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## Recent Developments in Federal Income Taxation: The Year 2006

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**Recent Developments in Federal Income Taxation:  
The Year 2006**

by

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Martin J. McMahon, Jr.

*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. Any mistakes in this outline are Marty's responsibility; any political bias or offensive language is Ira's.*

**I. ACCOUNTING**

**A. Accounting Methods**

1. **Tax Court rules that trader in securities failed to make timely mark-to-market election.** Lehrer v. Commissioner, T.C. Memo. 2005-167 (7/11/05). The taxpayers (in an amended petition to the Tax Court) sought to make an election under § 475(f) to treat stock trading losses as ordinary losses instead of capital losses, which would have substantially reduced the IRS's assessments for the three years involved. The

IRS argued that even if Mr. Lehrer was a “trader in securities” during the years in issue, he failed to make an effective mark-to-market election under § 475(f) pursuant to Rev. Proc. 99-17, 1999-1 C.B. 503, and moved for summary judgment. The Lehrers conceded that they did not make a mark-to-market election on their tax returns but argued that an effective mark-to-market election was made on their first amendment to petition the Tax Court. Further, the Lehrers argued that Rev. Proc. 99-17 lacks “precedential value as it simply announces the Service’s position.”

- The Tax Court further stated:

A taxpayer engaged in a trade or business as a trader in securities is eligible to elect to recognize gain or loss on any security held in connection with his trade or business at the close of the taxable year as if the security were sold for its fair market value at year end. Sec. 475(f)(1)(A)(i); see *Chen v. Commissioner*, T.C. Memo. 2004-132. In general, any gains or losses resulting from the mark-to-market election shall be treated as ordinary income or loss. Sec. 475(d)(3)(A), (f)(1)(D). If a taxpayer is in the business as a trader in securities and made a mark-to-market election with respect to sales of securities held in connection with his business, his net loss from that business would be an ordinary loss, deductible in full under section 165; if the mark-to-market election is not made, the net loss would be a capital loss deductible only to the extent of any capital gains plus \$3,000. See secs. 165(a), (c), (f), 1211(b)(1); *Chen v. Commissioner*, *supra*.

In *Chen*, we held that the taxpayer was not a ‘trader in securities’ for the relevant year for purposes of section 475(f) and, therefore, did not address the taxpayer’s argument regarding whether he should be permitted to make an untimely, retroactive mark-to-market election because section 475(f) was not available to him. As a result, we are presented with a novel issue: whether an allegation contained in an amendment to petition qualifies as an effective mark-to-market election. The statute and regulations do not provide procedures that specify the time and manner to make a mark-to-market election. \*\*\* The legislative history states that ‘The election will be made in the time and manner prescribed by the Secretary of the Treasury and will be effective for the taxable year for which it is made and all subsequent taxable years, unless revoked with the consent of the Secretary.’ See H. Conf. Rept. 105-148, at 446 (1997), 1997-4 C.B. (Vol. 1) 323, 768. Thus, the Secretary has authority to prescribe the time and manner of the election.”

a. **But another taxpayer who failed to make a timely mark-to-market election under § 475 is granted relief by the Tax Court.** Vines v. Commissioner, 126 T.C. 279 (5/11/06). Taxpayer was a Birmingham, Alabama plaintiffs' lawyer who settled a class action lawsuit during 1999 and received compensation of about \$17 million in each of the years 1999 and 2000. In 2000, he decided to leave the practice of law and begin a business of trading securities; between January 28 and April 14, 2000 [the day his trading account was liquidated for failure to cover a margin call after technology stocks declined], he had net trading losses of more than \$25 million. He did not make a § 475(f) election with his application for automatic extension of his 1999 income tax return, which was filed timely on April 17, 2000, because neither he nor his CPA was aware of the applicability of that provision. In June 2000, he became aware of a possibility of deducting his trading losses as ordinary losses, and promptly sought § 9100 relief from the April 17th due date that was prescribed in Rev. Proc. 99-17, 1999-1 C.B. 503, for the filing of Form 3115 to adopt the mark-to-market method for his securities trading business. Judge Wells granted relief under Reg. § 301.9100-3(c) because the taxpayer made no securities trades between April 14 and July 21, the date on which he filed his § 475(f) election, and therefore the taxpayer gained no advantage or benefit of hindsight from the delay.

(1) **Attorney's fees, however, were denied.** Vines v. Commissioner, T.C. Memo. 2006-258 (11/30/06). The court held that the government's position was substantially justified because the issue was one of first impression and "[b]ased on the lack of guidance available at the time, [the court could not] say that it should have been 'obvious' to respondent from the onset of the litigation that respondent's position was in error."

2. **Accountant's persistent omission of a step in the computation of the LIFO value of inventories required a change of accounting method to correct.** Huffman v. Commissioner, 126 T.C. 322 (5/16/06). A correction to the inventory method employed by S corporations that owned automobile dealerships constituted an accounting method change that requires a § 481 adjustment, and was not simply the correction of a mistake in arithmetic. Judge Halpern held this to be an accounting method change because the accountant reached an erroneous result over a 10- to 20-year period by omitting a computational step required by Reg. § 1.472-8, related to the link-chain, dollar-value method of pricing LIFO inventories, which caused understatements and overstatements in the LIFO value of inventories but did not result in the permanent omission of gross income.

- The correction of an erroneous formula – one that omitted a step for calculating inventories under the link-chain, dollar value method of valuing inventory over a 10 to 20 year period – resulted in a timing error, not a mere computational error. Generally, corrections to the taxpayer’s inventory accounting method constitute a change of accounting method. Furthermore, correction of a systematic erroneous method of calculating inventories on a recurring basis without a change in the overall inventory method, constitutes a change of accounting method rather than the correction of a computational error.

#### **B. Inventories**

There were no significant developments regarding this topic during 2006.

#### **C. Installment Method**

There were no significant developments regarding this topic during 2006.

#### **D. Year of Receipt or Deduction**

1. **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). The court held that the 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 one of the retail customers.

## **II. BUSINESS INCOME AND DEDUCTIONS**

### **A. Income**

1. **Supplier’s advances are immediately includible in income.** 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.

a. **The Ninth Circuit disagrees.** Westpac Pacific Food v. Commissioner, 451 F.3d 970 (9th Cir. 6/21/06), *rev'g* T.C. Memo. 2001-175 (7/16/01). “Cash advance trade discounts” received by a retailer from a manufacturer in exchange for volume purchase commitments, subject to pro rata repayment if the volume commitments were not met, were not includable in gross income when received because these amounts were adjustments to the cost of goods sold and the cash advances were includable in income by virtue of taxpayer’s inventory accounting system.

2. **Taxpayer has COD income when liabilities are discharged by a guarantor’s payment to the creditor after waiving any right to reimbursement from the taxpayer.** Miller v. Commissioner, T.C. Memo. 2006-125 (6/15/06). Taxpayer-debtor realized COD income upon guarantor’s payment of debt to the creditor because guarantor had waived any right to reimbursement rights in advance. Judge Gale further held that liabilities the cancellation of which give rise to COD income are counted in full as liabilities even though, because taxpayer was insolvent and the loan was guaranteed by a solvent third party, there was virtually no likelihood that taxpayer-debtor would be called upon to pay them. The primary obligor on a recourse obligation is “at-risk” notwithstanding a guarantor’s waiver of right to reimbursement because the creditor had the right to enforce the loan against taxpayer, and taxpayer had no rights to reimbursement from any other person. The fact that taxpayer was insolvent when the loan fell due and the creditor sought repayment directly from the guarantor was not relevant.

3. **No current taxation of settlement funds beneficially owned by a governmental entity.** TIPRA § 201(a) added Code §§ 468B(g)(2) and (3), which provide that certain settlement funds established before 2011 pursuant to consent decrees in order to resolve claims under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) are treated as beneficially owned by a state or federal governmental entity, and are thus exempt from tax under § 468B(g)(1).

a. These provisions were made permanent by the **Tax Relief and Health Care Act of 2006** § 409.

## B. Deductible Expenses versus Capitalization

1. **IRS identifies issues to be addressed in forthcoming proposed regulations on tangible property costs.** Notice 2004-6, 2004-1 C.B. 308 (12/23/03). 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. **At long last, the long-promised tangible property proposed regulations are out.** REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 71 F.R. 48590 (8/21/06). The proposed regulations include a repair allowance system that would permit expenditures on each class of property up to a specified percentage of cost to be deducted as repairs, with any excess required to be capitalized; the percentage is to be determined based on the principle that a taxpayer will spend 50 percent of cost on repairs over the MACRS recovery period. There are other rules, such as a twelve-month rule, unit-of-property rules for four categories of property [regulated industry property, buildings and structural components, other personal property, and other real property], but there is no *de minimis* rule – however, the absence of a *de minimis* rule does not change the current practice of permitting agreements between taxpayers and IRS examining agents not to select assets with minimal cost for review. Amounts paid that materially increase the value of a unit of property must be capitalized, as must be amounts paid that substantially prolong economic useful life.

• These proposed regulations would expressly provide that “[a] taxpayer must capitalize amounts paid to acquire or produce real or personal property having a useful life substantially beyond the taxable year, including land and land improvements, buildings, machinery and equipment, and furniture and fixtures . . . having a useful life substantially beyond the taxable year [, and also] amounts paid to acquire real or personal property for resale and to produce real or personal property for sale.” Transaction costs to acquire property also are expressly required to be capitalized. The proposed regulations also expressly require capitalization of any amount paid “for permanent improvements or betterments made to increase the value of any property.” The proposed regulations provide detailed rules for determining the proper “unit of property” with respect to which the



capitalization requirement will be applied. The unit of property concept is employed to distinguish deductible repairs to a component of a unit from capitalized replacement costs of a unit of property that contributes to the functionality of another larger unit of property. For example, a truck, aircraft, or boat engine might or might not be a separate unit of property from the remainder of the truck, aircraft, or boat.

- The test under these proposed regulations for distinguishing capital expenditures from repairs is whether the expenditure improves the property. An expenditure improves a unit of property if the expenditure either (1) materially enhances the value of the property as compared with the status of the property prior to the condition necessitating the expenditure, or (2) restores the property. The “materially enhances the value” test will apply in both cases of normal wear and tear as well as cases when the expenditure arises from a sudden, unexpected, or unusual external circumstance. Under the proposed regulations, when the event necessitating the expenditure is normal wear and tear, the condition of the property immediately prior to the event necessitating the expenditure is the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear or, if the taxpayer has not previously corrected the effects of normal wear and tear, the condition of the property when it was first placed in service by the taxpayer. This comparison rule for wear and tear applies even if the taxpayer engages in regular, cyclical maintenance of the property to correct the effects of normal wear and tear.

- The “materially enhances value” test does not require an actual determination of an increase in the fair market value of the property. The IRS rejected an actual valuation test in favor of conventions. An expenditure materially increases the value of property only if it: (1) ameliorates a condition or defect that either existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of the acquisition or production, (2) is for work performed prior to the date the property actually is placed in service by the taxpayer, (3) adapts the unit of property to a new or different use (including a permanent structural alteration to the unit of property), (4) results in a betterment (including a material increase in quality or strength) or a material addition (including an enlargement, expansion, or extension) to the unit of property; or (5) results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, or quality of output of the unit of property.

- The proposed regulations also provide that a Federal, state, or local regulatory requirement that a taxpayer perform certain repairs or maintenance is not relevant in determining whether

the amount paid improves the property. Furthermore, the proposed regulations provide that repairs that do not directly contribute to an improvement are not required to be capitalized under § 263(a) merely because they are made at the same time as an improvement. This rule rejects the judicial “plan of rehabilitation doctrine” under which otherwise deductible repairs incurred as part of a general plan of rehabilitation must be capitalized. Nevertheless, expenditures that otherwise would have been deductible as repairs but which contribute to a specific improvement that must be capitalized likewise must be capitalized.

- The repair allowance rules in these proposed regulations are similar to those in the class life asset depreciation rules (CLADR), which were in effect from the late 1960s to 1980 (when they were superseded by ACRS). Under the new comprehensive elective repair allowance rule, if the taxpayer elects to use the repair allowance method, it must be used consistently for all property and for all future years until the election is revoked, which requires the IRS’s consent. Under the proposed regulations, all amounts paid for materials and labor during the taxable year to repair, maintain, or improve repair allowance property are deductible under § 162 to the extent they do not exceed the “repair allowance amount.” The “repair allowance amount” is determined separately for each MACRS property class, and for any particular class is determined by multiplying the repair allowance percentage in effect for that class by the average unadjusted basis of repair allowance property in that class. For buildings that are repair allowance property, the repair allowance method is applied separately to each building.

- Amounts paid to repair, maintain, or improve the repair allowance property in any particular MACRS class (or with respect to a particular building) that exceed the repair allowance amount must be capitalized. Taxpayers may choose between two methods for depreciating the capitalized amount. One method is to treat the capitalized amount as a separate single asset and to depreciate the asset in accordance with the appropriate MACRS class. The other method is to allocate the capitalized amount for a particular MACRS class among all repair allowance properties in the particular MACRS class in proportion to the unadjusted basis of each item of property in that MACRS class as of the beginning of the taxable year. For purposes of subsequent depreciation, regardless of which method is elected, the capitalized amount is treated as a § 168(i)(6) improvement and is treated as placed in service by the taxpayer on the last day of the first half of the taxable year in which the amount is paid, before application of the convention under § 168(d). For example, the capitalized amount for a calendar year taxpayer would be treated as placed in service on June 30 of the taxable year. Although the single asset method entails less complexity, that method does not allow a taxpayer to take the capitalized amount into account in computing gain or loss

recognized on the disposition of any particular item of repair allowance property.

2. Anschultz Co. v. Commissioner, T.C. Memo. 2006-40 (3/13/06), *reconsideration denied*, T.C. Memo. 2006-124 (6/14/06). The taxpayer properly made a first-level allocation under Reg. §§ 1.263A-1(e)(3)(i) and 1.451-3(d)(6)(i) of indirect costs between (1) property produced under long-term contract [which was not subject to § 263A], and (2) property produced and held by the taxpayer for its own use [which was subject to § 263A]. Judge Haines held that the “reasonableness” standard of Reg. § 1.263A-1(f)(4) does not apply to interpret “reasonable allocation” in Reg. § 1.451-3(d)(6)(i) when only § 460 is at issue.

3. **Big loser in 1996 Olympics: Corporate president paid \$5 million to indemnify his corporation, lost his job, and got no deduction either.** Tigrett v. United States, 96 A.F.T.R.2d 2005-5649 (W.D. Tenn. 8/3/05), *as amended*, 96 A.F.T.R.2d 2005-6341 (9/2/05). The \$5 million paid to a corporation by its president/minority shareholder in satisfaction of his contractual obligation to indemnify the corporation against losses from a specific venture [the House of Blues venue in Centennial Park in Atlanta during the 1996 Olympics] that he advocated the corporation to 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.

a. **Tigrett affirmed**, 99 A.F.T.R.2d 2007-501 (6th Cir. 1/12/07). Taxpayer failed to prove that the contribution to capital was an ordinary business expense or a business loss.

### C. Reasonable Compensation

There were no significant developments regarding this topic during 2006.

### D. Miscellaneous Deductions

1. **The IRS never seems able to catch up with 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.

a. **The IRS noticed that fuel prices went up recently, so a 9/1/05 increase in mileage rates was announced.** Announcement 2005-71, 2005-2 C.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. **Splitting the difference between the first eight months of 2005 and the last four for 2006.** Rev. Proc. 2005-78, 2005-2 C.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).

c. **The IRS knows that gas prices are scheduled to increase after the 2006 elections, just as they knew back in December 2005 that they were scheduled to decrease before the 2006 elections.** Rev. Proc. 2006-49, 2006-47 I.R.B. 936 (11/1/06). For 2007, it is 48.5 cents per business mile and 20 cents per medical and moving mile. The statutory rate for charitable mileage under § 170(i) remains at 14 cents per mile.

2. Section 201 of the **Jobs Act of 2004** amends § 179 to extend the \$100,000 amount for expensing [and the \$400,000 phase-out threshold] for small businesses through years beginning before 2008.

a. **Increased § 179 amount extended through 2009.** TIPRA § 101 amends § 179 to extend the increased amount for expensing through years beginning before 2010.

3. **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. §§ 199(a) and (b). 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. § 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. § 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.

a. **If the statute appears to have a short shelf-life, the guidance under it should be even more ephemeral.** Notice 2005-14, 2005-1 C.B. 498 (1/19/05). This notice provides 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: Deduction, 70 F.R. 67220 (11/4/05). The IRS published voluminous [224 pages] proposed regulations [§§ 1.199-1 through -8] relating to the deduction for U.S. manufacturing income under § 199. The “shrinking back” concept of taking

the deduction for only the value of the beans in a cup of brewed coffee, or for the value of the U.S.-manufactured shoelaces on a pair of foreign-manufactured sneakers is being much discussed.

c. **Finally, final regulations! Final § 199 regulations are out and are 247 pages long in the Internal Revenue Bulletin, but that is only 137 pages in Lexis and 55 pages in the Federal Register.** T.D. 9263, Income Attributable to Domestic Production Activities, 71 F.R. 31268, 2006-25 I.R.B. 1063 (6/1/06). You have to be addlepatated if you expect a summary.

d. **“W-2 wages” include only those allocable to domestic production activities.** TIPRA § 514 amends § 199(b) to provide that “W-2 wages” includes only wages properly allocable to domestic production gross receipts.

e. Rev. Proc. 2006-22, 2006-23 I.R.B. 1033 (5/24/06). This revenue procedure provides guidance for calculating W-2 wages that reflects the additional limitations imposed by TIPRA. Three methods are provided for the calculation, the unmodified box method, the Modified Box 1 method, and the tracking wages method.

f. T.D. 9293, TIPRA Amendments to Section 199, 71 F.R. 61662 (10/19/06). The IRS has promulgated temporary regulations regarding the proper allocation of W-2 wages to domestic production gross receipts. Proposed regulations, REG-127819-06, are based on the text of the temporary regulations.

4. **Tool allowance is not paid under an accountable plan.** 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, he was not obligated to return any excess advances to the employer.

a. **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.

5. **IRS rules on accountable plans.** Rev. Rul. 2006-56, 2006-46 I.R.B. 874 (11/13/06). If employers pay expense allowances in excess of the amount that may be deemed substantiated without requiring actual substantiation of all the expenses or repayment of the excess amount and the expense allowance arrangement has no mechanism or process to determine when an allowance exceeds the amount that may be deemed substantiated, then the failure of the arrangement to treat the excess allowances as wages for employment tax purposes causes all payment made under the arrangement to be treated as made under a nonaccountable plan. This rule is not effective for taxable periods ending on or before 12/31/06 in the absence of intentional noncompliance.

