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# RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION: THE YEAR 2007

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# RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION: THE YEAR 2007

*by*

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*This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during 2007 — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide Dan and Marty the opportunity to mock our elected representatives. The outline focuses primarily on topics of broad general interest (to the three of us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services. Please read this outline at your own risk; we take no responsibility for any misinformation in it, whether occasioned by our advancing ages or our increasing indifference as to whether we get any particular item right. Any mistakes in this outline are Marty's responsibility; any political bias or offensive language is Ira's; and any useful information is Dan's.*

# I. ACCOUNTING

## A. Accounting Methods

**1. The method of determining "fair market value" under § 475 falls within the definition of "method of accounting" for § 446(b)'s requirement that the taxpayer's method of accounting must clearly reflect income.** In re Heilig Meyers Co., **232 F.App'x 240** (4th Cir. 5/9/07). The determination of the fair market value of accounts receivable under the mark-to-market rules of § 475 is an accounting method subject to § 446(b)'s clear reflection of income requirement. The court relied heavily on *JPMorgan Chase & Co. v. Commissioner*, 458 F.3d 564 (7th Cir. 8/9/06), which held that the valuation of interest swaps, which also were subject to the § 475 mark-to-market rules, was an accounting method, in rejecting the taxpayer's argument that "the dispute was 'a valuation case,' as opposed to a method of accounting case."

**2.** Notice 2007-88, 2007-46 I.R.B. 993 (11/13/07). This Notice requests comments regarding a proposal to change the process by which taxpayers obtain the consent of the Commissioner to change a method of accounting. It describes the automatic and nonautomatic consent processes, and suggests they be replaced with a system under which a taxpayer requests "standard consent," "specific consent," or "letter ruling consent" and describes these processes.

## B. Inventories

There were no significant developments regarding this topic during 2007.

## C. Installment Method

There were no significant developments regarding this topic during 2007.

## D. Year of Inclusion or Deduction

**1. The IRS just says 'no" to the recurring item exception.** Rev. Rul. 2007-3, 2007-4 I.R.B. 350 (1/22/07). Under the recurring-item exception to the economic performance rule in § 461(h)(3), taxpayers can accrue deductions no sooner than the year in which the all-events test is satisfied. The IRS concluded that liabilities were not "established" under the all-events test in the year in which two contracts were executed. In the first situation, the contract, executed in Year 1, did not

require the performance of services and payment until Year 2. In the second situation, the contract, executed in Year 1, did not provide insurance coverage or payment for that coverage until Year 2. The IRS concluded that, in both cases, the mere execution of the contract, "without more," did not establish the taxpayer's liability. Thus, the recurring-item exception could not apply.

**2. Deducting payroll taxes in a year before the compensation is deducted.** Rev. Rul. 2007-12, 2007-11 I.R.B. 685 (3/12/07). Section 404 does not control the year of deduction of an employer's liability for payroll taxes, even if the payroll tax liability relates to deferred compensation subject to the rules of § 404. Section 404 does not affect the timing of the accrual of payroll tax liability under § 461; if the all-events test and the recurring item exception in § 461 and Reg. § 1.461-5(b)(1) are otherwise met, an accrual method taxpayer may deduct payroll tax liability in Year 1, even though the compensation to which the liability relates is deferred compensation that is deductible under § 404 in Year 2. This Ruling modifies Rev. Rul. 96-51, 1996-2 C.B. 36, which concluded that, under the all-events test, an accrual method employer may deduct in Year 1 its otherwise deductible payroll taxes imposed on year-end wages properly accrued in Year 1 but paid in Year 2, provided the employer satisfies the requirements of the recurring item exception in Reg. § 1.461-5.

**3.** Rev. Rul. 2007-32, 2007-21 I.R.B. 1278 (5/21/07). An accrual method bank is required to take interest into income with respect to loans that are declared by Federal Banking Rules to be a "non-accrual loan" for which the bank is required to treat interest payments as a return of principal. Where the bank uses the conformity method of accounting under Reg. § 1.166-2(d), uncollected accrued interest is treated as worthless for § 166 purposes in the year that the amount is charged off for regulatory financial accounting purposes.

**a.** Rev. Proc. 2007-33, 2007-21 I.R.B. 1289 (5/21/07). This Revenue Procedure describes procedures for automatic consent to a change of accounting method that uses a prescribed safe-harbor to determine for each tax year the amount of uncollected accrued interest that is expected to have a reasonable expectancy of repayment using a recovery percentage for the bank.

**4. The saga of whether advance trade discounts are currently includible in gross income.**

a. **Yes, says the Tax Court.** 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, there was no unconditional obligation to repay the advance. The amounts under the note were due only if the supply agreement was materially breached by the taxpayer.

b. **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 includible in income by virtue of taxpayer's inventory accounting system.

c. **And the IRS caves.** Rev. Proc. 2007-53, 2007-30 I.R.B. 233 (7/23/07). The IRS will follow *Westpac Pacific Food v. Commissioner* and allow accrual method taxpayers who receive advance trade discounts to adopt the "Advance Trade Discount" method of accounting as a change of accounting method. Taxpayers who report advance trade discounts as reductions in the price of inventory for financial purposes may do so for tax reporting purposes. Taxpayers who lack applicable financial statements must reduce the cost of the specific items of inventory to which the discount relates.

d. **But the Third Circuit disagrees with the Ninth Circuit and affirms the Tax Court decision in *Karns*. Did the IRS cave too soon in issuing Rev Proc 2007-53?** Karns Prime & Fancy Food, Ltd v. Commissioner, 494 F.3d 404 (3d Cir. 7/20/07). The Third Circuit affirmed the Tax Court decision in *Karns* and specifically rejected the reasoning and Ninth Circuit's holding in *WestPac Foods*. The court (Judge Sloviter) reasoned that the key question is whether, at the time of receipt of the funds, the recipient was unconditionally obligated to make repayment. Under the logic of *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990), a receipt is not a loan if the taxpayer controls whether it will be entitled to retain the payment. Because Karns alone controlled whether it would meet the contractual requirements, the receipt was analogous to an advance payment includable in gross income. Although

Judge Sloviter acknowledged that the facts in *Westpac Pacific Foods* differed somewhat, he concluded that in *Westpac* the Ninth Circuit had completely ignored the significance of *Indianapolis Power*. The Third Circuit treated payments under a supply agreement as advance payments includible in income because the taxpayer was free to keep the money as long as it fulfilled its part of the bargain. The taxpayer thus had complete dominion and control over the money. The court rejected the taxpayer's assertion that the advance was a loan because the taxpayer, by performing under the agreement, was in a position to control whether it was obligated to repay.

- Judge Ambro caustically entitled a section of his concurring opinion "The Ninth Circuit Tax Shelter, or How to Make Money By Buying Things." The concurring opinion noted that the Third Circuit's position has always been that income may be considered to be a loan only when there is an unconditional repayment obligation; it characterized the Ninth Circuit as the "first and only" Court of Appeals to conclude that trade discounts paid by the supplier to a taxpayer to offset the taxpayer's required minimum purchases are loans rather than advance payments.
- Judge Brody dissented on the ground that the agreements between the supplier and Karns did not assure that Karns could keep the funds, because the supplier retained "immense latitude" to cancel the agreement before Karns had met its purchase obligations, a factual conclusion with which the majority disagreed.
- In light of Rev. Proc. 2007-53, in which IRS indicated that it will generally follow *Westpac Pacific Foods,* the Third Circuit's decision appears to be of little importance with respect to the specific issue of whether advance trade discounts must be taken into gross income when received, but it nevertheless is an important general precedent regarding the determination of whether other receipts are a loan versus an income item.

**5. Not all accruals are created equal.** The Charles Schwab Corp. v. Commissioner, 495 F.3d 1115 (9th Cir. 8/2/07). Schwab was required to pay a yearly California franchise tax. For the years in question, California calculated a corporation's franchise tax liability based upon the corporation's income from the preceding year – the so-called "income" year. Schwab used the accrual method of accounting; under § 461(a) it deducted expenses for the year in which they accrued. Under California law, Schwab's state franchise tax liability accrued on the last day of the year in which Schwab earned the income forming the basis for the tax assessment (December 31 of the "income" or "measuring" year). However, § 461(d)(1) provides, that a taxpayer's accrual date for federal tax purposes may be no earlier than it would have been under state law as it existed at the end of 1960. Under pre-1961 California law, the franchise tax did not accrue

until the first day of the year following the income year (January 1 of the "taxable" year). California amended its franchise tax in 1972. Under pre-1972 law, a corporation that stopped doing business did not pay any franchise tax on the income earned during its final year of operation. The Court of Appeals affirmed the Tax Court, 122 T.C. 191, 203 (2004), holding that § 461(d)(1) required Schwab to determine the timing of its franchise tax accruals pursuant to pre-1961 law. As a result, Schwab's liability accrued on January 1 of the taxable year rather than December 31 of the preceding income year, meaning Schwab was entitled to deduct on its 1989-1992 federal tax returns its franchise tax obligations based upon its 1988-1991 income.

**6. Who needs constructive receipt when you have actual receipt?** Burns v. Commissioner T.C. Memo. 2007-271 (9/12/07). The taxpayer was owed over $145,000 as the last installment of an award under a whistleblower statute. A private investigator, who had assisted the taxpayer in the investigation that led to the award, obtained a judgment against the taxpayer for failure to pay him pursuant to their contract. To avoid execution of the private investigator's judgment lien on the funds, the taxpayer filed a voluntary petition in bankruptcy, and the funds were paid over to the bankruptcy trustee by the taxpayer's debtor. Judge Carluzzo held that the funds were *actually* received by the taxpayer in the year they were paid over to the bankruptcy trustee. No reference to the constructive receipt doctrine was necessary. The funds were actually received because the taxpayer's voluntary action resulted in the payment to the bankruptcy trustee.

## II. BUSINESS INCOME AND DEDUCTIONS

### A. Income

**1. Settlement funds beneficially owned by a governmental entity are tax-exempt. Tax Increase Prevention and Reconciliation Act of 2005** § 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**.**

**2. Here's how the IRS's vigorishly reconstructed a bookie's income from 4 days of records that we bet he wishes he hadn't kept.** Paterson v. Commissioner, T.C. Memo. 2007-109 (4/30/07). The Tax Court (Judge Kroupa) upheld the IRS's complex reconstruction of an illegal bookmaker's income based on records for 4 days of betting seized in a police raid. The method applied consisted of five computational steps: (1) adding 10 percent vigorish to the bets listed on the sheet that did not carry vigorish and adding all bets together to find the gross wagers; (2) dividing total gross wagers by 4 days of betting to obtain the average daily bet; (3) using the call records for the taxpayer's cellular phones to determine the number of days people called the taxpayer to place bets; (4) multiplying the average daily bet by the number of days people placed bets for each year to arrive at the gross wagers for each year; and (5) multiplying the gross wagers for the year by 4.54 percent, which represented the profit percentage a bookmaker would make if his or her books were balanced.

**3.** Notice 2007-63, 2007-33 I.R.B. 353 (8/13/07). This Notice deals with the tax treatment of "market gain" associated with the repayment of Commodity Credit Corporation (CCC) loans under the nonrecourse marketing assistance loan program authorized under the Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, 116 Stat. 134 (2002). A taxpayer that has made an election under § 77 to take the loan into income accounts for market gain for the year in which a CCC loan is repaid by making an adjustment to the basis of the commodity that secures the loan. A taxpayer that has not made an election under § 77 reports market gain as income for the year in which a CCC loan is repaid.

### B. Deductible Expenses versus Capitalization

**1. 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 2005-6431 (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. Affirmed**, 213 F.App'x 440 (6th Cir. 1/12/07). Taxpayer failed to prove that the contribution to capital was an ordinary business expense or a business loss.

**2. Simplifying complexity.** T.D. 9318, Guidance Regarding the Simplified Service Cost Method and the Simplified Production Method, 72 F.R. 14675 (3/29/07). The Treasury has promulgated final regulations under the uniform capitalization rules of 263A with respect to the simplified service cost method and simplified production method of capitalizing mixed service costs (costs that benefit production activities and other activities) and production costs that were not capitalized under the taxpayer's method of accounting before the effective date of § 263A. The rules are applicable to eligible property that consists of self-constructed assets produced by the taxpayer on a routine and repetitive basis in the regular course of the taxpayer's trade or business. The regulations provide that property is produced on a routine and repetitive basis if numerous substantially identical units of tangible personal property are produced within a tax year using standardized designs and assembly line techniques and the recovery period for the assets is not longer than 3 years.

**3. The cost of double-wides just went up.** Load, Inc. v. Commissioner, T.C. Memo. 2007-51 (3/6/07). Costs attributable to placement of model manufactured homes on leased retail sales lots for sale by local independent sellers are includible in inventory under § 263A. The costs are not on-site storage costs under Reg. § 1.263A-1(e)(3)(iii)(I) because transfers to independent re-sellers prevented taxpayer from being considered as selling exclusively to retail customers.

**4. The IRS adopts an uncharacteristic position by requiring deduction instead of capitalization.** ILM 200721015 (1/16/07). In this legal memorandum the IRS has determined under Reg. § 1.266-1(b)(1)(iv) that a flat fee paid to a stockbroker for investment services is not a carrying charge. The legal memorandum arrived at this result by virtue of the following reasoning:

> Fees for consulting and advisory services are better viewed as currently deductible investment expenses. Consulting and advisory fees are not carrying charges because they are incurred independent of a taxpayer's acquiring property and because they are not a necessary expense of holding property. Stated differently, consulting and advisory fees are not closely analogous to common carrying costs, such as insurance, storage, and transportation. (citation omitted).

- This prevents taxpayers from capitalizing § 212 expenditures, the deduction of which would produce no tax benefit as a

result of either the § 67 limitation on miscellaneous itemized deductions or the disallowance of such deductions under the AMT.

**5. Environmental remediation may or may not be deductible depending upon the facts.** Kerr-McGee Corp. v. United States, 77 Fed. Cl. 309 (6/29/07). The Court of Federal Claims denied summary judgment to the taxpayer on a claim for refund based on deductions for environmental remediation of the site of an oil refinery and uranium processing operation. Kerr-McGee purchased the site, which had continuously operated as an oil refinery since 1915, in 1956, sold it in 1972, and reacquired portions in 1984 and 1987. The court (Judge Sweeney) held that environmental remediation costs are deductible if the taxpayer caused the contamination and incurred expenses to return the property to the condition it was in before the contamination, regardless of whether the taxpayer continuously owned the property. Expenses are required to be capitalized if the remediation allowed the taxpayer to put the property to a new or better use, whether or not the taxpayer caused the contamination, or if the remediation is part of a plan of renovation, rehabilitation, or improvement. Ultimately the court determined that the record before it presented factual determinations necessary to reach a judgment. The court specifically noted, however, that it was "not prepared, based on the record before it, to find that Kerr-McGee can deduct remediation expenses for contamination that occurred from 1915 to 1956. In order to make such a ruling, the court would need evidence that contamination on the ... site prior to 1956 can be attributed to Kerr-McGee."

**6.** Tarter v. Commissioner, T.C. Memo. 2007-320 (10/25/07). The taxpayer was denied deductions for his employee benefits and payroll taxes, outside services, equipment rental, and depreciation for his business of pouring concrete foundations and flatwork for residential projects because he failed to meet the burden of countering the IRS claim that these items had been included in cost of goods sold by the taxpayer. Accuracy-related penalties were sustained.

### C. Reasonable Compensation

**1. Group affected by limitations on executive compensation is redefined.** Notice 2007-49, 2007-25 I.R.B. 1429 (6/18/07). Section 162(m) limits deductible compensation paid to covered employees to $1,000,000 (plus performance bonuses). This Notice responds to revisions of regulations by the SEC defining covered employees, which the IRS says will now include the principal executive officer and compensation paid to employees that is required to be reported to shareholders under the

Securities Exchange Act of 1934 by virtue of being among the three highest paid officers of the corporation during the taxable year other than the principal executive officer or the principal financial officer.

**2. Healthy $2 million and $1 million annual compensation to the CEO and sole owner of the taxpayer corporation is reasonable given the CEO's skill at developing and marketing skin care products, tanning lotions, diet aids, sports performance products, nutritional supplements, health food products, and indoor tanning salons.** Vitamin Village, Inc. v. Commissioner, T.C. Memo. 2007-272 (9/12/07). In a case appealable to the Ninth Circuit, the Tax Court (Judge Haines) substantially rejected the IRS's arguments that the taxpayer paid its sole shareholder (Daniel Reeves) unreasonable compensation. Judge Haines allowed taxpayer to deduct compensation in the form of bonuses in the amounts of $2,000,000 (out of $2,278,000 paid) in one year and of the entire $1,012,000 paid in another year. The Tax Court applied the five factor test of the Ninth Circuit from *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983): (1) The employee's role in the company; (2) comparison with other companies; (3) the character and condition of the company; (4) potential conflicts of interest; and (5) internal consistency in compensation.

- The shareholder functioned as the corporate president, secretary, and treasurer. In the prior 13 years, Reeves' compensation had never exceeded $310,000 and in 11 of those years was $47,000 or less. The court found that Reeves, who was the taxpayer's sole executive officer and manager, was the driving force behind its success. "His vision and hard work resulted in ... a shareholders return on equity of 93 percent and 25 percent in the respective fiscal years at issue," and Reeves had been underpaid in prior years.

- The Tax Court also allowed deductions for $1.1 million of advertising expenses for promoting suntan products paid to the taxpayer's sister corporation, wholly owned by Reeves, but disallowed depreciation deductions on a newly constructed houseboat and floating garage on the Willamette River adjacent to Reeves's residence, which were sold in 2002 to Mr. Reeves wife's company in Reeves's bankruptcy.

**a.** Reeves v. Commissioner, T.C. Memo. 2007-273 (9/12/07). The Tax Court held that amounts expended by the corporation for construction of the houseboat and floating garage did not

result in a constructive dividend to Reeves, noting that the corporation was reimbursed from the proceeds of Reeve's bankruptcy sale.

**b. But salary paid by a related support organization proves to be too much.** Universal Marketing, Inc. v. Commissioner, T.C. Memo. 2007-305 (10/9/07). An additional $509,000 paid to Reeves was too much for Judge Haines on top of the compensation paid by Vitamin Village. Applying the *Elliotts, Inc.* factors, the Tax Court found that the taxpayer failed to establish that the amount of time spent on the affairs of the corporation whose sole source of receipts was its sister corporation, Vitamin Village, justified the salary.

### D. Miscellaneous Deductions

**1. The IRS never seems able to catch up with movements in the price of gasoline.** Rev. Proc. 2006-49, 2006-47 I.R.B. 936 (11/20/06). The optional standard mileage rate for business use of automobiles for 2007 is 48.5 cents per business mile. The optional standard mileage rate for medical and moving expenses is 20 cents per mile. The statutory rate for charitable mileage under § 170(i) remains at 14 cents per mile.

**a. The IRS keeps chasing increases in the price of gasoline. Or, is the groundhog sending out mixed signals?** Rev. Proc. 2007-70, 2007-50 I.R.B. 1162 (12/10/07), *superseding* Rev. Proc. 2006-49, 2006-47 I.R.B. 936. The optional standard mileage rate for business use of automobiles for 2008 increases to 50.5 cents per business mile. The depreciation component of the mileage rate is 21 cents. The optional standard mileage rate for medical and moving expenses goes down to 19 cents per mile. The statutory rate for charitable mileage under § 170(i) remains at 14 cents per mile.

**2. Oh, the joy of legitimately deducting large capital expenditures (except for SUVs)!** The **Small Business and Work Opportunity Tax Act of 2007** amended § 179 to increase the amount deductible under § 179 to $125,000 for tax years beginning after 2006 and before 1/1/11. The phase-out threshold was increased to $500,000. Both amounts are indexed for inflation after 2007, using 2006 as a base year. The **2007 Act** also extends the inclusion of off-the-shelf computer software as § 179 property for one year, until 1/1/11, and likewise extends the increased deductible amount (up to an additional $100,000), and the increased phase-out ($600,000) for Gulf Opportunity Zone Property until 1/1/11.

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

**a. Partnership that extracts minerals is a qualified in-kind partnership.** Rev. Rul. 2007-30, 2007-21 I.R.B. 1277 (5/21/07). Under Reg. § 1.199-9(i)(1) and Temp. Reg. § 1.199-3T(i)(7)(i), each partner of a qualifying in-kind partnership is treated as having manufactured, produced, grown, or extracted property that is manufactured, produced, grown, or extracted by the partnership that is distributed to the partner. The IRS ruled that the extraction and processing of minerals (as defined in Reg. § 1.611-1(d)(5)) is an activity qualifying a partnership under these provisions. Thus, a partnership engaged solely in the extraction and processing of minerals within the United States will be a qualifying partnership as of the effective date of § 199.

**b.** Rev. Proc. 2007-34, 2007-23 I.R.B. 1345 (6/4/07). This Revenue Procedure provides procedures that allow certain large partnerships and widely held Subchapter S corporations to calculate, at the entity level, qualified production activities income and W-2 wages for purposes of the § 199 domestic production deduction.

**c.** Rev. Proc. 2007-35, 2007-23 I.R.B. 1349 (6/4/07). This Revenue Procedure provides statistical sampling methodologies for various allocations between domestic and non-domestic production activities.

**4. 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.

**5.** The **Tax Relief and Health Care Act of 2006** § 108 extends the § 62(a)(2)(D) above-the-line $250 deduction for K-12 teacher classroom expenses to 2006 and 2007.

**6.** The **Tax Relief and Health Care Act of 2006** § 109 extends the expensing of brownfields remediation costs under § 198 to 2006 and 2007. It also provides that sites contaminated by petroleum products will be eligible for the deduction.

**7. Deductions go up in smoke. Distributing California legal medical marijuana is illegal drug trafficking.** Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner, 128 T.C. 173 (5/15/07). Taxpayer is a California public benefit corporation engaged in the business of providing care services to its members with a secondary purpose to provide medical marijuana to members pursuant to the California Compassionate Use Act of 1996 and to instruct those individuals on how to use medical marijuana to benefit their health. Section 280E disallows deductions in a trade or business of trafficking in controlled substances within the meaning of schedules I or II of the Controlled Substances Act, which includes marijuana. The Tax Court (Judge Laro) held that supplying medical marijuana to taxpayer’s members is trafficking in a controlled substance, and disallowed all deductions with respect to distributing the marijuana. However, the court also found that the taxpayer’s care-giving activities for terminally ill patients were a separate trade or business from its medical marijuana delivery. Expenses allocable to the care-giving activity remained deductible as ordinary and necessary business expenses. The court allocated expenses between the two businesses on the basis of the number of employees and the portion of the taxpayer’s facilities devoted to each.

- The Commissioner conceded that § 280E did not operate to deny the cost of goods sold to the taxpayer. That concession was based on case law predating the enactment of the last sentence of § 263A(a)(2). See, e.g., *Franklin v. Commissioner*, T.C. Memo. 1993-184 (1993). The last sentence of § 263A(a)(2) states: “Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.” This provision was intended to preclude taking into account as inventory costs items that could not be deducted as business expenses if they did not relate to

inventory, e.g., fines and penalties, bribes, etc. A straightforward reading of § 280E and the last sentence of § 263A(a)(2), taken together, would deny any recovery of cost of goods sold for illegal drug dealers. The concession appears to have been erroneous.

**8. Proposed regulations outline rules for deducting entertainment use of business aircraft.** REG-147171-05, Deductions for Entertainment Use of Business Aircraft, 72 F.R. 33169 (6/15/07). The Treasury has proposed new detailed regulations, Prop. Reg. § 1.274-9, regarding deductions for entertainment use of business aircraft. In *Sutherland Lumber-Southwest, Inc. v. Commissioner*, 255 F.3d 495 (8th Cir. 2001), the court allowed a deduction under the exception of § 274(e)(2) that exceeded the amount included in income by the employee for personal use of the company aircraft (the corporation was an S corporation so the deduction passed through to the employee/owner and more than offset the amount included in income). The **American Jobs Creation Act of 2004** enacted § 274(e)(2)(B), reversing the result in *Sutherland Lumber-Southwest* to limit the deduction for expenses attributable to personal use to the amount included in income by the employee, but the provision only applies to personal use by officers, directors, and more-than-10 percent owners. The proposed regulations identify the persons subject to the limitations of § 274(e)(2)(B), including related parties under §§ 267(b) and 707(b), provide rules for the allocation of expenses between entertainment and other uses (including an option to allocate expenses on a flight-by-flight basis rather than using the occupied seat per mile basis or hour formula), rules for allocating expenses for travel that involves both business and entertainment (the entertainment portion is the excess of total expenses over the business portion), among other things.

**9. Revisiting what is insurance? This fund for clean-up costs is not a deductible insurance premium.** Rev. Rul. 2007-47, 2007-30 I.R.B. 127 (7/23/07). A domestic corporation that engages in a business practice that is "inherently harmful to people and property" acquired an insurance policy for future clean-up costs. While the exact cost of the future clean-up was unknown, there was no uncertainty that the cost will be incurred. The corporation estimated that the present value of the future cost is $150x. The corporation acquired an insurance policy with a premium of $150x that would reimburse future clean-up costs up to $300x. The ruling concludes that the arrangement is not insurance because of the absence of any risk that the corporation will be required to incur the clean-up costs. The arrangement is described as a prefunding of the corporation's future costs. The corporation is not allowed a deduction for the insurance premium. In addition, the insurance company is not allowed to account for

the arrangement as an insurance contract, meaning that the premium is taken into income without any offset for discounted unpaid losses under § 832(b)(5).

- Note *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858 (7th Cir. 1992), in which Judge Easterbrook stated:

> What is "insurance" for tax purposes? The Code lacks a definition. *Le Gierse* mentions the combination of risk shifting and risk distribution, but it is a blunder to treat a phrase in an opinion as if it were statutory language. *Zenith Radio Corp. v. United States,* 437 U.S. 443, 460-62,, 98 S. Ct. 2441, 2450-51 (1978), 57 L. Ed. 2d 337. Cf. *United States v. Consumer Life Insurance Co.,* 430 U.S. 725, 740-41, 97 S. Ct. 1440, 1448-49, 52 L. Ed. 2d 4 (1977). The Court was not writing a definition for all seasons and had no reason to, as the holding of *Le Gierse* is only that paying the "underwriter" more than it promises to return in the event of a casualty is not insurance by any standard. …
>
> Corporations accordingly do not insure to protect their wealth and future income, as natural persons do, or to provide income replacement or a substitute for bequests to their heirs (which is why natural persons buy life insurance). Investors can "insure" against large risks in one line of business more cheaply than do corporations, without the moral hazard and adverse selection and loading costs: they diversify their portfolios of stock. Instead corporations insure to spread the costs of casualties over time. Bad experience concentrated in a single year, which might cause bankruptcy (and its associated transactions costs), can be paid for over several years. See generally David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance,* 55 J. Bus. 281 (1982). Much insurance sold to corporations is experience-rated. An insurer sets a price based on *that firm's* recent and predicted losses, plus a loading and administrative charge. Sometimes the policy is retrospectively rated, meaning that the final price is set *after* the casualties have occurred. Retrospective policies have minimum and maximum premiums, so the buyer does not bear all of the risk, but the upper and lower bounds are set so that almost all of the time the insured firm pays the full costs of the losses it generates. Both experience rating and

> retrospective rating attempt to charge the firm the full cost of its own risks over the long run, a run as short as one year with retrospective rating. The client buys some time-shifting (very little in the case of retrospective rating) and a good deal of administration. Insurers are experts at evaluating losses, settling with (or litigating against) injured persons, and so on. A corporation thus buys loss-evaluation and loss-administration services, at which insurers have a comparative advantage, more than it buys loss distribution. If retrospectively rated policies, called "insurance" by both issuers and regulators, are insurance for tax purposes--and the Commissioner's lawyer conceded for purposes of this case that they are--then it is impossible to see how risk shifting can be a *sine qua non* of "insurance."

**10. Professional gamblers can have net operating losses.** Tschetschot v. Commissioner, T.C. Memo. 2007-38 (2/20/07). A professional tournament poker player's net gambling losses are limited by § 165(d). However, the IRS conceded that deduction of non-wagering expenses was not limited by § 165(d).

**11. Blue Cross/Blue Shield wins again on the fresh start basis of cancelled health insurance contracts.** Highmark, Inc. v. United States, 78 Fed. Cl. 146 (8/22/07). Following *Trigon Ins. Co. v. United States*, 215 F. Supp. 2d 687, 701, 706 (E.D. Va. 2002) and *Capital Blue Cross v. Commissioner*, 122 T.C. 224, 237–38 (2004), *rev'd on other grounds*, 431 F.3d 117 (3d Cir. 2005), the Court of Federal Claims granted partial summary judgment in favor of the successor to Blue Cross/Blue Shield on refund claims of $21 million plus interest. When Blue Cross and Blue Shield were transformed into taxable entities by the Tax Reform Act of 1986, Congress included a provision that "for purposes of determining gain or loss, the adjusted basis of any assert held on" January 1, 1987, will be its fair market value. The taxpayer claims that assets include terminated and cancelled contracts in existence on that date. The court rejected the government's assertion that "assets" did not include the insurance contracts issued by Blue Cross/Blue Shield, and that losses included only losses realized on a sale or exchange of assets, not termination of contracts. The court held that the plain language of the statute applies to allow the claimed losses. The court also rejected the government's argument that the amended returns claiming the losses represented a change in accounting method.

**12. The interest deduction for a bank with tax-exempt interest income is limited.** PSB Holdings, Inc. v. Commissioner,

129 T.C. 131 (11/1/07). Peoples Bank and Peoples Investment Company were wholly owned members of a consolidated group filing consolidated returns whose widely held parent company is PSB Holdings. The Bank and the Investment Company held tax-exempt securities. Some of the Investment Company's tax-exempt securities were purchased by the Bank and transferred to the Investment Company as contributions to capital. Other tax-exempt securities were purchased directly by Investment Company. Only Bank claimed deductions for interest expense.

- Section 265(a)(2) disallows deductions for interest on indebtedness incurred to purchase or carry tax-exempt obligations. In the case of a bank, § 265(b), adopting a fungibility approach, provides that interest subject to the § 265(a)(2) limitation is the portion of the amount of interest that bears the same ratio to total interest as "the taxpayer's average adjusted bases ... of tax exempt obligations," bears to the average adjusted bases of all of the taxpayer's assets. While § 265(a)(2) under this formula disallows 100 percent of a bank's interest attributable to tax-exempt obligations, § 291(e), enacted prior to § 265(b), disallows 20 percent of a bank's interest attributable to tax-exempt obligations, determined under the same formula as § 265(b)(2). See § 291(e)(1)(B)(ii). Section 291(e) applies to interest expense attributable to tax-exempt obligations acquired before August 8, 1986, the date § 265(b) was enacted. However, the 20 percent reduction of §291(e) (rather than the 100 percent reduction of § 265(a)(2)) continues to apply to tax-exempt obligations of small issuers. All of the taxpayer's exempt-obligations were qualified small issues.

- The IRS argued that for purposes of determining Bank's interest deduction under the allocation formulas of §§ 265(b)(2) and 291(e)(1)(B), the numerator of the allocation formula should include tax-exempt obligations held by Investment Company because Bank included the basis of its Investment Company stock in the denominator. Focusing on the "text" of the allocation formula, the Tax Court concluded that the numerator included only tax-exempt obligations held by the taxpayer, here, the bank alone. (Bank itself included in the numerator tax-exempt obligations purchased by Bank and transferred to Investment Company.) The Tax Court rejected the contrary holding of Rev. Rul. 90-44, 1990-1 C.B. 54, stating that a revenue ruling, while representing an interpretation based on experience and informed judgment, is not entitled to the same deference as regulations under *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

**13. The Third Circuit cans Alcoa's claim of right doctrine benefits.** Alcoa, Inc. v. United States, 509 F.3d 173 (3d Cir. 11/28/07). Alcoa's production of aluminum products produces substantial waste. Under heightened environmental clean-up standards enacted in the Comprehensive Environmental Response, Compensation, and Liability Act

of 1980 (CERCLA), and others, Alcoa was forced to incur substantial environmental remediation expense to clean up several of its manufacturing sites. Alcoa deducted these expenses in 1993 then filed a $12 million claim for refund in the District Court. Alcoa cleverly argued that its 1993 expenses should have been included in its cost of goods sold in manufacturing operations for the years 1940-1987. Its reduced cost of goods sold for those years generated excess income, received under a claim of right, which it was forced to return in the form of the deductible environmental remediation expenses incurred in 1993. Alcoa then claimed under § 1341 that, rather than taking the deduction in 1993 for the expense, that it was entitled to a return of the taxes paid in 1940-1987 on its increased gross income resulting from the under-inclusion of disposal costs in its cost of goods sold. The Third Circuit concluded that Alcoa's obligation to return gross income in the form of increased remediation expenses "did not arise from the same *circumstances*, *terms*, and *conditions* as the initial failure to spend additional funds on environmental clean-up. Rather, the obligations were created by *new* circumstances, terms, and conditions, namely, by an intervening change in environmental legislation." Thus, there is no nexus between the income asserted to have been received under a claim of right, and the expenditure claimed as a refund of that income. The court ultimately concluded that the § 1341 benefits are not available "because Alcoa's expenditure of funds in 1993 was not the restoration of particular moneys to the rightful owner and did not arise from the same circumstances, terms, and conditions as Alcoa's original acquisition of the income."

**14. A sole proprietor can create deductible medical plans by hiring a spouse.** Frahm v. Commissioner, T.C. Memo. 2007-351 (11/27/07). A taxpayer farmer (who reported farming income on Schedule F) claimed deductions under § 162(a) (ordinary and necessary business expense) for health insurance premiums on plans for his sole employee, his spouse. The employee health plans and medical reimbursement plans included coverage for the employee's spouse, the sole-proprietor. For the years at issue, deductions under § 162(*l*) for health insurance premiums paid by a sole-proprietor were limited. The Tax Court held that all premiums paid by the taxpayer for the employee health benefit plans that covered the employee's spouse were deductible.

**a. But you have to follow proper form to create the employee benefit.** Eyler v. Commissioner, T.C. Memo. 2007-350 (11/27/07). The taxpayer operated a tiling business that had one full-time employee, the taxpayer's spouse. Judge Cheichi rejected the taxpayer's claim that the taxpayer's health insurance policy under which the taxpayer

was the primary beneficiary was part of an unwritten benefit's plan established for the taxpayer's sole employee. The court noted the lack of any credible evidence that the health insurance premiums paid directly by the taxpayer were a contribution to a health benefit plan for the taxpayer's employee. The taxpayer was allowed by the IRS to deduct the insurance premiums under § 162(*l*) up to the applicable percentage allowed for 2003, which was 60 percent.

