JUDICIAL UPDATE

Speaker:
Todd Welty
Dentons US LLP
Email: todd.welty@dentons.com

60th Annual Texas CPA Tax Institute

San Antonio and Dallas, Texas
November 21 and 22, 2013

Speaker's Note:

I would like to thank Ira B. Shepard, Bruce A. McGovern, Martin J. McMahon, Jr., and Daniel L. Simmons for the use of their thorough and always-helpful outline, "Recent Developments in Federal Income Taxation." While the outline is comprehensive and often humorous, the authors' views are not necessarily my own.

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

"Recent developments are just like ancient history, except they happened less long ago."

By

Ira B. Shepard
Professor Emeritus of Law
University of Houston Law Center
Houston, Texas 77204-6060
Tele: 713-743-2246
Fax: 713-743-2131
e-mail: ishepard@uh.edu

Bruce A. McGovern
Vice President, Associate Dean and
Professor of Law
South Texas College of Law
Houston, Texas 77002
Tele: 713-646-2920
e-mail: bmcgovern@stcl.edu

Houston Tax Roundtable
September 11, 2013

Note: This outline was prepared jointly with Martin J. McMahon, Jr., James J. Freeland Eminent Scholar in Taxation and Professor of Law, University of Florida College of Law, Gainesville, FL and Daniel L. Simmons, Professor Emeritus of Law, University of California Davis, Davis CA.

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

I. ACCOUNTING

A. Accounting Methods

1. When is income recognized when, as often happens, a customer never redeems the gift card? Rev. Proc. 2013-29, 2013-33 I.R.B. __ (7/24/13). This revenue procedure allows a taxpayer to defer recognizing in gross income certain advance payments

received from the sale of gift cards that are redeemable for goods or services by an unrelated entity. Where a gift card is redeemable by an entity whose financial results are not included in the taxpayer's applicable financial statement, the taxpayer will recognize the payment in income to the extent the gift card is redeemed. For a taxpayer without an applicable financial statement, the taxpayer will recognize the payment in income when it is earned, which, in this situation, is when the gift card is redeemed. Any payment received by the taxpayer that is not recognized in income in the year of receipt, must be recognized in the subsequent year. The revenue procedure modifies and clarifies Rev. Proc. 2011-18, 2011-5 I.R.B. 443, *modifying and clarifying* Rev. Proc. 2004-34, 2004-1 C.B. 991. It is effective for taxable years ending on or after 12/31/10.

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. The fabled Plotkin diamond always comes with a curse – Mr. Plotkin. Plotkin v. Commissioner, 110 A.F.T.R.2d 2012-6752 (11th Cir. 11/27/12). Taxpayer received an economics degree from the University of Pennsylvania's Wharton School, class of 1963, and a law degree from St. Louis University, class of 1972, before he purchased a controlling interest in a nursing home empire from the father of his ex-wife in 1980. As the result of a complex series of financial machinations and fund diversions through his girlfriend(s) during the years 1991, 1992 and 1993, he was convicted on three counts of willfully making and subscribing false income tax returns under § 7206(1) in 1999 and sentenced to five years of probation. The Commissioner determined that he failed to report in excess of $1.5 million of Schedule C self-employment income during the years 1991 through 1995. In this unpublished per curiam opinion, the Eleventh Circuit affirmed a Tax Court decision upholding the Commissioner's determination, finding taxpayer's argument that he received non-taxable partnership distributions not supported by the facts because taxpayer deliberately chose not to be a partner in the entity from which he received financial benefits.

2. Cash value life-insurance through off-shore insurance companies and LLCs don't produce deductible premiums. Salty Brine 1, Ltd. v. United States, 111 A.F.T.R.2d, 2013-2308 (N.D. Tex. 5/16/13). In a marketed insurance tax shelter arrangement case, the court denied § 162 deductions for premiums paid for business protection insurance issued by off-shore affiliates of Fidelity and Citadel Insurance companies. The policies included cash value life insurance and related annuities that the court found did not protect the business from risk and merely represented an attempt to funnel cash from the businesses to families of the owners. Section 6662 penalties were upheld.

3. El Niño has not yet won a major, but he claims a partial victory in the Tax Court. Garcia v. Commissioner, 140 T.C. No. 6 (3/14/13). Professional golfer Sergio Garcia, a resident of Switzerland, derived income from an endorsement agreement with TaylorMade Golf Co. The agreement required Garcia to "exclusively wear and use golf products produced by TaylorMade and associated brands (TaylorMade products), and TaylorMade . . . receive[d] the right to use [Garcia's] image, likeness, signature, voice, and any other symbols associated with his identity to promote TaylorMade products." Garcia also was required to make a specified number of personal appearances and to play in a specified number of tournaments each year. An amendment to the endorsement agreement allocated 85% of Garcia's compensation to royalties for use of his image rights and 15% to his personal services. The government argued that the vast majority of Garcia's income was attributable to his personal services. The Tax Court (Judge Goeke) considered expert reports submitted by the parties and judicial precedent, including a prior decision of the Tax Court on the same issue in connection with golfer Retief Goosen's endorsement agreement with TaylorMade, *Goosen v. Commissioner*, 136 T.C. 547 (2011) (where Judge Kroupa found a 50%-50% split). The court concluded that 65% of Garcia's compensation was royalties and 35% was compensation for personal services.

The court also held that Garcia's royalty income was not, as the government argued, income derived as an entertainer and therefore taxable in the United States under article 17 of the U.S.-Swiss tax treaty, but rather was royalty income that is not taxable in the United States under article 12 of the treaty. The court held that all of Garcia's U.S.-source personal service income was taxable in the United States and rejected as untimely Garcia's argument, raised for the first time in a post-trial brief, that a portion of his service income was not taxable in the United States.

4. Pay me now or pay me later. The 2009 ARRA, § 1231(a), added Code § 108(i), which defers and then ratably includes income arising from business indebtedness discharged by the reacquisition of a debt instrument. This provision allows a taxpayer to irrevocably elect to include cancellation of debt income realized in 2009 and 2010 ratably over five tax years, rather than in the year the discharge occurs, if the debt was issued in connection with the conduct of a trade or business or by a corporation. For partnerships and S corporations, the election is made by the partnership or corporation, not by the individual partners or shareholders. I.R.C. § 108(i)(5)(B)(iii). Under the § 108(i) election, income from a debt cancellation in 2009 is recognized beginning in the fifth taxable year following the debt cancellation; the income is recognized ratably in each of 2014 through 2018. Income from a debt cancellation in 2010 is recognized beginning in the fourth taxable year following the debt cancellation; the income is recognized ratably in each of 2014 through 2018. If a taxpayer elects to defer debt cancellation income under § 108(i), the § 108(a) exclusions for bankruptcy, insolvency, qualified farm indebtedness, and qualified real property business indebtedness do not apply to the year of the election or any subsequent year. § 108(i)(5)(C). Thus, the election cannot be used to move the year of inclusion to a year in which it is expected that one of the exceptions will apply. Once the election is made, inclusion is inevitable; the statute requires acceleration of inclusion to the taxpayer's final return in the event of the intervening death of an individual or liquidation or termination of the business of an entity. § 108(i)(5)(D). The acceleration rule also applies in the event of the sale or exchange or redemption of an interest in a partnership or S corporation by a partner or shareholder.

a. Many of the questions have been answered. Rev. Proc. 2009-37, 2009-36 I.R.B. 309 (8/17/09). This revenue procedure provides the exclusive procedure for taxpayers to make § 108(i) elections. Debt cancellation in connection with a property transfer is included in § 108(i). Section 4.04(3) permits partial elections, with the partnership permitted to determine "in any manner" the portion of the COD income that is the "deferred amount" and the portion of the COD income that is the "included amount" with respect to each partner. Section 4.11 permits protective elections where the taxpayer concludes that a particular transaction does not generate COD income but fears that the IRS may determine otherwise. A partner's deferred § 752(b) amount, arising from a decrease in his share of partnership liabilities, will be treated as a current distribution of money in the year that the COD income is included. Taxpayers are allowed an automatic one-year extension from the due date to make the election, and taxpayers who made elections before the issuance of the revenue procedure will be given until 11/16/09 to modify (but not revoke) their existing elections. Corporate taxpayers making a § 108(i) election are required to increase earnings and profits for the year of the election.

b. Temporary Regulations allocate deferred cancellation of debt income. T.D. 9498, Application of Section 108(i) to Partnerships and S Corporations, 75 F.R. 49380 (8/13/10). Section 108(i) provides an election to include cancellation of indebtedness income resulting from a reacquisition (broadly defined in § 108(i)(4)) of a debt instrument, issued by a C corporation or other person engaged in a trade or business, ratably over five years beginning with the fifth year following reacquisition occurring in 2009, and the fourth year following reacquisition in 2010. Under § 108(i)(5)(B)(iii) an election is made by the partnership, not the partners individually. Section 108(i)(6) requires a partnership to allocate the COD income to partners according to partnership share on the day immediately preceding reacquisition and provides that the discharge will not trigger § 752(b) recognition under § 731 because of a reduction in a partner's share of partnership liabilities.

- Temp. Reg. § 1.108(i)-2T(d)(1) provides five safe harbors where debt instruments issued by a partnership or S corporation will be treated as issued in a trade

or business: (1) The gross fair market value of the trade or business assets of the partnership or S corporation represent at least 80 percent of the fair market value of all of its assets on the date of issuance, (2) trade or business expenses of the partnership or S corporation represent at least 80 percent of all expenditures, (3) at least 95 percent of the interest paid on the debt instrument is allocable to trade or business expenditures under the interest allocation rules of Temp. Reg. § 1.163-8T, (4) at least 95 percent of the proceeds from the debt instrument were used to acquire trade or business assets within six months of the issue of the debt, or (5) the partnership or S corporation issued the debt instrument to the seller of a trade or business to acquire the trade or business. Absent anchoring in one of the safe harbors, qualification of a trade or business debt is a matter of facts and circumstances.

- While § 108(i)(5)(B)(iii) requires the election to be made at the partnership level, Temp. Reg. § 1.108(i)-2T(b)(1) allows the partnership to allocate both deferred and included portions of COD income to the partners. The temporary regulations first require that COD income be allocated to the partners in the partnership immediately before the reacquisition in the manner the income would be included in distributive shares under § 704, then the partnership must determine the amount of COD income from the applicable instrument that is the deferred amount includible in the partner's share and the amount that is immediately includible. With respect to deferred COD income of an S corporation, Temp. Reg. § 1.108(i)-2T(c)(1) requires that on an election by the S corporation, deferred income must be shared pro rata on the basis of stock ownership immediately prior to the reacquisition.
- Temp. Reg. § 1.108(i)-2T(b)(2) provides that a partner's basis is not adjusted under § 705(a) to account for the partner's share of partnership deferred COD income until the deferred item is recognized by the partner. Likewise, § 1.108(i)-2T(c)(2) provides that neither an S corporation shareholder's basis under § 1367 nor the shareholder's accumulated adjustment account is adjusted for deferred COD income until the shareholder recognizes the deferred COD income.
- Following the rules of Rev. Proc. 2009-37, and applying the rules of § 108(i)(6), Temp. Reg. § 1.108(i)-2T(b)(3) provides that reduction in a partner's share of partnership liabilities is determined under § 752(b) when a debt instrument is reacquired, but that the reduction in liabilities is not treated as a distribution of money until deferred COD income is recognized by the partner. The temporary regulations provide additional rules for determining a partner's deferred amounts where the partner would recognize § 731 gain in the year of the reacquisition.
- Partners' capital accounts are adjusted as if no § 108(i) election were made.
- Temp. Reg. § 1.108(i)-2T(d)(3) provides that gain attributable to a reduction in a partner's or S corporation shareholder's amount at-risk under § 465(e) will not be taken into account in the year of reacquisition and will be deferred to the date the COD income is recognized.
- In the case of an acceleration event under § 108(i)(5)(D) that requires a partnership or S corporation to recognize deferred items, under Temp. Reg. § 1.108(i)-2T(c)(3) the partners or S corporation shareholders must account for deferred COD in the year that the accelerating event takes place. In addition, the temporary regulations describe[d] various circumstances in which a partner or S corporation shareholder terminates the interest in the entity that will require acceleration of deferred COD income, including death, liquidation, sale or exchange, redemption, or abandonment.
- Identical proposed regulations were issued simultaneously. REG-144762-09, Application of Section 108(i) to Partnerships and S Corporations, 75 F.R. 49427 (8/13/10).

c. Significant guidance on a soon to expire beneficial Code section that leaves a nasty hangover. T.D. 9497, Guidance Regarding Deferred Discharge of Indebtedness Income of Corporations and Deferred Original Issue Discount Deductions, 75 F.R. 49394 (8/13/10). The IRS and Treasury have promulgated Temp. Reg. §§ 1.108(i)-0T through 1.108(i)-3T providing detailed rules for C corporations regarding the acceleration of deferred

COD income and deferred OID deductions under § 108(i)(5)(D), and the calculation of earnings and profits as a result of an election under § 108(i). The regulations also provide rules applicable to all taxpayers regarding deferred OID deductions under § 108(i) as a result of a reacquisition of an applicable debt instrument by an issuer or related party.

- Identical proposed regulations were issued simultaneously. REG-142800-09, Guidance Regarding Deferred Discharge of Indebtedness Income of Corporations and Deferred Original Issue Discount Deductions, 75 F.R. 49428 (8/13/10).

d. Final guidance on an expired Code section. T.D. 9622, Guidance Regarding Deferred Discharge of Indebtedness Income of Corporations and Deferred Original Issue Discount Deductions, 78 F.R. 39984 (7/2/13). The Treasury Department has finalized the proposed regulations (REG-142800-09, 75 F.R. 49428 (8/13/10)) regarding deferred discharge of indebtedness income of corporations and deferred original issue discount deductions and replaced the Temporary Regulations promulgated in T.D. 9497, 75 F.R. 49394 (8/13/10), without significant changes.

e. More final guidance on an expired Code section. T.D. 9623; Application of Section 108(i) to Partnerships and S Corporations 78 F.R. 39973 (7/2/13). The Treasury Department has finalized the proposed regulations (REG-144762-09, 75 F.R. 49427 (8/13/10)) regarding application of § 108(i) to partnerships and S corporations, and has replaced the Temporary Regulations promulgated in T.D. 9498, 75 F.R. 49380 (8/13/10), with some changes.

B. Deductible Expenses versus Capitalization

1. Temporary and proposed regulations provide extensive rules for the acquisition, production, or improvement of tangible personal property. T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11), and REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81128 (12/27/11). The Treasury Department has promulgated temporary regulations, generally effective for tax years beginning on or after 1/1/12, addressing capitalization requirements for expenditures to acquire and improve tangible property. The temporary regulations adopt provisions of regulations proposed in 2008 (REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 73 F.R. 12838 (3/10/08)), which were in turn based on a 2006 proposal that was substantially modified by the 2008 proposed regulations (REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 71 F.R. 48590 (8/21/06)). The temporary regulations provide detailed capitalization rules and several bright-line standards under §§ 162(a) and 263(a) regarding the acquisition, improvement, or repair of tangible real and personal property. The temporary regulations also revise rules under § 168 regarding disposition and maintenance of general asset accounts for MACRS property. In general, the regulations adopt the provisions of the 2008 proposed regulations, but with multiple modifications. Temp. Reg. § 1.263(a)-2T provides rules for amounts paid for the acquisition or production of tangible property, and § 1.263(a)-3T provides rules for amounts paid for the improvement of tangible property. However, these new proposed regulations provide many additional rules. The temporary regulations define material and supplies to treat as deductible (1) the cost of any property with a useful life that does not exceed one year and (2) any item that cost not more than $100. They add a book-conformity de minimis rule, a safe-harbor for routine maintenance, and an optional simplified method for regulated taxpayers. The temporary regulations contain provisions defining a unit of property as a key concept and address capitalization of expenditures that improve or restore a unit of property. The regulations do not provide for a detailed repair allowance rule, but do provide for future I.R.B. guidance regarding industry-specific repair allowance methods.

a. IRS specifies the procedures for adopting new accounting methods under the Temporary Regulations. Rev. Proc. 2012-19, 2012-14 I.R.B. 689 (3/7/12), *modifying* Rev. Proc. 2011-14, 2011-1 C.B. 330. The IRS has provided lengthy and detailed rules regarding automatic changes in methods of accounting under Temp Reg. §§ 1.162-3T and -4T

(materials and supplies), 1.263 (a)-1T (capital expenditures in general), 1.263 (a)-2T (transaction costs), and 1.263(a)-3T (improvements), all added by T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11). These changes are for taxable years beginning on or after January 1, 2012.

b. LB&I provides guidance under Rev. Proc. 2012-19. LB&I-4-0312-004 (3/15/12). This directive to the field applies to taxpayers who adopted a method of accounting relating to the conversion of capitalized assets to repair expense under § 263(a).

c. Have your clients been wasting time trying to comply with the Temporary Regulations in 2012? Yes, they have. Further guidance announcing that pending final regulations will apply only in years beginning in 2014 and thereafter. Notice 2012-73, 2012-51 I.R.B. 713 (11/20/12). The IRS announced that pending final regulations will apply to taxable years beginning on or after 1/1/14, but that taxpayers will be permitted to apply the final regulations to taxable years beginning on or after 1/1/12. The notice also indicates that the temporary regulations may be revised with respect to the de minimis rule of § 1.263(a)-2T(g); dispositions under §§ 1.168(i)-1T and 1.168(i)-8T; and the Safe Harbor for Routine Maintenance under § 1.263(a)-3T(g).

d. Technical amendments so revise the Temporary Regulations. More important, the effective date of the 12/27/11 temporary regulations is delayed to years beginning on or after 1/1/14, with optional retroactive applicability. T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 77 F.R. 74583 (12/17/12). These include the following explanation:

> [T]he IRS and the Treasury are concerned that taxpayers are expending resources to comply with temporary regulations that may not be consistent with forthcoming final regulations.

e. This announcement amends — really!!?? Announcement 2013-7, 2013-3 I.R.B. 308 (1/14/13). An announcement amending regulations — the temporary regulations (T.D. 9564), regarding the deduction and capitalization of expenditures under §§ 162(a) and 263(a) relating to tangible property to apply to taxable years beginning on or after 1/1/14, while permitting taxpayers to apply the temporary regulations for taxable years beginning on or after 1/1/12, and before the applicability date of the final regulations.

f. A minor fix. Ann. 2013-4, 2013-4 I.R.B. 440 (1/18/13). The IRS corrected the temporary regulations to provide in § 1.168(i)-l(*l*)(2) rules for making general asset account elections on Form 4562. The amendment corrects paragraph numbering mistakes.

2. Electricity and hot air — the IRS defines unit of property for generators of steam and electricity. Rev. Proc. 2013-24, 2013-21 I.R.B. 1142 (4/30/13). Under Temp. Reg. § 1.263(a)-3T, which requires capitalization of expenditures to improve, better, or restore a unit of property, interdependent major components are treated as a part of a unit of property. Temp. Reg. § 1.162-4T allows as a deductible repair expense any costs that are not required to be capitalized under Temp. Reg. § 1.263(a)-3T. In the case of power plants generating steam or electricity, the Revenue Procedure provides a list of properties that will be treated, at the taxpayer's election, as separate units of property within a power station and identifies major components of the units of property. The revenue procedure adds that a taxpayer's method for determining whether an expenditure must be capitalized or is deductible, including the taxpayer's definitions of a unit of property or major components of a unit of property, is a method of accounting under § 446 and will be subject to § 481 adjustments and the automatic consent rules for adopting the unit of property definitions provided in Appendix A of the revenue procedure. In general, the Appendix lists numerous systems within a generating facility (such as turbines) as separate units of property and identifies major components of the units of property. The definitions of Rev. Proc. 2013-24 are limited to determinations for purposes of the capitalization/repair rules and may not be used for other purposes such as depreciation.

3. Proposed regulations restrict negative numbers in allocating indirect costs under the complicated "simplified methods rules." REG-126770-06, Allocation of Costs

Under the Simplified Methods, 77 F.R. 54482 (9/5/12). Section 263A requires capitalization of all direct and indirect costs into goods produced during the year and inventory, so-called § 471 costs that must be included in inventory. Section 263A costs may be allocated on a facts and circumstances basis, or the taxpayer may use the simplified resale or simplified production methods provided in Reg. §§ 1.263A-2(b) and 1.263A-3(d) to allocate costs to eligible property produced or held for resale in lieu of a facts-and-circumstances allocation method. Under the simplified method a pool of additional capitalized § 263A costs (indirect costs not otherwise includible in inventory under the taxpayer's method of accounting) may be allocated among ending inventory and costs of goods sold based on an "absorption ratio" of such costs to the taxpayer's total § 471 inventory costs. In some circumstances the simplified method will produce negative amounts that cause distortions in inventory accounting, generally when a taxpayer capitalized a cost as an inventory cost that is greater than the amount required to be capitalized for tax purposes. Proposed Reg. § 1.263A-2(b) would, with certain exceptions, prevent taxpayers from using negative amounts in determining additional § 263A costs. Producers with average annual gross receipts of less than $10,000,000 would be allowed to continue to include negative amounts in additional § 263A costs. Retailers who use the simplified resale method would be permitted to remove inventory costs that are not required to be capitalized for tax purposes from ending inventory by treating them as negative additional § 263A costs.

- The proposed regulations include a modified simplified production method that would allow producers to separately determine the allocation of preproduction related additional § 263A costs using a preproduction cost absorption ratio applied to capitalized inventory costs for raw materials.

- The proposed regulations would redefine a taxpayer's "additional § 263A costs" for purposes of the simplified methods as costs, other than interest, that a taxpayer capitalized to its inventory in its financial statements. The definition would provide, however, that a taxpayer must include all direct costs in its § 471 costs regardless of the taxpayer's treatment of the costs in its financial statements.

4. Tax expenditures for movies and television. The Compromise Tax Relief Act of 2010, § 744, extends the election under Code § 181 to expense up to $15 million of qualified film and television production costs if 75 percent of total compensation is for services performed in the U.S. The limit is $20 million for production costs incurred in low-income or distressed communities through 2011.

a. Final regulations come out just in time for the expiration date of the statute. T.D. 9551, Deduction for Qualified Film and Television Production Costs, 76 F.R. 60721 (9/30/11). Section 181 provides for an election to deduct qualified film or television production costs incurred in productions commenced prior to 1/1/12, as an expense not chargeable to capital account in an amount up to $15 million for each production, or $20 million for production expenses incurred in certain low income or distressed county areas. A production qualifies for the election if at least 75 percent of the total compensation for the production is for services performed in the United States by actors, directors, producers, and production personnel. Final regulations §§ 1.181-1 through -6, replacing temporary and proposed regulations, clarify the owner of production costs, the definition of aggregate production costs for purposes of the election and limitations, and provisions applicable to participations and residuals.

b. Temporary and proposed regulations update the rules. REG-146297-09, Deduction for Qualified Film and Television Production Costs, 76 F.R. 64879 (10/19/11). The temporary (Reg. §§ 1.181-0T, 1.181-1T) and proposed regulations clarify that the $15 million (or $20 million) limitation under amendments to § 181 applies to limit the aggregate deduction for production costs paid or incurred by all owners of a qualified film or television production for each qualified production, rather than limit the aggregate production costs.

c. And now, "final" final regulations after the provision expired. T.D. 9603, Deduction for Qualified Film and Television Production Costs, 77 F.R. 72923 (12/7/12). The final regulations (Reg. §§ 1.181-0, 1.181-1) remove the temporary regulations,

and provide that whether production costs qualify for pre- or post-1/1/08 limitations, compensation to actors is allocated to first unit principal photography.

d. Special expensing rules for film and television productions were extended to 2012 and 2013. The 2012 Taxpayer Relief Tax Act, § 317, extends through the end of 2013 the election under Code § 181 to expense up to $15 million of qualified film and television production costs if 75 percent of total compensation is for services performed in the U.S.

- The limit is $20 million for production costs incurred in low-income or distressed communities. Are any members of the film crew residents of those communities?

5. Law firm advances of litigation expenses were loans, not deductible expenses. Humphrey, Farrington & McClain v. Commissioner, T.C. Memo. 2013-23 (1/17/13). The cash method taxpayer plaintiff's law firm maintained a classification system for litigation costs advanced to clients in contingent fee cases. If the firm considered the likelihood of reimbursement to be high, the advanced costs were capitalized. In riskier cases where the firm considered the likelihood of reimbursement to be low, the firm deducted the advanced expenses, and reported reimbursement as income as advances were repaid. The Tax Court (Judge Morrison) held that the advanced litigation costs were loans in all cases, even if eventual recovery of the advances was contingent, and disallowed the deductions. The court found that there was a significant possibility of reimbursement, a factor that supported treating the advances as loans. The court also agreed with the IRS that the treatment of the advances as loans was a change in the taxpayer's method of accounting, which did not clearly reflect income, and, therefore, allowed adjustments under § 481 with respect to prior years. Nonetheless, the court found that the taxpayer's classification method was a reasonable attempt to ascertain the tax treatment of advanced expenses which qualified for the reasonable cause exception to § 6662 penalties.

6. Protecting directors from cement shoes in a shareholder class-action arising from a merger subject to capitalization. Why apply modern regulations when old case law will do the trick? Ash Grove Cement Company v. United States, 111 A.F.T.R.2d 2013-767 (D. Kan. 2/6/13). The taxpayer settled a class action lawsuit by minority shareholders against itself and its directors arising out the acquisition of another corporation in a reorganization. The District Court (Judge Murguia) granted summary judgment for the government, holding that both the settlement payment and litigation expenses incurred by the taxpayer in resolving the class action lawsuit were capital expenditures under § 263. The origin of the claim for which the taxpayer incurred the expenses arose from a capital transaction. Even though the payments related to the taxpayer's 2005 return, the court applied the case law based "origin of the claim" test, *e.g.*, *Woodward v. Commissioner*, 397 U.S. 572 (1970), rather than Reg. § 1.263(a)-5, which was promulgated in 2003. The court held that the litigation expenses arose out of the acquisition transactions and were thus capital expenses under the origin of the claim test. The court rejected the taxpayer's argument that expenses incurred to indemnify directors from legal claims were deductible. The court pointed out that under the taxpayer's approach, "companies could always deduct litigation expense any time a director acting in good faith is sued in connection with a capital transaction so long as the company has an indemnity obligation."

7. With global warming these plants are growing faster. Notice 2013-18, 2013-14 I.R.B. 742 (2/19/13); Rev. Proc. 2013-20, 2013-14 I.R.B. 744 (2/19/13). The IRS has revised the categories of "berries" as plants that do not have a pre-productive growth period in excess of two years to segregate blueberry, blackberry, and raspberry plants, and removed papaya plants from the list. Under § 263A(d)(1) and Reg. § 1.263A-4(d) farmers who are not required to use the accrual method of accounting (and who are not tax shelters) are not required to capitalize the costs of raising animals or the costs of producing plants with a pre-productive period of two years or less. The IRS maintains a list of qualifying plants based on the nationwide pre-productive period for plants. The accompanying revenue procedure provides procedures for a taxpayer to obtain automatic consent to not apply § 263A to the production of plants removed

from the list of plants that have a nationwide weighted average pre-production period in excess of two years.

8. Research to eliminate uncertainty is deductible under proposed regulations. What about the uncertainty of tax advice? REG-124148-05, Research Expenditures, 78 F.R. 54796 (9/6/13). Section 174 allows either deduction or 60 month amortization of research and experimental expenditures, but under § 174(c) the § 174 deduction is not applicable to expenditures for the acquisition or improvement of land or depreciable property. Reg. § 1.174-2(a)(1) defines research and experimental expenditures as expenditures that represent "research and development costs in the experimental or laboratory sense" and provide in § 1.174-2(b)(1) that depreciation allowances on depreciable property used in research are § 174 expenditures. The proposed regulations would provide that expenditures may qualify under § 174 regardless of whether a resulting product is sold or used in the taxpayer's trade or business and that the depreciable property rule is an application of the general definition of research and experimental expenditures.

- The proposed regulations § 1.174-2(a)(1) would provide that the ultimate success, failure, sale or use of a product in not relevant to a determination of eligibility of expenditures as research or experimental expenditures under § 174.
- As an application of the general definition of research expenditures, the depreciable property rule should not be applied to exclude otherwise eligible expenditures.
- Under Reg. § 1.174-(a)(2) research expenditures to develop a product include development of a pilot model. Prop. Reg. § 1.174-2(a)(4) would define a pilot model as "any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product."
- The proposed regulations would amend Reg. § 1.174-2(a)(1) to "clarify" that production costs after uncertainty is eliminated are not eligible under § 174 by providing that "Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated."
- Prop. Reg. § 1.174-2(a)(5) would adopt a "shrinking back rule" that would provide that research and experimental expenditures for the improvement of a component of a larger design may be eligible under § 174, but uncertainty with respect to a component does not necessarily indicate uncertainty with respect to the product as a whole.
- Although the proposed regulations will be effective on publication of final regulations in the Federal Register, the proposed regulations indicate that the IRS will not challenge expenditures that conform to the proposed regulations.

C. Reasonable Compensation

1. You can save the failing nursing home, but don't pay yourself too much. Thousand Oaks Residential Care Home I, Inc. v. Commissioner, T.C. Memo. 2013-10 (1/14/13). The husband and wife shareholders took over a failing retirement home and turned it into a profitable operation. In the years at issue the Fletchers each received approximately $200,000 of compensation plus contributions to a defined benefit plan for each of approximately $191,000 for services respectively as the overall manager and head nurse. The Tax Court (Judge Goeke) agreed that the compensation to the taxpayers was catch-up compensation for years when the corporation provided little compensation, that the compensation levels were below national norms, that the corporation's cash-flow was marginally sufficient to pay its bills including acquisition indebtedness, but that the Fletchers as the shareholders used all of the profits to pay salaries and never received a dividend. The deciding factor for the court's holding that the compensation was unreasonable was that independent investors would have demanded at least a 10 percent return on their investment and that the compensation packages "did not leave enough of the corporation's assets to be paid back to the hypothetical investor as a return on investment." The court also held that compensation paid to the Fletchers' daughter was unreasonable. The court further declined the IRS's invitation to impose additions to tax under § 6651 and § 6662 accuracy related penalties, finding that the taxpayer reasonably relied on the advice of its

accountant (with the exception of penalties related to the compensation paid to the Fletchers' daughter).

a. And don't press your luck by seeking costs as a prevailing party. Thousand Oaks Residential Care Home I, Inc. v. Commissioner, T.C. Memo. 2013-156 (6/20/13). The taxpayers moved for reasonable administrative and litigation costs pursuant to § 7430, which permits the award of such costs to a prevailing party. The IRS "conceded that . . . petitioners ha[d] 'substantially prevailed with respect to the most significant issues or set of issues in . . . [their] case[s] . . . .'" Nevertheless, the court (Judge Wherry) denied the taxpayers' motion on the ground that the position of the IRS in the case was reasonable and substantially justified. "The testimony of [the IRS's] expert, the numerous factual issues surrounding the decision, and the total disallowance of all compensation paid to the owner-employees' daughter ... demonstrate that [the IRS] acted reasonably given the facts and circumstances." Therefore § 7430(c)(4)(B) precluded awarding attorney's fees.

2. IRS experts prevail on reasonable compensation issues – surprise! K&K Veterinary Supply, Inc. v. Commissioner, T.C. Memo. 2013-84 (3/25/13). The taxpayer, a wholesaler of animal health products, was wholly owned by John Lipsmeyer, who was employed as its chief executive and worked as a principal sales representative. The taxpayer employed John's wife, Melissa, as vice president, secretary and assistant financial officer, John's brother David as senior vice president of sales, co-chief executive officer and co-chief operative officer who also handled 50 accounts, and David's daughter Jenifer as the chief financial officer. Accepting the IRS expert's evaluation, the Tax Court (Judge Cohen) reduced the corporation's deductions for compensation paid to the sole shareholder/employee and related parties. The court considered nine factors in evaluating reasonable compensation. Among those factors, the court determined that although John and David had significant experience with the corporation's operations and were important to its success, the record did not establish that either of them was the primary reason for the taxpayer's growth. The court indicated Jennifer's importance to the corporate success, but stated that the record fell short of establishing that she was exceptionally qualified or the primary reason for the corporation's growth. The court also stated that the record fell "far short" of establishing Martha's exceptional qualification or contribution to growth. Rejecting the taxpayer's expert analysis, the court accepted the prevailing salary comparison figures offered by the IRS expert and the IRS expert's conclusion of reasonable compensation from comparable companies at the 75th percentile.

- The court also rejected the taxpayer's assertion of an "equitable recoupment" to reduce the corporation's tax liability by the amount of lower taxes payable by shareholders if the excess compensation had been distributed to the shareholder as a dividend rather than reported by them as compensation income. The court listed four elements required for equitable recoupment to apply: "(1) the overpayment or deficiency for which recoupment is sought by way of offset is barred by an expired period of limitation; (2) the time-barred overpayment or deficiency arose out of the same transaction, item, or taxable event as the overpayment or deficiency before the Court; (3) the transaction, item, or taxable event has been inconsistently subjected to two taxes; and (4) if the transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes that the taxpayers should be treated as one." *United States v. Dalm*, 494 U.S. 596 (1990). The court held that equitable recoupment was not available to the corporation because the denial of the corporate level deduction and the tax on dividends involved two or more taxpayers with insufficient identity of interest to be treated as a single taxpayer. The court observed that a corporation formed for legitimate business purposes and its shareholders are separate entities.

3. Increasing the value of the company deserves some bonus, but not all of it. Aries Communications, Inc. v. Commissioner, T.C. Memo. 2013-97 (4/10/13). In another case appealable to the Ninth Circuit, the Tax Court (Judge Wherry) applied the five factors of *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241(9th Cir. 1983), plus additional consideration of whether an independent investor would compensate the employee at the claimed amount, to reduce the taxpayer's corporate deduction for compensation to its sole shareholder. The taxpayer sold its radio stations in the year at issues for a price that was $6 million higher than an initial

offer. The taxpayer's development of the stations and the higher purchase price were attributable to the efforts of the shareholder/CEO, Arthur Astor, who received annual compensation plus a bonus totaling approximately $6.9 million.

- The court concluded that Astor was the most important employee of the taxpayer and agreed that compensation attributable to prior years service as catch-up compensation allowed compensation that need not be reasonable in the year paid. The fact that Astor played a pivotal role in both operating the taxpayer and negotiating the higher price for the sale of assets functioning as an employee of the taxpayer was a factor favoring the taxpayer's deduction of the compensation.
- The court considered the linear regression analysis of dueling experts regarding comparison with salaries of similar companies, but had difficulty with application comparisons with publically held companies. The court ultimately concluded that a bonus equivalent to one-third of the negotiated increased sales price was reasonable.
- The court described the character of the company as a large asset-laden complex business with a negative net income and bleak financial picture, a factor that favored the IRS evaluation of reasonable compensation.
- The court indicated that Astor's conflict of interest in protecting the company as a going concern and his interest as owner in garnering the highest price for the assets and receiving the reward as deductible salary favored the IRS.
- The corporation's internal inconsistency in treatment of payments to employees as bonuses at the end of the year when it could predict profits and potential federal income tax liability favored the IRS.
- Finally, as a factor added to the *Elliotts* list, the court determined that the corporation retained sufficient earnings to satisfy an independent investor at 20 percent compound annual return on equity, the independent investor test supported the corporation's level of compensation.
- At the end of the day, the court determined, based on the experts' testimony that Astor's fixed compensation was underpaid but the bonus was unreasonable and allowed a deduction of $2,660,889. The court also imposed an accuracy related penalty under § 6662(a) finding that the Astor's conversation with the corporation's accountants was not reasonable reliance on a tax professional.

D. Miscellaneous Deductions

1. Standard mileage rate rules published in a revenue procedure while the amounts will be disclosed in a separate notice. Rev. Proc. 2010-51, 2010-51 I.R.B. 883 (12/3/10). The IRS indicated that beginning in 2011 it will publish mileage rates in a separate annual notice. The revenue procedure indicated that a taxpayer may use the business standard mileage rate to substantiate expenses for business use of an automobile in lieu of fixed and variable costs. Parking fees and tolls are deductible as separate items. The basis of an automobile used for business is reduced by a per-mile amount published in the annual notice. Separate rates are provided both for charitable use of an automobile and medical and moving use of an automobile. The revenue procedure also provides details for treating as substantiated a fixed and variable rate allowance for expenses incurred by an employee in driving an automobile owned or leased by the employee in performing services for the employer.

a. Add one cent per mile for 2013 (except for charitable service). Notice 2012-72, 2012-50 I.R.B. 613 (11/21/12). The standard mileage rate for business miles in 2013 goes up to 56.5 cents per mile (with 23 cents representing depreciation), and the medical/moving rate goes up to 24 cents per mile. The charitable mileage rate remains fixed by § 170(i) at 14 cents.

b. The IRS announces per diem rates for travel away from home. Notice 2012-63, 2012-42 I.R.B. 496 (9/26/12). Per diem reimbursement rates in lieu of substantiated expenses under Rev. Proc. 2011-47, 2011-42 I.R.B. 520, effective for travel after 10/1/12, are unchanged from 2011. One revision, however, removes transportation expenses between points, lodging and meals, and mailing expense for travel vouchers from incidental

expenses, so that these items may be separately reimbursed for travelers using the per diem method. Per diem rates are as follows:

- The special meals and incidental rates for the transportation industry are $59 within CONUS and $64 OCONUS.
- Incidental expense deduction for any location is $5 per day (the IRS believes in cheap tippers).
- Rates for travel within CONUS are $242 per day for high cost localities (listed in the notice) and $163 for all others. The portion allowed for meals is $65 in a high-cost locality and $52 for others.

c. Rev. Rul. 2012-27, 2012-41 I.R.B. 435 (10/4/12). The IRS has provided standard industry fare level cents-per-mile and terminal charges for the second half of 2012 for determining the value of non-commercial flights on employer provided aircraft. Under Reg. § 1.61-21(g) the value of a non-commercial flight is determined by multiplying the standard industry fare cents-per-mile rate by the applicable aircraft multiple and adding the applicable terminal charge.

2. IRS values noncommercial flight. Rev. Rul. 2013-8, 2013-15 I.R.B. 763 (4/4/13). The value of noncommercial flights on employer owned aircraft is determined by multiplying the cents-per-mile for the applicable period by the appropriate aircraft multiple and adding the applicable terminal charge. The mileage rates for the first half of 2013 are $0.2655 per mile up to 500 miles, $0.2024 for 501-1500 miles, then $0.1946 over 1500 miles. The terminal charge for the first half of 2013 is $48.54.

3. The Tax Court strikes a blow to the travel expense of two-earner couples. Noz v. Commissioner, T.C. Memo 2012-272 (9/24/12). The court (Judge Morrison) disallowed travel expense deductions to married taxpayers who worked as university professors, one in New York, one in Stockholm. Although the married taxpayers collaborated with each other on articles and books, the court held, "On the basis of the frequency of travel, the personal relationship between the petitioners, and the petitioners' failure to offer any evidence, beyond broad generalities, of how the trips advanced any stated business purpose, we find that the New York-Stockholm trips were motivated primarily by personal concerns."

4. Selling insurance is a service business not allowed a cost of goods sold, even to a former IRS agent. Perry v. Commissioner, T.C. Memo. 2012-237 (8/16/12). Along with denying unsubstantiated travel and business expenses (including $3,000 to an airline employee to be designated her "travel companion" for discounted airfare), the Tax Court (Judge Kroupa) held that the taxpayer's business of selling insurance was not the sale of a material product to which direct cost may be allocated to reduce gross receipts as cost of goods sold.

5. IRS tries to put a lid on wages recharacterized as reimbursements. Rev. Rul. 2012-25, 2012-37 I.R.B. 337 (9/10/12). The IRS ruled that certain employer arrangements that substitute reimbursement for tools, travel, supplies and the like under a purported "accountable plan" for compensation for services do not meet the business connection requirement of § 62(c) and therefore fail as accountable plans. The IRS noted that such plans are intended to avoid the two-percent limitation on deduction of employee business expenses and payment of employment taxes on wages that are recharacterized as reimbursements. Citing Reg. § 1.62-2(d), the ruling indicates with three factual situations that the business connection requirement is not met where hourly compensation is reduced and replaced with a reimbursement arrangement that pays the same gross amount to the employee regardless of whether the employee incurs deductible business expenses. The ruling states that the fact that the employee actually incurs a deductible expense in connection with employment does not cure the wage recharacterization. Second, a plan that pays the same amount of reimbursement to employees who have not actually incurred deductible expenses in connection with the employer's business fails the business connection requirement. In situation 4 of the ruling, the IRS indicates that a plan that reduces hourly compensation but only reimburses employees who incur expenses in connection with the employer's business and who are required to substantiate expenses, qualifies as a reimbursement plan notwithstanding substitution for the reimbursement plan for a portion of the hourly compensation.

6. Texas professors denied bad debt deductions for related entity loans. Herrera v. Commissioner, T.C. Memo. 2012-308 (11/5/12). The Tax Court (Judge Wherry) denied business bad debt deductions under § 166 for advances by one LLC to its sister, both of which were owned by two University of Texas El Paso engineering professors who used the LLCs for consulting and metal fabrication activities. Citing the 13 factors identified by the Fifth Circuit in *Texas Farm Bureau v. United States*, 725 F.2d 307 (5th Cir. 1984), the court found that advances were not bona fide debt, stressing the lack of a promissory note, the lack of a definitive maturity date, the lack of a repayment schedule, de facto subordination of the debt to other creditors, the absence of a requirement for security, and the fact that the source of payment was tied to the fortunes of the business. The court stressed the fact that no interest was paid as being particularly important.

7. Friends from the Cheers bar don't provide business bad debt deductions until all hope is gone. Alioto v. Commissioner, 699 F.3d 948 (6th Cir. 11/7/12). After the taxpayer hired John Ratzenberger (famous for his role in Cheers) he entered into a business venture with Ratzenberger to use celebrity talent in short form media to be sold as internet advertising. The taxpayer contended that he expected to be fully reimbursed for advances of his own money to the venture. Affirming the Tax Court (T.C. Memo. 2011-151), the Sixth Circuit (Judge Moore) denied business bad debt deductions because the taxpayer failed to meet his burden of proof that his losses were no longer subject to a reasonable prospect of recovery. The court rejected the taxpayer's testimony that he had received an e-mail from Ratzenberger's agent notifying the taxpayer that no further reimbursement would be forthcoming as insufficient proof, nor did the court accept the fact that the taxpayer filed bankruptcy as evidence that the debt was not recoverable. The court also denied the taxpayer's claim for a theft loss on the ground that there was no proof that Ratzenberger's actions amounted to larceny under Massachusetts law.

8. Puerto Rico may not be a state, but it's part of the U.S.A. for § 199 domestic production purposes. The 2012 Taxpayer Relief Tax Act, § 318, extends inclusion of manufacturing and production activities in Puerto Rico as domestic production activities for purposes of the § 199 domestic production activities deduction for the first eight years of a taxpayer beginning after 12/31/05 and before 1/1/14. Previously § 199 applied to the first six years of a taxpayer beginning after 12/31/05 and before 1/1/12.

9. Extended power to empowerment zones. The 2012 Taxpayer Relief Tax Act, § 327, extends designations of empowerment zones through 12/31/13. The designations, which were set to expire on 12/31/11, extends a 20 percent wage credit under § 1396, additional $35,000 of first year expensing under § 179, tax-exempt bond financing under § 1394, and capital gains deferral on replacement of qualified assets under § 1397B.

10. Really bad timing in the real estate appraisal business does not the debt make bad. Bishop v. Commissioner, T.C. Memo. 2013-98 (4/10/13). In April 2006 the taxpayer, shortly before leaving his position as President of IMPAC Mortgage Holdings, Inc., where he bought and sold pools of loans, advanced $300,000 (which he borrowed from a commercial lender) to Landmark Equities Group to assist in developing a public offering of Landmark. Landmark had developed an "Automated Valuation Model" product designed to quickly value mortgage loans for investment banks by aggregating title insurance information. The written note required monthly interest payments and was due in April 2007. Landmark failed to make payments on the note when due in 2006. The taxpayer indicated in testimony that he reviewed the financial health of Landmark and concluded that it should have been able to pay the interest, even though the real estate market was showing signs of trouble in 2006, but that Landmark would not be able to pay principal in 2006 if the taxpayer had invoked an acceleration clause in the note on default of the interest payments. Judge Laro concluded that the note was a bona fide indebtedness rejecting the IRS assertion that the advance was not a bona fide debt because the note was unsecured, Landmark was unable to borrow from a commercial lender, and the taxpayer did not demand payment in full when Landmark defaulted on interest payments. The court determined, however, that the taxpayer's unsubstantiated testimony regarding Landmark's financial health was insufficient to carry the burden of proof that the loan became

worthless in 2006. Because Landmark remained a going concern into 2007, the court indicated that some evidence of Landmark's ability or inability to turn the business around and generate income to pay the note was crucial. The court also sustained the IRS assertion of § 6662(a) penalties indicating that the taxpayer's failure to provide documentary evidence of Landmark's financial health to the taxpayer's CPA who prepared the return claiming the deduction prevented the taxpayer's reasonable reliance on the tax professional.

11. The threat of impending death does not reduce substantiation requirements. Striefel v. Commissioner, T.C. Memo. 2013-102 (4/11/13). The taxpayer worked as an independent contractor performing field engineering services for an engineering company. The taxpayer's work required travel away from home. The taxpayer received a "traumatic medical diagnosis" and was told that he would likely die soon. On his release from the hospital the taxpayer destroyed all of his old business records that he kept in a file cabinet. While expressing some sympathy regarding the hospitalization, the Tax Court (Judge Kerrigan) refused to accept the taxpayer's testimony and limited bank records as substantiation for automobile travel, meal, and lodging expenses. The court did allow deductions for some lodging expenses where the taxpayer's bank records matched his calendar entries and allowed deduction of per diem for meals on those dates. The court also sustained a § 6662(a) accuracy penalty stating that, "Although petitioner was understandably upset at the time, his actions were not justifiable, reasonable, or prudent under the circumstances. We find that petitioner acted negligently."

- Query whether his doctor told him to stop buying green bananas, or merely to stop taking out multi-year magazine subscriptions?
- Query whether taxpayer may recover for physician malpractice?

12. Stock valuation settlement produces imputed interest. Colorcon, Inc. v. United States, 111 A.F.T.R. 2d 2013-1843 (Fed. Cl. 4/30/13). To push out a minority shareholder, DB Trust, the taxpayer undertook a short-form merger of an 84 percent owned subsidiary under Pennsylvania law, which did not require a shareholder vote. After offering the minority interest holder an $82 million promissory note in 1999 at the time of the merger, the taxpayer in 2002 settled a suit claiming dissenter's rights and other claims with a payment of $191 million. The taxpayer filed a refund claim asserting that $31 million of the payment was deductible as imputed interest under § 483. Section 483 requires a taxpayer to impute unstated interest on account of a sale or exchange of property under a contract under which some or all of the payments are due more than one year after the sale or exchange. The IRS conceded that the 1999 merger was a sale or exchange. The IRS argued, however, that the payment was made pursuant to the 2002 settlement agreement in an action that sought to rescind that 1999 merger transaction, rather than payment for the stock in 1999. Looking to Pennsylvania law, the Court of Federal Claims (Judge Firestone) held that the 1999 short-form merger transaction transferred property as a matter of law and that at least a part of the $191 million settlement was paid for the shares. Granting summary judgment to the taxpayer, the court also held that the IRS did not raise a genuine factual dispute as to whether any portion of the $191 million payment was attributable to other claims.

13. A judge lets the jury decide how much of $126,796,262 of a $385,147,334 settlement payment under the False Claims Act is compensatory and how much is a nondeductible penalty. Fresenius Medical Care Holdings, Inc. v. United States, 111 A.F.T.R.2d 2013-1938 (D. Mass. 5/9/13). The taxpayer deducted the full amount of a $385,147,334 settlement with the government under the False Claims Act (for Medicare and Medicaid fraud), which provides for a penalty of not less than $5,000 and not more than $10,000 plus three times the amount of damages the government sustains. The settlement agreement was silent regarding the allocation of the payment between compensatory and punitive amounts, although it did allocate $65,800,555 to *qui tam* relators' awards. The agreement expressly disclaimed any resolution of the tax treatment of the payment. The IRS allowed a portion of the deduction but disallowed as a fine or similar penalty, which is nondeductible under § 162(f), $126,796,262 of the claimed deduction. The District Court denied cross motions for summary judgment because "real disputes remained about the purpose of the payments," and on a motion

for entry of judgment held that the jury properly determined that $95,000,000 of the disputed amount of the settlement paid to the government was compensatory and therefore deductible. The court explained that "a manifest agreement is not necessary for [the taxpayer] to establish that all or some portion of the payments at issue were made in settlement of non-punitive FCA liability." It concluded that "to determine whether the payments made by [the taxpayer] to the government in excess of the amount already deemed deductible by the IRS were compensatory damages, it was necessary to consider both the language of the settlement agreements and non-contractual evidence regarding the purpose and application of the payments."

14. The one who eats the food may not get the haircut: Final regulations allocate the § 274(n) limitations with respect to reimbursed meals. T.D. 9625, Reimbursed Entertainment Expenses, 78 F.R. 46502 (8/1/13). Section 274(n) limits otherwise allowable deductions for meals and entertainment to 50 percent of the expense. In the case of reimbursed meal or entertainment expenses that are not treated as income to the payor, § 274(e)(3) applies the limitation to the person claiming a deduction for the reimbursement. In *Transport Labor Contract/Leasing, Inc. v. Commissioner,* 461 F.3d 1030 (8th Cir. 2006), the court held that in a three-party reimbursement arrangement the § 274 limitation applied to the client who reimbursed an employee leasing company for meal expenses paid by the leasing company employer to contract truck drivers who were leased to a trucking company. The Eighth Circuit's opinion defined reimbursement arrangements by reference to definitions of an employer's accountable plan under § 62(a)(2)(A) and Reg. § 1.62-2. The regulations provide an independent definition of a reimbursement or expense allowance arrangement independent of the rules of § 62(a)(2)(A) and (c). Reg. § 1.274-2(f)(2)(iv)(a)(D) defines a reimbursement arrangement as one under which an employee or independent contractor receives an advance, allowance, or reimbursement from an employer, client, or contractor for expenses incurred by the recipient. A reimbursement plan involving payments to an independent contractor would have to be memorialized in a written agreement that identifies the party subject to the § 274 limitations.