- The facts of this ruling involve reimbursement of long-haul truck drivers for meal and incidental expenses on a "cents-per-mile driven" basis that regularly exceeds \$52 per day – the amount determined by § 4.04 of Rev. Proc. 2005-67, 2005-2 C.B. 729.

6. **This truck driver case applies the reimbursement doctrine twice.** Transport Labor Contract/Leasing, Inc. v. Commissioner, 461 F.3d 1030 (8th Cir. 8/23/06). Taxpayer provided professional employer organization ("PEO") services to small- and medium-sized trucking companies by hiring truck drivers as its employees and then leasing them back to its trucking company clients. The issue was whether it or the trucking company had to take the § 274(n) haircut when the drivers were paid a fixed per diem, with the per diem being treated as an expense reimbursement. The Tax Court held that the PEO was the common law employer, and stopped there. The Eighth Circuit (Judge Loken) reversed as a matter of law on the ground that the § 274(e)(3)(B) exception applied because the taxpayer itself incurred the per diem expenses "under a reimbursement or other expense allowance arrangement" with the trucking companies for which it accounted to them.

7. **"Sleep or rest" does not require a hotel room.** Bissonnette v. Commissioner, 127 T.C. 124 (10/23/06). The Tax Court (Judge Haines) allowed a deduction for meal expenses incurred by a ferryboat captain during six- to seven-hour layovers in harbor during single-day, 15- to 17-hour sea voyages because the taxpayer's very demanding job required sleep or rest during the layovers and the length of the layovers

increased his expenses because he had to buy meals. However, meal expenses incurred during one-hour layovers (and occasional longer layovers) during which the taxpayer did not rest were not deductible.

8. The **Tax Relief and Health Care Act of 2006** § 108 extends the § 62(a)(3) above-the-line \$250 deduction for K-12 teacher classroom expenses to 2006 and 2007.

9. The **Tax Relief and Health Care Act of 2006** § 109 extends the expensing of brownfields remediation costs to 2006 and 2007. It also provides that sites contaminated by petroleum products will be eligible for the deduction.

#### **E. Depreciation & Amortization**

1. **TIPRA** § 207 adds new § 167(g)(8) to provide for the election of 5-year amortization of costs of musical compositions and copyrights placed in service during years beginning after 2005 but before 2011. A taxpayer not making the election may use any cost recovery method otherwise permitted, including the income forecast method.

2. The **Tax Relief and Health Care Act of 2006** § 113 extends the § 168(e)(3)(E) 15-year depreciation periods for leasehold improvements and for restaurant improvements to 2006 and 2007.

#### **F. Credits**

1. The **Tax Relief and Health Care Act of 2006** § 104 extends the research credit through 2007 and creates an additional alternative simplified credit for 2007.

a. **More time to make research credit elections for 2006 years.** The **Tax Relief and Health Care Act of 2006** § 123 extends the time for making research credit elections for taxable years ending after 2005 to the later of 4/15/07 or such time as specified by the Treasury. A similar rule shall apply to other elections under expired provisions.

#### **G. Natural Resources Deductions & Credits**

1. **FIRST: Energy efficient commercial buildings; “greening-up” an existing building.** 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 regulation (with the statute providing an interim target, in the case of lighting system retrofits).

- a. The **Tax Relief and Health Care Act of 2006** § 204 extends the § 179D deduction for energy efficient commercial buildings to 2008.

2. **SECOND: 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.

- The credit is effective for homes substantially completed after 8/08/05 and sold after 12/31/05 but before 1/01/08).

a. **Procedures for getting the home certified.**

Notice 2006-27, 2006-11 I.R.B. 626 (2/22/06), updated by Announcement 2006-88, 2006-46 I.R.B. 910 (10/30/06). The IRS has published procedures that an eligible contractor may follow to certify that a dwelling unit, other than a manufactured home, is an energy efficient home that satisfies the requirements of § 45L(c)(1). Certification must be performed by RESNET or an equivalent energy rating network. RESNET's website is located at <http://www.natresnet.org>.

b. Notice 2006-28, 2006-11 I.R.B. 628. This notice contains procedures that an eligible contractor may follow to certify that a dwelling unit that is manufactured home satisfies the requirements of §§ 45L(c)(2) and (3).

c. **The Tax Relief and Health Care Act of 2006** § 205 extends the Code § 45L credit for new energy efficient homes to 2008.

3. **THIRD: 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. § 30B(h)(6). A taxpayer claiming the credit must reduce his basis in the vehicle by the amount of the credit.

- A new qualified hybrid motor vehicle is a vehicle, the original use of which commences with the taxpayer that uses both an internal combustion engine and a rechargeable battery system, that meets specified emission standards, and that 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. Section 30B(d) is effective for property placed in service after 12/31/05 and generally before 1/01/10. Hybrid vehicles are the only *green* vehicles currently being mass produced.<sup>1</sup> The new hybrid motor vehicle credit applies, in differing amounts, to passenger automobiles and light trucks, and other hybrid motor vehicles.

a. **IRS Releases Notice 2006-9 Providing Guidance on the Qualified Hybrid Tax Credit.** Notice 2006-9, 2006-6 I.R.B. 413 (1/13/06). This notice sets forth interim guidance, pending the issuance of regulations, relating to the new advanced lean-burn technology motor vehicle credit under § 30B(a)(2) and (c) of the Internal Revenue Code and the new qualified hybrid motor vehicle credit under § 30B(a)(3) and (d).

b. IR-2006-56 (4/7/06). The IRS acknowledges the certification by Ford of certain models of the Ford Escape and Mercury Mariner hybrids for credit amounts between \$1,950 and \$2,600.

c. IR-2006-57 (4/7/06). The IRS acknowledges the certification by Toyota of certain models of the Toyota Prius, the Toyota Highlander, and the Lexus RX400h for credit amounts between \$2,200 and \$3,150.

d. **Let no good deed go unpunished.** IR-2006-112 (7/13/06). Employer incentives in the form of cash rebates to employees who purchase environmentally friendly hybrid vehicles are to be included in the employees' income as compensation.

4. **FOURTH: Nonbusiness energy property credit. Certification is obtained by the manufacturer.** 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

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1. But see manufacturers' web sites for other available colors.

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.

a. **Certification to be obtained from manufacturer.** Notice 2006-26, 2006-11 I.R.B. 622 (2/22/06). Pending the issuance of regulations, this notice provides procedures that manufacturers may follow to certify property as either an “eligible building envelope component” or “qualified energy property.” It also provides guidance regarding the conditions under which taxpayers seeking to claim the § 25C credit may rely on a manufacturer’s certification (or, in the case of certain windows, an “Energy Star” label).

5. **FIFTH: Credit for residential energy efficient property, e.g., solar panels.** 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.

a. The **Tax Relief and Health Care Act of 2006** § 206 extends the Code § 25D credit for residential energy efficient property to 2008.

6. **Interim guidance under the CS, etc. credit.** Notice 2006-88, 2006-42 I.R.B. 686 (9/26/06). This Notice provides interim guidance on the tax credit under § 45(c)(1)(C) for electricity produced from open-loop biomass.

7. The **Tax Relief and Health Care Act of 2006** § 118 extends the Code § 613A(c)(6)(H) temporary suspension of the 100 percent of taxable income limit on percentage depletion for oil and natural gas produced from marginal properties to taxable years beginning in 2006 and 2007.

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

1. Jefferson Smurfit Corp. v. United States, 439 F.3d 448 (8th Cir. 3/6/06), *rehearing denied*, 2006 U.S. App. LEXIS 13606 (6/1/06). Judge Murphy held that a tentative NOL carryback allowed under § 6411 is subject to adjustment after the subsequent audit of the year in which the NOL arose – even if the Tax Court has issued a final order determining the taxpayer’s liability for the carryback year.

#### **I. At-Risk and Passive Activity Losses**

There were no significant developments regarding this topic during 2006.

### **III. INVESTMENT GAIN**

#### **A. Capital Gain and Loss**

1. The **Third Circuit devised a new test for determining whether the sale of a right to an income stream produced capital gain or ordinary income.** Lattera v. Commissioner, 437 F.3d 399 (3d Cir. 2/14/06), cert. denied, 127 S. Ct. 1328 (2/20/07). The taxpayer sold all of his rights to all of the remaining payments under a winning lottery ticket. The court rejected the “substitute for ordinary income” analysis as overly-broad, and instead devised a test related to the “family resemblance” of a particular transaction to traditional capital assets analysis. The family

resemblance test was based on the (1) “type of ‘carve out’” – horizontal versus vertical – and the (2) “character of asset” involved. The court reasoned that “[b]ecause a vertical carve-out could signal either capital-gains or ordinary-income treatment, ... when we see a vertical carve-out, we proceed to the second factor – character of the asset – to determine whether the sale proceeds should be taxed as ordinary income or capital gain.”

- Under the character of the asset analysis, assets that constitute a right to earn income from the property accrued in the future merit capital-gains treatment, while assets that constitute a right to receive income accrued in the past merit ordinary-income treatment. Applying this analytical model the court concluded, “because a right to lottery payments is a right to earned income (i.e., the payments will keep arriving due simply to ownership of the asset), the lump-sum payment received by the Latteras should receive ordinary-income treatment.” Note that under this test, the taxpayer in *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), would continue to be entitled to capital gains treatment on the sale of a life estate, because the income therefrom would not yet have accrued at the time of the sale.

- Other courts of appeals that have addressed the issue likewise have held that the proceeds from the sale of lottery winnings are ordinary income, not capital gains, although the reasoning of the different courts varies.

a. **Lottery winners’ sale of rights to lottery installments results in ordinary income under the substitute-for-ordinary-income doctrine.** *Watkins v. Commissioner*, 447 F.3d 1269 (10th Cir. 5/10/06). The court followed earlier lottery assignment cases in so holding, including *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004), and *Davis v. Commissioner*, 119 T.C. 1 (2002). Particularly, the court followed the reasoning in *Commissioner v. P.G. Lake Inc.*, 356 U.S. 260 (1958), which held that the “substance of what was assigned was the right to receive future income” and the “substance of what was received was the present value of income which the recipient would otherwise obtain in the future” and “consideration was [not] paid for an increase in the value of the income-producing property.”

- The court held that the proceeds were ordinary income under the “substitute-for-ordinary-income doctrine,” while “refus[ing] to enter the fray” regarding whether the analysis under *Maginnis* or that under *Lattera* should be applied, and while declining to “formulate any specific test regarding the doctrine’s application.”

b. *Wolman v. Commissioner*, 180 Fed. Appx. 830 (10th Cir. 5/19/06), followed *Watkins*.

2. **Capital gain treatment for sales of self-created musical works.** TIPRA § 204 adds new § 1221(b)(3) to permit taxpayers to elect to treat the sale or exchange of self-created musical compositions or copyrights in musical works sold or exchanged after 12/31/06 and before 1/1/11 as the sale or exchange of a capital asset. This capital asset treatment is to be inapplicable for § 170(e) purposes, so the amount of the charitable deduction of such assets continues to be reduced by the amount of appreciation inherent in such assets. Section 1221(b)(3), added to the Code in 2006, permits a taxpayer to elect to treat a self-created musical work as a capital asset, if the taxpayer sells or exchanges the work before 2011. The 2006 legislation, however, also amended § 170(e)(1)(A) to provide that new § 1221(b)(3) is not taken into account in determining the amount of any charitable deduction for the donation of a self-created musical work.

a. **Made permanent by the Tax Relief and Health Care Act of 2006 § 412.**

3. REG-109367-06, Section 1221(a)(4) Capital Asset Exclusion for Accounts and Notes Receivable, 71 F.R. 44600 (8/7/06). Proposed regulations to clarify when accounts or notes receivable are acquired in payment for inventory or services rendered within the meaning of § 1221(a)(4), which has the effect of permitting loss on the sale or exchange of such accounts or notes receivable to be ordinary. These regulations would exclude situations where the accounts or notes receivable are acquired for consideration other than § 1221(a)(1) property or services.

4. Merlo v. Commissioner, 126 T.C. 205 (4/25/06). The Tax Court (Judge Haines) held that limitations on capital losses under §§ 1211 and 1212 apply for purposes of calculating alternative minimum taxable income. Thus, capital losses realized in 2001 upon worthlessness of stock acquired pursuant to the exercise of incentive stock options did not create an AMT NOL that could be carried back to reduce AMTI in 2000 [the year of exercise].

5. **Proposed regulations will treat taxpayers who exchange property for an annuity as if they had sold the property.** REG-141901-05, Exchanges of Property for an Annuity, 71 F.R. 61441 (10/18/06). The Treasury has published proposed regulations that would provide a single set of rules for the taxation of an exchange of property for an annuity contract. Essentially, the proposed rules will treat the transaction as if the property was sold for cash equal to the value of the annuity contract [as determined under § 7520] and the proceeds were used to buy an annuity

contract; however, taxpayers may continue to structure transactions as § 453(b) installment sales. These proposed regulations do not change existing Reg. § 1.1011-2 for charitable gift annuities, but will change prior law on exchanges of appreciated property for private annuities to the extent it permitted open transaction treatment or ratable recognition as the annuities were paid. The effective date is 10/18/06, with a delayed effective date of 4/18/07 for non-abusive transactions.

- These proposed regulations would bring the current treatment of exchanges of appreciated property for private annuities into line with the tax treatment of exchanges for commercial annuities. Before these regulations are applicable, the law generally postponed tax on the exchange based on the assumption that the value of a private annuity contract could not be determined for federal income tax purposes.

## B. Interest

1. **Interest-free loans to continuing care facilities may be without limit through 2010.** TIPRA § 209 adds new § 7872(h), which removes the \$100,000 dollar cap for excepting interest-free loans to continuing care facilities from the imputed interest rules for years through 2010. It also reduces the minimum age of qualifying lenders from 65 to 62.

- a. Made permanent by the Tax Relief and Health Care Act of 2006 § 425.

## C. Section 1031

1. **While all exchanges of real property interests are not, ipso facto, like-kind exchanges under § 1031, this taxpayer's exchange was.** Peabody Natural Resource Co. v. Commissioner, 126 T.C. 261 (5/8/06). The Tax Court (Judge Gerber) held that receipt of coal mining property and appurtenant coal supply contracts with electric utility companies in exchange for gold mining property without supply contracts was a § 1031 exchange without boot. The coal supply contracts were not separate intangible property. The Tax Court articulated the standard to be applied in deciding whether real property interests are considered to be like-kind as follows.

To decide whether an exchange is like kind within the meaning of section 1031(a), we must compare the exchanged properties to ascertain whether the nature and character of the transferred rights in and to the respective properties are substantially alike.... In making this comparison, consideration is to be given to the respective



interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality.

- For example, under this standard, rights appurtenant to land, such as leases and mineral supply contracts, are part of the bundle of rights incident to ownership of the land that are not separate property interests but merely constitute a distinction in the grade or quality of the old and new mining properties.

#### D. Section 1033

There were no significant developments regarding this topic during 2006.

### IV. COMPENSATION ISSUES

#### A. Fringe Benefits

1. **Guidance on Health Savings Accounts.** Notice 2004-2, 2004-1 C.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. REG-138647-04, Employer Comparable Contributions to Health Savings Accounts Under Section 4980G, 70 F.R. 50233 (8/26/05). The Treasury proposed regulations that would provide guidance on employer comparable contribution to HSAs under § 4980G, which provides an excise tax on the failure of an employer to make “comparable contributions” to the HSAs 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.

b. **Final regulations in Q&A form.** T.D. 9277, Employer Comparable Contributions to Health Savings Accounts Under Section 4980G, 71 FR 43056 (7/28/06). The final regulations provide guidance on how to interpret the comparable contribution rules that

employers must follow if they contribute funds to an employee's health savings account.

c. The **Tax Relief and Health Care Act of 2006**, § 302, adds new Code § 106(e) to permit one-time transfers to health savings accounts from health flexible spending arrangements and health reimbursement arrangements.

d. The **Tax Relief and Health Care Act of 2006**, § 303, amends Code § 223(b)(2) to repeal the annual deductible limitation on HSA contributions and allow contributions of \$2,700 (\$5,454 family) even if the deductible is less than those amounts.

e. The **Tax Relief and Health Care Act of 2006**, § 302, adds new Code § 4980G(d) to provide for an exception to the current requirement that employer contributions to HSAs be "comparable" for all employees by allowing employers to provide additional contributions to lower-paid workers.

f. The **Tax Relief and Health Care Act of 2006**, § 307, adds new Code § 408(d)(9) to permit one-time distributions from IRAs to fund HSAs. This would allow those who cannot afford to fully fund an HSA with direct contributions to move IRA money to a more tax-advantaged position.

2. **The IRS rules that if a self-funded health reimbursement plan provides medical expense reimbursements for non-dependents after the death of the employee and the last of his dependents, it will "mess up" the entire plan for all employees by making such reimbursements includible in income of any employee who receives reimbursements under the plan.** Rev. Rul. 2006-36, 2006-36 I.R.B. 353 (8/14/06). Medical expense reimbursements made to employees for payments of the medical expenses of a beneficiary other than the employee's spouse or dependents are not excludable from gross income under § 105(b). Additionally, none of the payments from the reimbursement plan during the plan year to ANY person, including amounts paid to reimburse the medical expenses of an employee or the employee's spouse or dependents, is excludable from gross income.

- This ruling is effective for health reimbursement plans after 2008, except that it is immediately effective for health reimbursement plans that added such a provision after 8/14/06.

- To what extent will this ruling mess up plans that provide for payments for non-dependent domestic partners? The

IRS has previously ruled that insured plans that offer domestic partner coverage will not be completely “tainted,” but that the cost of such insurance will be includible in the employee’s income.

## **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 Treasury has 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, §§ 1.401(k)-1(f) and 1.401(k)-2(b), require a pre-tax alternative elective contribution to the Roth account. They also require an irrevocable designation to be made by the employee at the time of the cash or deferred election, and require that Roth contributions be maintained by the plan in a separate designated Roth account for the employee. Matching contributions will not be permitted to be allocated to a designated Roth account. The regulations are effective for taxable years beginning after 12/31/05.

- The final regulations retain the requirement that a designated Roth contribution must satisfy the requirements applicable to any other elective contributions made under a qualified cash or deferred arrangement. Thus, designated Roth contributions are subject to the nonforfeitability and distribution restrictions applicable to elective contributions and are taken into account under the actual deferral percentage test (ADP test) of § 401(k)(3) in the same manner as pre-tax elective contributions. Similarly, designated Roth contributions may be treated as catch-up contributions and serve as the basis for a participant loan.

