allowed the individuals involved to deduct 80 percent of the fees.

- The court held under *Hernandez* that tuition paid for religious education is a payment for services that is not deductible as a charitable contribution. The court pointed to statements in *Hernandez* that attempts to distinguish payments for religious benefits from secular services would involve the court in impermissible entanglements between church and state.

- The court rejected the taxpayers' argument that 1993 amendments to §§ 170(f)(8) and 6115 (requiring reporting of the value of benefits received from quid pro quo payments to charities) overruled the *Hernandez* holding that a portion of payments for services are not allowable as a charitable contribution. Quoting from *Sklar I*, the court noted that these are procedural provisions that do not revise substantive law.

- The taxpayers failed to establish that the fees and tuition payments represented dual payments that included a portion in excess of the value of the education benefit provided by the schools which represented a gift to the religious schools as charitable originations.

- Finally, the court held that the Scientology closing agreement does not require the IRS to allow charitable contribution deductions for the taxpayers' tuition payments. Again quoting from *Sklar I*, the court expressed reservations under the Establishment Clause of the First Amendment about the impact of the closing agreement that discriminates among religions. The court also indicated concern that allowing deductions for tuition for attending religious schools would create a preference for religion that is questionable under the Establishment Clause. In addition, the court concluded that the tuition payments for the taxpayers' children were not similar to the auditing, training and other qualified religious services provided by the Church of Scientology. Thus, the taxpayers in *Sklar* could not assert an administrative inconsistency claim that the IRS favored Scientologists over adherents to other religions.

X. TAX PROCEDURE

A. Interest, Penalties and Prosecutions

1. **The standard for preparer penalties is broadened to include preparers of all tax returns, and is heightened from “realistic possibility of success” to “more likely than not.”** The **2007 Small Business Tax Act**, § 8246, amended Code §§ 6694 and 7701 to expand the applicability of the § 6694 return preparer penalties from “income tax return preparers” to all tax return preparers. It also heightened the standards of conduct to avoid the imposition of the return preparer penalty for undisclosed positions with a requirement that there be a reasonable belief that the tax treatment of the position was “more likely than not” the proper treatment. For disclosed positions, the standard was increased from “non-frivolous” to “reasonable basis.” Penalty amounts were increased from \$250 to the greater of \$1,000 or 50 percent of the income to be derived by the preparer under § 6694(a) [negligent], and from \$1,000 to the greater of \$5,000 or 50 percent of the income to be derived by the preparer under § 6694(b) [willful or reckless]. These changes are effective for tax returns prepared after 5/25/07.

a. **But practitioners were given a pass under the new rules for 2007.** Notice 2007-54, 2007-27 I.R.B. 12 (6/11/07). This notice provided transitional relief for all returns, amended returns and refund claims due on or before 12/31/07, to estimated tax returns due on or before 1/15/08, and to employment and excise tax returns due on or before 1/31/08. The transitional relief was that the standards set forth under previous law and current regulations would be applied in determining whether the IRS would impose penalties under § 6694(a), but the transitional relief was not available for penalties under § 6694(b), which applies to return preparers who exhibit “willful or reckless conduct.”

b. **Placeholder proposed Circular 230 regulations.** REG-138637-07, Regulations Governing Practice Before the Internal Revenue Service, 72 F.R. 54621 (9/26/07). These proposed regulations would amend the Circular 230 standards of practice, § 10.34 to conform with the § 6694 provisions in the **2007 Small Business Tax Act**. Deborah Butler, IRS Associate Chief Counsel (Procedure and Administration), has stated that the proposed regulation contains merely “placeholder language,” and that the government will first get out § 6694 guidance before considering whether the historical linkage between § 6694 and Circular 230 remains appropriate.

c. **Three subsequent notices clarified Notice 2007-54.**

(1) **2007 tax advice given by nonsigning preparers.** Notice 2008-11, 2008-3 I.R.B. 279 (1/2/08). This notice provides that advice given before 1/1/08 by nonsigning preparers will be governed by standards under former § 6694.

(2) **Which returns require a preparer signature?** Notice 2008-12, 2008-3 I.R.B. 280 (1/2/08). This notice specifies which returns require a preparer signature and which returns do not.

(3) **A notice temporarily relaxes the requirements on practitioners, but it is puzzling in places and is not a free pass.** Notice 2008-13, 2008-3 I.R.B. 282 (1/2/08). This notice provides interim guidance on the application of the tax return preparer penalties as amended by the **2007 Small Business Tax Act**. These amendments did not modify the exception to liability under § 6694 that is applicable when it is shown, considering all the facts and circumstances, that the tax return preparer has acted in good faith and there is reasonable cause for the understatement.

d. **Proposed tax return preparer regulations anticipated to be effective after 2008.** REG-129243-07, Tax Return Preparer Penalties Under Sections 6694 and 6695, 73 F.R. 34560 (6/17/08). Proposed regulations under §§ 6694 and 6695 (as well as under §§ 6060, 6107, 6109, 6696 and 7701(a)(36)) would implement the amendments made by § 8246 of the **Small Business and Work Opportunity Tax Act of 2007**. The proposed regulations provide that the “reasonable belief that the position would more likely than not be sustained on its merits” standard is satisfied if the tax return preparer analyzes the pertinent facts and authorities and, in reliance upon that analysis, reasonably concludes in good faith that the position has a greater than 50 percent likelihood of being sustained on its merits. Prop. Reg. § 1.6694-2(b)(1). The test is applied on the date the return is prepared. Prop. Reg. § 1.6694-2(b)(6). Whether a tax return preparer met this standard is determined based upon all the facts and circumstances, including the tax return preparer’s due diligence. The conclusion cannot be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. Prop. Reg. § 1.6694-2. The possibility that the position will not be challenged by the IRS, because the taxpayer’s return may not be audited or because the issue may not be raised on audit, cannot be considered.

• **Substantial authority plus a chat is all that will be required.** The more-likely-than-not rule is administratively relaxed, as it was in Notice 2008-13, and is replaced by a standard of a position that will not result in taxpayer penalties plus a discussion with the client about taking a position that would not result in a preparer penalty provided that the discussion is memorialized in a non-boilerplate manner.

- If a signing tax return preparer does not believe that a position is more likely than not, the requirements of § 6694 could be satisfied by disclosure in one of five ways. Prop. Reg. § 1.6694-2(c)(3)(i).

(1) The position may be disclosed on a properly completed and filed Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, as appropriate, or on the tax return in accordance with the annual revenue procedure. [See, e.g., Rev. Proc. 2008-14, 2008-7 I.R.B. 435].

(2) If there is a “reasonable basis” (as defined in Reg. § 1.1662-3(b)(3)) but there is not “substantial authority” (as defined in Reg. § 1.6662-4(d)) for the position, disclosure is adequate if the tax return preparer provides the taxpayer with a prepared tax return that includes the appropriate disclosure.

(3) If there is “substantial authority” for the position, disclosure is adequate if the tax return preparer advises the taxpayer of all of the penalty standards applicable to the taxpayer under § 6662.

(4) If the position involves a tax shelter, as defined § 6662(d)(2)(C), or a reportable transaction to which § 6662A applies, disclosure is adequate if the tax return preparer advises the taxpayer that (i) there must be “substantial authority” for the position, (ii) the taxpayer must possess a “reasonable belief that the tax treatment [on the return] was more likely than not” the proper treatment, and (iii) disclosure will not protect the taxpayer from assessment of an accuracy-related penalty.

(5) For tax returns or claims for refund that are subject to penalties other than the accuracy-related penalty for substantial understatements under sections § 6662(b)(2) and (d), the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under § 6662. The fifth rule addresses situations in which the penalty standard applicable to the taxpayer is based on compliance with requirements other than disclosure on the return.

- If the position was not actually disclosed on the return, to establish that the tax return preparer’s disclosure obligation was satisfied under alternatives (2) through (5), the tax return preparer must contemporaneously document in his files that the required information or advice was provided to the taxpayer.

- In the case of a nonsigning tax return preparer (as defined in Prop. Reg. § 301.7701-15(b)(2), a position that is not more likely than not correct, but for which there is a reasonable basis, may be disclosed in one of three ways. Prop. Reg. § 1.6694-2(c)(3)(ii).

(1) The position may be disclosed on a properly completed and filed Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, as appropriate, or on the tax return in accordance with the annual

revenue procedure.

(2) The nonsigning tax return preparer advises the taxpayer of all opportunities to avoid penalties under § 6662 that could apply to the position and advises the taxpayer of the standards for disclosure to the extent applicable, and contemporaneously documents in his files that this advice was provided.

(3) The nonsigning tax return preparer advises another tax return preparer that disclosure under § 6694(a) may be required, and contemporaneously documents in his files that this advice was provided.

- For both signing and nonsigning return preparers, if a position for which there is a “reasonable basis” but for which the tax return preparer does not have a “reasonable belief that the position would more likely than not be sustained on the merits” is not disclosed on or with the return, each return position must be addressed by the tax return preparer. Prop. Reg. § 1.6694-2(c)(3)(iii). The advice to the taxpayer with respect to each position must be particular to the taxpayer and tailored to the taxpayer’s facts and circumstances.

- A signing tax return preparer is any tax return preparer who signs or who is required to sign a return or claim for refund as a tax return preparer. Prop. Reg. § 301.7701-15(b)(1). A “nonsigning return preparer is a person who renders tax advice on a position that is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund will be regarded as having prepared that entry, even if the person does not sign the return. Prop. Reg. § 301.7701-15(b)(2) and (3). Whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion is determined based upon whether the person rendering the tax advice knows or reasonably should know that the tax attributable to the schedule, entry, or other portion of a return or claim for refund is a substantial portion of the tax required to be shown on the return or claim for refund. Prop. Reg. § 301.7701-15(b)(3). A *de minimis* exception applies for nonsigning preparers if the item giving rise to the understatement is less than (1) \$10,000, or (2) less than \$400,000 if the item is also less than 20 percent of the taxpayer’s gross income (or, for an individual, the individual’s adjusted gross income). Reg. § 301.7701-15(b)(3)(ii).

- **Write up your hours heavily during the planning process, but bill by the minute after the events have occurred.** Time spent on advice that is given after events have occurred that represents less than 5 percent of the aggregate time incurred by such individual with respect to the position(s) giving rise to the understatement is not taken into account in determining whether the individual is a return preparer. Prop. Reg. § 301.7701-15(b)(2). Like the current regulations, the proposed regulations provide that the § 6694 penalty can be avoided if, considering all the facts and circumstances, the preparer demonstrates that the understatement was due to reasonable cause and that the tax return preparer acted in good faith. Prop. Reg. § 1.6694-2(d). The proposed

regulations provide that one of the factors that can avoid the penalty is that the preparer “reasonably relied in good faith on generally accepted administrative or industry practice in taking the position that resulted in the understatement.” Prop. Reg. § 1.6694-2(d)(6). This factor does not appear in the current regulations. “[F]or purposes of determining whether the tax return preparer has a reasonable belief that the position would more likely than not be sustained on the merits, a tax return preparer may rely in good faith without verification upon information furnished by the taxpayer, advisor, other tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer’s firm).” A preparer may rely in good faith without verification upon a tax return that has been previously prepared by a taxpayer or another tax return preparer and filed with the IRS, but may not ignore implications of information actually known by the preparer; preparer may not rely on information provided by a taxpayer with respect to legal conclusions on Federal tax issues. Prop. Reg. § 1.6694-2(b)(1); Prop. Reg. § 1.6694-1(e). “[A] position must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, a position must not be based on a representation or assumption that the tax return preparer knows, or has reason to know, is inaccurate.” Prop. Reg. § 1.6694-2(b)(2).

