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Recent Developments in Federal Income Taxation: The Year 2001

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This current developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the year 2001.[1] *Most Treasury Regulations, however, are so complex that they cannot be discussed in detail; only the basic topic and fundamental principles are highlighted. Amendments to the Internal Revenue Code generally are not discussed except to the extent that they have either led to administrative rulings and regulations or have affected previously issued rulings and regulations otherwise covered by the outline. The outline focuses primarily on topics of broad general interest — 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, but generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.*

I. ACCOUNTING

A. Accounting Methods

1. Final word on that otherworldly accounting method. T.D. 8929, Accounting for Long Term Contracts, 66 F.R. 2219 (1/11/01). The Treasury has promulgated final regulations [Regs. §§ 1.460-1 through 1.460-6] under § 460. [These regulations were proposed in REG-208156-91, 64 F.R. 24096 (5/5/99).] The final regulations generally follow the proposed regulations with a number of modifications. Costs are allocated to long-term contracts under a single standard linked to the Uniform Capitalization rules of § 263A. Subcontracted costs are either direct material or direct labor costs that must be allocated. The look-back rule is modified to apply first in the year in which the long-term

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1. This outline is based on prior current developments outlines presented by the authors at numerous continuing legal education conferences over the past year. Among the conferences at which one or both of the authors presented current developments based on this outline during the year 2001: ABA Tax Section Midyear Meeting, American Institute on Federal Taxation, American Petroleum Institute, Denver Tax Institute, Houston Bar Association Tax Section, Lewis and Clark Northwestern School of Law Tax Conference, University of North Carolina Tax Institute, Southern Federal Tax Institute, Southwestern Legal Foundation Institute on Oil and Gas Law and Taxation, State Bar of Texas Tax Section, Tax Executives Institute, Tennessee Tax Institute, Texas Society of CPAs (Austin Chapter) Institute, Tulane Tax Institute, University of Virginia Conference on Federal Taxation, Wednesday Tax Forum (Houston), William & Mary Tax Conference.

contract is completed and accepted. Hybrid contracts involving both the manufacture of personal property and the construction of real property can electively be reported under the percentage of completion method. If the customer breaches before completion, previously reported gross income is reversed and the adjusted basis of the retained property equals previously deducted costs.

2. Proposed regulations on adopting and changing taxable years. REG-106917-99, Changes in Accounting Periods, 66 F.R. 31850 (6/13/01). The Treasury has published proposed amendments to regulations under §§ 441, 442, 706, and 1378 regarding the requirement to obtain the approval of the Commissioner to adopt, change, or retain an annual accounting period. Prop. Reg. §§ 1.441-1 through 1.441-4 generally are substantively the same as Temp. Reg. §§ 1.441-1T through 1.441-4T, including the general rules for the period for computing tax, numerous definitions, and the requirement that partnerships, S corporations, and PSCs generally must demonstrate a business purpose and obtain approval to adopt or retain a taxable year other than their required taxable year, but the proposed regulations are reorganized.

- Prop. Reg. § 1.441-1(c) provides that a taxable year is adopted by filing the first federal income tax return using that taxable year. Filing an application for an EIN, filing an extension, or making estimated tax payments, indicating a particular taxable year would not constitute an adoption of that year. Rev. Rul. 57-589 (1957-2 C.B. 298), and Rev. Rul. 69-563 (1969-2 C.B. 104), holding that the filing of an extension and estimated tax payments establishes a taxable year, will be superseded.
- The proposed regulations under § 442 continue to require that the taxpayer demonstrate a business purpose for changing taxable years. The proposed regulations use the term "business purpose" rather than the "substantial business purpose" of the temporary regulations, but, according to the preamble, the Treasury does not intend the language change to change the standard. Under Prop. Reg. § 1.442-1(b), Form 1128 would have to be filed by the 15th day of the third [rather than second] month of the first effective [the short] year. The automatic approval provisions have been deleted in favor of the standards of Rev. Proc. 2000-11, 2000-3 I.R.B. 309.
- Prop. Reg. § 1.706-1 reflects the 1986 Act's required taxable year rules and the least aggregate deferral standard. Generally speaking, the substantive rules incorporate Temp. Reg. § 1.706-1T, but the proposed regulations elaborate the standards for determining a partner's interests in profits and capital for purposes of applying those tests – income interests are determined with respect to taxable income, not book income, and capital interests are determined with respect to a hypothetical liquidation.

Procedural rules for requesting a year other than a required year have been removed in favor of the Prop. Reg. § 1.442-1 procedures.

• Prop. Reg. § 1.1378-1 would not implement any substantive changes, but procedural rules for requesting a year other than a required year have been removed in favor of Prop. Reg. § 1.442-1 procedures.

a. Notice 2001-34, 2001-23 I.R.B. 1302 (6/4/01). The IRS has published a proposed revenue procedure dealing with procedures under § 442 for taxpayers outside the scope of the revenue procedures providing automatic approval to adopt, change, or retain, a taxable year [see, e.g., Rev. Proc. 2000-11, 2000-3, I.R.B. 309; Notice 2001-35, 2001-23 I.R.B. 1314, and Rev. Proc. 66-50, 1966-2 C.B. 1260] to establish a business purpose and request approval to adopt, change, or retain a taxable year. Under the proposed revenue procedure, the IRS would no longer weigh the merit of a taxpayer's stated business purpose against the amount of distortion of income. Taxpayers generally would be granted approval to adopt, change to, or retain a natural business year under the proposed revenue procedure. Establishing a natural business year generally will be the only circumstance under which a partnership, S corporation, electing S corporation, or PSC will be granted approval. Other taxpayers that do not establish a natural business year generally would be granted approval under the proposed revenue procedure if they agree to certain additional terms, conditions, and adjustments designed to neutralize the tax effects of substantial distortion of income resulting from the change.

b. Notice 2001-35, 2001-23 I.R.B. 1314 (6/4/01). This notice provides a proposed revenue procedure that will provide the procedures under § 442 for certain partnerships, S corporations, electing S corporations, and PSCs to obtain automatic approval to adopt, change, or retain their taxable years. When finalized, the revenue procedure will supersede Rev. Proc. 87-32, 1987-2 C.B. 396.

3. <u>Brookshire Brothers Holding, Inc. v. Commissioner</u>, T.C. Memo. 2001-150 (6/22/01). The taxpayer filed amended returns changing its cost recovery period for convenience stores from 31.5 and 39 years to 15 years, as permitted by a Specialized Program Coordinated Issue Paper. The IRS asserted that the change required consent under § 446(e), but the Tax Court (Judge Nims) held that Treas. Reg. § 1.446-1(e)(2)(ii)(b) [providing that a change of useful life is not an accounting method change] applied to changing the § 168 ACRS cost recovery period.

B. Inventories

1. This one "floors" us; now carpets are not inventory, tomorrow. Smith v. Commissioner, T.C. Memo. 2000-353 (11/14/00). A flooring contractor who installed custom ordered, and often custom designed, flooring was not required to maintain inventories or to use the accrual method. Judge Wells found that Smith Carpets was a service provider because all floor coverings were specially ordered from the manufacturer to the customer's specifications and even though the taxpayer maintained a warehouse [to store the flooring pending installation], it did not maintain a stock of goods to sell to the public merchandise within the meaning of Reg. § 1.471-1 [although it did maintain a stock of supplies, e.g., padding, glue, etc.] *RACMP Enterprises, Inc. v. Commissioner*, 114 T.C. 211 (2000), was held to be controlling.

a. IRS changes its litigating position. Chief Counsel Notice CC-2001-10 (2/9/01). Until further guidance is issued, the IRS will not assert that taxpayers in businesses similar to those in *Smith* are required to use inventory accounts and an accrual method of accounting. The Notice specifically applies to construction contractors involved in paving, painting, roofing, drywall, and landscaping. The policy does not apply to taxpayers that are resellers, manufacturers, or otherwise required by § 448 to use an accrual method of accounting [such as C corporations with gross receipts of $5 million or more].

2. IRS ends the small-dollar aspect of its crusade against the cash method, but continues the crusade against "small" taxpayers with gross receipts between $1 million and $5 million. Rev. Proc. 2001-10, 2001-2 I.R.B. 272 (1/8/01), *modifying and superseding* Rev. Proc. 2000-22, 2000-20 I.R.B. 1008 (4/28/00). The Commissioner will exercise his discretion to except a "qualifying taxpayer," i.e., one with average annual gross receipts of $1 million or less [as determined under Reg. § 1.448-1T(f)(2)(iv)] from the requirements of accounting for inventories and using an accrual method of accounting for purchases and sales of merchandise. A business that adopts the cash method under this revenue procedure will treat inventory items as materials and supplies that are *not* incidental under Reg. § 1.162-3. This means that the taxpayer must capitalize the cost or actual purchases of goods or materials to be resold or incorporated into manufactured products and offset the capitalized amounts against the amount realized when the goods are resold, but the taxpayer may deduct currently all other manufacturing and handling costs (including labor, warehousing, and other direct and indirect costs that normally must be capitalized under § 263A). An automatic change in accounting method to the cash method under Rev. Proc. 2000-22 is available under Rev. Proc. 99-

49, 1999-2 C.B. 725. Small businesses using an accrual method of accounting that are not required under § 471 to account for inventories may use the automatic consent provisions to change to the cash method. These procedures are effective for tax years ending after December 16, 1999.

3. The small-dollar limit goes up to $10 million of gross receipts, but with significant exceptions. Notice 2001-76, 2001-52 I.R.B. 613 (12/11/01). Pursuant to the discretion granted the Commissioner under §§ 446 and 471, this notice provides a proposed revenue procedure that will allow qualifying small business taxpayers with "average annual gross receipts" of more than $1 million but less than $10 million to use the cash receipts and disbursements method of accounting as described in the proposed revenue procedure with respect to eligible trades or businesses.

• Ineligible businesses include ones that derive the largest percentage of gross receipts from any of the following activities: (a) mining activities within the meaning of NAICS codes 211 and 212; (b) manufacturing within the meaning of NAICS codes 31-33; (c) wholesale trade within the meaning of NAICS code 42; (d) retail trade within the meaning of NAICS codes 44-45; and, (e) information industries within the meaning of NAICS codes 5111 and 5122.

a. Notice 2001-76 will be available for 2001. Notice 2002-14, 2002-8 I.R.B. 548 (2/1/02). The change in method permitted under Notice 2001-76 will be available for any taxable year ending on or after 12/31/01. Taxpayers must attach a Form 3115 to a timely filed (including extensions) income tax return, file a duplicate copy with the Internal Revenue Service's National Office, and comply with the provisions of Rev. Proc. 2002-9, 2002-3 I.R.B. 327.

4. Mom-and-pop bulk fuel dealers still must maintain inventories and use the accrual method. Cross Oil Co. v. Commissioner, T.C. Memo. 2001-126 (5/30/01). The Commissioner did not abuse his discretion in requiring an oil and gas distributor to maintain inventories and use the accrual method. The taxpayer, whose gross receipts were between $2 and $3 million, generally maintained an inventory of not more than 2 and ½ weeks worth of goods and had most oil and gas loaded at the refinery and delivered directly to customers. The taxpayer's business was the sale and delivery of merchandise, and there was not a substantial identity of results between the taxpayer's hybrid method and the required method.

5. Judge Chiechi writes a treatise on taxpayer's impermissible use of LIFO inventory. Consolidated Manufacturing, Inc. v. Commissioner, 111

T.C. 1 (7/20/98). An automobile parts remanufacturer sold reconditioned automobile engines, transmissions, etc. It purchased most of the parts it used, except that it received most of the used engines, used transmissions, and similar used parts it reconditioned (taxpayer's "used core inventory"), as trade-ins from customers in exchange for a relatively high price reduction in goods sold to customers. (This, of course, meant that the cost of taxpayer's used core inventory was relatively high.) Taxpayer employed a method of reporting the bulk of its goods inventory under LIFO, except that it reported its used core inventory under FIFO (and lower-of-cost-or-market). The Commissioner determined that the taxpayer's inventory method was contrary to the regulations under § 472 and did not clearly reflect income; the Commissioner also determined that the LIFO election should be terminated. Judge Chiechi held that taxpayer's method of accounting did not clearly reflect income because it contravened § 472 and the regulations thereunder. The Commissioner did not abuse her discretion under § 446(b) in terminating the LIFO election even though the method might have been acceptable under GAAP. Reg. § 1.472-1(c) – permitting a LIFO election to apply only to costs of all or some of raw materials incorporated into finished goods, while other costs are taken into account under FIFO – did not authorize taxpayer's method, which purported to apply LIFO to labor and overhead and some raw materials but FIFO to other raw materials. Under the taxpayer's method, LIFO did not apply to any entire good, either raw material or finished; and the regulations do not authorize taking labor and overhead into account under LIFO separately. The court determined that the "purchase cost" of core parts acquired in exchange-like transactions involving the sale of remanufactured parts in exchange for cash and used core parts to be the stated credit price for the core parts. The Commissioner did not abuse her discretion in determining that the lower of cost or market for core parts was determined under Reg. § 1.471-4(a) as the bid price for replacement core parts in the market in which it acquired them, not at the scrap amount at which it carried a substantial number of core parts.

a. And the Tenth Circuit says she got it right for the most part. Affirmed in part, reversed in part. 249 F.3d 1231, 87 A.F.T.R.2d 2111, 2001-1 U.S.T.C. ¶ 50,400 (10th Cir. 5/8/01). The Court of Appeals agreed that Reg. § 1.472-1(a) did not permit the mixed LIFO / FIFO method employed by the taxpayer and that the Commissioner did not abuse her discretion by terminating the taxpayer's LIFO election. With respect to the Tax Court's holding that the Commissioner did not abuse her discretion in determining that under Reg. § 1.471-4(a), the lower of cost or market for core parts was the bid price for replacement core parts in the market in which it acquired them [i.e., the price it paid its customers, from which it acquired a majority of its cores], however, the Court of Appeals reversed, on the grounds that the

Commissioner's method did not clearly reflect income. But the court did not accept the taxpayer's argument that the "market" was the salvage yard market, since the taxpayer did not purchase cores in that market. [On appeal the taxpayer conceded that its original method of valuing a substantial number of core parts at scrap value did not clearly reflect income.] Although the taxpayer's customer price reflected "price," as far as "market" was concerned, the proper market was the professional supplier market (as adjusted for certain differences such as transportation and guarantees), because that was the only "open market" in which the taxpayer acquired any cores. The case was remanded for market valuation, and comparison with price, under this standard.

6. She went to the animal fair . . . the elephant sneezed . . . and that was the end of her accounting method. Suzy's Zoo v. Commissioner, 273 F.3d 875, 2001-2 U.S.T.C. ¶ 50,766, 88 A.F.T.R.2d 6916 (9th Cir. 11/21/01), *aff'g* 114 T.C. 1 (1/6/00). The Court of Appeals (Judge Sneed) affirmed the Tax Court's decision that the "small reseller" exception to § 263A provided in § 263A(b)(2)(B) did not apply to greeting card business that produced cartoon characters and contracted with independent printers for production of cards and other products bearing the characters likenesses according to taxpayer's standards. Even though the contracts provided that printers owned materials and bore risk of loss during production, taxpayer owned the images and had exclusive rights to the cards; the printers had no right to sell produced cards or cartoon characters to anyone other than taxpayer. Thus, the taxpayer was the "producer" of the cards, not a small "reseller" to whom the § 263A(b)(2)(B) exception applied. All costs were subject to capitalization under § 263A. For purposes of the § 481 adjustment, pursuant to § 803(d) of the TRA '86, the year of the change was the year ending June 30, 1994, the subject year, not the year ended June 30, 1987, the taxpayer's first year after the effective date of § 263A.

C. Installment Method

1. The **Tax Relief Extension Act of 1999** amended § 453 by adding new § 453(a)(2) denying accrual method taxpayers the privilege of installment reporting on any sales of property whatsoever. Even though the taxpayer uses the accrual method, however, § 453(a)(2) does not disallow the installment reporting under § 453(l) for dispositions of property used or produced in the trade or business of farming or dispositions of residential lots or time-share condominium units.

a. The **Installment Tax Correction Act of 2000**, signed December 28, 2000, retroactively repealed the 1999 addition of § 453(a)(2) and restored the availability of § 453 installment reporting to accrual method taxpayers on the same basis that it was available before the 1999 legislation.

b. Automatic consent to revoke elections out of installment method. Notice 2001-22, 2001-12 I.R.B. 911 (3/19/01). An accrual method taxpayer that entered into an installment sale on or after December 17, 1999, and filed a federal income tax return by April 16, 2001, reporting the sale on the accrual method may revoke its election out of § 453. The taxpayer must file, within the applicable period of limitations, amended federal income tax returns for the taxable year in which the installment sale occurred, and for any other affected taxable year, reporting the gain on the installment method.

D. Year of Receipt or Deduction

1. T.D. 8917, Section 467 Rental Agreements Involving Payments of $2,000,000 or Less, 66 F.R. 1038 (1/5/01). Former Reg. § 1.467-3(b)(1)(iii) provided that if a lease did not require more than $2 million of rent and other consideration and all payments are due in the year to which the rent relates or the preceding or succeeding year, the effect of § 467 was limited to requiring both the lessor and the lessee to take the rent into account in the year to which it relates rather than in the year in which it is paid, thus exempting such leases from the rent-leveling rules. This $2 million safe harbor has been eliminated from the regulations, effective for leases entered into on or after July 19,1999.

2. Credit card fees are not payments for "services" under Rev. Proc. 71-21. American Express Co. v. United States, 47 Fed. Cl. 127, 2000-2 U.S.T.C. ¶ 50,575, 86 A.F.T.R.2d 5217 (6/30/00). Before 1987, the taxpayer included annual credit card fees in income when the fees were billed. In 1987 the taxpayer changed its method of accounting on the basis of FASB 91 to include the fees ratably over the 12-month period for which they were billed and sought the Commissioner's approval for the change in accordance with Rev. Proc. 71-21, 1971-2 C.B. 549. The Court of Federal Claims held that the Commissioner's denial of the request was within his discretion, on the ground that Rev. Proc. 71-21 and G.C.M. 39434 (10/25/85) provide an adequate basis for the determination that the fees were not for services. The G.C.M. viewed card fees as payments for credit, not as payments for "contingent services."

- The court held that *Barnett Banks of Florida, Inc. v. Commissioner*, 106 T.C. 103 (1996) (allowing ratable inclusion of refundable credit card fees) was decided on its own facts [which are, in fact, difficult to distinguish] and did not as a mater of law require overturning the

Commissioner's discretion in this case. The court further noted that the *Barnett Banks* court did not "fully address[] the question of whether there was an adequate basis for the Commissioner's exercise of discretion under Rev. Proc. 71-21" and that the Court of Federal Claims will not make close factual judgments where there is no abuse of discretion.

a. Affirmed. IRS interpretation of its own regulations is entitled to substantial deference, even if *Chevron* deference was not earned. 262 F.3d 1376, 88 A.F.T.R.2d 5568, 2001-2 U.S.T.C. ¶ 50,596 (Fed. Cir. 8/23/01). The Federal Circuit (Judge Dyk) affirmed, describing the sole issue as "whether the IRS properly interpreted its own Revenue Procedure by treating 'services' as not including fees for the acquisition of credit." Even though under the standards of *United States v. Mead Corp.*, 121 S.Ct. 2164, 2171 (2001), "[t]he interpretation of Rev. Proc. 71-21 contained in the General Counsel Memorandum and the IRS decision under the Revenue Procedure is not reflected in a regulation adopted after notice and comment and probably would not be entitled to *Chevron*[2] deference," "[t]he Supreme Court has firmly established that agency interpretations of their own regulations are entitled to substantial deference." The court distinguished *Hewlett-Packard Co. v. United States*, 71 F.3d 398 (Fed. Cir. 1995) [rejecting the Commissioner's determination that a taxpayer's pool of rotable spare parts used to repair computers it had sold was inventory rather than a § 1231 asset] as involving a factual determination, not an interpretation of a regulations. The court rejected the Tax Court's holding in *Barnett Banks of Florida, Inc. v. Commissioner*, 106 T.C. 103 (1996) that the annual fee payments received by a credit card company qualified as "services" under Rev. Proc. 71-21.

3. <u>WICOR, Inc. v. United States</u>, 263 F.3d 659, 2001-1 U.S.T.C. ¶ 50,576, 88 A.F.T.R.2d 5474 (7th Cir. 8/14/01), *aff'g* 116 F.Supp.2d 1028, 86 A.F.T.R.2d 6567, (E.D. Wis. 2000). Section 1341 does not apply to the restoration to a utility of prior years' overcharges through reduced rates in future years. There was no payment in the later year to which to apply § 1341; the taxpayer merely realized less gross income than it otherwise would have.

4. Elective deferral rules are not available without adhering to the conditions. <u>Bob Wondries Motors, Inc. v. Commissioner</u>, 268 F.3d 1156, 88 A.F.T.R.2d 6489, 2001-2 U.S.T.C. ¶ 50,733 (9th Cir. 10/23/01). The taxpayer-automobile dealers elected to report income and deductions on extended warranty agreements under the "service warranty income" method of Rev. Proc.

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

92-98, 1992-2 C.B. 512, and Rev. Proc. 92-97, 1992-2 C.B. 510, which permit deferral of customer receipts in turn paid for insurance [to which is added an interest factor] over the life of the agreement [but not more than six years]. However, the taxpayer deviated from Rev. Proc. 92-97 by amortizing in the first year a full year's worth of the insurance premium expense rather than a pro-rated amount based on the actual date of the contract. The Ninth Circuit affirmed the Tax Court's decision upholding the Commissioner's disallowance of the deferral method. Elective deferral rules are not available without adhering to the conditions.

5. *Boylston Market*[3] reigns in the Tax Court. U.S. Freightways Corp. v. Commissioner, 113 T.C. 329 (11/2/99). An accrual method trucking company was required to capitalize expenditures for licenses and insurance that had an effective period extending beyond the tax year. Judge Nims held that taxpayer's argument – whether or not the argument is well taken – that the expenditures should be currently deductible if their benefit extends "less than 12 months into the subsequent tax period" is inapplicable to an accrual method taxpayer. Judge Nims relied, however, on § 263 and the capitalization rules, rather than on the "clear reflection of income" standard of § 446(b), which also was argued by the Commissioner.

a. But maybe not in the Seventh Circuit. *U.S. Freightways* reversed on the capitalization holding and remanded to see if the same result follows under the "clear reflection of income" standard. 270 F.3d 1137, 88 A.F.T.R.2d 6703, 2001-2 U.S.T.C. ¶ 50,731 (7th Cir. 2001). The Seventh Circuit Court of Appeals (Judge Wood) reversed the Tax Court's decision that § 263 required that the deduction be prorated over the two taxable years. Judge Wood found the Tax Court's distinction of how the capitalization rules applied to cash method taxpayers and accrual method, which resulted in capitalizing U.S. Freightways' expenses when like expenses of a cash method taxpayer might not have been required to be capitalized [a point that the Tax Court did not concede but accepted *arguendo* for this case] to be untenable. The court of appeals remanded the case to the Tax Court to consider whether the deduction nevertheless should be prorated over the two taxable years under the "clear reflection of income" standard of § 446(b).

II. Business Income and Deductions

A. Income

3. 131 F.2d 966 (1st Cir. 1942).

1. Rev. Rul. 2001-20, 2001-18 I.R.B. 1143 (4/10/01). The "purpose" requirement under Reg. § 1.110-1(b)(3) does not require a lease agreement to provide that the entire construction allowance is for the purpose of constructing or improving qualified long-term real property. However, only the portion of the construction allowance actually so expended may qualify.

2. A self-inflicted tax wound. Catalano v. Commissioner, 240 F.3d 842, 2001-1 U.S.T.C. ¶ 50,233, 87 A.F.T.R.2d 2001-874 (9th Cir. 2/14/01) (per curiam). The taxpayer, an attorney, leased three yachts to his wholly owned S corporation, which in turn used the yachts for entertaining clients. Not surprisingly, the S corporation's deduction for rental payments was disallowed as expenses for "entertainment facilities" that are nondeductible under § 274(a)(1)(B). Also, not surprisingly, the taxpayer nevertheless was required to include the rental receipts in gross income.

3. GAAP, Schmap! WestPac Pacific Foods v. Commissioner, T.C. Memo. 2001-175 (7/16/01). The taxpayer was required to include in gross income cash payments received from various manufacturers as "advance trade discounts" upon agreeing to use the manufacturer as its primary or exclusive supplier for various products to be sold in its retail stores. The Tax Court (Judge Vasquez) held that Reg. § 1.471-3(b), providing that only net *invoice price* be taken into account in inventory costs, did not justify an exclusion of amounts received that are not related to the purchase of specific goods. That the taxpayer's accounting method followed GAAP did not save the day.

4. Money now, taxes, later. Nice result, if you can get. Smartheath, Inc. v. Commissioner, T.C. Memo. 2001-145 (6/20/01). Customer overpayments that were commingled with the taxpayer's other receipts and routinely applied against the customers' future orders were not includable under the claim of right doctrine because the taxpayer would have been willing to refund the overpayments if requested.

5. Apportioning basis to an expectancy. Gladden v. Commissioner, 262 F.3d 851, 2001-2 U.S.T.C. ¶ 50,597, 88 A.F.T.R.2d 5543 (9th Cir. 8/20/01), *rev'g and remanding* 112 T.C. 209 (4/15/99). The taxpayer was a partner in a partnership engaged in farming that received (indirectly) from the Department of the Interior payments in exchange for surrender of its rights to a water allotment from the Colorado River, which were appurtenant to the land. The Tax Court held that the gain was a capital gain because the water rights were a property interest. The Commissioner's argument that the transaction resulted in ordinary income under *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958), was rejected because use of the water rights themselves did not directly produce ordinary income. They were simply one component of the taxpayer's investment in its business. Even though the amounts were received in exchange for the surrender of the rights back to the Interior Department and the court referred to the payments received by the taxpayer as "relinquishment funds," there was no discussion of the fact that the rights were terminated in favor of the granting party rather than transferred to a third party in which they continued and therefore arguably there was no "sale or exchange." (Under the 1997 amendments to § 1234A, the surrender of an interest in property would be deemed a "sale or exchange.") The Tax Court held, however, the taxpayer, who acquired the land in 1976 and acquired the appurtenant water rights in 1983, could not allocate any portion of the basis of the land to the water rights [under Reg. § 1.61-6(a)] to offset the amount realized on the disposition of the water rights in 1992 because the water rights were not vested at the time the land was purchased.

- The only issue on appeal was whether the taxpayer could allocate any portion of the basis of the land to the water rights. The Ninth Circuit (Judge Fletcher) disagreed with the conclusion that no portion of the basis of the land could be allocated to the water rights. It reasoned that if there had not been an expectation of a subsequent allocation of water rights to the land at the time of its purchase, none of the cost of the land would have been apportionable to the water rights. But because there was an expectation of a subsequent allocation of water rights to the land at the time of its purchase, the land could have commanded a premium that properly should have been allocated to the basis of the water rights. The Ninth Circuit refused to follow *Inaja Land Co., Ltd. v. Commissioner*, 9 T.C. 727 (1947), and permit each taxpayer to apply the amount received against his basis in the land. Instead, it remanded for a trial to determine what portion of the cost of the land was a premium paid for the water rights later acquired, or whether it is "impracticable or impossible" to determine what that premium may have been.

B. Deductible Expenses versus Capitalization

INDOPCO[4] aftermath: "Deductions are exceptions to the norm of capitalization." (Blackmun, J.)

1. Extending expensing of certain environmental remediation costs. As originally enacted in 1997, § 198, "expensing of environmental remediation costs . . . which [are] paid or incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site," applied only

4. 503 U.S. 79 (1992).

to expenditures paid or incurred between 8/5/97 and 12/31/00. In 1999, Congress extended the provision's sunset date to 12/31/01.

a. In the **Community Renewal Tax Relief Act of 2000**, P.L. 106-554, the expiration date of this provision was extended until the end of 2003 and the targeted area requirement was eliminated. This means that expenditures paid or incurred after December 21, 2000, with respect to any Brownfields site – but not including a CERCLA site – certified by a State environmental agency qualify for expensing under § 198.

b. The **2001 Act** extended the expensing under § 198 of environmental remediation costs for Brownfields sites through 12/31/01.

2. 𝄞♬♪Fly the repaired skies of . . . . ♬♪ Rev. Rul. 2001-4, 2001-3 I.R.B. 295 (12/22/00). The IRS provided significant guidance regarding the dividing line between repair costs deductible under § 162 and replacement and rehabilitation costs that must be capitalized. The ruling dealt with costs incurred by an airline with respect to work on aircraft airframes in three specific situations involving fully depreciated aircraft. At the time the aircraft were placed in service, it was anticipated that, if maintained, they would be useful for up to 25 years, although they were depreciable under §§ 167 and 168 over seven years. The IRS ruled that heavy maintenance expenses generally are deductible under § 162. But costs incurred in conjunction with a heavy maintenance visit must be capitalized to the extent they materially add to the value of, substantially prolong the useful life of, or adapt the airframe to a new or different use. Costs incurred as part of a plan of rehabilitation, modernization, or improvement also must be capitalized.

- In the first situation, a heavy maintenance, taking 45 days, was performed for the purpose of preventing deterioration of the inherent safety and reliability levels of the airframe. The aircraft was substantially disassembled, inspected, repaired, and reassembled, after which it was tested, and returned to service. Although numerous parts were replaced, the maintenance visit did not extend the useful life of the airframe beyond the originally anticipated 25-year useful life, but merely kept it in an efficient operating condition. It was used for the same purposes and in the same manner as prior to the maintenance. The expenses were fully deductible.

- In the second situation, significant wear and corrosion of fuselage skins necessitated replacement of a significant portion of all of the skin panels of the aircraft, and the work performed materially added to the value of the airframe. While the aircraft was disassembled for the heavy maintenance, it was upgraded by the addition of a cabin smoke and fire detection and suppression system, a ground proximity warning system, and an air phone system to enable passengers to send and receive voice calls, faxes, and other electronic data while in flight. The expenses incurred with respect to this aircraft had to be allocated between the deductible heavy maintenance and the skin replacement and electrical upgrades, which had to be capitalized.

- In the third situation, the aircraft, which was 22 years old and nearing the end of its anticipated useful life, was substantially improved to increase its reliability and extend its useful life. All of the expenses, including what otherwise would have been deductible routine heavy maintenance expenses, on the third aircraft had to be capitalized as part of a plan of general rehabilitation and modernization that materially increased the value and life of the aircraft. In addition, because the work was considered the production of property, under § 263A, allocable indirect costs as well as direct costs had to be capitalized.

3. "[T]he exercise of . . . a sound and reasonable business practice under which a taxpayer . . . acts to minimize its recurring operating costs is not a significant future benefit that requires capitalization of the related nonasset-producing expenditures." Metrocorp, Inc. v. Commissioner, 116 T.C. 211 (4/13/01) (reviewed, 10-6-1). Metrocorp acquired the assets of Community [a failed S&L] through a "conversion transaction" in which, as a condition of assumption of Community's deposit liabilities, Metrocorp was required to pay the FDIC an exit fee of $309,565 and an entrance fee of $43,339 [in five annual installments of $71,518], neither of which were refundable, to shift the deposit insurance from the Savings Association Insurance Fund (SAIF) to the Bank Insurance Fund (BIF). In addition, normal deposit insurance premiums were paid. The Tax Court, in a (10-2-6) reviewed opinion by Judge Laro, upheld the taxpayer's deduction of the entrance and exit fees, rejecting the Commissioner's argument that they produced significant long-term benefit and thus were capital. The exit fees were imposed "to protect the integrity of the SAIF" and were a "final premium" for insurance already received, compensating the SAIF for a loss of future premium revenues. The purpose of the entrance fee was "to protect the integrity of the BIF" by preventing dilution of reserves; it was a nonrefundable fee for first year insurance coverage. The majority said it would not "second guess" taxpayer's management decision to reduce expenses by structuring its acquisition in such a manner that required the payment of the entrance and exit fees rather than in a manner that left the deposits insured by SAIF, which would have resulted in higher annual premiums. The majority specifically noted that its decision was based solely on rejecting the Commissioner's significant long-term benefit/*INDOPCO* argument, and that since the Commissioner had not argued that the expenditures were capital because they were incurred in connection with an asset [core deposits], it would not decide the case on that basis; it reserved any discussion of how the case might be decided if that issue were raised. Nevertheless, the majority pointed out that unlike the case in *Lincoln Savings,* the payments in the case at bar did not create a fund.

• Judge Ruwe (with five judges joining) dissented on the grounds that the deficiency notice was broad enough to include capitalization on the grounds that the fees related to the acquisition of a separate and distinct asset, and that the Tax Court has inherent power to decide cases on grounds not argued by either part as long as there is no "surprise" or "prejudice." Judge Ruwe's dissent found the fees to be capital because they were incident to the acquisition of a separate and distinct asset, and the SAIF exit fees, in any event, were not insurance premiums because Metrocorp never received any insurance benefit from SAIF.

• Judge Halpern's dissent (with five judges joining) focused on the point that the taxpayer failed to prove that the purpose of the payments was an ordinary and necessary business expense. He reasoned that the entrance and exit fee calculation was complex, the legislative history of the statutes requiring the payments did not clearly articulate their purpose, that the majority's description of their purposes was surmise, and that the taxpayer thus failed to prove that there was no significant long-tem benefit.

• Judge Beghe's dissent focused on the point that the Commissioner's broad assertion that the payments produced a long-term benefit inherently included the narrower assertion that the payments were part of the cost of the asset acquisition, and the stipulated record clearly established that the fees were paid in connection with the acquisition of assets. Furthermore, even if the payments were insurance premiums, they were in the nature of prepaid insurance. Thus, the fees should have been capitalized.

4. But the Tax Court still believes in the capitalization requirement. Lychuk v. Commissioner, 116 T.C. 374 (5/31/01) (reviewed, 8-1-7). The taxpayers' S corporation was in the business of acquiring and servicing multi-year installment contracts from used car dealers. It acquired each contract at 65 percent of its face value and thereafter collected and kept all principal and interest payments. Its primary business activities consisted of credit investigation, credit evaluation, documentation, and monitoring collections on the installment contracts. Its key employees performed credit reviews to decide whether to acquire contracts offered to it and processed payments to the selling car dealers. Over the two years in question, it acquired 1,513 contracts out of 3,982 offered to it. The corporation deducted all of its expenses, but the Commissioner determined that all of the salaries, benefits, and overhead (printing, telephone, computer, rent, and utilities) relating to the corporation's acquisition of the installment contracts were capital expenditures. [These expenses had been identified by the corporations' auditors and capitalized for financial accounting.] He also required capitalization of expenditures (i.e., professional fees and commissions) relating to an offering of notes in 1993 and a second offering that was planned in 1993 and abandoned in 1994. The Commissioner did not attempt to require capitalization of the salaries, benefits, and overhead attributable to servicing the contracts. In total, the Commissioner capitalized $213,028 out of $280,222 of total compensation and benefits, including virtually all of the amounts attributable to employees other than the president and vice-president, and over two thirds of the overhead (including rent).

- The Tax Court, in a reviewed opinion by Judge Laro, held that the salaries and benefits were capital expenditures because these items were directly related to the process of anticipated acquisition of assets with expected useful lives exceeding one year. Judge Laro's opinion was grounded primarily on the principles of *Lincoln Savings and Loan Ass'n*, 403 U.S. 345 (1971), *Idaho Power Co.*, 418 U.S. 1 (1974)*, Woodward v. Commissioner*, 397 U.S. 572 (1970), and *Helvering v. Winmill*, 305 U.S. 79 (1938). The court expressly rejected the taxpayer's argument that the salaries and benefits were deductible because they were fixed costs that flowed from employment and were not occasioned by the acquisitions of the contracts, and distinguished the Eighth Circuit's opinion in *Wells Fargo & Co. v. Commissioner,* 224 F.3d 874 (8th Cir. 2000), as involving an important factual distinction. In *Wells Fargo*, the acquisition in question was "extraordinary" to the taxpayer's business and to the daily course of the employees' duties; they would have been paid the same salaries anyway. *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822 (3d Cir. 2000), *rev'g* 110 T.C. 349 (1998), however, was found not to be meaningfully factually distinguishable. Rather, the Tax Court expressly rejected the Third Circuit's holding [that the recurring nature of the salary expenses that were connected to current income removed them from capitalization] and followed its own prior opinion. But the Tax Court nevertheless allowed the overhead expenses to be deducted currently because these items were not directly related to the anticipated acquisitions — they would have been incurred even if the corporation's business had only encompassed servicing the contracts, and their amount did not vary with the number of credit applications processed — and any future benefit received from these expenses was merely "incidental." A loss deduction under § 165(a) was allowed with respect to the portion of the capitalized salaries and benefits that was attributable to installment contracts that were never acquired. The offering expenditures were capital because they produced significant future benefits, but a § 165 loss deduction was allowed with respect to the offering expenditures attributable to the abandoned offering.
- **Seven judges**, in three separate opinions

authored by Judges Ruwe, Halpern, and Beghe, concurred with the court's opinion requiring that the salaries and benefits be capitalized, but **dissented** from the portion of the opinion allowing the overhead to be deducted. The dissenters would have required capitalization of the overhead as well. Judge Beghe wrote separately only to emphasize the following point:

> . . . It bears observing that the oft-quoted passage in the opinion of the Court of Appeals for the Seventh Circuit in *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 217 (7th Cir.1982), *rev'g*. T.C. Memo.1981-255, which includes the statement that "The administrative costs of conceptual rigor are too great," was uttered in the course of sustaining the Commissioner's determination that the costs in issue in that case had to be capitalized. However, the Court of Appeals then suggested that the distinction between recurring and nonrecurring costs might provide the line of demarcation in some cases, but went on to observe that the distinction wouldn't make sense when the taxpayer's sole business was the creation or acquisition of capital assets. Although ACC's business includes the servicing as well as the acquisition of capital assets, the relatively short average time the acquired loans remain outstanding raises questions about administrability, the costs of conceptual rigor, and whether the exercise has been worth the candle.
>
> These musings lead me to suggest the time has come to request respectfully that the Congress step in and enact some bright-line rules that will provide guidance to the business community and the Internal Revenue Service and reduce the burdens of compliance and controversy on the public, the Service, and the courts. Sections 195 and 197 come to mind as possible starting points or models.

- See also, FSA 200136010.

5. Is there is a *de minimis* exception to the rule of capitalization if expensing clearly reflects income? Alacare Home Health Services, Inc. v. Commissioner, T.C. Memo. 2001-149 (6/22/01). A Medicare-certified home health care agency deducted $467,000 and $351,000 for numerous purchases of equipment in the years in question. The equipment items each cost $500 or less and had a life of two years or less; and the expensing treatment was consistent with Medicare accounting. The Tax Court (Judge Colvin) upheld the Commissioner's position requiring the expenditures to be capitalized because the taxpayer's treatment did not clearly reflect income. Judge Wells distinguished *Union Pacific Railroad Co., Inc. v. United States*, 208 Ct. Cl. 1 (1975), cert. denied 429 U.S. 827 (1976), and *Cincinnati, New Orleans & Tex. Pac. Railway Co. v. United States*, 191 Ct. Cl. 572 (1970), both of which allowed a railroad to expenses *de minimis* capital expenditures under an ICC directed accounting method, on the grounds that the deductions in those cases were a much lower percentage of gross receipts – .03% to .07% in the railroad cases compared with .85% and .71% in the instant case – and that the treatment in the railroad cases clearly reflected income. Nevertheless, penalties were not upheld because taxpayer had consistently followed the method in the past and had reasonably relied on its return preparer.

6. More capitalized environmental remediation costs.[5] United Dairy Farmers, Inc. v. United States, 267 F.3d 510, 88 A.F.T.R.2d 6116 (6th Cir. 10/3/01), *aff'g* 107 F.Supp.2d 937, 2000-1 U.S.T.C. ¶ 50,538, 85 A.F.T.R.2d 2235 (S.D. Ohio 5/23/00). Taxpayer incurred environmental remediation expenses to clean-up pollution caused by prior owners who operated gas stations on the site of a convenience store. Even though the taxpayer was unaware of the pollution at the time of the purchase and thus "overpaid" for the property, the expenses were required to be capitalized because they "increased the value of the property." Rev. Rul. 94-38, 1994-1 C.B. 35 did not apply. The Sixth Circuit concluded that "when a taxpayer improves property defects that were present when the taxpayer acquired the property, the remediation of those defects are capital in nature..... [W]hen a taxpayer has improved defects that were present when the taxpayer acquired the property, *Plainfield-Union* [*Water Co. v. Commissioner*, 39 T.C. 333 (1962)] does not apply." Rather, *Dominion Resources, Inc. v. United States*, 219 F.3d 359 (2000), was more apposite.

• On another issue, the court held that accounting fees paid to Ernst & Young in connection with a corporate reorganization incident to making an S election had to be capitalized.

7. Kudos from practitioners; pans from professors. Advanced Notice of Proposed Rulemaking ("ANPRM") REG-125638-01, Guidance Regarding Deduction and Capitalization of Expenditures, 67 F.R. 3461 (1/24/02). Describes rules and standards Treasury and IRS plan to propose under § 263(a) [and not under §§ 195, 263(g), 263(h) or 263A] to provide a framework for addressing capitalization issues with respect to expenditures incurred in

5. Under § 198, certain environmental remediation costs that are paid or incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site may be currently deducted.

acquiring, creating, or enhancing intangible assets. Safe harbors and simplifying assumptions including a "one-year rule" under which expenditures relating to short lived intangibles need not be capitalized and "de minimis rules" under which certain types of expenditures under a specified dollar amount are not required to be capitalized.

- Specifically (A1) loan portfolios would have to be capitalized; (A2) amounts paid for § 197 intangibles would have to be capitalized; (B1) no capitalization would be required under the 12-month rule;[6] (B2) prepaid items beyond 12 months would have to be capitalized; (B3) market entry payments would have to be capitalized, but not costs to obtain ISO 9000 certification; (B4) amounts paid for government licenses that are valid indefinitely would have to be capitalized; (B5) amounts paid to modify contractual rights would have to be capitalized, but not those paid where the parties do not enter into a new or renegotiated agreement; (B6) amounts paid by a lessor to terminate a lease would have to be capitalized over the remaining period of the lease; (C) transaction costs would have to be capitalized, but this rule would not require capitalization of employee compensation, fixed overhead costs, or costs that do not exceed a specified dollar amount such as $5,000. Loan origination costs would be deductible, following the Third Circuit's opinion in *PNC Bancorp,* and giving up the IRS's victories in the Tax Court in *PNC Bancorp* and *Lychuck.*

C. Reasonable Compensation

1. It looks like maybe you can't always zero out a professional service corporation's taxable income. Pediatric Surgical Associates, P.C. v. Commissioner, T.C. Memo. 2001-81 (4/02/01). The Tax Court (Judge Halpern) upheld in part the disallowance of deductions for bonuses to the four shareholder-employees of a medical professional corporation that had 20 employees, including two surgeons who were not shareholders. The question, said the court, was not whether the amounts paid were reasonable but whether they were received for services. Because the shareholder-physicians were not the only physicians, what the physicians could have earned if self-employed was therefore not determinative. Rather, Judge Halpern examined the acts to determine the portion of the corporation's profit attributable to the services of the nonshareholder-physicians, and disallowed the deduction to that extent.