**b. The IRS disagrees with its Web Site and affirms deductibility of medical plan premiums for an S corporation shareholder.** Notice 2008-1, 2008-2 I.R.B. 251 (1/14/08). Contrary to advice posted in the IRS web site last year, the IRS has indicated that a two percent shareholder-employee of a Subchapter S corporation is entitled to deduct under § 162(l) accident and health insurance premiums paid or reimbursed by the S corporation. This is an above-the-line deduction. Following Rev. Rul. 91-26, 1991-1 C.B. 184, an S corporation is treated as maintaining a medical care coverage plan if the corporation makes premium payments on behalf of a two percent shareholder-employee (and the employee's spouse and dependents), or the two percent shareholder-employee pays the premiums and on furnishing proof of payment is reimbursed by the S corporation. The Notice adds that in order for the employee to deduct the premiums under § 162(*l*), the S corporation must report premiums paid as wages to the employee on a Form W-2 for the year of payment, and the employee must report the premiums as gross income.

**E. Depreciation & Amortization**

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

**2. Using the tax code for subsidies where direct action has failed: First-year depreciation recovery for specified Gulf Opportunity Zone extension property.** Notice 2007-36, 2007-17 I.R.B. 1000 (4/23/07). This Notice provides guidance with respect to the 50 percent original first year deprecation deduction provided under § 1400N(d). A 50 percent first year depreciation allowance is provided for property placed in service in the so-called GO Zone. The **Tax Relief and Health Care Act of 2006** § 120, adding Code § 1400N(d)(6), extends the place in service date for GO Zone extension property to 12/31/10. GO Zone extension property is property the substantial use of which is on one or more portions of the GO Zone (listed in the Notice) and which is either nonresidential real property or residential rental property, or personal property that is used in such real

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

**3. Wine grape trellises don't make good fences, but they are in the same class.** Trentadue v. Commissioner, 128 T.C. 91 (4/3/07). The Tax Court held that wine grape trellises (in one of our favorite wine areas) are ten year class life property under Rev. Proc 87-56, 1987-2 C.B. 674, as agricultural equipment in class 01.1, which includes machinery and equipment, grain bins, and fences, but no other land improvements. The court analogized the trellises to fences "with the major difference being that one is intended to keep things in or out and the other to support grape growing equipment or train grapevines." The taxpayer's irrigation system and wells, however, were found to constitute land improvements with a 20 year class life in class 00.3. The court noted that components of the taxpayers' drip irrigation system are buried in the ground and that a substantial portion of it will remain buried until the vines are removed. Applying the six factor test from *Whitco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975), the court focused to some degree on the fact that the trellises, but not the irrigation pipes (and especially not the well), were movable and in fact were moved on occasion.

**4. Rotable spare parts are depreciable property.** Rev. Proc. 2007-48, 2007-29 I.R.B. 110 (7/16/07). After losing the issue in the courts and announcing in Rev. Rul. 2003-37, 2003-1 C.B. 717, that rotable spare parts maintained by a manufacturer for the purpose of repairing customers' equipment (mostly computers) are depreciable assets rather than inventory, the IRS has announced a safe-harbor method of accounting with automatic consent to treat rotable spare parts as depreciable. The revenue procedure applies to a taxpayer that repairs customer-owned equipment under warranty or maintenance agreements for no charge or for a maintenance fee and which has a depreciable interest in a pool of spare parts that are exchanged for defective parts in the customers' equipment. The taxpayer is required to capitalize the cost of the parts and depreciate the assets in the asset class specified in the revenue procedure. The safe-harbor is available only if the taxpayer's gross sales of rotable spare parts do not exceed 10 percent of the taxpayer's gross revenues from its maintenance operations.

### F. Credits

**1.** The **Tax Relief and Health Care Act of 2006** § 104 extended the § 41 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.

**2.** The **2007 Act**, § 8211(a) extends the § 51 Work Opportunity Credit to wages paid before August 31, 2011.

- "High Risk Youths"[1] are redesignated as "designated community residents." Youths include otherwise qualifying individuals between ages 18 and 40 on the hiring date. The credit is extended to employment of individuals with a work plan under the Social Security Act "ticket to work plan," and qualified veterans who are certified as meeting the local food stamp requirement.

**3. This telephone booth does not shelter income.** Sita v. Commissioner, T.C. Memo. 2007-363 (12/10/07). This is another Alpha Telcom telephone equipment investment shelter where the taxpayer claimed depreciation deductions and disabled access credits under § 44 on the purchase of seven pay phones for $5,000 each. See *Arevalo v. Commissioner*, 469 F.3d 436 (5th Cir. 2006). The taxpayer was provided with legal title to pay phones under an equipment purchase agreement that described telephone equipment but did not identify the pay phones subject to the purchase or their locations. The agreement included a service agreement under which Alpha Telcom selected the pay phone locations, installed and serviced the phones, and collected the revenue. Alpha Telcom filed for bankruptcy in the year the taxpayer's purchased the phone equipment and was the subject of a civil action by the SEC for selling unregistered securities. Judge Haines denied the taxpayer's claim for disabled access credits because the taxpayers failed to demonstrate that they maintained an eligible small business that operated a place of public accommodation or were a common carrier of voice transmission services. The court also denied depreciation deductions because the taxpayers did not obtain the benefits and burdens of ownership with respect to the pay phones.

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1. Pronounced "Utes" by people from New York City.

### G. Natural Resources Deductions & Credits

**1. 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. 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 (2/21/06), 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 a 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 through 2008.

**3. 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 originally was 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 placed in service in 2008.

**4. Credit for biodiesel and renewable diesel used as fuel.** Section 40A, added to the Code by the **American Jobs Creation Act of 2004**, and amended by the **Energy Tax Incentives Act of 2005**, provides a nonrefundable credit of 50 cents per gallon of biodiesel mixed with regular diesel in the production of a qualified biodiesel mixture, 50 cents per gallon of straight biodiesel used in the taxpayer's trade or business or sold at retail, a $1 per gallon credit for agri-biodiesel, and a $1 per gallon credit for renewable diesel, which is diesel fuel derived from biomass using a thermal depolymerization process.

**a. Renewable diesel defined**. Notice 2007-37, 2007-17 I.R.B. 1002 (4/23/07). This revenue ruling clarifies that depolymerization is defined broadly to include processes that use heat and pressure with or without the presence of catalysts, and otherwise defines renewable diesel.

**5.** 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.

**6. Guidance Issued for the § 30C alternative fuel vehicle refueling property credit.** Notice 2007-43, 2007-22 I.R.B. 1318 (5/29/07). Pending issuance of regulations, this Notice provides definitions of qualified alternative fuel vehicle (QAFV) refueling property, dual use property, alternative fuel, qualifying biodiesel mixture, and rules for computing the credit. The credit is 30 percent of the cost of depreciable property placed in service as a QAFV refueling property, up to $30,000 per property, or $1,000 for other property. Proposed technical corrections would limit the credit to a single $30,000 or $1,000 amount.

**7.** Notice 2007-64, 2007-34 I.R.B. 385 (8/20/07). The § 43 enhanced oil recovery credit for taxable years beginning in the 2007 calendar year is phased out completely, because the reference price for the 2006 calendar year ($59.68) exceeds $28 multiplied by the inflation adjustment factor for the 2006 calendar year ($39.82) by $19.86.

**8.** Notice 2007-65, 2007-34 I.R.B. 386, (8/20/07). The applicable percentage under § 613A to be used in determining percentage depletion for marginal oil and gas properties for the 2007 calendar year is 15 percent.

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

**1. Heads the government wins, tails the taxpayer loses.** Bilthouse v. United States, 100 A.F.T.R.2d 2007-6191 (N.D. Ill. 9/28/07). The taxpayer was a shareholder in an S corporation engaged in the construction of public works that sustained substantial losses. In 1995 the corporation was insolvent and, as found by the court, the corporation had zero liquidation value. Also in 1995, the corporation was unable to obtain construction bonds required for public works projects. The taxpayer had substantial passive activity losses from the S corporation. The taxpayer asserted that cancellation of indebtedness income realized by the insolvent S corporation in 1997 increased the taxpayer's stock basis and that the stock became worthless in 1997, thereby allowing the taxpayer to treat the worthlessness as a disposition, permitting deduction of the passive activity losses. Without addressing whether the corporation had cancellation of indebtedness income in 1997, the court concluded that the taxpayer failed to meet his burden of proving that the stock was not worthless in 1995, when the corporation became insolvent, had zero liquidation value, and could no longer perform work, rather than in 1997 when a lawsuit against the City of Jacksonville was terminated without recovery. The court noted that the mere hope of a recovery from the lawsuit did not preclude a finding of worthlessness in the earlier year.

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

**1. The Ninth Circuit upholds self-rental regulations to the taxpayer's disadvantage: Following decisions in the First, Fifth, and Seventh Circuits, the Ninth Circuit rejected the taxpayers' arguments that the regulation is arbitrary and capricious in its application to C corporations.** Beecher v. Commissioner, 481 F.3d 717 (9th Cir. 3/23/07). The taxpayers worked full time for two wholly owned C corporations that rented office space from the taxpayers. The taxpayers also owned other rental properties. They reported net income from the leases of the office space to their corporations and losses from the other rental properties that exceed the net income from the office rental. The taxpayers treated all of the rental activities as passive under § 469 and offset their rental income from the offices with the losses. The IRS determined that the income from the office leases was non-passive income under the "self-

rental" rule in Reg. § 1.469-2(f)(6) (applying to rentals to an activity in which the taxpayer materially participates). Applying the *Chevron* (*Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)) standard, requiring that because "there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation," the court must afford the Commissioner's interpretation "controlling weight unless . . . [it is] arbitrary, capricious, or manifestly contrary to the statute," the Court of Appeals upheld the validity of the regulation. Furthermore the court rejected the taxpayer's argument that Congress's delegation of authority to issue the self-rental rule under § 469(*l*) was unconstitutional, following *Krukowski v. Commissioner*, 279 F.3d 547, 552 (7th Cir. 2002), which held the same. Finally, the court rejected the taxpayers' argument that the self-rental rule applies only to "abusive tax shelters" and does not apply to bona fide business transactions. "The relevant statutory distinction under Section 469 is not between taxpayers who contrive to limit their tax liability and those who do not. …Rather, the distinction between passive and non-passive activities is that in the case of passive activities, the 'taxpayer does not materially participate' in the business. ... This question hinges on the extent to which the taxpayer is involved in the affairs of both sides of a given transaction, not the taxpayer's motivation for structuring the transaction in a particular manner."

**2. Due process does not protect this tax attorney's real estate investments from the passive activity loss rules.** Ziegler v. Commissioner, T.C. Memo. 2007-166 (6/27/07). The Tax Court rejected Stephen Ziegler's argument that application of the passive activity loss rules to investment real estate purchased in 1984, two years before the effective date of § 469, was a retroactive application of the law constituting a taking under the due process clause of the Fifth Amendment. The court observed that tax legislation is not a promise and that the taxpayer has no vested right in the Internal Revenue Code.

**3. Seeing through entity boundaries, an equipment leasing LLC is treated as part of the same economic unit as a radiological services limited partnership.** Candelaria v. United States, 518 F. Supp. 2d 852 (W.D. Tex. 10/05/07). Under Reg. § 1.469-4(c)(2), activities that constitute an appropriate economic unit may be treated as a single activity under the facts and circumstances. Reg. § 1.469-4(d) provides that a rental activity may not be grouped with a trade or business unless either the rental activity or the trade or business is insubstantial in relation to the other. The taxpayer was a principal in an LLC formed to lease imaging equipment to a related limited partnership that provided radiological services. The ownership of the two entities was not identical, but the owners of the LLC

owned identical interests in the general partner of the limited partnership. The gross receipts of the leasing LLC, which only leased equipment to the limited partnership, were between three and eleven percent (depending on the taxpayer's or the IRS' position) of the combined gross receipts of the two entities. The District Court granted summary judgment to the taxpayer holding that the two entities constituted a single economic unit under the regulation's facts and circumstances test, and that the activities of the leasing LLC were insubstantial next to the trade or business income of the limited partnership. The taxpayer was permitted to treat losses from the leasing company as active business losses.

## III. INVESTMENT GAIN

### A. Capital Gain and Loss

**1. Consigning *McAllister* to the dustbin of history.** Prebola v. Commissioner, 482 F.3d 610 (2d Cir. 3/27/07) (per curiam). The taxpayer sold all of her rights to future lottery payments. The court followed *Watkins v. Commissioner*, 447 F.3d 1269 (10th Cir. 2006), to hold that the sales proceeds were ordinary income under the "substitute-for-ordinary-income" principle. This decision is significant because is was handed down by the Second Circuit, the court that decided *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), holding that a taxpayer could treat as a capital gain the lump-sum payment she received when she sold her entire rights to future payments from a life estate in a trust. The court stated: "We recognize that there are contexts in which the substitute-for-ordinary-income doctrine does not or should not apply. ... But whatever the doctrine's outer limits, this case falls squarely within them ... ." The court further noted that *McAllister* was decided before the Supreme Court decided *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958), which held that capital gains treatment was not applicable where "[t]he 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."

**2. Capital gain treatment for sales of self-created musical works. TIPRA** § 204 added 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.

**a.** Section 1221(b)(3) was made permanent by the **Tax Relief and Health Care Act of 2006** § 412.

**3. Proposed regulations would 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 (Prop. Reg. §§ 1.72-6(e)(1), 1.1001-1(j)) that would provide a single set of rules for the taxation of an exchange of property for an annuity contract. Essentially, the proposed rules would 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 would not change existing Reg. § 1.1011-2 for charitable gift annuities, but would 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.
- Note that under Rev. Rul. 85-13, 1985-1 C.B. 184, a transfer of assets to a grantor trust is not a recognition event.

**4. Distributorship agreement is a capital asset if you've invested in it.** Rev. Rul. 2007-37, 2007-24 I.R.B. 1390 (6/11/07). The cancellation of a distributor agreement between a manufacturer and a distributor is treated as a sale or exchange of property that results in capital gain (or § 1231 gain) if the distributor has made a substantial capital investment in the distributorship and the investment is reflected in physical assets. The ruling refers to automobile distributorships that receive payment from the manufacturer for cancellation of the agreement when the manufacturer decides to no longer produce the car. Amounts received in cancellation of certain distributor agreements are treated as capital gain by § 1241, which provides deemed "sale or exchange" treatment for cancellation of a lease or distributorship, but does not itself provide capital asset status. Gain from the disposition of a distributorship agreement that was subject to amortization under § 197 is treated as § 1231 gain. The ruling

also concludes that gain attributable to amortization of the acquisition costs of a distributorship agreement under § 1253 (25 year amortization prior to the effective date of § 197) will also be treated as property subject to the depreciation allowance of § 167 thereby producing § 1231 gain. Section 1231 gain on cancellation of the distributorship is subject to recapture under § 1245.

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

**6. The ever-expanding deemed sale or exchange concept limits ordinary loss deductions.** REG-101001-05, Abandonment of Stock and Other Securities, 72 F.R. 41468 (7/30/07). Prop. Reg. § 1.165-5(i) would provide that a security that has been abandoned is treated as a wholly worthless security. To abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for it. Thus, if the abandoned security (other than a security in an affiliated corporation subject to § 165(g)(3)) is a capital asset, the resulting loss is a capital loss incurred on the last day of the taxable year. All the facts and circumstances determine whether the transaction is properly characterized as an abandonment or other type of transaction, such as an actual sale or exchange, contribution to capital, dividend, or gift. These proposed regulations will be effective after the date of publication of final regulations.

**7. The same brokerage account can't be both a trader's account and an investor's account.** Arberg v. Commissioner, T.C. Memo. 2007-244 (8/27/07). The duty of consistency prevented the taxpayers

from treating losses incurred on stock traded in a brokerage account as ordinary losses incurred by the husband as a securities trader when gains from the same account in a prior closed year had been reported as capital gains on the wife's separate return in a prior year.

**B. Interest**

**1. Interest-free loans to continuing care facilities may be without limit through 2010. TIPRA** § 209 added 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.** This provision was made permanent by the **Tax Relief and Health Care Act of 2006** § 425.

**C. Section 121**

**1. More tax breaks for exiting home ownership.** The **Mortgage Forgiveness Debt Relief Act of 2007** amended § 121 to extend the $500,000 ceiling for excludable gain on the sale of a principal residence to a sale by an unmarried surviving spouse, if the sale occurs not later than two years after the death of the deceased spouse, and the surviving spouse and the deceased spouse would have qualified for the $500,000 ceiling immediately before the death of the deceased spouse. For all taxpayers other than married couples filing joint returns and qualifying surviving spouses, the ceiling on excludable gain remains $250,000.

**D. Section 1031**

**1. Regulations explain depreciation for MACRS property acquired in a §1031 exchange of MACRS property, or acquired in replacement of involuntarily converted MACRS property to which §1033 applies.**

**a. Temporary regulations.** T.D. 9115, REG-106590-00 and REG-138499-02, Depreciation of MACRS Property That Is Acquired in a Like-Kind Exchange or as a Result of an Involuntary Conversion, 69 F.R. 9529 (3/1/04). The Treasury published final, temporary, and proposed regulations dealing with depreciation of property acquired in a § 1031 like-kind exchange or as § 1033 replacement property and withdrew Prop. Reg. §§ 1.168(a)-1 and 1.168(b)-1 (which were in the July 2003 proposed regulations). Under these temporary and proposed regulations, to the extent the taxpayer's basis in the acquired MACRS property does not

exceed the taxpayer's adjusted basis in the exchanged or involuntarily converted MACRS property, the acquired property is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, the exchanged or involuntarily converted property if the useful life of the replacement property is the same or shorter than the relinquished property. Any additional basis in the acquired property is treated as newly purchased MACRS property. (This is the same method as provided for ACRS property in Prop. Reg. § 1.168-5(f) (1984).) If the replacement property has a longer useful life, depreciation is computed as if the replacement property had originally been placed in service when the relinquished property was placed in service by the acquiring taxpayer. Any excess basis is treated as property placed in service in the year the acquiring taxpayer places it in service. There are specific rules for deferred exchanges and reverse exchanges, as well as for automobiles. As announced in Notice 2000-4, 2000-3 I.R.B. 313, these rules are effective for acquired MACRS property placed in service on or after January 3, 2000, in a like-kind exchange of MACRS property under § 1031, or as a result of an involuntary conversion of MACRS property under § 1033. For property acquired before January 3, 2000, taxpayers who treated the entire basis as new MACRS property may continue to do so, or may change accounting methods to conform.

**b. Final regulations.** T.D. 9314, Depreciation of MACRS Property That is Acquired in a Like-Kind Exchange or As a Result of an Involuntary Conversion, 72 F.R. 9245 (3/1/07). The proposed regulations have been adopted, with the addition of some clarifying language and examples provided in response to comments. The rules for MACRS property exchanged in §§ 1031 and 1033 transactions are in Reg. § 1.168(i)-6.

**2. Have you heard about how you can do § 1031 like-kind exchanges of vacation homes? Don't drink that Kool-Aid!**[2] Moore v. Commissioner, T.C. Memo. 2007-134 (5/30/07). The taxpayer exchanged land with a mobile home, which the taxpayer used as a vacation residence, for another vacation property, and claimed the transaction qualified for nonrecognition under § 1031 because both vacation properties were acquired and held with the expectation that they would appreciate and thus were "investment" property. The court (Judge Halpern) held that the exchange did not qualify. The mere expectation that property will appreciate does not establish investment intent if the taxpayer uses the property as a

2. More correctly, Grape Flavor-Aid.

residence. There was no evidence that taxpayer made either property available for rent or held either property primarily for sale at a profit.

**a. And renting it out for a few weeks just before the exchange does not work. The IRS provides a safe-harbor for vacation home swappers.** Rev. Proc. 2008-16, 2008-10 I.R.B. 547 (3/10/08). This revenue procedure provides safe-harbor guidance regarding whether a residential property that the taxpayer held or intends to hold for mixed uses, e.g., personal vacation use and rental/investment purposes qualifies as property held for productive use in a trade or business or for investment under § 1031. Under the revenue procedure, the relinquished property qualifies if: (1) the property was owned by the taxpayer for at least 24 months immediately before the exchange, and (2) within that period, in each of the two 12-month periods immediately preceding the exchange, (a) the taxpayer rented the property to another person or persons at a fair rental for 14 days or more, and (b) the taxpayer's personal use of the property did not exceed the greater of 14 days or 10 percent of the number of days during each 12-month period that the dwelling unit was rented at a fair rental. (For this purpose, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day) and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day)). The replacement property qualifies if (1) the property is owned by the taxpayer for at least 24 months immediately after the exchange, and within that period, in each of the two 12-month periods immediately after the exchange (a) the taxpayer rents the property to another person or persons at a fair rental for 14 days or more, and (b) the taxpayer's personal use of the property does not exceed the greater of 14 days or 10 percent of the number of days during each 12-month period that the property is rented at a fair rental. (For this purpose, the first 12-month period immediately after the exchange begins on the day after the exchange takes place and the second 12-month period begins on the day after the first 12-month period ends.) Personal use of a dwelling unit occurs on any day on which a taxpayer is deemed to have used the dwelling unit for personal purposes under § 280A(d)(2) (taking into account § 280A(d)(3) but not § 280A(d)(4)).

## E. Section 1033

There were no significant developments regarding this topic during 2007.

### F. Section 1035

**1. A check in hand leaves the § 1035 tax-free exchange of annuities behind the bush.** Rev. Rul. 2007-24, 2007-21 I.R.B. 1282 (5/21/07). Section 1035 provides for nonrecognition of gain or loss on the exchange of an annuity contract for another annuity contract. Applying a rule similar to the rule of § 1031 barring the receipt and control of cash in a like-kind exchange, the IRS has ruled that the taxpayer's receipt of a check from an insurance company issuing one annuity, which the taxpayer endorsed over to another insurance company for a replacement annuity, is not entitled to nonrecognition under § 1035. The transaction was not an exchange of the annuity contracts. The taxpayer was required to recognize gross income under § 72. The ruling seems to contradict the holding in *Greene v. Commissioner*, 85 T.C. 1024 (1985), which allowed nonrecognition treatment under § 1035 where, without a binding obligation, the taxpayer received a check from one annuity contract that she endorsed in the purchase of a new annuity contract. The annuities in Rev. Rul. 2007-24 were not in qualified plans. In *Greene* the funds were moved between qualifying § 403(b) plans, but the rollover rules of § 403(b)(8) were not applicable in *Greene*.

## IV. COMPENSATION ISSUES

### A. Fringe Benefits

**1. Guidance on Health Savings Accounts.** Notice 2004-2, 2004-1 C.B. 269 (1/12/04). 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.** 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.

**b.** 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 monthly contributions of $2,250 for individuals and $4,500 per family, adjusted for inflation, $2,700 ($5,454 family) even if the deductible is less that those amounts. For 2007, the

inflation adjusted amount was $2,850 for individuals and $5,650 per family. Rev. Proc. 2006-53, 2006-48 I.R.B. 996, § 3.24.

**c.** The **Tax Relief and Health Care Act of 2006** § 306 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.

**d.** 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.** Rev. Rul. 2007-17, 2007-13 I.R.B. 805 (3/26/07). This Ruling updates mileage rates for employer-provided non-commercial aircraft for the first half of 2007.

**3.** T.D. 9349, Section 125 – Cafeteria Plans, 72 F.R. 41891 (8/1/07). The IRS has removed temporary regulations on benefits that may be offered under a § 125 cafeteria plan because these temporary regulations – published more than two decades ago – have been rendered obsolete by subsequent proposed regulations and other § 125 guidance.

**a.** REG-142695-05, Employee Benefits – Cafeteria Plans, 72 F.R. 43937 (8/6/07). New cafeteria plan regulations under § 125 are proposed, including: general rules on qualified and nonqualified benefits in cafeteria plans (new Prop. Reg. § 1.125-1); general rules on elections (new Prop. Reg. § 1.125-2); general rules on flexible spending arrangements (new Prop. Reg. § 1.125-5); general rules on substantiation of expenses for qualified benefits (new Prop. Reg. § 1.125-6); and nondiscrimination rules (new Prop. Reg. § 1.125-7). The new proposed regulations, Prop. Reg. §§ 1.125-1, 1.125-2, 1.125-5, 1.125-6 and § 1.125-7, consolidate and restate Prop. Reg. § 1.125-1 (1984, 1997, 2000), § 1.125-2 (1989, 1997, 2000) and § 1.125-2T (1986).

## B. Qualified Deferred Compensation Plans

**1. 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.

• Note that employer matching costs should be expected to increase because participation can be expected to increase.

a. **Polly want a QACA?** REG-133300-07, Automatic Contribution Arrangements, 72 F.R. 63144 (11/8/07). Proposed regulations relating to automatic contribution arrangements. These proposed regulations would amend Reg. § 1.401(k)-3 to provide a new design-based safe-harbor for a qualified automatic contribution arrangements ("QACA") under § 401(k)(13).

2. **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 paragraph is effective with respect to plan years beginning after 12/31/06.

a. Notice 2006-107, 2006-51 I.R.B. 1114 (12/18/06). This Notice provides transitional guidance regarding § 401(a)(35), together with a model notice, to plan participants concerning employer securities.

3. **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).

a. **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), *cert. denied*, 127 S. Ct. 1143 (1/16/07), *rev'g* 274 F. Supp. 2d 1010 (S.D. Ill. 7/31/03). The Seventh Circuit (Judge Easterbrook) analyzed 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 made 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 ascribed to the district court a 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 stated 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 rejected this interpretation of the statute that "treats the time value of money as age discrimination."

- Judge Easterbrook reinforced 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?"

**b. 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.

**c. Or is it?** In re Citigroup Pension Plan ERISA Litigation, 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.

**d. It is!** Register v. PNC Financial Services Group, Inc., 477 F.3d 56 (3d Cir. 1/30/07). The Third Circuit followed *Cooper*, and noted that only a few district courts in the Second Circuit have held otherwise.

**e. And, further, it is!** Wheeler v. Pension Value Plan for Employees of The Boeing Co., 99 A.F.T.R.2d 2007-1557 (S.D. Ill. 3/13/07). This decision followed *Cooper* with respect to McDonnell Douglas employees moved to the Boeing cash balance plan. Also, rejects the employees' assertion that the plan is backloaded because swings in interest rates on 30 year Treasury securities are "likely" to cause interest credits allocated to plan participants' cash balance accounts at a rate more than one-third higher (under the 133-1/3% test) than the rate of accrual of the benefits in early years. The court pointed to Reg. § 1.411(b)-

1(b)(2)(ii)(D) that provides that relevant factors used to compute plan benefits are treated as remaining constant.

f. **The IRS opens the door for cash balance plans.** Notice 2007-6, 2007-3 I.R.B. 272 (1/16/07). The IRS announced that it is beginning to process a determination letter and examine 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**.

**4.** T.D. 9319, Limitations on Benefits and Contributions Under Qualified Plans, 72 F.R. 16878 (4/5/07). The Treasury has updated regulations last issued in 1981 addressing contribution and benefits limits with respect to qualified plans under § 415. Among other things, the final regulations incorporate statutory changes to the § 415 limitations subsequent to 1981, including the 2001 Act (EGTRRA).

**5. Final regulations are issued regarding distributions from Roth accounts in 401(k) and 403(b) qualified plans.** T.D. 9324, Designated Roth Accounts Under Section 402A, 72 F.R. 21103 (4/30/07). These final regulations provide guidance on the taxation of distributions of amounts designated in § 401(k) plans and § 403(b) plans as Roth type contributions, requiring separate accounting. Exclusion from income or permissible rollover to a Roth type IRA depends on whether the distribution is a qualified distribution determined under the regulations.

**6.** T.D. 9340, Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts, 72 F.R. 41128 (7/26/07). The IRS has published final regulations providing a comprehensive revision of the current regulations on § 403(b) tax-sheltered annuity contracts of public schools and § 501(c)(3) tax-exempt organizations. These regulations generally apply for taxable years beginning after 12/31/08.

**7.** Notice 2007-94, 2007-51 I.R.B. 1179 (12/17/07). This Notice publishes the 2007 cumulative list of changes in plan qualification requirements.

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

**1. Section 409A added a new layer of rules for nonqualified deferred compensation.** Section 885 of the **Jobs Act of 2004**

added new § 409A, which modifies the taxation of nonqualified deferred compensation plans for amounts deferred after 2004. Section 409A has changed the tax law governing nonqualified deferred compensation by making it more difficult to 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 (1/10/05), *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. Interim guidance on withholding and reporting requirements for 2005 and 2006.** Notice 2006-100, 2006-51 I.R.B. 1109 (12/18/06). This Notice provides interim guidance to employers 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.

**d. Final regulations.** T.D. 9321, Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 F.R. 19234 (4/17/07). Final regulations have been adopted that generally follow the format and structure of the proposed regulations with a number of clarifications and additions in response to comments.

**e. Transition relief extended for NQDC under § 409A.** Notice 2006-79, 2006-43 I.R.B. 763 (10/23/06). 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.

**f. And is sort-of extended for one more year through the end of 2008.** Notice 2007-78, 2007-41 I.R.B. 780 (10/9/07). This Notice provides some 2008 transition relief and additional guidance on the application to § 409A to nonqualified deferred compensation plans.

**g. Now, transition relief is really extended through the end of 2008.** Notice 2007-86, 2007-46 I.R.B. 990 (11/13/07), *revoking and superseding* Notice 2007-78. This Notice extends to 12/31/08 the transition relief that was scheduled to expire on 12/31/07, as provided in Notice 2006-79.

**h. More guidance.** Notice 2007-89, 2007-46 I.R.B. 998 (11/13/07). This notice provides interim guidance to employers regarding reporting and wage withholding requirements for calendar year 2007 with respect to deferrals of compensation and amounts includible in gross income under § 409A. It also provides interim rules on calculating amounts includible in gross income under § 409A. Notice 2005-1 was modified; Notice 2006-100 was not affected by this Notice.

**i. Section 409A as applied to split-dollar life insurance contracts.** Notice 2007-34, 2007-17 I.R.B. 996 (4/23/07). This Notice provides guidance regarding the application of § 409A to split-dollar life insurance contracts. Split-dollar life insurance arrangements (other than arrangements that provide only death benefits to the service provider) are deferred compensation arrangements subject to § 409A. A split-dollar life insurance arrangement entered into before September 17, 2003, is not subject to § 409A unless the arrangement has been materially modified. This Notice also provides guidance with respect to which modifications to comply with § 409A will not be treated as material modifications for purposes of the transition rule.

- Section 409A is not applicable to earnings on § 409A grandfathered benefits, which include any increase in the policy cash value attributable to continued services, compensation earned, or premium payments, or other contributions made on or after January 1, 2005. The portion of benefits attributable to grandfathered arrangements can be determined by any reasonable method, but the Notice describes a proportional method as reasonable.

- A split-dollar insurance plan provides deferred compensation for purposes of § 409A if the arrangement provides a

service provider with economic benefits in the current year (access to policy cash value or any other economic benefit) payable to the service provider in a later taxable year.

- Split-dollar insurance arrangements that are treated as loans (the policy is owned by the service provider with premiums from a non-owner) generally will not give rise to deferred compensation subject to § 409A.

**2. 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, Rudy Giuliani and Cristyne Lategano, Newt Gingrich and Callista Bisek, or Barney Frank and Steve Gobie? 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 (2/26/07). 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.

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

- This results from an anti-Enron provision in the 2004 Act.

**4. 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, 475 F.3d 1380 (Fed. Cir. 2/12/07), *aff'g* 70 Fed. Cl. 87 (2/28/06). Taxpayers exercised nonqualified stock options in 2000 using

funds obtained through borrowing on a margin account with a third party lender (Oppenheimer) with the loan secured by the purchased stock. They contended that the transfer took place in 2001 when they paid off the margin loan used to purchase the stock. 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 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 taxpayers.

- The Federal Circuit (Judge Mayer) held that a transfer occurs when the employer corporation is paid for the stock, whether the transfer was funded with the buyer's own cash or from a broker's margin loan, and there was no evidence that taxpayer's rights to the stock could have been revoked by the corporation.

**a. 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.

**b.** Racine v. Commissioner, 493 F.3d 777 (7th Cir. 7/3/07). The Seventh Circuit reached the same result. There is some discrepancy between the Court of Appeals opinion, which describes the taxpayer as personally liable for a loan from the brokerage house to exercise the option, and the Tax Court's (T.C. Memo. 2006-162) description of the loan as nonrecourse.

**5. It's hard to believe this case, but read it and wonder.** Kimberlin v. Commissioner, 128 T.C. 163 (5/8/07). In a mostly factual determination, the Tax Court (Judge Foley) held that stock warrants issued to a venture capital firm under a settlement and release agreement executed following a dispute regarding termination of services for a private placement offering were not received for past, present, or future services and therefore not subject to § 83.[3] The court determined that the warrants had an ascertainable value in the year of the grant and were, therefore, includable in income in that year rather than in the year of exercise when the value was substantially higher. Finally, the warrants were treated as dividend income to

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3. But note John Milton's, "They also serve who only stand and wait."

the taxpayer as a distribution from the taxpayer's venture capital corporation.

**6. Tax treatment of vested stock that becomes subject to a substantial risk of forfeiture is explained.** Rev. Rul. 2007-49, 2007-31 I.R.B. 237 (7/30/07). When in the course of corporate affairs employee stock that is vested becomes subject to a risk of forfeiture, and, therefore, non-vested, the transaction may or may not constitute a taxable event.

- In situation 1, the taxpayer holding vested stock makes an additional investment in the corporation for stock and agrees that all of the stock will be subject to a substantial risk of forfeiture. Since the vested stock is already owned by the taxpayer under § 83, there is no transfer caused by the imposition of restrictions on the stock.
- In situation 2, the taxpayer receives substantially non-vested stock for vested stock in a tax-free reorganization. The substantially non-vested shares are treated as being received in exchange for services subject to § 83. The fair market value of the vested shares is treated as the amount paid for the non-vested shares, resulting in zero recognition if the amount paid is greater than the value of the non-vested shares.
- In situation 3, the taxpayer exchanges vested stock for substantially non-vested stock in a taxable merger. The transaction is treated as an exchange under § 1001.