- The proposed regulations provide that a tax return preparer has not recklessly or intentionally disregarded a rule or regulation if the position contrary to the rule or regulation has a “reasonable basis” and is adequately disclosed as provided in the proposed § 6694 regulations. Reg. § 1.6694-3(c)(2). A position contrary to a regulation must represent a good faith challenge to the validity of the regulation and the return preparer must identify the regulation being challenged. In the case of a position contrary to a revenue ruling or notice, a tax return preparer also is not considered to have recklessly or intentionally disregarded the ruling or notice if the preparer reasonably believes that the position would more likely than not be sustained on its merits. Reg. § 1.6694-3(c)(3).

- **Simplicity is replaced by complexity in determining who within a firm is the preparer.** The one-preparer-per-firm rule will be abolished in favor of a one-preparer-per-position scheme. A signing tax return preparer will be considered to be the person who is primarily responsible for all the positions on the return unless another person within that same firm was primarily responsible for the positions. Similarly, for a nonsigning tax return preparer, the person with overall supervisory responsibility for the position(s) giving rise to the understatement is the tax return preparer. This substitutes a “facts and circumstances” inquiry for a clear rule.

e. **“God’s in His Heaven, all’s right with the world.”** The **Tax Extenders and Alternative Minimum Tax Relief Act of**

2008, § 506, brings the standard for the § 6694 tax return preparer penalty for undisclosed positions into line with the taxpayer standard, i.e., substantial authority. It penalizes the taking of an “unreasonable position,” which is defined as a position “unless there is or was substantial authority for the position” or is a disclosed position “unless there is a reasonable basis for the position.” For tax shelters and reportable transactions, the position is an “unreasonable position . . . unless it is reasonable to believe that the position would be more likely than not be sustained on its merits.” The provision contains a reasonable-cause-and-good-faith exception. It is retroactive to 5/22/07, except that the tax shelter provision applies to returns prepared for taxable years ending after 10/3/08.

f. Notice 2009-5, 2009-3 I.R.B. 309 (12/15/08), *modifying and clarifying* Notice 2008-13, 2008-3 I.R.B. 282. This notice provides guidance on the implementation of the tax return preparer penalty as amended by the **Tax Extenders and Alternative Minimum Tax Relief Act of 2008**.

- The notice states that “‘substantial authority’ has the same meaning as in [Reg.] § 1.6662-4 (d) (2)” and that “[s]olely for purposes of section 6694(a), a tax return preparer nevertheless will be considered to have met the standard in section 6694(a)(2)(A) if the tax return preparer relies in good faith and without verification on the advice of another advisor, another tax return preparer, or other party.”

- For tax shelter transactions, Until further guidance is issued, solely for purposes of section 6694(a), a position with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) will not be deemed an “unreasonable position” described in section 6694 (a) (2) (A) through (C) if there is substantial authority for the position and the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer in the event that the transaction is deemed to have a significant purpose of Federal tax avoidance or evasion. This advice to the taxpayer must explain that, if the position has a significant purpose of tax avoidance or evasion, then there needs to be at a minimum substantial authority for the position, the taxpayer must possess a reasonable belief that the tax treatment was more likely than not the proper treatment in order to avoid a penalty under section 6662(d) as applicable, and disclosure in accordance with § 1.6662-4(f) will not protect the taxpayer from assessment of an accuracy-related penalty if section 6662(d)(2)(C) applies to the position. The tax return preparer must contemporaneously document the advice in the tax return preparer’s files.

If a nonsigning tax return preparer provides advice to another tax return preparer regarding a position with respect to a tax shelter (as defined in section 6662 (d) (2) (C) (ii)), the position will not be deemed an “unreasonable position” described in section 6694 (a) (2) (A) through (C) if there is substantial authority for the position and the nonsigning tax return preparer provides a statement to the other tax return preparer about the penalty standards applicable to the tax return preparer under section 6694. Contemporaneously prepared documentation in the nonsigning tax return preparer’s files is sufficient to establish that the statement was given to the other tax return preparer. If a nonsigning tax return preparer and other tax return preparer are employed by the same firm, then contemporaneous documentation of advice provided by any tax return preparer in that firm to the taxpayer regarding applicable penalty standards, as described in the immediately preceding paragraph, is also sufficient to establish that the statement was given by a nonsigning tax return preparer to the other tax return preparers within the firm.

The above interim penalty compliance rules do not apply to a position described in section 6662A (a reportable transaction with a significant purpose of Federal tax avoidance or evasion or a listed transaction).

• The effective dates of this notice are as follows.

For positions other than tax shelters and reportable transaction positions, this notice is effective for all advice rendered or returns, amended returns, and claims for refund prepared after May 25, 2007. The interim guidance in this notice for tax shelters (within the meaning of section 6662(d)(2)(C)(ii)) and reportable transactions to which section 6662A applies is effective for tax shelter and reportable transaction positions on tax returns for taxable years ending after the 2008 Act’s date of enactment, October 3, 2008.

g. Despite the amended statute, IRS and Treasury still release final tax return preparer penalty regulations. T.D. 9436, Tax Return Preparer Penalties Under Sections 6694 and 6695, 73 F.R. 78430 (12/22/08). The proposed regulations were largely left intact, with provisions reserved for the changes made in 2008, i.e., the reduction of the standard for undisclosed positions to one of “substantial authority.”

- **Preparer per position.** The final regulations maintain a framework defining “a ‘preparer per position within a firm’” with a presumption that “the nonsigning tax return preparer within the firm with overall supervisory responsibility for the position(s) giving rise to the understatement generally will be considered the tax return preparer who is primarily responsible for the position.” If the information presented “would support a finding that either the signing tax return preparer or a nonsigning tax return preparer within a firm is primarily responsible,” then the IRS may assess the penalty against either, but not against both.

- **May rely on taxpayer’s legal conclusions.** The rule that a tax return preparer may not rely on legal conclusions regarding Federal tax issues furnished by taxpayers was removed from the final regulations with the caveat that tax return preparers nevertheless have to meet the diligence standards otherwise imposed.

- **Estimates.** The final regulations will not include any general rule regarding the use of estimates.

- **Opportunity for disclosure.** Nonsigning preparers must advise clients of the opportunity to avoid penalties for positions for which there is a reasonable basis but not substantial authority by making appropriate disclosure.

- **Anti-abuse exception to 5-percent rule.** The final regulations contain an anti-abuse rule which provides that if a tax professional is abusing the 5-percent rule to avoid tax return preparer status by deliberately performing all the return preparation work before the transaction takes place, then the rule is inapplicable.

1. Rev. Proc. 2009-11, 2009-3 I.R.B. 313 (12/15/08). This revenue procedure identifies the returns that are subject to the § 6694(a) penalty. It is effective 1/1/09 and renders obsolete Notice 2008-12 and Notice 2008-46 and modifies and supersedes the list of forms in Notice 2008-13.

2. **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.

3. **You do the crime, you do time! One year in a half-way house, five years probation, and a \$10,000 fine is too lenient.** United States v. Taylor, 499 F.3d 94 (1st Cir. 8/17/07). In an opinion by Judge Torruella, the First Circuit vacated a tax return preparer’s sentence of one year in a half-way house, five years probation and a \$10,000 fine as unreasonably lenient, and remanded the case for resentencing. The tax return preparer, who

was a full time school teacher and part time return preparer, was convicted on sixteen counts of aiding and abetting the filing of false returns, resulting from false claims of charitable contributions in amounts ranging from \$9,000 to \$16,000, about which he advised his clients to lie to IRS agents. The court noted, that the “offense ... is a serious crime ... at its heart, it is theft, specifically theft of money to which the public is entitled,” and that “the tax fraud committed here was not part of an indigent’s effort to avoid personal tax liability, but rather, the supplemental business of a moderately successful man who misled his clients.”

a. Then again, maybe you don’t have to do time for a tax crime. Taylor v. United States, 128 S. Ct. 8783 (1/7/08). The Supreme Court vacated the judgment and remanded the case to the First Circuit Court of Appeals for further consideration in light of *Gall v. United States*, 128 S. Ct. 586 (2007), which held that there is no rule that requires “extraordinary” circumstances to justify sentence outside Guidelines range.

4. Déjà vu. United States v. Carlson, 498 F.3d 761 (8th Cir. 8/20/07). A non-prison sentence for a conviction [pursuant to a guilty plea] under § 7202 for willful failure to pay over trust fund taxes was vacated as too unreasonably lenient under the sentencing guidelines. The case was remanded for resentencing.

5. And baby makes three. United States v. Tomko, 498 F.3d 157 (3d Cir. 8/20/07). A sentence of one year of home confinement, “the very mansion built through the fraudulent 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. But the court has second thoughts about jailing tax cheats. Rehearing granted and opinion vacated, 513 F.3d 360 (3d Cir. 1/17/08), rehearing, en banc granted, 538 F.3d 644 (3d Cir 8/19/08).

6. But will he be a “survivor” in the U.S. Court for the District of Rhode Island? A Justice Department news release, dated 9/8/05, announced that Richard Hatch was indicted on charges of tax evasion for failing to report about \$1,037,000 dollars of income from the television reality series and about \$391,000 of income from other sources. He was convicted on 1/25/06, 2006 TNT 17-6.

a. The First Circuit says “Down the hatch,” or is it “Up the chute”? United States v. Hatch, 514 F.3d 145 (1st Cir. 2/1/08), cert. denied 129 S. Ct. 103 (10/6/08). The First Circuit (Judge Campbell)

affirmed Survivor Richard Hatch's convictions on three counts of filing false tax returns omitting his winnings from Survivor in violation of §§ 7201 and 7206(1), as well as his sentence of 51 months. Hatch never supplied any predicate evidence or testified at trial about why he believed he had a deal with the show's producers that they, rather than he, would pay the taxes on his winnings. His sentence was also affirmed. The court of appeals rejected his argument that the trial court otherwise erred by imposing a perjury enhancement; the record showed multiple instances of perjury.

7. 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*, 128 S. Ct. 1168 (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 distribution 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)." It 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).

- In footnote 7 to the opinion the Court cited Isenbergh, "Review: Musings on Form and Substance in Taxation," 49 U. Chi. L. Rev. 859 (1982), for the proposition that the tax consequences of a transaction should depend on what was actually done, and not on whether alternative routes would have offered better or worse tax consequences.

- 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.