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6. See Zaninovich v. Commissioner, 616 F.2d 429 (9th Cir. 1980) (prepayment of rent for twelve-month period straddling two taxable years deductible when made; an allocation not required because benefits did not extend *substantially* beyond close of taxable year).

2. Not all courts accept the hypothetical investor test. Eberl's Claim Service, Inc. v. Commissioner, 249 F.3d 994, 2001-1 U.S.T.C. ¶ 50,396, 87 A.F.T.R.2d 2075 (10th Cir. 5/4/01). The taxpayer operated a catastrophic claims adjustment service and paid its sole shareholder $4,340,000 and $2,080,000 in compensation, most of which was contingent, for the years in question. The adjusters employed by taxpayer were compensated five to ten percent above industry standard. Applying a multi-factor test, the Tax Court allowed $2,340,000 and $1,080,00, in the respective years, as reasonable compensation to the employee-sole shareholder. The Court of Appeals, likewise applying a multi-factor test, affirmed. In doing so, the court specifically declined to follow the lead of *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999), in which Judge Posner castigated the Tax Court (and other courts) for reliance on "factors" in resolving "reasonable compensation" cases and held that as long as the payments were intended to be compensation the inquiry turns completely on whether a hypothetical investor would be satisfied with the return on the investment that resulted form the employee/shareholder's management activities.

- The court of appeals summarized its approach and contrasted it with that of other circuits:

> Whatever the relative wisdom of the two approaches, absent en banc rehearing we are bound to the use of a multi-factor approach by our prior decision in *Pepsi-Cola Bottling* [528 F.2d 176 (10th Cir. 1976)]. n6
>
> > n6 Further, of those Circuits that have embraced an independent investor test, only the Seventh has gone so far as to jettison the multi-factor approach entirely. Others have merely committed to viewing the totality of the circumstances through the "lens" of, Dexsil Corp., 147 F.3d at 101, or "from the perspective of," Elliotts, 716 F.2d at 1245, a hypothetical outside investor. Those Circuits have retained the totality of the circumstances approach that this Court embraced in Pepsi-Cola Bottling.

3. The court recited factors, but in the end it was all independent investor based analysis. Wagner Construction, Inc. v. Commissioner, T.C. Memo. 2001-160 (6/29/01). In a reasonable compensation case [appealable to the Eighth Circuit], the Tax Court (Judge Parr) carefully recited the analysis of the compensation under a ten-factor test. Then, in the conclusion, determined the aggregate amount that was reasonable compensation by (1) calculating the dollar amount of a reasonable return on invested capital (based on the evidence regarding a reasonable rate of return [28.2% before-tax] and the amount of invested capital [beginning of the year equity]), (2) adding together the two officer/shareholders' compensation for the year and retained earnings for the year, and (3) subtracting the fair return amount from the latter amount. The court simply announced how much of the aggregate reasonable compensation related to each officer/shareholder.

4. Does it look like a trend is developing? Damron Auto Parts, Inc. v. Commissioner, T.C. Memo. 2001-197 (7/30/01). In a reasonable compensation case [appealable to the Eleventh Circuit], the Tax Court (Judge Foley) analysis briefly mentioned various relevant factors. Then, focusing entirely on the 39 percent annual compound rate of return [in appreciation], found that the compensation was reasonable because, according to the Commissioner's expert, an independent investor would have been satisfied with a 14.3 percent return. Ten percent of aggregate compensation was disallowed, however, because it was for services performed for other related corporations.

5. More creeping influence of the hypothetical independent investor test. B&D Foundations, Inc. v. Commissioner, T.C. Memo. 2001-262 (10/3/01). In a reasonable compensation case [appealable to the Tenth Circuit], Judge Beghe applied the multi-factor test of *Erbel's Claim Service, Inc. v. Commissioner*, 249 F.3d 994 (10th Cir. 2001) and *Pepsi Cola Bottling Co. of Salina v. Commissioner*, 528 F.2d 176 (10th Cir. 1975), [citing the *Golsen* rule] to uphold the Commissioner's disallowance of a deduction for $353,911, out of $1,113,800 of compensation paid to the husband and wife employee/shareholders. Notably, Judge Beghe included an extensive discussion of the return to a hypothetical independent investor as a factor, even though that item was not a factor applied in either *Erbel's Claim Service* or *Pepsi Cola Bottling Co.*

D. Miscellaneous Expenses

1. Just a *de minimis* whipsaw. Leschke v. Commissioner, T.C. Memo. 2001-18 (1/26/01). The taxpayer's S corporation was allowed to deduct the full cost of $61 nut baskets and $100 bills given to employees at Christmas. Section 274(c) did not limit the deduction to $25 because § 102(c) precluded treating as gifts items given to employees. That the employer did not report the nut baskets [which we, but not the court, note possibly could qualify as *de minimis* fringe benefits under Reg. § 1.132-6] or the $100 bills as compensation on the employees' Forms W-2 or withhold taxes did not preclude characterizing the items as deductible compensation.

2. New leveraged lease guidelines. Rev. Proc. 2001-28, 2001-19 I.R.B. 1156 (5/7/01). This revenue procedure provides guidelines that the IRS will apply to advance ruling requests to determine whether leveraged lease transactions will be treated as leases for tax purposes. Rev. Proc. 75-21, 1975-1 C.B. 715, is modified and superseded. Among the many requirements is the continued requirement that the lessor expects to receive a profit from the transaction apart from the tax benefits arising from the transaction. The most significant change is a modification permitting certain restricted investments in the property by the lessee. Generally speaking, "severable investments" are eligible, but investments that render the property "limited [to the lessee's] use" for substantially its entire useful life are disqualified. Rev. Proc. 2001-29, 2001-19 I.R.B. 1160 (5/7/01), sets forth the information and representations required to be furnished by taxpayers in requests for advance rulings on leveraged lease transactions.

3. The deduction was more than the includible compensation – And it was legal! Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197 (3/28/00). Pursuant to Reg. § 1.162-25T, an employer-corporation that provided private nonbusiness flights on a company owned airplane to employees was permitted to deduct the cost of providing the flights because the fair market value of the flights was included in the employees' reported compensation under Reg. § 1.61-21(b). Accordingly, pursuant to § 274(e)(2), the limitations of § 274 did not apply even though the airplane otherwise could be considered to be an entertainment facility. Furthermore the employer's deduction was not limited to the lesser amount includable by the employees under special fringe benefit valuation rules in Reg. § 1.61-21(g).

a. Affirmed by: Sutherland Lumber-Southwest, Inc. v. Commissioner, 255 F.3d 495, 88 A.F.T.R.2d 5026, 2001-2 U.S.T.C. ¶ 50,503 (8th Cir. 7/3/01) (per curiam). The court stated:

> In this case of first impression, we must determine the amount of expenses corporations may deduct on their income tax returns when they allow their officers to use corporate aircraft for personal vacations. . . . Confronted by this textual ambiguity, the Tax Court employed standard canons of construction. . . . The court found the Commissioner's general

> purpose-based arguments less persuasive than the specific extratextual indications that subsection (e)(2) was meant to remove properly reported entertainment expenses from the ambit of subsection (a), and ruled in favor of Sutherland. This conclusion obviated the need to determine whether a corporate aircraft could as a matter of fact and law constitute a "facility used in connection with [entertainment, amusement, or recreation]" under § 274. . . . After a complete review de novo, we agree with the Tax Court's well-reasoned opinion, and affirm on the basis of the analysis set forth therein. See 114 T.C. 197 (2000). Because we have nothing of substance to add to the Tax Court's thorough analysis, further discussion is superfluous.

b. Acquiescence. 2002-6 I.R.B. 459 (2/11/02).

4. Janus-like, the same payments that were deductible compensation in the Tax Court are travel reimbursements exempt from employment tax in the Court of Claims. United Airlines wins on one theory in the Tax Court. UAL Corp. v. Commissioner, 117 T.C. 7 (7/13/01) (reviewed opinion; the alignment of the concurring opinions is too convoluted to explain; 3½ dissents). Pursuant to union contracts, United Airlines paid pilots and flight attendants a per diem allowance regardless of whether they were away from home overnight; flight attendants received $1.50 times the number of hours on duty or on flight assignment; pilots received $1.50 per hour and $1.55 per hour after 4/1/86. [United also paid actual overnight lodging expenses.] United did not require employees to substantiate use of the per diem and there was no written substantiation as to the employees' actual use of the allowances. United originally deducted the per diem payments as travel expenses, and reduced its deductions under § 274(n) after 1987. The Commissioner disallowed the deductions for lack of substantiation, and when United argued that the payments should be fully deductible as compensation, the Commissioner denied the deduction for want of compensatory intent at the time the payments were made, even though reasonableness was not at issue. The majority, in an opinion by Judge Laro, allowed the deduction:

> The presence of such a bona fide employment relationship and such a need to pay per diem allowances in order to secure personal services is enough under the facts at hand to persuade us that United paid the per diem allowances to the employees for their services. . . . Respondent places undue emphasis on the fact that the union contracts do not specifically characterize

> the per diem allowances as personal service compensation. Such a characterization by the parties to the contracts is not dispositive as to the characterization of the per diem allowances for Federal income tax purposes.

The court noted that in a related case pending in the Court of Federal Claims the government was arguing that the same payments were wages for employment tax purposes.

- Judge Ruwe, concurring, cogently, explained that:

> [T]he relevant statute [§ 162(a)(1)] and regulations [Reg. § 1.167-7(a)] do not require an "intent to compensate" as a prerequisite to deductibility under section 162(a)(1). Although an "intent to compensate" requirement has been applied by the courts in numerous cases, the instant situation is factually distinguishable from the situation in those cases which involved corporate payments to shareholders or employees in positions of control. [citations omitted] In the context of corporate payments to shareholders, careful scrutiny is required to determine whether the alleged compensation is in fact a disguised dividend. . . . [As the majority opinion correctly states, the payor's intent is simply a pertinent factor to consider, not a prerequisite to deductibility.]

- Judge Ruwe also thought it necessary to explain exactly why the payments were not travel expenses, i.e., payments for meals for day-trippers simply cannot be travel expenses, and travel expenses under a nonaccountable plan that exceed the relevant per diem allowances, which the amounts in the case did exceed, must be included by the employee and as a corollary are deductible by the employer.
- **Dissent**. Noting that the period of limitations had expired with respect to the employees [who undoubtedly included nothing], Judge Swift's dissent focused on the inconsistency of United's positions, rather than the inconsistency of the government's positions.

> The more significant concern with regard to "inconsistent" characterizations in this case should be with United's efforts to recharacterize entirely the per diem allowances that *United, its employees, and the labor unions, for all other purposes, treated as employee travel expenses*. *United now*, years later, and *solely for Federal income tax purposes*, attempts to inconsistently treat such travel expenses

> as employee compensation, outside the scope of the substantiation requirements of section 274(d), and fully deductible under section 162(a)(1).
>
> An extensive body of case law limits a taxpayer's ability to change the treatment of reported items of income and deductions. [emphasis in original; footnote omitted]

• Judge Swift also was concerned with the "the casual manner by which the majority opinion bypasses the substantiation requirements of section 274(d)."

a. And on a different issue with respect to same items, United Air Lines wins in the Court of Claims on a mutually inconsistent theory. United Air Lines, Inc. v. United States, 88 A.F.T.R.2d 5459, 2001-2 U.S.T.C. ¶ 50,577 (Ct. Cl. 8/10/01). The Commissioner simultaneously treated the payments in *UAL Corp.*, *supra*, as wages for employment tax purposes. The Court of Federal Claims held that the payments were exempt from FICA and withholding because they were intended to reimburse employees for travel expenses and taxpayer should not be required [under Reg. §§ 31.3401(a)-1(b)(2) and 31.3121(a)-1(h)] retroactively "to demonstrate objective proof" in addition to the union contracts that it had a "reasonable belief" that the reimbursements did not exceed travel expenses. The court noted that in *UAL Corp.*, the taxpayer had prevailed in deducting the entire amount of the per diem as compensation, but that did not affect its reasoning; it stated that United "in the first instance, will elect its preferred treatment of the reimbursements."

5. The IRS never seems able to catch up with the movements in the price of gasoline. Rev. Proc. 2001-54, 2001-48 I.R.B. 530 (11/7/01), updating Rev. Proc. 2000-48, 2000-49 I.R.B. 570. The optional standard mileage rate for business use of automobiles will increase on 1/1/02 from 34.5 cents per mile to 36.5 cents per mile, the mileage rate for medical and moving will increase from 12 cents per mile to 13 cents per mile, and the mileage rate for giving services to a charitable organization will remain at 14 cents per mile.

E. Depreciation & Amortization

1. Patton v. Commissioner, 116 T.C. 206 (4/13/01). A § 179 election to expense otherwise depreciable assets must be made on the taxpayer's first return for the year or on a timely amended return [see Reg. § 1.179-5(a)], and cannot be modified without the Commissioner's consent. The Commissioner did not unreasonably withhold consent to modify the original election [to expense a single $4,100 asset] to apply to other capital expenditures that were reclassified as such on audit after taxpayer deducted them as "supplies." [It's also worth noting that although taxpayer originally reported a loss of $38,826 for the year, a bank deposit method audit turned up $135,638 of unreported gross receipts in addition to the erroneous deduction.]

2. Section 197 amortization applies to noncompete agreements ancillary to stock redemptions. Frontier Chevrolet Co. v. Commissioner, 116 T.C. 289 (5/15/01). The Tax Court (Judge Ruwe) held that § 197 applied to a covenant not to compete entered into when a corporation redeemed the stock of its 75-percent owner. The covenant not to compete had to be amortized over 15 years under § 197, even through it was for only a 5-year term because the redemption constituted the acquisition of an interest in a trade or business. [The holding is consistent with Reg. § 1.197-2(b)(9), which was not applicable because the case arose prior to its effective date.]

3. What would Groucho Marx say? Important guidance on depreciation for the country club set. Rev. Rul. 2001-60, 2001-51 I.R.B. 587 (11/29/01). This revenue ruling provides guidance clarifying what golf course land preparation costs can be depreciated. Land preparation undertaken in the original construction or reconstruction of push-up or natural soil greens is inextricably associated with the land and, therefore, the costs attributable to that land preparation are not depreciable. However, the costs of land preparation of modern greens that are closely associated with depreciable assets, such as a network of underground drainage tiles or pipes, that the land preparation will be retired, abandoned, or replaced contemporaneously with those depreciable assets are to be capitalized and depreciated over the recovery period of the depreciable assets with which the land preparation is associated.

F. Credits

1. The peripatetic research credit regulations.

a. The final research credit regulations that weren't. In T.D. 8930, Credit for Increasing Research Activities, 66 F.R. 280 (1/3/01), the IRS promulgated final regulations relating to the computation of the credit under § 41(c) and the definition of qualified research under § 41(d). The final regulations immediately came under withering criticism from the business sector, and, in an unusual move, in Notice 2001-19, 2001-10 I.R.B. 784 (2/1/01), the Treasury (Secretary O'Neill, himself, actually) announced that it will review the "final" regulations by reconsidering the comments submitted and requesting additional comments on the regulations to be received by 4/2/01. Any additional changes to the regulations will be made in proposed form. The regulations, including any future changes, will not be effective until the review is complete, except for the retroactive effective date [12/31/85] of the taxpayer-friendly changes to internal-use computer software rules. Taxpayers may rely on the final rules pending new regulations.

• **What the suspended final regulations said.** The final regulations covered the requirements to qualify for the credit, rules for computing the credit, and rules for electing and revoking the election of the alternative incremental credit, and take into account the Legislative history of the Tax Relief and Extension Act of 1999.

• The final regulations did not change the definition of gross receipts from that in the Proposed Regulations. REG-105170-97, 63 F.R. 66503 (12/2/98).

• The final regulations retained the requirement in the proposed regulations that a taxpayer seek to discover information that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field of science or engineering.[7] But, in response to comments regarding the discovery requirement, the final regulations made a number of changes.

• In order to satisfy the discovery requirement, research must have been undertaken for the purpose of discovering information that is beyond the knowledge that *should be known* to skilled professionals had they performed a reasonable investigation of the existing level of knowledge *in the particular field of science or engineering* [instead of technology or science], but there was no requirement that a taxpayer actually conduct such an investigation in order to claim the credit. The regulations also stated, by example, that trade secrets generally are not within the common knowledge of skilled professionals (because they are not reasonably available to skilled professionals not employed, hired, or licensed by the owner of such trade secrets). Underlying principles of science or engineering used in the research need not be novel. Obtaining a patent [other than a design patent] raises a conclusive taxpayer favorable presumption.

• The prescribed four-step process in the definition of experimentation in Prop. Reg. § 1.41-4(a)(5) was eliminated.

• The requirement of experimental record

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7. A discovery requirement was applied in United Stationers, Inc. v. United States, 163 F.3d 440 (7th Cir. 1998), *cert. denied*, 119 S. Ct. 2369 (1999), Norwest v. Commissioner, 110 T.C. 454 (1998), and WICOR, Inc. v. United States, 116 F. Supp. 2d 1028 (E.D. Wis. 2000).

keeping in Prop. Reg. § 1.41-4(a)(5) was eliminated.

- The shrinking-back rule was modified in response to comments. Reg. § 1.41-4(b).
- The exclusion of most activities after commercial production has commenced was retained. The *per se* exclusion list retained debugging, but not correction of flaws.
- Research with respect to internal-use software that satisfied both the general conditions for credit eligibility and the three-part test was eligible for the credit. The final regulations retained the definition of internal-use software and the additional qualifying test in the proposed regulations, but provide a new exception (pursuant to § 41(d)(4)(E)) under which certain internal-use software used to deliver noncomputer services to customers with features that are not yet offered by a taxpayer's competitors is not subject to the additional tests. Following the Conference Report to the 1999 Act, the final regulations clarified that software that is intended to be used to provide noncomputer services to customers is internal-use software, while software that is to be used to provide computer services is not developed primarily for internal use.
- The final regulations clarified (1) that the three-part test in the proposed regulations is the high threshold of innovation test, and not a separate requirement, and (2) how the three-part part high threshold of innovation test supplements the discovery requirement. Research with respect to internal-use software is credit eligible only if it is intended to exceed, expand, or refine the common knowledge of skilled professionals (as defined in Reg. § 1.41-4(a)(3)(ii)) to a degree that is substantial and economically significant.

b. The new research credit proposed regulations that are. REG-112991-01, Credit for Increasing Research Activities 66 F.R. 66362 (12/26/01). The Treasury published new proposed regulations under § 41 that expand the definition of qualified research by eliminating the "discovery test" included in the 1/3/01 regulations.

- Treasury and IRS have eliminated in these proposed regulations the requirement that qualified research must be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering. Rather, Treasury and the IRS believe that the requirement that qualified research be "undertaken for the purpose of discovering information which is technological in nature" is intended to distinguish technological research, which may qualify for the research credit, from non-technological research, which does not.
- The proposed regulations repeat the

requirement from Reg. § 1.174-2(a)(1) by stating that research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty, for purposes of this requirement, exists if the information available to the taxpayer does not establish the capability or method of developing or improving the business component, or the appropriate design of the business component.

- The proposed regulations revise the shrinking-back rule to conform it to the rule in the legislative history to the 1986 Act. These proposed regulations also reiterate that the shrinking-back rule may not itself be applied as a reason to exclude research activities from credit eligibility.
- No separate research credit-specific documentation requirement is included in these proposed regulations.

- The preamble notes that the Service will not generally challenge return positions that are consistent with the proposed regulation.

3. WICOR, Inc. v. United States, 263 F.3d 659, 88 A.F.T.R.2d 5474, 2001-2 U.S.T.C. ¶ 50,576 (7th Cir. 8/14/01), *aff'g* 116 F. Supp. 2d 1028 (E.D. Wis. 2000). In an opinion by Judge Posner, the Seventh Circuit affirmed the denial of the § 41 research credit to the taxpayer with respect to internal use software that did not "discover" technological information. That Andersen Consulting, which developed software integrating purchase software into a single system for the taxpayer and which [under the contract] owned the source code for the system software, did not bother to retain a copy of the source code itself was probative that nothing usable by anyone else was "discovered."

4. No, you can't have 15 years to amend your return. Chrysler Corp. v. Commissioner, 116 T.C. 465 (6/29/01). Chrysler claimed a deduction for foreign income taxes on its 1980, 1981, and 1982 tax returns. On July 24, 1995, Chrysler filed amended returns electing to claim the foreign tax credit for those years and amended its 1985 return to claim a refund from a carryover of the foreign tax credits to 1985 (which freed-up ITCs from 1985 to carry forward to future years). The Tax Court (Judge Laro) upheld the Commissioner's determination that the election to claim the foreign tax credit was untimely. The ten year period for electing the foreign tax credit under § 901(a) and § 6511(a) and (d)(3)(A) [extending the period from 3 years to 10 years] begins with the year with respect to which the foreign tax credit is elected, not [as argued by the taxpayer] the later year to which it is carried.

5. Big brother may be watching your mouth, but he won't give your dentist a tax credit for it. Fan v. Commissioner, 117 T.C. 32 (6/24/01). Dr. Fan, who had some hearing-impaired patients, purchased an intraoral camera system [consisting of a camera and monitor, video presentations and educational materials] for use in his dental practice, which was an eligible small business as defined in § 44(b). The system was useful with respect to all of his patients, but because Dr. Fan considered the system to be a more effective and efficient way to communicate with hearing-impaired patients, he claimed the § 44 disabled access credit for the cost of the system. The Tax Court upheld the Commissioner's disallowance of the credit on the grounds that the system was not an "eligible access expenditure" as defined in § 44(c). Dr Fan was already ADA compliant; and the system was not marketed as, acquired, or used specifically as an auxiliary aid or service to ensure effective communication to comply with the applicable requirements of the ADA.

6. Tax credit provisions in the **2001 Act**.

a. The § 51 work opportunity credit was extended through 12/31/01.

b. The hiring date for eligibility for the § 51A welfare-to-work credit was extended through 12/31/01.

7. New § 45F was added. Starting in 2002, it provides a credit of up to $150,000 to an employer for 25 percent of the employer's "qualified child care expenditures" and 10 percent of the employer's "qualified child care resource and referral expenditures." The credit is available with respect to a broad range of expenditures incurred to provide childcare facilities and services for the taxpayer-employer's employees. Myriad special rules, worthy of any direct spending government subsidy program, are imposed on qualification for this tax expenditure, including a recapture of a credit if a facility ceases to be used for child care after the credit is allowed with respect to the facility. In general, the benefits received by the employees as a result of the expenses for which the employer receives the credit are excludable from gross income under § 129.

G. Natural Resources Deductions & Credits

1. A § 29 credit no-ruling issue. Rev. Proc. 2000-47, 2000-46 I.R.B. 482 (11/13/00). Rev. Proc. 2000-3, § 5, 2000-1 I.R.B. 103, is amplified by adding to the list of issues on which the IRS will not issue advance rulings the question of whether a solid fuel other than coke or a fuel produced from waste coal is a qualified fuel under § 29(c)(1)(C). Waste coal for this purpose is limited to waste coal fines from normal mining and crushing operations and does not include fines produced (for example, by crushing run-of-mine coal) for the purpose of claiming the credit.

a. Rulings will again be available. But Treasury didn't revert to pre-suspension ruling standards. Rev. Proc. 2001-30, 2001-19 I.R.B. 1163 (4/22/01), *modified by* Rev. Proc. 2001-34, 2001-22 I.R.B. 1293 (5/8/01). The ruling provides the circumstances under which the Service will issue private letter rulings regarding whether a solid fuel produced from coal is a qualified fuel under § 29(c)(1)(C). The circumstances necessary for the Service to issue a private letter ruling include the presence of coal feedstock particles no larger than a specific size, and the performance of specific activities in processing the feedstock in order to effectuate a significant chemical change. The chief requirement is that the fuel be "synthetic." To be synthetic "a fuel must differ significantly in chemical composition, as opposed to physical composition, from the substance used to produce it." Examples of "favorable processes" set forth in the revenue procedure include "gasification [sic] and liquefaction [sic] and production of solvent refined coal that result[s] in substantial chemical changes to the entire coal feedstock rather than changes that affect only the surface of the coal."

b. Eleven days later, the Treasury did revert to pre-suspension ruling standards. The world is again safe for sellers of processes and tax advantages. Rev. Proc. 2001-34 modifies Rev. Proc. 2001-30 to expand the range of sizes of coal feedstock and to eliminate one particular activity as a necessary part of a process that results in a qualified fuel.

2. The Exxon Saga: After an initial setback in the Tax Court, Exxon has been meeting with success in the Federal Circuit on the issue of taking percentage depletion on fixed contract natural gas on representative market or field prices that are greatly in excess of the actual sale price for the gas.

a. Tax Court: Taxpayer not permitted to follow the literal language of the regulations. Exxon Corp. v. Commissioner, 102 T.C. 721 (6/6/94). Taxpayer was not permitted to follow the literal language of Reg. § 1.613-3(a) and use "representative market or field prices" (RMFP) in determining "gross income from the property" for purposes of computing percentage depletion under § 613A(b)(1)(B) ["fixed contract" exception]. Even though the regulation states that "the gross income from the property shall be assumed to be equivalent to RMFP" with respect to natural gas transported from the premises prior to sale, the purpose of that provision was to prevent integrated producers from taking depletion deductions on transportation, refining, etc. -- and not to permit a taxpayer to take depletion based upon a RMFP price five times the actual sale price of the natural gas to an Exxon affiliate. The actual contract sale price was therefore reduced by royalties and transportation expenses to determine "gross income from the property."

b. Same issue in Court of Federal Claims. Exxon Corp. v. United States, 33 Fed. Cl. 250, 75 A.F.T.R.2d 1733, 95-1 U.S.T.C. ¶ 50,245 (Fed. Cl. 4/11/95). On the same issue, the court held that while the amount upon which depletion can be taken is not necessarily limited by actual gross income [21 cents], the RMFP calculated by Exxon [41 cents] was not a reasonable basis upon which depletion may be taken and [based upon the burden of proof] the complaint was dismissed. **But reversed . . . .**

c. Federal Circuit holds that RMFP which exceeds actual gross receipts is not precluded, nor is it per se "unreasonable." Exxon Corp. v. United States, 88 F.3d 968, 77 A.F.T.R.2d 2521, 96-2 U.S.T.C. ¶ 50,324 (Fed. Cir. 6/20/96), *cert. denied* (3/17/97), *rev'g and remanding* 33 Fed. Cl. 250, 75 A.F.T.R.2d 1733, 95-1 U.S.T.C. ¶ 50,245 (Fed. Cl. 1995). Court finds taxpayer entitled to calculate its depletion deduction based upon an RMFP of 39 cents based upon the wellhead price that would be realized by nonintegrated producers. The court further held that the Court of Federal Claims should not have limited the price by making an independent assessment of the reasonableness of the price because the § 611(a) language "reasonable allowance . . . in each case" refers to the different types of depletable resource, not to individual taxpayers.

d. And you thought you couldn't deplete more than your gross income. Of course you can! Exxon Corp. v. United States, 45 Fed. Cl. 581, 2000-1 U.S.T.C. ¶ 50,116, 84 A.F.T.R.2d 7235 (Fed. Cl. 12/2/99). Exxon sought a $172.6 million refund based on percentage depletion for 1975, under § 613A(b)(1)(B), allowing § 613 percentage depletion for natural gas sold under a fixed contract. The long-term contracts in issue were with Houston Lighting & Power Co. (HL&P) and with Southwestern Electric and Power Co. (SWEPCO). The IRS assessed a deficiency for 1975 on the grounds that Exxon was not entitled to use the RMFP under Reg. § 1.613- 3(a) to compute percentage depletion because the fixed-contract exception in § 613A(b)(1)(B) did not permit use of the RMFP. Exxon filed suit, and the Court of Claims initially denied the government's motion for summary judgment, in which the government argued that Reg. § 1.613-3(a) did not apply to post-1974 depletion allowed under the fixed contract exception.

• On the government's motion for summary judgment, the court (Senior Judge Gibson) held that: (1) Reg. § 1.613-3(a), absent evidence that the regulation systematically causes a material distortion of the "gross income from the property," was not facially invalid as applied to percentage depletion deduction pursuant to the post-1974 fixed contract exception [even if the RMFP exceeded the actual sales price, which it can under *Exxon Corp. v. United States*, 88 F.3d 968 (Fed. Cir. 1996)], and (2) evidence raised genuine issues of material fact that the regulation produced a result that was arbitrary, capricious, or manifestly contrary to the post-1974 statutory percentage depletion scheme. 40 Fed. Cl. 73 (1998).

After trial, the court held:

• First: Not all of the natural gas was eligible under Reg. § 1.613A-7(c)(5) and (d). Exxon failed to prove that its contract with HL&P qualified as a "fixed contract." The HL&P excess royalty reimbursement and additional gas contract terms permitted Exxon, in part, to raise prices after Feb. 1, 1975, by amounts tied to the market price for natural gas [which would allow it to recover through price increases increased tax liabilities arising from the repeal of percentage depletion], and the sales prices did in fact increase. Exxon did not prove by "clear and convincing evidence" that the price increase did not "to any extent" permit it to recoup tax increases attributable to the repeal of percentage depletion. The contract with SWEPCO, however, was qualified. Although the contract had a price adjustment clause under which Exxon "could potentially have recovered a portion of its increased income tax liabilities," the contract qualified as a "fixed contract" because the contract price did not in fact increase after February 1, 1975.

• Second: For calculating Exxon's 1975 percentage depletion allowance, the RMFP is $0.6831 per thousand cubic feet (Mcf) of natural gas that is eligible for percentage depletion. (1) The Texas Gulf Coast/East Texas region, rather than the entire state, constituted a "market area that was geographically 'representative'" of Exxon's 1975 production from the properties at issue. (2) In determining whether that region was the relevant market area, Judge Gibson found that Exxon's 1975 "gas well gas production" – comprising 90.24 percent of the gas in issue – was comparable or superior to gas produced and sold generally through the region; only 9.74 percent [casinghead gas] was not comparable and must be excluded from the computation of Exxon's allowance: (3) After determining the appropriate RMFP transaction sample and adjusting for the pre-sale costs of compression and dehydration, the court held that the RMFP for purposes of Reg. § 1.613-3(a) was $0.6831 per Mcf.

• Exxon had argued that every sale of raw gas at a delivery point anywhere on the producer's leased property was a transaction in which the sale price was untainted by transportation before the sale. The court held that Exxon failed to support that position, and that it was not feasible to cure tainted transactions by subtracting the transportation cost from the gas sale price.

e. Affirmed in part, reversed in part. Literalism triumphs in the Federal Circuit. Taxpayer celebrates a little bit more. Exxon Mobil[8] Corp. v. United States, 244 F.3d 1341, 2001-1 U.S.T.C. ¶ 50,348, 87 A.F.T.R.2d 1508 (Fed. Cir. 4/3/01). The Federal Circuit affirmed the Court of Federal Claims holding that percentage depletion should be calculated with respect to an RMFP that exceed the taxpayer's actual sale price. Judge Michel rejected the government's argument that Reg. § 1.613-3(a) here would lead to "absurd results," and would "thwart the obvious purpose" of the 1975 Act by noting that Treasury considered, but declined to fix, the "perceived anomaly." He so held because "it is not the province of this court to remedy anomalies in the tax laws that Congress and the [Treasury] have refrained from correcting." The 1975 addition of § 613A "may have changed pre-1975 law by redefining what kinds of gas are eligible for percentage depletion, nothing in the regulation changes . . . the method of computing the AMOUNT of percentage depletion or eligible gas." (emphasis in original)

- He also affirmed the trial court's holding that casinghead gas [gas that was dissolved in oil at reservoir conditions but becomes gaseous at atmospheric pressure at the top – or "casinghead – of an oil well] should be excluded from the computation of the RMFP because it was not comparable to its gas well gas. Finally, the court of appeals reversed the trial court's holding that the HL&P contract was not a "fixed price contract," holding as a matter of law that it was a fixed price contract, thereby entitling Exxon to percentage depletion on the gas sold pursuant to that contract. Under the contract, Exxon could not raise the price of gas unless HL&P exercised its rights under the additional gas clause. That did not alter the fact that the price for the original quantity of gas was fixed from Exxon's perspective. HL&P controlled whether the additional gas clause, and thus the price increase, would be invoked.

3. To "produce" or to "transport" gas, that is the question. Saginaw Bay Pipeline Co. v. United States, 88 A.F.T.R.2d 6019, 2001-2 U.S.T.C. ¶ 50,642 (E.D. Mich. 8/23/01). Natural gas gathering systems are used to

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8. In Texas, this word is silent when the name of the taxpayer is pronounced.

transport gas [Class 46.0] – not in production [Asset Class 13.2] – and thus are depreciable over 15 years rather than seven years. The District Court described *Duke Energy Natural Gas Corp. v. Commissioner*, 172 F.3d 1255 (10th Cir. 1999), as "wrongly decided."

4. No second bite at the apple on the definition of "tar sands oil." Shell Petroleum, Inc. v. United States, 50 Fed. Cl. 524, 88 A.F.T.R.2d 6448, 2001-2 U.S.T.C. ¶ 50,724 (10/12/01). The government was granted summary judgment that Shell did not qualify for the § 29 credit. Hydrocarbons produced by means of enhanced recovery techniques in commercial use prior to 4/2/80 are crude oil, not "tar sands oil." Oil produced from tar sands is defined by FEA Ruling 1976-4 [under the Emergency Petroleum Allocation Act], as oil produced from rock types containing "extremely viscous hydrocarbon which is not recoverable in its natural state by conventional oil well production methods including currently used enhanced recovery techniques." Shell was barred by collateral estoppel from litigating the meaning of "currently used enhanced recovery techniques" because it had been previously litigated in *Shell v. United States*, 182 F.3d 212 (3d Cir. 1999), which held that Shell was not entitled to the § 29 credit for oil produced using the same methods.

H. Loss Transactions, Bad Debts and NOLs

1. Notice of Proposed Rulemaking, Equity Options with Flexible Terms; Qualified Covered Call Treatment, REG-115560-99, 66 F.R. 4751 (1/18/01). Section 1092(c)(4) excludes from the definition of a straddle writing a qualified covered call option [which must be publicly traded and not deep in the money] and holding the stock covered by the option. The proposed regulations would permit certain equity options with flexible terms – instruments that have been developed by the securities markets since the current regulations were promulgated – to qualify as long as, among other things, the term is not more than one year and options on the underlying equity with standard terms are outstanding.

2. Is reporting interest income a "super factor" in debt/equity analysis? Cerand & Co., Inc. v. Commissioner, 254 F.3d 258, 2001-2 U.S.T.C. ¶ 50,518, 88 A.F.T.R.2d 5061 (D.C. Cir. 7/6/01). The taxpayer advanced over $1 million to three sibling corporations on "open account." When the sibling corporations went out of business, the taxpayer claimed bad debt deductions. The Tax Court upheld the Commissioner's disallowance of the deduction, finding that the evidence relating to the transfers did not treating them as loans: there were no debt instruments or signed agreements; no fixed maturity date or repayment schedule, no predetermined interest rate, repayments were inconsistent and appeared dependent on financial success, and the objective likelihood of repayment was low due to thin capitalization and no historical success. The District of Columbia Circuit, *applying an abuse of discretion standard*, *vacated and remanded*, stating as follows:

> The critical flaw in the tax court's analysis is its failure . . . to consider Cerand's contemporaneous treatment of sums received from its sister corporations as in part the payment of "interest," taxable as income to Cerand. Over a period of several years, Cerand received $414,220 from the three corporations, of which it booked more than $175,000 as interest income. . . .
>
> Although the tax court abused its discretion by omitting from its analysis a highly significant bit of evidence, we cannot say that, had the court properly weighed this evidence, it necessarily would have reached a different conclusion, because we do not know what weight it assigned to the other evidence.

a. On remand, the Tax Court, not surprisingly, still reaches the same result. T.C. Memo. 2001-271 (10/9/01). On remand Judge Gerber found that the somewhat sporadic reporting of interest that was not uniform in amount or percentage, ranging from 4.7 percent to 11.3 percent, with an average far below the going rate, was inadequate evidence to support a finding a true debtor-creditor relationship. Furthermore, purported principal repayments were merely book entries that were offset by larger advances. The bad debt deduction was disallowed.

3. Intermet Corp. v. Commissioner, 117 T.C. 133 (10/2/01), *on remand from* 209 F.3d 901 (6th Cir. 4/20/00). Under the pre-1999 version of § 172(f), state tax deficiencies and interest on state and federal tax deficiencies were a specified liability losses subject to a 10-year carryback. Judge Wells followed *Host Marriott Corp. v. United States*, 113 F.Supp.2d 790 (D.Md. 2000), *aff'd by order,* 267 F.3d 363, 88 A.F.T.R.2d 5176, 2001-2 U.S.T.C. ¶ 50,580 (4th Cir. 7/20/01), and distinguished *Sealy Corp. v. Commissioner*, 107 T.C. 177, *aff'd*, 171 F.3d 655 (9th Cir. 1999) [holding that accounting and other costs to comply with the 1934 Securities Act and ERISA were not specified liability losses].

I. At-Risk and Passive Activity Losses

1. The statute was self-executing; the taxpayer doesn't have to wait for regulations on self-charged management fees. Hillman v. Commissioner, 114 T.C. 103 (2/29/00). The taxpayer's S corporation performed management services for real estate partnerships in which the taxpayer directly or indirectly was a partner. The taxpayer received passthrough nonpassive income from the S corporation and passthrough passive deductions from the partnerships. Based on § 469(*l*)(2) and its legislative history, under circumstances analogous to those in Prop. Reg. § 1.469-7, 56 F.R. 14034 (4/5/91), permitting the offsetting of "self-charged" interest incurred in lending transactions, the taxpayer offset passive management fee deductions against the corresponding nonpassive management fee income. Section 469(*1*)(2) provides that the IRS "shall" promulgate regulations "which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income)." Prop. Reg. § 1.469-7 permits offsetting of "self-charged" interest incurred in lending transactions, but the IRS did not issue any regulation for self-charged items other than interest. Under the proposed regulations, a taxpayer who was both the payor and recipient of interest was allowed, to some extent, to offset passive interest deductions against nonpassive interest income. The Commissioner argued that the taxpayer could not set off the deductions and income because the IRS had not issued regulations for self-charged items other than interest and had thereby limited the offset. The court (Judge Gerber) held that the substantive set-off rule was self-executing and the taxpayer was entitled to offset the passive management deductions against the nonpassive management income. Such self-charged treatment was congressionally intended not only for interest, but also for other appropriate items, and the Commissioner did not argue that there was any distinction of substance between interest and management fees within the self-charged regime.

a. Well, now, not for this taxpayer and not in the Fourth Circuit. What "plain meaning" giveth in *Gitlitz*,[9] it taketh away in *Hillman*. Reversed, 250 F.3d 228, 2001-1 U.S.T.C. ¶ 50,354; 87 A.F.T.R.2d 1731 (4th Cir. 4/17/01), *rehearing en banc denied*, 2001 TNT 150-12 (6/30/01). The Court of Appeals (Judge Hamilton) reversed, finding "nothing in the plain language of IRC section 469 suggests that an exception to IRC section 469(a)'s general prohibition against a taxpayer's deducting passive activity losses from

9. Gitlitz v. Commissioner, 121 S. Ct. 701, 2001-1 U.S.T.C. ¶ 50,147, 87 A.F.T.R.2d 417 (1/9/01), discussed at VI.D.1.

nonpassive activity gains exists where, as in the present case, the taxpayer essentially paid a management fee to himself." The court reasoned that Hillmans' argument for ignoring the plain language of the statute could prevail only if one of "two extremely narrow exceptions to the Plain Meaning Rule" applied: (1) "when literal application of the statutory language at issue produces an outcome that is demonstrably at odds with clearly expressed congressional intent to the contrary"; or (2) "when literal application of the statutory language at issue 'results in an outcome that can truly be characterized as absurd, i.e., that is so gross as to shock the general moral or common sense.'" In the eyes of the court, neither of those situations was present.

2. A rule that usually helps the taxpayer has a dark side. Bailey v. Commissioner, T.C. Memo. 2001-296 (11/07/01). A real estate rental activity involving rentals under short term contracts – less than seven days – is excluded by Reg. § 1.469-1T(e)(3) from the definition of rental activities under § 469(j)(8) and Reg. § 1.469-9(b)(3). As a result, hours devoted to such an activity are not taken into account in determining the taxpayer's participation in a real estate rental business for purposes of applying the § 469(c)(7) exception to the passive activity rules [material participation for more than 750 hours in one or more real estate businesses that constitutes more than one-half of taxpayer's personal services hours for the year].

3. Good hour logbook – poor use of hours. DeGuzman v. United States, 147 F.Supp.2d 274, 88 A.F.T.R.2d 6805, 2001-2 U.S.T.C. ¶ 50,560 (D.N.J. 5/24/01). The taxpayer-wife was a physician with substantial income; taxpayer-husband reported no taxable income, but performed various services relating to real estate activities, including managing rental real estate owned by the taxpayers and managing the leased premises where the wife's medical practice was conducted. The taxpayers claimed the losses from rental real estate against the wife's medical income under the § 469(c)(7) exception for professional services, based on approximately 800 hours of real estate "business" activity by husband in each of the years in question. The court held that hours proving services relating to property leased from a third party and used in a non-real estate business are not counted toward meeting the 750-hour requirement. Accordingly, because the husband spent approximately 100 hours in each year managing the wife's medical office facilities, the more-than-750-hour requirement was not met and the rental real estate deductions were disallowed passive activity losses.

III. INVESTMENT GAIN

A. Capital Gain and Loss

1. A safe harbor for debt modifications; the debt substitute election is now permanent.

a. Rev. Proc. 99-18, 1999-1 C.B. 736 (3/1/99). This revenue Procedure provides for an election to treat a substitution of publicly traded debt instruments as a realization event for federal income tax purposes, even though it does not result in a significant modification under Reg. § 1.1001-3 (and is, therefore, not an exchange). The election is made by a written agreement between the issuer and the holders of the debt instruments. Under this election, taxpayers do not recognize any realized gain or loss on the date of the substitution, but instead take the gain or loss into account over the term of the new debt instruments. The issuer treats the new instrument as an OID instrument or an instrument with bond premium. The holder takes a substituted basis and treats the new instrument as market discount bond if the redemption price exceeds the substituted basis. The election is applicable to substitutions that occur between 3/1/99 and 6/30/00.

b. Rev. Proc. 2000-29, 2000-28 I.R.B. 113 (6/23/00). This revenue procedure makes the debt substitution election of Rev. Proc. 99-18 permanent [it eliminates the 6/30/2000 sunset date]. Under this election a taxpayer can treat a substitution of debt instruments as a realization event for federal income tax purposes even though there is no "significant modification" under Reg. § 1.1001-3; the taxpayer would not recognize any realized gain or loss immediately, but would take gain or loss into account over the term of the new debt instrument. Rev. Proc. 2000-29 applies to substitutions after March 1, 1999.

c. Rev. Proc. 2001-21, 2001-9 I.R.B. 742 (2/26/01), *modifying and superseding* Rev. Procs. 99-18 and 2000-29. The significant changes are: (1) the newly issued debt may be debt issued in a qualified reopening; (2) the outstanding debt may have been issued with premium; and (3) the determination of whether a substitution does or does not result in a significant modification may be made on the substitution date or, in most cases, on the date that is two business days before the date on which the substitution offer commences.