**7. More AMT pain.** Merlo v. Commissioner, 492 F.3d 618 (5th Cir. 7/17/07). The taxpayer exercised an incentive stock option and purchased $1,075,289 worth of stock for only $9,225. The employer's insider trading policy prevented employees from trading the company's stock during certain blackout periods, but employees could exercise a stock option during a blackout period. The taxpayer had exercised the stock option during a blackout period. Less than a year later, the stock was worthless. The Tax Court (Judge Haines), T.C. Memo. 2005-178, held that the restrictions on the taxpayer's ability to sell the stock during the blackout period was not a substantial risk of forfeiture under § 83, and that the spread was includable in alternative minimum taxable income pursuant to § 56(b)(3). Judge Haines later held, 126 T.C. 205 (4/25/06), that the limitations on capital losses under §§ 1211 and 1212 apply for purposes of calculating alternative minimum taxable income. Thus, the capital loss realized in 2001 upon worthlessness of the 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. The Fifth Circuit (Judge King) affirmed on both issues. First, Judge King held that "[t]he blackout period

within the insider trading policy is insufficient to create a substantial risk of forfeiture because the remedy for non-compliance does not include forfeiture of the shares." Second, she rejected the taxpayer's argument that § 56(d)(2)(A)(i) creates an exception to the § 172(d) rule that capital losses are taken into account in an NOL only to the extent of capital gains, reasoning that the starting point for the AMT NOL is the NOL under § 172(c) and (d). None of the modifications made pursuant to § 56(d)(2)(A) override the § 172 limitations.

**8. The difference between the adjusted AMT basis and the regular tax basis of stock received through the exercise of an ISO is not a tax adjustment taken into account in the calculation of an AMT NOL in the year the stock is sold.** Marcus v. Commissioner, 129 T.C. 24 (8/15/07). In a series of transactions between 1998 and 2000, the taxpayer exercised incentive stock options (ISOs) to acquire 40,362 shares of his employer's stock. In 2001, he sold 30,297 shares, which had a regular tax basis equal to the $127,920 exercise price, for $1,688,875. The taxpayer's AMT basis in the shares was $4,472,288 – the exercise price increased by the amount included in alternative minimum taxable income (AMTI) under § 56(b)(3) resulting from the exercise of the ISOs. Judge Haines rejected the taxpayer's argument that the difference between the adjusted AMT basis and the regular tax basis of the shares sold created an AMT NOL under § 56(d) that could be carried back to 2000. The taxpayer's argument was based on the rules in § 56(d)(1)(B)(i) and (2)(A) providing that the AMT NOL is determined by taking into account adjustments to taxable income under §§ 56 and 58 (and preference items under § 57). Judge Haines reasoned that the only adjustment under § 56(b)(3) was made in the year the option was exercised; there was no basis adjustment to take into account in the year of the sale exercise. He explained that basis recovery through depreciation deductions is not analogous to the recovery of basis upon the sale of stock, because stock is a nondepreciable capital asset. When stock is sold at a loss, the capital loss limitations in §§ 1211, 1212, and 172(d)(2) are applicable for AMT purposes as well as for the regular tax.

## D. Individual Retirement Accounts

There were no significant developments regarding this topic during 2007.

## V. PERSONAL INCOME AND DEDUCTIONS

### A. Rates

1. **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.

a. **The 2007 Act further tightens the kiddie tax, but only from 2008 forward.** The **2007 Act**, § 8241(a), extends application of the § 1(g) kiddie tax to "children" over the age of 18 and under 24 who are full-time students if their earned income does not exceed the amount of their support. The amendment is effective for tax years beginning after 5/25/07.

- For at least one of us, this is getting personal.
- For another one of us, this is exactly what he suggested in a 1981 law review article – five years before the kiddie tax was enacted.

### 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 rejected taxpayer's argument that her award was for "bruxism" which she argued was a physical injury or physical sickness. However, 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 Government moved for rehearing *en banc*. In response, the panel vacated its opinion. Before the opinion was vacated, it temporarily threw the treatment of compensatory damages for nonphysical personal injuries into a state of chaos. 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 C.B. 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 any other courts 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 ignored 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 not specifically excluded by the statute (Sol. Mem. 957, 1 C.B. 65 (1919) (libel); Sol. Mem. 1384, 2 C.B. 71 (1920) (alienation of affection)). In 1922 the Bureau reversed its position solely because of the holding in *Eisner v. Macomber*, 252 U.S. 189 (1920), which at that time was read to limit the constitutional meaning of "income" to "gain derived form 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.

**a. Compensation for a non-physical personal injury is income under the Sixteenth Amendment, and in any event the tax is an indirect tax. By the way, forget about filing those protective claims for refund.** Murphy v. IRS, 493 F.3d 170 (D.C. Cir. 7/3/07). Judge Ginsburg had a change of heart on rehearing. The court ultimately concluded (1) that Murphy's award was not received on account of physical injuries, (2) that gross income under § 61 includes an award for non-physical injuries such as Murphy's, and (3) that even if the damages are not income, the tax on damages is not a direct tax subject to apportionment.

**2. 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(e) 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). A taxpayer who has 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 amount 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.

**3. The Vietnam War era returns—religious objections to paying for the military don't avoid taxes.** Jenkins v. Commissioner, 483 F.3d 90 (2d Cir. 3/6/07). The Second Circuit affirmed a Tax Court judgment rejecting the taxpayer's claims that he had the right under the First and Ninth Amendments to the Constitution to withhold a portion of federal taxes on the basis of religious objections to military spending. The court also affirmed a $5,000 penalty for frivolous arguments.

**4. There's no transition rule in § 104(a)(2).** Polone v. Commissioner, 505 F.3d 966 (9th Cir. 10/11/07), *aff'g* T.C. Memo. 2003-339. The application of the 1996 amendments to § 104(a)(2) (which denied exclusion for damages received on account of non-physical personal injuries for payments received after 8/20/96) to post-8/20/96 payments received on account of a settlement agreement finalized in May 1996, was not a retroactive application of a newly enacted tax statute. The Ninth Circuit (Judge Thomas) held that three of four installment payments from settlement of a defamation suit by the taxpayer talent agent before the effective date of the physical injury amendment of § 104(a)(2) were includible in income. The plain language of the statute applies to damages received after August 20, 1996, unless the parties contracted prior to September 13, 1995. The taxpayer settled his claims for $4 million in May 1996 and received four payments of $1 million each after the effective date of the amendments. The court also rejected the taxpayer's Constitutional claims that application of the statute to payments received after the effective date of the settlement was an impermissible retroactive application of the statute in violation of the taxpayer's due process rights under the Fifth Amendment.

- Judge Thomas stated, "'[a] statute does not operate 'retrospectively' merely because it is applied in a case arising from conduct antedating the statute's enactment,'" quoting *Landgraf v. USI Film Products*, 511 U.S. 244 (1994).

**5. A joint account is not a completed gift that transfers gain from stock sale.** Estate of Freedman v. Commissioner, T.C.

Memo. 2007-61 (3/19/07). Taxpayer deposited stock, which she received from her sale of an internet casino to a corporation, in a joint brokerage account, naming her son as the other joint owner. The Tax Court held that under the relevant state (Texas) law ownership of a joint account is proportional to contributions. Since the evidence demonstrated that the account was established with contributions from the taxpayer, her estate was taxable on 100 percent of the gain from the sale of the stock in the joint account.

**6. Form controls over asserted substance: Family transactions produce income and an accuracy-related penalty where the burden of producing "strong proof" was not met.** O'Malley v. Commissioner, T.C. Memo. 2007-79 (4/3/07). The taxpayer, Patrick O'Malley, purchased a 48.5 acre parcel in Anne Arundel County, Maryland. The parcel was subject to subdivision into lots held by family members for a minimum of five years. Three lots had houses, one of which was occupied by the taxpayer. Because he needed funds to meet various financial obligations, the taxpayer transferred two lots to brothers Kevin and Edward. Kevin borrowed $254,400 from a bank, transferred the proceeds to the taxpayer, and gave the taxpayer a second deed of trust note for $47,000. The written documentation described the transaction as a sale. Subsequently the taxpayer issued a $54,400 check to Kevin with a notation indicating "loan repayment." The taxpayer also forgave the $47,000 second loan. He did not report this arrangement as a sale and claimed that the "venture" was a financing arrangement. The Tax Court rejected the taxpayer's arguments, indicating that "strong proof" is required where the taxpayer asserts that a transaction, in form a sale of property, is not a sale for tax purposes. The Tax Court also rejected the taxpayer's somewhat novel argument that the return of $54,400 to Kevin was a purchase price reduction under § 108(e)(5), because there was no indebtedness from the taxpayer to Kevin that was reduced. The taxpayer was also found liable for the § 6662(a) accuracy-related penalty because of the substantial understatement of income attributable to the sale to Kevin.

- In a second transaction the taxpayer conveyed a second parcel to brother Edward under an oral agreement that the transaction was a sale. Edward borrowed $180,000 from a bank secured by the property and transferred the proceeds to the taxpayer. The balance of the property's fair market value was reflected as a loan to Edward by the taxpayer on which no payments were required. The taxpayer made all payments on the loan and paid the real property taxes. Edward was to retransfer the property to the taxpayer at the end of five years. The Tax Court concluded, with respect to this transaction, that the taxpayer satisfied his burden of showing by strong proof that this transaction was not a sale.

**7. Some tax exemptions are found in federal statutes outside of the Internal Revenue Code.** Wallace v. Commissioner, 128 T.C. 132 (4/16/07). Payments of $16,393 received by a veteran under a compensated work therapy program administered by the Department of Veterans Affairs were excluded from gross income even though the taxpayer was required to perform work as part of a veterans' construction team as part of the program. 38 U.S.C. § 5301(a) exempts from taxation benefits payments to the beneficiary of veterans' benefits. See also I.R.C. § 140(a)(3). Broadly construing the exemption, the Tax Court rejected the Commissioner's argument that amounts received under the work therapy program were includible in gross income because of the work requirement.

**a. And the IRS now agrees.** Rev. Rul. 2007-69, 2007-49 I.R.B. 1083 (12/3/07). Payments made by the U.S. Department of Veterans Affairs under the compensated work therapy program described in 38 U.S.C. § 1718 are exempt from income tax as veterans' benefits pursuant to 38 U.S.C. § 5301(a)(1), which provides that payments of benefits due or to become due under any law administered by the VA made to, or on account of, a beneficiary are tax-exempt.

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

**9. Selling your life insurance policy to yourself is not a transfer for value.** Rev. Rul. 2007-13, 2007-11 I.R.B. 684 (3/12/07). A grantor who under the grantor trust rules is treated as the owner of a trust that owns a life insurance contract on the grantor's life is treated as the owner of the contract for purposes of the transfer for value limitations of § 101(a)(2). Relying upon Rev. Rul. 85-13, 1985-1 C.B. 184, the IRS ruled that the transfer of a life insurance contract between two grantor trusts that are treated as wholly owned by the same grantor is not a transfer for value

within the meaning of § 101(a)(2). The transfer of a life insurance contract to a grantor trust that is treated as wholly owned by the insured is a transfer to the insured within the meaning of § 101(a)(2)(B) and is thus excepted from the transfer for value limitations under § 101(a)(2).

**10. Antarctica is not a foreign country. Income earned in "outer space" is not excluded foreign source compensation.** Kunze v. Commissioner, T.C. Memo. 2007-179 (7/5/07). On summary judgment the Tax Court denied claims of 150 individuals that wages earned for services performed in Antarctica are not excluded from income under § 911 as income earned in foreign country. The Court held that activity in Antarctica is deemed space or ocean activity relying on *Arnett v. Commissioner*, 126 T.C. 89 (2006), *aff'd*, 473 F.3d 790 (7th Cir. 2007).

**11. You have to prove physical injury, not just allege it.** Gibson v. Commissioner, T.C. Memo. 2007-224 (8/13/07). The taxpayer received a damage award pursuant to a consent decree entered in a class action lawsuit that provided payments for violation of civil rights, emotional distress, physical injuries, and physical sickness. Judge Vasquez held that no portion of the damage award was received on account of personal physical injury or physical sickness, because the taxpayer failed to prove to the Tax Court that the defendant in the class action lawsuit caused his alleged personal physical injury or physical sickness.

**12. No exclusion for punitive damages in a wrongful death deep in the heart of Texas, even though there is an exclusion where the stars fell on Alabama.**[4] Benavides v. United States, 497 F.3d 526 (5th Cir. 8/17/07). Punitive damages received in a wrongful death suit under Texas law were not excludable under § 104(c), because Texas law provides for both compensatory and punitive damages in wrongful death suits.

**13. All social security benefits are taxed the same way, regardless of why you collect them.** Green v. Commissioner, T.C. Memo. 2007-217 (8/7/07). The exclusion under § 104(a)(1) (dealing with worker's compensation) does not apply to Social Security disability benefits, the tax treatment of which are determined under § 86. Social Security disability benefits are taxed in the same manner as Social Security old-age

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4. The difference is that § 104(c) is directed at only Alabama where the sole remedy for wrongful death is denoted "punitive damages." Ala. Code §§ 6-5-391, 6-5-410 and 6-11-20. The reference to falling stars is to an 1833 Leonid meteor shower, commemorated a century later by a jazz song.

benefits, because the Social Security Act provides for disability benefits for an injury regardless of whether the injury occurred in the course of employment.

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

### C. Profit-Seeking Individual Deductions

**1. This one can bite a lawyer/fiduciary who is employed by his own PSC if you're not careful.** Chaplin v. Commissioner, T.C. Memo. 2007-58 (3/12/07). Judge Haines held that the expenses of a professional fiduciary who was employed by a corporation in which he was a shareholder, but which was not itself authorized to serve a fiduciary and conducted business by having its employees serve as named fiduciaries, were employee business expenses. The taxpayer was subject to the control of the corporation in the exercise of his fiduciary powers and the manner in which he conducted business. The opinion provides extensive discussion of the factors that indicate an employment relationship exists.

**2. Employer reimbursement frozen? Ask anyway.** Contreras v. Commissioner, T.C. Memo. 2007-63 (3/19/07). Taxpayer's employer, Federal Express, froze travel reimbursement but allowed employees to obtain reimbursement with approval of a company vice-president. The court held that employee business expenses are deductible

only to the extent that the taxpayer could not be reimbursed by the employer. Taxpayer's deduction for unreimbursed employee travel was denied where taxpayer did not try to obtain approval. In addition, taxpayer's offer of credit card statements, ticket stubs, and conclusory testimony was inadequate to substantiate the expenditures.

**3. Even a former IRS auditor can't get the substantiation correct and ends up footing the bill.** Karason v. Commissioner, T.C. Memo. 2007-103 (4/26/07). Taxpayer had worked for the IRS as an industry specialist in the fields of healthcare, horse operations, farming operations, and as a large case manager in the San Francisco Office. The Tax Court denied § 179 deductions and depreciation on medical equipment that the taxpayer claimed to have purchased from his brother's incorporated podiatry practice and leased back in the taxpayer's trade or business of medical equipment leasing. The taxpayer's oral purchase and leaseback arrangement with his brother was substantiated only by their oral testimony at trial, which failed to satisfy the requirements of Reg. § 1.179-5(a) that the taxpayer maintain records which specifically identify each item of § 179 property, demonstrate how the property was acquired, and when the property was placed in service. The taxpayer was also denied loss deductions from a family investment partnership for failure to substantiate the taxpayer's partnership basis. In addition, given his experience as an IRS employee, the taxpayer was found liable for the 20 percent accuracy-related penalty under § 6662(a).

**4. Lodging not away from home for the benefit of the employer may still be deductible. The IRS comes to the rescue of beloved tax-free company retreats.** Notice 2007-47, 2007-24 I.R.B. 1393 (6/11/07). Reg. § 1.262-1(b)(5) provides that the costs of a taxpayer's lodging not incurred in traveling away from home are personal expenses and are not deductible unless they qualify as deductible expenses under § 217 (moving expenses). Treasury has apparently concluded that some employer-provided lodging while not away from home should be an excludable working condition fringe benefit when provided for the convenience of the employer. Thus, the Notice indicates that Treasury expects to amend Reg. § 1.262-1(b)(5) to add that employee expenses for lodging not incurred in traveling away from home are personal expenses, unless they qualify as deductible expenses under § 162 or § 217. The Notice indicates that pending the issuance of additional guidance, Reg. § 1.262-1(b)(5) will not be applied to limit deduction of employee expenses for lodging that an employer provides or requires the employee to obtain under the following conditions: (1) the lodging is on a temporary basis; (2) the lodging is necessary for the employee to participate in or be available for a bona fide business meeting or

function of the employer; and (3) the expenses are otherwise deductible by the employee, or would be deductible if paid by the employee, under § 162(a). This position affects the exclusion of employer-provided working condition fringe benefits under Reg. § 1.132-5(a), which requires that to be excluded from income a working condition fringe benefit must be an expenditure that is deductible under §§ 162 or 167.

**5. Bumped airline employees are not traveling away from home at a new work location.** Stockwell v. Commissioner, T.C. Memo. 2007-149 (6/13/07). Taxpayer was a mechanic for Northwest Airlines, who was laid off at his work location in Minneapolis. He exercised seniority rights to bump others at different locations, and was himself bumped in turn. He worked in Milwaukee and Detroit for indefinite periods. Because of the indefinite nature of the employment at the alternative locations, the taxpayer was not allowed to deduct living expenses as temporarily away from home. The court allowed the taxpayer's deduction for uniform cleaning expenses based on estimates, but disallowed deductions for internet services, depreciation on tools, and cell phone expenses.

- The Tax Court has reached the same result in additional cases with the same issues: Wasik v. Commissioner, T.C. Memo. 2007-148 (6/13/07); Bogue v. Commissioner, T.C. Memo. 2007-150 (6/14/07); Farran v. Commissioner, T.C. Memo. 2007-151 (6/14/07); Wilbert v. Commissioner, T.C. Memo. 2007-152 (6/14/07); and Riley v. Commissioner, T.C. Memo. 2007-153 (6/14/07).

**6. This salesman is an employee.** Colvin v. Commissioner, T.C. Memo. 2007-157 (6/19/07). Taxpayer, a computer hardware salesman, was denied schedule C deductions because he was a common law employee. The taxpayer signed an employment agreement and was subject to control of the employer even though the taxpayer set his own hours and sales territory, worked primarily from home, was not required to utilize the employer's support staff, nor attend routine meetings. The court noted that the employer had the right to control the taxpayer, whether or not exercised.

**7. If you are trying to be in a trade or business for tax purposes, it does not help that you are collecting unemployment.** Cameron v. Commissioner, T.C. Memo. 2007-260 (8/30/07). The Tax Court (Judge Laro) upheld the IRS's determination that the taxpayer was not a trader in stock and securities, and disallowed deductions under § 162, relegating them instead to § 212. In 2002, the taxpayer's activity consisted of 46 purchases and 14 sales. In 2003, he completed 109 purchases and 103 sales. During the years at issue, petitioner did not trade 5 days a week. Of

the years at issue, he traded on more than 10 days in a given month only twice. That the taxpayer was collecting unemployment compensation during 2003 further undermined his argument that he was engaged in a trade or business during that year.

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

**1. After divorce, do what you love, love what you do, and they can be integrated into a single for-profit business.** Topping v. Commissioner, T.C. Memo. 2007-92 (4/17/07). After her divorce, the taxpayer formed a profitable business designing homes and barns for the wealthy Florida horse set. The taxpayer was an accomplished equestrian who made contacts with potential clients while she competed in events at the Jockey Club, described as an elite private club. She convinced the Tax Court (Judge Goeke) that her riding activities were an integral part of her design business, even though she reported her design and horse activities on separate schedules C.[5] Thus, her horse-related expenditures were fully deductible as a profit seeking activity.

- Because the scope of an activity is a factual issue, the presentation of the taxpayer's case can make all of the difference. For example, in this case the Tax Court held that the taxpayer's money-losing equestrian activities were an integral part of her profitable business designing homes and barns, even though she reported her equestrian and design activities on separate Schedule Cs, because she used the equestrian activities to make contacts with potential "extraordinarily wealthy" clients while she competed in events at an elite private equestrian club. The court found that the taxpayer did not advertise her interior design business through advertising media, because "the ethos of the Jockey Club and its members perceive that kind of generic advertising of a personal service business as tacky or gauche," and she instead "relie[d] on her exposure and reputation as both a rider and owner, and also her popularity among the members of the Jockey Club." Furthermore, she "use[d] her general knowledge of horses and specifically her knowledge of the idiosyncrasies of each of her client's horses to evolve her barn designs."

**2. A horse lover who mucks stalls must be in it for profit rather than fun.** Rozzano v. Commissioner, T.C. Memo. 2007-177

5. Marty would change the penultimate sentence to read, "The citizen's ingenious counsel convinced the Tax Court that her riding activities were an integral part of her design business, even though she reported her design and horse activities on separate schedule Cs." This is because taxpayer's attorney makes a practice of never referring to a client as a "taxpayer," but only as a "citizen."

(7/3/07). The taxpayer took a position as a corporate CEO that required a move to Chicago. He then converted his Ohio farm into a horse boarding facility. The farm had 27 stalls and an indoor arena. The taxpayer used his business skills to develop computer-based spreadsheets and accounting systems for the activity. He spent weekends doing the heavy work of the farm such as mowing, mucking, and mending. In 1999 the taxpayer determined that, due to events beyond his control, the farm would continue to produce losses. The property was offered for sale in 2001 and sold in 2003. The Tax Court concluded that the taxpayer's careful accounting systems and general business practices justified treating the activity as engaged in for profit, notwithstanding the taxpayer's testimony that he realized in 1999 that the activity would not be profitable. The taxpayer maintained the operation in order to facilitate a sale of the property.

**3. This taxpayer, a nurse and doctor's wife, was not able to treat her direct marketing activities as engaged in for profit.** Smith v. Commissioner, T.C. Memo. 2007-154 (6/14/07). While working as a registered nurse, the taxpayer, who was a physician's wife, engaged in numerous direct marketing enterprises in which she sold vitamins, energy supplements, marketing opportunities on the internet, and for a company called Renaissance the Tax People, Inc, she sold "Tax Relief Systems" that were designed to generate federal tax deductions. The court noted however, that most of her activity involved recruiting additional downline distributors. All of these activities produced approximately $160,000 of losses over a four year period. The Tax Court concluded that the taxpayer did not operate in a business-like manner because of the absence of any indicia of analysis of the market, the potential for profit, or plan to alter the business to make it successful. The business plan provided by the taxpayer was largely prepackaged by the company for which she was selling. The court observed that the records presented by the taxpayer were more indicative of someone preparing for an IRS examination rather than someone seeking a profit. The Tax Court declined to impose an accuracy related penalty on the ground that the taxpayer reasonably relied on her accountant's advice that the deductions were permissible.

## 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), *aff'd sub nom.* Knight v. Commissioner, 128 S. Ct. 782 (1/16/08).

**a. No.** The Tax Court (Judge Wherry) held that amounts paid for investment management advice by trusts set up by a family involved in the founding of the Pepperidge Farm food products company (which was sold to Campbell Soup Company in the 1960s) are not subject to the § 67(e) exception to the § 67(a) floor of 2 percent of AGI (which limits the deductibility of employee business expenses and miscellaneous itemized deductions to amounts exceeding that floor). In reaching this result, the Court determined that these expenses did not qualify for the exception in § 67(e)(1), under which costs paid or incurred in connection with the administration of a trust that wouldn't have been incurred if the property weren't held in the trust are allowed as deductions in arriving at adjusted gross income. The Tax Court explained that the statutory text of § 67(e)(1) creates an exception allowing for deduction of trust expenditures without regard to the 2 percent floor where two requirements are satisfied: (1) the costs are paid or incurred in connection with administration of the trust and (2) the costs would not have been incurred if the property were not held in trust.

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

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

> The Tax Court reasoned that "[i]ndividual investors routinely incur costs for investment advice as an integral part of their investment activities." Nevertheless, they are not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves. Therefore, fiduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise

> proper skill and care with the assets of the trust. (994 F.2d at 304)

**b. 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 Sotomayor held that § 67(e) was unambiguous and permitted a full deduction only for those types of trust expenses that an individual could not possibly incur.

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

- Under the reasoning of *National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 545 U.S. 967 (2005), a court's interpretation of a statute trumps an agency's subsequent regulation "under the doctrine of *stare decisis* only if the prior court holding 'determined a statute's clear meaning.' ... [A] court's prior interpretation of a statute ... overrides an agency's interpretation only if the relevant court decision held the statute unambiguous." Otherwise the validity of the regulation is determined under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

**d. The Supreme Court issued the writ of certiorari to resolve the conflict between the Second and Sixth Circuits, but decided to follow the Federal and Fourth Circuits.** The Supreme Court affirmed *sub nom.* Knight v. Commissioner, 128 S. Ct. 782 (1/16/08) (9-0). The Court affirmed the Second Circuit in an opinion written by Chief Justice Roberts but rejected the Second Circuit test in favor of the test of

whether individuals commonly employ investment advisors set forth in *Mellon Bank* and *Scott*.

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

2. **Who does the kid belong to?** 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(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 allow monthly contributions of $2,250 for

individuals and $4,500 per family, adjusted for inflation, even if the deductible is less that those amounts. For 2007, the inflation adjusted amount was $2,850 for individuals and $5,650 per family. Rev. Proc. 2006-53, 2006-48 I.R.B. 996, § 3.24.

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

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

**10. Jailed murderess qualifies for the earned income credit.** Rowe v. Commissioner, 128 T.C. 13 (2/22/07) (reviewed, 5-5-6-1).[6] Taxpayer and her two young children lived together in 2002 until her arrest on June 5; she continued to support her children after her arrest until July 2. She was confined in jail for the rest of the year. The taxpayer was entitled to the earned income credit because her absence due to being held in jail after her arrest – she was convicted of murder in 2003 and sentenced to life imprisonment – does not prevent her from qualifying for the EIC. There was a whole lot of fuss as to (1) whether Reg. § 1.2-2(c)(1), which required that it be reasonable to assume she would return to her home after the temporary absence, would apply, or (2) whether *Hein v. Commissioner*, 28 T.C. 826 (1957), *acq*., and Rev. Rul. 66-28, 1966-1 C.B. 31, which required only the

6. Five judges joined in Judge Kroupa's principal opinion, five judges joined concurring opinions by Judges Gale and Goeke, six judges joined Judge Halpern's dissent, and Judge Chiechi did not participate.

absence of intent on the part of the taxpayer to change her place of abode, would apply.

- Judge Halpern's dissent forcefully rejected the applicability of *Hein* and Rev. Rul. 66-28 on the grounds that the Tax Court should not lightly assume that the Commissioner has, *sub silentio*, amended Reg. § 1.2-2(c)(1).

**11. Finding every last dollar of deductible medical expenses in continuing care retirement community fees.** Finzer v. United States, 99 A.F.T.R.2d 2007-1577 (N.D. Ill. 3/7/07). The court held that the fact that a continuing care retirement community residency agreement specified that the monthly fee included medical services does not necessarily mean that the entrance fee did not also include medical services. That the entrance fee can be refunded under certain circumstances and may be used to cover a portion of the monthly fees if the taxpayer is unable to pay also does not necessarily affect whether a portion of the entrance fee is allocable to medical care. Whether the entrance fee also includes medical services is a question of fact. The government was denied summary judgment.

**a. Well, then again, not every last dollar.** Finzer v. United States, 496 F. Supp. 2d 954 (N.D. Ill. 7/20/07). After trial, the court ruled against the taxpayers. The taxpayers filed an amended return claiming a refund on the grounds that 41 percent of the $723,800 entrance fee for the continuing care retirement community was for medical expenses, not the 18 percent claimed on the original return. The court rejected the claim on several grounds. First, there was undisputed testimony that the CCRC residents paid different entrance fees based on the size of the residential unit they selected, and that the taxpayers would have received the same access to medical care if they had selected a smaller unit that required an entrance fee of only $275,000. Thus the portion of the entrance fee over $275,000 related solely to housing and had no relationship to medical costs. The court noted that assuming *arguendo* that 41 percent of $275,000 properly could be deducted as a medical expense, the taxpayers' deduction would be $112,750, which is less than the $136,798 they claimed on their original return. Second, the taxpayers failed to prove that any portion of the entrance fee was properly attributable to medical expenses. The residency agreement stated that the proceeds of the entrance fees are not used to provide services to the residents, and the unrebutted testimony of the CCRC's executives was that the monthly fees were the sole source of payment for medical expenses incurred by residents. Finally, the "entrance fee," which was represented by a promissory note from the CCRC to the taxpayers the obligation on which was reduced by 2 percent per year of

residency, but which was otherwise refundable if the taxpayers left the CCRC, was held to be a loan, not a payment.

**12. It might take a village to raise kids, but not all the costs of village people are eligible for the dependent care credit.** T.D. 9354, Expenses for Household and Dependent Care Services Necessary for Gainful Employment, 72 F.R. 45338 (8/14/07). The Treasury has promulgated final regulations, Reg. §§ 1.21-1 through 1.21-4, regarding the § 21 credit for expenses for household and dependent care services to reflect statutory amendments since 1984 and to renumber the regulations under § 21, rather than under § 44A (which previously was the Code section prior to 1984).

- Reg. §§ 1.21-1(a)(1), (b)(1), and (g) reflect the changes in the **Working Families Tax Act of 2004** that incorporate the uniform definition of child. For taxable years beginning after December 31, 2004, a qualifying individual is: (1) a dependent (who is a qualifying child within the meaning of § 152) who has not attained age 13; (2) a dependent (as defined in § 152, without regard to subsections (b)(1), (b)(2), and (d)(1)(B)) who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year; or (3) the taxpayer's spouse who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year.

- The requirements of § 21 and the regulations are applied at the time the services are performed, regardless of when the expenses are paid. Reg. § 1.21-1(a)(4). The status of an individual as a qualifying individual is determined on a daily basis, Reg. § 1.21-1(b)(3), only expenses before a disqualifying event, such as a child turning 13, may be taken into account. A taxpayer must allocate the cost of care on a daily basis if expenses are paid for a period during only part of which the taxpayer is employed or in active search of gainful employment. Reg. § 1.21-1(c)(2). A safe-harbor treats an absence of no more than two consecutive calendar weeks as a short, temporary absence from work. Reg. § 1.21-1(c)(2)(ii). Thus, for example, costs of a day care center that charges by the month and does not refund amounts attributable to days a child is absent, qualify in full if the child is absent for no more than two consecutive weeks for a family vacation. Reg. § 1.21-1(c)(3), Ex. (4).

- Employment-related expenses must be for the care of a qualifying individual and may not be for other services such as education. Expenses for a child in nursery school, pre-school, or similar programs for children below the kindergarten level are for the care of a qualifying individual and may be employment-related expenses. Expenses for a child in kindergarten or a higher grade are not for care and therefore, are not

employment-related expenses. However, expenses for before- or after-school care of a child in kindergarten or a higher grade may be for care. Reg. § 1.21-1(d)(5).

- The full amount paid for a day camp or similar program may be for the care of a qualifying individual although the camp specializes in a particular activity, such as soccer or computers. For administrative convenience, no allocation is required in this situation between the cost of care and amounts paid for learning a specialized skill. Expenses for summer school and tutoring programs are not creditable. Reg. § 1.21-1(d)(7).
- The cost of overnight camp is not an employment-related expense. Reg. § 1.21-1(d)(6). But the cost of overnight care (other than overnight camp) can be an employment-related expense for a taxpayer who works at night.
- Boarding school expenses must be allocated between expenses for the care of a qualifying individual and expenses for other goods or services, unless the other goods or services are incidental to and inseparably a part of the care. Reg. § 1.21-1(d)(2), (12), Ex. 2.
- If a domestic employee cares for qualifying children and also performs other services for the taxpayer, an allocation is required unless the expense for the other purpose is minimal or insignificant or if an expense is partly attributable to the care of a qualifying individual and partly to household services. Reg. § 1.21-1(d)(1) - (3), (12), Ex. 3.
- The additional cost of providing room and board for a caregiver over usual household expenses (including an increase in utilities, such as electric, water, and gas) may be an employment-related expense. Reg. § 1.21-1(d)(10) and (11).
- The regulations apply to taxable years ending after 8/14/07.

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

**14. You don't have to be sick to incur deductible medical expenses.** Rev. Rul. 2007-72, 2007-50 I.R.B. 1154 (12/10/07). The

IRS has ruled that following expenses are deductible medical expenses under § 213: (1) Amounts paid for an annual physical examination for diagnosis, even though the taxpayer is not experiencing any symptoms of illness; (2) amounts paid for a full-body scan for diagnosis, and which serves no non-medical function, even though the taxpayer is not experiencing symptoms of illness and has not obtained a physician's recommendation before undergoing the procedure; and (3) amounts paid for an over-the-counter pregnancy test kit, even though its purpose is to test the healthy functioning of the body rather than to detect disease.

### F. Divorce Tax Issues

**1. Proposed regulations would identify which divorced or separated parent can claim the dependency exemption.** REG-149856-03, Dependent Child of Divorced or Separated Parents or Parents Who Live Apart, 72 F.R. 24192 (5/2/07). Prop. Reg. § 1.152-4 interprets § 152(e), as amended by the **2005 Act (GOZA)**, to provide that a child of parents who are divorced, separated, or living apart may be claimed as a qualifying child of the non-custodial parent if the child receives over one-half of his/her support from the parents, the child is in the custody of one or both parents during the calendar year, and the custodial parent signs a written declaration that the custodial parent will not claim the exemption (which must be attached to the non-custodial parent's return), or a pre-1985 instrument allocates the exemption and the non-custodial parent contributes at least $600 for the support of the child during the year.

- Under the proposed regulations: (1) The custodial parent is the parent with whom the child spends the greatest number of nights during the taxable year. A child who is temporarily away is treated as spending the night with the parent with whom the child would have resided. If another person is entitled to custody for a night, then the child is treated as spending the night with neither parent. (2) The proposed regulations incorporate the rules of Temp. Reg. § 1.152-4T regarding the required written declaration and they provide that the declaration must contain an unconditional statement that the custodial parent will not claim the exemption for the specified year or years, and a declaration is not unconditional if it conditions the custodial parent's release of the right to claim to the exemption on the noncustodial parent meeting a support obligation. (3) The custodial parent may revoke a revocation by providing written notice to the non-custodial parent specifying the years of the revocation. A revocation will be effective in the first calendar year after the year in which the revoking parent provides notice to the other parent. (4) Never-married parents who live apart are entitled to agree by written declaration to transfer the exemption to the non-custodial parent (following *King v. Commissioner*, 121 T.C. 245 (2003)).

**a. And don't forget to attach the form.** Chamberlain v. Commissioner, T.C. Memo. 2007-178 (7/5/07). A noncustodial parent failed to attach to his 2003 return the Form 8332, or its equivalent, signed by the custodial parent releasing her claim to the dependency exemption. The Tax Court held that, notwithstanding submission at trial of a letter from the custodial parent releasing claims to the dependency exemption, it could not retroactively cure the taxpayer's failure to attach the required statement to his return for the year at issue.