8. Lying in the OIC got the taxpayer 46 months in the Big House. United States v. Miller, 520 F.3d 504 (5th Cir. 3/18/08), cert. denied 129 S. Ct. 185 (10/6/08). The Fifth Circuit (Judge Higginbotham) upheld the taxpayer's [nontaxpayer's?] conviction under § 7201 for attempting to evade payment of his tax liabilities. The taxpayer owed over \$2 million of taxes, interest and penalties. After surreptitiously transferring over \$1 million of assets to offshore accounts, he filed an offer in compromise based on doubt as to collectability, in which he claimed that because he had insufficient assets and income he could only afford to pay \$7,500. Even though after the fact the taxpayer discovered that the \$1 million had "disappeared" – maybe you can't trust people who promise to hide your money for you while you're committing tax fraud – at the time he filed the offer in compromise, "he believed he had \$1 million squirreled away overseas."

- Query whether making a statement that is literally true, i.e., that the transferred money was not available to pay his tax obligations, can be criminal?

9. It's no defense to a criminal failure to pay charge that you squandered the money and couldn't have paid it 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.

10. Steven N.S. Cheung, Inc. v. United States, 545 F.3d 695 (9th Cir. 9/23/08). The flush language of § 6621(a)(1) provides for a one and a half point reduction in the overpayment rate, from 2 points above the

Federal short term rate to ½ point above the Federal short term rate, if an overpayment of tax by a corporation exceeds \$10,000. The Ninth Circuit held that the flush language of § 6621(a)(1) applies to interest payable by the government to a corporate taxpayer pursuant to a wrongful levy judgment.

11. Williams v. Commissioner, 131 T.C. No. 6 (10/2/08). Because § 6404(e) authorizes the Commissioner to “abate the assessment” of interest, § 6404(e) operates only after there has been an assessment of interest; Thus, Tax Court has no jurisdiction under § 6404(h) to review the IRS’s decision not to abate interest until interest has been assessed and the IRS has mailed a “final determination not to abate such interest.” Nor does the Tax Court have jurisdiction to review the assessment of foreign bank account reporting (FBAR) penalties imposed under 31 U.S.C. § 5321(a) (and assessed under 31 U.S.C.) for violations of the reporting requirements in 31 U.S.C. Under the statute, FBAR penalties are assessed without a deficiency notice – a deficiency notice is neither authorized under § 6212(a) nor required by § 6213(a) before the assessment may be made.

12. **He was convicted of criminal tax fraud, but in the civil case, the IRS couldn’t prove any of 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 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 taxpayer’s argument that because the government’s theory with respect to the unreported fees was different in the civil action than 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 there 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.

B. Discovery: Summonses and FOIA

1. An attorney can be compelled to testify if the client uses him to submit fraudulent documents to the IRS. United States v. Cleckler, 265 Fed. Appx. 850, cert. denied 128 S. Ct. 2976 (6/23/08). (11th Cir. 2/19/08). In a criminal fraud prosecution, the defendant's attorney was properly compelled to testify about a conversation he had with the defendant in the course of a civil audit of the taxpayer's businesses' incomes that led to taxpayer submitting fabricated documents to the IRS through his attorney. The attorney had told the defendant that it would be helpful to document any sales by one of the businesses. The attorney received documentation (including invoices and deposit slips) from the defendant and produced them to the IRS. When the IRS agent requested additional documentation to support the submitted invoices, the attorney asked the defendant if he had any additional documentation, and the defendant provided the fabricated documentation. The attorney was properly required to testify about the content of the conversation that resulted in the production of the fabricated documentation.

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. 6/2/07), “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. 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 are 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.

3. **A district court agrees that tax accrual work workpapers are protected by the work product doctrine.** Regions Financial Corp. v. United States, 101 A.F.T.R.2d 2008-2179 (N.D. Ala. 5/8/08), appeal dismissed on Government’s motion, 12/30/08. Judge Proctor held that the taxpayer’s tax accrual work workpapers were protected by the work product privilege and did not have to be turned over pursuant to an IRS summons. He rejected the government’s argument that the Eleventh Circuit had adopted the Fifth Circuit’s “primary motivating purpose” test, but nevertheless found that high standard to have been satisfied. He applied the reasoning of the court in *United States v. Textron*, 507 F. Supp. 2d 138 (D. R.I. 2007). “Were it not for

anticipated litigation, Regions would not have to worry about contingent liabilities and would have no need to elicit opinions regarding the likely results of litigation. ... It is clear in this case that Regions was primarily motivated by litigation when it solicited opinions about the potential outcomes of litigation from Alston & Bird and E&Y. The fact that Regions undertook the time and expense of consulting outside firms to assess its potential liabilities shows that it believed litigation to be likely, and this court cannot say that Regions' subjective belief was objectively unreasonable." He rejected the government's argument that the workpapers were not protected, i.e., "Regions has not offered any proof that the [documents] were not created, used by or available for use by the independent auditors of Regions'[s] public financial statements," on the ground that there is "no support for the conclusion that a party must show that it was motivated by preparation for litigation *and nothing else* in order to claim that a document is protected work product." (emphasis in original).

4. T.D. 9395, Suspension of Statutes of Limitations in Third-Party and John Doe Summons Disputes and Expansion of Taxpayers' Rights To Receive Notice and Seek Judicial Review of Third-Party Summonses, 73 F.R. 23342 (4/30/08). The Treasury has promulgated final regulations, Regs. §§ 301.7603-1, 301.7603-2, and 301.7609-1 through 301.7609-5, regarding the service of third-party record-keepers summonses, the expanded class of third-party summonses subject to notice requirements and other procedures, and the suspension of periods of limitations if a court proceeding is brought involving a challenge to a third-party summons, or if a third party's response to a summons is not finally resolved within six months after service.

5. **The IRS now permanently can rat out terrorists.** The **Emergency Economic Stabilization Act of 2008** made permanent the § 6103(i)(3) exception for terrorists to the return confidentiality rules.

6. **You can't quash a summons on a tax advisor just because he's the one who has been referred to the Justice Department for criminal prosecution.** Khan v. United States, 548 F.3d 549 (7th Cir. 11/20/08). The court upheld the validity of Reg. § 301.7602-1(c)(1), which limits the application of the § 7602(d)(1) bar on the IRS summons only when there is a Justice Department referral of the person whose tax liability is at issue. Section 7602(d) does not authorize quashing a summons on a third party tax advisor in connection with an investigation of taxpayer's liability even if there had been a Justice Department referral with respect to the tax advisor.

C. Litigation Costs

There were no significant developments regarding this topic during 2008.

D. Statutory Notice of Deficiency

There were no significant developments regarding this topic during 2008.

E. Statute of Limitations

1. Existence of a durable power of attorney forecloses tolling of the statute of limitations under § 6511(h). Bova v. United States, 80 Fed. Cl. 449 (2/13/08). Section 6511(h) tolls the statute of limitations on filing refund claims for any period that the taxpayer is unable to manage his financial affairs by reason of a medically determined physical or mental impairment that will result in death or that has lasted or can be expected to last at least twelve months, unless another person has been authorized to manage the taxpayer's financial affairs. The court (Judge Firestone) held that this exception applied where the taxpayer had executed a durable power of attorney granting another person the power to manage her financial affairs.

2. Rock, scissors, paper – Code covers Constitution. United States v. Clintwood Elkhorn Mining Co., 128 S. Ct. 1511 (4/15/08). The taxpayer sought a refund of taxes paid on coal exports under § 4121(a), which had been held unconstitutional as applied to coal exports in Ranger Fuel Corp. v. United States, 33 F. Supp. 2d 466 (1998), a decision that the Government did not appeal, and in which the IRS acquiesced. See Notice 2000-28, 2000-1 C. B. 1116. The taxpayers filed timely administrative claims for coal taxes paid in 1997 through 1999, which the IRS refunded. The taxpayer filed suit in the Court of Federal Claims seeking a refund of taxes paid between 1994 and 1996, but did not file any claim for those taxes with the IRS, because any such claim would have been denied as untimely under § 6511. In an opinion by Chief Justice Roberts, the Supreme Court held that the Code's provisions override the more lenient six year statute of limitations for claims against the government under the Tucker Act, 28 U. S. C. § 1491(a)(1), even where the claim is based on the unconstitutionality of the tax in question.

3. The AMT statute of limitations is the same as regular tax statute of limitations. Nemitz v. Commissioner, 130 T.C. No. 9 (5/15/08). The Tax Court (Judge Cohen) held that the statute of limitations rule

of § 6501(h) – providing “[i]n the case of a deficiency attributable to the application to the taxpayer of a net operating loss carryback * * * such deficiency may be assessed at any time before the expiration of the period within which a deficiency for the taxable year of the net operating loss * * * which results in such carryback may be assessed” – applies for AMT purposes where the taxpayer erroneously treated an AMT capital loss (incurred with respect to stock acquired pursuant to a qualified stock option) as an AMT net operating loss carryback. The court rejected the taxpayer’s argument that § 6501(h) did not apply because “the only situations where the statute of limitations is kept open by reference to a loss year for noncorporate taxpayers is in the case of deficiencies attributable to a net operating loss carryback since such taxpayers cannot have a capital loss carryback,” and that the taxpayer’s loss was a capital loss, not a net operating loss. The court reasoned that § 6501(h) was not applicable to the factual situation in this case because the taxpayers had claimed the carryback as a net operating loss. Finally, the court held that the absence of a reference in § 6501(h) to an AMT net operating loss carryback specifically did not prevent its application for AMT purposes, because the AMT net operating loss carryback is itself based on § 172.

4. Figure out whether your NOL is a specific liability loss or not and the year to which it should be carried back before the statute of limitations expires. Barrick Resources (USA), Inc. v. United States, 529 F.3d 1252 (10th Cir. 6/20/08). In 2001, the taxpayer filed a timely refund claim seeking to carryback to 1994 and 1995 net operating losses incurred in 1997. In 2002 and 2003 the taxpayer filed additional refund claims treating the 1997 NOLs as specified liability losses (with a ten-year carryback under § 172(f)), that carried the losses back to 1991 and 1992, amending that year’s return; and in 2003 the taxpayer filed additional refund claims carrying specified liability losses from 1997 and 1998 back to 1991. The court (Judge Tymkovich) held that the amended returns for 1991 and 1992, based on treating the 1997 and 1998 NOLs as specified liability losses, were not amendments of the timely-filed refund claims based on carryback to 1994 and 1995 the 1997 NOL but rather were new refund claims filed outside the period of limitations.

5. Section 6511(d)(8), added by the Heroes Earnings Assistance and Relief Tax Act of 2008, extends the statute of limitations for the filing of refund claims by retired military personnel who receive disability determinations from the Department of Veterans Affairs (thereby resulting in the retroactive conversion of military retirement benefits from taxable benefits based on length of service to disability benefits excluded under §104(a)(4)). This provision generally extends the period for filing a refund claim until one year after the date of the disability determination.

6. You have to raise the statute of limitations the first time you get the chance or forever hold your peace. Golden v. Commissioner, 548 F.3d 487 (6th Cir. 11/26/08). Settlement of all claims in an earlier tax court proceeding barred the taxpayer from raising a claim in a subsequent CDP proceeding that the original deficiency notice was outside the three-year statute of limitations. Principles of res judicata apply to bar consideration of issues, including the statute of limitations, that could have been raised in a prior judicial proceeding.