2. The *Corn Products* doctrine is dead. Long live the § 1221(a)(7) hedging regulations. Notice of Proposed Rulemaking, Hedging Transactions, REG-107047-00, 66 F.R. 4738 (1/18/01). The Tax Relief Extension Act of 1999 added new § 1221(a)(7) to exclude from the definition of "capital asset" any hedging transaction that has been clearly identified as such before the close of the day on which it was acquired, originated, or entered into. This provision in effect largely codified previously promulgated Reg. § 1.1221-2]. The Treasury has proposed comprehensive amendments to Reg. § 1.1221-2 to reflect the enactment and legislative history of § 1221(a)(7). The proposed regulations revise the Treasury regulations to reflect the "risk management" standard elucidated in the legislative history.

- Citing, in the preamble, the legislative history [S. Rep. No. 201, 106th Cong., 1st Sess. 25 (1999)], the proposed regulations claim exclusivity as the means for characterizing gains and losses on hedging transactions as ordinary. If a transaction is outside the regulations, gain or loss from the transaction will not be ordinary even if the property is a surrogate for a non-capital asset, the transaction serves as insurance against a business risk, the transaction serves a hedging function, or the transaction serves a similar function or purpose.

A hedging transaction is defined generally as a transaction entered into in the normal course of business primarily to manage the risk of interest rate or price changes or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings. The preamble states that the definition will include most common types of business hedges. A transaction satisfies the risk management standard if it reduces risk. To enter into a hedging transaction, the taxpayer must have risk when all of its operations are considered (i.e., there must be risk on a "macro" basis). A hedge of a single asset or liability, or pool of assets or liabilities, will be respected as managing risk if the hedge reduces the risk attributable to the item or items being hedged and if the hedge is reasonably calculated to reduce the overall risk of the taxpayer's operations. Transactions that reverse or counteract hedging transactions also are considered to be hedges.

A transaction that is not entered into primarily to reduce risk is not a hedging transaction unless specifically treated as such in the regulations. The regulations provide, for example, that a so-called "store-on-the-board" transaction, in which a taxpayer disposes of its production output and enters into a long futures contract with respect to the same product, is not a hedging transaction.

A hedge of property or of an obligation is a hedging transaction only if a sale or exchange of the property, or performance or termination of the obligation, could not produce capital gain or loss. In this regard, § 1221(a)(8) provides ordinary gain or loss treatment for consumable supplies held or acquired on or after 12/17/99.

A hedging transaction does not include a transaction entered into to manage risks other than interest rate or price changes, or currency fluctuations, unless a regulation, revenue ruling, or revenue procedure provides otherwise. The regulations do not apply where a taxpayer hedges a dividend stream, the overall profitability of a business unit, or other business risks that do not relate directly to interest rate or price changes or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings.

The acquisition of investment assets may not be a hedging transaction, even though the acquisition may involve some risk reduction, because they typically are not acquired primarily to manage risk. For example, even though a taxpayer's interest rate risk from a floating rate borrowing may be reduced by the purchase of debt instruments that bear a comparable floating rate, the acquisition of the debt instruments is not a hedging transaction. Ordinary treatment does not apply to gain or loss from the disposition of stock where, for example, the stock is acquired to protect the goodwill or business reputation of the acquirer or to ensure the availability of goods.

The proposed regulations retain the single-entity approach, and the separate-entity election, of the current regulations for hedging by members of a consolidated group.

Pursuant to § 1221(a)(7), the proposed regulations provide that hedging transactions must be identified before the close of the day on which they are entered into. The item, items, or aggregate risk being hedged must be identified no more than 35 days after entering into the hedging transaction. Relief may be granted for inadvertent errors, and, as could have been anticipated, if a taxpayer does not identify a transaction as a hedge but has no reasonable grounds for treating it as anything other than a hedge, the IRS can reclassify the gain as ordinary, but the taxpayer is bound to capital loss treatment by the failure to identify the transaction as a hedge. Likewise, designation of the transaction as a hedge does not entitle the taxpayer to ordinary loss treatment if the transaction is not in fact a hedge.

3. Post-*Corn Products* era hedging rules applied. Pine Creek Farms, Ltd. v. Commissioner, T.C. Memo. 2001-176 (7/17/01). Transactions in hog futures by a taxpayer engaged in grain farming were not hedges under Reg. § 1.1221-2 because they did not manage risks with respect to price changes in ordinary property. The losses were capital losses. Activities of the corporation's major shareholder (an individual) or other corporations he controlled are not attributed to the taxpayer corporation. The regulatory hedging rules are exclusive.

4. Effective capital gains rates for the new Millennium. For years after 2001, the preferential rates for long-term capital gains, taking into account the 8 percent and 18 percent preferential rates under § 1(h)(2), as well as the creation of the new 10 percent bracket and the gradual reduction under § 1(i)(2) of the 28 percent bracket to 27.5 percent for 2001, 27 percent for 2002 and 2003, 26 percent for 2004 and 2005, and 25 percent for 2006 and thereafter, are as follows:

Rate	Application
5%	Gain on "Small Business Stock," subject to § 1202 50% exclusion, if otherwise taxable at 10% [beginning in 2002]
7½%	Gain on "Small Business Stock," subject to § 1202 50% exclusion, if otherwise taxable at 15%
8%	Gain on assets held > 5 years if otherwise taxable at 10% or 15%, excluding prior depreciation on real estate
10%	Gain on assets, other than collectibles, held > one year, if otherwise taxable at 15%, excluding prior depreciation on real estate; and gain on collectibles held > one year if not otherwise taxable at ≥ 15%
14%[10]	Gain on "Small Business Stock," subject to § 1202 50% exclusion, if otherwise taxable at ≥ 25%, depending on year
15%	Gain on collectibles and on depreciable real estate held > one year to the extent of prior depreciation deductions, if taxpayer is not otherwise taxed ≥ 25%
18%	Gain on assets held > 5 years and with a holding period beginning after Dec. 31, 2000 (with some exceptions), if otherwise taxable ≥ 25%, excluding prior depreciation on real estate
20%	Gain on capital assets, other than collectibles, held > one year, if otherwise taxable ≥ 25%, excluding prior depreciation on real estate
25%	Gain, to the extent of prior depreciation deductions on depreciable real estate held > one year, if otherwise taxable ≥25%
28%[11]	Gain, if otherwise taxable at ≥ 25% but not ≥ 28%, on collectibles held > one year

10 The 14% rate assumes that the § 1202 exclusion is exactly 50%. In some cases the exclusion will be less than 50%, and in such cases the exact effective rate varies widely.

11 A taxpayer in the 27.5% bracket for 2001 [27% for 2002 and 2003, 26% for 2004 and 2005, or 25% for 2006 and thereafter] can have collectibles gain taxed at his normal marginal rate if his other capital gains are small enough in amount that the § 1(h) computation of tax liability exceeds the computation under § 1(a) - (d), as applicable.

5. The 18% rate *and* a tax-free step-up? No way! Rev. Rul. 2001-57, 2001-46 I.R.B. 488. An individual who elects under § 311(e) of the Taxpayer Relief Act of 1977 to treat his principal residence as being both sold and reacquired for an amount equal to FMV on 1/1/01 – in order to secure the 18% capital gains rate for assets acquired on or after that date and held for five years thereafter – may not exclude from gross income any of the gain recognized from the deemed sale.

6. Modified carryover basis at death starting in 2010. The **2001 Act** repealed the estate tax as of 1/1/10. In this context, Congress also enacted § 1022, which will replace § 1014 on 1/1/10. Section 1022(a) sets forth a "general rule" under which the basis of inherited property would be the lesser of the decedent's adjusted basis for the property or the fair market value of the property on the decedent's date of death. This general rule, however, is limited by an exception in § 1022(b)(1)(A) that provides an aggregate basis increase of up to $1,300,000 for all of the property passing from the decedent.[12] The resulting basis cannot exceed the property's fair market value. Section 1022(c) provides a special rule providing an additional basis increase of up to $3,000,000 for property inherited by a surviving spouse of the decedent. This greater spousal basis increase is not available for most terminable interests, although it is available for property passing to certain types of trusts for the benefit of a surviving spouse. Section 1022(d)(4) provides that both the $1,300,000 and $3,000,000 basis increase allowances are subject to adjustment for inflation beginning in 2011, which is a year after the changes in the 2001 Act sunset.

- If a husband and wife own property as joint tenants, the deceased spouse is treated as owning fifty-percent of the property immediately before his or her death. IRC § 1022(d)(1)(B). In the case of other joint tenancies, the decedent is treated as owning a percentage of the property proportionate to the consideration provided to acquire and improve the property. If a husband and wife own property as community property, the deceased spouse is treated as owning all of the property. IRC § 1022(d)(1)(C). This special rule is analogous to § 1014(b)(6) and permits the basis increase to apply to the entire property rather than only to one-half of the surviving spouse's interest as is the case in common law states.

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12. The aggregate basis increase is increased by the amount by which the basis of any property exceeds the property's fair market value if a loss would have been allowed under § 165 if the decedent had sold the property, IRC § 1022(b)(2)(C), even though a particular item of property may not take a basis in the hands of the heir that exceeds its fair market value.

• The basic $1,300,000 basis increase and the special $3,000,000 spousal basis increase can be pyramided. A surviving spouse who is the sole heir or legatee of the decedent thus can obtain an aggregate basis increase of $4,300,000. See IRC § 1022(c)(1). Alternatively, another heir can obtain a basis increase of $1,300,000 while the spouse obtains a basis increase of up to $3,000,000.

• If the aggregate appreciation in all of a decedent's assets does not exceed the applicable limit, then no problem of apportioning the basis increase among assets arises. But if the aggregate appreciation in the decedent's assets exceeds the applicable limit, then the basis increase must be apportioned. Section 1022(c) provides that the decedent's executor shall allocate the basis increase, but provides no rules for how to allocate it.

• Section 1022(d)(1)(C) denies the basis increase with respect to any property received by the decedent by gift, except from the decedent's spouse, within three years prior to death. (Section 1014(e) currently provides an analogous rule if a decedent acquires property by gift within one year of death.)

7. Dad, the accommodation pledgor, escapes tax on the foreclosure, but what about sonny boy? Friedland v. Commissioner, T.C. Memo. 2001-236 (9/10/01). The taxpayer pledged to a bank appreciated stock in a closely held corporation to secure an indebtedness of his adult son to the bank. When the son defaulted on the loan, the taxpayer's stock was transferred to the bank. Judge Vasquez held that the taxpayer had no amount realized on the transfer and thus recognized no gain. Reg. § 1.1001-2(a)(1) treats as an amount realized only the amount of the taxpayer's own indebtedness that is discharged by the transfer of property – not the amount of indebtedness of a third party – citing *Landreth v. Commissioner*, 50 T.C. 803 (1968) [guarantor does not realized COD income when debtor is discharged from a debt].

B. Interest

1. A tough-nosed step transaction approach in the D.C. Circuit. Del Commercial Properties, Inc. v. Commissioner, 251 F.3d 210, 2001-2 U.S.T.C. ¶ 50,474, 87 A.F.T.R.2d 2451 (D.C. Cir. 6/8/01), cert. denied, 122 S. Ct. 903 (1/14/02). The taxpayer structured a loan transaction from one of its subsidiaries as a back-to-back loan from a Canadian affiliate to a Dutch affiliate to itself, for the purpose of bringing the loan under the U.S.-Netherlands treaty, which exempted the interest, rather than the Canadian treaty, which did not. The Eighth Circuit upheld the Tax Court's decision that the back-to-back structure had no business purpose and should not be respected; the Dutch affiliate was merely a conduit for the loan from the Canadian affiliate. The court interpreted *Minnesota Tea Co. v. Helvering,* 302 U.S. 609 (1938) to stand for the proposition that "a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes."

C. Section 1031

1. Reverse Exchanges

a. Here's a PLR in which benefits and burdens of ownership were defined very broadly; query whether it may be relied upon. PLR 200111025 (12/8/00). This private letter ruling approved a reverse like-kind exchange that was outside the safe-harbor of Rev. Proc. 2000-37 [because the transaction predated the effective date, and because the accommodation party held the property for more than 180 days]. The taxpayer held property on which it had granted an option that contained a like-kind-exchange cooperation agreement. With respect to the replacement property, pursuant to a "real estate acquisition agreement": (1) the accommodation party financed the acquisition through loans (bearing market-rate interest) from a bank and from the taxpayer; (2) the bank loan was guaranteed by the taxpayer; (3) the taxpayer leased the property from the accommodation party under a triple net lease for one year, with an extension option, at a rental that exceeded the accommodation party's operating costs (including debt service); (4) the taxpayer and the accommodation party agreed to report income treating the taxpayer as a lessee and the accommodation party as the owner; (5) the taxpayer had the option to purchase the replacement property from the accommodation party at fair market value, which was deemed to be the accommodation party's acquisition cost if the taxpayer purchased the property within 18 months; (6) if the option terminated without the taxpayer purchasing the property, the accommodation party could sell the property and obtain the benefit of certain loss-limiting contract rights if it followed specified procedures, but if the procedures were not followed or the accommodation party kept the property, it bore the benefits and burdens of economic gain or loss; and (7) the taxpayer would provide the accommodation party general environmental release and indemnification. The IRS ruled that the transaction qualified as a § 1031 like-kind exchange, citing *Coastal Terminals, Inc. v. United States*, 320 F.2d 333 (4th Cir. 1963), and *J.H. Baird Pub. Co. v. Commissioner*, 39 T.C. 608 (1962), *acq*., 1963-2 C.B. 4, as authority that reverse exchanges qualified under § 1031. It distinguished *DeCleene v. Commissioner*, as involving a fact pattern that was not actually a reverse exchange because in that case the purported accommodation party never obtained any benefits and burdens of ownership and there was no integrated plan to obtain the replacement property for the exchanged property. On the PLR facts, there was an intent from the outset to effect a like-kind exchange pursuant to an interdependent integrated plan. Finally, applying the six factor test for agency of *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949), with the gloss on that test provided by *Commissioner v. Bollinger*, 485 U.S. 340 (1988), the accommodation party was not the taxpayer's agent.

2. The erosion of the Glass-Steagall Act changes the face of like-kind exchanges. T.D. 8982, Definition of Disqualified Person, amendments to Reg. § 1.1031(k)-1, 67 F.R. 4907 (2/1/02). Amendments to Reg. § 1.1031(k)-1(k)(4) [proposed in REG-107175-00, Definition of Disqualified Person, 66 F.R. 3924 (1/17/01)] generally provide that a bank that is a member of a controlled group that includes an investment banking or brokerage firm as a member will not be a disqualified person [with respect to deferred like-kind exchanges through an intermediary] merely because the investment banking or brokerage firm has provided services to an exchange customer within a two-year period ending on the date of the transfer of the relinquished property by that customer. The amendments are applicable to transfers of property made on or after 1/17/01.

3. Was it a deferred like-kind exchange or an installment sale? Only time will tell. Smalley v. Commissioner, 116 T.C. 450 (6/14/01). In 1994, the taxpayer entered into a deferred exchange agreement through a qualified intermediary under which he relinquished timber-cutting rights on land he owned in fee and in 1995 [within the period required by § 1031(a)(3)], the taxpayer received fee simple interests in three parcels of real estate. In 1994, the transferee paid cash to a qualified escrow account as defined in Reg. § 1.1031(k)-1(g)(3). The Commissioner asserted that the taxpayer realized gain in 1994 because the timber cutting rights were personalty and thus not like-kind to a fee simple. Finding the relevant state [Georgia] law characterization of whether timber-cutting rights were realty or personalty "less than a seamless web of jurisprudence," Judge Thorton held that in any event, no income was realized in 1994. At the beginning of the exchange period, the taxpayer had a bona fide intent to enter into a deferred exchange of like-kind property within the meaning of Reg. § 1.1031(k)-1(j)(2)(iv), and under Reg. § 1.1031(k)-1(g)(3) was not in actual or constructive receipt of property in 1994. Whether the transaction was a like-kind exchange or an installment sale with payment received in 1995 was a question left to another day [presumably the year in which the replacement land is sold]. Oh, by the way, by the time the case had been decided, the statute of limitations had run on 1995 [for which year it appears that the taxpayer reported the closing of the transaction as a like-kind exchange, not receipt of an installment payment].

D. Section 1041

1. For just how long are you a "former spouse" "incident to a divorce" under § 1041?

a. For a long, long time. Young v. Commissioner, 113 T.C. 152 (8/20/99). A former husband defaulted on a $1.5 million promissory note given to his former wife in a divorce settlement in 1989 and satisfied a judgment on the note by transferring real estate, which he had received in the original divorce, to his former wife in 1992. She subsequently sold the property for $2.2 million.[13] The value of the real estate equaled the sum of the principal of the note, accrued but unpaid interest, the wife's attorney's fees, and certain costs. The Tax Court (Judge Foley) held that the husband's transfer of the real estate was "incident to the divorce." Accordingly, under § 1041, the husband recognized no gain on the transfer and the wife held it at her husband's adjusted basis.

b. Affirmed. Young v. Commissioner, 240 F.3d 369, 2001-1 U.S.T.C. ¶ 50,244, 87 A.F.T.R.2d 889 (4th Cir. 2/16/01) (2-1). The Court of Appeals rejected Mrs. Young's argument that she received the property as a "judgment creditor," finding that the only relevant status was her status as a "former spouse." The sole reason for the 1992 transfer of the real estate from Mr. Young to Mrs. Young was to resolve ongoing disputes that originated in the divorce.

> Had the Youngs reached this settlement at the time of their divorce, there is no question that this transaction would have fallen under § 1041. There is no reason for the holding to differ here where the same result occurred through two transactions instead of one.

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13. John's basis in the property was $130,794. He transferred the land to Louise to satisfy a debt totaling $2,153,845, including $1,500,000 in principal, $344,938 in interest, $300,606.08 in attorney's fees, and $8,300 in collection costs. John reported no capital gain from his use of the appreciated property to satisfy his debt. Louise sold the property for $2,265,000 and reported a $100,000 short-term capital gain and $356,500 in interest income.

> The policy animating § 1041 is clear. Congress has chosen to 'treat a husband and wife [and former husband and wife acting incident to divorce] as one economic unit, and to defer, but not eliminate, the recognition of any gain or loss on interspousal property transfers *until the property is conveyed to a third party outside the economic unit*.' *Blatt v. Commissioner*, 102 T.C. 77, 80 (1994) (emphasis added) . . . Thus, no taxable event occurred and no gain was realized by either Mr. or Mrs. Young until Mrs. Young sold the 59 acres to a third party.

• Judge Wilkins, in dissent, argued that the 1992 agreement was not a divorce or separation agreement and that this fact raises the presumption that the property transfer was not related to the cessation of the marriage, and that the government failed to show "that the transfer was made to effect the division of [marital] property" as required by Temp. Reg. § 1.1041-1T(b).

> . . . Because the division of marital property was completed years before the property transfer – when the parties released their marital claims against one another and Louise accepted the promissory note – I would hold that the Government failed to make the necessary showing.
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> A property transfer is not made for the purpose of effecting a marital property division when the marital property division has already been completed. The Youngs completed this division when John delivered the promissory note to Louise. His payments on the note did not transfer marital property; the note itself accomplished that. . . . The 1992 property transfer was made simply to satisfy a judgment between them, *for reasons bearing no relationship to the fact that the parties were previously married*.
>
> . . . The majority concludes that the 1992 property transfer should not be treated as a taxable event because that would have been the result had Louise agreed to the property transfer as part of the 1989 divorce settlement. . . . [T]he hypothetical transaction offered by the majority and the transaction that actually occurred are not alike. In fact, they differ in the most critical way: In the hypothetical, Louise would have obtained the property as a means of severing her economic union with

her former spouse, thereby justifying treatment of the transfer as if it were made within a single economic unit, whereas in the actual transaction, the property was transferred after the Youngs' economic union had already been completely severed.

2. 'Tis doubly blessed to get redeemed in divorce than in marital bliss. Read v. Commissioner, 114 T.C. 14 (2/4/00). Mr. and Mrs. Read (H & W) owned substantially all of the stock of Mulberry Motor Parts, Inc. (MMP). When they divorced, the final judgment ordered (1) that W sell to H, or at H's election to MMP or MMP's ESOP plan, all of her MMP stock, and (2) that H, or at H's election MMP or MMP's ESOP plan, pay $838,724 to W ($200,000 down and the balance by interest bearing note). H elected to cause MMP to purchase and pay for W's stock, and the transaction was so structured. W argued that she was entitled to nonrecognition under § 1041(a) and Reg. § 1.1041-1T(c), Q&A-9, which treats certain transfers to third parties as a transfer of property by the transferring spouse directly to the nontransferring spouse that qualifies for nonrecognition treatment under § 1041 followed by an immediate transfer of the property by the nontransferring spouse to the third party in a transaction that is not subject to § 1041 – i.e., H would have a redemption treated as a dividend. H argued that § 1041(a) and Reg. § 1.1041-1T(c), Q&A-9 were inapplicable because he never had an unconditional obligation to purchase W's MMP stock, and that accordingly he recognized no income and W recognized gain on the redemption of her stock. The Commissioner took the position that he was a mere stakeholder and had issued deficiency notices to both taxpayers in the joined cases to avoid a whipsaw, but the Commissioner argued that W "has the better argument."

• The Tax Court, in a reviewed opinion (9-7) by Judge Chiechi, agreed with the Commissioner and W. The court held that in cases involving corporate redemptions in a divorce setting, the primary-and-unconditional-obligation standard that generally applies in "bootstrap-acquisitions" [see Rev. Rul. 69-608, 1969-2 C.B. 42] is not the appropriate standard to apply to determine whether the transfer of property by the transferring spouse to a third party is on behalf of the nontransferring spouse within the meaning of Reg. § 1.1041-1T(c), Q&A-9. Applying the common, ordinary meaning of the phrase "on behalf of" in Q&A-9, W's transfer of her stock to MMP was a transfer of property by W to a third party on behalf of H within the meaning of the regulation. Thus, under § 1041(a), no gain was recognized by W and H recognized a dividend. The majority reasoned that *Hayes v. Commissioner*, 101 T.C. 593 (1993), did not limit the treatment of a redemption of one divorcing spouse's stock as a § 1041 transfer by that spouse and a dividend to the nonredeeming spouse. It distinguished *Blatt v. Commissioner*, 102 T.C. 77 (1994), because in that case the record did not establish that corporation acted on behalf of husband in redeeming wife's stock; and the majority attempted to distinguish the Tax Court's prior opinion in *Arnes v. Commissioner*, 102 T.C. 522 (1994), as involving an instance in which the husband did not have an unconditional obligation to acquire the wife's stock.

- Dissents by Judges Ruwe, Halpern, and Beghe, all argued in one way or another that the primary-and-unconditional-obligation standard that generally applies in bootstrap-acquisitions was the appropriate standard to apply, nothing in Reg. § 1.1041-1T(c), Q&A-9 indicated otherwise, and that on the facts H did not have a primary and unconditional obligation to purchase W's stock.

- A joint dissent by Judges Laro and Marvel argued that Reg. § 1.1041-1T(c), Q&A-9, never should apply to redemptions like those in any of these cases.

a. But the contrary case law still prevails in the Tax Court and the Ninth and Eleventh Circuits – and will prevail until the proposed regulations become final. Affirmed *sub. nom*. Mulberry Motor Parts, Inc. v. Commissioner, 273 F.3d 1120, 88 A.F.T.R.2d 6182 (11th Cir. 9/20/01) (per curiam). The court affirmed the Tax Court's decision in *Read*, holding that it was bound by *Craven v. United States*, 215 F.3d 1201, 2000-2 U.S.T.C. ¶ 50,541, 85 A.F.T.R.2d 2229 (11th Cir. 2000).

> After the Eleventh Circuit relied on the Tax Court opinion in *Read* in deciding *Craven* in the first place, the Eleventh Circuit panel in *Read* now finds itself to be bound by its holding in *Craven*.

3. And the Treasury comes to the rescue – Subchapter C principles apply; otherwise, form controls. REG-107151-00, Constructive Transfers and Transfers of Property to a Third Party on Behalf of Spouse, 66 F.R. 40659 (8/3/01). Because of the inconsistent standards applied by the courts in dealing with redemptions of stock incident to a divorce, the Treasury has proposed regulations [Prop. Reg. § 1.1041-2] to provide greater certainty in determining which spouse will be taxed on stock redemptions occurring during marriage or incident to divorce. Reg. § 1.1041-1T(c) Q&A-9 no longer will control after the regulations are finalized.

- The proposed regulations apply only where the nonredeemed spouse owns stock of the redeeming corporation either immediately before or immediately after the stock redemption. If a corporation redeems stock of one spouse, and that redemption is treated as a constructive distribution to the other spouse under Subchapter C principles – the primary and unconditional obligation standard of *Wall v. United States*, 164 F.2d 462 (4th

Cir. 1947) and *Sullivan v. United States*, 363 F.2d 724 (8th Cir. 1966) – the redemption is treated as a distribution to the spouse who continues as a shareholder. See also Rev. Rul. 69-608, 1969-2 C.B. 42. Section 1041 applies to the deemed transfer of the stock by the redeemed spouse to the continuing shareholder spouse. Section 1041 does not apply to the deemed transfer of stock from the nontransferor spouse to the redeeming corporation. Any property actually received by the redeemed spouse from corporation is treated as flowing through the continuing shareholder-spouse, and § 1041 applies to that transfer. In all other cases, the form of the stock redemption will be respected; the redeemed spouse will be taxed on the redemption and the continuing spouse has not tax consequences. The preamble specifically states:

> [I]f the rules of the proposed regulations had applied in the *Arnes* case,[14] because the husband did not have a primary and

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14. **Ninth Circuit applies § 1041 to exclude gain on wife's stock redemption**. Arnes v. United States, 981 F.2d 456 (9th Cir. 1992). The Ninth Circuit (Judge Hall) affirmed a district court's grant of summary judgment to taxpayer, holding that the divorce-settlement redemption of taxpayer's stock (in a McDonald's franchise corporation she owned equally with her former husband) qualified for exemption under § 1041. The former husband was held to have been relieved of an obligation by the corporate redemption, so A-9 of Temp. Reg. § 1.1041-1T would treat taxpayer's stock as having been transferred to her former husband, and then retransferred to the corporation (the "third party") in a non-§ 1041 transaction. The $450,000 cash is to be treated as paid to taxpayer by the corporation on behalf of her former husband (and presumably constituting a taxable distribution to her former husband). See Temp. Reg. § 1.1041-1T, A-2, Example (3).

But Tax Court holds § 1041 does not apply to tax her husband on the redemption, so neither is taxed. Arnes v. Commissioner, 102 T.C. 522 (1994) (reviewed, 7 judges dissenting). Redemption of wife's stock [in corporation owned 50-50 by husband and wife] was not a constrictive dividend to husband because he did not have a primary and unconditional obligation to purchase wife's stock, relying on Rev. Rul. 69-608, 1969-2 C.B. 42. Dissents on ground that the Ninth Circuit has passed on the legal issue, citing Golsen v. Commissioner, 54 T.C. 742 (1970) *aff'd*, 455 F.2d 985 (10th Cir. 1971), and on the untenable result that neither stockholder will incur tax consequences as a result of the $450,000 stock redemption.

The Tax Court disagrees with the Ninth Circuit's *Arnes* case, and Judge Beghe has the correct answer. Blatt v. Commissioner, 102 T.C. 77 (1994) (reviewed, 3 judges dissenting). Wife's redemption (pursuant to a divorce decree) of all her stock in a corporation she owned entirely with her husband was not governed by § 1041, and was taxable to her. The court refused to follow the Reg. § 1.1041-1T, Q&A-9 theory that the redemption was a transfer to the corporation on behalf of her husband, as held in Arnes v. United States, 981 F.2d 456 (9th Cir. 1992), which the court refused to follow. Judge Beghe's concurring opinion stated that the proper interpretation of that regulation should be that no redemption should be considered to be "on behalf of" the unconditional obligation to purchase the wife's stock, the redemption would have been taxed in accordance with its form with the result that the wife would have incurred the tax consequences of the redemption.

• A special rule applies if an *effective* divorce or separation instrument, or a written agreement between the spouses [executed before the due dates of their returns], requires the spouses to file their Federal income tax returns in a consistent manner that treats the stock as being redeemed from the continuing shareholder spouse rather than from the spouse from whom it was actually redeemed. In such a case spouses and former spouses will treat a redemption that otherwise would be taxed according to its form as a redemption from the continuing shareholder spouse involving: (1) a deemed § 1041 transfer of the stock by the redeemed spouse to the continuing shareholder spouse, and (2) a deemed § 1041 transfer by the continuing shareholder spouse to the redeemed spouse of the redemption proceeds.

IV. COMPENSATION ISSUES

A. Employee Compensation: Fringe Benefits and Qualified Plans

1. Keeping up with ever-changing cafeteria plan rules

a. T.D. 8921, Tax Treatment of Cafeteria Plans, 66 F.R. 1837 (1/10/01). Amendments to the cafeteria plan regulations under § 125 on midyear election changes modify the March 2000 final regulations [T.D. 8878, Tax Treatment of Cafeteria Plans, 65 F.R. 15548 (3/23/00), permitting a mid-year cafeteria plan election with respect to medical and group term life insurance by an employee who has a change of status, such as change in marital status or number of dependents, employment, work site, etc., during the year] also to permit employees to elect to increase or decrease group-term life insurance or disability coverage in response to a change-of-status event, including birth, adoption, or death. [Employees generally are permitted to make elections between cash or qualified tax free benefits only at the beginning of the plan year.]

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remaining spouse unless it discharges that spouse's primary and unconditional obligation to purchase the redeemed stock, as set forth in the examples of Rev. Rul. 69-608, 1969-2 C.B. 42.

b. T.D. 8966, Additions to Final Cafeteria Plan Regulations Under § 125, 66 F.R. 52675 (10/17/01). The Treasury has promulgated final regulations, in Q&A format, relating to cafeteria plans that reflect changes made by the Family and Medical Leave Act of 1993.

2. Fundamental changes in the treatment of split-dollar life insurance. Notice 2001-10, 2001-5 I.R.B. 459 (1/29/01). This notice provides interim guidance on split-dollar life insurance contracts. It notes that the P.S. 58 rates no longer reflect the current fair market value of insurance protection. The Notice requires that employer payments be consistently treated as: (1) interest-free loans under § 7872, (2) investments by the employer in the contract, or (3) payments of compensation. The Service had long rejected interest-free loan treatment of the employer investment in the cash value of split dollar life insurance, but the enactment of § 7872 in 1984 enables interest-free loan treatment to be used as a valid model. The alternative is to have the true cost of insurance protection reflected in the employee's income; insurance companies will be required to provide rates at which comparable term policies will be available to the general public (instead of the low-ball rates that had been provided in the past). This notice revokes Rev. Rul. 55-747, 1955-2 C.B. 228, and provides that, after 2001, P.S. 58 rates may not be used.

a. Not so fast! IRS revokes Notice 2001-10 and for future arrangements requires taxation under one of two mutually exclusive regimes. Notice 2002-8, 2002-4 I.R.B. 398 (1/3/02), *revoking* Notice 2001-10, 2001-5 I.R.B. 459. When the Treasury and Service publish proposed regulations providing comprehensive guidance regarding the tax treatment of split-dollar life insurance arrangements, they will provide the following treatment in employment-related arrangements:

- If the employer is formally designated as owner of the life insurance contract, then the employer will be treated as providing current life insurance protection and other economic benefits to the employee. A transfer of the life insurance contract to the employee would be taxed under § 83, but an employer would not be treated as having made a transfer of the cash surrender value for purposes of § 83 "solely because the interest or other earnings credited to the cash surrender value of the contract cause the cash surrender value to exceed the portion thereof payable to the employer." This has the effect of leaving that issue unresolved, and would change the position in Notice 2001-10 that the employee would be taxed under § 83 on the transfer of a beneficial interest in the cash surrender value.
- If the employee is formally designated as owner, the premiums paid by the employer would be treated as a series of loans by the employer to the employee – if the employee is required to repay the

employer out of insurance proceeds or otherwise. The loans are subject to taxation under the §§ 1271-1275 OID provisions and the § 7872 compensation-related below-market loan provision. If the employee is not required to repay the employer, then the premiums paid are treated as compensation income to the employee when paid.

• The new rules will be effective for arrangements entered into after the date of publication of final regulations. There will be special provisions for valuing current life insurance protection entered into before 1/28/02 (P.S. 58 is OK) and for arrangements entered into before the date of publication of final regulations.

3. New comprehensive employee plan correction guidance (EPCRS). Rev. Proc. 2001-17, 2001-7 I.R.B. 589 (1/19/01), *modifying and superceding* Rev. Proc. 2000-16, 2000-6 I.R.B. 518. Modifications include: (1) allowing master and prototype sponsors and third-party administrators to correct failures affecting more than one plan sponsor; (2) allowing anonymous "John Doe" submissions; (3) adding procedures for SEPs; and (4) allowing retroactive amendments related to hardship withdrawals, employees participating before they are eligible, and ineligible employers who sponsored a 401(k) plan.

4. Would the *Gitlitz*[15] Court uphold this Revenue Ruling? Rev. Rul. 2001-6, 2001-6 I.R.B. 491 (1/19/01). Payments in redemption of stock held by an ESOP that are used to make distributions to terminating ESOP participants are not deductible as "applicable dividends" under § 404(k)(1), but are disallowed under § 162(k)(1) [and § 04(k)(5)(A), which authorizes the IRS to disallow a deduction under § 404(k)(1) for any dividend that, in substance, constitutes an evasion of taxation].

> . . . [T]he treatment of redemption proceeds as "applicable dividends" under section 404(k) would produce such anomalous results that section 404(k) cannot reasonably be construed as encompassing such payments. See, e.g., *Helvering v. Hammel*, 311 U.S. 504, 510-511 (1941) (The words of a statute must be given "a restricted rather than a literal or usual meaning . . . where acceptance of that meaning would lead to absurd results . . . or would thwart the obvious purpose of the statute.")

15. Gitlitz v. Commissioner, 531 U.S. 206, 2001-1 U.S.T.C. ¶ 50,147, 87 A.F.T.R.2d 417 (1/9/01), discussed at VI.D.1

5. The **2001 Act** made extensive technical changes in the rules governing qualified pension plans. The unindexed benefits limit for defined contribution plans has been increased from $90,000 to $160,000. The unindexed contributions limit for defined benefit plans has been increased from $30,000 to $40,000.

a. Special rules in new § 414(v) allow increased elective contributions to defined contribution plans by employees age 50 or older. The amendments to the qualified pension plan rules permit extensive rollovers between qualified plans and between qualified plans and IRAs as employees change jobs. More specifically,

- For defined contribution plans: (1) the § 415(c)(1)(A) annual addition limit was increased from the lesser of 25% of compensation or $35,000 [$30,000 as indexed through 2001] to the lesser of 100% of compensation or $40,000; (2) the annual elective deferral limitation on § 401(k) plans, § 403(b) annuities, etc., will be increased to $11,000 in 2002, with annual increases of $1,000 until $15,000 is reached in 2006 (after which it will be indexed for inflation); and (3) the annual compensation limit that may be taken into account in determining contributions will be increased from its current $170,000 to $200,000 in 2002 (and indexed thereafter).
- Employees age 50 and older may make "catch up" additional elective deferrals of $1,000 for 2002, increasing in $1,000 annual increments to $5,000 in 2006 (and indexed for inflation thereafter).
- For defined benefit plans, the annual benefit limit will increase from its current $140,000 [$90,000 as indexed through 2001] to $160,000 in 2002, and the annual compensation limit that may be taken into account in determining benefits will be increased to $200,000 in that year as well.

- Employer contributions must be vested more quickly to either: (1) cliff vesting in two years, or (2) gradual vesting at 20 percentage point increments from the second to sixth year of employment.
- Beginning in 2006, § 401(k) plans and § 403(b) plans may incorporate a "qualified Roth contribution program" pursuant to which participants may elect to have all or a portion of their elective deferrals to the plan designated as after-tax "Roth contributions." Rollovers to individual Roth IRAs will be permitted.

(1) Guidance on § 415 changes. Rev. Rul. 2001-51, 2001-45 I.R.B. 427 (10/17/01), *modifying* Rev. Rul 98-1. Provides guidance in Q&A form relating to the increases in the limitations of § 415 enacted as part of the 2001 Act. Specifically, this revenue ruling provides questions and answers on: (1) Benefit increases that may be provided as a result of the increased § 415 limitations; (2) Plan amendments that may be adopted to take into account the increased § 415 limitations; (3) The effect of the increased § 415 limitations on other qualification requirements; and (4) How the "sunset" provision of EGTRRA is taken into account for purposes of §§ 412 and 404.

(2) How to apply the "ketchup" at the 2001 Act picnic. REG-142499-01, Proposed Regulations on Catch-up Contributions, 66 F.R. 53555 (10/23/01). These proposed regulations would implement new § 414(v) by providing that an employer plan is not treated as violating any provision of the Code solely because the plan permits individuals age 50 or older to make catch-up contributions. Catch-up contributions generally are elective deferrals made by a catch-up eligible participant that exceed an otherwise applicable limit and that are treated as catch-up contributions under the plan, but only to the extent they do not exceed the maximum amount of catch-up contributions permitted for the taxable year. See also, Announcement 2001-93, 2001-44 I.R.B. 416, for information on how to report participants' elective pension deferrals on Form W-2, Box 12, and in the totals reported for codes D through H and S.

b. Small Employer Tax Credit for Plan Start-Up Costs. New § 45E provides a nonrefundable credit (for tax years beginning *after 2001*) equal to 50 percent of the first $1,000 of administrative and retirement-education start-up costs [paid or incurred in tax years beginning after December 31, 2001] for any small business that adopts a *new* qualified defined benefit or defined contribution pension plan. The credit is available only with respect to the first three years of the plan's existence. The employer may elect to claim the credit in the year preceding the first plan year (but not before 2002) and may elect not to claim the credit for a given tax year. Only employers that did not have more than 100 employees whose compensation exceeded $5,000 in the preceding year qualify. An employer is not eligible if, during the 3-year period before the first year for which a credit is allowable, the employer established or maintained a qualified plan. Controlled group aggregation rules apply for these purposes. The plan must cover at least one nonhighly compensated employee in order to qualify. Thus, the credit is not available to a sole proprietor with no employees, or the owner of single member LLC that employs only the owner. The credit is part of the general business credit. If the credit is claimed, the one-half of the expenses with respect to which the credit is allowed are automatically nondeductible; the remaining one-half of the qualifying expenses are deductible to the extent otherwise allowable. Thus, if an eligible employer has $5,000 in qualified startup costs, 50 percent of the first $1,000 give rise to a $500 credit, making $500 of the $5,000 in qualified costs nondeductible. But the remaining $4,500 of such costs may be deducted.

6. Qualified retirement planning services will become an excludable fringe benefit in 2002. Section 132(a)(7), added by the 2001 Act, excludes "qualified retirement planning services" beginning in 2002. Qualified retirement planning services are defined in § 132(m) as retirement planning advice or information provided to an employee and his spouse by an employer maintaining a qualified pension plan. Interestingly, nothing on the face of the statute limits the advice to matters related to the qualified pension plan on which eligibility is based, and the legislative history clearly states that the information and advice is not so limited. It may extend to retirement income planning generally and how the employer's plan fits into the employee's overall retirement income planning. The exclusion does not, however, extend to tax preparation, accounting, legal and brokerage services related to retirement planning. The exclusion is subject to a nondiscrimination rule that makes it available to highly compensated employees "only if such services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified employer plan." The legislative history indicates that under this standard the IRS should permit employers to limit certain types of advice to individuals nearing retirement.

7. Effective date guidance. Notice 2001-56, 2001-38 I.R.B. 277 (9/17/01). This notice provides guidance regarding application of the effective date rules for amendments to: (1) § 401(a)(17) [and related sections], increasing the compensation limit [to $200,000] – effective for plan years beginning on or after 1/1/02, even if the plan uses annual compensation for a period beginning before 1/1/02; (2) § 416, regarding determination of top-heavy status – effective for plan years beginning after 12/31/01, even if the determination date is before 1/1/02; and (3) revisions to the regulations relating to hardship distributions under § 401(k)(2)(B)(i)(IV), as mandated by § 636(a) of EGTRRA – regulations to be effective for calendar years beginning after 12/31/01.

8. Sample plan amendments. Notice 2001-57, 2001-38 I.R.B. 279 (9/17/01). The IRS has published sample plan amendments to conform qualified plans to the changes effected by the Economic Growth and Tax Relief Reconciliation Act of 2001.

9. Prolong the GUST-o. Rev. Proc. 2001-55, 2001-49 I.R.B. 552 (11/14/01). The Service has extended the GUST remedial amendment period under § 401(b) of the code for qualified retirement plans to 2/28/02. For plans affected by the September 11th terrorist attack, the extension is to 6/30/02, with a possible further extension to 12/31/02.

- "GUST" refers to the following: (1) the Uruguay Round Agreements Act, Pub. L. 103-465; (2) the Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. 103-353; (3) the Small Business Job Protection Act of 1996, Pub. L. 104-188; (4) the Taxpayer Relief Act of 1997, Pub. L. 105-34; (5) the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206; and (6) the Community Renewal Tax Relief Act of 2000, Pub. L. 106-554.

10. Flynn v. Commissioner, 269 F.3d 1064, 88 A.F.T.R.2d 6586, 2001-2 U.S.T.C. ¶ 50,737 (D.C. Cir. 10/30/01), *aff'g* T.C. Memo. 2000-223. The Court of Appeals affirmed the Tax Court's decision upholding Reg. § 1.7476-1(b)'s "interested parties" rule, which excludes former employees from the group entitled to bring an action under § 7476 seeking a declaratory judgment regarding the status of a qualified plan [except in cases involving plan terminations]. Accordingly, the taxpayer lacked standing to challenge the IRS's favorable determination following a plan amendment, even though he may have been adversely affected.

11. Flahertys Arden Bowl, Inc. v. Commissioner, 271 F.3d 763, 2001-2 U.S.T.C. ¶ 50,770, 88 A.F.T.R.2d 6850 (8th Cir. 11/16/01) (per curiam). Participant's plan made loans to taxpayer/corporation [57% owned by participant]. Even though ERISA § 404(c) excepted participants who direct their own accounts from the definition of fiduciary, § 4975 does not contain any parallel provision and the corporation was a disqualified person under the § 4975 excise tax provisions. But penalties were not upheld, because participant followed the advice of an attorney who advised him that the loans would not violate ERISA or cause liability under § 4975.