2. **MRD requirements apply to designated Roth accounts in qualified plans, but not to amounts rolled over to Roth IRAs.** 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 years of age, or is made after the employee's death, or is attributable to the employee's being disabled. The 5-taxable-year period, during which a distribution is not a qualified distribution, begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the plan and ends when 5 consecutive taxable years have been completed. However, if a direct rollover is made from a designated Roth account under another plan, the 5-taxable-year period for the recipient plan begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the other plan, if earlier.

3. **How to implement what God hath Roth.** Notice 2006-44, 2006-20 I.R.B. 889 (4/24/06). This notice contains a sample amendment to enable plan sponsors to provide for designated Roth contributions in their 401(k) plans.

4. T.D. 9256, Revised Regulations Concerning Disclosure of Relative Values of Optional Forms of Benefit, 71 F.R. 14798-02 (3/24/06). Final regulations under § 417(a)(3) address the content requirements applicable to explanations of qualified joint and survivor annuities and qualified preretirement survivor annuities payable under retirement plans. These regulations provide that the explanation must disclose the relative value of any optional forms of benefit compared to the value of the QJSA if the actuarial present value of that optional form of benefit is less than that of the QJSA. Effective for explanations provided for annuity starting dates beginning on or after 2/1/06.

5. **Plan participants can now get some help on investing their 401(k) accounts. Pension Protection Act, § 601,** amends ERISA § 408 and Code § 4975 to permit employers and plan trustees to provide investment advice through an "eligible investment advice arrangement" to participants and beneficiaries of defined contribution plans who direct the investment of their accounts, by creating another exclusion from prohibited transaction treatment. These provisions are effective for advice provided after 12/31/06.

6. **Congress – in reaction to Enron – requires that 401(k) participants get what Peter Lynch calls “di-worse-ification” rights with respect to employer securities.** Pension Protection Act § 901 adds new Code § 401(a)(35) to provide diversification rights with respect to publicly traded employer securities held by a defined contribution plan. This subsection is effective with respect to plan years beginning after 12/31/06.

a. Notice 2006-107, 2006-51 I.R.B. 1114 (11/30/06). This notice provides transitional guidance regarding § 401(a)(35), together with a model notice to plan participants concerning employer securities.

7. **Cash balance plan proposed regulations provide a green light for adoptions of cash balance plans favoring younger employees, including permission to require quasi-geriatrics to spin their [retirement accrual] wheels during “wear-away” periods.** REG-209500-86 and REG-164464-02, Reductions of Accruals and Allocations Because of the Attainment of any Age; Application of Nondiscrimination Cross-Testing Rules to Cash Balance Plans, 67 F.R. 76123 (12/11/02). These proposed regulations provide guidance on age discrimination requirements under §§ 411(b)(1)(H) and 411(b)(2), including the allocation of these requirements to cash balance pension plans.

- A cash balance plan is a defined benefit plan under which an employee has a hypothetical individual account that provides a benefit upon retirement based upon pay credits and interest credits – a concept that closely resembles a defined contribution plan. Section 411(b)(1)(H) provides that a defined benefit plan fails to comply with the age discrimination rules of § 411(b) if benefit accrual is ceased or reduced on the attainment of any age, and § 411(b)(2) provides that a defined contribution plan similarly fails to comply unless the rate at which amounts are allocated to an employee’s account is not similarly ceased or reduced because of age.

- A cash balance qualifies, *inter alia*, only if “the participant accrues the right to future interest credits (without regard to future service) at a reasonable rate of interest that does not decrease because of the attainment of any age.”

- The rules for conversion of traditional defined benefit plans to cash balance plans require that either (1) the converted plan defines the benefit as the sum of the benefits under the traditional defined benefit plan and the cash balance account, or (2) the converted plan must establish each participant’s opening account balance as an amount not less than the actuarial present value of the participant’s prior accrued benefit. The second alternative would permit a “wear-away” period during which the participant will not accrue net benefits for some period after the conversion.

a. **Treasury and IRS withdraw the proposed cash-balance plan nondiscrimination regulations.** Announcement 2003-22, 2003-17 I.R.B. 846 (4/7/03). The proposed nondiscrimination regulations under § 401(a)(4) that would have required a modified form of cross-testing, which were proposed at the same time as the proposed cash balance regulations, are withdrawn because (as proposed) they would make it difficult “for plan sponsors converting long-standing traditional pension plans to cash balance plans to provide different types of transitional relief to plan participants.” The announcement states that the withdrawn proposed regulations will be re-proposed.

b. Section 205 of the **Consolidated Appropriations Act, 2004**, Pub. L. 108-199 (enacted 1/23/04), provided that none of the funds made available in the appropriations act could be used to issue any rule or regulation that implemented the proposed age-discrimination regulations or any regulations reaching similar results.

c. **Proposed cash balance plan regulations are completely withdrawn.** Announcement 2004-57; 2004-2 C.B. 15 (6/15/04). The December 2002 proposed regulations were withdrawn in order to give Congress the opportunity to consider the administration’s legislative proposal and to address cash balance plan issues through legislation.

d. **District court finds that IBM cash balance plan violates ERISA – but case is reversed after Congress passes the Pension Protection Act of 2006.** Cooper v. IBM Personal Pension Plan, 274 F. Supp. 2d 1010 (S.D. Ill. 7/31/03). The court held that the plan violated ERISA §§ 204(b)(1)(G) [reduction of accrued benefit solely on increases in age or service] and 204(b)(1)(H) [rate of benefit accrual decreases once a certain age is attained].

e. **Seventh Circuit reverses IBM case, but only after Congress acts to legalize cash balance plans.** Cooper v. IBM Personal Pension Plan, 457 F.3d 636 (7th Cir. 8/7/06), *rehearing denied*, 2006 U.S. App. LEXIS 23227 (7th Cir. 9/1/06), *rev’g* 274 F. Supp. 2d 1010 (S.D. Ill. 7/31/03). The Seventh Circuit (Judge Easterbrook) analyzes the situation by comparing ERISA § 204(b)(1)(H) [the anti-age discrimination provision applicable to defined benefit plans] with ERISA § 204(b)(2)(A) [the anti-age discrimination provision applicable to defined contribution plans]. Judge Easterbrook makes the point that “benefit accrual” in § 204(b)(1)(H) does not have the same meaning as “accrued benefit,” which

is defined in ERISA § 3(23)(A) as an amount “expressed in the form of an annual benefit commencing at normal retirement age.”

- Judge Easterbrook ascribes to the district court its conclusion that cash balance plans discriminate on account of age based on an example comparing the benefit received by a 30-year-old who leaves IBM at age 50 with the benefit received by a 45-year-old who retires at age 65, and states that the district court based its conclusion of discrimination on the fact that the difference in accrued benefit at age 65 – attributable to 15 additional years of compound interest – is not counterbalanced by the fact that older workers generally draw higher salaries. He rejects this interpretation of the statute that “treats the time value of money as age discrimination.”

- Judge Easterbrook reinforces this conclusion by noting it is identical to the view of the Treasury Department expressed in the December 2002 proposed regulations which concluded that the proper question to ask is, “if this employee were younger, would the hypothetical balance have grown more this year?”

f. **The world is now safe for cash balance plans.** Pension Protection Act § 701 amends ERISA §§ 203, 204 and 205, Code §§ 411 and 417, and ADEA § 4(i)(2) to provide that cash balance plans do not per se violate the prohibition on age discrimination.

g. **Or is it?** In re Citigroup Pension Plan ERISA Legislation, 470 F. Supp. 2d 323 (S.D. N.Y. 12/12/06). The court (Judge Scheindlin) disagreed with the Seventh Circuit’s *Cooper* decision and found that cash balance plans violate the prohibition on age discrimination.

h. Notice 2007-6, 2007-3 I.R.B. 272 (1/16/07). The IRS is beginning to process determination letter and examination cases in which an application for a determination letter or a plan under examination involves an amendment to change a traditional defined benefit plan into a cash balance plan. This notice also provides transitional guidance on the requirements of Code §§ 411(a)(13) and 411(b)(5), which were added by § 701(b) of the Pension Protection Act.

8. **The increased funding limits provided in the 2001 Act are made permanent.** Pension Protection Act § 811 repeals the sunset provision of EGTRRA as applied to the provisions relating to pensions and IRAs.

9. **Pension Protection Act § 812** makes the Code § 25B saver’s credit permanent.

10. **Beginning in 2008, 401(k) plans may contain an automatic contribution feature.** Pension Protection Act § 902 adds new Code § 401(k)(13) to permit qualified automatic enrollment in 401(k) plans, under which an employee is enrolled to make elective contributions unless he or she affirmatively elects otherwise. This provision is effective for plan years beginning after 12/31/07.

11. **Nonspouse plan beneficiaries can receive the same treatment as nonspouse IRA beneficiaries.** Pension Protection Act § 829 adds new Code § 402(c)(11) to permit nonspouse beneficiaries to roll their benefits over to an “inherited IRA,” which will be subject to the distribution rules applicable to beneficiaries, i.e., distributions over the life of the beneficiary under Code § 401(a)(9).

12. **Enron survivors get some “catchup” to go with their tea and sympathy.** Pension Protection Act § 831 amends Code § 219 to permit certain 401(k) plan bankruptcy survivors to make additional deductible “catchup” contributions to an IRA during the years 2007 to 2009, if transactions related to the bankruptcy led to an indictment or a conviction.

13. **Anti-cutback rules were not violated by plan amendments in accordance with statutory change [from PBGC rate to Treasury rate] in the applicable interest rate for the present value calculation of pension plan lump-sum payments to retirees.** 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.

a. **Affirmed**, 456 F.3d 320 (3d Cir. 7/27/06). The Hercules plan was amended before the expiration of the deadline, as extended by the Commissioner, for making such amendments.

14. T.D. 9280, Section 411(d)(6) Protected Benefits, 71 F.R. 45379 (8/9/06). These final regulations provide guidance in the interaction between the § 411(d)(6) anti-cutback rules and the § 411(a) nonforfeitability requirements. Under these regulations, plan amendments that change the plan’s vesting computation period do not violate § 411(d)(6)



– even though amendments affecting vesting, accrued benefits, or protected benefits do violate that provision.

### **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.

a. **Section 409A guidance provides transition rules and excludes stock appreciation rights from the purview of that section.** Notice 2005-1, 2005-1 C.B. 274 (12/20/04), *modified by* Notice 2006-100, 2006-51 I.R.B. 1109 (12/18/06). These notices provide guidance in Q&A form with respect to the application of § 409A.

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).

c. **IRS allows almost two years to bring offshore rabbi trust assets home.** Notice 2006-33, 2006-15 I.R.B. 754 (3/21/06). This notice provides transition relief with respect to the application of § 409A(b) to provide that nonqualified plan assets remaining in offshore trusts on 3/21/06 will not trigger income inclusion if the plan conforms with the requirements of § 409A(b) by 12/31/07.

d. **Transition relief extended for NQDC under § 409A.** Notice 2006-79, 2006-43 I.R.B. 763 (10/5/06). Although the IRS expects that the proposed regulations will become final by the end of 2006, the proposed effective date of 1/1/07 for the final § 409A regulations is extended to 1/1/08. Additional transition relief is provided through 12/31/07.

e. **Interim guidance on withholding and reporting requirements for 2005 and 2006.** Notice 2006-100, 2006-51 I.R.B. 1109 (11/30/06). Interim guidance to employers and payers on their wage withholding requirements for calendar years 2005 and 2006 with respect to compensation and amounts includible in gross income under § 409A, as well as guidance to service providers on their income tax reporting and payment requirements for amounts includible in gross income under § 409A for those years.

2. **Underfunded plan restricts NQDC for certain top employees. Pension Protection Act § 116** adds new Code § 409A(b)(3) to provide that any assets set aside in a nonqualified deferred compensation arrangement for top employees [those covered by Code § 162(m)(3) or subject to § 16(a) of the Securities Exchange Act of 1934] will be currently taxable to them if the transfer is made during any period that the employer's defined benefit pension plan is in a so-called "at-risk status."

3. **Stock options are not exercised when the service recipient provides nonrecourse financing because such exercise is merely the continuation of the option, but they ARE exercised when a third-party lender provides financing on a nonrecourse basis.** Palahnuk v. United States, 70 Fed. Cl. 87 (2/28/06), *aff'd* 475 F.3d 1380 (Fed. Cir. 2/12/07). The purchase of employer's stock pursuant to a nonstatutory stock option using funds obtained through borrowing on a margin account with a third party lender, with the loan secured by the purchased stock, constituted a completed transfer for purposes of § 83; the arrangement was not in substance a continuing option under Reg. §§ 1.83-3(a)(2) and 1.83-1(a)(7), Ex. (2), because the benefits of ownership and risk of decline in value had been transferred to taxpayer.

a. Facq v. Commissioner, T.C. Memo. 2006-111 (5/23/06). This case reaches the same result under virtually identical facts.

b. **Ninth Circuit tells taxpayer, "That's tough."** United States v. Tuff, 469 F.3d 1249 (9th Cir. 12/4/06), *aff'g* 359 F. Supp. 2d 1129 (W.D. Wash. 2/4/05). In this case compensatory stock was

transferred and vested for purposes of § 83 when the option was exercised with funds provided as margin debt by a third party brokerage firm. These stock purchases do not qualify for the Reg. § 1.83-3(a)(2) exception for treating a stock option exercised with a nonrecourse note as in substance the grant of an option.

4. Rev. Proc. 2006-31, 2006-27 I.R.B. 32 (6/13/06).

This revenue procedure provides the procedures to request consent to the revocation of a § 83(b) election. Reg. § 1.83-2(f) permits a § 83(b) election to be revoked only with the consent of the Commissioner. Consent will be granted only where the election was made under a mistake of fact as to the underlying transaction. Valuation mistakes, a decline in the property's value, and failure to satisfy conditions for the property vesting are not considered mistakes of fact. The failure of a service provider to understand the substantial risk of forfeiture associated with the transferred property or to understand the tax consequences of making a § 83(b) election is not a mistake of fact.

5. **Remember when “inappropriate dating” was just a reference to Wayne Hays and Elizabeth Ray, Gary Hart and Donna Rice, Bill Clinton and Monica Lewinsky, Gary Condit and Chandra Levy, or Barney Frank and Steve Gobic? Backdated stock options give rise to tax problems, but “innocent employees” may have their § 409A taxes paid by their employer.** Announcement 2007-18, 2007-9 I.R.B. 625 (2/8/07). This announcement institutes a compliance resolution program that permits employers to pay the additional § 409A taxes due to the exercise in 2006 of discounted stock options and stock appreciation rights for employees who are not corporate insiders. This is because the backdated stock options and stock appreciation rights were “in the money” when issued, and are, therefore, not excluded from § 409A by the regulations thereunder. Of course, these employer payments will be additional wages in the year in which they are made.

- This program offers only administrative convenience, and does not result in any benefit to the taxpayers involved.

#### D. Individual Retirement Accounts

1. **Mr. Gotbucks will be able to convert his traditional IRA to a Roth after 2009.** TIPRA § 512 amends § 408A(c) to remove the \$100,000 modified adjusted gross income limitation for the conversion of a traditional IRA to a Roth IRA, effective for taxable years

beginning after 2009. For conversions made in 2010, at the election of the taxpayer, the amount required to be included in gross income will not be taxed in 2010 but will be taxed ratably in 2011 and 2012.

2. The **HERO Act** adds new Code § 219(f)(7) to allow members of the Armed Forces serving in a combat zone to make contributions to their individual retirement plans even if the compensation on which such contribution is based is excluded from gross income. The provision is retroactive to 2004.

3. **Middle-aged geriatrics can make direct contributions from their IRAs to charities, and thus avoid deduction reductions under § 68.** Pension Protection Act, § 1201, adds new Code § 408(d)(8) to permit tax-free distributions up to \$100,000 directly to charities that are publicly supported under § 509(a)(1) and (2) [but not § 509(a)(3)] from IRAs owned by individuals over 70½ years of age. This provision has the effect of negating the erosion of charitable contribution deductions under § 68; these direct contributions will also be counted toward the minimum distribution requirements. This provision will be effective only for 2006 and 2007.

a. Announcement 2006-93, 2006-48 I.R.B. 1017 (11/7/06). This announcement provides procedures that § 501(c)(3) tax-exempt organizations may use to request a change in their public charity classification in light of the **Pension Protection Act**. These procedures would permit middle-aged geriatrics to use new Code § 408(d)(8) to permit tax-free distributions up to \$100,000 directly to charities that are publicly supported under § 509(a)(1) and (2) [but not § 509(a)(3)] from IRAs owned by individuals over 70½ years of age.

4. Gee v. Commissioner, 127 T.C. 1 (7/24/06). An early distribution from the IRA into which taxpayer's deceased spouse's IRA was rolled over was a premature distribution subject to the 10% penalty tax under § 72(t) because the amount received from the deceased spouse's IRA lost its character as a distribution made to a beneficiary upon a decedent's death when it was transferred to taxpayer's separately owned IRA, and thus was not exempt from the 10% penalty tax under § 72(t)(2)(A)(ii).

## V. PERSONAL INCOME AND DEDUCTIONS

### A. Rates

1. **TIPRA** § 101 extends through 12/31/10 the 15 percent rates for capital gains and dividends which had been scheduled to expire in 2008.

2. **TIPRA** § 301 amends § 55(d)(1) to extend the increased AMT exemption amount for individuals for the 2006 year.

a. **TIPRA** § 302 amends § 26(a)(2) to extend the use of certain nonrefundable personal credits through the 2006 year.

3. **TIPRA** § 510 amends § 1(g)(2)(A) to increase the age below which the kiddie tax is applicable from 14 to 18, effective for years beginning after 2005.

### B. Miscellaneous Income

1. **Who Threw the Overalls in Mrs. Murphy's Chowder? Compensation for a personal injury that relates to something that could have been enjoyed tax-free is not income under the Sixteenth Amendment.** Murphy v. IRS, 460 F.3d 79 (D.C. Cir. 8/22/06), *vacated*, 99 A.F.T.R.2d 2007-396 (12/22/06). Taxpayer received environmental whistleblower damages of \$70,000 from the New York National Air Guard in 2000. The damages were awarded "for mental pain and anguish" and "for injury to professional reputation." The court (Judge Ginsburg) held that § 104(a)(2), as amended in 1996 to exclude non-physical personal injuries from the exemption, was unconstitutional because "compensation for a non-physical personal injury is not income under the Sixteenth Amendment if, as here, it is unrelated to lost wages or earnings." Judge Ginsburg's rationale was based upon the consideration that the award of compensatory damages was a substitute for a "normally untaxed" personal quality, good or asset, citing *O'Gilvie v. United States*, 519 U.S. 79 (1996) (punitive damages were taxable pre-1996 Act because they were not a substitute for a normally untaxed benefit), and *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110 (1st Cir. 1944) ("In lieu of what were the damages awarded?"). Judge Ginsburg looked to the commonly understood meaning of the term "incomes" at the time of the adoption of the Sixteenth Amendment, and found that the term did not include damages for nonphysical personal injuries that were unrelated to lost wages or earning capacity.