7. You can't rely on an unclarified informal refund claim to beat the statute of limitations. Greene-Thapedi v. United States, 549 F.3d 530 (7th Cir. 12/3/08). To satisfy the jurisdictional requirements of § 7422(a) authorizing district court review of the IRS's denial of a refund, the taxpayer's timely informal refund claim must be followed by a subsequent formal refund claim. "The informal claim doctrine is predicated on the expectation that any formal deficiency will at some point be corrected. ... To hold otherwise would eliminate, as a practical matter, the formal claim requirement."

F. Liens and Collections

1. Ever expanding Tax Court jurisdiction. Rock, scissors, paper: Statutory amendment beats old case law. Callahan v. Commissioner, 130 T.C. 44 (2/5/08). The Tax Court (Judge Haines) held that under § 6330(d), as amended in 2006 to confer on the Tax Court jurisdiction to hear all appeals of CDP determinations, the Tax Court has jurisdiction to review the IRS's determination to review assessment of § 6702 frivolous return penalties. Van Es v. Commissioner, 115 T.C. 324 (2000), which reached contrary result before the 2006 statutory amendment, is no longer controlling. Judge Haines denied the IRS's motion for summary judgment. Because the validity of the underlying tax liability, i.e., the penalties, was properly at issue, the court reviewed the matter de novo, see Sego v. Commissioner, 114 T.C. 604, 610 (2000). Judge Haines denied the IRS's motion for summary judgment. "Although petitioners' Form 1040 is confusing and unorthodox, their arguments are not substantially similar to positions previously held to be frivolous or those that display a desire to delay or impede the administration of Federal income tax laws. ... Until the record is better developed, we cannot say as a matter of law that petitioners have taken a frivolous position or that they desired to delay or impede the administration of Federal income tax laws."

2. "No prior involvement" really means "no prior involvement." Cox v. Commissioner, 514 F.3d 1119 (10th Cir. 1/30/08), *rev'g*

126 T.C. 237 (5/3/06). The Tax Court (Judge Wherry) held that an Appeals Officer is not disqualified from conducting a collection due process hearing for a later year by virtue of conduct of a prior collection due process hearing for the same taxpayer with respect to an earlier year. Judge Wherry held that the conduct of the CDP hearing for the prior year was not “prior involvement” within the meaning of § 6330(b)(3) where the record did not otherwise call into question the Appeals Officer impartiality. The Tenth Circuit (Judge Kelly) reversed, holding that “no prior involvement” within the meaning of § 6330(b)(3) must be interpreted broadly. In denying the taxpayers’ challenge to a proposed levy for the earlier year, which involved a determination of their ability to pay the prior year’s tax liability, the Appeals Officer had considered taxpayers’ tax liability for the subsequent years in question in this case. Even though the prior consideration of the tax liability for the subsequent year in question in this case was “not technically ... determination,” because “the statute does not say ‘no prior participation in a hearing or matter with respect to the unpaid tax,’ [and] it simply says ‘no prior involvement with respect to the unpaid tax,’” it was prior involvement. That involvement disqualified the Appeals Officer from hearing taxpayers’ challenge to proposed levy to collect taxes for the subsequent years. “[C]onsideration of those liabilities during the CDP hearing for [prior years] was a material factor in his decision and constitutes prior involvement.”

3. The last CDP determination is the only CDP determination. Kelby v. Commissioner, 130 T.C. 79 (4/28/08). In a CDP hearing, Appeals makes a single determination, which may or may not be supplemented. When supplemental determinations are issued, the Tax Court reviews the IRS’s decision in the last supplemental determination and does not consider the position stated in prior notices of determination.

4. ♪♪ You say, lien, I say levy, lets call the whole thing off. ♪♪ First American Title Insurance Co. v. United States, 520 F.3d 1051 (9th Cir. 3/27/08) The title insurance company paid tax liens to satisfy claim filed by third party purchasers who had acquired the property directly or indirectly from an estate that had not paid all of the estate tax due that was attributable to an assessment after audit. The title insurance company challenged the assessment arguing that the district court had jurisdiction under 28 U.S.C. § 1346 and United States v. Williams, 514 U.S. 527 (1995). The Ninth Circuit affirmed the district court’s decision that it lacked jurisdiction. The title insurer company argued that Williams, rather than EC Term of Years Trust v. United States, 127 S. Ct. 1763 (2007), which held that § 7426(a)(1) provides the exclusive remedy if the IRS levies on property to collect taxes owed by another person; the levy may not be challenged through a refund suit under § 1346(a)(1), because like Williams, this case involved a lien. The Ninth Circuit rejected this argument because § 7426(c) specifically precludes any challenge to the assessment in an

action by a third party to recover taxes. “[A] challenge to an assessment ... , not a levy, ... is a distinction without a difference. ... § 7426 is the sole remedy here, for the same reason that it was in *EC Term of Years*.”

a. ♪♪ Let’s hear that tune again, but it’s a different Circuit this time. ♪♪ *Munaco v. United States*, 522 F.3d 651 (6th Cir. 4/15/08). The Sixth Circuit (Judge Boggs) applied the reasoning of *EC Term of Years Trust v. United States*, 127 S. Ct. 1763 (2007), to hold that a third party who satisfied a tax lien on property acquired from the delinquent taxpayer and who failed to pursue the administrative remedies available under § 6325(b)(4) and judicial remedies under § 7426(a)(4), which were enacted in 1998, could not maintain a refund suit under 28 U.S.C. § 1346(a)(1). The precisely drawn and detailed remedies available in those provisions trump and displace the more generally stated remedies.

5. The IRS wants the § 6323 regulations to reflect current law and practice. REG-141998-06, Withdrawal of Regulations Under Old Section 6323(b)(10), 73 F.R. 20877 (4/17/08). The IRS has published proposed regulations to update the regulations under § 6323 regarding the validity and priority of the federal tax lien against persons other than the taxpayer. The proposed regulations also: (1) would provide that a notice of Federal tax lien (NFTL) relating to real property does not meet the filing requirements until it is both filed and indexed in the office designated by the state if the real property is located in a state where a deed is not valid against a purchaser unless it is recorded in a public index; (2) would provide that the lien will be extinguished if an NFTL contains a certificate of release and the NFTL is not timely refiled; and (3) would clarify the IRS’s authority to file NFTLs electronically if the state permits electronic filing.

6. Bankruptcy doesn’t discharge taxes where bankrupt taxpayer was convicted of criminal tax fraud, and perfected tax lien for penalties, trumps Bankruptcy Act provision discharging penalties. *Bussell v. Commissioner*, 130 T.C. No. 13 (5/29/08). The Tax Court’s jurisdiction to review a collection action under §§ 6320 and/or 6330 includes the authority to determine whether a taxpayer’s unpaid tax liabilities were discharged in a bankruptcy proceeding. The taxpayer was collaterally estopped from denying that her tax liabilities for the years in issue were excepted from discharge under 11 U.S.C. § 523(a)(1)(C), because she had been convicted of tax evasion under § 7201 for the years at issue. Interest accrued on a tax liability excepted from discharge is also nondischargeable. However, penalties assessed for the years in issue were discharged under 11 U.S.C. § 523(a)(7)(B), which provides for the discharge of any tax penalty “imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition,” but

because the federal tax lien had been properly filed before the taxpayer filed for bankruptcy, the lien, which was not extinguished by the subsequent bankruptcy discharge, could be enforced by levy.

7. An OIC is a prerequisite to challenging a CDP determination on the grounds that the IRS failed to consider collection alternatives. Kohler v. Commissioner, T.C. Memo. 2008-127 (5/5/08). The Tax Court (Judge Jacobs) held that the IRS's failure to consider collection alternatives in a CDP hearing was not an abuse of discretion because taxpayers admittedly failed to submit an offer-in-compromise.

8. Claiming in a CDP hearing that a tax liability was discharged in bankruptcy is not a challenge to the underlying tax liability. Imarah v. Commissioner, T.C. Memo. 2008-137 (5/20/08). The Tax Court (Judge Marvel) held that the IRS improperly refused to consider the taxpayers' claim in a CDP hearing that the tax liability had been discharged in an earlier bankruptcy case. Their discharge argument was not an argument contesting the underlying liability, but went to whether collection activity was lawful. Further, the court held that the tax liabilities had been discharged in bankruptcy.

9. Same year, different basis for deficiency, properly assessed this time; taxpayer loses. Freije v. Commissioner, 131 T.C. No. 1 (7/7/08). In an earlier case involving the same taxpayer for the same year, *Freije v. Commissioner*, 125 T.C. 14 (2005), the Tax Court held that the IRS had improperly disallowed certain deductions for 1999 as mathematical or clerical errors under § 6213(b) and barred a levy. The IRS disallowed other deductions that were not at issue in *Freije I* and properly sent a notice of deficiency; the taxpayer did not file a Tax Court petition. In reviewing a CDP determination, with respect to the deficiency, the Tax Court lacked jurisdiction to consider the merits of the underlying tax liability associated with the second assessment for 1999 based upon the deficiency notice. The issue of that liability was not before the court in *Freije I* and the taxpayer had a previous opportunity to contest the deficiency.

10. The IRS can't pretend a con lives at home with his wife when it knows he's living in the Big House. Conn v. Commissioner, T.C. Memo. 2008-186 (8/5/08). Under § 6330(c)(2)(B) and Reg. § 301.6330-1(e)(3), Q&A-E2, the *receipt* of a notice of deficiency, not its mailing, is the relevant event. A taxpayer who did not actually receive a properly mailed deficiency notice in time to petition the Tax Court is entitled to challenge the underlying liability in a CDP hearing. Because the Commissioner did not introduce into evidence a U.S. Postal Service Form 3877, which would raise the presumption of actual receipt of the deficiency notice, the fact that the taxpayer's wife filed a

timely petition for innocent spouse relief with respect to the tax liability to which the deficiency notice related (tax on embezzlement income) did not establish actual receipt of the deficiency notice by the husband where his last known address – prison – was different from his wife’s.

- The IRS should have realized this when it saw his name.

11. Timely request a CDP hearing or forever hold your peace. Wilson v. Commissioner, 131 T.C. No. 5 (9/10/08). The taxpayer failed to timely request a CDP hearing with Appeals with respect to a proposed levy. Following a late request, Appeals held an equivalent hearing and issued a form letter “NOTICE OF DETERMINATION CONCERNING COLLECTION ACTION(S) UNDER SECTION 6320 and/or 6330.” The Tax Court dismissed the taxpayer’s petition for review for lack of jurisdiction. The court held that because the taxpayer did not timely request a hearing, Appeals did not make a § 6330 determination pursuant to the equivalent hearing, and thus the letter to the taxpayer was not a valid notice of determination under § 6330 that the taxpayer was entitled to appeal pursuant.

12. Present all your claims at the CDP hearing or lose your right of Tax Court review. Brecht v. Commissioner, T.C. Memo. 2008-213 (9/15/08). When reviewing a CDP determination, the Tax Court will not consider an issue regarding abatement of interest under § 6404(e) if it was not properly raised at the CDP hearing and/or considered in the notice of determination.

