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## Recent Developments in Federal Income Taxation: The Year 2005

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**RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION:  
THE YEAR 2005**

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 the most recent twelve months – and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted. 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 Marty the opportunity to mock our elected representatives. The outline focuses primarily on topics of broad general interest [to the two 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. See VIII.C. for restrictions on your use of this Outline. i.e., readers are not permitted to use anything contained in this outline for purposes of giving advice to clients on any tax avoidance technique.*

**I. ACCOUNTING**

**A. Accounting Methods**

**1. Rev. Proc 2006-11, 2006-3 I.R.B. 309 (12/21/05).**

This revenue procedure provides procedures by which taxpayers may request accounting method changes so they can comply with § 263A cost capitalization under the simplified service cost method and the simplified production method contained in regulations set forth in T.D. 9217.

2. T.D. 9217, Guidance Regarding the Simplified Service Cost Method and the Simplified Production Method, 70 F.R. 44467 (8/3/05). Temp. Regs §§ 1.263-1T and 1.263-2T have been amended.

**B. Inventories**

There were no significant developments regarding this topic during 2005.

**C. Installment Method**

There were no significant developments regarding this topic during 2005.

**D. Year of Receipt or Deduction**

1. Hightower v. Commissioner, T.C. Memo. 2005-274 (11/28/05). Funds received pursuant to arbitrator's decision regarding forced-buyout of corporate stock were includable in income, even though taxpayer continued to contest the decision, because he accepted the check, endorsed it, and deposited the proceeds in an interest bearing account under his sole control. Taxpayer's creation of a separate account did not evidence unconditional renunciation of the right to funds.

2. **The writer of a put option does not have income until the year the option expires unexercised.** Fed. Home Loan Mortgage Corp. (Freddie Mac) v. Commissioner, 125 T.C. 248 (11/21/05). The Tax Court (Judge Ruwe) held that nonrefundable commitment fees that loan originators pay to Freddie Mac are not income in the year of receipt by Freddie Mac; instead, they are premiums for put options and should be treated as such for tax purposes, i.e., they reduce taxpayer's basis in the loans purchased if the option is exercised and they are income in the year the option lapses if the option is not exercised. The premium received by the writer of a put option that is not exercised is ordinary income for the taxable year in which the failure to exercise the option becomes final; if a put option is exercised, the premium received by the writer is an offset against the option price, which reduces the basis of the property acquired pursuant to the put option.

- The Commissioner argued that the nonrefundable portion of commitment fees were income in the year of receipt under the all events test of § 451.

3. **Anticipated warranty expenses are not deductible in the year taxpayer sold warranted motor vehicles.** Chrysler Corp. v.

Commissioner, 436 F.3d 644 (6th Cir. 2/8/06), *aff'g* T.C. Memo. 2000-283 (8/31/00). Taxpayer was not permitted to deduct anticipated warranty expenses in the year it sold warranted motor vehicles to its dealers because the warranty claims had not yet been made. The court followed *United States v. General Dynamics Corp.*, 481 U.S. 239 (1987), and distinguished *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986), when it followed the tax court in holding that the last event in the fixing of petitioner's liability occurred no sooner than when a warranty claim was filed with petitioner by one of its dealers or by the retail customer.

## II. BUSINESS INCOME AND DEDUCTIONS

### A. Income

1. **The IRS changes position on the tax treatment of rebates.** Rev. Rul. 2005-28, 2005-19 I.R.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.

2. **If he didn't destroy the daily cash register tapes, it would have been much harder for him to skim.** Kikalos v. United States, 408 F.3d 900 (7th Cir. 5/24/05). Taxpayer owned three liquor stores that did not accept credit cards. Most of his sales were cash sales. The problem as put by Judge Posner is "Kikalos's stubborn refusal to retain the [daily cash register] tapes has engendered a protracted (since at least 1998) struggle with the Internal Revenue Service." What taxpayer does daily is to manually record the total receipts from each store in a log book, and then destroys the tape. The government used the "percentage markup" method to estimate his income based on taxpayer's purchase invoices.

- Taxpayer sought to use expert testimony as to his income based upon both the "bank deposits" method and the "increase in net worth" method but the district court ruled that once the government chose the method to base income upon, taxpayer could not introduce evidence of another method.

- The Seventh Circuit reversed the district court's judgment denying a refund of income taxes in the years 1998 and

1999, and held that taxpayer could introduce expert testimony as to his income based upon a method other than the one selected by the government. Judge Posner's opinion also stated that taxpayer could also introduce his log books into evidence. Additionally, Judge Posner found fault with the jury instructions:

These instructions were incorrect (as well as confusing – what would a term like “without any rational basis” mean to the average juror?). . . . The judge was telling the jury that it was not enough for the plaintiffs to prove that the government's estimate of their tax deficiencies was incorrect. They had to prove that it was irrational. In so ruling, the judge added an element to the statutory entitlement to a refund. All the statute requires is that the taxpayer prove that he overpaid his taxes. It doesn't require him to prove that the government's assessment was not only inaccurate but irrational. Suppose Nick Kikalos was a highly credible witness and the jury believed he'd been scrupulous about transferring the data in the Z tapes to his log book, a belief the jury might find corroborated by the results of the alternative indirect methods used by the plaintiffs' expert. We do not see on what basis a jury would be *required* to disbelieve Kikalos's testimony in favor of a rough method of estimation, just because the estimation could not be deemed irrational. There is nothing in the Internal Revenue Code or its implementing regulations to suggest the imposition of so insuperable a burden on a refund plaintiff.

**a. Meanwhile the Seventh Circuit affirms the Tax Court judgment sustaining his deficiency for 1997 income taxes.** Kikalos v. Commissioner, 434 F.3d 977 (7th Cir. 1/19/06). After the audits for years 1990-1992, taxpayer and the IRS executed an “Agreement to Maintain Adequate Books and Records,” which specified the retention of daily cash register tapes. The audit focused on the cigarette sales by Kikalos's stores and his treatment of “buydown” payments from cigarette companies for discounts that were supposed to have been passed on to customers. This IRS audit was triggered by a bank reporting to the IRS that Kikalos purchased thirty-one cashier's checks in 1997 in the total amount of \$809,734.51 using cash and third-party checks that the Tax Court found had not been included in income by taxpayer and were largely unreported “buydown” payments. Taxpayer had not told his accountant about these “buydown” checks, and the Tax Court found that they did not overlap with the “buydown” checks that were included in income. The 20 percent negligence penalty was also upheld.

3. **When is an advance includable in income, as opposed to it being excludable debt?** Karns Prime & Fancy Food, Ltd. v. Commissioner, T.C. Memo. 2005-233 (10/5/05). A \$1.5 million advance received by the taxpayer-retailer from a supplier that was evidenced by a promissory note with the proper indicia of debt nevertheless was not a true debt, because the parties concurrently entered into a supply agreement pursuant to which the debt would be forgiven if the taxpayer purchased the quantity of product required under the supply agreement over its term; in substance, there was no unconditional obligation to repay the advance because the amounts under the note were due only if the supply agreement was materially breached by taxpayer.

4. Coburn v. Commissioner, T.C. Memo. 2005-283 (12/5/05). Debtor's release of collateral to creditor did not give rise to income from discharge of indebtedness income because taxpayer-debtor remained liable for the balance of the debt.

## B. Deductible Expenses versus Capitalization

1. **How to change accounting methods for the 2003 year to comply with the final regulations.** Rev. Proc. 2004-23, 2004-16 I.R.B. 785. This revenue procedure provides an exclusive administrative procedure for taxpayers to obtain automatic consent to change to a method of accounting pursuant to Reg. §§ 1.263(a)-4, 1.263(a)-5, and 1.167(a)-3(b), the final capitalization of intangible regulations for the 2003 tax year.

a. **Changing accounting methods for years after 2003 to comply with the final regulations.** Rev. Proc. 2005-9, 2005-2 I.R.B. 303 (12/13/04). This procedure is similar to, but not identical with, Rev. Proc. 2004-23.

b. Rev. Proc. 2005-17, 2005-13 I.R.B. 797 (3/8/05). This revenue procedure modifies Rev. Proc. 2005-9 to provide guidance for a taxpayer's second year ending on or after 12/31/03 [for a calendar year taxpayer, the 2005 year]. This makes the five-year prior change scope limitation inapplicable to that year.

2. **IRS identifies issues to be addressed in forthcoming proposed regulations on tangible property costs.** Notice 2004-6, 2004-3 I.R.B. 308 (12/22/03). These issues include [using the numbering from the Notice]: (1) What general principles of capitalization should be applied? (2) What is the appropriate "unit of property"? (3) What is the starting point for determining whether property value is increased or useful life is prolonged? (11) Should the regulations provide "repair allowance" type rules? (12) Should the regulations provide a *de minimis*

rule? (13) When should the “plan of rehabilitation” doctrine be applied? (15) Are there circumstances where tax treatment should follow financial or regulatory accounting treatment?

**a. Would you like to fly on a jet without its engines?** FedEx Corp. v. United States, 91 A.F.T.R.2d 2003-1940, U.S.T.C. ¶ 50, 91 (W.D. Tenn. 4/8/03). The district court denied the taxpayer’s motion for summary judgment that expenditures for its off-wing engine maintenance program were deductible repairs under Reg. § 1.162-4. The court found that there was a genuine issue of fact regarding whether the appropriate unit of property for measuring whether the expenditures added value or materially prolonged life was (1) the entire aircraft, as argued by FedEx, or (2) the jet engines and auxiliary power units, as argued by the government. The court concluded that there is no ‘entire vehicle’ rule of law requiring that repairs be measured against the entire vehicle rather than against components.

**b. You don’t have to, at least in Memphis.** FedEx Corp. v. United States, 291 F. Supp. 2d 699 (W.D. Tenn. 2003). Taxpayer was permitted to deduct the costs of engine shop visits for jet aircraft engine inspection, heavy maintenance, and repair because the relevant unit of property was held to be the entire aircraft, not the engine.

**c. Affirmed by the Sixth Circuit in an unpublished opinion, which holds that engines are part of a jet plane even when they are “off wing.”** FedEx Corp. v. United States, 412 F.3d 617 (6th Cir. 2/16/05). The \$70 million in taxes and accrued interest determined by the IRS having capitalized the costs incurred for “off-wing maintenance” of its jet aircraft engines and auxiliary power units in 1993 and 1994 were improperly collected because FedEx was entitled to deduct “such maintenance costs” as incidental repairs that did not appreciably prolong the life of the aircraft.

**3. Just when you thought you were safe from capitalization under § 263(a), § 263A rears its ugly head.** Rev. Rul. 2004-18, 2004-8 I.R.B. 509 (2/23/04). Costs incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of its manufacturing plant must be capitalized under § 263A and included in inventory costs. Rev. Rul. 98-25, 1998-1 C.B. 998, and Rev. Rul. 94-38, 1994-1 C.B. 35, are clarified by providing that the otherwise deductible amounts at issue are subject to capitalization to inventory under § 263A.

**a. Allocating environmental remediation costs of a manufacturer. It’s easy – just allocate them to inventory produced during the year in which the costs are incurred.** Rev. Rul.



2005-42, 2005-28 I.R.B. 67 (6/20/05). This ruling extends Rev. Rul. 2004-18 and sets forth five situations of groundwater cleanup costs which it finds to be allocable under § 263A to the inventory produced during the taxable year the costs are incurred. The ruling also provides for an automatic change of method of accounting.

4. Rev. Rul. 2004-17, 2004-8 I.R.B. 516 (2/6/04). Costs paid or incurred in the taxable year to remediate environmental contamination that occurred in prior taxable years do not qualify for treatment under § 1341.

a. Reynolds Metals Co. v. United States, 389 F. Supp. 2d 692 (E.D. Va. 8/22/05). Section 1341 does not apply to environmental remediation expenses relating to prior years' income because in incurring the remediation expenses there is no "restoration of an item of income to an entity from whom the income was received or to whom the item of income should have been paid."

5. Tigrett v. United States, 96 A.F.T.R.2d 2005-5649 (W.D. Tenn. 8/3/05), *as amended*, Sept. 2, 2005. Amounts paid to corporation by president/minority shareholder of a corporation in satisfaction of his contractual obligation to indemnify corporation against losses from a specific venture that he advocated corporation undertake constituted a capital contribution, not a business expense, because taxpayer had no possibility of personal business profit from the specific venture by the corporation.

6. Rev. Rul. 2005-47, 2005-32 I.R.B. 261. Credit card issuers treat third-party ATM surcharge fees incurred by their cardholders as additional amounts loaned to those cardholders.

### C. Reasonable Compensation

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

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

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

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

#### **D. Miscellaneous Expenses**

1. **The IRS never seems able to catch up with the movements in the price of gasoline, and more tinkering is in store for 2005.** Rev. Proc. 2004-64, 2004-49 I.R.B. 898 (11/17/04), *superseding* Rev. Proc. 2003-76, 2003-43 I.R.B. 924. The optional standard mileage rate for business use of automobiles will increase on 1/1/05 from 37.5 cents per mile to 40.5 cents per mile; the mileage rate for medical and moving will increase from 14 cents per mile to 15 cents per mile; and the mileage rate for giving services to a charitable organization will remain at 14 cents per mile.

• Query whether increasing the deduction for driving to the doctor so it is now greater than the deduction for driving to the charitable board meeting – in 2003, the deduction for medical mileage was less than charitable mileage – is because many more taxpayers deduct charitable miles than medical miles?

a. **The IRS noticed that fuel prices went up recently, so a 9/1/05 increase in mileage rates is announced.** Announcement 2005-71, 2005-41 I.R.B. 714 (9/12/05). On 9/1/05, the optional standard mileage rate for business use of automobiles will increase to 48.5 cents per mile, and the standard mileage rate for medical and moving expenses will increase to 22 cents per mile. The rate for charitable miles remains at the statutory [§ 170(i)] 14 cents per mile.

**b.** Under the **Katrina Tax Act**, the charitable standard mileage rate would be 70 percent of the standard mileage rate for businesses if the use of the vehicle is for the purpose of providing relief related to Hurricane Katrina. Effective for the use of a passenger automobile between 8/25/05 and 12/31/06.

**c. Splitting the difference between the first eight months of 2005 and the last four for 2006.** Rev. Proc. 2005-78, 2005-51 I.R.B. 1177 (12/2/05). Mileage rates effective on or after 1/1/06 are as follows: business, 44.5 cents per mile; medical and moving, 18 cents per mile; general charitable contribution deduction, 14 cents per mile (statutory); Hurricane Katrina charitable contribution deduction, 32 cents per mile (with a Hurricane Katrina charitable use of automobile reimbursement rate permitted without income effect of up to 44.5 cents per mile).

**2.** Section 201 of the **Jobs Act of 2004** amends § 179 to extend the \$100,000 amount for expensing for small businesses through years beginning before 2008.

**a.** Rev. Proc. 2004-71, 2004-50 I.R.B. 970 (11/19/04). The amount is indexed for inflation, and for 2005, the indexed amounts are \$105,000 and \$420,000, respectively.

**b.** Rev. Proc. 2005-70, § 3.18, 2005-47 I.R.B. 979 (10/29/05). For taxable years beginning in 2006, the inflation adjusted amount a taxpayer may elect to expense under § 179 cannot exceed \$108,000, and the phase-out threshold begins at \$430,000.

**c. Final § 179 regulations.** T.D. 9209, Section 179 Elections, 70 F.R. 40189 (7/13/05). The regulations are amended to take into account the increased limits of the Jobs Act.

**3.** Section 907 of the **Jobs Act of 2004** amends § 274(e) to limit the deduction in regard to expenses incurred with respect to personal use by “specified individuals” of corporate aircraft or other corporate facilities to the amount treated as compensation and included in the individual’s income as wages. Specified individuals are those who are subject to the requirements of § 16(a) of the Securities Exchange Act of 1934 or would be subject to such requirements if the taxpayer were subject to the Act, which generally means they are officers, directors, or own 10 percent or more of the corporation’s stock. This reverses the holding to the contrary in *Sutherland Lumber-Southwest, Inc. v. Commissioner*, 114 T.C. 197 (2000), *aff’d*, 255 F.3d 495 (8th Cir. 2001).

- The amendment is applicable to expenses incurred after the date of enactment (10/22/04).

**a. Implementing the limitation on deduction of airplane costs.** Notice 2005-45, 2005-24 I.R.B. 1228 (5/27/05). This notice provides interim guidance to taxpayers on the limitation under § 274(e) on the deductible amount of trade or business expenses for use of a business aircraft for entertainment, i.e., personal use, and provides a methodology and examples as to how expenses are to be allocated to flights. Applicable to expenses incurred after 6/30/05.

**4. This deduction should prove so effective that it will be extended to all business income.** Section 102 of the Jobs Act of 2004 adds new § 199 to provide a nine percent deduction for U.S. manufacturing income, i.e., “income attributable to domestic production activities.” For corporations, the deduction allowed by § 199 is a percentage of the lesser of “qualified production activities income” or taxable income. For individual taxpayers engaged in manufacturing, the taxable income limitation is replaced by a limitation based on adjusted gross income. The deduction will be phased in over six years, beginning with 2005. The percentage begins at three percent for 2005 and rises to nine percent after 2009, but in no event can the deduction exceed 50 percent of the W-2 wages paid by the taxpayer during the year for which the deduction is sought. IRC § 199(d)(5). Thus, the deduction is unavailable to a sole proprietor or partnership with no employees. Although the deduction is available to individuals, corporations, and pass through entities, only items attributable to the conduct of a trade or business can be taken into account; Section 199(d)(5).

- Qualified production activities income is defined as the excess of “domestic production gross receipts” over the sum of (1) the cost of goods sold allocable to domestic production gross receipts, (2) other deductions, expenses, or losses directly allocable to domestic production gross receipts, and (3) a ratable portion of other deductions, expenses, and losses not directly allocable to domestic production gross receipts or to any other class of income. IRC § 199(c)(1). Domestic production gross receipts are gross receipts derived from (1) the lease, rental, license, or sale, exchange, or other disposition of (a) “qualifying production property,” defined as tangible personal property, computer software, and sound recordings, produced (in whole or in significant part) by the taxpayer in the United States, (b) a “qualified film” produced by the taxpayer, or (c) electricity, natural gas, or potable water produced by the taxpayer in the United States; (2) construction performed within the United States, or (3) architectural or engineering services performed in the United States for United States construction projects. Section 199(c)(4)(B) excludes from the definition of domestic production gross receipts

any receipts from (1) the sale of food and beverages prepared by the taxpayer at a retail establishment, or (2) the transmission or distribution (as contrasted with the production) of electricity, natural gas, or potable water.

- Because the deduction is a percentage of a specified type of net income, rather than an allowance for actual expenses incurred by the taxpayer, its effect can be viewed as reducing the effective tax rate on qualified production activities income. (Indeed, it originated in a proposal to reduce the corporate tax rate generally, but through the legislative process metamorphosed into its current structure.) Suppose a taxpayer has \$100,000 of qualified production activities income and sufficient income from other sources to be subject to a marginal rate of 35 percent (the highest statutory rate for both individuals and corporations). The § 199 deduction reduces the taxpayer's taxable income derived from qualified production activities from \$100,000 to \$91,000. At 35 percent, the tax on \$91,000 is \$31,850, which is an effective tax rate of only 31.85 percent on the \$100,000 of qualified production activities income.

- Section 199 is unique in allowing a deduction equal to a portion of *net* income generated by a general type of business activity. Most tax expenditures for businesses accelerate deductions, provide deductions for amounts not otherwise deductible, allow a deduction related to gross income from a specified activity, or take the form of a credit. Most tax experts believe the provision to be so complex, and the distinctions and pigeon-holing of sources of income and the purpose for which deductible expenditures were incurred that are required to calculate the amount of the deduction to be so difficult to ascertain, that the provision cannot be reasonably and consistently administered. A footnote in the conference committee report on the **2004 Jobs Act** unintentionally illustrates the problem even in a simple context.

The conferees intend that food processing, which generally is a qualified production activity under the conference agreement, does not include activities carried out at [a] retail establishment. Thus, under the conference agreement while the gross receipts of a meat packing establishment are qualified domestic production gross receipts, the activities of a master chef who creates a venison sausage for his or her restaurant menu cannot be construed as a qualified production activity.

The report goes on to state:

The conferees recognize that some taxpayers may own facilities at which the predominant activity is domestic production as defined in the conference agreement and other

facilities at which they engage in the retail sale of the taxpayer's produced goods and also sell food and beverages. For example, assume that the taxpayer buys coffee beans and roasts those beans at a facility, the primary activity of which is the roasting and packaging of roasted coffee. The taxpayer sells the roasted coffee through a variety of unrelated third-party vendors and also sells roasted coffee at the taxpayer's own retail establishments. In addition, at the taxpayer's retail establishments, the taxpayer prepares brewed coffee and other foods. The conferees intend that to the extent that the gross receipts of the taxpayer's retail establishment represent receipts from the sale of its roasted coffee beans to customers, the receipts are qualified domestic production gross receipts, but to the extent that the gross receipts of the taxpayer's retail establishment represent receipts from the sale of brewed coffee or food prepared at the retail establishment, the receipts are not qualified domestic production gross receipts. However, the conferees intend that, in this case, the taxpayer may allocate part of the receipts from the sale of the brewed coffee as qualified domestic production gross receipts to the extent of the value of the roasted coffee beans used to brew the coffee. The conferees intend that the Secretary provide guidance drawing on the principles of section 482 by which such a taxpayer can allocate gross receipts between qualified and nonqualified gross receipts. The conferees observe that in this example, the taxpayer's sales of roasted coffee beans to unrelated third parties would provide a value for the beans used in brewing a cup of coffee for retail sale. (H. Rep. No. 108-755, at 13, n. 27 (2004))

- One is left to wonder whether Starbucks is pleased that its lobbyists did such a good job in obtaining as much of a benefit as Starbucks gets from this obvious direction to the Treasury Department regarding what the to-be-promulgated regulations will provide for Starbucks or whether Starbucks is displeased that it did not get even more advantageous treatment.

- This provision resulted from efforts to retain some of the tax expenditure benefits provided to exporters by the extraterritorial income ("ETI") regime that, like the domestic international sales corporation ("DISC") and the foreign sales corporation ("FSC") regimes before it, were found to violate U.S. obligations under international trade agreements. Because the objectionable feature of the ETI, FSC, and DISC regimes was that they provided tax benefits only for certain export activity and were thus found by the World Trade Organization to provide for prohibited export subsidies, the

new deduction applies regardless of whether the manufactured goods are exported. The deduction of extraterritorial income (ETI) will be eliminated in 2007 after being phased out in 2005 [80 percent deduction] and 2006 [60 percent deduction]. A WTO panel has found the phase-out to be itself in violation of international trade agreements.

**a. If the statute appears to have a short shelf-life, the guidance under it should be even more ephemeral.** Notice 2005-14, 2005-7 I.R.B. 498 (1/19/05). Lengthy guidance on the new manufacturing deduction. Pending promulgation of what surely will be voluminous regulations governing the allocation of deductions, expenses, and losses for the purpose of calculating qualified production activities income, Notice 2005-14 provides interim guidance.

**b. Proposed regulations.** REG-105847-05, Income Attributable to Domestic Production Activities, 70 F.R. 67220 (11/4/05). Massive [224 pages] proposed regulations [§§ 1.199-1 through -8] deal with 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 being much discussed.

**5. The IRS attempts to define “insurance” in terms of risk shifting and risk distribution, which means that the insurance company must insure more than one person. Note how twelve single-member LLCs may or may not be more than one person.** Rev. Rul. 2005-40, 2005-27 I.R.B. 4 (6/17/05). This ruling provides guidance to clarify 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 are held to be “not insurance” and they involve an unrelated person receiving premiums to insure the risk of a single taxpayer that operates a large fleet of automotive vehicles in the courier transport business, including (in Situation 3) twelve 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 elects to be classified as an association, and the arrangement is held to be “insurance.”

• Compare the different view of insurance in *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858, 861-62 (1992), where Judge Easterbrook stated:

What is “insurance” for tax purposes? The Code lacks a definition. *Le Gierse* mentions the combination of risk

shifting and risk distribution, but it is a blunder to treat a phrase in an opinion as if it were statutory language. . . . Corporations accordingly do not insure to protect their wealth and future income, as natural persons do, or to provide income replacement or a substitute for bequests to their heirs (which is why natural persons buy life insurance). Investors can “insure” against large risks in one line of business more cheaply than do corporations, without the moral hazard and adverse selection and loading costs: they diversify their portfolios of stock. Instead corporations insure to spread the costs of casualties over time.

**6. Tool allowance is not paid under an accountable plan.** Rev. Rul. 2005-52, 2005-35 I.R.B. 423 (8/3/05). A tool allowance paid by an employer in the automobile repair and maintenance business to its service technicians based upon the numbers of hours worked by each service technician is not an accountable plan such that the payments are excluded from the employees’ gross income and exempt from the withholding and payment of employment taxes because it fails to meet both the “substantiation” and the “return of excess” requirements (although it does meet the “business connection” requirement). The set amount for each hour worked paid by the automobile repair business to the employee-mechanics, who were required to purchase their own tools, as a “tool allowance” was includable in gross income as an itemized employee business expense deduction, because employees were not required to provide any substantiation of expenses incurred for tools and employer did not require employees to return any portion of the tool allowances that exceeded their actual expenses.

**a. To the same effect.** Namyst v. Commissioner, T.C. Memo. 2004-263 (11/17/04). Reg. § 1.62-2(f) conditions application of the netting rule [permitting an above-the-line deduction of employee business expenses pursuant to an accountable plan] on the employee being required to return excess advances to the employer. The taxpayer, instead, was required to include expense reimbursements in gross income because although he was required to [and did meticulously] account to the employer for his expenses, the taxpayer was not obligated to return any excess advances to the employer.

**(1) Affirmed.** Namyst v. Commissioner, 435 F.3d 910, 2006-1 U.S.T.C. ¶ 50,163 (8th Cir. 1/27/06). These payments did not meet the standards set forth in Reg. § 1.62-2 for payments to qualify as being part of an “accountable plan” because the payments were not differentiated between reimbursements of expenses and for payments



with respect to tools. The court affirmed the Tax Court's refusal to treat substantiated payments as made under a qualified accountable plan while treating unsubstantiated payments as payments under a nonaccountable plan because the plan as a whole must meet the requirements of an accountable plan for such treatment.

7. **The deduction for the cost of clothing purchased under a "once-wear" policy was disallowed because the clothing was not unsuitable for personal wear.** Deihl v. Commissioner, T.C. Memo. 2005-287 (12/15/05). The Tax Court (Judge Wherry) held *inter alia* that clothing to be worn only once at conventions or other promotional meetings was not deductible under the test that it must be "not suitable for general or personal wear" as applied objectively. The clothing would not meet that test under a subjective methodology because the court found taxpayer's testimony to that effect "overly broad and exaggerated." Pevsner v. Commissioner, 628 F.2d 467 (5th Cir. 1980), followed.

#### E. Depreciation & Amortization

1. Maguire/Thomas Partners Fifth & Grand, Ltd. v. Commissioner, T.C. Memo 2005-34 (2/28/05). The Tax Court (Judge Colvin) held that the costs incurred to obtain a zoning change with respect to land are not depreciable, but the costs to obtain a zoning variance relating to a specific building to be constructed on a specific parcel of land are depreciable as part of the cost of the building.

2. Section 1245(b)(8), added to the Code by the **Energy Tax Incentives Act of 2005**, provides that if a taxpayer disposes of several § 197 intangibles in one transaction, or in a series of related transactions, all the intangibles are treated as a single asset for purposes of calculating § 1245 recapture.

#### F. Credits

1. Arevalo v. Commissioner, 124 T.C. 244 (5/18/05). Taxpayer's \$10,000 investment in pay phones gave him merely legal title but did not give him the benefits and burdens of ownership with respect to the pay phones; he was therefore not entitled either to depreciation or to the § 44 disabled access credit. In particular, he was not entitled to the credit because the investment in pay phones was not an eligible access expenditure. Taxpayer who "purchased" unidentified pay phones that he never possessed or controlled, which continued to be operated and serviced by a corporation related the seller, with respect to which the taxpayer bore no risk of loss and never paid taxes, insurance, or license fees, and from which the taxpayer was

guaranteed a minimal fixed return, did not have a depreciable interest in the telephones because he did not have the benefits and burdens of ownership.

2. The **Katrina Tax Act** provides a “Work Opportunity Tax Credit” for Hurricane Katrina employee survivors and an “employee retention credit” for employers affected by Hurricane Katrina.

3. Section 41(b)(3)(D), added to the Code by the **Energy Tax Incentives Act of 2005**, permits taxpayers to take into account 100 percent of contract research expenses paid to eligible small businesses, universities, and federal laboratories.

4. Section 41(a)(3), added to the Code by the **Energy Tax Incentives Act of 2005**, provides a credit equal to 20 percent of a taxpayer’s share of the expenses of an “energy research consortium.” To be qualified, a consortium must be an organization described in § 501(c)(3), and must have received payments (including contributions) from at least five unrelated persons during the calendar year (with no more than half of the payments coming from any single person). In contrast with the usual rule under § 41, the energy research consortium credit applies to all described expenditures, rather than only to expenditures in excess of some base amount.

#### G. Natural Resources Deductions & Credits

1. The **Energy Tax Incentives Act of 2005** classified natural gas gathering lines as seven-year property. IRC § 168(e)(3)(C)(iv).

2. Iowa 80 Group, Inc. v. IRS, 406 F.3d 950 (8th Cir. 5/4/05), *aff’d* 371 F. Supp. 2d 1036 (S.D. Iowa 2004). Floor space of truck stop occupied by a movie theater, arcade, television lounge, restaurant, showers, and laundromat was not devoted to petroleum marketing sales because such features are not normally associated with a service station; taxpayer failed 50 percent test of § 168(e)(3)(E)(iii).

3. The **Energy Tax Incentives Act of 2005** added two new classes of fifteen-year property: (1) section 1245 property used in the transmission of electricity at sixty-five or more kilovolts, and (2) certain natural gas distribution lines. IRC §§ 168(e)(3)(E)(vii), 168(e)(3)(E)(viii).

4. **Energy efficient commercial buildings.** Section 179D, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a deduction for the cost of “energy efficient commercial building property” placed in service during 2006 or 2007. Qualified property must be installed in a building within the United States as part of (1) the interior

lighting systems, (2) the heating, cooling, ventilation, and hot water systems, or (3) the building envelope, and must be certified as being installed pursuant to a plan designed to reduce the building's total annual energy and power costs by at least 50 percent in comparison to a hypothetical reference building. The deduction may not exceed \$1.80 per square foot of the property. The statute directs the Treasury Department, in consultation with the Department of Energy, to promulgate regulations setting forth methods of calculating and verifying energy and power costs. In the case of an expenditure made by a public entity (such as a public school), the statute directs the Treasury Department to promulgate regulations allocating the deduction to the designer of the property in lieu of the owner.

- If a building does not satisfy the overall 50 percent reduction standard, a partial deduction (limited to \$0.60 per square foot) is allowed for system-specific energy efficient property, if a specific system (i.e., (1) interior lighting, (2) heating, cooling, ventilation and hot water, or (3) building envelope) satisfies system specific targets to be established by regulations (with the statute providing an interim target, in the case of lighting system retrofits).

**5. The Energy Tax Incentives Act of 2005** liberalized § 613A(d)(4); the new limit is 75,000 barrels per day, and it is based on average daily production for the entire year rather than maximum daily production on any day.

**6. Under § 167(h), added to the Code by the Energy Tax Incentives Act of 2005,** amounts incurred in connection with geological and geophysical exploration within the United States may be amortized ratably over a 24-month period.

**7. The Energy Tax Incentives Act of 2005** extended the carryback period to five years with respect to a portion of the NOLs of certain electric utility companies arising in taxable years ending in 2003, 2004, and 2005. IRC § 172(b)(1)(I).

**8. The Energy Tax Incentives Act of 2005** added two new components to the energy credit: (1) a credit equal to 30 percent of the cost of "qualified fuel cell property," and (2) a credit equal to 10 percent of the cost of "qualified microturbine property." The new components of the credit are available only for property placed in service in 2006 or 2007. In addition, the Act increases the credit rate to 30 percent for solar energy property, for 2006 and 2007. Also for only those two years, the Act provides a 30 percent credit for the cost of fiber-optic solar lighting systems.

9. A credit under § 45 is allowed under the **Energy Tax Incentives Act of 2005** for the production of “Indian coal,” defined as coal produced from reserves which were owned by (or held in trust by the United States for the benefit of) an Indian tribe or its members on June 14, 2005. To qualify for the credit, the coal must be produced by a facility placed in service before January 1, 2009. The credit is available for coal produced during the years 2006 through 2012, and sold by the taxpayer to unrelated persons during the same time frame. The credit amount is \$1.50 per ton of Indian coal during the years 2006 through 2009, and \$2.00 per ton thereafter.

10. The **Energy Tax Incentives Act of 2005** redesignated § 29 as § 45K, and made it part of the general business credit. It also added a credit for qualified facilities producing coke or coke gas. A qualified facility must have been placed in service before 1993, or after June 30, 1998, and before January 1, 2010. The credit amount is \$3.00 (adjusted for post-2004 inflation) per barrel-of-oil equivalent, subject to a ceiling of an average barrel-of-oil equivalent of 4,000 barrels per day. With respect to production from a particular facility, the credit is available only for the four-year period beginning on the later of January 1, 2006, or the date the facility is placed in service.

11. The **Energy Tax Incentives Act of 2005** added a third credit to the § 40A mix, the “small agri-biodiesel credit.” The credit equals 10 cents per gallon of qualified agri-biodiesel production (which is limited to 15 million gallons per year). It is available only to producers with an annual productive capacity of no more than 60 million gallons. The 2005 Act also provides that “renewable diesel” is treated in the same manner as biodiesel for purposes of the BMC and the BC, except that the credit amount is increased to \$1.00 per gallon. Renewable diesel is defined as diesel fuel derived from biomass using a thermal depolymerization process. All credits under § 40A are scheduled to expire at the end of 2008.

12. **Credit for production from advanced nuclear power facilities.** Section 45J, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a credit of 1.8 cents per kilowatt-hour of electricity produced at a qualifying advanced nuclear power facility during the eight-year period beginning on the date the facility is placed in service. For a facility to qualify, the taxpayer must have received an allocation of megawatt capacity from the IRS, and the facility must have been placed in service before January 1, 2021. If the megawatt allocation to the facility by the IRS is less than the facility’s rated nameplate capacity, the otherwise allowable credit per kilowatt hour produced by the facility is proportionately reduced. For example, if the megawatt allocation were one-third of the rated nameplate capacity, the credit would be 0.6 cents per kilowatt hour. A

taxpayer's annual credit during the eight-year period may not exceed \$125 million per 1,000 megawatts of allocated capacity. Thus, for example, the credit ceiling for a taxpayer with 200 megawatts of allocated capacity would be \$25 million.

**13. Credits for investments in clean coal facilities.**

The **Energy Tax Incentives Act of 2005** introduced two new credits for investments in clean coal facilities. Section 48A provides a credit for investments in "qualifying advanced coal projects," defined as projects using integrated gasification combined cycle (IGCC) and other advanced coal-based technologies for generating electricity. The credit rate is 20 percent of qualifying investments for IGCC projects, and 15 percent for other projects. The credit is available only for projects certified by the IRS, following consultation with the Energy Department. Aggregate credits allowed for certified projects may not exceed \$800 million for IGCC projects, and \$500 million for other projects. Section 48B provides a 20 percent credit for investments in "qualifying gasification projects," defined as projects involving the conversion of coal, petroleum residue, biomass, or certain other materials into a synthesis gas composed primarily of carbon monoxide and hydrogen. Like its companion credit, this credit is available only for projects certified by the IRS, in consultation with the Department of Energy. Total credits allocable by the IRS are limited to \$350 million, of which no more than \$130 million may be allocated to any single gasification project.

**14. New energy efficient home credit.**

Section 45L, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a credit, in the amount of either \$2,000 or \$1,000, to an eligible contractor (including the producer of a manufactured home) who constructs and sells an energy efficient home to a person who will use the home as a residence. To qualify for the \$2,000 credit, the home must be certified (in accordance with guidance to be prescribed by the Treasury Department) as having a level of annual heating and cooling energy consumption at least 50 percent below the level of a comparable hypothetical reference dwelling unit, with at least one-fifth of the energy savings attributable to the building envelope. The \$1,000 credit, which applies only to manufactured homes, requires at least a 30 percent reduction in energy consumption, of which at least one-third must be attributable to the building envelope. Manufactured homes are also eligible for the \$2,000 credit, if they satisfy the usual requirements for that credit. The credit is available only with respect to homes the construction of which is substantially completed after 2005, and which are purchased during 2006 or 2007. The credit is part of the general business credit.