- The issue is whether there was a pre-§ 104(a)(2) common law exclusion that survived the codification in 1918 and the amendments in 1996.

- The court rejected taxpayer's argument that her award was for "bruxism" which she argued was a physical injury or physical sickness.

- The court further dismissed the IRS as a defendant, holding that only the co-defendant United States was a proper defendant.

- The Government moved for rehearing *en banc*. In response, the panel vacated its opinion.

- This decision temporarily threw the treatment of compensatory damages for nonphysical personal injuries into a state of chaos when the court held the 1996 amendment to § 104(a)(2) requiring damages received for nonphysical personal injuries includable in gross income to be unconstitutional. The court found that "the damages were awarded to make Murphy emotionally and reputationally 'whole' and not to compensate her for lost wages or taxable earnings of any kind. The emotional well-being and good reputation she enjoyed before they were diminished by her former employer were not taxable as income." From this starting point, the court reasoned that because the damages were received in "in lieu of" something 'normally untaxed' ... her compensation is not income under the Sixteenth Amendment; it is neither a 'gain' nor an 'accession[ ] to wealth.'" The court found further support for its holding by looking to what it determined to have been "the commonly understood meaning of the term [income] which must have been in the minds of the people when they adopted the Sixteenth Amendment." The court concluded that "the framers of the Sixteenth Amendment would not have understood compensation for a personal injury — including a nonphysical injury — to be income." This conclusion was based largely on two 1918 rulings, one by the Attorney General [31 Op. Att'y Gen. 304 (1918)] and one by the Treasury Department [T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918)], both of which predated the enactment of the statutory predecessor of § 104(a)(2), which concluded that payments received as compensation for personal injuries (without specifying the nature of the injury) were "'capital' as distinguished from income" (in the Attorney General's opinion) and "doubtful whether ... required to be included in gross income" (in the Treasury Department ruling). The court considered its conclusion to be bolstered by a 1922 ruling of the Bureau of Internal Revenue [Sol. Op. 132, I-1 CB 92 (alienation of affection; defamation of personal character)] that damages received for a nonphysical tort were income, noting that the ruling "regarded such compensation not merely as excludable under the IRC, but more fundamentally as not being income at all."

- The court's reasoning in the opinion is tenuous, at best, and it is unlikely that other circuits or the Tax Court will follow this opinion. There are two salient weaknesses, among others, in the court's reasoning. First, it is very difficult to see any connection between the 1918 administrative pronouncements and the intent of those who adopted the Sixteenth Amendment five years earlier. Second, the court ignores that in 1921, after the enactment of the statutory predecessor of § 104(a)(2), but before the 1922 ruling cited by the court, the Bureau of Internal Revenue changed its position and ruled that damages for nonphysical personal injuries were includable in gross income because they are not specifically excluded by the statute [Sol. Mem. 957, 1 CB 65 (libel); Sol. Mem. 1384, 2 CB 71 (alienation of affection)]. In 1922 the Bureau reversed its position solely because of the holding in *Eisner v. Macomber*, 252 U.S. 434 (1920), which at that time was read to limit the constitutional meaning of "income" to "gain derived from capital, from labor, or from both combined." This narrow crabbed view of the constitutional meaning of income has long since been discredited by subsequent Supreme Court cases, allowing virtually all accessions to financial wealth from any source, and in any form, to be includable in gross income under the statute. After *Eisner v. Macomber* was shorn of its vitality, the IRS again took the position that in many cases damages for nonphysical personal injuries were includable in gross income, but prior to 1996 the courts generally held such damages were excluded under the statutory provisions of § 104(a)(2) and its predecessors, not because the damages were not "income" within the meaning of the Sixteenth Amendment.

- In other words, the reasoning of the Court of Appeals for the District of Columbia in *Murphy* was grounded in the Supreme Court's view of the constitutional meaning of "income" under the Sixteenth Amendment in 1920. Congress, on the other hand, enacted the 1996 statutory amendments taxing all damages for nonphysical personal injury in light of subsequent Supreme Court's jurisprudence regarding the constitutional meaning of "income" under the Sixteenth Amendment that effectively relegated the narrow *Eisner v. Macomber* view to the dustbin of constitutional law history. Depending on the court's opinion following rehearing, the flawed reasoning of the original decision in *Murphy* similarly should be relegated to the dustbin of judicial history.

2. **California registered domestic partners may not use *Poe v. Seaborn* to split income between themselves because that case applies only to a property status arrangement that is "an incident of matrimony."** ILM 200608038, 2006 TNT 39-13 (2/24/06). A registered domestic partner under the California Domestic Partner Rights and Responsibilities Act of 2003 is required to include in gross income all of his

earned income, and not one-half of the combined income earned by both registered domestic partners. The legal memorandum relies on *Commissioner v. Harmon*, 323 U.S. 44, 48 (1944), which in holding *Poe v. Seaborn* inapplicable to arrangements under an Oklahoma statute allowing married couples to elect community property status, stated, “The important fact is that the community system of Oklahoma is not a system, dictated by State policy, as an incident of matrimony.”

3. **Congress serves up some Alka-Seltzer to those caught by the AMT in the dot com bubble.** The **Tax Relief and Health Care Act of 2006** § 402 added new Code § 53(c) to make the AMT credits for prior years’ AMT liability into a refundable credit [as opposed to a credit limited to the difference between the regular tax liability and the tentative AMT liability for the year]. Taxpayers who have unused AMT credits – including those arising from incentive stock option grants – will be allowed to claim a refundable credit in the amount of the greater of (1) 20 percent of his long-term unused AMT credits, or (2) the lesser of (a) \$5,000 or (b) the amount of the taxpayer’s long-term unused minimum credit for the year. This latter is the portion attributable to tax years before the third tax year immediately preceding the tax year in question. The relief phases out for higher income taxpayers in the same manner as the phase-out of personal exemptions when AGI exceeds \$150,000. These provisions are effective only for years 2007-2012.

### C. Profit-Seeking Individual Deductions

1. **You can rely on Eeny, on Meeny and on Miny – but you cannot rely on Moe. A tax lawyer may not rely on his accountants to avoid penalties.** *Kovacevich v. Commissioner*, 177 Fed. Appx. 561 (9th Cir. 4/12/06). The amount paid by an attorney to settle a lawsuit brought against him by a former client was an unreimbursed employee business expense because the attorney was a statutory employee of his wholly owned legal professional corporation through which he practiced. Therefore, the amount paid was deductible only as a miscellaneous itemized deduction, subject to the various applicable limitations.

- A § 6662 penalty was imposed despite taxpayer’s claim that he relied on his outside accountants, Moe & Associates, because he had a “reputation as a competent tax attorney” with “self-avowed expertise in the field of tax law.”



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

There were no significant developments regarding this topic during 2006.

#### **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), *aff'd*, 467 F.3d 149 (2d Cir. 10/18/06) (2-0). The Tax Court (Judge Wherry) held that amounts paid for investment management advice by trusts set up by a family involved in the founding of the Pepperidge Farm food products company (which was sold to Campbell Soup Company in the 1960s) are not subject to the § 67(e) exception to the § 67(a) floor of 2 percent of AGI (which limits the deductibility of employee business expenses and miscellaneous itemized deductions to amounts exceeding that floor). In reaching this result, the Court determined that these expenses did not qualify for the exception in § 67(e)(1) under which costs paid or incurred in connection with the administration of a trust that wouldn't have been incurred if the property weren't held in the trust are allowed as deductions in arriving at adjusted gross income. The Tax Court explained that the statutory text of § 67(e)(1) creates an exception allowing for deduction of trust expenditures without regard to the 2% floor where two requirements are satisfied: 1) The costs are paid or incurred in connection with administration of the trust; and 2) the costs would not have been incurred if the property were not held in trust.

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

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

The Tax Court reasoned that "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)

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

2. Notice 2006-86, 2006-41 I.R.B. 680 (9/20/06). This notice provides interim guidance to clarify the rule under § 152(c)(4) [as amended by the Working Families Tax Relief Act of 2004] for determining which taxpayer may claim a qualifying child when two or more taxpayers claim the same child. The tie-breaking rule is to apply to the following provisions as a group: (1) head of household filing status, (2) the § 21 child and dependent care credit, (3) the § 24 child tax credit, (4) the § 32 earned income credit, (5) the § 129 exclusion for dependent care assistance, and (6) the § 151 dependency deduction.

3. **The Tax Relief and Health Care Act of 2006**, § 101, extends the above-the-line deduction for higher education expenses under Code § 222 to 2006 and 2007.

4. **The Tax Relief and Health Care Act of 2006**, § 102, extends the Code § 164(b)(5) election to deduct state and local general sales taxes [instead of state income taxes] to 2006 and 2007.

5. **The Tax Relief and Health Care Act of 2006**, § 302, adds new Code § 106(e) to permit one-time transfers to health savings accounts from health flexible spending arrangements and health reimbursement arrangements.

6. **The Tax Relief and Health Care Act of 2006**, § 302, adds new Code § 4980G(9)(d) to provide for an exception to the current requirement that employer contributions to HSAs be "comparable"

for all employees by allowing employers to provide additional contributions to lower-paid workers.

7. The **Tax Relief and Health Care Act of 2006**, § 303, amends Code § 223(b)(2) to repeal the annual deductible limitation on HSA contributions and to allow contributions of \$2,700 (\$5,454 family) even if the deductible is less than those amounts.

8. The **Tax Relief and Health Care Act of 2006** § 307 adds new Code § 408(d)(9) to permit a once-in-a-lifetime, tax-free transfer from an IRA to fund the taxpayer's HSA deductible contribution amount. This would allow those who cannot afford to fully fund an HSA with direct contributions to move IRA money to a more tax-advantaged position.

9. The **Tax Relief and Health Care Act of 2006**, § 419, adds new Code § 163(h)(3)(E) to establish a new itemized deduction for the cost of mortgage insurance on a qualified personal residence. The deduction is phased-out ratably by 10% for each \$1,000 by which the taxpayer's AGI exceeds \$100,000. Thus, the deduction is unavailable for a taxpayer with an AGI in excess of \$110,000. The provision is effective for amounts paid or accrued (and applicable to the period) after 12/31/06 and before 1/1/08 for mortgage contracts issued after 12/31/06.

## F. Education

1. **Section 529 plan treatment made permanent.** The **Pension Protection Act**, § 1304, provides that the changes contained in the 2001 Act [EGTRRA] with respect to Code § 529 qualified tuition programs will be permanent, i.e., will not sunset in 2011. These include the provision that makes qualified withdrawals from qualified tuition accounts exempt from income tax, and the provisions that permit rollovers from one beneficiary to another [including first cousins].

## VI. CORPORATIONS

### A. Entity and Formation

1. **Debt vs. equity discussed at length.** Indmar Products Co. v. Commissioner, 444 F.3d 771 (6th Cir. 4/14/06) (2-1), *rev'g* T.C. Memo. 2005-32 (2/23/05). In a case disallowing interest deductions for

the years 1998-2000, Judge McKeague held that advances made beginning in the 1970s to a company by its shareholders more closely resembled debt than equity because of the fixed 10 percent interest rate and regular monthly interest payments, as well as the execution of demand promissory notes beginning in 1993. The opinion contains a lengthy discussion of the debt vs. equity issue.

- In his concurring opinion Judge Rogers, in drawing the distinction between issues of fact and issues of law, stated:

For instance, assume an ordinance taxes the keeping of pet dogs. Jo is assessed a tax for keeping Fido, and Jo appeals. The question “Is Fido a dog?” may be factual or it may be legal. If Jo claims only that Fido is a really a cat, then the issue is factual. No one argues that the legal definition of dog includes cats; the only dispute is regarding the actual nature of Fido. On the other hand, if both parties agree that Fido is a prairie dog, the question “Is Fido a dog?” is a purely legal one. There is no dispute about the nature of Fido; the only dispute involves what the legal meaning of “dog” is. Of course if the city says Fido is a schnauzer while Jo says that Fido is actually a prairie dog, the question “Is Fido a dog” is mixed if *both* legal and factual aspects of the seemingly single question are in dispute.

- Judge Moore dissented on the ground that the Tax Court’s findings were not clearly erroneous.

## **B. Distributions and Redemptions**

1. **Basis can live long after the stock is “redeemed.”**  
**Who’d a thunk it?** REG-150313-01, Redemptions Taxable as Dividends, 67 F.R. 64331 (10/18/02). The IRS has proposed replacing the “proper adjustment” to the basis of remaining stock rule of Reg. § 1.302-2(c), which takes into account the unused basis of redeemed stock when the redemption is treated as a § 301 distribution. Prop. Reg. § 1.302-5 would provide that the redeemed shareholder [who is taxed under § 301] would retain the basis of the redeemed stock as a basis item separate from any remaining shares, whether or not the shareholder continues to actually own the stock of the redeeming corporation, and take it into account as a loss deduction at some future date. The loss subsequently can be claimed under either the “final inclusion date” rule or the “accelerated loss inclusion date” rule. The “final inclusion date” rule allows the loss deduction on the date on which the redeemed shareholder would have qualified under § 302(b)(1), (2) or (3) if the facts on that date had been the facts immediately after the redemption, or

alternatively, when an individual shareholder dies or a corporate shareholder is liquidated in a transaction to which § 331 applies. The “accelerated loss inclusion date” rule allows the redeemed shareholder to claim a loss attributable to the unutilized basis when the shareholder subsequently recognizes a gain on stock of the redeeming corporation, but the loss may be claimed only to the extent of the gain recognized. Because the loss attributable to the basis of the redeemed stock is treated as recognized on the redemption date, the attributes (e.g., character and source) of the loss are fixed on the redemption date, even if such loss is not taken into account until after the redemption date. These rules apply to § 304(a)(1) transactions taxed under § 301 by treating the unutilized basis in the redeemed corporation stock as basis in the stock of the acquiring corporation. Special rules apply to partnerships, in consolidated returns [Prop. Reg. § 1.1502-19(b)(5)], and to foreign corporations. These rules do not apply to redemptions of § 306 stock, but they do generally apply even in the case of a corporation wholly owned by a single shareholder, whether a corporation or an individual.

- These regulations are a reaction, in part, to basis shifting transactions, such as that described in Notice 2001-45, 2001-2 C.B. 129 [the so-called Bank of America transaction].

- It has been noted that if nuclear disaster ever overcomes the Earth, only the cockroach and basis would survive.

a. **They ran the proposed regulations up the flagpole, but nobody saluted. Back to the drawing board “for further study.”** Announcement 2006-30, 2006-19 I.R.B. 879 (5/8/06). The IRS announced the withdrawal on 4/19/06 of the 2002 proposed regulations on the treatment of the basis of stock redeemed or treated as redeemed in distributions governed by § 301.

### C. Liquidations

There were no significant developments regarding this topic during 2006.

### D. S Corporations

1. **Pension Protection Act**, § 1203, amends Code § 1367(a)(2) to provide that on the charitable contribution of appreciated property by an S corporation, the reduction in shareholder basis in the S

corporation stock is limited to the shareholder's pro rata share of the basis of the contributed property.

2. Garwood Irrigation Co. v. Commissioner, 126 T.C. 223 (5/1/06). An S corporation that is due a refund in excess of \$10,000 with respect to a § 1374 built-in gains tax is entitled to interest at two percentage points above the federal short-term rate. Interest is not limited to the lower corporate rate of one-half percent above the AFR because § 6621 applies only to C corporations, not to S corporations. However, because taxpayer was a corporation, the noncorporate rate of three percent above the AFR did not apply – even though taxpayer was an S corporation.

3. T.D. 9302, Prohibited Allocations of Securities in an S Corporation, 71 F.R. 76134 (12/20/06). These final regulations provide guidance concerning requirements under § 409(p) for ESOPs holding stock of S corporations. They provide that if there is a prohibited allocation during a nonallocation year, the ESOP fails to satisfy the § 4975(e)(7) requirement and is no longer an ESOP; as a result of this, the plan also would fail to satisfy the § 401(a) qualification rules and the S corporation would face a § 4979A excise tax.

#### E. Reorganizations

1. 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.

2. **All cash (D) reorgs are now in the regs.** T.D. 9303, 71 F.R. 75879 (12/19/2006). Temp. Reg. § 1.368-2T provides that the distribution requirement under §§ 368(a)(1)(D) and 354(b)(1)(B) is deemed to have been satisfied despite the fact that no stock and/or securities are actually issued in a transaction otherwise described in section 368(a)(1)(D) if the same person or persons own, directly or indirectly, own all of the stock of the transferor and transferee corporations in identical proportions. To a limited extent, the attribution rules in § 318 are invoked to determine whether the same person or persons own, directly or indirectly, own all of the stock of the transferor and transferee. An individual and all members of

his family that have a relationship described in § 318(a)(1) are treated as one individual; and stock owned by a corporation is attributed proportionally to the corporation's shareholder without regard to the 50 percent limitation in § 318(a)(2)(C).

- Ownership in absolutely identical proportions is not required. A *de minimis* variation in shareholder identity or proportionality of ownership in the transferor and transferee corporations is disregarded. The regulations give as an example of a *de minimis* variation a situation in which A, B, and C each own, respectively, 34%, 33%, and 33% of the transferor's stock and A, B, C, and D each own, respectively, 33%, 33%, 33% and 1% of the transferee's stock. Stock described in § 1504(a)(4) — nonvoting limited preferred stock (that is not convertible) — is disregarded for purposes of determining whether the same person or persons own all of the stock of the transferor and transferee corporations in identical proportions.

- When a transaction qualifies as a § 368(a)(1)(D) reorganization under the regulations, a nominal share of stock of the transferee corporation will be deemed to have been issued in addition to the actual consideration. That nominal share of stock is deemed to have been distributed by the transferor corporation to its shareholders and, in appropriate circumstances, further transferred to the extent necessary to reflect the actual ownership of the transferor and transferee corporations.

## F. Corporate Divisions

1. **TIPRA** § 202 amended Code § 355(b) to simplify the active trade or business test by looking at all corporations in the distributing corporation's and the distributed subsidiary's affiliated groups to determine if the active trade or business test is satisfied.

- a. The **Tax Relief and Health Care Act of 2006**, § 410, made the **TIPRA** modification to § 355(b) permanent.

## G. Miscellaneous Corporate Issues

1. **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. Inc. 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 3-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 be 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 of appeals 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, which 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 2006.

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

There were no significant developments regarding this topic during 2006.