13. Hoyle v. Commissioner, 131 T.C. No. 13 (12/3/08). Judge Wells held that whether the Appeals officer verified as required by § 6330(c)(1) that all procedural requirements, including that a deficiency notice had been properly mailed to the taxpayer, will be considered on Tax Court review without regard to whether the issue was raised by the taxpayer at the Appeals CDP hearing. [*Giamelli v. Commissioner*, 129 T.C. 107 (2007), held that in reviewing an Appeals officer’s CDP determination the Tax Court does not consider issues that are not a part of that determination.] Because the court was unable to ascertain the basis for the Appeals officer’s verification that the requirements of § 6330(c)(1) were met, the case was remanded to Appeals to clarify the record.

14. Live by your OIC or pay up. Trout v. Commissioner, 131 T.C. No. 16 (12/16/08). The taxpayer entered in a compromise of tax liability pursuant to § 7122(a), pursuant to which he agreed to file his tax returns, and pay any tax due, on time for the next five years. He failed to file returns for two of the required years, and the IRS declared him in default and sought to levy

on his assets. On review of a CDP hearing sustaining the levy, the Tax Court, in a reviewed opinion by Judge Holmes, held that the IRS did not abuse its discretion in declaring the OIC in default and seeking to levy on taxpayer's assets. An accepted offer in compromise is a contract and if the taxpayer fails to satisfy the condition that the taxpayer file his tax returns and pay any tax due on time for a specified period of subsequent years, the IRS may void the compromise and collect the original tax liability in full. In interpreting the compromise agreement to determine whether its terms have been satisfied or breached, the federal common law of contracts, not any particular state law, applies. Judge Holmes held that the breach was not immaterial.

15. The government's rights as a lien-holder under the Code trump conflicting state law. Russell v. United States, 102 A.F.T.R.2d 2008-7337 (10th Cir. 12/19/08) Section 7425(b) provides for the discharge of a junior federal tax lien by a nonjudicial sale by a senior lien holder, if proper notice is provided to the government. The Tenth Circuit reversed a district court opinion that vacated the tax lien because the government did not redeem or purchase the property for the senior lien within the period after the sale of the property as provided by state [Colorado] law, even though the government did not receive notice of the sale. The Tenth Circuit held that § 7425(b) preempts state law and leaves federal tax liens undisturbed where the government did not receive notice of a nonjudicial sale.

G. Innocent Spouse

1. No "plain language" limitation of the Tax Court's jurisdiction in this case. Ewing v. Commissioner, 118 T.C. 494 (5/31/02). The taxpayer and her husband filed a joint return but did not pay all of the tax shown on the return. Subsequently, before the IRS asserted any deficiency, the taxpayer requested equitable relief from joint and several liability under § 6015(f). The IRS denied relief and mailed a notice of determination that was not mailed to the taxpayer's last known address, but was actually received by the 88th day after it was mailed. The taxpayer's petition for review was postmarked 92 days after the mailing of the notice, and was received and filed seven days later. The Commissioner moved to dismiss on the ground that the petition was not timely filed. The Tax Court *sua sponte* raised the issue of whether it had jurisdiction under § 6015(e) to review the IRS's denial of § 6015(f) relief where no deficiency had been asserted. [Section 6015(e), granting the Tax Court jurisdiction to review denials of § 6015 relief, as amended by the Consolidated Appropriations Act of 2001, begins, "In the case of an individual against whom a deficiency has been asserted and who elects to have subsection (b) or (c) apply..."] In a reviewed opinion by Judge Ruwe, the majority (9-4) held that the Tax Court has jurisdiction to review a denial of § 6015(f) relief in a stand alone

petition where the taxpayer is seeking relief from liability of tax shown on the return, without a deficiency having been asserted. The court further held that the petition was timely because it was filed more than 6 months after the date the taxpayer submitted her request for relief [see. § 6015(e)(1)(A)], the IRS failed to mail the notice of determination to taxpayer's last known address, and the misaddressed notice prejudiced the taxpayer's ability to file her petition within 90 days after the mailing of the notice. The court concluded that:

[T]he language "against whom a deficiency has been asserted" was inserted into section 6015(e) to *** to prevent taxpayers from submitting premature requests to the Commissioner for relief from potential deficiencies before the Commissioner had asserted that additional taxes were owed. *** Congress was concerned with the proper timing of a request for relief for underreported tax and intended that taxpayers not be allowed to submit a request to the Commissioner regarding underreported tax until after the issue was raised by the IRS.

There is nothing in the legislative history indicating that the amendment of section 6015(e) ***, was intended to eliminate our jurisdiction regarding claims for equitable relief under section 6015(f) over which we previously had jurisdiction. The stated purpose for inserting the language "against whom a deficiency has been asserted" into section 6015(e) was to clarify the proper time for a taxpayer to submit a request to the Commissioner for relief under section 6015 regarding underreported taxes. We conclude that the amendment of section 6015(e) does not preclude our jurisdiction to review the denial of equitable relief under section 6015(f) where a deficiency has not been asserted. In the instant case, petitioner filed a claim for relief from joint and several liability for an amount of tax correctly shown on the return but not paid with the return. Because respondent has not challenged the tax reported on the return, no deficiency has been asserted. In this situation, petitioner may be entitled to relief under section 6015(f) because subsection (f) applies where "it is inequitable to hold the individual liable for *any unpaid tax or any deficiency.*" [citations omitted].

- Judge Laro's dissent argued that the Tax Court lacked jurisdiction to review the denial of § 6015 relief in the absence of a deficiency, because he considered § 6015(e)(1) to be a "clear statutory mandate from Congress" limiting the Tax Court's jurisdiction to review denials of § 6015 relief to deficiency cases.

a. Ewing v. Commissioner, 122 T.C. 32 (1/28/04).

In a reviewed opinion by Judge Colvin, the Tax Court held that even though the standard for reviewing the Commissioner's failure to grant equitable relief under § 6015(f) is abuse of discretion, the Tax Court's review is not necessarily limited to the facts that were in the administrative record. Judges Halpern, Holmes, Chiechi, and Foley dissented.

b. **Reversed, vacated and dismissed because the Tax Court did not have jurisdiction over taxpayer's petition in which she claimed innocent spouse relief.** Commissioner v. Ewing, 439 F.3d 1009 (9th Cir. 2/28/06), *reversing* 118 T.C. 494 (2002) and *vacating* 122 T.C. 32 (2004). Judge Tashima held that the Tax Court did not have jurisdiction to review wife's petition for equitable relief under § 6015(f) because there was no deficiency asserted against her and she did not elect relief under § 6015(b) or (c), as is required by § 6015(e) in order for the Tax Court to have jurisdiction on an innocent spouse claim. The phrase in § 6015(e) "against whom a deficiency has been asserted" was added in 2001. The court further held that the Tax Court could not consider evidence that was not in the administrative record.

c. **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. No. 10 (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 (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."

2. **Duplicative claim for innocent spouse relief does not reopen period for seeking Tax Court review of IRS's denial or original claim.** Barnes v. Commissioner, 130 T.C. No. 14 (6/11/08). IRS Letter 3657C (which according to the IRM is used to "explain" that a claim for § 6015 relief

“has been previously disallowed”) is not a “final determination” of relief under § 6015. Issuance of IRS Letter 3657C following taxpayer’s filing of a second Form 8857 seeking § 6015(f) relief over 5 years after the IRS initially denied relief does not extend the period for petitioning the Tax Court for review of the denial of relief if the taxpayer did not timely seek review after receipt of IRS Letter 3279 denying initial petition for relief. The second Form 8857 did not raise new grounds for relief but merely reiterated the grounds on which relief initially was sought and denied. Judge Thornton stated, “we do not believe, the 90-day limitations period of section 6015(e)(1)(A) should be defeated or protracted by the simple expedient of filing a succession of duplicative claims.”

3. California community property law comes to the aid of the IRS. Ordlock v. Commissioner, 533 F.3d 1136 (9th Cir. 7/24/08), *aff’g* 126 T.C. 47 (2006) (reviewed, 10-8). Even though the taxpayer spouse was entitled to § 6015 relief, she could not obtain a refund of her husband’s tax liability satisfied with her interest in community property, because under California law creditors of either spouse could reach all community assets and thus the federal tax lien under § 6321 attached to 100 percent of the community property. Neither § 6015(a) nor §6015(g) preempts community property law for purposes of the issuance of a refund to an innocent spouse.

4. Kollar v. Commissioner, 131 T.C. No. 12 (11/25/08). Judge Marvel held that the Tax Court’s jurisdiction under § 6015(e)(1) to review the denial by the IRS of § 6015(f) equitable relief extends to relief solely from liability for interest on a tax deficiency where relief from the principal deficiency is not in issue. Sections 6601(e)(1) and 6665(a) provide that “‘tax’ for purposes of the Code included interest and penalties, except in certain cases not relevant to [the question of § 6015(e)(1) jurisdiction].”

H. Miscellaneous

1. 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). 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”

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.

b. And the Tax Court's procedures are vindicated and taxpayer Kanter's Estate loses on appeal on the fraud issue in the Eleventh 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 Tax Court's findings on the issues of deficiencies, fraud, and penalties, but reversed as to other findings.

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 Circuits 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 not 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 in 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. 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 this case to a regular Tax Court judge who had no involvement in the preparation of the aforementioned “collaborative report” and who shall give “due regard” to the credibility determinations of Judge Couvillion, presuming that his fact findings are correct unless manifestly unreasonable [in dealing with the remaining issues of tax deficiency]; 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. Ballard v. Commissioner, 522 F.3d 1229, (11th Cir. 4/7/08). The Eleventh Circuit (Judge Fay) reversed, vacated and remanded the Tax Court decision, T.C. Memo. 2007-21 (2/1/07), 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. **And on.** Estate of Lisle v. Commissioner, 541 F.3d 595 (5th Cir. 8/25/08). The Fifth Circuit followed the Eleventh Circuit’s decision and reversed and remanded Judge Haines’s decision.

2. **Long live the common law mailbox rule.** Philadelphia Marine Trade v. Commissioner, 523 F.3d 140 (3d Cir. 4/15/08). The Third Circuit held that the application of common law mailbox rule is unaffected by § 7502 where there is evidence that the document was mailed in manner than in the normal course would have resulted in receipt before the deadline. The taxpayer could avail itself of the mailbox rules because it produced evidence of mailing the documents in question on May 8 and June 13 by overnight and first class mail, respectively, which would have resulted in arrival well before the June 25 deadline.

- Note there is a split in the circuits. The Eighth, Ninth, and Tenth Circuits agree with the Third Circuit that a taxpayer may rely on the common law mailbox rule to prove that a return was timely filed, *Estate of Wood v. Commissioner*, 909 F.2d 1155 (8th Cir. 1990); *Anderson v. United States*, 966 F.2d 487 (9th Cir. 1992); *Sorrentino v. United States*, 383 F.3d 1187 (10th Cir. 2004), *cert. denied*, 546 U.S. 812 (2005), but the Second Circuit, *Deutsch v. Commissioner*, 599 F.2d 44 (2d Cir. 1979), and Sixth Circuit, *Miller v. United States*, 784 F.2d 728 (6th Cir. 1986) have reached a contrary result, rejecting any application of the common law mailbox rule.