- In the case of an employer, the limitations of § 274 apply to the employer's deduction of reimbursed expenses, except to the extent that the employer treats the reimbursement or other payment as compensation paid to the employee and wages for withholding purposes.
- In case of reimbursements to an independent contractor, the limitations apply to the independent contractor to the extent that the independent contractor does not account to the client or customer for meals and entertainment expenses under the substantiation rules of § 274(d). Where the independent contractor accounts for meal and entertainment expenses, the limitations are applicable to the client or customer. The person responsible for the § 274 limitations can be specified in a written agreement between the parties.
- The examples in the regulations indicate that in a multiple party arrangement each relationship will be treated as a two-party relationship subject to the independent contractor rules, which thus would impose the § 274 limitations upon the party that reimburses expenses substantiated to it by another party. Again, persons in multiparty reimbursement arrangements would be permitted to specify by agreement which party is subject to the § 274 limitations.

15. Its quest for § 199 deductions was not to be harried by the IRS. Houdini seals a wine bottle in a basket and escapes with domestic production deductions. United States v. Dean, 112 A.F.T.R.2d 2013-____ (C.D. Cal. 5/7/13). The court granted summary judgment to the taxpayer in the IRS's § 7405 suit to recover amounts erroneously refunded. The IRS had granted refunds to the taxpayer shareholders of an S corporation claiming § 199 deductions for domestic production activities. The S corporation, Houdini, Inc. ("Houdini") packages and markets gift baskets with wine and food items. Houdini purchases baskets manufactured to its specifications in China, plus fill materials and wine and food items from various suppliers. Houdini designs and packages gift baskets in its facilities in California. Section 199 provided a deduction for qualified production activities income of 3 percent for the years at issue and provides a deduction of 9 percent currently. "Qualified production activities income" is defined in § 199(c)(1) as the taxpayer's "domestic production gross receipts"

("DPGR") minus the related cost of goods sold and other expenses, losses, or deductions. DPGR is defined, in relevant part, as the taxpayer's gross receipts derived from "any lease, rental, license, sale, exchange, or other disposition of ... qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States." Reg. § 1.199-3(e)(1) defines manufacturing, etc. as "manufacturing, producing, growing, extracting, installing, developing, improving, and creating [qualified production property ("QPP")]; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles" but Reg. § 1.199-3(e)(1) adds that if a taxpayer "performs minor assembly of QPP and the taxpayer engages in no other MPGE [manufactured, produced, grown, or extracted] activity with respect to that QPP [qualified production property], the taxpayer's packaging, repackaging, labeling, or minor assembly does not qualify as MPGE with respect to that QPP." The District Court (Judge Selna) rejected the IRS's argument that Houdini's assembling gift baskets was merely assembly or packaging activity by noting that, "Houdini makes products suitable for use as gifts using machinery, according to an organized plan and with division of labor. Therefore, Houdini's production process may qualify as manufacturing or producing." Also noting that Houdini's activities may also qualify as packaging the court stated that, Houdini's "complex production process relies on both assembly line workers and machines. The final products, gift baskets and gift towers, are distinct in form and purpose from the individual items inside. The individual items would typically be purchased by consumers as ordinary groceries. But after Houdini's production process, they are transformed into a gift that is usually given during the holiday season." The court refused to interpret Reg. § 1.199-3(e), Ex. 6, indicating that customizing automobiles with purchased parts is not a manufacturing or production activity, as barring Houdini's § 199 deduction.

16. These fees are in the bag for the taxpayer who is in the trade or business of being a whistleblower. Bagley v. United States, 112 A.F.T.R.2d 2013-5602 (C.D. Cal. 8/5/13). The taxpayer was awarded $27,244,000 plus statutory attorney's fees of $9,407,295 as a relator in a False Claims Act prosecution of TRW that ultimately resulted in the recovery of $111 million by the U.S. government. In the taxpayer's refund suit the court concluded that the taxpayer was engaged in a trade or business of prosecuting the litigation and that the attorney's fees were deductible as ordinary and necessary business expenses under § 162(a). The taxpayer was actively involved with his attorneys in pursuing the claim from 1993 (when the taxpayer was laid off by TRW) until 2003, the year of the award. The court accepted the taxpayer's assertion that he performed the services in order to obtain the award and thus had a good faith expectation of profit from the venture. The taxpayer was said to conduct himself in much the same manner as a lawyer prosecuting a lawsuit and the taxpayer's expertise as an accountant with knowledge of TRW's systems, procedures, and where the bodies were buried, plus his expertise with Federal Acquisition Regulations, were critical to the government's recovery. The court observed the size and amount of the FCA award to the taxpayer "makes it clear that it found his expertise vital to the prosecution of these claims." The fact that the taxpayer knew about the fraudulent claims because he participated in them before he was laid off provided him with the knowledge and skills relevant to the subsequent trade or business. The court further observed that the taxpayer devoted significant time and effort to the activity that did not have recreational or personal aspects, which indicated an indication to derive a profit. The court indicated that devoting effort to an opportunity to earn a single substantial profit (without a history of similar profit and loss activity) can constitute a trade or business. Finally, the court concluded that the taxpayer's activities were regular and continuous in pursuit of profit.

> [I]t is indisputable that Bagley's activity as a relator occurred over a substantial period of time, and during that time period, Bagley devoted much of his time and energy to the tasks and responsibilities of investigating and litigating the FCA lawsuit. He pursued the FCA lawsuit "full time, in good faith, and with regularity," by performing a multitude of tasks: attending meetings, reviewing

documents that had been produced, creating and revising documents (memoranda, summaries, and court filings), doing damage calculations, and generally assisting his attorneys and the government in understanding the nature of the fraudulent claims and where they could find the documents and witnesses necessary to effectively litigate the case. This was not a hobby or an activity Bagley engaged in for pleasure or amusement.

- The court also rejected the IRS's assertion that under the origin of the claim test the taxpayer's award had its origin in the taxpayer's role as an informer whose contribution to the *qui tam* action is no different from other types of informants. The court concluded that the origin of the *qui tam* action is fraud against the government and indicated that the relator "acts as an agent or private attorney general for the government, and is provided an award for the 'information and services' provided while prosecuting that claim" and that the taxpayer's services had the indicia of a business enterprise.

E. Depreciation & Amortization

1. Shockwave's shocking mechanical defects fail to hook GO Zone bonus depreciation. Blakeney v. Commissioner, T.C. Memo. 2012-289 (10/15/12). In February 2006 the taxpayer took possession of a new $3.9 million charter fishing yacht, Shockwave, to be based in Orange Beach, Alabama, a city within the Gulf Opportunity Zone. Unfortunately multiple mechanical difficulties forced the boat to be tied up for repairs in the Caribbean until October 2006 when it was delivered to Orange Beach. Unfortunately, the fishing season ended in September so that the taxpayer was not able to charter the boat in Orange Beach during the remainder of 2006. The taxpayer did, however, manage to charter the boat in the Caribbean for 43 days between repairs. The 50 percent bonus depreciation deduction of § 1400N is available for property placed in service after 8/28/05, substantially all of the use of which in the active conduct of a trade or business is in the Gulf Opportunity Zone. The court (Judge Vasquez) held that the 74 days during which the boat was available for charter in Orange Beach constituted use within the GO zone, even though the boat was not hired for charter during that period. The court also held that the boat was not available for use during the time it was laid up for repairs. However, the court treated the 43 days of charter service in the Caribbean as use outside of the GO zone and held that the 63 percent use (74/117) within the GO zone was not substantially all under § 1400N(d)(2)(A)(ii). The court indicated that it was not necessary to address whether the 80 percent use requirement of Notice 2006-77, 2006-2 C.B. 590, was entitled to deference under *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

2. First year bonus depreciation extended for one year by the 2012 Taxpayer Relief Tax Act. The first year bonus depreciation of 50 percent of adjusted basis of property with a MACRS recovery period of 20 years or less is extended to property placed in service before 1/1/14 and to certain transportation property placed in service before 1/1/15. The 50 percent allowance is available for depreciable machinery and equipment and most other tangible personal property, and is available for computer software and certain leasehold improvements, the first use of which began with the taxpayer. The 2012 Act also extends the provisions in § 168(e)(3)(E) treating qualified leasehold improvement property and qualified restaurant property as 15 year property, also eligible for the first year bonus depreciation.

3. Section 179 limits are extended again – is this becoming permanent like research credits? The 2012 Taxpayer Relief Act, § 315(a) retroactively extended, the Code § 179 first year expensing for tax years beginning in 2012 and 2013 in an amount not to exceed $500,000 with a phase-out amount beginning at $2,000,000. For tax years beginning after 2013 the maximum deduction drops to $25,000 with the phase-out beginning at $200,000 (at least until the business community again makes sufficient campaign contributions to extend the higher numbers into later years).

a. The sunny side of inflation. Rev. Proc. 2011-52, 2011-45 I.R.B. 701, § 3.20 (11/7/11). As adjusted for inflation and before extension by the 2012 Act, as provided in § 179(b)(6), the 2012 ceiling for expensing machinery and equipment and certain other § 1231 property was $139,000, and the phase-out threshold was $560,000. The retroactive

application of the 2012 extension to tax years beginning in 2012 provided a windfall to taxpayers who exceeded the 2012 thresholds.

b. Section 179 is applied to computer software for another year. The 2012 Taxpayer Relief Act, extends for another year eligibility as qualified Code § 179 property to off-the-shelf computer software placed in service before 2014.

4. Mine safety equipment eligible for 50 percent expensing. The 2012 Act, § 316, extends the election under § 179E to expense 50 percent of mine safety equipment to apply to property placed in service on or before 12/31/13.

5. 2012 depreciation tables for business autos, light trucks, and vans are to be increased by the 2012 Tax Relief Act with an additional $8,000 of first year recovery. Rev. Proc. 2012-23, 2012-14 I.R.B. 712 (3/2/12). The IRS published depreciation tables with the depreciation limits for business use of small vehicles:

Passenger Automobiles with § 168(k) first year recovery,

1st Tax Year	*$11,160*
2nd Tax Year	*$5,100*
3rd Tax Year	*$3,050*
Each Succeeding Year	*$1,875*

Trucks and Vans with § 168(k) first year recovery,

1st Tax Year	*$11,360*
2nd Tax Year	*$5,300*
3rd Tax Year	*$3,150*
Each Succeeding Year	*$1,875*

Section 168(k), as extended by the 2012 Act to property placed in service by 12/31/13, provides an additional $8,000 first year recovery

Passenger Automobiles not eligible for § 168(k) first year recovery,

1st Tax Year	*$3,160*
2nd Tax Year	*$5,100*
3rd Tax Year	*$3,050*
Each Succeeding Year	*$1,875*

Trucks and Vans not eligible for § 168(k) first year recovery,

1st Tax Year	*$3,360*
2nd Tax Year	*$5,300*
3rd Tax Year	*$3,150*
Each Succeeding Year	*$1,875*

- The revenue procedure also has tables for leased vehicles.

6. The IRS identifies property eligible for 100 percent depreciation, including the unintended consequences for business autos. Rev. Proc. 2011-26, 2011-16 I.R.B. 664 (3/29/11). 2010 tax acts extended the placed-in-service date for property to be eligible for the § 168(k)(1) 50 percent first year depreciation allowance to property placed in service before 2013 (2014 in the case of certain property described in § 168(k)(2)(B) and (C)) and adopted § 168(k)(5) to allow a 100 percent depreciation deduction for qualified property acquired after 9/8/10 and before 1/1/12, and placed in service before 1/1/12. The revenue procedure sets out several rules for the application of these provisions.

- Reg. § 1.168(k)-1(b)(4)(iii)(C)(1) and (2) provide that if the larger part of self-constructed property commences before the applicable dates for the 50 percent depreciation deduction, components self-constructed after the effective date are also ineligible for the accelerated deduction. If the construction of the larger part of self-constructed property begins

before 9/9/10, but the qualified property otherwise qualifies for the 50 percent depreciation deduction, self-constructed components after 9/9/10, that are qualified property may be subject to an election to claim 100 percent depreciation deductions with respect to the component.

- Section 168(k)(2)(D)(iii) provides an election not to claim first year depreciation with respect to a "class of property" placed in service during the taxable year. Reg. § 1.168(k)-1(e)(2)(i) applies the election to each class of property described in § 168(e). The revenue procedure allows an election to claim 50 percent first year depreciation rather than 100 percent depreciation for a class of property.

a. The passenger automobile anomaly. The additional first year depreciation allowance is limited to $8,000 for passenger automobiles and light trucks subject to the § 280F limitations ($3,060, $4,900, $2,950 in years one through three respectively, and $1,775 in years four through six). Thus the first year depreciation allowance in year one is $11,060 ($3,060 plus $8,000). This allowance is treated as the 100 percent depreciation deduction. Under § 280F(a)(1)(B)(i), unrecovered passenger automobile basis is treated as a deductible expense (up to $1,775) in each year after the sixth year. Unless the taxpayer elects to forego 100 percent depreciation recovery with respect to a passenger automobile, the taxpayer would be treated as claiming 100 percent depreciation in year one, with no further deductions allowable in years two through six. The revenue procedure provides a safe harbor method of accounting that the taxpayer is deemed to apply by deducting depreciation of the passenger automobile for the first taxable year succeeding the placed-in-service year. In effect, the revenue procedure continues to treat passenger automobile and light truck depreciation as if the first year deduction were 50 percent depreciation.

b. The 2012 Act extends the eligibility to property placed in service before 1/1/14.

7. Not all self-created intangibles are nonamortizable. Fitch v. Commissioner, T.C. Memo. 2012-358 (12/26/12). The taxpayer sold his CPA practice to another accountant for $900,000 after suffering severe medical problems that led to brain surgery. Approximately 4-1/2 months after the sale, the purchaser suffered a seizure and was hospitalized. Five days later and in the same year as the original sale, the purchaser sold the practice back to the taxpayer for $900,000. The taxpayer claimed § 197 amortization deductions with respect to the cost of intangibles reflected in the $900,000 repurchase price, and the IRS denied the deductions. The IRS position was based on alternative arguments that (1) "the alleged sales agreements petitioners submitted are untrustworthy and the alleged sales did not take place," (2) that the original transaction was rescinded, and (3) that the taxpayer reacquired self-created intangibles in a series of related transactions. The Tax Court (Judge Vasquez) found that in light of the circumstances leading to each transaction, the two sales and purchase transactions were unrelated and genuine. Furthermore, the second transaction was not a mere rescission. Thus, the exception to the prohibition on amortization of certain self-created intangibles in Reg. § 1.197-2(d)(2)(iii)(C), which allows amortization if a taxpayer disposes of a self-created intangible and subsequently reacquires the intangible from a seller (in whose hands the intangible is amortizable) in an unrelated transaction, applied.

- The court dealt with the government argument that the second transaction was a rescission of the first by noting that a rescission required putting the parties back in the same place they were before the first transaction occurred, and this was not possible for an active business four and one-half months after the first transaction occurred. *See generally*, Sheldon I. Banoff, "Unwinding or Rescinding A Transaction: Good Tax Planning or Tax Fraud?" 62 Taxes 942 (December 1984).

- This case takes to an extreme the first part of the quotation from Heraclitus, who said "No man ever steps in the same river twice, for it's not the same river and he's not the same man." Compare *Hutcheson v. Commissioner*, T.C. Memo. 1996-127 (3/14/96), where the Tax Court (Judge Raum) rejected an argument that there was a rescission of a large block of Wal-Mart stock sold in the stock market because rescission would have required that each of the buyers in the sale be located and be persuaded to reverse each sale, and that was not done.

8. Tax incentives for "first peoples" -- accelerated depreciation for property on Indian Reservations is extended. The 2012 Tax Relief Act, extends the shortened recovery periods of § 168(j) to property placed in service on Indian reservations before 12/31/13.

9. No chickening out of the allocation agreement in an applicable asset acquisition — even after a cost segregation study. Peco Foods, Inc. v. Commissioner, T.C. Memo. 2012-18 (1/17/12). The taxpayer entered into an agreement with the sellers of two poultry processing plants that allocated a large portion of the purchase price to processing plants on which the taxpayer claimed depreciation deductions as nonresidential real property with a MACRS life of 39 years. The agreements separately listed agreed-upon prices for land, buildings, and machinery and equipment. Subsequently, after a cost segregation study, the taxpayer attempted to change its method of accounting to separate out components of the buildings as equipment and machinery and claim accelerated depreciation on the basis of shorter MACRS recovery periods. The Tax Court (Judge Laro) held that under *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967), and § 1060, unless the taxpayer could show fraud, undue influence, duress, etc., the taxpayer was bound by the purchase price allocation agreement. The court rejected the taxpayer's argument that nothing in § 1060 precluded the taxpayer from segregating components of assets broadly described as a production plant into components consisting of the real property and related equipment and machinery. The court also refused to accept the taxpayer's assertion that the agreements with the sellers should be disregarded because the use of the terms "processing plant building" and "real property improvements" were ambiguous. Finally the court agreed with the IRS that the IRS did not abuse its discretion in prohibiting the taxpayer from adopting depreciation schedules that were inconsistent with the terms of the purchase agreements.

a. And the Court of Appeals plucks the taxpayer too. Peco Foods, Inc. v. Commissioner, ___Fed. Appx. ___, 112 A.F.T.R.2d 2013-___ (11th Cir. 7/2/13). In a decision by Judge Hill, the Eleventh Circuit affirmed the Tax Court's decision. The Court of Appeals noted that (1) "both agreements contain the statement that the original allocation shall be used 'for all purposes (including financial accounting and tax purposes),'" (2) "[t]he parties allocated the purchase price among three assets: 'Real Property: Land,' 'Real Property: Improvements,' and 'Machinery, Equipment, Furnitures *[sic]* and Fixtures,'" (3) Peco intended "Processing Plant Building" to be treated as a single asset when it entered into the agreement, and (4) the term "processing plant building" in the agreements was unambiguous.

F. Credits

1. You can't consume your supplies in research and sell them too. Union Carbide Corp. v. Commissioner, 697 F.3d 104 (2d Cir. 9/7/12), *aff'g* T.C. Memo. 2009-50, *cert. denied* (3/18/13). The Second Circuit (Judge Pooler) held that raw materials used in three discontinued research products that were ultimately converted to products sold by the taxpayer were not eligible for inclusion as part of qualified research expenditures for the 20 percent research credit of § 41(a). The court specifically held that the costs of supplies used during research projects that would have been used in the course of the taxpayer's manufacturing process regardless of the research do not qualify under §§ 41(b)(2)(A)(ii) and 41(h)(1)(B) as "an amount paid or incurred for supplies used in the conduct of qualified research." The court, not willing to make "a fortress out of the dictionary," determined that the phrase "used in the conduct of qualified research" encompassed only supplies purchased for the purpose of conducting research, although supplies consumed in the normal manufacturing process were necessary to the research focused on more efficient methods of converting the raw materials to finished product. The court also noted that any ambiguity in the statute could be resolved by giving deference to the agency interpretation of the statute "even if that interpretation appears in a legal brief." The court found that the IRS's interpretation of the statute was consistent with the purpose of the research credit. In a concurring opinion Judge Pooler observed that if Congress had intended the supplies at issue to be creditable, it would have so provided in precise terms on a subject of industry lobbying.

2. Gross receipts are not defined by the narrow definition of Black's Law Dictionary, the regulations provide better guidance. Hewlett-Packard Company v. Commissioner, 139 T.C. No. 8 (9/24/12). For the tax years at issue the taxpayer elected the alternative incremental research credit (AIRC) method of computing the § 41 research credit, which provided a credit equal to the sum of: (i) 2.65% (1.65% for 1999) of so much of the qualified research expenditures (QRE) from the tax year as exceeded 1% of annual adjusted gross receipts (AAGR), but did not exceed 1.5% of those AAGR; (ii) 3.2% (2.2% for 1999) of so much of the QRE from the tax year as exceeded 1.5% of AAGR, but did not exceed 2% of those AAGR; and (iii) 3.75% (2.75% for 1999) of so much of the QRE from the tax year as exceeded 2% of AAGR. In 1999 Treasury proposed regulations to provide that adjusted gross receipts for this purpose include in addition to sales receipts (as adjusted for returns and allowances) other sources of gross income such as interest, dividends and rents. The final regulations adopted the provision but with an effective date for tax years beginning after the date of the final regulations, 1/3/01. For its tax years 1999 through 2001 the taxpayer calculated its credit on the basis of adjusted gross receipts that did not include income other than sales income. The Tax Court (Judge Goeke) concluded that the final regulations were a proper interpretation of the statutory language and legislative intent and that the Treasury's logic in embracing a definition of gross receipts as articulated in the preamble to the proposed regulations applies to taxable years preceding the effective date of the regulations. Thus the court adopted a definition of gross receipts that includes the total amount derived by a taxpayer from all activities and sources. The court rejected the taxpayer's argument that by adopting § 41(c)(4) (excluding "returns and allowances" from gross receipts), Congress indicated an intent to limit the concept of gross receipts for § 41 purposes to sales receipts. The court also refused to adopt a narrow "common law meaning" of gross receipts from Black's Law Dictionary as undermined by numerous statutory authorities using the term. Further, the court indicated that the maximum "*expressio unius est exclusio alterius*" applies to indicate that congressional enumeration of specific exceptions to gross receipts means that other exceptions are not to be implied.

3. Business tax credits extended and liberalized by the 2012 Taxpayer Relief Tax Act. The business tax credits extended include:

a. Research credit of § 41 for 20 percent of research expenditures over a base amount, 20 percent of basic research payments to universities and 20 percent of qualified energy research by an energy consortium is retroactively extended for two years to cover research expenditures incurred before 1/1/14. The new law also provides that the acquirer of a trade or business, or of a substantial portion of a business unit, may include certain qualified research expenditures of the predecessor and must include the gross receipts of the predecessor in calculating credits available to the acquirer. For controlled corporations, under § 41(f) all of the members are treated as a single taxpayer and the research credit and the credit allowable to each member is to be determined in proportion to its share of research expenditures.

b. Railroad track maintenance. The 2012 Act, § 306, extends the 50 percent credit of § 45G for qualified railroad track maintenance expenditures of up to $3500 per mile incurred by a qualified railroad owner to tax years beginning before 1/1/14.

c. Mine Rescue Training. The 2012 Act, § 307, extends the 20 percent credit of § 45N for costs of training qualified mine rescue employees to taxable years beginning before 12/31/13.

4. Fifty ways to determine when construction begins. Notice 2013-29, 2013-20 I.R.B. 1085 (4/15/13). The American Taxpayer Relief Act of 2012 extend the renewable electricity production tax credit of § 45 and the elective § 48 alternative investment tax credit for electricity produced at a qualified facility if construction of the facility is commenced before 1/1/14. Qualified facilities include wind facilities, closed-loop biomass facilities, open-loop biomass facilities, geothermal facilities, landfill gas facilities, trash facilities, hydropower facilities, and marine and hydrokinetic facilities. The notice provides that a taxpayer can demonstrate that construction has commenced by establishing that "physical work of a significant nature" is undertaken, or by meeting a safe harbor that five percent of the cost of a project is incurred before 1/1/14. The IRS may determine that construction has not commenced if

the taxpayer does not maintain a continuous program of work. Significant physical work includes excavating foundations and the manufacture of components under a binding written contract that are not components held in inventory by the vendor. Significant physical work includes work on component parts of multiple facilities that will be treated as single facility that are integral to a project such as roads, but not fences or buildings. Significant physical work does not include preliminary work such as planning, design or licensing activities. The safe harbor is available if the taxpayer incurs five percent or more of the total cost of a facility before 1/1/14, and the taxpayer makes continuous progress towards completion of the facility as indicated by relevant facts and circumstances specified in the notice.

- Woe to the taxpayer who incurs cost overruns so that the pre-1/1/14 expenses do not amount to the requisite five percent. The safe harbor is not satisfied if total costs of the facility cause the amount incurred before 1/1/14, to be less than five percent of total cost. However, the credits may be claimed on some but not all of the facilities constituting a single project.

5. Funded versus unfunded research for the § 41 credit. Geosyntec Consultants v. United States, 112 A.F.T.R.2d 2013-____ (S.D. Fla. 4/15/13). A magistrate judge granted summary judgment to the taxpayer and IRS on issues relating to whether research was funded or unfunded for purposes of the § 41 20 percent credit for increased research expenditures. Under § 41(d)(4)(H) the research credit is not available to a taxpayer if another party has funded otherwise qualifying research. Reg. § 1.41-4A(d) provides that, "Amounts payable under any agreement that are contingent on the success of the research and thus considered to be paid for the product or result of the research (see § 1.41-2(e)(2)) are not treated as funding. ..." Reg. § 1.41-4A(d)(1)(iii) provides that an expense is incurred for qualified research under an agreement with third parties only if the agreement requires the taxpayer to bear the expense even if the research is not successful. *Fairchild Industries, Inc. v. U.S.*, 71 F.3d 868, 870 (Fed. Cir. 1995), interprets these regulations to allocate "the tax credit to the person that bears the financial risk of failure of the research to produce the desired product or result." The magistrate judge held that research expenditures incurred under the taxpayer's fixed price contracts were eligible for the research credit, and that the research was not subject to funded contracts. Under those contracts the taxpayer was obligated to perform environmental clean-up activities for a fixed price subject to approval of the client. The court observed that, "The nature of fixed-price contracts makes them inherently risky to contractors. Under these types of contracts, to the extent a contractor's performance is unsuccessful, the contractor must remedy the performance without additional compensation. Thus, these contracts generally place maximum economic risk on contractors who ultimately bear responsibility for all costs and resulting profit or loss." The magistrate judge also held that research performed under "capped" contracts was funded research. The capped contracts provided for reimbursement of costs up to a capped amount. The court indicated that, "A distinctive feature of the capped contracts at issue is that each one obligates the client to reimburse [taxpayer] for pre-defined tasks at pre-defined rates in accordance with a detailed project budget." The magistrate judge indicated that the capped contracts were similar to cost plus contracts that placed the risk of failed research on the client, and thus were funded contracts that did not cause the taxpayer to incur research expenditures eligible for the credit.

G. Natural Resources Deductions & Credits

1. Business energy related tax credits extended by the 2012 Taxpayer Relief Tax Act. The tax credits extended include:

a. Alternative vehicle fuel property. Section 402 of the Act extends the Code § 30C alternative fuel vehicle refueling property 30 percent credit, limited to $30,000 for depreciable property and $1,000 for other property, to property placed in service before 1/1/14.

b. Electric vehicles. Section 403 of the Act extends the Code § 30D credit for two or three wheel electric vehicles of $2,500 to $5,000 depending on battery power to vehicles acquired before 1/1/14.

c. Plant gas. Section 404 of the Act extends the per gallon credit for alcohol used as fuel to production before 1/1/14, and provides rules for using algae as qualified feedstock for fuel produced after 1/2/13 [the date of enactment]. In addition, § 410(b) of the Act extends the additional 50 percent depreciation allowance of Code § 168(l)(2) for biofuel plant property placed in service before 1/1/14.

d. Biodiesel, i.e., the timing of the Iowa primary; even Al Gore has given up on ethanol. Section 405 of the Act extends the Code § 40A $1.00 per gallon credit for biodiesel mixtures to fuel sold or used before 1/1/14.

e. Indian coal. Section 406 of the Act extends the $2 per ton additional renewable energy credit under § 45(e)(10) for coal produced at an Indian coal production facility and sold by the taxpayer during an eight year period beginning on 1/1/06.

f. Energy efficient homes. Section 407 of the Act extends the Code § 45L credit to contractors of $2,000 (or $1,000 in the case of certain manufactured homes) that are certified as energy efficient to homes acquired from the contractor for use as a residence on or before 12/31/13.

g. Refrigerators, dishwashers and washing machines. Section 409 of the Act retroactively extends for two years the credit under Code § 45M to energy efficient appliances manufactured in 2012 and 2013.

h. Transmission line sales. Section 411 of the Act extends the Code § 451(i) eight year amortization of gain recognized on sales of transmission lines by a qualified vertically integrated electric utility to an independent transmission company to sales before 1/1/14.

i. Alternative fuel excise tax credit. Section 412 of the Act retroactively extends through 2013 the excise tax credits of Code § 6426 for alternative fuels and fuels mixtures.

2. Hurry to get in line for Qualified Advanced Energy Project credits. Notice 2013-12, 2013-10 I.R.B. 543 (2/7/13). The IRS has announced that phase II of § 48C credits for establishing a manufacturing facility to produce advanced energy property will provide an allocation of $150,228,397 of credits. Section 48C(a) provides a 30 percent credit for investment in the taxable year in a qualifying advanced energy project certified by the IRS on recommendation by the Department of Energy. The maximum credit for any project is $30 million. A concept paper must be submitted to DOE (electronically) by 4/9/13. If invited by DOE, the § 48C application must be submitted by 7/23/13. The DOE will rank applications. The highest ranked application will receive the full $30 million credit, down the list until the amount of available credits is exhausted.

H. Loss Transactions, Bad Debts, and NOLs

1. Unless you think you have a CERT – no it's neither a breath nor a candy mint – or a CERIL, don't punish yourself by reading these proposed regulations just for fun. REG–140668–07, Regulations Regarding the Application of Section 172(h) Including Consolidated Groups, 77 F.R. 57452 (9/17/12). The corporate equity reduction transaction (CERT) rules of § 172(b)(1)(E) and (h) were enacted in 1989 to limit a corporation's ability to obtain tax refunds as the result of the carryback of NOLs that were attributable to interest deductions allocable to leveraged buyout transactions. Sections 72(b)(1)(E) and (h) limit the carryback of the portion of an NOL that constitutes a "corporate equity reduction interest loss" (CERIL) of an "applicable corporation" in any "loss limitation year." Prop. Reg. §§ 172(h)-0 through -5 provide general rules addressing whether a CERT has occurred, the computation of a CERIL, and the treatment of successor corporations.

2. ATNOLD is not a breath mint to relieve your AMT problems. Metro One Telecommunications Inc. v. Commissioner, 135 T.C. 573 (12/15/10). In computing AMTI, § 56(a)(4) allows a corporation to claim an AMT NOL in lieu of a regular NOL deduction allowed under § 72. The taxpayer claimed an AMT NOL deduction for 2002 based on a carryback of an AMT NOL from 2004. Analyzing a very complicated statutory pattern, Judge Paris held that § 56(a)(1) does not allow for an AMT NOL carryover to a prior year.

a. On appeal, the Ninth Circuit affirms and holds that a "carryover" is a "carryforward," but not a "carryback." Metro One Telecommunications Inc. v. Commissioner, 704 F.3d 1057 (9th Cir. 12/19/12). For tax years 2002 through 2009 the Relief Rule of § 56(d)(1) allowed taxpayers to offset 100 percent of AMTI by an alternative tax net operating loss deduction (ATNOLD) which consisted of NOLs that were (1) "carryovers" to the 2001 and 2002 tax years or (2) carried back from 2001 or 2002 tax years to a prior year. The Ninth Circuit (Judge N.R. Smith) ruled that Metro One was precluded from carrying back net operating losses from 2004 to offset 100 percent of 2002 AMTI, but was limited to offsetting 90 percent of the 2002 AMT under former § 56(d)(1)A)(i)(II). The court indicated that the "plain meaning" of the term "carryovers" in the Relief Rule prevents taxpayers from using NOLs that are carried back from a later tax year. The use of the term "carryover" in § 172 is synonymous with "carryforward."

3. Should the IRS tighten banks' bad debt deductions? Notice 2013-35, 2013-24 I.R.B. 1240 (5/20/13). The IRS is asking for comments whether the conclusive presumptions of Reg. § 1.166-2(d) regarding worthless bad debts should be revised in light of changes in banking regulation. Reg. §§ 1.166-2(d)(1) and (3) provide conclusive presumptions that bank's bad debts are worthless if either (1) a bank or other regulated corporation charges off a debt in obedience to a specific order or in conformity with established polices of the regulatory authority which confirms the charge-off, or (2) under the book conformity method a bank applies loan loss classification standards that are consistent with regulatory loan loss classification standards of the bank regulator. The conclusive presumptions are based on a policy that there is sufficient similarity between tax standards for the deduction and regulatory standards used to identify a loan that should be charged off. However, in 2004 bank regulators, relying on FASB pronouncements, determined that a security is deemed impaired if its fair value is less than its amortized costs and allowing a charge-off if the difference is other than temporary. In addition, under 2009 FASB guidance, with respect to debt held to maturity the portion of loss related to credit loss is recognized on the income statement while loss attributable to other factors is reported directly on the balance sheet. Among other things, the notice requests comments on whether the bank regulatory standards are sufficiently similar to worthless bad debt standards under § 166 and whether the conclusive presumption standards should be modified or replaced.

4. To successfully call it a loan, ya gotta prove that ya expected to be repaid. Shaw v. Commissioner, T.C. Memo. 2013-170 (7/24/13). The taxpayer was the bookkeeper and chief financial officer of a family corporation owned by herself, her mother, and her siblings. She loaned the corporation over $800,000 under a revolving line of credit, evidenced by an unsecured promissory note, with adequate interest and a specified due date. The funds were to be used to develop a real estate project. At the time the line of credit was established and the funds were advanced, the corporation was encountering financial difficulties, cash flow was tight, and not all creditors could be paid. By the end of the year in which the funds had been advanced, the development project had been "cancelled." The Tax Court (Judge Lauber) sustained the IRS's denial of a worthless debt deduction, finding that there was no bona fide debt; the advances either constituted equity or were gifts to the other family-member shareholders. The taxpayer (1) presented no documentary evidence of the corporation's creditworthiness, (2) did not request collateral despite the corporation's "questionable financial status," and (3) did not insist on financial covenants that would condition future line-of-credit advances on the corporation's adherence to specified income, net worth, or debt-to-equity benchmarks. The taxpayer's "behavior over the course of 2009 was likewise inconsistent with what one would expect from a third-party lender." As the corporation's "finances became more precarious ... rather than moderate her advances, [the taxpayer] left the spigot open." Finally, the taxpayer made no serious effort to obtain repayment of the advances — "she did not send a letter demanding payment; she did not contact an attorney; and she did not file suit. ... [A] creditor with a genuine expectation of repayment would have acted more aggressively." Finally, assuming arguendo that the advances were a loan, the taxpayer introduced no evidence of identifiable events indicating worthlessness.

I. At-Risk and Passive Activity Losses

1. Cell tower rentals escape the self-rental rule. Dirico v. Commissioner, 139 T.C. No. 16 (11/13/12). The taxpayer's wholly owned S corporation was engaged in the business of operating specialized mobile radio services (SMR, a precursor to cellular services) which included numerous antenna towers. The taxpayer individually leased towers to the S corporation, which in turn leased space on the towers to cellular companies. The S corporation reported all of its income from its combined activities as ordinary business income. The IRS recharacterized the taxpayer's rental income from profitable tower leases as non-passive activity income under the self-rental rule of Reg. § 1.469-2(f)(6), which applies to rental income from property rented for use in a trade or business in which the taxpayer is a material participant. (The IRS characterized losses from unprofitable leases as passive.) The Tax Court (Judge Halpern) rejected the IRS argument that the S corporation rented cell tower space to third parties as part of its SMR business. The court concluded that the minimal services provided by the S corporation to third-party lessees such as painting the towers, making sure the lights worked, and removing snow, meant that the leasing of towers and land to unrelated parties was a rental activity within the meaning of § 469(j)(8) and Temp. Reg. § 1.469-1T(e)(3)(i). The rental activity complemented, but was not part of the SMR business. The court also rejected the IRS argument that the S corporation's grouping of the rental income with ordinary business income was proper and binding on the taxpayer even though the taxpayer had the same proportionate ownership in the S corporation business and the rental property under Reg. § 1.469-4(d)(1)(i)(C). The court indicated that no portion of the S corporation's use of the towers in its SMR business was rental and thus its rental of towers to third parties produced only rental income. Thus, the corporation's use of the towers for rental did not produce trade or business income supporting application of the self-rental to the taxpayer that could properly be combined into a single economic activity. Because the taxpayer derived his rental income from the S corporation as a lessor to the corporation, and not as its shareholder, the court held that the erroneous grouping of activities by the corporation was not binding on the taxpayer under the last sentence of Reg. § 1.469-4(d)(5)(i) ("A shareholder *** may not treat activities grouped together by a section 469 entity as separate activities"). The court concluded that while Reg. § 1.469-4(e)(1) "prohibits only the regrouping of activities by "the taxpayer" (in this case, [the corporation]) and, therefore, constitutes a limitation on the manner in which the taxpayer (i.e., [the corporation]) reports its income for purposes of section 469. It does not affect petitioner's reporting of [the corporation's] rental payments to him."

- The IRS also classified land rental income as non-passive under Temp. Reg. § 1.469-2T(f)(3), which provides that if less than 30 percent of the unadjusted basis of rental property is subject to depreciation under § 167 net passive activity income from the property will be treated as non-passive income. The regulation converts rental income from raw land to non-passive income. The court agreed with the IRS that under Reg. § 1.469-4(d)(2) an activity involving the rental of real property and an activity involving the rental personal property cannot be combined into a single activity. Thus, the unadjusted basis of the towers and land could not be combined with the basis of raw land for purposes of the 30-percent rule.
- The court further rejected the taxpayer's argument that the IRS assertion of the 30-percent rule should be rejected because it was first raised on brief. While the court agreed that the IRS's raising the argument was not timely causing an element of surprise, the court found that the taxpayer was not prejudiced by the argument since all of the evidence necessary to resolve the issue was presented at trial.

2. Section 183 is a more powerful sword for the IRS than § 469. Disallowance is more powerful than basketing. Pederson v. Commissioner, T.C. Memo. 2013-54 (2/20/13). The Tax Court (Judge Goeke) upheld the IRS's application of § 183 to disallow losses claimed with respect to an investment in a marketed horse breeding "program" in which the taxpayer had no direct involvement. The taxpayer did not have a good-faith belief that the horse breeding activity would turn an overall profit; the amount invested was based principally on the amount necessary to produce the desired tax losses; and participation in the breeding

program was almost entirely motivated by tax benefits purportedly available to the taxpayer through such participation.

3. Judge Morrison finds an honest taxpayer. Montgomery v. Commissioner, T.C. Memo. 2013-151 (6/17/13). Temp. Reg. § 1.469-5T(f)(4) provides that the extent of an individual's participation in an activity may be established by any reasonable means. "'Reasonable means' ... include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries." However, "contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means." In the instant case however, Judge Morrison held that material participation has been established without any such documentary evidence being introduced. The taxpayers established material participation by their credible testimony providing details of the nature of the activities they conducted in starting and managing a business. They founded the company, negotiated contracts, hired 250 employees, and conducted daily business, "work[ing] on the business 'day in and day out.'"

- This case is notable because in most cases claims of material participation without written documentation fall on deaf ears in the courts. *See, e.g., Bailey v. Commissioner*, T.C. Memo. 2001-296 (2001) (log book of visits to rental real estate that did not include contemporaneous record of hours devoted to real estate activity was not sufficient to substantiate that taxpayer devoted requisite number of hours to real estate business; uncorroborated estimates of hours required to perform activities were unreliable because they were prepared years later in anticipation of litigation); *D'Avanzo v. United States*, 67 Fed. Cl. 39 (2005) (taxpayer did not offer contemporaneous written record of number of hours he spent performing personal services with respect to rental properties; noncontemporaneous log book of hours claimed to have been devoted to real estate activities and testimony at trial, alone, are inadequate evidence to establish that taxpayer devoted requisite number of hours to real estate business activities), *aff'd by order*, 215 Fed. Appx. 996 (Fed. Cir. 2007); *Lee v. Commissioner*, T.C. Memo. 2006-193 (2006) (full-time physician and full-time IRS employee could not establish that they worked more than one half of their time in their real estate partnership business; noncontemporaneous time logs submitted at trial that more than doubled hours in log books submitted during audit were not credible); *Goolsby v. Commissioner*, T.C. Memo. 2010-64 (2010) (activity log purporting to document hours of management activity was not credible; it was created after taxpayer's return was selected for audit and solely for purposes of the case; taxpayer had no contemporaneous records, such as appointment books, calendars, or narrative summaries to support activity log; "[i]ncredibly, the...activity log lists days during which [the taxpayer] allegedly logged more than 24 hours of work").

4. A "ballpark guesstimate" doesn't let you sing ♫♪ Yankee Doodle Dandy♫♪. Merino v. Commissioner, T.C. Memo. 2013-167 (7/16/13). The Tax Court (Judge Wherry) held that the taxpayer failed to prove that he was a real estate professional who materially participated in a real property rental activity, thereby escaping the passive activity loss limitations by way of § 469(c)(7). The taxpayer's only evidence was his own "summary of hours" that was prepared "using his estimates and his memory as to how much time he spent on certain tasks with respect to the real estate rental activity." It "was not created from contemporaneous documentation, but rather it [was] a postevent reconstruction from memory," that was "less of an approximation and more of a 'ballpark guesstimate.'"

5. The Tax Court generally requires contemporaneous records of hours devoted to activities to avoid section 469. Bartlett v. Commissioner, T.C. Memo 2013-182 (8/8/13). The Tax Court (Judge Kerrigan) rejected a "guesstimate" of hours worked on a ranch. The lack of any contemporaneous records or other records and documentation regarding what the taxpayer specifically did day-to-day and how much time he spent on matters relating to the activity was not cured by estimates made years after the fact in writing or by testimony.

6. Borrowed funds contributed to S corporation cellular company were neither at-risk nor did they create basis for loss deductions. Broz v. Commissioner, 137 T.C. 46 (9/1/11). In a structure typical for the industry, the taxpayer was the shareholder of two S corporations, RFB and Alpine, that held FCC licenses to operate cellular networks in rural areas.

RFB held licenses directly and was the original business. Alpine and Alpine LLC, a single member LLC owned by the taxpayer were formed to expand the business. Additional licenses were obtained and held by a number of LLCs (partnerships) that were owned 99 percent by the taxpayer and 1 percent by his brother. Alpine and the LLCs were formed at the insistence of creditors to isolate the liabilities of the thinly capitalized expansion. RFB owned and operated all of the equipment. Alpine and the LLCs owned only licenses, and RFB allocated some of its income to Alpine for use of the licenses. RFB obtained financing to construct cellular equipment and for working capital, and re-lent some of the loan proceeds to Alpine. Alpine and the taxpayer documented the loans from RFB to Alpine as shareholder loans. The taxpayer pledged RFB stock for the loans, but did not guarantee the loans, which were also secured by corporate assets.

- First, for purposes of determining the taxpayer's basis in Alpine, for purposes of applying the § 1366(d) limitation on passed-through losses, the court (Judge Kroupa) held that (1) the taxpayer had not established that he had borrowed money from the bank that he personally re-lent to Alpine because RFB did not advance the funds to Alpine on the taxpayer's behalf, i.e., the loan ran directly from RFB to Alpine; and (2) the taxpayer had not made any "economic outlay." Thus, the loans were not included in the shareholder's basis to support loss deductions.
- Second, for purposes of determining the taxpayer's at-risk amount with respect to Alpine, in what was described as an issue of first impression, the court held that the RFB stock pledged for the loans represented pledged property used in the business not eligible to be treated as an amount at-risk by virtue of § 465(b)(2)(A). Since Alpine was formed to expand RFB's cellular networks, the pledged RFB stock was related to Alpine's business. Thus, because the shareholder did not guarantee the loans to Alpine, the shareholder was not economically or actually at-risk with respect to his involvement with Alpine.
- Third, the court held that Alpine could not deduct interest, expenses, and depreciation during the years at issue because it was not yet engaged in an active trade or business utilizing the licenses it held. The court rejected the taxpayer's argument that operation of cellular networks by RFB could be attributed to Alpine. Acquisition of licenses and related equipment was not sufficient to establish Alpine as engaged in the active conduct of a trade or business. Alpine failed to attach the required statement to the return for the taxable year to claim § 195 amortization of start-up expenses [which it could not have deducted even if it had attached the form because it had not yet commenced business operations].
- Fourth, in another issue that the court described as one of first impression, the court concluded that deductions under § 197 for amortization of the costs of FCC licenses were not available in years in which the taxpayers were not yet engaged in a trade or business. The court concluded that the language of § 197 that provides the deduction "in connection with the conduct of a trade or business" requires that the intangibles "must be used in connection with a business that is being conducted."

a. "Losses are not tested under the at-risk rules until the shareholder has sufficient basis to deduct them." Broz v. Commissioner, ___ F.3d ___ (6th Cir. 8/23/13). The Sixth Circuit, in an opinion by Judge Rogers, affirmed, holding that the Tax Court correctly determined that the taxpayer did not have sufficient basis in Alpine to support the claimed passed-through losses. The court also upheld denial of the claimed § 162 expenses and § 197 amortization deductions for the license-holding entities because those entities were not engaged in an active trade or business. The court did not reach the at-risk issue.

- With respect to the § 1366(d) loss limitation issue, the Sixth Circuit found that there was no evidence that at the time the loan to Alpine was made the debt was intended to run directly from Alpine to either Broz or his wholly owned LLC. It was intended to run from Alpine to RFB. "After-the-fact reclassification cannot satisfy the requirement that the debt run directly from the S corporation to the taxpayer/shareholder." Because Broz had insufficient basis to support any passed-through loss deductions, the court did not reach the § 465 at-risk issue, stating that "losses are not tested under the at-risk rules until the shareholder has sufficient basis to deduct them." In dictum that followed, the court noted that "the at-risk limit in § 465 and the basis limit in § 1366(d) are functionally almost identical in the S corporation context."

- Turning to the § 162 expense deductions, the court held that "each entity's activity must be evaluated individually and not in conjunction with any other entity." Thus, Alpine's and the LLC's activities could not be amalgamated with RFB's activities. Viewed individually, neither Alpine nor the LLCs conducted any business during the year. Broz chose to employ separate entities for a business reason and could not have "'the best of both worlds' by having the Alpine entities treated as separate for purposes of avoiding or distinguishing liabilities, but treated as one entity together with RFB for tax purposes."
- Finally, turning to the § 197 amortization deductions, the court held that amortization deductions "do not begin upon acquisition of the intangible asset if the intangible asset is not yet held in connection with the conduct of a trade or business, because the assets are in that case not eligible as "amortizable section 197 intangibles." The court noted that although § 197(a) provides that the deduction is calculated beginning with the month in which the intangible asset is acquired, it allows the deduction only for "amortizable section 197 intangibles," which are defined in § 197(c) as intangible assets "held in connection with the conduct of a trade or business." Because the Alpine license-holding entities never actually leased the licenses to Broz's other businesses, the licenses were never held in connection with a trade or business that was actually being conducted. Thus, the licenses did not qualify as "amortizable section 197 intangibles," and were ineligible for amortization deductions.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. This case disproves the old adage "you can't lose for trying." Sollberger v. Commissioner, 691 F.3d 1119 (9th Cir. 8/16/12). The taxpayer entered into an agreement with Optech pursuant to which he transferred floating rate notes (FRNs) worth approximately $1 million to Optech in return for a nonrecourse loan of 90 percent of the value of the FRNs. Under the agreement Optech had the right to receive all dividends and interest on the FRNs, and the right to sell the FRNs during the loan term without Sollberger's consent. Optech did not hold the FRNs as collateral for the loan, but immediately sold the FRNs and transferred 90 percent of the proceeds to the taxpayer. The taxpayer treated the transaction as a loan rather than as a sale. The Ninth Circuit (Judge Smith) affirmed the Tax Court's holding (T.C. Memo. 2011-78) that the transaction was a sale. The court stated:

> Although the transaction took the form of a loan, Sollberger transferred the FRNs to Optech, and gave Optech the right to sell the FRNs (which Optech promptly exercised), to transfer the registration of the FRNs into its own name, and to keep all interest due from the FRNs. Sollberger would not be personally liable if he did not make payments on the loan since it was nonrecourse. . . . Nonrecourse financing, which is sometimes viewed as an "indicator of a sham transaction," *Sacks v. Comm'r*, 69 F.3d 982, 988 (9th Cir. 1995), placed Sollberger more in the position of a seller than a debtor. Nowhere in the Master Agreement or the Loan Schedule did Sollberger promise to repay the money "lent" to him. Instead, Optech merely agreed to return the FRNs if Sollberger repaid the loan at the end of the seven-year loan term, thereby giving Sollberger the option of repurchasing the FRNs in seven years, but not requiring him to do so. Thus, the transaction was more akin to an option contract, whereunder the FRNs were sold, but the seller retained a call option to reacquire them after seven years, if he elected to do so, than a true loan. . . .
>
> Sollberger's and Optech's conduct also confirms our conclusion that the transaction was, in substance, a sale. Although interest accrued on the loan, Sollberger stopped receiving account statements and making interest payments after the first quarter of 2005, less than one year into the seven-year loan term. Thus, neither Sollberger nor Optech maintained the appearance that a genuine debt existed for long. The total amount that Sollberger paid to Optech was *de minimis* compared to the size of the loan. The FRNs were also sold before Sollberger received the loan from Optech, which suggests that Optech funded the

> majority of the "loan amount" with the proceeds received from the sale of the FRNs. The apparent lack of any ability or intention by Optech to hold the FRNs as collateral to secure repayment of the loan further buttresses our conclusion that the transaction was merely a sale in the false garb of a loan.

- The court also rejected the taxpayer's argument that the transaction came within the § 1058 safe harbor for securities lending transactions because the requirements of that section had not been met.

2. The Cap Gemini exchange cases:

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

b. The Seventh Circuit affirmed taxable exchange treatment for an E&Y consulting partner in a Capgemini exchange. United States v. Fletcher, 562 F.3d 839 (7th Cir. 4/10/09), *aff'g* 101 A.F.T.R.2d 2008-588 (N.D. Ill. 1/15/08). In this 2000 exchange of taxpayer's partnership interest in E&Y for restricted stock of Capgemini, the Seventh Circuit (Judge Easterbrook) affirmed the summary judgment award to the government in this erroneous refund suit, and in the process "Fletcherized"[1] the E&Y consulting partner involved because she initially took the position of the parties to the transaction that all of the Capgemini shares received vested in the year 2000 [the year of the exchange], but after the stock declined in value took the position that she received income in 2000 only to the extent of cash she received in that year and the remainder of her income was recognized in 2003 [when the stock was worth less than one-fifth of its 2000 value].

- Judge Easterbrook did not appreciate the argument that she signed the "consulting partner transaction agreement" [which provided for taxable gain in 2000] only because she was afraid she would be fired if she did not do so. Both the district court and the Seventh Circuit held that under either *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), or the alternative "strong proof" test, taxpayer was bound by the agreement she signed. He stated that:

> Fletcher argues that she didn't "really" agree to the structure that Ernst & Young and Cap Gemini (and most of her partners) wanted in 2000. If she had voted no and refused to sign, she maintains, she would have been excluded from the economic benefits and might have been fired. If this is so, then she had a difficult choice to make; it does not relieve her of the choice's consequences. Hard choices may be gut-wrenching, but they are choices nonetheless. Even naïve people baffled by the fine print in contracts are held to their terms; a sophisticated business consultant who agrees to a multi-million-dollar transaction is not entitled to demand the deal's benefits while avoiding its detriments. The argument that Fletcher can avoid the terms as a matter of contract law is frivolous. All that matters now are the tax consequences of the contracts she signed.