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

1. Notice 2006-14, 2006-8 I.R.B. 498 (2/2/06). The IRS has requested comments on how to simplify the current regulations under § 751(b) (applicable to partnership distributions treated as sales or exchanges) on how to determine a partner's share of "hot assets" and how to treat disproportionate distributions.

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

There were no significant developments regarding this topic during 2006.

### E. Inside Basis Adjustments

There were no significant developments regarding this topic during 2006.

#### F. Partnership Audit Rules

There were no significant developments regarding this topic during 2006.

#### G. Miscellaneous

There were no significant developments regarding this topic during 2006.

### VIII. TAX SHELTERS

#### A. Tax Shelter Cases

1. **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). 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 v. Commissioner*, 752 F.2d 89 (1985), "[t]o treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose 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, 2001-1 C.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, 94 A.F.T.R.2d 2004-5690 (D. Md. 8/3/04). The facts as stated in the opinion were as follows.

In 1998, B & D sold three of its businesses. As a result of these sales, B & D generated significant capital gains. *Id.* 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's 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, 94 A.F.T.R.2d 2004-5690 (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, rejecting the government’s arguments that legislative history and public policy required reversal. He stated that “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.” He concluded that the contingent liability taxpayer transferred “falls within the § 357(c)(3) exception for ‘liability the payment of which . . . would give rise to a deduction.’”

• However, Judge Michael held that the government was entitled to a trial on the issue of whether the transaction was a sham, stating that the transaction should be scrutinized for its real economic effects, including whether there are reasonable expected profits from the transaction. He refused to follow *United Parcel Serv. of Am., Inc. v. Commissioner*, 254 F.3d 1014, 1019 (11th Cir. 2001).

2. **A second taxpayer victory in a listed contingent liability transaction is reversed on appeal.** Coltec Industries, Inc. v. United States, 62 Fed. Cl. 716 (Fed. Cl. 10/29/04), *vacated and remanded*, 454 F.3d 1340 (Fed. Cir. 7/12/06). Taxpayer transferred its asbestos liabilities to an asbestos case management entity [“Garrison”], which was an 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.

a. **Court of Federal Claims opinion:** 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.

b. **Federal Circuit opinion: Taxpayer is hung out to dry by the Federal Circuit on the economic substance issue.** The court (Judge Dyk) first found that the loss was allowable under the literal terms of the statute as it existed at the time of the transaction because (1) the liabilities fell within § 357(c)(3), (2) § 357(b)(1) was not relevant, and (3) § 358(d)(2) excluded the liabilities from “money received,” so that

the basis of the company's stock was increased by the note and was not reduced by the assumed contingent asbestos liabilities. However, Judge Dyk further found that the transaction that gave rise to the alleged tax benefit, which he narrowed down to say that the transfer of the \$375 million note to Garrison in exchange for the assumption of the contingent asbestos liabilities, had no meaningful economic purpose except the tax benefits to Coltec and, therefore, "must be ignored for tax purposes."

- In finding lack of economic substance, Judge Dyk adopted an objective view of the transaction, in which he found that the transfer of the asbestos liabilities to a subsidiary would not affect Coltec's obligation to pay them and had no effect on third-party asbestos claimants. He also held that the Fourth Circuit's disjunctive test for application of the economic substance doctrine, that it must both have the subjective motivation of tax avoidance and lack the objective motivation of business purpose [i.e., a reasonable possibility of pre-tax profit], was inapplicable and that the law of the Federal Circuit was changed to require that taxpayer meet both prongs to pass the economic substance test. Two of the cases upon which Judge Dyk relied were *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), and *UPS v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001).

3. **The Second Circuit reverses a taxpayer victory in a self-liquidating partnership note transaction, in which the lion's share of taxable income was allocated to tax-indifferent parties, on the ground that the tax-indifferent Dutch banks were not really equity partners.** *TIFD III-E, Inc. v. United States*, 342 F. Supp. 2d 94 (D. Conn. 11/1/04), *rev'd*, 459 F.3d 220 (2d Cir. 8/3/06), *taxpayer petition for rehearing*, 2006 TNT 188-17 (9/18/06) ("Castle Harbour").

a. **District court opinion:** 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, the tax-indifferent partner was allocated 98 percent of the book income and 98 percent of the tax income.

- The book income was net of depreciation and the tax income did not take depreciation into account [because the airplanes were fully depreciated]. Depreciation deductions for

book purposes were on the order of 60 percent of the rental income for any given year.

- Scheduled distributions in excess of book income would have resulted in the liquidation of the investment of the Dutch banks in eight years, with the Dutch banks receiving a return of approximately nine percent, with some “economically substantial” upside and some downside risk. Castle Harbour was terminated after five years because of a threatened change in U.S. tax law, but during that period about \$310 million of income was shifted to the Dutch banks for a tax saving to the GECC subsidiaries of about \$62 million.

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

- This appears to be a lease-stripping transaction in which the income from the lease was assigned to foreign entities while the benefits of ownership were left with a domestic entity.

- The court (Judge Underhill) held that satisfaction of the mechanical rules of the regulations under § 704(b) transcended both an intent to avoid tax and the avoidance of significant tax through agreed upon partnership allocations. In this partnership, 2 percent of both book and taxable income was allocated to GECC, a United States partner, and 98 percent of both book and taxable income was allocated to partners who were Dutch banks. The Dutch banks were foreign partners who were not liable for United States taxes and thus were indifferent to the U.S. tax consequences of their participation in the partnership. Because the partnership had very large book depreciation deductions and no tax depreciation, most of the partnership’s taxable operating income, which was substantially in excess of book taxable income, was allocated to the tax-indifferent foreign partners, even though a large portion of the cash receipts reflected in that income was devoted to repaying the principal of loans secured by property that GECC had contributed to the partnership. The overall partnership transaction saved GECC approximately \$62 million in income taxes, and the court found that “it appears likely that one of GECC’s principal motivations in entering into this transaction – though certainly not its only motivation – was to avoid that substantial tax burden.” The court understood the effects of the allocations and concluded that “by allocating 98% of the income from fully tax-depreciated aircraft to the Dutch Banks, GECC avoided an enormous tax burden, while shifting very little book income. Put another way, by allocating income less depreciation to tax-neutral parties, GECC was able to “re-depreciate” the assets for tax purposes. The tax-neutrals absorbed the tax consequences of all the income allocated to them, but actually received only the income in excess of book depreciation.” Nevertheless, the court upheld the allocations. “The tax benefits of the \*\*\* transaction were the result of the allocation of large

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

- Judge Underhill concluded:

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

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

- In *ACM Partnership v. Commissioner*, T.C. Memo. 1997-115, *aff’d*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999). [Colgate], Judge Laro wrote a 100+ page analysis to find that there was no economic substance to the arrangement. The next contingent payment installment sale case in the Tax Court was *ASA Investings Partnership v. Commissioner*, 118 T.C. 423 (2002), *aff’d*, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000) [Allied Signal],



in which Judge Foley wrote a much shorter opinion finding that the Dutch bank was not a partner; the D.C. Circuit affirmed on Judge Foley's holding that the Dutch bank was not a partner. The IRS began to pick up this lack-of-partnership argument and began to use it on examinations. Later, the Tax Court (Judge Nims) used the economic substance argument in *Saba Partnership v. Commissioner*, T.C. Memo. 1999-359, *vacated*, 273 F.3d 1135 (D.C. Cir. 2001), *on remand*, T.C. Memo. 2003-31 [Brunswick], which the DC Circuit remanded based on *ASA Investering*s to give taxpayer the opportunity to argue that there was a valid partnership [which it could not do, as Judge Nims found on remand]. Even later, the D.C. Circuit reversed the district court in *Boca Investering*s Partnership v. *United States*, 314 F.3d 625 (D.C. Cir. 2003), *rev'g* 167 F. Supp. 2d 298 (D.D.C. 2001), *cert denied*, 540 U.S. 826 (2003) [Wyeth, or American Home Products] case based upon this lack-of-partnership argument – even though Cravath planned *Boca* carefully so that if the Dutch bank was knocked out, there would still be a partnership – based upon its *ASA Investering*s and *Saba* findings on appeal that there was no partnership. Now we have Judge Leval of the Second Circuit adopting the lack-of-partnership argument that Judge Foley used because he preferred to rest his decision on this ground as opposed to making a finding of lack of economic substance.

4. **A District Court finds for the taxpayer in a COLI case 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 found 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% with partial [cash] withdrawals (from policies whose cash value had been previously borrowed) and 10% 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% 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% 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 *In re CM Holdings*, 301 F.3d 96 (3d Cir. 2002), and *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762 (S.D. Ohio 2001), 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.

a. **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.

b. **Dow is reversed by the Sixth Circuit.** Dow Chemical Co. v. United States, 435 F.3d 594 (6th Cir. 1/23/06) (2-1), *cert. denied*, 127 S. Ct. 1251 (2/10/07). 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 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.

5. **Tax avoidance scheme works in the Court of Federal Claims.** Principal Life Insurance Company v. United States, 70 Fed. Cl. 144 (3/17/06). The court (Judge Allegra) upheld a transaction structured to eliminate the § 453A interest charge on the deferred tax liability for the gain to be recognized on about \$478 million of installment notes held by each of taxpayer and Prudential Life Insurance Company. These installment notes (arising from a sale of commercial mortgages to one another) were in turn sold to wholly-owned consolidated subsidiaries in order to trigger gain recognition under § 453B(a)(1) and eliminate the interest charge while the triggered gain was deferred under [pre-1991] Reg. § 1.1502-13. Judge Allegra held that the sale of the notes to the consolidated subsidiary was bona fide, and was not a capital contribution under § 351 because “while [the subsidiary] might be viewed as thinly capitalized, there is no indication that it was inadequately capitalized,” following *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). The one non-tax purpose found by the court for using taxpayer’s subsidiary to hold the Prudential installment notes was as a so-called “bankruptcy-remote entity” often used in securitized lending to lessen the likelihood that a bankruptcy court will order a substantive consolidation of an insolvent parent with a solvent subsidiary.

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

a. **Fighting duplication and acceleration of losses through partnerships before June 24, 2003.** T.D. 9062, Assumption of Partner Liabilities, 68 F.R. 37414 (6/24/03). Temp. Reg. § 1.752-6T provides rules, similar to the rules applicable to corporations in § 358(h), to prevent the duplication and acceleration of loss through the assumption by a partnership of a liability of a partner in a nonrecognition transaction. Under the temporary regulations, if a partnership assumes a liability, as defined in § 358(h)(3), of a partner (other than a liability to which § 752(a) and (b)

apply) in a § 721 transaction, after application of §§ 752(a) and (b), the partner's basis in the partnership is reduced (but not below the adjusted value of such interest) by the amount of the liability. For this purpose, the term "liability" includes any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for Federal tax purposes. Reduction of a partner's basis generally is not required if: (1) the trade or business with which the liability is associated is transferred to the partnership, or (2) substantially all of the assets with which the liability is associated are contributed to the partnership. However, the exception for contributions of substantially all of the assets does not apply to a transaction described in Notice 2000-44, 2000-2 C.B. 255 (or a substantially similar transaction).

- The temporary regulations purport to be effective for transactions occurring after 10/18/99 and before 6/24/03.

b. **Klamath on the merits: It does not work because it lacks economic substance, but no penalties. The authorities discussed in the Holland & Hart and Olson Lemons opinions provide "substantial authority."** Klamath Strategic Investment Fund, LLC v. United States, 99 A.F.T.R.2d 2007-850, 2007-1 U.S.T.C. ¶ 50,223 (E.D. Tex. 1/31/07). The transactions lacked economic substance because the loans would not be used to provide leverage for foreign currency transactions, but no penalties were applicable because taxpayers passed on a 1999 investment and they thought they were investing in foreign currencies and the tax opinions they received that relied on relevant authorities set forth in the court's earlier opinion provided "substantial authority" for the taxpayers' treatment of their basis in their partnerships.

7. Transcapital Leasing Associates 1990-II, L.P. v. United States, 97 A.F.T.R.2d 2006-1916 (W.D. Tex. 3/31/06). In a complex mainframe computer leasing transaction, the taxpayer essentially received over \$11,000,000 in tax deductions, without any corresponding income or economic loss, in consideration of a \$559,947 fee; the 20:1 tax write-off was "an artificial creation of a tax avoidance structure that bifurcated 'phantom' income from 'phantom' loss." The court applied a sham transaction analysis to find that the taxpayer "had no legitimate business purpose other than tax avoidance for entering into the [leasing transaction] and there was no reasonable expectation of profit. ... The ... transaction [was] solely shaped by tax avoidance objectives and completely lacking in profit potential."

8. **This decision might have a "colming" effect on the IRS.** COLM Producer, Inc. v. United States, 460 F. Supp. 2d 713 (N.D. Tex. 10/16/06). The court (Judge Godbey) upheld the disallowance of a loss

of about \$102.7 million on the sale of a limited partnership interest in December 1999. The partnership interest was funded by the Ettman Family Trust with \$2 million plus the contribution of the \$102.5 million proceeds of the short sale of \$100 million (face value) of U.S. Treasury Notes subject to the obligation to replace the borrowed T-notes. The partnership interest was then sold to an unrelated third party for \$1.8 million. Held, the obligation to replace the borrowed T-notes [on the closing of the short sale] should have been treated as a liability under § 752. Judge Godbey held that – although contingent liabilities were not included as liabilities under § 752 – the obligation to close the short sale was a “liability” based upon his reading of the Black’s Law Dictionary definition [“the quality or state of being legally obligated or accountable” or “a financial or pecuniary obligation”]; he reinforced his conclusion by citing Rev. Rul. 95-26, 1995-1 C.B. 131, and *Salina Partnership LP v. Commissioner*, T.C. Memo. 2000-352.

9. **Hi-Lili, Hi-Lili, LILO! District court grants summary judgment to the government in a LILO transaction.** BB&T Corp. v. United States, 2007-1 U.S.T.C. ¶50,130, 99 A.F.T.R.2d 2007-376 (M.D. N.C. 1/4/07). Taxpayer, a financial services corporation, leased equipment from a wood pulp manufacturer [a head lease] and re-leased it back to the wood pulp manufacturer in a “lease-in-lease-out” (LILO) transaction and claimed substantial rent and other deductions. The court held that the form of the transaction should not be respected for tax purposes because taxpayer did not acquire a current leasehold interest in the equipment and incurred no risk of loss. The reciprocal offsetting obligations were disregarded because, in substance, the taxpayer acquired only a future interest in the right to use and possess the equipment – and acquired that interest only if the owner-sublessee did not exercise its option to buy-out taxpayer’s interest in the head lease. The transaction did not substantially affect the wood pulp manufacturer’s rights to use and possess the property.

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

1. **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.

2. **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, 2002-1 C.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 into 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 18 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 18-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, 2002-1 C.B. 992 (5/6/02). The transaction in this notice involves the use of a notional principal contract (NPC) 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 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, 2002-1 C.B. 971.

- 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, 2002-1 C.B. 992.

### 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 under the Internal Revenue Code.” 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”; several of those indicted were partners in KPMG’s Washington National Tax group.

d. **Judge Kaplan refuses to find prosecutorial misconduct in the deferred prosecution agreement.** United States v. Stein, 428 F. Supp. 2d 138 (S.D.N.Y. 4/4/06), *as corrected* 4/5/06. Judge Kaplan denied a motion to dismiss based upon alleged prosecutorial misconduct by reason of the alleged manipulation of KPMG in the deferred prosecution agreement. This DPA required the firm “upon pain of corporate death, [to] espouse a government-approved version of [the] facts.” Judge Kaplan based his decision on the ethical provision applicable to all attorneys that prohibits them from coercing witnesses to give false testimony. He further held that nothing in the DPA pressures individual KPMG employees to testify in any particular way, but that the DPA merely requires the firm to disavow any assertion by an affiliated individual that is inconsistent with the DPA’s Statement of Facts.

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

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



- Judge Kaplan's decision has been appealed to the Second Circuit, which has stayed its implementation pending the appeal.
- The Thompson Memorandum was replaced on 12/11/06 by the McNulty Memorandum which requires threats to prosecute entities "unless" they do something [e.g., waive attorney client privilege] or "if" they do something [e.g., advance legal fees] to emanate from a higher level of the Justice Department.

f. **Judge Kaplan indefinitely postpones the federal criminal trial against 16 former KPMG employees, an outside investment adviser and a lawyer.** *United States v. Stein*, 461 F. Supp. 2d 201 (S.D.N.Y. 11/13/06). Judge Kaplan cited fears that defendants may be unable to pay their lawyers in postponing the trial, which was scheduled to begin in January 2007. The issues are now in the Second Circuit. See Lynnley Browning's article in the New York Times Business Section (11/15/06).

(1) On 12/20/06, Judge Kaplan stated that jury selection for the trial would begin on 9/17/07. 2006 TNT 246-2.

2. **Is this really the last chance global settlement initiative?** Announcement 2005-80, 2005-2 C.B. 967 (11/14/05). The IRS announced settlement initiative for 21 transactions, not all of them listed as "abusive tax shelters," together with the accuracy-related penalty that will be imposed [varying from 5% and 20%] 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 the 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 Code § 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 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 (2/3/06). Proposed regulations have been issued after considering 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 American Jobs Creation 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 reasonably 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. **Warm-up the photocopier for those tax accrual workpapers.** Announcement 2002-63, 2002-2 C.B. 72 (7/8/02). In auditing returns filed after 7/1/02 that claim any tax benefits from a “listed transaction,” see Notice 2001-51, 2001-2 C.B. 190, *superseded by* Notice 2003-76, 2003-2 C.B. 1181, *superseded by* Notice 2004-67, 2004-2 C.B. 600, the IRS may request tax accrual workpapers. Listed transactions will be determined “at the time of the request.” Neither the attorney client privilege nor the § 7525 tax practitioner privilege protects the confidentiality of the workpapers.

a. **Specific procedures regarding requests for tax accrual workpapers.** Chief Counsel Notice CC-2003-012 (4/9/03). This notice provides procedures to be used regarding requests for tax accrual and other financial audit workpapers.

b. **The definition of “tax accrual workpapers” is clarified.** Chief Counsel Notice CC-2004-010 (1/22/04), *supplementing* CC-2003-012. The general definition is as follows:

Tax accrual workpapers are those audit workpapers, whether prepared by the taxpayer or by an independent accountant, relating to the tax reserve for current, deferred and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to footnotes disclosing those tax liabilities on audit financial statements. They reflect an estimate of a company’s tax liabilities and may also be referred to as the tax pool analysis, tax liability

contingency analysis, tax cushion analysis, or tax contingency reserve analysis.