**15. Energy efficient appliance credit.**

Section 45M, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a

credit to the manufacturer of certain energy efficient dishwashers, clothes washers, and refrigerators. The credit applies only to appliances produced in 2006 and 2007. In the case of dishwashers, the credit is available only for dishwashers satisfying the (not yet known) Energy Star standards for 2007. The per-dishwasher credit amount is the product of \$3 and the percentage by which the 2007 standards exceed the 2005 standards, subject to a \$100 ceiling. In the case of clothes washers, the credit amount is \$100 for each washer manufactured in 2006 or 2007 which meets the 2007 Energy Star standards. For refrigerators, the credit amount rules are rather complex: \$75 for a refrigerator manufactured in 2006 and exceeding 2001 energy conservation standards by at least 15 percent, \$125 for a refrigerator manufactured in 2006 or 2007 and exceeding 2001 standards by at least 20 percent, and \$125 for a refrigerator manufactured in either year and exceeding 2001 standards by at least 25 percent. The credit applies only to appliances which constitute "excess production," which is defined as the excess of the number of appliances produced by the taxpayer in the United States during the calendar year (2006 or 2007) over the taxpayer's average production during the preceding three years (or over 110 percent of the average production over the preceding three years, in the case of refrigerators). The total amount of credits a taxpayer may claim under § 45M, for the two years combined, is limited to \$75 million, and the credit allowed in any one year may not exceed 2 percent of the taxpayer's annual average gross receipts for the three preceding taxable years. The credit is part of the general business credit.

**16. Alternative motor vehicle credit.** Section 30B, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a credit for certain "alternative motor vehicles." The credit is available in the year a qualifying vehicle is placed in service—for either business or personal use – by the taxpayer. The credit is generally allowed to the owner of the vehicle, including the lessor of a vehicle subject to a lease. If a vehicle is sold to a tax exempt user, the person who sold the vehicle to the user may claim the credit, but only if the seller clearly discloses the amount of the credit to the user. IRC § 30B(h)(6). A taxpayer claiming the credit must reduce his basis in the vehicle by the amount of the credit. The credit has four components: (1) the new qualified fuel cell motor vehicle credit, (2) the new advanced lean burn technology motor vehicle credit, (3) the new qualified hybrid motor vehicle credit, and (4) the new qualified alternative fuel motor vehicle credit.

- A qualifying fuel cell vehicle is a vehicle, the original use of which commences with the taxpayer, which is propelled by power derived from one or more cells which convert chemical energy into electricity by combining oxygen with hydrogen fuel, and which satisfies certain emission standards established by the Environmental Protection

Agency (in the case of cars and light trucks). The basic fuel cell credit amount depends on the gross vehicle weight rating, and ranges from \$8,000 for a vehicle with a rating of 8,500 pounds or less (but only \$4,000 for a vehicle placed in service after 2009), to \$40,000 for a vehicle with a rating of more than 26,000 pounds. The credit is increased, by amounts ranging from \$1,000 to \$4,000, if the vehicle satisfies specified fuel economy standards.

- A qualifying advanced lean burn technology vehicle must (1) have an internal combustion engine designed to operate using more air than is necessary for complete combustion, (2) use direct injection, (3) achieve at least 125 percent of 2002 model year city fuel economy, and (4) have been certified as satisfying certain emission standards established by the Environmental Protection Agency. The original use of the vehicle must commence with the taxpayer. The credit for lean burn vehicles has two components. The fuel economy component depends on the vehicle's fuel economy as a percentage of 2002 model year city fuel economy, and ranges from a low of \$400 (for at least 125 percent of the 2002 standard) to a high of \$2,400 (for at least 250 percent of the 2002 standard). The conservation component depends on the vehicle's gallons of lifetime fuel savings, and ranges from \$250 (for savings of at least 1,200 gallons) to \$1,000 (for savings of at least 3,000 gallons). The savings are based on an assumption of 120,000 lifetime miles, and are calculated relative to a comparable 2002 model year vehicle.

- A new qualified hybrid motor vehicle is a vehicle, the original use of which commences with the taxpayer, which uses both an internal combustion engine and a rechargeable battery system, which meets specified emission standards, and which meets specified minimum standards for maximum available power. For cars and light trucks, the credit amount is the sum of the fuel economy component and the conservation component, determined under the same rules applicable to lean burn vehicles. For other vehicles, the credit is a percentage of the excess of the manufacturer's suggested retail price (MSRP) for the vehicle over the MSRP of a comparable non-hybrid vehicle – 20 percent if the vehicle achieves at least a 20 percent increase in city fuel economy relative to a comparable non-hybrid vehicle, 30 percent for an increase of at least 40 percent, and 40 percent for an increase of at least 50 percent.

- A new qualified alternative fuel motor vehicle is a vehicle, the original use of which commences with the taxpayer, which is capable of using only an alternative fuel (natural gas, liquefied petroleum gas, hydrogen, or any liquid consisting of at least 85 percent methanol by volume). The credit is a percentage of the excess of the MSRP of the vehicle over the MSRP of a comparable non-alternative fuel vehicle – generally 50 percent, but increased to 80 percent if the vehicle has been certified as meeting certain emissions standards. A reduced credit is available for vehicles which use a mix of gasoline and an alternative fuel. If a vehicle uses at

least 75 percent alternative fuel the credit is 70 percent of the credit which would be available if the vehicle used only an alternative fuel, and if the vehicle uses at least 90 percent alternative fuel the credit is 90 percent of the credit which would be available for a vehicle using only an alternative fuel.

- The alternative motor vehicle credit applies to vehicles placed in service after 2005 and purchased before 2015 (for fuel cell vehicles), 2011 (for lean burn vehicles and alternative fuel vehicles), or 2010 (for hybrid vehicles). In the case of hybrid vehicles and lean burn vehicles, the amount of the credit is phased down – first to 50 percent of the otherwise available credit, then to 25 percent, and finally to nothing – for vehicles sold after the manufacturer has sold 60,000 hybrid and/or lean burn vehicles for use in the United States. As Congress surely realized and intended, this phasing down of the credit is likely to impact certain Japanese manufacturers sooner than it impacts any American manufacturers.

- For business taxpayers the credit is part of the general business credit. When claimed as a personal credit, the credit is allowable only to the extent of the excess of the regular tax (as reduced by specified other credits) over the tentative minimum tax.

**17. Alternative fuel vehicle refueling property credit.** Section 30C, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a credit equal to 30 percent of the cost of any qualified alternative fuel vehicle refueling property placed in service by the taxpayer. Qualifying fuels are ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and mixtures of diesel and biodiesel containing at least 20 percent biodiesel. For a business taxpayer, the credit may not exceed \$30,000. The credit is also available to a taxpayer installing a refueling facility on the grounds of his personal residence for personal use, but the maximum amount of the nonbusiness credit is \$1,000. The business credit is part of the general business credit, and the personal credit is allowed only to the extent of the excess of the regular tax (reduced by certain other credits) over the tentative minimum tax. The credit is not available for property placed in service after 2009 (or after 2014, in the case of property relating to hydrogen).

**18. Nonbusiness energy property credit.** Section 25C, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a nonrefundable credit for certain expenditures to improve the energy efficiency of a taxpayer's principal residence. In the case of "qualified energy efficiency improvements" (QEEIs), the credit equals 10 percent of the cost of the improvements. A QEEI is any energy efficient building component (i.e., insulation, exterior windows and doors, and certain coated metal roofs) satisfying criteria established by the 2000 International Energy Conservation Code, if the original use of the component commences with the



taxpayer and the component is expected to remain in use for at least five years. The other category of credit-eligible costs is “residential energy property expenditures” (REPEs). REPEs are expenditures for the following types of property, if they are installed in the taxpayer’s principal residence and satisfy energy efficiency standards to be promulgated by the Secretary of the Treasury pursuant to detailed statutory instructions: (1) main air circulating fans, (2) natural gas, propane or oil furnace or hot water boilers, and (3) “energy efficient building properties” (electric heat pump water heaters, electric heat pumps, geothermal heat pumps, central air conditioners, and water heaters using natural gas, propane, or oil). For REPEs the credit amount is established by schedule: the first \$50 of the cost of a main air circulating fan, the first \$150 of the cost of a natural gas, propane, or oil furnace or hot water boiler, and the first \$300 of the cost of any item of energy-efficient building property. There is a lifetime limit of \$500 on the aggregate credits a taxpayer may claim under § 25C, of which no more than \$200 may be based on expenditures for windows. The credit is available only for property placed in service in 2006 or 2007.

#### **19. Credit for residential energy efficient property.**

Section 25D, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a nonrefundable credit for certain expenditures on residential energy efficient property. Qualifying property is of three types: photovoltaic property (which uses solar energy to generate electricity), solar water heating property, and fuel cell property (which converts a fuel into electricity using electrochemical means). The property must be installed in a dwelling unit located in the United States and used by the taxpayer as a residence (principal residence, in the case of fuel cell property). Expenditures allocable to a swimming pool or hot tub are not eligible for the credit. The credit equals 30 percent of qualifying expenditures, subject to annual ceilings (on the credit amounts, not on credit-eligible expenditures) of \$2,000 for photovoltaic property, \$2,000 for solar water heating property, and \$500 per half kilowatt of capacity of fuel cell property. The credit is available only for property placed in service in 2006 or 2007.

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

**1. Malone v. Commissioner, T.C. Memo. 2005-69 (4/4/05).** Parent who provided funds to pay expenses of business conducted by his minor children could not deduct expenses because they were not incurred in his business.

## I. At-Risk and Passive Activity Losses

1. Rabinowitz v. Commissioner, T.C. Memo. 2005-188 (7/27/05). Apparel design and distribution business conducted through an S corporation and jet chartering activity conducted as a sole proprietorship, which chartered the jet to the apparel business, as well as to other customers, were two separate activities because there was no organizational relationship other than common ownership, no close economic relationship, and the activities were dissimilar.

2. Hubert Enterprises, Inc. v. Commissioner, 125 T.C. 72 (9/21/05). A member of a limited liability company (LLC) taxed as a partnership is not at-risk for any amount borrowed by the LLC with full recourse against the LLC because under relevant state law LLC members were not liable for LLC's debts and the member did not guarantee the debt.

- The aggregation of § 1245 property leasing activities of a partnership under § 465(c)(2)(B)(i) applies only to leases in which the property is placed in service in the same year; activities involving leased property placed in service in different years may not be aggregated.

3. Rev. Rul. 2005-64, 2005-39 I.R.B. 600 (9/26/05). If the owner of an aircraft leases it to others for transportation but provides the services of the pilot and crew with the aircraft, the use of the aircraft by the lessee is incidental to its receipt of the extraordinary personal services provided the lessor, and the activity therefore is not a rental activity for purposes of § 469; if the owner of the aircraft does not provide the services of the pilot and crew the activity is a rental activity for purposes of § 469.

4. D'Avanzo v. United States, 67 Fed. Cl. 39 (7/26/05), *appeal dismissed*, No. 05-5174, 2006 U.S. App. LEXIS 4545 (Fed. Cir. 2/14/06). Taxpayer did not offer a contemporaneous written record of the number of hours he spent performing personal services with respect to rental properties; noncontemporaneous log book of hours claimed to have been devoted to real estate activities and testimony at trial, alone, are inadequate evidence to establish that taxpayer devoted requisite number of hours to real estate business activities.

5. Ramsburg v. Commissioner, T.C. Memo. 2005-252 (10/31/05). Section 469(g)(1) does not apply to permit deduction of suspended passive activity losses following the distribution by the partnership to taxpayer-partner [in a tax-free distribution under § 731] of assets used by partnership in an activity with respect to which the taxpayer-partner was passive.

6. Misko v. Commissioner, T.C. Memo. 2005-166 (7/6/05). A lawyer practicing through a C corporation had nonpassive losses from renting computer and other equipment to the corporation. Temp. Reg. § 1.469-1T(e)(3)(i)(D) excludes from the definition of rental activities that are *per se* passive any rental that is “incidental,” as defined in Temp. Reg. § 1.469-1T(e)(3)(vi), to a nonrental activity of the taxpayer. To qualify for the incidental activity exception the property must predominantly be used in the taxpayer’s active trade or business – which may be conducted individually, through a closely held corporation in which he is a shareholder, or through a partnership in which he is a partner – during the taxable year or during at least two of the five immediately preceding taxable years, and the gross rental income from the property for the taxable year must be less than 2 percent of the lesser of the unadjusted basis or fair market value of the property. This rule can be a sword for the taxpayer. An individual who conducts a business through a corporation, and who owns and leases to the corporation equipment used by the corporation in the conduct of its business, can recharacterize losses from the rental activity as nonpassive losses and deduct those losses against the salary received from the corporation.

7. Assaf v. Commissioner, T.C. Memo. 2005-14 (1/31/05). This case applied the exception contained in Temp. Reg. § 1.469-1T(e)(3)(i)(D) where the taxpayer leased office space to attorneys and provided to its tenants various support services – a paralegal, a legal intern, a law clerk, an up-to-date law library, a computer with legal research capabilities, two conference rooms, staff who performed client intake, answered phones, took messages, filed documents at the courthouse and state capitol, typed briefs, took dictation, referred cases, scheduled depositions and court reporters, arranged travel, managed a file room and file storage, and performed legal research – because the tenants “leased space exclusively so that they would have the benefit of those services.” The regulations provide a special exception to the *per se* rule where “extraordinary personal services” are provided by (or on behalf of) the lessor in connection with “making such property available for use by customers (without regard to the average period of customer use). Temp. Reg. § 1.469-1T(e)(3)(ii)(C). This exception applies only where the use by customers of the rented property is incidental to their receipt of services. Temp. Reg. § 1.469-1T(e)(3)(v).

### III. INVESTMENT GAIN

#### A. Capital Gain and Loss

1. Vision Information Services, LLC v. Commissioner, 419 F.3d 554 (6th Cir. 8/22/05). Outsourcing agreement for use of taxpayer’s “business plan” and conditional “exclusive” license of taxpayer’s software to

Fox Video, under which taxpayer could “sell” its business model to others if the use of the model was limited to certain products not covered by the taxpayer’s agreement with Fox Video in exchange for fixed installment payments was not a sale or exchange; agreement was for the taxpayer to use its know-how and the software to provide direct-to-retail services on Fox Video’s behalf. The arrangement is merely a nonexclusive license, there has been no sale or exchange and the licensor realizes ordinary income. Although § 1235 can apply to an exclusive software license, a conditional “exclusive” license of taxpayer’s software to implement a “business plan” to Fox Video, under which taxpayer retained rights to license use to others if the use of the software and business plan was limited to certain products not covered by the taxpayer’s agreement with Fox Video did not qualify as a transfer of all substantial rights because it did not cover “all practical fields-of-use.”

**2. House sales by transferred employees.** Rev. Rul. 2005-74, 2005-51 I.R.B. 1153 (11/30/05). This Ruling sets forth three situations relating to whether a transferred employee sold his home to his employer (via the relocation company retained by the employer), or whether he sold it to a third party. The first two were held to be a sale to the employer, either pursuant to an appraisal (Situation 1) or an appraisal with an “amended value option” that increases the sale price if a third-party buyer makes a higher offer (Situation 2). The third was held to be a sale to a third party buyer, where the relocation company merely pays the employee the value of his equity based on the higher amended value only if the sale to the third party buyer closes (Situation 3). The ruling applied a transfer of benefits and burdens of ownership analysis to the various structures of employer sponsored relocation programs involving the purchase of the employee’s home by the employer through the employer’s agent or to a third party facilitated by the employer’s agent. Execution of blank deed by employee and delivery to employer’s agent company may be consistent with, but does not necessarily evidence, closed sale. A price adjustment contingent on management relocation company receiving a bona fide third party offer at a higher price subsequent to closing with employee does not necessarily mean benefits and burdens of ownership have not passed. A price adjustment contingent on management relocation company entering into contract to resell at a higher price subsequent to closing with employee indicates that benefits and burdens of ownership have not passed.

- Query whether the employee has income because he apparently pays no brokers’ commissions on the sale of his house.

**3. Questioning the collar.** IRS Tech. Advice Mem. 200604033 (10/20/05), first discussed in a David Cay Johnston story in the

New York Times, 12/30/05. He discusses a then-unreleased TAM that says that a loan of shares subject to a prepaid variable forward results in a sale for tax purposes because the agreement provided that the shares that were the subject of the forward contract would be lent to the forward contract counterparty. It also provided that § 1058, which provides for the nonrecognition of gain in some securities lending transactions, does not apply because the taxpayer had given up all indicia of ownership, including most risk of loss and opportunity for gain. The TAM distinguished the transaction at issue from the type permitted under Rev. Rul. 2003-7.

**a. This collar just plain clean works.** Rev. Rul. 2003-7, 2003-5 I.R.B. 363 (1/16/03). The IRS ruled that a shareholder has neither sold stock currently nor caused a constructive sale of stock under § 1259 where he (1) receives a fixed amount of cash, (2) simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date [but which does provide a “collar” on the number of shares of stock to be delivered, in effect providing a “collar” on the ultimate sale price], (3) pledges the maximum number of shares for which delivery could be required, (4) has the unrestricted right to deliver the pledged shares or to substitute cash or other shares on the delivery date, and (5) is not economically compelled to deliver the pledged shares.

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

**4. IRS backs down on its effort to have tax return preparers enter all security sales transactions on Schedule D or Schedule D-1.** On 1/9/06, the IRS published on its web site the following Notice of Clarification of the 2005 Instructions for Schedule D (Form 1040):

The IRS has received many inquiries about a new instruction that was added on page D-6 of the 2005 Schedule D instructions for completing lines 1 and 8. The new instruction states:

You must enter the details of each transaction on a separate line. If you have more than five transactions to report on line 1 or line 8, report the additional transactions on Schedule D-1. Use as many Schedules D-

1 as you need. Enter on Schedule D, lines 2 and 9, the combined totals from all your Schedules D-1. Do not enter “see attached” and summary totals from an attachment in lieu of reporting the details of each transaction directly on Schedule D or D-1.

The new instructions on page D-6 were meant to highlight and clarify [the existing] rules, not to change them. Therefore, taxpayers may continue to use a substitute statement to provide all of the same information and in a similar format to lines 1 and 8 of Schedules D and D-1. They are not required to use the official version of Schedules D and D-1 to provide the details on each transaction. However, the details of each transaction still must be provided with the tax return and not just upon request.

a. One of the inquiries was a 12/23/05 letter from the Chair of the AICPA Tax Executive Committee, which stated that tax-return preparers traditionally reported the summary totals found on year-end brokerage statements directly onto the Schedule D, with a notation to “see attached” brokerage statements [for taxpayers who are involved with numerous security sales transaction during the course of the calendar year]. The letter noted that large corporations that use summary form procedures may state on their return that transactional data details will be made available upon request.

5. David Taylor Enterprises, Inc. v. Commissioner, T.C. Memo. 2005-127 (5/31/05). “Classic cars” sold by automobile dealer whose primary sales were new automobiles were ordinary assets, not capital assets; although the “classic cars” were physically segregated from the new car inventory because sales of classic cars were frequent and substantial, the dealership’s accounting treatment of the classic cars did not differ from its accounting treatment of the inventory of new and used cars, and it advertised and otherwise marketed the classic cars for sale.

## **B. Section 1031**

1. **Exclusion of gain under §§ 121 and 1031 when a single property is both a personal residence and a business or investment property, either sequentially or simultaneously.** Rev. Proc. 2005-14, 2005-7 I.R.B. 528 (2/3/05) (as corrected). This revenue procedure provides guidance on how a homeowner can exclude gain on the sale or exchange of a home under § 121 and also defer gain from a like-kind exchange on the same property under § 1031. This guidance also clarifies that the property can be

used consecutively or concurrently as a home and a business, i.e., use as rental property or an office in the home, respectively. Detailed examples are included.

**2. Nonrecognition denied – Caught by a targeted anti-abuse rule.** Rev. Rul. 2002-83, 2002-49 I.R.B. 927 (11/26/02). Individual A owned highly appreciated real property held for investment (Property 1) and individual B, related to individual A within the meaning in § 267(b), owned real property (Property 2), which was not appreciated. In a multiparty like-kind exchange A and B each transferred their properties to a qualified intermediary. C, an unrelated purchaser of Property 1, transferred cash to the qualified intermediary, who transferred Property 2 to A, Property 1 to C, and the cash to B. The IRS ruled that pursuant to § 1031(f), a taxpayer – A – who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under § 1031(a) if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property. Based on the legislative history [H.R. Rep. No. 101-247 at 1340 (1989)], the IRS reasoned that the purpose of § 1031(f) is to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. Accordingly, the IRS applied § 1031(f)(4) because the multi-party exchange was “part of a transaction (or a series of transactions) structured to avoid the purposes of § 1031(f)(1).”

**a. Reality overtakes Rev. Rul. 2002-83.** Teruya Brothers, Ltd. v. Commissioner, 124 T.C. 45 (2/9/05). Taxpayer transferred properties to a qualified intermediary, who sold them to unrelated third parties and used the proceeds to purchase like-kind replacement property from a related party. Judge Thornton held that the transactions were economically equivalent to direct exchanges between the taxpayer and related party, followed by the related party’s sale of the properties to unrelated third parties, and that they were structured to avoid the purposes of § 1031(f). It further held that taxpayer failed to prove that avoidance was not one of the principal purposes of the transactions under the § 1031(f)(4) exception because even though more gain was recognized by the related party on some of the properties, the only tax consequences of the gain recognition were reduction of the related party’s net operating loss – as opposed to current taxation for taxpayer.

**3. New rules on like-kind personal property classes.** T.D. 9202, Additional Rules for Exchanges of Personal Property Under Section 1031(a), 70 F.R. 28818 (5/19/05). Final regulations replace the use

of the Standard Industrial Classification (SIC) system with the North American Industry Classification System (NAICS) for taxpayers that engage in like-kind exchanges of depreciable tangible personal property to determine what properties are of a like class for purposes of § 1031.

- The regulations are effective to transfers of property made on or after 8/12/04, but may be elected for property transfers made on or after 1/1/97 (open years only). Additionally, taxpayers may use the old SIC rules for property transfers made on or before 5/19/05.

### C. Section 1033

1. **Payments made by a state agency to reimburse losses that a “qualifying business” incurred for damage or destruction of real and personal property on account of a disaster.** Rev. Rul. 2005-46, 2005-30 I.R.B. 120 (7/8/05). Disaster relief grants under a state reimbursement program are not excludible from gross income under the general welfare exclusion, nor as a gift, nor as a qualified disaster relief payment under § 139, nor as a contribution to the capital of a corporation under § 118; instead, they may be deferred under § 1033. The payments are included in amount realized on the involuntary conversion of the property destroyed and any gain is thus eligible for § 1033 treatment provided that qualified replacement property is acquired.

a. **Amounts received from employer may be excluded as § 139 qualified disaster relief; amounts received from a state agency are excluded as gifts.** Rev. Rul. 2003-12, 2003-3 I.R.B. 283 (12/19/02). Amounts received by an individual from an employer to reimburse the individual for necessary medical, temporary housing, or transportation expenses incurred as a result of a flood are not excludable as a gift under § 102, but are excluded from gross income as qualified disaster relief under § 139 if the flood was a Presidentially declared disaster. Similar amounts received from a state agency are excludable under the administrative general welfare exclusion; and similar amounts received from a charity are excluded under § 102.

## IV. COMPENSATION ISSUES

### A. Fringe Benefits

1. **Guidance on Health Savings Accounts.** Notice 2004-2, 2004-2 I.R.B. 269 (12/23/03). The IRS has issued guidance in Q&A form on Health Savings Accounts under new § 223 (added by § 1201 of the **Medicare Prescription Drug Improvement, and Modernization Act of 2003**). This guidance provides basic information about HSAs. This new



provision offers health spending accounts without the “use it or lose it” requirement of health FSAs.

a. Notice 2004-23, 2004-15 I.R.B. 725 (3/30/04). The notice provides a safe harbor for preventive care benefits allowed to be provided by a high deductible health plan (“HDHP”) without satisfying the § 223(c)(2) minimum deductible. Preventive care under the safe harbor includes “annual physicals” (including tests and diagnostic procedures), routine prenatal and well-child care, child and adult immunizations, tobacco cessation programs, obesity weight-loss programs and a long list of “screening services” (for cancer, heart and vascular diseases, infectious diseases, mental health conditions and substance abuse, metabolic, nutritional and endocrine conditions, musculoskeletal disorders, obstetric and gynecologic conditions, pediatric conditions, and vision and hearing disorders); however, it does not generally include any service or benefit intended to treat an existing illness, injury or condition.

• This notice also provides that the definition of “preventive care” is a question of federal tax law, and not a question of state law. Therefore, a service required by state law to be provided on a first-dollar basis is not necessarily a “preventive service,” and a plan that complies with state law may well be disqualified from being an HDHP.

b. Notice 2004-43, 2004-27 I.R.B. 10 (6/18/04). This notice provides transition relief for plans that include state-mandated first-dollar coverage. These plans would not be disqualified for that reason alone for months before 1/1/06, provided that the state law was in effect on 1/1/04.

c. **Transition relief for plans with noncalendar year renewal dates.** Notice 2005-83, 2005-49 I.R.B. 1075 (11/8/05). This notice permits the Notice 2004-43 period to extend beyond 12/31/05 until the plan’s next renewal date (but not beyond 12/31/06) because health plans may not reduce existing benefits before the plan’s renewal date.

d. Notice 2004-50, 2004-33 I.R.B. 196 (7/23/04). This notice provides that any treatment that is incidental or ancillary to a preventive care service or screening described in Notice 2004-23 also falls within the safe harbor for preventive care.

e. Notice 2004-25, 2004-15 I.R.B. 727 (3/30/04). This notice provides general transition relief for 2004 from the rule that medical expenses may be paid or reimbursed by an HSA only if

they were incurred after the HSA had been established for eligible individuals who establish an HSA before 4/16/05.

**f. The inability to get general prescription drug coverage is the sticking point for many potential users of HSAs.** Rev. Rul. 2004-38, 2004-15 I.R.B. 717 (3/30/04). An individual who had prescription drug coverage that was not subject to the annual deductible of the HDHP is not eligible to make contributions to (or have his employer make contributions to) an HSA.

**g.** Rev. Proc. 2004-22, 2004-15 I.R.B. 727 (3/30/04). This revenue procedure provides transition relief for the months before 2006 for an individual who is covered by both an HDHP and a separate plan or rider that provides drug benefits on a co-pay basis or in some other manner before the minimum annual deductible of the HDHP is met.

**h.** Rev. Rul. 2004-45, 2004-22 I.R.B. 971 (5/11/04). This ruling provides guidance on the interactions of the HSA rules with the rules concerning health flexible spending arrangements (“health FSA”) (under Prop. Reg. § 1.125-1, Q&A 7) and health reimbursement arrangements (“HRA”) (under Notice 2002-45, 2002-2 C.B. 93). An individual can be eligible for making HSA contributions while being covered by a limited-purpose health FSA or HRA, a suspended HRA, a post-deductible health FSA or HRA, or a retirement HRA.

**2.** Notice 2005-8, 2005-4 I.R.B. 368 (1/24/05). This notice provides guidance regarding a partnership’s contributions to a partner’s HSA and an S corporation’s contributions to a 2-percent shareholder-employee’s HSA. Generally, the contributions are included in the income of the partner or shareholder-employee and are deductible by him or her as HSA contributions.

**a.** Rev. Rul 2005-25, 2005-18 I.R.B. 971 (4/13/05). A married individual who otherwise qualified as an eligible individual under § 223(c)(1)(A) can contribute to an HSA even if his spouse has nonqualifying family coverage provided that he is not covered under the spouse’s plan.

**3.** REG-138647-04, Employer Comparable Contributions to Health Savings Accounts Under Section 4980G, 70 F.R. 50233 (8/26/05). These proposed regulations provide guidance for employer comparable contribution to HSAs under § 4980G, which provides an excise tax on the failure of an employer to make “comparable contributions” to the

HSA's of all comparable participating employees [employees in the same category of "self-only" or "family"] when it makes a contribution to any employee's HSA.

**4. If the only thing the employee or his family could receive are medical expense reimbursements, then reimbursements under the plan qualify for the § 105(b) exclusion.** Rev. Rul. 2005-24, 2005-16 I.R.B. 892 (4/5/05). Reimbursements under an employer-sponsored § 125 salary-reduction medical reimbursement arrangement are not excludable from the employee's gross income under § 105(b) where unused benefits could be paid to the employee in cash or other benefits. However, reimbursements do qualify for the § 105(b) exclusion where they are made under a plan where unused benefits are made available for future medical care expenses of the employee [both before and after retirement] as well as those of the employee's spouse and dependents.

**5. In the future, employees may be able to avoid the late December rush at the optometrist's office and have until March 15th to buy eyeglasses.** Notice 2005-42, 2005-23 I.R.B. 1204 (5/18/05). This notice extends the "use it or lose it" rules for flexible spending arrangements by allowing employers to extend the deadline for reimbursement of health and dependent care expenses up to two and one half months after the end of a cafeteria plan year.

**6.** Rev. Rul. 2005-60, 2005-37 I.R.B. 502 (8/25/05). The employer subsidy for maintaining prescription drug coverage is not considered in computing the applicable employer cost when determining whether the minimum cost requirement of § 420(c)(3) is met with respect to transfer of the excess pension assets of a defined benefit plan to a health benefits account which is part of the plan.

## **B. Qualified Deferred Compensation Plans**

**1. "Mr. Gotbucks, meet Senator Roth."** REG-152354-04, Designated Roth Contributions to Cash or Deferred Arrangements Under Section 401(k), 70 F.R. 10062 (3/2/05). The IRS has published proposed regulations relating to an election under § 402A that will be available beginning in 2006 for employees to designate contributions to a 401(k) plan made under a qualified cash-or-deferred arrangement as Roth contributions. These contributions will be currently includible in gross income, but qualified distributions will be excludable from gross income.

**a. Final regulations on Roth contributions under qualified cash or deferred arrangements under § 401(k).** T.D.

9237, Designated Roth Contributions to Cash or Deferred Arrangements under Section 401(k), 71 F.R. 6 (1/3/06). These final regulations require a pre-tax alternative elective contribution to the Roth contribution. They also require an irrevocable designation to be made by the employee at the time of the cash or deferred election, and they require that Roth contributions be maintained by the plan in a separate designated Roth account for the employee. A matching contribution will not be permitted to be allocated to a designated Roth account. The regulations are effective for taxable years beginning after 12/31/05, but under current law the Roth 401(k) provisions do not apply to years beginning after 12/31/10.

2. REG-146459-05, Designated Roth Accounts Under Section 402A, 71 F.R. 4320 (1/26/06). These proposed regulations provide comprehensive guidance on the taxation of distributions from designated Roth accounts. There is no inclusion in income if the distribution is a qualified distribution, which is a distribution that is made after a 5-taxable-year period of participation and that is either made after the employee attains 59-1/2, made after the employee's death, or is attributable to the employee's being disabled.

3. **"Hercules! Hercules! Hercules!"<sup>1</sup>** Stepnowski v. Commissioner, 124 T.C. 198 (4/26/05). In this declaratory judgment case, Judge Cohen held that an amendment made by petitioner's employer, Hercules Incorporated, to its pension plan's lump-sum option did not violate the anti-cutback rule of § 411(d)(6). The amendment was made in 2001 during the GUST amendment period and permitted the plan sponsor to use the higher 30-year Treasury bond discount rate permitted under § 417(e)(3)(A) in computing the lump sum, as opposed to the lower PBGC rate that was required by that Code provision prior to its amendment by the Uruguay Round Agreements Act of 1994, Pub. L. 103-465.

4. **More work for benefits lawyers – this time under § 415.** REG-130241-04, Limitations on Benefits and Contributions Under Qualified Plans, 70 F.R. 31214 (5/31/05). These proposed regulations provide comprehensive guidance on § 415 limitations on benefits and contributions under qualified plans that are effective for plan years beginning in 2007. They are long.

5. **Final regulations crack down on abusive § 412(i) plans that understate the value of life insurance contracts distributed from a qualified retirement plan to employees, and require that they be taxed at their full fair market value.** T.D. 9223, Value of Life Insurance

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1. "Show me muscle again, oh, Hercules! Hercules! Hercules!" Mama Klump in "The Nutty Professor" (1996).

Contracts When Distributed From a Qualified Retirement Plan, 70 F.R. 50967 (8/29/05), making final proposed regulations published at 69 F.R. 7384 (February 2004). A tax-qualified retirement plan funded entirely by a life insurance contract of an annuity is a "section 412(i) plan." Such plans permit employer contributions to the plan to be deducted, with the contributions used to purchase a specially designed life insurance contract, with the cash surrender value temporarily depressed well below the premiums paid at the time the policy is distributed or sold to the employee for the amount of the temporarily depressed cash surrender value. After the transfer, the cash surrender value then increases significantly.

6. Under the **Katrina Tax Act**, withdrawals of up to \$100,000 from retirement plans made between 8/29/05 and 12/31/06 for relief relating to Hurricane Katrina would not be subject to the 10 percent premature withdrawal tax under § 72(t). This exception applies to withdrawals from IRAs as well.

7. Under the **Katrina Tax Act**, recontributions of withdrawals for home purchases cancelled due to Hurricane Katrina would be treated as rollovers if made before 3/1/06.

8. Under the **Katrina Tax Act**, loans of up to \$100,000 from qualified plans made between 9/24/05 and 12/31/06 for relief relating to Hurricane Katrina will receive favorable treatment.

9. The principle of *Poe v. Seaborn* applies whenever under state community property law a nonemployee spouse has ownership rights in the employee spouse's salary or benefits. Dunkin v. Commissioner, 124 T.C. 180 (4/22/05, as amended, 5/31/05). The taxpayer reached eligibility for retirement and had he retired his former spouse would have been entitled to receive one-half of his pension. Because he continued working and delayed receipt of his pension benefits, under community property law he was required to pay his former wife an amount equal to one-half of the pension benefits that he had earned during the marriage. The court held that *Poe v. Seaborn* rather than *Lucas v. Earl* controlled, and thus he was entitled to exclude from gross income the amounts paid to his former wife.

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

1. Section 409A adds a new layer of rules for nonqualified deferred compensation. Section 885 of the Jobs Act of 2004 adds 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 successfully 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. This was later reiterated in Notice 2005-1, 2005-2 I.R.B. 274, which reminded taxpayers that

although the statute makes a number of fundamental changes, § 409A does not alter or affect the application of any other provision of the Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under § 409A may nevertheless be required to be included in income under § 451, the constructive receipt doctrine, the cash equivalency doctrine, § 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Code or common law tax doctrine.

- In order to qualify under § 409A, a plan must require that distributions may be allowed only upon separation from service, disability, death, a specified time (or pursuant to a fixed schedule), change of control in a corporation (to be defined in regulations), occurrence of an unforeseeable emergency, or if the participant becomes disabled; distributions may not be allowed other than upon the permissible distribution events and the plan may not permit acceleration of a distribution except as provided in regulations. In the case of officers, directors and ten percent shareholders of publicly-held corporations and to persons holding the same positions in non-publicly held corporations, distributions upon separation from service may not be made earlier than six months after the date of separation from service.

- The plan must provide that compensation for services performed during a taxable year may be deferred only if the election is made before the beginning of the year in which the services are performed (or, if contingent compensation, at least six months before the end of the year in which the services are performed).

- A plan may permit changes in the time and form of distribution, so-called "second [deferral] elections" will have to be made at least twelve months before the payment was to have been made, and must postpone the payment for at least five years from the date it otherwise would have been made. Additionally, offshore rabbi trusts are not permitted. Generally, any such subsequent election to extend the deferral must extend the first payment date by at least five years and cannot be made or take effect within twelve months of the due date of the first payment.

- Violations of these rules would make immediately taxable all amounts not subject to a substantial risk of forfeiture, plus interest at one percentage point above the underpayment rate plus additional tax of 20 percent of the amount improperly deferred.

- These new rules do not apply to nonqualified stock options, incentive stock options and employee stock purchase plans, but apparently do apply to stock appreciation rights.

- Benefits earned through the end of 2004 are grandfathered if the plan complied with prior law and it was not materially modified after 10/3/04.

**a. Section 409A guidance provides transition rules and excludes stock appreciation rights from the purview of that section.** Notice 2005-1, 2005-2 I.R.B. 274 (12/20/04). This notice provides in Q&A form guidance with respect to the application of § 409A. It answers a variety of interpretive questions regarding the application of § 409A by providing various definitions, including a definition of substantial risk of forfeiture, and guidance on the application of § 409A to various kinds of plans as well as to stock appreciation rights and arrangements between partners and partnerships. The notice provides that § 409A applies whenever a service provider is (a) an individual, (b) a personal service corporation (as defined in § 269A(b)(1)), or a noncorporate entity that would be a personal service corporation if it were a corporation, or (c) a qualified personal service corporation (as defined in § 448(d)(2)), or a noncorporate entity that would be a qualified personal service corporation if it were a corporation. (Q&A-8). However, § 409A does not apply if both (a) the service provider is actively engaged in the trade or business of providing substantial services, other than as an employee or as a director of a corporation, *and* (b) the service provider provides such services to two or more service recipients to which the service provider is not related and that are not related to one another. (Q&A-8).