3. **According to the Third Circuit, the Tax Court just doesn’t understand Chevron.** Swallows Holding, Ltd. v. Commissioner, 515 F.3d 162 (3d Cir. 2/15/08), *rev’g* 126 T.C. 96 (1/26/06). The Tax Court, in a reviewed opinion (12-2-3) by Judge Laro, invalidated a regulation [Reg. § 1.882-4(a)(2) and (3)(i)] issued under § 882(c)(2), because the statute required that a tax return be filed in the “manner” prescribed by statute and regulations, but the regulation denied a substantive tax benefit if the return was not timely filed. In doing so, the Tax Court analyzed the impact of the Supreme Court’s decision in *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) on the application of the *National Muffler Dealers Ass’n* standard [*Natl. Muffler Dealers Association v. United States*, 440 U.S. 472 (1979)] for reviewing the validity of interpretive regulations issued under the general authority in § 7805(a):

The question arises from the timing of these two decisions whether the Supreme Court intended for [*Chevron*] to replace [*Natl. Muffler Dealers Ass'n*] in the review of a Federal tax regulation. We have previously stated with respect to that question: “we are inclined to the view that the impact of the traditional, i.e., *National Muffler* standard, has not been changed by *Chevron*, but has merely been restated in a practical two-part test with possibly subtle distinctions as to the role of legislative history and the degree of deference to be accorded to a regulation.” *Central Pa. Sav. Association & Subs. v. Commissioner*, 104 T.C. 384, 392 (1995) Here, we conclude likewise that we need not parse the semantics of the two tests to discern any substantive difference between them. While we apply a *Natl. Muffler* analysis, our result under a *Chevron* analysis would be the same.

- The court further noted that a legislative regulation, in contrast to an interpretive regulation, when scrutinized under the *Chevron* standard will be upheld “unless arbitrary, capricious, or manifestly contrary to the statute.” Nevertheless, the Tax Court held that Reg. § 1.882-4(a)(2) and (3)(i) was invalid because it failed to pass muster under several of the *National Muffler* factors: (1) the regulation was not a substantially contemporaneous construction of the statute, (2) the regulation evolved after the Fourth Circuit Court of Appeals and the Board of Tax Appeals had held that the statute did not include a particular requirement that was imposed by the regulations, (3) the regulations were issued after multiple reenactments of the statutory text, (4) the regulations departed from a prior IRS interpretation of earlier regulations, and (5) the statute had been reenacted several times without change to the governing statutory language.

- The Third Circuit reversed the Tax Court’s decision on the grounds that (1) the Tax Court erred in applying the *National Muffler* test rather than the *Chevron* test, which the court of appeals held established a different standard, and (2) because the statute was ambiguous and the regulation in question was a permissible construction of the statute, it deserved deference under the *Chevron* test. The Third Circuit expressly rejected the continuing relevance after *Chevron* of (1) whether regulation had been promulgated contemporaneously with enactment of the statute it interprets, (2) the length of time the regulation had been in force, and (3) whether the statute had been reenacted since the regulation had been promulgated, all of which were relevant inquiries under *National Muffler*.

Our inquiry would be a simple one if, as the Tax Court suggested, the result of this case would be the same regardless of which standard we apply. This, however, is not the case. The Tax Court relied heavily on factors that, although relevant to

the *National Muffler* standard, are not mandatory or dispositive inquiries under *Chevron*. As we set out above, the Tax Court reasoned that the challenged regulation was not a contemporaneous construction of the statute; the Tax Court found that the Fourth Circuit Court of Appeals and the Board of Tax Appeals had interpreted the statute as not including a timing element, and the Tax Court relied on the existence of several reenactments of the statute without any change to the governing statutory language.

Even if we were to assume that all of these observations are true, conclusive reliance on them is misplaced. When *Chevron* deference is owed, *Chevron*'s demands are clear. If the statutory text is ambiguous, an agency is given the discretion to promulgate rules that interpret the ambiguous provisions. Judicial deference to an agency's rule-making authority ends only when the agency's construction of its statute is unreasonable.

- In addition to the Third Circuit, six other circuits have applied *Chevron* to analyze the validity of Treasury Regulations. *Hospital Corp. of Am. & Subs. v. Commissioner*, 348 F.3d 136 (6th Cir. 2004); *Bankers Life & Cas. Co. v. United States*, 142 F.3d 973 (7th Cir. 1998); *Redlark v. Commissioner*, 141 F.3d 936 (9th Cir. 1998); *In re Craddock*, 149 F.3d 1249 (10th Cir. 1998); *Beard v. United States*, 992 F.2d 1516 (11th Cir. 1993); *Tax Analysts v. Commissioner*, 350 F.3d 100 (D.C. Cir. 2003). Four Circuits have applied the *National Muffler* standard (or *National Muffler* with a *Chevron* gloss). *Snowa v. Commissioner*, 123 F.3d 190 (4th Cir. 1997) (general authority regulations get *National Muffler* review under *Chevron*); *Nalle v. Commissioner*, 997 F.2d 1134 (5th Cir. 1993); *United States v. Tucker*, 217 F.3d 960 (8th Cir. 2000); *Schuler Indus. Inc. v. United States*, 109 F.3d 753 (Fed. Cir. 1997). Although several courts of appeals have applied the *National Muffler* standard rather than the *Chevron* standard in reviewing interpretive Treasury Regulations, the Third Circuit Court of Appeals reading of the import of *Chevron* is much closer to the mainstream of administrative law generally, and one could expect the Tax Court to be reversed in the future if it continues to apply *National Muffler* to invalidate regulations that would pass muster under *Chevron*, as that case is generally being interpreted and applied by the courts of appeals.

4. Expanding equitable recoupment jurisdiction in the Tax Court. *Menard, Inc. v. Commissioner*, 130 T.C. 54 (2/19/08). Judge Marvel held that the Tax Court has jurisdiction to apply the equitable recoupment doctrine to allow the taxpayers, an employee [CEO of Menard, Inc.]/shareholder and his employer [Menard, Inc.] to offset their income tax deficiencies with FICA hospital taxes they overpaid on the portion of the CEO/shareholder's

compensation that the Tax Court previously had held was a disguised dividend in *Menard, Inc. v. Commissioner*, T.C. Memo. 2004-207 (*Menard I*), and *Menard, Inc. v. Commissioner*, T.C. Memo. 2005-3 (*Menard II*). Even though the Tax Court lacks jurisdiction to redetermine FICA taxes, under the second sentence of § 6214(b), added by the **Pension Protection Act of 2006**. [“ ... [T]he Tax Court may apply the doctrine of equitable recoupment to the same extent that it is available in civil tax cases before the district courts of the United States and the United States Court of Federal Claims”], the Tax Court can apply equitable recoupment doctrine as ancillary to its original jurisdiction over deficiency redetermination. Judge Marvel rejected the IRS’s argument that the Tax Court’s jurisdiction to apply equitable recoupment is limited to taxes over which it has deficiency or overpayment jurisdiction [income, estate, and gift taxes and excise taxes imposed under chapters 41, 42, 43, and 44] on the ground that the “legislative history underlying the recent amendment to section 6214(b) indicates Congress intended to eliminate confusion over the Court’s authority to apply the doctrine created by conflicting Court of Appeals opinions and to provide simplification benefits to both taxpayers and the Commissioner.” Furthermore, the IRS’s narrow construction of the statute was “inconsistent with the central policy underlying the doctrine of equitable recoupment; i.e., to prevent an inequitable windfall to a taxpayer or the Government that would otherwise result from the inconsistent tax treatment of a single transaction, item, or event.” However, in computing *Menard, Inc.*’s tax liability for the year in question, it was required to reduce its deduction for the FICA taxes with respect to which equitable recoupment was allowed.

5. The court didn’t care to hear Professor Shepard’s analysis of whether this tax shelter worked. *Stobie Creek Investments, LLC v. United States*, 81 Fed. Cl. 358 (4/1/08). In this tax shelter case, the government filed a motion *in limine* to exclude the expert witness report and testimony of the taxpayer’s expert witnesses, Professor Ira B. Shepard, University of Houston Law Center and Stuart A. Smith, a New York tax attorney and former Tax Assistant to the Solicitor General on the grounds that “it ‘impinge[s] on the role of this Court’ by testifying as to the law or the application of the law to facts.” The government characterized Professor Shepard’s report as “‘nothing but legal analysis and application of his view of the law to his view of the facts of this case,’ *** [that] ‘contains lengthy descriptions of numerous cases and sets forth in detail the manner in which [Professor] Shepard would decide this case if he were the judge.’” The government characterized Smith’s report as “‘legal argument dressed up as an opinion of an expert witness’ that amounts to ‘[n]ot only . . . a legal conclusion, [but] a conclusion based on the wrong law.’” The taxpayer asserted that Professor Shepard “‘will address whether the opinion provided by Jenkens & Gilchrist to the Welles family was an appropriate ‘more likely than not opinion’ at the time that it was issued such that a taxpayer could

reasonably rely on it,' and that 'Mr. Smith will testify as to the quality of the Jenkens & Gilchrist opinion, which is relevant to the taxpayer's ability to rely in good faith on that opinion.'" After extensively discussing the nature of the experts' reports the court (Judge Miller) granted the government's motion to exclude the expert witness reports and testimony because "[taxpayer's] legal experts are applying the law to the facts, rather than permissibly explaining law in a manner that could inform or assist the finder of fact."

• See, Wolfman, Bernard. "Expert Testimony on The Law, Twelfth Annual Erwin N. Griswold Distinguished Lecture," *57 Tax Lawyer* 709 (2004), where he stated:

In fact, expert legal testimony is usually admissible in standard-of-care cases, and it should be. In other types of cases involving domestic law, those in which the parties differ as to the meaning of the law applicable to a case, generally the judge, not the jury, should decide, and generally the parties should present their positions by argument not testimony. If, however, the case is one in which law and fact are significantly intertwined, it may be sensible and helpful to have legal experts offer their understanding of the law that underlies the parties dispute, and so their testimony should be admissible and subject to cross examination.

Moreover, even in the absence of the significant intertwining of law and fact, a trial judge should have the discretion on his own motion to appoint a legal expert to testify on domestic law, or to allow such testimony when a party proffers it. When the judge believes that the area of law is one that calls for highly specialized legal expertise that he does not have sufficiently, and he thinks that a jury will be more likely to understand the law or legal setting applicable to the facts of the case if it hears the testimony of legal experts for both sides who present their opinions subject to cross examination, the proffered testimony should be admitted. Indeed, I think that serious consideration should be given to amending Federal Rule of Civil Procedure 44.1 so that it will not be limited to foreign law and will read as follows: ". . . The court, in determining foreign or domestic law, may consider any relevant material or source, including testimony, whether or not submitted by a party or admissible under the Federal Rules of Evidence. . . ."