- Documents created prior to or outside of the consideration of whether reserves should be created are not within the definition of tax accrual workpapers nor are workpapers reconciling book and tax income, but they both “likely fall within the scope of the general IDRs issued at the beginning of an examination and should be produced ... even though no request for the tax accrual workpapers has been made.”

c. **The government seeks summons enforcement for Textron’s tax accrual workpapers.** United States v. Textron, Inc., 2006 TNT 84-19 (D. R.I. 4/28/06). In its supporting brief, 2006 TNT 84-4, the government argued that all tax accrual workpapers should be disclosed because Textron engaged in several listed transactions, specifically, six separate sale-in, lease-out (“SILO”) transactions in 2001, which were designated as listed transactions in Notice 2005-13, 2005-1 C.B. 630.

- *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984), which held that tax accrual workpapers to be available to the government because they were relevant to a legitimate IRS inquiry, is strongly supportive of the government’s position. Taxpayer may rely upon the work product doctrine for protection because the tax accrual workpapers clearly are not covered by the attorney-client privilege.

5. **The work product doctrine works in the Sixth Circuit.** United States v. Roxworthy, 457 F.3d 590 (6th Cir. 8/10/06). In response to an IRS informal document request, Yum! Brands, Inc. claimed that seven documents were protected by the work product doctrine. It turned over five of the documents under a limitation of waiver agreement but refused to turn over the remaining two documents, which were memoranda both dated 3/29/00, prepared by KPMG that analyzed the tax consequences of stock transfers made in connection with the creation of a captive insurance company, which involved a loss of \$112 million for tax purposes, but not book purposes. On summons enforcement [against Yum’s vice president, tax] the magistrate and district court ordered the documents produced, but the Sixth Circuit (Judge Cole) held that the two memoranda were protected work product because they included they were prepared in anticipation of litigation and included “possible arguments that the IRS could mount against Yum’s chosen tax treatment of the transactions and possible counter-arguments.”

- The court stated:

[I]n *United States v. Adlman*, 68 F.3d 1495, 1496 (2d Cir. 1995) (*Adlman I*), an accounting firm prepared documents evaluating the tax consequences and likely IRS challenges to a company's proposed reorganization in which the company would claim a capital loss of \$290 million. The Second Circuit held that the district court erred in concluding that the prospect of litigation was too remote for work-product privilege to apply, observing that "[i]n many instances, the expected litigation is quite concrete, notwithstanding that the events giving rise to it have not yet occurred." *Id.* at 1501. The court remanded the matter for the district court to apply the proper standard.

- The standard test to be used to establish whether documents were prepared "in anticipation of litigation" is the question of whether the "documents can be said to have been created because of the prospect of litigation" (the "because of" test) – as opposed to whether they would have been prepared in substantially the same form in the absence of prospective litigation. In applying the test, the court is to ask "(1) whether a document was created because of a party's subjective anticipation of litigation, as contrasted with an ordinary business purpose, and (2) whether that subjective anticipation of litigation was objectively reasonable."

- The court noted that the reason for the requesting party to seek such documents is usually to see the "[tax professionals'] assessment of the [transaction's] legal vulnerabilities, in order to make sure it does not miss anything in crafting its legal case," which it noted was precisely the type of discovery protected by the work product doctrine.

- The court rejected the IRS argument that the memoranda were not prepared in anticipation of litigation, but "were more likely prepared to assist Yum in the preparation of its taxes and the avoidance of understatement penalties if the IRS disagreed with Yum's tax treatment . . . ."

- The court finally held that the fact that the memoranda bore an attorney-client privilege designation, not a work-product designation, should not alone settle the inquiry as to whether they were prepared in anticipation of litigation.

#### 6. **New disclosure and list maintenance regulations.**

T.D. 9295, AJCA Modifications to the Section 6011, 6111, and 6112 Regulations, 71 F.R. 64458 (11/2/06). These final and temporary regulations

are part of a package of four regulations and proposed regulations that modify the rules for disclosing reportable transactions and list maintenance requirements following the enactment of the **Jobs Act of 2004**.

a. REG-103038-05, AJCA Modifications to the Section 6011 Regulations, 71 F.R. 64488 (11/2/06). These proposed regulations modify the rules on the disclosure of reportable transactions. They also eliminate the special rule for lease transactions, making those transactions subject to the same disclosure rules as other transactions.

b. REG-103039-05, AJCA Modifications to the Section 6111 Regulations, 71 F.R. 64496 (11/2/06). These proposed regulations provide rules for the disclosure of reportable transactions under § 6111 by material advisors.

c. REG-103043-05, AJCA Modifications to the Section 6112 Regulations, 71 F.R. 64501 (11/2/06). These proposed regulations would provide rules for material advisors who must prepare and maintain investor lists under § 6112. The list must identify each person who was advised with respect to any reportable transaction. The proposed regulations would also require the material adviser to include the names of other material advisers to the transaction and any designation agreement to which the material adviser is a party. They also clarify that the list must include an itemized statement of information, a detailed description of the transaction, and copies of documents related to the transaction.

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

1. United States v. Gleason, 94 A.F.T.R.2d 2004-6344 (M.D. Tenn. 8/25/04), *aff'd*, 432 F.3d 678 (6th Cir. 12/29/05). Tax shelter promoter was permanently enjoined under § 7408 from selling the so-called “Tax Toolbox” which would permit the deduction of personal expenses by falsely characterizing them as business expenses.

a. Anderson v. IRS, 442 F. Supp. 2d 365 (E.D. Tex. 5/18/06). Penalties under § 6700 were imposed on a customer-promoter, who sold 81 “Tax Toolbox” tax reduction schemes.

2. Mortensen v. Commissioner, 440 F.3d 375 (6th Cir. 2/28/06). The court (Judge Martin) affirmed the imposition of the § 6662(a) negligence penalty imposed for the 1991 year on an investor in “The 1,000 lb. Tax Shelter,” which was one of the Hoyt cattle-breeding partnerships. The court found that taxpayer, who was college educated with a degree in engineering, could not reasonably rely on his father’s telling him that he [the

father] showed the information about the investment to [an unnamed] tax attorney and that the “attorney looked over it and he said there was nothing illegal.” The court further held he could not rely on information provided by Hoyt and Hoyt’s “enrolled agent” status because Hoyt had a conflict of interest, and he could not rely on a co-worker’s trip to the Hoyt ranch where he saw cows and an operating business.

- Taxpayer did not show “reasonable cause” under § 6664(c)(1) with respect to penalties on disallowed cattle tax shelter deductions resulting from the “Hoyt 1000 lb. Tax Shelter” where (1) taxpayer claimed reliance on the advice of tax shelter promoter, who happened to be an enrolled agent, (2) taxpayer never sought any advice from a disinterested tax professional with whom he dealt directly regarding the partnership investment generally or correctness of the his Schedule K-1 from the partnership, despite continuing large losses resulting from a small investment and receipt of continuous warnings from the IRS that the deductions were improper, and (3) taxpayer claimed reliance on the Tax Court’s opinion in *Bales v. Commissioner*, T.C. Memo. 1989-568, which upheld deductions claimed by other taxpayers in different years in a different cattle tax shelter partnership organized by the same promoter.

- The court further held that Mortensen’s reliance on *Bales v. Commissioner*, T. C. Memo. 1989-568, was unwarranted because it involved “different investors, different partnerships, different taxable years, and different issues,” although the court held that while “we believe it to be a closer case on this issue, we cannot conclude that the Tax Court clearly erred.”

- The court stated, “The issue is not whether a taxpayer is wholly successful in determining the tax legitimacy of a desired investment, but whether he is negligent for not reasonably investigating in the first place,” and “a reasonable taxpayer after *Bales* would still have sought independent counsel.”

a. Van Scoten v. Commissioner, 439 F.3d 1243 (10th Cir. 3/9/06). The Tenth Circuit made a substantially similar analysis on substantially similar facts denying the § 6664(c)(1) “reasonable cause” exception to accuracy related penalties for another investor in the “Hoyt 1000 lb. Tax Shelter.”

3. **Tax-exempt organizations will be subject to tax shelter penalties.** TIPRA § 516(a) adds new § 4965 to impose an excise tax on tax-exempt entities entering into prohibited tax shelter transactions. The tax will be 35 percent of the greater of (a) the entity’s net income or (b) 75

percent of the proceeds received by the entity that are attributable to the transaction.

a. **TIPRA** § 516(b) also amends § 6033(a) to provide disclosure requirements and amends § 6652(c) to provide penalties for nondisclosure.

b. **TIPRA** § 516(b) also adds new Code § 6011(g), which requires a taxable party to a prohibited tax shelter transaction to provide a disclosure statement to any tax-exempt entity which is also a party to the transaction, indicating that the transaction is a prohibited tax shelter transaction. A failure to make a disclosure required under § 6011(g) is subject to penalty under § 6707A, the penalty amounts being equal to those imposed for other violations of § 6011 that are penalized by § 6707A.

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

1. **“Too good to be true?”** Notice 2006-31, 2006-15 I.R.B. 751 (3/16/06). This notice reminds taxpayers not to engage in abusive tax-avoidance schemes that purportedly allow them to reduce or eliminate taxes based on “false or frivolous arguments.” The notice states that “[i]f an idea to save on taxes seems too good to be true, it probably is.”

a. The rulings concurrently released and published are: Rev. Rul. 2006-17, 2006-15 I.R.B. 748 (3/16/06) (inserting the phrase “*nunc pro tunc*” on a return or other document has no legal effect); Rev. Rul. 2006-18, 2006-15 I.R.B. 743 (3/16/06) (submitting zero-income returns through a misinterpretation of § 3401(c) to the effect that “wages” are paid only to federal employees and persons living in Washington, DC is a frivolous position); Rev. Rul. 2006-19, 2006-15 I.R.B. 749 (3/16/06) (attributing income to a purported trust and claiming expense deductions for “fiduciary fees” in the amount of that income is a frivolous position); Rev. Rul. 2006-20, 2006-15 I.R.B. 746 (3/16/06) (claims that American Indians are exempt from taxes under a general “Native American Treaty” have no merit); and Rev. Rul. 2006-21, 2006-15 I.R.B. 745 (3/16/06) (claiming there is no requirement to file an income tax return because the instructions do not display a current control number assigned by OMB under the Paperwork Reduction Act of 1980, Pub. L. No. 96-511 [codified at 44 U.S.C. § 3501] is a frivolous position).

• While the above rulings involve tax protester-type schemes, the phrase “too good to be true” is not the be-all and end-all of tax planning. *See*, N. Jerold Cohen, “Too Good To Be True and Too



Bad To Be True,” 109 Tax Notes 1437 (Dec. 12, 2005), described as follows: “In this report, the author questions whether it is fair to impose penalties on taxpayers on the grounds that their tax results were ‘too good to be true’ when the literal language of our code often produces results that many would think were either too good or too bad to be true.”

## IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

### A. Exempt Organizations

1. **IRS rules that seller-funded down-payment assistance programs do not qualify for exemption because the donors benefit from the transactions.** Rev. Rul 2006-27, 2006-21 I.R.B. 915 (5/4/06). This ruling examines three scenarios, the first and third [which conduct broad-based fundraising programs] qualify for exemption, but the second [which relies on a payment from the home seller] does not.

2. **According to the Fifth Circuit, it was the IRS that should have stayed home when it tried to show there was value in a group of home healthcare agencies that lost money on every transaction but might have made a profit on the volume.** Caracci v. Commissioner, 456 F.3d 444 (5th Cir. 7/11/06) (per curiam), *rev'g* 118 T.C. 379 (2002). The Fifth Circuit reversed the Tax Court and held that § 4958 excise taxes on excess benefits [intermediate sanctions] of more than \$250 million [?!?!] were improperly proposed against the Sta-Home agencies, a group of family-owned and operated home health care agencies, on their conversion from tax-exempt corporations to nonexempt corporations. The decision was based on the significant errors in the analysis of the government’s valuation expert, who provided the only support for the imposition of excise taxes. The Fifth Circuit concluded that, based on the record, the taxpayers did not receive any “net excess benefit” as a matter of law.

- The court faulted the government for issuing deficiency notices based on a brief intermediate internal analysis because the taxpayers refused to consent to an extension of the statute of limitations.

3. **Pension Protection Act § 1212 amends Code §§ 4941-4945 to double the excise taxes on self-dealing and excess benefit transactions.**

4. **IRS announces its credit counseling compliance project for tax-exempt credit counseling organizations.** Chief Counsel

Advice Memorandum, CCA 200620001 (5/9/06). This memorandum contains two examples of credit counseling organizations: (1) ABC, which uses an educational methodology, and qualifies for exempt status under § 501(c)(3), and (2) DEF, which primarily promotes debt management plans without considering whether it is appropriate in light of each client's individual circumstances, and does not qualify for exempt status.

- The IRS also provided a Core Analysis Tool to help determine whether the credit counseling organization qualifies for exemption. 2006 TNT 94-12 (5/15/06).

- a. IR-2006-80 (5/15/06). The IRS released a report on tax-exempt credit counseling agencies. The executive summary may be found at 2006 TNT 94-10.

- b. **The IRS receives an assist from Congress in weeding out the “bad” credit counseling organizations. Pension Protection Act**, § 1220, adds new Code § 501(q) to provide more definite rules governing tax-exempt credit counseling organizations, including, e.g., a limitation on the portion of the exempt organization's income that may be derived from debt management plan services.

5. **All tax-exempt organizations will be required to file annual electronic notices. Pension Protection Act**, § 1223, adds new Code § 6033(i) to require electronic filing of an annual informational notice by all exempt organizations not currently required to file [specifically, organizations with gross receipts under \$25,000 and churches] on pain of losing tax-exempt status. This provision is effective for years beginning in 2007.

6. **Pension Protection Act** § 1225 amends Code § 6014 to require public disclosure of unrelated business income tax returns of § 501(c)(3) organizations. This provision is effective for returns filed after date of enactment.

7. **Pension Protection Act** §§ 1231-1235 provide for new rules and greater accountability for donor advised funds and sponsoring organizations [e.g., community foundations], which are defined in these provisions. They also provide new requirements for supporting organizations, which are excluded from private foundation status under Code § 509(a)(3); private foundation grants to Type III supporting organizations that are not functionally integrated supporting organizations are not “qualifying distributions” and may give rise to excise taxes.

a. Announcement 2006-93, 2006-48 I.R.B. 1017 (11/7/06). This announcement provides procedures that § 501(c)(3) tax-exempt supporting organizations described in § 509(a)(3) may use to request a change in their public charity classification in light of the effect of the **Pension Protection Act**. These changes would permit middle-aged geriatrics to use new Code § 408(d)(8) to make tax-free distributions from their IRAs [owned by individuals over 70½ years of age] up to \$100,000 directly to charities that are publicly supported under § 509(a)(1) and (2) [but not § 509(a)(3)].

b. Notice 2006-109, 2006-51 I.R.B. (12/4/06). Interim guidance regarding the application of requirements in the **Pension Protection Act** with regard to the criteria for private foundations considering distributions to supporting organizations that can be used to determine whether the supporting organization is a Type I, Type II, or functionally-integrated Type III supporting organization. The Notice also provides for relief for payments that were made pursuant to an agreement that was binding on the organization on the 8/17/06 date of enactment – even though the amended statute became effective for transactions occurring after 7/25/06.

8. The **Tax Relief and Health Care Act of 2006** § 424 amends Code § 664(c) to replace the rule that removes the tax exemption of a charitable remainder trust for any year in which the trust has any unrelated business taxable income. Instead, there will be a 100-percent excise tax on the UBTI of a charitable remainder trust.

## **B. Charitable Giving**

1. Sklar v. Commissioner, 125 T.C. 281 (12/21/05), *as amended*, 2/7/06. Taxpayers have repeatedly 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 were unable to demonstrate any charitable intent in paying the tuition. The special exception for religious benefits does not apply to payments to religious schools.

2. **No full fair market value deduction for contributed self-created musical compositions and copyrights. TIPRA**

§ 204 amends § 170(e)(1)(A) to provide that capital asset treatment, i.e., full fair market value deduction, is to be inapplicable to contributed self-created musical compositions and copyrights. The amount of the charitable deduction for the contribution of such assets is still to be reduced by the amount of appreciation inherent in non-LTCG assets, and, therefore, contributions of such assets will give rise to a deduction equal only to basis.

3. **Not asking is not the same as asking, getting and giving up by contribution – because he could not have gotten what he said he could have gotten.** Turner v. Commissioner, 126 T.C. 299 (5/16/06). A real estate developer, who purchased property that could be subdivided into 30 residential lots under current zoning, could not get a contribution deduction for a § 170(h)(1) qualified conservation easement by forgoing an application for denser zoning usage under which he claimed to be entitled to develop up to 62 residences on smaller lots. One-half of the parcel was wetlands that could not have been developed, and only 30 houses could have built on the parcel in any event. Therefore, the conveyance did not “preserve” any open space that otherwise could have been developed. The 20-percent accuracy-related penalty was also upheld.

4. Glass v. Commissioner, 124 T.C. 258 (5/25/05). The Tax Court 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.

a. **Glass affirmed.** Glass v. Commissioner, 471 F.3d 698 (6th Cir. 12/21/06). The Sixth Circuit held that the easements prohibited any activity or use of the encumbered property that would undermine their stated conservation purpose, and the reserved rights were carefully limited so as to ensure that the identified plant and wildlife habitats on the encumbered property continued to be protected.

5. The **Pension Protection Act** makes the following changes to rules governing charitable contributions:

a. **Pension Protection Act** § 1213 amends Code § 170(h)(4) to provide that a donated façade easement must include an enforceable restriction which preserves the entire exterior of the building,

and prohibits any change inconsistent with the historical character of the exterior.

b. **Bwana can deduct only the cost of taxidermy when he donates his big game trophies to a museum. Pension Protection Act** § 1214 adds new Code § 170(f)(15) to provide a limitation on deductibility of trophy mounts to the lesser of the fair market value of the trophy or the cost of taxidermy, effective for contributions after 7/26/06.

c. **Pension Protection Act** § 1215 adds new Code § 170(e)(7) to provide for recapture of the deduction in excess of the basis of exempt use tangible personal property if the property is disposed of within three years of the date of the donation. A civil penalty of \$10,000 is provided under § 6720B for fraudulent identification of exempt use property.

d. **President Clinton could no longer deduct the underwear he contributes to charity, but Monica might still deduct her blue dress with white polka dots. Pension Protection Act** § 1216 adds new Code § 170(f)(16) to deny deductions for clothing and household items unless such clothing or household item is in “good used condition or better.” Treasury may issue regulations denying a deduction for a contribution of clothing or household items of minimal monetary value. There is an exception for a contribution of a single item of clothing or a household item for which a deduction of more than \$500 is claimed if the taxpayer attaches to his tax return a qualified appraisal with respect to the property.

e. **Those \$20 bills placed in the collection plate each week will no longer be deductible without a receipt. Pension Protection Act** § 1217 adds new Code § 170(f)(17) to deny deductions for monetary gifts unless the donor has a bank record or a receipt showing the name of the donee organization, the date of the contribution and the amount of the contribution. This provision is effective in 2007.