**2. Voluntary alimony is still "alimony," as long as you have a court order.** Webb v. Commissioner, T.C. Summ. Op. 2007-91 (6/4/07). In a very persuasive nonprecedential summary opinion, the Tax Court (Special Trial Judge Armen) held that payments made pursuant to a court order that specified that the payments were not mandatory, but that the payments, if made, were to be deductible by the payor and includable by the payee, qualified as alimony. The court reasoned that although prior to the 1984 revisions to § 71 there was a requirement that payments be pursuant to a legal enforceable obligation to be considered to be alimony, that requirement was eliminated by the 1984 amendments. The court further observed that although the pre-1984 "legal obligation requirement" was still reflected in a provision of the regulations (Reg. § 1.71-1(b)(2)(i)) that has been amended since 1984, a Temporary Regulation (Temp. Reg. § 1.71-1T(a), Q&A-3) interpreting the 1984 amendments "makes very clear that 'the [requirement] that alimony or separate maintenance payments be … made in discharge of a legal obligation … [has] been eliminated.'"

- This holding should be reflected in some precedential form because it could be useful for planning purposes.

**3. Equality yes, but not alimony.** Sarchett v. Commissioner. T.C. Memo. 2007-180 (7/9/07). Fixed payments denominated as "equalization payments" in a settlement agreement, the stated purpose of which was to equalize the division of the parties community property and debts, were not treated as alimony, because the obligation did not terminate at death, but rather payments were required until a fixed amount had been paid. Judge Cohen refused to consider the taxpayer's argument that his obligation would terminate on death under state law. She concluded that there was no evidence that the payments constituted alimony, and, therefore, there was no need to resort to state law.

**4. Who says the 1984 Act made it easier to sort out alimony from property settlements? The husband's marginal tax rate became enormous because he continued working past the date he was eligible for retirement.** Commissioner v. Dunkin, 500 F.3d 1065 (9th Cir.

8/31/07), *rev'g* 124 T.C. 180 (3/31/05). The divorced taxpayer reached eligibility for retirement, and had he retired, his former spouse would have been entitled to receive one-half of his pension. Because he continued working and delayed receipt of his pension benefits, under community property law he was required to pay his former wife an amount equal to one-half of the pension benefits that he had earned during the marriage. The Tax Court held that *Poe v. Seaborn* rather than *Lucas v. Earl* controlled, and thus he was entitled to exclude from gross income the amounts paid to his former wife. On appeal, the Ninth Circuit Court of Appeals reversed the Tax Court's decision, and held that *Poe v. Seaborn* was not controlling. The payments were made out of post-divorce wages and were not an actual distribution of community property from the pension plan. Because under California law, the wages paid to the former spouse were not community property, *Lucas v. Earl* was the controlling precedent. Thus, the payments made to the former spouse by the taxpayer were not excludable from his income.

- Nor were the payments deductible as alimony under § 71. The taxpayer was required to make payments for as long as he was employed by the employer that provided the pension plan, even if his former wife died before his retirement. Because the taxpayer's liability did not terminate upon the payee's death, the payments were not "alimony" within the meaning of § 71.

- Query whether a qualified domestic relations order (QDRO) might have alleviated taxpayer's distress?

**5. Labeling a payment in the divorce instrument as part of the division of marital property does not preclude the payment from being alimony.** Proctor v. Commissioner, 129 T.C. 92 (10/10/07). Pursuant to a divorce decree, upon his subsequent retirement from the Navy, the taxpayer was required to pay his former wife 25 percent of his disposable retirement pay pursuant to the Uniformed Services Former Spouses' Protection Act (USFSPA), 10 U.S.C. § 1408. When taxpayer failed to comply, pursuant to further proceedings, he was ordered to pay his former wife $5,313 relating to her share of his retirement pay by the end of 2002. The IRS argued that the payment of a share of taxpayer's retirement pay was a division of marital property and did not qualify as alimony. Judge Foley held that the payments in discharge of the obligation were alimony, because (1) the divorce instrument did not designate the payment as a payment that was not includible in gross income and not allowable as a deduction, and (2) under USFSPA the payments were to terminate upon the death of either party. Judge Foley rejected the IRS's argument that the payment was not alimony because the divorce decree referred to the payments as part of a division of the marital property. "The classification of a payment as part of

the division of marital property does not, however, preclude the payment from being alimony."

**6.** Amarasinghe v. Commissioner, T.C. Memo. 2007-333 (11/6/07). Provisions in a divorce instrument requiring the husband to withdraw funds from his pension trust to pay alimony and child support were not a QDRO because the instrument did not give the husband's former wife any direct interest in the pension trust. Rather, the order directed the husband to "cash out" a particular amount and pay it over his former wife. *Hawkins v. Commissioner*, 86 F.3d 982 (10th Cir. 1996), was distinguished. Alternatively, the purported QDRO did not qualify because an order cannot be a QDRO unless it is delivered to the pension trustee (*Karem v. Commissioner*, 100 T.C. 521 (1993)), which the instrument in this case was not. Accordingly, husband was required to include the full distribution in gross income and was allowed to deduct the portion paid over to the former wife as alimony, and the wife was required to include only the portion of the payment that was alimony.

### G. Education

**1. Up, up and away? No, the deduction goes down in flames.** Thompson v. Commissioner, T.C. Memo. 2007-174 (7/03/07). Judge Haines held that an aeronautical engineer could not deduct flight school expenses leading to a commercial pilot's license, even though the taxpayer did not thereafter become a commercial pilot. Even though commercial pilot training improved his engineering skills, the education qualified him for a new trade or business as a pilot. Under Reg. § 1.162-5(b)(3)(ii) Ex. (2), educational expenses incurred to qualify for a new trade or business are nondeductible even if the individual does not engage in the new activity. The mere capacity to engage in a new trade or business is sufficient to disqualify the expenses for the deduction.

## VI. CORPORATIONS

### A. Entity and Formation

There were no significant developments regarding this topic during 2007.

### B. Distributions and Redemptions

**1. Redemption that reduces shareholder's interest by 0.22 percent is essentially equivalent to a dividend.** Conopco, Inc. v.

United States, 100 A.F.T.R.2d 2007-5296 (D. N.J. 7/18/07). Conopco routinely redeemed shares of its voting preferred stock from its ESOP Trust to fund distributions to employees. It claimed a deduction under § 404(k)(1) for the amount of the redemption proceeds on the grounds that the payments were deductible "applicable dividends," because each redemption was so minor that it did not constitute a meaningful reduction under § 302(b)(1). The largest single redemption was 4,746 shares of approximately 2 million shares owned by the Trust. That redemption reduced the Trust's proportionate interest in Conopco from 2.7884 percent to 2.7809 percent. The court (Judge Greenaway) first held that the redemption was a dividend because it did not qualify under § 302(b)(1). The reduction in voting, dividend, and liquidation rights represented a reduction of only 7.5 thousandths of 1 percent. The court rejected the government's argument that Rev. Rul. 76-385, 1976-2 C.B. 92, supported redemption treatment. That ruling held that a redemption that reduced a shareholder's interest in a public corporation from 0.0001118 percent of 28 million shares to 0.0001081 percent, which was only a 3.7 millionths of 1 percent reduction, was sufficiently meaningful to warrant sale or exchange treatment under § 302. The court reasoned that in addition to the percentage decrease in the shareholder's stock, the percentage decrease in the corporation's outstanding stock also was relevant. While the number of shares redeemed in Rev. Rul. 76-385 was minuscule compared to the corporation's 28 million shares, it constituted a 3.3 percent reduction in the shareholder's already "minimal" holding of about approximately 31.304 shares (0.0001118 percent of 28 million equals 31.304 shares). In contrast, the 4,746-share redemption reduced the Trust's approximately 2 million-share holding by only 0.22 percent, a far less meaningful reduction as far as the Trust was concerned. Because the 4,746-share redemption did not meaningfully reduce the Trust's proportionate interest in Conopco, none of the hundreds of other, smaller redemptions did so either. Therefore, Conopco's distributions in redemption of stock from the Trust were "essentially equivalent to a dividend," and accordingly, they were dividends for purposes of the § 404(k)(1) deduction. However, the court went on to hold that because the distributions were made "in connection with the reacquisition of its stock," the deduction was disallowed under § 162(k)(1).

### C. Liquidations

There were no significant developments regarding this topic during 2007.

### D. S Corporations

**1.** 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.

**2.** Alpert v. United States, 481 F.3d 404 (6th Cir. 3/23/07). The Circuit Court upheld a summary judgment denying taxpayer's attempt to claim discharge of indebtedness income, which would increase basis of Subchapter S stock and thereby allow suspended losses barred by § 1366(d) under a bankruptcy case that was "substantially complete." Notwithstanding a receiver's report that indicates that the bankrupt S corporation's assets were insufficient to pay the debts, the court required an identifiable event that fixes the loss with certainty in order to trigger discharge of indebtedness income. The court required that the bankruptcy proceeding be completed to constitute the requisite identifiable event.

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

**4. A bad day for the owner of New Day.** Meeks v. United States, 99 A.F.T.R.2d 2007-2493 (W.D. La. 4/2/07). The taxpayer was the sole shareholder of an S Corporation (New Day) that had converted from a C corporation within the 10 preceding years. He timely filed his 1999 tax return, which included gain on the sale of certain assets of New Day, on April 15, 2000. Subsequently, the IRS audited New Day and asserted a deficiency for built-in gains tax under § 1374. On December 29, 2003, New Day and the IRS settled by agreeing that New Day owed $713,780.00 of built-in gains tax for the 1999 taxable year. On January 12, 2004, less than one month after the New Day settlement, but more than 3 years after the taxpayer filed his individual return for 1999, the taxpayer filed an amended return reflecting a $735,194.00 reduction in personal taxable income due to the built-in gain tax paid by New Day (§ 1366(f)(2)) seeking a refund of $151,236. The IRS denied the refund claim as untimely. The court sustained the government's position and held that the doctrine of equitable recoupment was not applicable to provide an independent basis for jurisdiction.

> The court is not unsympathetic to the arguably inequitable and harsh result in this case. However, in the field of taxation, statutes of limitation sometimes enure to the benefit of the Government, and at other times they work to the taxpayer's advantage. ... The instant plaintiffs are also not entirely free from fault. The Internal Revenue Code contains provisions for extending the limitations period upon mutual agreement of the parties. *See*, 26 U.S.C. §§ 6501(c)(4) & 6511(c), yet there is no indication that the taxpayers here availed themselves of that opportunity during the pendency of the proceedings against New Day.

**5. ESBT allowed to deduct acquisition indebtedness from its share of S corporation income.** For tax years beginning after 12/31/06, the **2007 Act**, § 8236(a), amends Code § 641(c)(2) to allow an electing small business trust (a permitted S corporation shareholder) to deduct interest paid on debt incurred to acquire the S corporation stock against its share of S corporation taxable income. An ESBT is taxable at the top corporate rate on its share of S corporation income. Thus, the interest deduction offsets income at the highest rate.

**6. QSub stock sale treated as an asset sale.** The **2007 Act**, § 8234(a), amends Code § 1361(b)(3)(C)(ii), to provide that failure to meet the 100 percent ownership requirement to qualify an S corporation subsidiary as a QSub because of a stock sale will cause the stock sale to be treated as a sale of QSub assets in proportion to the stock sale. The deemed

asset sale is followed by a deemed § 351 transfer of assets and assumption of liabilities by the former QSub. The legislative history states that where the S corporation sells 21 percent of the stock, it will be treated as selling 21 percent of the QSub assets. Section 351 will apply to the transaction (even though there is a loss of control), so gain is limited to 21 percent.

**7. S corporation passive investment income no longer includes gains on sales of stocks and securities.** The **2007 Act**, § 8231(a), amends Code § 1362(d)(3)(C) to exclude gain from the sale of stock or securities from the definition of passive investment income of an S corporation with earnings and profits for purposes of the § 1375 tax and termination of S status under § 1362(d)(3). The § 1375 tax is imposed on an S corporation with earnings and profits if it has passive investment income in excess of 25 percent of gross receipts. Section 1362(d)(3) will cause termination of the S election if that situation occurs for three consecutive taxable years.

**8. Pre-1983 S corporation earnings and profits disappear.** The **2007 Act**, § 8235, provides that a corporation that was not an S corporation for its first taxable year beginning after 12/31/96, may reduce accumulated earnings and profits by an amount equal to the portion of any E&P accumulated in pre-1983 S corporation years. The Small Business Job Protection Act of 1996 had already eliminated pre-1983 S corporation E&P for a corporation that was an S corporation for its first taxable year beginning after 12/31/96.

**9. A little help for S corporation banks.** The **2007 Act**, § 8233, allows banks that elect S corporation status to account for § 481 adjustments incurred because of a change in the reserve method for bad debts in the first taxable year for which the S election is in effect. Section 8232(a) of the **2007 Act** amends Code § 1361(f)(2)(A) to provide that restricted stock held by an individual in order to serve as a bank director will not be treated as a second class of stock. Distributions on such stock are includible in income by the holder and deductible by the S corporation.

**10. New additional simplified (and free) method to request relief for late S corporation elections.** Rev. Proc. 2007-62, 2007-41 I.R.B. 786 (10/9/07). This revenue procedure supplements Rev. Proc. 2003-43, 2003-1 C.B. 998, and Rev. Proc. 2004-48, 2004-2 C.B. 172, and provides an additional simplified method for certain eligible entities to request relief for late S corporation elections and late entity classification elections. The procedures are in lieu of the letter ruling process ordinarily used to obtain relief for a late S corporation election and a late corporate

classification election filed pursuant to § 1362(b)(5), Regs. §§ 301.9100-1 and 301.9100-3. Thus, user fees do not apply to corrective actions under this revenue procedure.

**11. Proposed regulations implementing the ever-easing standards for qualifying as an S.** REG-143326-05, S Corporation Guidance Under AJCA of 2004 and GOZA of 2005, 72 F.R. 55132 (9/28/07). The Treasury has published proposed amendments to various regulations under Subchapter S, including, among others, Prop. Regs. §§ 1.1361-1(e) (number of shareholders); 1.1361-1(h) (special rules relating to trusts eligible to be shareholders); 1.1361-1(m) (ESBTs); 1.1361-4 (inadvertent terminations and inadvertently invalid elections); and 1.1366-2 (limitations on deduction of passed-though losses).

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

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

- Proposed amendments to Reg. § 1.1362-4 implement 1996 amendments to § 1362(f), which provide relief for

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

- Section 235 of **AJCA** amended § 1366(d)(2) to provide that if the stock of an S corporation is transferred between spouses or incident to divorce under § 1041(a), any loss or deduction with respect to the transferred stock that could not be taken into account by the transferring shareholder in the year of the transfer because of the basis limitation in § 1366(d)(1) is treated as incurred by the corporation in the succeeding taxable year with regard to the transferee. Proposed amendments to Reg. § 1.1366-2(a)(5) would implement this exception to the general rule of nontransferability of losses and deductions. Losses and deductions carried over to the year of transfer that are not used by the transferor spouse in that year will be prorated between the transferor spouse and the transferee spouse based on their stock ownership at the beginning of the succeeding taxable year.

### E. Reorganizations

**1. All cash (D) reorganizations are now in the regulations.** T.D. 9303, Corporate Reorganizations; Distributions Under Sections 368(a)(1)(D) and 354(b)(1)(B), 71 F.R. 75879 (12/19/06). The Treasury has promulgated temporary regulations that provide guidance regarding the qualification of certain transactions as reorganizations described in § 368(a)(1)(D) where no stock and/or securities of the acquiring corporation is issued and distributed in the transaction. This is because under the circumstances of ownership by the same persons in the same proportions, the issuance of stock is a "meaningless gesture." 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 § 368(a)(1)(D) if the same person or persons own, directly or indirectly, 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, 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.
- REG-125632-06, Corporate Reorganizations; Distributions Under Sections 368(a)(1)(D) and 354(b)(1)(B), 71 F.R. 75898 (12/19/06). Identical proposed regulations have been published by cross-reference.

**a. Guidance is amended to eliminate an unintended glitch.** T.D. 9313, Corporate Reorganizations; Additional Guidance on Distributions Under Sections 368(a)(1)(D) and 354(b)(1)(B), 72 F.R. 9262 (3/1/07). Under previous guidance, there may have been the unintended consequence of causing related party triangular C reorganizations to be treated as D reorganizations, with the voting stock of the corporation in control of the acquiring corporation being treated as boot; they also may cause forward subsidiary mergers to be disqualified by the deemed issuance of a nominal share of stock of the acquiring corporation (not permitted under § 368(a)(2)(D)(i)). Consequently, these transactions are excepted under the amended regulations.

- REG-157834-06, Corporate Reorganizations; Additional Guidance on Distributions Under Sections 368(a)(1)(D) and 354(b)(1)(B), 72 F.R. 9284 (3/1/07). Proposed regulations were published by cross-reference.

**2. Section 357(c)(1) does not apply to acquisitive reorganizations because the transferor corporation no longer exists and cannot be enriched by the assumption of its liabilities.** Rev. Rul. 2007-8, 2007-7 I.R.B. 469 (2/12/07). Section 357(c)(1) does not apply to transactions that qualify as reorganizations described in §§ 368(a)(1)(A),

(C), (D) (provided the requirements of § 354(b)(1) are satisfied), or (G) (provided the requirements of § 354(b)(1) are satisfied) and to which § 351 applies. Rev. Rul. 75-161, 1975-1 C.B. 114, and Rev. Rul. 76-188, 1976-1 C.B. 99, are obsolete. Rev. Rul. 78-330, 1978-2 C.B. 147, is modified to the extent it holds that § 357(c)(1) is applicable to a transaction that qualifies as a reorganization described in § 368(a)(1)(A) or (D) (that satisfies the requirements of § 354(b)(1)).

**3. When to measure the value of consideration to determine whether continuity of interest exists: It is the business day before the day on which the binding contract is entered into. Continuity of interest regulations revised.** T.D. 9316, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest, 72 F.R. 12974 (3/20/07). This Treasury decision promulgates temporary and proposed regulations, Temp. Reg. § 1.368-1T(e)(2), amending the 2005 continuity of interest regulations, Reg. § 1.368-1(e). Under the 2005 regulations, the value of consideration received in a reorganization for purposes of determining whether shareholders received a sufficient proprietary interest in the acquiring corporation was to be determined as of the last business day before the contract is binding. The temporary regulations apply the signing date value only where the contract provides for a fixed consideration. The definition of fixed consideration is modified to provide that consideration is fixed where the contract specifies the number of shares of the issuing corporation to be exchanged for all or each proprietary interest in the target corporation. Definitions referring to the percentage of proprietary interests are deleted. The temporary regulations treat transactions that allow for shareholder elections as providing for fixed consideration regardless of whether the agreement specifies a maximum amount of money or a minimum amount of stock of the issuing corporation. (In any event the shareholders are subject to the economic fortunes of the issuing corporation as of the signing date.) The rule that modifications of the contract that increase the number of shares to be issued does not change the signing date is broadened to also state that a modification that decreases the amount of cash or other property to be issued also does not change the signing date. The temporary regulations also tighten the contingent consideration rules by providing that a contract will not be treated as providing a fixed consideration if provisions for contingent consideration prevent the target shareholders from being subject to the economic benefits and burdens of ownership of the issuing corporation as of the signing date. Finally, the temporary regulations provide that the signing date value must be adjusted to take into account the effect of any anti-dilution clause adjustments to reflect changes in the issuing corporation capital structure.

**4. Making post-reorganization intra-group restructurings even easier.** T.D. 9361, Corporate Reorganizations; Transfers of Assets or Stock Following a Reorganization, 72 F.R. 60552 (10/25/07), *making final* REG-130863-04, Corporate Reorganizations; Transfers of Assets or Stock Following a Reorganization, 69 F.R. 51209 (8/18/04). The Treasury has finalized regulations dealing with (1) the continuity of business enterprise requirement (Reg. § 1.368-1(d)) and (2) the definition of a "party to a reorganization" requirement (Reg. § 1.368-2(f)) to liberalize the rules regarding permissible post-acquisition restructurings of acquiring corporations in a controlled group of corporations. In addition to post-acquisition drops of assets to lower-tier subsidiaries, certain post-acquisition distributions by an acquisition subsidiary that is member of the acquiring corporation's group to a corporation that controls the acquiring corporation of either the target corporation's stock (following a § 368(a)(1)(B) or § 368(a)(2)(E) reorganization) or assets (following a § 368(a)(1)(A), § 368(a)(1)(C), or § 368(a)(2)(E) reorganization), and certain cross chain transfers, subsequent to the acquisition, do not disqualify the acquisition from reorganization treatment, even though there is no statutory provision expressly providing that such distributions do not affect the validity of reorganization treatment, provided that the distribution would not result in the distributing corporation being treated as liquidated for income tax purposes. The regulations thus permit the acquiring corporation to significantly rearrange ownership of the target corporation's assets or stock, as the case may be, among the members of its qualified group (based on § 368(c) control) without disqualifying the reorganization. Furthermore, the final regulations (Reg. § 1.368-1(d)(4)(ii)), unlike the proposed regulations, permit qualified group members to aggregate their direct stock ownership of a corporation, in a manner similar to aggregation under § 1504(a), in determining whether they have the requisite § 368(c) control of such corporation (provided that the issuing corporation has § 368(c) control in at least one other corporation).

**5. Proposed amendments to regulations governing the marriage of accounting methods in tax-free reorganizations.** REG-151884-03, Update and Revision of Sections 1.381(c)(4)-1 and 1.381(c)(5)-1, 72 F.R. 64545-02 (11/16/07). The Treasury Department has published proposed amendments to Reg. §§ 1.381(c)(4)-1 and 1.381(c)(5)-1, dealing with the carryover of tax attributes, including accounting and inventory methods, in corporate reorganizations and tax-free § 332 liquidations. Generally, following a § 381(a) transaction, the accounting method or combination of methods used by the parties to the transaction would continue to be used. If the businesses of the parties to a § 381(a) transaction are combined by the surviving party and different methods have been used,

then the principal and special method (including the inventory method) rules would apply. However, when the prior accounting methods cannot be continued after the transaction, Reg. § 1.381(c)(4)-1 would identify the accounting method to be used after the transaction; Reg. §1.381(c)(5)-1 would provide similar rules regarding inventory accounting methods. "[T]he current regulations are inconsistent in the treatment of adjustments for inventory methods and for other accounting methods, and that there is confusion regarding the appropriate procedure for making accounting method changes required by section 381." The proposed amendments generally would continue many of the provisions of the existing regulations regarding the accounting method or combination of methods to be used by the corporation that acquires the assets of another corporation in a § 381(a) transaction, but are designed to eliminate confusion and uncertainty and to provide simplicity and uniformity. Unlike the current regulations, the proposed regulations have a default rule to determine the principal method if there is no principal method.

### 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.

b. **Proposed regulations to carry out the amendment are anything but simple.** REG-123365-03, Guidance Regarding the Active Trade or Business Requirement under Section 355(b), 72 F.R. 26012 (5/8/07). For purposes of determining whether the active business requirement of § 355(b)(1) has been met, Prop. Reg. § 1.355-3(b) would treat all of the members of a separate affiliated group (SAG) as a single corporation. Thus, the subsidiaries of the common parent of a SAG are treated as divisions of the common parent for purposes of determining whether either the distributing or controlled SAG is engaged in a qualified trade or business.

- A corporation's SAG is the affiliated group that would be determined under § 1504(a) if the corporation were the common parent (and § 1504(b) did not apply). Thus, the separate affiliated group of the distributing corporation (DSAG)[7] is the affiliated group consisting of the distributing corporation and all of its affiliated corporations.

7. This acronym has no relationship to Cooper's Droop Syndrome.

The separate affiliated group of a controlled corporation (CSAG) is determined in a similar manner, but by treating the controlled corporation as the common parent. Accordingly, prior to a distribution, the DSAG includes CSAG members if the ownership requirements are met. Prop. Reg. § 1.355-3(b)(1)(iii).

- The SAG rule is applied for purposes of determining whether a corporation has conducted a trade or business throughout the requisite five-year period preceding the distribution and whether the distributing and controlled corporations are actively conducting a trade or business following distribution. These proposed regulations will affect the application of the active business requirement in a number of respects.

- First, if ownership requirements are met, members of the distributing corporation SAG and the controlled corporation SAG will be treated as belonging to a single SAG during the pre-distribution period, which facilitates identifying the appropriate trades or businesses regardless of how the assets are distributed among the SAG members. Prop. Reg. § 1.355-3(b)(3)(i).

- Second, the SAG rule applies for purposes of determining whether there has been a taxable acquisition of the trade or business within the five years preceding the distribution under § 355(b)(2)(C) or (D). Because, the subsidiaries of the common parent of a SAG are treated as divisions of the common parent, a stock acquisition of a corporation that becomes a member of a SAG is treated as an asset acquisition (which affects the application of § 355(b)(2)(D) regarding acquisition of control of a corporation conducting an active business). Prop. Reg. § 1.355-3(b)(1)(ii).

- Third, Prop. Reg. § 1.355-3(b)(4)(iii) would permit certain taxable acquisitions of the assets of a trade or business by the distributing corporation without violating the restrictions of § 355(b)(2)(C) and (D), which are interpreted as preventing the use of the assets of distributing to acquire a trade or business in lieu of dividend distributions. The proposed regulations disregard a taxable acquisition by the controlled SAG from the distributing SAG, disregard the use of cash to pay off fractional shares, and to a limited extent, disregard taxable acquisitions from members of the same SAG. However, the proposed regulations do not disregard the recognition of gain or loss in transactions between affiliated corporations unless the affiliates are members of the same SAG. (Analogous to current regulations, taxable acquisitions to expand an existing business within a SAG are disregarded. Prop. Reg. § 1.355-3(b)(3)(ii)).

- Fourth, application of § 355(b)(2)(D)(i) (control acquired by any distributee corporation) would be limited to situations designed to avoid the impact of the repeal of the *General Utilities* doctrine.

Thus, the proposed regulations allow a taxable acquisition by a distributee corporation of control of distributing in a transaction where the basis of the acquired distributing stock is determined in whole or by reference to the transferor's basis. Prop. Reg. § 1.355-3(b)(4)(iii)(C).

- Fifth, the proposed regulations interpret §§ 355(b)(2)(C) and (D) to have the common purpose of preventing the direct or indirect acquisition of the trade or business (to be relied on a distribution to which § 355 would otherwise apply) by a corporation in exchange for assets other than its stock. Thus, if (1) a DSAG member or controlled acquires the trade or business solely for distributing stock, (2) distributing acquires control of controlled solely for distributing stock, or (3) controlled acquires the trade or business from distributing solely in exchange for stock of controlled, in a transaction in which no gain or loss was recognized, §§ 355(b)(2)(C) and (D) are satisfied. However, if the trade or business is acquired in exchange for assets of distributing (other than stock of a corporation in control of distributing used in a reorganization) §§ 355(b)(2)(C) and (D) are not satisfied. Under this rule, for example, an acquisition by a controlled corporation (while controlled by the distributing corporation) from an unrelated party in exchange for controlled stock has the effect of an indirect acquisition by distributing in exchange for distributing's assets. Such an acquisition violates the purpose of § 355(b)(2)(C), and will be treated as one in which gain or loss is recognized. Prop. Reg. § 1.355-3(b)(4)(ii).

c. **Transition relief from § 355 SAG regulations.** Notice 2007-60, 2007-35 I.R.B. 466 (8/27/07). This Notice provides transition relief to taxpayers applying §§ 355(b)(2)(C) and 355(b)(2)(D) and Reg. § 1.355-3(b)(4)(iii) to certain transactions that would be adversely affected by the changes to the active business requirement for § 355 tax-free divisions in these provisions.

- First, Reg. § 1.355-3(b)(4)(iii) provides an exception to the general no gain or loss rule in § 355(b)(2)(C) and (D) by disregarding an acquisition of a trade or business by one member of an affiliated group from another member of the group. (Although Reg. § 1.355-3(b)(4)(iii) is facially applicable to distributions on or before 12/15/87, the IRS has applied it administratively to distributions occurring after that date). The preamble to the proposed SAG regulations questioned whether Reg. § 1.355-3(b)(4)(iii) appropriately reflects § 355(b) as amended in 2006. This Notice announced that consistent with past administrative practice, the IRS will not challenge the application of the rule in Reg. § 1.355-3(b)(4)(iii) to distributions effected on or before the date of publication in the Federal Register of temporary or final regulations modifying that rule.

- Second, the proposed regulations would treat a stock acquisition that results in the acquired corporation becoming a

subsidiary member of the acquiring corporation's SAG as an asset acquisition for purposes of § 355(b). As a result, acquisitions of stock of the controlled corporation that result in the controlled corporation becoming a member of the distributing corporation's SAG are treated as asset acquisitions subject to § 355(b)(2)(C) regardless of whether the distributing corporation already controlled the controlled corporation. Such an acquisition could violate § 355(b)(2)(C) notwithstanding the fact that it would not violate § 355(b)(2)(D) because there was no acquisition of control. This Notice provides that the IRS will not challenge the distributing corporation's (or its SAG's) acquisition of additional stock of the controlled corporation as a violation of § 355(b)(2)(C) with respect to the controlled corporation in the case of distributions effected on or before the date the temporary or final regulations are published, provided that the transaction satisfies the requirements of § 355(b)(2)(D) as in effect before the enactment of § 355(b)(3).

**2.** Rev. Rul. 2007-42, 2007-28 I.R.B. 44 (6/21/07). A distributing corporation that owns a 33-1/3 percent interest in an LLC, which is engaged in owning and managing office buildings, is engaged in the active conduct of a trade or business. However, a 20 percent ownership interest in an LLC is not sufficient to enable the corporate LLC member to treat the LLC's activities as the active conduct of a trade or business by the corporation.

### G. Miscellaneous Corporate Issues

**1. Tax Court holds that you do not have to be a CPA to practice "accounting."** Rainbow Tax Service, Inc. v. Commissioner, 128 T.C. 42 (3/8/07). Tax return preparation and bookkeeping services by a corporation that is neither a public accounting firm nor the performer of services that require its employees to hold CPA licenses is nevertheless a "qualified personal service corporation" as defined under § 448(d)(2) because it performs "accounting services." Therefore, its income is taxed at the flat 35 percent rate under § 11(b)(2), not at the graduated rates claimed by taxpayer. The Tax Court (Judge Swift) noted the distinction between "public accounting" and "accounting," and noted that tax return preparation and bookkeeping services are services in the field of accounting.

- Note that veterinarians are considered to perform services in the field of "health." Rev. Rul. 91-30, 1991-1 C.B. 61.

**a. And yet another 35 percent rate PSC.** W.W. Eure, M.D., Inc. v. Commissioner, T.C. Memo. 2007-124 (5/17/07). A

corporation that was wholly owned by a radiation oncologist/surgeon and which operated a radiation therapy medical practice was a professional service business subject to the 35 percent tax rate under § 11(b)(2), because 95 percent or more of its employee's time was spent providing healthcare directly to patients or performing ancillary services.

**2. Taking from the big and contributing to the small does not produce excluded contributions to capital.** United States v. Coastal Utilities, Inc., 483 F.Supp.2d 1232 (S.D. Ga. 3/28/07). Summary judgment was granted to the Government denying a utility's refund claim based on its assertion that payments received from the Universal Service Administration Company and the State of Georgia Access Funds were contributions to capital excluded from gross income under § 118. The payments were part of state and federally mandated programs funded by fees collected from telecommunications carriers based on revenues. Payments are made to carriers with high cost obligations to provide universal access to telephone services. Based on undisputed facts, and following an in-depth analysis of the relevant authorities distinguishing non-shareholder contributions to capital from gross income, the District Court concluded that the purpose of the payments was to supplement income. The court focused on the mechanisms used to calculate the amount of universal support, which, although largely related to investment expenditures, took into account operation, maintenance, administrative, and other expenses that were unrelated to capital investment.

**a. The IRS concludes the same by ruling.** Rev. Rul. 2007-31, 2007-21 I.R.B. 1275 (5/21/07). The IRS ruled that universal service support payments received are not a non-shareholder contribution to capital under § 118(a).

**b. And the Eleventh Circuit agrees too. Coastal Utilities is affirmed.** United States v. Coastal Utilities, 514 F.3d 1184 (11th Cir. 1/23/2008). The Eleventh Circuit adopted in full the district court's order.

**3. Debt treated as equity results in a constructive dividend.** Hubert Enterprises, Inc. v. Commissioner, 230 F.App'x 526 (6th Cir. 4/27/07). Hubert Enterprises, a closely held family corporation, advanced funds to an LLC owned by family members, which in turn was the 97 percent general partner in a real estate development partnership. The partnership had difficulty acquiring financing for its development project. The $2.4 million note had no fixed maturity date, was a demand note, was not secured, and called for interest payable at the applicable federal rate. The

borrower made only one payment of interest on the note. The Sixth Circuit affirmed the Tax Court holding denying the taxpayer's claimed bad debt deduction under § 166 for the worthless note. The Court affirmed the Tax Court's conclusion that the note was equity under the factors specified in the Sixth Circuit's opinion in *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986). Further, the Sixth Circuit also affirmed the Tax Court holding that the corporation was not entitled to deduct the amount advanced to the LLC as a loss of capital because the advance represented a constructive dividend conferring an economic benefit on its shareholders (the owners of the LLC). The corporation retained no ownership interest in the LLC.

**4. Tightening the belt (noose?) on § 382 limitations.** T.D. 9330, Built-in Gains and Losses Under Section 382(h), 72 F.R. 32792 (6/14/07). Temp. Reg. § 1.382-7T(a) provides that prepaid income received before a change date that is attributable to services performed after the change date is not recognized built-in gain for purposes of computing the § 382 limitations on NOL carryovers following an ownership change. The term prepaid income means any amount received prior to the change date that is attributable to performance occurring on or after the change date. Examples to which the temporary regulation applies include, but are not limited to, income received prior to the change date that is deferred under § 455, Reg. § 1.451–5, or Rev. Proc. 2004–34 (or any successor revenue procedure). According to the preamble:

> The IRS and Treasury Department believe that prepaid income is distinguishable from the income items described in the committee report examples. In each of the committee report examples, the item of income is attributable to the pre-change period because that is the period in which performance occurred and expenses were incurred to earn the income. By contrast, prepaid income is attributable to the post-change period because that is the period in which performance occurred and expenses were incurred to earn the income. Therefore, because prepaid income is attributable to the post-change period rather than the pre-change period ... such prepaid income should not be treated as [recognized built-in gain] under section 382(h).

- Identical regulations have been published in proposed form. REG–144540–06, Built-in Gains and Losses Under Section 382(h), 72 F.R. 32828 (6/14/07).