- Judge Easterbrook concluded:

[1] Horace Fletcher (1849–1919), a health food faddist, argued that food should be chewed thirty-two times before being swallowed. "Nature will castigate those who don't masticate."

> The more likely it is that the conditions will be satisfied, and all restrictions lifted, the more sensible it is to treat all of the stock as constructively received when deposited in the account. To see this, suppose that the parties had wanted to defer the recognition of income and had put $2.5 million in each partner's account, with the condition that the whole amount would be forfeited if the temperature in Barrow, Alaska, exceeded 80 [degrees] F on January 1, 2005. Would the remote possibility of an Arctic heat wave enable the partners to defer paying taxes? Surely not. *See Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008). If, on the other hand, the parties agreed that the ex-partners would receive $ 2.5 million only if the temperature in Barrow on January 1, 2005, exceeded 80 [degrees] F, then none of the partners would constructively receive income in 2000; everything would depend on events in 2005.
>
> The sort of contingencies that could lead to forfeitures were within the ex-partners' control. That implies taxability in 2000, for control is a form of constructive possession. And the agreement to discount the stock by only 5% tells us that the parties deemed forfeitures unlikely. Fletcher's acknowledgment that the risk of forfeiture was small shows that the conditions of constructive receipt in 2000 have been satisfied.
>
> Thus although we agree with Fletcher that the ex-partners are entitled to contest the tax treatment called for by the 2000 contracts, we hold that the shares are taxable in 2000 at their value on the date of deposit to the accounts at Merrill Lynch. Income was constructively received in that year not because the contract said that everyone would report it so to the IRS, but because the parties were *right* to think that this transaction's actual provisions made the income attributable to 2000. That the price of Capgemini stock dropped in 2001 and later does not entitle the parties to defer the recognition of income. Fletcher must repay the refund (and amend her returns for later years to reflect receipt of the income in 2000).

c. Ex-post recharacterization is not an option for taxpayers. United States v. Bergbauer, 602 F.3d 569 (4th Cir. 4/16/10). The Fourth Circuit affirmed a summary judgment for the government in an erroneous refund suit. The taxpayer exchanged her partnership interest in Ernst & Young for stock of Cap Gemini, a corporation acquiring E&Y's consulting business, in a transaction that was not a statutory nonrecognition event; however, the stock was held in escrow to enforce a forfeiture provision if the seller-taxpayer failed to perform certain services as an employee of the acquiring corporation. The taxpayer initially reported that all of the Cap Gemini shares received vested in the year 2000 (the year of the exchange), but after the stock declined in value took the position that income was realized in 2000 only to the extent of cash received in that year and the remainder of the income was recognized in 2003 (when the stock was worth less than one-fifth of its 2000 value). The court held that if a taxpayer exchanges one property for a different property, the gain realized on the exchange must be recognized in the year the exchange occurs, even though the property received in the exchange is forfeitable if contractual provisions or representations in the contract for exchange are not subsequently satisfied and even though the property received in the exchange is held in escrow to assure enforcement of the forfeitability provisions. Furthermore, the court refused to accept the taxpayer's argument that the transaction could be recast into a form different than that which it had taken.

> To put it plainly, we have bound taxpayers to "the 'form' of their transaction" when they attempt to recharacterize an otherwise valid agreement bargained for in good faith. [citation omitted] We have also refused to entertain arguments "that the 'substance' of their transaction triggers different tax consequences." [citation omitted] This precept not only maintains the vital public policy of enforcing otherwise valid contracts, but also assures the reliability of agreed tax consequences to the public fisc. . . .

> There is no "disparity" in allowing "the Commissioner alone to pierce formal" agreements as "taxpayers have it within their own control to choose in the first place whatever arrangements they care to make." [citation omitted]

- Earlier cases that reached the same result for other taxpayers involved in the same transaction include *United States v. Fletcher*, 562 F.3d 839 (7th Cir. 4/10/09); *United States v. Culp*, 99 A.F.T.R.2d 2007-618, 2007-1 U.S.T.C. ¶50,399 (M.D. Tenn. 12/29/06); and *United States v. Nackel*, 105 A.F.T.R.2d 2010-474 (C.D. Cal. 10/20/09).

d. Judge Dyk stuck his finger into the Cap Gemini pie and pulled out a constructive receipt plum. Hartman v. United States, 694 F.3d 96 (Fed. Cir. 9/10/12). This Cap Gemini case was decided in favor of the government, as were all of the other Cap Gemini cases. The Federal Circuit (Judge Dyk) rejected the government's argument that taxpayer was bound under *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), by his agreement to recognize for federal income tax purposes in the year 2000 all the shares of Cap Gemini that were placed in escrow for him in that year because *Danielson* was limited to situations where "a taxpayer challenges express allocations of monetary consideration." Instead, Judge Dyk found that taxpayer was in constructive receipt of all the Cap Gemini stock that was received for him in exchange for his E&Y partnership interest even though the stock was placed into an escrow account and he could not receive the stock until subsequent years – subject to the risk of forfeiture should he sooner voluntarily terminate his employment with Cap Gemini.

3. Extended tax-free capital gains for "small" C corporation stock. The 2012 Taxpayer Relief Tax Act extends help to qualified small business stock. Gain realized on a sale or exchange of qualified small business stock under § 1202, which was acquired after the date of enactment of the 2010 Small Business Act [9/27/10] and before 1/1/11 [subsequently extended to "before 1/1/12"], was subject to 100 percent exclusion from gross income. The 2012 Act, § 324(b), extends the 100 percent exclusion to stock acquired before 1/1/12 to before 1/1/14. Gain attributable to qualified small business stock acquired between 9/27/10 and 1/1/14 is not treated as an AMT preference item. The exclusion is applicable to noncorporate shareholders who acquire stock at original issue and hold the stock for a minimum of five years. Under the former 50 percent and 75 percent exclusions, included gain was subject to tax at the 28 percent capital gains rates. The amount of excluded gain attributable to any one corporation is limited to the greater of ten times the taxpayer's basis in a corporation's stock sold during the taxable year or $10 million reduced by gain attributable to the corporation stock excluded in prior years. Qualified small business stock is stock issued by a C corporation engaged in the active conduct of a trade or business with gross assets (cash plus adjusted basis of assets) not in excess of $50 million.

4. Application of the step transaction doctrine obviates the need to apply a statutory anti-abuse rule. G.D. Parker, Inc. v. Commissioner, T.C. Memo. 2012-327 (11/27/12). A Panamanian corporation (Vicmar) owned a minority interest in a Peruvian telecommunications corporation (Tele2000). The stock had a built-in loss of over $12 million. In March 2004 BellSouth, the owner, though a subsidiary of the majority interest, agreed to sell its stock of Tele2000 to Telefonica (a Spanish corporation). Telefonica's announced plan was to purchase 100 percent of Tele2000. During the period between March 2004 and December 21, 2004, Vicmar took steps to transfer its stock of Tele2000 to the taxpayer, G.D. Parker, Inc. On December 16, the parties, including the taxpayer, entered into a share transfer and settlement agreement, and the sale was finalized on 12/21/04. The taxpayer was made a party to the share transfer agreement at the last minute after the sole shareholder of Vicmar represented to Bell South and Telefonica that the taxpayer was the owner of the Tele2000 shares. Before the last-minute representation, BellSouth's representative was unaware of the taxpayer's existence. Applying the end result version of the step transaction doctrine, the Tax Court (Judge Haines) held that Vicmar, the Panamanian corporation, not the taxpayer U.S. corporation, was the true seller of the stock and disallowed the taxpayer's loss deduction.

> [I]t is clear from the record that, from the start, the acquisition of the Tele2000 shares by petitioner and the subsequent sale to Telefonica were really steps of a

> single transaction intended to be taken for the purpose of reaching the ultimate result. Those steps constituted part of a prearranged plan to have Telefonica obtain the Tele2000 shares while having the capital loss shifted to petitioner. Had Telefonica acquired the shares directly from Vilanova, this shift in the capital loss would not have occurred, and petitioner would have been obligated to report a capital gain rather than a capital loss that it could carry back to prior years. Petitioner may not avoid this result by employing mere formalisms thinly disguised to mask its true intentions. . . . Hence under the end-result test petitioner's ownership of the Tele2000 shares must be ignored, with Telefonica being viewed as having acquired the shares from Vilanova.

- The IRS also argued that § 362(e), which would have reduced the taxpayer's basis in the stock to fair market value, applied, but Judge Haines concluded that there was no need to reach a decision with respect to § 362(e) because under the step transaction doctrine there was no transfer of the stock from Vicmar to the taxpayer for income tax purposes.

5. The taxpayer passed the benefits and burdens of ownership to his wholly owned corporation, so he sold the property and recognized a gain. Gaggero v. Commissioner, T.C. Memo. 2012-331 (11/29/12). In the early 1990s, the taxpayer bought, for $3 million, and moved into a rundown beach house in Malibu that was renovated into a splendid mansion while he lived in it as his primary residence. Before renovations in 1991, he entered into a Land Contract Purchase and Sale Agreement and a Development Contract with BCC, a real estate development corporation that was wholly owned by the taxpayer. The essence of the deal was that BCC would provide the development services and BCC would receive an equal share in any increase in the property's value between the time the contract was signed and the time the property was sold to a third party, even though the taxpayer would pay most of the costs of the project. BCC would receive its interest if it completed its work. The project was completed in 1997 and the residence was sold for $9.6 million. The taxpayer reported a receipt of $6.6 million, but claimed that pursuant to former § 1034 none of it was recognizable because he purchased a new residence for $6.7 million. BCC reported ordinary income of $3 million. The IRS contended that the taxpayer never sold any interest in the residence to BCC and that he realized $9 million on its sale and should have reported a $2.9 million gain. The Tax Court (Judge Holmes) engaged in an extensive factual inquiry of whether the benefits and burdens of ownership in a partial interest in the residence had passed to BCC prior to the sale to the ultimate purchaser, and concluded that because benefits and burdens of ownership had been transferred, a partial ownership had passed from the taxpayer to BCC prior to the sale to the ultimate purchaser. That the taxpayer continued to maintain the property as his primary residence did not alter that fact. Accordingly, a sale had occurred. However, the sale from the taxpayer to BCC occurred in 1997, when BCC's interest vested, and the amount realized on that sale was $3 million; the remaining $6.6 million was realized by the taxpayer on the sale the remaining interest. Since he realized $9.6 million of the sale of his residence and purchased a replacement residence for only $6.7 million, he should have recognized a gain of $2.9 million. However, the court did not uphold penalties, finding that the taxpayer relied in good faith on his tax advisor.

6. A proposed *de minimis* exception from wash sale rules for money market fund losses. Notice 2013-48; 2013-31 I.R.B. ___(7/3/13). This Notice proposes a revenue procedure that would provide a *de minimis* exception to the § 1091 wash sale rules for certain redemptions of shares of money market funds that, under regulations proposed by the SEC, would no longer maintain a constant share price. Under the proposed revenue procedure, if a taxpayer realizes a loss upon a redemption of shares in such a fund, and the amount of the loss is not more than .5 percent of the taxpayer's basis in the shares, the IRS will treat the loss as not subject to § 1091. The purpose of the *de minimis* rules is to mitigate tax compliance burdens that may result from the changes in money market fund redemption prices. If the SEC does not adopt its proposed rules in substantially the same form as they have been proposed, the revenue

procedure proposed by the Notice might not be adopted or might be adopted in a materially modified form.

7. Caught in a zero basis trap for lack of adequate records of stock purchase price. United States v. Youngquist, 111 A.F.T.R.2d 2013-2293 (Magistrate D. Ore. 4/17/13), *adopted by the court*, 111 A.F.T.R.2d 2013-2467 (D. Ore. 6/21/13). The District Court (Judge Brown) adopted Magistrate Judge Papak's findings and recommendations and held that a taxpayer's basis in stock sold through one of his brokerage accounts was zero because the taxpayer introduced no evidence of the cost of any particular block of shares sold, citing *Coloman v. Commissioner*, 540 F.2d 427 (9th Cir. 1976). The taxpayer's evidence of the amount deposited as the opening cash balance of the brokerage account did not suffice to prove the basis of any block of stock. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), did not apply to allow an estimate of the basis of any of the shares because no authority supported an "aggregate theory of proving basis."

- Taxpayer began his day trading in the brokerage account in question on November 5, 1996 and closed the account on December 20, 1996; nevertheless the IRS found, and the court concluded, that he had $1,456,076 of income from the account during that period.

B. Interest, Dividends, and Other Current Income

1. What does "traded on an established securities market" mean in the Internet era? REG-131947-10, Property Traded on an Established Market, 76 F.R. 1101 (1/7/11). Under the OID rules, if a debt instrument is issued for stock or other debt instruments (or other property) that is traded on an established securities market (often referred to as "publicly traded"), the issue price of the debt instrument is the fair market value of the stock or other property. Similarly, if a debt instrument issued for property, such as another debt instrument, is traded on an established securities market, the issue price of the debt instrument is the fair market value of the debt instrument. See Reg. § 1.1273-2(c). Among other issues, a debt-for-debt exchange (including a significant modification of existing debt) in the context of a work-out may result in a reduced issue price for the new debt, which generally would produce (1) COD income for the issuer (i.e., debtor), (2) a loss to a holder (i.e., creditor) whose basis is greater than the issue price of the new debt, and (3) OID that must be accounted for by both the issuer and the holder of the new debt. The Treasury has published proposed regulations that are intended to simplify and clarify the determination of when property is traded on an established market. Prop. Reg. § 1.1273-2(f)(1) would identify four ways for property to be traded on an established market: (1) the property is publicly traded on an exchange (as defined), which is relatively unusual for debt instruments other than corporate bonds; (2) a sales price for the property is reasonably available – it appears in a medium that is made available to persons that regularly purchase or sell debt instruments, or persons that broker purchases or sales of debt instruments" ("a sale that is reported electronically at any time in the 31-day time period, such as in the Trade Reporting and Compliance Engine ("TRACE") database maintained by the Financial Industry Regulatory Authority, would cause the instrument to be publicly traded, as would other pricing services and trading platforms that report prices of executed sales on a general basis or to subscribers"); (3) if a firm price quote to buy or sell the property is available; or (4) a price quote (other than a firm quote) that meets certain standards set forth in the regulations is provided by a dealer, a broker, or a pricing service (an indicative quote). In all four cases, the time for determining whether the property is publicly traded is the 31-day period ending fifteen days after the issue date of the debt instrument. There would be an exception for "small debt issues – those below $50,000,000. The regulations will apply to debt instruments that have an issue date on or after the promulgation of final regulations.

a. Finalized with some important changes. T.D. 9599, Property Traded on an Established Market, 77 F.R. 56533 (9/13/12). Final Reg. § 1.1273-2(f)(1) substantially follows the framework of the proposed regulations but provides only three rules for determining that property is traded on an established market. Reg. § 1.1273-2(f)(1) provides that property is traded on an established market if at any time in the 31-day time period ending 15

days after the issue date of a debt instrument: (1) a sales price for the property is reasonably available – it appears in a medium that is made available to persons that regularly purchase or sell debt instruments, or persons that broker purchases or sales of debt instruments (a sale that is reported electronically such as in the Trade Reporting and Compliance Engine (TRACE) database maintained by the Financial Industry Regulatory Authority, would cause the instrument to be publicly traded, as would other pricing services and trading platforms that report prices of executed sales on a general basis or to subscribers); (2) a firm price quote to buy or sell the property is available; or (3) a price quote (other than a firm quote) that meets certain standards set forth in the regulations, is provided by a dealer, a broker, or a pricing service (an "indicative quote"). Very significantly, Reg. § 1.1273-2(f)(6) provides that a debt instrument will not be treated as traded on an established market if at the time the determination is made the outstanding stated principal amount of the issue that includes the debt instrument does not exceed $100 million (rather than $50 million as provided in the proposed regulations). The other significant change made in the final regulations is to require that the issue price be reported consistently by issuers and holders.

- The regulations generally apply to a debt instrument issued on or after 11/13/12.
- According to the preamble:

> The final regulations dispense with the category of exchange listed property because the small amount of debt that is listed rarely actually trades over the exchange. Moreover, although stock, commodities, and similar property are commonly listed on and traded over a board or exchange, such property typically will be the subject of frequent sales or quotes and would be covered in a separate category of publicly traded property. A debt instrument that is issued for stock, commodities, or similar exchange traded property is therefore tested under the rule for property where there is a sales price or quote within the 31-day period ending 15 days after the issue date of the debt instrument. Eliminating the category of property listed on an exchange also eliminates the need for the de minimis trading exception in the proposed regulations, which was intended to exclude property that is listed on an exchange but trades in a negligible quantity.

2. Ouch! He got nothing in pocket, but his realized income was $29,093.30. Brown v. Commissioner, 693 F.3d 765 (7th Cir. 9/11/12). The taxpayer owned an insurance policy on which he had borrowed money in excess of the cash surrender value. At the time that the policy was cancelled by the insurance company, the taxpayer had paid $44,205.00 in premiums, but the insurance company had applied $31,063.30 of policy dividends to the purchase of additional insurance above the $100,000 face value of the policy, and $4,869.94 of dividends had been applied to pay premiums and repay policy loans. The additional paid up life insurance had been surrendered for its cash value to repay policy loans prior to the cancellation of the base $100,000 policy. The Seventh Circuit (Judge Posner) affirmed a Tax Court decision holding that the taxpayer's investment in the contract had been reduced from $44,205.00 to $8,271.76 as a result of the application of $35,933.24 of dividends as described. Accordingly, because the cash surrender value of the policy, which was applied against policy loans when it was cancelled was $37,365.06, taxpayer realized income of $29,093.30 ($37,365.06 - $8,271.76).

3. Exempt financing for New York Liberty Zone bonds extended. The 2012 Taxpayer Relief Act, § 328, extends the issue date for exempt New York Liberty Bonds to bonds issued before 1/1/14.

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

1. Rental property occupied by the taxpayer's son was investment property, not personal-use property. Adams v. Commissioner, T.C. Memo. 2013-7 (1/10/13). The taxpayer engaged in a deferred like-kind exchange through an intermediary in which he

surrendered a property held for rental and acquired a new residential property that was dilapidated and in need of rehabilitation. The taxpayer and his son entered into an agreement whereby the son and his family could live in the new house after renovations. The son and his family worked on the house an aggregate of 60 hours per week for three months before moving in. The son and his family bore all of the rehabilitation expenses; their services were worth $3,600. After three months of work, the son's family moved in, resided in the house for three years, and paid rent that was a few hundred dollars per month less than the fair rental value. The IRS took the position that the transaction was not a § 1031 like-kind exchange because the taxpayer acquired the new house for personal purposes – i.e., "with the intention of letting his son and family live there at below market rent" – and that the taxpayer thus must recognize gain on the sale. The Tax Court (Judge Morrison) found that the taxpayer had acquired the new house for investment purposes and that the transaction thus qualified as a § 1031 like-kind exchange. Furthermore, the limitations on deductions imposed by § 280A did not apply to the new house rented to the son. Pursuant to § 280A(d)(2), a taxpayer is treated as using a dwelling unit during the taxable year as a residence if the taxpayer rents the dwelling unit to a family member, unless the taxpayer rents the dwelling unit to the family member "at a fair rental" and for use as that family member's principal residence. The son used the residence as his principal residence and, although the $1,200 per month cash rent was slightly below market, it was fair rent considering the work that the son had performed with respect to the house. Thus the § 280A(a) prohibition of deductions for dwelling units used as residences did not apply.

2. Swapping both a personal residence and business property for a new personal residence and business property invokes both § 1031 and § 121 and provides a computational challenge. Yates III v. Commissioner, T.C. Memo 2013-28 (1/24/13). Through a qualified intermediary, the taxpayers exchanged a property that qualified as a principal residence under § 121 and a business property for a new principal residence and two business properties. The issues in the case dealt mainly with the proper valuations of the properties, which determined the amount of gain realized that was not sheltered by § 1031; and there is nothing noteworthy about the valuation determinations. The important point of the case is that the Tax Court (Judge Goeke) applied Reg. § 1.1031(j)-1(a)(1), which provides that where multiple properties are transferred in a like-kind exchange, the properties are separated and arranged for analysis into "exchange groups" based on shared characteristics. A "residual group" is created if the aggregate fair market value of the properties transferred in all of the exchange groups qualifying for § 1031 treatment differs from the aggregate fair market value of the properties received in all the exchange groups. Both residences were treated as part of the residual group, with the new residence treated as boot, but § 121 applied to provide nonrecognition (for up to $500,000) of gain on the exchange of the old personal residence for a new one. The exact computations were left to be made under Rule 155.

3. Tax ain't horseshoes: When the regulations say thirty years, they don't mean 21 years and 4 months. VIP's Industries Inc. v. Commissioner, T.C. Memo 2013-157 (6/24/13). Through a QI, the taxpayer exchanged a leasehold with 21 years and 4 months remaining for a fee interest in other real estate. The only significant issue was whether the leasehold and fee interests were like-kind under Reg. § 1.1031-1(c), which states that § 1031 nonrecognition can apply to an exchange of a leasehold with 30 years or more to run for a fee interest. Applying *May Department Stores Co. v. Commissioner*, 16 T.C. 547 (1951), which held that a 20-year leasehold was not like-kind to a fee interest, Judge Marvel held that the exchange of a leasehold with 21 years and 4 months remaining for a fee interest in other real estate did not qualify as a like kind exchange.

4. That the residual method of valuing goodwill was the proper method was a slam dunk for the government, but its valuation amount bounced off the rim when the facts were analyzed by the court. Deseret Management Corp. v. United States, ___ Fed. Cl. ___, 112 A.F.T.R.2d 2013-5530 (7/31/13). The taxpayer exchanged a highly appreciated radio station in Los Angeles (KZLA) for several radio stations in St. Louis and reported that pursuant to § 1031 no gain had been recognized. The government asserted that the taxpayer was required to recognize gain with respect to the exchange of KZLA's goodwill because Reg.

§ 1.1031(a)-2(c)(2) provides that "[t]he good will or going concern value of a business is not of a like kind to the goodwill or going concern value of another business." The taxpayer took the positions that (1) as a matter of law goodwill never attached to the business of a broadcast radio station, and (2) if goodwill could attach to the business of a broadcast radio station, on the facts the value of the goodwill of KZLA was zero. The parties agreed that the aggregate value of the exchanged property was $185 million and stipulated that the value of all tangible assets of KZLA was $3,384,637, and that the value of all intangible assets of KZLA, apart from its FCC License and any goodwill, was $4,858,317. The taxpayer took the position that the value of the FCC license was the $176,757,046 that remained after accounting for those other assets, leaving nothing to be assigned to goodwill under the residual method. First, the Court of Federal Claims (Judge Allegra) rejected the taxpayer's argument that as a matter of law goodwill never attached to the business of a broadcast radio station. The taxpayer argued that a radio station can never possess goodwill because audience loyalty is a matter of format and online personalities. Judge Allegra responded

> That listeners might flee a station that suddenly changes its format or on-air personalities, however, does not prove plaintiff's point—any more than it would be true to say that other types of businesses cannot have goodwill because they would lose their customers if they fundamentally changed their business plan. Can it be that nationally-recognized restaurant chains lack goodwill because their customers might flee if they radically changed their menus; or that sporting goods stores lack goodwill because they might decide to sell only flowers; or that familiar chains of coffee purveyors lack good will because they would lose their current business if they sold only soda? One would think not. ... Put another way, whether goodwill exists as part of the assets acquired in a transaction cannot depend upon whether the buyer concludes that it is in its best interests to sustain the prior business model—that the prior goodwill must be accounted for if the prior business model is maintained, but not if that model is modified.

- Turning next to the factual valuation issue, Judge Allegra handed the taxpayer a complete victory, based not on the taxpayer's expert's report and analysis, which he had rejected but by using the government's expert's methodology, modified to correct what he found to be errors in the methodology. In the end, applying the residual valuation method, Judge Allegra concluded that the value of the FCC license, determined by discounting the expected net cash flow from the license as if it belonged to a start-up company, was at least $176,757,046, leaving nothing to be assigned to goodwill.

F. Section 1033

G. Section 1035

H. Miscellaneous

1. T.D. 9635, Debt That is a Position in Personal Property That is Part of a Straddle, 78 F.R. 54568 (9/5/13). The Treasury has promulgated temporary regulations to provide guidance under § 1092 regarding when an issuer's obligation under a debt instrument may be a position in actively traded personal property and, therefore, may be part of a straddle. Temp. Reg. § 1.1092(d)-1T(d) provides that if a taxpayer is the obligor under a debt instrument one or more payments on which are linked to the value of personal property or a position with respect to personal property, then the taxpayer's obligation under the debt instrument is a position with respect to personal property and may be part of a straddle. The provision applies to straddles established on or after 1/17/01.

- The twelve year retroactivity is based on the fact that the Treasury Decision adopted Prop. Reg. § 1.1092(d)-1(d) in the form proposed on 1/18/01, (REG-105801-00).

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. **Putin might be fighting American adoptions, but Congress likes adoptions.** The 2012 Taxpayer Relief Tax Act, § 104, made permanent the Code § 137 exclusion for employer-provided adoption assistance. The maximum exclusion is $12,170 (adjusted for inflation), and the phase-out range is $182,520 to $222,520 (adjusted for inflation).

2. **This ruling is expressly for lactating mothers.** Announcement 2011-14, 2011-9 I.R.B. 532 (2/10/11). This announcement held that breast pumps and supplies that assist lactation are medical care under § 213(d) because "they are for the purpose of affecting a structure of the body of the lactating woman." The announcement did not refer at all to the health of the baby.

a. **Making what was recently held to be a deductible medical expense into a mandatory freebee. A new mandate under Obamacare makes all this stuff mandatory for group plans, as well as miraculously free for the insureds.** T.D. 9541, Medical Loss Ratio Reporting, 76 F.R. 46621 (8/3/11). Temp. Reg. § 54.9815-2713T(a)(1)(iv) requires coverage by all group plans of contraceptive, breast-feeding and many other services for women without co-pays and without deductibles. REG-120391-10, Medical Loss Ratio Reporting, 76 F.R. 46677 (8/3/11), promulgates identical proposed regulations. The effective date is 8/1/12.

b. **Proposed Regulations require free contraceptives.** REG-120391, Coverage of Certain Preventive Services Under the Affordable Care Act, 78 F.R. 8456 (2/6/13). These proposed regulations would require that insurance companies for tax-exempt religious organizations, including hospitals, universities and schools, provide free contraceptive services to all women insured by them (including students at universities), but would provide that the insurance companies will be reimbursed for the costs of individual contraceptive-only policies by the government. However, HHS Secretary Sibelius stated that the taxpayers would not pay for these reimbursements either. Thus, services that cost $18,000 per woman would become free under Obamacare.

3. **You may have trouble with these proposed regulations if you don't know the meaning of MV, EHB, HAS, HRA, FPL, and "metal level."** REG-125398-12, Minimum Value of Eligible Employer-Sponsored Plans and Other Rules Regarding the health Insurance Premium Tax Credit. 78 F.R. 25909 (5/3/13). The IRS has issued proposed regulations on the § 36B health insurance premium tax credit that provide guidance on determining whether health coverage under an eligible employer-sponsored plan provides minimum value.

B. Qualified Deferred Compensation Plans

1. Rev. Proc. 2013-12, 2013-4 I.R.B. 313 (12/31/12), *modifying and superseding* Rev. Proc. 2008-50, 2008-2 C.B. 464. This revenue procedure updates the comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements of §§ 401(a), 403(a), 403(b), 408(k), or 408(p) of the Code, but that have not met these requirements for a period of time. This system, the Employee Plans Compliance Resolution System ("EPCRS"), permits Plan Sponsors to correct these failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis. The components of EPCRS are the Self-Correction Program ("SCP"), the Voluntary Correction Program ("VCP"), and the Audit Closing Agreement Program ("Audit CAP").

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

1. Schwab v. Commissioner, 111 A.F.T.R.2d 2013-1746 (9th Cir. 4/24/13). The Court of Appeals, in an opinion by Judge M. Smith, affirmed the Tax Court's decision, rejecting the government's argument that "because section 72 contemplates the 'cash value' of a non-annuity 'without regard to any surrender charge,' I.R.C. § 72(e)(3)(A)(i), then section 402(b)(2) must also apply without regard to any surrender charge." In addition to being an erroneous interpretation of § 72(e)(3)(A), the government's interpretation of § 402(b)(2) would "read[] the phrase 'amount actually distributed or made available' entirely out of section 402(b)(2)." The Court of Appeals also refused to defer to the government's interpretation of Reg. § 1.402(b)-1(c) as prohibiting the consideration of surrender charges in valuing a life insurance policy for purposes of § 402(b)(2). The court also rejected the government's argument that

surrender charges could not be considered under § 402(b) because in *Matthies v. Commissioner*, 134 T.C. 141 (2010), the Tax Court concluded that, under the pre-2005 regulations, surrender charges should not be considered when valuing a life insurance policy under § 402(a). The Tax Court decided *Matthies* based on the regulation's requirement to account for the "entire cash value" of the policy, while the regulation interpreting § 402(b)(2) contains no such language. Accordingly, the Tax Court "correctly equated the 'amount' in section 402(b)(2) with the fair market value of the policies that were actually distributed." Finally, the Tax Court did not err in the determination of the fair market value of the policies after taking into account the surrender charges.

2. Substance over form determines that an option to purchase shares of the taxpayer's employer was granted to him by the corporation, not by his ex-wife to whom he transferred the shares in a divorce. Davis v. Commissioner, 111 A.F.T.R.2d 2013-1979 (11th Cir. 5/16/13), *aff'g* T.C. Memo. 2011-286. In connection with the taxpayer's divorce, he transferred one-half of his shares of a family corporation of which he was a shareholder and key employee to his ex-wife, who granted him an option to purchase those shares. Contemporaneously, the corporation agreed to grant him an option to purchase additional stock in the corporation as an inducement for him to continue his employment. However, instead of granting him the option, as contemplated by the parties all along, the corporation redeemed the shares transferred to the taxpayer's ex-wife and assumed the obligation under the option from the ex-wife to permit the taxpayer to purchase the shares from the corporation. Subsequently, that option was modified in several significant respects before it ultimately was exercised. The taxpayer did not report income under § 83(a) upon exercise of the option, but the corporation claimed a deduction under § 83(h). The Eleventh Circuit, in an opinion by Judge Ripple, affirmed the Tax Court's decision that the taxpayer was required to recognize income under § 83 and that the corporation was entitled to a deduction. The court rejected the taxpayer's argument that because the option originally was granted to him by his ex-wife incident to their divorce, his exercise of it was shielded from recognition by § 1041, holding instead that it was granted to him in connection with his performance of services. A key fact supporting the holding was that the revised option from the corporation imposed the requirement that the taxpayer notify the corporation in writing if he chose to make a § 83(b) election. Applying substance over form, the court held that the corporation was the true counter-party to the option granted by the ex-wife and that the option from the corporation, with substantially different rights than those granted by the ex-wife's option, was a different option, despite being termed an "amendment" of the option from the ex-wife. Furthermore, the court added that had the taxpayer exercised the option granted by the ex-wife, it's exercise would not have been governed by § 1041, because § 1041 applied only to the initial transfer of stock and the grant of the option; it does not apply to subsequent dispositions of property received in the divorce. Interestingly, the court went on to state in dicta that the exercise in that case still would have produced ordinary income. This conclusion is puzzling because apart from § 83, the exercise of an option to purchase property, even at a bargain, is not a realization event.

D. Individual Retirement Accounts

1. Their IRAs got flecked by a prohibited transaction, which piqued the interest of the IRS. Peek v. Commissioner, 140 T.C. No. 12 (5/9/13). Two unrelated taxpayers, Peek and Fleck, established self-directed IRAs to purchase a business. The IRAs were funded with rollovers from other IRAs and 401(k) accounts. The purchase was accomplished by (1) Peek and Fleck forming a new corporation, the stock of which was issued to their IRAs for the cash that had been rolled into the IRAs, and (2) the corporation purchasing the business assets from the seller for cash received from the IRAs, proceeds from a bank loan, and the corporation's promissory note, which was guaranteed by Peek and Fleck. The IRAs subsequently sold the stock of the corporation, and the IRS asserted deficiencies against Peek and Fleck on the grounds that the IRAs had failed to qualify under § 408 because the loan guarantees were prohibited transactions under § 4975. Section 408(e)(2)(A) provides that an account ceases to qualify as an IRA if "the individual for whose benefit any individual retirement account is

established ... engages in any transaction prohibited by section 4975." Section 4975(c)(1)(B) prohibits "any direct or indirect ... lending of money or other extension of credit between a [retirement] plan and a disqualified person." The taxpayers argued that the prohibition applies only to an extension of credit that, whether direct (like a loan) or indirect (like a loan guaranty), is "between a plan and a disqualified person," and that the loan guaranties at issue were between disqualified persons (Mr. Fleck and Mr. Peek) and an entity other than the plans, i.e., the corporation that was owned by the IRAs, rather than the IRAs themselves. The Tax Court (Judge Gustafson) rejected the taxpayer's argument and upheld the deficiency.

> [The taxpayers'] reading of the statute, however, would rob it of its intended breadth. Section 4975(c)(1)(B) prohibits "any direct or indirect *** extension of credit between a plan and a disqualified person". ... The Supreme Court has observed that when Congress used the phrase "any direct or indirect" in section 4975(c)(1), it thereby employed "broad language" and showed an obvious intention to "prohibit[] something more" than would be reached without it." Commissioner v. Keystone Consol. Indus., Inc., 508 U.S. 152, 159-160 (1993). As the Commissioner points out, if the statute prohibited only a loan or loan guaranty between a disqualified person and the IRA itself, then the prohibition could be easily and abusively avoided simply by having the IRA create a shell subsidiary to whom the disqualified person could then make a loan. That, however, is an obvious evasion that Congress intended to prevent by using the word "indirect". The language of section 4975(c)(1)(B), when given its obvious and intended meaning, prohibited Mr. Fleck and Mr. Peek from making loans or loan guaranties either directly to their IRAs or indirectly to their IRAs by way of the entity owned by the IRAs.

- Accuracy related penalties were upheld.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. DOMA could be on its way to the Supreme Court. On the other hand, might this case lead to DOMA becoming the Twenty-Eighth Amendment? Massachusetts v. United States Dept. of Health and Human Services, 682 F.3d 1 (1st Cir. 5/31/12), *aff'g* Gill v. Office of Personnel Management, 699 F. Supp. 2d 374 (D. Mass. 7/8/10). In an opinion by Judge Boudin, the First Circuit held that § 3 of the Defense of Marriage Act, 1 U.S.C. § 7, which limits the meaning of the word "marriage" to "a legal union between one man and one woman as husband and wife," and provides that "the word 'spouse' refers only to a person of the opposite sex who is a husband or wife" for purposes of all federal laws is an unconstitutional denial of equal protection in violation the equal protection principles embodied in the Due Process Clause of the Fifth Amendment. Joint return filing status under the Code was one of the issues addressed in the case, as well as government benefits available to married individuals, e.g., employee health benefits and social security benefits. The court further ordered:

> Anticipating that certiorari will be sought and that Supreme Court review of DOMA is highly likely, the mandate is stayed, maintaining the district court's stay of its injunctive judgment, pending further order of this court.

a. The Second Circuit agrees in a split decision. Windsor v. United States, 699 F.3d 169 (2d Cir. 10/18/12) (2-1), *cert. granted*, 184 L. Ed. 2d 527 (12/7/12). In an appeal from a grant of summary judgment in a tax refund suit by the District Court for the Southern District of New York, the Second Circuit (Chief Judge Dennis Jacobs) affirmed the grant of summary judgment to the surviving spouse of a same-sex couple that was married in Canada in 2007 and resided in New York at the time of her spouse's death in 2009 who was denied the benefit of the § 2056 marital deduction for federal estate tax on the ground that the Defense of Marriage Act violated the Equal Protection Clause for want of a rational basis.

- The court concluded that review of § 7 required heightened scrutiny because (A) homosexuals as a group have historically endured persecution and discrimination; (B) homosexuality has no relation to aptitude or ability to contribute to society;

(C) homosexuals are a discernible group with non-obvious distinguishing characteristics, especially in the subset of those who enter same-sex marriages; and (D) the class remains a politically weakened minority. The circuit court further concluded that the class was quasi-suspect (rather than suspect) based on the weight of the factors and on analogy to the classifications recognized as suspect and quasi-suspect. The circuit court held that the rationale premised on uniformity was not an exceedingly persuasive justification for DOMA, and that DOMA was not substantially related to the important government interest of protecting the fisc.

- Judge Straub dissented on the following basic ground:

> The majority holds DOMA unconstitutional, a federal law which formalizes the understanding of marriage in the federal context extant in the Congress, the Presidency, and the Judiciary at the time of DOMA's enactment and, I daresay, throughout our nation's history. If this understanding is to be changed, I believe it is for the American people to do so. . . .
>
> At bottom, the issue here is marriage at the federal level for federal purposes, and not other legitimate interests. The Congress and the President formalized in DOMA, for federal purposes, the basic human condition of joining a man and a woman in a long-term relationship and the only one which is inherently capable of producing another generation of humanity. Whether that understanding is to continue is for the American people to decide via their choices in electing the Congress and the President. It is not for the Judiciary to search for new standards by which to negate a rational expression of the nation via the Congress.

b. Same-sex spouses in valid marriages now get to share in marriage penalties and marriage bonuses when filing income tax returns. United States v. Windsor, 133 S. Ct. 2675 (6/26/13). The Defense of Marriage Act (DOMA), Pub. L. No. 104–199, 110 Stat. 2419 (1996), defines "marriage" in any act of Congress, which (of course) includes the Code, as a legal union "between one man and one woman" as husband and wife. DOMA also defines the word "spouse" to mean only a person of the "opposite sex" who is a husband or wife. This case involved whether the § 2056 estate tax marital deduction was allowable with respect to a bequest to a same-sex spouse whose marriage to the decedent was recognized under local law. The Supreme Court held that § 3 of DOMA — the provision that limits the meaning of the word "marriage" to "a legal union between one man and one woman as husband and wife," and provides that "the word 'spouse' refers only to a person of the opposite sex who is a husband or wife" — is an unconstitutional denial of equal protection in violation of the Due Process Clause of the Fifth Amendment. As a result, the § 2056 estate tax marital deduction was allowable. It follows that for income tax purposes same-sex married couples whose marriages are recognized by local law are eligible to file a joint return and if they do not file a joint return must file as married filing separately.

- Whether this result applies to a same sex married couple that has moved from a state that recognizes same sex marriage to a state that does not recognize same sex marriage is not entirely clear. The *Windsor* Court limited its holding to the definition of marriage in § 3 of DOMA and did not address § 2, which allows states to refuse to recognize same-sex marriages from other states. Section 2 was not challenged in *Windsor*. Some clue to future guidance might be found in Rev. Rul. 58-66, Rev. Rul. 58-66, 1958-1 C.B. 60, in which the IRS ruled that taxpayers who entered into a common-law marriage in a state that recognized common law marriage would be treated as married for tax purposes even if they later moved to a state in which a ceremony is required to initiate the marital relationship.
- Other questions for a future time include whether same sex spouses can toggle into and out of marriages when they change residence and whether domestic partnerships in some states that are not called marriage will be treated as marriage under federal law.

c. A deceased attorney's same-sex spouse is recognized as a surviving spouse and therefore entitled to death benefits under an ERISA-qualified plan.

Cozen O'Connor, P.C. v. Tobits, 112 A.F.T.R.2d 2013-5597 (E.D. Pa. 7/29/13). The Cozen O'Connor firm brought this interpleader action to resolve the issue of whether the parents or the same-sex spouse of a deceased plan participant were entitled to benefits under the firm's ERISA-qualified profit sharing plan. A female attorney with the firm became eligible to participate in the firm's profit sharing plan. She married a woman in Canada, which permits same-sex marriage. The couple resided in Illinois, which at the time of their Canadian marriage did not issue marriage licenses to same-sex couples, but recognized civil unions. The attorney subsequently died. Her parents and her spouse both claimed they were entitled to her benefits under the plan. As required for qualified plans, the plan provided that a death benefit equal to the qualified pre-retirement survivor annuity be paid to the participant's "surviving Spouse." The plan permitted the participant to designate a beneficiary other than the surviving spouse, but only with the consent of the surviving spouse. The parents presented a designation of beneficiary form, the authenticity of which was disputed, that was dated the day before the attorney's death and that listed them as primary beneficiary. The attorney's same-sex spouse had not consented to designation of the parents as beneficiaries. Thus, the issue was whether the attorney's same-sex spouse was a "surviving Spouse" within the meaning of the plan. The plan did not define the term "spouse," except to say that a spouse is the person to whom the participant has been married throughout a defined one-year period. The court relied on *United States v. Windsor*, 570 U.S. ___, 133 S. Ct. 2675 (2013), discussed in section V.A. above, for the proposition that, "where a state has recognized a marriage as valid, the United States Constitution requires that the federal laws and regulations of this country acknowledge that marriage." The court concluded that Illinois had already recognized the same-sex couple's Canadian marriage through a state court order that declared the couple to be parties to a civil union and declared the surviving member of the couple to be the deceased attorney's sole heir. Accordingly, the court concluded that the attorney's same-sex spouse was a "surviving Spouse" under the terms of the plan.

- Because the couple in this case was lawfully married under Canadian law, the result in the case is consistent with Rev. Rul. 2013-17, 2013-38 I.R.B. ___ (8/29/13), discussed in section V.A. below, in which the Service ruled that same-sex couples who are lawfully married under the laws of a state or foreign jurisdiction will be recognized as married for federal tax purposes.

d. Shakespeare called it "The Merry Wives of Windsor." And the IRS interprets *Windsor* broadly – a same-sex marriage celebrated under the laws of one state is a federal tax "marriage" in every state. Rev. Rul. 2013-17, 2013-38 I.R.B. ___ (8/29/13). In the wake of *United States v. Windsor*, 570 U.S. ___, 133 S. Ct. 2675 (2013), the IRS ruled that the marital status of individuals of the same-sex who are lawfully married under the laws of a state that recognizes such marriages will be recognized for all purposes. The ruling held that for Federal tax purposes (1) the terms "spouse," "husband and wife," "husband," and "wife" include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term "marriage" includes such a marriage between individuals of the same sex; and (2) a marriage of same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two individuals of the same sex will be recognized even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages. However the terms "spouse," "husband and wife," "husband," and "wife" do not include individuals (whether of the opposite sex or the same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under the laws of that state, and the term "marriage" does not include such formal relationships.

- Taxpayers may file amended returns, adjusted returns, or claims for credit or refund for any overpayment of tax resulting from this ruling if the statute of limitations is open. The ruling applies retroactively with respect to any employee benefit plan or arrangement or any benefit provided thereunder for purposes of filing original returns, amended returns, adjusted returns, or claims for credit or refund of an overpayment of tax concerning employment tax and income tax with respect to employer-provided health coverage benefits or

fringe benefits that were provided by the employer and are excludable from income under §§ 106, 117(d), 119, 129, or 132 based on an individual's marital status.

2. Net investment income tax of 3.8 percent. Section 1411 of the Code, added by the Health Care and Education Reconciliation Act of 2010, imposes a 3.8 percent tax on the net investment income of individuals, estates, and trusts in taxable years beginning after 12/31/12. For individuals (except nonresident aliens), the tax applies only to the lesser of (1) net investment income or (2) the excess of modified adjusted gross income over a threshold amount. Section 1411(a)(1). The threshold amount is $250,000 for spouses filing a joint return or a surviving spouse, $125,000 for married individuals filing separate returns, and $200,000 for single taxpayers (including heads of household). Section 1411(b). These threshold amounts for individuals are not adjusted for inflation. Modified adjusted gross income is adjusted gross income increased by the amount of foreign earned income excluded under § 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income). Section 1411(d). For estates and trusts, the tax is levied on the lesser of (1) undistributed net investment income, or (2) the excess of adjusted gross income (as defined in § 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins for the tax year ($11,950 for 2013). Section 1411(a)(2). The tax does not apply to a trust that is tax-exempt under § 501, is a charitable remainder trust tax-exempt under § 664, or all of the unexpired interests of which are devoted to charitable purposes. Net investment income is investment income reduced by the deductions properly allocable to that income. Investment income is the sum of (1) gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the tax does not apply), (2) other gross income derived from any trade or business to which the tax applies, and (3) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply. Section 1411(c)(1). The § 1411 tax applies to trade or business income from (1) a passive activity, and (2) trading financial instruments or commodities (as defined in § 475(e)(2)). Section 1411(c)(2). It does not apply to any other trade or business income. However, income on the investment of working capital is not treated as derived from a trade or business and is subject to tax under § 1411. Section 1411(c)(3). Gain or loss from the disposition of a partnership interest or stock in an S corporation is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Section 1411(c)(4). Thus there is a deemed basis adjustment that results in taking into account only the net gain or loss attributable to the entity's property that is not attributable to an active trade or business. Investment income does not include any distributions from a qualified retirement plan or any income subject to self-employment tax. Section 1411(c)(5)-(6). Unlike self-employment taxes, no part of the § 1411 tax is deductible in computing taxable income under Chapter 1. The tax on net investment income is subject to the estimated tax provisions. Section 6654(a).

a. Proposed regulations provide extensive guidance on the tax on net investment income. On 11/30/12, the Treasury Department issued proposed regulations regarding the § 1411 tax on net investment income. REG-130507-11, Net Investment Income Tax, 77 F.R. 72612 (12/05/12). Prop. Reg. § 1.469-11 is amended and Prop. Regs. §§ 1.1411-0 through 1.1411-10 have been published to provide guidance under § 1411, regarding the 3.8 percent net investment income tax. The proposed regulations are proposed to be effective for tax years beginning after 12/31/13. The Treasury Department intends to issue final regulations during 2013. However, § 1411 is effective for tax years beginning after 12/31/12. Taxpayers may rely on the proposed regulations for purposes of complying with § 1411 until the effective date of the final regulations. The general principles underlying them are:

- *General provisions.* Section 1411 is the only provision in chapter 2A of subtitle A of the Code. Chapter 2A does not contain any other operational or definitional provisions. The proposed regulations provide that, except as otherwise provided, all Code provisions that apply for purposes of chapter 1 in determining taxable income as defined in § 63(a) also apply in determining the tax imposed by § 1411. Prop. Reg. § 1.1411-1(a).

- *Application to estates and trusts*. The proposed regulations provide as a general rule that the § 1411 tax applies to all estates and trusts that are subject to the provisions of part I of subchapter J of chapter 1 of subtitle A of the Code. Prop. Reg. § 1.1411-3(a)(1)(i). Accordingly, the § 1411 tax does not apply to trusts that are not classified as trusts under the check-the-box regulations (such as business trusts). It also does not apply to trusts that are exempt from taxes imposed by subtitle A of the Code. Prop. Reg. § 1.1411-3(b)(2)-(4). This is true even if the trust is subject to tax on its unrelated business taxable income. The proposed regulations clarify that grantor trusts are not subject to the tax. The grantor or other person who takes into account the grantor trust's income and deductions is treated as receiving and paying those items directly for purposes of calculating that person's liability for the § 1411 tax. Prop. Reg. § 1.1411-3(b)(5). Special computational rules apply to electing small business trusts and charitable remainder trusts. Prop. Reg. § 1.1411-3(c)(2). Although charitable remainder trusts are not subject to the tax, annuity and unitrust distributions may be net investment income to the non-charitable beneficiary who receives them. The proposed regulations provide detailed rules regarding the calculation of an estate or trust's undistributed net investment income. Prop. Reg. § 1.1411-3(c)(e). Generally, the rules for calculating undistributed net investment income are guided by the subchapter J concept of distributable net income, which apportions income between the trust and its beneficiaries.
- *Net investment income*. Because trade or business income from a passive activity is net investment income, the status of activities as passive and the grouping of activities for purposes of the passive activity loss rules are significant. The proposed regulations provide taxpayers with a fresh start to regroup activities in the first tax year that begins after 12/31/13 in which § 1411 would apply to the taxpayer. Prop. Reg. § 1.469-11(b)(3)(iv). Net investment income, which is investment income reduced by the deductions properly allocable to that income, cannot be less than zero. Deductions that exceed investment income can be carried forward only to the extent provided in chapter 1 of the Code. Prop. Reg. § 1.1411-4(f)(1)(ii). Deductions carried over to a tax year because they were suspended or disallowed by other provisions, such as the investment interest, basis, at-risk or passive activity loss limitations, and allowed for that year in determining adjusted gross income are also allowed in determining net investment income. This is true regardless of whether the taxable year from which the deductions are carried precedes the effective date of § 1411. If items of net investment income (including the properly allocable deductions) pass through to an individual, estate, or trust from a partnership or S corporation, the allocation of the items must be separately stated under § 702 or § 1366. The proposed regulations provide detailed guidance on determining the net investment income arising from the disposition of interests in partnerships or S corporations. Prop. Reg. § 1.1411-7.
- *International issues*. Under § 951(a), United States shareholders who own stock in a controlled foreign corporation on the last day of the corporation's taxable year must include in gross income their pro rata share of the CFC's subpart F income. Similarly, United States persons who hold stock of a passive foreign investment company and elect to treat the PFIC as a qualified electing fund must include in gross income currently under § 1293 a pro rata share of the PFIC's earnings and profits. When the CFC or PFIC later distributes its earnings, the shareholders can exclude the distributions from gross income to the extent they previously were taxed on them. These income inclusions and exclusions result in positive and negative stock basis adjustments. Because these income inclusions are not treated as dividends unless expressly provided for in the Code, the proposed regulations do not treat the income inclusions as net investment income for purposes of § 1411. Instead, CFC shareholders and PFIC shareholders who have made a qualified electing fund election must treat actual distributions of previously taxed earnings as net investment income. Prop. Reg. § 1.1411-10(c)(2)(i). One effect of this rule is that a CFC or PFIC shareholder can have one stock basis for purposes of chapter 1 of the Code and a different stock basis for purposes of the § 1411 tax. To avoid these complexities, the proposed regulations allow a taxpayer to elect to treat the income inclusions required by § 951(a) and § 1293 as net investment income. Prop. Reg. § 1.1411-10(g). The election can be revoked only with the Service's consent. Although the proposed regulations do not address the issue, it appears that the § 1411 tax cannot be reduced with foreign tax credits because foreign tax credits reduce taxes imposed by chapter 1 of the Code, and § 1411 is located in chapter 2A.