(1) Notice 2006-110, 2006-51 I.R.B. 1127 (12/2/06). A contribution made by payroll deduction can be substantiated by (1) a pay stub, Form W-2, or other document furnished by the employer that sets forth the amount withheld during a taxable year by the employer for the purpose of payment to a donee organization, together with (2) a pledge card or other document prepared by or at the direction of the donee organization that shows the name of the donee organization.

f. **Fractional interests in tangible personal property must carry with them substantial use by the donee in its exempt function. Pension Protection Act** § 1218 adds new Code § 170(o)

to provide for recapture of any deduction (plus interest) allowed with respect to any fractional interest in tangible personal property unless the donor conveys all of the remaining interest in the property to the charity within the earlier of ten years or the donor's death. Additionally, recapture will take place unless within that period the donee has had substantial physical possession of the property and used the property in a use related to a purpose or function constituting the basis for the organization's exemption.

g. **Pension Protection Act** § 1219 adds new Code §§ 170(f)(11)(E) and 6695A and amends Code §§ 6662, 6664 and 6696 to provide more oversight of appraisers, as well as impose stricter penalties on both appraisers and taxpayers.

(1) Notice 2006-96, 2006-46 I.R.B. 902 (10/19/06). This notice provides transitional guidance relating to the new definitions of "qualified appraisal" and "qualified appraiser" in §§ 170(f)(11)(E) and 6695A regarding substantial or gross valuation misstatements, as added by § 1219 of the **Pension Protection Act** of 2006.

## X. TAX PROCEDURE

### A. Interest, Penalties and Prosecutions

1. **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. [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, 2006 TNT 17-6.

2. **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, 2005-2 C.B. 1137 (12/12/05). This revenue Procedure updates guidance on whether disclosure of a position taken on a tax return is adequate for purposes of the § 6662(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 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.

3. United States v. Hempfling, 2006-1 U.S.T.C. ¶50,205, 96 A.F.T.R.2d 2005-6578 (E.D. Cal. 9/23/05). In a suit 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.”

a. United States v. Hempfling, 431 F. Supp. 2d 1069 (E.D. Calif. 2/22/06). The court again refused to dismiss on defendant’s contention that he had new evidence that the Sixteenth Amendment was never properly ratified. The court further held that the issuance of an injunction against the promotion of abusive tax shelters does not violate the *Noerr-Pennington* doctrine (see *Eastern R. Conf. v. Noerr Motors*, 365 U.S. 127 (1961); *Mine Workers v. Pennington*, 381 U.S. 657 (1965)), which protects the right to petition the government for redress of grievances.

4. T.D. 9309, Qualified Amended Returns, 72 F.R. 903 (1/9/07) Treas. Reg. § 1.6664-2(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 a return is not a qualified amended return if it is filed (1) after the IRS has served a John Doe summons on a third party with respect to the taxpayer’s tax liability, (2) for a taxpayer who has claimed tax benefits from undisclosed listed transactions, after the IRS requests information related to the transaction that is required to be included on a list under § 6112 from any person who made a tax statement to or for the benefit of the taxpayer, or any person who gave material aid, assistance, or advice to the taxpayer, or (3) after the date on which published guidance is issued announcing a settlement initiative for a listed transaction in which penalties, in whole or in part, are compromised or waived.

5. United States v. Petrino, 2006 TNT 87-7 (E.D. N.Y. 5/2/06). Robert Fink won a jury acquittal for Paul D. Petrino, an accountant charged with tax evasion for filing returns based on the argument that wages and salaries are not subject to federal income tax. Fink said, “The jury was convinced that the government did not negate [Petrino’s] good faith.”

6. McGowan v. Commissioner, 187 Fed. Appx. 915 (11th Cir. 6/28/06). Taxpayer’s conviction under § 7206(1) of willfully making and subscribing false individual income tax returns and under § 7206(2) of willfully aiding and assisting in the preparation of false corporate income tax returns for the his S corporation did not collaterally estop him from arguing successfully to a jury that his individual returns were not fraudulent because intent to evade taxes is not an element of crimes under § 7206.

7. **Government lawyers should “work with vigor” because the Seventh Circuit does a time-and-motion study of the DOJ Tax Division.** Szopa v. United States, 460 F.3d 884 (7th Cir. 8/21/06). Judge Easterbrook held that the DOJ Tax Division is setting the presumptive sanction for a frivolous appeal in this tax protest case too high because it should not take 53 attorney hours plus 8 hours of paralegal time to prepare a 15-page brief in response to taxpayer’s brief of 9 double-spaced typed pages based entirely on the argument that “non-corporate citizens of the United States need not pay ‘income taxes.’” The court did note that the Tax Division is free to request more when “the case is especially complex or the tax protester’s argument especially long and opaque.”

8. **The Tax Relief and Health Care Act of 2006** § 407 modifies the Code § 6702 penalty for frivolous tax submissions by increasing the amount of the penalty from \$500 to \$5,000 and by applying it to all taxpayers and to all types of federal taxes. The submissions to which the provision applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. The provision permits the IRS to disregard such requests, and to impose a penalty of up to \$5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

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

1. **Honi soit qui mal y pense.** United States v. BDO Seidman, LLP, 2005-1 U.S.T.C. ¶ 50,264, 95 A.F.T.R.2d 2005-1725 (N.D. Ill. 3/30/05). The district court ruled that only one of 267 documents withheld from IRS scrutiny by the intervenors were unprotected by privilege or work product, or both. [The unprotected document was an e-mail sent by



a BDO employee.] 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 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 2005-2 U.S.T.C. ¶ 50,447, 95 A.F.T.R.2d 2005-2835 (N.D. Ill. 5/17/05). Judge Holderman found that there was a *prima facie* case for the remaining document examined *in camera* not being 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 boiler-plate documents).

• Both of Judge Holderman’s decisions are on appeal to the Seventh Circuit.

2. **The *Powell* requirement that the summonsed documents provide information not already in the IRS’s possession is being more rigorously enforced.** United States v. Monumental Life Ins. Co., 440 F3d 729 (6th Cir. 3/3/06), *rev’g* 345 F. Supp. 2d 712 (W.D. Ky. 10/8/04). The Sixth Circuit reversed the district court and denied enforcement of an IRS summons because the IRS already had in its possession many of the documents containing the information sought in the summonsed documents – even though it obtained the information after the summons was issued. The burden is on the government rather than on the taxpayer to demonstrate that the government’s interests outweigh the taxpayer’s hardship, and the government was offered the opportunity to craft a more narrowly-tailored summons.

### C. Litigation Costs

1. Urban v. United States, 2006-1 U.S.T.C. ¶50,211, 97 A.F.T.R.2d 2006-751 (N.D. Ill. 1/24/06). Attorney’s fees were awarded in a § 6672 case where (1) the government’s “physical evidence was totally insufficient to prove its case,” and (2) the government based its case on testimony of witnesses that was “inherently incredible ... biased, self-serving, perhaps acquired in a deal with the IRS and ... impeached at trial.”

2. **The circuits are split on whether attorney’s fees may be awarded to a pro se taxpayer, but the Second Circuit has not yet spoken. A bankruptcy court in New York answers “yes.”** In re Hudson, 97 A.F.T.R.2d 2006-2693 (Bankr. N.D. N.Y. 5/16/06). A pro se taxpayer who prevails against government’s position that was not substantially justified can recover an amount equal to reasonable attorney’s fees.

### D. Statutory Notice

1. **In cases where the IRS has determined that the taxpayer realized unreported income, the Commissioner must provide a minimal evidentiary foundation for the deficiency determination before the presumption of correctness attaches to it.** McManus v. Commissioner, T.C. Memo. 2006-057 (3/27/06). Without a minimal evidentiary foundation for the deficiency determination, Judge Haines held that the burden of going

forward with the evidence shifts from the taxpayer to the Commissioner – wholly apart from § 7491 – on the ground that the notice of deficiency is arbitrary.

#### E. Statute of Limitations

1. Benson v. Commissioner, T.C. Memo. 2006-55 (3/27/06). Items on the tax returns of brother-sister corporations reflecting payments between them, which on the facts were found to be constructive dividends to their common shareholder, did not constitute adequate disclosure with respect to the shareholder's return to prevent the § 6501(3)(1)(A) six-year statute from being applicable.

2. **The informal claim doctrine may not apply in a suit for refund.** Computervision Corp. v. United States, 445 F.3d 1355 (Fed. Cir. 4/20/06). An amendment of a refund claim filed after the statute of limitations had run and which claimed a different amount under a different theory was not germane to the original refund claim and thus did not relate back.

a. **Or, it may apply.** Parker Hannifin Corp. v. United States, 71 Fed. Cl. 231 (Fed. Cl. 5/23/06). An amendment of a refund claim after the statute of limitations had run on an original timely-filed refund claim seeking approximately \$89,000 of allegedly overpaid interest on a deficiency, to increase the claim to approximately \$9.1 million, was germane to the original refund claim because it was based on the same theory, and thus related back.

#### F. Liens and Collections

1. Greene-Thapedi v. Commissioner, 126 T.C. 1 (1/12/06). The Tax Court is divested of jurisdiction where the IRS applies an overpayment from another year to satisfy a deficiency after issuing a determination in a 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 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.

2. **Tax Court makes it easier to find abuse of discretion in collection due process hearings, but the courts of appeals won't play along.** Robinette v. Commissioner, 123 T.C. 85 (7/20/04) (reviewed, 14-3), *rev'd*, 439 F.3d 455 (8th Cir. 3/8/06). In 1995, the taxpayer had entered into an offer in compromise (based on doubt 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 may not consider new issues). The court held that the Administrative Procedures Act review provisions do not apply to § 6330(d) proceedings, and admitted the 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 the Tax Court's decision in *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), *aff'd*, 469 F.3d 27 (1st Cir. 11/20/06). The Tax Court (Judge Halpern) declined to overrule *Robinette*, but excluded as irrelevant the 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. ***Robinette* 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.

d. ***Murphy* affirmed; Eighth Circuit decision in *Robinette* followed.** 469 F.3d 27 (1st Cir. 11/20/06). The First Circuit affirmed the Tax Court’s decision in *Murphy*, but on different grounds. The court of appeals held that the administrative record rule applies to a taxpayer’s CDP hearing appeal to the Tax Court, citing the Eighth Circuit’s decision in *Robinette*. Judicial review normally should be confined to the information that was before the IRS when making the challenged rulings.

3. *Manko v. Commissioner*, 126 T.C. 195 (4/20/06). On the taxpayer’s challenge to enforcement of a levy, Judge Kroupa held that where a taxpayer has executed a closing agreement on Form 906, which only finally determines one or more separate items affecting the taxpayer’s liability, the IRS must nevertheless issue a statutory notice of deficiency before proceeding to collect any deficiency.

4. *Zapara v. Commissioner*, 126 T.C. 215 (4/25/06). Where the IRS failed to comply with taxpayer’s request to sell seized stock within 60 days, the Tax Court (Judge Thornton) granted equitable relief by granting taxpayer a credit for the value of the seized stock as of the date by which it should have been sold under the statute; because the IRS’s failure to adhere to follow the statutory mandate in § 6335(f) frustrated taxpayer’s ability to use the stock to satisfy tax liabilities and increased taxpayer’s risk with respect to the stock. Therefore, the IRS must assume the risk of loss with respect to the stock.

5. Cox. v. Commissioner, 126 T.C. 237 (5/3/06). An Appeals officer is not disqualified from conducting a collection due process hearing for a later year by virtue of conduct of a prior collection due process hearing for the same taxpayer with respect to an earlier year, which is not “prior involvement” within the meaning of § 6330(b)(3), where the record does not otherwise call into question his impartiality.

6. Gorospa v. Commissioner, 451 F.3d 966 (9th Cir. 5/3/06), cert. denied, 127 S. Ct. 987 (1/8/07). The Ninth Circuit affirmed the Tax Court’s determination that it did not have jurisdiction over an appeal from collection due process proceedings with respect to trust fund recovery penalties under § 6630(d)(1)(B), because the Tax Court did not have jurisdiction over the underlying liability. [Section 6330(d) has been amended to provide the Tax Court with exclusive jurisdiction over review of all CDP determinations issued on or after 10/17/06.]

7. **Partial payment to be required on the submission of an offer-in-compromise.** TIPRA § 509 adds new § 7122(c) to require partial payments of 20 percent of lump-sum offers-in-compromise [oddly defined to include all offers featuring five or fewer installments], or the first installment of periodic payment offers-in-compromise, with the submission of such offers. Offers submitted without the required payments (unless a waiver is provided for under regulations to be issued) are to be returned to the taxpayer as unprocessable.

- TIPRA also added Code § 7122(f), which provides that an offer-in-compromise is deemed to have been accepted by the IRS if the IRS has not rejected it within two years of the date on which it was submitted.

a. Notice 2006-68, 2006-31 I.R.B. 105 (7/11/06). This notice contains interim guidance pending promulgation of final regulations. Payments accompanying lump sum offers will be treated as a payment of tax, and not as a refundable deposit. If the taxpayer submits a periodic payment offer, it must be accompanied by the first installment, and subsequent installments must be timely paid during the period of evaluation of the offer-in-compromise by the IRS, and will be similarly treated as payments of tax. Any applicable user fee must be paid along with the partial payment, but the user fee will serve to reduce the taxpayer’s tax liability dollar-for-dollar. Voluntary payments in excess of the required payments will be treated as refundable deposits if they are not designated as tax payments by the taxpayer. The payment requirement can be waived with

respect to an offer submitted by a low-income taxpayer or with respect to an offer submitted based solely on the basis of doubt as to liability.

8. Bell v. Commissioner, 126 T.C. 356 (5/22/06). The Tax Court (Judge Foley) held that taxpayer was properly barred from challenging the underlying liability in a § 6220 due process hearing because he had the opportunity to appeal to the Tax Court from a determination letter issued after a previous § 6330 due process hearing and failed to do so.

9. Barnes v. Commissioner, T.C. Memo. 2006-150 (7/24/06). The Tax Court (Judge Laro) held that the IRS properly rejected taxpayers' offer in compromise based on promotion of effective tax administration because the taxpayers failed to identify compelling considerations of public policy or equity. A compromise based on promotion of effective tax administration is further not warranted because taxpayer's liability arose from a tax shelter scheme in which they were allegedly defrauded by the promoter, because "[a] compromise on that basis would place the Government in the unenviable role of an insurer against poor business decisions by taxpayers." The IRS properly rejected the offer in compromise based on the alternative ground of doubt as to collectibility because the taxpayers offered less than they were able to pay and the IRS's rejection of the offer was "a reasonable application of the guidelines, which we decline to second guess," and was not abusive or unfair. Judge Laro noted that under Reg. § 301.7122-1(c)(3), "economic hardship" exists where a taxpayer is "unable to pay his or her reasonable basic living expenses," and the taxpayers must articulate with specificity the purported economic hardship they will suffer if they are not allowed to compromise their liability.

- Judge Laro refused to consider additional evidence offered by taxpayers that was not offered during the administrative proceeding, stating, "as we read petitioners' memorandum in the light of the record as a whole, petitioners wanted to include the external evidence in the record of this case to prove that [the Appeals officer] abused her discretion by not considering facts and documents that they had consciously decided not to give to her."

10. Cristopher Cross, Inc. v. United States, 461 F.3d 610 (5th Cir. 8/21/06). An Appeals Officer did not abuse her discretion in returning an offer in compromise as "nonprocessable" based upon the Internal Revenue Manual. Taxpayer had offered \$85,000 on a deferred payment schedule to settle an assessed liability for employment taxes of \$134,078 for four quarters. The offer was rejected because (1) the taxpayer had not timely made federal tax deposits of estimated tax, and (2) it had

more than sufficient equity in accounts receivable and moveable assets to pay the tax in full.

11. **Pension Protection Act** § 855 amends code § 6330(d) to provide that all appeals of collection due process determinations are to be made to the Tax Court. The provision is effective for determinations made more than 60 days after the August 17, 2006 date of enactment.

a. CC-2007-001 (10/13/06). 2006 TNT 201-7. The IRS has provided guidance regarding the amendment to § 6330(d) providing the Tax Court with exclusive jurisdiction over review of all CDP determinations issued on or after 10/17/06.

12. T.D. 9290, Miscellaneous Changes to Collection Due Process Procedures Relating to Notice and Opportunity for Hearing Upon Filing of Notice of Federal Tax Lien, 71 F.R. 60835 (10/17/06). These final regulations amend the regulations relating to a taxpayer's right to a hearing under § 6320 after the filing of a notice of Federal tax lien (NFTL). They make certain clarifying changes in the way collection due process hearings are held and specify the period during which a taxpayer may request an equivalent hearing. The final regulations affect taxpayers against whose property or rights to property the Internal Revenue Service (IRS) files a NFTL. These regulations are effective 11/16/06.

a. T.D. 9291, Miscellaneous Changes to Collection Due Process Procedures Relating to Notice and Opportunity for Hearing Prior to Levy, 71 F.R. 60827 (10/17/06). These final regulations amend the regulations relating to a taxpayer's right to a hearing before or, in limited cases, after levy under § 6330. They make certain clarifying changes in the way CDP hearings are held and specify the period during which a taxpayer may request an equivalent hearing. The final regulations affect taxpayers against whose property or rights to property the Internal Revenue Service (IRS) intends to levy. These regulations are applicable to requests for CDP hearings after 11/16/06.