**5. Corporate estimated tax regulations.** T.D. 9347, Corporate Estimated Tax, 72 F.R. 44338 (8/7/07). The Treasury has promulgated final regulations regarding corporate estimated tax payments to reflect numerous statutory changes since 1984. Reg. §§ 1.6425-2; 1.6425-3; 1.6655-1; 1.6655-2; 1.6655-3; 1.6655-4; 1.6655-5; 1.6655-6; 1.6655-7. The regulations address a variety of annualization issues, e.g., items that are generally incurred once or infrequently during tax year are not annualized, allow taxpayers to make reasonable allocations of certain items, the adjusted seasonal installment method, "large corporation" status, short taxable years, accounting method changes, and additions to tax. These regulations apply to taxable years beginning after 9/6/07.

### H. Affiliated Corporations and Consolidated Returns

**1. What hath Rite-Aid wrought?** REG-157711-02, Proposed Rules, Unified Rule for Loss on Subsidiary Stock, 72 F.R. 2964 (1/23/07). Proposed regulations would completely replace the current basis adjustment and loss suspension rules in Reg. §§ 1.337(d)-2 and 1.1502-35. Prop. Reg. § 1.1502-36 would provide "unified rules for loss on subsidiary stock" transferred by a member of an affiliated group filing a consolidated return. A transfer of stock includes any event in which (1) gain or loss would be recognized (apart from the rules in the proposed regulations), (2) the holder of a share and the subsidiary cease to be members of the same group, (3) a nonmember acquires an outstanding share from a member, or (4) the share is treated as worthless. The purpose of these rules is twofold, to prevent the consolidated return provisions from creating non-economic losses on the sale of subsidiary stock and to prevent members of the affiliated group filing the consolidate return from claiming more than one tax benefit from a single economic loss. Under the proposed regulations, any transfer of a loss share (defined as a share of stock of an affiliate having a basis in excess of fair market value) requires the application in sequence of three basis rules.

- First, a basis redetermination rule, under Prop. Reg. § 1.1502-36(b) is applied to deal with tax losses attributable to investment adjustment account allocations among different shares of stock under Reg. § 1.1502-32 that result in disproportionate reflection of gain or loss in shares. Second, if any share is a loss share after application of the basis redetermination rule, a basis reduction rule is applied under Prop. Reg. § 1.1502-36(c) to deal with loss duplication attributable to investment adjustment account adjustments, but this reduction does not exceed the share's "disconformity amount." Third, if any duplicated losses remain after application of the basis reduction rule, under Prop. Reg. § 1.1502-36(d) an attribute reduction rule is applied to the corporation the stock of which was

sold to prevent the duplication of a loss recognized on the transfer or preserved in the basis of the stock. If a chain of subsidiaries is transferred (rather than a single subsidiary) the order in which the rules are applied is modified. In this case, the basis redetermination rule and basis reduction rule are applied sequentially working down the chain, and the attribute reduction rule is then applied starting with the lowest tier subsidiary and working up the chain.

- *The Basis Redetermination rule.* Under the basis redetermination rule in Prop. Reg. § 1.1502-36(b), investment adjustments (exclusive of distributions) that were previously applied to members' bases in subsidiary stock are reallocated in a manner that, to the greatest extent possible, first eliminates loss on preferred shares and then eliminates basis disparity on all shares. This rule affects both positive and negative adjustments, and thus addresses both noneconomic and duplicated losses. First, positive investment adjustments (up to the amount of the loss) are eliminated from the bases of transferred loss shares. Second, to the extent of any remaining loss on the transferred shares, negative investment adjustments are removed from shares that are not transferred loss shares and are applied to reduce the loss on transferred loss shares. Third, the positive adjustments removed from the transferred loss shares are allocated to increase basis of other shares only after the negative adjustments have been reallocated. Note that this rules does not affect the aggregate basis of the shares, and thus has no impact, and thus does not apply, if all of the shares of a subsidiary are sold; it is important only when some, but not all, shares are sold. A number of special limitations on basis reallocation also must be considered in various specific circumstances.

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

- The "disconformity amount" with respect to a subsidiary's share is the excess of its basis over the share's allocable portion of the subsidiary's inside tax attributes (determined at the time of the transfer). Every share within a single class of stock has an identical allocable portion. Between shares of different classes of stock, allocable portions are determined by taking into account the economic arrangements represented by the terms of the stock. "Net inside attributes" is the sum of the subsidiary's loss carryovers, deferred deductions, cash, and asset basis, minus

the subsidiary's liabilities. The disconformity amount identifies the net amount of unrealized appreciation reflected in the basis of the share.

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

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

- Under the attribute reduction rule, the subsidiary's attributes are reduced by the "attribute reduction amount," which equals the lesser of (1) the net stock loss, or (2) the aggregate inside loss. The "attribute reduction amount" reflects the total amount of unrecognized loss that is reflected in both the basis of the subsidiary stock and the subsidiary's attributes. "Net stock loss" is the amount by which the sum of the bases (after application of the basis reduction rule) of all of the shares in the subsidiary transferred by members of the group in the same transaction exceeds the value of those shares. The subsidiary's "aggregate inside loss" is the excess of its net inside attributes over the value of all of the shares in the subsidiary. (Net inside attributes generally has the same meaning as in the basis reduction rule, subject to special rules for lower-tier subsidiaries.)

- The attribute reduction amount is first applied to reduce or eliminate items that represent actual realized losses, such as operating loss carryovers, capital loss carryovers, and deferred deductions. Any excess attribute reduction amount is then applied to reduce the basis of any publicly traded property (other than lower-tier subsidiary stock, which is subject to special rules) held by the subsidiary. Last, any remaining attribute reduction amount is applied to proportionately reduce the basis in assets, other than publicly traded property and cash and equivalents neither of which can

reflect loss). If the attribute reduction amount exceeds all of the attributes available for reduction, that excess amount generally has no effect. If, however, cash or other liquid assets are held to fund payment of a liability that has not yet been deducted but will be deductible in the future, e.g., a liability the deduction for which is subject to the economic performance rules of § 451(h), loss could be duplicated later, when the liability is taken into account. To prevent such loss duplication, the excess attribute reduction amount will be held in suspense and applied to prevent the deduction or capitalization of later payments with respect to the liability. Additional special rules apply to prevent excessive reduction of attributes when the subsidiary itself holds stock of a lower-tier subsidiary.

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

- *Worthlessness.* The proposed regulations would not remove Reg. § 1.502-80(c), dealing with worthlessness of subsidiary stock.

**2.** T.D. 9341, Treatment of Excess Loss Accounts, 72 F.R. 39313 (7/18/07). Two final consolidated return regulations have been promulgated.

- Reg. § 1.1502-19(d) (replacing Temp. Reg. § 1.1502-19T(d)) provides that, if a member of a consolidated group acquires new shares of a subsidiary that would have an excess loss account and the member owns one or more other shares of the same class of subsidiary stock, the basis of the other shares is allocated to the new shares to eliminate or to equalize any excess loss account that would otherwise be attributable to the new shares.

- Reg. § 1.1502-80(c) (replacing Temp. Reg. § 1.1502-80T(c)) provides that subsidiary stock is not treated as worthless before the earlier of (1) the time that the subsidiary ceases to be a member of the group, or (2) the time that the stock of the subsidiary is worthless within the meaning of Treas. Reg. § 1.1502-19(c)(1)(iii). Under Reg. § 1.1502-19(c)(1)(iii) a share of subsidiary stock is treated as worthless when the subsidiary disposes of substantially all of its assets, and the deferral of any worthless securities deduction until that time implements single-entity principles, or certain debt cancellations occur.

**3. Are "new and more precise mechanics" a synonym for "ever-more complicated"?** REG-107592-00, Consolidated

Returns; Intercompany Obligations, 72 F.R. 55139 (9/28/07). The IRS has proposed amendments to Reg. § 1.1502-13(g) with respect to the treatment of obligations between members of a consolidated group. Reg. § 1.1502-13(g) applies to three types of transactions: (1) transactions in which an obligation between a group member and a nonmember becomes an intercompany obligation, for example, the purchase by a consolidated group member of another member's debt from a nonmember creditor or the acquisition by a consolidated group member of stock of a nonmember creditor or debtor (inbound transactions); (2) transactions in which an intercompany obligation ceases to be an intercompany obligation, for example, the sale by a creditor member of another member's debt to a nonmember or the deconsolidation of either the debtor or creditor member (outbound transactions); and (3) transactions in which an intercompany obligation is assigned or extinguished within the consolidated group (intragroup transactions). The proposed regulations "adopt new and more precise mechanics" for the application of the deemed satisfaction-reissuance model to intragroup and outbound transactions. The following sequence of events is deemed to occur immediately before, and independently of, the actual transaction: (1) the debtor is deemed to satisfy the obligation for a cash amount equal to the obligation's fair market value, and (2) the debtor is deemed to immediately reissue the obligation to the original creditor for that same cash amount. The parties are then treated as engaging in the actual transaction but with the new obligation. With respect to inbound transactions, the IRS and the Treasury Department have concluded that the mechanics of the deemed satisfaction-reissuance model and its application produce appropriate results and, therefore, no change has been proposed.

## VII. PARTNERSHIPS

### A. Formation and Taxable Years

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

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

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

**1. Partnership deductions are in the proof, and that was lacking when taxpayer fired employees during Chinese New Year.** Chong v. Commissioner, T.C. Memo. 2007-12 (1/17/07). Yung Chong, a full-time Federal Express driver, formed a partnership with his brother, Lok Chong, an Australian citizen. At first the partnership successfully exported chicken parts from the United States to China, but when suppliers began exporting directly the chicken parts business dried up so the Chong brothers began exporting Australian dairy products, Western beef, and Mexican food to China. When they discovered that some of their Chinese employees were competing with them by importing yogurt from France, the Chong brothers made the mistake of firing employees during the Chinese New Year, a cultural taboo. In retaliation the fired employees ransacked the business, destroying business records in the process. The Tax Court found that a partnership existed between Yung Cong and Lok Chong, but disallowed the taxpayer's claimed $40,000 of partnership loss because the taxpayer was unable to substantiate the loss with adequate records, nor was the taxpayer able to reconstruct the claimed losses, due in large part to his brother's informal record keeping. In addition, the taxpayer was unable to establish his basis in his partnership interest for purposes of § 704(d).

- Note that this case has a moral: Don't fire employees during the Chinese New Year lest bad things happen to your tax benefits.

**2.** Burke v. Commissioner, 485 F.3d 171 (1st Cir. 5/4/07). The First Circuit affirmed a summary judgment in the Tax Court, *Burke v. Commissioner*, T.C. Memo. 2005-297 (12/27/05), holding that a partner is taxable on the partner's distributive share of partnership income notwithstanding the fact that the partnership income is held in an escrow, and is not available for distribution, pending resolution of a dispute between the two individual partners. Partners must report their share of partnership earnings in the year the partnership receives them, regardless of when or whether the partners actually receive them.

> It is well settled that partners' distributions are taxed in the year the partnership receives its earnings, regardless of whether the partners actually receive their share of partnership earnings: "Few principles of partnership taxation are more firmly established than that no matter the reason for nondistribution each partner must pay taxes on his distributive share." … Reg. § 1.702-1 (providing that a partner must separately account for his distributive share of partnership income "whether or not distributed"). Consistent with this long-standing principle, courts have uniformly held that partners must currently recognize in their individual incomes their proportionate shares of partnership income, even if the partnership income was not actually distributed to them for any reason, including disputes, consensual arrangements, ignorance, concealment, or force of law. (citations omitted).

**3.** Rev. Proc. 2007-59, 2007-40 I.R.B. 745 (10/1/07). This Revenue Procedure grants permission to a "qualified partnership" to aggregate built-in gains and losses from "qualified financial assets" for purposes of making reverse allocations of recognized gains and losses under § 704(c) principles. A management or investment partnership is permitted by Reg. § 1.704-3(e)(3) to aggregate built-in gains and losses from qualified financial assets, rather than follow the normal property-by-property approach required by regulations. The automatic permission to aggregate built-in gains and losses is granted to a qualified partnership, which is a partnership that allocates gains and losses in proportion to the partners' capital accounts, which reasonably expects to revalue its assets at least four times a year, holds publicly traded property of at least 90 percent of its non-cash assets, has at least 10 unrelated partners, and will make at least 200 trades of financial assets during the year.

**4. IRS publishes a safe-harbor for allocation of alternative energy tax credits.** Rev. Proc. 2007-65, 2007-45 I.R.B. 967 (11/5/07). Section 45 provides a 1.5 cent credit for each kilowatt of energy from qualified energy sources. Partnership allocations of tax credits that do not adjust partners' capital accounts can not have substantial economic effect. Reg. §§ 1.704-1(b)(5), Ex. (11) and 1.704-1(b)(4)(ii) provide that credits are allocated in proportion to the allocation of expenditures or receipts related to the credit. The revenue procedure indicates that the IRS will respect allocations of § 45 wind energy production credits under the principles of Reg. § 1.704-4(b)(4)(ii) if certain conditions are satisfied: (1) the developer must have a minimum one percent interest in the partnership

and the investors must each have a minimum five percent interest in each partnership material item, (2) the investor must maintain a minimum investment throughout the project equal to 20 percent of fixed capital contributions that is not protected from loss, (3) 75 percent of the investor's capital contribution must be fixed and determinable, (4) the developer or related parties may not have a right to purchase project property for less than fair market value, and (5) the company cannot have a fixed right to cause any party to purchase project property (except electricity).

**a.** Announcement 2007-112, 2007-50 I.R.B. 1175 (12/10/07). Rev. Proc. 2007-65 was revised to clarify that the requirements that must be met to qualify for the safe-harbor are neither intended to provide substantive rules nor to be used as audit guidelines.

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

**1. A distribution of appreciated property to a partner is a nonrecognition event, but a § 707(c) payment to a partner of appreciated property is a festival of taxation.** Rev. Rul. 2007-40, 2007-25 I.R.B. 1426 (6/18/07). The IRS has ruled that the transfer of appreciated property by a partnership to a partner in satisfaction of a guaranteed payment owed to the partner is a sale or exchange of the property by the partnership and not a distribution under § 731. Thus the partnership is required to recognize gain on the transfer. The ruling does not deal with whether the partnership is entitled to deduct the value of the property or whether it must capitalize that amount, as the case may be.

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

**1. Proposed regulations track built-in gain following an assets-over partnership merger.** REG-143397-05, Partner's Distributive Share, 72 F.R. 46932 (8/22/07). These proposed regulations adopt the approach of Rev. Rul. 2004-43, 2004-1 C.B. 842, revoked by Rev. Rul. 2005-10, 2005-1 C.B. 492. See also Notice 2005-15, 2005-1 C.B. 527. In an assets-over partnership merger, the merged partnership is treated as transferring its assets to the continuing partnership in exchange for an interest in the continuing partnership, which is then distributed to the partners of the merged partnership in liquidation of the merged partnership. The continuing partnership is the partnership whose members hold more than 50 percent interests in the resulting partnership. Section 704(c)(1)(B) requires recognition of gain or loss by the contributing partner on the distribution of property contributed to a partnership within seven years of

the date of contribution. The recognized gain is the amount of built-in gain or loss existing at the time of contribution that would be required by § 704(c)(1)(A) to be allocated to the contributing partner on a sale of the property for fair market value. Section 737 requires recognition of gain on a distribution to a partner who contributed built-in gain property within seven years of a contribution of built-in gain property. Under the proposed regulations, following an assets-over merger, with respect to the initial pre-contribution gain of contributed property, the seven year period continues to run from the date of the initial contribution. In addition, the proposed regulations provide that in the assets-over merger, built-in gain with respect to built-in gain property transferred by the merged partnership to the continuing partnership is subject to the recognition rules of §§ 704(c)(1)(B) and 737 beginning on the date of the merger. The proposed regulations also provide that a merger of two partnerships whose ownership interests in profits and capital are identical will not trigger a new counting period under the seven year rules. (This appears to be a technical error, because under Reg. § 1.708-1(c)(1), neither of the merged partnerships is the continuing partnership; both original partnerships have terminated and the resulting partnership is a new partnership. Expect this to be changed in the final regulations). The proposed regulations do not address built-in losses, which are the subject of another regulations project. The proposed regulations are applicable to distributions after January 19, 2005.

- The proposed regulations follow the holding of Rev. Rul. 2004-43, 2004-1 C.B. 842 (5/3/04), which was revoked by Rev. Rul. 2005-10, 2005-1 C.B. 492, after commentators asserted that the ruling was inconsistent with existing regulations. Notice 2005-15, 2005-1 C.B. 527, indicated that the IRS would promulgate regulations adopting the position of Rev. Rul. 2004-13, applicable to distributions after 1/19/05.

### E. Inside Basis Adjustments

There were no significant developments regarding this topic during 2007.

### F. Partnership Audit Rules

**1. Is this the period that never seems to end?** AD Global Fund, LLC v. United States, 67 Fed. Cl. 657 (9/16/05), *motion to certify appeal granted*, 68 Fed. Cl. 663 (11/8/05), *aff'd*, 481 F.3d 1351 (Fed. Cir. 3/2/07). The court held that § 6629(a) does not provide an independent statute of limitations for assessing partnership items; instead, it creates a minimum period that may extend the regular § 6501 statute of limitations for assessing tax with respect to partnership items. Therefore, the issuance of a

Final Partnership Administrative Adjustment (FPAA) more than three years after the partnership return is filed, but less than three years after the partners filed their returns, suspends the period of limitations under § 6501(a) for the partners.

**2. Closed year partnership items from Son of BOSS tax shelter can be reassessed to determine an open year's tax liability.** J & J Fernandez Ventures, L.P. v. United States, 99 A.F.T.R.2d 2007-2661 (Fed. Cl. 4/3/07). The government is not barred from recalculating items in a closed year in order to determine the basis of stock sold in an open year. The taxpayers' 2000-2003 tax liability for gain on the sale of stock was determined from basis adjustments claimed to result from Son of BOSS transactions in 1999, a closed year.

- The court follows the holding of *AD Global Fund, LLC v. United States* to hold that § 6229 creates a minimum period for assessing taxes attributable to partnership items that may extend the § 6501 3-year statute of limitations.
- The § 6501(a) limitation prohibits assessment of taxes for closed years, but it does not bar the use of information from closed years. Re-assessing basis determinations from closed years is not an assessment of taxes.
- Under *Barenholtz v. United States,* 784 F.2d 375, 380-381 (Fed.Cir. 1986), the government may recompute taxable income in a closed year in order to determine tax liability in an open year. The court in *Fernandez* held that the *Barenholtz* principle applies in the TEFRA context.

**3. The Tax Court follows.** G-5 Investment Partnership v. Commissioner, 128 T.C. 186 (5/30/07). The Tax Court (Judge Haines) held that § 6229(a) establishes the minimum period for the assessment of tax attributable to partnership items notwithstanding the period provided in § 6501. Section 6229 can extend the § 6501 period of limitations with respect to the tax attributable to a partnership item. Thus, §§ 6229(a) and 6501 "provide alternative periods within which to assess tax with respect to partnership items, with the later expiring period governing in a particular case."

- Under the facts of the case, the partnership filed its 2000 return on October 4, 2001. The partners reported capital loss carryovers attributable to the partnership 2000 tax year on their tax returns for 2002-2004. On April 12, 2006, the IRS issued an FPAA notice to the partnership for 2000, more than three years after the partnership return for 2000 was filed. However, the notice was within three years of the dates the partners filed their individual returns for the years 2002-2004. The IRS could

assess deficiencies against the partners attributable to the partnership's 2000 items for the partners' open 2002-2004 years.

**4. And extended by Jenkens & Gilchrist's response to the IRS summons in Son of BOSS transactions.** Kligfeld Holdings v. Commissioner, 128 T.C. 192 (5/30/07). An FPAA that was issued after § 6229(a) barred adjustments to partnership items, but before § 6501 barred assessment of tax against the partner, permitted assessment of deficiencies against the partner in the open year. The § 6501 statute of limitations was tolled under § 7609(e)(2) for the period during which Jenkens & Gilchrist provided information in response to the IRS summons for customers' names in the Son of BOSS shelter.

**5. A criminal fraud investigation of the tax matters partner helped another partner.** In re Martinez, 366 B.R. 604 (Bankr. E.D. La. 4/13/07). A consent to extend the statute of limitations for partnership level audit executed by tax matters partner was invalid with respect to the taxpayer-partner, because the tax matters partner was under criminal investigation with respect to the partnership and thus had a disabling conflict of interest with the other partners of which the IRS was aware.

**6.** River City Ranches #1 Ltd. v. Commissioner, T.C. Memo. 2007-171 (7/2/07). On remand from the Ninth Circuit, 401 F.3d 1136 (9th Cir. 2005), the Tax Court held that an asserted conflict of interest between the tax matters partner and the other partners did not invalidate waiver of the statute of limitations by the tax matters partner. In addition, the Tax Court found that the six-year statute of limitations for fraud was applicable and that the sheep breeding partnerships at issue were sham partnerships lacking economic substance, which justified increased interest penalties under § 6621(c).

**7. A closing agreement is not necessary for a settlement agreement prerequisite to starting the statute of limitations running.** Gingerich v. United States, 77 Fed. Cl. 231 (6/22/07), *on remand from* 82 F.App'x 35 (Fed. Cir. 2003). In a partnership level audit, pursuant to § 6229(f)(1) the IRS has one year to assess a deficiency against the partners with respect to items that pursuant to § 6231(b)(1)(C) became nonpartnership items as a result of a settlement agreement. In this case, while the partnership issue was before the Tax Court, the IRS district counsel and the partners' lawyers reached a settlement, which was reduced to a writing signed by the partners (the "Acceptance Forms"), but not by any representative of the IRS, which was delivered to the IRS, but which did not exactly follow the precise wording of the IRS's settlement offer. Both the

IRS and the taxpayer's lawyers expected that closing agreements would be signed expeditiously, but there was a delay. In the refund suit, the Court of Federal Claims (Judge Lettow) held that settlement agreement had been reached when the partners had signed and delivered the "Acceptance Forms" to the IRS, not on the later date on which the Closing Agreements had been signed. Accordingly, the deficiency, which was assessed more than one year after the Acceptance Forms, but within one year from the closing agreements, was not timely.

**8. Fear penalties determined in a TEFRA audit.** Fears v. Commissioner, 129 T.C. 8 (8/2/07). Section 6221 provides that the applicability of any penalty, including an accuracy-related penalty that relates to an adjustment of a partnership item must be determined at the partnership level if the TEFRA partnership audit rules apply. Accordingly, the Tax Court (Judge Foley) held that it lacked jurisdiction to consider an asserted partner-level defense relating to § 6662 penalties determined in the partnership level proceeding.

**9. "The [Subchapter B] deficiency procedures no longer apply to the assessment of any partnership-item penalty determined at the partnership level, regardless of whether further partner-level determinations are required." So, is the IRS supposed to assess penalties before the deficiency is determined?** Domulewicz v. Commissioner, 129 T.C. 11 (8/8/07). In a Son of BOSS transaction, the taxpayer claimed a $5,858,801 capital loss. The loss was created by a series of transactions in which the taxpayer entered into a short sale of U.S. Treasury notes and contributed the proceeds and the related obligation to a partnership (DIP). After DIP satisfied the obligation and received from its partners contributions of publicly traded stock purchased for a relatively nominal amount, the partners transferred their interests in DIP to DII, an S corporation of which they were shareholders. DIP then liquidated and distributed the stock to DII, following which DII sold the stock and passed through to the taxpayer a capital loss of $29,306,024 resulting from the claimed high basis of the stock. Following a TEFRA audit that recomputed the partnership's basis in the stock as zero (rather than the claimed $30,447,106), when no petition was filed as to the FPAA, the IRS did not assess any tax or accuracy-related penalty relating to DII's sale of the stock, but instead issued an affected items notice of deficiency to the taxpayer. The taxpayer filed a Tax Court petition and moved to dismiss this case for lack of jurisdiction, asserting that the normal deficiency procedures did not apply to the disallowance of the pass-through loss or the determination of the accuracy-related penalties. The Tax Court (Judge Laro) held that under § 6230(a)(2)(A)(i), the deficiency procedures were applicable to the

disallowance of the loss because partner-level factual determinations were necessary to determine deficiency. Among other things that had to be determined were DII's basis in its partnership interests at the time of the liquidating distribution, whether the stock that was sold by DII was the same stock distributed by DIP, the portion of the stock actually sold, the holding period for the stock, and the character of any gain or loss. "The fact that these partner-level determinations, once made, may not have changed respondent's partnership determinations as to DIP is of no concern. Neither the Code nor the regulations thereunder require that partner-level determinations actually result in a substantive change to a determination made at the partnership level."

- However, the IRS's determination of the accuracy-related penalties was not subject to the deficiency procedures by virtue of the parenthetical text added to § 6230(a)(2)(A)(i) by the Taxpayer Relief Act of 1997, Pub. L. 105-34, § 1238(b)(2), 111 Stat. 1026 — "(other than penalties, additions to tax, and additional amounts that relate to adjustments to partnership items)." Judge Laro finished his opinion with the following observation:

> We note in closing that we are not unmindful that a plain reading of section 6230(a)(2)(A)(i) ... may sometimes permit (as it apparently does here) the Commissioner to assess a partnership-item penalty before the deficiency to which the penalty relates is adjudicated. We doubt that the drafters of the statute and the regulations, in excluding partnership item penalties from the deficiency procedures, contemplated a situation like this where the deficiency underlying the partnership-item penalty is incorporated in an affected items notice and itself made subject to review under the deficiency procedures before it can be assessed. All the same, we apply the statute as written in accordance with its plain reading and leave to the legislators the job of rewriting the statute, should they decide to do so, to take into account the situation at hand.

**10. Son of BOSS Tax Court petition dismissed, because all items in the deficiency notice are TEFRA partnership audit items and that proceeding was still pending.** Nussdorf v. Commissioner, 129 T.C. 30 (8/16/07). The IRS issued an FPAA on 9/26/05 for 1999 and 2000 to Evergreen Trading, LLC with respect to offsetting currency options, and on the same date issued notices of deficiency to the individuals to whom Evergreen's losses flowed. Taxpayers contested the FPAA in the Court of Federal Claims and filed petitions in the Tax Court with respect to the

individual notices of deficiency. The Tax Court (Judge Chiechi) denied the taxpayer's motion to dismiss and granted the IRS's motion to dismiss the taxpayer's petition. The deficiency notices related only to partnership items, and the court did not have subject matter jurisdiction over any of the items, because it was not a partnership proceeding under § 6226.

- After the Tax Court petition had been filed, the taxpayer's pass-thru entity that was a partner, but not the tax matters partner, filed a complaint in the Court of Claims alleging errors in the FPAA and that suit was still pending. Judge Chiechi concluded that all of the following items were partnership items: (1) the character of the transfer in which the partnership received property from each partner, e.g., whether it was a contribution or a loan; (2) whether any such property should be aggregated with other property received from partner; and (3) and the basis to the partnership of any property contributed to it by partner, including necessary preliminary determinations, such as the partner's basis in the contributed property. She held that the basis of the property transferred to Evergreen is a partnership item under § 6231(a) and it is to be determined in the partnership proceeding.

**11.** Murphy v. Commissioner, 129 T.C. 82 (9/26/07). The taxpayer was the sole beneficiary of a trust that was partner in a Son of BOSS partnership. The IRS sent a notice of a final partnership administrative adjustment (FPAA) to the taxpayer, rather than to the trust, for the purpose of meeting the notice requirement of § 6223(a). Pursuant to § 6223(c)(3) and Reg. § 301.6223(c)-1T(f), mailing the FPAA to the taxpayer as an "indirect partner" met the notice requirement of § 6223(a).

**12.** Epsolon Limited v. United States, 78 Fed. Cl. 738 (10/10/07). The FPAA issued in a Son of BOSS case was timely because the issuance of a summons to Sidley Austin Brown & Wood seeking the identities of individual investors suspended the running of the statute of limitations.

### G. Miscellaneous

**1. The Sixth Circuit upholds the existing check-the-box rules, and further holds that subsequent proposed regulations making the LLC liable for employment taxes may be disregarded. Ironically, the rule in the proposed regulations calls for employment taxation at the entity level.** Littriello v. United States, 484 F.3d 372 (6th Cir. 4/13/07). The Sixth Circuit held that provisions in Reg. § 301.7701-3(b)(1)(ii) treating a sole-owner LLC as a disregarded entity are a valid exercise of Treasury's authority to issue interpretative regulations. The

taxpayer was the sole owner of several LLCs and claimed that the LLCs, not the taxpayer, were individually liable for unpaid employment taxes. Affirming the District Court, the Sixth Circuit held that the taxpayer was individually liable for the employment taxes. After the notice of appeal had been filed in the case, the Internal Revenue Service published proposed regulations that would treat single-owner disregarded entities as separate entities for employment tax purposes. See Prop. Reg. § 301.7701-2(c)(2)(iv), REG-114371-05, Disregarded Entities; Employment and Excise Taxes, 70 F.R. 60475 (10/18/05). The Sixth Circuit opined that an agency is entitled to consider alternative interpretations of a statute in proposing regulations before settling its view (citing *Commodity Futures Trading Commission v. Schor*, 478 U.S. 833 (1986)). The court stated that the proposed regulations do not undermine the District Court's determination that the current regulations are reasonable and valid.

**a. The Second Circuit reaches the same result for the same reasons.** McNamee v. Department of the Treasury, 488 F.3d 100 (2d Cir. 5/23/07). Judge Kearse ruled that the owner of a single member LLC was personally liable for the employment tax liabilities of his LLC that was properly formed under state law because he did not elect to have the LLC treated as a corporation. Judge Kearse stated:

> In light of the emergence of limited liability companies and their hybrid nature, and the continuing silence of the Code on the proper tax treatment of such companies in the decade since the present regulations became effective, we cannot conclude that the above Treasury Regulations, providing a flexible response to a novel business form, are arbitrary, capricious, or unreasonable.

- The court's summary of the interaction of the various Supreme Court decisions with respect to the weight to be accorded Treasury regulations promulgated under the "express" general delegation in § 7805 "to adopt regulations to fill in gaps in the Code" is especially worthy of note with respect to all cases in which a regulation might be challenged.

> In reviewing a challenge to an agency regulation interpreting a federal statute that the agency is charged with administering, the first duty of the courts is to determine "whether the statute's plain terms 'directly addres[s] the precise question at issue.'" *National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 545 U.S. 967, 986 ... (2005) (" National Cable ") (quoting

*Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 ... (1984)). "If the statute is ambiguous on the point, we defer ... to the agency's interpretation so long as the construction is 'a reasonable policy choice for the agency to make.'" *National Cable*, 545 U.S. at 986 (quoting *Chevron*, 467 U.S. at 845). As stated in *Chevron* itself,

> [f]irst, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, *the court does not simply impose its own construction on the statute*, as would be necessary in the absence of an administrative interpretation. Rather, *if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.* (467 U.S. at 842-43)

"If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation [, and s]uch legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." [*Chevron* ] at 843-44… . See also *United States v. Mead Corp.*, 533 U.S. 218, 226-27 ... (2001) ("administrative implementation of a particular statutory provision qualifies for *Chevron* deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority").

**b. But the Treasury issues final regulations disagreeing with its own victories.** T.D. 9356, Disregarded Entities; Employment and Excise Taxes, 72 F.R. 45891 (8/16/07). These final regulations promulgate Reg. §§ 1.34-1, 1.1361-4 and 301.7701-2, which treat disregarded entities as separate corporations for purposes of employment taxes. The regulations apply to disregarded single owner

entities and to qualified Subchapter S corporations. The IRS rejected comments that the regulations will complicate reporting requirements for disregarded entities whose owners assumed responsibility for excise taxes claiming that the regulations will avoid administrative inconvenience for the IRS in assessing employment taxes. The final regulations are effective 8/16/07. However, there is a more complex deferral arrangement:

> The employment tax provisions of these regulations apply to wages paid on or after January 1, 2009. The notice of proposed rulemaking provided that these regulations would become effective with respect to wages paid on January 1 following the year of publication of these final regulations in the Federal Register, which would have been January 1, 2008. However, in order to ensure that taxpayers have sufficient time to make any necessary changes to their systems in response to these regulations, the IRS and the Treasury Department have determined that it is appropriate to delay the effective date of these regulations until January 1, 2009.
>
> The IRS and the Treasury Department believe that the considerations that support a January 1, 2009, effective date for the employment tax provisions do not apply to the excise tax provisions. Thus, the excise tax provisions of these regulations apply to liabilities imposed and actions required or permitted in periods beginning on or after January 1, 2008. For periods beginning before that date, the IRS will treat payments made by a disregarded entity, or other actions taken by a disregarded entity, with respect to the excise taxes affected by these regulations as having been made or taken by the sole owner of that entity. Thus, for such periods, the owner of a disregarded entity will be treated as satisfying the owner's obligations with respect to the excise taxes affected by these regulations, provided that those obligations are satisfied either (1) by the owner itself or (2) by the disregarded entity on behalf of the owner.

**2. Treasury promulgates final regulations on qualified small business stock held by partnerships.** T.D. 9353, Section 1045 Application to Partnerships, 72 F.R. 45346 (8/14/07). Under § 1045 an individual holder of qualified small business stock (QSB stock), who has held the stock for more than 6 months, can defer recognition of gain on the sale if the individual acquires replacement QSB stock within 60 days. The

proposed regulations allowed a partner in a partnership to elect to defer gain on sales of QSB stock by a partnership that acquired replacement stock within the 60 day period. The proposed regulations did not treat a sale of an interest in a partnership that holds QSB stock as a sale of the QSB stock subject to § 1045. However, the final regulations (Reg. § 1.1045-1) provide that gain on sale of QSB stock may be deferred if the partner holds an interest in another partnership that acquires QSB stock during the statutory period The final regulations require basis adjustments under the principles of § 743(b) with respect to replacement QSB stock when a partner elects to defer gain under § 1045. The electing partner's basis in the partnership interest is also reduced by deferred gain. The final regulations also require an electing partner to recognize deferred gain if replacement QSB stock is distributed to another partner. An election under § 1045 may be made by the partnership affecting all partners. If a partnership elects to defer gain under § 1045, an individual partner is permitted to opt out of the election. An individual partner is also permitted to elect to defer gain on sale of QSB stock if the partnership does not make the election.