- *See also*, FAQs on the net investment income tax, released by the IRS on 11/29/12, 2012 TNT 232-47.

3. "Middle class" tax rates extended "permanently" by the 2012 Taxpayer Relief Tax Act, but the "rich" must pay more. These changes made by Act §§ 101 and 102 include:

- **Individual income tax rates.** The 10%, 15%, 25%, 28%, 33%, and 35% tax rates enacted in 2001 have been made permanent (including the expansion of the 15% bracket to mitigate the "marriage penalty"). However, the 39.6% rate from pre-2001 Act law has been restored for taxable incomes in excess of the following amounts: (1) $450,000 for married couples filing jointly and surviving spouses; (2) $425,000 for head-of-households; (3) $400,000 for single taxpayers; (4) $225,000 for married taxpayers filing separately. For tax years after 2013, these highest bracket threshold amounts are adjusted for inflation with 2012 as the base year. (For trusts and estates the brackets are 15%, 25%, 28%, 33% and, for income in excess of $11,950, 39.6%; there is no 35% rate bracket.)
- **Capital gains and dividends.** Taxing qualified dividends at the same rate as long-term capital gains has been made permanent, but the maximum rate has been increased. The maximum rates are as follows: 20% for income otherwise in the 39.6% bracket, 15% for income otherwise in the 25% or higher bracket (but below the 39.6%), and zero for income otherwise in the 10% or 15% bracket.
- **The above rates are in addition to the Affordable Care Act investment income tax.** Beginning in 2013, the 3.8% net investment income tax under Code § 1411 applies to taxpayers whose modified adjusted gross income exceeds (1) $250,000 for joint returns and surviving spouses; (2) $125,000 for separate returns, and (3) $200,000 for all other taxpayers. Thus, for qualified dividends and most capital gains, the overall rate for taxpayers in the 39.6% rate bracket will be 23.8%. For taxpayers who are subject to a 25%-or-greater rate on ordinary income, but whose income is below the 39.6% rate threshold and are subject to the net investment income tax, the rate will be 18.8%.

B. Miscellaneous Income

1. A creditor's bad debt does not necessarily create debtor's COD income. Abarca v. Commissioner, T.C. Memo. 2012-245 (8/27/12). The Tax Court (Judge Goeke) held that no cancellation of debt income was realized by a taxpayer where the only evidence that the debt was discharged was a letter stating that the loan had been "charged off," but also stated that the taxpayer "still remain[ed] obligated for the repayment of the debt," and no Form 1099-C was introduced into evidence.

2. It looks like-the home mortgage crisis continues, so the mortgage COD exclusion continues. The 2012 Taxpayer Relief Act, § 202, extends the exclusion from income of discharged principal residence indebtedness under § 108(a)(1)(E) to indebtedness discharged before 1/1/14.

3. Excludible mass transit and parking fringe benefits are brought to sweet harmony. For 2012, employees were allowed to exclude $240 per month for parking but only $125 for employer-provided mass-transit and vanpool benefits. Congress came to the rescue in the 2012 Taxpayer Relief Act to provide the same benefit (indexed to $245) through 2013. Congress did not explain how the benefit will apply retroactively in 2012. Perhaps the IRS can figure it out.

4. No COD from collateralized welfare benefit fund borrowing. Pinn v. Commissioner, T.C. Memo. 2013-45 (2/11/13). The taxpayer brothers were sole-shareholders and employees of their home construction company. The taxpayers caused the corporation to appoint Local 707 of the National Production Workers Union (of which four office employees became members) to facilitate the creation of an employee death benefit arrangement in which the taxpayers as owner/employees were allowed to participate. The union set up the American Fund as a voluntary employees beneficiary association (VEBA) which provided a trust for guaranteed death benefits. The trust funded several million dollars of death benefits by purchasing life insurance policies. The cost was paid with deductible expenses by the taxpayers'

corporation. Each of the taxpayers then borrowed $500,000 as a hardship loan, justified by them because of unexpected taxes. The loans were repayable with annual $50,000 quarterly payments plus interest, or as a reduction in death benefits. No payments were made. At the insistence of its impendent accountant, the trust reported the loans in 2002 on a schedule to its form 5500 as in default or uncollectable. The Tax Court (Judge Holmes) rejected the IRS assertion that the taxpayers recognized COD income in 2002. The court concluded that the loans remained collectable from the taxpayers' death benefits with the insurance policies provided as collateral. The court rejected the IRS argument that the insurance policies were insufficient because they were owned by the trust, not the taxpayers. The court observed that, "It follows that if a reduction in the Pinns' death benefits or capture of insurance proceeds owed (in some way) to them is an adequate alternative form of repayment, there should be no COD income just because the Pinns failed to make their quarterly payments—any more than we would find COD income only because a homeowner stopped making payments on a $50,000 mortgage secured by a house worth a million." The court held further that, when a debt is collectible and fully secured (where the fair market value of the collateral exceeds the loan balance), default alone will not result in COD income." The court also observed that the trust could collect the full value of the loans with a reduction in the taxpayers' death benefits.

5. **The IRS says that a cut scrape or bruise is all you need for 100 percent exclusion under § 104(a)(2).** Private Letter Ruling 201311006 (released 3/15/13). This ruling dealt with the scope of the exclusion for damages for physical personal injury under § 104 that were paid out a qualified settlement fund. It involved damages paid to victims of a fire and close relatives and estates of deceased victims. Each of the victims received damages because he or she either suffered a cut, scrape, bruise, or other physical injury in the incident, or inhaled thick smoke and, as a result, suffered smoke inhalation during the fire. With no further explanation than "each of the Victims suffered a personal physical injury or physical sickness as a result of the Incident," the IRS ruled that 100 percent of the damages were excludable. The ruling made no effort to separate damages for the physical injuries and emotional injuries suffered by the survivors, and it does not mention punitive damages.

- **Compare: It looks like damages for physical sickness caused by emotional distress can be excluded if they go beyond mere symptomatic manifestations of the underlying emotional distress.** Domeny v. Commissioner, T.C. Memo. 2010-9 (1/13/10). The taxpayer received approximately $33,000 in settlement of a claim for claims for wrongful termination of employment one-third of amount received in settlement of claims for wrongful termination of employment and violations of various civil rights statutes. The taxpayer's former employer paid approximately $8,000 to her that was reflected on a Form W-2 as employee compensation, $8,000 to the taxpayer's lawyer, for which no information return was filed, and $17,000 to the taxpayer that was reflected on a Form 1099-MISC as "nonemployee compensation." The Tax Court (Judge Gerber) held that the $8,000 paid directly to the taxpayer was includable wage compensation, and the remaining amount was excludable under § 104(a)(2) as damages for physical injuries attributable to exacerbation of multiple sclerosis caused by a hostile work environment. The payor-former employer's intent in settlement of the claim was evidenced by the issuance of separate checks and different information returns; these facts indicated that the former employer intended amount in excess of wages due to be in settlement of tort claims for physical injuries attributable to the exacerbation of multiple sclerosis.
- The legislative history indicates that physical manifestations of emotional distress, such as insomnia, headaches, and stomach disorders, are not to be treated as physical injuries. H.R. Rep. No. 737, 104th Cong., 2d Sess. 143, n.56 (1996).
- **Compare: Having a heart attack can improve your tax heath.** Parkinson v. Commissioner, T.C. Memo. 2010-142 (6/28/10). The Tax Court (Judge Thornton) held that one-half of the amount received by the taxpayer in settlement of suit for intentional infliction of emotional distress was excludable under § 104(a)(2), because the payor intended it to be compensation for a heart attack suffered as a result of the emotional distress. He reasoned that "a heart attack and its physical aftereffects constitute physical injury or sickness rather

than mere subjective sensations or symptoms of emotional distress." The other one-half of the settlement was not excludable because it was compensation for the emotional distress itself.

- **Compare: The IRS's treatment of innocent ex-cons.** ILM 201045023, Tax Treatment of Compensation to Exonerated Prisoners (11/4/10, released 11/12/10). An individual who was wrongfully convicted of a crime and was wrongfully incarcerated for several years may exclude from gross income under § 104(a)(2) the compensation he receives from the state where "[t]he individual suffered physical injuries and physical sickness while incarcerated." It may have helped the result that one of the individuals involved, while meeting with IRS officials, suffered a seizure and had to be carried out of the room by paramedics – apparently the result of head injuries sustained while in prison.

- **Compare: Compensation to victims of human trafficking is tax-free. The IRS would have been pilloried if it had ruled the other way.** Notice 2012-12, 2012-6 I.R.B. 365 (1/19/12). Mandatory restitution payments awarded under 18 U.S.C. § 1593, which criminalizes (1) holding a person to a condition of peonage; (2) kidnapping or carrying away a person to sell the person into involuntary servitude or to be held as a slave, (3) providing or obtaining a person's services or labor by actual or threatened use of certain means including force, physical restraint, serious harm, and abuse of legal process, and (4) sex trafficking of children or by force, fraud, or coercion, are excluded from gross income.

- **But see** LTR 200041022 (7/17/00), which required that a damage award be allocated between (a) damages awarded for the period of sexual harassment without observable injury and (b) damages awarded for the period after an incident of sexual harassment that resulted in physical injury occurred.

6. "Neither a borrower nor a lender be, for loan oft loses both itself and friend," and a loan gives rise to excludable COD income, not compensation income. McAllister v. Commissioner, T.C. Memo. 2013-96 (4/8/13). During 2005, the taxpayer borrowed a total of $78,849 from his employer and executed promissory notes in favor of the employer. The promissory notes, which did not have repayment dates and did not require interest payments, required the taxpayer to repay the loans from bonuses he earned through incentive plans that formed part of his compensation. The taxpayer's employment ended in 2007 when his employer encountered financial difficulties. The taxpayer did not report any portion of the $78,849 as income on his return for 2007, which he timely filed in March 2008. The employer was acquired by a corporation that issued to the taxpayer in May 2008 a Form 1099-MISC that reported $78,849 as nonemployee compensation for 2007. The Tax Court (Judge Morrison) rejected the government's contention that the taxpayer's employer paid to the taxpayer in 2007 a constructive bonus, which the taxpayer used to repay the loans. Instead, the court concluded that the taxpayer had $78,849 of cancellation of indebtedness income in 2007 because the Form 1099-MISC memorialized the decision of the corporation that acquired the employer to forgive the debt. The fact that the Form 1099-MISC classified the income as nonemployee compensation was "a bookkeeping error." The court also concluded that, immediately before the discharge of indebtedness, the taxpayer was insolvent in the amount of $22,641 and therefore could exclude this portion of the income under § 108(a)(1)(B). The court declined to impose the accuracy-related penalty for a substantial understatement of income tax imposed by § 6662(a) and (b)(2). The court concluded that the taxpayer had reasonable cause for and acted in good faith with respect to the underpayment and therefore was not liable for the accuracy-related penalty pursuant to § 6664(c)(1).

7. Equal tax rights for nonresident alien gamblers who lose. Park v. Commissioner, ___ F.3d ___ (D.C. Cir. 7/9/13), *rev'g* 136 T.C. 569 (2011). In an opinion by Judge Kavanaugh, the D.C. Circuit held that a nonresident alien who has gambling winnings in the United States should be treated the same as a U.S. citizen and should be allowed to subtract losses from their wins within a gambling session to arrive at per-session wins or losses. The court rejected the IRS's argument that for purposes of § 871, which taxes non-resident aliens for all "interest . . ., dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income" received from sources in the United States, gambling winnings are computed on a

per bet rule. The court quoted IRS Office of Chief Counsel Memorandum AM2008-11 (2008) [CCA 2008011]: "'We think that the fluctuating wins and losses left in play are not accessions to wealth until the taxpayer redeems her tokens and can definitively calculate' her net gains. ... Because gain or loss may be calculated over a series of wagers, a 'taxpayer who plays the slot machines[] recognizes a wagering gain or loss at the time she redeems her tokens.' ... Therefore, U.S. citizens do not 'treat every play or wager as a taxable event.' ... The result is that U.S. citizens can measure their gambling winnings and losses on a per-session basis." The court cited *Shollenberger v. Commissioner*, T.C. Memo. 2009-306, for that same proposition.

- The Tax Court (Judge Cohen) had reasoned that a nonresident alien cannot "deduct or offset gambling losses against gambling winnings," in part because for a U.S. citizen, the deduction for gambling losses is an itemized deduction. "Thus, a nonresident alien who is not engaged in gambling as a business within the United States is subject to tax under section 871(a)(1) on gross income from gambling without a deduction for gambling losses." The Tax Court opinion did not address the reasoning of IRS Office of Chief Counsel Memorandum AM2008-11, 4 (2008).

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

1. Computing the home office deduction just got easier, but qualifying for it still remains as difficult as ever. Rev. Proc. 2013-13, 2013-6 I.R.B. 478 (1/15/13). This revenue procedure provides an optional safe harbor method that taxpayers may use to determine the amount of expenses deductible under § 280A for business use of a portion of a personal residence, i.e., the "home office deduction," in lieu of calculating, allocating, and substantiating of actual expenses. Taxpayers using the safe harbor method must satisfy all requirements of § 280A for determining eligibility to claim a deduction. Under the revenue procedure, in lieu of depreciation, and allocable repairs, utilities, and insurance, a taxpayer may deduct $5 per square foot for up to 300 square feet (i.e., a maximum of $1,500 per year) for the portion of the residence used *exclusively* for business as required by § 280A. A taxpayer electing the safe harbor method for a taxable year cannot deduct any actual expenses related to the qualified business use of that home, but may deduct all of the qualified home mortgage interest and real estate taxes, as well as any allowable casualty losses, as itemized deductions. (Depreciation for the year is treated as zero.) A taxpayer using the safe harbor method may deduct allowable trade or business expenses unrelated to the qualified business use of the home, such as advertising, wages, and supplies. An election for any taxable year is irrevocable, but the election is year-by-year, and changing from the safe harbor method in one year to actual expenses in a succeeding taxable year, or vice-versa, is not a change of accounting method. The safe harbor method does not apply to an employee with a home office if the employee receives from an employer advances, allowances, or reimbursements for expenses for the business use of the employee's home. There are other details and several examples.

- For one of the gotchas that still remains, see *Hamacher v. Commissioner*, 94 T.C. 348 (1990).

2. What the taxpayer says his tax lawyer said is a "fair" price is not probative evidence. DiDonato v. Commissioner, T.C. Memo. 2013-11 (1/14/13). Among the many issues in this case, virtually all of which went disastrously for the taxpayer, was the applicability of the § 280A limitation on deductions for personal residences used for mixed business and personal purposes. The taxpayer rented a property to his father as the father's principal residence for the entire year in question. Notwithstanding the general rule in § 280A(d) that a family member's use of a dwelling unit is treated as personal by the taxpayer, § 280(d)(3) provides that a taxpayer is not treated as using the property for personal purposes for any period for which the dwelling unit is rented to the family member for use as the family member's principal residence at a fair rent. The Tax Court (Judge Laro) held that the taxpayer failed to prove that the rent was "fair" because the taxpayer "offered no evidence at trial as to the fair rental value of the ... property other than [his own] testimony that the amount of rent to be charged was set by his tax attorney and, in [his own] view, the rent was fair by virtue of his belief that the property was in "deplorable shape." That testimony alone was unpersuasive,

because the legislative history makes clear that the fairness component be determined on the basis of comparable rents in the area. See H.R. Rept. No. 97-404, at 8 (1981).

• **See an earlier opinion in this case.** DiDonato v. Commissioner, T.C. Memo. 2011-153 (6/29/11). The Tax Court (Judge Laro) denied a 2004 charitable contribution deduction on grounds of lack of substantiation under § 170(f)(8). The alleged donation was memorialized by a 2004 contract between taxpayer and the charitable recipient but the formal transfer did not occur until 2006, when the donation was acknowledged. The 2006 acknowledgment was too late to substantiate a 2004 deduction because it was received by taxpayer after his 2004 federal income tax return was filed.

D. Deductions and Credits for Personal Expenses

1. An incomplete effort to collect on a homeowner's insurance policy is all that's necessary to secure a casualty loss deduction. Ambrose v. United States, 106 Fed. Cl. 152 (Fed. Cl. 8/3/12). The taxpayers' home was destroyed in a fire, and the next day they filed a timely claim with their homeowner's insurance company. However, they failed to file a timely "proof of loss" as required by the insurance policy; they sued the insurance company in state court and lost. The IRS applied § 165(h)(5)(E) to deny the taxpayer's claim for a casualty loss deduction. Section 165(h)(5)(E) provides that "[a]ny loss of an individual described in subsection (c)(3) to the extent covered by insurance shall be taken into account under this section only if the individual files a timely insurance claim with respect to such loss." The Court of Federal Claims (Judge Allegra) upheld the taxpayers' refund claim, allowing the casualty loss deduction, on the ground that § 165(h)(5)(E) does not apply to a taxpayer who files a timely claim but whose claim is rejected by the insurance company when the taxpayer fails to timely file a "proof of loss" as required by the insurance policy. Reading from Webster's Dictionary to define the meaning of the terms "file" and "claim" in § 165(h)(5)(E), Judge Allegra concluded that there is a "distinction between the filing of a claim, i.e. the 'deliver[y] . . . to the proper officer' of a 'demand for something due or believed to be due' and the subsequent submission of proof of the validity of that claim," and that in enacting § 165(h)(5)(E), Congress intended to require only the former. He rejected the government's argument that "an insurance 'claim' [includes fulfilling] all of the conditions on recovery found in a given policy."

2. If you don't plead the right theory, you lose – even though had you pled the correct theory, you might have won. Halata v. Commissioner, T.C. Memo. 2012-351 (12/19/12). In 2007, the taxpayer was suckered by her female paramour into paying $180,000 in a scam "bank guarantee transaction" that promised a return of $2.5 million, with the first installment to be received only a few weeks after the payment was made. The "opportunity" was presented through one Montgomery, a California lawyer, who provided the taxpayer with documents memorializing the transaction. No funds ever were received. The taxpayer hired a lawyer to attempt to recover the funds. Montgomery insisted that the purported bank-guaranty transaction was a legitimate transaction, that he was merely a facilitator of the transaction, received no money, and had no information about how the transaction worked or the identities and roles of the parties to the transaction. In 2009, the taxpayer's lawyer advised her that a suit against Montgomery likely would be fruitless. The taxpayer did not claim a theft deduction on her 2007 tax return and did not file a 2008 tax return. The IRS audited her for 2007 and 2008 and proposed deficiencies. In the Tax Court, the taxpayer argued that she suffered a theft loss in 2007 and 2008 that would offset her otherwise unreported income. The Tax Court (Judge Morrison) agreed with the taxpayer that a theft had occurred under the relevant state law and that Montgomery most likely was the thief, but denied a deduction for the year before the court because the loss was not sustained until 2009. Based on all of the facts, prior to 2009, she had a reasonable prospect of recovery. Furthermore, the taxpayer never filed a pleading asserting her theory that there was a net-operating loss for 2009 that should be carried back to prior years. Judge Morrison concluded:

> 3. The effect of the theft-loss deduction for 2009 on Halata's tax liabilities for 2007 and 2008

> The next issue to resolve is whether Halata's theft loss in 2009 creates a net-operating loss for 2009 that should be carried back and deducted against her 2007 or 2008 income. The difference between gross income and deductions is a net-operating loss. See sec. 172(c). A net-operating loss for 2009 exists if Halata's deductions for 2009, including the theft-loss deduction, exceed her gross income for 2009. The general rule for carrying back net-operating losses is that a net-operating loss is first deducted from income in the tax year that is two years before the year of the net-operating loss. See sec. 172(b)(1)(A)(i). The year of the net-operating loss that would result from Halata's theft loss is 2009, and, therefore, under the general rule, the first year of the carryback period would be 2007. The year 2007 is before us jurisdictionally. The problem is that Halata never filed a pleading asserting her theory that there was a net-operating loss for 2009 that should be carried back to prior years. See Tax Ct. R. Pract. & Proc. 34(b)(4) (petition is required to "assign[]", i.e., state, every error alleged to have been made by the IRS in the determination of the deficiency). The Court and the IRS were not advised of her theory until after trial. See Tax Ct. R. Pract. & Proc. 31(a) (purpose of pleadings is to give parties and Court fair notice of matters in controversy). Therefore she is barred from asserting it. See Tax Ct. R. Pract. & Proc. 34(b)(4) (any issue not raised in assignments of error in petition is deemed conceded). Also, Halata would have had the burden of proof regarding the net-operating loss. She adduced no evidence regarding her gross income for 2009 and her deductions for 2009 (other than the $ 181,104 theft-loss deduction). Without this information, her net-operating loss cannot be calculated. She would not have met her burden of proof. See Paulson v. Commissioner, T.C. Memo. 1991-508, 62 T.C.M. (CCH) 968, 974 (1991).

- The lawyer who represented the taxpayer in this matter appeared to have been unaware of Rev. Rul. 2009-9, 2009-2 C.B. 735 (the "Madoff" ruling, which discussed the three-year carryback for theft losses under § 172(b)(1)(F)) until after the trial.

3. One P&S, one loan, one property – all residence. Norman v. Commissioner, T.C. Memo. 2012-360 (12/27/12). The taxpayers purchased a principal residence on 8.875 acres of land for $1.8 million. The land was zoned for 1/4 acre lots, and the taxpayers hired a civil engineering firm to study the feasibility of development. However, the purchase contract did not allocate the price between the residence with a limited amount of acres and remaining acreage, and the taxpayers obtained a single mortgage of $1,860,000. The land was never subdivided. The taxpayers deducted all of the interest on the mortgage, but the IRS allowed only the interest on $1.1 million as qualified home mortgage interest, rejecting the taxpayer's claim that they paid $1 million for the dwelling unit plus three acres and $800,000 for "investment property" consisting of the other 6.875 acres. The Tax Court (Judge Thornton) upheld the deficiency, largely on the grounds that the purchase contract did not allocate the price between the residence and the acreage that was purportedly investment property and the acquisition was financed with a single loan, which included not only the purchase price, but also a line of credit for renovations to the house.

4. Miscellaneous not-so-permanent extensions through 2013. The 2012 Taxpayer Relief Tax Act extends multiple expiring individual deductions, but only through 2013, so Congress can be sure it has some work to do next year. These include extenders for:

a. Teachers. Section 201 of the Act extends the § 62(a)(D) above-the-line deduction for up to $250 of classroom related expenditures of elementary and secondary school teachers for expenses incurred in taxable years beginning in 2012 and 2013.

b. Mortgage insurance. Section 204 of the Act extends the Code § 164(b)(5) deduction as qualified residence interest provided for mortgage insurance premiums incurred in connection with acquisition indebtedness for a qualified residence that are paid or accrued before 1/1/14.

c. State and local taxes: A not-so-permanent extension of the election to deduct state sales taxes. Section 205 extends the Code § 164(b)(5) election to deduct state and local sales and use taxes in lieu of state and local income taxes to tax years beginning before 1/1/14.

- **Thank you!** Professor Shepard (Texas) and Professor McMahon (Florida) thank Congress and the President for their solicitude on this issue. For Professor Simmons (California), this provision is irrelevant.

5. Standard deduction marriage penalty relief is now permanent. The 2012 Taxpayer Relief Tax Act made permanent the provisions in Code § 63 providing a basic standard deduction for a married couple filing a joint return double the basic standard deduction for single individuals. The basic standard deduction for married taxpayers filing separately is the same as the basic standard deduction for single taxpayers.

6. PEP and PEASE zombie-like arise from the grave.

a. PEP. The 2012 Taxpayer Relief Tax Act permanently revived the phase-out of personal exemptions for high-income taxpayers for years beginning after 2012. The phase-out kicks in the following AGI levels: (1) $300,000 for joint returns or surviving spouses; (2) $150,000; and for married taxpayers filing separately; (3) $275,000 for heads of household; and (4) $250,000 for single taxpayers. After 2013, the threshold amounts are adjusted for inflation. The amount of the phase-out, as previously, is 2% of the exemption amount for each $2,500 ($1,500 for married taxpayers filing separate returns), or portion thereof, by which AGI exceeds the phase-out threshold.

b. PEASE The Act also permanently revived for years beginning after 2012 the limitation on itemized deductions. Like PEP, the phase-out begins at the following AGI levels: (1) $300,000 for joint returns filers or surviving spouses; (2) $150,000; and for married taxpayers filing separately; (3) $275,000 for heads of household; and (4) $250,000 for single taxpayers. After 2013, the threshold amounts are adjusted for inflation. The amount of the phase-out, as previously, is 3% of the excess of certain itemized deductions over the threshold amount, but not by more than 80% of the itemized deductions subject to the limitation. (As previously, the limitation does not apply to medical expenses, investment interest, casualty and theft losses, and wagering losses.)

7. Making children permanently cheaper. The Taxpayer Relief Tax Act extended permanently the increase of the § 24 child credit for taxpayers having children under age 17 to $1,000. (No inflation adjustment has been added.) The refundability of the credit to the extent of 15% of the taxpayer's earned income in excess of $3,000 (unindexed) has been extended only through 2017.

8. Send the kids to day care, get a tax break. The Taxpayer Relief Tax Act extended permanently the increases to the § 21 dependent care credit in the EGTRRA 2001. The credit is 35% of up to $3,000 of eligible expenses (maximum $1,050) for one qualifying dependent, and 35% of up to $6,000 of eligible expenses (maximum $2,100) for two or more qualifying dependents. The 35% credit rate is reduced, but not below 20%, by one percentage point for each $2,000 (or fraction thereof) of AGI above $15,000.

9. It's tax-smart to adopt rather than to procreate. The Taxpayer Relief Tax Act extended permanently the EGTRRA Code § 23 credit for adoption expenses, but not the changes in the credit in the Patient Protection and Affordable Health Care Act. As a result: (1) the maximum per-child credit is $10,000 (inflation adjusted) for all adoptions; (2) the credit begins to phase-out at a modified AGI of $150,000 (inflation adjusted); (3) for special needs adoptions, the credit is $10,000 regardless of actual expenses; and (4) the credit is allowed against the AMT. The credit remains nonrefundable. For 2013 the maximum credit is expected to be approximately $12,770 and the phase-out is expected to begin at approximately $189,710, after inflation adjustments.

10. EITC 2001 simplification and expansion is made permanent and 2009 expansion is extended five years. The Taxpayer Relief Tax Act made permanent the 2001 simplifying revisions to the Code § 32 earned income tax credit, as amended by the 2003 Jobs and Growth Tax Relief Reconciliation Act and the 2004 Working Families Tax Relief Act, and

also extended the 2009 increases in the earned income credit for taxpayers with three or more qualifying children through 2017. Through 2017, the phase-out threshold for married taxpayers filing joint returns will be $5,000 (inflation adjusted) higher than for other taxpayers, and starting in 2018 the phase-out threshold for married taxpayers filing joint returns will be $5,000 (inflation adjusted) higher than for other taxpayers.

11. Is this a casualty loss in limbo? Alphonso v. Commissioner, 136 T.C. 247 (3/16/11). The taxpayer owned stock in a N.Y. cooperative housing corporation from which she rented an apartment as her personal residence. When a retaining wall on the grounds of the apartment complex collapsed, the corporation levied an assessment for the cost of repairs, and the taxpayer paid $26,390, with respect to which she claimed a casualty loss deduction of $23,188 (reflecting computational limitations in § 163(h)). The IRS disallowed the deduction, and the Tax Court (Judge Chiechi) upheld the disallowance. Judge Chiechi reasoned that under the relevant state law and controlling legal instruments, the taxpayer had no property interest in the retaining wall, which was part of the common grounds — nothing in the lease, the corporation charter and by-laws, or any other governing documents indicated that the taxpayer possessed a leasehold interest, an easement, or any other property interest in the common grounds. Finally, Judge Chiechi rejected the taxpayer's argument that § 216, which allows cooperative apartment owners to deduct their shares of the real estate taxes and mortgage interest paid by the cooperative corporation, should be extended by judicial interpretation to casualty losses. Although Judge Chiechi rejected the IRS's argument that the absence of a reference to casualty losses in § 216 conclusively determined that it did not apply to casualty losses, after examining the legislative history she concluded that Congress intended § 216 to apply only to interest and real estate taxes.

a. No, it's not in limbo; the loss is allowed by the Second Circuit. Alphonso v. Commissioner 111 A.F.T.R.2d 756 (2d Cir 2/6/13), *rev'g* 136 T.C. 247 (2011). The Second Circuit, in an opinion by Judge Kearse, reversed the Tax Court's decision. The Court of Appeals concluded that the right of a stockholder in a cooperative housing corporation to use the grounds and to exclude persons who are not tenants or the guests of tenants, coupled with obligations as a tenant stockholder under the cooperative lease, constituted a property interest in the land sufficient to entitle the taxpayer to the claimed casualty loss deduction.

12. Home mortgage interest is deductible only if you actually pay it. Smoker v. Commissioner, T.C. Memo. 2013-56 (2/21/13). For the years in question, the taxpayer paid over $40,000 of home mortgage interest and approximately $28,000 of home mortgage interest was deferred and capitalized into the principal amount. Although the statutory language of § 163(h)(3) allows a deduction for qualified residence interest that is "paid or accrued" during the taxable year, the Tax Court (Judge Laro) upheld the denial of a deduction for the accrued but unpaid interest, because the taxpayer was an individual on the cash method — which is the method applicable to all individuals with respect to personal expenses. Under well-established precedents, a cash method taxpayer may deduct in any taxable year only interest actually paid during that taxable year. The accrued but unpaid qualified residence interest would not be deductible until actually paid. Inasmuch as no evidence was introduced to show that taxpayer relied on professionals in preparation of his tax return, the accuracy-related penalty was upheld.

a. Deductible interest. Hargreaves v. Commissioner, T.C. Summ. Op. 2013-37 (5/15/13). Taxpayers purchased a home in California with a "negative amortization loan" from a bank. For the year 2007, they received a substitute Form 1098, which characterized interest as (1) gross interest paid of $59,554; (2) interest shortage of $33,288; and (3) net interest paid of $26,266, with the interest shortage added to the balance of the loan. In their self-prepared federal income tax return for 2007, they deducted the gross interest amount. The Tax Court (Judge Haines) in this S case held that only the net interest was deductible, but did not uphold the accuracy-related penalty because taxpayer husband "credibly testified that he reported the interest deduction using what he thought the Form 1098 stated."

13. The Court of Federal Claims rejects as a "shibboleth"[2] the proposition that whether a "theft" has occurred, for purposes of § 165(c)(3) depends upon whether a theft has occurred under state law. Goeller v. United States, 109 Fed. Cl. 534 (3/20/13). The Court of Federal Claims (Judge Allegra) denied both the taxpayers' and the government's cross-motions for summary judgment in a refund suit involving whether the taxpayers suffered a theft loss deductible under § 165(c)(3) as result of a failed investment in a real estate business. The court observed that both the taxpayers and the government accepted, and cited authority for, the proposition that whether a "theft" has occurred, for purposes of § 165(c)(3) depends upon whether a theft has occurred under state law, but disputed whether the controlling law is that of Ohio or of California. However, in denying the motions on the ground that there were material factual issues to be resolved by trial, the court unequivocally rejected the proposition that whether a "theft" has occurred, for purposes of § 165(c)(3) depends upon whether a theft has occurred under state law. Rather, the court held that there was a federal tax law concept of theft based on "a long-standing and well-accepted meaning" of the term theft found in Black's Law Dictionary, which "defines that term as '[t]he fraudulent taking of corporeal personal property belonging to another, from his possession, or from the possession of some person holding the same for him, without his consent, with intent to deprive the owner of the value of the same, and to appropriate it to the use or benefit of the person taking.'" The court also observed that "by the time the 1954 [Internal Revenue] Code was enacted, it also was well-accepted, based on Black's Law Dictionary that the definition of 'theft' includes a crime in which one 'obtains possession of property by lawful means and thereafter appropriates the property to the taker's own use.'" Furthermore, "these definitions of 'theft' are largely indistinguishable from that employed in the Model Penal Code, which defines a 'theft' as occurring where a person 'unlawfully takes, or exercises unlawful control over, movable property of another with purpose to deprive him thereof.' ... This is relevant because the Model Code's provisions have often been employed in determining the scope of an offense referenced in a Federal statute." These "well-accepted definitions of 'theft'" thus render reference to state law unnecessary. The court concluded that "where a federal statute uses a common-law term of established meaning without otherwise defining it, the practice is to give that term its common meaning," and saw "no reason why this rule ought not apply to section 165(c)(3)." Nothing in the statutory language, its legislative history, or the relevant regulations suggested otherwise.

- For authorities holding that to claim a theft loss, the taxpayer must prove that a theft occurred under the applicable state law, see, e.g., *Citron v. Commissioner*, 97 T.C. 200 (1991) (mere refusal to return property was not equivalent of embezzlement under state law); *Paine v. Commissioner*, 63 T.C. 736 (1975), *aff'd by order*, 523 F.2d 1053 (5th Cir.1975) (denying a loss deduction under § 165(c)(3) to an investor who purchased publicly traded stock at a price that was inflated by fraudulent financial statements; no "theft" had occurred under state law because the taxpayer failed to prove a causal connection between the misrepresentations and the loss); *Alioto v. Commissioner*, 699 F.3d 948 (6th Cir. 2012) (taxpayer failed to demonstrate that investment loss was due to false statements that would constitute theft under relevant state law); *Estate of Meriano v. Commissioner*, 142 F.3d 651 (3d Cir. 1998) (estate was entitled to theft loss for attorney's failure to return excessive amounts withdrawn from the estate because a theft occurred under state law; extensive analysis of relevant state law); *Bellis v. Commissioner*, 540 F.2d 448 (9th Cir. 1976) (denying a theft loss deduction because under relevant state law no theft had occurred).

14. Another case where married filing separately significantly changes the ground rules. Field v. Commissioner, T.C. Memo. 2013-111 (4/18/13). Married taxpayers must file a joint return in order to claim the § 26 credit for adoption expenses. The Tax Court (Judge

[2] [**5**] The Gileadites captured the fords of the Jordan leading to Ephraim, and whenever a survivor of Ephraim said, "Let me cross over," the men of Gilead asked him, "Are you an Ephraimite?" If he replied, "No," **[6]** they said, "All right, say 'Shibboleth.'" If he said, "Sibboleth," because he could not pronounce the word correctly, they seized him and killed him at the fords of the Jordan. Forty-two thousand Ephraimites were killed at that time. (Judges 12:5-6 (NIV).)

Thornton) held that the joint filing requirement does not violate the constitutional right to equal protection even though the married taxpayer who filed separately had adopted a child alone, without her husband also adopting the child.

E. Divorce Tax Issues

1. Counting to six distinguishes child support from alimony. Schilling v. Commissioner, T.C. Memo. 2012-256 (9/5/12). The Tax Court (Judge Swift) applied § 71(c) and Temp. Reg. § 1.71-1T(c), Q&A 18, to hold that the amount by which payments received pursuant to a divorce decree were reduced on dates that corresponded to taxpayer's children attaining age 18 or starting college were child support. However, an amount by which payments were reduced to zero on a fourth date, in the sixth post-separation year was treated as alimony. Although the complete termination of payments occurred within six months of one child's twenty-first birthday, which ordinarily would be treated as related to a contingency relating to a child under § 71(c)(2)(B), Temp. Reg. § 1.71-1T(c), Q&A 18, expressly provides that complete cessation of support payments during the sixth post-separation year does not qualify as a contingency relating to a child.

2. The validity and effect of an admittedly executed Form 8332 is beyond question. George v. Commissioner, 139 T.C. No. 19 (12/19/12). The taxpayer, who was the custodial spouse following a divorce, in compliance with a state court order, executed a Form 8332 (Release of Claim to Exemption for Child of Divorced or Separated Parents), which stated that "I agree not to claim an exemption for" her daughter as a dependent for the years at issue. However, the taxpayer believed that the state court order was improper, because she thought that court lacked jurisdiction to issue such an order and because any such order should have taken into account her former husband's past arrears in child support before enabling him to obtain the dependency exemption. As a result, she nevertheless claimed a dependency exemption and a child tax credit for the child. The taxpayer's former spouse also claimed the child as a dependent for those years and attached the executed Form 8332 to his tax returns. The Tax Court (Judge Gustafson), held that the taxpayer was not entitled to the dependency exemption. The executed Form 8332 was not rendered invalid by any error in the state court order requiring it or by the fact that the taxpayer signed the Form 8332 under the compulsion of that state court order. The release of the claim to the exemption was valid. Likewise the child credit was disallowed.

3. If an ex-spouse disobeys a court order to sign Form 8332, the noncustodial spouse still loses. Armstrong v. Commissioner, 139 T.C. No. 18 (12/19/12). The taxpayer and his wife divorced, and his ex-wife had custody of their son. A state court order provided that the taxpayer would be entitled to the dependency exemption and explicitly required his ex-wife to execute in his favor a Form 8332, "Release of Claim to Exemption for Child of Divorced or Separated Parents") provided that the taxpayer met child support obligations. The taxpayer met his child support obligations, but his ex-wife failed to provide the executed Form 8332. The IRS disallowed the taxpayer's claimed dependency exemption, even though he appended to his tax return the court order and provided the IRS evidence that he had met his support obligations. In a reviewed opinion (12-3) by Judge Gustafson, the Tax Court upheld the denial of the exemption. The state court order, even though countersigned by the taxpayer's ex-wife was not a substitute for a Form 8332 because it failed to unconditionally declare that the ex-wife "will not claim such child as a dependent" for the year at issue. That defect is not cured by the noncustodial parent's proof that he has fulfilled support conditions beyond those in the statute. Likewise the child credit was disallowed.

- Judge Holmes wrote a very, very lengthy dissent, in which Judges Halpern and Vasquez joined. The essence of the dissent was that the statutory requirement to "attach" the waiver to the tax return properly requires only that it be "associated with" or "connected to by attribution" to the return. Thus, all relevant documents should be considered to be "attached" to a taxpayer's return, without regard to the point in time those documents are provided to the IRS.

4. Shifting taxation of child support payments to the custodial spouse if state law allows it. DeLong v. Commissioner, T.C. Memo. 2013-70 (3/11/13). The Tax Court

(Judge Kroupa) held that an unallocated family support allowance that under California law was intended to provide both spousal and child support that terminated entirely upon the death of the custodial payee spouse, but was not by its terms reduced upon emancipation of the children, was entirely alimony.

5. Dueling lawyers' letters do not a divorce or separation instrument make. Faylor v. Commissioner, T.C. Memo. 2013-143 (6/5/13). The Tax Court (Judge Vasquez) held that a series of letters between divorcing spouses' lawyers regarding temporary support prior to the entry of a divorce decree did not constitute a divorce or separation agreement where neither spouse signed two proposed temporary support agreements. Accordingly, payments by the husband to the wife during the pendency of the divorce were not deductible as alimony.

F. Education

1. Congress encourages universities to raise tuition even more in the next five years. The Taxpayer Relief Tax Act extended the 2009 expansion of the Code § 25A American Opportunity Tax Credit (formerly known as the Hope Scholarship credit) through 2017.

a. Doubling down on encouraging universities to raise tuition even more in the next five years. Section 207 of the Taxpayer Relief Tax Act reinstates and extends the above-the-line deduction of higher education expenses provided in Code § 222(d) for expenses incurred in taxable years 2012 and 2013. Previously § 222(d) applied only to expenses incurred before 12/31/11.

2. Helping banks keep student loan interest rates higher. The 2012 Tax Act made permanent the EGTRRA changes to the Code § 221 above-the-line deduction for qualified higher education student loan interest.

3. Helping banks market education IRAs. The 2012 Tax Act made permanent the many EGTRRA changes to the Coverdell education savings account ("Coverdell ESA," or "CESA," formerly called an "education IRA") rules (§§ 25A, 530). The 2001 changes that have been extended permanently are extensive and since they have been in place for twelve years, we won't bore you with them.

4. Encouraging employers to pay for employee's education. The 2012 Tax Act made permanent the Code § 127 tax-free fringe benefit for up to $5,250 annually for amounts paid or expenses incurred by the employer in providing educational assistance to employees under an educational assistance program (including graduate courses).

G. Alternative Minimum Tax

1. Permanent AMT relief! The 2012 Taxpayer Relief Tax Act, § 104, has provided permanent AMT relief. Beginning in 2012, the AMT exemption amount has been increased to: (1) $78,750 for married couples filing jointly and surviving spouses; (2) $39,375 for married individuals filing separate returns; and (3) $50,600 for single taxpayers. These amounts are subject to automatic adjustment for inflation after 2012 using 2011 as the base year. The AMT exemption is phased out by an amount equal to 25% of the amount by which AMT exceeds the following thresholds: (1) $150,000 for married couples filing jointly and surviving spouses; (2) $75,000 for married individuals filing separate returns; and (3) $112,500 for single taxpayers. The phase-out thresholds are likewise subject to inflation adjustments. (The 2012 Act did not change the $22,500 exemption amount for estates and trusts.) The 2012 Act also provides permanent 0%, 15%, and 20% (for taxpayers otherwise in the 39.6% bracket for ordinary income) AMT rates for long-term capital gains and qualified dividends. The rule under Code § 26(a)(2) allowing various nonrefundable personal credits to offset AMT has been made permanent. Finally, by an amendment to Code § 26, the § 24 refundable child credit offset of AMT has been made permanent.

VI. CORPORATIONS

A. Entity and Formation

1. Saving the world from double deductions. The details emerge only nine years after Congress acted. T.D. 9633, Limitations on Duplication of Net Built-in Losses,

78 F.R. 5426 (8/30/13). The Treasury Department has promulgated final regulations, Reg. § 1.362-4, under § 362(e)(2), which was enacted in 2004, with only minor clarifying changes from the proposed regulations (71 F.R. 62067), which were published in 2006. Section 362(e)(2) prevents taxpayers from transmuting a single economic loss into two (or more) tax losses by taking advantage of the dual application of the substituted basis rules in § 358 for stock received in a § 351 transaction and in § 362 for assets transferred to a corporation in a § 351 transaction. If the aggregate basis of the property transferred to a corporation in a § 351 transaction exceeds the aggregate fair market value, the aggregate basis of the property must be reduced to its fair market value. The final regulations include examples illustrating the application of § 362(e)(2) to transactions qualifying as both § 351 transactions and reorganizations, as well as an example illustrating the nonapplicability of § 362(e)(2) to triangular reorganizations that do not include a transfer to which § 362(a) applies. The regulations provide two exceptions to the application of § 362(e)(2). First, a transaction will not be subject to § 362(e)(2) to the extent that the transferor distributes the stock received in the transaction and, in the distribution, no gain or loss is recognized and no person takes the stock or other property with a basis determined by reference to the transferor's basis in the distributed stock. This exception applies principally to distributions subject to § 355(a). In this situation there is no duplicated loss that could be recognized by any taxpayer. Second, a transaction will not be subject to § 362(e)(2) if the transaction is between persons not connected to the United States, the transaction does not become relevant for federal tax purposes within two years of the transfer, and the transaction is not undertaken pursuant to a plan to reduce or avoid federal taxes. This exception relates to transfers between foreign subsidiaries. The assumption of a transferor's liabilities by the transferee generally does not affect the application of § 362(e). However, if a § 362(e)(2)(C) election is made, the reduction to stock basis is limited to the amount that the transferee would otherwise reduce its basis in the transferred assets. This prevents the reduction of stock basis attributable to contingent liabilities associated with a trade or business, for which basis is specifically preserved under § 358(h)(2)(A). Furthermore, when the property transferred is an interest in a partnership with liabilities, the final regulations provide that the value of a partnership interest is the sum of cash that the transferee would receive for such interest, increased by any Reg. § 1.752-1 liabilities (as defined in Reg. § 1.752-1(a)(4)) of the partnership that are allocated to the transferee with regard to such transferred interest under § 752. See Reg. § 1.362-4(h), Ex. 8(ii). Finally, Reg. § 1.362-4(d) provides details on how to make the § 362(h)(2)(C) election to reduce the transferor's stock basis in lieu of the corporation reducing asset basis; the regulations generally adopt the rules set forth in Notice 2005-70, 2005-2 C.B. 694, and the proposed regulations, but expand those rules significantly. A § 362(e)(2)(C) election is irrevocable. It may be made protectively and will have no effect to the extent it is determined that § 362(e)(2) does not apply. For an election to be effective, (1) prior to filing "a Section 362(e)(2)(C) Statement" the transferor and transferee must enter into a written, binding agreement to elect to apply § 362(e)(2)(C), and (2) detailed requirements for filing the "Section 362(e)(2)(C) Statement," which is required to contain extraordinarily detailed information about the transfer, must be followed. If the transferor is a person required to file a U.S. return for the year of the transfer, the transferor must include the "Section 362(e)(2)(C) Statement" on or with its timely filed (including extensions) original return for the taxable year in which the transfer occurred. There is a long list of the persons required to file the statement if the transferor is not required to file a U.S. return for the year of the transfer.

B. Distributions and Redemptions

1. Is section 306 like the human appendix — a vestige of something that might have once served a purpose? The 2012 Taxpayer Relief Tax Act made permanent the treatment as qualified dividend income of ordinary income realized under Code § 306. The only effect of § 306 now is to affect basis recovery.

2. Leona Helmsley, eat your heart out! Welle v. Commissioner, 140 T.C. No. 19 (6/27/13). The taxpayer was the sole shareholder of Terry Welle Construction, Inc. (TWC). He used TWC to facilitate the construction of a new home for himself and his wife. To

keep track of material and other construction costs, the taxpayer caused TWC to open a "cost plus" job account on its books, but he personally acted as the general contractor during construction. The taxpayer personally hired the subcontractors and ordered building supplies from the vendors in TWC's name. TWC kept track of construction costs and TWC's framing crew framed the home. The taxpayer reimbursed TWC for its costs, including overhead, but did not pay TWC an amount equal to the profit margin of 6% to 7% that TWC normally charged its customers. The IRS asserted that the taxpayer received a constructive dividend from TWC in an amount equal to TWC's forgone profit. The IRS's theory was that *Magnon v. Commissioner*, 73 T.C. 980 (1980), which held that a shareholder of a corporation received a constructive dividend when the corporation performed electrical contracting services on the shareholder's personal property primarily for the shareholder's own benefit and without any expectation of repayment, stood for the proposition that the amount of the dividend included not only the costs incurred by the corporation, but also an amount equal to the corporation's customary profit margin. The Tax Court (Judge Marvel) rejected the IRS's claim, stating that in *Magnon* "we did not hold, and the Commissioner did not assert, that the constructive dividend the shareholder received included an amount corresponding to the corporation's forgone profit." Judge Marvel held that there was no constructive dividend because "[a] finding that a shareholder received a constructive dividend from a corporation is only appropriate where 'corporate assets are diverted to or for the benefit of a shareholder,'" and that did not occur in this case. Judge Marvel concluded that *Melvin v. Commissioner*, 88 T.C. 63 (1987), *aff'd on other grounds*, 894 F.2d 1072 (9th Cir.1990), in which the rental by a corporation to its shareholders for personal purposes at a rental equal to the corporation's costs with respect to the vehicles resulted in a dividend equal to the amount by which the fair rental values of the automobiles exceeded the reimbursements paid to the corporation, was distinguishable. Her reasoning was as follows:

> TWC maintained its corporate infrastucture and workforce for business purposes. Mr. Welle's use of TWC during the construction of petitioners' lakefront home was at most incidental to those purposes. The most that can be said about Mr. Welle's use of TWC is that he used the corporation as a conduit in paying subcontractors and vendors and that he obtained some limited services from corporate employees. Mr. Welle fully reimbursed the corporation for all costs, including overhead, associated with those services, and TWC did not divert actual value otherwise available to it by failing to apply its customary profit margin in determining the amount Mr. Welle had to reimburse the corporation. We therefore conclude that this arrangement did not operate as a vehicle for the distribution of TWC's current or accumulated earnings and profits within the meaning of section 316(a).

- The result in this case turns on the fact that, except possibly with respect to the use of TWC's framing crew by the taxpayer, nothing in the facts indicates that the taxpayer's use of TWC's services resulted in TWC foregoing profits that could have been earned from transactions with third parties had TWC not been used by the taxpayer to facilitate construction of his personal residence in the manner he did. In other words, TWC incurred no opportunity costs. Had TWC incurred opportunity costs, the result very well might have been different.

C. Liquidations

1. Adios collapsible corporations. But how will tax professors be able to torture their students now? The 2012 Taxpayer Relief Tax Act permanently repealed the infamous Code § 341.

D. S Corporations

1. The lifetime of built-in gain gets shorter every year. The Small Business Jobs Act of 2010 shortened the holding period under § 1374 for recognizing unrealized built-in gain on conversion from a C corporation to an S corporation to five years preceding the corporation's tax year beginning in 2011. Before the change the holding period was ten years for

sales or exchanges in tax years beginning before 2009, and seven years for tax years beginning in 2009 or 2010.

a. And again. The 2012 Taxpayer Relief Act, § 326(a)(2), extends the Code § 1374 five-year holding period reduction to five years for recognized built-in gain in 2012 and 2013.

2. S corporation charitable contributions favored with reduced basis deductions. The 2012 Taxpayer Relief Act, § 325, extended Code § 1367(a)(2), enacted in 2006, which provides that shareholders of an S corporation reduce stock basis by the adjusted basis of property contributed to a charity, even though the full fair market value of the contributed property is passed through to the shareholder as a charitable contribution. Prior law applied to contributions made in tax years beginning before 1/1/12. The two-year extension applies to contributions made in tax years beginning before 1/1/14.

3. Realized but unrecognized gain is not tax-exempt income. Ball v. Commissioner, T.C. Memo. 2013-39 (2/6/13). The taxpayers owned stock of an S corporation that had a wholly-owned subsidiary for which it made a QSub election. They argued that the basis of their S corporation stock had been increased by the amount of built-in gain on the stock of the QSub that went unrecognized pursuant to § 332 as a result of the QSub election, and that the increased basis supported claimed passed-through loss. Their position was based on the argument that the unrecognized gain was tax-exempt income that resulted in a basis increase under § 1367(a)(1)(A). The Tax Court (Judge Kerrigan) rejected the taxpayer's argument, and held that unrecognized gain resulting from a QSub election does not create an item of income or tax-exempt income pursuant to § 1366(a)(1)(A). The court reasoned that nonrecognition rules do not exempt income from taxation but merely defer recognition through substituted basis rules.