- A plan provides for deferral of compensation only if, “under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year.” (Q&A-4) Compensation is not treated as deferred compensation, however, if it is received after the last day of the service provider’s taxable year pursuant to the service recipient’s normal payroll period. (Q&A-4). Furthermore, compensation is not treated as deferred if it is required to be paid and is actually or constructively received by the service provider by the later of: (i) the date two and one half months after the end of the service provider’s first taxable year in which the amount is no longer subject to a substantial risk of forfeiture or (ii) the date two and one-half

months after the end of the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

- Stock options, stock appreciation rights, and other equity-based compensation generally are considered to be deferred compensation subject to § 409A, unless certain specified conditions have been met. (Q&A-4(d)) A nonstatutory stock option is not considered to be deferred compensation for purposes of § 409A if the following conditions have been met: (1) the exercise price may never be less than the fair market value of the underlying stock on the date the option is granted, (2) the option is subject to taxation under § 83, and (3) the option does not include any deferred compensation feature other than deferred income recognition until the later of the exercise or disposition of the option. A stock appreciation right is not deferred compensation if the following conditions are met: (1) the value of the stock the excess over which the right provides for payment upon exercise may never be less than the fair market value of the underlying stock on the date the right is granted, (2) the stock is traded on an established securities market, (3) only such stock may be delivered in settlement of the right, and (4) the right does not include any deferred compensation feature other than the deferral of recognition of income until the exercise of the right. (Q&A-4(d)).

- The notice provides the following standards regarding the existence of a substantial risk of forfeiture:

Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. . . . [A] condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value or a liquidity event). Any addition of a substantial risk of forfeiture after the beginning of the service period to which the compensation relates, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, in either case whether elected by the service provider, service recipient or other person (or by agreement of two or more of such persons), is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services. For purposes of § 409A, an amount will not be considered subject to a



substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the amount subject to a substantial risk of forfeiture (ignoring earnings) is materially greater than the amount the recipient otherwise could have elected to receive. For example, a salary deferral generally may not be made subject to a substantial risk of forfeiture. However, where an election is granted to receive a materially greater bonus amount in a future year rather than a materially lesser bonus amount in an earlier year, the materially greater bonus may be made subject to a substantial risk of forfeiture.

**b. Proposed regulations incorporate much of the guidance in Notice 2005-1.** REG-158080-04, Application of Section 409A to Nonqualified Deferred Compensation Plans, 70 F.R. 57930 (10/4/05). These proposed regulations incorporate much of the guidance provided in Notice 2005-1, as well as “substantial additional guidance.” They identify the plans and arrangements covered by § 409A and describe the requirements for deferral elections and the permissible timing for deferred compensation payments. They also extend the deadline for “documentary compliance” to 12/31/06, but 1/1/05 remains as the effective date for statutory compliance (although there are transition rules applicable for 2005). Prop. Reg. §§ 1.409A-1 (definitions and covered arrangements); 1.409A-2 (deferral elections); 1.409A-3 (permissible payments); 1.409A-6 (statutory effective dates). (Prop. Reg. § 1.409A-3(g)(3) defining unforeseeable emergency as: (1) a severe financial hardship resulting from an illness or accident of the service provider or the service provider’s spouse or dependent (as defined in § 152(a)); (2) loss of property due to casualty (including the need to rebuild a home following damage to a home not otherwise covered by insurance, for example, not as a result of a natural disaster), or other similar extraordinary and unforeseeable circumstances arising as a result of uncontrollable events; (3) medical expenses; and (4) funeral expenses of a spouse or a dependent); Prop. Reg. § 1.409A-1(i) (generally, a qualifying accelerated payment either (1) must be due on an objectively determinable date or according to an objectively determinable fixed schedule at the time the event occurs, or (2) must be within an objectively determinable calendar year following the year in which the event occurs; payment may be upon the earliest or latest of more than one qualified event). Prop. Reg. § 1.409A-3(h) (permitting acceleration in the event of a conflict of interest, to satisfy a qualified domestic relations order (QDRO)), described in ¶ 36.09[5], main volume, pursuant to § 414(p)(1)(B), as a de minimis cash-out, or to pay FICA taxes. The proposed regulations are proposed to be effective as of January 1, 2007.

**c. IRS gives employers a pass on reporting and wage withholding requirements for 2005.** Notice 2005-94, 2005-52 I.R.B. 1208 (12/8/05). The Notice suspends employers' and payers' reporting and wage withholding requirements for calendar year 2005 with respect to deferrals of compensation within the meaning of § 409A, but FICA must be properly paid under § 3121(v)(2). It does not affect a service provider's filing requirements, individual income tax liability and interest on underpayments of tax but the IRS will not assert late-payment, failure to pay estimated taxes or accuracy-related penalties against the service provider if he reports and pays any taxes due with in accordance with future published guidance.

2. Rev. Rul. 2005-39, 2005-27 I.R.B. 1 (6/16/05). Unvested shares of restricted stock for which an election under § 83(b) has been made are treated as outstanding stock for purposes of the change of control provisions of § 280G, the golden parachute provisions.

3. Rev. Rul. 2005-48, 2005-32 I.R.B. 259 (8/2/05). If an employee exercises a nonstatutory stock option more than six months after grant, but it is subject to restrictions on his ability to sell the stock so obtained under rule 10b-5 under the Securities Exchange Act of 1934 and during a contractual "lock-up period," then upon exercise of the option he is required under § 83 to include in his compensation income an amount determined without regard to the share-transfer restrictions imposed because these are "lapse restrictions" that are ignored under § 83(a) in valuing the shares.

4. Merlo v. Commissioner, T.C. Memo. 2005-178 (7/20/05). If an employee exercises a stock option outside the period covered by § 16 of the Securities Exchange Act of 1934 but is subject to restrictions on his ability to sell the stock obtained through exercise of the option by contractual provisions imposed by the employer, the stock is not subject to a substantial risk of forfeiture, because full enjoyment of the shares is not conditioned on any obligation to provide future services.

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

1. **The Supreme Court holds that IRAs are exempt from the bankruptcy estate.** Rousey v. Jacoway, 544 U.S. 320 (4/4/05). Inasmuch as rights to the funds in an IRA are on account of the holder's age and an IRA is similar to any other retirement plans, the assets in the plan are exempt from the holder's Chapter 7 bankruptcy estate. Justice Thomas held that the § 72(t) tax penalty of 10 percent on amounts withdrawn before age

59-1/2 makes the IRA one in which the right to receive payments effectively limits their right to payment of the IRA balance until that age is reached.

- The amounts in the Rouseys' IRA in this case were rolled over from a qualified plan, but the Court's decision was not based on that factor.

**a. Bankruptcy Act changes on protection of IRAs.** Section 224 of the Bankruptcy Act of 2005, 11 U.S.C. § 522, protects from creditors (1) assets in qualified plans, (2) assets in IRAs that were rolled over from qualified plans, and (3) other assets in IRAs of not more than \$1 million (indexed).

**2. What a way to mess up! Coppola v. Beeson (In re: Joseph C. Coppola), 419 F.3d 323 (5th Cir. 7/25/05).** In a *per curiam* opinion, the court held that a faculty member's pledging of his § 403(b) retirement account as security for alimony payments to his ex-wife totaling \$220,000 caused that amount to be deemed distributed and no longer entitled to the exemption from bankruptcy under Texas law.

**3. Rev. Proc. 2006-13, 2006-3 I.R.B. 315 (12/29/05).** This Revenue Procedure provides safe harbors for determining the fair market value of an annuity contract in the conversion of a traditional IRA to a Roth IRA.

**4. Thomas v. Commissioner, T.C. Memo. 2005-258 (11/1/05).** IRA distributions before age 59-1/2 to a taxpayer whose disability required scaling back from full-time to part-time work did not qualify for an exception to the § 72(t) penalty under § 72(t)(2)(A)(iii) because the taxpayer was not disabled as defined in § 72(m)(7), which requires that a taxpayer be "unable to engage in any substantial gainful activity."

## V. PERSONAL INCOME AND DEDUCTIONS

### A. Rates

There were no significant developments regarding this topic during 2005.

### B. Miscellaneous Income

**1. Prejudgment interest in a personal injury lawsuit is not excluded from income. Chamberlain v. United States, 401 F.3d 335 (5th Cir. 2/18/05).** Prejudgment interest recovered in a personal injury lawsuit is not excluded from income under § 104(a)(2) because it was

compensation for the lost time value of money and is not received “on account of” the personal injury.

- May prejudgment interest be excluded if there is a settlement? More specifically, post-judgment interest exclusion is permitted by the exclusion of the entire amount of any future payment received pursuant to a structured settlement. Does this create a difference between a recovery by way of settlement and a recovery by way of judgment?

2. Lindsey v. Commissioner, 422 F.3d 684 (8th Cir. 9/2/05). Although the taxpayer’s physician testified that the taxpayer “suffered from hypertension and stress-related symptoms, including periodic impotency, insomnia, fatigue, occasional indigestion, and urinary incontinence” as a result of the emotional distress inflicted by the defendant, the settlement agreement identified the taxpayer’s claims as tort claims for damage to his emotions, reputation and character. Physical symptoms that are merely manifestations of the underlying emotional distress for which damages are received do not result in the damages being treated as received on account of personal injury if there is no “direct causal link between any physical sickness suffered by [the taxpayer] and [any] damages paid out to him.”

3. Rivera v. Baker West, Inc., 430 F.3d 1253 (9th Cir. 6/17/05). No portion of settlement of claim for unlawful workplace discrimination and unlawful termination was compensation for physical personal injuries where settlement agreement was silent regarding the nature of the injuries addressed, and the only evidence of the payor’s intent regarding the claims settled was a statement that the defendant would pay taxpayer a sum of money “less all lawfully required withholdings.” The inference was that the defendant considered that some or all of the payment represented back pay.

4. **Annuity death benefits are IRD.** Rev. Rul. 2005-30, 2005-20 I.R.B. 1015 (4/28/05). If the owner-annuitant of a deferred annuity contract dies before the annuity starting date, any amounts received by a beneficiary in excess of the owner-annuitant’s investment in the contract are includible in gross income as income in respect of a decedent under § 691. These amounts are also subject to the rules of § 72 if the beneficiary receives an annuity rather than a lump-sum.

### C. Profit-Seeking Individual Deductions

1. **The alternative minimum tax (“AMT”) trap for attorneys’ fees on large recoveries will continue to be an issue despite**

**legislation and a Supreme Court decision. The Supreme Court decides the AMT trap issue in favor of the government, following the majority of courts that have faced this issue. Commissioner v. Banks, 543 U.S. 426 (1/24/05) (eight to zero).** Justice Kennedy's unanimous opinion held that a contingent fee agreement should be viewed as an anticipatory assignment of income to the attorney by the client. He relied on the assignment of income doctrine cases, e.g., *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst*, 311 U.S. 112 (1940), and found this doctrine to be relevant in arm's length transactions as well as family transactions, stating: "We hold that as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee." The Court ruled that the attorney-client relationship was governed by agency law and not by partnership law (although, later in the opinion, it refused to rule on the partnership argument because it was raised too late).

- The Court did not rule on whether attorneys' fees awarded pursuant to claims brought under federal statutes that authorize fee awards to prevailing plaintiffs, noting that Banks settled his discrimination case and the fee paid to his attorney was based upon the contingent fee agreement, and was not awarded by a court.

**a. Congress grants relief for civil rights plaintiffs, but not for all clients of plaintiffs' lawyers. AMT trap to be closed, but only prospectively and not with respect to taxable recoveries not listed in new § 62(e).** Section 703 of the Jobs Act of 2004 added new paragraph (19) to § 62(a) which would permit above-the-line deductibility of contingent attorneys' fees in lawsuits for unlawful discrimination (which is defined in § 62(e) to include 18 separate categories of civil rights-type lawsuits, but not simple defamation, consumer fraud and punitive damages). The provision applies to judgments and settlements occurring after the date of enactment.

- Congress did not address attorney's fees relating to recoveries for consumer fraud, defamation and possibly employment contract disputes, as well as punitive damages and taxable interest in personal injury cases.

**b. Banks followed for a contingent attorney's fee. Allum v. Commissioner, T.C. Memo. 2005-177 (7/20/05).** No part of a \$500,000 payment received in 1999 for a civil rights claim may be excluded from gross income because it was not for a personal physical injury or physical sickness. The Tax Court (Judge Marvel) further held that the contingent fee the taxpayer paid to his attorney from the settlement proceeds is also included in gross income, based upon the *Banks case*, because general references in a complaint to unspecified physical injuries in

a suit for wrongful discharge of employment do not support exclusion of any portion of the settlement under § 104(a)(2).

**2. Fees paid for MBA were deductible because the degree did not qualify the taxpayer for a new trade or business.** Allemeier v. Commissioner, T.C. Memo. 2005-207 (8/31/05), *motion for fees denied*, T.C. Memo 2006-28 (2/16/06). Orthodontic appliance salesman who was promoted to a management position after starting MBA could deduct cost of MBA; education was not a “minimum requirement” because promotion was not contingent on beginning or completing MBA program, and it did not qualify taxpayer for a new trade or business because the basic nature of taxpayer’s work activities did not change as a result of additional education, even though taxpayer was awarded new titles and positions and advanced more rapidly; the MBA merely improved pre-existing skills.

- May an employer avoid both the § 127 dollar limit on reimbursement of the costs of an employee’s MBA program and the § 127 nondiscrimination requirement by treating payment of such costs as § 132(a)(3) working condition fringe benefit?

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

There were no significant developments regarding this topic during 2005.

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

**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). The Tax Court (Judge Wherry), in a case appealable to the Second Circuit, found 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). The court follows the Fourth and Federal Circuits, and adheres to its earlier opinion in the *O’Neill v. Commissioner*, 98 T.C. 227 (1992), which was reversed by the Sixth Circuit, 994 F.2d 302 (1993).

- The Sixth Circuit’s rationale was stated as follows:

The Tax Court reasoned that “individual 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)

**2. No 10-percent-of-AGI floor for the deduction of Katrina losses.** Under the **Katrina and GO Zone Acts**, new § 1400S(b) is added, under which individual taxpayers would be permitted to claim casualty or theft losses attributable to Hurricanes Katrina, Rita and Wilma regardless of whether the loss exceeds \$100, and in addition, these personal casualty or theft losses would be deductible without regard to whether the loss exceeds 10 percent of a taxpayer’s adjusted gross income.

**3. Lofstrom v. Commissioner, 125 T.C. 271 (11/22/05).** A third-party debt instrument transferred in satisfaction of a state court ordered alimony payment is not “cash” and thus is not alimony for purposes of § 71. (Applying Reg. § 1.71-1T(b), Q&A-5 requiring payment solely by cash, check or money order; denying § 215 deduction to transferor).

**4. We now have a uniform definition of “child” but it is not very user-friendly.** Sections 201-208 of the **Working Families Tax Relief Act of 2004** provide a uniform definition of “child” for head of household, dependent care credit, child tax credit, earned income tax credit, and dependent exemption purposes. This changes prior law by making irrelevant the fact that Forms 8332 were signed by the custodial parent. Instead, what would be required to shift the dependency deduction to the non-custodial parent is a provision in the divorce decree or separation agreement.

- Under the pre-2004 version of § 152(e)(2), the noncustodial parent was treated as having provided over half of the child’s support for the year if the custodial parent signed a written declaration that he would not claim the child as a dependent for any tax year beginning within that calendar year, and the noncustodial parent attached the declaration to his return for the taxable year in which he claimed the dependency exclusion. The declaration by the custodial parent could pertain to only one year, or could specify that it applied to two or more years, and a permanent declaration might be made at the time of the divorce. Temp. Reg. § 1.152-4T(a) Q & A 4. The actual signature of the custodial spouse on the declaration was crucial to shifting the exemption to the noncustodial parent. The

pre-2004 version of § 152(e)(2) also applied to determine which of the never-married and non-cohabiting parents of a minor child was entitled to the dependency exemption.

• As amended by the **Working Families Tax Relief Act of 2004**, § 152(e)(2) now provides that the noncustodial spouse will be entitled to the dependency exemption for the couple's minor child if a decree of divorce or separate maintenance or written separation agreement between the parents provides either (1) that the noncustodial parent is entitled to the dependency exemption for the child, or (2) that the custodial parent will sign a written declaration that she will not claim the child as a dependent for a particular taxable year. The 2004 amendments change the rules in a number of respects. First, amended § 152(e)(2), rather than deeming the noncustodial parent to have provided over one-half of the child's support, now treats the child as a "qualifying child" under § 151 with respect to the noncustodial parent. This has the effect of assuring (consistently with prior law) that if the right to the exemption is awarded to the noncustodial spouse, that spouse also obtains the right to claim the § 24 child credit. Second, under the amended version of § 152(e)(2), unlike under the pre-2004 version, a provision in a divorce instrument awarding the exemption to the noncustodial spouse is effective without any action on the part of the custodial spouse to sign a waiver. Furthermore, under the strict wording of the statute, if the divorce instrument does not specifically award the dependency exemption to the noncustodial spouse but directs the custodial spouse to sign the waiver, it appears that the right to claim the exemption is effectively transferred to the noncustodial spouse even if the custodial spouse subsequently refuses or otherwise fails to sign the waiver. Thus, the divorce instrument is now the key document, whereas under prior law the written waiver by the custodial spouse was the key document. Finally, unlike the pre-2004 version of § 154(e), which permitted parents who were never married to agree that the noncustodial spouse would be entitled to the dependency exemption through a waiver by the custodial parent, the current version of § 152(e)(2) requires a provision in a divorce or written separation agreement. Unless the courts interpret the term "written separation agreement" to encompass agreements between parents who were never married, the noncustodial parent of a child whose parents never married will not be able to obtain the dependency exemption with respect to the child. In such a case, § 152(e)(1)(A)(iii) always awards the exemption to the custodial parent.

a. **But the definition was completely changed in Technical Corrections under the GO Zone Act of 2005.** The **Gulf Opportunity Zone Act of 2005** contains technical corrections to previously enacted legislation including the Working Families Tax Relief Act of 2004 and The American Jobs Creation Act of 2004. The custodial parent is defined by the GO Zone Act as the parent having custody of the



child for the greater portion of the calendar year. The Working Families Tax Relief Act of 2004 had changed the wording of § 152(e) to say that the custodial parent was “the parent with whom a child shared the same principal place of abode for the greater portion of the calendar year.” This meant that beginning in 2005, the parent with whom the child lived for the greater portion of the year was the custodial parent (and therefore “in charge” of the personal exemption for that child) even though the other parent had been granted legal custody of the child by the courts. Now, the technical correction made by the GO Zone Act of 2005 changes the language to say that the custodial parent “means the parent having custody for the greater portion of the year.” This is identical to the definition of the “custodial parent” prior to the amendment of § 152(e) by the Working Families Tax Relief Act of 2004. Therefore, the GO Zone Act of 2005 has changed the definition of the custodial parent back to the old definition effective as of January 1, 2005. The effect of this change is that (as for 2004 and previous years) a parent is the custodial parent if the judge grants the parent legal custody of the child for the greater portion of the year. However, if the parents have joint legal custody, then (as under the law before its amendment by the Working Families Tax Relief Act of 2004) the parent with whom the child spends the greater portion of the year will be the custodial parent.

**5. Rev. Rul. 2005-11, 2005-14 I.R.B. 816 (3/17/05).**

Interest paid on a home mortgage that has been refinanced is deductible as qualified housing interest for AMT purposes if the interest on the mortgage that was refinanced was qualified housing interest, but only to the extent that the amount of the mortgage indebtedness was not increased.

**F. Education**

**1. Education expenses for the current year only.**

Lodder-Beckert v. Commissioner, T.C. Memo. 2005-162 (7/5/05). Amounts withdrawn from an IRA in 2001 to pay off credit card debt deriving from the payment of tuition in previous years was subject to the 10 percent additional tax of § 72(t)(1). Taxpayer incurred the credit card debt in 1999 and 2000 to pay education expenses because her former employer, the State of Ohio, was in the process of significantly increasing the amount in her retirement account, which was rolled over into the IRA in 2001. The Tax Court (Judge Laro) held that the exception from penalty tax in § 72(t)(2)(E) applies only to withdrawals used to pay education expenses for the current taxable year.

## VI. CORPORATIONS

### A. Entity and Formation

1. Section 836(a) of the **Jobs Act of 2004** adds new § 362(e) to provide limitation on the importation, or transfer in § 351 transactions, of built-in losses to corporations. The aggregate basis of the property so received will be limited to its fair market value immediately after the transaction. This rule is applied on a transferor-by-transferor basis.

- Section 362(e)(2) prevents taxpayers from transmuting a single economic loss into two (or more) tax losses by taking advantage of the dual application of the substituted basis rules in § 358 for stock received in a § 351 transaction and in § 362 for assets transferred to a corporation in a § 351 transaction. If the aggregate basis of the property transferred to a corporation in a § 351 transaction exceeds the aggregate fair market value, the aggregate basis of the property must be reduced to its fair market value. Thus, for example, if A transfers Blackacre, with a basis of \$1,000 and a fair market value of \$600 to newly formed X Corporation in exchange for all of the X Corporation stock, X Corporation's \$1,000 basis in Blackacre, determined under § 362(a), will be reduced to \$600 under § 362(e)(2).

- **Geriatrics should consider making an alternative election.** A and X Corporation may jointly elect to reduce A's basis in the X Corporation stock, which is otherwise an exchanged basis of \$1,000 pursuant to § 358, to its fair market value [presumably \$600], with the transferee, X Corporation, taking a normal transferred basis under § 362(a) [\$1,000].

- The operation of § 362(e)(2) is more complex where multiple assets are involved. When a transferor also transfers some appreciated property to the corporation, § 362(e)(2) does not necessarily result in the basis of every item of loss property being reduced to its fair market value. Section 362(e)(2)(A) requires that the aggregate basis of the transferred property be reduced by the excess of the aggregate basis over the aggregate fair market value, and § 362(e)(2)(B) requires that the aggregate basis reduction be allocated among the transferred properties in proportion to the built-in losses in the properties before taking into account § 362(e)(2). Assume, for example, that B transferred three properties to newly formed Y Corporation in exchange for all of the stock: a copyright, fair market value \$4,500, basis \$3,000; land, fair market value \$7,000, basis \$9,000; and a machine, fair market value \$4,000, basis \$5,000. The aggregate fair market value of the three properties is \$15,500 and their aggregate basis is \$17,000, thus requiring a basis reduction of \$1,500 (\$17,000 - \$15,500) with respect to the land and the machine, the two properties with a basis that exceeds fair market value. The land has a built-in loss of \$2,000 and the machine has a built-in loss of \$1,000. The \$1,500 basis

reduction is allocated 2/3 to the land ( $\$2000 / (\$2,000 + \$1,000)$ ), and 1/3 to the machine ( $\$1000 / (\$2,000 + \$1,000)$ ). Thus the basis of the land is reduced by \$1,000 ( $2/3 \times \$1,500$ ), from \$9,000 to \$8,000, leaving an unrealized loss of \$1,000 ( $\$8,000$  basis -  $\$7,000$  fair market value) inherent in the land and the basis of the machine is reduced by \$500 ( $1/3 \times \$1,500$ ), from \$5,000 to \$4,500, leaving an unrealized loss of \$500 ( $\$4,500$  basis -  $\$4,000$  fair market value) inherent in the land.

a. Notice 2005-70, 2005-41 I.R.B. 694. (9/12/05). Interim guidance on making § 362(e)(2)(C) elections to reduce to fair market value a transferor's basis in stock received in exchange for loss property.

2. **Net value requirement in § 351 transfers.** See VI.C., below. Proposed amendments to Reg. § 1.351-1 would add a requirement that there be both (1) a contribution of net value and (2) a receipt of net value as a prerequisite for § 351 to apply. Prop. Reg. § 1.351-1(a)(1)(iii)(A) would provide that stock will not be treated as issued for property if either (1) the fair market value of the transferred property does not exceed the sum of the amount of liabilities of the transferor that are assumed by the transferee in connection with the transfer and the amount of any money and the fair market value of any other property (other than stock permitted to be received under § 351(a) without the recognition of gain) received by the transferor in connection with the transfer, or (2) the fair market value of the assets of the transferee does not exceed the amount of its liabilities immediately after the transfer. Prop. Reg. § 1.351-1(a)(2), Ex. 4, illustrates the rule by concluding that a transfer of real property encumbered by a nonrecourse mortgage in excess of the property's fair market value to a wholly owned corporation, which remains solvent after the transaction, in exchange for additional stock is not subject to § 351. Although the example does not recharacterize the transaction, it presumably is a sale on which gain must be recognized and which gives rise to a purchase price basis under § 1012 for the corporation. Loss recognition would be subject to possible disallowance under § 267.

3. **The member of a single-member LLC that operated a nursing home is individually liable for the company's failure to pay withholding and FICA taxes because he failed to check the box, so the tax liability was that of a disregarded entity. In the process, the "check-the-box" regulations were held valid.** Litriello v. United States, 2005-1 U.S.T.C. ¶ 50,385 (W.D. Ky. 5/18/05). The court held that the "check-the-box" regulations of Reg. 301.7701-1 through -3 were valid, and found the sole member of a single-member LLC that did not elect to be treated as a corporation liable for unpaid withholding and FICA taxes,

because the LLC is considered a disregarded entity for federal tax purposes. Judge Heyburn granted summary judgment and rejected Littriello's argument that § 6672 was the government's sole recourse because the IRS imposed liability upon him as the owner of a sole proprietorship.

**a. United States 1, Professor Gregg Polsky**

**0.** Same decision on motion for reconsideration, 96 A.F.T.R.2d 2005-5764 (8/3/05):

Plaintiff has moved to reconsider the Court's Memorandum Opinion and its Order dated May 18, 2005, on the grounds that the check-the-box regulations are invalid under *Morrissey v. Commissioner*, 296 U.S. 344, 80 L. Ed. 263, 56 S. Ct. 289, 1936-1 C.B. 264 (1935) as argued in a Law Review article by Professor Gregg D. Polsky of the University of Minnesota Law School. Polsky, "Can Treasury Overrule the Supreme Court?," 84 BU. L. Rev. 185 (2004). Thus, this motion states new grounds for Plaintiff's relief. The Court will consider the argument even though it amounts to a renewed motion rather than a true reconsideration.

When confronted with the question posed by Professor Polsky's title, one would naturally answer, "No." However, that is not precisely the question before this Court nor can it be fairly said that Treasury's check-the-box regulations have such an effect. The Court has reviewed *Morrissey* in its proper context and does not find that it requires invalidating the check-the-box regulations.

Certainly, the check-the-box regulations are the subject of academic and theoretical questioning. Professor Polsky has proposed that the Treasury has gone too far in adopting regulations concerning corporations and other associations. However, it is a theory only that the check-the-box regulations violate the Internal Revenue Code definitions because those definitions were made in effect permanent by *Morrissey*. The Court does not believe that *Morrissey* forever incorporated in all future Treasury regulations a particular definition of an "association."

**B. Distributions and Redemptions**

**1. Pushing the envelope on complete termination.**  
Hurst v. Commissioner, 124 T.C. 16 (2/3/05). This case illustrates that the

“prohibited interest” test is based on a formalistic analysis rather than the totality of the circumstances. All of the taxpayer’s stock in a corporation (HMI) in which his son continued as a 51 percent shareholder was redeemed for \$2.5 million dollars payable quarterly, with 8 percent interest, over fifteen years. The payment obligation was represented by a promissory note that was secured by all of the corporation’s assets, as well as by a cross-collateralization pledge of the son’s stock and the stock of the unrelated shareholders. In addition, HMI entered into a ten-year employment contract with the redeemed shareholder’s wife, who personally had not owned any stock, giving her a small salary and fringe benefits, including medical insurance, and pursuant to which she performed “various administrative and clerical tasks.” Finally, at time of the redemption the corporation signed a new lease on the building owned by the redeemed shareholder, in which it conducted its business, pursuant to which it paid rent of \$8,500 per month, adjusted for inflation. Although the Commissioner “acknowledg[ed] that each relationship between the Hursts and their old company – creditor under the notes, landlord under the lease, employment of a non-owning family member – passes muster, he argue[d] that the total number of related obligations resulting from the transaction gave the Hursts a prohibited interest in the corporation by giving Richard Hurst a financial stake in the company’s continued success.” The Tax Court (Judge Holmes) rejected this “holistic view,” examining each obligation in turn.

- The court first addressed the terms of the promissory notes:

Neither the amount nor the timing of payments was tied to the financial performance of HMI. Although the notes were subordinate to HMI’s obligation to its bank, they were not subordinate to general creditors, nor was the amount or certainty of the payments under them dependent on HMI’s earnings. . . . All of these contractual arrangements had cross-default clauses and were secured by the buyers’ stock. This meant that should *any* of the notes go into default, Mr. Hurst would have the right to seize the stock and sell it. The parties agree that the probable outcome of such a sale would be that Mr. Hurst would once again be in control of HMI. . . . But in *Lynch v. Commissioner*, 83 T.C. 597 (1984), revd. on other grounds 801 F.2d 1176 (9th Cir.1986), we held that a security interest in redeemed stock does not constitute a prohibited interest under section 302. We noted that “The holding of such a security interest is common in sales agreements, and . . . not inconsistent with the interest of a creditor. . . .” Furthermore, at trial, the Hursts offered credible evidence from their professional advisers that these transactions, including the grant of a security interest to Mr.

Hurst, were consistent with common practice for seller-financed deals.

• Second,

the lease called for a fixed rent in no way conditioned upon the financial performance of HMI. Attorney Ron David, who was intimately familiar with the transaction, testified convincingly that there was no relationship between the obligations of the parties and the financial performance of HMI. The transactional documents admitted into evidence do not indicate otherwise. There is simply no evidence that the payment terms in the lease between the Hursts and HMI vary from those that would be reasonable if negotiated between unrelated parties. And the Hursts point out that the IRS itself has ruled that an arm's-length lease allowing a redeeming corporation to use property owned by a former owner does not preclude characterization as a redemption.

Furthermore, the court did not find the fact that subsequent to the redemption the parties modified both the lease and the note in a transaction in which the corporation surrendered an option to purchase the leased property in exchange for a reduction in the interest rate on the note issued for the stock indicated that Hurst's rights under the lease were in fact a retained interest.

• Third,

Mrs. Hurst did not own any HMI stock. Thus, she is not a "distributee" unable to have an "interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor. . . ." The Commissioner is thus forced to argue that her employment was a "prohibited interest" for Mr. Hurst. And he does, contending that through her employment Mr. Hurst kept an ongoing influence in HMI's corporate affairs. He also argues that an employee unrelated to the former owner of the business would not continue to be paid were she to work Mrs. Hurst's admittedly minimal schedule. And he asserts that her employment was a mere ruse to provide Mr. Hurst with his company car and health benefits, bolstering this argument with proof that the truck used by Mrs. Hurst was the same one that her husband had been using when he ran HMI. None of this, though, changes the fact that her compensation and fringe benefits were fixed, and again – like the notes and lease – not subordinated to HMI's general creditors, and not subject to any fluctuation related to HMI's financial performance. Her duties, moreover, were various administrative and clerical tasks – some of the same chores

she had been doing at HMI on a regular basis for many years. And there was no evidence whatsoever that Mr. Hurst used his wife in any way as a surrogate for continuing to manage (or even advise) HMI's new owners.

• Somewhat surprisingly, perhaps, the court concluded that the fact that a default by the corporation on its obligations to Mrs. Hurst under the employment contract, as did a default under the lease, also constituted a default on the promissory note to Mr. Hurst, thereby triggering his right to reacquire the stock did not, under all of the facts and circumstances, constitute a prohibited retained interest. The Commissioner argued that “intertwin[ing] substantial corporate obligations with the employment contract of only one of 45 employees . . . [was] proof that the parties to this redemption contemplated a continuing involvement greater than that of a mere creditor.” The court responded that “the proof at trial [demonstrated] that there was a legitimate creditor’s interest in the Hursts’ demanding [the cross collateralization provisions]. . . . They were, after all, parting with a substantial asset (the corporations), in return for what was in essence an IOU from some business associates. Their ability to enjoy retirement in financial security was fully contingent upon their receiving payment on the notes, lease, and employment contract. . . . The value of that security, however, depended upon the financial health of the company. Repossessing worthless shares as security on defaulted notes would have done little to ensure the Hursts’ retirement. The cross-default provisions were their canary in the coal mine. If at any point the company failed to meet any financial obligation to the Hursts, Mr. Hurst would have the option to retrieve his shares immediately, thus protecting the value of his security interest instead of worrying about whether this was the beginning of a downward spiral. This is perfectly consistent with a creditor’s interest, and there was credible trial testimony that multiple default triggers are common in commercial lending.” Accordingly, the court held that “the cross-default provisions protected the Hursts’ financial interest as creditors of HMI, for a debt on which they had received practically no downpayment, and the collection of which (though not ‘dependent upon the earnings of the corporation’ as that phrase is used in section 1.302-4(d), Income Tax Regs.) was realistically contingent upon HMI’s continued financial health. . . . The number of legal connections between Mr. Hurst and the buyers that continued after the deal was signed did not change their character as permissible security interests. Even looked at all together, they were in no way contingent upon the financial performance of the company except in the obvious sense that all creditors have in their debtors’ solvency.”

**2. The IRS was “buffeted” when it attempted to show linkage between taxpayer’s borrowings and its investments in portfolio stock.** OBH, Inc. (formerly Berkshire Hathaway Inc.) v. United States, 2005-2 U.S.T.C. ¶ 50,627 (D. Neb. 10/28/05). The court held that

taxpayer is entitled to a full dividends-received deduction because § 246A, which reduces the dividends-received deduction allowable under § 243(a) for dividends that are paid on “debt-financed portfolio stock,” was not applicable. The court looked to legislative history (House Report), which stated that portfolio indebtedness is debt that is “clearly incurred for the purpose of acquiring dividend paying stock or otherwise directly traceable to such an acquisition.”

- It found that the proceeds of the four borrowings in question were not able to be traced to specific purchases of portfolio stock, i.e., they were not “directly attributable” to portfolio stock purchases. It further held that “directly traceable” should be given a “plain meaning” definition, i.e., that “direct” connotes an “immediate result,” and the IRS failed to show an immediate connection between the debt proceeds and the stocks. The court further found that the IRS tracings do not satisfy the “purpose” test either.

- The opinion states that the court is cognizant of the fact that current statutory and regulatory regime makes it virtually impossible for the Service to trace debt proceeds and thus assess tax deficiencies under § 246A against companies like OBH who engage in numerous investment transactions. However, any decision to loosen the “direct” connection required between debt proceeds and the purchase of dividend-paying stocks must be made by Congress or the Service, not the courts. In fact, the Service, apparently recognizing the difficulty in applying § 246A to companies like Berkshire, has already taken steps to alter the necessary linkage required by § 246A. On May 7, 2004, the Service issued an announcement requesting comments on whether regulations should be adopted that would supplement the specific tracing rule in § 246A with a pro rata allocation rule to determine the use of borrowings that are not traceable to a specific use. See 69 F.R. 25534.

## C. Liquidations

1. **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 note, however, that even though a liquidation of a subsidiary might not qualify under § 332, the transaction nevertheless might qualify as a tax-free reorganization under § 368. See Prop. Reg. § 1.332-2(e), Ex. 2. The preamble to the proposed regulations notes that the Treasury adopted the approach in *Spaulding Bakeries*



*v. Commissioner*, 252 F.2d 693 (2d Cir. 1963), *aff'g* 27 T.C. 684 (1957), and *H. K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986), because it concluded that it is appropriate for a corporation to recognize loss when it fails to receive a liquidating distribution on a class of its subsidiary because the parent corporation would recognize such a loss if the distribution qualified as a reorganization under § 368.

- The proposed regulations also provide guidance on the treatment of creditors of an insolvent corporation, who will be treated as proprietors to determine whether continuity of interest is preserved.

- Finally, the proposed regulations provide that the requirements of § 332 are satisfied only if the recipient corporation receives at least partial payment for each class of stock that it owns in the liquidating corporation. A distribution in redemption of less than all of the shares one corporation owns in another corporation, but in which the recipient corporation receives partial payment for at least one class of stock may qualify as a reorganization.

#### **D. S Corporations**

**1. Members of one (greatly extended) family are treated as one shareholder.** Section 231 of the **Jobs Act of 2004** amends § 1361 to treat members of a family as one shareholder at the election of any family member. Shareholders with a common ancestor going back six generations are members of the same family.