B. Section 83 and Stock Options

1. A deductible redemption, thanks to § 83. Riverton Investment Corp. v United States, 170 F.Supp.2d 608, 2001-1 U.S.T.C. ¶ 50,318, 87 A.F.T.R.2d 1430 (W.D. Va. 3/6/01). Under § 83 non-lapsing restrictions may so limit the employee's beneficial ownership of property that the property will not be considered ever to have been transferred to the employee. [See Reg. § 1.83-3(a)(5), providing "an indication that no transfer has occurred is the extent to which the consideration to be paid the transferee upon surrendering the property does not approach the fair market value of the property at the time of surrender," and Reg. § 1.83-3(a)(5) providing "an indication that no transfer has occurred is the extent to which the transferee does not incur the risk that the value of the property at the time of the transfer will decline substantially."] The District Court held that the taxpayer-corporation could deduct the cost of "repurchasing" stock issued to an employee subject to the condition that it be resold to the corporation upon termination of employment at a price equal to the greater of the amount paid by the employee of 60 percent of book value. The stock was never "transferred"; thus the payment was not in redemption by the corporation. The "repurchase" was simply the payment of compensation.

2. Although the exercise of a statutory stock option does not result in taxable income, it does result in wages for FICA/FUTA purposes – but not until 2003. REG-142686-01, Proposed Regulations on Application of the Federal Insurance Contributions Act, Federal Unemployment Compensation Act, and Collection of Income Tax at the Source to Statutory Stock Options, 66 F.R. 57023 (11/14/01). Prop. Regs. §§ 31.3121(a)-1(k), 31.3306(b)-1(*l*), and 31.3401(a)-1(b)(9) would provide that the holder of a statutory stock option [§ 422(b) ISO or § 423(b) ESPP] receives wages for FICA and FUTA purposes upon exercise of the option, but no withholding is required because no gross income has been received. The amount of the wages received is the excess of the fair market value of the stock over the amount paid. The IRS will develop "rules of administrative convenience" permitting employers to deem the wages to have been paid on a specific date or over a specific period of time. Income tax withholding is not required because the individual does not receive income at the time of exercise of an ISO or employee stock purchase plan. However, the IRS will not assert FICA or FUTA tax that is based upon the exercise of a statutory stock option that occurs prior to 1/1/03.

a. Notice 2001-73, 2001-49 I.R.B. 549 (12/3/01). The IRS announced and requested comments on proposed "rules of administrative convenience" permitting employers to deem the wages to have been paid on a specific date for FICA and FUTA purposes. FICA and FUTA wages could be treated as paid on a pay period, quarterly, semi-annual, annual, of other.

b. Notice 2001-72, 2001-49 I.R.B. 548 (12/3/01). The IRS announced and requested comments on proposed rules regarding the employer's income tax withholding and reporting obligations on the sale by an employee of stock received pursuant to exercise of a statutory stock option. The employer is not required to withhold, but is required to report if the amount is at least

$600, unless the employer has made reasonable efforts to determine if reporting is necessary and has been unable to do so.

3. A contractual forfeiture provision piggy-backed on an extended § 16(b) period isn't good enough to avoid current recognition. Tanner v. Commissioner, 117 T.C. 237 (12/10/01). Pursuant to an agreement to acquire control of a corporation, the taxpayer signed a lockup agreement that restricted his sale of stock by providing that if he sold any stock within 2 years of its acquisition, he would be subject to § 16(b) of the Securities Exchange Act of 1934. On 6/9/93, the taxpayer received a nonstatutory employee stock option from C; on 9/7/94, he exercised this stock option. He pledged some of this stock as collateral for a loan, and the stock was subsequently sold by the lender. The Commissioner determined that the taxpayer realized income in 1994 from the exercise of the stock option based on the difference between the option price and the price the stock was selling for on the date the option was exercised. The taxpayer argued that during 1994 the stock was subject to risk of forfeiture under § 83(c)(3) as a result of the lock-up agreement. Judge Vasquez held that § 83(c)(3) was inapplicable because the 6-month restricted period under § 16(b) of the Securities Exchange Act of 1934 commenced on the date of grant of the option and had expired on the date of exercise. Furthermore, for purposes of § 83(c)(3) the six-month period in § 16(b) cannot be extended by agreement. Accordingly, the taxpayer realized income at the time the option was exercised.

C. Individual Retirement Accounts

1. They're taking all the fun out of calculating minimum required distributions from plans and IRAs. REG-130477-00 and REG-130481-00, Required Distributions from Retirement Plans, 66 F.R. 3928 (1/17/01). Proposed regulations under § 401(a)(9), etc., substantially simplify the calculation of minimum required distributions from qualified plans, IRAs, and other related retirement savings vehicles. The changes in the proposed regulations are based on the concept of a uniform lifetime distribution period. The regulations provide a single table that any recipient can use to calculate his or her yearly MRD amount by plugging in his or her age and the prior year-end balance of his or her retirement account or IRA. The table eliminates the need to elect recalculation of life expectancy, determine a designated beneficiary by the required beginning date, or satisfy a separate incidental death benefit rule. The proposed regulations will result in reducing MRDs for the vast majority of employees and IRA holders. Although MRDs will be calculated without regard to the beneficiary's age, the regulations will continue to permit a longer payout period if the beneficiary is a spouse more than 10 years younger than the employee.

2. "Active participation" in a plan turns on accruing any slight benefit, not on having a chance of actually getting anything back from the plan. Wade v. Commissioner, T.C. Memo. 2001-114 (5/14/01). Mrs. Wade, who was a part-time community college teacher, was an active participant in a qualified plan by virtue of an $84.89 mandatory contribution to a defined benefit plan in a year in which she accrued approximately 1/120th of the service required for benefits to vest. As a result both Mrs. and Mr. Wade, whose combined AGI was $77,000, were denied deductions for their $2,000 IRA contributions under the § 219(g) AGI phase-out rule.

3. IRA changes in the 2001 Act

a. Section 25B, which is effective only for the years 2002 through 2006, provides a nonrefundable credit to low- and moderate-income taxpayers making contributions to individual retirement accounts or to employer-sponsored retirement plans. The credit is not available to taxpayers with adjusted gross income over $50,000 (joint returns), $37,500 (heads of households), or $25,000 (all others). Below those ceilings, the credit equals a percentage of the taxpayer's "qualified retirement savings contributions." The percentage is 50 percent, 20 percent, or 10 percent, depending on the taxpayer's AGI, with the percentage decreasing as AGI increases. There are cliff effects as the credit percentage is stepped down. For example for a married couple with an AGI of $30,000, the credit is 50 percent of qualified retirement savings contributions; for a married couple with an AGI of $30,001, however, the credit is only 20 percent of qualified retirement savings contributions.

• The ceiling on credit-eligible contributions is $2,000 for each eligible individual. To be eligible, an individual must be at least 18 years old, and must not be a dependent or a full-time student. "Qualified retirement savings contributions" include elective contributions under §§ 410(k), 403(b) and 457, voluntary after-tax employee contributions to a qualified retirement plan, and contributions to IRAs (regular and Roth). The amount of credit-eligible contributions is reduced by taxable distributions received by the taxpayer (or the taxpayer's spouse) from qualified retirement plans or IRAs, during a "testing period" extending over more than three years. Credit eligible contributions are also reduced by nontaxable distributions from a Roth IRA.

• The credit may be used to offset AMT liability, as well as regular tax liability.

b. The **2001 Act** amended § 219 to increase the ceiling on deductible contributions to an IRA account to $3,000 for 2002 through 2004,

$4,000 for 2005 through 2007, and $5,000 for 2008 and thereafter. Beginning in 2008, the $5,000 ceiling will be adjusted annually for inflation. In addition,

taxpayers age 50 and older may deduct an additional $500 of contributions for 2002 through 2005 and an additional $1,000 for 2006 and thereafter.

4. Kitt v. United States, 2002-1 U.S.T.C. ¶ 50,167, 89 A.F.T.R.2d 497 (Fed. Cir. 1/10/02). Retroactive application of the [July] 1998 IRS Restructuring Act provision subjecting amounts rolled over from a traditional IRA to a Roth IRA and then immediately withdrawn to the 10-percent § 72(t) penalty to an April 1998 withdrawal was constitutional because Congress was correcting a mistake in the 1997 Taxpayer Relief Act. *United States v. Carlton*, 512 U.S. 26 (1994), followed.

V. Personal Income and Deductions

A. Miscellaneous Income

1. COD income on reduction in FmHA mortgage could not be avoided by an agreement to recapture the debt reduction should the farm be sold within ten years. Jelle v. Commissioner, 116 T.C. 63 (1/31/01). Taxpayers owned agricultural property subject to outstanding mortgages totaling $269,828 to the Farmers Home Administration (FmHA) that exceeded the $92,057 net recovery value of the property by $177,772. Upon payment of the net recovery value, the FmHA wrote off the remaining loan balance subject to a "net recovery buyout recapture agreement" under which taxpayers agreed to repay the amounts written off in the event they disposed of the land within a 10-year period; and the FmHA issued a Form 1099-C [reporting COD income] to taxpayers in the amount of $177,772. Taxpayers argued that they did not have COD income until the expiration of the 10-year period. Judge Nims held that taxpayers had immediate COD income under § 61(a)(12) because there was a present cancellation of liability with only "the mere chance of some future repayment." The recapture agreement was held not to be a substitute for taxpayers' former obligation. An accuracy related penalty was upheld because taxpayers did not report any tax liability nor did they disclose the COD income for which they received a Form 1099-C. Taxpayers did not contend that any of the statutory exceptions to COD income was applicable.

2. Exempt assets are included for purposes of the § 108(d)(3) insolvency definition; the Service had warned about this in TAM 199932013. Carlson v. Commissioner, 116 T.C. 87 (2/23/01). The taxpayers had capital gain in the amount of $28,621 and discharged indebtedness in the amount of $42,142 upon the foreclosure sale of their fishing vessel. They also owned a fishing permit with a fair market value of $393,400, which was arguably an asset exempt from the claims of creditors under Alaska law. Judge Chiechi held that this exempt asset must be included in the determination of whether taxpayers were insolvent. She refused to follow *Cole v. Commissioner,* 42 B.T.A. 1110 (1940), because § 108(e)(1) precludes reliance upon the judicial insolvency doctrine except to the extent it was codified in § 108(a)(1)(B). She quoted the Supreme Court as follows, "Section 108(e) precludes us from relying on any understanding of the judicial insolvency exception that was not codified in § 108." *Gitlitz v. Commissioner,* 121 S. Ct. 701, 2001-1 U.S.T.C. ¶ 50,147, 87 A.F.T.R.2d 417 (1/9/01). Judge Chiechi compared the definition of "insolvent" under the Bankruptcy Code [11 U.S.C. § 101(26)], which expressly excludes exempt property from the calculation, with the definition under § 108(d)(3), which does not do so, and concluded that the difference was intentional and that in intentionally using the different definition Congress intended that exempt assets are not to be excluded from the calculation in determining whether the taxpayer is insolvent for purposes of § 108.

> Although an asset of a debtor may be exempt from the claims of creditors under applicable State law, if that asset and the debtor's other assets exceed the debtor's liabilities, the debtor has the ability to pay an immediate tax on income from discharged indebtedness. In the instant case, immediately preceding the foreclosure sale on February 8, 1993, the aggregate fair market value of petitioners' assets was $875,251, which included petitioners' fishing permit valued at $393,400 that they claim is exempt from the claims of creditors under the law of the State of Alaska. At that time, petitioners' liabilities totaled $515,930. On the record before us, we find that petitioners had the "ability to pay an immediate tax on" . . . the $42,142 of DOI income resulting from the foreclosure sale in question. Requiring petitioners to include that income in their gross income for the year at issue and pay a tax thereon is a result that is consistent with the intention of Congress in enacting *section 108(a)(1)(B)* and related provisions into the Code.

• Of course, the taxpayers could have avoided this result by filing a bankruptcy petition and having the indebtedness cancelled in that proceeding.

• An accuracy related penalty was imposed for taxpayers' failure to include the realized capital gain of $28,621 in income.

a. Exempt assets counted in insolvency determination. TAM 199935002 (5/3/99). The fair market value of any assets exempt from a creditor's claims under state law is included in determining a taxpayer's insolvency under § 108(d). The contrary conclusion reached in TAM 9130005 was revoked.

3. The tax benefit rule found the pea under the walnut shell. Hornberger v. Commissioner, 87 A.F.T.R.2d 877, 2001-1 U.S.T.C. ¶ 50,234 (4th Cir. 2/15/01) (per curiam, unpublished), *aff'g* T.C. Memo. 2000-042. A grantor trust established by the sole beneficiary of an estate paid interest on the estate tax owed by the estate, and the beneficiary deducted the interest payment. When a portion of the interest was later refunded to the estate, which distributed it to the beneficiary, who transferred it to the trust, the beneficiary was required to include the refunded interest in income under the tax benefit rule.

4. Lower rates coming to your neighborhood tax return soon. The Economic Growth and Tax Relief Reconciliation Act of 2001 amended § 1 in a number of ways. First, § 1(i) provides an initial 10 percent marginal rate bracket, carved out of the broader 15 percent bracket, effective as of 2001.[16] The upper limit of this new 10 percent bracket, however, is not adjusted for inflation for years before 2009. Second, beginning in 2001, the 28 percent, 31 percent, 36 percent, and 39.6 percent rates will be reduced according to the following schedule.

Taxable year	Rate to be substituted in § 1 for the 2000 rates:			
	28%	31%	36%	39.6%
2001	27.5%	30.5%	35.5%	39.1%
2002 & 2003	27%	30%	35%	38.6%
2004 & 2005	26%	29%	34%	37.6%
2006 and thereafter	25%	28%	33%	35%

a. The 15 percent bracket rate will not be reduced.[17] Like all of the amendments to the Code in the 2001 Act, these changes sunset on December 31, 2010. Thus, absent further congressional action, in 2011 § 1 will revert to

16. For 2001, § 6428 provides a rate reduction credit in lieu of the 10 percent rate bracket.

17. Beginning in 2005, however, the 2001 legislation will increase the width of the 15 percent bracket for married couples filing joint returns. See § 1(f)(8). In 2009, the 15 percent bracket under § 1(a) will be twice as large as the 15 percent bracket under § 1(c), thus eliminating the marriage penalty in the 15 percent bracket.

the five brackets in effect for 2000, with inflation adjustments in the dollar-denominated bands.

b. Marriage penalty relief (part 1)[18]: the 15 percent bracket. The 2001 Act increased the width of the 15 percent rate bracket for married couples filing jointly relative to unmarried individuals filing a single return. The upper limit of the 15 percent bracket for married couples filing a joint return will be double the upper limit of the 15 percent bracket for unmarried individuals filing a single return. The effective date is delayed to 2005, and then it is phased in over five years, with the result that the full effect of the changes will not be in force until 2009. Like all of the other amendments to the Code in the 2001 Act, however, these changes sunset on December 31, 2010.

B. Profit-Seeking Individual Deductions

1. The alternative minimum tax ("AMT") trap for attorneys' fees on large recoveries.

a. Cases decided in past years by the First, Fourth, Ninth and Federal Circuits sprang the AMT trap. More Circuits climb on board in 2001. Attorney's fees incurred by an individual in a nonbusiness profit-seeking transaction are [§ 212] miscellaneous itemized deductions [§ 67] and may not be deducted for AMT purposes. To avoid this result, taxpayers in a number of cases in recent years have argued the portion of a taxable damage award retained by the taxpayer-plaintiff's attorney as a contingent fee is excluded from the taxpayer-plaintiff's income and treated as income earned directly by the attorney. The Tax Court and most Courts of Appeals have reached conflicting results on this question. Generally, the Tax Court holds that attorney's fee awards paid directly to a plaintiff's attorney [or the portion of a damage award that is the attorney's contingent fee that is so paid] are nevertheless includable in the litigant's gross income, and that the taxpayer then may claim a deduction, subject to any applicable limitations, including disallowance of the deduction for AMT purposes if it is a §212 deduction. *Bagley v. Commissioner*, 105 T.C. 396 (1995), *aff'd* 121 F.3d 393 (8th Cir. 1997). *Accord Baylin v. United States*, 43 F.3d. 1451 (Fed. Cir. 1995); *Alexander v. IRS*, 72 F.3d 938, 96-1 U.S.T.C. ¶ 50,011 (1st Cir. 1995), *aff'g* T.C. Memo. 1995-51; *Coady v. Commissioner*, 213 F.3d 1187, 2000-1 U.S.T.C. ¶ 50,528 (9th Cir. 2000); *Benci-Woodward v. Commissioner*, 219 F.3d 941, 2000-2 U.S.T.C. ¶ 50,595 (9th Cir. 7/18/00).

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18. See V.D.1.c.

b. But the Fifth and Sixth Circuits see things differently.

(1) In *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), however, the Fifth Circuit held that attorney's fees so paid directly to a plaintiff's attorney are not includable by the litigant. The court of appeals reasoned that under the Alabama attorney's lien law, the ownership of the portion of the award representing attorney's fees vested in the attorney *ab initio*. Subsequently, in *Srivastava v. Commissioner*, 220 F.3d 353, 2000-2 U.S.T.C. ¶ 50,597 (5th Cir. 2000) (2-1), *rev'g*, T.C. Memo. 1998-362, a majority decision of a Fifth Circuit panel held that *Cotnam* applied to attorneys' fees under Texas law because there is no difference in the "economic reality facing the taxpayer-plaintiff" between Alabama and Texas attorney's liens and any distinction between them does not affect the analysis required by the anticipatory assignment of income doctrine. A dissent by Judge Dennis distinguished *Cotnam* on the ground that Alabama law gives the holders of attorney's liens greater power than does Texas law.

(2) Estate of Clarks v. Commissioner, 202 F.3d 854, 2000-1 U.S.T.C. ¶ 50,158, 85 A.F.T.R.2d 405 (6th Cir. 2000). The Sixth Circuit applied, to hold that the taxpayer was not required to include the portion of the taxable interest attached to a damage award excluded under § 104(a)(2) that was paid directly to the taxpayer's attorney. The court discussed the particularities of the attorney's fee statutory lien law in *Cotnam*, found the Michigan attorney's fees common law lien law to be similar to the Alabama law involved in *Cotnam,* and stated that it was following *Cotnam.* But the court also provided a broader explanation for its decision, concluding that the opinions representing the weight of authority, e.g., *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995), inappropriately relied on the assignment of income doctrine cases, e.g., *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst*, 311 U.S. 112 (1940), which, while relevant in family transactions, were not relevant in an arm's length transaction.

(3) In the Eleventh Circuit (as derived from pre-split Fifth Circuit precedents[19]), under the *Golsen* rule Attorney's fees are not included in the income of Alabama taxpayer who received a large punitive damages award. Davis v. Commissioner, T.C. Memo. 210 F.3d 1346, 2000-1 U.S.T.C. ¶ 50,431, 85 A.F.T.R.2d 1567 (2000) (per curiam), *aff'g*

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19. Under Bonner v. City of Prichard, Alabama, 661 F.2d 1206 (11th Cir. 1981), Fifth Circuit decisions rendered before the Eleventh Circuit was created are binding precedent in the Eleventh Circuit.

1998-248 (7/7/98). The Eleventh Circuit panel held that with respect to Alabama taxpayers, it was bound by *Cotnam*.

c. This year, the Fourth, Seventh, and Tenth Circuits join the parade.

(1) Wisconsin attorney's fees subject to the AMT trap because of assignment of income doctrine. Tax Court majority holds that it was Congress's doing; dissents state that courts can cure the problem, Kenseth v. Commissioner 259 F.3d 881, 2001-2 U.S.T.C. ¶ 50,570, 88 A.F.T.R.2d 5378 (7th Cir. 8/7/01), *aff'g* 114 T.C. 399 (5/24/00) (reviewed, 8-5). The Tax Court adhered to its prior decisions that contingent attorney's fees paid in an age discrimination settlement are includible in taxpayer's gross income. The Seventh Circuit affirmed the Tax Court's decision.

> [Kenseth] concedes as he must that had he paid the law firm on an hourly basis, the fee would have been an expense. It would have been a deduction from, not a reduction of, his gross income . . . . We cannot see what difference it makes that the expense happened to be contingent rather than fixed. If a firm pays a salesman on a commission basis, the sales income he generates is income to the firm and his commissions are a deductible expense, even though they were contingent on his making sales. Of course there is a sense in which contingent compensation constitutes the recipient a kind of joint venturer of the payor. But the plaintiff concedes, as again he must, that Wisconsin law does not make the contingent-fee lawyer a joint owner of his client's claim in the legal sense any more than the commission salesman is a joint owner of his employer's accounts receivable. . . .
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> There is nothing exotic about this analysis – nothing, indeed, that depends on the particular contractual setting, that of a contingent-fee contract with a lawyer, out of which this case arises. The settlement of Kenseth's age-discrimination suit against his former employer presumably replaced lost income, which would have been taxable; and many of the expenses of producing that income, such as the cost of commuting, would not have been deductible. So incomplete deductibility here is not surprising or anomalous or inappropriate. We mentioned the commissioned salesman; consider now the operation of a construction business. All receipts are counted as gross

> income, and outlays to subcontractors and materialmen are deductible, even though these subcontractors have liens on the work and even though the general contractor could say that he just "assigns" a part of the job to the sub. . . .
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> Enough; for in any event it is not a feasible judicial undertaking to achieve global equity in taxation . . . especially when the means suggested for eliminating one inequity (that which Kenseth argues is created by the alternative minimum income tax) consists of creating another inequity (differential treatment for purposes of that tax of fixed and contingent legal fees). And if it were a feasible judicial undertaking, it still would not be a proper one, equity in taxation being a political rather than a jural concept. Indeed the cases that reject the Tax Court's position seem based on little more than sympathy for taxpayers. . . . [The *Cotnam*] rationale badly flunks the test of neutral principles. It is often the case that to obtain income from an asset one must hire a skilled agent and pay him up front; that expense is a deductible expense, not an exclusion form income.

(2) The Fourth Circuit rejects *Cotnam* too. Young v. Commissioner, 240 F.3d 369, 2001-1 U.S.T.C. ¶ 50,244, 87 A.F.T.R.2d 889 (4th Cir. 2/16/01), *aff'g*, 113 T.C. 152 (8/20/99). A former husband defaulted on a $1.5 million promissory note given his former wife in a divorce settlement in 1989 and satisfied a judgment on the note by transferring real estate, which he had received in the original divorce, to his former wife in 1992. The value of the real estate equaled the sum of the principal of the note, accrued but unpaid interest, the wife's attorney's fees, and certain costs. The Tax Court held that under *Old Colony Trust Co*., 279 U.S. 716 (1929), the wife recognized gross income equal to the value the property attributable to her attorney's fees and costs. In affirming the Tax Court's decision, the Court of Appeals for the Fourth Circuit rejected Mrs. Young's argument that it should follow the reasoning of *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), to exclude the amount, noting that only the Sixth Circuit in *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000), has followed *Cotnam* and expressly joined the circuits that have rejected *Cotnam*.

(3) The Tenth Circuit says "us too". Hukkanen-Campbell v. Commissioner, 274 F.3d 1312, 88 A.F.T.R.2d 7283, 2001-2 U.S.T.C. ¶ 50, (10th Cir. 12/19/01). Attorneys' fees in pre-1991 Title VII sex discrimination are includable in plaintiff's income in computing AMT.

d. The Eleventh Circuit applies *Cotnam* in another Alabama case. We're still waiting to hear what the Eleventh has to say if the case arises in Georgia or Florida. Foster v. United States, 244 F.3d 1275, 2001-1 U.S.T.C. ¶ 50,392, 87 A.F.T.R.2d 2011 (11th Cir. 4/30/01), *rev'g* 106 F.Supp.2d 1234, 2000-1 U.S.T.C. ¶ 50,353, 85 A.F.T.R.2d 1649 (N.D. Ala. 3/13/00). Taxpayer received a favorable jury verdict that included $1,000,000 of [taxable] punitive damages. Under an Alabama statute, the trial judge reduced the punitive damage award to $250,000, which was later restored to $1,000,000 when the statute was found to be unconstitutional. Taxpayer had agreed to pay her attorney a contingent fee of 50% for the trial. For the appeal, the contingent fee arrangement was amended to treat all post-judgment interest collected as an additional contingent fee. The district court held that under *Cotnam* [263 F.2d 119 (5th Cir. 1959)], the taxpayer could treat the originally agreed upon contingent as excluded from gross income and received directly by the attorney, but the post judgment interest paid as the additional contingent fee was includable in gross income and deductible under § 212. At the point that contingent fee arrangement was negotiated, the taxpayer's claim, which had been upheld by the jury, had value and the "uncertainties" of the appellate process were not sufficient to displace the applicability of the assignment of income principles. The Court of Appeals affirmed the District Court except with respect to the post judgment interest paid as the additional contingent fee. The Court of Appeals held that the post-judgment agreement was analogous to a pretrial contingency fee agreement, and thus, because the case arose in Alabama, under *Cotnam* the interest retained by the attorney as the fee was not includable in the taxpayer's gross income. The taxpayer was entitled to her litigation costs under § 7430 because the IRS was not substantially justified in litigating the issue in the Eleventh Circuit on the basis of attempting to overturn *Cotnam* as wrongly decided.

e. The AMT trap snaps shut on attorney's fees that aren't even part of the plaintiff-taxpayer's award. Sinyard v. Commissioner, 268 F.3d 756, 2001-2 U.S.T.C. ¶ 50,645, 88 A.F.T.R.2d 6034 (9th Cir. 9/25/01) (2-1), *aff'g* T.C. Memo. 1998-364. The taxpayer was required to include in gross income the portion of the settlement of an ADEA suit that was paid directly to the attorneys as their fee pursuant to the settlement agreement, even though had the suit gone to trial and the taxpayer won, under the ADEA the defendant would have been statutorily liable for the taxpayer-plaintiff's attorneys' fees in addition to compensatory damages to the plaintiff. Judge McKeown, who wrote the Ninth Circuit's opinion in *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000), which held that contingent attorneys' fees are included in the successful plaintiff's gross income, dissented. He reasoned that the instant case was distinguishable from *Benci-Woodward* and *Old Colony Trust* on the grounds that by virtue of the ADEA statutory attorney's fees provisions, contingent attorney's fees incurred in an ADEA suit never become a debt of the taxpayer and the payment is not an indirect payment of a damage award or settlement to the taxpayer. He focused on the purpose of the ADEA attorney's fees provision being to make the plaintiff whole without incurring attorney's fees. He noted that it is still up to Congress to solve the AMT trap for contingent attorney's fees generally. His dissent draws a fine line, but we think he is correct.

2. Who says it's a "net" income tax? What happened to those § 212 deductions? There's a split in the circuits, but apparently the Supremes won't sing. Mellon Bank, N.A. v. United States, 265 F.3d 1275, 2001-2 U.S.T.C. ¶ 50,621, 88 A.F.T.R.2d 5800 (Fed. Cir. 9/7/01, *aff'g* 2001-1 U.S.T.C. ¶ 50,153, 86 A.F.T.R.2d 6432 (Ct. Cl. 9/18/00), *earlier proceedings* at 47 Fed. Cl. 186, 2000-2 U.S.T.C. ¶ 50,642, 86 A.F.T.R.2d 5321 (Fed. Cl. 7/17/00). The Court of Federal Claims held that investment advisor's fees incurred by a trust are excluded from the § 67 haircut on miscellaneous itemized deductions only if the expenses "would not have been incurred if the property were not held in such trust." The court reached a conclusion similar to that of the Tax Court and contrary to the Sixth Circuit in W*illiam J. O'Neill Revocable Trust v. Commissioner*, 98 T.C. 227 (1992) (investment adviser fees paid by irrevocable trust are not "administration fees" excluded from § 67 disallowance rules by § 67(e)), *rev'd*, 994 F.2d 302 (6th Cir. 1993) (investment adviser's fees that would not have been incurred if property had not been held in trust are not subject to 2 percent floor pursuant to § 67(e)). Summary judgment was granted to the government because the taxpayer stipulated that its evidence would not meet the requisite legal standard to prevail. On appeal, the Federal Circuit (Judge Meyer) rejected the taxpayer's argument that investment advisory fees are deductible to a trust without regard to the two percent floor of § 67 because they are occasioned by the trustee fulfilling its fiduciary duty. The court reasoned that the requirement of the second clause of § 67(e)(1), excepting from the floor costs that would not have been incurred if the property were not held by a trust or estate "focuses not on the relationship between the trust and costs, but the type of costs, and whether those costs would have been incurred even if the assets were not held in a trust." Only those trust-related administrative expenses "that are unique to the administration of a trust and not customarily incurred outside of trusts" are fully deductible. The court concluded that the plain language of the statute compelled the result, and found nothing to the contrary in the legislative history.

• Taxpayer's attorney has stated that it will not seek certiorari.

3. Loose lips sink ships.[20] O'Connell v. Commissioner, T.C. Memo. 2001-158 (6/29/01). The taxpayer was an insurance agent; he also was an avid fisherman who particularly enjoyed billfish (e.g., marlin, and sailfish) tournaments. His S corporation, which owned and occasionally chartered out an ocean going fishing yacht which was used primarily for sport fishing by the taxpayer, lost approximately $1.4 million over seven years. The losses were disallowed under § 183. Notably the court quoted an interview the taxpayer gave for MARLIN magazine, in which he stated:

> You have to be in competitive offshore fishing for the sport . . . not the money. What you win could never cover the expenses. That's just a drop in the bucket! . . . If you're in tournament fishing for the money, you'll go broke. . . .
>
> In my mind, it is inconceivable to make any money at tournament fishing . . . . This is strictly a sport. If a guy only fished one or two tournaments in a year and he won one of them, then he might end up in the black for that year . . . . If you fish them a lot, though, it is really tough.

Nuf said!

4. State income taxes are always itemized deductions. Strange v. Commissioner, 270 F.3d 786, 88 A.F.T.R.2d 6752, 2001-2 U.S.T.C. ¶ 50,753 (9th Cir. 11/8/01), *aff'g* 114 T.C. 206 (2000). The taxpayers paid nonresident state income taxes to nine states on net royalty income derived from interests in oil and gas wells located within those states. In calculating total net royalty income, and thus AGI, the taxpayers deducted the state income taxes they paid. The Court of Appeals affirmed the Tax Court (Judge Parr) holding that the revision of § 164 by the Revenue Act of 1964 did not alter the pre-existing law under which state income taxes were deductible only as itemized deductions. State nonresident income taxes [unlike property taxes] are not "attributable" to property held for the production of royalties and, therefore, are not deductible under § 62(a)(4) in computing AGI.

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

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20. These words appeared on posters throughout the country during World War II, as well as in numerous internal documents in the Clinton White House [referring to Monica Lewinsky's failure to keep various things to herself].

1. Music may be a spirit without space, but the space in which it is created is deductible. Popov v. Commissioner, 246 F.3d 1190, 2001-1 U.S.T.C. ¶ 50,353, 87 A.F.T.R.2d 1735 (9th Cir. 4/17/01). The taxpayer was allowed a home office deduction for the portion of the rent on her one bedroom apartment (which was occupied by the taxpayer, her husband and four-year-old child) attributable to the living room because the living room was used exclusively to practice the violin in connection with her work as a professional violinist for orchestras and recording studios. The court found that her living room was her principal place of business under the *Soliman* [506 U.S. 168 (1993)] test. The "point of delivery" test does not apply to professional musicians because, quoting the German poet Heinrich Heine,[21] "music stands 'halfway between thought and phenomenon, between spirit and matter, a sort of nebulous mediator, like and unlike each of the things it mediates – spirit that requires manifestation in time, and matter that can do without space.'" Since most of the taxpayer's time was spent practicing in her living room – where of course her four-year-old daughter *never never* got underfoot – that was her principal place of business and the deduction was allowed under § 280A.

21. Note: Heine left his estate to his wife on condition that she remarry, explaining in his will that as a consequence "there will be at least one man to regret my death." His last words were, "Of course God will forgive me; that's His job."

D. Deductions and Credits for Personal Expenses

1. Deduction and credit provisions in the **2001 Act** include:

a. A "now you see it, now you don't" increase in the AMT exemption. For 2001 through 2004, the 2001 Act increased the alternative minimum tax exemption amount to $35,750 for single taxpayers and $45,000 for married taxpayers filing joint returns.

b. Personal Income Phaseout (PEP) is itself phased-out from 2006 through 2010. The 2001 Act amended § 151 to phase-out over time the reduction of the amount allowable as personal exemptions under § 151(d) to increasingly lesser percentages — to 2/3 of the base formulaic reduction amount in 2006 and 2007 and 1/3 of the base formulaic reduction amount in 2008 and 2009. The reduction of personal exemptions is completely eliminated in 2010. See IRC § 151(d) and (f). Like all of the amendments in the 2001 Act, however, these changes sunset on December 31, 2010. Thus, absent further congressional action § 151(d) would be revived in its current form in 2011.

c. Marriage penalty relief: the standard deduction (part 2).[22] The 2001 Act increases the basic standard deduction for married couples filing a joint return to twice the basic standard deduction for unmarried individuals filing a single return. The effective date of the increase is delayed to 2005 and even then it is phased in over five years, with the result that the full effect of the change will not be in force until 2009. Like all of the other amendments to the Code in the 2001 Act, however, these changes sunset on December 31, 2010.

d. Pease phase-out. The 2001 Act amended § 68 to phase-out the reduction in itemized deductions to increasingly lesser percentages — to 2/3 of the base formulaic amount in 2006 and 2007 and 1/3 of the base formulaic amount in 2008 and 2009 — before eliminating the operation of § 68 completely in 2010. See IRC § 68(f) and (g). Absent further congressional action, the Pease limitation will be resurrected in 2011.

e. Child credit increased, made partially refundable, and made creditable against both regular tax and AMT. The amount of the credit was increased to $600 for taxable years 2001 through 2004, and is scheduled to increase in steps to $1,000 for 2010. The 2001 Act amended § 24 to provide for

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22. See V.A.4.b.

partial refundablity of the child credit in 2001 through 2010. For 2001 through 2004, the credit is refundable to the extent of ten percent of the taxpayer's income in excess of $10,000 (indexed for inflation beginning in 2002). IRC § 24(d)(1)(B)(i). For 2005 through 2010, the percentage increases to 15 percent. Section 24(d) continues to allow families with three or more children a refundable child credit equal to amount by which social security taxes exceed the sum of nonrefundable credits and the earned income credit if that amount exceeds the amount otherwise refundable. IRC § 24(d)(1)(B)(ii). The child credit is now creditable against both the regular tax and the alternative minimum tax. See IRC § 24(b)(3).

f. Earned income tax credit (EITC) changes in 2001 Act. The 2001 Act made a number of changes in the earned income tax credit. First, the "modified gross income concept" in § 32(a)(2)(B), upon which the phase-out is based, was eliminated and the phase-out is based simply on adjusted gross income. This is a major simplification. Second, the "marriage penalty" imposed by triggering or accelerating the phase-out when an eligible taxpayer married and filed a joint return with a spouse who had income that affected the phase-out was mitigated somewhat by the addition of § 32(b)(2)(B), which provides higher thresholds for triggering the phase-out on joint returns than on single and head of household returns claiming the credit.[23] The "earned income" base for the credit is now limited to earned income that is included in gross income. IRC § 32(c)(2)(A). The definition of "qualifying child" is simplified by broadening the relationships that qualify. In addition to a child, grandchild, stepchild, or foster child, brothers, sisters, step brothers and sisters, and descendants of any of them can qualify if the taxpayer cares for the person as the taxpayer's own child. IRC § 32(c)(3)(B).

g. You don't have to rush to establish your MSA. The deadline for establishing a Medical Savings Account has been extended to 2002. Section 62(a)(18) was added by the **2001 Act** to allow a deduction for contributions to an MSA by a taxpayer who does not itemize deductions. See, Announcement 2001-99, 2001-42 I.R.B. 340 (9/29/01).

h. More help with day-care costs. Starting in 2003, the § 21 dependent care credit percentage increases to 35 percent of eligible expenses. The 2001 Act also increased the ceiling amount of employment-related

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23. The beginning and end of the phase-out range is increased by $1,000 in 2002, 2003 and 2004, by $2,000 in 2005, 2006 and 2007, and by $3,000 for years after 2007.

expenses that qualify for the credit to $3,000 if there is only one qualifying individual or $6,000 if there are two or more qualifying individuals in the household. The maximum dependent care credit thus is $1,050 in the case of one qualifying individual and $2,100 in the case of two or more qualifying individuals. Under the 2001 Act, the reduction in the credit begins at $15,000 of adjusted gross income rather than $10,000. Thus, a taxpayer with more than $38,000 of adjusted gross income is entitled to a credit of only 20 percent of employment-related qualifying expenses.

i. Adoption credit expanded and made "permanent." The 2001 Act made the § 23 adoption credit a "permanent" provision, subject to sunset after 2010 like all of the other provisions of the 2001 Act. In addition, the 2001Act increased the ceiling on the credit to $10,000, subject to an annual inflation adjustment. Starting in 2003, a $10,000 (as adjusted for inflation) credit is allowed with respect to the adoption of a "special needs" child even if no qualified adoption expenses have been incurred. IRC § 23(a)(1)(B). Section 23(b)(2) was amended to begin the phase-out of the adoption credit at an adjusted gross income of $150,000, subject to an annual inflation adjustment. Apart from the inflation adjustment, it is now completely phased out when adjusted gross income exceeds $190,000. The adoption credit is allowed against the AMT permanently (under old law it would not have been for years after 2001).

j. Adoption assistance tax-free fringe benefits expanded and made permanent by 2001 Act. The 2001 Act amended § 137 (the exclusion for employer provided benefits under an adoption assistance program) to make it a "permanent" provision, subject, however, to sunset in 2011 like all of the other provisions of the 2001 Act. In addition, the ceiling on the exclusion was increased to $10,000, subject to an annual inflation adjustment. The phase-out rule was amended to begin the phase-out when the employee's adjusted gross income exceeds $150,000, subject to an annual inflation adjustment. Apart from the inflation adjustment, the exclusion is completely phased out when the employee's adjusted gross income exceeds $190,000.

E. Education: Helping Pay College Tuition (Or is it helping colleges increase tuition?[24])

24. The American higher education system is up to the task of increasing tuition sufficiently so as to sop up any increase in savings for college.

1. Qualified tuition programs now provide a tax exemption. The 2001 Act extensively revised § 529. The most significant change is the amendment of § 529(c)(3)(B) to provide a complete exclusion for in-kind benefits, e.g., tuition waivers, and distributions expended for qualified higher education benefits. Section 529 qualified tuition plans thus have been transformed from vehicles to secure an effective assignment of investment income to a lower bracket taxpayer to vehicles to provide tax-exempt income. In addition, § 529(b)(1) has been amended to permit private institutions of higher education to establish trusts that can qualify for § 529 treatment. Such private § 529 plans can qualify, however, only with respect to purchases of tuition credits or certificates on behalf of the designated beneficiary; cash contribution to a savings plan are not permitted with respect to private § 529 qualified tuition programs. Section 539(c)(3)(C) rollover treatment has been extended to transfers from one plan to another plan on behalf of the same beneficiary. This new rule will facilitate transfers from state qualified tuition plans to new private qualified tuition plans. If a beneficiary receives distributions from both a § 529 qualified tuition plan and from an EIRA, in the same year and the combined distributions exceed the qualified expenditures, new § 539(c)(3)(B)(vi) requires that qualifying expenses be allocated among distributions from the § 529 plan and the EIRA to determine how much of the distribution form each is excludable. Finally, even though a taxpayer – usually the student's parent – may claim the HOPE credit or Lifetime learning credit under § 25A with respect to a student, the exclusion under § 529(c)(3) is available – to the student – for distributions from a § 529 plan with respect to the student as long as the distributions from the § 529 plan are not traced to the expenditures with respect to which the credit is claimed. In other words, both benefits are available as long as qualified expenditures for the year equal or exceed the sum of the distributions from the § 529 plan and the base on which the § 25A credit is calculated.

a. Notice 2001-55, 2001-39 I.R.B. 299 (9/8/01). This notice provides guidance to qualified tuition programs described in § 529 and participants in § 529 programs regarding the restriction on investment direction described in § 529(b)(5), and sets forth a special rule under which a program may permit investments in a § 529 account to be changed annually and upon a change in the designated beneficiary of the account.

b. Notice 2001-81, 2001-52 I.R.B. 617 (12/11/01). Provides guidance regarding record keeping, reporting, and other requirements applicable to § 529 qualified tuition programs in light of the 2001 Act amendments.

2. EIRAs Get a Whole Lot Better. The 2001 Act made a number of changes in the § 530 Education IRA (EIRA) rules that are effective beginning in 2002. First, EIRAs have been renamed "Coverdell Education Savings Accounts" in honor of the late Senator Paul Coverdell (R, GA). Second, the annual limit on contributions was increased from $500 to $2,000. Contributions can qualify for a year as long as they are made during the year or during the following year but before the due date of the tax return for the year to which the contribution relates. IRC § 530(f). Third, the phase-out rules in § 530 (c) were modified to provide a phase-out range for married taxpayers filing joint returns that is twice the range for single taxpayers. Thus, the phase-out range for married taxpayers filing jointly is between $190,000 and $220,000 of adjusted gross income. The 18-year old age ceiling on the eligible beneficiary was removed in the case of "special needs" children. In addition, § 530(b)(2) was amended to extend the exemption from tax to distributions for qualified elementary and secondary school expenses, including expenses of attending religious elementary and secondary schools and the purchase of family computers. Finally, a taxpayer may both take advantage of the exclusion under § 530(d)(2) and claim the HOPE credit or Lifetime Learning Credit under § 25A on behalf of the same student as long as the distributions from the EIRA are not traced to the expenditures with respect to which the credit is claimed. IRC § 25(d)(2)(C)(i). In other words, both benefits are available as long as qualified expenditures for the year equal or exceed the sum of the distributions from the EIRA and the base on which the § 25A credit is calculated.

3. Deductible College Tuition – but you have to run the numbers twice. The 2001 Act added a special deduction for qualified tuition and related expenses in § 222. Section 222 operates completely independently of the rules of Reg. § 1.162-5 and is intended primarily to provide a deduction for parents who pay college tuition for their dependent children. The deduction is available to students who are not claimed as dependents by another taxpayer and pay their own tuition. See IRC § 222(c)(3). The deduction is limited to tuition and related academic fees and does not extend to room and board. See IRC § 222(d)(1), cross-referencing to § 25A(g)(2). As is true with respect to the other tax expenditure provisions intended to subsidize higher education expenses, the deduction is not available for high-income taxpayers. Unlike most other tax expenditure benefits, which are phased-out over an income range, however, the § 222 deduction is subject to a cliff-effect disallowance rule. In 2002 and 2003, for single taxpayers whose adjusted gross income does not exceed $65,000 and for married taxpayers filing a joint return whose gross income does not exceed $130,000 the maximum deduction is $3,000. Taxpayers whose adjusted gross income exceeds those ceilings may not claim any deduction whatsoever. For 2004 and 2005, a maximum deduction of $4,000 is allowed for single taxpayers whose adjusted gross income does not exceed $65,000 and for married taxpayers filing a joint return whose gross income does not exceed $130,000. A maximum deduction of $2,000 is allowed for single taxpayers whose adjusted gross income does not exceed $80,000 and for married taxpayers filing a joint return whose gross income does not exceed $160,000. Taxpayers whose adjusted gross income exceeds the applicable $80,000 or $160,000 ceiling may not claim any deduction. Section 222(c) provides elaborate rules designed to deny the deduction if the taxpayer claims the § 25A HOPE scholarship or lifetime learning credit. Section 222(c) also reduces the deduction by any exclusions under §§ 135, 529, or 530. The § 222 deduction is allowed in

reducing gross income to adjusted gross income; a taxpayer is not required to itemize deductions to claim the § 222 qualified tuition deduction. Section 222 sunsets completely after 2005.