4. S corporation shareholders aren't allowed to just make up their own basis adjustment rules. Barnes v. Commissioner, T.C. Memo. 2012-80 (3/21/12). The Tax Court (Judge Morrison) agreed with the IRS in holding that there is no upward stock basis adjustment under § 1367 for amounts that are erroneously reported by the shareholder as § 1366 pass through income but that do not correspond to, but exceed, the shareholder's actual pro rata share of pass through income. Likewise, § 1367(a)(2)(B) requires an S corporation shareholder to reduce stock basis by any losses that the shareholder is required to take into account under § 1366(a)(1)(A), even if the shareholder does not actually claim the pass through losses on the shareholder's return. Because the taxpayer had reported gain rather than loss in a prior year in which a very large loss had been passed through, the shareholder had no basis to support passed-through losses in the year in question.

a. And the D.C. Circuit sees it the same way — "the Barneses paid more in taxes than they owed. But so it goes." Barnes v. Commissioner, 111 A.F.T.R.2d 2013-1529 (D.C. Cir. 4/5/13). The Court of Appeals affirmed.

> Nothing in [sections 1366 and 1367] suggests that a shareholder's basis is not reduced if the shareholder fails to take a deduction for the corporation's losses. Indeed, the fact that the Code explicitly provides that a shareholder's basis is increased by corporate income "only to the extent such amount is included in the shareholder's gross income on his return," ... but provides no similar exception for corporate losses, militates against the Barneses' preferred reading. See Russello v. United States, 464 U.S. 16, 23 (1983) ("[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." (internal quotation marks omitted)). This difference makes sense. Although Congress had every reason to prevent taxpayers from reaping a double benefit by failing to report income while still being credited with an increased basis, it had no reason to permit them to indefinitely delay the realization of losses.

5. The Third Circuit says that QSub status isn't "property" under the Bankruptcy Code and tells the Ninth Circuit that it was all wrong when it held that S

corporation status was "property" under the Bankruptcy Code. In re The Majestic Star Casino, LLC, 111 A.F.T.R.2d 2013-2028 (3d Cir. 5/21/13), *rev'g* 109 A.F.T.R.2d 2012-698 (Bankr. D. Del. 1/24/12). A debtor QSub, but not its parent S corporation, was in bankruptcy. After the bankruptcy petition was filed the parent corporation revoked its S corporation status, which under § 1361(b)(3)(C) automatically terminated the debtor-subsidiary's QSub status, converting it into a C corporation. The bankruptcy court held that, the parent corporation's action that terminated pass-through tax benefits that the debtor subsidiary had enjoyed was a voidable transfer of estate property in violation of Bankruptcy Code § 549. The debtor's QSub status was property of the bankruptcy estate, and as a result of the loss of that status was required to, and did, pay state income taxes it would not otherwise have been required to pay. (The corporation had not paid any federal income taxes, but the IRS's claim for any deficiency would be affected, so the IRS opposed the debtor's argument that its QSub status was property of the bankruptcy estate.) Accordingly, the revocation of the parent's status as an S corporation and the termination of the debtor's status as a QSub were held to be "void and of no effect." The bankruptcy court relied on *In re Prudential Lines, Inc.*, 107 B.R. 832 (Bankr. S.D.N.Y. 1989), *aff'd*, 928 F.2d 565 (2d Cir. 1991), which held that a subsidiary's NOL carryforward was property of the subsidiary's bankruptcy estate and that the parent's plan to claim a worthless stock deduction, which would have eliminated the NOL would violate the automatic stay, and its progeny holding that S corporation status is "property" and that the termination of an S election can be a voidable transfer. See *In re Bakersfield Westar*, 226 B.R. 227 (B.A.P. 9th Cir. 1998); *In re Frank Funaro Inc.*, 263 B.R. 892 (B.A.P. 8th Cir. 2001); *In re Trans-Lines W., Inc.*, 203 B.R. 653 (Bankr. E.D. Tenn. 1996); *In re Cumberland Farms, Inc.*, 162 B.R. 62 (Bankr. D. Mass. 1993).

- The Third Circuit in an opinion by Judge Jordan, reversed, first finding based on nuances of the Bankruptcy Code, that the Internal Revenue Code, rather than state law, governs whether an entity's tax status is a property interest for purposes of the Bankruptcy Code. The court of appeals concluded that the extension of *Prudential Lines*, by *In re Trans-Lines West, Inc.*, 203 B.R. 653 (Bankr. E.D. Tenn. 1996), and a series of cases that followed it, which held that a corporation's revocation of its S corporation status prior to filing for bankruptcy was a prepetition transfer of property avoidable by the trustee pursuant to Bankruptcy Code § 548 was "untenable." First, NOLs are not contingent at all; a bankrupt corporate debtor has a specific amount of NOL at the time of the bankruptcy filing that are a function of the debtor's operations prior to bankruptcy; the NOLs "are not subject either to revocation by the shareholders or termination by the IRS." In contrast, under § 1362, the shareholders of an S corporation can terminate its status at will, "regardless of how long it has been an S-corp and whatever its pre-bankruptcy operating history has been"; "the tax status of the entity is entirely contingent on the will of the shareholders." Second, NOLs have a readily determinable value that is available to the bankruptcy estate, either as a carryback or a carryforward against future earnings, while the value of the S corporation election is dependent on it not being revoked and the amount and timing of future earnings. NOL carryforwards may be monetized while S corporation status cannot. Third, S corporation status cannot be a property interest because S corporation status can be automatically terminated by a variety of manners in which the corporation can become ineligible to be an S corporation. Fourth, even if S corporation status had some value to the estate, because it allows the debtor corporation to "place its tax liabilities on a non-debtor" shareholder, a "tax classification over which the debtor has no control is not a 'legal or equitable interest[] of the debtor in property' for purposes of § 541 [of the Bankruptcy Code]." Finally, to allow all of the debtor corporation's profits to remain in the bankruptcy estate while transferring the tax liability to the non-debtor shareholders would be inequitable. After so reasoning that S corporation status was not "property" under the Bankruptcy Code, the court of appeals found that "QSub status is an *a fortiori* case." A QSub's continuing status as such is contingent on a number of factors entirely outside of the QSub's control, and a QSub cannot "transfer or otherwise dispose of its QSub status." Thus, QSub status cannot be "property." Furthermore, even if QSub status is property, it could not be property of the bankruptcy estate; it would be property of the subsidiary's S corporation parent. For tax purposes a QSub does not exist. Finally, the court added:

Moreover, allowing QSub status to be treated as the property of the debtor subsidiary rather than the non-debtor parent, as the Bankruptcy Court did in this case, places remarkable restrictions on the rights of the parent, restrictions that have no foundation in either the I.R.C. or the Code. First, the corporate parent loses not only the statutory right to terminate its subsidiary's QSub election, see I.R.C. § 1361(b)(3)(B), (D), but also its right to terminate its own S-corp election, see id. § 1361(d). Second, the corporate parent loses the ability to sell the subsidiary's shares to any purchaser other than an S-corp, and would then be required to sell 100 percent of the shares, because any other sale would trigger the loss of the subsidiary's QSub status. See id.§ 1361(b)(3)(B). Third, the S-corp parent and its shareholders lose the ability to sell the parent to a C-corporation, partnership, or other non-S-corp entity, to a non-resident alien, or to more than 100 shareholders, because any of those transactions would also trigger the loss of the subsidiary's QSub status. See id., § 1361(b)(1)(B), (C), (A). Filing a bankruptcy petition is not supposed to "expand or change a debtor's interest in an asset; it merely changes the party who holds that interest." *In re Saunders*, 969 F.2d 591, 593 (7th Cir. 1992). But under the Bankruptcy Court's holding in this case, a QSub in bankruptcy can stymie legitimate transactions of its parent as unauthorized transfers of property of the estate, even though the QSub would have had no right to interfere with any of those transactions prior to filing for bankruptcy.

6. Another taxpayer fails in the never-ending quest for S corporation debt basis without an economic outlay. Montgomery v. Commissioner, T.C. Memo. 2013-151 (6/17/13). In 2006, the taxpayer guaranteed a loan to an S corporation in which he was a shareholder. The corporation passed through losses to the taxpayer for 2007 in excess of the taxpayer's basis in the stock and loans the taxpayer had made to the corporation. The taxpayer claimed that the fact that the corporation defaulted on the loan in 2008, he defaulted on the guarantee in that year, and in 2009 the creditor obtained a judgment against the taxpayer for $435,169.54, should give rise to a basis increase in that amount for the corporation's debt that he obtained through subordination. Judge Morrison was unimpressed by the argument.

> "[I]t is the payment by the guarantor of the guaranteed obligation that gives rise to indebtedness on the part of the debtor to the guarantor. The mere fact that the debtor defaults and thereby renders the guarantor liable is not sufficient." [Quoting from *Underwood v. Commissioner*, 63 T.C. 468, 476 (1975), *aff'd*, 535 F.2d 309 (5th Cir. 1976)] .Patrick Montgomery did not make any payments on the SunTrust Bank loan during 2007. Therefore his guarantee of the SunTrust Bank loan did not give rise to a debt to him from Utility Design, Inc., during 2007.

7. Rev. Proc. spells relief for late elections. Rev. Proc. 2013-30, 2013-36 I.R.B. 173 (8/14/13). The IRS has consolidated multiple rulings into a single procedure for requesting relief from late S corporation, QSST, and Q Sub elections. In general the procedure requires that a requesting entity has reasonable cause for making a late election and has acted diligently to correct the mistake upon its discovery. The request must be made within 3 years and 75 days of the effective date of the election.

E. Mergers, Acquisitions and Reorganizations

1. This District Court decision, if followed, makes it much much more difficult to ever have personal goodwill as an employee-shareholder. Howard v. United States, 106 A.F.T.R.2d 2010-5533 (E.D. Wash. 7/30/10). The taxpayer was a dentist who practiced through a solely owned (before taking into account community property law) professional corporation until the practice was sold to a third party. He had an employment agreement with the corporation including a noncompetition clause that survived for three years after the termination of his stock ownership. The purchase and sale agreement allocated $47,100 to the corporation's assets, $549,900 for the taxpayer-shareholder's personal goodwill, and $16,000 in consideration of his covenant not to compete with the purchaser. The corporation did

not "dissolve" until the end of the year following the sale. The taxpayer reported $320,358 as long-term capital gain income resulting from the sale of goodwill (the opinion does not explain how the remainder of the sales price was reported, but the IRS recharacterized the goodwill as a corporate asset and treated the amount received by the taxpayer from the sale to the third party as a dividend from the taxpayer's professional service corporation. Because the sale occurred in 2002, when dividends were taxed at higher rate than capital gains, a deficiency resulted. The government's position was based on three main reasons: (1) the goodwill was a corporate asset because the taxpayer was a corporate employee with a covenant not to compete for three years after he no longer owned any stock; (2) the corporation earned the income, and correspondingly earned the goodwill; and (3) attributing the goodwill to the taxpayer-shareholder did not comport with the economic reality of his relationship with the corporation. After reviewing the principles of *Norwalk v. Commissioner*, T.C. Memo. 1998-279, and *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998), the court held that because the taxpayer was the corporation's employee with a covenant not to compete with it, any goodwill generated during that time period was the corporation's goodwill. The court also rested its holding that the goodwill was a corporate asset on its conclusions that the income associated with the practice was earned by the corporation and the covenant not to compete, which extended for three years after the taxpayer no longer owned stock in the corporation rendered any personal goodwill "likely [of] little value."

- See *Solomon v. Commissioner*, T.C. Memo. 2008-102, for an extended discussion of the issues underlying an attempted sale of individual goodwill.

a. Affirmed – "Dr. Howard has offered no compelling reason why he should be let out of the corporate structure he chose for his dental practice." 108 A.F.T.R.2d 2011-5993 (9th Cir. 8/29/11) (nonprecedential opinion). The Ninth Circuit affirmed the district court in an opinion that contains an elegantly concise summary of the current state of the law.

> Goodwill "is the sum total of those imponderable qualities which attract the custom of a business, □ what brings patronage to the business." *Grace Brothers v. Comm'r*, 173 F.2d 170, 175-76 (9th Cir. 1949). For purposes of federal income taxation, the goodwill of a professional practice may attach to both the professional as well as the practice. *See, e.g., Schilbach v. Comm'r*, 62 T.C.M. (CCH) 1201 (1991). Where the success of the venture depends entirely upon the personal relationships of the practitioner, the practice does not generally accumulate goodwill. *See Martin Ice Cream Co. v. Comm'r*, 110 T.C. 189 at 207–08 (1998). The professional may, however, transfer his or her goodwill to the practice by entering into an employment contract or covenant not to compete with the business. *See, e.g., Norwalk v. Comm'r*, 76 T.C.M. (CCH) 208, *7 (1998) (finding that there is no corporate goodwill where "the business of a corporation is dependent upon its key employees, *unless* they enter into a covenant not to compete with the corporation or other agreement whereby their personal relationships with clients become property of the corporation") (emphasis added); *Martin Ice Cream Co.*, 110 T.C. at 207-08 (finding that "personal relationships ... are not corporate assets when the employee has *no* employment contract [or covenant not to compete] with the corporation") (emphasis added); *Macdonald v. Comm'r*, 3 T.C. 720, 727 (1944) (finding "no authority which holds that an individual's personal ability is part of the assets of a corporation ... where ... the corporation does *not* have a right by contract or otherwise to the future services of that individual") (emphasis added). In determining whether goodwill has been transferred to a professional practice, we are especially mindful that "each case depends upon particular facts. And in arriving at a particular conclusion ... we ... take into consideration all the circumstances ... [of] the case and draw from them such legitimate inferences as the occasion warrants." *Grace Brothers v. Comm'r*, 173 F.2d 170, 176 (9th Cir. 1949).

- Looking at the facts as found by the District Court, the Ninth Circuit concluded that "while the relationships that Dr. Howard developed with his patients may be accurately described as personal, the economic value of those relationships did not belong to him, because he had conveyed control of them to the Howard Corporation." Furthermore, the court rejected the taxpayer's argument that the purchase and sale agreement impliedly terminated both the employment contract and the non-competition agreement, thereby transferring the accumulated goodwill of the practice back to Dr. Howard; the court added that even if it accepted that argument, "such a release would constitute a dividend payment, the value of which would be equivalent to the price paid for the goodwill of the dental practice."

b. Has Judge Holmes breathed new vitality into *Martin Ice Cream*? H&M, Inc. v. Commissioner, T.C. Memo. 2012-290 (10/15/12). H&M, Inc. conducted a small town insurance agency business for many years. In the years before it sold its business it paid Schmeets, its principal employee/sole shareholder, an annual salary of approximately $29,000. In an integrated transaction, a bank bought H&M, Inc.'s insurance business for $20,000 and entered into an employment agreement with Schmeets pursuant to which he was paid total compensation of over $600,000 over a six-year period for continuing to run the insurance business on behalf of the bank that purchased the insurance agency. Schmeets kept H&M, Inc. alive and converted its business to (unsuccessfully) exploiting patents developed by its sole shareholder. The IRS asserted a deficiency against H&M, Inc. based on the "substance over form" theory that a significant portion of the compensation paid to Schmeets by the bank under the employment agreement actually was a payment to H&M, Inc. for the sale of the insurance business, and that H&M, Inc. thus realized significant capital gains and interest income over the period the compensation was paid to Schmeets. The IRS's argued that all of the compensation that was fixed in amount actually was part of the purchase price and that only the portion of the compensation that varied (the greater of $50,000 or 45% of "net adjusted income" for the year) was actually compensation. The Tax Court (Judge Holmes) rejected the IRS's argument completely. Applying *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998), and *MacDonald v. Commissioner*, 3 T.C. 720 (1944), Judge Holmes concluded that payments by a purchaser of a corporate business to a controlling shareholder for that shareholder's customer relationships were not taxable to the corporation "where the business of a corporation depends on the personal relationships of a key individual [i.e., the controlling shareholder], unless he transfers his goodwill to the corporation by entering into a covenant not to compete or other agreement so that his relationships become property of the corporation." Judge Holmes found the instant case to be like *MacDonald* and *Martin Ice Cream Co*. The insurance business was "'extremely personal,' and the development of [the] business before the sale was due to Schmeets's ability to form relationships with customers and keep big insurance companies interested in a small insurance market." Furthermore, the compensation paid to Schmeets was reasonable, and there were no other intangibles to be accounted for in the purchase price.

- The IRS won on a whole raft of run-of-the-mill other issues, typically found in closely held corporations, none of which are particularly interesting.

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

1. The ELA was triggered in a closed year. LPCiminelli Interests, Inc. v. United States, 110 A.F.T.R.2d 2012-6631 (W.D. N.Y. 11/13/12). The IRS asserted a deficiency against the taxpayer's consolidated group on the grounds that an inactive subsidiary realized COD income in 2004. The taxpayer paid the deficiency and sought a refund. In the refund proceedings, the government conceded the COD issue but asserted that pursuant to Reg. § 1.1504-19, the taxpayer recognized gain from the subsidiary's excess loss account (ELA) upon the worthlessness of the subsidiary's stock in 2004. The taxpayer proved that between 1999 and the end of 2003, the subsidiary's assets declined from more than $8.2 million to $4,128, and that under the pre-2008 version of Reg. § 1.1504-19, the subsidiary's stock was worthless by the end of 2003 — a year beyond the statute of limitations — because the subsidiary had disposed of substantially all of its assets. Accordingly, the court held that the income was not realized in

2004. The government further asserted that even if the subsidiary had disposed of substantially all of its assets prior to 2004, the ELA was properly included in 2004 under the "anti-avoidance rule" of Reg. § 1.1502-19(e), which provides: "If any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section." The government's theory was based on the argument that the taxpayer "acted with the purpose of avoiding the regulations by not reporting [the subsidiary] as an inactive subsidiary prior filing its consolidated return for tax year 2004, and by failing to file an amended return for the year (or years) during which the income from [the subsidiary's] ELA was actually realized." The court rejected this argument for two reasons. First, the taxpayer had fully disclosed the facts to the IRS during the audit and had offered to extend the statute of limitations for 2001-2003 on the issue, and while the limitations periods from 2001–2003 were open, the IRS examined the matter and chose not to assess tax based on any realized ELA income. Second, there is no obligation to file an amended return.

2. Twenty-seven years after the authorizing statute was enacted, the Treasury and IRS finalize regulations to prevent triple taxation resulting from sales, exchanges and distributions of corporate stock resulting from *General Utilities* repeal. T.D. 9619, Regulations Enabling Elections for Certain Transactions Under Section 336(e), 78 F.R. 28467 (5/15/13). The IRS published regulations under § 336(e). Section 336(e), enacted as part of the TRA 1986 repealing the *General Utilities* doctrine, authorizes regulations allowing a corporation that sells, exchanges, or distributes stock in another corporation (target) meeting the requirements of § 1504(a)(2) to elect to treat the disposition as a sale of all of target's underlying assets in lieu of treating it as a sale, exchange, or distribution of stock, as under § 338(h)(10). The purpose of a § 336(e) election is to prevent creation of a triple layer of taxation — one at the controlled corporation level, one at the distributing corporation level and, ultimately, one at the shareholder level. Reg. §§ 1.336-0 through 1.336-5 provide the requirements and mechanics for, and consequences of, treating a stock sale, exchange, or distribution that would not otherwise be eligible for a § 338 election. Under the regulations, the results of a § 336(e) election generally are the same (with certain exceptions) as those of a § 338(h)(10) election. The structure of the regulations resembles the § 338(h)(10) regulations regarding the allocation of consideration, application of the asset and stock consistency rules, treatment of minority shareholders, and the availability of the § 453 installment method, although certain definitions and concepts differ to reflect differences between § 336 and § 338(h)(10). Unlike under § 338(h)(10), however, a § 336(e) election is a unilateral election by the seller. A transaction that meets the definition of both a qualified stock disposition and a qualified stock purchase under § 338(d)(3) generally will be treated only as a qualified stock purchase and does not qualify for a § 336(e) election. Reg. § 1.336-1(b)(6)(ii).

- *General Rules*. A qualified stock disposition for which a § 336(e) election may be made is any transaction or series of transactions in which stock meeting the requirements of § 1504(a)(2) (80 percent of voting and value) of a domestic corporation is either sold, exchanged, or distributed, or any combination thereof, by another domestic corporation or the shareholders of an S corporation in a disposition (as defined in Reg. § 1.336-1(b)(5)), during the 12-month disposition period (as defined in Reg. § 1.336-1(b)(7)). (All members of a consolidated group are treated as a single transferor. Reg. § 1.336-2(g)(2)). Stock transferred to a related party (determined after the transfer) is not considered in determining whether there has been a qualified stock disposition. Reg. §§ 1.336-1(b)(5)(i)(C) and 1.336-1(b)(6)(i). A section 336(e) election is available for qualifying dispositions of target stock to non-corporate transferees, as well as to corporate transferees. Reg.§ 1.336-1(b)(2)
- Because the regulations require only that stock meeting the requirements of § 1504(a)(2) be transferred, the transferor (or a member of its consolidated group) may retain a portion of the target stock. Reg. §§ 1.336-2(b)(1)(v) and 1.336-2(b)(2)(iv). Furthermore, the regulations allow amounts of target stock transferred to different transferees, in different types of transactions to be aggregated in determining whether there has been a qualified

stock disposition. For example, the sale of 50 percent of target's stock to an unrelated person and a distribution of another 30 percent to its unrelated shareholders (who might or might not be the purchasers of the 50 percent that was sold) within a 12-month period would constitute a qualified stock disposition. Reg. § 1.336-1(b)(5).

- *Election*. The election is made by the seller and the target by entering into a binding written agreement before the due date of the tax return for the year of the stock disposition and filing a required statement of election with the tax return for the appropriate year. The consent of both seller and the target (on behalf of the buyer) are required so avoid surprises to the buyer. An election for an S corporation target requires a binding written agreement between the target S corporation and all of the S corporation shareholders, including shareholders who do not sell stock, before the due date of the tax return for the year of the stock disposition and an election statement attached to the return for the year of the disposition. In both cases, the target must retain a copy of the written agreement. If the seller and target are members of a consolidated group, the seller and target must enter into a binding written agreement, retained by the parent of the consolidated group, and the common parent of the group must attach an election statement to the consolidated return for the year of the disposition. Reg. § 1.336-2(h).
- *Sales or Exchanges of Target Stock*. In general, if a seller sells or exchanges target stock in a qualified stock disposition, the treatment of old target, seller, and purchaser are similar to the treatment of old target (old T), S, and P under § 338(h)(10). If a § 336(e) election is made, the sale or exchange of target stock is disregarded. Instead, target (old target) is treated as selling all of its assets to an unrelated corporation in a single transaction at the close of the disposition date (the deemed asset disposition). Old target recognizes the deemed disposition tax consequences from the deemed asset disposition on the disposition date while it is a subsidiary of seller. In the case of a deemed asset sale by a Subchapter S corporation, the tax consequences of the deemed asset sale pass through to the S corporation shareholders. See Reg. § 1.336-2(b)(i)(A). Old target is then treated as liquidating into seller which in most cases will be treated as a § 332 liquidation to which § 337 (or § 336) applies. Additionally, the deemed purchase of the assets of old target by new target constitutes a deemed purchase of any subsidiary stock owned by target, and a § 336(e) election may be made for the deemed purchase of the stock of a target subsidiary if it constitutes a qualified stock disposition. A § 336(e) election generally does not affect the tax consequences, e.g., stock basis, to a purchaser of target stock.
- *Distributions of Target Stock Not Subject to § 355*. A § 336(e) election can be made for a taxable distribution of target stock (e.g., dividend, redemption, liquidation), but the election does not affect the tax treatment of the shareholders. Special rules assure that the tax consequences to a distributee are the same as if no § 336(e) election was made. If a distribution is a qualified stock disposition, the distributing corporation is treated as purchasing from new target (immediately after the deemed liquidation of old target) the amount of stock distributed and to have distributed the new target stock to its shareholders. The distributing corporation recognizes no gain or loss on the distribution (old target having recognized gain on the deemed asset sale). Reg. § 1.336-2(b)(1)(iv). If the distribution is a § 301 distribution, the portion that is a dividend may be affected by the difference between (1) the § 311 gain, and thus E&P, that would have been recognized on a stock distribution and (2) the gain, and thus E&P, that results from the deemed asset disposition and liquidation of target. See Reg. § 1.336-2(c). Realized losses on the deemed asset disposition are allowed to offset realized gains, Reg. § 1.336-2(b)(1)((i)(B)(*2*)(i). However, the regulations disallow a net loss recognized on the deemed asset disposition in proportion to the amount of stock disposed of by the seller in one or more distributions during the 12-month disposition period. Reg. § 1.336-2(b)(1)((i)(B)(*2*)(*ii*).
- *Section 355 Distributions*. The regulations allow a corporation that would otherwise recognize gain with respect to a qualified stock disposition resulting, in whole or in part, from a disposition described in § 355(d)(2) or (e)(2) to make a § 336(e) election. However, to preserve the E & P allocation consequences of a § 355 distribution under Reg. § 1.312-10, the regulations provide special rules. Old target is not deemed to liquidate into the distributing corporation, but is treated as acquiring all of its assets from an unrelated person and the distributing corporation is treated as distributing the stock of the controlled corporation (old

target) to its shareholders. Reg. § 1.336-2(b)(2)(i)(A). Because the controlled corporation (old target) is not treated as liquidated, it will retain its tax attributes despite the § 336(e) election. Furthermore, the controlled corporation will take into account the effects of the deemed asset disposition to adjust its E&P immediately before allocating E&P pursuant to Reg. § 1.312-10. Reg. § 1.336-2(b)(2)(vi). Net losses from the deemed asset sale will be recognized only in relation to the amount of stock sold or exchanged in the qualified stock disposition during the 12-month disposition period. Reg. §§ 1.336-2(b)(2)(i)(B)(*2*)(*iii*). However, if the controlled corporation (old target) has any subsidiaries for which a § 336(e) election is made, the general deemed asset disposition methodology shall apply. This prevents taxpayers from effectively electing whether the attributes of the lower tier subsidiary become those of target, by doing an actual sale of target subsidiary's assets followed by a liquidation of target subsidiary, or remain with target subsidiary, by making a § 336(e) election for target subsidiary.

- *Intragroup Transfers Prior to External Dispositions*. If target stock is transferred within an affiliated group and is then transferred outside the affiliated group, a § 336(e) election is not available for the intragroup transfer (because a qualified stock disposition may not be made between related sellers and purchasers). Even if a § 336(e) election is made for the transfer outside of the group, the affiliated group would recognize gain both on target's assets and the target stock. To solve this problem the final regulations modify Reg. § 1.1502-13(f)(5)(ii)(C) to allow a § 1.1502-13(f)(5) election to treat the deemed liquidation of target into the seller as a taxable liquidation in order to provide the consolidated group with a stock loss to offset some, if not all, of the intragroup seller's stock gain from the intragroup transaction. Reg. § 1.366-2(b)(2)(i)(A)(*2*) also provides that in the case of a § 355(d)(2) or (e)(2) transaction that is preceded by an intragroup transaction, for purposes of the § 1.1502-13(f)(5) election, immediately after the deemed asset disposition of target's assets, target is deemed to liquidate into seller, which provides seller with a stock loss that can offset some or all of the group's intercompany gain on the transfer of target stock.

- *Aggregate Deemed Asset Disposition Price (ADADP) and Adjusted Grossed Up Basis (AGUB)*. To calculate old target's gain under a § 336(e) election, the regulations define a new term, "aggregate deemed asset disposition price" (ADADP). New target's asset basis is determined with reference to adjusted grossed up basis (AGUB), as used in § 338 and Reg. § 1.338-5. Under Reg. §§ 1.336-3 and 1.336-4, ADADP and AGUB are determined similarly to the way ADSP and AGUB are determined under the § 338 regulations. The regulations account for the lack of an actual amount realized on a stock distribution by treating the grossed-up amount realized as including in the amount realized the fair market value of distributed target stock on the date of distribution. Reg. § 1.336-3(c)(1)(i)(B). In addition, because in the case of a § 336(e) election (unlike in the case of a § 338 election, where there is only one purchasing corporation and it is relatively easy to determine the purchaser's basis in nonrecently purchased stock in order to determine AGUB), there can be multiple purchasers or distributees who acquired target stock prior to the 12-month disposition period, the regulations provide that "nonrecently disposed stock," which has a similar meaning to the term "nonrecently purchased stock" in § 338(b)(6)(B), includes only stock in a target corporation held by a purchaser (or a related person) who owns (with § 318(a) attribution, other than § 318(a)(4)), at least 10 percent of the total voting power or value of the stock of target that is not recently disposed stock. Reg. § 1.336-1(b)(18).

- New target is treated as acquiring all of its assets from an unrelated person in a single transaction at the close of the disposition date, but before the deemed liquidation (or, in the case of a § 355 distribution, before the distribution) in exchange for an amount equal to the AGUB. With certain modifications, Reg. § 1.336-4 generally resembles Reg. § 1.338-5 to determine target's AGUB for target. New target allocates AGUB among its assets in the same manner as in Reg. §§ 1.338-6 and 1.338-7. Reg. §§ 1.336-2(b)(1)(ii) and 1.336- 2(b)(2)(ii).

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

2(b)(2)(iv). A continuing minority shareholder is generally unaffected by the § 336(e) election. Reg. § 1.336-2(d).

- A holder of nonrecently disposed stock may irrevocably elect (similarly to under § 338) to treat the nonrecently disposed stock as being sold on the disposition date. Reg. § 1.336-4(c). The gain recognition election is mandatory if a purchaser owns (after applying § 318(a), other than § 318(a)(4)) 80 percent or more of the voting power or value of target stock. Reg. §§ 1.336-1(b)(15) and 1.336-4(c).
- A taxpayer will be allowed to make a protective § 336(e) election if it is unsure whether a transaction constitutes a qualified stock disposition, e.g. the disposition date is the first day of the 12-month disposition period that may span two taxable years. A protective election will have no effect if the transaction does not constitute a qualified stock disposition, but it will otherwise be binding and irrevocable. Reg. § 1.336-2(j).
- *Correction to Reg. § 1.338-5*. Reg. § 1.338-5(d)(3)(ii) is corrected to use the grossed-up basis of recently purchased stock in determining the basis amount, rather than the non-grossed-up basis.
- *Effective date*. The regulations apply to any qualified stock disposition for which the disposition date is on or after May 15, 2013.

H. Miscellaneous Corporate Issues

1. Have you thought about the personal holding company or accumulated earnings taxes recently? Bet not! The 2012 Taxpayer Relief Tax Act permanently increased from 15% and set at 20% the § 531 accumulated earnings tax and the § 541 personal holding company tax.

2. There goes corporate letter ruling practice! Rev. Proc. 2013-32, 2013-28 I.R.B. ___ (6/25/13), modifying Rev. Proc. 2013-1, 2013-1 I.R.B. 116. The IRS will no longer rule on whether a transaction qualifies for nonrecognition treatment under §§ 332, 351, 355, or 1036, or on whether a transaction constitutes a reorganization within the meaning of § 368, regardless of whether the transaction presents a significant issue and regardless of whether the transaction is an integral part of a larger transaction that involves other issues upon which the IRS will rule. However, the IRS will rule on one or more issues under those sections to the extent that such issue or issues are significant. There is no limit on the number of significant issues that may be the subject of a single letter ruling. A "significant issue is an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction."

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. Section 47 historic rehabilitation credits were allowed to an LLC (taxed as a partnership) in which Pitney Bowes was a 99.9 percent member despite an IRS challenge under the anti-abuse provisions of Reg. § 1.701-2, but it was too late to keep the Miss America Pageant in Atlantic City. Historic Boardwalk Hall, LLC v. Commissioner, 136 T.C. 1 (1/3/11). The Tax Court (Judge Goeke) held that the ownership interest on the historic East Hall of the Atlantic City Boardwalk Hall under a 35-year lease belonging to the New Jersey Sports and Exposition Authority could be transferred to Historic Boardwalk Hall, LLC, in which Pitney Bowes (through a subsidiary and an LLC) was the 99.9 percent member (and the NJSEA was the 0.1 percent member). Along with ownership went the § 47 Federal tax credit of 20 percent of the qualified rehabilitation expenditures incurred in transforming the run-down East Hall from a flat-floor convention space to a "special events facility" that could host concerts, sporting events, and other civic events. Pitney Bowes became the 99.9 percent member of Historic Boardwalk Hall, LLC, following an offering memorandum sent to nineteen large corporations, which described the transaction as a "sale" of tax credits (although that description was not repeated in any of the subsequent documents relating to the transaction). NJSEA lent about $57 million to Historic Boardwalk Hall. and Pitney Bowes made capital contributions of more than $18 million to that LLC, as well as an investor loan of about $1.2 million. In that offering memorandum, losses were projected over the first decade of operation of East Hall. The

IRS argued that the bulk of the Pitney Bowes contributions were paid out to NJSEA as a "development fee" and that the entire transaction was a sham because NJSEA was going to develop East Hall regardless of whether Pitney Bowes made its capital contributions and loan.

- Judge Goeke held that one of the purposes of § 47 was "to encourage taxpayers to participate in what would otherwise be an unprofitable activity," and the rehabilitation of East Hall was a success, leading to the conclusion that Historic Boardwalk had objective economic substance. He also held that "Pitney Bowes and NJSEA, in good faith and acting with a business purpose, intended to join together in the present conduct of a business enterprise" and that while the offering memorandum used the term "sale," "it was used in the context of describing an investment transaction." Finally, Judge Goeke used Reg. § 1.701-2(d), Example (6), involving two high-bracket taxpayers who joined with a corporation to form a partnership to own and operate a building that qualifies for § 42 low-income housing credits, to conclude that Reg. § 1.701-2 did not apply to the Historic Boardwalk transaction because that regulation "clearly contemplate[s] a situation in which a partnership is used to transfer valuable tax attributes from an entity that cannot use them . . . to [a taxpayer] who can . . . ."
- Query whether "economic substance" requirements are applicable when the tax benefits take the form of tax credits enacted to encourage specific types of investments?

a. "'[T]he sharp eyes of the law' require more from parties than just putting on the 'habiliments of a partnership whenever it advantages them to be treated as partners underneath.' ... Indeed, *Culbertson* requires that a partner '*really and truly intend*[] to … shar[e] in the profits and losses' of the enterprise. ... And, after looking to the substance of the interests at play in this case, we conclude that, because Pitney Bowes lacked a meaningful stake in either the success or failure of Historic Boardwalk Hall, it was not a bona fide partner." Historic Boardwalk Hall LLC v. Commissioner, 694 F.3d 425 (3d Cir. 8/27/12), *cert. denied*, 5/28/13. In a unanimous opinion by Judge Jordan, the Third Circuit reversed the Tax Court and held that Pitney Bowes was not a bona fide partner in Historic Boardwalk Hall LLC. The court's reasoning was based on the *Culbertson* test [*Commissioner v. Culbertson*, 337 U.S. 733 (1949)], as applied by the Second Circuit in *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 232 (2d Cir. 2006) (*Castle Harbour II*), to find that the Dutch banks were not partners, and the reasoning of the Fourth Circuit in *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), to find that the investors who acquired the Virginia Historic Rehabilitation credits through the partnership bore no "true entrepreneurial risk," which the Third Circuit concluded was a characteristic of a true partner under the *Culbertson* test. The Third Circuit concluded that Pitney Bowes was not a partner because, based on an analysis of the facts, as the transaction was structured, (1) Pitney Bowes "had no meaningful downside risk because it was, for all intents and purposes, certain to recoup the contributions it had made to HBH and to receive the primary benefit it sought — the HRTCs or their cash equivalent," and (2) Pitney Bowes's "avoidance of all meaningful downside risk in HBH was accompanied by a dearth of any meaningful upside potential." The analysis was highly factual and based on substance over form. As for downside risk, the Court of Appeals reversed as clearly erroneous the Tax Court's finding that Pitney Bowes bore a risk because it might not receive an agreed upon 3% preferred return on its contributions to HBH. Referring to *Virginia Historic Tax Credit Fund,* the Third Circuit treated the 3% preferred return as a "return on investment" that was not a "share in partnership profits," which pointed to the conclusion that Pitney Bowes did not face any true entrepreneurial risk. As for upside potential, applying the substance over form doctrine, the court concluded that "although in form PB had the potential to receive the fair market value of its interest . . . in reality, PB could never expect to share in any upside." The court noted that it was mindful "of Congress's goal of encouraging rehabilitation of historic buildings," and that its holding might "jeopardize the viability of future historic rehabilitation projects," but the court observed that it was not the tax credit provision itself that was under attack, but rather the particular transaction transferring the benefits of the credit in the manner that it had.

- The opinion makes it very clear that the decision was based on applying the "substance over form" doctrine rather than the "economic substance" doctrine to determine that Pitney Bowes was not a partner.

b. The IRS builds on its *Historic Boardwalk* victory. FAA 20124002F, 2013 TNT 41-18 (dated 8/30/12; released 10/5/12). This Field Attorney Advice dealt with whether a taxpayer was a partner in a partnership that generated § 47 historic rehabilitation tax credits. The FAA held that under the *Culbertson* test as applied in *Castle Harbour*, the taxpayer was not a partner. The taxpayer had no meaningful downside risk in that it was assured of receiving the benefit of its bargain, and it had no upside potential. All it could receive was a specified priority return. Alternatively, the purported partnership was a sham that served no business purpose. Its only purpose was to effect a sale of the rehabilitation tax credits to the taxpayer. *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), which held that a sale-leaseback transaction involving solar energy equipment had economic substance even though the investment had a negative rate of return before taking into account tax benefits, was distinguished on the ground that the transaction at issue in *Sacks* otherwise had economic substance in terms of risk and reward. In reaching the conclusion, the FAA states as follows:

> In any event, the notion that a court may consider tax benefits in evaluating the economic substance of a transaction involving — or of a purported partnership engaged in — tax-favored activity finds no support apart from *Sacks*. Two circuits, in analyzing the economic substance of American Depository Receipts (ADR) transactions, determined that it was inappropriate to deduct the cost of foreseeable foreign taxes imposed on the transaction in determining the expected pre-tax profit of the transaction. See Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001) and IES Industries, Inc. v. United States, 253 F.3d 350 (8th Cir. 2001). These holdings address the calculation of pre-tax profit to be used in determining whether transactions resulted in pre-tax economic losses; they do not stand for the proposition that United States tax credits may serve as a substitute for economic profit. As such, these cases do not adopt the court's holding in Sacks that a court may consider tax benefits in evaluating the economic substance of a transaction involving — or of a purported partnership engaged in — tax-favored activity.

- The FAA's position is questionable given the purpose of tax credits is to encourage taxpayers to engage in otherwise unprofitable activities. A holding that an activity that is unprofitable before taking tax credits into consideration lacks economic substance defeats that purpose and is at odds with statements made by both the Tax Court and the Third Circuit. As discussed above the Tax Court openly rejected that position and the Third Circuit decided the issue under the "substance over form" doctrine instead of the "economic substance" doctrine.

2. Deathbed estate planning with intended contributions creates a limited partnership under Texas law. Keller v. United States, 637 F.3d 238 (5th Cir. 9/25/12). On May 10 the decedent met in her hospital room with advisors to structure estate planning AB trusts as partners with an LLC in a family limited partnership. The decedent executed partnership agreements and indicated that she intended to fund the partnership with community property bonds. The decedent also wrote a check to the partnership which was never cashed. The decedent died on May 15. After attending a CLE conference, the taxpayer's advisors re-thought the estate's estate tax payment and claimed a $147 million refund of estate taxes on the basis of a valuation discount attributable to the assets in the family limited partnership. The IRS asserted that the partnership was never funded. The court, affirming findings by the District Court, held that under "[w]ell-established principles of Texas law" the decedent's intent to make an asset partnership property caused the bonds to be equitably owned by the partnership. Thus the estate was entitled to the valuation discount for the partnership property.

3. Final regulations cover noncompensatory options on partnership interests. T.D. 9612, Noncompensatory Partnership Options, 78 F.R. 7997 (2/5/13). Final

regulations under § 721 generally provide for nonrecognition of gain or loss to the partnership or option holder on the exercise of a noncompensatory stock option that grants the holder the right to acquire an interest in the issuer (defined as an option not issued in connection with the performance of services) on the transfer of money or property to the partnership. The regulations also address the maintenance of partnership capital accounts and the determination of partners' distributive shares. As a brief and admittedly incomplete summary of the lengthy regulation–

- The regulations provide that § 721 does not apply to the transfer of property in exchange for an option or the satisfaction of a partnership obligation by issuance of an option. The transfer or satisfaction will result in recognition of gain or loss to the option recipient and open transaction treatment with respect to the partnership. The regulations do provide for § 721 treatment for the receipt of convertible equity in exchange for property.
- Section 721 does not apply to the issuance of an option for accrued but unpaid interest, interest on convertible debt, rent, or royalties.
- The nonrecognition rule of § 721 does not apply to the exercise of a noncompensatory option issued by a disregarded entity what would become a partnership if the option were exercised.
- The investment partnership rules of § 721(b) apply to cause recognition if the partnership would be treated as an investment company.
- Cash settlement of a noncompensatory option is treated as a sale or exchange of the option under § 1234 rather than as a contribution to a partnership.
- Lapse of a noncompensatory option is treated as recognition of gain to the partnership and a loss to the option holder to the extent of the option premium. For this purpose, proposed regulations under § 1234 would treat partnership interests as securities for purposes of § 1234 (REG-106918-08, Treatment of Grantor of an Option on a Partnership Interest, 78 F.R. 8060 (2/5/13)).
- Redemption of an interest following exercise of a noncompensatory option may be treated as a disguised sale. In addition, general tax principles will apply to determine the nature of the transaction if the exercise price of a noncompensatory option exceeds the capital account received by the option holder.
- The regulations permit revaluation of partnership capital accounts on issuance of a noncompensatory option and provide further that any revaluation of partnership capital accounts must take into account the fair market value of any outstanding noncompensatory options. The value of partnership property must be adjusted to reflect the difference (if any) between the value of outstanding noncompensatory options and the amount paid by the option holder as consideration for the option.
- The regulations require corrective allocations to account for any shift in partner's capital accounts that results from capital account reallocations pursuant to exercise of a noncompensatory option. Corrective allocations to the option holder can only include items properly allocable to a partner who suffered a capital account reduction.
- Noncompensatory options are generally not characterized as partnership equity. However, an option holder will be treated as a partner if the option holder's rights are "substantially similar" to rights afforded to a partner, and there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and option holder's aggregate Federal tax liabilities under the facts and circumstances. The relevant facts and circumstances include the likelihood that the option would be exercised. The regulations contain a couple of safe harbors indicating that an option is not reasonably expected to be recognized (exercisable more than 24 months after the measurement date with a strike price equal to or greater than 110 percent of the value of the interest, or the strike price is equal to or greater than fair market value of the interest on the exercise date. The facts and circumstances determination whether an option holder has partner attributes includes whether the option holder has managerial rights in the partnership and rights to share in partnership profits through current and liquidating distributions, and has partnership obligations.

4. Even the used car salesman has to provide evidence of partnership status. Azimzadeh v. Commissioner, T.C. Memo. 2013-169 (7/23/13). The Tax Court (Judge

Holmes) rejected the taxpayer's assertion that his small California used car business was a partnership with a person called Barghi, who was also in the automobile sales business. The court indicated that partnership status was a question of Federal tax law, regardless of whether the taxpayers formed a separate state law entity, and applied the eight factors of *Luna v. Commissioner*, 42 T.C. 1067 (1964), to answer the ultimate test of *Commissioner v. Culbertson*, 337 U.S. 733 (1949), described as "whether the parties intended to and did in fact join together for the present conduct of an undertaking or enterprise." Looking to the *Luna* factors the court determined that the absence of a partnership agreement weighed against partnership status, the lack of proof regarding mutual contributions to the venture was neutral, Barghi's authority to write checks as control over income favored partnership status, that proof of the nature of the relationship with Barghi as a co-proprietor or suppler "left only the muddiest of tracks," the absence of K-1s and other partnership return filings, the absence of partnership books indicating Barghi's interest in the enterprise, weighed against partnership status, and the absence of evidence of Barghi's joint control other than signature authority on the checking account was a neutral factor. Thus, only one of the *Luna* factors supported partnership status while the rest were negative or neutral. The partnership went down by the count. The court also affirmed the IRS's reconstruction of the taxpayer's income from bank deposits and the IRS's denial of cost of goods sold and other claims.

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

1. De minimis partners become substantial under proposed regulations. REG-109564-10, Partner's Distributive Share, 76 F.R. 66012 (10/25/11). The economic effect of a partnership allocation is not substantial under Reg. § 1.704-1(b)(2)(iii)(*a*) if, at the time the allocation (or allocations) becomes part of the partnership agreement: (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. Reg. § 1.704-1(b)(2)(iii)(*e*) provides that the tax attributes of a de minimis partner (a partner who owns less than 10 percent of partnership capital or profits) need not be taken into account in applying the substantiality tests. The proposed regulation would remove the de minimis partner rule "in order to prevent unintended tax consequences." The preamble to the proposed regulation indicates that the de minimis partner rule was "not intended to allow partnerships to entirely avoid the application of the substantiality regulations if the partnership is owned by partners each of whom owns less than 10 percent of the capital or profits, and who are allocated less than 10 percent of each partnership item of income, gain, loss, deduction, and credit." The regulations will be effective when finalized.

a. De minimis partners are still partners under the substantiality test. T.D. 9607, Partner's Distributive Share, 77 F.R. 76380 (12/28/12). Reg. § 1.704-1(b)(2)(iii)(e) is amended to remove the de minimis rule that provided that in determining whether the economic effect of a partnership allocation is substantial under Reg. § 1.704-1(b)(2)(iii) the tax consequences to a less than 10 percent partner could be ignored. The final regulation is applicable to allocations that become part of a partnership agreement after 12/28/12, and is applicable for all partnership taxable years beginning on or after 12/28/12, regardless of when an allocation became part of the partnership agreement.

2. Family farm is a partnership. Holdner v. Commissioner, T.C. Memo. 2010-175 (8/4/10). When his son Randal expressed little interest in going to college, William Holder, an accountant, invested in developing a small family farm for his son to operate with an agreement to divide the profits with an undefined equity interest in the property. As the farming operation expanded, father and son took title to property as tenants in common. On his returns William reported one-half of the income and claimed deductions for all operating expenses. The Tax Court (Judge Marvel) held that the arrangement was a partnership, rejecting the taxpayer's arguments that they each operated as independent sole proprietors. Judge Marvel noted that both

William and Randal contributed properties and labor to the venture which conducted business activities. She also found that the taxpayers failed to rebut a presumption that the partners shared equal capital interests in the partnership that applied to all items of income and expenditure, and that differing capital contributions did not justify an allocation of all expenditures to William. The court sustained an accuracy related penalty under § 6662 finding that William failed to make a reasonable attempt to ascertain the correctness of his reporting positions.

a. Not clearly erroneous says the Ninth Circuit. Holdner v. Commissioner, 483 Fed. Appx. 383 (9th Cir. 10/12/12). Affirming the Tax Court in an unpublished opinion, the Ninth Circuit upheld Judge Marvel's conclusion that the farming operation was a 50-50 partnership, as opposed to a mere co-ownership of property. It also rejected the taxpayer's argument that the Notice of Deficiency was not adequate because it failed to inform the taxpayer of what would be relevant at trial.

3. Allocations to foreign partners, withholding at one rate, taxable at another. Ann. 2013-30, 2013-21 I.R.B. 1134 (4/24/13). Partnership income effectively connected to a U.S. trade or business allocable to a foreign partner is subject to withholding at the highest rate specified in §§ 1 or 11. Fiscal year partnerships for a year beginning in 2012 must withhold at rates in effect for 2012. Foreign partners who include partnership income for a partnership year ending in 2013, however, are subject to tax at the 2013 rates as increased by the American Taxpayer Relief Act of 2012.

C. Distributions and Transactions Between the Partnership and Partners

1. DAD follows the Son of Boss into the tax shelter abyss. Superior Trading, LLC v. Commissioner, 137 T.C. 70 (9/1/11). This case involved a so-called distressed asset/debt (DAD) tax shelter structure created by John Rogers, tax lawyer and purported international finance expert. The court (Judge Wherry) described the structure by noting that, "true to the poet's sentiment that 'The Child is father of the Man,' the DAD deal seems to be considerably more attenuated in its scope, and far less brazen in its reach, than the Son-of-BOSS transaction." At the top of Rogers' pyramid, Warwick Trading, LLC acquired uncollectable receivables from a bankrupt Brazilian retailer under a contribution arrangement. Warwick claimed a transferred basis in the receivables equal to their face value under § 723. The receivables were then contributed through multiple tiers of trading companies, interests in which were sold to individual investors. Not long after the contribution transaction, the interest of the Brazilian retailer in Warwick was redeemed, but no § 754 election to adjust basis under § 743(b) was made. Ultimately the individual investors claimed loss deductions though their interests in the trading company partnerships as the receivables were liquidated at their depreciated value through an accommodating party. These transactions occurred before the October 2004 revisions to §§ 704(c), 734 and 743 (requiring allocations of built-in loss only to the contributing party, limiting basis to FMV at the time of contribution, and requiring mandatory basis adjustments on distributions involving substantial basis reductions). The court found multiple grounds on which to undo these transactions.

- First, the court held that the original contribution of the receivables was not a partnership transaction under § 721 with § 723 transferred basis, but was instead a sale. The court concluded that the Brazilian retailer was never a partner in a partnership with a joint-profit motive, and thus the transfer of the receivables in the initial transaction was not a § 721 contribution to a partnership.
- The Brazilian retailer's receipt of money within two years of the transfer of the receivables supported recharacterization of the transaction as a sale under § 707(a)(2)(B).
- From the Brazilian retailer's financial statements the court found that the receivables had a zero basis at the time of the contribution in any event.
- And if that was not enough, the court collapsed the transaction under the step-transaction doctrine into a single transaction that consisted of a sale of the receivables for the amount of cash payments eventually made to the Brazilian retailer on redemption

of its interest. Thus, Warwick's basis in the receivables was no higher than the cash payment, which the taxpayer failed to substantiate, resulting in a zero basis.