**3. Purchase of fancy life insurance products in the guise of an employee benefit plan fails to produce claimed deductions.** V.R. DeAngelis M.D.P.C. v. Commissioner, T.C. Memo. 2007-360 (12/5/07). The taxpayer doctors each owned a Subchapter S corporation that was a partner in a partnership through which they practiced medicine. Each individual doctor was an employee of the doctor's S corporation. The S corporations made contributions to the partnership which in turn contributed to the Severance Trust Executive Program Multiple Employer Supplemental Benefit Plan and Trust (STEP), a plan promoted to wealthy professionals as a qualified welfare benefits fund that was part of a 10 or more employer plan under § 419A(f)(6). The plan purchased cash-laden whole life insurance policies on behalf of each doctor. Judge Laro described the case as "arising from a plan designed aggressively to bolster the sale of insurance products through a claim of permissible tax savings." The court disallowed deductions as ordinary business expenses for contributions to the "welfare benefit plan" finding that "the facts of these cases establish that the plan was nothing more than a subterfuge through which the participating doctors, through VRD/RTD, used surplus cash of the PCs to purchase cash-laden whole life insurance policies primarily for the benefit of the participating doctors personally." The court rejected the IRS's additional assertion that contributions by the S corporations were included in the doctors' gross income, finding instead that the contributions represented distributions to the doctors as shareholders of their respective S corporations.

## VIII. TAX SHELTERS

### A. Tax Shelter Cases

**1. 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, Reg. § 1.752-6 (See T.D. 9062), was not effective retroactively, and was therefore invalid as applied to these transactions. Judge Ward held that there was clear authority existing at the time of the transaction that the premium portion of the loan did not reduce taxpayer's basis in the partnership.

**a. 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, 472 F. Supp. 2d 885 (E.D. Tex. 1/31/07), on appeal to the Fifth Circuit (9/19/07). The transactions lacked economic substance because the loans would not be used to provide leverage for foreign currency transactions, but no penalties were applicable because taxpayers passed on a 1999 investment and they thought they were investing in foreign currencies and the tax opinions they received that relied on relevant authorities set forth in the court's earlier opinion provided "substantial authority" for the taxpayers' treatment of their basis in their partnerships.

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

**2. 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.

**3. Hi-Lili, Hi-Lili, LILO! District court grants summary judgment to the government in a LILO transaction.** BB&T Corp. v. United States, 99 A.F.T.R.2d 2007-376 (M.D. N.C. 1/4/07). 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.

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

- Cemco claimed a $3.563 million loss on the sale of the Euros. CIP claimed a $3.6 million basis in the long currency position, and that the contingent obligation of the short position is not treated as a liability for § 752 purposes, which would otherwise have reduced basis on termination of the contracts. (See *Helmer v. Commissioner*, T.C. Memo. 1975-160). Cemco asserted that while CIP had a total tax basis of $3.6 million, its only assets were the Euros and cash in its possession. Thus, the basis of the Euros distributed in liquidation would be $3.6 million less the $45,847 cash, producing a loss on the sale of Euros. The Tax Court held that Notice 2000-44, 2000-2 C.B. 255, which was issued on 9/5/00 (predating the transaction), and Reg. § 1.752-1(a)(4)(ii), issued in June 2003, established that the contingent obligation represented by the short sale would be treated as a liability to prevent the creation of artificial basis in transactions designed to create artificial tax losses by overstating basis. Thus, Cemco's losses are disallowed.
- Cemco's major claim was that that the FPAA should have been issued to CIP, which was the partnership that executed the transactions and thereby generated the basis figure with respect to property distributed to Cemco. Agreeing with the Government, the District Court held that, although the basis of the Euros was a partnership item of CIP, Cemco was also required to correctly determine the basis of the Euros contributed to it and could not merely carry over the basis as determined by either CIT or CIP. Thus, the FPAA issued to Cemco was not premised on CIP's errors.
- The summary judgment also affirmed imposition of the § 6662(a) accuracy related penalty, increased to 40 percent under § 6662(e) for a gross valuation misstatement.

**5. There's red ketchup all over. Six million dollars of financial profit and a $124 million tax loss. A redemption is treated as a dividend disregarded for lack of business purpose.** H.J. Heinz Co. v. United States, 76 Fed. Cl. 570 (5/25/07). Heinz Credit Company (HCC, a Delaware lending subsidiary formed to minimize state taxes on intercompany loans) purchased on the open market 3,500,000 shares of its parent's (H.J. Heinz) stock with cash acquired from commercial lenders. H.J. Heinz redeemed 3,325,000 of these shares giving HHC a subordinated zero coupon convertible note. H.J. Heinz and HHC treated the transaction as a dividend from H.J. Heinz to HCC under §§ 301 and 302(d). HCC thus asserted that its basis in the full 3,500,000 shares shifted to its remaining 175,000 H.J. Heinz shares. Thereafter, HHC sold the 175,000 shares to an unrelated party claiming a $124 million capital loss, which was reported on the H.J. Heinz consolidated return. At the end of three years, HHC converted the note into H.J. Heinz stock. Between the times it acquired the note and the conversion date, the price of H.J. Heinz stock increased from about $39

to $83 per share. The Court of Federal Claims (Judge Allegra) found that HCC possessed the benefits and burdens of ownership of the H.J. Heinz stock and that its transfer of the stock to H.J. Heinz met the definition of a redemption under § 317(b). Nonetheless, the court concluded that the transaction was a sham because the only purpose of the transaction was to produce a capital loss to wipe out capital gains realized on another transaction, and the transaction had no business purpose. The court also applied the step transaction doctrine to disregard the HCC purchase and redemption of shares. The court concluded:

> A Heinz promotion from the late 1950s and early 1960s touted its tomato ketchup by stating - "It's Red Magic Time!" But no amount of magic, red or otherwise, can hide the meat of the transactions in question, the connective tissues and gristle of which have been revealed by the multi-tined substance-over-form doctrine. *Sans sa sauce*, it becomes plain that plaintiffs' transaction simply was not "the thing which the statute intended." *Gregory*, 293 U.S. at 469.

**6. Interest is suspended under § 6404(g) because of the absence of fraud.** Sala v. United States, 99 A.F.T.R.2d 2007-2551 (D. Colo. 5/1/07). If an individual files a timely return (including extensions) and the IRS has not sent the taxpayer a notice of additional liability (e.g., a math error notice of deficiency), including an explanation of the basis for the liability, within one year following the later of (1) the due date of the return (*without* regard to extension), or (2) the date on which the taxpayer filed the return, § 6404(g)(1) suspends the accrual of interest for the period beginning one year after the due date (or filing, if applicable) of the return. Interest resumes running twenty-one days after the IRS sends a notice to the taxpayer. Section 6404(g) does not apply at all if an underpayment is due to fraud. In this case, the district court held that the fraud exception to § 6404(g) does not apply to a deficiency from a tax shelter transaction ("Baby BOSS") that lacked economic substance, unless the government shows that the taxpayer engaged in some act of concealment or misrepresentation. Even though the taxpayer entered into the transaction knowing that it was a listed transaction (Notice 2000-44), and knowing that it would not be registered with the IRS in order to conceal his participation, because taxpayer relied on a "more likely than not opinion" by R.J. Ruble that the tax results of the transaction would be upheld, the taxpayer acted in good faith and the government could not prove that the taxpayer had fraudulent intent. Summary judgment was entered for the taxpayer.

**a. Was it a "qualified amended return"?** Sala v. United States, 99 A.F.T.R.2d 2007-1709 (D. Colo. 5/30/07). On plaintiff's motion for partial summary judgment, Judge Babcock held that the amended 2000 return filed by Sala on 11/18/03 was possibly not a "qualified amended return" because the date that the IRS notified KPMG that it was under a § 6700 examination was 10/17/03. The resolution of this issue depends upon the scope of the § 6700 examination at the time the amended return was filed, and an issue of fact exists that would preclude summary judgment. The court refused to stay the case pending the availability of testimony from Sala's KPMG accountant, Tracie Henderson, and from R.J. Ruble, both of whom indicated they would invoke their Fifth Amendment rights, because the delay would be substantial and would prejudice Sala.

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

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

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

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

**B. Identified "Tax Avoidance Transactions."**

**1. Loss importation transactions are listed tax avoidance transactions.** Notice 2007-57, 2007-29 I.R.B. 87 (7/16/07). Listed transactions include loss importation by a Subchapter S corporation that acquires a foreign entity classified as a corporation. The foreign entity

engages in offsetting positions in foreign currency. After the gain is recognized, the foreign entity elects to be treated as a disregarded entity preserving the loss side of the transactions for the S corporation.

**2. 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. "Transactions of Interest"** 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. These proposed regulations would create a new category, "transaction of interest," as a reportable transaction category.

**(1) The regulations are now final.** T.D. 9350, AJCA Modifications to the Section 6011 Regulations, 72 F.R. 43146 (8/3/07). This Treasury Decision adopts the proposed regulations as Treas. Reg. § 1.6111-4, without change.

**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.

**(1) The regulations are now final.** T.D. 9351, AJCA Modifications to the Section 6111 Regulations, 72 F.R. 43157 (8/3/07). This Treasury Decision adopts the proposed regulations as Treas. Reg. § 301.6111-3.

**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 advisor to include the names of other material advisors to the transaction and any designation agreement to which the material advisor 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.

**(1) The regulations are now final.** T.D. 9352, AJCA Modifications to the Section 6112 Regulations, 72 F.R. 43154 (8/3/07). This Treasury Decision adopts the proposed regulations as Treas. Reg. § 301.6112-1.

**3. Now the IRS doesn't want to be "TOI-ed" with.** Notice 2007-72, 2007-36 I.R.B. 544 (9/4/07). The transaction described as a "transaction of interest" is one in which a taxpayer purchases the successor member interest in an LLC holding real estate from his Advisor (who continues to own the membership interests in the LLC for a term of years). The taxpayer then transfers the successor member interest more than one year after he acquired it to a charity, and claims a deduction significantly higher than the amount paid by the taxpayer. The IRS designated this and similar transactions as "transactions of interest" for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112.

**a.** Notice 2007-73, 2007-36 I.R.B. 545 (9/4/07). In this Notice, the IRS expressed concern over transactions involving turning grantor status on and off in a short time period for the purpose of allowing the grantor to claim a tax loss greater than any actual economic loss sustained or to avoid inappropriately the recognition of gain, and designated such transactions as "transactions of interest."

- In IR-2007-143 (8/14/07), Treasury and IRS explained that it believes "transactions of interest" have the potential for abuse, but that they lack sufficient information to determine whether the transactions should be identified specifically as tax avoidance transactions. Treasury and the IRS further explained that they may take one or more future actions, including designating the transactions as listed transactions, or providing a new category of reportable transaction.

- Speaking to the Tax Executives Institute on 10/23/07, 2007 TNT 206-2, Chief Counsel Donald Korb's explanation of the significance of the classification "transaction of interest" was reported as follows:

> Korb said the creation of the new transactions of interest designation is the direct result of the penalties Congress added for listed transactions in the American Jobs Creation Act of 2004.

> "They piled on," he said. "So once the penalties become so draconian, it really takes away from us the ability to use this tool. It's that simple."
>
> Korb said the IRS has only listed two new transactions since he joined the agency because it has to be so careful when listing brings with it so many penalty implications. He called transactions of interest the new "junior listed transaction."

### C. Disclosure and Settlement

**1. First was Merrill Lynch.** IR-2001-74, (8/29/01). The IRS announced that Merrill Lynch agreed to settle a penalty case that the IRS had brought against it for promotion of the contingent installment sale shelter involved in *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), and other cases. The amount of the penalty settlement was described as "substantial."

**a. The Big Four settle with the IRS on tax shelters.** Deloitte cooperated with the IRS and settled for a de minimis penalty, which was decided upon after the IRS settled with the other three large accounting firms.

**b. 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.

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

**2. The KPMG deal: the price of settling goes up dramatically.** IR-2005-83 (8/29/05). The IRS and the Justice Department

announced that KPMG LLP has admitted to criminal wrongdoing and agreed to pay $456 million in fines, restitution, and penalties as part of an agreement to defer prosecution of the firm. Nineteen individuals, chiefly former KPMG partners including the former deputy chairman of the firm (Jeffrey Stein), as well as a New York lawyer (R.J. Ruble) were indicted in the Southern District of New York in relation to the "multi-billion dollar criminal tax fraud conspiracy;" several of those indicted were partners in KPMG's Washington National Tax group.

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

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

- Judge Kaplan suggested that the constitutional violation could be rendered harmless if the defendants could successfully force KPMG to pay their legal expenses, and *sua sponte* instructed the clerk of the district court to open a civil docket number for an expected contract claim by the defendants against KPMG for payment of their defense costs. Judge Kaplan stated that the court would "entertain the claims pursuant to its ancillary jurisdiction over this case." The defendants subsequently filed the anticipated complaints against KPMG.
- Judge Kaplan subsequently refused to eliminate from his opinion a statement that prosecutors in the case were "economical with the truth." He also refused to eliminate from his opinion the names of the prosecutors involved. 2006 TNT 130-10.
- The Thompson Memorandum was replaced on 12/12/06 by the McNulty Memorandum which requires threats to prosecute entities "unless" they do something (e.g., waive attorney client privilege) or "if" they do something (e.g., advance legal fees) to emanate from a higher level of the Justice Department.

**c. 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 reaffirmed his earlier holding that ancillary jurisdiction existed over the contractual fee dispute between the defendants and KPMG. He rejected KPMG's argument that the defendant's claims were foreclosed by written agreements, and found that enforcement of any applicable arbitration clause would be contrary to public policy, because it might interfere with the ability to ensure a speedy trial, could lead to a dismissal of meritorious criminal charges, would endanger the defendants' rights to a fair trial, and might impose unnecessary costs on taxpayers if the defendants became indigent. Judge Kaplan cited fears that defendants may be unable to pay their lawyers in further postponing the trial, which was scheduled to begin in January 2007.

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

> The prejudice to KPMG in having these claims resolved in a proceeding ancillary to a criminal prosecution in the Southern District of New York is clear. At stake are garden variety state law claims, albeit for large sums. KPMG

> believed that contractual disputes between it and the appellees would be resolved by arbitration. Instead, KPMG is faced with a federal trial of more than a dozen individuals' multi-million dollar "implied-in-fact" contract claims. Moreover, because such a proceeding is governed by no express statutory authority, the district court has indicated its intention to apply to this expedited undertaking an *ad hoc* mix of the criminal and civil rules of procedure determined on the fly, as it were. ...
>
> First, "the interrelationship of the factual issues underlying the finding of constitutional violations and the asserted contract claims is marginal. ...
>
> Second, while the ancillary proceeding is a major undertaking, its contribution to the efficient conclusion of the criminal proceeding is entirely speculative. ...
>
> Third, even if there were constitutional violations and even if KMPG is contractually obligated to advance [defendants'] attorneys' fees and costs, creating an ancillary proceeding to enforce that obligation was not the proper remedy. ...
>
> Finally, on the present record, a proceeding ancillary to a criminal prosecution was not necessary either to avoid perceived deficiencies in ordinary civil contract actions to enforce the alleged advancement contracts or to remove some barrier to the [defendant's] bringing of such actions.

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

**3. Taps for Jenkens & Gilchrist.** The Justice Department announced it would defer the prosecution of the Jenkens & Gilchrist law firm and that the firm would shut down on 3/31/07 and also be liable for a $76 million promoter penalty on account of the tax shelter practice of Paul Daugerdas in its Chicago office. 2007 TNT 62-2, 3/30/07.

**4. POPS goes the COBRA; the IRS FLIPs off Sidley Austin.** IR-2007-103 (5/23/07). The IRS announced that Sidley Austin LLP reached a settlement in which it agreed to pay $39.4 million in penalties for promotion of abusive tax shelters and failure to comply with tax shelter registration requirements. The firm issued tax shelter opinions marketing BOSS, COBRA, BLIPS, COINS, FLIP, OPIS, and POPS.

**5. These "value ideas" did produce extraordinary results for E&Y tax partners, but not the results they expected.** United States v. Coplan. Two current and two former partners of Ernst & Young – all members of its VIPER[8] group – were indicted on 5/30/07 in the Southern District of New York for crimes relating to tax shelters promoted by E&Y. The shelters included CDS ("Contingent Deferred Swap"); COBRA ("Currency Options Bring Reward Alternatives"); CDS Add-On; and PICO ("Personal Investment Corporation"). 2007 TNT 105-1.

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

**D. Tax Shelter Penalties, Etc.**

**1. 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.

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8. Value Ideas Produce Extraordinary Results.

**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.

**c.** **And now the regulations.** T.D. 9334, Requirement of Return and Time for Filing, 72 F.R. 36871 (7/6/07). Proposed and temporary regulations require the filing of Form 4720, "Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code," by exempt entities and entity managers who are liable for the § 4965 excise tax on certain tax-exempt entities and entity managers who are parties to tax shelter transactions. The return is due on the 15th day of the 5th month following the end of the entity's accounting period. Managers of retirement plan entities who are subject to the excise tax are required to file Form 5330, "Return of Excise Taxes Related to Employee Benefit Plans."

**2.** Rev. Proc. 2007-21, 2007-9 I.R.B. 613 (2/26/07). This revenue procedure provides procedures for requesting rescission of a § 6707A penalty and a nonexclusive list of factors that weigh in favor and against granting rescission. Rescission must be requested in writing within 30 days after the IRS sends notice and demand for payment, or, if the penalty (not including interest) has been paid in full prior to notice and demand, within 30 days from the date of payment.

## IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

### A. Exempt Organizations

**1.** **Pension Protection Act** §§ 1231-1235 amended Code §§ 170, 508, 2055, 2522, 4943, 4958, and 6033, and added Code §§ 4966 and 4967 to provide new rules and greater accountability for donor advised funds and sponsoring organizations (e.g., community foundations), which are defined in these provisions. The new provisions 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 (11/27/06). 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. 1121 (12/18/06). This Notice provides 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.

**2. This is a real sleeper! 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.

**a. Calendar year organizations must do this by May 15, 2008.** IR-2008-25 (2/25/08). Tax-exempt organizations not required to file Forms 990 or 990-EZ are required to file Form 990-N, "Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required to File Form 990- or 990-EZ" for tax years beginning in 2007. Section 6033(i) provides that organizations that do not file Form 990-N for three consecutive years will lose their tax-exempt status.

**3. Charitable remainder trusts no longer lose exempt status with one dollar of unrelated business taxable income.** 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.

**4. Let there be light on charities' UBIT.** Organizations exempt from tax under § 501(a) are required by § 6104(d) to make certain returns and other materials available for public inspection. Section 6104(d)(1)(A)(ii), added by the **Pension Protection Act of 2006**, requires public disclosure of returns filed relating to the unrelated business income tax of § 511, Form 990-T.

**a. The IRS issues guidance regarding public inspection of unrelated business income tax returns.** Notice 2007-45, 2007-22 I.R.B. 1320 (5/29/07). This Notice provides interim guidance under § 6104(d)(1)(A)(ii). All organizations exempt under § 501(a) and described in § 501(c)(3) are now required to make available for public inspection a copy of their Form 990-T filed with the IRS. The Notice specifically points out that churches and state schools and universities that are not otherwise required to disclose returns, are required to disclose Form 990-T where they are subject to tax under § 511. There is an exception for Form 990-T filed solely to claim a refund of the telephone excise tax. The Notice indicates that Treasury will propose regulations under § 6104(d) to comply with § 6104(d)(1)(A)(ii).

**5.** CRSO v. Commissioner, 128 T.C. 153 (4/30/07). Taxpayer was denied tax exemption as a feeder organization because under § 502 its holding of debt financed commercial real estate subject to a triple net lease is the conduct of a trade or business rather than the receipt of rental income excluded from unrelated business taxable income under § 512(b)(3). Rental income from the properties is not excluded from UBIT under § 512(b)(3) because the rental income is derived from debt financed property subject to the exception of § 512(b)(4).

**6. Charities jump into the 2008 Presidential race at their peril.** Rev. Rul. 2007-41, 2007-25 I.R.B. 1421 (6/18/07). While a § 501(c)(3) exempt charity can conduct educational activities regarding political campaigns, a § 501(c)(3) organization may not participate or intervene directly or indirectly in a political campaign for or against a candidate for elected office. This ruling contains 21 situations providing guidance to locate the line between political education and campaigning. The ruling indicates that while officials of organizations are not constrained to speak for themselves, leaders of exempt organizations cannot make

partisan comments in official organization publications or at official functions of the organization.

**7. Just like the seventeen-year cicada.** Rev. Proc. 2007-52, 2007-30 I.R.B. 222 (7/23/07), *superseding* Rev. Proc. 90-27, 1990-1 C.B. 514. The IRS published an update of procedures for requesting recognition of tax-exempt status.

**8.** REG-155929-06; Payout Requirements for Type III Supporting Organizations That Are Not Functionally Integrated, 72 F.R. 42335 (8/2/07). This document provides advance notice of rules that the Treasury Department and the IRS anticipate proposing in a notice of proposed rulemaking regarding the payout requirements for Type III supporting organizations that are not functionally integrated, the criteria for determining whether a Type III supporting organization is functionally integrated, the modified requirements for Type III supporting organizations that are organized as trusts, and the requirements regarding the type of information a Type III supporting organization must provide to its supported organization(s) to demonstrate that it is responsive to its supported organization(s).

**B. Charitable Giving**

**1. Being a tree-hugger is good for your tax health.** Glass v. Commissioner, 471 F.3d 698 (6th Cir. 12/21/06), *aff'g* 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.

- 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.

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

**a. 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 (12/18/06). 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.

**b.** **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 (11/13/06). 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**.

**c.** Section 170(b)(1)(E), enacted in the **Pension Protection Act**, expands the limitations for contributions of qualified conservation easements.

**(1)** **Greener got better. Questions answered regarding contributions of conservation easements.** Notice 2007-50, 2007-25 I.R.B. 1430 (6/18/07). Normally the value of contributions of capital gain property is limited to 30 percent of the taxpayer's adjusted gross income. After 2005 and before 2008, charitable contribution deductions of the value of contributed qualified conservation easements are available to the extent of the excess of 50 percent of adjusted gross income over otherwise allowable charitable contribution deductions. The excess contribution may be carried forward fifteen years. With respect to qualified farmers, the contribution limit is 100 percent of AGI. The Notice explains the application of these limitations.

**3.** **Charitable contributions for donated clothing were reduced from the claimed $49,000 to $9,000 because she overestimated the value of the gently-worn designer clothing she contributed.** Stamoulis v. Commissioner, T.C. Summ. Op. 2007-38 (3/8/07). A Goldman Sachs investment banker with an AGI under $115,000

claimed a $55,764 charitable contribution deduction on her 2002 federal income tax return. The Tax Court (Special Trial Judge Carluzzo) reduced the amount claimed for contributions of designer clothing from $49,000 to $9,000 but did not impose the negligence penalty for her overstatement of the fair market values of the donated property, because the determination of the fair market value of personal items is "less than an exact science."

- In relation to the values claimed by Bill Clinton for his used underwear, Ms. Stamoulis was conservative. Compare the size of the deduction Monica might have received had she donated her blue dress with white polka dots.

**4. One of Timothy McVeigh's lawyers loses again, but the consequences are not as severe this time.** Jones v. Commissioner, 129 T.C. 1466 (11/1/07). Sherrel Jones, one of Timothy McVeigh's lawyers in the criminal proceeding stemming from the Oklahoma City Federal Building bombing, donated to the University of Texas copies of documents received by him from the government in the course of his representation of Timothy McVeigh and claimed a charitable contribution deduction for the appraised value. Judge Cohen upheld the IRS's disallowance of any deduction on the ground that under the relevant state law (Oklahoma), the materials were not attorney work product and not being attorney work product, the client, not the lawyer, was the owner of the materials in the case file. Because the taxpayer "was not the legal owner of the materials, he was not legally capable of divesting himself of the burdens and benefits of ownership or effecting a valid gift of the materials." Alternatively, even if the material in the file was attorney work product, by virtue of § 1221(a)(3) it was an ordinary income asset, and thus under § 170(e)(1)(A) the deduction was limited to basis, which was zero.

## X. TAX PROCEDURE

### A. Interest, Penalties and Prosecutions

**1. "Too good to be true?" Common frivolous positions that can result in frivolous return penalties, § 6662 penalties, or civil fraud penalties.** Rev. Rul. 2007-19, 2007-14 I.R.B. 843 (4/2/07) (claiming that wages are not taxable income); Rev. Rul. 2007-20, 2007-14 I.R.B. 863 (4/2/07) (claiming that complying with the internal revenue laws is voluntary and that taxpayers are not legally required to file federal tax returns or pay federal tax because the filing of a tax return or the payment of tax is a matter of choice); Rev. Rul. 2007-21, 2007-14 I.R.B 865 (4/2/07) (claiming that before the IRS may collect overdue taxes, it must provide taxpayer with a summary record of assessment made on a Form 23C,

Assessment Certificate-Summary Record of Assessments, or on another particular form); Rev. Rul. 2007-22, 2007-14 I.R.B 866 (4/2/07) (claims by taxpayers that they are not subject to federal income tax, or that their income is excluded from taxation, because either (1) they claim to have rejected or renounced United States citizenship and are citizens exclusively of a state (sometimes characterized as a "natural-born citizen" of a "sovereign state"), or (2) they are not persons as identified by the Internal Revenue Code).

**a.** Notice 2007-30, 2007-14 I.R.B. 883 (4/2/07) (updating list of frivolous return positions).

**2. What is a qualified amended return, and what can it do for the taxpayer submitting it?** T.D. 9309, Qualified Amended Returns, 72 F.R. 902 (1/9/07). 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.

**3.** 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.

**4. The continuing troubles of Marion Barry.** <u>United States v. Barry</u>, 477 F. Supp. 2d 146 (D. D.C. 3/12/07). A magistrate denied the Government's motion to revoke the probation of Marion Barry on the grounds that Mr. Barry failed to file Federal and District of Columbia tax returns while on probation pursuant to a plea agreement to two counts of

failure to file returns. The magistrate ruled that under the rules of the court, the court would entertain a motion to revoke probation only on the request of the Probation Office, which was not involved in the proceeding. Mr. Barry also represented through counsel that the returns had been filed.

**a. But the District Court Chief Judge disagrees. He reverses and remands, so go to jail--maybe.** United States v. Barry, 99 A.F.T.R.2d 2007-2484 (D. D.C. 4/26/07). Notwithstanding that the "long standing practice" of the court is to schedule probation revocation hearings only on motion of the probation office, Chief Judge Hogan ruled that neither the Federal Rules of Criminal Procedure nor the Local Criminal Rules indicate who is empowered to move for probation revocation proceedings. He reversed the magistrate's dismissal of the revocation motion and remanded the case for a decision on the merits.

**5. Death and taxes are a certainty. Abusive shelter penalties survive the death of the promoter!** Reiserer v. United States, 479 F.3d 1160 (9th Cir. 3/20/07). A tax shelter promoter and his law firm promoted an abusive tax arrangement known as offshore employee leasing. The promoter died after the IRS had issued a summons to the promoter's and law firm's bank as part of an investigation into whether penalties should be imposed on the promoter. The Ninth Circuit held that liability for a § 6700 penalty for promoting abusive tax shelters and for a § 6701 penalty for aiding and abetting the understatement of tax liability would survive the death of the attorney against whom the penalties are sought to be imposed because those penalties are civil, not criminal. On another issue, the attorney-client privilege did not protect the identity of clients of the attorney under investigation for promoting abusive tax shelters and aiding and abetting understatement of tax liability because revealing the clients' identities would not disclose communications between the attorney and clients. In addition, a subpoena on a bank to produce all checks deposited and drawn on the attorney's trust account was enforced. The tax shelters involved were offshore employee leasing arrangements.

**6. Criminal conviction reversed and remanded: The trial court should have let the defendant testify about consulting tax experts.** United States v. Moran, 493 F.3d 1002 (9th Cir. 7/6/07), *amending and superseding* 482 F.3d 1101 (9th Cir. 4/2/07). Pamela and James Moran were convicted, among other things, of conspiracy to defraud the United States, as well as aiding and assisting — don't you love legal redundancies? — in the preparation and filing of false federal income tax returns. The Morans were the "Executive Education Officers" who trained the sales force of Anderson's Ark and Associates. The company offered several forms of

tax reduction plans that generally involved shifting funds through Costa Rica entities and not paying taxes. The trial court sustained the government's hearsay objection to Mrs. Moran's testimony regarding advice she had received from a CPA and testimony regarding legal opinions she received about the tax program. The testimony was offered not for the truth of what was told to Mrs. Moran, but as evidence of her good faith reliance on the advice of experts as a defense against the willfulness of her actions, and was, therefore, not hearsay. The Ninth Circuit concluded that the error was not harmless error. The court rejected defendants' claims that the trial court erred in allowing expert testimony that the marketed transactions were shams, by giving an improper *Pinkerton* instruction to the jury, i.e., each member of a conspiracy may be convicted of a crime committed by another member, and by admitting computer records of a co-conspirator as statements.

**7. A unanimous Supreme Court resolves another pressing tax issue because the Circuits disagreed over who has authority to abate interest.** Hinck v. United States, 127 S. Ct. 2011 (5/21/07). Section 6404(e)(1) permits the Commissioner to abate interest on a deficiency attributable to unreasonable error by the IRS. Section 6404(h) provides that the Tax Court has jurisdiction to determine whether failure to abate interest was an abuse of discretion. (Relief is not available to taxpayers whose net worth exceeds $2 million or who own a business worth in excess of $7 million. § 7430(c)(4)(A)(ii).) The Supreme Court held that § 6404(h) grants exclusive jurisdiction over interest abatement to the Tax Court. The District Courts and Court of Federal Claims do not have jurisdiction to review interest abatement claims under their general jurisdiction over refund claims. The decision affirms the Federal Circuit's holding in the case, which conflicted with the Fifth Circuit's opinion in *Beall v. United States,* 336 F.3d 419 (2003).

**8. The standard for preparer penalties is broadened to include preparers of all tax returns, and is heightened from "realistic possibility of success" to "more likely than not."** The **2007 Act**, § 8246, amends Code §§ 6694 and 7701 to expand the applicability of the § 6694 return preparer penalties from "income tax return preparers" to all tax return preparers. It also heightens the standards of conduct to avoid the imposition of the return preparer penalty for undisclosed positions with a requirement that there be a reasonable belief that the tax treatment of the position was "more likely than not" the proper treatment. For disclosed positions, the standard is increased from "non-frivolous" to "reasonable basis." Penalty amounts are increased from $250 to the greater of $1,000 or 50 percent of the income to be derived by the

preparer under § 6694(a), and from $1,000 to the greater of $5,000 or 50 percent of the income to be derived by the preparer under § 6694(b). These changes are effective for tax returns prepared after 5/25/07.

**a. But practitioners will be given a pass under the new rules for the rest of 2007.** IR-2007-115 and Notice 2007-54, 2007-27 I.R.B. 12 (7/2/07). This Notice provides transitional relief for all returns, amended returns and refund claims due on or before 12/31/07, to estimated tax returns due on or before 1/15/08, and to employment and excise tax returns due on or before 1/31/08. The transitional relief is that the standards set forth under previous law and current regulations will be applied in determining whether the IRS will impose penalties under § 6694(a), but the transitional relief is not available for penalties under § 6694(b), which applies to return preparers who exhibit "willful or reckless conduct."

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

**c.** Three subsequent notices released on 12/31/07 clarified Notice 2007-54.

**(1)** Notice 2008-11, 2008-3 I.R.B. 279 (1/22/08). This Notice provides that advice given before 1/1/08 by nonsigning preparers will be governed by standards under former § 6694.

**(2)** Notice 2008-12, 2008-3 I.R.B. 280 (1/22/08). This Notice specifies which returns require a preparer signature and which returns do not.

**(3) A notice temporarily relaxes the requirements on practitioners, but it is puzzling in places and is not a free pass.** Notice 2008-13, 2008-3 I.R.B. 282 (1/22/08). This Notice provides interim guidance on the application of the tax return preparer penalties as amended by the **2007 Act**. These amendments did not modify the exception to liability under § 6694 that is applicable when it is shown,

considering all the facts and circumstances, that the tax return preparer has acted in good faith and there is reasonable cause for the understatement.

- The Notice provides that a tax return preparer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment (without taking into account the possibility that the tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled) if the tax return preparer analyzes the pertinent facts and authorities in the manner described in Reg. § 1.6662-4(d)(3)(ii) and, in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS.

- It further provides that a tax return preparer may rely in good faith without verification upon information furnished by the taxpayer, as provided in Reg. § 1.6694-1(e). In addition, a tax return preparer may rely in good faith and without verification upon information furnished by another advisor, tax return preparer, or other third party. A tax return preparer will be found to have acted in good faith when the tax return preparer relied on the advice of a third party who is not in the same firm as the tax return preparer and who the tax return preparer had reason to believe was competent to render the advice.

- A *signing tax return* preparer shall be deemed to meet the requirements of § 6694 with respect to a position for which there is a reasonable basis but for which the tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits, if the tax return preparer meets any of the following requirements:

> 1. The position is disclosed in accordance with § 1.6662-4(f) (which permits disclosure on a properly completed and filed Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, as appropriate, or on the tax return in accordance with the annual revenue procedure described in § 1.6662-4(f)(2));
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> 2. If the position would not meet the standard for the taxpayer to avoid a penalty under section 6662(d)(2)(B) without disclosure, the tax return preparer provides the taxpayer with the prepared tax return that includes the disclosure in accordance with § 1.6662-4(f);
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> 3. If the position would otherwise meet the requirement for nondisclosure under section 6662(d)(2)(B)(i), the tax return preparer advises the taxpayer of the difference between the

> penalty standards applicable to the taxpayer under section 6662 and the penalty standards applicable to the tax return preparer under section 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided; or
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> 4. If section 6662(d)(2)(B) does not apply because the position may be described in section 6662(d)(2)(C), the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662(d)(2)(C) and the difference, if any, between these standards and the standards under section 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided.

- A *nonsigning tax return preparer* shall be deemed to meet the requirements of § 6694 with respect to a position for which there is a reasonable basis but for which the nonsigning tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits, if the advice to the taxpayer includes a statement informing the taxpayer of any opportunity to avoid penalties under § 6662 that could apply to the position as a result of disclosure, if relevant, and of the requirements for disclosure
- One of the examples has raised a good bit of interest.

> Example 10. A corporate taxpayer hires Accountant J to prepare its tax return. Accountant J encounters an issue regarding various small asset expenditures. Accountant J researches the issue and concludes that there is a reasonable basis for a particular treatment of the issue. Accountant J cannot, however, reach a reasonable belief whether the position would more likely than not be sustained on the merits because it was impossible to make a precise quantification regarding whether the position would more likely than not be sustained on the merits. The position is not disclosed on the tax return. Accountant J signs the tax return as the tax return preparer. The IRS later disagrees with this position taken on the tax return. Accountant J is not subject to a penalty under section 6694.

- Anita Soucy, spokesperson for the Treasury Office of Tax Policy explained at a New York State Bar Association meeting that Example 10 should not be relied on because it is a sympathetic

case with mitigating circumstances. Deborah Butler echoed that statement at the same meeting, saying: "The rules aren't in the examples," and "Don't overdiagnose the examples. They're not going to be there in a year." 2008 TNT 24-8.