4. Expanded deductibility of educational loan interest. The **2001 Act** amended the § 221 deduction for interest on educational loans in two significant respects. First, § 221(d), which limited the availability of the deduction to interest paid for the first sixty months of the loan repayment period, was repealed. Second, the phase-out range under § 221(b) was increased. For years after 2001, the deduction is phased out for single taxpayers whose "modified" adjusted gross income exceeds $50,000 and for married taxpayers filing a joint return whose modified gross income exceeds $100,000. The deduction is completely phased out for single taxpayers whose modified adjusted gross income exceeds $65,000 and for married taxpayers filing a joint return whose modified adjusted gross income exceeds $130,000. These phase-out thresholds continue to be indexed for inflation after 2001. See IRC § 221(g).

VI. CORPORATIONS

A. Entity and Formation

1. T.D. 8936, Definition of Contribution in Aid of Construction Under Section 118(c), 66 F.R. 2252 (1/11/01). Final Reg. § 1.118-2 deals with the exclusion from gross income of qualified contributions in aid of construction received by a regulated public utility that provides water or sewage services.

2. Read the dictum; the 1999 amendments to §§ 357(c) and 358(d) wouldn't have changed the result. Seggerman Farms, Inc. v. Commissioner, T.C. Memo. 2001-99 (4/25/01). The Tax Court (Judge Cohen) held that § 357(c) requires gain recognition when the liabilities assumed by the corporation exceed the transferor shareholder's basis in the property even if the transferor remains liable as a guarantor. Although the case arose prior to the 1999 amendments to § 357(c) and (d), the court noted that the result would not be different under the current statute. The court stated:

> In 1999, Congress enacted changes to section 357(c) that were effective for transactions occurring after October 18, 1998. See Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. 106-36, sec. 3001(e), 113 Stat. 127, 184. The amendment struck the words "plus the amount of liabilities to which the property is subject," from section 357(c)(1) and essentially provided relief for the taxpayer who transferred assets subject to liabilities and remained personally liable on the debt, but where the corporation did not assume the liability. Id. sec. 3001(d)(4), 113 Stat. 182. Congress also added section 357(d), which provides guidance in determining the amount of liabilities that are assumed and states in section 357(d)(1)(A) that "a recourse liability (or portion thereof) shall be treated as having been assumed if . . . the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability." Id. sec. 3001(b), 113 Stat. 182.
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> The 1999 amendment does not apply to these cases, because the transactions in these cases occurred in 1993. Even if section 357(d)(1)(A) as enacted in 1999 did apply; petitioners' personal liability on the debt that was transferred to the corporation would continues [sic] to be irrelevant. Even after congressional amendments to section 357, Congress has refrained from providing relief to taxpayers in petitioners' situation.

B. Distributions and Redemptions

1. Recourse debts are assumed only when they really are assumed. T.D. 8964, Liabilities Assumed in Certain Corporate Transactions, 66 F.R. 49278 (9/27/01). In January [in T.D. 8924, Liabilities Assumed in Certain Corporate Transactions, 66 F.R. 723 (1/4/01)], the Treasury promulgated Temp. Reg. § 1.301-1T(g), which applies rules similar to those of § 357(d) [for determining when a liability is assumed] for purposes of determining when the amount of a distribution will be reduced under § 301(b). [Identical proposed regulations were published in REG-106791-00 (1/3/01).] A recourse debt has been assumed only if, based on all the facts and circumstances, the transferee has agreed to pay the debt regardless of whether or not the transferor has been relieved of liability vis-à-vis the creditor. A transferee is treated as assuming any nonrecourse debt encumbering property it receives, but the amount of the debt assumed is reduced by the lesser of: (1) the amount of the debt secured by assets not transferred that another person or corporation has agreed (and is expected) to satisfy, or (2) the fair market value of the other assets secured by the debt. In September, Temp. Reg. § 1.301-1T(g) was replaced by final Reg. § 1.301-1(g), which is identical to the temporary regulations.

2. E&P is more than just an esoteric accounting concept. Rev. Rul. 2001-1, 2001-9 I.R.B. 726 (2/26/01). Corporate E&P is reduced to reflect the corporation's deduction under §§ 83(h) and 162 when an employee receives stock upon exercise of a nonstatutory stock option. Because this item reduces earnings and profits, § 56(g)(4)(C)(i) does not disallow the deduction of the item in computing adjusted current earnings for AMT purposes.

3. Don't you forget it! Section 304 trumps § 351. Combrink v. Commissioner, 116 T.C. 296 (5/15/01), *withdrawn and reissued*, 117 T.C. 82 (8/23/01). The taxpayer owned all the stock of two corporations, Cost Oil and Links Investments. Over a number of years, Cost Oil had lent the taxpayer approximately $175,000. The taxpayer, in turn, had lent approximately $89,000 of that amount, plus an additional $163,000, to Links Investments, which made book entries of accounts payable to the taxpayer and issued promissory notes to him. Subsequently, approximately $175,000 of the loan from the taxpayer to Links Investments was converted to additional paid-in capital (without the issuance of any shares) and the corporate indebtedness of Links Investments to the taxpayer was reduced to approximately $77,000. Shortly thereafter, the taxpayer transferred all his stock in Links Investments to Cost Oil in exchange for Cost Oil discharging him from his $175,000 debt obligation. The Tax Court (Judge Nims) held that the transfer of the Links Investments stock to Cost Oil in exchange for Cost Oil's release of the taxpayer's indebtedness was a redemption and a distribution of property under §§ 304 and 317(a). The taxpayer argued that the exception in § 304(b)(3)(B) applied because the transfer could be treated as a § 351 transaction in which Cost Oil "assumed" the taxpayer's debt to Cost Oil and the debt was traceable to his acquisition of stock in Links Investments. Judge Nims granted him only limited relief. The court accepted the recapitalization as establishing that $174,000 was used to acquire Links Investment stock within the meaning of § 304(b)(3)(B)(i). But because the $89,000 of the assumed liability from the taxpayer to Cost Oil that was traceable to the taxpayer's investment in Links Investments exceeded the $77,000 debt from Links Investment to Cost Oil that continued to remain outstanding after the transaction, only $12,000 of the $174,000 debt "assumed" by Cost Oil had been used to acquire stock or equity in Links Investment. Thus, because the taxpayer was the sole stockholder before and after the transfer, $161,000 of the discharged/assumed debt from the taxpayer to Cost Oil was characterized as a dividend under §§ 302(d) and 301.

4. The mark of the devil? Reallocation of $666,000 from covenant not to compete to goodwill produces a double tax. Bemidji Distributing Co. v. Commissioner, T.C. Memo. 2001-260 (10/1/01). In a [pre-§ 197] sale of the corporation's assets, no amount was allocated to intangible assets, including goodwill or going concern value, but $1,000,000 was allocated to the shareholder's covenant not to compete and $200,000 to a two-year consulting contract [compared to $817,461 for the assets]. Based on all the facts and circumstances, e.g., the seller's ability to compete and expert witnesses's valuation testimony, the Tax Court (Judge Parr) found that the value of the covenant was only $334,000 and that $666,000 allocated to the covenant by the taxpayer was really the price of goodwill. Thus, the corporation realized an additional $666,000 of gain on the sale if its [zero basis] intangible assets, and the shareholders who received the payments recognized constructive dividends.

C. Liquidations

1. More check-a-box fallout. T.D. 8970, Amendment, Check the Box Regulations, 66 F.R. 64911 (12/17/01), proposed in REG-110659-00 Proposed Regulations, Amendment, Check the Box Regulations, 66 F.R. 3959 (1/16/01). Treas. Reg. § 301.7701-3(g)(2)(ii) provides that if an unincorporated entity that previously had elected to be taxed as a corporation elects to convert to a partnership, it is treated as distributing all of its assets to its shareholders in a taxable liquidation, followed by the contribution of all the assets to a newly formed partnership. If the entity elects to convert from a corporation to a disregarded entity, it is deemed to have distributed its assets to its owner. Sections 332 and 337 can apply if the owner is a corporation. To facilitate application of § 332, the proposed regulations provide that a plan of liquidation is deemed to have been adopted immediately before the deemed liquidation resulting from the election to change entity classification, unless a formal plan of liquidation that contemplates the filing of the elective change was adopted at an earlier date. The amendments are applicable to elections filed on or after 12/17/01, with retroactivity permissible for elections filed on or after 11/29/99 if the parties take consistent positions.

D. S Corporations

1. Cancellation of indebtedness income of insolvent S corporations

a. "Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern ["that, if shareholders were permitted to pass through the discharge of indebtedness income before reducing any tax attributes, the shareholders would wrongly experience a 'double windfall'"]." Gitlitz v. Commissioner, 531 U.S. 206, 2001-1 U.S.T.C. ¶ 50,147, 87 A.F.T.R.2d 417 (1/9/01). Gitlitz and Winn each owned 50 percent of the stock of an S corporation that realized $2,021,096 of COD income. At that time the corporation was insolvent to the extent of $2,181,748. Thus all of the COD income was excluded under § 108(a)(1)(B). Both shareholders had carried losses that had been suspended under § 1366(d)(1) as well as operating losses that would be further suspended unless the excluded COD income increased their basis in their stock under § 1367(a)(1).

b. The Tax Court followed its reviewed decision in Nelson v. Commissioner**,** 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152 (10th Cir. 7/6/99), which held that a shareholder of an insolvent S corporation may not increase his stock basis under §§ 1367(a)(1)(A) and 1366(a)(1)(A) by the amount of his pro rata share of the corporation's [excluded under § 108(a)] discharge of indebtedness income on the theory that the COD income was passed-through exempt income. The Tax Court agreed with the IRS that § 108(d)(7)(A) requires that the exclusion of income applies at the S corporation level, so that the reduction of tax attributes applied by § 108(b) also applies at the corporate level and the discharge of indebtedness income never passes through to the shareholder. Section 108, through the attribute reduction rules, is generally intended to defer the recognition of income, not to exempt it totally from income.

c. Affirmed. 182 F.3d 1152, 99-2 U.S.T.C. ¶ 50,646, 84 A.F.T.R.2d 5067 (10th Cir. 8/6/99). The Court of Appeals for the Tenth Circuit affirmed, but on different reasoning. It assumed that the COD income was "tax exempt income" under § 1366(a)(1)(A) that potentially could passthrough to the shareholders and increase basis. [fn 7] The court agreed with the Commissioner and the Tax Court, however, that § 108(d)(7)(A) requires that the exclusion of income applies at the S corporation level, so that the reduction of tax attributes applied by § 108(b) also applies at the corporate level and the discharge of indebtedness income never passes through to the shareholder. The court further concluded that § 108(d)(4)(A) merely requires that attribute reduction is the last step in the calculations; it does not necessarily defer the attribute reduction until the year following the year in which the excluded COD income is realized.

Thus, there was no corporate level income to pass through to the shareholders and to increase their basis. Furthermore, the reduction in tax attributes under § 108(b) absorbed the shareholders losses carried over from prior years under § 1366(d)(1).

d. Reversed – A total victory for the taxpayers. The Supreme Court, in an 8-1 decision by Justice Thomas, held that the statute's plain language establishes that COD income realized by an insolvent S Corporation that is excluded under § 108(a) is an item of tax-exempt income that passes through to shareholders under § 1366(a)(1)(A) and increases their bases in the S corporation's stock under § 1367. Furthermore, the pass-through occurs before the reduction of the S corporation's tax attributes under § 108(b), and thus shareholder's carried-over losses [which § 108(d)(7)(B) treats as a corporate NOL for purposes of § 108(b)] to the year in which the COD occurs may be deducted against the basis increase without reduction in that year. Any suspended losses remaining then will be treated as the S corporation's net operating loss and reduced by the discharged debt amount.

- Justice Breyer dissented and would have held that § 108(d)(7)(A) [applying § 108(a), (b), (c), and (g) at the corporate level] precludes any pass through of COD income realized by an insolvent S corporation. In response to the majority's last paragraph, he stated, "it is . . . difficult to see why, given the fact that the 'plain language' admits either interpretation, we should ignore the policy consequences . . . The arguments from plain text on both sides here produce ambiguity, not certainty. And other things being equal, we should read ambiguous statutes as closing, not maintaining, tax loopholes. Such is an appropriate understanding of Congress' likely intent."

e. And the reasoning of the opinion should partially invalidate Reg. § 1.1366-1(a)(2)(viii). As part of its effort to deal with this issue, in T.D. 8852, 64 F.R. 71641 (12/22/99), the Treasury amended Reg. § 1.1366-1(a)(2)(viii) to provide that COD income excluded at the corporate level under § 108 is not "tax exempt" income for purposes of §§ 1366 and 1367. Although the opinion is not a model of clarity, the last sentence states that "the Codes' plain text permits the taxpayers here to receive these benefits." This would indicate that the Treasury has no power to alter the result by regulation. But at another point, integral to the analysis the opinion states: "This section [§ 1366] expressly includes 'tax-exempt' income, but this inclusion does not mean that the statute must therefore exclude 'tax-deferred' income. The section is worded broadly enough to include any item of income, even tax-deferred income, that 'could affect the liability for tax of any shareholder.'" This language is not nearly so definitive as to the clarity of the statutory language and leaves open the possibility that the courts might not invalidate the regulation. But we doubt it.

f. The technical result in *Gitlitz* sleeps the big sleep, but the method of statutory analysis might have everlasting life. The **Job Creation and Worker Assistance Act of 2002** reversed the result of Gitlitz v. Commissioner, 121 S. Ct. 701 (1/9/01), by providing that excluded cancellation of indebtedness income of S corporations is not to result in an adjustment to the basis of stock in the hands of the shareholders. The statutory rule is applicable to discharges of indebtedness after 10/11/01 (but not to discharges of indebtedness before 3/1/02 pursuant to a plan of reorganization filed with a bankruptcy court on or before 10/11/01).

2. *Gitlitz* notwithstanding, sometimes the shareholder still needs a real economic outlay to get the deductions. Grojean v. Commissioner, 248 F.3d 572, 87 A.F.T.R.2d 1673, 2001-1 U.S.T.C. ¶ 50,355 (7th Cir. 4/13/01), *aff'g* T.C. Memo. 1999-425 (12/29/99). An S corporation shareholder, rather than guaranteeing a loan from a bank to his wholly owned S corporation, as initially demanded by the lending bank, instead acquired a $1.2 million loan participation interest in the bank's $10 million loan to the corporation. The participation was financed by a borrowing from the bank at an interest rate identical to the interest rate on the loan to the corporation, and the participation was subordinated to the bank's interest. The shareholder's note and the corporation's note had identical terms and the bank automatically credited payments on the corporation's note against the shareholder's note. No cash passed hands between the shareholder and bank in the circular transaction, and shareholder made no economic outlay. If the loan was repaid, the two loans would cancel out and the taxpayer never would receive or be out any cash. If the S corporation defaulted, the shareholder would have to make good to the bank a portion of its loss equal to the loan to the shareholder. According to Judge Posner, "'business realities' cast Grojean in the role of guarantor rather than lender; no business realities compelled him to recharacterize his guarantee as a loan participation." The shareholder thus acquired no additional basis to support passed-through losses. In the course of his analysis, Judge Posner wrote:

> The difference between a loan and a guaranty may seem a fine one, since, when the amount is the same, the lender and guarantor assume the same risk (subject to a possible wrinkle, concerning bankruptcy). The difference between the two transactional forms may seem to amount only to this: the loan supplies funds to the borrower, and the guaranty enables funds

> to be supplied to the borrower. That is indeed the main difference, but it is not trivial or nominal ("formal").
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> At a high enough level of abstraction, it is true, the difference between providing and enabling the provision of funding may disappear. Indeed, at that level, the difference between equity and debt, as methods of corporate financing, disappears. . . . But at the operational level, because of various frictions that some economic models disregard, such as transaction and liquidity costs, really is a substantive and not merely a formal difference between lending and guaranteeing. In contrast, the difference between a guaranty and the form that Grojean's loan participation assumed was nothing but the label. It was a purely formal difference, and in federal taxation substance prevails over form.

3. REG-106431-01, Qualified Subchapter S Trust Election for Testamentary Trusts, 66 F.R. 44565 (8/24/01). These proposed regulations would amend Reg. § 1.1361-1 to reflect amendments to § 1361 in 1996 permitting a testamentary trust or a former qualified subpart E trust, whether or not the entire corpus was included in the deemed owner's gross estate, to be a permitted S corporation shareholder for a 2-year period [rather than 60 days]. The proposed regulations eliminate the special rules for determining whether trusts consisting of community property qualify for the 2-year period. The proposed regulations also provide that former qualified subpart E trusts and testamentary trusts can continue as permitted shareholders after the end of the 2-year period through a QSST election under § 1361(d) or an electing small business trust election under § 1361(e), if eligible. The QSST election must be made within the 16-day-and-2-month period following the end of the S-year period.

4. Normal operating income of a timber, coal or iron-ore mining company is not § 1374 built-in gain. Rev. Rul. 2001-50, 2001-43 I.R.B. 343 (10/10/01). The § 1374 built in gains tax does not apply when a former C corporation (or S corporation that acquired the property from a C corporation) cuts and sells timber during the 10-year recognition period and recognizes gain under § 631(a), (b), or (c) with respect to a timber cutting contract or disposal of timber, coal or iron ore with a retained economic interest. The IRS applied by analogy Reg. § 1.1374-4(a)(3), Ex. (1), which provides that the extraction of oil from a working interest held on the conversion date is not subject to § 1374. Section 631 was intended to provide a tax benefit for operating income and there is not indication that the deemed capital gain treatment was intended to result in application of § 1374.

5. If they had followed a different form, maybe they could have gotten some additional basis. Estate of Alton Bean v. Commissioner, 268 F.3d 553, 2001-2 U.S.T.C. ¶ 50,669, 88 A.F.T.R.2d 6111 (8th Cir. 10/1/01). The Eighth Circuit (Judge Hansen) affirmed the Tax Court's holding that the shareholders of an S corporation acquired no additional basis in their stock of corporation by virtue of the transfer of assets, subject to liabilities, from a partnership they controlled, to the S corporation, in a transaction originally treated as a sale [on which neither gain nor loss was realized]. Even if there was equity in the party in the partnership's assets, it was the partnership's equity, not the shareholder/partner's equity.

> The partnership was an entity distinct from its partners, and the partners cannot bootstrap their bases in the corporation by transfers made by the partnership. . . . The fact that the partnership was dissolved following the sale in 1992 does not change the form of the transaction that the taxpayers chose to utilize — selling the assets from the partnership to the corporation. Once chosen, the taxpayers are bound by the consequences of the transaction as structured, even if hindsight reveals a more favorable tax treatment.

E. Affiliated Corporations

1. The "single entity" approach of consolidated returns carries the day. United Dominion Industries, Inc. v. United States, 121 S. Ct. 1934, 2001-1 U.S.T.C. ¶ 50,430, 87 A.F.T.R.2d 2377 (6/4/01), *rev'g* 208 F.3d 452, 2000-1 U.S.T.C. ¶ 50,310, 85 A.F.T.R.2d 1512 (4th Cir. 3/24/00). The taxpayer was the parent of a consolidated group that reported NOLs for four consecutive years during which a portion of the deductions were product liability expenses (PLEs) incurred by profitable members of the group. Product liability losses (PLLs) — which are the lesser of the taxpayer's PLEs or the taxpayer's NOL — can be carried back for 10 years under § 172(b)(1) [rather than the normal 2 years]. The taxpayer: (1) calculated its CNOL under Reg. § 1.1502-11(a), and (2) aggregated its individual members' PLEs. Because the CNOL was greater than the sum of its members' PLEs, the taxpayer treated the full amount of the PLEs as consolidated PLLs eligible for 10-year carryback.

• The Court of Appeals for the Fourth Circuit held that under Reg. §§ 1.1502-12 and 1.1502-21A the consolidated group could not carry back PLEs incurred by the profitable members because they did not enter into the consolidated NOL. The court reasoned that § 172 refers to specified liability losses, not to specified liability expenses. Only that portion of a member's separate net operating loss attributable to specified liability losses could be taken into account in computing the portion of the consolidated NOL attributable to specified liability losses.

- The Supreme Court reversed, applying a "single entity approach" to allow the 10-year carryback. Justice Souter's opinion reasoned that there is only a single definition of consolidated net operating loss in Reg. § 1.1502-21(f) and no definition in the consolidated return regulations of a component member's separate NOL. He rejected the government's argument that an individual group member's separate taxable income (STI) under Reg. § 1.1502-12, is analogous to a "separate" NOL, and that accordingly a member having positive STI could have no product liability losses. Since there is no NOL below the CNOL, there is nothing for comparison with PLEs to produce PLL at any stage before the CNOL calculation. Nothing in the Code or regulations indicated the essential relationship between NOL and PLL for a consolidated group would differ from their relationship for a conventional corporate taxpayer. The fact that several member companies throwing off large PLEs also, when considered separately, generated positive taxable income was of no significance.

- Justice Thomas concurred in the case with the following opinion:

> I agree with the Court that the Internal Revenue Code provision and the corresponding Treasury Regulations that control consolidated filings are best interpreted as requiring a single-entity approach in calculating product liability loss. I write separately, however, because I respectfully disagree with the dissent's suggestion that, when a provision of the Code and the corresponding regulations are ambiguous, this court should defer to the government's interpretation. See post, at 1-2. At a bare minimum, in cases such as this one, in which the complex statutory and regulatory scheme lends itself to any number of interpretations, we should be inclined to rely on the traditional canon that construes revenue-raising laws against their drafter. See *Leavell v. Blades*, 237 Mo. 695, 700-701, 141 S.W. 893, 894 (1911) ("When the tax gatherer puts his finger on the citizen, he must also put his finger on the law permitting it."); *United States v. Merriam*, 263 U.S. 179, 188, 68 L. Ed. 240, 44 S. Ct. 69 (1923) ("If the words are doubtful, the doubt must be resolved against the government in favor of the taxpayer."); *Bowers v. New York & Albany Literage Co.*, 273 U.S. 346,

> 350, 71 L. Ed. 676, 47 S. Ct. 389 (1927) ("The provision is part of a taxing statute; and such laws are to be interpreted liberally in favor of the taxpayers."). *Accord American Net & Twine Co. v. Worthington*, 141 U.S. 468, 474, L. Ed. 821, 12 S. Ct. 55 (1891); *Benziger v. United States*, 192 U.S. 38, 55, 48 L. Ed. 331, 24 S. Ct. 189 (1904).

• Justice Stevens, in his dissent, responded in the following footnote:

> Justice Thomas accurately points to a tradition of cases construing "Revenue-raising laws" against their drafter. See Ante, at 1 (THOMAS, J., concurring). However, when the ambiguous provision in question is not one that imposes tax liability but rather one that crafts an exception from the general revenue duty for the benefit of some taxpayers, a countervailing tradition suggests that the ambiguity should be resolved in the government's favor. See, e.g., *INDOPCO, Inc. v. Commisioner*, 503 U.S. 79, 84, 117 L. Ed. 2d 226, 112 S. Ct. 1039 (1992); *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593, 87 L. Ed. 1607, 63 S. Ct. 1279 (1943); *Deputy v. Du Pont*, 308 U.S. 488, 493, 84 L. Ed. 416, 60 S. Ct. 363 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440, 78 L. Ed. 1348, 54 S. Ct. 788 (1934); *Woolford Realty Co. v. Rose*, 286 U.S. 319, 326, 76 L. Ed. 1128, 52 S. Ct. 568 (1932).

a. Tax Court had ruled to the contrary, but the sixth circuit court had reversed and also had held for the taxpayer. Intermet Corp. v. Commissioner, 111 T.C. 294 (12/8/98), *rev'd*, 209 F. 3d 901, 2000-1 U.S.T.C. ¶ 50,382, 85 A.F.T.R. 2d. 1387 (6th Cir. 4/20/00). Judge Wells held that under Reg. §§ 1.1502-12 and 1.1502-21A, a consolidate group's specified liability losses did not include deductions attributable to members of the group that reported positive separate taxable income because the deductions did not contribute to the groups consolidated NOL. The Court of Appeals reversed and allowed them to be carried back under the special rule. The Court reasoned that the subsidiaries specified liability loss deduction items reduced the subsidiaries separate taxable income dollar-for-dollar and thus contributed to the consolidated NOL. An individual component members taxable income has not independent significance; it is merely a step in computing consolidated NOL. There was no basis Reg. § 1.1502-21A for treating a specified liability loss as constituting part of the consolidated NOL when the member that incurred the deduction had negative taxable income but not when that member had positive separate taxable income [as long as a SRLY year is not involved].

(1) Intermet Corp. v. Commissioner, 117 T.C. 113 (10/2/01), *on remand from* 209 F. 3d 901 (6th Cir. 4/20/00). See II.H. above.

2. But the Federal Circuit doesn't appear to buy into the single entity theory. Regulation § 1.1502-20, which prohibited recognition of loss in the transactions involving, *Inter alia,* "duplicated losses," was held to be "manifestly contrary to the statute." Rite Aid Corp. v. United States, 255 F.3d 1357, 2001-2 U.S.T.C. ¶ 50,516, 88 A.F.T.R.2d 5058 (Fed. Cir. 7/6/01), *rev'g* 46 Fed. Cl. 500, 2000-1 U.S.T.C. ¶ 50,429, 85 A.F.T.R.2d 1439 (Fed. Cl. 4/21/00). Rite Aid sold a subsidiary (Encore) and realized a taxable loss of $33 million and an "economic loss" of $22 million, which it claimed should be deductible. Reg. § 1.1502-20, subject to certain exceptions, disallows *any* loss realized by a member of a consolidated group upon the disposition of the stock of a subsidiary. Under Reg. § 1.1502-20, the amount of loss that is disallowed is limited to the sum of (1) income or gain resulting from "extra ordinary gains dispositions," which are defined as dispositions of capital assets, depreciable property used in the trade or business, certain bulk asset dispositions, and discharge of indebtedness income, (2) positive investment adjustments (other than those attributable to extra ordinary gain dispositions), and (3) "duplicated loss," which is the aggregate of the subsidiaries asset basis and loss carryovers over the value of the subsidiaries assets. Any losses in excess of these amounts are deductible. Reg. § 1.1502-20 is designed to prevent "duplicated losses" — the deduction by both the parent and subsidiary of the same economic loss. The Court of Federal Claims upheld the validity of Reg. § 1.1502-20 and because Encore's built-in loss of $28 million [as calculated by] exceeded Rite Aids' economic loss, no loss deduction was allowed. The Court pointed out that Rite Aid could have avoided Reg. § 1.1502-20 by finding a buyer who would agree to a § 338(h)(10) election.

- The Federal Circuit (Judge Meyer) reversed, declaring the "duplicated loss factor" in Reg. § 1.1502-20 invalid because it allows a loss that is otherwise allowed by § 165 and is "manifestly contrary to the statute." Because " realization of the loss [on the stock sale] does not stem from the filing of a consolidated return, . . . the denial of the deduction imposes a tax on income that otherwise would not be taxed," something that § 1502 does not authorize the Treasury to do. The Federal Circuit summarily rejected the government's argument that Reg. § 1.1502-20 is necessary to prevent a double deduction, stating that the subsidiary's future deductions were not created by the consolidated return rules because the same duplication occurs outside the consolidated return context, and Congress has addressed the problem by the enactment of §§ 382 and 383. Judge Mayer concluded that "the duplicated loss factor distorts rather than reflects the tax liability of consolidated groups and contravenes Congress' otherwise uniform treatment of limiting deductions from the subsidiary's losses."

• B. John Williams of Shearman & Sterling –the new IRS Chief Counsel – represented the taxpayer.

a. Initially, the IRS threatened to keep going. In Chief Counsel Notice CC-2001-042 (8/30/01), the IRS advised chief counsel attorneys that it did not agree with the Federal Circuit decision in *Rite Aid Corp. v. United States* and that it had filed a petition for rehearing en banc with the Federal Circuit.

b. Now, it will change the regulations instead. Notice 2002-11, 2002-7 I.R.B. 526 (2/1/02). The IRS still believes that the Federal Circuit's analysis and holding in *Rite Aid* were incorrect, but it will not appeal. Nevertheless, the Service announced that "the interests of sound tax administration will not be served by continuing to litigate the validity of the loss duplication factor of § 1.1502-20." However, "because of the interrelationship in the operation of all of the loss disallowance factors," the IRS will promulgate new rules governing loss disallowance on sales of stock of a member of a consolidated group. Interim regulations [to be effective prospectively from the date of their issuance] "will require consolidated groups to determine the allowable loss on a sale or disposition of subsidiary stock under an amended § 1.337(d)-2 instead of under § 1.1502-20." For transactions (including those for which a return has been filed) completed before promulgation of interim regulations [or for which there is a binding contract before that date] certain choices will be allowed with respect to a disposition of subsidiary stock, including a choice to apply § 1.337(d)-2 as amended. The IRS and Treasury will consider broadly the regulations necessary to implement § 337(d) with respect to affiliated groups filing consolidated. The IRS takes the position that the *Rite Aid* holding is very narrow:

> It is the Service's position that the *Rite Aid* opinion implicates only the loss duplication aspect of the loss disallowance regulation and that the authority to prescribe consolidated return regulations conferred on the Secretary is limited only by the requirement that the Secretary, in his discretion, has determined such rules necessary clearly to reflect consolidated tax liability.

3. A kinder and gentler approach to captive insurance. Rev. Rul. 2001-31, 2001-26 I.R.B. 1348 (6/25/01). The IRS will no longer invoke the "economic family" theory of Rev. Rul. 77-316, 1977-2 C.B. 53, to attack captive insurance arrangements. Rev. Rul. 77-316 is obsoleted. The IRS may continue to challenge certain captive insurance transactions on a case-by-case basis.

4. Deferred intercompany transaction timing rules are a method of accounting. Reg-125161-01, Conforming Amendments to Section 446, 66 F.R. 56262 (11/7/01). These proposed regulations would conform Reg. § 1.446-1(c)(2)(iii) to Reg. § 1.1502-13(a)(3), promulgated in 1995, which provides that the deferred intercompany transaction rules are a method of accounting, which members are required to apply in addition to their usual methods of accounting.

• In *General Motors Corp. v. Commissioner*, 112 T.C. 270 (1999), the Tax Court held that the timing rule of former [pre-1995] Reg. § 1.1502-13(b)(2) was not a method of accounting for purposes of § 446(e). The proposed regulations confirm the IRS's position that the timing rules of current § 1.1502-13 are a method of accounting.

5. The IRS acts to eliminate an anomaly that would hurt corporate taxpayers in consolidated returns. REG-137519-01, Consolidated Returns; Applicability of Other Provisions of Law; Nonapplicability of Section 357(c), 66 F.R. 57021 (11/14/01). A proposed amendment to Reg. § 1.1502-80(d) would clarify that liabilities described in § 357(c)(3) are not taken into account as a basis reduction with respect to § 351 transfers to which § 357(c) is inapplicable.

F. Reorganizations and Corporate Divisions

1. The wrath of *General Utilities* repeal rewritten. REG-107566-00, Notice of Proposed Regulations, Guidance Under Section 355(e): Recognition of Gain on Certain Distributions of Stock or Securities in Connection with an Acquisition, 66 F.R. 76 (1/2/01). The Treasury has revised Prop. Reg. § 355-7 and withdrawn proposed regulations issued in REG-116733-98 (64 F.R. 46155, 8/24/99). The new proposed regulations provide that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. They include nonexclusive lists of facts and circumstances to be considered in making the determination and six safe harbors.

• If an acquisition follows a distribution, the distribution and acquisition are considered part of a plan if the distributing corporation (D), the controlled corporation (C), or any of their controlling shareholders intended on the date of the distribution that the acquisition or a similar acquisition occur in connection with the distribution. If an acquisition precedes a distribution, the distribution and acquisition are considered part of a plan if D, C, or any of their controlling shareholders intended on the date of the acquisition that a distribution occur in connection with the acquisition. All acquisitions of stock of a corporation that are pursuant to a plan are aggregated to determine whether the 50 percent threshold of § 355(e)(2)(A)(ii) is met.

- *Facts and Circumstances* — There are two nonexclusive lists of factors to consider, one list tends to demonstrate that a distribution and an acquisition are part of a plan and the other list tends to demonstrate that a distribution and an acquisition are not part of a plan. The weight of the factors varies and the determination does not depend on merely counting factors.

- *Factors indicating a plan*: Six factors [3 with respect to pre-acquisition distributions and 2 with respect to post-acquisition distributions] focus on whether D, C, or their respective controlling shareholders discussed the second transaction of the pair with outside parties before the first transaction occurred. The seventh factor considers whether the distribution was motivated by a purpose to facilitate the acquisition or a similar acquisition of D or C; evidence of such a purpose exists if there was a reasonable certainty that within 6 months after the distribution an acquisition would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding an acquisition. Elaborate "operating rules" describe the impact of numerous scenarios. The eighth factor considers whether an acquisition and a distribution occurred within 6 months of each other, or whether there was an agreement, understanding, arrangement, or substantial negotiations regarding the second transaction (or, if an acquisition is the second transaction, a similar acquisition) within 6 months after the first transaction. The ninth factor considers whether the debt allocation between D and C made an acquisition of D or C likely in order to service the debt.

- *Factors indicating the absence of a plan:* Five factors [3 with respect to pre-acquisition distributions and 2 with respect to post-acquisition distributions] focus on the absence of any discussions between D, C, or their respective controlling shareholders, with outside parties regarding the second transaction of the pair before the first transaction occurred. One of the factors in each category is that there was an identifiable, unexpected change in market or business conditions after the first transactions that resulted in the second, unexpected transaction. The sixth nonplan factor is the existence of a real and substantial corporate business purpose, other than a purpose to facilitate the acquisition or a similar acquisition, for the distribution [using principles similar Reg. § 1.355-2(b)(1)]. The seventh factor is that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a previously proposed similar acquisition.

• *Safe harbors*: A distribution and an acquisition are not part of a plan if they are described in one of the safe harbors.

(1) An acquisition more than 6 months after a distribution if there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution and the distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate an acquisition is not part of a plan. This safe harbor applies if the distribution was motivated in whole or substantial part by a nonacquisition business purpose.

(2) An acquisition more than 6 months after a distribution for which there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution is not part of a plan. This safe harbor applies where the distribution was motivated in whole or substantial part by a business purpose to facilitate an acquisition of no more than 33% of the stock of either D or C, and no more than 20 percent of the stock of the corporation whose stock was acquired in the acquisition that motivated the distribution was either acquired or the subject of an agreement, understanding, arrangement, or substantial negotiations before a date that is 6 months after the distribution.

(3) An acquisition more than 2 years after a distribution if there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter is not part of a plan.

(4) An acquisition more than 2 years before a distribution if there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within 6 months thereafter is not part of a plan.

(5) If D or C is listed on an established market, an acquisition if the stock is transferred between shareholders of D or C who are not 5- percent shareholders is not part of a plan. This safe harbor is subject to certain exceptions.

(6) An acquisition of stock by an employee or director in connection with the performance of services, including an acquisition resulting from the exercise of certain compensatory stock options, is not part of a plan.

• For all purposes, depending on all relevant facts and circumstances, parties can have an agreement, understanding, or arrangement even though they have not reached agreement on all terms. Under certain circumstances, such as in public offerings or auctions of D or C stock, an agreement, understanding, arrangement, or substantial negotiations can exist regarding an acquisition even if the acquirer has not been specifically identified. Special rules deal with options. These proposed rules are to be effective upon the publication of final regulations.

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

2. When the statute is unhelpful, call on the legislative history of a related provision for some help. Rev. Rul. 2001-24, 2001-22 I.R.B. 1290 (6/29/01). The IRS ruled that the parent acquiring corporation in a § 368(a)(2)(D) forward triangular merger may drop the acquisition subsidiary into a different subsidiary. Under Reg. § 1.368-1(d)(4), the continuity of business enterprise requirement is met. Reg. § 1.368-2(f) provides that a corporation remains a "party to the reorganization" if following an acquisition, stock or assets are transferred in a transaction described in Reg. § 1.368-2(k), but Reg. § 1.368-2(k) refers only to reverse triangular mergers under § 368(a)(2)(E). If the transaction were recast under the step transaction doctrine as a merger into a second tier subsidiary, the parent would not be a party to the reorganization. Because the legislative history of § 368(a)(2)(E) suggests that forward and reverse triangular mergers should be treated similarly, the IRS will not apply the step transaction doctrine. The transaction qualifies under § 368(a)(2)(D). Section 368(a)(2)(C), which does not apply, is permissive rather than restrictive.

3. "Holds" in § 368(a)(2)(E) means the same as "acquire[s]" in § 368(a)(1)(C). Rev. Rul. 2001-25, 2001-22 I.R.B. 1291 (5/29/01). The IRS has ruled that a reverse triangular merger that otherwise qualified under § 368(a)(2)(E) was not disqualified by virtue of the fact that immediately after the merger and as part of a plan that included the merger, the surviving target corporation sold fifty percent of its operating assets to an unrelated corporation for cash. The IRS concluded that Rev. Rul. 88-48, 1988-1 C.B. 117, should be applied to conclude that the "substantially all of the properties" requirement had been met when 50 percent of the target's assets were sold for cash immediately before the acquisition and the cash was transferred to the acquirer along with the other assets. The reasoning of Rev. Rul. 2001-25 was as follows.

> Section 368(a)(2)(E) uses the term "holds" rather than the term "acquisition" as do §§ 368(a)(1)(C) and 368(a)(2)(D) because it would be inapposite to require the surviving corporation to "acquire" its own properties. The "holds" requirement of § 368(a)(2)(E) does not impose requirements on the surviving corporation before and after the merger that would not have applied had such corporation transferred its properties to another corporation in a reorganization under § 368(a)(1)(C) or a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D).

4. Does the IRS now like the *King Enterprises* step transaction analysis? Rev. Rul. 2001-26, 2001-23 I.R.B. 1297 (6/4/01). The IRS has ruled that a two-step acquisition involving a voting stock for stock tender offer exchange for 51 percent of the outstanding T corporation stock, followed by a merger of a P subsidiary into T in which the remaining 49 percent of the T shareholders receive two-third P stock and one-third cash (the cash being 16.67 percent of total consideration) can qualify as a § 368(a)(2)(E) reverse triangular merger. The ruling assumes that all requirements for a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(E), other than the requirement under § 368(a)(2)(E)(ii) that P acquire control of T in exchange for its voting stock in the transaction, have been satisfied. The ruling also assumes that under general principles of tax law, including the step transaction doctrine as applied in *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969), the tender offer and the statutory merger are treated as an integrated acquisition by P of all of the T stock. The ruling reaches the same result in a situation in which before the merger, S initiates the tender offer for T stock and, in the tender offer, acquires 51 percent of the T stock for P stock provided by P.

5. From "qualified stock purchase" to "reorganization" with a wave of step transaction doctrine's magic wand. Rev. Rul. 2001-46, 2001-42 I.R.B. 321 (9/25/01). P acquired T by merging P's shell subsidiary S into T in a reverse triangular merger in which the T shareholder's receive 70 percent P voting stock and 30 percent cash (the Acquisition Merger). Following the acquisition, "as part of the plan," T merges into P (the Upstream Merger). The ruling assumes that (1) "absent some prohibition against the application of the step transaction doctrine, the step transaction doctrine would apply to treat the Acquisition Merger and the Upstream Merger as a single integrated acquisition by [P] of all the assets of T," and (2) "the single integrated transaction would satisfy the nonstatutory requirements of a reorganization under § 368(a). The ruling holds that Acquisition Merger is not a qualified stock purchase under § 338 followed by a § 332 liquidation, but instead is a statutory merger of T into P under § 368(a)(1)(A). No § 338 election is available. The ruling reaches the same result – type (A) merger if the T shareholders receive solely P voting stock [instead of a § 368(a)(1)(E) reverse triangular merger].

- The IRS applied Rev. Rul. 67-274, 1967-2 C.B. 141, holding that if P acquires the stock of T in exchange P voting stock and thereafter liquidates T into P, the transaction is a type (C) reorganization rather than a type (B) reorganization. It distinguished Rev. Rul. 90-95, 1990-2 C.B. 67 (Situation 2), holding that the cash merger of a newly formed wholly owned S into T followed by the merger of T into P will be treated as a qualified stock purchase of T followed by a § 332 liquidation of T.
- Pursuant to § 7805(b) the IRS will not apply the ruling to challenge a taxpayer's contrary position with respect to an acquisition before 9/25/01, or acquisition of stock of the target corporation meeting the requirements of § 1504(a)(2) by the purchasing corporation pursuant to a written agreement binding on 9/24/01 if: (1) a timely § 338(g) or (h)(10) or § 338(g) has been filed and (2) the taxpayer does not take an inconsistent position.
- The IRS is considering whether to issue regulations that reflect the principles of the ruling, but nevertheless allow § 338(h)(10) elections pursuant to a written agreement that requires or permits the § 338(h)(10) election.

6. The "active business" of REIT. Rev. Rul. 2001-29, 2001-26 I.R.B. 1348 (6/25/01). A REIT can be engaged in the active conduct of a trade or business within the meaning of § 355(b) solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property within the meaning of § 856(d) of the Code. Rev. Rul. 73-236, 1973-1 C.B. 183 is obsoleted. "The obsolescence of Rev. Rul. 73-236, which denied § 355 treatment to a distribution of stock by a C corporation that converted to a REIT because the REIT was not engaged in the active conduct of a trade or business, does not imply a view as to whether a distribution of stock involving a REIT election by the distributing or controlled corporation would otherwise satisfy the requirements of § 355, including the corporate business purpose requirement of § 1.355-2(b)."

7. Treasury does an "about-face" on mergers into disregarded entities. REG-126485-01, Statutory Mergers and Consolidations, 66 F.R. 57400 (11/15/01). The Treasury has withdrawn proposed regulations [REG-106186-98, 65 F.R. 31115 (5/16/00)], which would have provided that neither the merger of a disregarded entity into a corporation nor the merger of a target corporation into a disregarded entity was a statutory merger qualifying as a reorganization under § 368(a)(1)(A), and has proposed new more liberal regulations [Prop. Reg. § 1.368-2(b)(1)]. Under the new proposed regulations, a merger of a corporation into a disregarded entity that is wholly owned by another corporation could qualify as a type (A) merger. As the IRS is wont to do these days, the new proposed regulations introduce more definitional jargon. The term "disregarded entity" means a business entity (as defined in Reg. § 301.7701-2(a)) that is disregarded as an entity separate from its owner for Federal tax purposes, including single member corporate-owned LLCs, qualified REIT subsidiaries, and Q-Subs. "Combining entity" means a business entity that is a corporation [as defined in Reg. § 301.7701-2(b)] that is not a disregarded entity. "Combining unit" means a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for Federal tax purposes. Under the proposed regulations, a statutory merger or consolidation under § 368(a)(1)(A) must be effected pursuant to the laws of the United States or a State or the District of Columbia. [Foreign statutory mergers still do not qualify, but the domestic statute no longer needs to be a "corporate" law.] All of the following events must occur simultaneously: (1) all of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharged in the transaction) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and (2) the combining entity of each transferor unit ceases its separate legal existence for all purposes. The examples provide all the details in the rules: (Ex. 1) Divisive mergers [see Rev. Rul. 2000-5, 2000-1 C.B. 436] cannot qualify; (Ex. 2 & 3) Forward triangular mergers (into a disregarded entity owned by S) are allowed; (Ex. 4) The owner of the disregarded entity must be a corporation; (Ex. 5) Mergers of disregarded entities into corporations do not qualify; and (Ex. 6) None of the consideration received by the T shareholders may be interests in the disregarded entity.