- Interestingly, the court concluded that it was not necessary to address the broad judicial economic substance doctrine that other courts had used to disallow the tax benefits of the Son-of-Boss cases. The court said that, "Because of a DAD deal's comparatively modest grab and highly stylized garb, we can safely address its sought-after tax characterization without resorting to sweeping economic substance arguments" and added that, "we need only look at the substance lurking behind the posited form, and where appropriate, step together artificially separated transactions, to get to the proper tax characterization."
- All of that was followed by an accuracy related penalty under § 6662.

a. The Seventh Circuit goes back to the generic economic substance doctrine and addresses the penalties. Superior Trading, LLC v. Commissioner, 112 A.F.T.R.2d 2013-____ (7th Cir. 8/26/13). Rather than focus on the technical application of the partnership provisions, with a generic tax shelter analysis, Judge Posner states flat out that the partnership is a sham and says that, "If the only aim and effect are to beat taxes, the partnership is disregarded for tax purposes." The court's opinion is interesting for its holding on the § 6662 40 percent gross valuation misstatement penalty. The Seventh Circuit joins the majority view that "a taxpayer who overstates basis *and* participates in sham transactions, as in this case, should be punished at least as severely as one who does only the former." The minority view is that the gross valuation penalty is only applicable to an overstatement of value and thus not applicable to deficiencies attributable to transactions that lack economic substance. As discussed in section VIII.D. of this outline, the Supreme Court has granted certiorari in *Woods v. United States*, 471 Fed. Appx. 320 (5th Cir. 6/6/12), to resolve the conflict among the circuits.

b. The *Superior Trading* promoter also had additional taxable income. Rogers v. Commissioner, 112 A.F.T.R.2d 2013-____ (7th Cir. 8/26/13). John Rogers, the promoter of the DAD shelter in *Superior Trading*, was the sole shareholder of an S corporation, Portfolio Properties, Inc. (PPI), which received $2.4 million in payments from investors in the DAD shelter. Of that money, $1.2 million was transferred to the LLC that was the general partner in the shelter as the purchase price for the depreciated receivables used in the shelter. Rogers argued that the full $2.4 million was held in trust for the shelter partnership, Warwick. The Seventh Circuit (Judge Posner) agreed that the money actually transferred to Warwick was received by PPI impressed with a fiduciary obligation and therefore not taxable to PPI. However, the court stated that the Tax Court was not required to believe Rogers' testimony that the funds not transferred to Warwick were held in trust. The Tax Court's conclusion was bolstered by the fact that a portion of the funds were distributed to Rogers.

D. Sales of Partnership Interests, Liquidations and Mergers

1. Former PWC consultant was required to recognize ordinary income attributable to her interest in partnership unrealized receivables on her receipt of convertible promissory notes in connection with the sale of the PWC consulting business to IBM. Mingo v. Commissioner, T.C. Memo. 2013-149 (6/12/13). The taxpayer was a partner in the management consulting and technology services business (consulting business) of PWC until PWC sold its consulting business to IBM. The sale was structured by PWC transferring its consulting business to a newly formed partnership, PwCC, the partners of which were subsidiaries of PWC. Among the assets PWC transferred to PwCC were its consulting business' uncollected accounts receivable for services it had previously rendered (unrealized receivables). PWC then transferred to each of the 417 consulting partners an interest in PwCC and cash in exchange for the partner's interest in PWC. The taxpayer was one of the partners who received a partnership interest in PwCC and cash from PWC in exchange for her partnership interest in PWC. Then the PWC subsidiaries sold their interests in PwCC to IBM, and the 417 consulting partners sold their interests in PwCC to IBM in exchange for convertible promissory notes. The value of the taxpayer's partnership interest in PwCC was $832,090, of which $126,240 was attributable to her interest in partnership unrealized receivables, which were uncollected accounts

receivable for services. The taxpayer reported her entire gain on the sale under the § 453 installment method, but the IRS asserted a deficiency on the ground that the gain on the § 751(c) unrealized receivables was not eligible for installment reporting. The Tax Court (Judge Paris) held that § 453 installment reporting is not available for gains attributable to § 751(c) unrealized receivables that represent uncollected cash-method accounts receivable for services. The court relied on *Sorensen v. Commissioner*, 22 T.C. 321 (1954), which held that installment reporting was not available with respect to the sale of options to purchase stock that had been granted as compensation for his services, because "[t]he provisions of section [453] relate only to the reporting of income arising from the sale of property on the installment basis. Those provisions do not in anywise purport to relate to the reporting of income arising by way of compensation for services."

- Furthermore, the IRS's determination that the gain attributable to the unrealized receivables was not eligible for § 453 installment sale reporting, after the taxpayer had reported on the installment method, was a change of accounting method subject to § 481(a). As a result the court sustained the IRS's adjustment for the year 2003, the year the IRS initiated the change, even though the gain properly was reportable in 2002, the year of the sale. The court cited *Bosamia v. Commissioner*, 661 F.3d 250 (5th Cir. 2011), *aff'g* T.C. Memo. 2010-218, for the principle that a § 481(a) adjustment may include amounts attributable to tax years outside the statute of limitations on assessments.
- Finally, because the taxpayer was required to recognize $126,240 of ordinary income relating to partnership unrealized receivables in 2003, the taxpayer was entitled to increase the basis of the note by that amount, which reduced the reported long-term capital gain for the year in which the note was satisfied by conversion into IBM stock.

E. Inside Basis Adjustments

F. Partnership Audit Rules

1. A Notice of Deficiency relating to the partner level loss limitation rules need not wait for an FPAA. Meruelo v. Commissioner, 691 F.3d 1108 (9th Cir. 8/16/12, as amended 11/14/12). The taxpayer reported losses from a single-member LLC (disregarded entity) that was a partner in Intervest, which reported losses from foreign currency transactions. Neither the Intervest returns nor the taxpayer's individual returns identified the status of the disregarded LLC. Although the IRS was investigating Intervest for fraud, and there was a related grand jury proceeding, the IRS did not notify Intervest that it would begin an audit, nor did it issue an FPAA for the year at issue. The IRS issued a notice of deficiency to the taxpayers shortly before the three-year statute of limitations would have expired with respect to their individual returns. Affirming the Tax Court, 132 T.C. 355 (2009), the Court of Appeals (Judge N.R. Smith) held that even though application to a partner of the loss limitation rules of §§ 704(d) and 465 are affected items that require a partner-level determination, a notice of deficiency to a partner based on the application of the loss limitation rules of §§ 704(d) and 465 was not issued prematurely and was valid. The Tax Court had jurisdiction over the petition. While the TEFRA audit rules require completion of partnership proceedings when a partnership item or a related item is involved before issuing a notice of deficiency to partners, the court held that TEFRA does not limit the issuance of a notice of deficiency when no partnership proceeding is pending and no notice of deficiency has been sent. The court also stated that although § 6225(a) provides that "'no assessment of a deficiency attributable to any partnership item may be made . . . before' 150 days after the date a notice of FPAA is mailed or a proceeding in Tax Court has been finalized[,]" [a]ssessment of a deficiency is not equivalent to providing notice of a deficiency." The court also rejected the taxpayer's argument that the notice of deficiency was improper when issued because the IRS was considering a criminal investigation that might have found fraud. The court held that the IRS's contemplation of initiating future proceedings is irrelevant and that requiring the IRS to prove that it had no interest in future partnership-level proceedings would serve no purpose.

2. Asset management joint venture is not a partnership, so take that ordinary income. Rigas v United States, 107 A.F.T.R.2d 2011-2046 (S.D. Tex. 5/2/11).

Hydrocarbon Capital, LLC, which held a number of oil and gas industry financial assets, entered into a loan management and servicing agreement (specifically stating the arrangement was not a partnership) with Odyssey Energy Capital I, LP, formed by five individual limited partners with an LLC general partner. The management agreement provided for a performance fee representing 20 percent of profits after provisions for disposition of income realized on the asset portfolio designed to recoup Hydrocarbon's expenses, the capital value of the portfolio, and a 10 percent preferred return. In a claim for refund, the taxpayer, one of Odyssey's limited partners, claimed pass-through capital gain treatment on gains from disposition of the managed assets. The District Court (Judge Ellison) agreed with the IRS determination that the income to the Odyssey partners was ordinary income as a service fee rather than pass-through partnership income from a joint venture with Hydrocarbon. The court indicated that notwithstanding the unambiguous text of the management agreement eschewing partnership status, it may still look to the conduct of the parties to determine whether the arrangement was a partnership. The court indicated that the Odyssey partners contributed both capital and services to the relationship with Hydrocarbon, and the arrangement provided for a profit sharing and some risk of loss for the Odyssey partners, which supported treating the arrangement as a partnership. Odyssey maintained significant management responsibility for the Hydrocarbon assets, but it did not have authority to withdraw funds from Hydrocarbon bank accounts, it could not increase Hydrocarbon's capital commitment to a particular asset, it could not enter into binding agreements in Hydrocarbon's name, and it could not dispose of an asset without Hydrocarbon's written approval. Odyssey did not share control over bank accounts that corresponded to companies in the asset portfolio, nor could it disburse funds from the accounts, and thus lacked control over the assets and income of the venture. Finally, the court pointed to the fact that neither Hydrocarbon nor Odyssey filed tax returns treating the arrangement as a partnership. Thus, the court found that the IRS established by a preponderance of the evidence that a partnership did not exist.

- The court also held that it had jurisdiction to consider the taxpayer's refund claim under TEFRA as a partner item based on its holding that the taxpayers' amended returns qualified as a partner Administrative Adjustment Request as being in substantial compliance with the requirements of Reg. § 301.6227(d)-1, notwithstanding the absence of a timely filed form 8802 as required by the regulations.

a. The Fifth Circuit reverses the District Court but the taxpayer still loses. This case proves that the TEFRA audit rules are ridiculously complicated and result in a Catch-22. Rigas v. United States, 486 Fed. Appx. 491 (5th Cir. 8/21/12). The taxpayer was one of five limited partners in Odyssey Energy Capital I, LP (Odyssey), which entered into a loan management and servicing agreement with Hydrocarbon Capital, LLC. The agreement provided for a performance fee representing 20 percent of profits after provisions for disposition of income realized on the asset portfolio designed to recoup Hydrocarbon's expenses, the capital value of the portfolio and a 10 percent preferred return. The agreement specifically stated that the arrangement was not a partnership. In 2004 Hydrocarbon recognized approximately $110 million of gain on a disposition of assets and paid a performance fee to Odyssey of approximately $20 million. Odyssey originally reported the $20 million as a management fee constituting ordinary income, and the Odyssey partners reported their share of the ordinary income on individual returns. Subsequently Odyssey filed an amended return claiming it was in a partnership with Hydrocarbon and its $20 million share of proceeds was capital gain. The partners filed amended individual returns claiming refunds. Apparently the IRS allowed refunds to four partners, but denied Rigas's claim. In Rigas's refund suit, the District Court held that there was no partnership between Odyssey and Hydrocarbon and the fees paid to Odyssey were properly treated as ordinary income. *Rigas v United States*, 107 A.F.T.R.2d 2011-2046 (S.D. Tex. 5/2/11). The District Court also held that it had jurisdiction to consider the taxpayers' refund claims under TEFRA as a partner item based on its holding that the taxpayers' amended returns qualified as a partner Administrative Adjustment Request as being in substantial compliance with the requirements of Reg. § 301.6227(d)-1, notwithstanding the absence of a timely filed Form 8802 as required by the regulations. With a complicated meander through the limitations on filing refund actions by partners under TEFRA, the Fifth Circuit in a

lengthy per curiam opinion reversed the District Court's holding that it had jurisdiction to hear the refund action, denied the taxpayer's claim that he was entitled to consideration of whether the partnership item was capital gain, held that the District Court had jurisdiction to determine whether the taxpayer was given inconsistent settlement treatment, but alas concluded that there was no settlement.

- Section 7422(h) bars jurisdiction to consider a refund claim by a partner attributable to partnership items except as provided in §§ 6228(b) or 6230(c). Section 6228(b) allows a refund suit attributable to partnership items if the IRS responds to a partner's Administrative Adjustment Request (AAR), filed as provided in § 6227(d), by mailing a notice indicating that partnership items will be treated as non-partnership items, or if the IRS fails to allow the AAR and no notice is mailed. Section 6230(c) provides for claims arising from erroneous computations and was not at issue in the case. The Court of Appeals rejected the District Court's holding that the taxpayer's filing an amended return was substantial compliance with the AAR requirement. The court held that the requirement of Reg. § 301.6627(d)-1 that the taxpayer file a specific form (Form 8082) is a procedural requirement that may be met with substantial compliance, but that the requirement that the taxpayer provide a detailed explanation of the claim is a substantive requirement that must be satisfied so that the IRS can properly decide whether to allow the AAR. The court held that Rigas' amended return failed to meet the substantive requirements because it had not been filed in the Service Center where the partnership return had been filed, and it did not provide a detailed explanation of the claim for refund.
- The court held that a partner's claim to settlement terms consistent with the terms of a settlement between the IRS and another partner under § 6224(c)(2) is an item that depends upon whether the particular partner has been properly offered consistent settlement terms and is, therefore, not a partnership item. Thus, the court has jurisdiction to consider a refund claim on that basis. However, the court concluded that as a matter of law the IRS's payments of refunds to the other Odyssey partners were not settlement agreements under § 6224 because there was no partnership-level administrative proceeding.
- Finally, the court rejected the taxpayers alternate claim that since the character of the income was adjusted at the partnership level in the partnership amended return, the taxpayer is entitled to tax treatment consistent with the treatment of the partnership item. The court held that the District Court lacked jurisdiction to consider a refund claim on this basis under § 7422(h) because the taxpayer's "claim that the Performance Fee was recharacterized as capital gains instead of ordinary income at the partnership level and that they are entitled to a refund based on a similar characterization at the partner level, their claim is attributable to a partnership item." The court noted in support of its finding that the item is a partnership item that characterization of the performance fee at the partnership level affects both the partnership's reporting and the reporting of the other partners.

3. Penalties assessed on outside basis adjustments are not a partnership item. Arbitrage Trading, LLC v. United States, 111 A.F.T.R.2d 2013-409 (Fed. Cl. 1/30/13). Following *Petaluma FX Partners*, and *Tigers Eye Trading LLC*, the Court of Federal Claims held in this Son-of-BOSS TEFRA proceeding that the court lacked jurisdiction to consider the application § 6662 accuracy related penalties on adjustments to the taxpayer's outside basis, which is an affected item in the partnership proceeding. The court further held that it had jurisdiction to consider accuracy related penalties related to adjustment of the disregarded partnership's losses and other deductions.

4. Rely on the IRS for legal advice, you lose. Kearney Partners Fund, LLC v. United States, 111A.F.T.R.2d 2013-1408 (M.D. Fla. 3/27/13). Reconsideration denied, 111 A.F.T.R.2d 2013-2043 (M.D. Fla. 5/20/13). The taxpayer invested in a transaction called the "Family Office Customized" (FOCus) program by acquiring a direct interest in an LLC called Nebraska Partners, which included indirect interests in Lincoln Partners LLC, owned 99% by Nebraska, and Kearney Partners LLC, owned 99% by Lincoln. On initiation of a TEFRA audit procedure, the IRS mailed the required Notice of Beginning of Administrative Proceedings (NBAP) to the partnerships but not the partners. Section 6223(a) requires notice of initiation of an audit at least 120 days before issuance of a Final Partnership Administrative Adjustments

(FPAA) to partners whose names and addresses are furnished to the IRS. Section 6223(e) allows a partner who was not provided a required notice to opt-out of the partnership proceeding. In issuing its FPAA to Kearney Partners, the IRS attached a cover letter indicating that since the taxpayer had not been issued an NBAP the taxpayer was entitled to opt-out of the partnership proceeding, which he elected to do. However, shortly after the taxpayer notified the IRS of his election to opt-out, the IRS sent a letter to the taxpayer indicating that it erred in informing the taxpayer of an election to opt-out because the taxpayer was not directly entitled to an NBAP in the first instance. The taxpayer's petition to the Tax Court following a separately issued notice of deficiency was dismissed for lack of jurisdiction but the basis for the decision was not specified. The District Court rejected the taxpayer's motion that the court lacked jurisdiction over the taxpayer in the partnership proceeding because of the taxpayer's election to opt-out. First, the court rejected the taxpayer's argument that the IRS was collaterally stopped from asserting jurisdiction in the partnership proceeding. The court concluded that since the basis for the Tax Court's determination that it lacked jurisdiction over the notice of deficiency issued to the taxpayer was not clear, the issue was not fully litigated in the Tax Court, and, therefore, collateral estoppel did not apply. The court then found that the taxpayer was not initially entitled to receive an NBAP because the partnership failed to provide the names and addresses of partners on either a partnership return or by separate statement as required by § 6223(c). Further, the court held that the IRS is not required to search its records for other information that may be available to it that identifies the names and addresses of partners. That applies even if the IRS is aware of the partner's identity. Finally, the court indicated that, "[w]hile the Agency's error (subsequently rescinded) is regrettable to the extent it muddied the waters, it does not alter the fact that there was no legal obligation to provide the NBAP to [the taxpayer] in the first place and the letter to the contrary does not change that circumstance."

a. Strike two, same partner, different argument. Kearney Partners Fund, LLC v. United States, 111 A.F.T.R.2d 2013-1789 (M.D. Fla. 4/25/13). In this action the court denied summary judgment motions by the partnerships and the 99 percent partner challenging IRS assertions that the FOCus investment lacked economic substance so that all of the gains and losses emanating from the transaction should be disregarded and alternatively that if the losses allocated to the partner are respected then under the step transaction doctrine gains recognized before the partner acquired his interest should also be allocated to the partner. The transaction involved offsetting straddle gains allocated to one owner (and eliminated on the owner's return) and losses, allocated to the later acquiring partner. The court noted that both IRS positions are predicated on the conclusion that FOCus is an abusive tax shelter and observed that both the economic substance doctrine and the step transaction theory have been applied to give effect to both the cost and income functions of a transaction or to neither. The court concluded that the IRS offered sufficient evidence to create a material issue over whether the 99 percent partner intended to benefit from the inception of the transaction and that the losses were generated through an interrelated series of transactions. Further, citing the partnership anti-abuse rule of Reg. § 1.701-2 as a complement to the economic substance doctrine, the court indicated that the IRS may determine to disregard the entire transaction.

b. And a win for the taxpayer in another court on an earlier date. Kearney Partners Fund, LLC v. United States, 111 A.F.T.R.2d 2013-1780 (N.J. 7/13/12). A magistrate judge denied the IRS motion to compel production of documents reflecting communications between the 99 percent partner and Rabner, Allcorn, Baumgart & Ben-Asher, P.C. The court concluded that the documents were protected by the attorney-client privilege and rejected, after an *in camera* review, the IRS argument that the firm was providing financial advice. The court found that the attorney was providing legal and tax advice. The court also held that even if the partner were a party in the Florida TEFRA litigation, the partner did not waive the attorney-client privilege by intending to call the attorney as a witness in that matter because the partner would not rely on the attorney's advice in that case. The court also held that the documents were prepared in anticipation of litigation because of the aggressive nature of the transaction.

c. And a partial loss and partial win for the taxpayer who seems to have unlimited attorney fee resources for pre-trial motions. Kearney Partners Fund, LLC v. United States, 111 A.F.T.R.2d 2013-1963 (M.D. Fla. 5/10/13). In this round the court denied the taxpayer's objection to a Magistrate's ruling that certain documents sought by the taxpayer from the IRS were protected under the "deliberative process privilege." The privilege attaches to documents that precede an agency's final determination or outcome on a policy or legal matter and which reflect the give-and-take of the consultative process that is antecedent to final agency action. After in *in camera* review of the requested documents, the court found that all of the documents, except one, were subject to the privilege reflecting inter-agency opinions and recommendations of IRS investigators, examiners and counsel at the Office of Chief Counsel that preceded the IRS final determination of the taxpayer's tax obligations concerning the FOCus partnerships and application of accuracy related penalties. The court rejected the taxpayer's argument that lower-level determinations relating to tax-return examinations were not subject to the privilege noting that the entire body of work of auditors are subject to the deliberative process privilege. However, a legal memorandum written by Debra Butler, Associate Chief Counsel Procedure and Administration, in response to a request for assistance as to whether accuracy related penalties could be imposed on taxpayers notwithstanding their disclosure of participation in the FOCus partnerships, was described by the court as the type of legal document relied upon by recipients as statements of law and public policy that are not pre-decisional and therefore not subject to the privilege. The court cited Tax Analysts v. Internal Revenue Service, 117 F.3d 607 (D.C. Cir. 1997) holding that Field Service Advice Memoranda could not be viewed as pre-decisional because the documents represented statements of the agency's legal position. The court described the document as follows:

> Similarly, the memorandum here reflects the Office of the Chief Counsel's statements of law and assessments of Plaintiffs' tax obligations. The opinion appears to be in its final form, with no visible marks or edits. The tone of the document is impersonal with distinct conclusion, facts, and law and analysis sections. Although the memorandum indicates that it may not be used or cited as precedent, the document is a representation of the IRS's legal position in this case. 3 And even if the document precedes the IRS's final decisions in Plaintiffs' case, there is no indication that it precedes the Agency's final legal position.

- The court also found that, although the memorandum, is subject to the attorney-client privilege, it should be produced because it reflects the IRS's final legal position regarding the taxpayer's tax obligations. The court also upheld the Magistrate's ruling that other documents from an attorney in Chief Counsel advising revenue agents were not protected by the attorney-client privilege and subject to disclosure. The court indicated that it was unable to ascertain whether the attorney conducted factual and legal analysis as counsel to the revenue agents or as one of the revenue agents, and that the IRS thus failed to meet its burden of identifying the underlying facts demonstrating the existence of the privilege.

d. And the waiver of penalties raises issues that may or may not be considered in the partnership proceeding. Kearney Partners Fund, LLC v. United States, 111 A.F.T.R.2d 2013-2082 (M.D. Fla. 5/22/13). In this decision the court determined that it had jurisdiction to determine under Ann. 2002-2, 2002-1 C.B. 304, whether voluntary disclosure filed by the partner entitled him to waiver of accuracy related penalties under the terms of the Announcement. The court held that since the Announcement consists of an agency directive designed to confer important benefits to taxpayers who disclose their involvement in tax shelters in exchange for the waiver of penalties, the thrust of the Announcement was to provide a benefit to taxpayers, not to internally regulate IRS affairs. In addition, the specific procedures and requirements enumerated in the Announcement provided the necessary law to evaluate the taxpayer's eligibility for penalty waiver. Thus, the court determined that it may review whether the taxpayer's voluntary disclosure satisfied the Announcement's requirements. In addition, however, the court considered whether the penalty provisions were subject to review in the partnership level proceeding, or whether it lacked subject matter jurisdiction to determine the

penalty as a partner item. That question turned on whether the partner who provided the disclosure had authority under the LLC agreements to disclose on behalf of the partnership so that the disclosure was a partnership matter. The court determined that question depended on a showing of facts not in the record on summary judgment and thus denied summary judgment on the penalty issue.

- The court also held that it did not have jurisdiction to review whether the IRS followed it own internal procedures for reviewing penalty waivers as the IRS internal memorandum requiring approval of the Director of Field Operations for penalties, which were determined at the Office of Chief Counsel instead, represented internal general statements of policy and rules governing internal agency operations that do not have the force of law and, therefore, are not binding on the agency.

5. Wise guys respond to the wrong notice, it's their problem even though the IRS made the mistake. Wise Guys Holdings, LLC v. Commissioner, 140 T.C. No. 8 (4/22/13). The IRS mailed a FPAA to the tax matters partner from one office, and nine months later sent a second notice from a different office. The first and second FPPAs were similar in content, set forth the same adjustments, but contained different contact information for the IRS. After the deadline for challenging the first FPAA had expired, the taxpayer filed a petition in response to the second FPAA. Too bad says the court (Judge Thornton). Section 6223(f) provides that, "If the Secretary mails a notice of final partnership administrative adjustment for a partnership taxable year with respect to a partner, the Secretary may not mail another such notice to such partner with respect to the same taxable year of the same partnership in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact." Thus, concluded the court, the second FPAA is invalid and the taxpayer failed to file a timely petition in response to the first FPAA. Reasoning from cases considering a statutory notice of deficiency, the court indicated that the Tax Court's jurisdiction proceeds from a valid petition, which must be filed from a valid statutory notice (citing *Stamm Int'l Corp. v. Commissioner*, 84 T.C. 248, 252 (1985)). The court also indicated that it does not have authority to apply equitable principles such as estoppel to acquire jurisdiction.

6. The IRS doesn't have to search for the addresses of notice partners. Taurus FX Partners, LLC v. Commissioner, T.C. Memo. 2013-168 (7/22/13). Bricolage Capital, LLC was the tax matters partner (TMP) and FX Trading Co., LLC was a notice partner of Taurus FX Partners LLC. Richard Postma was the sole member of FX Trading Co., which was thereby a disregarded entity. The IRS sent both the notice of beginning of administrative proceeding and the notice of final partnership administrative adjustment (FPAA) to the tax matters partner and the notice partner, plus Postma, to the addresses shown on the partnership's 2000 return, the year under review. Postma filed a petition with the Tax Court as a partner other than the TMP after the 150 day period for filing had expired. The court (Judge Buch) rejected Postma's assertion that the FPAA was invalid because the IRS did not mail the notices to the addresses shown on the partnership's 2001 return, the partner's last known address which was different than the addresses on the 2000 return subject to the audit. Section 6223(c)(1) provides that the IRS "shall use the names, addresses, and profits interest shown on the partnership return" and § 6223(c)(2) provides that the IRS shall use such additional information furnished to it under regulations. Temp. Reg. § 301.6223(c)-1T(a) required a written statement to the Service Center where the partnership return was filed that identifies the partners, the years involved, and provides addresses. The court held that in the absence of the notice required by the regulations, it was sufficient for the IRS to mail the FPAA to the tax matters partner and the notice partner at the addresses shown on the partnership's 2000 return, notwithstanding the fact that the partnership's 2001 return had different addresses. The court stated that, "Although the Commissioner may use other information in its possession, he is not obligated to search his records for information that is not expressly furnished on the 2000 return or pursuant to the regulations," citing Temp. Reg. § 301.6223(c)-1T(f). The court also rejected Postma's argument that he should have received a copy of the FPAA as a notice partner. The court indicated that Postma was not identified as an indirect partner in a statement to the IRS as required by Temp. Reg. § 301.6623(c)-1T, even though Postma was named on the Schedule K-1 as the contact person for FX Trading, the

disregarded entity in which Postma was the sole member. The court indicated that the language of Temp. Reg. § 301.6223(c)-1T(f), which provides that the IRS "may use other information in its possession," does not create an obligation on the IRS to search its records for information not expressly provided under the regulations. The court ultimately held that the FPAA was valid and that the court lacked jurisdiction to hear the case because Postma's petition was filed more than 150 days after the FPAA was issued to the TMP.

7. The grantor of a trust is not a partner under TEFRA audit rules. Sugarloaf Fund, LLC, JetStream Business Limited v. Commissioner, 41 T.C. No. 4 (9/5/13). This TEFRA audit case is an offshoot of the John Rogers Depreciated Asset/Debt (DAD) tax shelter rejected by the courts in *Superior Trading* (discussed part C of this section). In the DAD shelter, Sugarloaf LLC transferred depressed Brazilian receivables to Main Trust (an Illinois common law business trust) which in turn allocated the receivables to a Sub-Trust. The taxpayer Elmes (who was represented by Rogers) transferred cash to the Main trust for the entire interest in Sub-Trust. Elmes claimed a § 166 bad debt deduction for the receivables. The deduction depended upon the transferred basis of the receivables from Sugarloaf. The Tax Court (Judge Wherry) rejected Elmes's assertion that he was a partner in Sugarloaf because his basis in the receivables was dependent on Sugarloaf's basis. For purposes of participating in a TEFRA proceeding, a partner is defined in § 6231(a)(2) as "any other person whose income tax liability *** is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership." Partners also include indirect partners defined by § 6231(a)(10) to include "person[s] holding an interest in a partnership through 1 or more pass-thru partners. " The court concluded that Elmes's Sub-Trust had no interest in the Sugarloaf partnership. The court also concluded that a trust is not necessarily a partner merely because the trust received assets from the partnership. The court indicated that the fact that assets were transferred to the trusts did not depend upon any legal relationship among Elmes, the trusts and the partnership. The court distinguished the relationship of other investors in the DAD shelter noting that in other cases before the court by noting that each of those investors owned an interest in a trading company through one or more pass-through partners.

8. Thirty years after investing in a tax shelter, the taxpayers find no help from the courts. Acute Care Specialists II v. United States, 112 A.F.T.R. 2013-____ (7th Cir. 8/22/13). In the mid-1980's the taxpayers invested in tax shelters created by American Agri-Corp. which were found by the Tax Court in a partnership proceeding to lack economic substance and amount to nothing more than tax-avoidance schemes, with appropriate penalties. The taxpayers filed suit in the District Court challenging deficiency assessments resulting from the partnership proceeding. The Seventh Circuit affirmed the District Court holdings that it lacked subject matter jurisdiction because the taxpayers' assertions regarding statutes of limitations and penalties were partnership-level determinations.

G. Miscellaneous

1. Hiding abusive shelter transactions behind disregarded entities makes the indirect partner an unidentified partner for statute of limitations purposes. Gaughf Properties L.P. v. Commissioner, 139 T.C. No. 7 (9/10/12). The taxpayers invested in KPMG/Jenkens & Gilchrist currency options tax shelters through a partnership consisting of two disregarded LLCs and a wholly owned corporation. After the IRS caught up with the taxpayers from information obtained through John Doe summons issued to Jenkens & Gilchrist, the IRS asserted that the statute of limitations remained open with respect to the taxpayers under § 6229(e), which extends the limitation period for one year after the name and address of a partner is furnished to the IRS where (1) the name, address, and TIN of the partner is not "furnished" on the partnership return, and the IRS has sent notice of an FPAA within the statute of limitations, or (2) the taxpayer has taken an inconsistent position and failed to provide the notice required by § 6222(b). The Tax Court (Judge Goeke) held that the statute remained open under both provisions. Following the holding in *Costello v. United States*, 765 F. Supp. 1003 (C.D. Cal. 1991), the court held that, although Schedule K-1s are required only for direct partners, an indirect partner who is not identified on a partnership return remains an

"unidentified partner" for purposes of § 6229(e)(1). The court rejected the taxpayer's argument that because the IRS was in possession of identifying information from applications for taxpayer identification numbers for the disregarded entities (Forms SS-4) and information from Jenkens & Gilchrist and KPMG's John Doe summons more than one year before issuing assessment notices. The court upheld the validity of requirements in Temp. Reg. § 301.6223(c)-1T that information be "filed" with the IRS at the Service Center where the taxpayer's returns are filed and that the identifying information be specific. The court interpreted § 6229(e)'s use of term "furnished" as sufficiently close to the filing requirement of the temporary regulations to indicate that the regulation was a valid exercise of administrative authority under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) and § 7805(a).

- The court also held that the taxpayer took an inconsistent position on returns reporting the partnership transactions because of the way the partnership netted contributions of long and short options which the taxpayer reported separately in claiming basis increases. As a result, the taxpayer was found to have failed to provide the statement required by § 6222(b), thereby extending the statute of limitations under § 6229(e)(2).
- The court also rejected the taxpayer's arguments that the IRS was estopped from assessing a deficiency (1) because of IRS delays in issuing Notice 2000-44, 2000-2 C.B. 255 (notifying taxpayers of the issues raised by the shelter transaction); (2) because of the long period before the IRS issued an FPAA to the taxpayer's partnership; or (3) because the IRS had withheld and destroyed evidence or placed witnesses beyond the reach of the taxpayer because of criminal investigations.

2. The First Circuit intrudes on tax law in an ERISA case between private litigants and may resolve carried interest issues. Sun Capital Partners III, L.P. v. New England Teamsters and Trucking Industry Pension Fund, 2013 U.S. App. LEXIS 15190, 2013 WL 3814984 (1st Cir. 7/24/13). In an ERISA case two private equity funds organized as limited partnerships sought to withdraw from liability for contributions to the Teamsters multi-employer plans on the grounds that the funds were merely passive investors in a bankrupt company owned by one of the funds. In a decision that could have implications for application of tax principles, the court affirmed summary judgment that at least one of the funds was not merely a passive investor in the bankrupt portfolio company. Under the Multiemployer Pension Plan Amendments Act of 1990 (29 U.S.C. § 1381 *et. seq.*) (MPAA) all employees of trades or businesses that are under common control are treated as employed by a single employer, which becomes liable for obligations under defined benefit plans. Applying the principles of *Commissioner v. Groetzinger*, 480 U.S. 480 U.S. 23 (1987), the court concluded that the private equity fund was in the trade or business of developing companies and selling them at a profit. Along the way the court rejected the equity funds' argument that investing was not a trade or business under either *Higgins v. Commissioner*, 312 U.S. 212 (1941) or *Whipple v. Commissioner*, 373 U.S. 193 (1963). The court distinguished *Higgins* by indicating that the taxpayer in that case was not engaged in the management of the companies represented in the taxpayer's investment portfolio. The court concluded that *Whipple* did not bar trade or business status because, paraphrasing the language of *Whipple*, the funds "did not simply devote time or energy to [the bankrupt company] 'without more.' Rather they were able to funnel management and consulting fees to [the fund's] general partner and its subsidiary." Quoting from Rosenthal, "Taxing Private Equity Funds as Corporate Developers," Tax Notes, Jan. 21, 2013 at 361, the court stated that, "[P]rivate equity funds are active enough to be in a trade or business."

- While the court was clear that it based its opinion on its independent interpretation of the MPAA, the court deferred under the standard of *Skidmore v. Swift*, 323 U.S. 134 (1944) (the weight of the agency opinion depends upon its thoroughness and validity of its reasoning), to a 2007 PPGC letter concluding that an equity fund was engaged in a trade or business under the *Groetzinger* two-part test on findings that the fund was engaged in an activity with the primary purpose of income or profit and that it conducted that activity with continuity and regularity. The PPGC letter indicated that the size of the fund involved in the ruling, the size of its profits, and the management fees paid to the general partner of the fund established the requisite continuity and regularity.

- The court rejected the equity funds' assertion that the phrase "trade or business" must have a uniform interpretation across federal statutes in the context of the application of *Higgins* and *Whipple*. Nonetheless, the court found no inconsistency in its interpretation of trade or business under those cases and *Groetzinger*, which leaves wide open the possibility that fees and the profits interests of an equity fund represent ordinary income derived from services in the trade or business of acquiring and managing business operations.

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. Had this opinion been issued on October 25th, the taxpayer might have had a chance. However, the opinion was issued on March 14th, so success was not in the cards. Crispin v. Commissioner, T.C. Memo. 2012-70 (3/14/12), on appeal to the Third Circuit. The taxpayer, an experienced CPA, entered into a CARDS transaction in 2001 to shield about $7 million of shared fees (ordinary income) from his wholly owned S corporation that engaged in a business related to a pool of collateralized mortgage obligations. The promoter was a longtime friend who did not charge the taxpayer any fee to participate in the CARDS transaction. The Tax Court (Judge Kroupa) held that the transaction lacked economic substance because it lacked business purpose and profit expectation, stating, "[w]e have consistently held that CARDS transactions lack economic substance," and noting that an appeal in this case lies in the Third Circuit, which decided *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998).

- Judge Kroupa also upheld the 40 percent gross valuation misstatement accuracy-related penalty. The tax opinion the taxpayer received from his advisors relied on "false representations [the taxpayer] made," including that he had a business purpose for entering into the CARDS transaction and that he anticipated earning a profit, absent tax benefits, from the CARDS transaction, which were "material to the conclusions reached in the tax opinion." Furthermore, the taxpayer had not actually relied on the opinion.

a. This opinion was issued on February 25th so the taxpayer was again out of luck. Crispin v. Commissioner, 708 F.3d 507 (3d Cir. 2/25/13). The Third Circuit (Judge Jordan) upheld the Tax Court determination that the CARDS transaction failed both the objective and subjective tests for economic substance. The Third Circuit further found that the Tax Court did not abuse its discretion in deciding not to credit either taxpayer's evidence as to business purpose (in that he approached the lender to substitute aircraft for cash as collateral) or the expert opinion by taxpayer's expert (in that potential profit could be generated by using the CARDS loan proceeds to purchase aircraft). The penalty issue was decided against taxpayer, following *Gustashaw v. Commissioner*, 696 F.3d 1124 (11th Cir. 9/28/12).

2. District Court upholds BLIPS tax shelter on taxpayer's partial summary judgment motion. Klamath Strategic Investment Fund, LLC v. United States, 440 F. Supp. 2d 608 (E.D. Tex. 7/20/06). The court (Judge Ward) held that the premium portion of the loans received from the bank in connection with the funding of the instruments contributed to a partnership was a contingent obligation, and not a fixed and determined liability for purposes of § 752. The transaction was entered into prior to the release of Notice 2000-44, 2000-2 C.B. 255, which related to Son-of-BOSS transactions. Judge Ward held that a regulation to the contrary, Reg. § 1.752-6 (*see* T.D. 9062), was not effective retroactively, and was therefore invalid as applied to these transactions. Judge Ward held that there was clear authority existing at the time of the transaction that the premium portion of the loan did not reduce taxpayer's basis in the partnership.

a. Klamath on the merits: It does not work because it lacks economic substance, but no penalties. The authorities discussed in the Holland & Hart and Olson Lemons opinions provide "substantial authority." Klamath Strategic Investment Fund, LLC v. United States, 472 F. Supp. 2d 885 (E.D. Tex. 1/31/07). The transactions lacked economic substance because the loans would not be used to provide leverage for foreign currency transactions, but no penalties were applicable because taxpayers passed on a 1999 investment, they thought they were investing in foreign currencies, and the tax opinions they

received that relied on relevant authorities set forth in the court's earlier opinion provided "substantial authority" for the taxpayers' treatment of their basis in their partnerships.

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

c. Affirmed in part, vacated in part, and remanded, Klamath Strategic Investment Fund, LLC v. United States, 568 F.3d 537 (5th Cir. 5/21/09). In ruling unfavorably on the taxpayers' cross-appeal of the holding that the transaction lacked economic substance, the Fifth Circuit (Judge Garza) followed the majority rule, which "is that a lack of economic substance is sufficient to invalidate the transaction regardless of whether the taxpayer has motives other than tax avoidance." He stated, "[t]hus, if a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations."

- In ruling unfavorably on the government's appeal of the non-imposition of penalties, Judge Garza stated:

> The district court found that Patterson and Nix sought legal advice from qualified accountants and tax attorneys concerning the legal implications of their investments and the resulting tax deductions. They hired attorneys to write a detailed tax opinion, providing the attorneys with access to all relevant transactional documents. This tax opinion concluded that the tax treatment at issue complied with reasonable interpretations of the tax laws. At trial, the Partnerships' tax expert [Stuart Smith] concluded that the opinion complied with standards established by Treasury Circular 230, which addresses conduct of practitioners who provide tax opinions. Overall, the district court found that the Partnerships proved by a preponderance of the evidence that they relied in good faith on the advice of qualified accountants and tax lawyers.

d. A small lagniappe to the taxpayers in a tax shelter. Klamath Strategic Investment Fund v. United States, 110 A.F.T.R.2d 2012-6021 (E.D. Tex. 9/24/12). On appeal, the Fifth Circuit Court of Appeals disallowed losses generated by a BLIPS tax shelter investment which was held to lack economic substance. *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009). The Court of Appeals remanded the case to the District Court to determine whether partnership operational expenses of $903,000 and fees for investment advice to the partner investors were deductible under § 212. Based on findings by the trial court, the Court of Appeals indicated that although the transaction lacked economic substance, the profit motive of the individual investors would permit the deduction of their economic outlays if the investors effectively controlled the partnership activities so that their profit motive would be attributable to the partnership. (The managing partners were held to have lacked the necessary profit motive to support the deductions.) The District Court (Judge Gilstrap) found that the partnerships were formed to effect an investment strategy selected by the investors, the managing partners were the managing partners "only because [the investors] made it so," the managing partners were confined to the investment strategy directed by the investors "who could shut down the whole process by withdrawing from the partnerships they had created." The court thus held that the investors were the parties having effective control over the partnerships. The court also held that $250,000 of investment fees paid to investment advisors who provided guidance with respect to the partnerships' foreign currency investments were deductible. The court concluded from its reading of the Court of Appeals remand that it had

jurisdiction to order the refund in the partnership proceeding notwithstanding the fact that the expenses were not paid or incurred by the partnerships.

3. Taxpayer victory in the Court of Federal Claims in a lease-in, lease-out (LILO) transaction with a Dutch utility. Consolidated Edison Co. of New York v. United States, 90 Fed. Cl. 228 (10/21/09). The Court of Federal Claims (Judge Horn), in a long and detailed opinion held that, under the particular facts of this case, the LILO transaction taxpayer entered into with a Dutch utility had economic substance, i.e., that no decision as to whether particular options would be exercised was "pre-ordained" and that taxpayer "bore the burdens and benefits of ownership." In finding that taxpayer had shown that the transaction was a true lease and should be respected, she distinguished factually other LILO cases decided for the government, such as *BB & T Corporation v. United States*, 523 F.3d 461 (4th Cir. 2008), and *AWG Leasing Trust v. United States*, 592 F. Supp. 2d 953 (N.D. Ohio 2008).

- A large portion of the opinion consists of Judge Horn's analysis of the expert evidence, with pointed criticism of one expert who "failed to conduct in-depth studies of the … [t]ransaction and gave almost automatic and generalized conclusions on the flaws of LILO and SILO transactions for tax purposes."
- Alleged "spoliation of evidence" in 2000 by reason of a switch in e-mail systems without preserving all of the then-existing e-mails, and the desire to protect 1997 memoranda as work product, come into conflict with bad result for the credibility of an in-house lawyer. ("He was considered by the court an unreliable witness, perhaps willing to write or say whatever he thought would assist his then current assignment.") The court found that litigation was not reasonably anticipated until 2002 at the earliest because negotiations in connection with the IRS audit were ongoing until at least that year. The 1997 memoranda were ordered disclosed.

a. LILO transaction with a Dutch Utility – Taxpayer Victory Reversed: Consolidated Edison Co. of New York, Inc. v. United States, 703 F.3d 1367 (Fed. Cir. 1/9/13). In an opinion by Judge Dyk, the Federal Circuit reversed Judge Horn. The court applied the substance-over-form doctrine under its decision in *Wells Fargo & Co. v. United States*, 641 F.3d 1319 (Fed. Cir. 2011), to conclude disallow ConEd's claimed deductions for rent and interest. Because there was a reasonable likelihood that the tax-indifferent entity in the LILO Transaction (the lessor of the master lease) would exercise its purchase option at the conclusion of the ConEd sublease, the master lease was illusory. Therefore, the LILO Transaction did not constitute a true lease and ConEd's rent deductions were disallowed. The interest deductions were disallowed because the loan proceeds effectively remained in an account to satisfy ConEd's loan obligation to the lender; ConEd did not have the use of the funds. Therefore, there was no genuine indebtedness. The case was remanded to the Court of Federal Claims for the limited purpose of determining only the refund of previously paid interest ConEd might be entitled to receive.

4. A Tax Court judge sees a MidCoast deal as immune from transferee liability. Frank Sawyer Trust of May 1992 v. Commissioner, T.C. Memo. 2011-290 (12/27/11). The Tax Court (Judge Goeke) refused to uphold transferee liability against the shareholders of a corporation who sold the stock of the corporation engaged to a midco (Fortrend, which was brought into the deal by the infamous MidCoast to provide financing) after an asset sale. He found that the shareholders knew little about the mechanics of the transaction and exercised due diligence.

> The trust representatives believed Fortrend's attorneys to be from prestigious and reputable law firms. They assumed that Fortrend must have had some method of offsetting the taxable gains within the corporations. They performed due diligence with respect to Fortrend to ensure that Fortrend was not a scam operation and that Fortrend had the financial capacity to purchase the stock. The trust representatives believed Fortrend assumed the risk of overpaying for the Taxi corporations if they did not have a legal way for offsetting or reducing the tax liabilities.

- Judge Goeke applied state fraudulent conveyance law to determine whether the transactions should be collapsed and concluded that they should not, because

the IRS, which has the burden of proof in transferee liability cases, did not prove that "the purported transferee had either actual or constructive knowledge of the entire scheme." Because in this case the transaction was structured in such a manner that the corporation never made any payments to the shareholders, there was no actual or constructive fraudulent transfer to the shareholders. Finally, turning to federal tax law, Judge Goeke held that "substance over form and its related doctrines [were] not applicable," because the transaction was an arm's length stock sale between the shareholders and a purchaser in which the parties agreed that the purchaser would be responsible for reporting and paying the corporation's income taxes. "There was no preconceived plan to avoid taxation ... ." Judge Goeke distinguished *Feldman v. Commissioner*, T.C. Memo. 2011-297 (2011), because in that case "[i]t was 'absolutely clear' that the taxpayer was aware the stock purchaser had no intention of ever paying the tax liabilities [and] the taxpayer did not conduct thorough due diligence of the stock purchaser ... ."

a. The First Circuit says Judge Goeke was correct to review Massachusetts law but additional considerations remain. Frank Sawyer Trust of May 1992 v. Commissioner, 712 F.3d 597 (3/29/13). The First Circuit, in an opinion by Judge Lynch, vacated and remanded the Tax Court's decision. The Court of Appeals held that the Tax Court correctly looked to Massachusetts law to determine whether the Trust could be held liable for the corporations' taxes and penalties, rejecting the IRS's argument that the Tax Court should have applied the federal tax substance-over-form doctrine to determine whether the Trust should be considered a "transferee" of the four corporations' assets. However, the Court of Appeals held that the Tax Court erred in construing Massachusetts fraudulent transfer law (which is the Uniform Fraudulent Transfer Act) to require, as a prerequisite for the Trust's liability, either (1) that the Trust knew of the new shareholders' scheme or (2) that the corporations transferred assets directly to the Trust. The IRS had presented evidence of fraudulent transfers from the four corporations to the midco entities, and the midco entities purchased the four corporations from the Trust. The Court of Appeals concluded that if on remand the Tax Court were to find that at the time of the purchases, the assets of these midco entities were unreasonably small in light of their liabilities and that the midco entities did not receive reasonably equivalent value in exchange for the purchase prices, then the Trust could be held liable for taxes and penalties assessed upon the four corporations regardless of whether it had any knowledge of the new shareholders' scheme.

5. Another generic tax shelter litigated to the bitter end. Nevada Partners Fund, L.L.C. v. United States, 111 A.F.T.R.2d 2013-___ (5th Cir. 6/24/13). The Fifth Circuit in an opinion by Judge Dennis, affirmed a District Court decision, 714 F. Supp. 2d 598 (S.D. Miss. 2010), denying the taxpayer's deduction for losses purportedly generated by a KPMG FOCus tax shelter transaction. The shelter involved three tiers of partnerships and foreign currency transaction straddles that produced offsetting economic gains and losses. A transitory partner would recognize the gains while the taxpayer would recognize the losses through an inflated partnership basis. The transaction was substantially similar to the listed transaction described in Notice 2000-44, 2000-2 C.B. 255. The Court of Appeals concluded that the District Court "did not err legally or factually in determining that the partnerships failed to meet their burden of proving that the transactions giving rise to the $18 million tax loss in question had economic substance." The District Court correctly held that the transactions "served no other purpose than to provide the structure through which Williams could enjoy the reduction of his tax burden for that year." That in subsequent years the taxpayer made significant profits from currency transactions and other investments effected through the tax shelter promoter was not relevant; the later year's transactions were separate transactions. A § 6662 negligence penalty was upheld notwithstanding that Arnold & Porter had issued an opinion that the losses "more likely than not" would be allowable. The taxpayer, Williams, was not a partner at the time the opinion letter was issued. Furthermore, "the partnerships could not reasonably rely on Arnold & Porter's tax opinions in good faith because Williams and the partnerships failed to prove by a preponderance of the evidence that they supplied the professional with all pertinent information necessary to assess the purpose and elements of the transactions at issue as they were actually effectuated."

6. You say SILO/LILO, but the courts keep singing bye-bye tax benefits. John Hancock Life Insurance Company v. Commissioner, 141 T.C. No. 1 (8/5/13). This case was the first SILO/LILO transaction to come before the Tax Court. After detailed fact findings and an examination of the various Courts of Appeals opinions in earlier SILO/LILO cases, the Tax Court (Judge Haines) held for the IRS. In each of four different transactions, the substance of the transaction was not consistent with its form. There was only *de minimis* risk to the taxpayer and the terms of the agreements assured that the taxpayer would receive its expected return on its equity investments. Judge Haines stated:

> This guaranteed return is not indicative of a leasehold or ownership interest. Rather, it is reflective of what is better described as a very intricate loan from John Hancock to the lessee counterparties.

- Thus – even though the court did find that the transactions had economic substance – because the taxpayer was in substance a lender, its claimed deductions for rent, interest and depreciation were disallowed.

7. Another tax shelter strategy bites the dust. WFC Holdings Corp. v. United States, 112 A.F.T.R.2d 2013-____ (8th Cir. 8/22/13). The court affirmed a district court ruling that a KPMG contingent liability tax reduction strategy sold to Wells Fargo Bank failed to produce claimed capital loss deductions because the transaction lacked economic substance.

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

1. Not all losses are tax shelter losses. Rev. Proc. 2013-11, 2013-2 I.R.B. 269 (12/6/12). This revenue procedure provides that certain losses are not taken into account in determining whether a transaction is a reportable transaction for purposes of the disclosure rules under Reg. § 1.6011-4(b)(5). However, these transactions may be reportable transactions for purposes of the disclosure rules under Reg. § 1.6011-4(b)(2), (b)(3), (b)(4), (b)(6), or (b)(7). Among the losses not subject to § 6011 are losses (1) with respect to the sale or exchange of property where the basis was determined with respect to *cash* paid by the taxpayer, or under §§ 358, 1014, 1015, or 1031(d); (2) from fire, storm, shipwreck, or other casualty, or from theft, as those terms are defined for purposes of § 165(c)(3); (3) from compulsory or involuntary conversions as described in § 1231(a)(3)(A)(ii) and (a)(4)(B); (4) to which § 475(a) or § 1256(a) applies; (5) arising from hedging transactions described in § 1221(b), if the taxpayer properly identifies the transaction as a hedging transaction, or from a mixed straddle account under Reg. § 1.1092(b)-4T; (6) attributable to the abandonment of depreciable tangible property that was used by the taxpayer in a trade or business and that has a basis determined in clause (1), *supra*; (7) arising from the bulk sale of inventory if the basis of the inventory is determined under § 263A; and (8) that are equal to, and determined solely by reference to, a payment of cash by the taxpayer.

D. Tax Shelter Penalties, etc.

1. If it's "too good to be true," it ain't true. Gustashaw v. Commissioner, T.C. Memo. 2011-195 (8/11/11). In an opinion by Judge Halpern, the Tax Court upheld accuracy related penalties of over $1,000,000 against an investor in a CARDS tax shelter, with respect to which the investor had an opinion from Brown & Wood. Judge Halpern concluded as follows:

> A reasonable and ordinarily prudent person would have considered as "too good to be true" a carryover deduction generated from a previously claimed $9,938,324 tax loss when he did not suffer an associated economic loss and invested only $800,000 in the transaction. As such, he would have conducted a thorough investigation before claiming the deduction on his tax return. ...
>
> [The taxpayer] did not attempt to understand the mechanics of the CARDS transaction, executed the transaction documents without reading them and without an attorney's review, and, although aware of the transaction's untested tax ramifications, declined to seek a ruling from the IRS. Further, he did not question

the claimed carryover loss amount even though he knew that he did not suffer an associated economic loss.