• One of Professor McMahon's former students was on the government's trial team and deposed Professor Shepard in connection with the case.

a. The Court of Federal Claims refused to exclude most of Stuart Smith's report. Murfam Farms LLC v. United States, 102 A.F.T.R.2d 2008-6319 (Fed. Cl. 9/19/08). Judge Damich permitted Stuart Smith to opine on whether the Proskauer Rose opinions were of a quality that the taxpayers could reasonably rely on them, but not on whether the Proskauer Rose opinions were correct.

Plaintiffs present Mr. Stuart Smith, a tax attorney, to opine on whether the Proskauer Rose opinions were of the type, character, and quality upon which a taxpayer could reasonably rely. The Government makes two primary arguments for the exclusion of Mr. Smith's testimony: (1) that, because Mr. Smith relies on the wrong law (i.e., certain Treasury Circular 230 and not Treasury Regulation 1.6664-4), the testimony contained in Mr. Smith's report is unreliable, and (2) that Mr. Smith presents nothing more than legal analysis.

The Government first asserts that Mr. Smith's analysis is unreliable because the only standard by which to properly gauge a reasonable cause defense to accuracy-related penalties is I.R.C. section 6664(c) and the Treasury Regulations promulgated under that section. In response, Plaintiffs assert that Mr. Smith's report does not state that Treasury Circular 230 is the correct standard by which to consider a reasonable cause defense. Instead, Plaintiffs assert, "Mr. Smith references the Circular 230 standards only in his evaluation of the quality of the tax opinions to demonstrate that such opinions were 'objectively reasonable.'"

The Court does not find that Mr. Smith's analysis is unreliable under Rule 702. The Court notes that Mr. Smith's report states, quite unmistakably, that "it is plainly not necessary for an opinion to satisfy the particular requirements of this Circular for a taxpayer to act reasonably in relying on it." Moreover, it seems reasonable to the Court that a tax professional might look to a Treasury Circular for at least general guidance in determining the level of quality necessary for a tax opinion. As such, the Court agrees with Plaintiffs that Mr. Smith's discussion of Treasury Circular 230 does not render his report "unreliable" under Rule 702.

The Government also argues that Mr. Smith's report simply presents an argument on an issue of law to be decided by the Court. As Plaintiffs point out, however, Mr. Smith's report does not opine that the Proskauer Rose opinions were legally correct. Rather, Mr. Smith's report simply opines that the Proskauer Rose opinions appear to have been prepared

based on a certain standard of care, and are of a threshold quality such that taxpayers such as the Plaintiffs could reasonably rely on them.

The Court finds that only certain portions of Mr. Smith's report constitute improper testimony on a legal issue. While discussing the characteristics of the Proskauer Rose opinions in a section titled "(2) Relate Law to Facts," Mr. Smith's report also analyzes the Internal Revenue Service's legal position on the COBRA transactions at issue, finding it to "lack an objective appearance of reasonableness." Despite Mr. Smith's attempt to disguise his legal discussion as an objective analysis of the quality of the Proskauer Rose opinions, this section of Mr. Smith's report appears to be little more than a legal argument that Plaintiffs' analysis of the transactions is correct while the Government's analysis is not. There is a difference between opining that a legal analysis is thorough-enough to be reasonably relied upon and opining that the legal analysis is correct while another is incorrect. The former opinion can be helpful to the court, while the latter is not. In addition, the merit of the Internal Revenue Service's subsequent legal position on the COBRA transactions at issue would play no part in a determination of whether the Proskauer Rose opinions could reasonably have been relied upon prior to execution of the transactions. Similarly, Mr. Smith provides a discussion of the Eastern District of Texas's decision in *Klamath Strategic Investment Fund v. United States*, which was issued well after the Proskauer Rose opinions were written (citing *Klamath*, 472 F. Supp. 2d 885 (E.D. Tex. 2007)). Mr. Smith attempts to use the *Klamath* opinion as subsequent corroboration that the analysis contained in the Proskauer Rose opinions was correct. Neither of these discussions is helpful to the Court.

6. The IRS makes it easier for its agents to prepare § 6020(b) substitute returns. T.D. 9380, Substitute for Return, 73 F.R. 9188 (2/20/08). Revised Reg. § 301.6020-1 provides that a document (or set of documents) signed by an authorized Internal Revenue Officer or employee is a return under § 6020(b) if the document(s) identifies the taxpayer by name and TIN, contains sufficient information from which to compute the taxpayer's tax liability, and the document(s) purports to be a return under § 6020(b). A Form 13496, "IRC Section 6020(b) Certification," or any other form used to identify a document (or set of documents) containing the required information constitutes a valid § 6020(b) return. A name or title of an Internal Revenue Officer or

employee appearing on a § 6020(b) return is a sufficient subscription without regard to whether the name or title is handwritten, stamped, typed, printed or otherwise mechanically affixed to the document. The document(s) and subscription may be in written or electronic form. The purpose of these changes was to reverse the result in *Cabirac v. Commissioner*, 120 T.C. 163 (2003).

a. The IRS foot-faulted on preparing a tax protestor's substitute return and lost the failure to pay penalty. *Cabirac v. Commissioner*, 120 T.C. 163 (2003). The taxpayer filed income tax return forms with zeros on the relevant lines for computing tax liability. The IRS prepared unsubscribed substitute returns showing zeros, and sent a deficiency notice based on a calculation of taxable income and tax shown in a revenue agent's report, which had not been attached to the substitute returns. The Tax Court (Judge Ruwe) held that the taxpayer was liable for the § 6651(a)(1) failure to file penalty, but not for the § 6651(a)(2) failure to pay penalty. The unsubscribed substitute returns showing zero taxes did not meet the requirements for a § 6020(b) return, and the subsequently prepared notice of proposed adjustments and the revenue agent's report, which were not attached to the unsubscribed substitutes for return, whether viewed separately or in conjunction with the substitute return, were not an adequate § 6020(b) return.

7. The Tax Court's not a court! So says the Sixth Circuit in affirming the Tax Court's own decision to that effect. *Mobley v. Commissioner*, 532 F.3d 491 (6th Cir. 7/8/08). The Sixth Circuit affirmed the Tax Court's decision that it lacked authority to transfer a refund claim, over which it had no jurisdiction, to a district court under 28 USC § 1631. That provision "by its terms applies only to a "court" as defined in 28 U.S.C. sec. 610" and ... the Tax Court is not included among the courts listed in 28 U.S.C. sec. 610."

a. And the Court of Federal Claims agrees. *DaCosta v. United States*, 82 Fed. Cl. 549 (7/11/08). The Court of Federal Claims cannot transfer to the Tax Court a case filed in the Court of Claims but over which it lacks jurisdiction because exclusive jurisdiction is vested in the Tax Court. The Tax Court is not a "court" for this purpose because the Tax Court is not listed in 28 U.S.C. § 610 as a court to which a case can be transferred pursuant to 28 U.S.C. § 1631.

8. Why rush before April 15th! — Wait until October 15th, or is it September 15th? T.D. 9407, Extension of Time for Filing Returns, 73 F.R. 37362-01 (7/1/08). The Treasury promulgated final regulations relating to extensions of time to file tax returns. Individual have an automatic 6-month extension if they file an application on or before the return due date. Reg.

§ 1.6081-4. For partnerships, estates, and trusts, the automatic extension period is only five months. Temp. Reg. §§ 1.6081-2T (partnerships), 1.6081-6T (estates and trusts).

9. Or, wait until January 5th, if you are a Hurricane Ike survivor. IR-2008-107, Sept. 18, 2008.

Specifically, the relief postpones until Jan. 5, 2009, certain deadlines for taxpayers who reside or have a business in the disaster area. The postponement applies to return filing, tax payment and certain other time-sensitive acts due on or after Sept. 7, 2008, and before Jan. 5, 2009 — including individual estimated tax returns and corporate tax returns that were due Sept. 15, and extended individual returns due Oct. 15.

In addition, the IRS will waive the failure to deposit penalties for employment and excise deposits due on or after Sept. 7 and before Sept. 22, 2008, as long as the deposits are made on or before Sept. 22.

10. Complying with IRS withholding instructions does not defraud an employee. Nino v. Ford Motor Company, 102 A.F.T.R.2d 2008-5837 (E.D. Mich. 8/8/08). Summary judgment was granted to plaintiff's employer in a pro se proceeding claiming that the employer defrauded the plaintiff by wage withholding pursuant to IRS instructions to disregard the plaintiff's claimed 99 exemptions. The court indicated that it could find no legal authority requiring an employer to make a determination of a worker's status before withholding taxes.

11. Beware of showing the "real books" to the guy who claims he wants to buy your business. The **Emergency Economic Stabilization Act of 2008** made permanent the IRS's Code § 7608(c) authority to engage in undercover operations.

12. Claims for a method for hedging risk in commodities trading are held not to concern patent-eligible subject matter. This leads to the conclusion that tax strategies are not patentable. In re Bilski, 545 F.3d 943 (Fed. Cir. 10/30/08) (9-3), petition for cert. filed, No. 08-964 (1/28/09). 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.

13. A tie goes to the taxpayer, otherwise § 7491 doesn't count. *Knudsen v. Commissioner*, 131 T.C. No. 11 (11/12/08). Section 7491 does not require the trial court to decide whether the burden of proof has been shifted to the Government in all cases where the issue of a burden shift is raised. Where parties have satisfied their burden of production by offering some evidence, the party supported by the weight of the evidence prevails “regardless of which party bore the burden of persuasion, proof or preponderance.” “[A] shift in the burden of preponderance has real significance only in the rare event of an evidentiary tie.”

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*, 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 is granted by the District Court holding 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, 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.

2. Vacation with pay in a sunny safe harbor, at least for the employer. Rev. Proc. 2008-25, 2008-13 I.R.B. 686 (3/11/08). The IRS originally maintained the position that payroll taxes for year-end wages, including accrued vacation pay, could not be deducted in the year accrued

because it was unclear whether the employee would meet the payroll tax threshold in the subsequent year when wages were actually paid. The IRS lost the issue in *Eastman Kodak Co. v. United States*, 534 F.2d 252 (Ct. Cl. 1976), *acq.* 1996-2 C.B. 1. This revenue procedure provides a safe harbor method of accounting under the recurring item exception of Reg. § 1.446-5 allowing deduction of accrued FICA and FUTA taxes in the taxable year in which all events have occurred that establish the fact of the related compensation liability and the amount of the related compensation liability can be determined with reasonable accuracy. The revenue procedure grants blanket permission for a change of accounting to the safe harbor method.