- This means that a shareholder and his fifth cousin are members of the same family. This would have the effect of making the entire population of Arkansas members of the same family.

**a. How many S corporation shareholders know the name of any of their great-great-great grandfathers?** Notice 2005-91, 2005-51 I.R.B. 1164 (11/22/05). This provides advance notice of what the regulations will say under § 1361(c)(1)(D) election to aggregate family members for 100 shareholder limit. Lists additional shareholders who will be counted in aggregation (trust beneficiaries, etc.) Describes the manner by which the election to treat members of a family as one shareholder may be made for taxable years of the S corporation beginning after 12/31/04. "The election is made by notifying the corporation to which the election applies. The notification shall identify by name the member of the family making the election, the 'common ancestor' of the family to which the election applies, and the first taxable year of the corporation for which the election is to be effective." Members of the family also include beneficiaries of permitted trusts, etc. A smaller family may be

subsumed into a larger family, with members of the larger family all being counted as one shareholder.

**2. *Coggin Automotive* would be reversed by a proposed regulation.** REG-149524-03, LIFO Recapture Under Section 1363(d), 69 F.R. 50109 (8/13/04). Prop. Reg. § 1.1363-2(b)-(d) (2004) would reverse the rule in *Coggin Automotive Corp. v. Commissioner*, 292 F.3d 1326 (11th Cir. 2002), for future years and require LIFO recapture when a corporation that conducts business through an interest in a partnership makes an S election.

**a. The regulation is now final.** T.D. 9210, LIFO Recapture under Section 1363(d), 70 F.R. 39920 (7/12/05), *corrected by*, 70 F.R. 46758 (8/11/05), with an effective date of 8/13/04.

**b. In the Tax Court, the aggregate theory of partnership taxation was applied.** *Coggin Automotive Corp. v. Commissioner*, 115 T.C. 349 (10/18/00). Taxpayer originally was a holding company that had a number of controlled subsidiaries engaged in the retail sale of motor vehicles. The subsidiaries maintained their inventories under the LIFO method, and all of the corporations filed a consolidated return. In 1993, the taxpayer restructured to make an S election. Six new S corporations were formed to become the general partners in six limited partnerships. Each subsidiary contributed its dealership assets to a limited partnership in exchange for a limited partnership interest, following which the subsidiaries were liquidated and the taxpayer became the limited partner in each. The Commissioner asserted that the taxpayer's conversion to an S corporation triggered the inclusion of the affiliated group's pre-S-election LIFO reserves (approximately \$5 million) under § 1363(d). The Commissioner argued alternatively (1) that the restructuring should be disregarded because it had no purpose independent of tax consequences, and (2) that under the aggregate approach to partnerships, a pro rata share of the pre-S-election LIFO reserves (approximately \$4.8 million) was attributable to the taxpayer as a partner. The Tax Court (Judge Jacobs) rejected the Commissioner's first argument, holding that the restructuring was a genuine multiple-party transaction with economic substance, compelled by business realities and imbued with tax-independent considerations. But Judge Jacobs accepted the Commissioner's second argument, holding that application of the aggregate approach [rather than the entity approach] to partnership taxation furthered the purpose of § 1363(d). Thus, the taxpayer was treated as owning a pro rata share of the partnerships' inventories and as a result of its election it was required to include \$4.8 million of LIFO recapture.

• In reaching its decision regarding Subchapter K, the Tax Court followed *Casel v. Commissioner*, 79 T.C. 424

(1982), applying the aggregate approach to apply § 267 to disallow losses between related parties; *Holiday Village Shopping Center v. United States*, 773 F.2d 276 (Fed. Cir. 1985), applying the aggregate approach for purposes of determining depreciation recapture when a corporation distributed a partnership interest to its shareholders; and *Unger v. Commissioner*, 936 F.2d 1316 (D.C. Cir. 1991), in determining permanent establishment. It distinguished as inapposite the entity approach applied in *P.D.B. Sports, Ltd. v. Commissioner*, 109 T.C. 423, (1997) applying the entity approach for purposes of applying § 1056; *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521, 564 (1979), *aff'd*, 633 F.2d 512 (7th Cir.1980), applying the entity approach in determining whether expenditures are deductible under § 162 or nondeductible start-up expenditures, and the Eighth Circuit's decision in *Brown Group, Inc. v. Commissioner*, 77 F.3d 217 (8th Cir.1996), *vacating* 104 T.C. 105 (1995), concluding that the entity approach, rather than the aggregate approach, should be used in characterizing income (subpart F income) earned by a partnership. The differences, the court found, were based on the determination of the relevant Congressional intent in enacting the non-subchapter K provision involved in each case.

**(1) But the Eleventh Circuit sees things differently, and reverses the Tax Court. "Plain language" requires application of the entity theory, and the aggressive tax plan put together by KPMG worked. Coggin Automotive Corp. v. Commissioner, 292 F.3d 1326, 89 A.F.T.R.2d 2002-2826, 2002-1 U.S.T.C. ¶ 50,448 (11th Cir. 6/6/02).** Expressly applying the *Gitlitz* "plain language" principle, the Eleventh Circuit (Judge Hill) reversed the Tax Court. The Court of Appeals held that § 1363(d) LIFO recapture is triggered only if the corporation electing S status itself directly owned the LIFO inventory. Since the result turned on "plain language" rather than the purpose of the statutory pattern, Judge Hill was spared the need to write a lengthy opinion.

**3. Governments have to collect.** T.D. 9183, Modification of Check the Box, 70 F.R. 9220 (2/25/05). These final regulations under §§ 856, 1361 and 7701 clarify that qualified REIT subsidiaries, qualified subchapter S subsidiaries and single-owner eligible entities separate from their owners are treated as separate entities for federal tax liability purposes.

**4. Unincorporated entities making S elections will be deemed to have checked the box as well.** T.D. 9203, Deemed Election To Be an Association Taxable as a Corporation for a Qualified Electing S Corporation, 70 F.R. 29452 (5/23/05), *corrected by*, 71 F.R. 3219 (01/20/06). Final regulations that deem eligible entities that file timely S

elections to have elected to be classified as associations taxable as corporations.

- Those making late elections may seek relief under Rev. Proc. 2004-48, 2004-32 I.R.B. 172. Alternatively, they may submit a ruling request under Reg. § 301.9100-3 to file a late classification election and under § 1362 to file a late S corporation election.

- These provisions apply retroactively, effective back to 7/20/04.

- Forming an LLC that will be taxed as an association in order to make an S election is a procedure employed in order to take advantage of the greater flexibility given to LLCs under state law (as compared with corporations).

## **E. Affiliated Corporations**

**1. Loss limitation rules are provided in temporary and proposed regulations.** T.D. 9118, Loss Limitation Rules, 69 F.R. 12799 (3/18/04); REG-153172-03, Loss Limitation Rules, 69 F.R. 12811 (3/18/04). Temporary regulation amendments relate to the deductibility of losses under the temporary regulations under § 337(d) and the anti-duplication temporary consolidated returns regulations relating to the claiming of a worthless stock deduction with respect to a subsidiary's stock. The proposed regulations cross-reference the temporary regulations.

**a. Basis disconformity rule will be permitted.** Notice 2004-58, 2004-39 I.R.B. 520 (8/25/04). The IRS will permit taxpayers to use the basis disconformity method or other methods, e.g., tracing, for determining the amount of stock loss or basis that is not attributable to the recognition of built-in gain on the disposition of an asset; such stock loss will be allowed. Such amount of stock loss will not be disallowed and such amount of subsidiary stock basis will not be reduced.

- Under the basis disconformity method the loss is disallowed or the basis reduced, as the case may be, in an amount equal to the least of (1) the "gain amount," (2) the "disconformity amount," or (3) the "positive investment adjustment amount." For this purpose, the gain amount is the sum of all gains (net of directly related expenses) recognized on asset dispositions of the subsidiary that are allocable to the share while the subsidiary is a member of the group. The disconformity amount is the excess, if any, of the share's basis over the share's proportionate interest in the subsidiary's "net asset basis." The positive investment adjustment amount is the excess, if any, of the sum of the positive adjustments made to the share under § 1.1502-32 over the sum of the negative adjustments made to the share under § 1.1502-32, excluding adjustments for distributions under § 1.1502-32(b)(2)(iv).

**b. Regulations are now final.** T.D. 9187, Loss Limitation Rules, 70 F.R. 10319 (3/3/05). These final regulations under §§ 337(d) and 1502 follow the rules described in Notice 2004-58.

## **F. Reorganizations**

**1. COI and COBE are not required for E and F reorganizations.** REG-106889-04, Reorganizations Under Section 368(a)(1)(E) or (F), 69 F.R. 49836 (8/12/04). These proposed regulations would amend Reg. § 1.368-1(b) to provide that a continuity of interest and a continuity of business enterprise are not required for a transaction to qualify as a reorganization under § 368(a)(1)(E) [recapitalization] or (F) [mere change in form]. They also provide comprehensive definitions of E and F reorganizations.

**a. Now final.** T.D. 9182, Reorganizations Under Section 368(a)(1)(E) and Section 368(a)(1)(F), 70 F.R. 9219 (2/25/05). These final regulations promulgated Reg. § 1.368-2(m), comprehensively dealing with the definition of a reorganization under § 368(a)(1)(F). These regulations had been issued in identical proposed form in 2004.

**2. Net value requirement in reorganizations.** See V.I.C., above.

**3. Sale vs. reorganization?** Tribune Company v. Commissioner, 125 T.C. 110 (9/27/05), *as amended*, (10/13/05). In this attempted reverse triangular merger, taxpayer's predecessor, the Times Mirror Co. ("TM") wanted to divest its low-basis Matthew Bender subsidiary ("MB"). TM was represented by E&Y, Gibson, Dunn & Crutcher, and Goldman Sachs. Reed Elsevier ("Reed") was interested in acquiring MB and was willing to pay \$1.375 billion to make the acquisition. Reed was represented by Price Waterhouse. In the transaction, Reed subsidiaries organized a special-purpose corporation, MB Parent, and held relatively low value, nonparticipating preferred stock with 80 percent control. MB Parent, in turn owns preferred stock and nonvoting common stock in an acquisition subsidiary that will merge with MB, as well as a nonvoting interest in a single member LLC that holds the \$1.375 billion of cash. As a result of the merger of MB into the acquisition subsidiary, TM will own all the common stock and the remaining 20 percent voting power of MB Parent. Even though, TM will not have voting control over MB Parent, it will control the LLC by virtue of being the sole (nonequity) manager of the LLC.

• The plan was for the merger of MB into the acquisition subsidiary in exchange for MB Parent common and

preferred stock to qualify as a tax free reverse subsidiary merger, even though the stock received does not carry with it voting control. At some later date, by mutual agreement, the MB and MB Parent preferred stock could be redeemed at face value and the nonvoting common could be redeemed at a formula price, which would leave Reed as the sole owner of MB and TM as the sole owner of MB Parent, with the ability to liquidate MB Parent and the LLC without a tax cost.

- The Tax Court (Judge Cohen) held that TM received both common stock in MB Parent and the management authority over the LLC, which had to be valued separately. Inasmuch as the MB Parent common stock lacked control over any assets, it was worth far less than \$1.1 billion [80 percent of \$1.375 billion], and the transaction failed to qualify as a reorganization under § 368(a)(2)(E). Moreover, it did not qualify as a “B” reorganization because TM received consideration other than stock, i.e., the management authority over the LLC. Judge Cohen based her conclusion on the facts that TM intended a sale and that MB Parent serves no purpose and performs no function apart from TM’s attempt to secure the desired tax consequences.

**4. When to measure the value of consideration to determine whether continuity of interest exists.** T.D. 9225, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest, 70 F.R. 54631 (9/16/05), *corrected by*, 70 F.R. 60132-02. As amended, Reg. § 1.368-1(e)(2) provides that if the consideration to be provided to the target corporation shareholders is fixed in the binding contract and includes only stock of the issuing corporation and money, the determination of whether the continuity of interest requirement is satisfied is based on the value of the consideration to be exchanged for the proprietary interests in the target corporation as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization. The number of shares of stock of the acquiring corporation that will be exchanged for stock of the target corporation generally is fixed by agreement at a time significantly in advance of the actual closing of the transaction. The regulation is intended to eliminate uncertainty where the target corporation shareholders receive cash (or debt instruments) in addition to acquiring corporation stock and, at the time the transaction is agreed upon, the amount of the boot equals the value of the agreed upon number of shares of the acquiring corporation stock to be received. Otherwise, the transaction might fail to satisfy the continuity of interest requirement if the value of the acquiring corporation’s stock declined between the date the parties agreed to the terms of the transaction (the signing date) and the date the transaction closed if the quantitative aspect of the continuity of interest requirement were tested on the closing date rather than the signing date.

- Under Reg. § 1.368-1(e)(2)(iii), a contract that provides for either the percentage of the number of shares of each class of target corporation stock, or the percentage by value of the target corporation shares, to be exchanged for issuing corporation stock should be treated as providing for fixed consideration, as long as the target corporation shares to be exchanged for issuing corporation stock and the target corporation shares to be exchanged for consideration other than issuing corporation stock each represents an economically reasonable exchange. A condition outside the control of the parties does not prevent an instrument from being a binding contract. Examples of a condition outside the control of the parties include the completion of a tender offer being subject to a shareholder vote or the target corporation's shareholders tendering a sufficient amount of target stock. Reg. § 1.368-1(e)(2)(iii)(B)(2) provides that if the target corporation's shareholders may elect to receive either stock or money and the maximum amount of money that the target shareholders might receive can be determined, continuity of interest will be tested by assuming that the minimum number of shares will be issued and the maximum amount of money will be received, without regard to the number of shares and amount of money actually exchanged for the target corporation stock. Reg. § 1.368-1(e)(2)(iii)(C)(2) provides that stock that is escrowed to secure customary pre-closing covenants and representations or customary target warranties is not treated as contingent consideration, which would render the safe harbor unavailable. However, escrowed consideration that is forfeited is not taken into account in determining whether the continuity of interest requirement has been met. Reg. § 1.368-1(e)(2)(v), Ex. 2.

- The regulations include an example that lowers the administratively sanctioned threshold for adequate quantitative continuity of interest to 40 percent. Reg. § 1.368-1(e)(2)(v), Ex. (1). Conversely, Reg. § 1.368-1(e)(2)(v), Ex. (2), indicates that stock consideration of 25 percent is insufficient.

- The number of shares of stock of the acquiring corporation that will be exchanged for stock of the target corporation generally is fixed by agreement at a time significantly in advance of the actual closing of the transaction. Suppose that in a statutory merger the target corporation shareholders receive cash (or debt instruments) in addition to acquiring corporation stock and, at the time the transaction is agreed upon, the amount of the boot equals the value of the agreed upon number of shares of the acquiring corporation stock to be received. The transaction might fail to satisfy the continuity of interest requirement if the value of the acquiring corporation's stock declined between the date the parties agreed to the terms of the transaction (the signing date) and the date the transaction closed if the quantitative aspect of the continuity of interest requirement were tested on the closing date rather than the signing date. Prop. Reg. § 1.368-1(e)(2) (2004) would eliminate this uncertainty by providing that the determination of whether the continuity of interest requirement is satisfied is based on the value of the consideration to be

exchanged for the proprietary interests in the target corporation as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization, if the consideration to be provided to the target corporation shareholders is fixed in such contract and includes only stock of the issuing corporation and money. A condition outside the control of the parties would not prevent an instrument from being a binding contract. Examples of a condition outside the control of the parties include the completion of a tender offer being subject to a shareholder vote or the target corporation's shareholders tendering a sufficient amount of target stock. If the target corporation's shareholders may elect to receive either stock or money and the maximum amount of money that the target shareholders might receive can be determined, continuity of interest will be tested by assuming that the minimum number of shares will be issued and the maximum amount of money will be received, without regard to the number of shares and amount of money actually exchanged for the target corporation stock.

**5. Merging tax somethings into tax nothings is OK, but not the opposite!** T.D. 9038, Statutory Mergers and Consolidations, 68 F.R. 3384 (1/24/03), and REG-126485-01, Statutory Mergers and Consolidations, 68 F.R. 3477 (1/24/03). In REG-126485-01, Statutory Mergers and Consolidations, 66 F.R. 57400 (11/15/01), the Treasury withdrew the proposed regulations [REG-106186-98, Certain Corporate Reorganizations Involving Disregarded Entities, 65 FR 31115 (5/16/00)] that would have provided that neither the merger of a disregarded entity into a corporation nor the merger of a target corporation into a disregarded entity was a statutory merger qualifying as a reorganization under § 368(a)(1)(A), and proposed more liberal regulations [Prop. Reg. § 1.368-2(b)(1)]. Under the 2001 proposed regulations, a merger of a corporation into a disregarded entity that is wholly owned by another corporation could qualify as a type (A) merger. The Treasury Department has now promulgated the 2001 proposed regulations, with some modifications, as Temp. Reg. § 1.368-2T(b) and simultaneously published new identical proposed regulations.

- The main point of the regulations is that the merger of a target corporation into an LLC wholly owned by another corporation (thereby rendering the LLC a disregarded entity) can qualify as a type (A) reorganization [and under more complex structures as a triangular reorganization; that the merger of a corporation into a Q-Sub [also a disregarded entity] can qualify as a type (A) reorganization; and that a merger into a qualified REIT subsidiary can qualify as a type (A) reorganization.

- Nevertheless, the new regulations introduce significant definitional jargon. The term "disregarded entity" means a business entity (as defined in Reg. § 301.7701-2(a)) that is disregarded as an entity separate from its owner for federal tax purposes, including single member corporate-owned LLCs, qualified REIT subsidiaries, and Q-Subs. "Combining



entity” means a corporation [as defined in Reg. § 301.7701-2(b)] that is not a disregarded entity. “Combining unit” means a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for federal tax purposes. Under the proposed regulations, a statutory merger or consolidation under § 368(a)(1)(A) must be effected pursuant to the laws of the United States, a state or the District of Columbia. [Foreign statutory mergers still do not qualify, but the domestic statute no longer needs to be a “corporate” law.] All of the following events must occur simultaneously: (1) all of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharged in the transaction) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and (2) the combining entity of each transferor unit ceases its separate legal existence [although its formal existence can continue under state law for certain limited purposes that are not inconsistent with the “all of the assets” requirement.]. The examples provide all of the details of the rules: Divisive mergers [see Rev. Rul. 2000-5, 2000-1 C.B. 436] cannot qualify (Ex. 1); forward triangular mergers (into a disregarded entity owned by a subsidiary) are allowed (Ex. 2 & 4); the merger of a target S corporation that owns a Q-Sub into a disregarded entity owned by a C corporation qualifies as to both the target S corporation and its Q-sub (Ex. 3); the owner of the disregarded entity must be a corporation (Ex. 5); mergers of disregarded entities into corporations do not qualify (Ex. 6); none of the consideration received by the target shareholders may be interests in the disregarded entity (Ex. 7); and the target can be tailored by selling assets and distributing proceeds, as long as all of the remaining assets are transferred to the disregarded entity in the merger (Ex. 8).

a. T.D. 9242, Statutory Mergers and Consolidations, 71 F.R. 4259 (1/26/06). These final regulations adopt proposed regulations (REG-117969-00) issued in 2005 based upon temporary regulations (T.D. 9038) issued in 2003. The final regulations replace the requirement in Reg. § 1.368-2(b)(1) that a merger or consolidation under § 368(a)(1)(A) be effected under the laws of a state, etc. with more general language that qualifies transactions “effected pursuant to the statute or statutes necessary to effect the merger or consolidation.” Mergers involving disregarded entities qualify if all the assets and liabilities of the target are transferred to the acquirer and the target ceases to exist.

## G. Corporate Divisions

1. **The wrath of *General Utilities* repeal rewritten.** REG-107566-00, Guidance under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities In Connection with an

Acquisition, 66 F.R. 67 (1/2/01). The Treasury revised Prop. Reg. § 1.355-7 and withdrew proposed regulations (66 F.R. 76) issued in REG-116733-98 (64 F.R. 46155, 8/24/99). The proposed regulations provided that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. They included nonexclusive lists of facts and circumstances to be considered in making the determination and six safe harbors.

**a. And apparently the government thinks it did a better job on the regulations the second – or is this the third? – time around.** T.D. 8960, Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection With an Acquisition, 66 F.R. 40590 (8/3/01). The Treasury has promulgated temporary regulations identical to the Proposed Regulations, except that the temporary regulations reserve § 1.355-7(e)(6) (suspending the running of any time period during which there is a substantial diminution of risk of loss under the principles of § 355(d)(6)(B)) and Example 7 of the Proposed Regulations (interpreting the term “similar acquisition” in the context of a situation involving multiple acquisitions).

**b. The third (fourth?) time’s the charm.** T.D. 8988, 67 F.R. 20632 (4/26/02) (temporary regulations), and REG-163892-01, Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection an Acquisition, 67 F.R. 20711 (4/26/02) (proposed regulations). These regulations amend Temp. Reg. § 1.355-7T and identical Prop. Reg. § 1.355-7, and set forth new guidelines in the anti-*Morris Trust regulations*. The 2002 temporary and proposed regulations disregard the presumption of § 355(e)(2)(B) and provide that “whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances.” However, Temp. Reg. § 1.355-7T(b)(2) provides a “super-safe harbor” for an acquisition not involving a public offering that occurs within two years following the date of a distribution – the distribution and acquisition “can be treated as part of a plan *only* if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the 2-year period ending on the date of the distribution.” [italics added].

**c. Is the fifth time the charm?** T.D. 9198, Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection With an Acquisition, 70 F.R. 20279 (4/19/05). Final anti-*Morris Trust regulations under § 355(e)*.

- A perceived need for certainty has spawned complicated regulations providing guidance for identifying the

presence of the prohibited plan. These regulations disregard the presumption of § 355(e)(2)(B) and provide that “whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances.” Reg. § 1.355-7(b)(1). In the case of an acquisition not involving a public offering that occurs within two years following the date of a distribution, the distribution and acquisition “can be part of a plan *only* if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the two-year period ending on the date of the distribution.” Reg. § 1.355-7(b)(2) (*italics added*). The “super safe harbor” implicit in this rule trumps all other facts and circumstances. The regulations add that the existence of an agreement, understanding, arrangement, or substantial negotiations during the two-year period tends to show that the distribution and acquisition are part of a plan, and further describe such an understanding, etc., as merely a factor among the facts and circumstances to be evaluated. See Reg. § 1.355-7(b)(3)(i). Discussions with an investment banker regarding the acquisition are listed as a second factor indicating the existence of a plan. Treas. Reg. § 1.355-7(b)(3)(ii). The regulations add that in the case of an acquisition involving a public offering after the distribution, the absence of discussions with an investment banker within the two-year period ending on the date of the distribution is a factor indicating the absence of a plan. Reg. § 1.355-7(b)(4)(i)

- Whether there is an agreement, understanding, or arrangement also is a question of facts and circumstances. Reg. § 1.355-7(h)(1). A binding agreement is not required, but an agreement, understanding, or arrangement “clearly exists if a binding contract to acquire stock exists.” Also, an agreement may exist even though the parties have not reached agreement on all significant economic terms. “Substantial negotiations” are said to “require discussions of significant economic terms . . . by one or more officers or directors acting on behalf of [the corporation’s] . . . controlling shareholders” or “another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders.” Reg. § 1.355-7(h)(1)(iv). A controlling shareholder is a five percent shareholder who actively participates in the management or operation of the corporation. Treas. Reg. § 1.355-7(h)(3)(i). In the case of an acquisition involving a public offering, the existence of an agreement, etc., depends on discussions with investment bankers by one or more officers, directors, or controlling shareholders of either the distributing or controlled corporations. Treas. Reg. § 1.355-7(h)(1)(vi).

- Under Reg. § 1.355-7(e), the acquisition of stock pursuant to an option will result in the option agreement being treated as an agreement to acquire the stock as of the date the option was written, transferred, or modified if the option is more likely than not to be exercised as of such date.

- In the case of an acquisition that follows the distribution, the existence of a plan is indicated if within the two-year period preceding the distribution there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition. Reg. § 1.355-7(b)(3)(i). If the acquisition involves a public offering after the distribution, the presence of discussions during the two-year period preceding the distribution with an investment banker regarding a distribution is a factor indicating the existence of a plan. Reg. § 1.355-7(b)(3)(ii).

- In the case of an acquisition that precedes the distribution, the existence of a plan is indicated by discussions within the two-year period preceding the acquisition by either the controlled or distributing corporation with the acquirer regarding a distribution. Reg. § 1.355-7(b)(3)(iii). The absence of discussions regarding a distribution during the two-year period ending on the earlier to occur of (a) the acquisition, or (b) the first public announcement regarding the distribution, is a factor indicating that the acquisition and distribution were not part of a plan. Reg. § 1.355-7(b)(4)(iii). If the acquisition involves a public offering before the distribution, the presence of discussions during the two-year period preceding the acquisition with an investment banker regarding a distribution is a factor indicating the existence of a plan. Reg. § 1.355-7(b)(3)(iv). A change in the market or business conditions after the acquisition that results in a distribution that was otherwise unexpected is a factor that indicates that the acquisition and distribution are not part of a plan. Reg. § 1.355-7(b)(4)(iv).

- In the case of a distribution either before or after the acquisition, the regulations provide that the existence of a corporate business purpose, as defined in Reg. § 1.355-2(b), other than a business purpose to facilitate the acquisition, is a factor indicating the absence of a plan. Reg. § 1.355-7(b)(4)(v). Internal discussions and discussions with outside advisors, with officers and directors of either the distributing or controlled corporations, provide an indication of a business purpose for the distribution. Reg. § 1.355-7(c)(1). Similarly, the absence of a plan is indicated if the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition. Reg. § 1.355-7(b)(4)(vi). Reg. § 1.355-7(c)(2) provides that discussions with the acquirer regarding a distribution to decrease the likelihood of an acquisition of either the distributing or controlled corporation by separating it from the corporation that is likely to be acquired will be treated as having a business purpose to facilitate acquisition of the corporation that is likely to be acquired. Nonetheless, a distribution that facilitated trading in the stock of the distributing or controlled corporation will not be taken into account in determining whether a distribution and acquisition are part of a plan. Reg. § 1.355-7(c)(3).

- Reg. § 1.355-7(d) provides nine safe harbors from the stormy seas of prohibited plans.

## H. Miscellaneous Corporate Issues

1. **The sale of shares by a taxpayer to his brother in a closely held corporation claiming a net operating loss deduction resulted in a § 382 change of control that triggered the limitation on NOL carryovers.** Garber Industries Holding Co. v. Commissioner, 124 T.C. 1 (1/25/05). The Tax Court (Judge Halpern) held that the family aggregation rule of § 382(1)(3)(A)(i) applies solely from the perspective of individuals who are shareholders (as determined under the attribution rules of § 382(1)(3)(A)) of the loss corporation. Thus, the sale of stock from one sibling to another that resulted in a more than 50 percent increase in stock ownership by the purchasing sibling triggered the application of § 382. The fact that each sibling and either of their parents would be viewed as a single shareholder did not result in the siblings being treated as a single shareholder where neither of their parents was a shareholder. The court recognized the possibility that the rule it announced might result in arbitrary distinctions between cases in which a parent of the siblings also was a shareholder and cases in which the parent was not a shareholder, but concluded that the announced rule was the one most compatible with the statutory language and legislative history.

- One of the Garber brothers (Charles) had his interest in the corporation decreased from 68 percent to 19 percent and the other brother (Kenneth) had his interest increased from 26 percent to 65 percent in a 1986 “D” reorganization. In 1988, Kenneth sold all of his remaining shares to Charles, with the result that Charles’s interest in the corporation increased from 19 percent to 84 percent. The parents of Charles and Kenneth were both deceased and, when living, never had any ownership interest in the corporation.

- The court refused to follow taxpayers’ argument that siblings are treated as one individual under the NOL aggregation rule, which provides that an individual and all members of his family described in § 318(a)(1), i.e., spouses, children, grandchildren and parents, are treated as one individual.

- Judge Halpern also refused to follow the Commissioner’s argument that the family aggregation rule does not apply because none of the parents and grandparents of the Garber brothers were alive at the beginning of the three-year testing period immediately preceding the 1998 transaction. Instead, he concluded that a third interpretation was correct, i.e., that the family aggregation rule of § 382(1)(3)(A)(i) applies from the perspective of individuals who are shareholders of the loss corporation (as determined under the attribution rules of § 382(1)(3)(A)), and that the brothers were unrelated under this perspective. Judge Halpern held that the family aggregation rule of § 382(1)(3)(A)(i) applies solely from the perspective of individuals who are shareholders (as determined under the attribution rules of § 382(1)(3)(A)) of the

loss corporation. Thus, the sale of stock from one sibling to another that resulted in a more than 50 percent increase in stock ownership by the purchasing sibling triggered the application of § 382. The fact that each sibling and either of their parents would be viewed as a single shareholder did not result in the siblings being treated as a single shareholder where neither of their parents was a shareholder. The court recognized the possibility that the rule it announced might result in arbitrary distinctions between cases in which a parent of the siblings also was a shareholder and cases in which the parent was not a shareholder, but concluded that the announced rule was the one most compatible with the statutory language and legislative history.

**a. Affirmed by the Fifth Circuit.** 435 F.3d 555 (5th Cir. 1/9/06). The Court held that the Tax Court properly interpreted § 382 as applied to a sale of stock between two shareholder brothers when no parent or grandparent was a shareholder of the loss corporation because § 382 incorporates the limited family description from § 318 limits the relatives of a shareholder to spouse, parents, children and grandchildren.

## VII. PARTNERSHIPS

### A. Formation and Taxable Years

There were no significant developments regarding this topic during 2005.

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

**1. REG-128767-04, Treatment of Disregarded Entities** Under Section 752, 69 F.R. 49832 (8/12/04). These proposed regulations provide that in determining the extent to which a partner bears the economic risk of loss for a partnership liability, payment obligations of a disregarded entity are taken into account only to the extent of the net value of the disregarded entity except where the owner of the disregarded entity is otherwise required to make a payment with respect to the obligation of the disregarded entity.

- In recent years an increasing number of partnership interests have been held through limited liability companies (LLCs) that are treated as disregarded entities under Reg. § 301.7701-1 through Reg. § 301.7701-3. In such a situation, even though the limited liability company has an obligation to restore a negative capital account, the owner of the limited liability company, who is treated as the partner, has no such obligation under state partnership law. Because only the LLC's assets will be available to satisfy its payment obligations as a partner, the owner should be

treated as bearing the economic risk of loss for a partnership liability as a result of those payment obligations only to the extent of the net value of the disregarded entity's assets. This result can be reached through a careful reading and application of the current regulations, but Prop. Reg. § 1.752-2(k) clarifies this treatment by providing that in determining the extent to which a partner bears the economic risk of loss for a partnership liability under Reg. § 1.752-2, payment obligations of a disregarded entity are taken into account only to the extent of the net value of the disregarded entity (assets, including the disregarded entity's enforceable rights to contributions from its owner, but excluding the disregarded entity's interest in the partnership and the fair market value of property pledged to secure a partnership liability, minus the disregarded entity's liabilities), except to the extent the owner of the disregarded entity is otherwise required to make a payment with respect to the disregarded entity's obligation.

**2. Defining the term "liability" in § 752 and fighting duplication and acceleration of losses through partnerships.** REG-106736-00, Assumption of Partner Liabilities, 68 F.R. 37434 (6/24/03). The Treasury has proposed extraordinarily complex, verging on incomprehensible, regulations: (1) defining liabilities under § 752; (2) dealing with a partnership's assumption of certain fixed and contingent obligations in exchange for a partnership interest [Prop. Reg. § 1.752-7]; and (3) providing rules under § 358(h) for assumptions of liabilities by corporations from partners and partnerships [Prop. Reg. § 1.358-7]. Reg. § 1.752-1(a)(1)(i) would be amended to include the principles of Rev. Rul. 88-77, 1988-2 C.B. 128; an obligation is a liability to the extent that incurring the obligation: (1) creates or increases the basis of any of the obligor's assets (including cash); (2) gives rise to an immediate deduction; or (3) gives rise to an expense that is not deductible in computing taxable income and is not properly chargeable to capital. Prop. Reg. § 1.752-7 deals with the assumption by a partnership of a partner's fixed or contingent obligation to make payment that is not one of the three types described in Reg. § 1.752-1(a)(1)(i) [including accrual method liabilities the deduction for which was deferred under § 453(h)]. Unlike Temp. Reg. § 1.752-6T, the proposed regulations do not reduce the partner's outside basis when the partnership assumes a § 1.752-7 liability. If the partnership satisfies the liability while the partner remains in the partnership, the deduction with respect to the built-in loss associated with the § 1.752-7 liability is allocated to the partner, reducing that partner's outside basis. Alternatively, if one of three events occurs that separate the partner from the partnership, then the partner's outside basis is reduced immediately before the occurrence of the event. The events are: (1) a disposition (or partial disposition) of the partnership interest by the partner, (2) a liquidation of the partner's partnership interest, and (3) the assumption (or partial assumption) of the liability by another partner.

The basis reduction generally is the lesser of (1) the excess of the partner's basis in the partnership interest over the adjusted value of the interest, or (2) the remaining built-in loss associated with the liability. (In the event of a partial disposition, the reduction is pro rated.) Thereafter, to the extent of the remaining built-in loss associated with the liability, the partnership (or the assuming partner) is not entitled to any deduction or capital expense upon satisfaction (or economic performance) of the liability, but if the partnership notifies the partner, the partner is entitled to a loss or deduction. If another partner assumed the liability, the partnership must immediately reduce the basis of its assets by the built-in loss, and upon satisfaction, the assuming partner must make certain basis adjustments to his partnership interest. There are exceptions for (1) transfer of the trade or business with which the liability is associated is transferred to the partnership, and (2) *de minimis* transactions (liabilities less than 10 percent of the partnership's assets or \$1,000,000). Unlike under the temporary regulations, there is no exception for transactions in which substantially all of the assets with which the liability is associated are contributed to the partnership. When finalized, the regulations will be effective for transactions occurring after 6/24/03.

**a. Finally, final regulations.** T.D. 9207, Assumption of Partner Liabilities, 70 F.R. 30334 (5/26/05). Final and temporary regulations provide new rules dealing with a partnership's assumption of certain fixed and contingent obligations in connection with the issuance of a partnership interest. The regulations also provide rules under § 358(h) for assumptions of liabilities by corporations from partners and partnerships. There are also temporary regulations that provide additional rules under § 358(h) for assumptions of liabilities in pre-6/24/03 exchanges.

- The regulations ensure that tax losses cannot be duplicated or accelerated by transferring contingent obligations to partnerships.

- They also make final temporary regulations that address the "Son-of-Boss" tax shelter, § 1.752-6T [which were effective 10/19/99]; these provide that the exception contained in § 358(h)(2)(B) [where substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange] do not apply to transactions described in Notice 2000-44, 2000-2 C.B. 255.

(1) REG-106736-00, Assumption of Liabilities, 70 F.R. 30380 (5/26/05). Proposed regulations that are identical to the temporary regulations contained in T.D. 9207.

3. REG-144620-04, Partner's Distributive Share, 70 F.R. 69919 (11/18/05). The IRS published proposed regulations that *inter alia* provide rules for testing the substantiality of a § 704(b) allocation where



the partners are look-through entities or members of a consolidated group and revise the existing rules for determining the partners' interests in a partnership. They provide that the interaction of a partnership allocation with the tax attributes of owners of look-through entities must be taken into account when testing the substantiality of the allocation to a partner that is a look-through entity, and, similarly, tax attributes of a consolidated group must be taken into account with respect to the allocation to a partner that is a member of the consolidated group.

4. Burke v. Commissioner, T.C. Memo. 2005-297 (12/27/05). A partner is taxable on his share of partnership income even though he did not receive any of it. Judge Wells stated:

Petitioner argues, however, that the existence of a real controversy between petitioner and Mr. Cohen rendered the amount of his distributive share indefinite and that the partnership receipts in escrow are "frozen" and therefore unavailable to petitioner. Petitioner cites section 703(a) for the proposition that the taxable income of a partnership is computed in the same manner as that of an individual and cites several cases to support his argument that his dispute with his former partner postpones the inclusion of his distributive share because he does not have a claim of right to the income. . . .

The income was earned by the partnership during 1998, and there was nothing conditional or contingent about its receipt. Petitioner, therefore, was taxable on his distributive share of the partnership's profits for 1998, even though he did not receive it. See *First Mechs. Bank v. Commissioner*, 91 F.2d at 279. It is irrelevant that petitioner still may not know the full extent of the partnership income because of the deposits stolen by his partner, Mr. Cohen; the nonappearance of the deposits on the partnership books is not determinative. . . . A partner is taxable on his distributive share of partnership income when realized by the partnership despite a dispute among the partners as to their respective distributive shares. .