• The regulations will be effective when finalized.

8. Backing into control within 5 years of the spin-off backed them right out of § 355. McLaulin v. Commissioner, 276 F.3d 1269, 2002-1 U.S.T.C. ¶ 50,156, 88 A.F.T.R.2d 7324 (11th Cir. 12/21/01), *aff'g* 115 T.C. 255 (9/20/00). The taxpayers were shareholders of RPI, an S corporation. Until 1993, RPI owned 50 percent of the stock of Sunbelt (a C corporation); the other 50 percent was owned by Hutto. In 1993, after protracted negotiations regarding whether RPI should purchase Hutto's stock in Sunbelt or Hutto should purchase RPI's Sunbelt stock, Sunbelt redeemed all of Hutto's stock for cash [$828,943], which was borrowed from RPI, and property [$101,000], leaving RPI as Sunbelt's sole shareholder. Later on the same day as the redemption, RPI distributed all of the stock of Sunbelt to RPI's three equal shareholders – the taxpayers — in a transaction intended to qualify as a tax-free spinoff under § 355. The stated purposes of the distribution were to relieve RPI from any potential liabilities arising from Sunbelt's operations, to prepare Sunbelt to go public, and to preserve RPI's S election [the controlling version of § 1361(b) for the year in question prohibited the parent of an affiliated group from being an S corporation].

• The Tax Court (Judge Halpern) held that because RPI's distribution of the stock of Sunbelt occurred less than 5 years after RPI acquired control of Sunbelt in a transaction in which gain or loss was recognized [i.e., the redemption of Hutto's stock], the distribution failed to satisfy the active business requirement of §§ 355(a)(1)(C) and (b)(2)(D)(ii). Judge Halpern rejected the taxpayer's 'blanket assertion' that a redemption of stock of the other shareholder's stock, thereby backing the parent into control of the subsidiary, never could be treated as the acquisition of control within 5 years in a taxable transaction. He likewise declined to follow the Commissioner's argument directly to apply Rev. Rul. 57-144, 1957-1 C.B. 123, which would treat any instance in which a redemption resulted in the acquisition of control within 5 years as a disqualifying acquisition. Rather, he emphasized the negotiations leading up to the transaction and the fact that the cash for the redemption came from RPI to conclude that in this case there was no difference between the transaction as it occurred and a direct purchase by RPI.

• Accordingly, § 335(c)(1) did not apply to provide nonrecognition at the corporate level; under § 311(b), RPI recognized gain on the distribution of the Sunbelt stock, and the gain passed through to the RPI shareholders under § 1366(a). [The court did not address the Commissioner's argument that the shareholders failed to prove that the distribution was designed to achieve a corporate business purpose as required by Reg. § 1.355-2(b).]

• The Court of Appeals **affirmed** the Tax Court's decision with minimal discussion.

> The tax court found that the facts of Rev. Rul. 57-144 were not distinguishable from the present case in any significant way. We agree. . . . .
>
> We need make no distinction between indirect control of Sunbelt by Ridge at 50% ownership and direct control of Sunbelt by Ridge at 100% ownership. Under the plain meaning of the statute, Ridge acquired control on January 15th, the

> moment the taxable Hutto redemption occurred. This event resets the five-year clock and renders Ridge's distribution of the Sunbelt stock taxable, albeit stock that it had held for more than twelve years.
>
> As the tax court said, this is not the mere conversion of indirect control to direct control. It is the "acquisition of control where none had existed previously."

G. Personal Holding Companies and Accumulated Earnings Tax

1. Knight Furniture Co. v. Commissioner, T.C. Memo. 2001-19 (1/29/01). The accumulated earnings tax assessed by the Commissioner was not upheld because the taxpayer was reasonably accumulating earnings to redeem dissenting minority shareholders and had a history of funding redemptions with cash.

H. Miscellaneous Issues

1. Is it the harbinger of a negotiated tax system? Notice 2000-12, 2000-9 I.R.B. 727 (2/12/00). A pilot program existed for pre-filing agreements (PFAs), under which large businesses may request examination and resolution of specific issues relating to tax returns expected to be filed between September and December 2000. These PFAs would be treated as closing agreements, and would be characterized as confidential return information under § 6103(b)(2)(A).

a. PFAs available for all LMSB taxpayers. Rev. Proc. 2001-22, 2001-9 I.R.B. 745 (2/26/01). This procedure permits a taxpayer subject to the jurisdiction of the IRS Large and Mid-Size Business Division (LMSB) to request the examination of specific issues relating to a tax return before the return is timely filed. If the taxpayer and the Service are able to resolve the examined issues prior to the filing of the return, the taxpayer and the IRS may finalize their resolution by executing an LMSB Pre-Filing Agreement. It applies only to issues involving the application of well-settled principles of law; it does not apply to issues involving questions of law that are not well settled with respect to the material facts of the issue. LMSB PFAs are closing agreements under § 7121, and must comply with Rev. Proc. 68-16, 1968-1 C.B. 770.

b. The **Community Renewal Tax Relief Act of 2000** added § 6103(b)(2)(D) to provide specifically that these closing agreements (as are these pre-filing agreements) would be treated as confidential return information.

2. The final § 338 and § 1060 regulations provide only minor changes from the 2000 temporary regulations. T.D. 8940, Purchase Price Allocations in Deemed and Actual Asset Acquisitions, 66 F.R. 9925 (2/13/01). Final regulations §§ 1.338-1 through -10, 1.338(h)(10)-(1) and 1.1060-1, [proposed in REG-107069-97, 64 F.R. 43462 (8/10/99), and promulgated as temporary regulations (effective 1/6/00) in T.D. 8858, 65 F.R. 1236 (1/7/00)] clarify the treatment of, and provide consistent rules (where possible) for, both deemed and actual asset acquisitions under §§ 338 and 1060.

- Reg. §§ 1.338-1 through -10, § 1.338(h)(10)-(1) and 1.1060-1 are intended to clarify the treatment of, and provide consistent rules (where possible) for, both deemed and actual asset acquisitions under §§ 338 and 1060. The IRS identified three major deficiencies in the prior regulations: (1) their statement of tax accounting rules and their relationship to tax accounting rules for asset purchases outside of § 338; (2) the effects of the allocation rules; and (3) their lack of a complete model for the deemed asset sale (and, in the case of § 338(h)(10) elections, the deemed liquidation) from which tax consequences not specifically set forth in the regulations can be determined. The new regulations also take into account amendments to the Code enacted since the different portions of the current regulations were promulgated.
- The new regulations have four major aspects: (1) reorganization of the regulations; (2) clarification and modification of the accounting rules applicable to deemed and actual asset acquisitions; (3) modifications to the residual method mandated for allocating consideration and basis, increasing the number of classes to seven; and (4) miscellaneous revisions to the current regulations. Old target and new target (and any other affected parties, for example, when a § 338(h)(10) election is made) must determine their tax consequences as if they actually had engaged in the sale and purchase transactions deemed to have occurred under § 338. The consistency rules are unchanged.
- The seven classes are: Class I – cash and cash equivalents; Class II – CDs, securities, foreign currency; Class III – assets the target marks-to-market annually for tax purposes and debt obligations held by the taxpayer, [generally including accounts receivable, mortgages, credit card receivables], but not including debt instruments issued by a related person [determined after the acquisition], contingent debt instruments, or convertible debt; Class IV – inventory; Class V – all assets not included in the other classes and the stock of target affiliates; Class VI – section 197 assets other than goodwill and going concern value; and Class VII – section 197 goodwill and going concern value. The change relates to the addition of two new classes of "fast pay" assets, which must receive basis up to fair market value before there is any basis allocated to tangible property.
- Reg. §§ 1.338-4T and 1.338-5T significantly

revise the calculations of aggregate deemed sale price (ADSP) and adjusted grossed-up basis (AGUB), as well as various aspects of tax treatment of the deemed asset sale. Under the new regulations, ADSP is the grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock. Amount realized is determined as if old target itself were the selling shareholder. General tax law principles apply in determining the timing and amount of the elements of ADSP, and that ADSP is redetermined at such time and in such amount as an increase or decrease to the individual constituent elements of the definition of ADSP would be required under general principles of tax law. The new regulations also provide a parallel rule for AGUB. These changes may result in increased disparities between ADSP and AGUB if there is nonrecently purchased stock of the target involved.

- Old target's liabilities are taken into account in calculating ADSP as if old target sold its assets to an unrelated person for consideration that included the unrelated person's assumption of, or taking subject to, the liabilities. To be taken into account in AGUB, a liability must be a liability of target that is properly taken into account in basis under general principles that would apply if new target had acquired its assets from an unrelated person for consideration that included the assumption of, or taking subject to, the liability; the prior rule that liabilities are taken into account in calculating AGUB (and ADSP) only when such liabilities become fixed and determinable is eliminated. Old target's tax liability is deemed not assumed by new target only if the parties have agreed that (or the tax or non-tax rules operate such that) the seller, and not target, will bear the economic cost of that tax liability.

3. The Tax Court continues on its capitalization spree. Illinois Tool Works, Inc. v. Commissioner, 117 T.C. 39 (6/31/01). The taxpayer acquired the assets of another corporation [for approximately $126 million] in a taxable transaction in which the taxpayer assumed the target's liabilities, including a contingent liability for a patent infringement claim, [*Lemelson v. Champion Spark Plug Co.,* 975 F.2d 869 (1992)], for which it established a reserve of $350,000. Subsequently, the taxpayer, as the target's successor, was held liable for damages, interest, and court costs [totaling over $17 million], which it paid. The Tax Court (Judge Cohen) upheld the Commissioner's treatment requiring capitalization of the payments as a cost of acquiring the assets rather than a deductible expense, even though the parties had not adjusted the purchase price to reflect the contingent liability. The liability was known, was considered in setting the price, and was expressly assumed. That the taxpayer considered it highly unlikely that it would be called upon to pay was not relevant.

- The Commissioner conceded the deductibility of the judgment in two respects: (1) pre-judgment interest accruing after the acquisition date was deductible; and (2) to the extent that the additional purchase price was allocable to assets the taxpayer had disposed of, the judgment was deductible.

• Note that in many, if not most, cases, the disposition of a portion of target's assets will not affect the characterization of the payments because, under § 1060 and Reg. § 1.1060-1, the capitalized contingent liability will be allocated to Class VI and VII amortizable intangibles for which no loss is allowed until the complete disposition of all such intangibles acquired from the target. See IRC § 197(f)(1). The grounds for the Commissioner's concession were not clearly articulated in the opinion.

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. REG-104876-00, Proposed Regulations, Taxable Years of Partner and Partnership; Foreign Partners, 66 F.R. 3920 (1/17/01). For purposes of applying § 706(b) to determine the partnership's permitted year, Prop. Reg. § 1.706-4 would generally disregard foreign partners who are not subject to U.S taxation on a net basis, i.e., foreign partners who are not allocated any effectively connected income or, if claiming treaty benefits, that do not have a permanent establishment. These rules do not apply if the partnership year would be determined with reference to domestic partners no one of which holds at least a 10-percent interest and which in the aggregate hold less than 20 percent of the interests.

2. The profits-only partnership interest safe-harbor is dredged a little wider. Rev. Proc. 2001-43, 2001-34 I.R.B. 191 (8/3/01), *clarifying* Rev. Proc. 93-27, 1993-2 C.B. 343. This revenue procedure provides that whether an interest granted to a service provider is a profits interest is determined at the time the interest is granted, even if, at that time, the interest is substantially nonvested [under Reg. § 1.83-3(b)]. If the requirements of Rev. Proc. 93-27 are met the IRS will not treat the grant of the interest or the event that causes the interest to become substantially vested as a taxable event for the partner or the partnership. Taxpayers to which this revenue procedure applies do not need to file a § 83(b) election.

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

1. REG-106702-00, Determination of Basis of Partner's Interest; Special Rules, 66 F.R. 315 (1/3/01). Prop. Reg. § 1.705 would prevent what the

IRS has determined to be "inappropriate" increases or decreases in the adjusted basis of a corporate partner's interest in a partnership [consistent with Notice 99-57, 1999-2 C.B. 692] resulting from the partnership's disposition of the corporate partner's stock [under the general principles of Rev. Rul. 99-57, 1999-2 C.B. 678], when: (1) a corporation acquires an interest in a partnership that holds stock in the corporation, (2) the partnership does not have a § 754 election in effect for the year in which the corporation acquires the interest, and (3) the partnership later sells or exchanges the stock, then the increase or decrease in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain or loss that the corporate partner would have recognized (absent the application of § 1032) if, for the tax year in which the corporation acquired the interest, a § 754 election had been in effect. The proposed regulation is to be effective retroactively to gain or loss allocated on sales or exchanges of stock occurring after 12/06/99.

2. The § 704(b) regulations are so complicated that even the IRS doesn't understand them! Interhotel Co., Ltd. v. Commissioner, T.C. Memo. 2001-151 (6/22/01), *on remand from* 221 F.3d 1348, 87 A.F.T.R.2d 807, 2001-1 U.S.T.C. ¶ 50,501 (9th Cir. 5/22/00), *vacating*, T.C. Memo. 1997-44. The taxpayer was a partnership whose primary assets were interests in two lower tier partnerships, one of which owned a hotel subject to a nonrecourse mortgage and with respect to which the upper tier partnership in question was subject to a minimum gain chargeback. The upper tier partnership agreement provided for liquidation according to positive capital account balances but neither required the restoration of negative capital accounts nor provided a qualified income offset as required by Reg. § 1.704-1(b)(2)(ii)(d). A's pro rata partnership interest was stated as 85 percent and B's interest was stated as 15 percent but, prior to June 20, 1991, pursuant to a special allocation, the partnership income was allocated 1 percent to A and 99 percent to B, while losses were allocated 85 percent to A and 15 percent to B. As of June 20, 1991, A's capital account was negative $5,920,614, and B's capital account was positive $14,879,392. As of June 21, 1991, B's partnership interest was transferred to C, who succeeded to B's capital account, and the partnership agreement was amended to allocate all partnership income to any partner with a negative capital account, i.e., A, and thereafter in proportion to the partners' pro rata interests, i.e., 85 percent to A and 15 percent to C.

- In the **first Tax Court opinion**, Judge Jacobs held that the allocation of all of the post-June 20, 1991 income to A should not be respected, and the partnership's income was allocated in accordance with the partners' interests in the partnership. Because the partnership agreement provided for capital accounts and required liquidating distributions only to partners with positive capital accounts, the hypothetical liquidation test of Reg.

§ 1.704-1(b)(3)(iii) was applied. Accordingly, 99 percent of the income was allocated to C, the only partner with a positive capital account. The court held that in applying the hypothetical liquidation test, for purposes of adjusting the partners' capital accounts, a minimum gain chargeback of a lower tier partnership, i.e., a partnership in which the partnership in question owned an interest, was not triggered because lower tier partnerships are not treated as hypothetically liquidating when applying the hypothetical liquidation test.

• The Court of Appeals **vacated** because the IRS conceded "that it erred in convincing the Tax Court to refrain from including a minimum gain chargeback in the court's calculations for purposes of the comparative liquidation test."

• **On remand.** Judge Jacobs reaffirmed that the allocations did not have substantial economic effect under Reg. § 1.704-1(b)(2) because the partnership agreement did not require restoration of negative capital accounts or provide a qualified income offset. But in applying the comparative liquidation test, the deemed liquidation of the upper-tier partnership was treated as triggering its share of the minimum gain chargeback of the lower-tier partnerships, and that amount of minimum gain was allocated among the partners to determine their capital accounts pursuant to the hypothetical liquidation. Because A would have been allocated the first $5,920,614 of minimum gain in a hypothetical liquidation, allocation of all of the income to A as long as A had a negative capital account was permitted under the regulations. Judge Jacob rejected numerous IRS arguments regarding the constructions of the § 704(b) regulations that he [quite correctly in our opinion] characterized as "erroneous" readings of the regulations.

C. Sales of Partnership Interests, Liquidations and Mergers

1. Form controls partnership mergers and divisions. T.D. 8925, Partnership Mergers and Divisions, 66 F.R. 715 (1/3/01). Final Reg. § 1.708-1(c) and amendments to Reg. § 1.752-1(f) and (g) [proposed in REG-1111199-99] provide detailed rules regarding the treatment of partnership mergers and divisions. The tax consequences of mergers of partnerships depend on the form followed under the laws of the applicable jurisdiction, either the "Assets-Over Form" or the "Assets-Up Form" [even if none of the merged partnerships are treated as continuing for Federal income tax purposes]. Generally, [and if no particular form is chosen] the Assets-Over Form applies. (This approach is consistent with the treatment of partnership to corporation elective conversions under the check-the-box regulations and technical terminations under § 708(b)(1)(B).) But, if as part of the merger, the partnership titles the assets in the partners' names, the Assets-Up Form applies. If partnerships use the

Interests-Over Form to accomplish the result of a merger, the partnerships will be treated as following the Assets-Over Form for Federal income tax purposes.

- Under the Assets-Up Form, partners recognize gain under §§ 704(c)(1)(B) and 737 (and incur state or local transfer taxes) when the terminating partnership distributes the assets to the partners. However, under the Assets-Over Form, gain under §§ 704(c)(1)(B) and 737 is not triggered. See Regs. §§ 1.704-4(c)(4) and 1.737-2(b). Because the adjusted basis of the assets contributed to the resulting partnership is determined first by reference to § 732 (as a result of the liquidation) and then § 723 (by virtue of the contribution), the adjusted basis of the assets contributed may not be the same as the adjusted basis of the assets in the terminating partnership if the partners' aggregate adjusted basis of their interests in the terminating partnership does not equal the terminating partnership's adjusted basis in its assets. Under the Assets-Over Form, because the resulting partnership's adjusted basis in the assets it receives is determined solely under § 723, the adjusted basis of the assets in the resulting partnership is the same as the adjusted basis of the assets in the terminating partnership.
- When two or more partnerships merge under the Assets-Over Form, increases or decreases in partnership liabilities associated with the merger are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under § 752. A partner in the terminating partnership will recognize gain on the contribution under § 731 only if the net § 752 deemed distribution exceeds that partner's adjusted basis of its interest in the resulting partnership.
- The resulting partnership is treated as a continuation of a merged partnership, if the partners of the merged partnership own more than 50 percent of the capital and profits of the continuing partnership. If the partners of two or more of the merged partnerships own more than 50 percent of the capital and profits of the continuing partnership, the partnership is a continuation of the partnership that contributed the greatest net asset value.
- If the merger agreement (or some other contemporaneous agreement) specifies that the resulting partnership is purchasing an exiting partner's interest in the terminating partnership and the amount paid for the interest, the transaction will be treated as a sale of the exiting partner's interest to the resulting partnership.
- Form also will be followed, and the resulting differing tax consequences respected, with regard to corporate divisions if the partnership undertakes the steps of either the Assets-Over Form or the Assets-Up Form. Gain under §§ 704(c)(1)(B) and 737 often may be triggered when § 704(c) property or substituted § 704(c) property is distributed to certain partners in the context of partnership divisions. If a partnership divides, the

transfer to one new partnership can follow the Assets-Over Form while the transfer to the other follows the Assets-Up Form. All resulting partnerships are bound by the original partnership's elections.

- When a partnership divides into two or more partnerships, a resulting partnership will be a continuation of the original partnership if the partners of the continuing partnership owned more than 50 percent of the capital and profits of the original partnership. Other partnerships are new partnerships, and their partners are treated as having had their original partnership interests liquidated in the division.
- The rules are generally effective as of 1/4/01, with an elective effective date of 1/11/00.

D. Partnership Audit Rules

1. And you thought the partnership level audit rules were procedural simplification. GAF Corp. v. Commissioner, 114 T.C. 519 (6/29/00) (reviewed, 10-3). The question was whether the transfer of property to a partnership [Rhone-Poulenc Surfactants & Specialties, L.P.] was to be treated as a sale or as a contribution to capital – an $80 million question. The IRS issued both a statutory notice to GAF and an FPAA to the partnership. Judge Ruwe, for the majority, decided that a deficiency notice based on "affected items" issued prior to completion of the related partnership-level proceedings is invalid, so the Tax Court proceeding based on the deficiency notice must be dismissed for lack of jurisdiction.

- Judge Halpern, in dissent, would overrule the *Maxwell v. Commissioner*, 87 T.C. 783 (1986), line of cases to the extent they hold the Tax Court lacks subject matter jurisdiction to redetermine a deficiency attributable until the related partnership proceeding is completed. The minority would not dismiss, but only defer proceeding until consideration of the affected items is appropriate.

a. Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner, 114 T.C. 533 (6/29/00) (reviewed, 8-6). This case deals with GAF's motion for summary judgment [based upon the running of the statute of limitations] in the partnership level proceeding, which was denied. The majority did not view dismissal of the partner-level case as mooting the partnership-level case.

b. Appeal dismissed because there was no case or controversy. Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner, 249 F.3d 175, 2001-1 U.S.T.C. ¶ 50,412, 87 A.F.T.R.2d 2023 (3rd Cir. 5/1/01), *dismissing appeal from* 114 T.C. 533 (6/29/00). The Tax Court certified the denial of GAF's motion for summary judgment for interlocutory appeal under § 7482(a). The Court of Appeals held that the petition for interlocutory appeal was improvidently granted because the Tax Court had reserved for decision issues [whether the partnership was a sham and the transaction in question was a sale and not a contribution followed by a distribution] that would affect the ripeness for appeal. If the transaction were a sale, § 6233(a) would not extend the partnership audit rules to GAF because it never held an interest in the purported partnership.

2. Final Unified Partnership Audit Regulations. T.D. 8965, Unified Partnership Audit Rules, 66 F.R. 50541 (10/4/01). The final partnership audit regulations, Reg. §§ 301.6221-1 through 301.6233-1, inclusive, are substantially similar to the previously proposed and temporary regulations. Numerous clarifying changes have been made to reflect subsequent statutory changes impacting partnership level determinations and judicial interpretations of the temporary regulations.

- Partnerships with a nonresident alien partner cannot qualify for the small partnership exemption of § 6231(a)(1)(B)(i).
- The passive activity loss rules of § 469 are an affected item [Reg. § 301.62331(a)(5)-1] that will be directly assessed with respect to individual partners following the partnership level proceeding.
- If the IRS fails to provide a partner with timely notice of the beginning of an administrative proceeding (NBAP) as required by § 6223, the partner may, under Reg. § 301.6223(e)-2(c)(2), elect to have either the FPAA, a court decision, a consistent settlement agreement, or conversion to nonpartnership items apply to that partner's partnership items.
- The final regulations clarify that the election must be mailed within 45 days after the mailing of the FPAA, not the NBAP.

• The final regulations conform to changes in the 1997 Act providing that partnership-level proceedings include the determination of applicable penalties at the partnership level, and that partners could raise any partner-level defenses to the imposition of penalties only in a subsequent refund action.

• Reg. § 301.6224(c)-1 clarifies that a settlement agreement between the tax matters partner and the IRS with respect to penalties, like a settlement agreement with respect to partnership items, binds partners other than notice partners and members of a notice group.

• Reg. § 301.6226(e)-1 clarifies that in the case of a petition filed by a 5-percent group or pass-thru partner, the members of the group or the indirect partners holding an interest in the partnership through the pass-thru partner must deposit the aggregate amount by which their tax liabilities would be increased if the treatment of partnership items on the partners' returns were made consistent with the treatment of partnership items on the partnership return (effective for civil actions beginning on or after 4/2/02).

• The final regulations also incorporate the holding of *Callaway v. Commissioner*, 231 F.3d 106 (2d Cir. 2000), holding that a wife was not bound by the outcome of a unified partnership proceeding where her husband's partnership items converted to nonpartnership items during the proceeding.

3. Phillips v. Commissioner, 272 F.3d 1172, 2002-1 U.S.T.C ¶ 50,103, 88 A.F.T.R.2d 7092 (9th Cir. 12/4/01). IRS criminal investigation of Tax Matters Partner Hoyt does not disqualify him from consenting to an extension of the statute of limitations. Taxpayer argued that *Transpac Drilling Venture 1982-12 v. Commissioner*, 147 F.3d 221 (2d Cir. 1998), which held that a TMP under IRS criminal investigation had a disabling conflict of interest because his fiduciary duty to his partners conflicted with his desire to ingratiate himself with the IRS. Judge Noonan stated:

> Two circumstances differentiate this case. The IRS made no attempt to get waivers from limited partners. The partnerships for which Hoyt was being investigated have not been shown to be the partnerships involved in this case. It is not intuitively obvious that Hoyt did what is a routine accommodation – signing a waiver in order to avoid immediate assessment by the IRS – in order to ingratiate himself in the investigation of his partnerships. Phillips has speculated that Hoyt so acted; he has not proved it.

VIII. TAX SHELTERS

A. Corporate Tax Shelters

1. The saga of the Merrill Lynch marketed partnership/contingent installment sale corporate tax shelter deals continues.

a. Tax shelter benefits from § 453 contingent sale partnership tax shelter not allowed because the tax shelter is a sham and "serves no economic purpose other than tax savings." Merrill Lynch's persistence overcomes initial doubts of tax department. ACM Partnership v. Commissioner, T.C. Memo. 1997-115 (3/5/97) *aff'd*, 157 F.3d 231, 98-2 U.S.T.C. ¶ 50,790, 82 A.F.T.R.2d 6682 (3d Cir. 10/13/98) (2-1), *cert. denied,* 526 U.S. 1017 (1999). Judge Laro found a § 453 contingent sale partnership tax shelter to be a prearranged sham, "tax-driven and devoid of economic purpose," and "serv[ing] no economic purpose other than tax savings," following *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967). Under the scheme to shelter Colgate's $105 million 1988 capital gain, a partnership was formed in 1989; its three partners were affiliates of (a) a foreign bank (about 90%), (b) Colgate (about 9%), and (c) Merrill Lynch (about 1%). A bank note was purchased by the partnership and immediately sold for a large immediate payment and much smaller future contingent payments. Under the contingent payment sale provisions of the temporary regulations [§ 15a.453-1(c)] the partnership's basis was to be allocated ratably over the several years over which contingent payments could be made, resulting in a large 1989 installment sale gain to the partnership. The lion's share of that installment sale gain was allocated to the foreign bank (which was not taxable on U.S. source capital gain), followed by the redemption of the foreign bank's partnership interest. This left Colgate as the 90-percent partner. In 1991, the installment sale obligation was sold by the partnership, triggering about $100 million of capital losses, which Colgate attempted to use to shelter its 1988 capital gain.

- The Third Circuit affirmed the Tax Court's application of the "economic substance" doctrine, which eliminated the capital gains and losses attributable to ACM's application of the ratable basis recovery rule of the contingent installment sale provisions. The Third Circuit held, however, that out-of-pocket amounts were deductible.

b. Judge Foley finds another Merrill Lynch § 453 partnership plan does not work because, under the facts, there was no partnership. ASA Investerings Partnership v. Commissioner, T.C. Memo.

1998-305 (8/20/98). In another Merrill Lynch § 453 partnership plan to create capital losses to shelter earlier capital gains, AlliedSignal lost when Judge Foley held that the parties to the partnership agreement did not join together for a common purpose of investing in interest-bearing instruments, and they did not share profits and losses.

(1) Affirmed, ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 2000-1 U.S.T.C. ¶ 50,185, 85 A.F.T.R.2d 675 (D.C. Cir. 2/1/00). The D.C. Circuit's opinion noted that it disagreed with the Tax Court's statements that persons with "divergent business goals" are precluded from having the requisite intent to form a partnership; however, this view was not essential to the Tax Court's conclusion that the parties did not intend to join together as partners to conduct business activity for a purpose other than tax avoidance. The court held that there was a single business purpose rule.

c. And another deal bites the dust in the Tax Court. Saba Partnership v. Commissioner, T.C. Memo. 1999-359 (10/27/99). Brunswick's transactions that were identical to *ACM*'s were found to lack economic substance. Judge Nims held that the transactions lacked nontax business purposes and that Congress did not intend to favor such transactions "regardless of their economic substance." He held that fees paid for the organization of the partnership were deductible subject to the limitations of § 709(b) [60-month amortization], but that the fees paid with respect to the sham transactions were not deductible.

(1) D.C. Circuit vacates and remands *Saba* for reconsideration in light of its opinion in *ASA Investerings*. Saba Partnership v. Commissioner, 273 F.3d 1135, 2002-1 U.S.T.C. ¶ 50,145, 88 A.F.T.R.2d 7318 (D.C. Cir. 12/21/01), *remanding for reconsideration in light of ASA Investerings* T.C. Memo. 1999-359 (10/27/99). The court felt this case to be indistinguishable from *ASA Investerings*, which was decided on a sham partnership theory, as opposed to Judge Nims' decision in the Tax Court, which was grounded on a sham transaction theory. The court of appeals refused to simply affirm the Tax Court's decision on the alternative ground that the partnerships were shams. Even the government conceded that the sham transaction and sham partnership approaches yield different results; the adjustments under the sham partnership theory would be different from those under the sham transaction theory [although the government apparently conceded at oral argument that under either approach, Brunswick could deduct actual losses from the transactions]. The government argued that the court of appeals should apply *ASA Investerings* to hold that the partnerships were shams, and remand the case to the Tax Court for the limited purpose of determining the amount of any necessary adjustments. But the court of appeals accepted the taxpayer's argument that the "question of whether 'an entity should be regarded as a partnership for federal tax purposes is inherently factual,'" and remanded to allow the taxpayer to address the question to the trial court, even though it doubted that the Tax Court's "findings are inadequate because of 'significant differences'" alleged by the taxpayer "between the actions of [the taxpayer] in this case and those of [the taxpayer] in *ASA*." Indeed, the court of appeals opinion said: "As far as we can tell, the only difference between this case and *ASA* is that Brunswick and ABN did not meet in Bermuda." In remanding, Judge Tatel foreshadowed what he expected to be the result on remand:

> In any case, *ASA* makes clear that "the absence of a nontax business purpose is fatal" to the argument that the Commissioner should respect an entity for federal tax purposes. . . . Here, the Tax Court specifically found "overwhelming evidence in the record that Saba and Otrabanda were organized solely to generate tax benefits for Brunswick." . . . Arguably, this broader finding subsumes any factual differences that might exist between this case and *ASA*.
>
> . . . Although the present record might strongly suggest that Saba and Otrabanda were sham partnerships organized for the sole purpose of generating paper tax losses for Brunswick, fairness dictates that we ought not affirm on this ground. In particular, in presenting its case in the Tax Court, Brunswick may have acted on the mistaken belief that the Supreme Court's decision in *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 87 L. Ed. 1499, 63 S. Ct. 1132 (1943), established a two-part test under which Saba and Otrabanda must be respected simply because they engaged in some business activity, an interpretation that *ASA* squarely rejected. . . .

• Query the effect of this opinion on the *Boca Investerings* case, noted below?

d. Merrill Lynch pays for the contingent installment sale tax shelter. Did they pay too soon? News Release IR-2001-74 (8/28/01). IRS announced that Merrill Lynch agreed to settle a penalty case the IRS had brought against it under §§ 6700 [promoting abusive tax shelters, etc.], 6701 [aiding and abetting understatement of tax liability], 6707 [failure to furnish information regarding tax shelters by persons subject to the requirement to register a tax shelter under § 6111] and 6708 failure to maintain lists of investors in potentially abusive tax shelters] for the 1989-1990 promotion of the contingent installment sale shelter in *ACM Partnership v. Commissioner*, 157 F.3d 231 (8th Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999), and other cases.

e. Same arrangement as earlier failed shelters, different trial court judge – it's a business deal, not a shelter. Boca Investerings Partnership v. United States, 167 F.Supp.2d 298, 2001-2 U.S.T.C. ¶ 50,640, 88 A.F.T.R.2d 6252 (D. D.C. 10/5/01). American Home Products entered into a Merrill Lynch marketed tax shelter virtually identical to those in *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 10/13/98), *aff'g* T.C. Memo. 1997-115 (3/5/97), *cert. denied,* 526 U.S. 1017 (1999), *ASA Investerings Partnership v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2/1/00), *aff'g* T.C. Memo. 1998-305 (8/20/98), and *Saba Partnership v. Commissioner*, T.C. Memo. 1999-359 (10/27/99), *aff'd,* 273 F.3d 1135 (D.C. Cir. 12/21/01),. The losses from the transaction sheltered the gain on the sale of a corporate subsidiary. Judge Friedman held that a valid partnership existed and that the losses were allowable because he found that the taxpayer had both a business purpose and an objective profit potential in entering into the transaction. He applied the test used by the District of Columbia Circuit in *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992), [a commodities straddle case], which stated the test as: "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists." Judge Friedman found, as matters of fact, that "while potential tax benefits were considered by AHP, it was understood that AHP was not committing to engage in all of the transactions necessary under the Merrill Lynch presentation in order to give rise to a tax loss." Judge Friedman excluded much of the evidence offered by the IRS, including [under the attorney client privilege] the tax analysis portions of AHP's in-house lawyer's planning memorandum, but not the business planning portions of the memorandum, other internal memos, including one that summarized the installment sale shelter and described the timetable for the bank's exit from the partnership; and the testimony of a former Merrill Lynch banker who participated in the deal. Judge Friedman did not credit the testimony of the former Merrill Lynch banker because he was both impeachable and impeached.

2. Modifications of Circular 230 are proposed, including the standards for providing advice regarding tax shelters; firms will be required to have procedures to ensure compliance. REG-111835-99, Proposed Circular 230 Regulations, 66 F.R. 3276 (1/12/01). Changes proposed to Circular 230 include:

- § 10.21 would require practitioners to advise a client who had not complied with revenue laws of the manner in which the error or omission may be corrected and the possible consequences of not taking such corrective action.

- § 10.24 would limit the dissociation from a disbarred or suspended person only to matters constituting practice before the IRS.
- New § 10.35 would prescribe new standards for tax shelter opinions at the more-likely-than-not (or higher) level of confidence. These would include a requirement to make inquiry as to all relevant facts, and be satisfied that the material facts are accurately and completely described in the opinion. The regulations under §§ 6662 and 6664 will be modified to provide that only opinions that satisfy the standards of Circular 230 may be relied upon.
- § 10.33 would apply to all tax shelter opinions not governed by new § 10.35, and would also provide a series of requirements for compliance.
- § 10.36 would require that a practitioner who is a member of, associated with, or employed by a firm must take reasonable steps, consistent with his or her authority and responsibility for the firm's practice advising clients regarding matters arising under the Federal tax laws, to make certain that the firm has adequate procedures in effect for purposes of ensuring compliance with §§ 10.33, 10.34, and 10.35.

3. Corporate tax shelter disclosure and registration requirements.

a. Registration. T.D. 8876, Corporate Tax Shelter Registration, 65 F.R. 11215 and REG-110311-98, 65 F.R. 11215 (3/2/00), modified by T.D. 8896, Modification of Tax Shelter Rules, 65 F.R. 49909 (8/16/00) [effective 8/11/00], modified by T.D. 8961, Modification of Tax Shelter Rules II, 66 F.R. 41133 (8/7/01) [effective 8/2/01; but taxpayers may rely on modifications after 2/28/00]. Temporary and proposed regulations under § 6111(d) require registration of "confidential corporate tax shelters."

- Temp. Reg. § 301.6111-2T defines these as "any transaction" [including "all the factual elements necessary to support the tax benefits that are expected to be claimed with respect to any entity, plan, or arrangement"]: (i) a significant purpose of which is the avoidance or evasion of Federal income tax; (ii) that is offered to any potential participant under conditions of confidentiality; and (iii) for which the tax shelter promoters may receive aggregate fees in excess of $100,000. Registration is to be on Form 8264, "Application for Registration of a Tax Shelter."
- Avoidance or evasion transactions include: (1)"listed transactions" [see, e.g., Notice 2000-15, 2000-12 I.R.B. 826]; and (2) transactions structured to produce Federal income tax benefits that constitute an important part of the intended results of the transaction and that the promoter expects it to be presented in substantially similar form to more than one

potential participant (unless the participant is expected to participate in the ordinary course of its business in a form consistent with customary commercial practice and there is a "generally accepted understanding" that the Federal income tax benefits are allowable); as modified in August 2001, this exception is not foreclosed by "an IRS position that would be merely arguable or that would constitute merely a colorable claim." As originally promulgated, the exception to structured transactions required that the understanding that the expected Federal income tax benefits are allowable for substantially similar transactions be "long-standing," but this requirement was eliminated by the August 2001 modifications and replaced by a requirement that to be generally accepted, the structure of the transaction and the treatment has to have been in the public domain for a "period of years." Also, as originally promulgated, the regulations included transactions lacking economic substance — transactions in which the expected pre-tax profit (after foreign taxes and transaction costs) is insignificant relative to the present value of the expected net Federal income tax savings — but this requirement was removed by the August 2001 modifications because the Treasury believed that transactions in this category would be included in the structured transactions category.

- Registration will not be required for "excepted transactions," which are: (1) those [excluding listed transactions] for which the promoter reasonably determines that there is no basis under the standard imposed on taxpayers under Reg. § 1.6662-3(b)(3) for denial of any significant portion of the expected Federal income tax benefits" [thus this exception is not foreclosed by "an IRS position that would be merely arguable of that would constitute merely a colorable claim"]; or (2) those transactions that the IRS has determined are not subject to registration requirements. A ruling request procedure is provided." Prior to the August 2001 modifications the standard under exception (1) was "no reasonable basis" under applicable Federal tax law.

- "Conditions of confidentiality" is a facts and circumstances determination, with an exception for written agreements expressly authorizing disclosure. Under the August 2000 modifications, restrictions on disclosure of the structure or tax aspects of the transaction reasonably necessary to comply with securities laws are not considered to be a confidentiality agreement. The August 2001 modifications expanded the requirements for authorization of disclosure required to avoid the presumption of confidentiality by adding that any and all materials of any kind, including opinions and analyses provided to the offerees must be subject to disclosure to avoid the presumption.

- Under the August 2000 modifications, an exclusivity agreement (i.e., an agreement requiring the offeree to pay a fee to a promoter if the offeree engages in the transaction, whether or not the offeree uses the promoter's services) is a condition of confidentiality. But an exclusivity arrangement ordinarily will not result in an offer being treated as made under conditions of confidentiality if it provides express written authorization for disclosure. Limitations on disclosure or use constitute a condition of confidentiality only if the limitations relate to the structure or tax aspects of the transaction and the limitations are for the benefit of any person other than the offeree.

- Registration is to be made not later than the day on which the first offering for sale is made, with extensions generally until 8/26/00.

b. Red Flagging Returns. T.D. 8877, Tax Shelter Disclosure Statements, 65 F.R. 11205 (3/2/00), modified by T.D. 8896, Modification of Tax Shelter Rules, 65 F.R. 49909 (8/16/00) [effective 8/11/00], modified by T.D. 8961, Modification of Tax Shelter Rules II, 66 F.R. 41133 (8/7/01) [modifications effective 8/2/01; but taxpayers may rely on modifications after 2/28/00]; REG-103735-00, 65 F.R. 11269 (3/2/00). Temporary and proposed regulations under § 6011 require corporations to attach statements to their Federal corporate income tax returns that disclose tax shelters.

- Temp. Reg. § 1.6011-4T was issued under §§ 6001 [required records provision] and 6011(a) [general requirement of return or statement]. It requires that, for "reportable transactions," corporations must both attach a disclosure statement to their tax returns [separately mailing a copy to the IRS Large & Mid-Size Business Division] and retain all related documents until the expiration of the statute of limitations. Related documents include all marketing materials, all written analyses, all correspondence, etc. Under the August 2000 modifications, the required records include all documents and other records related to a transaction subject to disclosure under the regulations that are material to an understanding of the facts of the transaction, the expected tax treatment of the transaction, or the corporation's decision to participate in the transaction.

- A "reportable transaction" is either: (1) a "listed transaction" [see, e.g., Notice 2000-15, 2000-12 I.R.B. 826]; or (2) another reportable transaction if it possesses at least two of six of the following characteristics: (a) confidentiality; (b) protection against the possibility that intended tax benefits will not be sustained (including rescission rights, refunds of fees, insurance protection, and indemnities other than customary non-promoter indemnities); (c) promoter fees in excess of $100,000; (d) expected tax treatment expected to differ by more than $5 million from book treatment; and (e) the participation of a tax indifferent person. As originally promulgated the regulations also included as a factor that the expected characterization for

U.S. income tax purposes differs from that for foreign taxes; this factor was eliminated by the August 2001 modifications.

- Four exceptions are provided: (1) Transactions in the ordinary course of business in a form consistent with customary commercial practice if the taxpayer "reasonably determines" that it would have participated irrespective of the expected Federal income tax benefits; (2) Transactions [in ordinary course and customary commercial practice] if the taxpayer "reasonably determines" that there is a generally-accepted understanding that the expected Federal income tax benefits are allowable for substantially similar transactions; (3) Transactions for which the taxpayer "reasonably determines" that there is "no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits"; as modified in August 2001, this exception is not foreclosed by "an IRS position that would be merely arguable or that would constitute merely a colorable claim;" (4) Transactions identified in published guidance as being exempt from disclosure. As originally promulgated, the regulations required that the understanding that the expected Federal income tax benefits are allowable for substantially similar transactions in exception (3) be "long-standing," but this requirement was eliminated by the August 2001 modifications and replaced by a requirement that to be generally accepted the structure of the transaction and the treatment has to have been in the public domain for a "period of years."

c. Identified "tax avoidance transactions."

(1) Intermediary transactions tax shelters. Sellers of stock and buyers of assets will now have to care about what is in the black box between them. Notice 2001-16, 2001-9 I.R.B. 730 (1/19/01). The IRS will challenge the purported tax results of intermediary transactions tax shelters. The transactions generally involve a shareholder who desires to sell stock of a target corporation, an intermediary corporation, and a buyer who desires to purchase the assets, but not the stock, of the target. The shareholder purports to sell the stock of the target to the intermediary. The target then purports to sell some or all of its assets to the buyer. The buyer claims a basis in the target assets equal to its purchase price.

- Under one version of this transaction, the target is included as a member of the affiliated group that includes the intermediary, which files a consolidated return, and the group reports losses (or credits) to offset the gain (or tax) resulting from the target's sale of assets. In another form of the transaction, the intermediary may be an entity that is not subject to tax and that liquidates the target with no reported gain on the sale of the target's assets.

- Transactions that are the same as or similar to the one described in the notice are "listed transactions." Temp. Reg. §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2).