- It is important to note that the regulations expected to be finalized in 2008 may be substantially different from the rules described in this Notice, and in some cases more stringent.

**9. A new penalty is imposed upon refund claims made without a "reasonable basis."** The **2007 Act**, § 8247(a), adds new Code § 6676 to impose a penalty of 20 percent of the "excessive amount" on the person making an erroneous claim for refund or credit unless it is shown that "the claim for such excessive amount has a reasonable basis." The penalty does not apply to claims relating to the § 32 earned income credit. The penalty applies to claims made after the 5/25/07 effective date of the 2007 Act.

**10. In this case, the result of any amount multiplied by zero is greater than 400 percent of zero.** McDonough v. Commissioner, T.C. Memo. 2007-101 (4/25/07). If the taxpayer claims cost recovery allowances with respect to property to which he never received the benefits and burdens of ownership or with respect to property that never existed, the correct basis is zero. Pursuant to Reg. § 1.6662-5(g), the basis claimed on his return is considered to be 400 percent or more of the correct amount, and the enhanced accuracy related penalty (40 percent of the tax deficiency) for gross valuation misstatements under § 6662(h) applies.

**11. When valuation storms became threatening, the estate sought an Anchorage "in a remote location." Should it be penalized for doing so?** Estate of Thompson v. Commissioner, 499 F.3d 129 (2d Cir. 8/23/07), *vacating and remanding* T.C. Memo. 2004-174. At her death in 1998, decedent owned about 20 percent of a closely held company that produced business-to-business industrial and manufacturing directories and publications. However, the advent of the internet caused the profitability of the business to decline sharply from 2000 to barely break-even in 2002. The IRS valued decedent's interest in the company at $32 million, the estate valued it at $1.75 million, and the Tax Court (Judge Swift) valued it at $13.5 million. However, even though the claimed valuation was less than 150 percent of the value determined by the Tax Court, it declined to impose the § 6662(a) substantial undervaluation penalty of 40 percent of the underpayment because the valuation "was particularly difficult and unique" and the Court's own valuation was "closer to the estate's valuation than to [the Commissioner's] valuation."

• The Second Circuit held that this did not constitute a sufficient finding to support a determination that the § 6664(c) reasonable cause and good faith exception to the penalty applied. Chief Judge Jacobs questioned the estate's decision to hire a lawyer and accountant to perform the appraisal from the "remote location" of Anchorage, Alaska in order to achieve a more favorable valuation from the IRS office in Alaska than would be available from the IRS office in New York. The lawyer was experienced but conflicted because he was also appointed to act as administrator of the estate to handle the anticipated IRS audit, and the accountant who helped the lawyer with the appraisal "belong[ed] to no professional organizations or associations relating to his appraisal or valuation work."

**12. You do the crime, you do time! One year in a half-way house, five years probation, and a $10,000 fine is too lenient.** United States v. Taylor, 499 F.3d 94 (1st Cir. 8/17/07). In an opinion by Judge Torruella, the First Circuit vacated a tax return preparer's sentence of one year in a half-way house, five years probation and a $10,000 fine as unreasonably lenient, and remanded the case for resentencing. The tax return preparer, who was a full time school teacher and part time return preparer, was convicted on sixteen counts of aiding and abetting the filing of false returns, resulting from false claims of charitable contributions in amounts ranging from $9,000 to $16,000, about which he advised his clients to lie to IRS agents. The court noted, that the "offense ... is a serious crime ... at it's heart, it is theft, specifically theft of money to which the public is entitled," and that "the tax fraud committed here was not part of an indigent's effort to avoid personal tax liability, but rather, the supplemental business of a moderately successful man who misled his clients."

**a. Then again, maybe you don't have to do time for a tax crime**. Taylor v. United States, 128 S. Ct. 878 (1/7/2008). The Supreme Court vacated the judgment and remanded the case to the First Circuit Court of Appeals for further consideration in light of *Gall v. United States*, 128 S. Ct. 586 (2007), which held that there is no rule that requires "extraordinary" circumstances to justify sentence outside Guidelines range.

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

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

**a. But the court has second thoughts about jailing tax cheats.** Rehearing granted and opinion vacated, 513 F.3d 360 (3d Cir. 1/17/08).

**15. Even if Yaweh might oppose war and taxes that fund it, it's still criminal tax fraud to fail to render unto Caesar.** United States v. McKee, 506 F.3d 225 (3d Cir. 10/29/07). The Third Circuit (ironically, Judge McKee) upheld the conviction under § 7201 for tax evasion by two partners who failed to withhold and pay over income taxes and employment taxes with respect to employees, who like the partners, were members of the Reformed Israel of Yaweh (RIY), a small religious sect that opposes payment of taxes based upon the members' religious opposition to war and the taxes that fund it. One partner (Donato) and his wife (Inge Donato), who was the partnership's bookkeeper, signed the fraudulent Forms 941, and one or both partners distributed the "untaxed" paychecks to employees who were RIY members and "taxed" paychecks to employees who were not RIY members. When providing the partnership's payroll records to accountants for preparation of Forms 941, Inge Donato omitted payroll information for the employees who were members of RIY. For purposes of § 7201, the overt acts of the Donatos on behalf of the partnership were imputed to McKee because he shared the obligation of filing and paying employment taxes on behalf of the partnership. Furthermore, "even if [the defendants'] failure to accurately report the total wages subject to employment taxes was motivated by their desire to respect their employees' religious convictions, that 'innocent' motive does not exempt Defendants from their obligation to deduct federal taxes and accurately report the wages subject to that tax, particularly since the cornerstone of the tax system is voluntary self-reporting."

### B. Discovery: Summonses and FOIA

**1. Honi soit qui mal y pense.** United States v. BDO Seidman, LLP, 95 A.F.T.R.2d 2005-1725 (N.D. Ill. 3/30/05). The district court ruled that only one of 267 documents withheld from IRS scrutiny by

the intervenors was not protected by privilege or work product, or both.[9] 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 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.** 95 A.F.T.R.2d 2005-2835 (N.D. Ill. 5/17/05). Subsequently, 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

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

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.

**b. On appeal of Judge Holderman's decisions to the Seventh Circuit, Judge Ripple did not make waves but simply decided in favor of the government. He affirmed in part and vacated and remanded in part.** United States v. BDO Seidman, LLP, 492 F.3d 806 (7th Cir. 7/2/07). The Seventh Circuit (Judge Ripple) affirmed that document A-40 was unprotected by privilege because it fell within the fraud-crime exception. Judge Ripple rejected the IRS's position that the party asserting the § 7525 privilege must establish that the communication was not made in connection with the promotion of a tax shelter, and has held that the opponent of the IRS bears the burden of establishing that the communication falls within the § 7525(b) exception.

- He vacated the decision that 266 documents fell within a valid claim of privilege and remanded with respect to these documents so that the IRS could have the opportunity to show that the § 7525(b) tax shelter exception to the tax practitioner privilege applied.

**2. If the valuation is fraudulent, the crime-fraud exception to the attorney-client privilege will sting!** Shahinian v. Tankian, 242 F.R.D. 255 (S.D.N.Y. 5/7/07). In a civil suit involving an estate regarding the ownership, transfer by gift or sale, and valuation of paintings by an artist, the court (Judge Castel) applied the crime-fraud exception to the attorney-client privilege to allow discovery of communications between the legatees and executors of two estates (and a friend of the legatees / executors) and Weil, Gotshal & Manges, the law firm for the estates. The exception applied because the communications related to the fraudulent valuation and omission of art works on income tax and estate tax returns, and other statements made to the IRS. The record contained a relevant estate tax return, written statements made to the IRS in the course of an audit of that return, relevant income tax returns, and applications for extensions of time to pay certain taxes, as well as excerpts from the depositions of several witnesses and "documentary evidence demonstrating material variances between the statements made to the IRS and the actual facts." The court concluded that "comparing the estate and income tax returns and other communications with the IRS with the information collaterally developed in discovery ... cast significant doubt on the truthfulness of the statements made to the IRS, and the circumstances are sufficient to support the conclusion that communications ... were intended to facilitate the crime or fraud."

**3. Warm up the photocopier for those tax accrual workpapers.** Announcement 2002-63, 2002-27 I.R.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, 2001-34 I.R.B. 190, 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 audited 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, 2005-9 I.R.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.

**d. The work product doctrine works in the Sixth Circuit.** United States v. Roxworthy (Yum! Brands, Inc.), 457 F.3d 590 (6th Cir. 8/10/06). In response to an IRS informal document request, Yum 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 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.

**(1)** AOD 2007-04 (10/1/07). The IRS announced its nonacquiescence in *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006). The IRS took the position that a document prepared in anticipation of its annual audit by a CPA firm is not "prepared in anticipation of litigation," and that, *a fortiorari*, tax opinion letters prepared by KPMG to provide advice "with respect to the tax implications of forming a captive insurance company" prior to the formation of that company and provided by Yum! Brands to its CPA during its annual audit were not protected by the work product doctrine. The IRS further announced that it will challenge "unjustified assertions of the work product doctrine (and other privileges) in all appropriate cases, including those that would be appealable to the Sixth Circuit."

**e. District Court finds tax accrual workpapers protected by the "work product privilege" and denies the IRS petition for summons enforcement.** United States v. Textron Inc., 507 F. Supp. 2d 138 (D. R.I. 8/28/07). Textron engaged in six SILO transactions in 2001 before these became listed transactions in 2005. Under IRS procedures, engaging in more than one listed transaction means that the IRS will request the entire tax accrual workpapers file. Textron produced documents with respect to the SILO transactions but refused to turn over its entire workpaper file. Judge Torres held that the tax accrual workpapers were prepared "because of" anticipated litigation with the IRS. He refused to follow contrary authority from the Fifth Circuit in *United States v. The El Paso Company*, 682 F.2d 530 (1982), which used the more stringent primary

purpose test for determining whether documents are prepared "in anticipation of litigation." He also held that work product protection was not lost when the tax accrual workpapers were provided to Ernst & Young for its audit of the company because the AICPA Code § 301 on confidential client information made it very unlikely that the accounting firm would provide them to the IRS.

**4. The government also has privileges.** Deseret Management Corp. v. United States, 76 Fed. Cl. 88 (3/29/07). After the court's *in camera* review, taxpayer's motion to discover certain documents was denied on the basis of the attorney-client privilege applicable to communication among Justice Department lawyers, IRS lawyers, and IRS employees. Also, documents prepared in anticipation of litigation were protected from disclosure as work product.

**a. Work product privilege applies to IRS Chief Counsel's work too!** Ratke v. Commissioner, 129 T.C. 45 (9/05/07). After the taxpayer substantially prevailed of the merits of an asserted deficiency, the taxpayer sought attorney's fees. In the attorney's fees proceeding, the taxpayer sought discovery of a memorandum sent by the IRS Chief Counsel's trial counsel to the national office at the time the Commissioner's answer was filed in the case, and an unredacted version of the responding memorandum sent a few months later by IRS Chief Counsel's national office were protected by the work product doctrine from discovery by taxpayer's counsel. A redacted version of the latter memorandum, which contained fact-based work product, but not opinion based work product, had been provided to taxpayer's counsel. The Tax Court (Judge Chabot) held that the memoranda were protected from discovery under the opinion work product doctrine. The IRS's reference, in its brief in opposition to the taxpayer's motion for attorney's fees, to a pretrial exchange of memoranda between the IRS trial counsel and the IRS national office, did waive the work product privilege, because the reference in the brief was in the course of reciting the sequence of events leading to disclosure of redacted versions of memoranda, and was not testimonial in nature, i.e. it was not intended to show that IRS's position in case was substantially justified. Neither of the memoranda, both of which were examined *in camera*, contained information sufficiently important to outweigh the privacy and other concerns underlying the work product doctrine. The redacted version of the response memorandum and the IRS's summary of the unredacted version, which was provided to the taxpayer, together provided a fair representation of the legal strategies and opinions in the unredacted version memorandum. Because the taxpayer was given a fair representation of the unredacted legal strategies and opinions, and the

redacted portions would not impact the outcome of the motion for attorney's fees, the taxpayer did not have a compelling need to discover the opinion work product.

**5.** Snider v. United States, 468 F.3d 500 (8th Cir. 11/8/06). The court held that a CID agent's disclosures to third-party witnesses that included taxpayers' identities and a statement that the taxpayers were the subjects of grand jury investigation, were unauthorized disclosures under § 6103, and that the disclosures were neither necessary nor the result of good faith interpretation of § 6013 under § 7431. Each disclosure of each item of information to each person who heard disclosure counted as an "act" in calculating the $1,000 per act.

**a.** AOD 2007-03 (7/23/07). The IRS has nonacquiesced in *Snider v. United States*. The IRS considers it necessary to disclose the name of the taxpayer being investigated to efficiently interview third-party witnesses. The IRS will continue to litigate the position that neither the number of return items nor the number of people witnessing disclosure is a "legally significant factor."

**6. Tax Analysts continues successfully to be "respectfully disagreeable" with the IRS on disclosure issues.** Tax Analysts v. Internal Revenue Service, 495 F.3d 676 (D.C. Cir. 7/24/07). The court (Judge Henderson) affirmed a district court order, 416 F. Supp. 2d 119 (D. D.C. 2/27/06), granting summary judgment for Tax Analysts in its suit under § 6110 seeking disclosure of e-mails from lawyers in the IRS Chief Counsel's Office to field personnel containing legal advice. The request dealt with "all written legal advice documents, whether or not styled CCA, prepared by National Office components of OCC for the field, and which have been withheld from public disclosure on the ground that such written advice 'can be rendered in less than two hours,' or that such documents 'can be prepared in less than two hours.'" Judge Henderson held that e-mails clearly fell under the § 6110(i)(1)(A) definition of Chief Counsel Advice (CCA), as "written advice or instruction, *under whatever name or designation*, prepared by *any* national office component of the Office of Chief Counsel ... issued to field or service center employees of the Service or regional or district employees of the Office of Chief Counsel [which] conveys ... *any* legal interpretation of a revenue provision." She rejected the IRS's arguments that "informal advice" or advice rendered in a short time-frame was exempt from disclosure: "It requires no particular form or formality. Nor does it distinguish between advice a lawyer renders in less than two hours and advice that takes longer than two hours to prepare."

**7. The work product privilege claim didn't work, but the § 7525 privilege claim did.** Valero Energy Corp. v. United States, 100 A.F.T.R.2d 2007-6473 (N.D. Ill. 8/23/07). Valero sought to quash summonses issued by the IRS to Valero's tax advisor, Arthur Andersen, relating to certain branch transactions, foreign currency transactions, dual consolidated losses, overall foreign losses, and hedge positions in connection with fluctuation risks. The court (Judge Kennelly) rejected Valero's claim that the documents were protected by the work product doctrine. He found that the documents were "best categorized as having been prepared during the ordinary course of business, with the possibility of future litigation being secondary at most." He concluded that "Valero confuse[d] the possibility of litigation with the requirement that to be protected, a document must have been prepared *because* of anticipated litigation. The fact that Valero hired Arthur Andersen with an eye toward the complex nature of the transaction, and the possibility that the IRS might investigate, does not support a contention that Arthur Andersen prepared its materials because Valero or Andersen anticipated actual litigation." Under Seventh Circuit precedent, the work product doctrine applies only when "the document can fairly be said to have been prepared or obtained *because* of the prospect of litigation." *Logan v. Commercial Union Ins. Co.*, 96 F.3d 971, 976–77 (7th Cir. 1996) (emphasis in original). However, the documents were protected under the § 7525 tax practitioner's privilege as "confidential tax advice." Even though it had the effect of avoiding federal income taxes, the tax shelter exception in § 7525(b) did not apply for two reasons. First, as the taxpayer asserted, "the transactions in question did not involve the promotion of tax shelters"; nothing in the record indicated that Arthur Andersen had anything to do with "promotion" of participation in a tax shelter. Second, the tax shelter exception only applies to a transaction in which tax avoidance is a "significant purpose," and not where tax avoidance is merely "one of the purposes of the transaction." Nothing in the record indicated the purpose of the transactions. (Under Seventh Circuit precedent, *United States v. BDO Seidman, LLP*, 492 F.3d 806 (7th Cir. 6/2/07), "the burden rests on the opponent of the privilege to prove preliminary facts that would support a finding that the claimed privilege falls within an exception.")

## C. Litigation Costs

**1. The Russians are coming! The Russians are coming!** Pacific Fisheries, Inc. v. United States, 484 F.3d 1103 (9th Cir. 4/17/07). The government's position was not "not substantially justified" where in taxpayer's suit to quash a subpoena, the IRS withdrew the

subpoena, which it had issued at the behest of the Russian government, before an answer was due. Attorney's fees were not awarded to the taxpayer.

**2. This fees assessment was against taxpayer's lawyer because he knew the case had no merit.** Davis v. Commissioner, T.C. Memo. 2007-201 (7/24/07). The Tax Court (Judge Halpern) imposed a $25,800 sanction under § 6673(a)(2) on taxpayers' lawyer for excess attorney's fees the IRS incurred as result of his "abuse of the judicial process" by "unreasonable and vexatious multiplication" of taxpayer's CDP proceedings, including signing pleadings and other papers knowing taxpayer's claims to be meritless.

**a. Different taxpayer, same lawyer, same merits and arguments, same judge, substantially similar result.** Gillespie v. Commissioner, T.C. Memo. 2007-202 (7/24/07). This time the lawyer's sanction was only $12,798. Only a $5,000 sanction was imposed on the taxpayer himself.

**D. Statutory Notice of Deficiency**

There were no significant developments regarding this topic during 2007.

**E. Statute of Limitations**

**1. The taxpayer's conduct was not fraudulent, but maybe he wasn't an innocent babe in the woods either. The return was fraudulent even though the taxpayer did not know it.** Allen v. Commissioner, 128 T.C. 37 (3/5/07). Judge Kroupa held that the statute of limitations for a fraudulent return is extended under § 6501(c)(1), even though it was solely the return preparer, rather than the taxpayer, who had the intent to evade tax. The taxpayer was a truck driver who filed timely returns for the years at issue. He gave his Form W-2, 401(k) statement, mortgage interest statement, and other relevant documents to his return preparer (Goosby) who prepared the returns and filed them. As prepared by Goosby, the returns claimed false and fraudulent itemized deductions for charitable contributions, meals and entertainment, and pager and computer expenses, as well as various other expenses. The taxpayer received complete copies of the returns for the years at issue after they had been filed, but he did not file any amended tax returns. Judge Kroupa reasoned as follows:

> We do not find it unduly burdensome for taxpayers to review their returns for items that are obviously false or incorrect. It is every taxpayer's obligation. Petitioner cannot

> hide behind an agent's fraudulent preparation of his returns and escape paying tax if the Government is unable to investigate fully the fraud within the limitations period.

- She further noted that the IRS was seeking to collect only the deficiency (and interest) from the taxpayer.

**2. Deposit or payment affects limitation on suit for refund.** Huskins v. United States, 75 Fed. Cl. 659 (3/16/07). The taxpayer estate's tax counsel submitted a payment of $165,000 to the IRS that was described in counsel's cover letter as a "payment" of estate taxes. More than three years later the estate filed a return showing zero tax due and requested a refund of the prior payment. The government claimed that refund was barred by the three year limitation period of § 6511. The court concluded that the payment was an "undesignated remittance" treated as a deposit under Rev. Proc. 84-58, 1984-2 C.B. 501, and therefore refundable.

**3. This is indeed a taxing opinion.** Electrolux Holdings, Inc. v. United States, 491 F.3d 1327 (Fed. Cir. 6/20/07). In what the court describes as a "taxing case" the Federal Circuit interpreted § 6511(d)(2)(A), which provides that the 3-year statute of limitations to claim a refund for a year to which a capital loss carryback is allowed is determined from the year in which the loss providing the carryback was recognized rather than the carryback year. The taxpayer incurred a consolidated loss in 1994 that was ultimately allowed when the loss disallowance rules of Reg. § 1.1502-20 were declared invalid in *Rite-Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001). The taxpayer had agreed with the IRS to an extension of the statute of limitations for its 1994 year to 12/31/99. The IRS allowed the taxpayer's claim for refund for its 1994 year, a refund for its 1993 year to which part of the l994 loss was carried back, and refunds for 1996, 1997, and 1998, which were open years when the taxpayer filed its claim for refund on 12/31/99. However, the Federal Circuit agreed with the Commissioner and the Federal Claims Court that § 6511(d)(2)(A) did not permit the taxpayer to claim a refund for 1995. The court rejected the taxpayer's argument that § 6511(d)(2)(A) applied to its 1995 year because the amount of the loss carryforward to that year could not be determined until the loss was carried back to 1993. The court held that the taxpayer's 1995 overpayment was not due to the 1993 carryback and was thus not attributable to the capital loss carryback.

- Cutting to the chase, the essential holding of the case is that § 6511(d)(2)(A) extends the period of limitations for carrying back a loss, but not for carrying forward such loss, where the amount of the allowable loss is finally determined in a year later than it was incurred,

not all of the loss is absorbed in carryback years, and the carryforward year is closed.

**4. Overstating basis is not the same as gross income.** Bakersfield Energy Partners, LP v. Commissioner, 128 T.C. 207 (6/14/07). Overstated basis resulted in an understatement of § 1231 gain. Looking to precedent under the statutory predecessor of § 6501(e) in the 1939 Code (*Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958)), from which the 6-year statute of limitations in § 6229(c)(2) is derived and to which it is analogous, the Tax Court concluded that this understated gain was not an omission of "gross income" that would invoke the 6-year statute of limitations under § 6229(c)(2) applicable to partnership audits.

**a. And the Court of Federal Claims agrees.** Grapevine Imports, Ltd v. United States, 77 Fed. Cl. 505 (7/17/07). In a TEFRA partnership tax shelter case, the Court of Federal Claims (Judge Allegra) held that the § 6501(e) 6-year statute of limitations does not apply to basis overstatements under *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958). Section 6501(e), rather than § 6229(c)(2) as in *Bakersfield Energy Partners, LP*, because in earlier proceedings in the instant case, 71 Fed. Cl. 324 (2006), the court had held that § 6229 did not create an independent statute of limitations, but instead only provides a minimum period for assessment for partnership items that could extend the § 6501 statute of limitations, and because the FPAA was sent within this 6-year statute of limitations under § 6229(d) the statute of limitations with respect to the partners was suspended.

- However, citing *Barenholtz v. United States*, 784 F.2d 375 (Fed. Cir. 1986), the court rejected the taxpayer's argument that because the statute of limitations on 1999 had run, the IRS was barred from adjusting the amount of the NOL carryover from 1999 to 2000, which remained an open year.

**b. But a District Court in Florida disagrees.** Brandon Ridge Partners v. United States, 100 A.F.T.R.2d 2007-5347 (M.D. Fla. 7/30/07). The court refused to follow *Bakersfield Energy Partners* and *Grapevine Imports* and held that the § 6501(e) 6-year statute of limitations does apply to basis overstatements. The court reasoned that as a result of subsequent amendments to the relevant Code sections, the application of *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958) is limited to situations described in § 6501(e)(1)(A)(i), which applies to trade or business sales of goods or services. ("In the case of a trade or business, the term 'gross income' means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return)

prior to diminution by the cost of such sales or services."]. The court reasoned that to conclude otherwise would render § 6501(e)(1)(A)(i) superfluous. Because the transaction at issue was the partnership's sale of stock, which was not a business sale of goods or services, the gross receipts test did not apply. On the facts, the partners and partnership returns (and statements attached thereto), taken together "failed to adequately apprise the IRS of the true amount of gain on the sale of the ... stock." Thus, the partnership did not show that the extended limitations period was inapplicable.

**c. And this time the Court of Federal Claims agrees with the District Court in Florida and disagrees with its own prior opinion (by a different judge) in *Grapevine Imports*.** Salman Ranch Ltd. v. United States, 79 Fed. Cl. 189 (11/9/07), *amended*, 100 A.F.T.R.2d 2007-6893 (12/6/07). The court (Judge Miller) refused to follow *Bakersfield Energy Partners* and *Grapevine Imports* and held that the § 6501(e) 6-year statute of limitations does apply to basis overstatements. Judge Miller reasoned that an understatement of "gain" is an omission of gross income, and that omission can result from a basis overstatement as well as from an understatement of the amount realized. Like the *Brandon Ridge Partners* court, Judge Miller concluded that the application of *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), is limited to situations described in § 6501(e)(1)(A)(i), which applies to trade or business sales of goods or services. ("In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services."). Because the transaction at issue was the partnership's sale of a ranch, which was not a business sale of goods or services, the gross receipts test did not apply. On the facts, the partners' and partnership returns failed to adequately apprise the IRS of the amount of gain (in a variant of the Son of BOSS tax shelter). Accordingly, the partnership did not show that the extended limitations period was inapplicable. The amended order certified and interlocutory appeal and stayed the case pending further court order, because of the split of opinion between *Salman Ranch*, on the one hand, and *Bakersfield Energy Partners* and *Brandon Ridge Partners*, on the other hand.

## F. Liens and Collections

**1. 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 8/17/06 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.

**2.** 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 right to property the 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 Reg. § 301.6330-1, 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 IRS intends to levy. These regulations are applicable to requests for CDP hearings after 11/16/06.

**3. Sometimes small is big.** Schwartz v. Commissioner, 128 T.C. 6 (2/14/07). Judge Ruwe held that a small case proceeding was not available to review a § 6330 collection due process determination regarding the collection of $153,721 of unpaid tax attributable to seven taxable years, even though the unpaid tax attributable anyone taxable year did not exceed $37,315. In contrast to the annual $50,000 jurisdictional limit for a small case proceeding in deficiency cases, pursuant to § 7463(f)(2), the jurisdictional limit on small case procedures with respect to Tax Court review of a § 6330 due process hearing regarding collection of unpaid taxes is $50,000 in the aggregate for all of the years to which the determination relates, regardless of the number of years involved.

**4. It's not the government's fault it doesn't know your address.** Bullard v. United States, 486 F. Supp. 2d 512 (D. Md.

2/26/07). Notice to the taxpayer of his right to a collection due process hearing, addressed to the taxpayer at the address shown on his last filed return, was returned to the IRS as undeliverable. The IRS's responsibility is to serve notice on the taxpayer at the taxpayer's last known address. The onus is on the taxpayer to notify the IRS of any change of address.

**5.** Hansen v. Commissioner, T.C. Memo. 2007-56 (3/8/07). Another investor in a Hoyt tax shelter partnership was found to be able to pay more than is offered in compromise. As the court notes, this is just one of a long line of similar cases brought by investors in Hoyt partnerships involving levies to collect taxes attributable to participation in the partnerships.

**6.** United States v. Ryals, 480 F.3d 1101 (11th Cir. 3/12/07). The § 6331(k)(1) prohibition on making a levy while an offer in compromise is pending does not extend to a continuous levy on the taxpayer's wages that was in place before the offer in compromise was submitted.

**7.** Deutsch v. Commissioner, 478 F.3d 450 (2d Cir. 3/2/07). Even though taxpayer was never sent a deficiency notice, he had an opportunity to dispute the deficiency because the taxpayer's representative, who had a power of attorney, had signed a Form 4549 "Income Tax Examination Changes," consenting to assessment and waiving the right to contest the liability in the Tax Court.

**8. Your accountant is in the hospital with cancer, tough luck. File on time or pay the penalty. And, you only get one bite at the abatement apple.** Lewis v. Commissioner, 128 T.C. 48 (3/28/07). The taxpayer, a plumber, filed his 2002 tax return in January 2004, a little late because, the taxpayer claimed, his accountant who had the taxpayer's documents was hospitalized with stomach cancer. The taxpayer sought to abate the interest and late filing fees on appeal to the IRS, which was denied by the Appeals Officer. Subsequently the taxpayer received a notice of intent to levy, which prompted the taxpayer to request a Collection Due Process Hearing. Under § 6330(c)(4), a person cannot raise an issue in a collection review proceeding that has been considered at a previous administrative or judicial review. Reg. § 301.6330-1(e)(3), Q&A-E2, provides that where the taxpayer has a conference with the Appeals Office the amount of the underlying tax liability cannot be challenged in a collection review proceeding or in the Tax Court. The Tax Court upheld the regulation as valid, and determined that because the taxpayer had an opportunity to dispute the underlying tax liability in the prior procedure, there in the

Appeals Office, he was precluded from raising the issue in the collection action.

**9. It has to hurt a little more.** Smith v. Commissioner, T.C. Memo. 2007-73 (3/29/07). The Commissioner did not abuse his discretion by refusing to accept the taxpayer's offer of $11,552 to compromise an estimated $265,000 tax liability attributable to a Hoyt tax shelter. The appeals officer determined that the taxpayer had the financial wherewithal to pay a higher amount. The taxpayer's claims of having been defrauded, potential financial hardship, and potential future medical claims were not persuasive.

**10. The Justices of the Supreme Court can agree on important tax issues.** EC Term of Years Trust v. United States, 127 S. Ct. 1763 (4/30/07). A unanimous Supreme Court (Justice Souter) held that § 7426(a) is the exclusive remedy for third party wrongful levy claims. A third party who files a claim after the 9-month limitations period has expired is not entitled to pursue a refund action under § 1346(a)(1). The IRS collected over $3 million from trusts established by Elmer and Dorothy Cullers representing tax liabilities against the Cullerses for tax deductions claimed in the 1980s. Almost a year from the date amounts were paid pursuant to the levies, the trusts filed a district court action under § 7426(a) claiming wrongful levies. The district court dismissed the action because it was filed after the 9-month limitation period of § 6532(c)(1) had expired. The trusts then filed a claim for refund with the IRS, which was denied, followed by a suit for refund in the district court. The district court, affirmed by the Fifth Circuit, held that an action under § 7426(a) was the sole remedy available to the trusts, and dismissed the action. The Ninth Circuit had reached a contrary result in *WWSM Investors v. United States*, 64 F.3d 456 (1995). The Supreme Court granted certiorari to resolve the conflict. The Court concluded that the precisely drawn provisions of § 7426(a)(1) preempt the more general refund provision of § 1346(a)(1).

- The Court distinguished *United States v. Williams*, 514 U.S. 527 (1995), which held that a property owner who paid taxes of another to remove a lien could recover the payment through a refund suit, as involving a lien that was not subject to challenge under § 7426(a)(1), not a levy, and limited the holding of *Williams* to cases in which, wholly apart from statute of limitations issues, no remedy other than a refund suit under § 1346(a)(1) is open to the plaintiff. With the post-*Williams* enactment of §§ 6325(b)(4) and 7426(a)(4), providing exclusive remedies to remove a lien in a *Williams*-type situation, there is little left of the *Williams* doctrine.

**11.** T.D. 9344, Change to Office to Which Notices of Nonjudicial Sale and Requests for Return of Wrongfully Levied Property Must Be Sent, 72 F.R. 39737 (7/20/07). Reg. § 301.7425-3T provides revised procedures to obtain discharge of a junior federal tax lien by a nonjudicial sale pursuant to § 7425(b) by providing proper notice to the IRS.

**12. The IRS can't whipsaw a taxpayer out of the right to contest liability in a CDP hearing if no statutory notice was issued. However, "no harm, no foul" so IRS wins.** Perkins v. Commissioner, 129 T.C. 58 (9/13/07). On his tax return, the taxpayer claimed ordinary losses from "day trading" stock. The IRS disallowed the losses in excess of $3,000 (as allowed by § 1211) as a math adjustment pursuant to § 6213(b)(1), and assessed the increased taxes without issuing a deficiency notice. After expiration of the § 6213(b)(2) period to request abatement, the taxpayer appealed the adjustment. While consideration by Appeals was pending, the IRS issued a notice of intent to levy, and the taxpayer timely requested a CDP hearing pursuant to § 6330(a)(3)(B). Before a CDP hearing was scheduled, Appeals responded to the taxpayer's appeal of the adjustment by denying it. At the CDP hearing, the taxpayer was not allowed to challenge the underlying tax liability, on the grounds that the previous submission to Appeals constituted a prior opportunity to dispute the liability under § 6330(c)(2)(B). Upon review, the Tax Court (Judge Gale) held that the taxpayer did not have an "opportunity to dispute" his underlying tax liability within the meaning of § 6330(c)(2)(B), and the taxpayer was entitled to challenge the underlying tax liability in the Tax Court. An "Appeals conference opportunity…[is] not a prior opportunity where, as in this case, the requested conference opportunity is not resolved by Appeals until after the taxpayer has requested, but not received, a section 6330 hearing," because otherwise the IRS "could cut off judicial review in these circumstances by the simple expedient of processing the Appeals consideration of the liability outside section 6330 before offering the section 6330 hearing." On the merits, however, the taxpayer was found not to be eligible for ordinary loss treatment under § 475(f), because he never even attempted an election, so the § 1211(b) limitation applied.

**13. Even a properly addressed deficiency notice does not necessarily preclude challenging the deficiency at a CDP hearing.** Kuykendall v. Commissioner, 129 T.C. 77 (9/25/07). The taxpayer had moved and did not receive a deficiency notice sent to his last known address until only 12 days remained in the 90-day period within which to petition the Tax Court. The taxpayer did not file a Tax Court petition in response to the deficiency notice, which was based on inadequately documented claimed business expenses. After receiving notice of intent to levy, the taxpayer

requested a CDP hearing and attempted to provide documentation to support the claimed deductions. When the taxpayer was denied the opportunity to contest the deficiency at a CDP hearing, the taxpayer petitioned the Tax Court for review. Judge Haines held that the taxpayer was not afforded adequate time to file a petition, and accordingly was not barred from contesting the underlying tax liability at a CDP hearing.

**14. The Tax Court's jurisdiction under § 6330(d) to review CDP determinations is more limited that its jurisdiction under § 6213(a) to review deficiency determinations.** Giamelli v. Commissioner, 129 T.C. 107 (10/30/07) (reviewed opinion, 9-2-8). The majority of the Tax Court, in an opinion by Judge Goeke, held that the Tax Court's jurisdiction under § 6330(d) to review CDP determinations is more limited than its jurisdiction under § 6213(a) to review deficiency determinations. In contrast to deficiency cases, where "taxpayers may raise any issue regarding their tax liability for the period in question regardless of their prior communication of such issues to the Commissioner" because the Tax Court's "role in such cases is for a redetermination of [a] deficiency" and "to determine the amount of [an] overpayment," §§ 6213(a), 6512(b), review in appeals from CDP determinations is limited to issues that "have been raised properly when the Appeals officer made her determination." Applying this rule, the majority applied an earlier version of Reg. § 301.6330-1(f)(2), Q&A-F3 to preclude taxpayer from challenging on appeal to the Tax Court a previously self-assessed liability that was not properly contested in the administrative hearing before the Appeals Division.