..

Petitioner does not dispute the facts pertinent to the calculation of his distributive share of the partnership's income for the year in issue. Rather, petitioner argues that the deposits to the partnership's account for that year are not income to him as a matter of law. As we discussed above, a

partner must include his distributive share of partnership income whether or not it is distributed to him. Accordingly, we conclude that respondent is entitled to summary judgment on the issue of the calculation of petitioner's distributive share.

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

**1. Section 833 of the Jobs Act of 2004 amends §§ 704(c), 734 and 743.**

**a. Section 734(b) and § 743(b) basis adjustments will be mandatory with respect to built-in losses or adjustments that exceed \$250,000 at the partnership level. Such adjustments under §§ 734 and 743 had been heretofore optional, and need not have been made in the absence of a § 754 election. Section 734(b) and § 743(b) basis adjustments remain elective if the aggregate reduction to the partnership's basis would not exceed \$250,000 or if the adjustment would increase the aggregate basis of the partnership's assets. The purpose of this amendment is to prevent the duplication of losses in a manner that allows a partner to recognize for tax purposes a loss that was not realized economically.**

- **The amendment to § 743 requires adjustments under § 743(b) to the basis of the partnership's assets whenever the aggregate basis of the partnership's assets exceeds the aggregate fair market value of the partnership's assets by more than \$250,000. Section 743(b) basis adjustments remain elective if the aggregate reduction to the partnership's basis would not exceed \$250,000 or if the adjustment would increase the aggregate basis of the partnership's assets.**

- **A special rule for certain "electing investment partnerships" permits the partnership to avoid making the basis adjustment but limits the transferee partner's distributive share of any losses with respect to partnership property to the amount that exceeds the loss recognized by the transferor partner from whom the partnership interest was purchased. IRC § 743(e). The definition of a qualifying "electing investment partnership" in § 743(e)(6) is very restrictive and narrowly limits the application of the special rule. The election is made at the partnership level. See Notice 2005-32, 2005-16 I.R.B. 895 (4/1/05). The election requires outside basis adjustments to be made. This special rule for certain "electing investment partnerships" permits the partnership to avoid making the basis adjustment but limits the transferee partner's distributive share of any losses with respect to partnership property to the amount that exceeds the loss recognized by the transferor partner from whom the partnership interest was purchased. § 743(e). Section 743(f) provides an exception for "securitization partnerships."**

- The amendment to § 734 requires adjustments under § 734(b) to the basis of the partnership's assets whenever an aggregate basis reduction in excess of \$250,000 results. Section 734(b) basis adjustments remain elective if the aggregate reduction to the partnership's basis would not exceed \$250,000 or if the adjustment would result in a basis increase. Section 734(e) provides an exception for certain "securitization partnerships" as defined in § 743(f).

(1) Notice 2005-32, 2005-16 I.R.B. 895 (4/1/05). This Notice provides interim procedures for partnerships and their partners to comply with changes to the mandatory basis provisions of §§ 734 and 743 (with a couple of examples of a transfer of a partnership interest and a distribution of partnership property). The bulk of the Notice relates to the interim procedures to be followed for "electing investment partnerships" and their partners.

b. Section 704(c)(1)(C), provides that built-in losses are personal to the partner who contributed the loss property. If the contributing partner ceases to be a partner before the loss is realized, as far as the remaining partners are concerned the basis of the property is treated as being equal to its fair market value at the time of the contribution. This provision is intended to prevent the transfer of built-in tax losses from one partner (a low tax bracket, tax exempt, or foreign person) to another partner. Although the statute is silent on the point, if the property is depreciable (or amortizable) in the hands of the partnership that fair-market-value-at-date-of-contribution basis presumably must be adjusted for prior depreciation (or amortization) claimed by the partnership.

- There is no time limit on the application of § 704(c)(1)(C). Assume, for example, that A, B, and C formed the ABC Partnership with A and B each contributing cash of \$1,000 and C contributing property with a basis of \$7,000 and a fair market value of \$1,000. The \$6,000 built-in loss with respect to the property contributed by C can be allocated only to C. Assume further that eight years later C withdraws from the partnership, in which A and B continue as equal partners, and the next year the AB partnership sells the property contributed by C for any price between \$1,000 and \$7,000. The partnership does not recognize any loss. If, alternatively, the partnership sold the property for \$700, the partnership would recognize a \$300 loss and A and B each would be allocated a \$150 loss. Note that § 704(c)(1)(C) creates an asymmetrical basis rule. If the property were sold for more than \$7,000, the partnership's gain always would be computed with respect to the \$7,000 § 723 transferred basis. Section 704(c)(1)(C) would operate similarly if instead of C withdrawing from the partnership, which was continued by A and B, C sold the partnership interest to D. In the case of a transferred partnership

interest, the transferee partner does not “step into the shoes” of the transferor with respect to the § 704(c) built-in loss. The built-in loss is again eliminated.

- Note that this is the transaction involved in the *Long-Term Capital Holdings* case, as well as the *Santa Monica Pictures LLC* case.

**2. Section 83 rules prevail on transfers of partnership interests for services.** REG-105346-03, Partnership Equity for Services, 70 F.R. 29675 (5/24/05). Prop. Reg. § 1.83-3(e) and (l) and § 1.721-1(b) will apply § 83 to all partnership interests, without distinguishing between partnership capital interests and partnership profits interests, when the proposed regulations are finalized. These proposed regulations would conform the subchapter K rules to the § 83 timing rules, revise the § 704(b) regulations to take into account the possibility that allocations with respect to an unvested interest may be forfeited, and provide that a partnership generally recognizes no gain or loss on the transfer of an interest in the partnership in connection with the performance of services for that partnership.

- Under Prop. Reg. § 1.704-1(b)(2)(iv)(b)(1), the service provider’s capital account is increased by the amount the service provider takes into income under § 83 as a result of receiving the interest, plus any amounts paid for the interest. Under § 83, the economic benefit of receiving a partnership interest in connection with the performance of services is the amount that is included in the compensation income of the service provider, plus the amount paid for the interest. This is the amount by which the service partner’s capital account should be increased.

- Section 706(d)(1) provides generally that, if, during any taxable year of a partnership, there is a change in any partner’s interest in the partnership, each partner’s distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by regulations, which takes into account the varying interests of the partners in the partnership during the taxable year. This ensures that partnership deductions that are attributable to the portion of the partnership’s taxable year prior to a new partner’s entry into the partnership are allocated to the historic partners.

- Section 83(b) allows a person who receives nonvested property in connection with the performance of services to elect to include in gross income the difference between: (1) the fair market value of the property at the time of transfer (determined without regard to a restriction other than a restriction which by its terms will never lapse); and (2) the amount paid for such property. Under § 83(b)(2), the election under § 83(b) must be made within thirty days of the date of the transfer of the property to the service provider. Consistent with the principles of § 83, the proposed regulations provide that, if a partnership interest is transferred in connection with the

performance of services, and if an election under § 83(b) is not made, then the holder of the partnership interest is not treated as a partner until the interest becomes substantially vested. If a § 83(b) election is made with respect to such an interest, the service provider will be treated as a partner. These principles differ from Rev. Proc. 2001-43, 2001-2 C.B. 191, which provides that if a partnership profits interest is transferred in connection with the performance of services, then the holder of the partnership interest may be treated as a partner even if no § 83(b) election is made.

- Prop. Reg. § 1.83-3(I) would also provide a safe harbor under which a partnership interest received as compensation for services could be treated as having a fair market value equal to its liquidation value, which in the case of a profits-only partnership interest is zero. As under Rev. Proc. 93-27, 1993-2 C.B. 343, the safe harbor would not apply in the following three specific situations: (1) the partnership's profits are derived from a substantially certain and predictable stream of income, such as from high quality debt or a net lease; (2) the partner disposes of the partnership interest within two years of its receipt; or (3) the interest is a limited partnership interest in a publicly traded limited partnership as defined in § 7704(b).

- Prop. Reg. §§ 1.83-6(b) and 1.721-1(b)(2) would provide that a partnership does not recognize any gain or loss upon the transfer of a partnership interest to a new partner in exchange for services to the partnership (although the proposed regulations do preserve the recognition result in *McDougal v. Commissioner*, 62 T.C. 720 (1974), if the transfer of property in exchange for services creates a partnership). In *McDougal*, the property transferred was half of a horse.

- As a practical matter, upon admission of a partner it generally is necessary to revalue the partnership's property and adjust the partners' capital accounts to reflect the revaluation. Reg. § 1.704-1(b)(2)(iv)(f) specifically allows the partnership to revalue its property and adjust the existing partners' capital accounts in connection with the grant of an interest in the partnership (other than a *de minimis* interest) in consideration of services to the partnership by an existing partner acting in a partner capacity or by a new partner acting in a partner capacity or in anticipation of being a partner.

- Forfeitable interests: When a transferred partnership interest is subject to a substantial risk of forfeiture, unless an election is made under § 83(b) the holder of the partnership interest is not treated as a partner until the interest becomes substantially vested. See Reg. § 1.83-1(a)(1). If a § 83(b) election is made with respect to such an interest, the service provider will be treated as a partner, even though the interest remains forfeitable. These rules raise special problems regarding the tax treatment of allocation of items of gain or loss to a partner during the period in which the partner's interest remains forfeitable. If the partner who receives a forfeitable partnership interest in exchange for services does not make a § 83(b) election

with respect to that interest, the partner cannot be allocated any portion of partnership income or loss, and any distributions made to the service provider with respect to the partnership interest are treated as additional compensation and not partnership distributions. But if a service partner who receives a substantially nonvested partnership interest makes a valid § 83(b) election, the service provider is treated as a partner with respect to such an interest, and the partnership must allocate partnership items to the service provider as if the partnership interest were substantially vested. See Notice 2005-43, 2005-24 I.R.B. 1221 (5/20/05).

• Further complications arise if a service provider who has received a forfeitable compensatory partnership interest makes a § 83(b) election, is allocated items of partnership income and loss and subsequently forfeits the partnership interest. Prop. Reg. § 1.704-1(b)(4)(xii) would address these issues. The operation of the proposed regulations is described in the preamble as follows:

If an election under section 83(b) has been made with respect to a substantially nonvested interest, the holder of the nonvested interest may be allocated partnership items that may later be forfeited. For this reason, allocations of partnership items while the interest is substantially nonvested cannot have economic effect. Under the proposed regulations, such allocations will be treated as being in accordance with the partners' interests in the partnership if: (a) the partnership agreement requires that the partnership make forfeiture allocations if the interest for which the section 83(b) election is made is later forfeited; and (b) all material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interests for which a section 83(b) election has been made are recognized under section 704(b). This safe harbor does not apply if, at the time of the section 83(b) election, there is a plan that a substantially nonvested interest will be forfeited. All of the facts and circumstances (including the tax status of the holder of the substantially nonvested interest) will be considered in determining whether there is a plan that the interest will be forfeited. In such a case, the partners' distributive shares of partnership items shall be determined in accordance with the partners' interests in the partnership under [Treas. Reg. §] 1.704-1(b)(3).

Generally, forfeiture allocations are allocations to the service provider of partnership gross income and gain or gross

deduction and loss (to the extent such items are available) that offset prior distributions and allocations of partnership items with respect to the forfeited partnership interest. These rules are designed to ensure that any partnership income (or loss) that was allocated to the service provider prior to the forfeiture is offset by allocations on the forfeiture of the interest. Also, to carry out the prohibition under section 83(b)(1) on deductions with respect to amounts included in income under section 83(b), these rules generally cause a forfeiting partner to be allocated partnership income to offset any distributions to the partner that reduced the partner's basis in the partnership below the amount included in income under section 83(b).

Forfeiture allocations may be made out of the partnership's items for the entire taxable year. In determining the gross income of the partnership in the taxable year of the forfeiture, the rules of [Treas. Reg. §] 1.83-6(c) apply. As a result, the partnership generally will have gross income in the taxable year of the forfeiture equal to the amount of the allowable deduction to the service recipient partnership upon the transfer of the interest as a result of the making of the section 83(b) election, regardless of the fair market value of the partnership's assets at the time of forfeiture.

In certain circumstances, the partnership will not have enough income and gain to fully offset prior allocations of loss to the forfeiting service provider. The proposed revenue procedure includes a rule that requires the recapture of losses taken by the service provider prior to the forfeiture of the interest to the extent that those losses are not recaptured through forfeiture allocations of income and gain to the service provider. This rule does not provide the other partners in the partnership with the opportunity to increase their shares of partnership loss (or reduce their shares of partnership income) for the year of the forfeiture by the amount of loss that was previously allocated to the forfeiting service provider.

In other circumstances, the partnership will not have enough deductions and loss to fully offset prior allocations of income to the forfeiting service provider. It appears that, in such a case, section 83(b)(1) may prohibit the service provider from claiming a loss with respect to partnership

income that was previously allocated to the service provider. However, a forfeiting partner is entitled to a loss for any basis in a partnership that is attributable to contributions of money or property to the partnership (including amounts paid for the interest) remaining after the forfeiture allocations have been made. See [Treas. Reg. §] 1.83-2(a).

**a. Procedures to be followed in order to elect safe harbor treatment.** Notice 2005-43, 2005-24 I.R.B. 1221 (5/20/05). That the notice contains a proposed revenue procedure issued concurrently with these proposed regulations would allow a partnership, all of its partners, and the service provider to elect to treat the fair market value of a partnership interest as equal to the liquidation value of that interest. If such an election is made, the capital account of a service provider receiving a partnership interest in connection with the performance of services is increased by the liquidation value of the partnership interest received. The notice provides additional rules that partnerships, partners, and persons providing services to the partnership in exchange for interests in that partnership would be required to follow when electing under Prop. Reg. § 1.83-3(l) to treat the fair market value of those interests as being equal to the liquidation value of those interests. For this purpose, the liquidation value of a partnership interest is the amount of cash that the holder of that interest would receive with respect to the interest if, immediately after the transfer of the interest, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets, and then liquidated.

- Section 83 generally provides that the recipient of property transferred in connection with the performance of services recognizes income equal to the fair market value of the property, disregarding lapse restrictions. However, some authorities have concluded that, under the particular facts and circumstances of the case, a partnership profits interest had only a speculative value or that the fair market value of a partnership interest should be determined by reference to the liquidation value of that interest. See Reg. § 1.704-1(e)(1)(v); *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991); *St. John v. United States*, 84-1 U.S.T.C. ¶ 9158 (C.D. Ill. 1983). But see *Diamond v. Commissioner*, 492 F.2d 286 (7th Cir. 1974) (holding under pre-section 83 law that the receipt of a profits interest with a determinable value at the time of receipt resulted in immediate taxation); *Campbell v. Commissioner*, T.C. Memo 1990-162 (1990), *aff'd in part and rev'd in part*, 943 F.2d 815 (8th Cir. 1991).

- The proposed revenue procedure provides that when the regulations are finalized, Rev. Proc. 93-27 and Rev. Proc. 2001-43, will be revoked.



- Note: Practitioners should consider inclusion of provisions in partnership agreements that require all partners to consent to safe harbor treatment of partnership interests granted for services.

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

1. **Effect of partnership mergers on gain recognition under §§ 704(c)(1)(B) and 737(b).** Rev. Rul. 2004-43, 2004-18 I.R.B. 842 (4/12/04). This ruling deals with the application of §§ 704(c)(1)(B) and 737(b) in partnership mergers. The ruling holds that § 704(c)(1)(B) applies to newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger, but does not apply to newly created reverse § 704(c) gain or loss resulting from a revaluation of property in the continuing partnership. Similarly, for purposes of § 737(b), net precontribution gain includes newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger, but does not include newly created reverse § 704(c) gain or loss resulting from a revaluation of property in the continuing partnership. Thus, a distribution of property previously held by the disappearing partnership will trigger gain recognition if the distribution occurs within seven years after the merger.

a. **Rev. Rul. 2004-43 is revoked, and forthcoming regulations will be effective for distributions after 1/19/05.** Rev. Rul. 2005-10, 2005-7 I.R.B. 492 (1/19/05), *revoking Rev. Rul. 2004-43, 2004-18 I.R.B. 842.* The IRS revoked Rev. Rul. 2004-43 and announced that it intended to promulgate regulations implementing the principles of Rev. Rul. 2004-43, which will be effective after January 19, 2005.

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

There were no significant developments regarding this topic during 2005.

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

2. **AD Global Fund, LLC v. United States, 67 Fed. Cl. 657 (9/16/05).** Section 6629(a) provides an extended statute of limitations rather than a separate period of limitations; issuance of Final Partnership Administrative Adjustment (FPAA) suspends period of limitations under IRC § 6501(a), *motion to certify appeal granted*, 68 Fed. Cl. 663 (2005).

### G. Miscellaneous

There were no significant developments regarding this topic during 2005.

## VIII. TAX SHELTERS

### A. Tax Shelter Cases

1. **Significant government victory in tax shelter case! Partnership's in-house tax counsel should have taken Nancy Reagan's advice when Don Turlington pitched him a tax planning idea. Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, (D. Conn. 8/27/04).** Judge Janet Bond Arterton poured out taxpayers by holding that the tax shelter transaction [under which preferred stock with an inflated basis was contributed to a partnership in a carryover basis transaction] lacked economic substance (or, in the alternative, that the step transaction doctrine required that it be recast into a direct sale of preferred stocks to taxpayers with the result that the basis was equal to the amount they paid) and by upholding the imposition of (in the alternative) both the 40 percent gross valuation misstatement and the 20 percent substantial understatement penalties. After that introductory statement, the remainder of the 198-page opinion was all downhill for taxpayers and their lawyers.

- The inflated basis was the result of several cross-border lease-stripping transactions which left a foreign entity holding several million dollars worth of preferred stocks at a basis \$385 million greater than value. The lease-stripping transactions were supported by "should" tax opinions issued by Shearman & Sterling when they were entered into.

- Taxpayers' in-house tax counsel became interested in the possible utilization of the losses when approached by Don Turlington, who suggested that the foreign entity contribute the preferred stock to one of taxpayers' related partnerships, after which the foreign entity would have its partnership interest redeemed. King & Spalding agreed to furnish a "should" tax opinion that taxpayers could utilize the foreign entity's losses, but did not actually provide the opinion until almost a year after the partnership filed the return that took the losses.

- Holdings included: (1) the burden of proof did not shift to the government under § 7491 because taxpayers failed to provide a PowerPoint presentation and accompanying handout for a presentation of Myron Scholes to the other eleven of taxpayers' principals and taxpayers' net worth was not unambiguously shown to be under \$7 million; (2) the transaction lacked economic substance because the reasonably expected return on it could not have resulted in a profit (with the court calling into question the credibility of the former King & Spalding lawyer who was the

primary drafter of the opinion); (3) the “end result” variety of the step transaction doctrine – the most liberal of the three varieties – was applied to conclude that taxpayers acquired the preferred stocks by purchase at a fair market value basis; (4) the gross valuation misstatement resulted from the claimed adjusted basis of the preferred stocks being more than 400 percent of the adjusted basis that was found by the court to equal fair market value; (5) the substantial understatement penalty was applied based upon taxpayers’ failure to show any authority that held a transaction devoid of economic substance could produce deductible losses; (6) the § 6664(c) “reasonable cause . . . and . . . good faith” exception did not apply because taxpayers failed to prove that the King & Spalding oral advice provided to it before 4/15/98 [the day it filed the relevant partnership return] satisfied the “reasonable cause” defense because of the vagueness and lack of credibility of testimony as to the content of the oral advice; and (7) the 1/27/99 written King & Spalding opinion did not provide reasonable cause because its facts were unsubstantiated and its legal analysis unsatisfactory in that it failed to discuss Second Circuit cases. Judge Arterton summarized the opinion as follows:

Finally, no other evidence such as companion memoranda discussing the application of the Second Circuit’s decisions in *Goldstein*, *Gilman*, *Grove*, *Blake*, and *Grove*, or the Tenth Circuit’s decision in *Associated* to the actual facts of the [foreign entity] transaction was offered to show research for King & Spalding’s legal analysis and opinions. Such background research does not involve obscure or inaccessible caselaw references, is basic to a sound legal product, especially for “should” level opinion and a premium of \$400,000. With hourly billing totals exceeding \$100,000 there could not have been research time constraints.

In essence, the testimony and evidence offered by Long Term regarding the advice received from King & Spalding amounted to general superficial pronouncements asking the Court to “trust us; we looked into all pertinent facts; we were involved; we researched all applicable authorities; we made no unreasonable assumptions; Long Term gave us all information.” The Court’s role as factfinder is more searching and with specifics, analysis, and explanations in such short supply, the King & Spalding effort is insufficient to carry Long Term’s burden to demonstrate that the legal advice satisfies the threshold requirements of reasonable good faith reliance on advice of counsel.”

- Myron Scholes and Robert Merton, who shared the 1997 Nobel prize in Economics were two of taxpayers' twelve principals. Taxpayers were the component parts of one of the highest-flying hedge funds until it had to be rescued from collapse by fourteen banks [acting at the instigation of the Federal Reserve] providing \$3.65 billion to take the hedge fund over.

- Query about where the substantial authority penalty fits when you have told all to a tax professional and he tells you that you have substantial authority – but the court finds that the underlying facts are different from the facts that both you and the tax professional believe to be true?

- Is there a duty on a client to read and understand a tax opinion beyond checking that the facts upon which the opinion is based are correct?

a. **On the appeal of the imposition of penalties, the Second Circuit affirms. Long-Term Capital Holdings, LP v. United States, 150 Fed. Appx. 40 (2d Cir. 9/27/05) (unpublished).** The court stated that taxpayer was not required to “second-guess the advice of its tax experts” but instead that it did not receive relevant tax advice upon which it relied in reporting the \$106 million loss, and – even if it had received such advice – it could not have relied upon the opinion’s assumptions of (1) valid and substantial business purpose independent of federal income tax considerations, (2) reasonable expectation of a material pre-tax profit, and (3) no preexisting agreement on the part of Onslow Trading Company to sell its partnership interest to the Long-Term Capital Management partnership. The court upheld the 40 percent penalty based upon a basis misstatement [specifically covered by the statute, but different from the typical valuation misstatement to which the penalty has been applied in the past] and held that a misstatement resulting from a legal dispute [as opposed to a factual dispute] was also covered by the penalty and that the 40 percent penalty applied where a transaction is “recast” for tax purposes under the economic substance doctrine.

2. **Significant taxpayer victory when its summary judgment motion was granted; the contingent liability transaction was upheld despite its being a listed transaction under Notice 2001-17. Black & Decker Corp. v. United States, 340 F. Supp. 2d 621 (D. Md. 10/20/04, revised, 10/22/04).** Government appeal pending. Judge Quarles held that the transaction could not be disregarded as a sham because it had economic implications for the parties to the transaction as well as to the beneficiaries of taxpayer’s health plans.

- Under the Fourth Circuit test in *Rice’s Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (1985), a transaction

will be treated as a sham only if the court finds that “the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists.” Taxpayer conceded for purposes of its motion “that tax avoidance was its sole motivation.” The court held that “[a] corporation and its transactions are objectively reasonable, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions.”

- Note how Judge Quarles shifted the second prong of the test from “reasonable possibility of profit” to “bona fide business transaction.”

- The transaction was a listed tax shelter under Notice 2001-17, 2001-9 I.R.B. 730.

- In 1998, Black & Decker sold three of its businesses and realized significant capital gains. That same year, Black & Decker created Black & Decker Healthcare Management Inc. (BDHMI), to which it transferred approximately \$561 million dollars, with BDHMI assuming \$560 million dollars in contingent employee healthcare claims against Black & Decker. Black & Decker then sold the BDHMI stock to a third-party for \$1 million dollars, and claimed a \$560 million loss on the grounds that its basis in the BDHMI stock was \$561 million dollars. The court concluded that §§ 357(c)(3) and 358(d)(2) applied and that Black & Decker’s basis in the BDHMI stock properly was not reduced by the amount of the contingent employee healthcare claims. It rejected the IRS contention that the claims had to be deductible by the transferee (BDHMI), and, based upon the legislative history of § 357(c)(3), concluded that there was no reduction in basis because the contingent claims were liabilities that would have been deductible by the transferor shareholder had it paid the claims.

**a. Government’s summary judgment motion had been denied earlier on a pro-taxpayer rationale. Black & Decker Corp. v. United States, 2004-2 U.S.T.C. ¶ 50,359 (D. Md. 8/3/04).**  
As the facts were stated in the opinion,

In 1998, B & D sold three of its businesses. As a result of these sales, B & D generated significant capital gains. That same year, B & D created Black & Decker Healthcare Management Inc. (“BDHMI”). B & D transferred approximately \$561 million dollars to BDHMI along with \$560 million dollars in contingent employee healthcare claims in exchange for newly issued stock in BDHMI. B & D sold its stock in BDHMI to an independent third-party for \$1 million dollars. Because B & D believed that its basis in the BDHMI stock was \$561 million dollars, the value of the

property it had transferred to BDHMI, B & D claimed approximately \$560 million dollars in capital loss on the sale, which it reported on its 1998 federal tax return. B & D applied a portion of the capital loss to offset its capital gains from selling the three businesses, and carried back and carried forward the remaining capital loss to offset gains in prior and future tax years. (citations omitted)

- The court went on to analyze and conclude that §§ 357(c)(3) and 358(d) applied so the basis of the subsidiary's stock is not reduced by the amount of the contingent employee healthcare claims. It rejected the IRS contention that the claims had to be deductible by the transferee [the subsidiary], and held that (based upon the 1978 legislative history to § 357(c)(3)) the only requirement is that the claims must be deductible by taxpayer [the transferor corporation].

- Section 358(h), added in 2000 and amended in 2002, would preclude this result for assumptions of liability after its 10/18/99 effective date. If the basis of stock received in a § 351 transaction otherwise would exceed its fair market value, § 358(h) requires that the basis of the stock be reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any § 357(c)(3) liability that was assumed by the corporation. For this purpose, "liability" is broadly defined to include "any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of [the income tax]."

**b. Black & Decker in the Fourth Circuit: the holding that basis was not reduced by contingent deductible liabilities was affirmed, but the holding that the transaction did not lack economic substance was reversed and the case was remanded for trial. Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. 2/2/06), *aff'g denial of government's motion for summary judgment at 2004-2 U.S.T.C. ¶ 50,359 (D. Md. 8/3/04)*, *rev'g grant of taxpayer's motion for summary judgment at 340 F. Supp. 2d 621 (D. Md. 10/22/04)*, and *remanding for trial*. Judge Michael's opinion held that the government motion for summary judgment was properly denied because the statute in effect at the time of the transaction permitted taxpayer to do what it did, stating:**

The IRS presses two arguments for why Taxpayer cannot claim the § 357(c)(3) exception. The first argument relies on legislative history. The IRS focuses on sentences such as the first of the two from the Senate Report quoted. It contends that Congress crafted the exception to protect a parent corporation from a tax double whammy when transferring both assets *and* associated liabilities to a subsidiary in

exchange for stock. From this perspective, Congress wanted to prevent such parent corporations from being twice penalized by (1) deprivation of the right to deduct the transferred liabilities as they accrued and (2) mandatory reduction of the stock basis by the amount of the liabilities transferred. Since Taxpayer only transferred the health claims but not the assets generating those claims, the IRS argues that Congress did not intend for Taxpayer to benefit from § 357(c)(3). Further, the IRS reads the quoted phrase “would have given rise to a deduction,” S. Rep. No. 96-498, at 62, to mean a deduction unavailable to the transferor once the liability has been transferred.

The legislative history argument does not persuade us. The prototypical transaction Congress had in mind in drafting § 357(c)(3) may well have been one in which a corporation exchanged liabilities as part of a transfer of an entire trade or business to a controlled subsidiary, but nothing in the section’s plain language embraces such a limitation. As a result we find no ambiguity in the statute that requires us to parse the congressional record and discern what *type* of business transactions Congress originally envisioned in enacting the section. The Senate Report’s use of the phrase “would have given rise” also does not go as far as the IRS would have us take it. On the contrary, we agree with one commentator’s observation that this language “does not imply . . . that Congress silently contemplated a case in which liabilities are transferred but the deduction is retained by the transferor and [then] concluded that § 357(c)(3) should not apply.” Ethan Yale, *Reexamining Black & Decker’s Contingent Liability Tax Shelter*, 108 Tax Notes 223, 234 (July 11, 2005).

The IRS’s second argument is based on sound administration of the tax laws, because the Taxpayer should not be allowed to take the “functional equivalent of a double deduction.” Appellant’s Br. at 59. Although Taxpayer has not claimed the employee health expenses as a deduction (BDHMI, not a party to this suit, claims them instead), the IRS argues that Taxpayer has the legal right to seek these deductions as health care costs accrue. In the IRS’s view, the \$560 million loss that Taxpayer reported effectively accelerates deductions for uncertain future health care costs through the year 2007. Such acceleration would contravene

the prohibition against claiming a deduction in a given tax year for an estimate of liabilities that have not become fixed by the end of that year. Here, receipt of medical care and filing of proper claims forms would fix the annual health care liability. *United States v. Gen. Dynamics Corp.*, 481 U.S. 239, 242-45, 107 S. Ct. 1732, 95 L. Ed. 2d 226 (1987).

Again, we are not convinced that the language of § 357(c)(3) is so unclear as to permit us to rely on this policy argument and adopt the IRS's reading. In addition, because BDHMI files a tax return separate from Taxpayer's and has been taking the deductions for the health care expenses as the expenses are incurred, the "double deduction" argument would only work if we were to treat BDHMI and Taxpayer as a single entity. We see no justification on the present record for disregarding the distinct corporate taxpayer identities of BDHMI and Taxpayer. Rather, we agree with Taxpayer: "BDHMI pays the claims; BDHMI takes the deductions - not Taxpayer." Appellee's Br. at 27.

We conclude that the contingent liability Taxpayer transferred to BDHMI falls within the § 357(c)(3) exception for "liability the payment of which . . . would give rise to a deduction." Therefore, under § 358(d)(2)'s exception to the general rule of § 358(d)(1), the liability need not be treated as "money received" by Taxpayer for basis reduction purposes. For this reason the district court's denial of the IRS's summary judgment motion was correct.

- Judge Michael held that the government was entitled to a trial on the issue of whether the transaction was a sham, stating:

The district court's approach to the objective prong strayed from our precedents. Although the district court quoted the pertinent language from *Rice's Toyota*, see 340 F. Supp. 2d at 623, it went on to assert: "A corporation and its transactions are objectively reasonable, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions." *Id.* at 623-24. In so reasoning, the district court mischaracterized the *Rice's Toyota* test, which focuses not on the general business activities of a corporation, but on the specific transaction whose tax consequences are in dispute. "The second prong of the sham inquiry, the economic substance



inquiry, requires an objective determination of whether a reasonable possibility of profit from *the transaction* existed apart from tax benefits.” *Rice’s Toyota*, 752 F.2d at 94 (emphasis added). Thus, many of the undisputed facts upon which the district court relied in concluding that Taxpayer was entitled to summary judgment - including the facts that BDHMI “maintained salaried employees” and paid health claims as they came due with BDHMI assets, 340 F. Supp. 2d at 624 – were simply not germane to the proper inquiry under the second prong of our circuit’s sham transaction test.

We do not agree with Taxpayer’s contention that the Supreme Court’s decision in *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 63 S. Ct. 1132, 87 L. Ed. 1499, 1943 C.B. 1011 (1943), supports the district court’s analysis of the objective prong under *Rice’s Toyota*. The Court in *Moline* held that a corporate taxpayer, the petitioner, “had a tax identity distinct from its stockholder,” an individual, such that gain realized on sales in two tax years were to be treated as income taxable to the corporation, not to the individual; 319 U.S. at 440. To reach this conclusion, the Court examined the purposes for the individual’s establishment of the corporation. *Id.* at 439-40. The Court recognized that in some tax cases “the corporate form may be disregarded where it is a sham or unreal.” *Id.* at 439. *Moline* is not implicated, however, by the IRS’s allegation that under the objective prong of the sham transaction test there was no reasonable profit opportunity in the two-phase transaction Taxpayer executed with BDHMI in November and December 1998. The IRS is not arguing at this point that BDHMI’s corporate identity separate from Taxpayer must be disregarded for tax purposes, such that income earned by one is to be attributed to the other. Shams under *Rice’s Toyota* are distinct from shams under *Moline*. In particular, a shareholder’s transaction with a controlled corporation may be a sham under *Rice’s Toyota* even if the corporation is entitled to regard its income as distinct from its shareholder’s because the corporation is not itself a sham under *Moline*.

*Hines* illustrates the proper analysis under the objective prong of the *Rice’s Toyota*. *Hines* involved an IRS challenge to investment interest and depreciation deductions stemming from a taxpayer’s purchase and lease back to the seller of

used computer equipment. We first noted that the payments on the transaction would leave the taxpayer “with a loss of \$127,324 over the eight years of the lease” to the seller; 912 F.2d at 739. We next identified all of the possible sources of revenue on the transaction and weighed them against this loss. *See id.* at 739-40. Viewing the evidence in the light most favorable to the taxpayer, which had won at trial, we nevertheless concluded that the transaction “failed to yield any reasonable expectation of a profit.” *Id.* at 739. *Hines* clarifies that under this circuit’s firmly established *Rice’s Toyota* standard, the objective prong of the sham transaction test focuses on reasonable expected profits from a transaction. There is no basis here for abandoning our standard by scrutinizing the transaction for its “real economic effects,” despite Taxpayer’s argument that we should do so based on the law of another circuit. *See United Parcel Serv. of Am., Inc. v. Comm’r*, 254 F.3d 1014, 1019 (11th Cir. 2001).

- As illustrated by Rev. Rul. 95-74, § 357(c)(3) applies not only to cash method accounts payable, but also to liabilities of accrual method transferors that have not yet been allowed as a deduction under the economic performance rules of § 461(h) or because the liability is too contingent. As a result, § 358(d)(2) applies and the transferor shareholder’s basis in the stock received in the exchange is not reduced by the liability. Aggressive tax planners took advantage of this pattern of the interaction of the various statutory provisions to create artificial double deductions.

3. A second taxpayer victory in a listed contingent liability transaction. *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (10/29/04), Government appeal pending. Taxpayer transferred its asbestos liabilities to an asbestos case management entity [“Garrison”], which was existing shell subsidiary that had no assets, together with a related party note for \$375 million and some other miscellaneous assets. It sold about 6.67 percent of the Garrison stock to two banks for a total of \$500,000 and reported a multimillion dollar loss that saved it over \$82 million in taxes. Judge Susan G. Braden found that this transaction satisfied all the requirements of existing law.

- Judge Braden rejected the concept of a court applying the economic substance doctrine to tax cases on the ground that taxpayers “must be able to rely on clear and understandable rules established by Congress to ascertain their federal tax obligations.” After discussing the complexity of the economic substance doctrine, she concluded “that where a taxpayer has satisfied all statutory requirements established by Congress, as

Coltec did in this case, the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers."

- As illustrated by Rev. Rul. 95-74, 1995-2 C.B. 36, § 357(c)(3) applies not only to cash method accounts payable, but also to liabilities of accrual method transferors that have not yet been allowed as a deduction under the economic performance rules of § 461(h) or because the liability is too contingent. As a result, § 358(d)(2) applies and the transferor shareholder's basis in the stock received in the exchange is not reduced by the liability. Aggressive tax planners took advantage of this pattern of the interaction of the various statutory provisions to create artificial double deductions. Here, in a transaction subject to § 351, one corporation, Garlock, contributed to another corporation, Garrison, cash, a \$375 million promissory note to Garlock from a related corporation, and certain other property. In connection with the transfer Garrison assumed \$371.2 million of Garlock's contingent liabilities for asbestos product liability damage claims (neither of the events necessary to establish the fact of the liability had occurred, i.e., the filing of a lawsuit asserting a claim and an adjudication of liability). Shortly thereafter, Garlock sold a significant number of the shares of Garrison and claimed approximately \$370 million of losses, having determined the basis of the Garrison stock with reference to an exchanged basis under § 358 that was not reduced to reflect the assumption of the contingent asbestos liabilities. Since the liabilities were contingent and the liabilities would have been deductible by the transferor upon payment, the court held that the liabilities were within those described in §§ 357(c)(3)(A) and 358(d)(2), and thus neither § 357(c)(1), requiring the recognition of gain to the extent that the amount of liabilities exceed the basis of the contributed assets, nor § 358(d)(1), requiring the reduction of the transferred basis assigned to the stock, applied. Therefore, Garlock's basis in Garrison properly was the exchanged based of the transferred property, unreduced by the amount of liabilities assumed by Garrison, and the loss was allowed.