- Furthermore, Judge Halpern held that the taxpayer's reliance of the Brown & Wood opinion was "unreasonable" because he should have known that Brown & Wood had an inherent conflict of interest; the promoter of CARDS both referred Brown & Wood to the taxpayer and supplied him with a model tax opinion letter describing a CARDS transaction that was not unique to the taxpayer's situation. The was no evidence that the taxpayer had an engagement letter with Brown & Wood, spoke to any attorney at the law firm, or directly compensated Brown & Wood for a tax opinion letter. The taxpayer "could not have reasonably believed that Brown & Wood was an independent adviser."

a. Affirmed by Eleventh Circuit on the penalty issues. Gustashaw v. Commissioner, 696 F.3d 1124 (11th Cir. 9/28/12). The Eleventh Circuit (Judge Hull) affirmed the imposition of penalties, including the 40 percent gross valuation misstatement penalty despite the fact that the deduction was disallowed for lack of economic substance – refusing to follow the contrary rule of the Fifth and Ninth Circuits.

2. The Tax Court now agrees with the majority of circuits on the 40 percent gross valuation overstatement penalty, leaving the Fifth and Ninth Circuits standing alone together. AHG Investments LLC v. Commissioner, 140 T.C. No. 7 (3/14/13). In a unanimous reviewed opinion by Judge Goeke, the Tax Court overruled its prior decisions in *Todd v. Commissioner*, 89 T.C. 912 (1987), *aff'd*, 862 F.2d 540 (5th Cir. 1988), and *McCrary v. Commissioner*, 92 T.C. 827 (1989), and held that a taxpayer may not avoid a 40 percent gross valuation misstatement penalty under § 6662(h) by conceding a deduction or credit on grounds unrelated to value or basis of property. The Tax Court was persuaded that in its earlier cases it had misinterpreted a passage in the GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981,which stated "The portion of a tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability. Thus, the underpayment resulting from a valuation overstatement will be determined by comparing the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation overstatement. The difference between these two amounts will be the underpayment that is attributable to the valuation overstatement." Upon reconsidering the issue in *AHG Investments*, the Tax Court quoted with approval the Federal Circuit opinion in *Alpha I, L.P. v. United States*, 682 F.3d 1009 (Fed. Cir. 2012), which stated:

> The Blue Book, in sum, offers the unremarkable proposition that, when the IRS disallows two different deductions, but only one disallowance is based on a valuation misstatement, the valuation misstatement penalty should apply only to the deduction taken on the valuation misstatement, not the other deduction, which is unrelated to valuation misstatement.
>
> The court in Todd mistakenly applied that simple rule to a situation in which the same deduction is disallowed based on both valuation misstatement-and non-valuation-misstatement theories.

- The Tax Court holding in AHG Investments follows the rule adopted by the majority of the Circuit Courts of Appeal. See, e.g., *Fidelity International Currency Advisor A Fund LLC v. United States*, 661 F.3d 667 (1st Cir. 2011); *Alpha I LP v. United States*, 682 F.3d 1009 (Fed. Cir. 2012); and *Gustashaw v. Commissioner*, 696 F.3d 1124 (11th Cir. 2012). The Fifth Circuit and Ninth Circuit follow the rule that The Tax Court established in *Todd* but repudiated in *AHG Investments LLC*. *See Todd v. Commissioner,* 862 F.2d 540 (5th Cir. 1988); *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990).

a. The Supreme Court will take up the conflict between the Fifth and Ninth Circuits, on the one hand, and the Tax Court and the other Circuits, on the other hand. Woods v. United States, 471 Fed. Appx. 320 (5th Cir. 6/6/12), *cert. granted*, 3/25/13. This case presents the issue of the applicability of the valuation overstatement penalty, more specifically whether tax underpayments are "attributable to" overstatements of basis when

the inflated basis claim has been disallowed based on a finding that the underlying transactions lacked economic substance. The Fifth Circuit in a per curiam opinion held that the issue was well-settled and required no discussion in light of *Bemont Invs., L.L.C. v. United States,* 679 F.3d 339 (5th Cir. 4/26/12); *Heasley v. Commissioner*, 902 F.2d 382 (5th Cir. 1990); and *Todd v. Commissioner,* 862 F.2d 540 (5th Cir. 1988). The Court also added a second question for the parties to brief: "Whether the district court had jurisdiction in this case under 26 U.S.C. § 6226 to consider the substantial valuation misstatement penalty." This issue involves the general question under TEFRA of which issues are to be resolved in a partner-level proceeding and which should be resolved at the partnership level.

b. The Seventh Circuit joins the majority. Superior Trading, LLC v. Commissioner, 112 A.F.T.R.2d 2013-___ (7th Cir. 8/26/13). In an opinion by Judge Posner the Seventh Circuit applied the 40 percent gross valuation misstatement penalty to a partnership tax shelter disregarded under the economic substance doctrine. The court opined that "a taxpayer who overstates basis *and* participates in sham transactions, as in this case, should be punished at least as severely as one who does only the former."

3. A total loss for this taxpayer was in the CARDS. Kerman v. Commissioner, 111 A.F.T.R.2d 2013-1554 (6th Cir. 4/8/13). The Sixth Circuit (Judge Ludington) decided the substantive issues in favor of the government, and the 40 percent valuation overstatement penalty was applied.

4. Partners are still liable for increased interest on substantial underpayments attributable to tax motivated transactions. Bush v. United States, 111 A.F.T.R.2d 2013-____ (Fed. Cir. 5/30/13). In an opinion by Judge Newman, the Court of Appeals affirmed the Court of Federal Claims, which dismissed the suit under § 7422(h) on the basis that it lacked jurisdiction under the TEFRA audit rules. *Bush v. United States*, 101 Fed. Cl. 791 (11/14/11). The taxpayers, who were partners of the Denver-based Dillon Oil Technology Partnership, challenged the IRS's assessment of enhanced interest for tax years 1983 and 1984 pursuant to former Code § 6621(c). Former § 6621(c) imposed an increased rate of interest "with respect to any substantial underpayment attributable to tax motivated transactions." The IRS had issued FPAA's to Dillon Oil for tax years 1983 and 1984 and to other similarly situated Denver-based partnerships disallowing losses of the partnerships. Dillon Oil and the other partnerships filed petitions in the Tax Court. The Tax Court proceedings were stayed pending resolution of *Krause v. Commissioner*, 99 T.C. 132 (1992), which was a test case for over 2,000 related cases. In *Krause*, the Tax Court disallowed losses of the partnerships under § 183 because the partnerships' activities lacked profit objectives and upheld the imposition of increased interest under former § 6621(c). After the *Krause* decision, several partnerships in the Tax Court proceeding involving Dillon Oil moved to compel the IRS to settle based on terms to which the IRS had agreed in some cases prior to the *Krause* decision. These terms allowed the partnerships to take deductions up to the amount of cash invested and imposed no penalties other than increased interest under former § 6621(c) (or its predecessor provision). (After *Krause*, the IRS settled by disallowing *all* deductions and imposing increased interest.) The Tax Court denied these motions and noted that it previously had concluded that partners who had not settled with the IRS prior to *Krause* were bound by the *Krause* decision. *Vulcan Oil Tech. Partners v. Commissioner*, 110 T.C. 153, 154-55 (1998). The Tax Court proceedings involving Dillon Oil ultimately were dismissed for lack of prosecution, and the Dillon Oil partners did not appeal the dismissal. The IRS later sent Form 4549A to the Dillon Oil partners informing them that they would be assessed increased interest under former § 6621(c). The Dillon Oil partners paid the interest and brought a refund action in the Court of Federal Claims, in which they argued that the *Krause* decision was "wrong as a matter of law" and that they were not bound by it. They noted that the Fifth Circuit, in a separate proceeding involving other partnerships, had held (contrary to other Circuits) that the Tax Court in *Krause* had erred in imposing increased interest pursuant to former § 6621(c) because the regulations under that provision permitted increased interest when losses were "disallowed for any period under section 183," and the deductions in *Krause* were not in fact disallowed under § 183, which by its terms applies to activities engaged in by individuals and S corporations. *Copeland v. Commissioner*, 290 F.3d 326 (5th Cir. 2002). The

Federal Circuit rejected the taxpayers' arguments and agreed with the Court of Federal Claims that the Dillon Oil partners were bound by the *Krause* decision, including its conclusion regarding the imposition of increased interest under former § 6621(c). The court reasoned that the Dillon Oil partners lost their opportunity to challenge *Krause* when their Tax Court proceeding was dismissed for lack of prosecution. To set aside the IRS's imposition of increased interest for tax motivated transactions, the court stated, would require relitigating the Tax Court's decision to bind Dillon Oil to the *Krause* decision. The court concluded that whether the Dillon Oil partnership is bound by *Krause* is a partnership level issue that must be determined at the partnership level rather than at the partner level.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. New Regulations concerning charitable hospital organizations. REG-106499-12, Community Health Needs Assessments for Charitable Hospitals, 78 F.R. 20523 (4/5/13). These proposed amendments to Reg. §§ 1.509(r)-1 through -7 provide detailed guidance to charitable hospital organizations on the community health needs assessment (CHNA) requirements, and related excise tax and reporting obligations, enacted as part of the Patient Protection and Affordable Care Act of 2010.

- Each § 501(c)(3) hospital organization is required to meet four general requirements on a facility-by-facility basis:

  -establish written financial assistance and emergency medical care policies;

  -limit amounts charged for emergency or other medically necessary care to individuals eligible for assistance under the hospital's financial assistance policy;

  -make reasonable efforts to determine whether an individual is eligible for assistance under the hospital's financial assistance policy before engaging in extraordinary collection actions against the individual; and

  -conduct a community health needs assessment (CHNA) and adopt an implementation strategy at least once every three years. (These CHNA requirements are effective for tax years beginning after 3/23/12.)

2. The ABA loses another tax case. ABA Retirement Funds v. United States, 111 A.F.T.R.2d 2013-1815 (N.D. Ill. 4/25/13). The District Court held that the ABA Retirement Funds (formerly known as the American Bar Retirement Association), a not-for-profit corporation that creates and maintains IRS-approved master tax-qualified retirement plans for adoption by lawyers and law firms, does not qualify as a tax-exempt "business league" under § 501(c)(6). To be a tax exempt business league, Reg. § 1.501(c)(6)-1 requires that an organization be (1) of persons having a common business interest; (2) whose purpose is to promote the common business interest; (3) not organized for profit; (4) that does not engage in a regular business of a kind ordinarily conducted for profit; (5) whose activities are directed to the improvement of business conditions at one or more lines of a business as distinguished from the performance of particular services for individual persons; and (6) of the same general class as a chamber of commerce or a board of trade. The court found that ABA Retirement Funds was engaged in a business generally carried on for profit. It competed with other retirement funds, and it "sought market share, not market welfare." The fees for its services were paid by individuals in proportion to the benefits they derived from those services. Most significantly, the court found that its activities were directed principally to individual lawyers and law firms rather than to promoting the well-being of the legal profession generally: "The requirement to promote the welfare of the general industry surely demands more than offering goods or services that may enhance the individual practices of the attorneys who purchase them."

- Although the ABA lost in the Supreme Court, *United States v. American Bar Endowment*, 477 U.S. 105 (1986) (American Bar Endowment's income from life insurance policy dividends retained represent profits from the insurance program rather than charitable donations from your members. The court further stated that if the members were given a choice between allowing the American Bar Endowment to retain the dividends and having the dividends refunded to them, then the dividends retained might constitute charitable donations rather

than unrelated business income.), it changed its insurance arrangements to achieve the same result by permitting cash refunds to policyholders who claimed them in writing each year, PLR 8725056 (3/25/87).

3. IRS Official pleads the Fifth. IRS official admits to using political criteria to target certain applicants for § 501(c)(4) status, and stated that this was known to upper-level officials in 2011. Lois Lerner is now on paid administrative leave, having reportedly refused to resign from the IRS. Under questioning by Congress in 2012, Commissioner Douglas Shulman denied that political criteria were used to target certain applications. A TIGTA (Treasury Inspector General for Tax Administration) report on this practice was released.

- In a prepared statement dated 5/21/13 for testimony before the Senate Finance Committee on the following day, the Treasury Inspector General for Tax Administration, J. Russell George, concluded that the IRS has still not satisfactorily resolved the problems identified in the report:

> IRS's Response to Our Recommendations
>
> TIGTA made nine recommendations to provide more assurance that applications are processed in a fair and impartial manner in the future without unreasonable delay. The IRS agreed to seven of our nine recommendations and proposed alternative corrective actions for two of our recommendations. However, we do not agree that the alternative corrective actions will accomplish the intent of the recommendations. One of these recommendations was that the IRS should clearly document the reason applications are chosen for further review for potential political campaign intervention. The second was that the IRS should develop specific guidance for specialists processing potential political cases and publish the guidance on the Internet. Further, the IRS's response also states that issues discussed in the report have been resolved. We disagree with this assertion. Until all of our recommendations are fully implemented and the numerous applications that were open as of December 2012 are closed, we do not consider the concerns in this report to be resolved. In addition, as part of our mission, TIGTA will also determine whether any criminal activity or administrative misconduct occurred during this process. The attached TIGTA report includes additional information on all nine recommendations and the IRS's planned corrective actions and completion dates.

- The Acting Commissioner of Internal Revenue, Steven Miller, was asked to resign, and Daniel Werfel was appointed as Acting Commissioner effective 5/22/13. Although he is a lawyer and worked in the Department of Justice Civil Rights Division, Werfel has no prior tax experience.

- Included among the "two rogue agents in Cincinnati" are Holly Paz (Acting Director of Rulings and Agreements at the IRS's Tax-Exempt and Government Entities Division, fired; replaced 6/10/13 as acting director by Karen Schiller, who was director for exam planning and delivery at the IRS Small Business/Self-Employed Division), Carter Hull (Washington lawyer, retiring), and Joseph Grant (Commissioner, of Tax Exempt and Government Entities division and Lois Lerner's boss, retired on 6/3/13).

a. IRS' expedited option for certain organizations trying to obtain tax-exempt status. FS-2013-8 (6/24/13). The IRS announced that it is offering certain organizations that have applied for § 501(c)(4) status an optional fast-track faster method to obtain tax-exempt status. The IRS will offer the expedited option to groups that have had their applications pending for more than 120 days and involve possible political campaign intervention or issue advocacy.

> This "safe-harbor" option will provide certain groups an approved determination letter granting them 501(c)(4) status within two weeks if they certify they devote 60 percent or more of both their spending and time on activities that promote social welfare as defined by Section 501(c)(4). At the same time, *they must certify that political campaign intervention involves 40 percent or less of both their*

spending and time. These thresholds apply for past, current and future years of operation. Solely for the purpose of determining eligibility for the expedited procedure, an organization must count, among other things, any public communication identifying a candidate that occurred within 60 days prior to a general election or 30 days prior to a primary as political campaign intervention. (Emphasis added)

- Section 501(c)(4) allows tax-exempt status for "[c]ivic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare … . In a bit of Orwellian logic, Reg. § 1.501(c)(4)-1(a)(2)(i), redefines "exclusively" as "primarily," but it really is doubtful that the language of the regulation was intended to allow any political activities. It most likely was intended to preserve tax-exempt status for organizations subject to UBIT. See Ellen Aprill, *The IRS's Tea Party Tax Row: How 'Exclusively' Became 'Primarily'*, http://www.psmag.com/politics/the-irss-tea-party-tax-row-how-exclusively-became-primarily-59451/.

b. These allegations are unanswerable. Van Hollen v. Internal Revenue Service (D. D.C., No. 1:13-cv-01276, filed 8/21/13). Representative Chris Van Hollen (D.-MD) and three nonprofit organizations filed a complaint in a District Court for the District of Columbia seeking declaratory, injunctive, and mandamus relief against the IRS and Treasury Department for allowing tax-exempt organizations to expend substantial sums on electoral activity, claiming it is contrary to the plain meaning of § 501(c)(4). The introduction to the complaint summarizes the cause of action as follows:

1. Plaintiffs Chris Van Hollen, Democracy 21, Campaign Legal Center, and Public Citizen bring this action under the Administrative Procedure Act (APA), 5 U.S.C. §§ 702, 703, 704, and 706(1) & (2)(A), to compel agency action unlawfully withheld and unreasonably delayed, and to set aside agency action that is contrary to law. Defendant Internal Revenue Service (IRS) has for many years violated the Internal Revenue Code (IRC) by allowing tax-exempt social welfare organizations to expend substantial sums on electoral activity. The IRC provides that tax-exempt social welfare organizations must be "exclusively" engaged in "promotion of social welfare." IRC § 501(c)(4). The IRS's implementing regulation recognizes that electoral activity does not fall within the scope of activity promoting social welfare. Treasury Regulation (TR) § 1.501(c)(4)-1(a)(2)(ii). But the IRS's regulation also purports to provide that an organization operates "exclusively" to promote social welfare as long as it is operated "primarily" for social welfare purposes. Id. § 1.501(c)(4)-1(a)(2)(i). By redefining "exclusively" as "primarily" in violation of the clear terms of its governing statutes, the IRS permits tax-exempt social welfare organizations to engage in substantial electoral activities in contravention of the law and court decisions interpreting it.

2. Instead of amending its rules to conform to the requirements of IRC section 501(c)(4), the IRS has recently taken action with precisely the opposite effect: It has issued a directive providing a "safe harbor" for certain organizations seeking exemption under section 501(c)(4) if they spend no more than 40% of their time and expenditures on electoral campaign activities and stating that even organizations that expend more than this percentage on electoral campaign intervention may qualify for tax-exempt status under section 501(c)(4) because the IRS may consider them to be "primarily" engaged in social welfare activities. The IRS's new directive confirms that the IRS interprets its regulation to allow substantial electoral campaign intervention by section 501(c)(4) organizations -- intervention up to and in some circumstances exceeding 40% of their activity -- despite the statutory requirement that they be exclusively engaged in social welfare activities. The IRS's action thus makes the extent of the conflict between its regulation and the statute even more explicit and will injure the plaintiffs by

fostering increased electoral campaign spending without donor disclosure by ostensible section 501(c)(4) organizations. The plaintiffs therefore request that the Court declare the IRS's new "safe harbor" directive unlawful insofar as it permits section 501(c)(4) organizations to spend amounts up to and exceeding 40% of their time and money on electoral campaign intervention.

c. The Taxpayer Advocate weighs in. National Taxpayer Advocate, Special Report to Congress, Political Activity and the Rights of Applicants for Tax-Exempt Status, www.TaxpayerAdvocate.irs.gov/2014ObjectivesReport (6/30/13). The Taxpayer Advocate identified several categories of problems including, among others: (1) the legal standard under the statute that a § 501(c)(4) exclusively engaged in promoting social welfare, interpreted as "primarily" engaged in promoting the common good is ambiguous, and there is no guidance as to the degree of permissible political activity, (2) unlike the case where an application for § 501(c)(3) status is rejected, there is no process for judicial review that might provide guidance, (3) the IRS as a tax agency may not be the most qualified governmental agency to make inherently controversial determinations about political activity, (4) the form 1024 application for recognition of exempt status does not include questions to identify excessive political activity, which is difficult to assess before operations have commenced, (5) EO failed to publically disclose its procedures and there are no checks and balances with regard to taxpayer rights, and (6) EO management failed to install an adequate inventory management system and failed to ensure that requests for guidance received a timely response.

4. It was really a partner of the home sellers, not a charitable partner. Partners in Charity, Inc. v. Commissioner, 141 T.C. No. 2 (8/26/13). PIC was established as a nonprofit corporation under state law and received a determination that it was a § 501(c)(3) organization based on its claim its primary activity was to provide down-payment assistance grants to home buyers. PIC's "down payment assistance" program provided home buyers with funds to use for down payments for home purchases. In practice, however, PIC obtained those funds (along with a fee) from home sellers. PIC provided down-payment assistance grants where the seller was not reimbursing the down payment and paying PIC's fee in only two-tenths of 1% of its transactions. The IRS retroactively revoked PIC's tax-exempt status on the ground that PIC was not operated exclusively for a charitable purpose. The Tax Court (Judge Gustafson) upheld that revocation and held further that the IRS did not abuse its discretion in retroactively revoking its determination that PIC was a § 501(c)(3) organization. In its operation, PIC failed to serve a charitable class, and a substantial amount of its activity did not further a charitable purpose, but rather furthered instead an unrelated business. PIC did not limit its grants to low-income home buyers. PIC engaged in two overlapping but distinct forms of activities: (1) activities that ultimately benefited the buyers — grants and homeowner education, and (2) activities that ultimately benefited the sellers — providing ready buyers, and promoting faster sales at generally higher prices. PIC's transactions with sellers generated revenues of over $28 million in 2002 and $32 million in 2003 and were clearly substantial. Even if PIC's buyer-benefitting activities served an exempt purpose, PIC's seller-benefitting activities failed to further an exempt purpose and defeated the argument that PIC was operated exclusively for a charitable purpose. "PIC's primary purpose was to broker as many transactions as possible and thus to generate significant net profits, regardless of whether the transactions achieved a charitable end."

B. Charitable Giving

1. Charitable deduction for conservation easement denied. Belk v. Commissioner, 140 T.C. No. 1 (1/28/13). The taxpayers claimed a charitable contribution deduction for the grant of a conservation easement on 184.627 acres of a golf course to a qualified organization. Specifically, they agreed not to develop the golf course. However, the conservation easement agreement permitted the taxpayers, with the donee's consent, to remove portions of the golf course from the easement and replace them with property not theretofore subject to the conservation easement. The IRS disallowed the deduction, and the Tax Court (Judge Vasquez) upheld the IRS's disallowance of the deduction. Section 170(h)(1)(A) requires the contribution of a "qualified" real property interest, and to be a "qualified" real property

interest, § 170(h)(2)(C) requires that the conservation easement limit in perpetuity the use that may be made of the property. Section 170(h)(2)(C) precluded the deduction because the taxpayers did not donate an interest in real property subject to a use restriction granted in perpetuity. The interest in real property was not subject to a use restriction granted in perpetuity. Because the conservation easement agreement allowed the parties to change the property subject to the conservation easement, it did not meet the perpetuity requirement. The court rejected the taxpayers' argument that the deduction nevertheless should be allowed because the substitution clause permitted only substitutions that would not harm the conservation purposes of the conservation easement. The court reasoned that the § 170(h)(5) requirement that the conservation purpose be protected in perpetuity is separate and distinct from the § 170(h)(2)(C) requirement that there be real property subject to a use restriction in perpetuity, and the taxpayers' conveyance failed to satisfy § 170(h)(2)(C). Satisfying § 170(h)(5) does not necessarily affect whether there is a qualified real property interest. Furthermore, it was argued that any substitution required the donee's consent: "There is nothing in the Code, the regulations, or the legislative history to suggest that section 170(h)(2)(C) is to be read to require that the interest in property donated be a restriction on the use of the real property granted in perpetuity unless the parties agree otherwise. The requirements of section 170(h) apply even if taxpayers and qualified organizations wish to agree otherwise."

a. Reconsideration denied. Belk v. Commissioner, T.C. Memo. 2013-154 (6/19/13). Judge Vasquez denied the taxpayer's motion for reconsideration. First, the taxpayer argued that the original opinion misinterpreted § 170(h)(2)(C), arguing that the Code and regulations do "not require the donation of an interest in 'an identifiable, unchanging, static piece of real property.'" The taxpayer argued that as long as it "agree[d] not to develop 184.627 acres of land, the Court (and the Internal Revenue Service (IRS)) should not be concerned with what land actually comprises those 184.627 acres." Judge Vasquez reiterated that the court had "rejected the notion of such 'floating easements' ... and found that section 170(h)(2)(C) requires that taxpayers donate an interest in an identifiable, specific piece of real property." Not being bound by any rule that arguments had to be consistent, the taxpayer's second argument was that because the taxpayer had intended to obtain a deduction for granting the conservation easement the court had misinterpreted the conveyance and applicable state law as permitting a substitution. This argument also feel on deaf ears: "Our interpretation of the parties' intention is governed by what the parties actually included in the conservation easement agreement. It is well settled that a taxpayer's expectations and hopes as to the tax treatment of his conduct in themselves are not determinative." Finally, the taxpayer argued that the original opinion "fail[ed] to consider that an element of trust and confidence is placed in a qualified organization that it will continue to carry out its mission to protect and conserve property." Judge Vasquez responded, "Because the parties have agreed petitioners are able to substitute land, there is no restriction on the golf course in perpetuity that we can trust SMNLT to enforce."

2. Another case allowing the taxpayer to write the receipt. You just have to remember to get it countersigned by the donee. RP Golf, LLC v. Commissioner, T.C. Memo. 2012-282 (10/3/12). The Tax Court (Judge Paris) held that a conservation deed signed by donee trust's representative, as well as by donor, satisfied the § 170(f)(8) written acknowledgment requirement. The deed provided a detailed description of property and easement, and was contemporaneous with donation. The deed "stated that the conservation easement was an unconditional gift, recited no consideration received in exchange for it, and stipulated that it constituted the entire agreement between the parties with respect to the contribution of the conservation easement." Accordingly, the "deed, taken as a whole, stated that no goods or services were received in exchange for the contribution."

3. Tax Court allows a charitable deduction for conservation easements. Irby v. Commissioner, 139 T.C. No. 14 (10/25/12). The Tax Court (Judge Jacobs) allowed a charitable contribution deduction for the contribution to a qualified organization, via a bargain sale, of conservation easements that placed on the use of property a variety of limitations that served to protect the relatively natural habitat for fish, wildlife, and plants and to preserve open space and agricultural resources. Although the donee was required to reimburse the government

agencies that funded the bargain purchase price in the event it received proceeds if the land to which the easements related was condemned and the easements were extinguished, the conservation purpose for the easements was protected in perpetuity. The donee would have received its full share of the condemnation proceeds vis-a-vis the donor taxpayers, and there was no risk that the donors would reap a windfall in the event of condemnation. While the donee was required to reimburse the funding governments, the requirement of Reg. § 1.170A-14(g)(6)(i) that all of the extinguishment proceeds would be used by donee in a manner consistent with the conservation purposes of the original contribution was met because the reimbursement under the terms of the conservation deeds would enhance the ability of the funding governmental agencies to conserve and protect more land, since the reimbursed funds would be used for that purpose. Judge Jacobs rejected the IRS's argument that the deduction should be denied on the ground that the taxpayer's appraisal report was not a "qualified appraisal" because the report did not include explicit statements that the appraisal was prepared for income tax purposes.

> [T]he appraisal report in this case included all of the required information either in the appraisal or in the appraisal summaries attached to petitioners' respective returns—it included a discussion of the purpose of the transaction (i.e., that the purpose of the appraisal was to value the donation of a conservation easement pursuant to the terms of section 170(h)) . . . ; it stated that fair market valuation was to be used in determining the value of the property; and Form 8283 was properly filed with petitioners' respective returns. The IRS has not provided to the public a specific form for the tax purpose statement, and respondent has not proffered any instance where a suboptimal tax purpose statement, by itself, invalidated an otherwise qualified appraisal.

- Finally, Judge Jacobs rebuffed the IRS's argument that the deduction should be disallowed on the ground that the taxpayers did not obtain contemporaneous written acknowledgments from the donee indicating the amount of goods or services that received for the contribution. He concluded that collectively (1) the option agreement between the donors and the donee, (2) the Forms 8283 attached to the taxpayers' tax returns, (3) letters from the donee to the donors states that it was a qualified § 170(h) organization and would receive and hold the conservation deeds with respect to the parcels, (4) the settlement statements prepared by the title company in the transaction, which list the amounts paid as part of the bargain sale, and (5) the conservation deeds, which stated the source of funding for the bargain purchase, described the donated property, and listed the responsibilities and rights that the donors and donees had regarding the enforcement of the easement – all of which were prepared before the taxpayers' income tax returns were filed – contained sufficient information to constitute a contemporaneous written acknowledgment despite the absence of any statement that no services were received by the donors (because goods were received by the donors in their bargain sales).

4. The Tax Court just says "no" to deductions for contributions of conservation easements on mortgaged properties. Kaufman v. Commissioner, 134 T.C. 182 (4/26/10). The Tax Court (Judge Halpern) held that as a matter of law no charitable contribution deduction is allowable for the conveyance of an otherwise qualifying conveyance of a facade conservation easement if the property is subject to a mortgage and the mortgagee has a prior claim to condemnation and insurance proceeds. Because the mortgage has priority over the easement, the easement is not protected in perpetuity – which is required by § 170(h)(5)(A). The deduction cannot be salvaged by proof that the taxpayer likely would satisfy the debt secured by the mortgage.

a. Tax Court reaffirms earlier decision. Kaufman v. Commissioner, 136 T.C. 294 (4/4/11). On the taxpayers' motion for reconsideration, the Tax Court (Judge Halpern) in a lengthy and thorough opinion reaffirmed its earlier decision that the conservation easement failed the perpetuity requirement in Reg. § 1.170A-14(g)(6), because under the loan documents, the bank that held the mortgage on the property expressly retained a "'prior claim' to all insurance proceeds as a result of any casualty, hazard, or accident occurring to or about the property and all proceeds of condemnation," and agreement also provided that

"the bank was entitled to those proceeds 'in preference' to [the donee organization] until the mortgage was satisfied and discharged." The court also disallowed a deduction in 2003, but allowed the deduction in 2004, for a cash contribution to the donee of the conservation easement in 2003 because the amount of the cash payment was subject to refund if the appraised value of the easement was zero, and the appraisal was not determined until 2004. The court also rejected the IRS's argument that the taxpayers received a *quid pro quo* for the cash contribution in the form of the donee organization accepting and processing their application, providing them with a form preservation restriction agreement, undertaking to obtain approvals from the necessary government authorities, securing the lender agreement from the bank, giving the taxpayers basic tax advice, and providing them with a list of approved appraisers. The facts in evidence did not demonstrate a *quid pro quo*, because, among other things, many of the tasks had been undertaken by the organization before the check was received.

- Finally, the court declined to uphold the § 6662 accuracy related penalties asserted by the IRS for the taxpayers' overstatement of the amount of the contribution for the conservation easement, but sustained the negligence penalty for the 2003 deduction for the cash payment. Because the issue of whether any deduction was allowed for the easement, regardless of its value, was a matter of law decided in the case as a matter of first impression, the taxpayers were not negligent, had reasonable cause, and acted in good faith.

b. The taxpayer wins the battle in the Court of Appeals with an excellent discussion of charitable contributions of easements on mortgaged property, but still might lose the war. Kaufman v. Shulman, 687 F.3d 21 (1st Cir. 7/19/12). The First Circuit, however, in an opinion by Judge Boudin, disagreed with the Tax Court, holding that a mortgagee's right to satisfy the mortgage lien before the donee of the conservation easement is entitled to any amount from the sales or condemnation proceeds from the property does not necessarily defeat the charitable contribution deduction. Judge Boudin's opinion noted that "the Kaufmans had no power to make the mortgage-holding bank give up its own protection against fire or condemnation and, more striking, no power to defeat tax liens that the city might use to reach the same insurance proceeds – tax liens being superior to most prior claims, 1 Powell on Real Property § 10B.06[6] (Michael Allan Wolf ed., Matthew Bender & Co. 2012), including in Massachusetts the claims of the mortgage holder." The opinion continued by observing that

> [G]iven the ubiquity of super-priority for tax liens, the IRS's reading of its regulation would appear to doom practically all donations of easements, which is surely contrary to the purpose of Congress. We normally defer to an agency's reasonable reading of its own regulations, *e.g.*, *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 220 (2001), but cannot find reasonable an impromptu reading that is not compelled and would defeat the purpose of the statute, as we think is the case here.

Thus, the First Circuit rejected the Tax Court's requirement that the donee of the conservation easement have "an absolute right" (136 T.C. at 313), holding that a "grant that is absolute against the owner-donor" is sufficient "and almost the same as an absolute one where third-party claims (here, the bank's or the city's) are contingent and unlikely."

- The First Circuit went on to reject the IRS's argument that contribution also failed to qualify for a charitable contribution deduction because a provision in the agreement between the Kaufmans and the donee trust stated that "nothing herein contained shall be construed to limit the [Trust's] right to give its consent (e.g., to changes in the Façade) or to abandon some or all of its rights hereunder," citing *Commissioner v. Simmons*, 646 F.3d 6 (D.C. Cir. 2011), which reasoned that such clauses permitting consent and abandonment "'have no discrete effect upon the perpetuity of the easements: Any donee might fail to enforce a conservation easement, with or without a clause stating it may consent to a change or abandon its rights, and a tax-exempt organization would do so at its peril.'" (quoting 646 F.3d at 10).
- The court also rejected various IRS arguments that the substantiation rules had not been met.

- However, the Court of Appeals did not necessarily hand the taxpayers a final victory. It remanded the case to the Tax Court on the valuation issue.

> When the Kaufmans donated the easement, their home was already subject to South End Landmark District rules that severely restrict the alterations that property owners can make to the exteriors of historic buildings in the neighborhood. These rules provide that "[a]ll proposed changes or alterations" to "all elements of [the] facade, ... the front yard ... and the portions of roofs that are visible from public streets" will be "subject to review" by the local landmark district commission.
>
> Under the *Standards and Criteria*, property owners of South End buildings have an obligation to retain and repair the original steps, stairs, railings, balustrades, balconies, entryways, transoms, sidelights, exterior walls, windows, roofs, and front-yard fences (along with certain "other features"); and, when the damaged elements are beyond repair, property owners may only replace them with elements that look like the originals. Given these pre-existing legal obligations the Tax Court might well find on remand that the Kaufmans' easement was worth little or nothing.

- The court took note of the fact that in persuading the Kaufmans to grant the easement, "a Trust representative told the Kaufmans that experience showed that such easements did not reduce resale value, and this could easily be the IRS's opening argument in a valuation trial."

c. The old adage "better late than never" didn't save the taxpayer's deduction for a conservation easement on mortgaged property. Mitchell v. Commissioner, 138 T.C. 324 (4/3/12). In 2003, the taxpayer contributed a conservation easement over 180 acres of unimproved land to a qualified organization. The property was subject to a mortgage, but the mortgagee did not subordinate the mortgage to the conservation easement deed until 2005. The taxpayer claimed a charitable contribution deduction on her 2003 Federal income tax return, which the IRS disallowed. The taxpayer argued that she had met the requirement of Reg. § 1.170A-14(g)(2) requiring subordination of a mortgage to the conservation easement because Reg. § 1.170A-14(g)(3) should apply to determine whether the requirements of Reg. § 1.170A-14(g)(2) had been satisfied. Reg. § 1.170A-14(g)(3) provides that a deduction will not be disallowed merely because on the date of the gift there is the possibility that the interest will be defeated so long as on that date the possibility of defeat is so remote as to be negligible. The taxpayer argued that the probability of her defaulting on the mortgage was so remote as to be negligible, and that the possibility should be disregarded under the so-remote-as-to-be-negligible standard in determining whether the conservation easement is enforceable in perpetuity. The Tax Court (Judge Haines) held that the so-remote-as-to-be-negligible standard of Reg. § 1.170A-14(g)(3) does not apply to determine whether the requirements of Reg. § 1.170A-14(g)(2), requiring subordination of a mortgage to the conservation easement have been satisfied, citing lain *Kaufman v. Commissioner*, 136 T.C. 294 (2011), *Kaufman v. Commissioner,* 134 T.C. 182 (2010), *Carpenter v. Commissioner*, T.C. Memo. 2012-1, and distinguishing *Simmons v. Commissioner,* T.C. Memo. 2009-208, *aff'd*, 646 F.3d 6 (D.C. Cir. 2011). Thus, the taxpayer did not meet the requirements of Reg. § 1.170A-14(g)(2), and the deduction was denied. However, the taxpayer was not liable for a § 6662 accuracy related penalty. She "attempted to comply with the requirements for making a charitable contribution of a conservation easement," she hired an accountant and an appraiser, but she "inadvertently failed to obtain a subordination agreement" and "upon being made aware of the need for a subordination agreement she promptly obtained one." She acted with reasonable cause and in good faith.

d. And the subsequent First Circuit decision in *Kaufman* doesn't change the result. Mitchell v. Commissioner, T.C. Memo. 2013-204 (8/29/13). In a supplemental memorandum opinion, the Tax Court (Judge Haynes) denied the taxpayer's motion for reconsideration. The taxpayer argued that the Tax Court erred in relying on *Kaufman v. Commissioner*, 136 T.C. 294 (2011) (*Kaufman* II), which was affirmed in part, vacated in part,

and remanded in part by the First Circuit in *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012) (*Kaufman* III), because *Kaufman* III was in intervening change in the law. In rejecting the taxpayer's argument Judge Haynes concluded that *Kaufman* III addressed different issues from *Mitchell*. *Kaufman* III addressed the proper interpretation of the proceeds requirement in Reg. § 1.170A-14(g)(6), in particular, the breadth of the donee organization's entitlement to proceeds from the sale, exchange, or involuntary conversion of property following the judicial extinguishment of a perpetual conservation restriction burdening the property. But *Kaufman* III did not state a general rule that protecting the proceeds from an extinguishment of a conservation easement would satisfy the in-perpetuity requirements of Reg. § 1.170A-14(g), which was the basis on which *Mitchell* was decided.

e. The Tax Court sticks by its guns on the mortgaged property conservation easement issue. Minnick v. Commissioner, T.C. Memo. 2012-345 (12/17/12). Once again, the Tax Court (Judge Morrison) has held that pursuant to Reg. § 1.170A-14(g)(2), no charitable contribution deduction is allowable for the donation of a conservation easement where a mortgage encumbering the property has not been subordinated to the interest of the donee of the easement. The court emphasized its holding in *Mitchell v Commissioner*, 138 T.C. 324 (2012), that the unlikelihood of default is irrelevant.

f. No "take backs" allowed if you want an allowable charitable contribution. Graev v. Commissioner, 140 T.C. No. 17 (6/24/13). The taxpayers contributed a facade conservation easement on property to the National Architectural Trust (NAT), a qualified charitable organization, along with a cash contribution. The conservation deed stated that "*nothing herein contained shall be constructed to limit the Grantee's right* to give its consent (e.g., to changes in a Protected Facade(s)) or *to abandon some or all of its rights hereunder*" [Emphasis added by the court], and NAT gave the taxpayers a letter stating, "In the event the IRS disallows the tax deductions in their entirety, we will promptly refund your entire cash endowment contribution and join with you to immediately remove the facade conservation easement from the property's title." Prior to the taxpayers making the donation, their accountants had advised them that in Notice 2004-41, 2004-2 C.B. 31, the IRS had announced increased scrutiny of deductions for conservation easement donations, and the taxpayers asked for and received from NAT assurance that their donation would be deductible. However, the year after the donation was made NAT sent the taxpayers a letter, which they had taken deliberate steps to obtain, stating that "It has recently been brought to our attention by our attorney that this offer of a refund may adversely affect the deductibility of the cash contribution as a charitable gift." Subsequently, the IRS disallowed the deductions of the facade easement and the cash as conditional gifts, and the Tax Court (Judge Gustafson) upheld the disallowance of the deductions. Under Reg. § 1.170A-1(e), a contribution that might be defeated by a subsequent event will be considered to have been "made" only if at the time of the contribution the possibility that it will be defeated is "so remote as to be negligible." Taking into account all of the facts and circumstances, including the enforceability of the side-agreement letter, the likelihood it would be honored by NAT even if it were unenforceable, the wording of the deed, and the various grounds on which the IRS might disallow a deduction for the contribution wholly apart from its conditionality, Judge Gustafson found that the likelihood that the condition would occur was not so remote as to be negligible at the time of the contribution. The court found that Notice 2004-41 made it clear that the contribution "would be subject to heightened scrutiny and that if any of the Graevs' positions were susceptible to challenge, the Commissioner would likely enforce a contrary position," and the taxpayers communications with NAT, "which stated that his accountants 'have advised [him] to be very cautious' reflected their understanding of this possibility." Because the condition requiring return was enforceable and NAT would act as promised in the letter, the contribution was conditional and the deductions were disallowed.

g. Conditionally revocable conservation easements are no-good. Carpenter v. Commissioner, T.C. Memo. 2012-1 (1/3/12). Conservation easements that could be extinguished by the mutual consent of the donor taxpayer and the donee organization failed as a matter of law to comply with the enforceability in perpetuity requirements under Reg. § 1.170A-

14(g). The easements were not protected in perpetuity and thus were not qualified conservation contributions under § 170(h)(1).

h. And the subsequent First Circuit decision in *Kaufman* doesn't change the result. Carpenter v. Commissioner, T.C. Memo. 2013-172 (7/25/13). Judge Haines denied the taxpayer's motion for reconsideration. The taxpayer argued that in its earlier opinion the Tax Court had erred in relying on *Kaufman v. Commissioner*, 136 T.C. 294 (2011) (Kaufman II), which was affirmed in part, vacated in part, and remanded in part by the Court of Appeals for the First Circuit in *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012) (Kaufman III). Specifically, the taxpayer argued that the First Circuit's emphasis on the destination of proceeds upon extinguishment of a conservation easement in *Kaufman* III, required the Tax Court to "take an overall approach in analyzing the in-perpetuity requirement of section 170(h)(5)(A) and section 1.170A-14(g), Income Tax Regs., and focus on any proceeds resulting from an extinguishment of the conservation easements." Judge Haines concluded, however, that *Kaufman* III did not support the taxpayer's argument that "putting into the hands of the parties to a conservation agreement the authority to determine when to extinguish the conservation easement so long as the donee organization gets its share of the proceeds of a subsequent sale," in that in *Kaufman* III the First Circuit limited its holding to situations in which the easement is extinguished by judicial proceeding.

5. Tax Court disagreed with valuation method used to value conservation easement. Whitehouse Hotel Limited Partnership v. Commissioner, 131 T.C. 112 (10/30/08). The Tax Court (Judge Halpern) held that, as a precondition to using the replacement cost approach to valuing real estate, the taxpayer must show that the property is unusual in nature and other methods of valuation, such as comparable sales or income capitalization, are not applicable. The income approach to valuation is favored only where comparable market sales are absent. On the facts, the value of the contribution of a conservation facade easement for a historic structure on the edge of the French Quarter in New Orleans was overstated. The accuracy-related penalty for gross overvaluation was proper because there was no good faith investigation into the value.

a. Regardless of which valuation method is used, it still must relate to the property's "highest and best use." Whitehouse Hotel Limited Partnership v. Commissioner, 615 F.3d 321 (5th Cir. 8/10/10). In an opinion by Judge Barksdale, the Fifth Circuit vacated the Tax Court's decision and remanded the case for a determination of the easement's value, although it rejected the taxpayer's arguments that the IRS's expert was unqualified and that his report was unreliable and should not have been admitted. But the Court of Appeals agreed with the taxpayers' argument that the Tax Court "miscomprehended the highest and best use" of the building subjected to the conservation easement, and thereby undervalued the easement.

> In sum, the tax court erred in declining to consider the Maison Blanche and Kress buildings' highest and best use in the light of both the reasonable and probable condominium regime and the reasonable and probable combination of those buildings into a single functional unit, both of which foreclosed the realistic possibility, for valuation purposes, that the Kress and Maison Blanche buildings could come under separate ownership. This combination affected the buildings' fair market value.

- As result the court did not reach the Tax Court's holding that the income and replacement-cost methods of valuation were inapplicable and directed the tax court to consider those methods, in addition to comparable sales method on remand. Because the holding on the valuation was vacated, the Tax Court's holding that the gross overvaluation penalty also was vacated.

b. Judge Halpern reconsiders the whole case in light of the Fifth Circuit decision and increases the allowable deduction by only $65,415, from $1,792,301 to $1,857,716. Whitehouse Hotel Limited Partnership v. Commissioner, 139 T.C. No. 13 (10/23/12). On remand, Judge Halpern elaborated at length on the proper valuation method to be

used to value the building under the "before and after" method, and once again accepted the IRS's argument that the value of the property should be determined using a comparable-sales method. The comparable-sales method applied by Judge Halpern was based on the sales of buildings suitable for conversion into hotels based primarily on local sales data, rejecting the taxpayer's argument that non-local sales data should be taken into account. He again rejected both the taxpayer's reproduction-cost method and income method to valuation. Judge Halpern explained that "[t]he reproduction cost of an historic building usually bears little relationship to its present economic value. Such cost is usually far in excess of the cost of construction of a similarly sized modern structure, and may reflect the price of materials and workmanship that are no longer readily available." Because reconstruction of the Maison Blanche Building, if destroyed, would not have been a reasonable business venture, there was no probative correlation between the taxpayer's expert's estimate of the reproduction cost of the Maison Blanche Building and the fair market value of the property. Judge Halpern rejected the income valuation method because in this case, where there was no ongoing business, it was based on too many contingencies, was inadequately developed, and thus was too speculative, particularly where the value could be established by comparable sales. He did not reject the income method of valuation as a matter of law. He stated: "We have no difficulty with the process. Where we have difficulty is with petitioner's call to trust on their face [the taxpayer's expert's] judgments as to values to be input to his model." Judge Halpern also again found that the easement conveyance did not deprive the partnership or any subsequent owner of the ability to add stories to the top of the Kress Building or blocking views of the Maison Blanche facade. However, in light of the Fifth Circuit's directive, Judge Halpern determined the value of the facade conservation easement based on the before- and after-restriction values of the combined Maison Blanche and Kress Building property. He concluded that the value of the easement was approximately $1.86 million, rather than $1.79 million as determined in his first opinion. Responding to the Fifth Circuit's determination that he had misapprehended the properties highest and best use, Judge Halpern reasoned that "although the highest and best use of property may determine a ceiling on how much a willing buyer would pay for the property, it does not necessarily determine a floor on how little a willing seller would accept. . . . [T]he hypothetical willing buyer and the hypothetical willing seller who populate our standard definition of fair market value will not invariably conclude their negotiation over price at a price reflecting the value of the property at its highest and best use." He turned to auction price theory to conclude that in determining the fair market value of the property, which is the relevant benchmark, "the equilibrium price at which the willing buyer and the willing seller would meet would be somewhere between the value of the property taking into account its most productive use (i.e., its highest and best use) and the value of the property taking into account its second most profitable use." Accordingly, he rejected the taxpayer's argument that the valuation should be based on the use of the buildings as the shell of a luxury hotel, there being no scarcity of buildings in New Orleans suitable for development as luxury hotels. "Only if there were sufficient scarcity would the partnership . . . capture a piece of the economic return to luxury hotel development of the building's shell." Finally, based on the $1.86 million value, the claimed value of the exceeded 400 percent of the actual value and the § 6662(h) gross valuation misstatement penalty applied. The § 6664(c) reasonable cause and good-faith exceptions did not apply, because Whitehouse failed to make a good-faith investigation of the value of the easement and did not reasonably rely on an appraisal.

6. Congress encourages taxpayers to give their IRAs to charity. The 2012 Taxpayer Relief Tax Act, § 208(b)(2), retroactively extends the allowance of Code § 408(d)(8) that permits taxpayers 70½ years or older to take a $100,000 IRA distribution and contribute it to charity without recognizing income and without affecting the charitable contribution limitation of § 170 to contributed distributions made in tax years before 1/1/14. In addition, taxpayers may elect to treat distributions made in January 2013 as made on 12/31/12. Taxpayers are also allowed to elect to treat any distribution in December 2012 as a qualified charitable distribution if the distribution was transferred in cash to a charitable organization by 1/31/13.

7. Let's go green for a few more years; contributions of conservation easements. The 2012 Taxpayer Relief Tax Act, § 206, extended through 2013 the provisions of

Code § 170 allowing a deduction for a qualified conservation contribution made by an individual or corporate farmer or rancher in tax years beginning after 12/31/05 of up to 100% of the taxpayer's taxable income. The limits under Code § 170(e) are 50% of the taxpayer's charitable conservation base over other allowable charitable contributions, 100% for farmers and ranchers, with a fifteen year carryforward.

8. You need an appraisal of the right property – here stock, and not real estate. Estate of Evenchik v. Commissioner, T.C. Memo. 2013-34 (2/4/13). The taxpayer donated shares of stock in a corporation to a charity. The donated shares constituted approximately 72 percent of the outstanding stock. The corporation's only assets were two apartment buildings. They attached appraisals for each building to their tax return, but never had obtained an appraisal of the stock. The Tax Court (Judge Holmes) upheld the denial of a charitable contribution deduction because the appraisals failed to comply with the qualified appraisal requirement in Reg. § 1.170A-13(c)(3)(ii). The appraisals valued the wrong property. The stock was the property that had to have been appraised. Furthermore the appraisals did not take into account the effect that the contribution of less than all of the stock might have had on value of the donated property. In addition, the appraisals failed to (1) provide a sufficient description of the property or (2) state the date or expected date of the contribution and the value of the property on those dates. Finally, the substantial compliance doctrine could not save the deduction. "This is not a case where the taxpayers provided most of the information but left out one insignificant datum. . . . This is a case where the appraisals had gaping holes of required information."

9. Quid pro quo can be in the favorable governmental action. Pollard v. Commissioner, T.C. Memo. 2013-38 (2/6/13). The Tax Court (Judge Jacobs) upheld the denial of a charitable contribution deduction for the conveyance to the county government of two conservation easements with respect to a 67 acre farm property that the taxpayer owned. The granting of the conservation easements to the county was part of a quid pro quo exchange for the county approving the taxpayer's subdivision exemption request that would allow him to build a second home on the property. Statements of the county commissioners during the course of public hearings indicated that the subdivision exemption would not have been approved if the taxpayer had not granted a conservation easement to the county. The approval of the subdivision exemption request was a substantial benefit to the taxpayer. He did not convey the conservation easements "for detached and disinterested motives but rather to secure a personal benefit."