3. You're laid off (or fired), here's a benefits check, but you have to pay your employment taxes. *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 3/6/08). With a lengthy analysis of the statute, legislative history, case law and prior IRS rulings practice, the court held that supplemental unemployment benefits paid to workers (including management, temporary and unionized employees) who are voluntarily or involuntarily separated from service are treated as wages subject to withholding under FICA and the Railroad Retirement Tax Act.

a. *United States v. JPS Composite Materials Corp.*, 101 A.F.T.R.2d 2008-1488 (D. S.C. 3/25/08). Summary judgment was granted to the United States in a suit to recover an erroneous refund of FICA and Medicare taxes paid with respect to supplemental unemployment compensation benefits. The case was being held pending resolution of the issue in *CSX Corp.*

4. Railroad ties bind a subsidiary to its related rail carrier for purposes of railroad retirement and unemployment taxes. *Trans-Serve, Inc. v. United States*, 521 F.3d 462 (5th Cir. 3/19/08). Commonly controlled subsidiary that derived 75 percent of its income from the manufacture and sale of railroad ties for its related rail carrier was held to provide "service in connection with transportation by rail." The subsidiary was thus held responsible for Railroad Retirement Act and Railroad Unemployment Act taxes on wages paid to employees. The court affirmed lower court holding rejecting the taxpayer's claim that it was required only to pay the lower FICA and FUTA taxes on wages.

5. Rev. Rul. 2008-29, 2008-24 I.R.B. 1149 (6/15/08). The ruling provides rules to determine withholding rates with respect to payment of supplemental wages in nine different situations.

6. The Heroes Earnings Assistance and Relief Tax Act of 2008 clarified that any amount excludable from gross income under §139B [certain qualified benefits to volunteer firefighters and emergency medical responders] is not subject to social security tax or unemployment tax.

7. Truck drivers are employees but relief was granted under § 530 of the Revenue Act of 1978. Peno Trucking, Inc. v. Commissioner, 296 Fed.Appx. 449 (6th Cir. 10/3/08). The taxpayer leased tractor-trailer combinations to another company and supplied the drivers. The drivers entered into agreements with the taxpayer that they were independent contractors and the taxpayer reported the drivers' incomes on Form 1099. The court affirmed the Tax Court's holding that the drivers were employees relying on the Tax Court's conclusions that (1) the taxpayer oversaw the drivers' responsibilities, determined the days they could work, and controlled the loads they would haul; (2) made a substantial investment to acquire and maintain the trucks; (3) the drivers did not assume a risk of loss; (4) the taxpayer had the right to discharge its drivers; (5) the drivers performed a service that was essential to the taxpayer's operations; (6) the drivers worked in the course of the taxpayer's business rather than having a transitory relationship with the taxpayer; and (7) although the taxpayer and its drivers entered into written agreements which expressly provided that the drivers were independent contractors, the facts indicated otherwise. The appellate court reversed the Tax Court's holding that the taxpayer was not entitled to relief under § 530 of the Revenue Act of 1978, which protected employers from employment tax if there was a reasonable basis for treating workers as independent contractors. The court noted that the taxpayer had consistently treated drivers as independent contractors and that the taxpayer reasonably relied on state workers' compensation decisions as a basis for that status.

8. Section 403(b) salary reduction agreements defined. T.D. 9367, Payments Made by Reason of a Salary Reduction Agreement, 72 F.R. 64939 (11/19/07). Treasury has finalized regulations, § 31.3121(a)(5)-2, defining contributions to § 403(b) plans under a salary reduction agreement that are subject to employment taxes. Employer contributions to a § 403(b) plan that are not made pursuant to a salary reduction agreement are not subject to employment taxes. A salary reduction agreement exists if the employee elects to reduce compensation pursuant to a cash or deferred election, the employee elects to reduce compensation under a one-time irrevocable election made at or before the time of initial eligibility to participate in the plan, or the employee agrees as a condition of employment (whether imposed by statute or otherwise) to make a contribution that reduces compensation.

a. The Seventh Circuit agrees with the IRS position on involuntary plans, with penalties. University of Chicago v. United States, 547 F.3d 773 (7th Cir. 10/29/08). Upholding the District Court (100 A.F.T.R.2d 2007-6261 (N.D. Ill. 8/21/07)), the appellate court held that contributions to employee § 403(b) plans were subject to FICA withholding. The University of Chicago required employees to make payments into a § 403(b) plan and referred to the employee contributions as being withheld from salaries. Employees were required to sign a “salary reduction agreement.” The University also contributed to the plan on behalf of employees. Section 3121(a)(5)(D) excludes from wages subject to employment taxes any payment under a § 403(b) annuity contract, “other than a payment for the purchase of such a contract which is made by reason of a salary reduction agreement.” The University argued that FICA taxes are payable only with respect to contributions only if the employee voluntarily agrees to receive a lower stated salary plus payments to the plan in lieu of cash. The court reasoned that § 3121(a)(5)(D) applies to salary supplement arrangements rather than plans that provide for a reduction in employee compensation to fund contributions.

- In addition, the court affirmed penalties in the amount of the employee withholding that the University failed to collect and failure to deposit and failure to pay penalties. The court found that the University’s failure to make the deposits was not due to reasonable cause. The University asserted under the “divisible tax doctrine” that its payment of a portion of the tax in order to bring the refund action absolved it of the penalty. The court indicated that the divisible tax doctrine is jurisdictional and does not absolve the taxpayer from applicable penalties.

9. Temporary and Proposed Regulations simplify filing for small employers. T.D. 9440, Employer’s Annual Federal Tax Return and Modifications to the Deposit Rules, 73 F.R. 79354 (12/29/08); REG-148568-04, Employer’s Annual Federal Tax Return and Modifications to the Deposit Rules, 73 F.R. 79423 (12/29/08); Rev.Proc. 2009-13, 2009-3 I.R.B. (12/29/08). Temp. Reg. § 31.6011(a)-1T(a)(5) provides for annual filing of employment tax returns for employers notified by the IRS to file annual returns on Form 944 (instead of quarterly filings on Form 941), generally applicable to employers with less than \$1,000 of annual employment tax liability (Social Security, Medicare, and wage withholding). The temporary regulations were revised to make the use of Form 944 optional for taxpayers who notify the IRS that they will file the quarterly Form 941 and permit taxpayers to change their filing method from year-to-year. Temp. Reg. §§ 31.6011(a)-1T(a)(5) and 31.6011(a)-4T(a)(4) allow taxpayers who estimate that their employment tax liability will be \$1,000 or less to contact the IRS to express a desire to file Form 944 instead of Form 941, following which the IRS will send a notice to the taxpayer directing the taxpayer to file the Form 944 annually. Taxpayer in

receipt of this notice must continue to file the Form 944 until they contact the IRS to change the filing requirement and receive confirmation from the IRS that their filing requirement has been changed. Rev. Proc. 2009-13 contains procedures for changing the filing status. The temporary regulations also modify the “look-back” rules for determining whether Form 941 filers with less than \$2,500 of employment tax liability in a quarter can file quarterly rather than monthly or semi-weekly deposits.

B. Self-employment Taxes

1. Edwards v. Commissioner, T.C. Memo. 2008-24 (2/7/08). Commissions based on insurance renewals paid to a retired insurance agent by his sole proprietorship agency are subject to self-employment tax. The fact that day-to-day operations of the insurance agency had been turned over to employees does not affect the result.

2. **Failure to meet mandatory electronic filing incurs penalties even though employment taxes in the correct amount are paid on a timely basis.** Fallu Productions v. United States, 101 A.F.T.R.2d 2008-855 (S.D. N.Y. 2/13/08). Reg. § 31.6302-1(h) requires that certain deposits of employment taxes be made electronically. The taxpayer, a film production company owned by the actor Joe Pesci paid its employment taxes by deposit in an approved bank, but not electronically. The court granted summary judgment imposing failure to pay penalties under § 6656 for failure to make the deposits in the required electronic fashion.

3. **Emergency Economic Stabilization Act of 2008**, Division C, § 504(c), provides that amounts received by taxpayer engaged in the fishing business from the settlement of Exxon Valdez litigation are not treated as self-employment income.

C. Excise Taxes

1. Worldwide Equipment v. United States, 546 F.Supp.2d 459 (E.D. Ky. 2/29/08). Summary judgment was granted to the government holding that Mack trucks designed primarily to haul coal from the mine to the tipples are subject to the 12% excise tax on the retail sale of heavy truck bodies and chassis. Customization activities by the dealer did not make the trucks unsuitable for highway use.

2. **Ahoy mates! Emergency Economic Stabilization Act of 2008**, Act § 306, retroactively extends the \$13.50 per gallon payment of excise tax to Puerto Rico (up from \$10.50) for imported rum.

3. **Benefits for Robin Hood's children hunting pork. Emergency Economic Stabilization Act of 2008**, Act § 503(a), amends § 4161(b)(2)(B) to exempt from excise tax all-natural arrow shafts measuring 5/16 of an inch that are not suited for use with bows drawing more than 30 pounds.

4. The **Emergency Economic Stabilization Act of 2008** [Division B], the **Energy Improvement and Extension Act**, § 113, extends the temporary increase in the coal excise tax of § 4121, funding the Black Lung Disability Trust, to 12/31/18.

- Section 202 extends the gasoline excise tax credit of § 6426 for biodiesel and renewable diesel fuels to fuels produced before January 1, 2010, and increases the biofuel credit from 50 cents to \$1 per gallon.

- Section 206 amends § 4053 by adding an exclusion from the heavy truck excise tax of § 4051 for truck heating and cooling devices that do not require operation of the main engine while the vehicle is parked.

XII. TAX LEGISLATION

A. Enacted

1. The **Economic Stimulus Act of 2008**, P.L. 110-185, was signed by President Bush on 2/13/08. The bill contains several tax provisions, including an increase for 2008 in the § 179 dollar limitation to \$250,000 (phase-out increase to \$800,000), and the application of the § 168(k) special allowance of 50 percent to property acquired during 2008.

2. The **Food, Conservation, and Energy Act of 2008**, (the "**2008 Farm Act**"), P.L. 110-234, was enacted over President Bush's veto on 5/22/08. The portion of the Farm Act containing tax provisions are referred to as the **Heartland, Habitat, Harvest, and Horticulture Act of 2008**.

3. The **Heroes Earnings Assistance and Relief Tax Act of 2008** (the "**HEART Act**"), P.L. 110-245, was signed by President Bush on 6/17/08.

4. The **Housing and Economic Recovery Act of 2008**, P.L. 110-289, was signed by President Bush on 7/30/08. The tax provisions in that Act are referred to as the **Housing Assistance Tax Act of 2008**.

5. The **Emergency Economic Stabilization Act of 2008** [Division A], the **Energy Improvement and Extension Act of 2008** [Division B], and the **Tax Extenders and Alternative Minimum Tax Relief Act of 2008** [Division C], P.L. 110-343 was signed by President Bush on 10/3/08.

- The provisions of these Acts authorize the Secretary of the Treasury to establish a Troubled Assets Relief Program to purchase troubled assets from financial institutions; provide Alternative Minimum Tax relief; extend expiring tax provisions and establish energy tax incentives; and temporarily increase Federal Deposit Insurance limits.

6. The **Fostering Connections to Success and Increasing Adoptions Act**, P.L. 110-351 was signed by President Bush on 10/7/08.

7. “I gets WRERA and sick of trying.” The **Worker, Retiree, and Employer Recovery Act of 2008** (“WRERA”), P.L. 110-458, was signed by President Bush on 12/23/08.