**4. The third taxpayer victory in thirteen days, in a self-liquidating partnership note transaction in which the lion's share of income was allocated to a tax-indifferent party. Satisfaction of the mechanical rules of the regulations under § 704(b) transcends both an intent to avoid tax and the avoidance of significant tax through agreed upon partnership allocations So far, this lease stripping transaction works for a burned-out tax shelter. TIFD III-E, Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 11/1/04), Government appeal pending. This case involved a tax shelter partnership in which 2 percent of both operating and taxable income was allocated to GECC, a United States partner, and 98 percent of both book and taxable income was allocated to partners who were Dutch banks, foreign partners who were not liable for U.S. taxes and thus were indifferent to the U.S. tax consequences of their participation in the**

partnership. Because the partnership had very large book depreciation deductions and no tax depreciation, most of the partnership's taxable operating income, which was substantially in excess of book income, was allocated to the tax-indifferent foreign partners, even though a large portion of the cash receipts reflected in that income was devoted to repaying the principal of loans secured by property that GECC had contributed to the partnership. The overall partnership transaction saved GECC approximately \$62 million in income taxes, and the court found that "it appears likely that one of GECC's principal motivations in entering into this transaction – though certainly not its only motivation – was to avoid that substantial tax burden." The court understood the effects of the allocations and concluded that "by allocating 98 percent of the income from fully tax-depreciated aircraft to the Dutch Banks, GECC avoided an enormous tax burden, while shifting very little book income. Put another way, by allocating income less depreciation to tax-neutral parties, GECC was able to 're-depreciate' the assets for tax purposes. The tax-neutrals absorbed the tax consequences of all the income allocated to them, but actually received only the income in excess of book depreciation." Nevertheless, the court upheld the allocations.

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

• Because the partnership had very large book depreciation deductions and no tax depreciation, most of the partnership's taxable operating income, which was substantially in excess of book taxable income, was allocated to the tax-indifferent foreign partners, even though a large portion of the cash receipts reflected in that income was devoted to repaying the principal of loans secured by property that GECC had contributed to the partnership. The overall partnership transaction saved GECC approximately \$62 million in income taxes, and the court found that "it appears likely that one of GECC's principal motivations in entering into this transaction – though certainly not its only motivation – was to avoid that substantial tax burden." The court understood the effects of the allocations and concluded that

“by allocating 98 percent of the income from fully tax-depreciated aircraft to the Dutch Banks, GECC avoided an enormous tax burden, while shifting very little book income. Put another way, by allocating income less depreciation to tax-neutral parties, GECC was able to ‘re-depreciate’ the assets for tax purposes.”

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

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

- Query whether § 704(b) was properly applied to this transaction?

- The court (Judge Underhill) held that satisfaction of the mechanical rules of the regulations under § 704(b) transcended both an intent to avoid tax and the avoidance of significant tax through agreed upon partnership allocations. In this partnership, 2 percent of both operating and taxable income was allocated to GECC, a United States partner, and 98 percent of both book and taxable income was allocated to partners who were Dutch banks. The Dutch banks were foreign partners who were not liable for United States taxes and thus were indifferent to the U.S. tax consequences of their participation in the partnership.

- Judge Underhill concluded:

The government is understandably concerned that the Castle Harbour transaction deprived the public fisc of some \$62 million in tax revenue. Moreover, it appears likely that one of GECC’s principal motivations in entering into this transaction – though certainly not its only motivation – was to avoid that substantial tax burden. Nevertheless, the Castle Harbour transaction was an economically real transaction, undertaken, at least in part, for a non-tax business purpose; the transaction resulted in the creation of a true partnership with all participants holding valid partnership interests; and the income was allocated among the partners in accordance

with the Internal Revenue Code and Treasury Regulations. In short, the transaction, though it sheltered a great deal of income from taxes, was legally permissible. Under such circumstances, the I.R.S. should address its concerns to those who write the tax laws.

- The *Castle Harbour* case has generated significant commentary suggesting that the court erred in its determination that the allocations had substantial economic effect. See, e.g., Karen C. Burke, *Castle Harbour: Economic Effect and the Overall-Tax-Effect Test*, 107 Tax Notes 1163 (May 30, 2005). Although the allocations might have had economic effect under Treas. Reg. § 1.704-1(b)(2)(ii), the allocations were not substantial under Treas. Reg. § 1.704-1(b)(2)(iii). The factual analysis is quite complex. Because the income stream was completely predictable and under the partnership agreement the end result was that the Dutch banks merely recouped their investment plus a guaranteed 8.5 percent return, the allocations were not substantial under Treas. Reg. § 1.704-1(b)(2)(iii)(a) because as a result of the allocations, when compared to an allocation of book income that simply reflected the amounts actually to be ultimately distributed to the partners under the agreement, that the after-tax economic consequences of the other partners were enhanced, and there was a strong likelihood that the after-tax consequences to the Dutch banks would not be diminished.

5. Santa Monica Pictures, LLC v. Commissioner, T.C. Memo. 2005-104 (5/11/05). The Tax Court (Judge Thornton) held that an LLC formed to purchase the high-basis, low-value assets of the former parent company of MGM, was not entitled to capital losses on the order of \$380 million because the transactions it undertook lacked economic substance and cannot be respected for Federal tax purposes, and that the LLC lacked basis in any of the assets it sold. Judge Thornton also imposed the 40 percent gross valuation misstatement and the 20 percent substantial understatement penalties.

6. **Deductions for interest on policy loans under Winn-Dixie's pre-1996 HIPAA leveraged COLI program were denied by both the Tax Court and Eleventh Circuit.** Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (10/19/99). In 1993, taxpayer entered into a broad-based leveraged corporate-owned life insurance group plan covering approximately 36,000 of its employees. The decision to shift from its existing "key-person" COLI program of individual policies [covering 615 managers] was made pursuant to a proposal that emphasized the "tax arbitrage created when deductible policy loan interest is paid to finance non-taxable policy gains." The proposal indicated that taxpayer would have a pre-tax loss totaling \$755 million for its 1993-2052 years, but would have total after-tax earnings of more than \$2.2 billion for the same period (as the result

of total projected income tax savings of more than \$3 billion). The COLI policies were terminated in 1997, following 1996 legislation that impacted the plan.

- Judge Ruwe held that the COLI program lacked substance and business purpose, and thus was a sham. He rejected taxpayer's argument that the policies could conceivably produce pre-tax benefits if some catastrophe were to occur that would produce large, unexpected death benefits. "We are convinced that this was so improbable as to be unrealistic and therefore had no economic significance." The court further found that the possible use of projected after-tax earnings to fund employee benefit plans would not cause the COLI plan to have economic substance, noting that, if so, "every sham tax-shelter device might succeed." In light of the \$3,000 per year premium paid to insure each employee or former employee, it was irrelevant that there was a relatively small death benefit of \$5,000 paid with respect to each dead employee or former employee. Judge Ruwe rejected taxpayer's position that the § 264 safe-harbor test protected its interest deductions. He noted that the right to an interest deduction is governed by § 163 [and not § 264], citing *Knetsch v. United States*, 364 U.S. 361 (1960). He further quoted, "But we do not agree with [taxpayer's] assertion that the legislative history should be turned into an open-ended license applicable without regard to the substance of the transaction . . . *Knetsch* . . . involved transactions without substance. Congress, in enacting section 264(a)(3), struck at transactions with substance. It is a *reductio ad absurdum* to reason, as [taxpayer] does, that Congress simultaneously struck down a warm body and breathed life into [taxpayer's] cadaver."

**a. Affirmed by the Eleventh Circuit, which holds that – even though the UPS insurance scheme has business reality – the COLI tax shelter is a sham. Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 6/28/01) (per curiam).** The Eleventh Circuit rejected taxpayer's primary argument that Congress specifically authorized the interest deduction in the 4-out-of-7 rule of § 264. It concluded that in *Knetsch* the Supreme Court clearly "rejected an argument based on section 264 that is at least a cousin of Winn-Dixie's present contention . . . that Congress's failure to close a loophole in section 264 equated to blessing the loophole." The Eleventh Circuit concluded that *Knetsch* stood for the proposition that "that the sham-transaction doctrine does apply to indebtedness that generates interest sought to be deducted under section 163(a), even if the interest deduction is not yet prohibited by section 264."

- The Eleventh Circuit held that the Tax Court properly applied the sham transaction doctrine:

That doctrine provides that a transaction is not entitled to tax respect if it lacks economic effects or substance other than

the generation of tax benefits, or if the transaction serves no business purpose. . . . The doctrine has few bright lines, but “[i]t is clear that transactions whose sole function is to produce tax deductions are substantive shams.” [Kirchman v. Comm’r, 862 F.2d 1486, 1492 (11th Cir. 1989)]. That was, as we read the tax court’s opinion, the rule the tax court followed. Nor did the court misapply the rule in concluding that the broad-based COLI program had no “function” other than generating interest deductions.

The tax court found, without challenge here, that the program could never generate a pretax profit. That was what Winn-Dixie thought as it set up the program, and it is the most plausible explanation for Winn-Dixie’s withdrawal after the 1996 changes to the tax law threatened the tax benefits Winn-Dixie was receiving. No finding of the tax court suggests, furthermore, that the broad-based COLI program answered any business need of Winn-Dixie, such as indemnifying it for loss of key employees. . . . [T]herefore, the broad-based COLI program lacked sufficient economic substance to be respected for tax purposes, and the tax court did not err in so concluding.

**b. Third Circuit comes down hard on COLI, with lots of language the government will love.** Internal Revenue Service v. CM Holdings Inc. (In re CM Holdings, Inc.), 301 F.3d 96 (3d Cir. 8/16/02), *aff’g* 254 B.R. 578 (D. Del. 10/16/00). In CMI’s bankruptcy, the IRS filed proofs of claim for taxes based on the disallowance of interest deductions that CMI claimed for its COLI plan (involving policies on 1400 employees).

- The district court held no interest deduction was allowable under § 163(a) because the entire transaction was a “sham in substance” that lacked subjective business purpose. Apart from tax savings from the interest deduction, CMI could not reasonably expect a positive cash flow from the COLI plan in any year and could not expect to benefit from the inside cash value build-up [which continuously remained at zero throughout the plan] or profit from the death benefits on covered employees. Interest deductions were disallowed, and § 6662 substantial understatement penalties were imposed because the transaction lacked economic substance. The transaction was entered into without a reasonable expectation of profit – in the absence of the interest deductions – over the life of the 40-year transaction from either the inside build-up or mortality components of the plan.

- The Third Circuit Court of Appeals (Judge Ambro) affirmed on the ground that the “COLI policies lacked economic



substance and therefore were economic shams.” [The court did not reach the issue of whether the transactions were factual shams.] The court dismissed out of hand the need to examine the “intersection of . . . statutory details.”

[P]ursuant to *Gregory v. Helvering*, 293 U.S. 465 (1935), and *Knetsch v. United States*, 364 U.S. 361 (1960), courts have looked beyond taxpayers’ formal compliance with the Code and analyzed the fundamental substance of transactions. Economic substance is a prerequisite to the application of any Code provision allowing deductions. . . . It is the Government’s trump card; even if a transaction complies precisely with all requirements for obtaining a deduction, if it lacks economic substance it “simply is not recognized for federal taxation purposes, for better or for worse.”

- In holding for the government, the court rejected the taxpayer’s argument that [based on *Gregory*, *Knetsch*, *ACM Partnership* and other cases] the application of the economic sham doctrine properly hinges on the “‘fleeting and inconsequential’ nature” of the transaction under scrutiny. Rather, the court concluded that “[d]uration alone cannot sanctify a transaction that lacks economic substance. The appropriate examination is of the net financial effect to the taxpayer, be it short or long term. The point of our analysis in *ACM Partnership* is that the transactions ‘offset one another with no net effect on ACM’s financial position.’” In any event, the court found the COLI transactions bore “striking similarities” to *Knetsch*. The court further rejected the argument that for analytical purposes the pre-tax profit should have been “grossed-up” by the anticipated tax benefits because,

[t]he point of the analysis is to remove from consideration the challenged tax deduction, and evaluate the transaction on its merits, to see if it makes sense economically or is mere tax arbitrage. Courts use “pre-tax” as shorthand for this, but they do not imply that the court must imagine a world without taxes, and evaluate the transaction accordingly. Instead they focus on the abuse of the deductions claimed: “[w]here a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes.” [citation omitted] Choosing a tax-favored investment vehicle is fine, but engaging in an empty transaction that shuffles payments for the sole purpose of generating a deduction is not.

- Finally, the court rejected the taxpayer’s argument that because “the transaction had objective non-tax economic effects . . . the Court must not look further,” and that the district court

improperly applied a subjective analysis. Rather, the Court of Appeals read *Gregory* to permit an inquiry into motive. “If Congress intends to encourage an activity, and to use taxpayers’ desire to avoid taxes as a means to do it, then a subjective motive of tax avoidance is permissible. But to engage in an activity solely for the purpose of avoiding taxes where that is not the statute’s goal is to conduct an economic sham.” Because the court found nothing in the statute to indicate that Congress intended to encourage leveraged COLI investments, the inquiry into motive was proper. In this regard, it was significant that “the plan was marketed as a tax-driven investment.” Because the COLI “plan had no net effect on Camelot’s economic position, . . . it fails the objective prong of the economic sham analysis.” Because there was no “legitimate business purpose behind the plan, . . . it fails the subjective prong as well.” Penalties were also upheld.

**c. But a District Court finds for the taxpayer in an incredible opinion.** Dow Chemical Co. v. United States, 250 F. Supp. 2d 748 (E.D. Mich. 3/31/03). In a carefully-detailed opinion Judge Lawson finds that Dow did correctly almost everything that Camelot and AEP did incorrectly. The interest rate on policy loans was not unreasonably high, and a positive pre-tax cash flow was expected. The court found that there was a business purpose for the COLI arrangements, i.e., to provide retiree benefits. The premiums for the first three years were payable with policy loans and the premiums for years four through seven were payable 90 percent with partial [cash] withdrawals (from policies whose cash value had been previously borrowed) and 10 percent with cash from the taxpayer. Judge Lawson found that the partial withdrawals were “shams in fact” because there was no cash value left in the policies to borrow, but that the § 264(c)(1) test was met because of the payments of 10 percent of the premiums by taxpayer with its own cash in years four through seven. The court found that the § 264(c)(1) safe harbor did not require level premiums over the first seven years and that the “premium” for each of years four to seven was the 10 percent paid in cash. Judge Lawson found that Reg. § 1.264-4(c)(1)(ii) (which required level premiums) was invalid, and he rejected the holding in both *CM Holdings* and *AEP* that the four-out-of-seven test required level premiums.

- In finding that taxpayer expected a positive pre-tax cash flow, Judge Lawson refused to admit into evidence a statement in taxpayer’s protest that could have led to a contrary conclusion on the ground that Rule 408 of the Federal Rules of Evidence provides that statements made during settlement negotiations are inadmissible at trial.

**d. There’s no harm in asking? Not from asking Judge Lawson!** Dow Chemical Co. v. United States, 278 F.Supp.2d 844 (E.D. Mich. 8/12/03). The government’s motion to amend the court’s judgment was granted in part and denied in part, but left intact the same

judgment and basic result. Ironically, since the motion opened up all findings of fact, Judge Lawson reversed his earlier finding that the partial withdrawals in years four through seven were “shams in fact,” thus making moot the government’s argument relating to the logical consequences of this earlier finding, i.e., that taxpayer did not meet the four-of-seven test because it did not pay the entire premium in each of years four through seven from its own funds.

**e. The circuit to which *Dow* is appealable (Sixth Circuit) holds for the government in a COLI case.** *American Electric Power Co., Inc. v. United States*, 326 F.3d 737 (6th Cir. 4/28/03). The Sixth Circuit Court of Appeals affirmed the District Court finding that taxpayer’s COLI plan was an economic sham because it would lose a substantial amount of money absent the policy-loan interest deductions. The court declined to decide whether the dividends in years four through seven, generated by circular cashless netting transactions, were factual shams.

**f. *Dow* is reversed by the Sixth Circuit.** *Dow Chemical Co. v. United States*, 435 F.3d 594 (6th Cir. 1/23/06) (2-1). The Sixth Circuit reversed and held that the Dow COLI plans were “economic shams” because there was little likelihood that Dow would make substantial cash infusions in the future, so the pre-tax cash flows would at all times be negative, following *Knetsch v. United States*, 364 U.S. 361 (1960). This holding eliminates the court’s need to decide the proper discount rate, as well as the issue of the exclusion of Dow’s tax protest letters under Rule 408 of the Federal Rules of Evidence [inadmissibility of statements made during settlement negotiations]. The court further held that there would be little or no inside build-up and that Dow’s possible mortality gains were limited under the plans.

- Judge Ryan dissented on the ground that the majority opinion improperly read *Knetsch* to hold as “a general principle of law that future profits are not even relevant to the economic substance inquiry when the taxpayer’s projected future investment in a particular plan is greater than its past investment in the plan, regardless whether the projected future investment is feasible and there is evidence that it is likely to occur;” instead, Judge Ryan states that *Knetsch* indicated only that the Court made a credibility assessment and determined that Mr. Knetsch did not intend to make the \$4 million future investment necessary to pay off the loan. Judge Ryan would also have found that the Dow plans transferred mortality risk to the insurers so mortality gains were possible.

**B. Identified “tax avoidance transactions.”**

1. **SILO transactions.** Interestingly enough, sale-in, lease-out (SILO) deals [under which a tax-exempt or foreign entity sells property to the taxpayer and leases it back, with the lessee depositing collateral in defeasance of its obligation] were not made “listed transactions,” although President Bush’s budget proposal seeks a legislative remedy for this widespread perceived abuse. See 2004 TNT 19-3.

a. **SILO transactions were closed retroactive to 3/12/04.** Section 848 of the **Jobs Act of 2004** adds new § 470 to disallow losses on leases of property for tax-exempt use that were entered into after 3/12/04. The disallowed losses would be carried over to the following year much as disallowed passive activity losses are carried over. There is a safe harbor provision contained in § 470(d).

b. **SILOs are now listed transactions even though the door was closed after 3/12/04.** Notice 2005-13, 2005-9 I.R.B. 630 (2/11/05). This notice distinguishes the SILO transaction from the one in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

c. **Relief for partnerships and pass-thru entities who looked like they fed from “SILOs” in 2004 but really didn’t.** Notice 2005-29, 2005-13 I.R.B. 796 (3/10/05). The Service will not apply § 470 to partnerships and pass-thru entities described in § 168(h)(6)(E) for taxable years that begin before 1/1/05 in order to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of § 168(h)(6) (describing property owned by a partnership that has both tax-exempt and non-tax-exempt partners).

2. **Transactions involving significant book-tax differences are removed from the list of reportable transactions because they are covered by Schedule M-3.** Notice 2006-6, 2006-5 I.R.B. 385 (1/6/06). Transactions involving significant book-tax differences are removed from the list of reportable transactions.

3. **Accrual over the term of the notional principal contract of the noncontingent component of the nonperiodic payment to be received at the end of the term is required.** Rev. Rul. 2002-30, 2002-21 I.R.B. 971 (5/6/02). When a notional principal contract provides for payment comprised of noncontingent and contingent components, the appropriate method for the inclusion in income or deduction of the noncontingent component of the nonperiodic payment is over the term of the NPC. Interest must also be accounted for in a manner consistent with Reg. §§ 1.446-3(f)(2) (ii) or (iii), and 1.446-3(g)(4).

- Taxpayer agrees to make quarterly payments to counterparty based on the three-month LIBOR multiplied by a notional principal amount of \$100,000,000. In return, at the end of eighteen months, the counterparty will pay taxpayer 6 percent per year multiplied by a notional principal amount of \$92,000,000 [or, \$8,280,000], and, in addition, the counterparty will either pay taxpayer \$8 million times the percentage increase in the stock index, or taxpayer will pay the counterparty \$8 million times the percentage decrease in the stock index. The ruling holds that, to offset the taxpayer's deductible quarterly payments, the taxpayer must ratably accrue over the eighteen-month term the \$8,280,000 that taxpayer will receive from the counterparty at the end of the term.

**a. An arrangement similar to that of Rev. Rul. 2002-30 is identified as a listed tax shelter.** Notice 2002-35, 2002-21 I.R.B. 992 (5/6/02). The transaction in this notice involves the use of a notional principal contract to claim current deductions for periodic payments made by a taxpayer, while disregarding the accrual of a right to receive offsetting payments in the future. Under the NPC, taxpayer is required to make periodic payments to a counterparty at regular intervals of one year or less based on a fixed or floating rate index. In return, the counterparty is required to make a single payment at the end of the term of the NPC that consists of a noncontingent component and a contingent component. The noncontingent component, which is relatively large in comparison to the contingent component, may be based upon a fixed or floating interest rate; the contingent component may reflect changes in the value of a stock index or currency.

- This transaction may be entered into without any initial cash investment by the taxpayer. The counterparty may lend the money to the taxpayer, who pays it back in installments as purportedly deductible payments. The taxpayer may engage in other transactions, such as interest rate collars, for purposes of limiting risk with respect to the NPC transaction.

- Taxpayer seeks to deduct the ratable daily portion of each periodic payment to which that portion relates, but taxpayer does not accrue income with respect to the nonperiodic payment until the year the payment is received.

- The proper treatment of the payments is that the nonperiodic payment to be received by the taxpayer at the end of the term of the NPC must be accrued ratably over the term of the NPC, as set forth in Rev. Rul. 2002-30.

- Transactions that are the same as, or substantially similar to, the transaction described are identified as "listed transactions" for purposes of Temp. Reg. §§ 1.6011-4T(b)(2) and 301.6011-2T(b)(2).

**b. Certain notional principal contracts are no longer listed transactions.** Notice 2006-16, 2006-9 I.R.B. 538 (2/13/06), *clarifying and modifying* Notice 2002-35, 2002-21 I.R.B. 992. “This notice clarifies Notice 2002-35, 2002-1 C.B. 992, by illustrating certain transactions that are not the same as or substantially similar to the transaction described in Notice 2002-35, and thus are not “listed transactions.”

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

**1. The Big Four settle with the IRS on tax shelters.** Deloitte settled with the IRS and agreed to a penalty to be determined after the IRS settled with the other three.

**a. The PwC deal.** IR-2002-82 (6/27/02). The IRS announced in a news release that it cut a deal with PricewaterhouseCoopers (PwC) “to resolve issues relating to tax shelter registration and list maintenance.” The IRS news release, which is similar to one issued last August regarding Merrill Lynch, says that without admitting or denying liability, PwC has “agreed to make a ‘substantial payment’ to the IRS to resolve issues in connection with advice rendered to clients dating back to 1995.” Under the agreement, PwC will provide to the IRS certain client information in response to summonses. It will also work with the IRS to develop processes to ensure ongoing compliance with the shelter registration and investor list maintenance requirements, according to the release.

**b. The EY deal.** IR-2003-84 (7/2/03). The IRS announced in a news release that it has settled Ernst & Young’s potential liability under the tax shelter registration and list maintenance penalty provisions for a nondeductible payment of \$15 million. See 2003 TNT 128-1.

**c. The KPMG deal: the price of settling goes up dramatically.** IR-2005-83 (8/29/05). The IRS and the Justice Department announced in a news release 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”; three of those indicted [Richard Smith, Philip Wiesner and Mark Watson] were partners in KPMG’s Washington National Tax group.

2. Is this really the last chance global settlement initiative? Announcement 2005-80, 2005-46 I.R.B. 967 (10/28/05). Settlement initiative for twenty-one transactions, not all of them listed as “abusive tax shelters,” together with the accuracy-related penalty that will be imposed [varying from 5 percent and 20 percent] unless the transaction was disclosed under Announcement 2002-2, 2002-1 C.B. 304, or the taxpayer relied upon a more-likely-than-not opinion from a non-disqualified tax advisor that considered all the relevant facts and did not assume any unreasonable facts. The terms of the settlement require that improperly-claimed tax benefits be disallowed, but transaction costs will generally be allowed as an ordinary loss. Promoters and related persons are not normally eligible for the settlement initiative, and persons engaged in a transaction that had been designated for litigation, persons in litigation, persons against whom the fraud penalty was imposed or considered and persons under criminal investigation are ineligible for the settlement initiative. Taxpayers must notify the IRS of their intent to participate by 1/23/06 by making an election on Form 13750 (“Election to Participate in Announcement 2005-80 Settlement Initiative”), and sending it, together with all required attachments, to the Service.

a. **Frequently Asked Questions.** (“FAQs”) on the Announcement 2005-80 Settlement Initiative (Rev. 12/12/05), 2005 TNT 239-8 and the IRS web site.

- Son-of-Boss transactions are ineligible for the settlement initiative.

b. **Strong encouragement for taxpayers to use Announcement 2005-80 global settlement initiative.** Section 303 of the **GO Zone Act of 2005** amends § 903 of the **Jobs Act of 2004** to provide that the § 6404(g) post-18-month interest suspension will not apply at all to reportable and listed transactions that are still open on 12/14/05 unless the taxpayer is participating in a settlement initiative described in Announcement 2005-80 or the IRS has determined that the taxpayer “has acted reasonably and in good faith.” Section 903 of the **Jobs Act of 2004** provided that the interest suspension for reportable and listed transactions would not apply after 10/3/04.

3. **Proposed revisions to Circular 230 related to tax shelters require disclosures in tax shelter opinions of relationship between practitioner and promoter, etc.** REG-122379-02, Regulations Governing Practice Before the Internal Revenue Service, 68 F.R. 75186 (12/30/03). New proposed amendments, which differ from the 1/12/01 proposed amendments in several ways: (1) § 10.33 prescribes best practices for all tax advisors; (2) § 10.35 combines and modifies the standards

applicable to “marketed” and “more likely than not” tax shelter opinions from former §§ 10.33 and 10.35; (3) § 10.36 contains the revised procedures for ensuring compliance with §§ 10.33 and 10.35; and (4) new § 10.37 contains provisions relating to advisory committees to the Office of Professional Responsibility.

- Under § 10.33 “best practices” include: (1) communicating clearly with the client regarding the terms of the engagement and the form and scope of the advice or assistance to be rendered; (2) establishing the relevant facts, including evaluating the reasonableness of any assumptions or representations; (3) relating applicable law, including potentially applicable judicial doctrines, to the relevant facts; (4) arriving at a conclusion supported by the law and the facts; (5) advising the client regarding the import of the conclusions reached; and (6) acting fairly and with integrity in practice before the IRS.

- Tax shelter opinions covered by § 10.35 are more-likely-than-not and marketed tax shelter opinions; they, however, do not include preliminary advice provided pursuant to an engagement in which the practitioner is expected subsequently to provide an opinion that satisfies § 10.35. The definition of “tax shelter,” tracking the one found in § 6662 which was contained in the 2001 proposed regulations, remains the same. The requirements for tax shelter opinions include: (1) identifying and considering all relevant facts and not relying on any unreasonable factual assumptions or representations; (2) relating the applicable law to the relevant facts in a reasonable manner; (3) considering all material Federal tax issues and reaching a conclusion supported by the facts and the law with respect to each issue; and (4) providing an overall conclusion as to the Federal tax treatment of each tax shelter item, and the reasons for that conclusion and providing an overall conclusion as to the Federal tax treatment of each tax shelter item and the reasons for that conclusion.

- Under § 10.35(d), a practitioner must disclose any compensation arrangement he may have with any person (other than the client for whom the opinion is prepared) with respect to the tax shelter discussed in the opinion, as well as any other referral arrangement relating thereto. The practitioner must also disclose that a marketed opinion may not be sufficient for a taxpayer to use for the purpose of avoiding penalties under § 6662(d), and must also state that taxpayers should seek advice from their own tax advisors. A limited scope opinion must also disclose that additional issues may exist and that the opinion cannot be used for penalty-avoidance purposes.

- Under § 10.36 procedures to ensure compliance are required to be followed by tax advisors with responsibility for overseeing a firm’s practice before the IRS. These include ensuring that the firm has adequate procedures in effect for purposes of complying with § 10.35.

- Under § 10.37 the Director of the Office of Professional Responsibility is authorized to establish advisory



committees to review and make recommendations regarding professional standards or best practices for tax advisors. They may also, more particularly, advise the Director whether a practitioner may have violated §§ 10.35 or 10.36.

**a. Extended statutory authority granted to Treasury with respect to Circular 230.** Section 822 of the **Jobs Act of 2004** amends 31 U.S.C. § 330(b) to permit the imposition of censures and monetary penalties for Circular 230 violations. It also clarifies the Treasury's authority to impose standards applicable to written tax shelter opinions.

**b. Tax shelter revisions to Circular 230 are made final. To paraphrase President Clinton, oral opinions are not real opinions.** T.D. 9165, Regulations Governing Practice Before the Internal Revenue Service, 69 F.R. 75839 (12/20/04).

**(1) Best practices for tax advisors.** As to final § 10.33, the preamble states:

The final regulations adopt the best practices set forth in the proposed regulations with modifications. These best practices are aspirational. A practitioner who fails to comply with best practices will not be subject to discipline under these regulations. Similarly, the provision relating to steps to ensure that a firm's procedures are consistent with best practices, now set forth in § 10.33(b), is aspirational. Although best practices are solely aspirational, tax professionals are expected to observe these practices to preserve public confidence in the tax system.

• These best practices are (1) communicating clearly with the client regarding the terms of the engagement; (2) establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts; (3) advising the client regarding the import of the conclusions reached, including, e.g., whether the client may avoid accuracy-related penalties; and (4) acting fairly and with integrity in practice before the IRS. Practitioners responsible for overseeing a firm's tax practice must take reasonable steps to ensure that firm's procedures applicable to all personnel in the firm are consistent with these best practices.

**(2) Requirements for covered opinions.** As to final § 10.35, the preamble states:

Under the final regulations, the definition of a *covered opinion* [i.e., one subject to § 10.35] includes written advice (including electronic communications) that concerns one or more Federal tax issue(s) arising from: (1) a listed transaction; (2) any plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax; or (3) any plan or arrangement, a significant purpose of which is the avoidance or evasion of tax if the written advice (A) is a reliance opinion, (B) is a marketed opinion, (C) is subject to conditions of confidentiality, or (D) is subject to contractual protection. A reliance opinion is written advice that concludes at a confidence level of at least more likely than not that one or more significant Federal tax issues would be resolved in the taxpayer's favor.

Written advice will not be treated as a reliance opinion if the practitioner prominently discloses in the written advice that it was not written to be used and cannot be used for the purpose of avoiding penalties. Similarly, written advice generally will not be treated as a marketed opinion if it does not concern a listed transaction or a plan or arrangement having the principal purpose of avoidance or evasion of tax and the written advice contains this disclosure. The Treasury Department and the IRS intend to amend 26 CFR 1.6664-4 to clarify that a taxpayer may not rely upon written advice that contains this disclosure to establish the reasonable cause and good faith defense to the accuracy-related penalties.

Written advice regarding a plan or arrangement having a significant purpose of tax avoidance or evasion is excluded from the definition of a covered opinion if the written advice concerns the qualification of a qualified plan or is included in documents required to be filed with the Securities and Exchange Commission. The final regulations also adopt an exclusion for preliminary advice if the practitioner is reasonably expected to provide subsequent advice that satisfies the requirements of the regulations.

Written advice that is not a *covered opinion* for purposes of § 10.35 is subject to the standards set forth in new § 10.37.

- There are substantial due diligence requirements for covered opinions.<sup>2</sup> All written opinions at the more-likely-than-not (or higher) level for listed transactions or transactions with a principal purpose of tax avoidance or evasion are covered opinions. For other non-excluded tax shelter opinions, the requirements of § 10.35 can be avoided with a statement that the opinion cannot be relied upon to avoid penalties- prominently disclosed “in a separate section at the beginning of the written advice in a bolded typeface that is larger than any other typeface used in the written advice.”

**To ensure compliance with requirements imposed by the U.S. Internal Revenue Service, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (1) avoiding tax-related penalties under the U.S. Internal Revenue Code or (2) promoting, marketing or recommending to another party any transaction or tax-related matters addressed herein.<sup>3</sup>**

**(3) Procedures to ensure compliance.**

As to final § 10.36, the preamble was silent.

- Practitioners responsible for overseeing a firm’s tax practice must take reasonable steps to ensure that the firm has adequate procedures in effect for all personnel to comply with § 10.35.

**(4) Requirements for other written**

**advice.** As to final § 10.37, the preamble states:

The final regulations also set forth requirements for written advice that is not a *covered opinion*. Under § 10.37 a practitioner must not give written advice if the practitioner: (1) Bases the written advice on unreasonable factual or legal assumptions; (2) unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person; (3) fails to consider all relevant facts; or (4) takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled. Section 10.37, unlike § 10.35, does not

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2. If you have to ask the requirements for a covered opinion, then you probably shouldn’t be writing one. *Cf.*, “J.P. Morgan famously said that if you have to ask the cost of a yacht, you probably can’t afford one.” David Taylor in “A Strange Downeaster,” *Forbes*, 6/20/05.

3. In other words, nothing in this outline may be used to save taxes for any of your clients.

require that the practitioner describe in the written advice the relevant facts (including assumptions and representations), the application of the law to those facts, or the practitioner's conclusion with respect to the law and the facts. The scope of the engagement and the type and specificity of the advice sought by the client, in addition to all other facts and circumstances, will be considered in determining whether a practitioner has failed to comply with the requirements of § 10.37.

- Practitioners may not give written advice based on (1) unreasonable factual or legal assumptions; (2) unreasonable reliance upon representations of the client or any other person; (3) consideration of less than all relevant facts; or (4) the possibility that a return may not be audited, that an issue is not raised on audit, or that an issue will be resolved through settlement.

**(5) Establishment of advisory committees.** As to final § 10.38 [§ 10.37 in the proposed regulations], the preamble states:

Newly designated § 10.38, formerly § 10.37 in the proposed regulations, is adopted as proposed with the following modifications. Section 10.38 is modified to clarify that an advisory committee may not make recommendations about actual practitioner cases, or have access to information pertaining to actual cases. The section also is modified to clarify that the Director of the Office of Professional Responsibility should ensure that membership of these committees is balanced among those individuals who practice as attorneys, accountants and enrolled agents.

**(6)** The provisions contained in the final regulations will generally become applicable on 6/21/05.

c. Announcement 2005-31; 2005-18 I.R.B. 996 (5/2/05). Minor corrections to § 10.35(b)(2)(ii)(B) and § 10.35(b)(4)(i).

d. **Pre-summer solstice changes to § 10.35 expand the definition of “excluded advice,” modify the definition of “prominently disclosed” and revise the definition of “the principal purpose [of tax avoidance].”** T.D. 9201, Regulations Governing Practice Before the Internal Revenue Service. 70 F.R. 28824 (5/19/05).

- **Post-return advice.** Excludes from the definition of a covered opinion advice given after a tax return is filed –

unless the practitioner knows or has reason to know that the taxpayer will rely on the advice to claim benefits in a subsequently-filed amended return.

- **In-house advice.** Excludes from the definition of a covered opinion written advice provided to an employer in the practitioner's capacity as an employee solely for the purposes of determining the tax liability of the employer.

- **How about "almost more likely than not"?** Excludes from the definition of a covered opinion negative advice unless the written advice also reaches a conclusion favorable to the taxpayer at any confidence level, e.g., not frivolous, realistic possibility of success, reasonable basis or substantial authority.

- **Need not come first to be "prominently disclosed."** Modifies the definition of "prominently disclosed" to a subjective facts-and-circumstances test of whether the item is "readily apparent" to the particular taxpayer in the context of the opinion. The item must be set forth in a separate section (and not in a footnote) in a typeface that is the same size or larger than the typeface of any discussion of the facts or law.

- **When is a tax avoidance purpose "consistent with the statute and Congressional purpose"?** Revises the definition of "principal purpose" to be similar to that of Reg. § 1.6662-4(g)(2)(ii), i.e., that the purpose is not to avoid or evade Federal tax if the purpose is "the claiming of tax benefits in a manner consistent with the statute and Congressional purpose."

e. **Proposed Circular 230 changes that do not relate to tax shelters are nevertheless controversial, what with new restrictions on the use of contingent fees, monetary penalties for practitioners and their firms, and public hearings before ALJs.** REG-122380-02, Regulations Governing Practice Before the Internal Revenue Service, 71 F.R. 6421 (2/8/06). Proposed regulations have been issued based upon consideration of comments received in response to questions posed in an advance notice of proposed rulemaking (ANPRM) at 67 F.R. 77724 (12/19/02), as well as amendments made to 31 U.S.C. § 330 by the **Jobs Act of 2004**. Changes include: (1) changing references to the office of the Director of Practice to the Office of Professional Responsibility; (2) adding to the definition of "practice before the [IRS]" in § 10.2(d) "rendering written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion;" (3) revoking the authorization of an unenrolled return preparer to represent a taxpayer during an examination of a return that he or she prepared; (4) eliminating the ability of a practitioner to charge a contingent fee for services rendered in connection with the preparation or filing of an amended tax return or claim for refund or credit, although contingent fees are permissible for services rendered in connection with the IRS's examination

of, or challenge to, an amended return or claim for refund or credit filed prior to the taxpayer receiving notice of the examination of, or challenge to the original tax return, § 10.27; (5) adding to the standards applicable with respect to tax return positions in § 10.34, the requirement that a practitioner may not advise a client to submit “a document, affidavit or other paper . . . to the [IRS]” if (a) its purpose is to delay or impede the administration of the Federal tax laws, (b) it is frivolous or groundless, or (c) it contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation; (6) adding to the sanctions in § 10.50 the authority to impose a monetary penalty on the practitioner who engages in conduct subject to sanction, as well as the authority to impose a monetary penalty on the “employer, firm or entity” of a practitioner acting on its behalf provided that the employer, firm or entity knew or reasonable should have known of such conduct; and (7) modifying the definition of disreputable conduct in § 10.51 to include willful failure to sign a tax return the practitioner prepared or unauthorized disclosure of returns or return information.