(2) Contingent liability tax shelters. Notice 2001-17, 2001-9 I.R.B. 730 (1/19/01). The IRS will disallow losses generated by contingent liability tax shelters. The shelter transactions involve the transfer of a high basis asset to a corporation in exchange for stock of the transferee corporation, and the transferee corporation's assumption of a liability that the transferor has not yet taken into account for federal income tax purposes. The transferor typically remains liable on the underlying obligation. The basis and fair market value of the transferred asset, which may be a security of another member of the same affiliated group of corporations, are generally only marginally greater than the present value of the assumed liability. Therefore, the value of the stock of the transferee received by the transferor is minimal relative to the basis and fair market value of the asset transferred to the transferee corporation.

(3) ITA [IRS Technical Assistance – Chief Counsel Advice] 200117039 (3/13/01). A partnership's transfer of a stripped lease to a corporation [following a typical lease stripping transaction as described in Notice 95-53, 1995-2 C.B. 334] is a taxable exchange and does not qualify under § 351. More specifically, the partnership transferred the note it held from the lease stripping to a controlled corporation in exchange for stock and the corporation's assumption of the partnership's obligation to make lease payments. The Service concluded that the exchange was substantially similar to the exchange in the contingent liability tax shelter discussed in Notice 2001-17, 2001-9 I.R.B. 730. There was no real purpose for the transactions apart from the creation of an asset, the stock, with a basis in excess of value to generate a tax loss and, therefore, the exchange is taxable. The Service further concluded that even if § 351 did apply, the partnership's basis in the stock would be reduced by the amount of the obligation to make rental payments assumed by the corporation under § 358(d)(1) or the assumption would be a distribution of money under § 357(b) that reduces the partnership's basis in the stock under § 358(a).

(4) "Customary" leasing transactions need not be registered as tax shelters. Notice 2001-18, 2001-9 I.R.B. 731 (1/19/01). This notice provides an exception from the registration requirements of § 6111(d) and the list maintenance requirement of § 6112 for certain customary leasing transactions. The exception applies to a leasing transaction that: (1) is a lease or sale leaseback between an owner-lessor of tangible personal property and a lessee who is the user of the property; (2) contains terms that are consistent with customary commercial practice for the leasing of similar items of property; (3) qualifies as a lease for federal income tax purposes under Rev. Proc. 75-21, 1975-1 C.B. 715[25] or under case law; (4) is not the same as or substantially similar to a listed transaction under Reg. § 301.6111-2T(b)(2), including a lease strip or lease in/lease out transaction; and (5) has a lessor and lessee who agree to consistently report the transaction as a lease.

(5) Basis shifting tax shelter is listed. Notice 2001-45, 2001-33 I.R.B. 129 (7/27/01). This Notice announces that the IRS will disallow benefits from certain "basis shifting" tax shelter transactions that involve a series of pre-arranged steps with the purpose of creating an artificially high tax basis in stock. The transaction involves the use of the attribution rules of § 318 to increase the basis of stock owned by a taxpayer that claims a loss (or reduced gain) upon disposition of that stock. In these transactions, there is a redemption of stock owned by a related person that is tax indifferent. Purportedly as a result of the application of the attribution rules of § 318 [e.g., the other person is foreign corporation of which the taxpayer owns an option to acquire 50% or more] the redemption of stock is claimed to be a dividend under § 301 rather than an exchange under § 302(a). The taxpayer takes the position that under Reg. § 1.302-2(c) the basis of the redeemed stock is added to its basis for stock in the redeeming corporation.

(6) Some of these are still being peddled to your clients. Notice 2001-51, 2001-34 I.R.B. 190 (8/20/01), *superseding* Notice 2000-15, 2000-1 C.B. 826. The IRS has identified sixteen listed transactions for purposes of Reg. § 1.6011-4T(b)(2) and § 301.6111-2T(b)(2). The listed transactions include: (1) Rev. Rul. 90-105, 1990-2 C.B. 69, transactions (deductions for contributions to certain pension plans attributable to future year's compensation); (2) Notice 95-34, 1995-1 C.B. 309, certain trust arrangements (purported multiple employer welfare benefit funds); (3) Notice 95-53, 1995-2 C.B. 334, "lease strips"; (4) Notice 98-5, 1998-1 C.B. 334, transactions in which the expected economic profit is insubstantial in comparison to the value of the expected FTCs; (5) *ASA Investerings*-type and *ACM*-type transactions; (6) Treas. Reg. § 1.643(a)-8 transactions involving distributions from charitable remainder trusts; (7) Rev. Rul. 99-14, 1999-1 C.B. 835, lease-in/lease-out [LILO] transactions; (8) Notice 99-59, 1999-2 C.B. 761, transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays that they have in fact recovered; (9) Treas. Reg. § 1.7701(1)-3 fast-pay arrangements; (10) Rev. Rul. 2000-12, 2000-11 I.R.B. 744, certain transactions involving the acquisition of two debt instruments the values of which are expected to change significantly at about the same time in opposite directions; (11) Notice 2000-44, 2000-36 I.R.B. 255,

25. Rev. Proc. 75-21 was modified and superseded by Rev. Proc. 2001-28, 2001-19 I.R.B. 1156 (5/7/01).

transactions generating losses resulting from artificially inflating the basis of partnership interests; (12) Notice 2000-60, 2000-49 I.R.B. 568, transactions involving the purchase of a parent corporation's stock by a subsidiary, a subsequent transfer of the purchased parent stock from the subsidiary to the parent's employees, and the eventual liquidation or sale of the subsidiary; (13) Notice 2000-61, 2000-49 I.R.B. 569, transactions purporting to apply § 935 to Guamanian trusts; (14) Notice 2001-16, 2001-9 I.R.B. 730, intermediary sales transactions; (15) Notice 2001-17, 2001-9 I.R.B. 730, contingent liability § 351 transfer transactions; and (16) Notice 2001-45, 2001-33 I.R.B. 129, certain redemptions of stock in transactions not subject to U.S. tax in which the basis of the redeemed stock purports to shift to a U.S. taxpayer.

d. IRS announces a tax shelter disclosure initiative through 4/23/02 for penalty waivers. Announcement 2002-2, 2002-2 I.R.B. 304 (12/22/01). The initiative would result in waiver of any of the § 6662 accuracy-related penalties if disclosure is made before the earlier of 4/23/02 or the date an issue about the disclosed item is raised during an examination. The disclosure statement must contain, *inter alia*: (1) the material facts of the item; (2) the taxpayer's tax treatment of the item; (3) the taxable years affected by the item; (4) the names and addresses of the promoters, solicitors, and recommenders of the item and (if known) the parties who advised the promoter, solicitor or recommender; and (5) an agreement to provide [if requested] all transactional documents, internal memoranda, and materials that provide a legal analysis of the item.

• Exceptions for transactions that: (1) did not in fact occur; (2) involved fraudulent concealment of the amount or source of any item of gross income; (3) involved concealment of an interest over a foreign financial account; (4) involved the concealment of a distribution from, a transfer of assets to, or that taxpayer was a grantor of a foreign trust; or (5) involved the treatment of personal, household, or living expenses as deductible trade or business expenses.

(1) Larry Langdon memorandum, dated 12/20/01, for LMSB personnel providing guidelines for applying the about-to-be-issued Ann. 2002-2, 2001 TNT 247-8 (12/21/01).

4. A $67,000,000 deficiency. Mercy! United Parcel Service v. Commissioner, T.C. Memo. 1999-268 (8/9/99), *rev'd*, 254 F.3d 1014, 87 A.F.T.R.2d 2565, 2001-2 U.S.T.C. ¶ 50,475 (11th Cir. 6/20/01). UPS generally limits its liability for damages to goods in transit to $100, but customers may pay [and UPS collects] "excess value charges" (EVCs) to insure the packages for greater amounts [even though UPS is not licensed as an insurance company]. Prior to 1984, UPS retained all of the EVCs, paid claims, and reported the income and deduction items on its return. Beginning in 1984 UPS restructured the manner in which it dealt with and reported EVCs. Although it did not change its practices for dealing with customers in handling receipts and claims, beginning in 1984 UPS remitted net [of claims paid] EVCs collected from customers and other shippers to an unrelated insurance company (National Union), which in turn, after deducting certain fees, remitted the net EVCs as a reinsurance premium to OPL. OPL was a Bermuda insurance company that was formed by UPS and 97.33% owned by UPS's 14,000 shareholders who received OPL stock as a dividend in a taxable spin-off. The OPL stock was subject to restrictions on transfer. After this arrangement was established, UPS did not report as income the $99,794,790 of EVCs collected and remitted to National Union in 1984, etc. However, UPS performed the same EVC functions and activities that it had performed before 1984 [when it had included the EVCs in income], and it remained responsible for bad debts or uncollectible items because neither National Union nor OPL had any control over the customers' premium payments.

a. The Tax Court says it's a sham. Bad news because there were more years in the pipeline for the same transaction with bigger amounts. The Tax Court (Judge Ruwe) upheld the IRS determination that UPS was taxable on the $99,794,790 of EVCs under the assignment of income doctrine regardless of the separate existence of OPL, which was accepted *arguendo*. Rather, the court found that the entire 1984 arrangement lacked business purpose and economic substance. The court rejected UPS's proffered business purpose – that its continued receipt of EVCs was potentially illegal under various state insurance laws – because no state insurance regulator ever questioned the prior practice. UPS never sought legal advice on the issue, federal common carrier law probably preempted state law in any event, and if federal law did not preempt state law the 1984 practice was probably as violative of state law as the pre-1984 practice. Judge Ruwe also was not convinced that the arrangement was designed to facilitate UPS rate increases. Nor was he impressed by UPS claim that a business purpose was to leverage the excess value profits into a new reinsurance company; he noted that "any investment of money into [the subsidiary reinsurer] could accomplish this purpose." After examining UPS's pre-1984 reinsurance practices [only of claims over $25,000] and the fairly consistent 70 percent ratio of net EVCs [over claims paid] retained to total EVCs collected Judge Ruwe did not accept the UPS claim that the National Union/OPL arrangement sufficiently reduced the risk to UPS core transportation activity assets to have economic substance. Finally, Judge Ruwe found that there was contemporaneous documentation that the transaction was tax motivated and concluded that the arrangement was "done for the purpose of avoiding taxes" and "had no economic substance or business purpose." To top it off, because the EVC restructuring was a sham transaction, the court denied UPS's deduction for approximately $1 million retained by National Union. And for the inevitable icing on the IRS's cake negligence and substantial understatement penalties, plus increased interest for tax-motivated transactions, were sustained.

b. Mercy indeed, Eleventh Circuit reverses. Was *Gregory* a Pyrrhic victory for the government? UPS rejoices. But Eleventh Circuit remands for consideration of the § 482 issue. More news to follow? The Eleventh Circuit (Judge Cox) held that the arrangement "had sufficient economic substance to merit respect in taxation." It created an obligation enforceable by an unrelated party, National Union. UPS and National Union had real insurance policies that gave National Union the right to receive the EVCs that UPS collected. The court noted that, contrary to the Tax Court's opinion, OPL was an independently taxable entity not under UPS's control and UPS lost the stream of income it had earlier gained from the excess-value charges. The court therefore concluded that the transaction was not a sham transfer in which the taxpayer retained the benefits of the income forgone.

• The Eleventh Circuit concluded the insurance policy between UPS and National Union was a "real insurance policy. . . that gave National Union the right to receive the excess-value charges that UPS collected." That National Union faced "slim" odds of losing money did not affect that conclusion, and "[a] history of not losing money on a policy is no guarantee of such a future."

• Even if National Union was merely a conduit for transmission of the excess-value payments from UPS to OPL, the court considered OPL to be independently taxable entity that was not under UPS's control. UPS really did lose the income it previously reaped from excess-value charges. The court found this fact to distinguish the case "from the paradigmatic sham transfers of income, in which the taxpayer retains the benefits of the income it has ostensibly forgone."

• Finally, the Eleventh Circuit found that the Tax Court had misapplied the business purpose test. The appearance of the EVC transactions to customers was not relevant.

> . . . The tax court's narrow notion of "business purpose"— which is admittedly implied by the phrase's plain language — stretches the economic-substance doctrine farther than it has been stretched. A "business purpose" does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a "business purpose," when we are talking

> about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business. See *ACM P'ship v. Commissioner*, 157 F.3d 231, 251 (3d Cir. 1998). This concept of "business purpose" is a necessary corollary to the venerable axiom that tax-planning is permissible. See *Gregory v. Helvering*, 293 U.S. 465, 469, 55 S. Ct. 266, 267 (1935) ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."). The Code treats lots of categories of economically similar behavior differently. . . . There may be no tax-independent reason for a taxpayer to choose between these different ways of financing the business, but it does not mean that the taxpayer lacks a "business purpose." To conclude otherwise would prohibit tax-planning. . . .
>
> The transaction under challenge here simply altered the form of an existing, bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax-avoidance motive.

• Judge Ryskamp dissented, stating that the overwhelming evidence demonstrates that UPS's reinsurance arrangements with National Union and OPL had no economic significance or business purpose outside of UPS's desire to avoid federal income and was therefore a sham transaction.

5. Corporate Owned Life Insurance ("COLI")

a. Deductions for interest on policy loans under Winn-Dixie's pre-1996 HIPAA leveraged COLI program were denied. Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313, 87 A.F.T.R.2d 2626, 2001-2 U.S.T.C. ¶ 50,495 (11th Cir. 6/28/01) (per curiam), *aff'g* 113 T.C. 254 (10/19/99). In 1993, taxpayer entered into a broad-based leveraged corporate-owned life insurance group plan covering approximately 36,000 of its employees. The decision to shift from its existing "key-person" COLI program of individual policies [covering 615 managers] was made pursuant to a proposal that emphasized the "tax arbitrage created when deductible policy loan interest is paid to finance non-taxable policy gains." The proposal indicated that taxpayer would have a pre-tax loss totaling $755 million for[26] its 1993-2052 years, but would have total after-tax earnings of more than $2.2 billion for the same period (as the result of total projected income tax savings of more than $3 billion). The COLI policies were terminated in 1997, following 1996 legislation that impacted the plan.

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

(2) Affirmed by the Eleventh Circuit, which holds that – even though the UPS insurance scheme has business reality – the COLI tax shelter is a sham. The Eleventh Circuit rejected taxpayer's primary argument that Congress specifically authorized the interest deduction if the 4-

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26. **Bye-bye to leveraged company-wide COLI**. The Health Insurance Portability and Accountability Act of 1996 § 501 amended § 264 to deny the deduction for interest on loans with respect to company-owned life insurance. There is an exception for key person insurance. Phased-in future effective dates and interest rates are provided. The Tax and Trade Relief Extension Act of 1998 § 4003(i) further amended § 264 to expand the definition of "unborrowed [insurance] policy cash value" to include "inside buildup," for purposes of the COLI pro rata interest disallowance rules.

out-of-7 rule of § 264. It concluded that in *Knetsch* the Supreme Court clearly "rejected an argument based on section 264 that is at least a cousin of Winn-Dixies's present contention . . . that Congress's failure to close a loophole in section 264 equated to blessing the loophole." The Eleventh Circuit concluded that *Knetsch* stood for the proposition that "that the sham-transaction doctrine does apply to indebtedness that generates interest sought to be deducted under section 163(a), even if the interest deduction is not yet prohibited by section 264."

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

> That doctrine provides that a transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, or if the transaction serves no business purpose. . . . The doctrine has few bright lines, but "[i]t is clear that transactions whose sole function is to produce tax deductions are substantive shams." [*Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989)] That was, as we read the tax court's opinion, the rule the tax court followed. Nor did the court misapply the rule in concluding that the broad-based COLI program had no "function" other than generating interest deductions.
>
> The tax court found, without challenge here, that the program could never generate a pretax profit. That was what Winn-Dixie thought as it set up the program, and it is the most plausible explanation for Winn-Dixie's withdrawal after the 1996 changes to the tax law threatened the tax benefits Winn-Dixie was receiving. No finding of the tax court suggests, furthermore, that the broad-based COLI program answered any business need of Winn-Dixie, such as indemnifying it for loss of key employees. . . . [T]herefore, the broad- based COLI program lacked sufficient economic substance to be respected for tax purposes, and the tax court did not err in so concluding.

b. Another COLI falls ill. IRS v. CM Holdings, Inc. (In re CM Holdings, Inc.), 254 B.R. 578, 2000-2 U.S.T.C. ¶ 50,791, 86 A.F.T.R.2d 6470 (D. Del. 10/16/00), on appeal to the 3d Circuit. In CMI's bankruptcy, the IRS filed proofs of claim for taxes based on the disallowance of interest deductions that CMI claimed for its COLI plan (involving policies on 1400 employees). The court held no interest deduction was allowable under § 163(a) because the entire transaction was a "sham in substance" that lacked subjective business purpose. Apart from tax savings from the interest deduction, CMI could not reasonably expect a positive cash flow from the COLI plan in any year and could not expect to benefit from the inside cash value build-up [which continuously remained at zero throughout the plan] or profit from the death benefits on covered employees. Interest deductions were disallowed and § 6662 substantial understatement penalties were imposed because the transaction lacked economic substance. The transaction was entered into without a reasonable expectation of profit – in the absence of the interest deductions – over the life of the 40-year transaction from either the inside build-up or mortality components of the plan.

- The court specifically rejected the IRS's argument that it should apply the "generic tax shelter test" of *Rose v. Commissioner*, 88 T.C. 386 (1987), *aff'd,* 868 F.2d 851 (6th Cir. 1989), to disallow the deductions, and questioned whether the Tax Court would continue to apply that test. Rather, the court exhaustively analyzed the facts.
- The § 264(c)(1) "four-out-of-seven" safe harbor test was not met because the premiums in years 4 through 7 were paid through so-called "loading dividends." Pursuant to its COLI plan CMI purchased individual, whole life insurance policies, of which it was the owner and beneficiary, on 1,400 employees. In the first three policy years, 1991-1993, CMI paid premiums largely through nonrecourse policy loans. In the fourth through seventh policy years, CMI "paid" the annual premiums largely through a combination of partial withdrawals and loading dividends [premium rebates to CMI]. The court (Judge Schwartz) found that the loans for the first three years were real, but that the loading dividends were factual shams that were created by circular accounting treatment, and that there thus was a substantial shortfall in the payment of annual premiums due in years four through seven. Thus, § 264(a) applied to disallow the deductions because the premiums were financed by systematic borrowing on the policies. The § 264 (c)(1) exception "if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium . . . was paid) is paid under such plan by means of indebtedness" did not apply. The court accepted the IRS's argument that "'annual premiums due' means the nominal annual premiums due less the 'loading dividends' that were offset against the contract premiums," rather than CMI's argument that annual premiums due meant the "contract-specified premiums." These were circular netting transactions for the sole purpose of reducing the annual cash premiums paid in those years, and were factual shams.

6. Are they intestinal tract bacteria? Does this "third strike" mean that COLI is eradicated? Or, are taxpayers' arguments too appealing? <u>American Electric Power, Inc. v. United States</u>, 136 F.Supp.2d 762, 2001-1

U.S.T.C. ¶ 50,232, 87 A.F.T.R.2d 917 (S.D. Ohio 2/20/01). This opinion largely follows the reasoning in *CM Holdings*, noted above.

7. Fifth and Eighth Circuits agree that Twenty First Securities marketed American Depository Receipts (ADR) arbitrage transactions do not lack economic substance.

a. New Rule in the Tax Court: No More Mr. Nice Guy! (Ms. Nice Gal?). Royal Dutch Shell ADRs peddled by an investment banking firm lacked economic substance. Compaq Computer Corp. v. Commissioner, 113 T.C. 214 (9/21/99), *rev'd*, 277 F.3d 778, 88 A.F.T.R.2d 7339, 2002-1 U.S.T.C. ¶ 50,144 (5th Cir. 12/28/01).[27] Compaq recognized a $232 million long-term capital gain in 1992. Shortly afterwards, an investment firm [Twenty-First Securities Corp.] contacted the Compaq Treasury Department with the suggestion that it take advantage of an ADR arbitrage transaction. (American Depository Receipts are transferable units in a trust that represent ownership of foreign stock.) This involved purchases of $888 million of Royal Dutch Shell ADRs cum dividend, followed by sales of those ADRs ex dividend within the hour for $868 million. Compaq then carried back $20 million of loss against the previously recognized gain. It also claimed a $3.4 million foreign tax credit for taxes withheld from the $22.5 million dividend received. Judge Cohen held that the transaction lacked economic substance because the net cash flow from the transaction without regard to tax consequences was a $1.5 million loss. The foreign tax credit was denied and a negligence penalty was imposed.

- Judge Cohen considered it important that Compaq did not perform a cash flow analysis, nor did it investigate the investment. She noted that Compaq shredded the spreadsheet provided by the promoter and "has chosen not to disclose any communications" indicating any reliance on the advice of its tax department or counsel. These factors were also important to the court in upholding a negligence penalty.
- Judge Cohen quoted *ACM Partnership* for the proposition that the business purpose requirement of the economic substance doctrine is only satisfied when "the transaction [is] rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and . . . economic situation." She continued, "This inquiry takes into account whether the taxpayer conducts itself in a realistic and legitimate business fashion, thoroughly considering and analyzing the ramifications of a questionable transaction, before proceeding with the transaction," citing the *UPS* case.
- "The ADR transaction was marketed to

27. See VIII.A.7.c.

petitioner by Twenty-First for the purpose of partially shielding a capital gain previously realized . . . . [Its] evaluation of the proposed transaction was less than businesslike with [the Assistant Treasurer] committing [Compaq] to this multimillion-dollar transaction based on one meeting with Twenty-First and on his call to a Twenty-First reference. . . . We conclude that [Compaq] was motivated by the expected tax benefits of the ADR transaction, and no other business purpose existed."

b. But the Eighth Circuit looks at different ADR deals peddled by the same investment banker and concludes that they did have economic substance. Was the difference that taxpayer satisfied the new "two-meeting rule," or was it that taxpayer sought outside advice on securities law and tax law, or was it that foreign withholding taxes did not reduce the amount of dividend income received (so taxpayer had a pre-tax profit)? Risk minimization was seen as "prudence," as opposed to "sham." <u>IES Industries v. United States</u>, 253 F.3d 350, 2001-1 U.S.T.C. ¶ 50,471, 87 A.F.T.R.2d 2492 (8th Cir. 6/14/01), *rev'g* 84 A.F.T.R.2d 6445, 2001-1 U.S.T.C. ¶ 50,470 (N.D. Iowa 9/22/99). Taxpayer purchased the ADRs from tax-exempt organizations, which paid no U.S. taxes, but were subject to foreign withholding on the dividends. The ADR arbitrage transaction created foreign tax credits (as in the *Compaq* case). On a motion for summary judgment by the government, Judge McManus held that the ADR transactions "did not change IES's economic position except for the transactions having resulted in the transfer of the claim to the foreign tax credit to IES." The court also did not permit deduction of taxpayer's out-of-pocket costs.

• The Eighth Circuit reversed, finding a business purpose and distinguishing *Compaq*. First, the court rejected the government's argument that "the tax benefits that were the sole reason for the transactions, [because] each series of ADR trade pairs resulted, as pre-planned, in an economic loss." It rejected the government's view that "IES purchased only the right to the net dividend – not the gross dividend"— a view which if accepted would result in IES realizing an economic benefit only if it received the foreign tax credit. Rather, the court concluded that the profitability of the transaction should be analyzed by considering the gross income realized by IES, not the cash flow. It concluded that "the economic benefit to IES was the amount of the gross dividend, before the foreign taxes were paid. . . . The fact that the taxes were withheld, and then paid, by the foreign corporation that issued the stock represented by the ADRs, so that IES received only 85% of the dividend in cash, is of no consequence to IES's liability for the tax. . . . Because the entire amount of the ADR dividends was income to IES, the ADR transactions resulted in a profit, an economic benefit to IES."

• Second, the Eighth Circuit concluded that the proper inquiry when applying the business purpose test is "whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved." The court described the business purpose test as "a subjective economic substance test," and invoked *Gregory* [293 U.S. 465, 469 (1935)] for the proposition that "the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted," concluding that a "taxpayer's subjective intent to avoid taxes thus will not by itself determine whether there was a business purpose to a transaction."

• The court rejected the government's argument that the transactions were shams because there was no risk of loss, focusing on the legal, as opposed to economic, risk of nonpayment of the dividends, and distinguishing *Compaq* by stating: "The risk may have been minimal, but that was in part because IES did its homework before engaging in the transactions. Company officials met twice with Twenty-First representatives and studied the materials provided. After that, IES consulted its outside accountants and its securities counsel for reassurances about the legality of the transactions and their tax consequences." The court noted that IES did its own investigation and rejected some of the ADR trades that Twenty-First proposed. That IES structured the transactions [e.g., making some trades when the U.S. markets were closed, in order to avoid the risk of fluctuations in market price of the ADRs between the purchase and sale and to prevent a third party from attempting to break up the trades] to avoid "any more risk than necessary," was characterized as "good business judgment consistent with a subjective intent to treat the ADR trades as money-making transactions." The court was "not prepared to say that a transaction should be tagged a sham for tax purposes merely because it does not involve excessive risk." Finally, the court emphasized that all of the parties involved were unrelated to IES and engaged in "legitimate business, and the transactions were at arms' length."

• In a footnote, the court noted that in 1997, Congress amended § 901(k) to increase to at least sixteen days the amount of time an ADR must be held within a thirty-day period that includes the dividend record date in order for the foreign taxes paid on the dividend to qualify for the foreign tax credit. But it attached no importance to that change either way.

c. Compaq reversed by the Fifth Circuit. Compaq Computer Corp. v. Commissioner, 277 F.3d 778, 88 A.F.T.R.2d 7339, 2002-1 U.S.T.C.

¶ 50,144 (5th Cir. 12/28/01), *rev'g* 113 T.C. 214 (9/21/99).[28] The Fifth Circuit followed the Eighth Circuit's *IES* opinion and relied heavily on *Frank Lyon Co. v. United States*, 435 U.S. 564 (1978), to the effect that where "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties." Judge Edith Jones held that the Tax Court erred by disregarding the gross amount of the Royal Dutch Shell dividend, and noted that the principles of *Old Colony Trust Co.* treated Compaq as having paid the Netherlands withholding tax on the dividend.

8. Lease-strip transaction by pseudo-black box intermediary fails in the Tax Court. Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (12/28/01). The taxpayer corporation's stock was sold to an intermediary [which then merged downstream], following which its assets were sold to the prearranged ultimate purchaser. To offset the gains realized on the asset sale, the taxpayer acquired by a § 351 transaction interests in certain equipment leaseback transactions [secured by trusts that resulted in a circular cash flow] that had no foreseeable value, which it immediately transferred to a Dutch bank, the sole consideration for which was assumption of taxpayer's obligations [of which there were in reality none]. Taxpayer claimed a $22 million ordinary business expense deduction as a result of the transfer of the leaseback interests. The deduction was denied because the transactions lacked business purpose and economic substance under "any version" of the tests. Judge Swift held that the transaction lacked business purpose and economic substance even as measured against the Eleventh Circuit's broad articulation of the test in *UPS* that "a transaction has a 'business purpose' when we are talking about a going concern, as long as it figures in a bona fide, profit-seeking business."

B. Individual Tax Shelters

1. Straddle losses outside of § 1092 disallowed where neither economic substance nor profit motive were present. Keeler v. Commissioner, 243 F.3d 1212, 2001-1 U.S.T.C. ¶ 50,272, 87 A.F.T.R.2d 1224 (10th Cir. 3/13/01), *aff'g* T.C. Memo. 1999-18. The Tenth Circuit upheld the disallowance of losses incurred by the taxpayer in a stock derivatives straddle program for years before § 1092 was extended to straddles involving stock. The transactions

28. See VIII.A.7.a.

were found not to have any economic substance or profit motive, because, among other reasons, their "*raison d'etre* was tax avoidance." [In late 1981 the taxpayer closed out the loss side of transactions realizing losses of $7,598,940 — an amount within $3,600 of his gross income; his 1982 losses offset 97% of his gross income.] The offsetting gains were consistently rolled forward. In addition, the transactions were so closely matched, in an artificial market maintained by the promoter, as to negate the possibility of realizing a pre-tax profit. Finally, the taxpayer paid significant up-front fees, and had a significant noninterest-bearing margin deposit.

2. Notice 2001-40, 2001-26 I.R.B. 1355 (6/25/01). The IRS warns taxpayers not to rely on promoters' assertions that §§ 861 through 865 and Reg. § 1.861-8 limit taxable "sources" of income to certain foreign-based activities and that income sourced within the U.S. is thereby non-taxable.

IX. Exempt Organizations and Charitable Giving

A. Exempt Organizations

1. Intermediate sanctions regulations are out; break out the supply of 1099s. REG-246256-96, 66 F.R. 2173 (1/10/01); T.D. 8920, 66 F.R. 2144 (1/10/01). The Treasury published proposed and temporary regulations under § 4958, which permits the IRS to impose excise taxes against disqualified persons who participate in excess benefit transactions with §§ 501(c)(3) and 501(c)(4) organizations. "Excess" benefits include benefits provided to insiders that are not reported as compensation. (These rules reflect the spirit under which § 4958 was enacted, which was to tax "excess" benefits provided by charities to insiders (including board members).)

a. Regulations made final. T.D. 8978, 67 F.R. 3076 (1/23/02). The regulations relating to the excise taxes on excess benefits transactions under § 4958 have been finalized.

2. Not-for-Profits have to pick their partners carefully, and pay attention to the governing structure of the partnership. Redlands Surgical Services v. Commissioner, 113 T.C. 47 (7/19/99). Redlands Surgical Services (RSS) was a nonprofit corporation that was affiliated with a nonprofit hospital. RSS's sole activity was participating as the co-general partner with a for-profit corporation in a limited partnership that was the general partner of an operating partnership that owned and operated an ambulatory surgery center. Nothing in the partnership agreements or any of the other agreements related to the operation of the surgery center, established any obligation that charitable purposes be put ahead of economic objectives in the surgery center's operations, and the profits of both partnerships were distributable to for-profit partners as well as RSS. After an exhaustive review of the terms of the partnership agreements, relevant contracts, and the actual management practices, on the facts RSS was found to have ceded effective control over the operations of the partnerships and thus the surgery center to for-profit parties. RSS had surrendered the ability to cause the surgery center to respond to community needs and nothing required the surgery center management to be guided by any charitable or community benefit, goal, policy, or objective. An impermissible private benefit was conferred. The Tax Court (Judge Thornton) reasoned:

> It is no answer to say that none of petitioner's income from this activity was applied to private interests, for the activity is indivisible, and no discrete part of the Operating Partnership's income-producing activities is severable from those activities that produce income to be applied to the other partners' profit. . . . Clearly, there is something in common between the structure of petitioner's sole activity and the nature of petitioner's purposes in engaging in it.
>
> To the extent that petitioner cedes control over its sole activity to for-profit parties having an independent economic interest in the same activity and having no obligation to put charitable purposes ahead of profit-making objectives, petitioner cannot be assured that the partnerships will in fact be operated in furtherance of charitable purposes. In such a circumstance, we are led to the conclusion that petitioner is not operated exclusively for charitable purposes.

The court also declined to find that RSS qualified for exemption as an integral part of the affiliated not-for-profit Redlands Hospital. The surgery centers patient population did not overlap substantially with that of Redlands Hospital and prior cases in which the integral part doctrine was applied were categorized as not involving any private benefit or control, unlike the instant case. RSS therefore was not operated exclusively for exempt purposes within the meaning of § 501(c)(3) and its petition for a declaratory judgment of its tax exempt status was denied.

- **The reasoning of the whole hospital joint venture ruling was applied**. Rev. Rul. 98-15, 1998-1 C.B. 718 (3/4/98) Two fact patterns: Situation 1 concludes that the exempt hospital will continue to be exempt where it will receive an interest in the combined operation equal in value to the assets it contributed and the board structure gives control of the joint venture to the exempt organization's appointees. There is a loss of exemption in Situation 2, where the joint venture's governing documents do not

require that it serve charitable purposes, board control rests with the taxable entity, and the taxable entity may unilaterally renew the management agreement. Both conclusions depend on "facts and circumstances.

a. Ninth Circuit affirms within 10 days of oral argument. Redlands Surgical Services v. Commissioner, 242 F.3d 904, 2001-1 U.S.T.C. ¶ 50,271, 87 A.F.T.R.2d ¶ 1249 (9th Cir. 3/15/01) (per curiam), *aff'g* 113 T.C. 47 (1999).

> Specifically, we adopt the tax court's holding that appellant Redlands Surgical Services "has ceded effective control over the operations of the partnerships and the surgery center to private parties, conferring impermissible private benefit. [Redlands Surgical Services] is therefore not operated exclusively for exempt purposes within the meaning of sec. 501(c)(3), IRC 1986." . . . We also affirm the tax court's conclusion that the benefit conferred on private parties by the surgery center's operations prevents Redlands Surgical Services from attaining tax exempt status under the integral part doctrine.

3. Campaign Finance Reform, the Internal Revenue Code, and the Constitution. National Federation of Republican Assemblies v. United States, 148 F.Supp.2d 1273, 2001-2 U.S.T.C. ¶ 50,456, 87 A.F.T.R.2d 2413 (S.D. Ala. 5/31/01). The plaintiff sought a declaratory judgment that §§ 527(i) [requiring registration with the IRS of certain political organization] and (j) [requiring political organizations to disclose contribution, with a penalty for failure to comply] are unconstitutional and a preliminary injunction against their enforcement. The government raised the anti-injunction act, § 7421(a), as a defense. The district court [Judge Vollmer], held that the anti-injunction act did not bar the suit because: (1) § 527(j) imposes a penalty rather that laying a tax and § 6671(a) did not apply to treat this penalty as a tax, and (2) a contributor [who joined in the suit on the grounds that he would be less inclined to contribute if his contribution were disclosed] lacked any other vehicle for challenging the provisions. Section 527(i), however, is a tax statute, because it confers taxable status on political organizations, and the challenge to it was subject to the Anti-Injunction Act, but individual plaintiffs lacked standing to challenge § 527(i).

4. Fund for Anonymous Gifts v. IRS, 2001-2 U.S.T.C. ¶ 50,649; 88 A.F.T.R.2d 6040 (D. D.C. 9/25/01). Although a donor directed fund was a § 501(c)(3) organization, it did not meet the requirements to be a publicly-supported charity so it was a private foundation. The charity did not meet its burden of proof on the public support issue, particularly because of its plans to rely on donors who are personally known to its Trustee.

5. Notice 2001-78, 2001-50 I.R.B. 576 (12/10/01). Provides interim guidance to charities regarding payments made by reason of the death, injury or wounding of an individual incurred as a result of the September 11, 2001 terrorist attacks. The Service will treat such payments made by a charity to individuals and their families as related to the charity's exempt purpose provided that the payments are made in good faith using objective standards. The notice is effective until the earlier of final legislation or 12/31/02.

a. The **Victims of Terrorism Tax Relief Act** clarifies that payments made by charities are for an exempt purpose even if made without demonstration of financial need if made in good faith under an objective formula consistently applied.

B. Charitable Giving

1. Abusive charitable remainder trusts curtailed. REG-116125-99, Prevention of Abuse of Charitable Remainder Trusts, 64 F.R. 56718 (10/21/99). The Treasury issued proposed regulations under §§ 643 and 664 to combat abuses in the use of charitable remainder trusts that occur when distributions in excess of income are made to non-charitable beneficiaries where the trustee borrows money or enters into a forward sale of the trust assets. The trust would be treated as having sold a pro rata portion of its assets to the extent that the distribution: (1) is not characterized as income under § 664(b), and (2) is made from amounts received by the trust that are neither (a) a return of basis nor (b) attributable to a deductible charitable contribution made in cash.

a. Regulations now final. T.D. 8926, 66 F.R. 1034 (1/5/01). The Treasury finalized the regulations under § 664 relating to the elimination of abusive transactions involving charitable remainder trusts.

2. REG-106513-00, Definition of Income for Trust Purposes, 66 F.R. 10396 (2/15/01). Proposed regulations would revise the definition of income under § 643(b) to take into account recent changes in the definition under state law of trust accounting income. Special rules address problems of pooled income funds and charitable remainder unitrusts.

X. TAX PROCEDURE

A. Penalties and Prosecutions

1. Eight commonly used tax scams. IR-2001-19 (2/18/01). The Service warns taxpayers not to fall victim to eight commonly used tax scams. They include: (1) No taxes being withheld from your wages; (2) "I don't pay taxes"; (3) African-Americans get a special tax refund; (4) "Pay the tax, then get the prize"; (5) "Untax yourself for $49.95"; (6) Social Security tax scheme; (7) "I can get you a big refund . . . for a fee!"; and (8) IRS "Agent" comes to your house to collect. To drop a dime, call 1-800-829-0433, except for #1 (1-800-829-1040) and #8 (1-800-366-4484).

a. Now there are a "Dirty Dozen." IR-2002-12 (1/31/02). The common tax schemes include: (1) no taxes being withheld from wages; (2) the concept that "I don't pay taxes -- why should you?"; (3) an African American special tax refund; (4) paying the tax and getting a prize; (5) untaxing yourself for $49.95; (6) a social security scheme; (7) the concept that "I can get you a big refund for a fee"; (8) sharing/borrowing earned income tax credit dependents; (9) the concept of "Put Your Money in a Trust And Never Pay Taxes Again"; (10) improper home-based business; (11) a disabled access credit for pay phones; and (12) an IRS agent coming to your house to collect your taxes.

2. You, too, can get free room and board for ten years if you are "misunderstood" by your employees. United States v. McLeod, 251 F.3d 78, 87 A.F.T.R.2d 2274 (2d Cir. 5/21/01). The tax loss caused by defendant tax preparer added up to $7,578,925, so the punishment totaled 121 months. The court explained as follows:

> At the sentencing hearing, however, McLeod challenged the inclusion of the tax loss resulting from the civil audit and disclaimed responsibility for the false returns covered by the audit. He testified that the willingness of his employees to claim false deductions could have only resulted from a misunderstanding. The Government rebutted McLeod's claim

with the testimony of an IRS agent who testified that the employees told him that McLeod taught them how to prepare returns: to assign the client a refund that is approximately half of their tax due, to give clients charitable deductions equal to approximately ten percent of their income, and to use names of child care providers from a list McLeod supplied, names unknown to the taxpayers.

B. Discovery: Summonses and FOIA

1. Depositions in the Tax Court! But the circumstances were unusual. GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner, 117 T.C. 1 (7/5/01). The joint application of the taxpayer and IRS to perpetuate taxpayer's officers testimony by deposition was granted even though a deficiency notice had not been issued. The matter was contentious, the § 482 dispute was likely to go to trial, and the executives were foreign residents of advanced age whose testimony was likely to be lost. Finally, there was no evidence that the depositions served a discovery purpose.

2. Cavallaro v. United States, 153 F.Supp.2d 52, 88 A.F.T.R.2d 6083 (D. Mass. 7/27/01). A summons was enforced against Ernst & Young for estate planning documents because E&Y was not hired to facilitate communication between the clients and the law firm of Hale and Dorr, and the law firm represented some – but not all – of the parties represented by E&Y.

3. Seawright v. Commissioner, 117 T.C. 294 (12/18/01). Judge Thornton held that § 7602(c), which generally requires the IRS to notify the taxpayer before contacting a third person in connection with examinations and collections, does not apply to contacts by IRS trial counsel with potential witnesses in the course of litigation. This result is consistent with Prop. Reg. § 301.7602-2(f)(7).

C. Litigation Costs

1. The high price of excessive zeal in representing a client. Johnson v. Commissioner, 116 T.C. 111 (2/27/01). In a case involving defense of a sham trust arrangement, Judge Cohen imposed sanctions and costs under § 6673 in the amount of $8,587.50 of IRS counsel expenses [at $150 per hour] and $807.06 of expenses against taxpayer's counsel [Joe Alfred Izen, Jr.], who was described, with citations to prior cases, as "having a long history of involvement with sham trusts" for multiplying the proceedings "unreasonably and vexatiously" by "pursu[ing] claims that have been rejected so frequently that they are 'entirely without colorable pretext or basis and are taken for reasons of harassment or delay or for other improper purposes'" and by "chronic failure to comply with discovery orders."

2. Request that Appeals conference if you expect to prevail and want to collect attorney's fees. Haas & Associates Accountancy Corp. v. Commissioner, 117 T.C. 48 (8/10/01). The taxpayer substantially prevailed on the merits in a deficiency proceeding and sought attorney's fees. In the deficiency proceeding, the taxpayer failed to request an Appeals conference, but did make a "qualified offer" pursuant to §§ 7430(c)(4)(E) [which deems the taxpayer to have substantially prevailed if the deficiency is determined to be less than the offer]. The Tax Court (Judge Swift) held that, consistent with Reg. § 301.7430-1(b)(1), failure to request an Appeals conference was, on the facts, a failure to exhaust administrative remedies barring recovery of attorney's fees. Making a "qualified offer" under § 7430(c)(4)(E) does not in and of itself constitute an exhaustion of administrative remedies.

D. Statutory Notice

1. An optional statutory provision? Rochelle v. Commissioner, 116 T.C. 356 (5/24/01). Section 3463(a) of the IRS Restructuring and Reform Act of 1998, an unmodified provision, states that the IRS "shall include on each notice of deficiency . . . the date determined by [the IRS] as the last day on which the taxpayer may file a petition in the Tax Court." The taxpayer received an otherwise valid deficiency notice that omitted the last date for filing a Tax Court petition and filed his petition 56 days late. In a reviewed opinion (10-6) by Judge Vasquez, the Tax Court held that the deficiency notice nevertheless was valid and dismissed the taxpayer's untimely petition. The court held that § 6213(a) [providing that a petition filed by the date indicated on the deficiency notice as the last date is timely] does not result in unlimited time to file a petition if no due date is specified. The taxpayer was not confused, misled, or prejudiced by the notice or the absence of a specified petition filing date.

• Judge Chabot (joined by Gale and Marvell) dissented, basically on the grounds that "shall" means "shall" and "each" means "each" and that failure to do what the IRS is directed to do must have consequences, specifically, rendering the deficiency notice invalid. Judge Swift would have found the notice valid but would have allowed a "reasonable extension" of time to file as the consequence of noncompliance with § 3463(a) of the 1998 Act and would have found the petition timely. Judges Foley and Colvin would have found that the deficiency notice was valid, but that there was no outside date for filing a petition.

E. Statute of Limitations

1. Final regulations under § 7502 relating to the treatment of a timely mailing as a timely filing. T.D. 8932, Timely Mailing Treated as

Timely Filed/Electronic Postmark, 66 F.R. 2257 (1/11/01). Under amended Reg. § 301.7502-1, in certain situations, a claim for credit or refund made on a late filed original income tax return will be treated as timely filed on the postmark date for purposes of § 6511(b)(2)(A) [consistent with *Weisbart v. United States*, 222 F.3d 93 (2d Cir. 2000)]. The same rule will apply to claims for credit or refund made on late filed original tax returns other than income tax returns, including Form 720, Quarterly Federal Excise Tax Return, and Form 706, U.S. Estate Tax Return. Late filed original tax returns also will be treated as filed on the postmark date.