## G. Innocent Spouse

1. **No “plain language” limitation of the Tax Court’s jurisdiction in this case.** Ewing v. Commissioner, 118 T.C. 494 (5/31/02). The taxpayer and her husband filed a joint return but did not pay all of the tax shown on the return. Subsequently, before the IRS asserted any deficiency, the taxpayer requested equitable relief from joint and several



liability under § 6015(f). The IRS denied relief and mailed a notice of determination that was not mailed to the taxpayer's last known address, but was actually received by the 88th day after it was mailed. The taxpayer's petition for review was postmarked 92 days after the mailing of the notice, and was received and filed seven days later. The Commissioner moved to dismiss on the ground that the petition was not timely filed. The Tax Court *sua sponte* raised the issue of whether it had jurisdiction under § 6015(e) to review the IRS's denial of § 6015(f) relief where no deficiency had been asserted. [Section 6015(e), granting the Tax Court jurisdiction to review denials of § 6015 relief, as amended by the Consolidated Appropriations Act of 2001, begins, "In the case of an individual against whom a deficiency has been asserted and who elects to have subsection (b) or (c) apply..."] In a reviewed opinion by Judge Ruwe, the majority (9-4) held that the Tax Court has jurisdiction to review a denial of § 6015(f) relief in a stand alone petition where the taxpayer is seeking relief from liability of tax shown on the return, without a deficiency having been asserted. The court further held that the petition was timely because it was filed more than 6 months after the date 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 90 days after the mailing of the notice. The court concluded that:

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

There is nothing in the legislative history indicating that the amendment of section 6015(e) \*\*\*, was intended to eliminate our jurisdiction regarding claims for equitable relief under section 6015(f) over which we previously had jurisdiction. The stated purpose for inserting the language "against whom a deficiency has been asserted" into section 6015(e) was to clarify the proper time for a taxpayer to submit a request to the Commissioner for relief under section 6015 regarding underreported taxes. We conclude that the amendment of section 6015(e) does not preclude our jurisdiction to review the denial of equitable relief under

section 6015(f) where a deficiency has not been asserted. In the instant case, petitioner filed a claim for relief from joint and several liability for an amount of tax correctly shown on the return but not paid with the return. Because respondent has not challenged the tax reported on the return, no deficiency has been asserted. In this situation, petitioner may be entitled to relief under section 6015(f) because subsection (f) applies where “it is inequitable to hold the individual liable for *any unpaid tax or any deficiency.*” [citations omitted].

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

- a. Ewing v. Commissioner, 122 T.C. 32 (1/28/04). In a reviewed opinion by Judge Colvin, the Tax Court held that even though the standard for reviewing the Commissioner’s failure to grant equitable relief under § 6015(f) is abuse of discretion, the Tax Court’s review is not necessarily limited to the facts that were in the administrative record. Judges Halpern, Holmes, Chiechi, and Foley dissented.

- b. **Reversed, vacated and dismissed because the Tax Court did not have jurisdiction over taxpayer’s petition in which she claimed innocent spouse relief.** Commissioner v. Ewing, 439 F.3d 1009 (9th Cir. 2/28/06). 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 over an innocent spouse claim. The phrase in § 6015(e) “against whom a deficiency has been asserted” was added in 2001.

2. 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 understated because under California state law community property is subject to an obligation of one spouse.

3. **Imagine the other stories he was ready to believe.** Motsko v. Commissioner, T.C. Memo. 2006-17 (2/2/06). The Tax Court

(Judge Holmes) held that a taxpayer who signed a joint return prepared by his subsequently-imprisoned wife more than a year late, at a time when he knew that prior returns were under audit, had a “duty of inquiry” because a reasonable person in his position would have gotten suspicious that [his wife] was no longer behaving as expected.” Inasmuch as the taxpayer made no inquiry, he did not qualify for the safe harbor in Rev. Proc. 2000-15, 2001-1 C.B. 448, § 4.02, and equitable relief was denied based on a balancing of the eight factors listed in the revenue procedure. Incidentally, taxpayer did not own the business he thought he owned; it was owned by a partnership between his wife and her brother.

4. Campbell v. Commissioner, T.C. Memo. 2006-24 (2/15/06). A wife who was financially unsophisticated had no knowledge of, and no duty to inquire as to, husband’s sham losses purportedly incurred in commodities trading account – even though the trades were through an account in her name – because she was only a nominee, the sophisticated transactions “looked legitimate on paper,” and “a reasonable person with [the wife’s] educational background, devoid of any specific knowledge in options trading, could not be expected to discover that the trades were fictitious.”

5. Rev. Rul. 2006-16, 2006-14 I.R.B. 694 (4/30/06). A taxpayer is not precluded from seeking innocent spouse relief under § 6015 by virtue of a prior bankruptcy case filed by the taxpayer and the taxpayer’s spouse in which the IRS filed a proof of claim, if the bankruptcy court did not make an actual determination of the liability. On the other hand, if the requesting spouse had been the debtor in the bankruptcy case and had meaningfully participated in the dischargeability proceeding, and the bankruptcy court had determined the tax liability on the merits, that determination generally would have precluded the requesting spouse from subsequently receiving § 6015 relief.

## H. Miscellaneous

1. **There is a Form 1099 for tax exempt interest in your future.** TIPRA § 502 amends Code § 6049(b)(2) to eliminate the exception for tax-exempt interest from reporting requirements. Thus payors of tax-exempt interest will be required to report such interest on Form 1099. This provision is applicable to interest paid after 12/31/05.

a. Notice 2006-93, 2006-44 I.R.B. 798 (10/4/06). Provides transitional relief for payors of tax-exempt interest during 2006 and the first quarter of 2007.

2. **Tax Court may apply the doctrine of equitable recoupment.** Pension Protection Act § 858 amends Code § 6214(b) to authorize the Tax Court to apply the doctrine of equitable recoupment.

3. **Duty of consistency prevents tax gamesmanship.** Janis v. Commissioner, 461 F.3d 1080 (9th Cir. 8/21/06). Taxpayer, as co-executor of his father's estate, agreed with the IRS on a discounted value [for blockage] of an extensive art collection held by his father [in a sole proprietorship, the Sidney Janis Art Gallery] included in the estate on the premise that flooding the market with the art works would depress the value of the art works. Later, in valuing the art gallery's inventory, taxpayer used the full undiscounted value of more than \$36 million instead of the estate tax value of \$14.5 million for purposes of calculating the gallery's income. Judge McKeown held that the duty of consistency should be applied in order to prevent inequitable shifting of positions by the taxpayer.

- The doctrine requires that there be (1) a representation by the taxpayer [here, as beneficiary and co-executor of his father's estate], (2) reliance by the Commissioner, and (3) a change in position by the taxpayer after the statute of limitations has run. The court noted that "[s]uch tax gamesmanship is exactly what the duty of consistency is designed to prevent."

4. **Houston SB/SE taxpayers may be guinea pigs for fast-track settlements.** Announcement 2006-61, 2006-36 I.R.B. 390 (8/22/06), *corrected by* Announcement 2006-97, 2006-50 I.R.B. 1108 (12/11/06). The IRS has extended the LMSB fast-track settlement program to SB/SE. The program will be available for a two-year test period, and for the first six months will be available only for taxpayers in Chicago, Houston, and St. Paul. Rev. Proc. 2003-40, 2003-1 C.B. 1044, implemented the program. The program is effective beginning 9/5/06.

5. **Tax Court grants taxpayer's motion for leave to file a motion to vacate an order dismissing his case for lack of jurisdiction, and holds that the motion should be deemed filed on the date it was mailed, rather than on the date it was received.** Stewart v. Commissioner, 127 T.C. 109 (10/3/06) (reviewed, 18-0). The Tax Court (Judge Ruwe) determined that the timely-mailing/timely-filing provisions of § 7502 would apply to a motion for leave to file a motion to vacate an order of dismissal for lack of jurisdiction, so the Tax Court's earlier decision would not become final after the 90-day period for appeal had elapsed under § 7481(a). The Tax Court will no longer follow its decision in *Manchester Group v. Commissioner*, T.C. Memo. 1994-604, *rev'd*, 113 F.3d 1087 (9th Cir. 1997).

6. **I'm from the IRS and I'm here to help you comply with FIN 48.** The IRS announced on 10/17/06 an LMSB initiative to help taxpayers resolve on an expedited basis their issues with Financial Accounting Standards Board Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109." 2006 TNT 201-17. Requests for FIN 48 resolution must be submitted at least 45 days before the end of taxpayer's fiscal year; the expedited procedure is not recommended for fiscal years ending after 3/31/07.

7. T.D. 9300, Guidance Necessary to Facilitate Business Electronic Filing, 71 F.R. 71040 (12/8/06). The Treasury has promulgated final regulations on eliminating regulatory impediments to businesses filing electronic returns.

8. **Individuals who follow Lauren Bacall's instructions will be entitled to between 15 and 30 percent of the collected proceeds resulting from their information. The Tax Relief and Health Care Act of 2006** § 406 amends Code § 7623 to reform the reward program for individuals who provide information regarding violations involving an individual whose gross income exceeds \$200,000 for the relevant year if the tax, penalties, interest and additional amounts in dispute exceed \$2 million. Generally, the provision establishes a reward floor of 15% and a cap of 30% of the collected proceeds (including penalties, interest, additions to tax and additional amounts) if the IRS moves forward with an administrative or judicial action based on information brought to the IRS's attention by an individual. Under certain specified circumstances, the provision permits awards of lesser amounts. The provision allows an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the individual in connection with any award for providing information regarding violations of the tax laws.

9. **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."

a. **So far, he is unable to wriggle out, the way he did 25 years ago when he was acquitted by a jury.**<sup>2</sup> 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>3</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.

b. **And the Tax Court's procedures are vindicated and taxpayer Ballard loses on appeal on the fraud issue in the Eleventh Circuit.** Ballard v. Commissioner, 321 F.3d 1037 (11th Cir. 2/13/03), *aff'g* T.C. Memo. 1999-407. The Eleventh Circuit affirmed the Tax Court decision and rejected the taxpayers' argument that changes allegedly made by the Tax Court Special Trial Judge were improper. Judge Fay stated:

Even assuming Dick's [taxpayers' lawyer's] affidavit to be true and affording Petitioners-Appellants all reasonable inferences, the process utilized in this case does not give rise to due process concern. While the procedures used in the Tax Court may be unique to that court, there is nothing unusual about judges conferring with one another about cases assigned to them. These conferences are an essential part of the judicial process when, by statute, more than one judge is charged with the responsibility of deciding the case. And, as a result of such conferences, judges sometimes change their original position or thoughts. Whether Special Trial Judge Couvillion prepared drafts of his report or subsequently changed his opinion entirely is without import insofar as our analysis of the alleged due process violation pertaining to the application of [Tax Court] Rule 183 is concerned. Despite the invitation, this court will simply not interfere with another court's deliberative process.

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2. His partner (and son-in-law) was convicted and imprisoned. See *United States v. Baskes*, 649 F.2d 471 (7th Cir. 1980), *cert. denied*, 450 U.S. 1000 (1981).

3. 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.

The record reveals, and we accept as true, that the underlying report adopted by the Tax Court is Special Trial Judge Couvillion's. Petitioners-Appellants have not demonstrated that the Order of August 30, 2000 is inaccurate or suspect in any manner. Therefore, we conclude that the application of Rule 183 in this case did not violate Petitioners-Appellants' due process rights. Accordingly, we deny the request for relief and save for another day the more troubling question of what would have occurred had Special Trial Judge Couvillion not indicated that the report adopted by the Tax Court accurately reflected his findings and opinion.

c. **And the Tax Court's procedures are vindicated and taxpayer Kanter's Estate<sup>4</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. The court found that the nondisclosure of the special trial judge's original report was proper, following the Eleventh Circuit's *Ballard* opinion. It affirmed the Tax Court's findings on the issues of deficiencies, fraud and penalties, but reversed on the issue of the deductibility of Kanter's expenses for his involvement in the aborted sale of a purported John Trumbull painting of George Washington because "Kanter has shown a distinct proclivity to seek income and profit through activities similar to the failed sale of the painting."

d. **And the Tax Court's procedures are vindicated but taxpayer Lisle's Estate wins on appeal on the fraud issue in the Fifth Circuit.** Estate of Lisle v. Commissioner, 341 F.3d 364, 2003 U.S.T.C. ¶ 50,606, 92 A.F.T.R.2d 2003-5566 (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. The court affirmed the findings of deficiencies, except for the deficiency in a closed year because the government's proof of Lisle's fraud did not rise to the level of "clear and convincing evidence."

e. **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

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4. Burton Kanter died on October 31, 2001.

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 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 notes, "Only by failing to abide by our own Rules can the Court hold that the Tax Court failed to follow its Rules."

f. **The Eleventh Circuit orders that the Special Trial Judge's report be added to the record.** Ballard v. Commissioner, 2005-1 U.S.T.C. ¶50,393 (11th Cir. 5/17/05). The report was 300 pages.

g. **Tax Court proposes new rule on Special Trial Judges' reports.** On July 7, 2005, 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 (9/8/05). 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 at the Tax Court's November 1992 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 press release, 9/21/05.** The Tax Court announced that it has adopted amendments to Tax Court Rules 182 and 183, relating to Special Trial Judges' reports in cases other than small tax cases. The Special Trial Judge's recommended findings of fact and conclusions of law are to be served on the parties, who may file written objections and responses. After the case is assigned to a regular Judge, any changes made shall be reflected in the record and "[d]ue regard shall be given to the circumstance that the Special Trial Judge had the opportunity to evaluate the credibility of witnesses, and the finding of fact recommended by the Special Trial Judge shall be presumed to be correct."

k. **Chief Counsel Notice CC-2005-017 (9/27/05).** This notice 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. 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.

n. Estate of Kanter v. Commissioner, T.C. Memo. 2006-46 (3/16/06). The Tax Court (Judge Haynes) denied the estate’s motion to abate the tax assessments entered after its initial decision [when it failed to post a bond under § 7485 to stay the assessment or collection of the tax liabilities in dispute during the pendency of the appeals] because under § 7486 in order for collection to be abated the appellate court must “disallow in whole or in part” the deficiency determined by the Tax Court, and no appeals court in this case made any finding regarding the correct amount of the estate’s deficiencies. Judge Haynes followed *Estate of Smith v. Commissioner*, 115 T.C. 342 (2000). Judge Haynes granted the Commissioner’s motion to stay proceedings and maintain the status quo in order to preserve his position in relation to other creditors. The estate had made an offer-in-compromise to the Appeals Office based on doubt as to liability and collectibility, which was denied.

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

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

- Judge Haynes found that – based upon factors such as (1) failure to report substantial amounts of income, (2) concealment of the true nature of the income and the identity of the earners of the income, (3) use of sham, conduit, and nominee entities, (4) reporting Kanter’s and Ballard’s income on IRAs [and another entity’s] tax returns, (5) commingling of Kanter’s and Ballard’s income with funds belonging to others, (6) phony loans, (7) false and misleading documents, and (8) failure to cooperate during the examination process by engaging in a “strategy of obfuscation and delay” – the Commissioner demonstrated by “clear and convincing evidence” that Kanter and Ballard filed false and fraudulent tax returns for each of the years at issue.

- Judge Haynes held that the Tax Court is “obliged to review the recommended findings of fact and credibility determinations set forth in the STJ report under a ‘manifestly unreasonable’ standard of review, and ... may reject such findings of fact and credibility determinations only if, after reviewing the record in its entirety, [it] conclude[s] that the recommended finding of fact or testimony (1) is internally inconsistent or so implausible that a reasonable fact finder would not believe it, or (2) is not credible because it is directly contradicted by documentary or objective evidence.” Furthermore, Judge Haynes held that a special trial judge’s credibility determinations may be rejected under the “manifestly unreasonable” standard of review without rehearing the disputed testimony.

- Judge Haynes further found that the appropriate standard for determining whether the assignment of income doctrine should be applied had been appropriately articulated in *United States v. Newell*, 239 F.3d 917, 919-920 (7th Cir. 2001), as follows:

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

## XI. WITHHOLDING AND EXCISE TAXES

### A. Employment Taxes

1. **TIPRA** § 511 adds new § 3402(t) to provide for a withholding tax of 3-percent on payments made to persons providing property or services to governmental entities.

### 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), *motion for rehearing en banc denied*, 2006 U.S. App. LEXIS 8294 (6th Cir. 3/30/06). 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, 2005-2 C.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.

d. **The Second Circuit agrees that the telephone excise tax does not apply.** Fortis Inc. v. United States, 447 F.3d 190 (2d Cir. 4/27/06) (per curiam).

e. So does the Third Circuit in a lengthy analysis of the meaning of the word "and" and a shorter analysis of the meaning of the word "distance." Reese Brothers, Inc. v. United States, 447 F.3d 229 (3d Cir. 5/9/06).

f. **"Enough, already!" The IRS cries, "Uncle."** Notice 2006-50, 2006-25 I.R.B. 1141 (5/25/06), *revoking* Notice 2005-79, 2005-2 C.B. 952 (11/14/05). The IRS announced that it will stop assessing the § 4251 telephone excise tax on long distance services, and that it will provide for refunds of taxes paid on services billed after 2/28/03 and before 8/1/06. These refunds are to be requested on 2006 Federal income tax returns, the right to which will be preserved by the IRS scheduling over-assessments under § 6407. Individuals are eligible to receive a safe harbor amount, which has not yet been determined. Interest received on the refunds will have to be reported as 2007 income.

g. **IRS announces safe harbor amounts for telephone tax refunds for individuals.** On 8/31/06, the IRS announced the safe harbor refund amounts of telephone tax available to individual taxpayers [without records or other proof of actual amounts paid] are \$30 for individual filers, with a \$10 increase for each additional exemption claimed on the 2006 return, up to a maximum of \$60. 2006 TNT 170-2.

h. **The IRS announces safe harbor amounts for telephone tax refunds for businesses.** On 9/16/06, the IRS announced the safe harbor refund amounts of telephone tax available to business taxpayers [without records or other proof of actual amounts paid]. The refund is to be computed on new Form 8913 based upon the taxpayer's April and September 2006 telephone bills, by making calculations based upon the

difference between the telephone tax charged on these two bills. 2006 TNT 222-11.

i. IR-2007-16 (1/25/07). The IRS said that early findings show some individual taxpayers have requested apparently improperly large amounts for the special telephone tax refund, such as requesting a refund on the entire amount of their phone bills, or making requests for thousands of dollars indicating they had phone bills in excess of \$100,000 – an amount exceeding their income. The IRS also noted that some tax preparers are helping their clients file apparently improper requests.

## **XII. TAX LEGISLATION**

### **A. Enacted**

1. The **Tax Increase Prevention and Reconciliation Act of 2005** (*sic*) (“**TIPRA**”), Pub. L. 109-222, was signed by President Bush on 5/17/06.

2. **Heroes Earned Retirement Opportunities Act** (“**HERO Act**”), Pub. L. 109-227, 120 Stat. 385, was signed by President Bush on 5/29/06.

3. The **Pension Protection Act of 2006** (“**Pension Protection Act**”), Pub. L. 109-280 was signed by President Bush on 8/17/06.

4. **A state may not tax nonresident partners on retirement income that is sourced in that state.** Pub. L. 109-264, which amends 4 U.S.C. § 114(b)(1) to limit state taxation of nonresidents on retirement income paid to partners on account of their in-state services performed during the years the retirement income was accrued, was enacted on 8/3/06. The provision was enacted in response to New York’s attempt to tax retirement income of partners based on the position that 4 U.S.C. § 114 applied to the retirement income of nonresident employees, and not partners.

### **B. Pending**

1. Pub. L. 109-432, the **Tax Relief and Health Care Act of 2006** was signed by President Bush on 12/20/06.