- The most controversial proposed change is a provision in § 10.72(d) that all hearings, reports, evidence and decisions in a disciplinary proceeding be available for public inspection, with protection of the identities of any third party taxpayers contained in returns and return information for use in the hearing.

**4. IRS settlement terms for executive stock option shelters.** Announcement 2005-19, 2005-11 I.R.B. 744 (2/22/05). Executive Stock Options Settlement Initiative. The offer, which extends until 5/23/05, is for payment of tax on the full amount of compensation received, plus interest and a 10 percent penalty (which is half of the 20 percent penalty). The parties must pay employment taxes, but they will be allowed to deduct their out of pocket transaction costs; the corporations will be permitted a deduction for the compensation expense when reported by the executive. Employment taxes are also due. The IRS has identified forty-two corporations, close to 200 executives and more than \$700 million of unreported income involved in the scheme, and will ask that the matter be referred to the audit committee of the board of directors for appropriate review. This transaction was listed in Notice 2003-47, 2003-30 I.R.B. 132.

- In IR-2005-17 (2/22/05), the transaction is described as follows:

The transaction first involves the transfer of stock options by the executive to a related entity, such as a family limited partnership, under terms of an agreement to defer payment to the executive. Next, the partnership exercises the options and sells the stock in the marketplace. The executive then takes the position that tax is not owed until the date of the

deferred payment, typically 15 to 30 years later, although the executive has access to the partnership assets undiminished by taxes. Tax laws require executives to include in income and pay tax on the difference between the amount they pay for the stock and its value when the option is exercised. Corporations are entitled to a deduction for the compensation when the options are exercised.

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

**1. A non-reviewable penalty for failure to disclose a reportable transaction that applies even if the courts uphold taxpayer's position.** Section 811 of the **Jobs Act of 2004** adds new § 6707A which provides a new penalty for any taxpayer who fails to include on his tax return any required information on a reportable transaction "of a type which the Secretary determines as having a potential for tax avoidance or evasion." The penalty would apply regardless of whether there is an understatement of tax and would apply in addition to any accuracy related penalty. The penalty would be \$10,000 for a natural person and \$50,000 for other taxpayers; for a listed transaction the penalty would increase to \$100,000 for a natural person and \$200,000 for other taxpayers.

- The Commissioner could rescind any portion of the penalty if it did not involve a listed transaction and rescinding would promote compliance and effective tax administration. A decision not to rescind may not be reviewed in any judicial proceeding.

**a. Doesn't the Commissioner trust his own Appeals Officers?** Notice 2005-11, 2005-7 I.R.B. 493 (1/19/05). This notice provides guidance on § 6707A, including a statement that the Commissioner's determination whether to rescind a § 6707A penalty "is not reviewable by the IRS Appeals Division or any court." Notice 2005-11, 2005-7 I.R.B. 493 (interim guidance regarding application of § 6707A pending issuance of regulations; a single penalty will be assessed for: (1) failure to attach a reportable transaction disclosure statement to an original or amended return; or (2) the failure to provide a copy of a disclosure statement to the Office of Tax Shelter Analysis (OTSA), if required).

**2. Modified accuracy-related penalty for reportable transactions.** Section 812 of the **Jobs Act of 2004** adds new § 6662A which would provide a modified accuracy related penalty on understatements with respect to reportable transactions. It would replace the § 6662 accuracy related penalty for tax shelters and would be in the amount of 20 percent – 30 percent if the transaction is not properly disclosed. Taxpayers could not rely on an opinion of a tax advisor to establish reasonable cause under new

§ 6664(d) [applicable to reportable transaction understatements] for any opinion: (a) provided by a “disqualified tax advisor” or (b) which is a “disqualified opinion.”

3. Notice 2005-12, 2005-7 I.R.B. 494 (1/19/05). This notice provides further guidance, including a statement that the new § 6664(d) defense is not available for the 30 percent penalty. It also provides guidance on when a material tax advisor participates in a transaction:

Consistent with the legislative history, a tax advisor, including a material advisor, will not be treated as participating in the organization, management, promotion or sale of a transaction if the tax advisor’s only involvement is rendering an opinion regarding the tax consequences of the transaction. In the course of preparing a tax opinion, a tax advisor is permitted to suggest modifications to the transaction, but the tax advisor may not suggest material modifications to the transaction that assist the taxpayer in obtaining the anticipated tax benefits. Merely performing support services or ministerial functions such as typing, photocopying, or printing will not be considered participation in the organization, management, promotion or sale of a transaction.

- Or, in other words, a “disqualified tax advisor” is any advisor who (a) is a material advisor under § 6111 (as defined in Reg. § 301.6112-1) and who participates in the organization, management, promotion or sale of the transaction, or is related (within the meaning of § 267(b) or § 707(b)(1)) to any person who so participates, (b) has a disqualified compensation arrangement (as defined in the Notice), or (c) has a disqualifying financial interest identified by the IRS; however, a tax advisor, including a material advisor, is not treated as participating in the organization, management, promotion or sale of a transaction if the tax advisor’s only involvement is rendering an opinion regarding the tax consequences of the transaction).

4. **The audit lottery that can never be won and taxpayer can never get repose! The statute of limitations never expires on listed transactions that are not disclosed.** Section 814 of the **Jobs Act of 2004** adds new § 6501(c)(10) to extend the statute of limitations for listed transactions which a taxpayer fails to disclose until one year after the transaction is disclosed by the taxpayer or by a material advisor’s satisfying the list maintenance requirement in connection with a request from Treasury.

5. Rev. Proc. 2005-26, 2005-17 I.R.B. 965 (4/8/05). Guidance on the procedures to be followed by taxpayers and material



advisors to disclose previously unreported listed transactions for purposes of the extended statute of limitations. Rev. Proc. 2005-26, 2005-17 I.R.B. 965 (procedures for disclosing a previously undisclosed listed transaction; taxpayer must submit a Form 8886, with appropriate cover letter, to the IRS Service Center at which the original return was filed; an amended return with the Form 8886 and cover letter is permitted but not required; a copy of the Form 8886 and cover letter also must be sent simultaneously to OTSA; date of disclosure of a previously undisclosed listed transaction is the first date upon which all of the following events have occurred: (1) original Form 8886 is received by the appropriate Internal Revenue Service Center, (2) a copy of the disclosure statement is received by OTSA and, (3) if applicable, a copy of the disclosure statement is received by the IRS examiner or Appeals officer).

**6. Material advisors are subject to increased disclosure.** Section 815 of the **Jobs Act of 2004** amends §§ 6111 and 6112 to require increased disclosure on an information return for each reportable transaction by any material advisor [in lieu of tax shelter registration]. “Material advisor” is defined more broadly to encompass any person who “provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction” and derives fees in excess of \$50,000 for tax shelters for natural persons (\$250,000 for tax shelters for other taxpayers).

- Notice 2005-17, 2005-8 I.R.B. 606 (2/28/05). This notice grants an extension of time for material advisors to comply with the new filing requirements under § 6111. This notice was clarified and modified by Notice 2005-22, 2005-12 I.R.B. 756.

**7.** Section 816 of the **Jobs Act of 2004** amends §§ 6707 and 6708 to increase the penalty for failure to file a return under § 6111 to \$50,000 – for listed transactions, the greater of \$200,000 or 50 percent of the gross income derived by the person required to file the return [75 percent if the failure was intentional].

**8.** Section 817 of the **Jobs Act of 2004** amends § 6708 to provide a penalty of \$10,000 per day on any material advisor for failure to make available to the IRS within 20 business days any investor list required to be maintained under the provisions of § 6112.

**9.** Section 818 of the **Jobs Act of 2004** amends § 6707 to increase the penalty on tax shelter promoters to 50 percent of the gross income to be derived from the activity on which the penalty is imposed.

**10.** Section 820 of the **Jobs Act of 2004** amends § 7408 to allow injunctions (a) against material advisors for violating reporting requirements and (b) for violating any of the Circular 230 rules.

**a. Interim guidance for material advisors.** Notice 2004-80, 2004-50 I.R.B. 963 (11/16/04). This notice provides interim guidance for the disclosure requirements for material advisors under § 6111 by defining the terms “reportable transaction” and “material advisor,” and specifying the applicable forms and filing dates. The form is Form 8264, as modified by instructions in the notice.

**(1) Several revenue procedures were issued on 10/16/04 to give “angels’ list” status to transactions that need not be reported.** They are Rev. Proc. 2004-65 [transactions with contractual protection], Rev. Proc. 2005-66 [loss transactions], Rev. Proc. 2004-67 [transactions with book-tax differences], and Rev. Proc. 2005-68 [transactions with brief asset holding periods]. They may be found at 2004-50 I.R.B. 965, 966, 967 and 969, respectively.

**(2)** Notice 2005-17, 2005-8 I.R.B. 606 (1/28/05). Extension for compliance with the reporting provisions to 3/1/05.

**(3)** Notice 2005-22, 2005-12 I.R.B. 756 (2/24/05). Additional guidance, and a further extension for compliance with the reporting provisions to 4/30/05.

**11.** Rev. Proc. 2005-51, 2005-33 I.R.B. 296 (8/15/05). Guidance for persons required to pay penalties under §§ 6662(h), 6662A or 6707A, who are required under § 6707A(e) to disclose those penalties on reports filed with the SEC. A failure to disclose shall be treated as a failure to disclose a listed transaction and will be subject to an additional penalty.

#### **E. Tax Shelters Miscellaneous**

There were no significant developments regarding this topic during 2005.

### **IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING**

#### **A. Exempt Organizations**

**1. If intermediate sanctions apply, is revocation far behind?** REG-111257-05, Standards for Recognition of Tax-Exempt Status if Private Benefit Exists or If an Applicable Tax-Exempt Organization Has Engaged in Excess Benefit Transaction(s), 70 F.R. 53599 (9/9/05). The

provisions of these proposed regulations clarify the relationship between the substantive requirements for tax exemption under § 501(c)(3) and the imposition of § 4958 excise taxes, i.e., intermediate sanctions – particular with respect to excess benefit transactions. Prop. Reg. §§ 1.501(c)(3)-1(g)(2)(ii) and (iii) read:

(ii) *Determining whether revocation of tax-exempt status is appropriate when section 4958 excise taxes also apply.* In determining whether to continue to recognize the tax-exempt status of an applicable tax-exempt organization (as defined in section 4958(e) and § 53.4958-2 of this chapter) described in section 501(c)(3) that engages in one or more excess benefit transactions (as defined in section 4958(c) and § 53.4958-4 of this chapter) that violate the prohibition on inurement under this section, the Commissioner will consider all relevant facts and circumstances, including, but not limited to, the following –

- (A) The size and scope of the organization’s regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred;
- (B) The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization’s regular and ongoing activities that further exempt purposes;
- (C) Whether the organization has been involved in repeated excess benefit transactions;
- (D) Whether the organization has implemented safeguards that are reasonably calculated to prevent future violations; and
- (E) Whether the excess benefit transaction has been corrected (within the meaning of section 4958(f)(6) and § 53.4958-7 of this chapter), or the organization has made good faith efforts to seek correction from the disqualified persons who benefited from the excess benefit transaction.

(iii) All factors will be considered in combination with each other. Depending on the particular situation, the Commissioner may assign greater or lesser weight to some factors than to others. The factors listed in paragraphs (g)(2)(ii)(D) and (E) of this section will weigh more strongly in favor of continuing to recognize exemption where the organization discovers the excess benefit transaction or transactions and takes action before the Commissioner

discovers the excess benefit transaction or transactions. Further, with respect to the factor listed in paragraph (g)(2)(ii)(E) of this section, correction after the excess benefit transaction or transactions are discovered by the Commissioner, by itself, is never a sufficient basis for continuing to recognize exemption.

## **B. Charitable Giving**

**1.** Section 882 of the **Jobs Act of 2004** amends §§ 170(e)(1) and 6050L which limits the amount of the deduction to the lesser of fair market value or the donor's basis in the property. This limitation was enacted because Congress was concerned that "taxpayers with intellectual property are taking advantage of the inherent difficulties in valuing such property and are preparing or obtaining erroneous valuations. In such cases, the charity receives an asset of questionable value, while the taxpayer receives a significant tax benefit." H.R. Rep. No. 108-548, pt. 1, 108th Cong., 2d Sess. 351 (2004).

- Because intellectual property often has no basis in the hands of its creator, to retain an incentive for donations of valuable intellectual property, Congress added new § 170(m), which allows the donor an additional deduction equal to a portion of the income recognized by the donee with respect to the donated intellectual property, reduced by the amount allowable as a deduction in the year the property was donated. The amount of the additional deduction is based on a sliding scale that allows a tentative deduction equal to 100 percent of the income attributable to the donated property in the first two years after the contribution. In the third year and every year thereafter the percentage of the income eligible for the additional deduction is reduced by 10 percent each year, but remains at 10 percent for the twelfth taxable year ending after the contribution. However, § 170(m)(4) provides that no additional deduction is allowed with respect to income received or accrued by the donee after the tenth anniversary of the donation, which renders the additional deduction for the twelfth taxable year illusory except in very narrow circumstances in which the donor and donee have different taxable years. The additional deduction based on the donee's income from the property is allowed only to the extent the aggregate tentative deductions calculated under the formula exceed the amount of the initial deduction claimed in the year the property was contributed. Assume that the donor properly claimed a deduction of \$500,000 with respect to a contribution of intellectual property, and the property generates \$400,000 of income in the first year. The donor's deduction will be limited to the \$500,000 basis and no additional deduction attributable to the income generated by the property will be allowed. If in the second year the property generates \$300,000 of income, the donor will be able to deduct an additional \$200,000 as a result of that income, because \$200,000 is the amount

by which the total income generated by the property (\$700,000) exceeds the amount the donor previously deducted (\$500,000). As a result of the sliding scale, if in the third year the property generates income of \$100,000, the donor will be able to deduct only an additional \$90,000 (90 percent).

- The intellectual property with respect to which the additional deduction under § 170(m) is allowed generally includes patents, certain copyrights, trademarks, trade names, trade secrets, know-how, some software and applications or registrations for such property but excludes property donated to many private foundations. The donor must inform the donee at the time of the contribution that she intends to use this provision.

2. T.D. 9206, Information Returns by Donees Relating to Qualified Intellectual Property Contributions, 70 F.R. 29450 (5/23/05). The Treasury has promulgated temporary regulations on qualified intellectual property contributions. REG-158138-04, 70 F.R. 29460 provides identical proposed regulations.

(1) Notice 2005-41, 2005-23 I.R.B. 1203. Related guidance including notification requirements.

3. **Does new § 170(f)(12) close the door to inflated deductions for motor vehicle contributions? Or, is the door left open wide enough to drive a truck [or other vehicle] through it?** Section 884 of the Jobs Act of 2004 amends § 170(f) by adding new paragraph twelve that requires written acknowledgment of contributions of motor vehicles, boats and airplanes that include the amount of the gross proceeds from any arm's length sale and a statement that the deduction may not exceed such amount. Its enactment was prompted by congressional concern that taxpayers who were donating used cars to charities were claiming deductions that far exceeded the amounts that the charities were receiving following the sale, often at auction, of the cars. Section 170(d)(12) applies if the claimed deduction is more than \$500 and provides different rules depending on what the donee charity does with the vehicle. If the donee uses the vehicle or materially improves it, the taxpayer must obtain from the donee, and include with the tax return, a contemporaneous written acknowledgment that provides certain identifying information and certifies the intended use or material improvement of the vehicle, states the intended duration of the use, and certifies that the vehicle will not be transferred or exchanged for money before the termination of such use or improvement. In this case the amount of the deduction is not affected. However, if the donee sells the vehicle without any significant intervening use or material improvement, the deduction cannot be more than the gross proceeds received from the sale, and other substantiation requirements apply. In addition to the other requirements, the donee's contemporaneous written acknowledgment must

certify that the vehicle was sold in an arms-length transaction to unrelated parties, state the gross proceeds from the sale, and inform the donor taxpayer that the deductible amount may not exceed the gross proceeds.

- Donees that fail to furnish the required acknowledgment or furnish a false or fraudulent acknowledgment are subject to a penalty under § 6720, which was also added in 2004. For vehicles sold without intervening use or improvement the penalty is at least the gross proceeds from the sale but could be as much as the sales price on the acknowledgment multiplied by the highest marginal rate under §1 if that is higher. For other vehicles the penalty is the greater of \$5,000 or the claimed value of the vehicle multiplied by the highest marginal rate under § 1.

**a. How much use is “substantial” when a charity uses a donated vehicle in its own endeavors?** Notice 2005-44, 2005-25 I.R.B. 1287 (6/3/05). The Notice provides interim guidance under the new rules for motor vehicle charitable contribution deductions. The most interesting examples are those where the charity puts the vehicle to use in delivering meals on wheels, where the question is whether the use is a “significant intervening use.” Example 6 says use of the vehicle to deliver meals only a few times is not. Example 7 says that use of the vehicle to deliver meals every day for one year is. Example 8 says that driving the vehicle to deliver meals a total of 10,000 miles over a one-year period is.

- The gross sales proceeds limitation does not apply to a sale to a needy individual at a price significantly below fair market value, or a gratuitous transfer to a needy individual, in direct furtherance of a charitable purpose of the donee organization of relieving the poor and distressed or the underprivileged who are in need of a means of transportation.

**4. Glass v. Commissioner, 124 T.C. 258 (5/25/05),** held that the contribution of a perpetual conservation easement that restricted development of certain portions of the taxpayers’ lakefront residential lot, but which did not otherwise affect the taxpayers’ use or enjoyment of the property, was a qualified conservation contribution under § 170(h) because it protected a relatively natural habitat of specifically identified wildlife, including bald eagles, and plants.

**5. Eight revenue procedures that contain sample CRUT declarations of various sorts make it just a little bit easier to give.** Revenue Procedures 2005-52 through 2005-59, 2005-34 I.R.B. 326, 339, 353, 367, 383, 392, 402 & 412, respectively (8/22/05). Sample charitable remainder unitrust declarations that meet the requirements of § 664.

6. Under the **Katrina Tax Act**, “qualified disaster contributions” made between 8/28/05 and 12/31/05 will be deductible without regard to the 50-percent-of-AGI limit.

7. Under the **Katrina Tax Act**, charitable deductions for contributions of food inventory would be permitted up to the lesser of (i) fair market value or (ii) twice basis; the same permitted deduction would apply to contribution of book inventory to public schools. Effective for contributions made between 8/28/05 and 12/31/05.

8. Sklar v. Commissioner, 125 T.C. 281 (12/21/05), *as amended*, 2/7/06. Another context in which taxpayers have repeatedly and unsuccessfully sought to claim charitable contribution deductions for payments with respect to which they have received a *quid pro quo* is tuition payments to religious schools that provide both secular and religious education. Even if tuition can be mathematically prorated between the portion attributable to the secular education and the portion attributable to religious education, or the taxpayer can demonstrate that the tuition exceeds the value of the secular education, the deduction has been disallowed because taxpayers have been unable to demonstrate any charitable intent in paying the tuition. The special exception for religious benefits does not apply to payments to religious schools.

## X. Tax Procedure

### A. Interest, Penalties and Prosecutions

1. The “common law” rule that one country does not prosecute for violation of another country’s tax law was not violated here. Practitioners should have a level of concern that is “somewhere between Chicken Little and Pollyanna.” Pasquantino v. United States, 544 U.S. 349 (4/26/05) (5-4). Criminal convictions for wire fraud in connection with the transportation of liquor from the United States into Canada without paying Canadian excise taxes were affirmed. The majority opinion by Justice Thomas held that the “common law revenue rule” [as it existed when the wire fraud statute was enacted in 1952] under which the tax liabilities of one sovereign will not be enforced by those of another sovereign, i.e. the rule bars “collection of tax obligations of foreign nations,” is not violated by this prosecution for wire fraud because the dominant characteristic of the case was the prosecution of fraud, and not foreign tax collection.

• The suggestion has been made that a practitioner’s reaction to this case should be “somewhere between Chicken Little and Pollyanna.”

2. T.D. 9186, Qualified Amended Returns, 70 F.R. 10037 (3/2/05). Temp. Reg. § 1.6664-2T(c) provides that the amount reported on a “qualified amended return” will be treated as an amount shown as tax on the taxpayer’s return for purposes of determining whether there is an underpayment of tax subject to an accuracy-related penalty. Generally speaking, an amended return is a “qualified amended return” if it is filed before the IRS first contacts the taxpayer concerning an examination of the return. Temp. Reg. § 1.6664-2T(c)(3).

3. Rev. Proc. 2005-34, 2005-24 I.R.B. 1233 (5/20/05). This revenue procedure sets forth procedures for appeals of proposed trust fund recovery penalty assessments arising under § 6672, updated to reflect amendments made by the Taxpayer Bill of Rights, P.L. 104-168. Effective for penalties proposed on or after 5/20/05.

4. **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. [http://www.usdoj.gov/opa/pr/2005/September/05\\_tax\\_463.htm](http://www.usdoj.gov/opa/pr/2005/September/05_tax_463.htm). He was convicted on 1/25/06. See 2006 TNT 17-6.

5. **When is disclosure adequate? There are different rules for disclosure of a tax shelter, of transactions that lack reasonable basis and supporting records, and for preparer penalty purposes.** Rev. Proc. 2005-75, 2005-50 I.R.B. 1137 (12/12/05). Updates guidance on whether disclosure of a position taken on a tax return is adequate for purposes of the § 3332(d) accuracy-related penalty and the § 6694(a) preparer penalty.

- There is a new paragraph in § 4.01(5) cautioning that the entry of an amount on a line will not provide adequate disclosure if it is attributable to a tax shelter or “if it does not have a reasonable basis and supporting records,” as well as a limitation on its effectiveness for preparer penalty purposes.

- There is also a requirement in § 4.02(1)(d) that the contemporaneous written acknowledgment required under § 170(f)(12) for charitable contributions of motor vehicles be attached to the return.

6. United State1 v. Hempfling, 96 A.F.T.R.2d 2005-6578, 2006-1 U.S.T.C. ¶ 50,205, (E.D. Cal. 9/23/05). In as lawsuit seeking an injunction under §§ 6700 and 7408 against a promoter of scheme: (1) purporting to demonstrate that there is no law requiring individuals to file



federal income tax returns or pay income taxes, and (2) insulating purchasers who stopped filing tax returns from any charge of willful failure to file a tax return, the court denied the promoter's motion to dismiss, holding that the First Amendment does not protect such "false or fraudulent commercial speech." On 2/22/06 at 2006 U.S. Dist. LEXIS 41582, the court again refused to dismiss on defendant's contention that he had new evidence that the Sixteenth Amendment was never properly ratified.

7. Lewis v. United States, 96 A.F.T.R.2d 2005-6301 (W.D. Tenn. 9/12/05). CEO/president who was aware of financial strains on corporation was informed by concerned subordinates on more than one occasion that the payroll taxes were not being paid, and whose "apparent choice to turn a blind eye and a deaf ear to these warnings," while shifting the blame to the CFO was liable for § 6672 penalty. Note that both CEO and CFO were responsible persons.

8. **Sentence of 360 months for torching the Colorado Springs IRS office was upheld.** United States v. Dowell, 430 F.3d 1100 (10th Cir. 12/6/05). The court upheld a conviction under § 7212(a) and 18 U.S.C. § 2 for forcibly interfering with IRS employees and administration by setting fire to an IRS office.

9. Bo v. Commissioner, T.C. Memo. 2005-150 (6/23/05). With respect to request for interest abatement under § 6404 (which is available for delays resulting only from ministerial acts), Judge Colvin held that erroneous advice to taxpayer from IRS agent, failure to reassign case while agent was on maternity leave, sending agent to on-the-job training, and agent taking annual leave while case was pending were not ministerial acts. However, losing file for over four months and erroneous failure to code file as released from collection due process hearing status were ministerial acts.

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

1. **Honi soit qui mal y pense.** United States v. BDO Seidman, LLP, 95 A.F.T.R. 2d 2005-1725, 2005-1 U.S.T.C. ¶ 50,264 (N.D. Ill. 3/30/05). The district court ruled that only one of 267 documents withheld from IRS scrutiny by the intervenors was unprotected by privilege or work produce, or both.<sup>4</sup> In ruling that the crime-fraud exception did not apply, Judge Holderman found that neither the existence of cookie-cutter tax opinions nor the IRS listing of substantially similar transactions as abusive tax shelters by the IRS was determinative because "the tax code and underlying regulations is [sic] full of complexities and uncertainties." He

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4. The unprotected document was an e-mail sent by a BDO employee.

further stated that “just because one of BDO’s consulting agreements has been found to have [been] fraudulent does not mean that all consulting agreements entered into by BDO were fraudulent.”

- Judge Holderman found the test for the § 7525(b) tax shelter exception to be the same as for the crime-fraud exception.

- Footnote 2 of the opinion sets forth the categories of information contained in the privilege log. Inasmuch as the adequacy of another privilege log in this litigation was questioned, the categories in this privilege log might be a useful guide.

**a. The attorney-client privilege does not attach to communications relating to planning to commit tax fraud.** Subsequently, at 95 A.F.T.R.2d 2005-2835, 2005-2, U.S.T.C. ¶ 50,447 (N.D. Ill. 5/17/05), Judge Holderman found that the remaining document examined *in camera* presented a *prima facie* case for being not privileged by reason of the crime-fraud exception, and the intervenors failed to present sufficient explanation to rebut that presumption. The document involved an investment in distressed debt with the sole motive of obtaining a loss for tax purposes.

- The government had argued that “document A-40 is not part of legitimate year-end tax planning, but instead is part of the overall abusive sham tax shelter transaction perpetrated by BDO and invested in by Intervenor Cullio and others.”

- Judge Holderman refused to quash the summons seeking production of document A-40, which he held related to an “abusive sham tax shelter investment,” because the IRS made a *prima facie* case that the crime-fraud exception to the attorney-client privilege applied and taxpayer failed to provide a satisfactory explanation of why the document should not be disclosed under the crime-fraud exception; there were eight indicators of potential fraud: (1) the marketing of pre-packaged transactions by BDO; (2) the communication by the taxpayer to BDO with the purpose of engaging in a pre-arranged transaction developed by BDO or a third party with the sole purpose of reducing taxable income; (3) BDO and/or the taxpayer attempting to conceal the true nature of the transaction; (4) actual or constructive knowledge by BDO that the taxpayers lacked a legitimate business purpose for entering into the transaction; (5) vaguely worded consulting agreements; (6) failure by BDO to provide services under the consulting agreement despite receipt of payment; (7) mention of a particular tax shelter that had been identified by the IRS as a “listed transaction”; and (8) use of boilerplate documents.

2. Jade Trading, LLC v. United States, 95 A.F.T.R. 2d 2005-2067, 2005-1 U.S.T.C. ¶ 50,320 (Fed. Cl. 4/22/05). The court (Judge Williams) held that any claim of executive privilege for background

materials relating to the IRS's publication of Notice 2000-44 on 8/13/00 (relating to the Son-of-Boss transaction) and relating to Treasury's publication of Reg. § 1.701-2 on 5/17/94 (in proposed form) and on 12/29/94 (in final form) had to be asserted only after personal consideration by the Commissioner and the Secretary, respectively.

- Note that Judge Williams uses the appellation "IRS Code" in her opinion.

3. In another opinion on the same date, Judge Williams denied BDO Seidman's motion to quash a subpoena requesting "all Form 1040 cover pages, Schedule D and Schedule K-1 for the years 1999-2000" for forty-six BDO clients who are not parties to the Jade Trading case [in order to ascertain the amount of capital gains and losses claimed by these taxpayers and the dates on which they were incurred] because § 6103 only prohibits disclosure of taxpayer return information "filed with" or "received by, recorded by, prepared by, furnished to, or collected by" Treasury and the IRS, and also because courts in tax cases have required brokers to produce records of other customers who used the same broker. Copies of tax returns given to BDO by its clients do not fall within the prohibition of § 6103.

4. United States v. Norwood, 420 F.3d 888 (8th Cir. 8/26/05). The court upholds enforcement of a summons seeking records of offshore bank credit card accounts because the act of production was not self-incriminatory. This is because, based on information obtained from MasterCard, the government already knew the name and location of the bank that created the records, the payment card numbers, and the details of a number of discrete transactions involving the cards and the account. It held that the "production of the records has no testimonial significance."

a. United States v. Elliot, 96 A.F.T.R.2d 2005-550, 2005-2 U.S.T.C. ¶ 50,522 (W.D. N.C. 7/14/05). Summons to produce "daily sheets" that recoded all receipts from taxpayer's dental practice was enforced because the records of gross receipts are "voluntarily prepared business records" that are not privileged under *United States v. Doe*, 465 U.S. 605 (1984), despite the record-keeping requirements of Reg. § 1.6601-1. The act of production was not self-incriminatory because, based on the testimony of taxpayer's accountant, "the existence, authenticity, and [taxpayer's] possession of the documents is a foregone conclusion."

### C. Litigation Costs

1. Blasius v. Commissioner, T.C. Memo. 2005-214 (9/14/05). Advance notice of proposed rule making (ANPRM) and proposed regulations are not "applicable published guidance" raising the presumption

that the government's position was not justified; nor is the IRS Chief Counsel's "priority guidance plan" to be considered "applicable published guidance."

2. Moulton v. United States, 429 F.3d 352 (1st Cir. 11/21/05). Attorney's fees in case in which § 6672 penalty was upheld for only one of five quarters were denied. The government's position was substantially justified because case was a "close case" and "[t]he closeness . . . was compounded by the fact that, once the IRS assessed [penalties] under § 6672, the burden of proof was on [taxpayers] to prove that they were not responsible persons (or that, if they were responsible, their failure to ensure that the taxes were paid was not 'willful'").

#### D. Statutory Notice

1. **A notice of determination gives the Tax Court jurisdiction, even if the notice is invalid.** Myong Soo Kim v. Commissioner, T.C. Memo. 2005-96 (5/3/05). The IRS erroneously issued an invalid notice of determination on a collection action under § 6330, when it should have issued a decision letter. The Tax Court (Judge Marvel) denied the Commissioner's motion to dismiss for lack of jurisdiction, but did grant the Commissioner summary judgment because the § 6330 hearing request was not made within the thirty-day period following the issuance of the notice of intent to levy.

2. Rev. Rul. 2005-51, 2005-31 I.R.B. 163 (7/12/05). IRS may not use the summary assessment procedures under § 6213(b) when taxpayer filed a return reporting an amount of wages and a tax liability, but attached a Form W-2 reflecting a different amount of wages; IRS must issue a deficiency notice under § 6212(a). Nor is the failure to report wages that were shown on a Form W-2 attached to the return a "mathematical or clerical error." In such a case the IRS must follow the normal deficiency procedures.

3. Freije v. Commissioner, 125 T.C. 14 (7/14/05). That a taxpayer has an opportunity to dispute the underlying tax liability in an appeal to the Tax Court in a § 6330 collection due process proceeding does not cure an assessment made in derogation of the taxpayer's rights under § 6213(a) to a deficiency proceeding in the Tax Court. Where taxpayer's appeal from a determination that a levy should proceed is grounded on a claim that the IRS improperly applied a remittance for the year with respect to which the determination was made to an outstanding liability for a prior year, the Tax Court has jurisdiction to redetermine the deficiency for the year to which the remittance was applied by the IRS because it is relevant to computing the unpaid tax for which the taxpayer made the remittance. The

IRS may not collect erroneous nonrebate refund by summarily applying remittances for a subsequent year to recoup the erroneous refund.

### **E. Statute of Limitations**

**1. The statute of limitations when taxpayers litigate identity privilege issues in lawsuits against their tax advisers.** John Doe 1 v. KPMG LLP, 93 A.F.T.R.2d 2004-1808, 2004-1 U.S.T.C. ¶ 50,270 (N.D. Tex. 4/2/04). Judge Barefoot Sanders denied the government's motion to require the John Doe taxpayers to sign consents to extend the statute of limitations, but found instead that the statute was suspended.

- Query why the court did not dismiss taxpayers' lawsuit unless they filed consents to extend the statute of limitations.

**a. United States v. KPMG LLP**, 316 F. Supp. 2d 30 (D. D.C. 5/4/04). Judge Hogan adopted the rationale of *KPMG* (N.D. Texas), and finds that the statute of limitations was similarly suspended during the pendency of the action.

**b. *John Doe 1* reversed on appeal by the Fifth Circuit; equitable tolling is inapplicable as an exception to the statute of limitations.** John Doe 1 v. KPMG, LLP, 398 F.3d 686 (5th Cir. 3/28/05). Judge Jones held that equitable tolling is unavailable to extend the § 6501 statute of limitations. She further held that the general jurisdiction granted by § 7402(a) to district courts to issue appropriate orders to enforce the internal revenue laws does not "authorize[] a court to inject an equitable tolling provision into a detailed, highly specific provision (Section 6501)."

**2. Bacigalupo v. United States**, 399 F. Supp. 2d 835 (M.D. Tenn. 11/15/05). Twelve-month limitation period governing claims filed in probate proceedings pursuant to state law did not bar claim for unpaid income taxes filed by the IRS against the estate in the probate proceeding; citing *United States v. Summerlin*, 310 U.S. 414 (1940), and *United States v. John Hancock Mutual Life Ins. Co.*, 364 U.S. 301 (1960). The statutes of limitations provided in the Internal Revenue Code pre-empt any state law statutes of limitations. The United States is not bound by any state law statutes of limitations that might require a claim to be asserted within a period shorter than the period provided by the Internal Revenue Code.

**3. Pacific Gas & Electric Co. v. United States**, 417 F.3d 1375 (Fed. Cir. 8/10/05), *rev'g* 55 Fed. Cl. 271 (2003), *rehearing en banc denied* on 1/13/06. Erroneous overpayment of interest on overpayment of taxes could be setoff against subsequent refund claim. In addition, the

government can setoff the erroneous refund against other refunds due to the taxpayer, but the IRS cannot set off erroneously paid interest against a taxpayer's timely refund claim with respect to the same year, if the statute of limitations on bringing suit for the erroneous payment of interest has expired.

## **F. Liens and Collections**

**1. Tax Court makes it easier to find abuse of discretion in collection due process hearings. Robinette v. Commissioner, 123 T.C. 85 (7/20/04) (reviewed, 14-3).** In 1995, the taxpayer had entered into an offer in compromise (based on doubts as to collectibility) relating to years prior to 1992, which required that he file timely returns for 1995 through 1999. The returns for 1995 through 1997 were timely filed, but the 1998 return was never received. The taxpayer and his accountant claimed that on the day the 1998 return was due, his accountant prepared it, the taxpayer signed it, and the accountant mailed it using a private postage meter [Uh-oh]. The IRS declared the compromise in default. After a due process hearing in which the taxpayer claimed good faith compliance and offered alternative proof of mailing, including a copy of the 1998 return, the Appeals Officer issued a notice of determination to proceed with collection, because the Appeals Officer would accept only a certified or registered mail receipt as proof of mailing. Even though the Tax Court's review of collection due process hearings is for abuse of discretion, in a reviewed opinion by Judge Vasquez (in which 5 judges joined), the Tax Court held that it may consider evidence presented at trial that was not in the administrative record (but not new issues). The court held that the Administrative Procedures Act review provisions do not apply to § 6330(d) proceedings, and admitted taxpayer's testimony that he signed and delivered returns to his accountant for mailing, the accountant's testimony regarding the procedures used to mail the return, and other evidence not in the administrative record indicating that the return was mailed. Although the testimony was admitted, it did not prove timely mailing because the accountant used a private meter and the return was not received until several years later when the copy was delivered to Appeals. Nevertheless, the court held that the taxpayer did not materially breach the offer in compromise and that the Appeals Officer abused his discretion in declaring the compromise in default. There were an indescribable number of overlapping concurrences by an additional nine judges, in some of which the five "majority" judges joined, and one of which concurring opinions was supported by more judges than supported the "majority" opinion; there were three dissents.