- Judge Swift's dissenting opinion (joined by four other judges) raised three arguments against the majority opinion. First, he argued that § 6330(d)(1)(A) confers on the Tax Court "'de novo' review over the 'matter' ... (namely, the underlying tax liability)," and not merely the IRS's determination. "Although titled 'Judicial review of determination' the statutory language in subparagraph (A) that grants our jurisdiction uses the word 'matter,' not 'determination.'" Second, he reasoned that by its reading of Reg. § 301.6320-1(f)(2), Q&A-F3, the majority opinion effectively adopted a jurisdictional restriction that did not harmonize with "the plain language of the statute, its origins, and its purpose." Third, he argued that *Magana v. Commissioner*, 118 T.C. 488 (2002), "prudently left open the possibility that we might consider issues not raised at Appeals because unusual situations may arise where it would make little sense not to consider such issues."

- Judge Vasquez separately dissented on the grounds that "[t]he legislative history establishes that in section 6330 cases Congress intended there to be a trial de novo in the Tax Court, that we can

receive evidence beyond the administrative record, and we may consider issues not raised at the section 6330 hearing."

- Judge Marvel, in a dissent joined by four judges (some of whom also joined in Judge Swift's dissent), argued that because the taxpayer before the court was the estate of the taxpayer, and the estate did not come into existence until after the decedent taxpayer's death following the CDP hearing, that the estate should not be foreclosed from raising issues on appeal not raised by the decedent in the administrative CDP hearing.

**15. "Abrupt" issuance of CDP determination letter is evidence of abuse of discretion.** Blosser v. Commissioner, T.C. Memo. 2007-323 (10/29/07). The Tax Court (Judge Goeke) held that the IRS abused its discretion by failing to consider issues regarding changed financial circumstances that might support consideration of collection alternatives raised by the taxpayer during a CDP hearing. In light of lack of transcript, the "abbreviated" nature of the entry in the Appeals officer's log regarding the telephonic hearing, and the "abrupt decision" by the settlement officer, the Tax Court was "forced to make ... inferences" that "the settlement officer indicates she did not consider the issues petitioner raised during the hearing as required by section 6330(c)(3)(B) before deciding to issue the notice of determination."

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

**17. The Tax Court tries to minimize game-playing by the Baltics in Nevada's answer to Monte Carlo on the Mediterranean.** Baltic v. Commissioner, 129 T.C. 178 (12/27/07). The Tax Court (Judge Holmes) held on summary judgment that taxpayers who received a notice of deficiency but did not file a Tax Court petition could not challenge their underlying tax liability by making an offer-in-compromise based on doubt as to liability ("OIC-DATL") and asking for audit reconsideration because that is a challenge to the "underlying tax liability" that is precluded by § 6330(c)(2)(B) ("The person may also raise at the hearing challenges to the existence or amount of the underlying tax liability

for any tax period if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability"). Judge Holmes held that the settlement officer who conducted the CDP hearing did not abuse her discretion when she referred the OIC-DATL and audit reconsideration request to the proper offices in the IRS, postponed collection by levy until the IRS had considered the OIC-DATL, but sustained the lien in order to give the IRS priority over other creditors.

- The taxpayers were residents of Ohio when they filed their petition, their lawyer is from Bellaire, Texas, and they chose Las Vegas, Nevada as their place of trial.

### G. Innocent Spouse

**1. Sometimes it really is just too darn late to raise an innocent spouse claim.** United States v. Boynton, 99 A.F.T.R.2d 2007-920 (S.D. Cal. 2/1/07). A claim for innocent spouse relief cannot be raised in a suit by the government to reduce to judgment a tax assessment.

**2. Innocent even though she knew the taxes weren't being paid.** Farmer v. Commissioner, T.C. Memo. 2007-74 (3/29/07). The IRS abused its discretion in denying innocent spouse relief to petitioner even though she worked in the ex-husband's business and was aware that taxes reflected on the joint return that she signed were not being paid. Factors favoring the petitioner included the fact that she was divorced from her ex-husband when she sought relief, the petitioner received no significant benefit from the money derived in the husband's business, the petitioner would suffer significant hardship even though she had remarried (her liabilities would prevent the petitioner from paying basic living expenses from her own resources), even though the petitioner knew the taxes were not being paid, the ex-husband had complete control over the business receipts and the petitioner had no direct access, and the tax underpayment was attributable to the ex-husband, not the petitioner.

**3. The bankruptcy petition of an ex-spouse does not bar the Tax Court from considering whether the other spouse is innocent.** Kovitch v. Commissioner, 128 T.C. 108 (4/4/07). The petitioner filed for relief from joint liability for a deficiency arising out of the 2002 tax year. She and her husband divorced after 2002. The ex-husband filed a petition to intervene in the action to eliminate the petitioner's joint liability. Shortly after filing the petition to intervene, the ex-husband filed for bankruptcy. The Tax Court held that the automatic stay of 11 U.S.C. § 362(a), which operates to bar "actions against or concerning the debtor or

property of the debtor," does not preclude consideration of the other spouse's petition for innocent spouse relief. The innocent spouse petition does not affect the ex-husband's joint and several tax liability. The Tax Court recognized, however, that granting innocent spouse relief could have a financial impact on the ex-husband.

**4. The IRS and the spouse agree that she's innocent, but the abusive ex complains.** Wilson v. Commissioner, T.C. Memo. 2007-127 (5/21/07). The petitioner and the IRS agreed that innocent spouse relief should be granted even though she was involved in her husband's business. The petitioner provided designs that were etched into engraved stones sold to customers. Intervenor husband maintained all of the business records and handled all of the money, although petitioner had signature authority over the business checking accounts. The Tax Court (Judge Haines) found that the intervenor maintained control of the business, that the intervenor was abusive, and demanded to have absolute authority over all financial aspects of the marriage and the business. The petitioner was not allowed to review business records or tax returns. The intervenor conceded that deficiencies arising from disallowed business expenses and increased employment taxes were attributable to him. The court concluded that innocent spouse relief was appropriate even if the petitioner had actual knowledge because of the abuse present in her relationship with intervenor.

**5. Small case status is determined differently for stand-alone innocent spouse petitions than it is for deficiency cases.** Petrane v. Commissioner, 129 T.C. 1 (7/24/07). Judge Ruwe held that for purposes of qualifying a § 6015(e) petition for review of the IRS's denial of innocent spouse relief as a small case under § 7463, the $50,000 threshold is determined by including the total amount of taxes, interest, and penalties (including accrued but unassessed interest and penalties) for all years as of the date the petition was filed. When the petition was filed, the amount for which the taxpayer sought relief did not exceed $50,000 for any single year, but the total of the amounts for all years did exceed $50,000. Because the total amount of relief the taxpayer sought for the years in issue exceeded $50,000, she was not eligible to proceed as a small case.

**a.** Schwartz v. Commissioner, 128 T.C. 6 (2/14/07). Judge Ruwe reached a similar conclusion in this case, which held that a small case proceeding was not available to review a § 6330 collection due process determination regarding the collection of more than $50,000 of unpaid tax attributable to multiple taxable years, no one of which had more than $50,000 in controversy.

**6. A trusting, but skeptical, wife earns innocent spouse relief from her husband's Hoyt hell.** Juell v. Commissioner, T.C. Memo. 2007-219 (8/8/07). The Tax Court (Judge Swift) held that the taxpayer was entitled to complete innocent spouse relief under § 6015(b), not merely apportioned relief under § 6015(c), with respect to a deficiency attributable to her husband's investment in a Hoyt cattle tax shelter. The taxpayer (1) was not involved in the preparation of the joint returns, (2) her husband told her, and she believed that because they were married they had to file joint tax returns, (3) her husband told her that because he was involved in the Hoyt partnerships, she was required to sign the documents attached to the returns relating to the Hoyt partnerships, relying on her husband, she signed the returns and attached materials, despite having not read them, because she felt she did not know enough to understand them. The taxpayer objected to signing the tax returns and asked her husband to get out of the Hoyt partnership investments. She reluctantly signed the tax returns only after her husband reassured her that tax professionals had prepared them and that she was required to sign. The taxpayer's standard of living remained constant, there were no lavish expenditures that benefited her, and she did not receive any benefit from the tax refunds and the tax reductions based on the Hoyt partnerships.

**7. It's what you know when you sign the original return, not when you sign the amended return, that determines what you know.** Billings v Commissioner, T.C. Memo. 2007-234 (8/16/07). Judge Holmes held that the IRS abused its discretion in denying equitable relief to the petitioner with respect to taxes on his spouse's embezzlement income. The petitioner had no knowledge of the embezzlement income at the time the original joint return was filed, but knew of it, and knew the taxes would not be paid, when on the advice of an attorney, he and his wife filed an amended return reporting the embezzlement income. Knowledge of income at the time the amended return was filed was not a negative factor because petitioner could have been accorded relief under § 6015(b) if, instead of an amended return having been filed, the IRS had audited the original return and asserted a deficiency. Petitioner received no benefit from the embezzlement income. The sole factor against granting relief – that petitioner would not suffer economic hardship – standing alone was not a sufficient ground for denying relief.

**8. Even a dead not-so-innocent spouse has standing to intervene, because "the Internal Revenue Code makes sure that taxes survive even death."** Fain v. Commissioner, 129 T.C. 89 (10/2/07). Suzanne Fain petitioned the Tax Court when the Commissioner refused to grant her innocent spouse relief from an unpaid tax liability. "Her case was

already on a trial calendar when Commissioner's counsel realized that the IRS had not notified her husband of his right to intervene. That turned out to be impossible – he was dead." Judge Holmes held that the nonrequesting spouse's right to intervene in proceedings on request for innocent spouse relief survives death; executors and administrators should be afforded an opportunity to intervene to oppose relief. "The survival of a decedent's tax liability means that as a practical matter his heirs or beneficiaries may be affected by the outcome of an innocent-spouse case. The opportunity to intervene is an opportunity to protect those interests, because granting innocent-spouse relief will make the estate of the nonrequesting spouse the only source of payment for any unpaid tax the deceased has left behind." When neither the IRS "nor the requesting spouse has any idea whether there is an estate and whether it has a personal representative ... it is appropriate ... to file an order requiring both parties to furnish the Tax Court, insofar as ascertainable and to the best of their abilities, the names and addresses of the heirs at law of the decedent, under the law of the jurisdiction wherein the decedent was a resident when his death occurred and for the court to then notify the heirs."

9. **The statute might not have correctly articulated the statutory cross reference, but the Tax Court got the drift of congressional intent anyway.** Adkison v. Commissioner, 129 T.C. 97 (10/16/07). The Tax Court does not have jurisdiction to review a claim for apportioned liability relief under § 6015(c) when the tax liability in question relates to partnership income and the deficiency notice on which the jurisdiction was asserted to be based is invalid because the partnership items are subject to determination in a TEFRA partnership level proceeding that has not yet been resolved. Section 6230(a)(3)(A), which still refers to former § 6013(e), the statutory predecessor of § 6015, evidences congressional intent that the spouse of a partner can initiate a claim for innocent spouse relief with respect to a deficiency attributable to an adjustment of a partnership item only after the IRS issues a notice of computational adjustment following the completion of the partnership-level proceeding. Judge Cohen concluded that Congress simply overlooked the need to correct the cross references in § 6230 when it replaced § 6013(e) with § 6015.

### H. Miscellaneous

1. **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).

**2. 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 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.

**3.** 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.

**4. 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 whistleblower reward floor of 15 percent and a cap of 30 percent 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.

**a.** Notice 2008-4, 2008-2 I.R.B. 253 (1/14/08). This Notice provides guidance on how to file whistleblower claims on IRS Form 211. One example of the grounds for not processing claims is "(2) Claims submitted by an individual who is required by Federal law or

regulation to disclose the information, or by an individual who is precluded by Federal law or regulation from making the disclosure."

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

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

**b. And the Tax Court's procedures are vindicated and taxpayer Kanter's Estate[10] loses on appeal on the fraud issue in the Eleventh Circuit.** Estate of Kanter v. Commissioner, 337 F.3d 833 (7th Cir. 7/24/03) (per curiam) (2-1), *aff'g in part and rev'g in part* T.C. Memo. 1999-407. The court found that the nondisclosure of the special trial judge's original report was proper, following the Eleventh Circuit's *Ballard* opinion. It affirmed the Tax Court's findings on the issues of deficiencies, fraud, and penalties, but reversed as to other findings.

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

**d. Justice Ginsburg to Tax Court judges: "You Article I judges don't understand your own rules, so let *me* tell you what you meant when you adopted them in 1983."** Ballard v. Commissioner, 544 U.S. 40 (3/7/05) (7-2), *reversing and remanding* 337 F.3d 833 (7th Cir. 7/24/03) and 321 F.3d 1037 (11th Cir. 2/13/03). Justice Ginsburg held that the Tax Court may not exclude from the record on appeal

10. 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) or under any statutory authority.

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

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

f. **Tax Court changes its rules.** (9/20/05). The Tax Court adopted amendments to Tax Court Rules 182 and 183, relating to Special Trial Judges' reports in cases other than small tax cases. The Special Trial Judge's recommended findings of fact and conclusions of law are to be served on the parties, who may file written objections and responses. After the case is assigned to a regular Judge, any changes made shall be reflected in the record and "[d]ue regard shall be given to the circumstance that the Special Trial Judge had the opportunity to evaluate the credibility of witnesses, and the finding of fact recommended by the Special Trial Judge shall be presumed to be correct."

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

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

(4) adhere strictly hereafter to the amended Tax Court Rule in finalizing Tax Court opinions.

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

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

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

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

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

**6. Tax return information gets out if you sue the IRS's towing company.** Bowers v. J&M Discount Towing, LLC, 99 A.F.T.R.2d 2007-1607 (D. N. Mex. 2/28/07) The District Court denied the taxpayer's motion to seal confidential tax records submitted by the IRS in support of its motion to dismiss the case against the IRS and a towing company retained by the IRS to tow the taxpayer's automobile to enforce a levy for delinquent taxes.

**7. Be careful about who you invite into your house.** United States v. Yang, 478 F.3d 832 (7th Cir. 3/7/07). Mr. Yang called the Eau Claire police to investigate a burglary in his home. In the course of the investigation, and with Mr. Yang's permission, the police took some spiral bound notebooks to examine for fingerprints. Unfortunately for Mr. Yang, who was also being investigated by the IRS for tax fraud, the notebooks contained financial information regarding the operation of restaurants by Mr. Yang and his brother. The police, who were aware of the tax fraud proceedings, notified the IRS, which subpoenaed the notebooks as evidence in the criminal tax fraud proceeding. The court denied Mr. Yang's motion to suppress the notebooks as evidence on Fourth Amendment grounds pointing out that the notebooks had been voluntarily given to the police thus ending any expectation of privacy.

**8. It's OK for the government to assist identity theft in lien notices.** Glass v. United States, 480 F. Supp. 2d 162 (D. Colo. 3/27/07). Taxpayer's pro se complaint for damages for disclosure of taxpayer identification information, including her social security number, in notices of tax liens filed with a county recorder. First, the taxpayer's action filed under § 7431 (private right of action if a government employee discloses return information in violation of § 6103) should have been filed under § 7433 (private right of action against the United States if a

government employee in connection with the collection of any tax knowingly or negligently violates a provision of Title 26 or the regulations), which is the exclusive remedy for unauthorized disclosure. In addition, the court held that disclosure of the taxpayer's personal information was permissible under § 6103 as necessary to locate assets in which the taxpayer has an interest, notwithstanding exposure to identity theft.

**9. Pick your attorney carefully.** United States v. Simcho, 99 A.F.T.R.2d 2007-2044 (N.D. Cal. 4/11/07). Judge Patel granted the Government's motion to dismiss the defendant's counsel, Joe Izen, in a prosecution for preparing false tax returns for others and filing false tax returns. The defendant's attorney had been a speaker at seminars conducted by the defendant to promote allegedly abusive tax avoidance trust schemes. Memoranda of witness interviews submitted by the government indicated that Izen was a featured speaker at seminars, that he was represented as a "big shot tax attorney from Texas who dealt with the IRS all the time," and that he "lectured about how trusts were legal and bragged about how he always won cases against the IRS." Reliance on Izen's advice would be a significant element of the defense. Judge Patel concluded that Izen's conflict-of-interest and his presence as an unsworn witness disqualified his representing the defendant. The court pointed out that an attorney acts as an unsworn witness, creating jury confusion, "when his relationship to his client results in his having first-hand knowledge of the events presented at trial."

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

**a. And Kevin Brown should have said the same thing.** Internal Revenue Service Acting Commissioner announced his resignation as of September to become Chief Operating Officer of the American Red Cross. 2007 TNT 145-24 (7/26/07).

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

follows: "As Deputy Commissioner for Operations Support, Stiff has overseen development of policy for IRS personnel services, technology and security. She has also been responsible for the accounting of tax revenues collected by the IRS."

**c. Wasn't anyone at the IRS good enough for Everson?** It appears that Everson was really "giving at the office." Mark Everson resigned his Red Cross presidency on November 27, 2007 because the Red Cross Board learned that he "engaged in a personal relationship with a subordinate employee."

**d. Now, it's time for the IRS to loosen up and shukel with the "shul-man."** President Bush nominated Douglas H. Shulman, Vice Chairman of the Financial Industry Regulatory Authority (formerly known as the National Association of Securities Dealers) on 11/21/07 to be Commissioner of Internal Revenue.

**11. Proposed Circular 230 changes that do not relate to tax shelters are nevertheless controversial, what with new restrictions on the use of contingent fees, monetary penalties for practitioners and their firms, and public hearings before ALJs.** REG-122380-02, Regulations Governing Practice Before the Internal Revenue Service, 71 F.R. 6421 (2/8/06). Proposed regulations issued based upon consideration of comments received in response to questions posed in an advance notice of proposed rulemaking (ANPRM) at 67 F.R. 77724 (12/19/02), as well as amendments made to 31 U.S.C. § 330 by the **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 other entity" of a practitioner acting on its behalf provided that the employer, firm or entity knew of reasonable should have known of such conduct; and (7) modifying the definition of disreputable conduct in § 10.51 to include willful failure to sign a tax return the practitioner prepared or unauthorized disclosure of returns or return information.

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

a. **Monetary penalties guidance.** Notice 2007-39, 2007-20 I.R.B. 1243 (5/14/07). This Notice provides guidance with respect to monetary penalties under § 10.52 of Circular 230. The examples indicate that the IRS Office of Professional Responsibility will interpret this provision broadly to encourage compliance with Circular 230.

b. **Final regulations.** T.D. 9359, Regulations Governing Practice Before the Internal Revenue Service, 72 F.R. 54540 (9/26/07). Final regulations, effective 9/26/07, adopted the February 2006 proposed regulations, with changes.

- As to whether rendering of written tax advice constitutes practice before the IRS, the final regulations hold that it does, but that the attorney or CPA is not required to file a Form 2848 power of attorney before doing so.
- The contingent fee rules were modified to permit a practitioner to charge a contingent fee for services related to filing an amended return or claim provided that the amended return or claim was filed within 120 days of taxpayer notification of an examination. Also permitted are contingent fees for interest and penalty reviews, as well as for services rendered in connection with a judicial proceeding. These changes apply to fee arrangements entered into after 3/26/08.
- As to disclosure of a disciplinary decision by an Administrative Law Judge, this disclosure is to be delayed until after the decision becomes final.

**12.** FleetBoston Financial Corp. v. United States, 483 F.3d 1345 (Fed. Cir. 4/19/07) The Federal Circuit interpreted Rev. Rul. 88-

98, 1988-2 C.B. 356, and Rev. Rul. 99-40, 1999-2 C.B. 441, to provide for interest to be charged where overpayments for a year with respect to which a deficiency subsequently was assessed were credited to the following year's estimated taxes even though the amount credited was not needed to meet the taxpayer's estimated tax obligations but was treated as a payment of the following year's estimated tax by operation of Reg. § 301.6402-3(a)(5). The court concluded that the result was not inconsistent with *Avon Products, Inc. v. United States*, 588 F.2d 342 (2d Cir. 1978).

**13.** T.D. 9327, Disclosure of Returns and Return Information in Connection With Written Contracts or Agreements for the Acquisition of Property or Services for Tax Administration Purposes, 72 F.R. 30974 (6/5/07). The Treasury has promulgated final regulations, Reg. § 301.6103(n)-1, regarding disclosure of confidential tax return information by federal and state tax agencies to independent contractors under agreements for goods or services. Disclosure is limited to that which is necessary for performance of the contract. In addition, the final regulations provide that a contractor receiving return information becomes liable for penalties for unauthorized redisclosure.

**14. Timely filing goes postal worker.** Blake v. Commissioner, T.C. Memo. 2007-184 (7/12/07). The taxpayer's Tax Court petition that bore uncancelled stamps and did not bear a postmark was received outside the 90-day period for timely filing. Judge Chiechi nevertheless held that the petition was timely filed based on the taxpayer's attorney's unrefuted credible testimony that when he found the local post office closed on last day of the 90-day period, he gave a stamped envelope containing the petition to a postal worker who was parked nearby and was assured by the postal worker that the envelope would be postmarked that day.

**15. These attorneys missed a procedural step to protect their own fees. Set-off sidesteps a possible trumping lien and lienor must file an administrative refund claim before suing to recover.** Dunn & Black v. United States, 492 F.3d 1084 (9th Cir. 7/11/07). The government set off unpaid taxes against the full amount due to a plaintiff, under a Court of Claims judgment relating to a government contract with plaintiff, notwithstanding the plaintiff's attorney's lien for fees with respect to the judgment award. The court held that the law firm lacked standing to sue for recovery of the fees because it failed to comply with the § 7422(a) requirement that an administrative refund claim must have been filed.

**16. These regulations were accompanied by two published rulings.** T.D. 9355, Clarification to Section 6411 Regulations, 72 F.R. 48933 (8/27/07) and REG-118886-06, Clarification to Section 6411 Regulations, 72 F.R. 48952 (8/27/07). Final, temporary, and proposed regulations § 1.6411-3T(d), that allow the IRS to reduce tentative adjustments with unassessed liabilities in some circumstances.

**a. Don't count on getting any refunds after the IRS has issued a 90-day letter for any other tax year. This would apply even if you are contesting the deficiency in the Tax Court**. Rev. Rul. 2007-51, 2007-37 I.R.B. 573 (9/10/07). Section 6402(a) permits the IRS to credit an overpayment against an unassessed tax liability if it has determined tax liability in a deficiency notice sent to the taxpayer pursuant to § 6212. Similarly, § 6411(b) permits the IRS to credit a decrease in tax resulting from a tentative NOL carryback adjustment against an unassessed tax liability if, within the 90-day period, it has determined the tax liability in a deficiency notice sent to the taxpayer.

- This ruling holds that § 6402(a) allows the IRS to credit an overpayment in one year against unassessed internal revenue tax liabilities determined in a notice of deficiency. There is a similar rule for tentative carryback adjustments. This appears to be based upon the principle of *Lewis v. Reynolds*, 284 U.S. 281 (1932), which held that taxpayers were not entitled to a refund unless they had overpaid their taxes, although the case was not cited.

**b. And it is even easier not to get a refund if you're bankrupt.** Rev. Rul. 2007-52, 2007-37 I.R.B. 575 (9/10/07). Pursuant to § 6402(a) the IRS may credit an overpayment against unassessed tax liabilities that have *not been identified* in a deficiency notice sent to the taxpayer, when the liabilities are identified in a proof of claim filed in a bankruptcy case. Pursuant to § 6411(b), the IRS may credit a decrease in tax resulting from a tentative NOL carryback adjustment against unassessed tax liabilities that have not been identified in a deficiency notice when the liabilities are identified in a proof of claim filed in a bankruptcy case.

**17. Unlike in a deficiency case, you can't diet your way down to small case status by conceding some of the tax in a CDP appeal to the Tax Court.** Leahy v. Commissioner, 129 T.C. 71 (9/17/07). The $50,000 "unpaid tax" limit for invoking the § 7463 small tax case procedures in an appeal of a § 6330 CDP determination includes interest accrued to the date of the IRS notice of determination. Even though the taxpayer disputed only $41,097.54 of liability, an amount below the $50,000 threshold, the case was held not to be eligible for small case status.

## XI. WITHHOLDING AND EXCISE TAXES

### A. Employment Taxes

**1. Wisdom from the Mount. Medical residents may be students for FICA taxes.** United States v. Mount Sinai, 486 F.3d 1248 (11th Cir. 5/18/07). Section 3121(b)(10) provides that employment taxes are not payable with respect to services performed in the employ of a college or university by a student who is enrolled and regularly attending classes. The Government argued that legislative history with respect to the repeal of an exemption for medical interns in 1965 (former § 3121(b)(13)) established as a matter of law that medical residents are subject to employment taxes. The Eleventh Circuit concluded that § 3121(b)(10) is unambiguous in its application to students and that the statute requires a factual determination whether the hospital is a "school, college, or university" and whether the residents are "students."

**a. And the same holds for residents at the Mayo Clinic.** Mayo Foundation for Medical Education v. United States, 503 F. Supp. 2d 1164 (D. Minn. 8/3/07). The District Court held in 2003 that stipends paid to medical residents in the Mayo Clinic were qualified for the student exclusion from FICA taxation, and that the Mayo is a school, college, or university for purposes of the exclusion. *United States v. Mayo Found. for Med. Educ. & Research*, 282 F. Supp. 2d 997 (D. Minn. 2003). The Treasury responded with Reg. § 31.3121(b)(10)-2(c), (d), which limits the definition of a school, college, or university to entitles whose "primary function is the presentation of formal instruction." The regulation also limits the definition of student to provide that only services provided as incident to pursuing a course of study and that a person whose work schedule is 40 hours or more per week is a full-time employee rather than a student. In granting a $1.6 million refund claim on summary judgment, the District Court determined that the regulation is invalid as inconsistent with the plain meaning of a statute that the court finds is unambiguous and held that stipends paid to medical residents are subject to the student exclusion.

**2.** Jordan v. United States, 490 F.3d 677 (8th Cir. 6/21/07). Meals, lodging, and transportation expenses paid by an air cargo carrier to a pilot for travel from his home in Minnesota to the location of his work assignment in Alaska (gateway expenses) are wages subject to withholding for FICA taxes. Employment taxes do not apply to amounts excluded from income by § 132 as statutory fringe benefits. The court rejected the taxpayer's argument that the gateway expenses were a working condition fringe. The gateway expenses would not have been deductible

under § 162 as expenses for travel away from home, and, therefore, do not qualify as a working condition fringe benefit.

**3. Without a contract, you're not your PSC's employee.** Arnold v. Commissioner, T.C. Memo. 2007-168 (6/27/07). The husband and wife taxpayers were, respectively, a realtor and an accountant, and each of them owned 100 percent of the stock of an S corporation as a "vehicle" for their respective businesses. They reported all of the income from their respective businesses as income of the corporations, which passed though to them under § 1366, but were not paid any salaries or other compensation and paid no wage taxes. However, there were no contracts between the taxpayers and their respective corporations recognizing the right of the corporations to control their performance of services. The court (Judge Vasquez) held that all of the income of each taxpayer was earned personally, and not by their respective corporations, and upheld deficiencies for self-employment taxes. Judge Vasquez noted that: "A corporation earns the income if: (a) The service provider is an employee of a corporation which has the right to direct or control that employee in some meaningful sense; and (b) there exists a contract or similar arrangement between the corporation and the person or entity using the services which recognizes the corporation's right to direct or control the work of the service provider."

**4.** T.D. 9337, Withholding Exemptions, 72 F.R. 38478 (7/13/07). This Treasury Decision finalizes Reg. § 31.3402(f)(2)-1 providing that employers are not required to submit employee Form W-4s that claim excessive exemptions, or no withholding, unless the employee receives notice from the IRS requiring submission of an employee's Form W-4. The regulations provide procedures for the IRS to issue the notice to employers.

**5.** Colorado Mufflers Unlimited, Inc. v. Commissioner, T.C. Memo. 2007-222 (8/13/07). Full time workers in the taxpayer's muffler shop are treated as employees where the taxpayer exercised control over the manner in which work was performed, provided tools and other facilities, paid the workers on a weekly basis, retained the right to discharge the workers, and the workers believed they were in an employment relationship. The court denied relief under § 530 of the Revenue Act of 1978 because it had treated workers as employees in previous years. The taxpayer was fined for advancing frivolous positions.

**6. Hold 'em – then withhold the winnings.** Rev. Proc. 2007-57, 2007-36 I.R.B. 547 (9/4/07). Sponsors of poker tournaments, including casinos, are required to withhold tax from winnings in excess of $5,000 under § 3402(q). Winnings include the proceeds of a wager, which

the IRS says are determined by reducing the amount received by the amount of the wager. The lucky winner is required to provide the payer a statement on Form W-25 or 5754 with identifying information. The withholding rate is the third highest rate of § 1(c), 31 percent. The Revenue Procedure is applicable to payments made on or after March 4, 2008.

**7. FICA taxes and penalties hit the University of Chicago's retirement payments.** University of Chicago v. United States, 100 A.F.T.R.2d 2007-6261 (N.D. Ill. 8/21/07). The University of Chicago required employees to make payments into a § 403(b) plan and referred to the employee contributions as being withheld from salaries. Employees were required to sign a "salary reduction agreement." The University also contributed to the plan on behalf of employees. Section 3121(a)(5)(D) excludes from wages subject to employment taxes any payment under a § 403(b) annuity contract, "other than a payment for the purchase of such contract which is made by reason of a salary reduction agreement." The University argued that this language is ambiguous and should not be interpreted to apply to every agreement that reduces an employee's current compensation. Granting summary judgment for the Government, the Court concluded that the "statute's language is not at all ambiguous, and covers just the set of facts that are present in this case." The employees' wages are subject to FICA withholding. In addition, the court found that the University's failure to make the deposits was not due to reasonable cause. The University asserted under the "divisible tax doctrine" that its payment of a portion of the tax in order to bring the refund action absolved it of the penalty. The Court indicated that "it is one thing to say that a taxpayer need not pay the total tax in order to gain entry to the courthouse, and quite another to say that the taxpayer may escape the penalty for failure to timely pay the tax by filing a lawsuit."

**8. This one hurts. Early retirement bonuses for tenured professors are wages subject to employment tax withholding.** University of Pittsburgh v. United States, 507 F.3d 165 (3d Cir. 11/02/07). In a 2-1 decision, reversing the District Court, the Third Circuit held that payments to early retirees to induce retirement are wages subject to FICA withholding rather than non-wage payments for relinquishment of contract rights to tenure. The Third Circuit follows *Appoloni v. United States*, 450 F.3d 185 (6th Cir. 2006), and joins the Sixth Circuit in rejecting the holding of *North Dakota State Univ. v. United States*, 255 F.3d 599 (8th Cir. 2001).

**9. Employment tax wage base for 2008.** Notice 2007-92, 2007-47 I.R.B. 1036 (11/19/07). The OASDI contribution and benefit base for remuneration paid in 2008 is $102,000. The minimum

amount that a domestic worker must earn to trigger employment tax liability for 2008 is $1,600.

**10. Section 403(b) salary reduction agreements defined.** T.D. 9367, Payments Made by Reason of a Salary Reduction Agreement, 72 F.R. 64939 (11/14/07). Treasury has finalized regulations, § 31.3121(a)(5)-2, defining contributions to § 403(b) plans under a salary reduction agreement that are subject to employment taxes. Employer contributions to a § 403(b) plan that are not made pursuant to a salary reduction agreement are not subject to employment taxes. A salary reduction agreement exists if the employee elects to reduce compensation pursuant to a cash or deferred election, the employee elects to reduce compensation under a one-time irrevocable election made at or before the time of initial eligibility to participate in the plan, or the employee agrees as a condition of employment (whether imposed by statute or otherwise) to make a contribution that reduces compensation.

**11.** Bennett v. Commissioner, T.C. Memo. 2007-355 (12/3/07). Self-employment income earned as a minister is subject to self-employment tax unless under § 1402(e)(3) the individual files a letter or Form 4361 certifying that the individual is conscientiously or on religious principles opposed to the acceptance of public insurance. Judge Swift rejected the taxpayer-pastor's claim for exemption in the absence of evidence that the taxpayer had filed the requisite certification. The IRS search of its files in the Ministerial Unit failed to discover a form filed by the taxpayer. The taxpayer was unable to produce documentary evidence of the filing, and the taxpayer had in fact paid employment taxes in some years subsequent to the taxpayer's claim of having filed the certificate in 1980.

**B. Excise Taxes**

**1.** 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.

**2. This taxpayer's $54.84 telephone excise tax refund claim challenges the IRS under the Administrative Procedure Act.** In Re Long-Distance Telephone Service Federal Excise Tax Refund Litigation, 501 F. Supp. 2d 34 (D. D.C. 8/10/07). The District Court denied

the IRS's motion to dismiss the taxpayer's claim under the Administrative Procedure Act (APA) that the refund procedure of Notice 2006-50, 2006-1 C.B. 1141, is arbitrary and unlawfully restricts the taxpayer's refund claim and potential class action suit by requiring refund claims to comply with the documentation requirements of the Notice or accept a safe-harbor amount. The District Court held that (1) the taxpayer has standing to raise the claim because of the taxpayer's alleged financial loss under the approach of the Notice, (2) the agency action issuing the Notice is not protected from APA review as an exercise of discretionary authority by the IRS, (3) the Notice is a final agency action subject to review under the APA, and (4) the taxpayer is not required to exhaust administrative remedies by following the refund procedure of the Notice in order to avoid the sovereign immunity of the IRS.

## XII. TAX LEGISLATION

### A. Enacted

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

2. **The Small Business and Work Opportunity Tax Act of 2007** (the **"2007 Act"**), which is contained in the **U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act**, Pub. L. 110-28, was signed by President Bush on 5/25/07. This legislation also increased the minimum wage.

3. The **Mortgage Forgiveness Debt Relief Act of 2007**, P.L. 110-142, was signed by President Bush on 12/20/07.

4. **A "blue Christmas" package is enacted on December 26th, or is it a Christmas package for the blue states?** The **Tax Increase Prevention Act of 2007**, P.L. 110-166, i.e., the one-year AMT patch, was signed by President Bush on 12/26/07.

5. The **Tax Technical Corrections Act of 2007**, P.L. 110-172, passed both houses of Congress by unanimous consent on 12/19/07 and was signed by President Bush on 12/29/07. It alters the definition of the alternative minimum tax refundable credit amount as provided in the Tax Relief and Health Care Act of 2006; changes certain rules in the Pension Protection Act (PPA) of 2006 for tax-free distributions from individual retirement accounts to charities; and modifies the § 355 special rule for the active business requirement as added by the Tax Increase Prevention and

Reconciliation Act of 2005. It also deals with § 470 SILO transactions for investment partnerships.