2. Just where on the return do you find "gross income"? Harlan v. Commissioner, 116 T.C. 31 (1/17/01). This case involved the calculation of gross income for purposes of determining whether the six-year statute of limitations in § 6501(e)(1)(A) applied. The Tax Court (Judge Chabot), in a matter of first impression, held that pursuant to § 702(c) the gross income of a partner in a partnership (the upper tier partnership) that holds an interest in another partnership (the lower tier partnership) includes the upper tier partnership's distributive share of the gross income of the lower tier partnership and not merely the gross income of the upper tier partnership.

3. Robinson v. Commissioner, 117 T.C. 308 (12/19/01). Under § 6501(a), the period of limitations for assessing tax attributable to a constructive dividend is determined with respect to the shareholder's return, not with respect to the corporation's return.

F. Liens and Collections

1. Sections 6220/6230 judicial review has a bite as well as a bark. Mesa Oil, Inc. v. United States, 2001-1 U.S.T.C. ¶ 50,130, 86 A.F.T.R.2d 7312 (D. Colo. 11/21/00). The district court (Judge Babcok) held that the IRS Appeals Officer had abused her discretion in failing to grant relief from a proposed levy [for unpaid employment taxes] pursuant to a §§ 6220/6230 hearing because the requirement of § 6330(c)(3) that the government's collection concerns be balanced against the intrusiveness of the collection had not been satisfied. The Appeals Officer's decision was based on the fact that the IRS had followed proper procedures but it did not take into account the impact that the levy would have on Mesa's continued operation as a going business. The court also stated that there must be enough information in the IRS documentation to permit a court to draw conclusions about whether the Appeals Officer had abused her discretion.

a. A.O.D. 2001-05, 2001 W.L. 953160 (8/20/01). The IRS has nonacquiesed in *Mesa Oil, Inc.*, "relating to whether a verbatim recording of a Collection Due Process hearing is required under §§ 6230 and 6330 to create a judicially reviewable administrative record."

2. A hearing isn't always a hearing. Moorhaus v. Commissioner, 116 T.C. 263 (4/23/01). The Tax Court held that the fact that the IRS has accorded the taxpayer an "equivalent hearing" following an untimely request for a § 6330 hearing following a notice of intent to levy does not constitute a waiver of the time deadline for requesting a hearing. Furthermore, a husband and wife are separate taxpayers for purposes of § 6330. Separate notices of intent to levy may be issued to each of them at different time with different time deadlines for requesting a hearing, and one can timely request a hearing while the other's request is not timely.

3. Begging for release of tax liens. T.D. 8951, Withdrawal of Notice of Federal Tax Lien in Certain Circumstances, 66 F.R. 33464 (6/22/01). Reg. § 301.6323(j)-1 clarifies the standards under which the Commissioner will withdraw a lien pursuant to § 6323(j). The regulations provide that the procedure and form to be followed by a taxpayer in filing a written request for withdrawal of a tax lien will be prescribed by the Commissioner, but set forth minimum required information.

4. Effective date controversy. Parker v. Commissioner, 117 T.C. 63 (8/21/01). The IRS filed a lien against the taxpayer's property before the effective date of §§ 6320 and 6330; after the effective date the IRS notified the taxpayer of its intent to levy on the property and provided the taxpayer an administrative hearing under § 6330. When Appeals issued a notice of determination that there was no reason not to levy, the taxpayer petitioned the Tax Court for review. The Commissioner argued that the court lacked jurisdiction because the lien was filed before the effective date of §§ 6320 and 6330 and the lien and levy were a single continuing collection action. The Tax Court (Judge Laro) rejected the Commissioner's argument and held that it had jurisdiction under § 6330 to review the determination to levy because liens and levies are separate actions within the collection process. The court did not reach the merits.

5. If we have to sign our tax returns, why doesn't the IRS have to sign assessments? Nicklaus v. Commissioner, 117 T.C. 117 (9/14/01). A certificate of assessment, Form 4340, is valid even if it has not been signed and dated by an IRS assessment officer.

6. Sarrell v. Commissioner, 117 T.C. 122 (9/25/01). Neither the timely mailed/timely filed rule of § 7502(a) that generally applies to Tax Court petitions nor the extended filing period under § 6213(a) for petitions from taxpayers receiving a notice addressed outside the United States applies to petitions under § 6330(d). The petition was dismissed for lack of jurisdiction.

7. When a 'hearing' isn't a hearing, but just a letter from the IRS.

a. Lunsford v. Commissioner, 117 T.C. 159 (11/30/01) (reviewed, 8-3-5). In deciding the validity of a notice of determination for purposes of ascertaining whether the Tax Court has jurisdiction to review the IRS determination in a § 6330 [due process before levy] proceeding, Judge Ruwe held that the court will not look behind the face of the notice of determination to inquire as to whether the taxpayer was afforded a proper hearing. *Meyer v. Commissioner*, 115 T.C. 417 (2000), is overruled to the extent it is to the contrary.

b. Lunsford v. Commissioner, 117 TC 183 (11/30/01) (reviewed, 7-2-7). A notice of determination to levy under § 6330 can be valid even though the taxpayer was not afforded a face-to-face hearing but instead was provided a documentary response by mail to his inquiry regarding the propriety of the levy. The taxpayer questioned whether there was a valid summary record of assessment and the Appeals officer responded by sending the taxpayer a Form 4340, Certificate of Assessments and Payments. The majority noted that other cases might arise where the nature of the question requires an actual hearing. Seven dissenting judges would have required an actual hearing as a prerequisite to upholding the notice of determination.

c. Johnson v. Commissioner, 117 T.C. 204 (11/30/01) (reviewed, 9-7). Section 6330(d) does not confer on the Tax Court jurisdiction to review an Appeals decision not to stay a levy pursuant to an assessed § 6702 frivolous return penalty. Section 6330(d) does not expand the Tax Court's jurisdiction to types of taxes over which the Tax Court does not ordinarily have jurisdiction. *Van Es v. Commissioner*, 115 T.C. 324 (2000), followed. If subject matter jurisdiction is lacking, the Tax Court will no longer look behind the face of the notice of determination to inquire as to whether the taxpayer was afforded a proper hearing as required by § 6330(b). *Meyer v. Commissioner*, 115 T.C. 417 (2000), is overruled to the extent it is to the contrary. Commissioner's motion to dismiss granted.

8. Downing v. Commissioner, 118 T.C. No. 2 (1/7/02). The Tax Court held it had jurisdiction under § 6330(d)(1)(A) to review the Commissioner's determination to proceed with collection of the § 6651(a)(2) addition to tax for the failure to pay.

9. Aguirre v. Commissioner, 117 T.C. 324 (12/28/01). A taxpayer who consents to immediate assessment [by signing Form 4589, Income Tax Examination Changes] has waived the right to a § 6330 per-levy administrative hearing. That the Form 4589 was executed prior to the effective date of § 6330 is not relevant.

10. T.D. 8979, Notice and Opportunity for Hearing Upon Filing of Notice of Lien, 67 F.R. 2558 (1/18/02); T.D. 8980, Notice and Opportunity for Hearing Before Levy, 67 F.R. 2558 (1/18/02). The Treasury Department has promulgated final regulations on the right to a collection due process hearing following a lien filing under § 6320 and on the right to a similar hearing before levy under § 6330.

G. Innocent Spouse Relief

1. When the legislative history is ambiguous, read the statute. Tax Court majority holds that the test for knowledge under the § 6015(c)(3)(C) separate liability election is the same as that under former § 6013(e)(1)(C), which is that knowledge of an item of omitted income is sufficient to deny relief even if the spouse has no reason to believe that the way the item was reported on the return was correct. Cheshire v. Commissioner, 115 T.C. 183 (8/30/00) (reviewed, 11-4), on appeal to the 5th Circuit. A spouse who has actual knowledge of the transaction giving rise to omitted income has "reason to know" of the understatement and is not entitled to innocent spouse relief under § 6015(b). The taxpayer's proposed standard based on a prudent taxpayer being expected to know of the understatement was rejected as providing too broad an escape hatch form liability. More importantly, the Tax Court (Judge Jacobs) held that for the spouse to be denied apportioned liability relief, § 6015(c)(3)(C) does not require actual knowledge of whether the entry on the return is or is not correct. The applicable knowledge standard under § 6015(c)(3)(C) is "an actual and clear awareness (as opposed to reason to know) of the existence of an item which gives rise to the deficiency (or portion thereof)." Thus because when the spouse seeking apportioned liability in *Cheshire* signed the joint return, she was aware of the amount, the source, and the date of receipt of a retirement distribution received by her then husband, she was denied apportioned liability, even though at that time she misunderstood how much of the retirement distribution properly was taxable and thus did not know that the amount of income was understated. The court declined to follow a statement in H. Conf. Rept. 105-599, at 253 (1998) that "if the IRS proves that the electing spouse had actual knowledge that an item on a return is incorrect, the election will not apply to the extent any deficiency is attributable to such item." The court did, however, find that the Commissioner abused his discretion in failing to grant equitable relief from penalties under § 6015(f), even though the failure to grant equitable relief on the underlying deficiency was not an abuse of discretion. The taxpayer relied on her husband's description of the tax consequences of the transaction and his representations that he had been advised by a CPA and had no reason to doubt him.

- Judge Jacobs writing for the majority held that the wife was properly denied innocent spouse treatment under § 6015(c)(3)(C) where she had knowledge that her husband had received a distribution from his retirement plan. The wife was told by her husband that their accountant had advised him that amounts used to pay off the mortgage could be excluded from income the same way that the portion of the distribution that was "rolled over" was treated. The majority held that the wife does not need to have knowledge of the tax consequences of the item or that the entry on the return is incorrect. The court relied on former § 6013 cases, such as *Wiksell v. Commissioner*, 215 F.3d 1335 (9th Cir. 2000), *aff'g without published opinion* T.C. Memo. 1999-32, and *Bokum v. Commissioner*, 94 T.C. 126 (1990), *aff'd*, 992 F.2d 1132 (11th Cir. 1993), to the effect that knowledge of the legal consequences of an item may be presumed if the spouse has knowledge of the item.

- The dissenting opinions (Judges Parr, Colvin, Marvel, and Gale), based on the legislative history, would limit denial of relief under § 6015(c)(3)(C) to cases in which the spouse actually knew of the understatement of the item). Judge Colvin's dissent is based upon the conclusion that § 6015(c) was enacted to make clear that the spouse must have had "actual knowledge that the treatment of the item on the tax return was incorrect" in order to be denied innocent spouse treatment.

a. Affirmed by "plain meaning" interpretation. 282 F.3d 326, 89 A.F.T.R.2d 2002-900, 2002-1 U.S.T.C. ¶ 50,222 (5th Cir. 2/8/02). On appeal, Mrs. Cheshire argued that the case was an erroneous deduction case that the knowledge-of-the-incorrect-deduction standard was applicable; the IRS argued that the case was an omitted income case and that the knowledge-of-the-transaction test was applicable. The Court of Appeals (Judge King) held that Mrs. Cheshire "knew or had reason to know" of the understatement under both the omitted income standard and the *Price* [887 F.2d 959 (9th Cir. 1989)] erroneous deduction standard. Thus, § 6015(b)(1)(C) barred innocent spouse relief. Section 6015(c) apportioned liability relief was denied because "the term ['item'] refers to an actual item of income, deduction, or credit, rather than the incorrect reporting of such an item." Mrs. Cheshire's argument that § 6015(c)(30(C) precludes relief only if the spouse has knowledge of incorrect tax reporting was inconsistent with the general rule that "ignorance of the tax laws is not a defense to a tax deficiency." The Court declined to interpret the legislative history as compelling a different result for two reasons.

> First, when interpreting a statute, this court "must presume that a legislature says in a statute what it means and means in a statute what it says there." [citations omitted.] Unless the text of a statute is ambiguous on its face, this court adheres to that statute's plain meaning. . . . Section 6015(c)(3)(C) is not facially ambiguous.
>
> Second, the legislative history of § 6015(c)(3)(C) is ambiguous. Some portions of the history appear to support the Commissioner's position. [citations omitted.] Other parts of the history, however, suggest that the § 6015(c)(3)(C) exception is intended to cover spouses with knowledge of the transaction giving rise to the deficiency in addition to spouses with knowledge that the tax return is incorrect. [citations omitted.] We decline to allow inconclusive legislative history to affect our interpretation of the plain meaning of § 6015(c)(3)(C).

The Court of Appeals noted that subsequent to deciding *Cheshire*, in *King v. Commissioner*, 116 T.C. 198 (2001), the Tax Court interpreted the applicable knowledge standard in erroneous deduction cases to be "actual knowledge of the factual circumstances which made the item unallowable as a deduction." Even under this standard, however, the Court of Appeals concluded that Mrs. Cheshire was not entitled to relief because her "actual and clear awareness" of Mr. Cheshire's retirement distribution satisfied the § 6015(c)(3)(C) knowledge standard for omitted income cases.

2. A little ray of mercy shines through. <u>Martin v. Commissioner</u>, T.C. Memo. 2000-346 (11/08/00). Section 6015(c) relief was granted to a wife who had only superficial incomplete knowledge of a complex transaction in which her husband disposed of stock in a purported § 351 transaction, which was designed to fraudulently deceive state insurance regulators, without the actual receipt of any cash or property by either spouse.

3. But hark, what light through yonder window breaks. Braden v. Commissioner, T.C. Memo. 2001-069 (3/22/01). Judge Marvel held that innocent spouse relief was available under § 6015(b)(1) to a husband who prepared a joint tax return that omitted distributions received by his wife from her deceased father's IRA, and from which he received no benefit. Because the husband had no knowledge of his [ex by the time case arose] father-in-law's financial affairs and the estate's attorney [an ex-IRS special agent] had led him to believe that the funds received by the wife were a nontaxable inheritance, the husband did not have "reason to know" under § 6015(b)(1)(C), even though he knew of the receipt, because he did not know that the receipt was from an IRA. Judge Marvel distinguished *Cheshire v. Commissioner*, 115 T.C. 183 (2000), *aff'd*, 282 F.3d 326, 89 A.F.T.R.2d 2002-900, 2002-1 U.S.T.C. ¶ 50,222 (5th Cir. 2/8/02), as involving a case in which the spouse denied innocent spouse relief knew of the source of the receipt but misunderstood its includability.

4. "Actual knowledge" in § 6015(c)(3)(C) means what it says. Culver v. Commissioner, 116 T.C. 189 (4/02/01). A husband was granted apportioned liability under § 6015(c) because he had no actual knowledge of his wife's embezzlement income, even though she channeled funds through their joint account and the total deposits to their account substantially exceeded their combined salaries. Section 6015(c)(3)(C) permits the Commissioner to defeat the apportioned liability election only if the Commissioner carries the burden of proof by a preponderance of the evidence that the spouse seeking apportioned liability had actual knowledge — not merely reason to know — of the unreported amounts received by the other spouse. Even though the husband should have inquired about the source of the funds, the standard under § 6015(c)(3)(C) "is not that of a hypothetical, reasonable person, but only that of the [spouse's] subjective knowledge."

5. *Cheshire* interpreted: wife is granted § 6015(c) relief because she couldn't read her husband's mind. King v. Commissioner, 116 T.C. 198 (4/10/01). Deductions attributable to taxpayer's husband's activities had been disallowed [under § 183(a)] because the husband lacked a profit motive. Wife sought apportioned liability under § 6015(c) and the Commissioner disallowed the claim under § 6015(c)(3)(C) because the wife knew of her husband's activity and that the deduction appeared on the return. Judge Ruwe adopted Special Trial Judge Cuvillion's opinion, which held that taxpayer met all the requirements for § 6015(c) apportioned liability relief because the Commissioner could not demonstrate that taxpayer had actual knowledge of the item giving rise to the deficiency at the time she signed the return. Where the fact giving rise to the disallowance was her husband's lack of a profit object at the time he claimed a loss from a cattle-raising activity, the Commissioner was required to show that wife had actual knowledge of this "lack of profit objective," which noted that the *Cheshire* standard "is an actual and clear awareness (as opposed to reason to know) of the existence of an item which gives rise to the deficiency (or a portion thereof)." The opinion noted that a footnote in *Cheshire* – an omitted income case – stated, "We leave to another day the manner in which the actual knowledge standard will be applied in erroneous deduction cases." The spouse will be determined to have actual knowledge of the item if she only lacks knowledge of the legal (tax) consequences of the operative facts.

6. Only one bite at the innocent spouse apple. Vetrano v. Commissioner, 116 T.C. 272 (4/25/01). Section 6017(g)(2) precludes any spouse who has meaningfully participated in a court proceeding involving the taxable year in issue from subsequently electing either innocent spouse relief under § 6015(b) or apportioned liability under § 6015(c). This *res judicata*-like bar precludes a subsequent stand-alone petition to the Tax Court, under § 6015(e), for innocent spouse relief or apportioned liability. A taxpayer is limited to a single administrative and judicial process to resolve all issues under § 6015. Thus, the Tax Court (Judge Whalen) denied the wife's motion to dismiss, without prejudice, her innocent spouse election raised in deficiency proceeding because dismissal would have to be with prejudice.

7. Another route to innocent spouse relief. Estate of Wenner v. Commissioner, 116 T.C. 284 (5/14/01). The Tax Court (Judge Laro) held that once its jurisdiction has been properly invoked under § 6404(i) by a petition to review the Commissioner's failure to abate interest, the taxpayer is entitled to raise available affirmative defenses to the underlying tax liability as well. Mrs. Wenner, who had previously paid the underlying deficiency, was allowed to seek innocent spouse relief under § 6015 with respect to the underlying tax liability, even though she had not previously requested administrative relief. A prior request for administrative relief is required only for a stand-alone petition under § 6015(e).

8. A little retroactive equity. Flores v. United States, 51 Fed. Cl. 49, 2002-1 U.S.T.C. ¶ 50,108, 88 A.F.T.R.2d 7020 (11/28/01). If a portion of the a tax liability that arose before the effective date of § 6015 has been paid and a portion remained unpaid, § 6015(f) equitable innocent spouse relief is available with respect to the entire liability if the facts warrant relief.

9. Limited apportioned liability relief to wife where husband's erroneous deductions exceeded his income. Mora v. Commissioner, 117 T.C. 279 (12/17/01). Mrs. Mora was denied innocent spouse relief under § 6015(b) because she had "reason to know" of an understatement attributable to her husband's erroneous tax shelter deductions that offset over two-thirds of the spouse's combined salary income (of less than $40,000). However, because the tax shelter investment was solely her husband's and she had no involvement with it or, under the standard of *King v. Commissioner*, 116 T.C. 198 (2001), "factual basis for the denial of the deductions," Judge Beghe held that Mrs. Mora was entitled to § 6015(c) apportioned liability relief. This principle applies to the spouse requesting apportioned liability even if the spouse who owned the limited partnership interest – and thus could not qualify for apportioned liability with respect to the item – had no "factual basis for the denial of the deductions." Nevertheless, Mrs. Mora received only partial relief because the disallowed deductions exceeded her husband's income and she received a tax benefit from the excess deductions. To the extent she benefitted from the deductions, § 6015(d)(3)(B) denies relief.

10. Proposed § 6015 regulations. REG-106446-98, Relief From Joint and Several Liability, 66 F.R. 3888 (1/17/01). The Treasury has published proposed regulations under § 6015 to reflect changes in the law made by the IRS Restructuring and Reform Act of 1998, where § 6013(e) was replaced with § 6015. They clarify that case law interpreting the language under former § 6013(e) will be used to interpret that same language under § 6015. Also, "knowledge or reason to know" of an understatement exists only when either the requesting spouse actually knew of the erroneous item giving rise to the understatement, or a reasonable person in similar circumstances would have known of the item. Knowledge of an item under the proposed regulations would be knowledge of the receipt or expenditure. The proposed regulations would further amend Reg. § 1.6013-4 to clarify that if a spouse asserts and establishes that he or she signed a joint return under duress, then the return is not a joint return, and he or she is not jointly and severally liable. Relief must be requested within two years from the first collection activity, but not before the taxpayer receives a notification of an audit or notice that there might be outstanding liability. Finally, the proposed regulations would provide that the nonrequesting spouse must be given notice that the requesting spouse has filed a claim for relief and be given an opportunity to participate in the proceedings. At the request of one spouse, the IRS would omit from shared documents information that would reasonably identify that spouse's location.

11. Proposed § 66 regulations for married individuals in community property states who do not file joint returns. REG-115054-01, proposed regulations under § 66, relating to the treatment of married individuals in community property states who do not file joint income tax returns, 67 F.R. 2841 (1/22/02).

H. Miscellaneous

1. Extended time for use of the revised Form W-9. Announcement 2001-15, 2001-8 I.R.B. 715 (2/3/01). This announcement advises persons required to file information returns of the availability and required use of Form W-9, Request for Taxpayer Identification Number and Certification (Rev. December 2000). In response to payor concerns about implementing the new certification requirements, the use of revised Form W-9 is optional until July 1, 2001. The major change to the form is that under Part III, Certification, a payee must now certify that he or she is a U.S. person (including a U.S. resident alien). Payors must use the revised Form W-9 for all new solicitations after June 30, 2001. A foreign person may not use Form W-9 to furnish his or her taxpayer identification number to the payor after December 31, 2000. Instead, foreign payees must use the appropriate Form W-8.

2. Section 7491 was all bark and no bite here. Higbee v. Commissioner, 116 T.C. 438, 446 (6/6/01) (Vasquez, J.). The burden of proof was not shifted to the Commissioner under § 7491 because the taxpayer did not have required documentary evidence to support claimed casualty loss, charitable contribution, unreimbursed employee business expense and rental activity expense deductions. Furthermore, § 7491(c), which provides that the Commissioner bears the "burden of production" with respect to any penalties, requires only that the Commissioner must "[come] forward with sufficient evidence indicating that it is appropriate to impose the relevant penalty" but "need not introduce evidence regarding reasonable cause, substantial authority, or similar provisions," negating the penalty. The negligence penalty was sustained.

3. The quality of equity is not strained. Estate of Branson v. Commissioner, 264 F.3d 904, 2001-2 U.S.T.C. ¶ 50,622, 88 A.F.T.R.2d 5726 (9th Cir. 9/5/01). The Ninth Circuit held that *Commissioner v. Gooch Milling & Elevator Co.*, 320 U.S. 418 (1943), in which the Supreme Court has held that [under the predecessor of § 6214(b)] the Tax Court lacks jurisdiction to apply equitable recoupment in income tax cases, does not bar equitable recoupment of an income tax overpayment for same year as estate tax deficiency. (The Sixth Circuit has held to the contrary in *Estate of Mueller v. Commissioner*, 153 F.3d 302 (6th Cir. 1998).) The estate's estate tax underpayment [resulting from an undervaluation of an asset] and the beneficiary's income tax overpayment [resulting form the consequent lower-than-appropriate § 1014 basis] were a single transaction to which equitable recoupment applied.

4. 9-11 relief

a. Notice 2001-61, 2001-40 I.R.B. 305 (9/21/01). The IRS announced relief under §§ 6081, 6161, and 7508A for taxpayers affected by the September 11, 2001, Terrorist Attack. Taxpayers who have difficulty in meeting their federal tax obligations because of disruption in the transportation and delivery of documents by mail or private delivery services resulting from the terrorist attack, and who do not otherwise qualify for relief, will have until 11/15/01 to file returns and make payments required to be made from 9/11/01, through 10/31/01.

b. Notice 2001-63, 2001-40 I.R.B. 308 (9/15/01). The IRS postponed the due date for all federal tax obligations falling between 9/10/01 and 9/24/01 until 9/24/01. This postponement of time covers the filing of returns and claims for refund, the payment of tax (including estimated tax payments), making elections, and filing any other federal tax documents.

c. Notice 2001-68, 2001-47 I.R.B. 504 (11/10/01). This notice expands and clarifies the definition of an affected taxpayer to include missing persons and lists additional acts for which a postponement is granted. The notice also clarifies relief available to S corporations and beneficiaries of trusts who are not themselves affected by the disaster. Further, it extends relief for affected partnerships that fail to file returns by magnetic media. Deadlines are postponed only if the last day for performing the act involved would otherwise be on or after November 2, 2001. The notice also contains postponements with respect to § 1031 exchanges where the last date for performing an act would fall between 9/11/01 and 11/30/01.

(1) Announcement 2001-117, 2001-49 I.R.B. 567 (11/10/01). The IRS grants relief to partners, shareholders, or beneficiaries that had income tax returns due between 9/11/01 and 11/2/01, but did not file the returns because the taxpayer believed that the IRS had granted a 120 day postponement solely by virtue of the taxpayer's interest in the affected entity. The IRS will waive any failure to file penalty if the taxpayer files his return by 12/15/01. Similar relief is provided for any failure to pay penalty.

(2) Announcement 2001-124, 2001-52 I.R.B. 630 (12/11/01). This announcement modifies and expands the relief granted in Announcement 2001-117. Partners, shareholders, and beneficiaries of an affected taxpayer are eligible for all the relief granted by Notice 2001-61 and

Notice 2001-68. Thus, for example, a partner that is an individual income taxpayer with an extended due date of October 15, 2001, for the 2000 return will have until February 12, 2002, to file the return.

- If a partner, shareholder, or beneficiary of an affected taxpayer qualifies for relief under this notice because an original due date fell within the specified period, and such partner, shareholder, or beneficiary has already obtained an extension of time to file, the IRS will supplement such extension with the relief granted by Notice 2001-61 and/or Notice 2001-68. Thus, for example, a corporate partner with an original due date during the specified period that has obtained the automatic six-month extension of time to file will be granted a six-month extension of time to pay and an additional 120 day postponement of time to file and time to pay.

d. Notice 2001-69, 2001-46 I.R.B. 491 (10/25/01). The Service will not assert that payments made by an employer to an organization described in § 170(c), in exchange for vacation, sick, or personal leave that the employee elects to forgo, constitute gross income or wages of an employee, provided that the payments are made to such organizations before 1/1/03. Similarly, the Service will not assert that the opportunity to make such an election results in constructive receipt of gross income or wages for employees.

e. Notice 2001-70, 2001-45 I.R.B. 437 (10/19/01). Treasury and the IRS intend to issue regulations permitting taxpayers to elect not to apply the mid-quarter convention rules contained in § 168(d)(3) to property placed in service in the taxable year that includes 9/11/01 in its third quarter.

- Section 168(d)(3) generally provides that, except as provided in regulations, if the aggregate basis of property placed in service during the last three months of the taxable year exceeds 40 percent of the aggregate basis of property (other than property described in § 168(d)(3)(B)) placed in service during the taxable year, the applicable depreciation convention for all property (other than property described in § 168(d)(2)) to which § 168 applies placed in service during the taxable year is the mid-quarter convention.

(1) Notice 2001-74, 2001-49 I.R.B. 551 (11/10/01). This notice expands Notice 2001-70 to also include taxpayers for whom September 11th falls in the fourth quarter. This would cover taxpayers who purchase substantial amounts of property to replace property destroyed on September 11th.

f. Rev. Proc. 2001-53, 2001-47 I.R.B. 506 (11/10/01). Lists certain acts, the time for which is postponed by reason of service in a combat zone or a Presidentially declared disaster.

g. Notice 2001-78, 2001-50 I.R.B. 576 (11/22/01). Provides interim guidance to charities regarding payments made by reason of the death, injury or wounding of an individual incurred as a result of the September 11, 2001, terrorist attacks. The Service will treat such payments made by a charity to individuals and their families as related to the charity's exempt purpose provided that the payments are made in good faith using objective standards. The notice is effective until the earlier of final legislation or 12/31/02.

h. Congress passed the **Victims of Terrorism Tax Relief Bill** on 12/20/01. H.R. 2884 provides tax relief for those who died or were injured in the terrorist attacks on 9/11/01, the Oklahoma City bombing in 1995, and bioterrorism involving anthrax on or after 9/11/01 and before 1/1/02. It also clarifies that the Secretary has the authority to disregard for up to one year some Code provisions by reason of Presidentially declared disaster or terrorist or military actions. It also broadens § 6103 to permit Treasury to share return information with federal law enforcement and intelligence agencies engaged in terrorist investigations.

i. Notice 2002-7, 2002-6 I.R.B. 489 (1/24/02). The due date for satisfying the § 412 minimum funding requirements (and the comparable requirements of § 302 of ERISA) for those directly affected by the Terrorist Attack on 9/11/01 for making contributions originally required to have been made between 9/11/01 and 9/23/01 is postponed to 9/24/02, and the date for applying for waivers originally due between 3/15/01 and 2/28/02 is postponed to 3/1/02.

5. Notice 2001-62, 2001-40 I.R.B. 307 (10/1/01). The IRS has published an updated list of designated private delivery services that qualify for the timely mailing is timely filing or payment rule of § 7502. UPS Worldwide Express Plus and UPS Worldwide Express have been added to the list.

6. <u>Ihnen v. United States</u>, 272 F.3d 577, 2001-2 U.S.T.C. ¶ 50,786, 88 A.F.T.R.2d 6976 (8th Cir. 11/27/01). Taxpayers were stopped to obtain a refund of taxes to which they agreed – in a settlement on Form 870-AD – where the statute of limitations had run on the IRS for the years covered by the settlement agreement.

7. T.D. 8969, Payment by Credit Card and Debit Card, 66 F.R. 64740 (12/14/01). The IRS has promulgated final regulations under § 6311, providing for the payment of taxes by credit card.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. How will this affect service in Cocco Pazzo? 330 West Hubbard Restaurant Corp. v. United States, 203 F.3d 990, 2000-1 U.S.T.C. ¶ 50,225, 85 A.F.T.R.2d 869 (7th Cir. 2/15/00). Under §§ 3111(a) & (b) and 3121(q), the IRS could validly assess the employer's share of FICA with respect to restaurant employees' unreported tips on the basis of an aggregate computation, without determining individual employees' shares. Following both the Federal and Eleventh Circuits, the Seventh Circuit held that the IRS is authorized to collect an employer's FICA taxes without first assessing individual employees and crediting their Social Securities earnings records. Judge Coffey also deferred to the IRS interpretation of § 3121(q).

2. But that same interpretation isn't reasonable on the West Coast. Let's see how it plays in Washington, DC, now that certiorari has been granted. Fior D'Italia, Inc. v. United States, 242 F.3d 844, 2001-1 U.S.T.C. ¶ 50,261, 87 A.F.T.R.2d 1118 (9th Cir. 3/7/01) (2-1), *cert. granted*, 122 S. Ct. 865 (1/11/02), *aff'g* 21 F. Supp. 2d 1097 (N.D. Calif. 9/18/98) (The IRS lacks authority to assess the employer's share of FICA without determining the tip income of individual employees). The IRS assessment of FICA taxes on unreported tip income, which was determined by applying the average tip rate on credit card receipts, applying that rate to the employer's gross receipts, and then subtracting reported employee tip income was invalid. Judge Kozinski held that the IRS lacks authority to assess employer FICA taxes on an estimated aggregate basis because the IRS method does not account for tips that might be outside the "wage band" [which excludes tips of less than $20 per month or above the social security wage base] from FICA tax. The IRS method does not account for the fact that cash tips are usually less than credit card tips, that tip sharing with busboys, dishwashers, etc. may result in employees receiving less than $20 per month, or "for an upscale restaurant like Fior D'Italia" how many employees' tips exceeded the social security wage base. Section 446 authority is unavailing to the IRS because it does not apply to FICA taxes, and the negative implication of § 446 not applying to FICA taxes is that the IRS has no authority to rely on estimates in assessing FICA taxes. Nor does § 3121(q) provide any such authority. Although the IRS can assess the employer's share of FICA taxes without assessing a deficiency against the employees, it may not do so without auditing the employees' records to determine tip income on an employee-by-employee basis.

> This does not mean that the IRS may assess the employer only if it also assesses each of its employees. Three other circuits

> have rejected this argument and, for reasons well expressed in those opinions, we reject it as well. See *330 West Hubbard Restaurant Corp. v. United States*, 203 F.3d 990, 995 (7th Cir. 2000); *Bubble Room, Inc.*, 159 F.3d at 565; *Morrison Restaurants, Inc. v. United States*, 118 F.3d 1526, 1529 (11th Cir. 1997). As the government correctly points out, the employer's portion of FICA is separate from the employee's, and the IRS need not collect the one as a condition for collecting the other. Having audited an employee and determined the precise amount of FICA wages the employee has received, the IRS may then choose to assess only the employer, only the employee, or both. If the IRS cannot or will not assess the employee for additional FICA tax, this will not jeopardize its right to assess the employer. That having been said, it does not follow that the IRS can dispense with auditing the employees' records or otherwise determining the amount each employee earned in tips. For the reasons explained, there is no way to determine the employer's FICA tax liability without making an employee-by-employee determination of the taxable tips each has earned. An aggregate assessment based on inaccurate estimates, as used by the IRS in this case, is simply not authorized. (footnotes omitted).

• Judge McKeown, in dissent, would have followed *330 West Hubbard Restaurant Corp. v. United States*, 203 F.3d 990 (7th Cir. 2000); *Bubble Room, Inc. v. United States*, 159 F.3d 553 (Fed. Cir. 1998); and *Morrison Restaurants, Inc. v. United States*, 118 F.3d 1526 (11th Cir. 1997), all of which upheld as reasonable IRS assessments based on similar methodology.

> Every circuit court that has addressed the aggregate assessment issue has come to the opposite conclusion from the majority. The majority's attempt to avoid the weight of circuit authority by suggesting that its position is somehow in line with that of *330 West Hubbard Restaurant* and *Morrison Restaurants* is transparently unsuccessful. See Maj. Op. at 2892 n.9 ("our holding is entirely consistent with those of the Seventh and Eleventh Circuits"). As noted above, both the Seventh and Eleventh Circuits held that the IRS has the authority to use the aggregate method with respect to unreported tip income without determining the under-reporting by individual

employees and crediting their wage history accounts. See *330 West Hubbard Restaurant*, 203 F.3d at 994, 997; *Morrison Restaurants*, 118 F.3d at 1529-30. Although the majority agrees that the IRS need not assess the employees in order to assess the employer, the majority concludes that the IRS may not rely on the aggregate method and must AUDIT the employees. See Maj. Op. at 2892 & n.9. Requiring an audit is simply another way of saying that the IRS cannot estimate and that the only way the IRS can assess taxes on unreported or under-reported tips is to undertake an individual accounting of employees. This view can hardly be viewed as "entirely consistent" with that of the Seventh and Eleventh Circuits. The IRS's authority to use the aggregate method was at the heart of the cases in those circuits. The majority's recharacterization can only pretend consistency with these cases.

a. Supreme Court reverses Seventh Circuit and upholds the IRS. United States v. Fior D'Italia, Inc., 122 S. Ct. 2117, 89 A.F.T.R.2d 2883, 2002-2 U.S.T.C. ¶50,459 (6/17/02) (6-3). The Court held that the IRS has broad power under § 6201(a) to determine the method it uses to make assessments, and that its use of the "aggregate estimation method" to determine the total amount of tip income upon which to base an assessment of FICA taxes on an employer is reasonable in light of the employer's stipulation of the accuracy of the calculation. The method used was an amount based upon a percentage of total restaurant checks (extrapolated from the percentage of tips on restaurant checks paid with credit cards) minus the tip income reported by each employee to the restaurant owner.

3. Tax Court exercises its new worker classification jurisdiction. Neely v. Commissioner, 115 T.C. 287 (9/27/00). The Tax Court (Judge Vasquez) decided that it has jurisdiction under its new § 7436 "worker classification" jurisdiction to decide (in the context of the case) whether the IRS is barred by the § 6501 statute of limitations from assessing a deficiency based upon worker classification because the statute of limitations is an affirmative defense.

a. Neely v. Commissioner, 116 T.C. 79 (2/13/01). In exercising its jurisdiction over worker classification cases under § 7436 pursuant to *Neely v. Commissioner*, 115 T.C. 287 (2000), the Tax Court held that the Commissioner was barred from assessing additional employment taxes by the three-year statute of limitations under in § 6501(a) because the elements of fraud were not present. The court (Judge Vasquez) rejected the Commissioner's argument that the failure of taxpayer's air conditioning contracting business to report as wages and pay employment taxes with respect to cash payments to three workers who demanded to be paid in cash was fraudulent. The elements of fraud are the same in an employment tax case as in the income, estate and gift tax context. Taxpayer filed Forms-1099 with respect to the workers, who were not regular workers but were hired by foremen at the jobsites, to which they reported directly for work, honestly believed the workers to be "independent contractors," and fully cooperated with the revenue agent assigned to the case.

4. The scheme worked until a labor dispute arose. United States v. Kontny, 238 F.3d 815, 2001-1 U.S.T.C. ¶ 50,197, 87 A.F.T.R.2d 390 (7th Cir. 1/4/01), *cert. denied*, 532 U.S. 1022 (2001). Judge Posner upheld a criminal conviction and sentencing for fraudulent nonpayment of payroll taxes. Kontny thought he could beat both the Fair Labor Standards Act and the IRC by not paying time-and-a-half for overtime but just not reporting or withholding on straight-time pay for overtime hours.

5. Yer out!!! United States v. Cleveland Indians Baseball Co., 121 S. Ct. 1433, 2001-1 U.S.T.C. ¶ 50,341, 87 A.F.T.R.2d 1706 (4/17/01), *rev'g* 215 F.3d 1325, 2001-1 U.S.T.C. ¶ 50,469, 85 A.F.T.R.2d 1761 (6th Cir. 5/10/00). An award of back pay to baseball players under a settlement is subject to FICA and FUTA taxes in the year the settlement award is paid, and not the year that the wages should have been paid. The Supreme Court (Justice Ginsburg) deferred to the IRS long-standing interpretation of Reg. §§ 31.3111-3 & -2(c) and 31.3301-2(c) & -3(b) as reflected in Rev. Rul. 89-35, 1989-1 C.B. 280 and Rev. Rul. 78-336, 1978-2 C.B. 255, even though the regulations themselves do not expressly apply to back pay.

6. United States v. Hatter, 121 S. Ct. 1782, 87 A.F.T.R.2d 2227 (5/21/01). In a case that has been dragging on nearly a decade, the Supreme Court held that application of Medicare taxes to federal judges taking office before 1983 is constitutional, but that application of increased social security taxes to federal judges taking office before 1984 is unconstitutional under Art. III, sec. 1.

7. North Dakota State University v. United States, 255 F.3d 599, 2001-1 U.S.T.C. ¶ 50,485, 87 A.F.T.R.2d 2522 (8th Cir. 6/18/01). Early retirement payments to tenured faculty members were held not to constitute wages subject to FICA withholding because that the retirement payments to tenured faculty members were payments for a property interest.

Be careful though also see DOL Op 99-01 A-Suffolk Univ. and PLR19903032.

8. When a per diem isn't really a per diem, it's wages. Worldwide Labor Support of Mississippi, Inc. v. United States, 2001-2 U.S.T.C. ¶ 50,463, 87 A.F.T.R.2d 2401 (S.D. Miss. 5/15/01). Per diem travel expense payments to non-local employees by taxpayer, which provided temporary skilled labor to various business were wages, subject to employment tax, and not employee expense reimbursement. The per diem amounts were not paid under an accountable plan [Reg. § 1.62-2] and were not eligible for the safe harbor in Reg. § 1.62-2(f), because the amount was determined with respect to hours worked and the term of employment, not anticipated expenses.

9. Janus-like payments were deductible compensation in a Tax Court case but now are travel reimbursements exempt from employment tax in the Court of Claims. United Air Lines, Inc v. United States, 51 Fed. Cl. 722, 2001-2 U.S.T.C. ¶ 50,577, 88 A.F.T.R.2d 5459 (8/10/01). See II.D., supra.

10. S corporation shareholders can't take unreasonably *low* compensation to avoid employment taxes. Veterinary Surgical Consultants P.C. v. Commissioner, 117 T.C. 141 (10/15/01). The taxpayer was an S corporation with a single shareholder, who was the only individual who provided any services on behalf of the corporation. All of the taxpayer-corporation's income was earned by virtue of services provided to a third party by the shareholder. The corporation paid the sole shareholder no salary, and he reported all of its income under § 1366; the income was distributed to him [subject to § 1368]. The corporation paid no employment taxes. Judge Jacobs held that the shareholder was an employee of the corporation and upheld the recharacterization of the amounts paid to him as salary. Section 530 relief was not available because the corporation had no reasonable basis for not treating the shareholder as an employee. Accordingly the wage tax deficiency was upheld. That the shareholder personally had paid the maximum *employee* FICA for the year by virtue of employment by another corporation was not relevant to the *employer's* wage tax.

11. Same scam, same answer. Yeagle Drywall Co., Inc. v. Commissioner, T.C. Memo. 2001-284 (10/15/01). *Veterinary Surgical Consultants P.C. v. Commissioner*, 117 T.C. 141 (10/15/01), was followed with respect to a 99 percent shareholder/officer in case involving a drywall contracting business that treated all of its workers as independent contractors.

12. Shotgun Delivery, Inc. v. United States, 269 F.3d 969, 2001-2 U.S.T.C. ¶ 50,700, 88 A.F.T.R.2d 6391 (9th Cir. 10/16/01). "Mileage reimbursements" paid by an employer-messenger service to its employee drivers were wages because they were not paid under an accountable plan [Reg. § 1.62-2]. Drivers were invariably paid a total amount, for wages and mileage, equal to 40 percent of delivery charges, with an amount equal to minimum wage denominated "wages" and the remainder denominated "mileage," without any regard to even approximating actual mileage.

13. Full service employment tax litigation in the Tax Court. Ewens and Miller, Inc. v. Commissioner, 117 T.C. 263 (12/11/01). A bakery's workers were employees, and the bakery was not entitled to relief under § 530 of the Revenue Act of 1978 [because it had before 1992 treated such workers as employees]. Judge Vasquez found that the workers who produced and marketed the product were common law employees under the seven-factor test: [(1) degree of control by principal, (2) who made the investment, (3) profit or loss opportunity, (4) whether the worker can be discharged, (5) whether part of principal's regular business, (6) permanency of the relationship, and (7) the relationship the parties believed they were creating] of *Weber v. Commissioner*, 103 T.C. 378 (1994), *aff'd per curiam*, 60 F.3d 1104 (4th Cir. 1995), and that the route drivers were statutory employees under the § 3121(d)(3)(A) agent-driver/commission driver provision.

- Judge Vasquez further held that the Tax Court's jurisdiction over worker classification gave it the jurisdiction to decide the correct amounts of employment taxes, as well as to decide the proper additions to tax and penalties. Section 7436, which grants the Tax Court jurisdiction to determine employment status and employment tax deficiencies in connection with such a determination, does not expressly provide jurisdiction to determine § 6656 penalties for underpayment of employment taxes. Nevertheless, jurisdiction to determine such penalties is founded on § 6665(a)(2) [providing that any reference in Title 26 to a tax imposed by Title 26 shall be deemed also to refer to the additions to tax, additional amounts, and penalties provided by chapter 68 of subtitle F] because § 6656 penalty is in chapter 68 of subtitle F and it applies to taxes imposed by Title 26, and § 7436(e) does not exclude additions to tax or penalties from the definition of employment tax.

B. Excise Taxes

1. REG-106892-00, Deposits of Excise Taxes, 66 F.R. 10650 (2/16/01). The IRS has proposed regulations relating to the requirements for excise tax deposits.