**a. Chief Counsel's response.** Chief Counsel Notice CC-2004-031 (9/1/04). Deborah Butler provides guidance to Chief Counsel attorneys as to how to handle Collection Due Process cases in light

of *Robinette*. The recommended course of action when such evidence is presented to the court is to ask for a remand of the case to Appeals for a supplemental determination.

b. Murphy v. Commissioner, 125 T.C. 301 (12/29/05). The Tax Court (Judge Halpern) declined to overrule *Robinette*, but excluded taxpayer's proffered testimony as to the nature of his illness which allegedly precluded him from making a larger offer in compromise because taxpayer had "more than an adequate opportunity to provide [the Appeals Officer] with all of the evidence" and declined to do so. The court went on to state: "An appeals officer does not abuse her discretion when she fails to take into account information that she requested and that was not provided in a reasonable time."

c. **Reversed because the case should have been reviewed based upon the evidence presented to the Appeals Officer.** Robinette v. Commissioner, 439 F.3d 455 (8th Cir. 3/8/06). Inasmuch as the Tax Court reviews the decision of an appeals officer under an "abuse of discretion" standard of review, the record on review under both the Administrative Procedure Act and general principles of administrative law is "ordinarily limited to consideration of the decision of the agency . . . and of the evidence on which it was based."

- Judge Colloton did not think that because the Tax Court traditionally conducts *de novo* proceedings in deficiency cases, Congress meant it to conduct such proceedings in collection due process cases.

2. **A trap for the unwary deprives Tax Court of jurisdiction with respect to a petition for lien or levy action.** Prevo v. Commissioner, 123 T.C. 326 (12/14/04). The Tax Court held it lacked jurisdiction with respect to a petition for lien or levy action filed by taxpayer after she filed a voluntary bankruptcy petition because the Tax Court petition for lien or levy action was filed in violation of the 11 U.S.C. § 362 automatic stay. Judge Gerber stated:

Unfortunately here, where the petition in bankruptcy was voluntary, petitioner has fallen victim to a trap for the unwary. As the notice of determination was issued to petitioner on February 23, 2004, petitioner normally would have had 30 days – until March 24, 2004 – to file a timely petition for lien or levy action with the Court. However, upon the filing of the bankruptcy petition on March 1, 2004, the automatic stay was invoked, and petitioner was barred from commencing a proceeding in this Court. n4 Further, the

automatic stay remained in effect until March 31, 2004 – 7 days after the 30-day statutory filing period under sections 6320(c) and 6330(d) expired. Thus, but for the provisions of section 11 U.S.C. section 362(a)(8) and the lack of a tolling provision analogous to section 6213(f), this Court would have jurisdiction over this case. n5

n4 Had petitioner first filed a petition with this Court and then filed a bankruptcy petition, the proceeding before this Court would have been active and then stayed, thereby preserving petitioner's ability to contest respondent's determination.

n5 See, however, sec. 6330(d), which provides in part: "If a court determines that the appeal was to an incorrect court, a person shall have 30 days after the court determination to file such appeal with the correct court." We do not decide herein whether our determination in this opinion that we lacked jurisdiction over the petition filed during the pendency of petitioner's bankruptcy case means that we are or are not the "incorrect" court for purposes of the above-quoted flush language. If we were the "incorrect" court, petitioner would have 30 days from the date decision is entered in this case to refile in the "correct" court. That issue, however, is not currently before the Court and was not briefed by the parties.

**a. But the trap does not exist where the IRS issued its notices after the taxpayer filed a bankruptcy petition. Smith v. Commissioner, 124 T.C. 36 (2/8/05).** Judge Gerber distinguished the *Prevo* case, and held the Tax Court lacked jurisdiction because the IRS notices were void because they violated the automatic stay under bankruptcy law.

**3. Kendricks v. Commissioner, 124 T.C. 69 (3/9/05).** Held that taxpayer could not contest deficiency in a collection due process hearing because she had the opportunity to contest tax liability in prior bankruptcy proceeding.

**4. Speltz v. Commissioner, 124 T.C. 165 (3/23/05),** on appeal to the Eighth Circuit. The Tax Court (Judge Cohen) held it was not an abuse of discretion for the IRS to reject an offer in compromise based upon "the unfair application of the alternative minimum tax (AMT) based on their



exercise of incentive stock options (ISOs) where the stock acquired by exercise of the ISOs has lost substantially all of its value subsequent to the acquisition of the stock.” Judge Cohen held that § 7122, which authorizes compromise of any civil tax case, did not evince “an intent of Congress to override application of specific provisions of the tax laws in every instance in which the liability is perceived to be unfair or inequitable,” and continued the tax lien in effect.

**5. Judge Wherry places limits on the use of CDP hearings for delay by permitting continued collection and imposing a penalty under § 6673.** Burke v. Commissioner, 124 T.C. 189 (4/12/05). The Tax Court (Judge Wherry) holds that the IRS may continue collecting by levy an individual’s unpaid taxes during the pendency of his hearings and appeals. This is possible when the IRS shows good cause, which is satisfied because taxpayer’s liability was determined in previous litigation and affirmed by the Ninth Circuit, and he used the collection review procedure to espouse frivolous and groundless arguments to delay collection. If a collection due process hearing has been timely requested, § 6330(e)(1) generally prohibits the IRS from proceeding to collect unpaid taxes by levy while any appeals from the hearing are pending. The Tax Court interprets § 6330(e)(1) to refer only to the pendency of the taxpayer’s appeal in the Tax Court (or district court, if that is the proper court) and not to extend to appeals to higher courts.

- Judge Wherry also imposed a \$2,500 penalty under § 6673 for delay.

**6. Living Care Alternatives of Utica, Inc. v. United States**, 411 F.3d 621 (6th Cir. 6/2/05). Since collection due process hearings are not required to have a record and normal review of administrative decisions requires the existence of a record, “Congress must have been contemplating a more deferential review of [collection due process hearing] appeals than of more formal agency decisions.”

**a. Olsen v. United States**, 414 F.3d 144 (1st Cir. 7/8/05). Follows *Living Care Alternatives*, supra, in applying an especially more deferential than usual application of abuse of discretion standard in reviewing IRS’s determination in collection due process hearings; because taxpayer did not cooperate fully in providing IRS with information regarding assets, IRS did not abuse discretion in failure to grant relief regarding offer in compromise.

**7. Wetzel v. Commissioner**, T.C. Memo. 2005-211 (9/12/05). A \$15,000 penalty was imposed under § 6673 for filing a frivolous petition to review IRS’s collection due process determination.

8. REG-150091-02, Miscellaneous Changes to Collection Due Process Procedures Relating to Notice and Opportunity for Hearing Prior to Levy, 70 F.R. 54687 (9/16/05); REG-150088-02, Miscellaneous Changes to Collection Due Process Procedures Relating to Notice and Opportunity for Hearing Upon Filing of Notice of Federal Tax Lien, 70 F.R. 54681 (9/16/05).

- Prop. Reg. § 301.6320-1(c)(2), Q&A-C1. Written request must state the taxpayer's reason for disagreeing with the lien filing. Taxpayers are encouraged to use Form 12153, Request for a Collection Due Process Hearing. A taxpayer must request a hearing in writing.

- Reg. § 301.6320-1(d)(1), Q&A-D6; see also Prop. Reg. § 301.6320-1(d)(2), Q&A-D8. Face-to-face conference concerning a taxpayer's underlying liability will not be granted if the request or other communication indicates that the taxpayer will only raise irrelevant or frivolous issues. A face-to-face conference concerning a collection alternative, such as an installment agreement or an offer to compromise liability, will not be granted if the alternative would not be available to other taxpayers in similar circumstances, for example, a face-to-face conference will not be offered to a taxpayer who wishes to make an offer to compromise but has not filed a return. A face-to-face conference need not be granted if the taxpayer does not provide the required information. If, however, the taxpayer fails to provide the IRS with information that he will raise substantive arguments that are not frivolous or tax-protester type arguments, the IRS may deny the taxpayer a face-to-face hearing and provide the hearing by correspondence or telephone.

- Prop. Reg. § 301.6320-1(d)(2), Q&A-D7. The proposed Regulations would clarify that a face-to-face meeting is merely one aspect of a collection due process hearing, and that a review of documentation and notes of oral conversations with the taxpayer can supplement, or constitute in and of themselves, the "hearing."

- Prop. Reg. § 301.6330-1(f)(2), Q&A-F7. The proposed regulations would expressly limit judicial review to issues (including a challenge to the underlying tax liability) that were properly raised in the taxpayer's collection due process hearing.

9. Clark v. Commissioner, 125 T.C. 108 (9/26/05). Taxpayer filed timely petition in Tax Court following receipt of notice of intent to levy. Furthermore, the Tax Court has held that § 6330(d) confers on it the jurisdiction to review an IRS determination to levy on the taxpayer's state income tax refund, even though § 6330(f) permits the IRS to so levy without first affording the taxpayer a pre-levy hearing.

10. Springer v. United States, 96 A.F.T.R.2d 2005-6846 (W.D. Okla. 10/6/05). The district court lacks jurisdiction to enjoin a levy for

income tax liability because jurisdiction to review IRS's determination in CDP hearing regarding income taxes lies to the Tax Court. In addition, § 6330(e)(1) authorizes the court to which jurisdiction to seek review of the IRS's determination in a collection due process hearing under §§ 6320 and 6330 lies to enjoin any attempt by the IRS to levy on the taxpayer's property during the period for which the administrative collection due process hearing and judicial review thereof are pending.

11. Drake v. Commissioner, 125 T.C. 201 (10/12/05). IRS abused its discretion by virtue of an *ex parte* communication from IRS agent to Appeals Officer assigned to conduct the collection due process hearing, because the communication revealed the IRS originating function's perception of the taxpayer's credibility in contravention of the requirements of Rev. Proc. 2000-43, 2002-2 CB 404; case remanded for a new collection due process hearing.

12. Magee v. Commissioner, T.C. Memo. 2005-263 (11/16/05). Levy based on tax liability reported on a joint return but which was not paid may be contested in a collection due process hearing, but claim that the taxpayer's signature on the joint return was forged does not necessarily place the underlying liability in issue.

13. Aranda v. Commissioner, 432 F3d 1140 (10th Cir. 12/20/05). The IRS did not abuse its discretion in granting relief from the fraud penalty and interest on the fraud penalty, but not from any portion of the underlying tax deficiency liability, pursuant to § 6015(f), even though taxpayer requested relief under § 6015(b), not § 6015(f), and the IRS notice mistakenly referred to relief being granted under § 6015(b).

14. Greene-Thapedi v. Commissioner, 126 T.C. 1 (1/12/06). Tax Court is divested of jurisdiction where IRS applies overpayment from another year to satisfy deficiency after issuing determination in CDP hearing, even though taxpayer is contesting existence of the liability on the asserted grounds that she had not received a deficiency notice; because there was neither an unpaid liability nor a levy, there was no action subject to review; taxpayer had "no independent basis to challenge" the underlying tax liability in the Tax Court because it could not exercise jurisdiction over a refund claim.

## G. Innocent Spouse

1. **The Commissioner cannot hide the ball in a notice of offset, and then claim that the notice starts the two-year period within which innocent spouse relief must be sought.** McGee v. Commissioner, 123 T.C. 314 (10/18/04). Section 6015(b)(1)(E) and (c)(3)(B)

provides that requests for relief under each of these two subsections must be made not later than two years after “the Secretary has begun collection activities.” The Commissioner sent notices to the taxpayer that refunds were being offset against the joint tax liability, but such notices did not advise the taxpayer of her right to seek relief under § 6015, and the taxpayer did not learn of such rights until the statutory period expired for seeking such relief after a collection activity. The Commissioner contended that the notices of offset constituted collection activity which began the running of the limitations period, but the offset notices were not collection-related and thus did not require an advisement of § 6015 rights. The Tax Court (Judge Cohen) held that the denial of innocent spouse relief as time-barred was an abuse of discretion since the application of the time limitation was based on the Commissioner’s inconsistent meanings of collection. The offset was clearly a collection action, and thus the notices of offset were collection-related notices which required an advisement of the taxpayer’s rights under § 6015. The Commissioner’s failure to provide the required notice therefore precluded any finding that the limitations period began to run from the date of the offsets.

a. Chief Counsel Notice CC-2005-010 (5/20/05). The IRS should not defend cases similar to *McGee* pending the issuance of procedures to ensure that future refund offsets will include notice to the taxpayer of the right to claim § 6015 relief.

b. Chief Counsel Notice CC-2005-011 (5/20/05). FAQs related to litigating § 6015 cases. Five topics are covered: (1) the nonpetitioning spouse; (2) the suspension of the collection statute when the taxpayer files a § 6015 claim; (3) the effect of agreements between the IRS and the requesting spouse; (4) the actual knowledge defense to a § 6015(c) claim; and (5) procedures under Chief Counsel Notice CC-2004-026.

2. Friday v. Commissioner, 124 T.C. 220 (5/12/05). Judge Gerber denied the Commissioner’s motion to remand to the IRS for reconsideration of its denial of taxpayer’s request for § 6015(b) relief. The Tax Court held that a stand-alone petition for innocent spouse relief (other than equitable relief under § 6015(f)) pursuant to § 6015(e) “is generally not a ‘review’ of the Commissioner’s determination in a hearing, but is instead an action begun in [the Tax] Court.” The clear inference of this holding is that the hearing in the Tax Court is de novo and not governed by an abuse of discretion standard.

3. 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 ninety-two 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 an 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 six months after the date she 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 ninety 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 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). 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.

4. Rev. Rul. 2005-59, 2005-37 I.R.B. 505 (9/12/05). Joint return prepared by revenue agent pursuant to § 6020(b) which was signed by both spouses is a valid joint return. Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment, prepared by revenue agent that was signed by both spouses is a not a valid joint return because Form 870 is not verified by a written declaration that it is made under the penalties of perjury.

5. Estate of Capehart v. Commissioner, 125 T.C. 211 (11/14/05). Computation of the deficiency and penalty amounts allocable to the innocent spouse/wife based upon disallowed losses and medical expenses [erroneous items] is to be made under the proportionate allocation method after the disallowed items were allocated equally between the two spouses. The Tax Court (Judge Jacobs) held that § 6015(d) does not limit the portion of the deficiency properly allocable to the wife to her proportionate share of the taxable income properly reported on the joint return because her husband received a tax benefit from the filing of a joint return; this which limits the amount of the erroneous items that will be allocated to him (with the excess to be allocated to the wife).

• Although items are allocated for this purpose as if the spouses had filed separate returns, the allocation does not require that the innocent spouse's ultimate tax liability be limited to the amount that would have been her tax liability if separate returns actually had been filed. The deficiency is not allocated in proportion to taxable income, but rather the deficiency is allocated in proportion to the erroneous items giving rise to the deficiency that are assigned to each spouse. Reg. § 1.6015-3(d)(4)(i)(A).

6. Aranda v. Commissioner, 432 F.3d 1140 (10th Cir. 12/20/05). IRS did not abuse discretion in granting relief from fraud penalty and interest on the fraud penalty, but not from any portion of the underlying tax deficiency liability, pursuant to § 6015(f), even though taxpayer requested relief under § 6015(b), not § 6015(f), and the IRS notice mistakenly referred to relief being granted under § 6015(b).

7. Ordlock v. Commissioner, 126 T.C. 47 (1/19/06) (reviewed, 10-8). Taxpayer is not entitled to a refund of amounts from community property used to pay her husband's tax liabilities understatements because under California state law community property is subject to an obligation of one spouse.

## H. Miscellaneous

1. Burton Kanter in trouble again. Investment Research Associates, Ltd. v. Commissioner, T.C. Memo. 1999-407 (12/15/99). In a 600-page opinion Burton Kanter was held liable for the § 6653 fraud penalty by reason of his being "the architect who planned and executed the elaborate scheme with respect to the kickback income payments. . . . In our view, what we have here, purely and simply, is a concerted effort by an experienced tax lawyer [Kanter] and two corporate executives [Claude Ballard and Robert Lisle] to defeat and evade the payments of taxes and to cover up their illegal acts so that the corporations [employing the two corporate executives] and the Federal Government would be unable to discover them."

• The taxpayers subsequently moved to have access to the special trial judge's "reports, draft opinions, or similar documents" prepared under Tax Court Rule 183(b). They based their motion on conversations with two unnamed<sup>5</sup> Tax Court judges that the original draft opinion from the special trial judge was changed by Judge Dawson before he adopted it. They were turned down because the Tax Court held that the documents were related to its internal deliberative processes. See, Tax Court Order denying motion, 2001 TNT 23-31 (4/26/00) and (on reconsideration) 2001 TNT 23-30 (8/30/00). Taxpayers sought mandamus from the Fifth, Seventh and Eleventh Circuits, but were unsuccessful.

**a. 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 by the Tax Court Special Trial Judge were improper.

**b. The Tax Court's procedures are vindicated and taxpayer Kanter's Estate<sup>6</sup> 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.

**c. 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 on 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). Justice Ginsburg so held because no

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5. Kanter's attorney revealed the names of the two judges when asked at oral argument to the Seventh Circuit as Tax Court Judge Julian Jacobs and Chief Special Trial Judge Peter J. Panuthos. See the text at footnote 1 of Judge Cudahy's dissent in the Seventh Circuit *Kanter Estate* opinion, below.

6. Burton Kanter died on October 31, 2001.



statute authorizes the concealment and the rule's "current text" does not warrant it. Her reading of Tax Court Rule 183 is that it does not authorize the Tax Court to treat the special trial judge's Rule 183(b) report as a draft subject to collaborative revision. She held that it is particularly important that the process be transparent in fraud cases such as this one.

- 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." He concludes that "Seminole Rock deference" [*Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410 (1945)] should extend to an Article I court's interpretation of its own rules as well as to an executive agency's interpretation of its rules. He further notes that the issue of compliance with Rule 183 was not presented to the Supreme Court, and that under Supreme Court Rule 14.1(a) the "Court does not consider claims that are not included within a petitioner's questions presented." He adds that, "Only by failing to abide by our own Rules can the Court hold that the Tax Court failed to follow its Rules."

**e. On remand from the Supreme Court, the Seventh Circuit remands the case to the Tax Court.** *Estate of Kanter v. Commissioner*, 406 F.3d 933 (7th Cir. 5/9/05).

**f. . . . while the Eleventh Circuit orders that the Special Trial Judge's report be added to the record.** *Ballard v. Commissioner*, 2005 TNT 99-26 (11th Cir. 5/17/05). The 300-page report may be found at 2005 TNT 107-16.

**g. Tax Court proposes new rule on Special Trial Judges' reports.** On 7/7/05 Tax Court Chief Judge Joel Gerber announced that the court proposes to amend its rules to provide (in proposed Rule 183) substantially the same procedure it had before the 1983 change, which would allow parties to review and file objections to a special trial judge's recommended findings of fact and conclusions of law before the case is reassigned to a presidentially appointed judge for decision.

**h. Tax Court releases judges' statements.** In an order dated 7/19/05, Chief Judge Gerber of the Tax Court released statements from Chief Judge Cohen, Judge Dawson and Special Trial Judge Couvillion outlining the procedures followed in the submission, review and adoption of the memorandum opinion in *Investment Research Associates, Ltd.* The statements were that the proposed report submitted by the Special Trial Judge was deemed unsatisfactory by Judge Dawson and then-Chief Judge Cohen in that the facts found did not support the proposed opinion. After the Chief Judge's request that Judge Jacobs take charge of the matter was declined because Kanter's lawyer was a close friend, Judge Couvillion

withdrew the proposed report the day before a scheduled meeting with Judge Dawson and Chief Judge Cohen. Following the withdrawal, Judge Dawson and Special Trial Judge Couvillion collaborated on the report.

**i. More fallout from the *Ballard* decision.**

The Tax Court identified and located 117 initial opinions submitted by Special Trial Judges under Tax Court Rule 183(b). 2005 TNT 175-2 (9/12/05). Four of the opinions were changed (other than that in *Ballard*), with the changes resulting in taxpayer-favorable holdings in three of the four. There is a dispute as to what happened in *Johnson v. Commissioner*, T.C. Memo. 1992-369, with taxpayer's attorney recalling that Special Trial Judge Goldberg congratulated him on his win in the case, and seemed surprised when taxpayer's attorney responded that he had lost the case; Special Trial Judge Goldberg disputes that the conversation took place.

**j. Tax Court adopts amendments to its rules.** Tax Court press release, 9/21/05. Announces that the Tax Court has adopted amendments to its 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."

**k. Chief Counsel Notice CC-2005-017 (9/27/05).** Describes procedures for handling motions filed by previous Tax Court petitioners "who now seek to vacate decisions based on Ballard-type claims in which they argue that the special trial judge's draft opinion was changed before the Tax Court issued it as a reported opinion."

**l. 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.

Specifically, the Eleventh Circuit ordered that former Chief Judge Cohen, Judge Dawson and Judge Couvillion are not to be involved in the new review.

**m. As does the Fifth Circuit.** Estate of Lisle v. Commissioner, 431 F.3d 439 (5th Cir. 11/22/05) (per curiam). Remands the case 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.

**2. You have a choice of forum for review of the Commissioner’s refusal to abate interest.** Beall v. United States, 336 F.3d 419 (5th Cir. 6/27/03). The Fifth Circuit (Judge Garwood) held that a district court has jurisdiction in a refund suit to review for abuse of discretion the Commissioner’s refusal to abate interest. Judge Garwood reasoned that the grant of jurisdiction to the Tax Court in § 6404(h) was not exclusive.

**a. A district court disagrees with *Beall*.** Ballhaus v. IRS, 341 F. Supp. 2d 1145 (D. Nev. 9/29/04). The court refused to follow *Beall* and held that it lacks jurisdiction to review Commissioner’s refusal to abate interest.

**b. And the Court of Federal Claims holds that *Beall* is not the “be all and end all” on this issue.** Hinck v. United States, 64 Fed. Cl. 71 (2/3/05). Judge Allegra held that the 1996 amendments to § 6404 gave the Tax Court jurisdiction to review the failure to abate interest under the “abuse of discretion” standard. Before 1996 the Federal courts did not have jurisdiction to review abatement decisions, and the 1996 amendments to § 6404 did not do so.

**3. Proposed regulations reject the mailbox rule and hold that – absent actual delivery – only registered or certified mail will suffice as proof.** REG-138176-02, Timely Mailing Treated as Timely Filing, 69 F.R. 56377 (9/21/04). Proposed regulations under § 7502 would provide that a registered or certified mail receipt is the only prima facie evidence of delivery of documents that have a filing deadline prescribed by the internal revenue laws – other than direct proof of actual delivery.

**a. But taxpayers can still prevail based upon the mailbox rule. Why did taxpayers' lawyer play games with love by not taking the petition to the post office? Grossman v. Commissioner, T.C. Memo. 2005-164 (7/5/05).** The envelope sent by certified mail that contained taxpayer's petition to the Tax Court was timely postmarked by a private postage meter but was received by the court after the ninety-day period for filing prescribed by § 6213(a). Taxpayer submitted evidence of a delay in delivery of this letter by reason of misdirection and irradiation to eliminate anthrax spores, as well as the testimony of their lawyer's office manager that she mailed the petition on the date it was postmarked by the private postage meter. The Tax Court (Judge Goeke) held that taxpayers met their burden of proof that their mailing was timely.

• For a tax return or other document mailed to the IRS, it is rumored that the IRS will accept the uncorroborated word of a practitioner believed to be credible as to the date of mailing.

**4. Speltz v. Commissioner, 124 T.C. 165 (3/23/05).** The IRS properly rejected taxpayer's offer in compromise of AMT liability that resulted from incentive stock options even though tax liability exceeded the amount for which the stock subsequently was sold later in the same year the options were exercised. Nor will a tax liability be compromised on the grounds that the statute as correctly applied produces a tax liability that is unfair or inequitable.

**5. Harrigill v. United States, 410 F.3d 786 (5th Cir. 3/31/05).** Application of refund to subsequent year's tax liability is a payment of estimated taxes, not a deposit, and pursuant to § 6513(b) is deemed to have been made on the due date of the return, without extension. A refund request filed within the three year period after late-filed return crediting prior year's refund to tax liability shown on return was not timely.

**6. "It is an ill wind. . . ." Notice 2005-66, 2005-40 I.R.B. 620 (9/9/05).** The IRS has postponed until 1/3/06 tax return filing and payment deadlines for taxpayers affected by Hurricane Katrina, i.e., taxpayers in three counties in Florida, six counties in Alabama, fifty-two counties in Mississippi and sixty-four parishes in Louisiana. The postponement was granted pursuant to § 7508A, which grants the IRS authority to postpone for a period of up to one year the time for performance of the acts listed in § 7508(a) by taxpayers affected by a Presidentially-declared disaster.

**a. IR-2005-112 (8/28/05) and Notice 2005-73, 2005-42 I.R.B. 723 (9/22/05).** Pursuant to the **Katrina Tax Act**, the deadlines to file tax returns, pay taxes, and perform other time-sensitive acts

is postponed until 2/28/06 for taxpayer affected by Hurricane Katrina. See 2005 TNT 188-13.

7. Service Employees International Union v. Commissioner, 125 T.C. 63 (9/15/05). The Tax Court lacked jurisdiction to review IRS's determination to collect § 6652(c)(1) penalties for exempt organization's failure to file § 6033 annual return.

8. Mobil Corp. v. United States, 67 Fed. Cl. 708 (9/22/05). Claims on original tax return that were disallowed on audit, combined with the parties' course of dealing during the audit of those claims conducted prior to the expiration of the statute of limitations for filing an administrative refund claim, established all of the elements of a valid informal claim: (1) notice to Commissioner, (2) the factual and legal basis of the claim, and (3) a written component.

9. **The four-month automatic extension will now be for six months.** T.D. 9229, Extension of Time for Filing Returns, 70 F.R. 67356 (11/7/05), and REG-144898-04, Extension of Time for Filing Returns, 70 F.R. 67397 (11/7/05). Final, temporary and proposed regulations (Temp. Reg. § 1.6081-4T; Prop. Reg. § 1.6081-4) that allow taxpayers required to file an individual income tax return an automatic six-month extension if taxpayers submit an application on Form 4868 ("Application for Automatic Extension of Time To File a U.S. Individual Income Tax Return") on or before the return due date.

- Will this mean that return preparers will face a jam-up before October 15th because the former August 15th filers will wait until October to assemble their data?

- Temp. Reg. § 1.6081-5T also allows pass-through entities to file an automatic six-month extension of time to file on new Form 7004 ("Application for Automatic 6-Month Extension of Time to File Certain Business Income Tax, Information and Other Returns"). Effective for applications for an automatic extension of time filed after 12/31/05. Treasury requests comments as to whether pass-through entities should receive a shorter extension of time.

10. **User fees for rulings increase.** IR-2005-144 (12/19/05). User fees for PLRs will increase from \$7,000 to \$10,000, with lower fees for taxpayers earning less than \$250,000 (\$625) and taxpayers earning from \$250,000 to \$1 million (\$2,500). The fee for requests for changes in accounting methods for businesses will increase from \$1,500 to \$2,500. Other fees will also increase to be reflected in Rev. Procs. 2006-1 and 2006-8.

11. In Re: John Ashton Wray, Jr., 433 F.3d 376 (4th Cir. 12/29/05). This lawyer properly filed all his income tax returns but did not pay all the taxes due, choosing instead to repay the lenders to his business. He pleaded guilty to a misdemeanor count of willful failure to pay income taxes. The opinion noted that it was not clear that the lawyer's conduct involved deceit, and that deceit was not a necessary element of § 7203. There was no deceit, as the liability was disclosed. The attorney, if anything, was foolish for not simply requesting a payment arrangement. That's not to excuse the failure to pay, but on the spectrum of offenses, from failure to file and willful nondisclosure, this one isn't quite as bad as it sounds.

12. **It's good to know that all is normal on the home front despite our military serving in dangerous circumstances overseas. In this CCA, the IRS denies relief to a reservist serving in a combat zone by using an exact reading of the statute to arrive at the conclusion that a partnership whose principal partner is serving in a combat zone is not entitled to suspension of interest on delinquent payroll taxes.** CCA 200613030 (12/15/05). Legal memorandum determining that a partnership is not entitled to a § 7508 suspension of interest on delinquent payroll taxes while its "principal partner" is serving in a combat zone.

## XI. WITHHOLDING AND EXCISE TAXES

### A. Employment Taxes

1. Section 251 of the **Jobs Act of 2004** amends various Code sections to provide that employment taxes (including withholding) are not required with respect to the spread on the exercise of incentive stock options and employee stock purchase plan stock options. This spread is includable for AMT purposes, but not for regular income tax purposes.

- There has been for the past several years a freeze in effect on the collection of employment taxes on the exercise of qualified options.

2. **Although the exercise of a statutory stock option does not result in taxable income, it does result in wages for FICA / FUTA purposes – but not until 2003.** REG-142686-01, Application of the Federal Insurance Contributions Act, Federal Unemployment Tax Act, and Collection of Income Tax at Source to Statutory Stock Options, 66 F.R. 57023 (11/14/01), issued as provided in Notice 2001-14, 2001-6 I.R.B. 516. Prop. Regs. §§ 31.3121(a)-1(k), 31.3306(b)-1(l), and 31.3401(a)-1(b)(15) would provide that the holder of a statutory stock option [§ 422 ISO or § 423 ESPP] receives wages for FICA and FUTA purposes upon exercise of the option, but no withholding is required because no gross income has been

received. The amount of the wages received is the excess of the fair market value of the stock over the amount paid. The IRS will develop “rules of administrative convenience” permitting employers to deem the wages to have been paid on a specific date or over a specific period of time.

**a.** Notice 2001-72, 2001-49 I.R.B. 548 (11/15/01). The IRS announced and requested comments on proposed rules regarding the employer’s income tax withholding and reporting obligations on the sale by an employee of stock received pursuant to exercise of a statutory stock option. The employer is not required to withhold, but is required to report if the amount is at least \$600, unless the employer has made reasonable efforts to determine if reporting is necessary and has been unable to do so.

**b.** Notice 2001-73, 2001-49 I.R.B. 549 (11/15/01). The IRS announced and requested comments on proposed “rules of administrative convenience” permitting employers to deem the wages to have been paid on a specific date for FICA and FUTA purposes. FICA and FUTA wages could be treated as paid on a pay period, quarterly, semi-annually, annually, or on another basis.

**c.** **IRS extends moratorium on assessment of employment taxes on stock options for two more years.** Notice 2002-47, 2002-28 I.R.B. 97 (6/27/02). Pending the completion of its review and the issuance of further guidance, the IRS will not assess FICA or FUTA taxes (nor will it seek federal income tax withholding) upon the exercise of a statutory stock option or disposition of stock acquired by an employee pursuant to the exercise of a statutory stock option. The notice further provides that it is contemplated that any final guidance that would apply employment taxes to statutory stock options will not apply to exercises of statutory stock options that occur before the January 1 of the year that follows the second anniversary of the publication of the final guidance.

**d.** **Congress makes the world safe for ISOs and ESPP stock options (except for the AMT).** Section 251 of the **Jobs Act of 2004** amends various Code sections to provide that employment taxes (including withholding) are not required with respect to the spread on the exercise of incentive stock options and employee stock purchase plan stock options. This spread is includable for AMT purposes, but not for regular income tax purposes.

**e.** **When it’s over, it should be over completely.** **REG-142686-01**, Withdrawal of Notice of Proposed Rulemaking, Application of the Federal Insurance Contributions Act, Federal

Unemployment Tax Act, and Collection of Income Tax at Source to Statutory Stock Options, 70 F.R. 38057 (7/1/05). The IRS has withdrawn proposed regulations that would have required FICA, FUTA and income tax withholding on incentive stock options and employee stock purchase plan stock options in view of the statutory amendment eliminating such requirements that is applicable to stock options exercised after 10/22/04.

## **B. Excise Taxes**

**1. Telephone excise tax inapplicable to charges that do not vary by distance, says the Eleventh Circuit in its latest pronouncement on the “plain meaning” of the tax statutes. American Bankers Insurance Group v. United States, 408 F.3d 1328 (11th Cir. 5/10/05).** The long distance services provided by AT&T to taxpayer were not within the “toll telephone service” to which § 4252(b)(1) applies because the rates do not vary by “distance and elapsed transmission time” and the unambiguous statute uses these terms conjunctively; the “plain meaning” of the statute requires both the time and the distance to vary. Even though there are separate charges for calls depending upon where they fall within one of three toll bands used (intrastate, interstate and international), the rates do not vary by distance per se because calls between places closer to one another often cost more than calls between places further apart. The Eleventh Circuit reversed the district court’s grant of summary judgment for the government.

**a. This one is the most fun to read because of the interplay between majority and dissenting opinions as to the meaning of “and.” OfficeMax, Inc. v. United States, 428 F.3d 583 (6th Cir. 11/2/05) (2-1).** Federal excise tax on long-distance calls does not apply unless the charges vary based upon both time and distance. The majority opinion held that “and” means “and” but the dissent argued that “and” could also mean “or.” When this three percent tax on toll telephone calls was enacted in 1965, there was only one long-distance telephone provider and its charges were based upon both the distance and time of the call [or on a flat rate for unlimited calling on a WATS line, to which the tax also applied]. The majority held that a literal reading of the statute was required because a tax should only apply to that which its language taxes. The dissent would “not encourage lawyers to play word games at the expense of the public fisc.”

**b. The IRS takes a hard line.** Notice 2005-79, 2005-46 I.R.B. 952 (11/14/05). The IRS will continue to litigate this issue and will continue to assess and collect the § 4251 tax on long distance communications services.



c. **Amtrak's long-distance telephone service is not subject to the excise tax on toll telephone services because the payment was based solely on time.** National Railroad Passenger Corp. (Amtrak) v. United States, 431 F.3d 374 (D.C. Cir. 12/9/05). The court affirmed the district court and concluded that the statute was unambiguous, and the "and" in § 4252 was to be read conjunctively.

2. **Taxpayer subject to tax on golden parachute payments because statute covers the payment and proposed regulations to the contrary have no legal force until they become final.** Yocum v. United States, 66 Fed. Cl. 579 (Fed. Cl. 7/1/05). On the issue of whether the § 4999 excise tax on "excess parachute payments" applies, taxpayer/executive relied upon proposed regulations to assert the inapplicability of the tax to the transaction in question. Judge Allegra held that "proposed regulations have no legal force until they become final," and that "these principles [do not] differ simply because the IRS allows a proposed regulation to linger unadopted over a long period of time."

## XII. TAX LEGISLATION

### A. Enacted

1. **The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("Bankruptcy Act of 2005")**, P.L. 109-8, was signed by President Bush on 4/20/05.

2. **The Energy Policy Act of 2005**, P.L. 109-58, was signed by President Bush on 8/8/05. Title XIII (Energy Policy Tax Incentives) of the Energy Policy Tax Act of 2005 may be cited as the **Energy Tax Incentives Act of 2005**.

3. **The Highway Reauthorization and Excise Tax Simplification Act of 2005**, P.L. 109-59, was signed by President Bush on 8/10/05.

4. **Kiss Me Kate.<sup>7</sup> Or, is it the powerful Katrin(k)a?<sup>8</sup> The Katrina Emergency Tax Relief Act of 2005 ("KETRA" or "Katrina Tax Act")**, P.L. 109-73, was signed by President Bush on 9/23/05.

5. **The Gulf Opportunity Zone Act of 2005 ("GO Zone Act of 2005")**, P.L. 109-135, was signed by President Bush on 12/21/05. The Act: (1) provides 50 percent bonus depreciation to businesses

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7. For Cole Porter devotees.

8. For readers of the old Toonerville Trolley comic strip.

rebuilt in the newly created Gulf Opportunity (GO) Zone; (2) doubles the amount that may be expensed under section 179 from \$100,000 to \$200,000 for investments made in the GO Zone and increase the phaseout floor from \$400,000 of annual investments to \$ 1 million; (3) allows businesses a five-year carryback of net operating losses attributable to investment in the GO Zone; (4) increases the amount of expensing allowed for reforestation costs of small timber owners within the GO Zone and within the areas affected by Hurricane Rita; (5) increases and enhances low-income housing credits within the GO Zone; (6) increases the rehabilitation tax credit for qualified expenditures within the GO Zone; (7) increases the cap on new markets tax credits and allocates the increased amounts to entities making low-income community investments in the GO Zone; and (8) creates additional tax-exempt bond authority for states and municipalities within the GO Zone and allows those states to issue debt service tax credit bonds to help devastated communities meet their debt service requirements as a result of the hurricanes.

- Casinos and other “sin facilities” [see Code § 144(c)(6)(B), e.g., massage parlors, liquor stores] are carved out from this bill but compromise language was added that would allow facilities attached to casinos – such as parking lots, hotels, and restaurants – to claim the tax relief.