10. Typos don't render a contemporaneous written acknowledgment defective. Crimi v. Commissioner, T.C. Memo. 2013-51 (2/14/13). The taxpayer conveyed a conservation easement to a qualified donee though a bargain purchase. After first dissecting all of the experts' report to expose their errors, the Tax Court (Judge Laro) determined the value of the contribution. Turning to the question of whether the requirements of a contemporaneous written acknowledgment required by § 170(f)(8) and a qualified appraisal required by § 170(f)(11) had been met, the court found for the taxpayer despite imperfect documentation. The court rejected the IRS's argument that the written acknowledgment had not been signed by a representative of the donee, finding that the signer was an agent of the donee. The court rejected the IRS's contention that a typographical error in the description of the property was grounds for denying the deduction in light of the fact that the appraisal and the Form 8283 attached to the return provided the accurate description of the contributed property. The court rejected the IRS's assertion that the contemporaneous written acknowledgment was defective because although it stated that the easement was valued at $2,950,000, in consideration for which the donee provided a cash consideration of $1,550,000, leaving a charitable contribution of $1.4 million, it failed to state whether the donee organization provided other goods, services, or valuable consideration. Finally, the court applied the substantial compliance doctrine to determine that the qualified appraisal requirement had been met despite the fact that the appraisal was for an earlier year because the taxpayer relied on a long-time CPA and tax advisor and had no reason to doubt them when they told him that an updated appraisal would not provide a different value. That a subsequent valuation prepared by the taxpayer's expert produced a value much higher than the

earlier appraisal indicated that it was reasonable for the taxpayer to believe the earlier appraisal "was not stale in substance and thus a good appraisal."

11. If you are both the contributor and the president of the charity, you must send yourself a contemporaneous written acknowledgment. Villareale v. Commissioner, T.C. Memo. 2013-74 (3/12/13). The taxpayer was a co-founder of NDM Ferret Rescue & Sanctuary, Inc. (NDM), an animal rescue organization that specializes in rescuing ferrets. During the year in issue, when she was NDM's president, she contributed $10,022 to NDM by electronic funds transfers. Twenty-seven contributions (totaling $2,393) were for less than $250 and 17 (totaling $7,629) were for $250 or more. The dates and amounts of the transfers are reflected in the taxpayer's and NDM's bank statements, but NDM never provided the taxpayer with a contemporaneous written acknowledgment containing a description of any property contributed, a statement as to whether any goods or services were provided in consideration, and a description and good-faith estimate of the value of any goods or services provided in consideration as required by § 170(f)(8). Accordingly, the Tax Court (Judge Vasquez) upheld the IRS's denial of the $7,629 of contributions that were for $250 or more. The court found it "immaterial" that taxpayer was on both sides of the transaction and rejected her contention that as the president of NDM "'it would have been futile to issue herself a statement that expressly provided that no goods or services were provided in exchange for her contributions.'" The deduction for the $2,393 of contributions that were in individual amounts of less than $250 was allowed.

- **Charitable deduction for unreimbursed. unsubstantiated charitable volunteer expenses was limited to $250.** Van Dusen v. Commissioner, 136 T.C. 515 (6/2/11). The taxpayer claimed charitable contribution deductions for out-of-pocket expenses incurred in caring for "foster cats" as a volunteer on behalf of Fix Our Ferals, a § 501(c)(3) organization. The Tax Court (Judge Morrison) applied the "substantial compliance doctrine" to allow a deduction for expenses incurred by a volunteer providing services to a charitable organization, even though the taxpayer's records did not strictly meet the specific requirements of Reg. § 170A-13(a)(1). The taxpayer's documents were "legitimate substitutes for canceled checks," because they contained all of the information that would have been on a canceled check — the name of the payee, the date of the payment, and the amount of the payment. Although the regulation requiring substantiation records to reflect the name of the donee was not written with unreimbursed volunteer expenses in mind, because the amounts expended exceeded $250 and the taxpayer failed to satisfy requirements of § 170(f)(8)(a) and Reg. § 1.170A-13(f)(1) for substantiation in the form of a contemporaneous written acknowledgment from the charitable organization, the deductible amount for each separate expenditure was limited to $250.

12. Quid-pro-quo can be very intangible. Boone Operations Co., L.L.C. v. Commissioner, T.C. Memo. 2013-101 (4/11/13). The taxpayer transferred fill dirt to the City of Tucson in a bargain sale and claimed a charitable contribution deduction for the difference between the appraised fair market value of the fill dirt and the cash purchase price. The fill dirt was used in the process of closing a City of Tucson landfill that was adjacent to the landfill operated by the taxpayer. The Tax Court (Judge Marvel) upheld denial of the deduction on almost every conceivable ground. First, the substantiation requirements of § 170(f)(8)(B) had not been met. Although the written agreement between the taxpayer and the City of Tucson stated the amount of cash Tucson agreed to pay for the fill, it also stated that Tucson provided goods and services in exchange for the contribution of fill, but lacked a good-faith estimate of the value of those goods and services. Furthermore, the Forms 8283 did not refer to any benefits received by the taxpayer in addition to the cash sale price. Second, the appraisal was not a qualified appraisal because, among other deficiencies, it used the wrong comparables and was based on the fair market value of delivered fill dirt, including transportation, but the taxpayer had deducted the transportation, which was the major component of the value of delivered fill dirt, as a business expense. Third, in addition to the cash price, the taxpayer received valuable consideration in the form of (1) a nonconforming use permit for the continued operation of its landfill, (2) the dismissal of a pending civil suit, (3) the City of Tucson's agreement not to pursue any criminal charges, and (4) indirect benefits from the City of Tucson closing its landfill and

maintaining and monitoring the methane gas system on the taxpayer's landfill. Accordingly, the taxpayer failed to prove that the fill dirt was sold to the City of Tucson at a bargain price.

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. One-time reduction of unpaid Section 6702 frivolous return penalty. Rev. Proc. 2012-43, 2012-49 I.R.B. 643 (11/5/12). This revenue procedure describes the limited circumstances in which a person may be eligible for a one-time reduction of any unpaid § 6702 frivolous return penalty. If a person satisfies all eligibility criteria, including filing all tax returns and paying all outstanding taxes, penalties (other than under § 6702), and related interest, the IRS will reduce all unpaid § 6702 penalties assessed against that person to $500.

2. Adequate disclosure update. Rev. Proc. 2012-51, 2012-51 I.R.B. 719 (11/26/12). This revenue procedure updates Rev. Proc. 2012-15, 2012-7 I.R.B. 369 and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and for the purpose of avoiding the tax return preparer penalty under § 6694(a), relating to understatements due to unreasonable positions). There have been no substantive changes. The revenue procedure does not apply with respect to any other penalty provisions, including § 6662(b)(1) accuracy-related penalties. If this revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275–R, as appropriate, attached to the return for the year or to a qualified amended return.

3. Freedom for preparers to use taxpayer return information to increase their own profitability. T.D. 9608, Disclosure or Use of Information by Preparers of Returns, 77 F.R. 76400 (12/28/12). The Treasury has finalized Prop. Reg. §§ 301.7216-2(n) through 301.7216-2(p) (REG-131028-09, Amendments to the Section 7216 Regulations – Disclosure or Use of Information by Preparers of Returns), replacing Temp. Reg. §§ 301.7216-2T(n) through 301.7216-2T(p). 75 F.R. 94 (1/04/10). Reg. § 301.7216-2(n) allows preparers to compile, maintain, and use a list containing solely the names, addresses, e-mail addresses, phone numbers, taxpayer entity classification, and income tax return form numbers of taxpayers whose tax returns the tax return preparer has prepared, if the list is used only to contact the taxpayers on the list either (1) to provide tax, general business, or economic information for educational purposes, or (2) for soliciting additional tax return preparation services. Reg. § 301.7216-2(o) allows return preparers to use tax return information, subject to limitations to produce a statistical compilation of data described in Reg. § 301.7216-1(b)(3)(i)(B) for a purpose relating directly to the internal management or support of the tax return preparer's tax return preparation business, or to bona fide research or public policy discussions concerning state or federal taxation; disclosure of the statistical compilation must be anonymous as to taxpayer identity, and may not disclose an aggregate figure containing data from fewer than ten tax returns. Reg. § 301.7216-2(p) allows return preparers to disclose return information without penalty for the purpose of a quality or peer review, but only to the extent necessary to accomplish the review. The information also may be used to perform a conflict of interest check.

4. It takes a paper trail to prove that stock is "qualified small business stock," but a bribery attempt by taxpayer's representative [an enrolled agent] during the audit was not sufficient to support a fraud penalty. Holmes v. Commissioner, T.C. Memo. 2012-251 (8/30/12). Section 1045 provides for elective nonrecognition of capital gain on the sale of "qualified small business stock," as defined in § 1202, if the stock has been held for more than six months, and if the taxpayer purchases replacement qualified small business stock within 60 days of the date of the sale. The taxpayer's efforts to defer gain on the sale of stock in this case failed. The Tax Court (Judge Halpern) held that § 1045 did not apply because, among other reasons, the taxpayer failed to prove that (1) as required by § 1202(c)(1)(B), he acquired the stock at its original issue in exchange for money, or (2) as required by § 1202(d)(1)(A) and (B), the corporation's aggregate gross assets immediately after the stock issuance did not exceed $50 million. The taxpayer offered no documentary evidence, such as stock certificates or book entries

from the corporation, indicating from whom he acquired the stock. Nor did the taxpayer introduce into evidence corporate balance sheets or other financial statements showing the amount of cash and property held by the corporation before and immediately after each date he acquired stock.

- Even though the taxpayer's return preparer/representative during the audit, an enrolled agent, attempted to bribe the Revenue Agent conducting the audit, behavior that Judge Halpern described as "highly inappropriate," such behavior was not sufficient to support imposition of a fraud penalty, because, among other facts, the record was "devoid of evidence indicating that Mr. Afshar's actions towards Agent Mahamoud, while highly inappropriate, were part of [taxpayer's] scheme of tax evasion initiated at the time of filing the subject tax returns. As we have stated above, it seems more likely that Mr. Afshar's actions were a continuation of his attempt at mitigating the tax preparation errors."

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

> We do not find it unduly burdensome for taxpayers to review their returns for items that are obviously false or incorrect. It is every taxpayer's obligation. Petitioner cannot hide behind an agent's fraudulent preparation of his returns and escape paying tax if the Government is unable to investigate fully the fraud within the limitations period.

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

5. Tax Court found that Taxpayer filed fraudulent tax returns. Fiore v. Commissioner, T.C. Memo. 2013-21 (1/17/13). The Tax Court (Judge Holmes) found that former estate planning lawyer Owen Fiore filed fraudulent 1996 and 1997 income tax returns; Fiore had pleaded guilty to evasion of 1999 taxes but claimed that he did not owe fraud penalties for the earlier years. Fiore had total control of the finances of his law firm and did not delegate even the most mundane tasks, e.g., preparation of checks for signature, to anyone else, but claimed that he simply was "a horrible recordkeeper." In a detailed and analytic opinion, Judge Holmes decided the issue on the ground that Fiore was short of cash during the 1996-1997 period and admittedly engaged in "willful blindness" to the possibility that he was underreporting his income; he also repeatedly stalled during the IRS examination of his tax returns. His opinion concludes:

> And with particular weight given to this willful blindness we find that the Commissioner has met his burden of proving by clear and convincing evidence that Fiore filed fraudulent returns. We cannot accept that a person of Fiore's intelligence, training, and experience was not aware when he filed his returns for 1996 and 1997 -- at a time when he knew his need for cash was ballooning -- that there was a high probability that he was underreporting his income. And we find that he deliberately avoided steps that would have confirmed that underreporting, since all he had to do was read his monthly bank statements to verify the accuracy of his estimates of taxable income that he put on his returns.

- From the website of Owen G. Fiore, JD:

> For over four decades, Owen Fiore was a tax and estate planning lawyer in California, representing families and business entities in developing and

implementing tax sensitive wealth succession, preservation and management plans, including using FLPs, LLCs, corporations and trusts in planning. He also had an active practice in tax controversies, especially those involving gift and estate taxes, evidenced by being lead counsel in a number of Tax Court cases, such as *Cristofani, Schauerhamer* and *Fontana*.

As the result of a personal income tax case leading to a plea agreement-based conviction and subsequent 14 months incarceration, Owen now is involved as a non-lawyer consultant to professional advisors and their clients in tax and estate planning matters. ***

Owen lives in Syringa, ID with his wife, Mary Ann, enjoying being on the Middle Fork of Idaho's wild and scenic Clearwater River.

- Section 10.24(a) of Circular 230 provides that "A practitioner may not, knowingly and directly or indirectly: (a) Accept assistance from or assist any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter or matters constituting practice before the Internal Revenue Service."

6. A sole shareholder gets 87 months of room and board from the federal government for fraudulently treating as independent contractors workers who were really employees. United States v. Deleon, 111 A.F.T.R.2d 2013-502 (1st Cir. 1/11/13). The First Circuit, in an opinion by Judge Stahl, affirmed the fraud conviction under § 7206(2), and various other criminal statutes, of a corporation's sole shareholder. The corporation paid most of its workers directly with checks and did not withhold payroll taxes from their wages or report or remit such taxes to the IRS. The shareholder told the tax preparers that the unreported payroll workers were independent contractors for whom she was not required to remit payroll taxes. The tax return preparers recorded the checks to individuals on the unreported payroll as a business expense and issued a Form 1099 to each of those workers. The shareholder will get room and board from the federal government for 87 months.

7. Taxpayer's reliance on his CPA, who did a little ($1.2 million) embezzling on the side, was reasonable; therefore, no penalties for underreporting income were imposed. Thomas v. Commissioner, T.C. Memo. 2013-60 (2/26/13). The Tax Court (Judge Gerber) stated the considerations for reasonable cause penalty avoidance based upon reliance upon a tax professional as follows:

> To establish reasonable cause through reliance on the advice of a tax adviser, the taxpayer must meet the following three-prong test, laid out in Neonatology Assocs., P.A. v. Commissioner, 115 T.C. at 98-99: (1) the adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer relied in good faith on the adviser's judgment. Finally, petitioner bears the burden of proof with respect to the defenses to the accuracy-related penalties. See Higbee v. Commissioner, 116 T.C. 438, 447 (2001).
>
> Petitioner met and became familiar with Steeves, his tax preparer, during 2003 when they began working together in a real estate investment business. After working with Steeves for some time, petitioner began his own businesses, which involved the same type of business activity in which he had worked with Steeves. Steeves was a certified public accountant and had seven years of experience in the same type of businesses as petitioner. Petitioner, having worked with Steeves and being aware of his professional background and experience, exclusively relied upon him to maintain his records, handle his business financial matters, and prepare his returns. Under these circumstances we find that it was reasonable for petitioner to perceive Steeves as a competent professional and to rely on him.
>
> Petitioner was reasonable in his reliance upon Steeves to correctly and accurately prepare his books. Petitioner understood that those books were used in the preparation of his 2006 and 2007 income tax returns. In addition, petitioners

provided Steeves with all other information Steeves requested that was necessary to complete their returns, including the amounts of mortgage interest and interest income and Forms W-2. Accordingly, petitioner was satisfied that Steeves had all necessary and accurate information needed to correctly prepare petitioners' income tax returns. We find that petitioner's efforts were sufficient to ensure his return preparer had adequate and accurate information.

Finally, we consider whether petitioner relied in good faith upon Steeves' judgment. In the setting of this case, there came a time when petitioner had doubts about the accuracy and quality of Steeves' recordkeeping. Ultimately, petitioner believed that Steeves was guilty of theft, fraud, and misappropriation of his money. However, his doubts about Steeves' ability or honesty did not arise until sometime after the 2006 and 2007 income tax returns were filed and respondent was conducting an audit examination of the returns. At the outset of that examination, petitioner continued to believe in and rely upon Steeves, to whom petitioner gave a power of attorney to represent him before the IRS.

Under these circumstances we hold that petitioner has carried his burden of showing reasonable reliance on the advice of a professional as a defense to the accuracy-related penalties for 2006 and 2007. Accordingly, petitioner is not liable for an accuracy-related penalty on any underpayment for 2006 or 2007.

8. CPA's incorrect advice about an estate return extended filing deadline does not excuse the late filing penalty imposed on the executor. Knappe v. United States, 111 A.F.T.R.2d 2013-1531 (9th Cir. 4/4/13). The Ninth Circuit (Judge Paez) held that reasonable cause did not exist to abate a late filing penalty where the CPA mistakenly told the executor that he had secured a twelve-month extension of both the filing and payment deadlines. The extended payment deadline was correct, but an extension of the filing deadline is limited to six months – unless the executor was out of the country, an exception that did not apply here. Judge Paez followed *United States v. Boyle*, 469 U.S. 241 (1985), which held that advice about a filing deadline was "nonsubstantive advice" which does not constitute reasonable cause for relying upon his tax advisor's determination of the extended filing deadline date. He quoted *Boyle* as follows:

> Reliance by a lay person on a lawyer is of course common; but that reliance cannot function as a substitute for compliance with an unambiguous statute. . . . It requires no special training or effort to ascertain a deadline and make sure that it is met. The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not "reasonable cause" for a late filing under § 6651(a)(1).

- Judge Paez used a second rationale to justify his holding:

> We acknowledge that the result today imposes a heavy burden on executors, who will affirmatively have to ensure that their agents' interpretations of filing and payment deadlines are accurate if they want to avoid penalties. This burden is justified by the government's substantial interest in ensuring that returns are timely filed. *See Boyle*, 469 U.S. at 249.
>
> Moreover, any other result would reward collusion between culpable executors and their agents. In cases like this one, lawyers and accountants would be incentivized to claim that they gave erroneous advice to the executor whether or not they did in fact. The agent who fell on his sword would risk nothing, because the waiver of the penalty would leave the executor without damages. Even in cases in which executors and their agents did not actively collude to propound a contrived misrepresentation defense, negligent agents would be unilaterally incentivized to persist in giving erroneous advice to their clients, even if they realized their error.

- Note that *Boyle* contains strong language permitting a taxpayer to rely on his tax advisor's substantive advice, and does not require the taxpayer to obtain a "second opinion"

9. Sometimes actual receipt is necessary, mailing of a notice by the IRS is not game, set, match. Lepore v. Commissioner, T.C. Memo. 2013-135 (5/30/13). In this CDP review, Judge Morrison held that the IRS improperly denied the taxpayer an opportunity to contest his liability for § 6672 trust fund penalty taxes at the CDP hearing, finding that the taxpayer had never had a previous opportunity to contest the liability because he had never actually received a Letter 1153. The taxpayer testified that he never saw the Letter 1153 or knew that it had arrived at his home, but the IRS argued that the determination by the Appeals Office was based on the legal conclusion that receipt of the Letter 1153 by the taxpayer's son of the Letter 1153, for which he signed, mailed to the taxpayer's house constituted receipt by the taxpayer. Judge Morrison found the taxpayer's testimony credible, as was the taxpayer's son's testimony that he "did not give the Letter 1153 to his father personally and that he instead 'threw' the Letter 1153 'somewhere' in the basement."

- Although the opinion notes that if the IRS mails the Letter 1153 to the taxpayer's last known address (§ 6212(b)), the notification requirement is satisfied even if the person did not actually receive the notice, § 6672(b)(1). *Mason v. Commissioner*, 132 T.C. 301 (2009), held that unless the taxpayer deliberately refuses to accept its delivery, a Letter 1153 will be considered as having provided a prior opportunity to dispute liability for the underlying trust fund recovery penalty only if it is actually received. Thus, even though the letter not only was mailed certified mail by the IRS to the taxpayer's last known address but actually was delivered there and signed for by his son, actual receipt was necessary. In essence, § 6672(b) is not relevant in the CDP context.[1] In *Mason*, the IRS mailed the Form 1153 by certified mail to the taxpayer's last known address, but the letter was returned to the IRS undelivered and marked "unclaimed." Nevertheless, in *Mason* the Tax Court allowed the taxpayer to challenge the merits of the § 6672 penalty liability. It held: "a section 6672(b)(1) notice that was not received, but not deliberately refused, by a taxpayer does not constitute an opportunity to dispute that taxpayer's liability [for CDP purposes]." That sounds like an "actual receipt" rule. The facts of *Lepore* were a step closer to actual receipt by the taxpayer than the facts of *Mason*. Nonetheless, the *Lepore* facts fall short of actual receipt.

a. But deliberately avoiding receipt of a Letter 1153 is game, set, and match for the IRS. Giaquinto v. Commissioner, T.C. Memo. 2013-150 (6/12/13). The IRS mailed a Letter 1153 and Form 2751, Proposed Assessment of Trust Fund Recovery Penalty, to the taxpayer's last known address. The letter was returned as unclaimed. Subsequently, the IRS sent by certified mail to the taxpayer's residence Forms 3552, Notice of Tax Due on Federal Tax Return. The letter was returned as unclaimed. Subsequently, the IRS sent by certified mail to the taxpayer's residence a Letter 3172, Notice of Federal Tax Lien Filing and Your Right to a Hearing Under IRC 6320 (lien notice). The letter was delivered to petitioner. The taxpayer asked for a CDP hearing, but at the hearing was denied any opportunity to contest liability because he had a prior opportunity to dispute it. The taxpayer sought review of the determination sustaining the levy. The Tax Court (Judge Marvel) upheld the IRS's determination, holding that the taxpayer had a prior opportunity to dispute the underlying liability. The taxpayer argued that he was entitled to contest his liability for the § 6672 trust fund recovery penalties in the CDP hearing because he never received the Letter 1153 sent to him by certified mail. *Mason v. Commissioner*, 132 T.C. 301 (2009), was inapplicable because on the facts in this case, the taxpayer's failure to claim delivery of the certified mail was deliberate. The taxpayer was fully aware that the IRS was considering whether to assert § 6672 trust fund recovery penalties against him, and either ignored or failed to claim at least one, and possibly two, USPS Forms 3849 that the mail carrier left for him with respect to the notices sent to him by certified mail.

[1]We are indebted to Professor Steve Johnson of Florida State University School of Law for helping us with the analysis that follows.

10. You gotta get your whole act together before filing a Tax Court petition. There's no second act in a Court of Claims refund suit. The Cheesecake Factory, Inc. v. United States, ___ Fed. Cl. ___ , 112 A.F.T.R.2d 2013-___ (7/3/13). The taxpayer sought a refund of interest and late payment penalties assessed for 2005. It previously had received a deficiency notice that did not reference the late payment penalty, and the 2005 year had been litigated and settled in the Tax Court. In the Court of Federal Claims, the taxpayer argued that § 6512(a), which bars a suit for a refund or credit of income tax for a taxable year with respect to which the taxpayer has filed a petition in the Tax Court in response to a notice of deficiency, did not apply in this case because the deficiency notice "had nothing to do with either of the interest and penalty assessments." The Court of Federal Claims (Judge Hewitt) held that the suit was barred by § 6512(a) because, once invoked, the Tax Court's jurisdiction "extends to the entire subject of the correct tax for the particular year. … It is immaterial whether "'the Commissioner issue[d] a Notice of Deficiency with respect to the penalties [and interest] . . . which are the subject of this Complaint.'"

11. Court upholds conviction of accountant for knowingly preparing false returns. United States v. Favato, 112 A.F.T.R.2d 2013-5617 (3d Cir. 8/5/13). The Court of Appeals upheld the conviction of a BDO accountant under § 7212(a) for obstructing tax law administration by knowingly preparing for a client returns that claimed depreciation on a yacht held for personal use and that claimed false charitable contribution deductions.

B. Discovery: Summonses and FOIA

1. The IRS is allowed a do-over in examining the taxpayer's documents. Action Recycling, Inc. v. United States, 112 A.F.T.R.2d 2013-5210 (9th Cir. 7/9/13). In declining to quash a summons as unnecessarily repetitive under § 7605(b), the Ninth Circuit rejected the taxpayer's argument that the IRS already "possesses" the summonsed information simply because a revenue agent has previously reviewed the documents.

2. TAWs for UTPs — some protected, some not. Wells Fargo & Co. v. United States, 112 A.F.T.R.2d 2013-5380 (D. Minn. 6/4/13). The IRS issued summonses to obtain information from Wells Fargo and KPMG related to Wells Fargo's financial reporting and its undisclosed tax positions. Wells Fargo turned over some information, but filed a petition to quash the summons issued to KPMG on a variety of grounds, including that information was protected by the work product doctrine and was subject to attorney client privilege. The court (Judge Tunheim) held that the IRS had established a legitimate purpose in seeking Wells Fargo's tax accrual workpapers. Wells Fargo's tax returns and UTPs were complex and "Wells Fargo ha[d] claimed tax benefits from listed transactions and engaged in other questionable tax practices in the past." Wells Fargo failed to establish that the Schedule M-3 and Form 8886 would allow the IRS to identify all transactions related to the UTPs, and the IRS did not have to prove that the tax accrual workpapers were "critical" to its ability to discover Wells Fargo's tax positions. Turning to the work product issues, the court first held that Wells Fargo's identification of UTPs around the time it entered into business transactions was not a task prepared in anticipation of litigation but rather an event that occurred in the ordinary course of business. Thus, the identity of the UTPs, and the process for identifying them, was not protected. However, after reviewing the TAWs relating to the UTPs, the court concluded that the recognition and measurement analysis reflected in its TAWs was prepared in anticipated of litigation, and thus was protected. The court further held that Wells Fargo's state and local TAWs were not relevant to its federal tax liability and thus quashed the summonses with respect to those documents.

C. Litigation Costs

1. When the IRS cuts the taxpayer a break in settling a case, the taxpayer is not a "prevailing party." Knudsen v. Commissioner, T.C. Memo. 2013-87 (4/1/13). On 5/14/09, the IRS denied the taxpayer' request for § 6015(f) relief on the ground that she had failed to seek relief within the two year period required by Reg. § 1.6015-5(b)(1). The taxpayer sought review in the Tax Court and on 3/15/11 the IRS stipulated that the taxpayer qualified for complete relief under § 6015(f) for all subject years if the two-year deadline was

invalid. On 7/25/11 "the IRS announced as a policy directive that the Department of the Treasury would expand the two-year deadline 'in the interest of tax administration and *** not reflective of any doubt concerning the authority of the Service to impose the two-year deadline' and that the two-year deadline would no longer be enforced in cases docketed in [the Tax Court]." See Chief Counsel Notice CC-2011-017 (July 25, 2011); Notice 2011-70, 2011-32 I.R.B. 135. In August 2011 the IRS conceded that the taxpayer was entitled to relief. Thereafter, the taxpayer sought attorney's fees under § 7430, but the Tax Court (Judge Thornton) denied the taxpayer's motion for attorney's fees because she was not a "prevailing party" as required by the statute. Section 7430 provides that a taxpayer qualifies as a prevailing party only if either (1) the taxpayer has made a "qualified offer" or (2) the IRS's position is not substantially justified, but the taxpayer relied on only the qualified offer rule. However, the qualified offer rule does not apply where the judgment is issued pursuant to a settlement." § 7430(c)(4)(E)(ii)(I), and the court held that the judgment in this case was based on a "settlement."

D. Statutory Notice of Deficiency

1. Are you "outside of the United States" if you live in another country but are visiting the United States when a deficiency notice is sent to your U.S. post office box? Smith v. Commissioner, 140 T.C. No. 3 (2/28/13). Section 6213(a) gives the taxpayer 90 days, or if the notice is addressed to a person outside the United States, 150 days, after the mailing of a deficiency notice to file a Tax Court petition. Prior to August 2007, the taxpayer lived in San Francisco. In 2007, the taxpayer moved from San Francisco to Canada and became a permanent resident of Canada. However, she continued to own a home and maintained a post office box in San Francisco. In late December 2007, the taxpayer returned to San Francisco briefly to complete moving her furniture to Canada. While she was in San Francisco, the IRS mailed a deficiency notice relating to the year 2000 to her San Francisco post office box. The respondent stated that the taxpayer had until March 26, 2008 (i.e., 90 days), to file a Tax Court petition. The taxpayer failed to pick up the notice before returning to Canada on 1/8/08. On 5/2/08, the taxpayer received a copy of the deficiency notice, and on 5/23/08, she filed a Tax Court petition. The IRS filed a motion to dismiss for lack of jurisdiction, contending that the petition was not timely filed. P objects and contends that, pursuant to § 6213(a), she is entitled to 150, rather than 90, days to file a petition. In a reviewed opinion (7-1-5) by Judge Foley, the Tax Court held that the 150-day period applied to the taxpayer because at the time the deficiency notice was sent she was permanent resident of Canada. The majority cited *Hamilton v. Commissioner,* 13 T.C. 747 (1949), which held that "the 150-day period applies to a taxpayer who regularly resides outside the United States but who through fortuitous circumstance happened to be physically in one of the States of the Union on the particular day the deficiency notice was mailed to him."

- Judge Halpern, in a dissent joined by three other judges, would have held that the petition was not timely. The dissent reasoned that the taxpayer "was present in the United States for a two-week period bracketing both the mailing and delivery of the notice to her address (a U.S. address) last known to the Commissioner, and, in the light of the words actually used by Congress and the relevant case law, that is sufficient for me to conclude that the notice was not addressed to a person outside the United States." The dissent concluded that "the 150-day rule applies either when the taxpayer is out of the country or when the address on the notice is a foreign address," and that "out of the country means 'physically located outside the United States'" Under this reasoning "residence" is irrelevant. "Absence from the United States, resulting in delay, is what matters."

2. A website reference is as good as the address and phone number the statue requires on a deficiency notice. John C. Horn and Associates, Inc. v. Commissioner, 140 T.C. No. 11 (5/7/13). Section 6212(a) requires that a deficiency notice inform the taxpayer of the taxpayer's right to contact a local office of the National Taxpayer Advocate and provide the location and phone number of the appropriate office. The taxpayer argued that a deficiency notice was invalid because the inclusion of a Web site address where the address and telephone number of the local office of the National Taxpayer Advocate may be found did not comply with

the statutory requirement. The Tax Court (Judge Cohen) held that the deficiency notice was valid. Section 6212 does not provide that a deficiency notice sent without the specified information is invalid. The taxpayer was not prejudiced by the form of the deficiency notice because the information described in § 6212(a) was made available, "although in a manner that may not be sufficient for a taxpayer without access to a computer or knowledge of how to access a Web site." But the notice was not misleading, and the taxpayer was able to file, and did file, a timely Tax Court petition.

E. Statute of Limitations

1. Don't screw up your certified mail customer receipt. Stocker v. United States, 111 A.F.T.R.2d 2013-556 (6th Cir. 1/17/13). On 10/15/07, the taxpayers mailed an amended return requesting a refund for 2003; their 2003 tax return had been timely mailed on 10/15/04. The IRS acknowledged that it received the amended return on 10/25/07, but rejected the refund claim on the ground that the request was untimely under § 6511(a), asserting that the envelope was postmarked October 19 — four days late. The taxpayers could not avail themselves of the timely mailed, timely filed rule of § 7502(a) because they could not produce a postmarked envelope; this was because the IRS, by its own admission, had not retained the envelope in which the return had been received. Nor could they present the customer copies of a certified mail receipts, because although they claimed to have sent the amended return by certified mail, they had — in a tragic comedy or errors — failed to present to the post office the customers' copy of the certified mail receipt to get them date-stamped. The Sixth Circuit, in an opinion by Judge Rosen, held that the taxpayers were not entitled to introduce extrinsic evidence of timely mailing of the refund request. The court followed the decisions of other courts holding that the exceptions provided by § 7502 are "exclusive and complete." *See, e.g. Deutsch v. Commissioner*, 599 F.2d 44 (2d Cir. 1979), and other cases cited therein). The court noted that in any event, the extrinsic evidence put forward by the taxpayers "did not purport to establish the fact of significance under § 7502(a)(1) — namely, the 'date of the United States postmark' on their amended 2003 return — but instead is directed at the separate factual question of when they presented this return to the post office for mailing." Thus, the denial of the refund was upheld.

2. You must react quickly to a jeopardy assessment if you want judicial review. Abraitis v. United States, 111 A.F.T.R.2d 2013-1023 (6th Cir. 3/4/13). The Sixth Circuit, in an opinion by Judge Cook, held that the availability of judicial review under § 7429(b) requires that the taxpayer either have made a timely request for administrative review or exhausted administrative remedies prior to seeking judicial review of the jeopardy assessment. (The statute permits the taxpayer to seek judicial review within 90 days after either (1) the sixteenth day after the taxpayer's request to the IRS for administrative review or (2) the day the IRS notifies the taxpayer of its determination on administrative review.) Furthermore, the court held that the requirement in § 7429(a)(2) that the taxpayer's request for administrative review must be filed within 30 days after receiving the written statement from the IRS explaining the jeopardy assessment is not subject to equitable tolling.

3. A sad story about employee misclassification. Karagozian v. Commissioner, T.C. Memo. 2013-164 (7/8/13). The taxpayer's employer mischaracterized him as an independent contractor from 2002 through 2008. The taxpayer filed tax returns as an independent contractor, paying self-employment tax. After the taxpayer filed an amended return for 2008, treating himself as an employee, the IRS assessed liability for the employer's share of unpaid FICA taxes for 2008 against the taxpayer. In a CDP review, the Tax Court (Judge Kerrigan) held that the taxpayer could not invoke equitable recoupment to reduce the 2008 liability for unpaid FICA taxes by overpaid FICA taxes for earlier years, when he filed tax returns as an independent contractor. Although the FICA taxes "paid in the time-barred years were paid on the same type of transaction (i.e., compensation ...) as in 2008, ... the overpaid FICA taxes from 2002 through 2007 are separate transactions, separate items, and separate taxable events from [the taxpayer's] 2008 tax deficiency."

4. The pro se taxpayer won on the jurisdictional issue but lost on the merits. Boeri v. United States, 112 A.F.T.R.2d 2013-5516 (Fed. Cir. 7/31/13). The Federal

Circuit, in an opinion by Judge Clevenger, held that the three-year "look-back" period of § 6511(b)(2)(A) limiting the amount of credit or refund is not a "statutory time limitation[]" but rather a "substantive limitation[] on the amount of recovery." The look-back provision is not jurisdictional and does not preclude the court from hearing the taxpayer's claim. The taxpayer lost on the merits.

F. Liens and Collections

1. CDP hearings raising the issue of liability for tax at a CDP doesn't require antique common law pleading by the taxpayer. Fielder v. Commissioner, T.C. Memo. 2012-284 (10/4/12). The Tax Court (Judge Laro) rejected the IRS's argument that a taxpayer was precluded from challenging his liability for taxes in a CDP hearing because he did not raise the issue in the Form 12153 hearing request. Neither the statute nor Tax Court case law requires a taxpayer to raise the liability issue in the request for a CDP hearing. The statutory rule only limits the taxpayer's ability to contest the underlying tax liability at the CDP hearing if the taxpayer did not receive a notice of deficiency or otherwise had a prior opportunity to dispute the tax liability. The statute does not specify the time for raising the issue. The underlying liability should be considered if a taxpayer raises it at any time during a CDP hearing.

2. Does this case pretend that most single-member LLCs are mere nominee owners on behalf of their single member? Berkshire Bank v. Town of Ludlow, 111 A.F.T.R.2d 2013-498 (1st Cir. 1/11/13). The First Circuit, in an opinion by Judge Stahl, affirmed a District Court decision holding that a tax lien against the owner of a single-member LLC (which was a disregarded entity) filed in 2009 was superior to judgment lien on land owned by the LLC arising in 2010. On the facts the LLC was a mere nominee for its owner: (1) the owner transferred the property to the LLC for no consideration; (2) no one else had any interest in the LLC, made decisions for it, or benefitted from its income, (3) the LLC operated out of its owner's home' (4) the owner exercised total control over the LLC's property and its development; (5) the owner had complete use and enjoyment of the property, as evidenced by his formulation and execution of the plan to subdivide the property and sell off the lots; (6) the LLC did not interfere with the owner's use of the property; (7) the owner used 10 to 15 percent of the revenue from the LLC to pay his personal expenses; (8) the owner of the LLC treated the property as if it belonged to him; (9) the owner testified that he set up the LLC and transferred title to the property solely to avoid legal liability "in case somebody got hurt on the property;" (10) the LLC's bank account was not in its own name, but in the owner's name.

3. The obligation to pay income taxes has priority over a religious obligation to tithe. Thompson v. Commissioner, 140 T.C. No. 4 (3/4/13). In reviewing a CDP hearing, the Tax Court (Judge Ruwe) held that it was not an abuse of discretion for the settlement officer to reject the taxpayer's contention that his (1) monthly tithing to his (the Mormon) Church and (2) monthly payments for his children's college expenses should be excluded from the monthly amount available to satisfy his unpaid tax liabilities. The court rejected the argument that failure to allow tithing as a necessary expense violated the taxpayer's First Amendment right to religious freedom and the Religious Freedom and Restoration Act of 1993.

> The Commissioner's interest in expeditiously collecting taxes is especially compelling given the specific facts of this case. Petitioner has a long history of not paying his income tax liabilities. As of the date of trial petitioner still had not paid his income tax liabilities for the taxable years 1992, 1995, 1996, 1999, and 2000. Additionally, respondent has assessed trust fund recovery penalties under section 6672 against petitioner for seven different tax periods.

4. BLIPS and bankruptcy: hiding assets after learning losses may be disallowed can make the subsequent tax liability non-dischargeable. Vaughn v. United States, 111 A.F.T.R.2d 2013-1481 (D. Colo. 3/29/13). The taxpayer used losses from a KPMG BLIPS tax shelter to offset gain from the 1999 sale of his interest in a cable company. After being informed by KPMG of the release of Notice 2000-44, 2000-2 C.B. 255, which identified losses in BLIPS-type tax shelters as nondeductible, and learning that the IRS was auditing the cable company's former CFO, who also had used BLIPS losses to offset gain, the taxpayer

purchased a $1.7 million home titled in his fiancée's name. After KPMG advised the taxpayer to disclose his BLIPS investment, but before he disclosed it, the taxpayer funded a $1.5 million trust for his stepdaughter. He also spent significant amounts on jewelry and home furnishings. The taxpayer later filed a chapter 11 bankruptcy petition and the IRS filed a proof of claim in that proceeding in the amount of $14,359,592. Under 11 U.S.C. § 523(a)(1)(C), a tax debt is not dischargeable in bankruptcy if the debtor either made a fraudulent return or willfully attempted to evade or defeat the tax. The Bankruptcy Court held that the taxpayer's tax liability was non-dischargeable on both grounds. The District Court affirmed the Bankruptcy Court's determination solely on the ground that the taxpayer had willfully attempted to evade or defeat tax. The District Court rejected the taxpayer's contention that he could not have willfully attempted to evade or defeat tax because there had been no assessment or quantification of his tax liability when he depleted his assets.

5. A good reason not to be the fiduciary of any estates or trusts that you represent. United States v. Tyler, ___ Fed. Appx. ___,111 A.F.T.R.2d 2013-2300 (3d Cir. 6/11/13). The Court of Appeals, in an opinion by Judge Jordan, held that 31 U.S.C. § 3713 imposes personal liability on an executor who distributes all of the funds from an estate thereby rendering the estate unable to pay the taxes due from the estate (including unpaid tax liabilities of the decedent), even though such a distribution "is not, strictly speaking, the payment of a debt," to which the statute refers. The court relied on *United States v. Coppola*, 85 F.3d 1015 (2d Cir. 1996), which reached the same result.

6. Who says the income tax is uniform throughout the country. Sometimes state law determines from whom the IRS can collect. Fourth Investments, LP v. United States, 111 A.F.T.R.2d 2013-2340 (9th Cir. 6/13/13). The Court of Appeals, in an opinion by Judge M. Smith, affirmed a District Court holding in favor of the government in a quiet title action in which the plaintiff partnerships sought to remove a tax lien on properties to which the partnerships held title. The lien was for back taxes of married individuals from whom partnerships had received properties without consideration. The court rejected the government's argument that nominee status was to be determined under federal common law, and held that the relevant state law controlled the determination of whether title to the property was held as a nominee. Nevertheless, the court concluded that the partnerships held the properties as nominees of the taxpayers under California law, which was the controlling state law.

- As for the controlling law, a similar result has been reached by other Circuits that have addressed the issue. See *Berkshire Bank v. Town of Ludlow*, 708 F.3d 249 (1st Cir. 2013) (clarifying that state law, rather than federal law, provides the "substantive rules" of nominee doctrine); *Holman v. United States*, 505 F.3d 1060 (10th Cir. 2007) (rejecting the government's argument that a "uniform federal rule should ... govern whether the nominee theory is to apply," and remanding for application of Utah law); *Spotts v. United States*, 429 F.3d 248 (6th Cir. 2005) ("Because there is no indication that the district court applied [state] law before determining the scope of the federal tax lien we must reverse.").

7. Unremitted withholding determined in criminal tax fraud trial was credible for determining civil tax liability. Dixon v. Commissioner, T.C. Memo. 2013-207 (9/3/13). In reviewing an IRS CDP determination, the Tax Court (Judge Holmes) held that the Dixons were entitled to a credit against their 1992 through 1995 income tax liability for $510,896 determined in their criminal tax fraud trial to have been withheld by their corporate employer (which they controlled) but not remitted. The withholding had been determined as part of the tax-loss computation from the then-still-extant books and records, even though many records subsequently disappeared before the CDP hearing. As part of their sentencing the taxpayers agreed to pay that sum in 1999 and 2000 to the corporation, and the corporation remitted the funds to the IRS with a designation that the funds be applied to the corporation's employment taxes for the years in question with respect to the taxpayers as representing withheld taxes.

a. An employer can designate which employee's withholding taxes it has paid. Dixon v. Commissioner, 141 T.C. No. 3 (9/3/13). In a related case reviewing the same CDP determination, the Tax Court, in a reviewed opinion by Judge Lauber (11-1-3),

held that "when an employer pays in a later year the nonwithheld income tax of an employee for an earlier year, the employee as a matter of law is not entitled to a credit under section 31." That did not, however, resolve the matter. In 1999 and 2000 the Dixons had remitted to the employer corporation $91,233 to be applied to their 1992 through 1995 income tax liabilities – the amount of their income tax liabilities in excess of the amounts for which the court in the related Tax Court memorandum opinion held that the corporation had withheld (but not remitted). The corporation remitted the funds to the IRS with a designation that they be applied to the corporation's employment taxes for the years in question with respect to the taxpayers as representing withheld taxes. But the payment was outside the period prescribed by § 6205(a)(1) for making a "proper adjustment" to under-withholding. The IRS applied the payment to other corporate tax liabilities. Nevertheless, the court held that the taxpayers should have received a credit of $91,223 against their 1992 through 1995 income tax liabilities by virtue of the corporation's designated payments. It rejected the IRS's argument that "there is no legal basis for insisting that the IRS honor the designation of a delinquent employment tax payment toward the income tax liability of a specific employee." However, the taxpayer's remained liable for interest and penalties attributable to the late payment.

- Judges Holmes, Buch, and Halpern dissented, and would have held that the relevant statutory scheme does not allow the corporation to designate a payment for its own benefit and also for the benefit of the employees.

G. Innocent Spouse

1. The significant benefit of getting to own your home free and clear of a mortgage lien precludes equitable relief. Haggerty v. Commissioner, 111 A.F.T.R.2d 2013-411 (5th Cir. 1/3/13). The taxpayer sought § 6015(f) equitable relief for taxes due with respect to her late husband's premature IRA withdrawal that was reported on their joint return for the year of his death. She had no knowledge of the withdrawal and the use of the funds to pay off a second mortgage lien on their home, which as a result of his death she owned outright, until after her husband's death. In a per curiam opinion, the Fifth Circuit upheld denial of relief. Because the taxpayer signed and filed the return after her husband's death and the income tax liability was properly reported but not paid, she knew that her husband would not pay the tax liability. The key to the holding, however, was that the taxpayer received a significant economic benefit when her husband paid off the second mortgage against their home.

2. The Tax Court's review of § 6015(f) relief denial is de novo and new evidence is admissible. Wilson v. Commissioner, 705 F.3d 980 (9th Cir. 1/15/13). The Ninth Circuit in a divided opinion (2-1) by Judge Thomas, held that, in reviewing the IRS's denial of § 6015 innocent spouse relief, the Tax Court properly considered new evidence outside the administrative record and correctly applied a de novo standard of review in determining the taxpayer's eligibility for § 6015(f) equitable relief. The court reasoned as follows:

> Section 6015(e)'s jurisdictional grant to determine whether equitable relief is warranted in a § 6015(f) case must be read alongside subsection (f)'s mandate to consider the totality of the circumstances before making an equitable relief determination. "Taking into account all the facts and circumstances" is not possible if the Tax Court can review only the evidence available at the time of the Commissioner's prior determination.

- The majority also rejected the IRS's argument that the Administrative Procedure Act applied to limit the Tax Court's review. The court reasoned that the "extensive legislative history of [§§ 6015(e) and (f)] demonstrates that the special procedures enacted by Congress displace application of the APA in innocent spouse tax relief cases, and the APA does not apply." The court emphasized that at no time before the Tax Court proceeding is there a formal administrative procedure at which the taxpayer can present the case before an administrative law judge; at no time during the administrative process is the taxpayer afforded the right to conduct discovery, present live testimony under oath, subpoena witnesses for trial, or conduct cross-examination. These procedures are available only in the Tax Court. Finally, the Ninth

Circuit acknowledged that "a de novo scope of evidentiary review is incompatible with an abuse of discretion standard," but concluded that "the nature of equitable relief ... favors de novo review."

> The Tax Court must be able to compile a de novo record if it is to consider "all the facts and circumstances" when deciding whether a taxpayer is entitled to relief from joint liability under § 6015(f), but it is pointless to do so if it can only review the Commissioner's denial of equitable relief for an abuse of discretion. The only way for the Tax Court to proceed de novo when hearing petitions for relief under § 6015(f) is by applying both a de novo standard and scope of review.

- Accordingly, the Ninth Circuit affirmed the Tax Court's decision granting relief.
- Judge Bybee dissented, arguing that the Administrative Procedure Act applied, and the Tax Court as a reviewing court is limited to the administrative record and a review for abuse of discretion by the IRS.
- In *Commissioner v. Neal*, 557 F.3d 1262 (11th Cir. 2009), the Eleventh Circuit, the only other circuit that has considered the scope of the Tax Court's review in § 6015(f) cases, reached the same conclusion as the Ninth Circuit majority.

a. The IRS throws in the towel on another innocent spouse procedural rule. CC-2013-011 (6/7/13). This Chief Counsel Notice provides that IRS attorneys will no longer argue (1) that the Tax Court should limit its review of § 6015(f) determinations to abuse of discretion or (2) the Tax Court should limit its review to evidence in the administrative record.

- This reflects the IRS's acquiescence in *Wilson v. Commissioner*, 705 F.3d 980 (9th Cir. 2013), *aff'g* T.C. Memo. 2010-134, in AOD 2012-07; 2013-25 IRB i.

3. Innocent spouses have longer to seek equity than to prove their innocence. REG-132251-11, Relief From Joint and Several Liability, 78 F.R. 49242 (8/13/13). The Treasury Department has published proposed amendments to Reg. §§ 1.66-4 and 1.6015-5 that would enshrine in the regulations the relief provided by Notice 2011-70, 2011-32 I.R.B. 125, providing that the otherwise applicable two-year deadline for seeking § 6015 relief (or the equivalent under § 66(c) with respect to income from community property) does not apply to equitable relief under § 6015(f) (or the equivalent under § 66(c). Prop. Reg. § 1.6015-5(b)(2) provides that if a requesting spouse files a request for equitable relief under Reg. § 1.6015-4 within the period of limitations on collection, the IRS will consider the request, but any relief in the form of a tax credit or refund depends on whether the limitation period for credit or refund was also open as of the date the claim for relief was filed and the other requirements relating to credits or refunds are satisfied. In cases in which the limitation period for credit or refund is the longer of the two periods and is open when a request for equitable relief is filed, the request can be considered for a potential refund or credit of any amounts collected or otherwise paid by the requesting spouse during the applicable look-back period of § 6511(b)(2), even if the collection period is closed. If a request for equitable relief is filed after the expiration of the period of limitations for collection of a joint tax liability, the IRS is barred from collecting any remaining unpaid tax from the requesting spouse. Similarly, if a request for equitable relief under Reg. § 1.6015-4 is filed after the expiration of the limitation period for a credit or refund, § 6511(b)(1) bars the IRS from allowing, and a taxpayer from receiving, a credit or refund. The IRS will not consider an individual's request to be equitably relieved from a tax that is no longer legally collectible. The proposed regulations have no effect on the two-year deadline to elect relief under § 6015(b) (and Reg. § 1.6015-2) or § 6015(c) (and Reg. § 1.6015-3).

H. Miscellaneous

1. The whistleblower made no noise, and kept his (?) identity secret. Whistleblower 14106-10W v. Commissioner, 137 T.C. No. 15 (12/8/11). In a reviewed opinion by Judge Thornton, the Tax Court granted summary judgment for the IRS in this case in which a whistleblower appealed the IRS's denial of a reward. The IRS filed the affidavit of a Chief Counsel Attorney "declaring, on the basis of his review of respondent's administrative and legal

files and on the basis of conversations with relevant IRS personnel, that the information petitioner provided resulted in respondent's taking no administrative or judicial action against X or collecting from X any amounts of tax, interest, or penalty," and the whistleblower did "not set forth, by affidavits or otherwise, any specific facts showing that there [was] a genuine issue for trial." The court granted the whistleblower's request for anonymity and redaction from the record of any identifying information because the potential harm from disclosing the whistleblower's identity as a confidential informant outweighed the public interest in knowing the whistleblower's identity in a case decided on summary judgment for the IRS denying an award. Because granting the request for anonymity and redaction adequately protected the whistleblower's privacy interests as a confidential informant, the motion to seal the record was denied.

a. Calculating collected proceeds in calculating whistleblower awards. T.D. 9580, Rewards and Awards for Information Relating to Violations of Internal Revenue Laws, 77 F.R. 10370 (2/22/12). The Treasury Department promulgated final regulations relating to the payment of rewards under § 7623(a) for detecting underpayments or violations of the internal revenue laws and whistleblower awards under § 7623(b) that amend Reg. § 301.7623-1. The amendments clarify the definitions of proceeds of amounts collected and collected proceeds and provide that the provisions of Reg. § 301.7623-1(a) concerning refund prevention claims are applicable to claims under § 7623(a) and (b). "[B]oth proceeds of amounts collected and collected proceeds include: Tax, penalties, interest, additions to tax, and additional amounts collected by reason of the information provided; amounts collected prior to receipt of the information if the information provided results in the denial of a claim for refund that otherwise would have been paid; and a reduction of an overpayment credit balance used to satisfy a tax liability incurred because of the information provided."

b. You could be the next one to strike it rich by ratting out your employer. IRS Summary Award Report, 9/11/12. The IRS Whistleblower Office recommended a payment of $104 million to former UBS banker Bradley Birkenfeld based on his 2009 claim under § 7623(b). The non-redacted portion of the recommendation read:

> Birkenfeld provided information on taxpayer behavior that the IRS had been unable to detect, provided exceptional cooperation, identified connections between parties to transactions (and the methods used by UBS AG), and the information led to substantial changes in UBS AG business practices and commitment to future compliance. The actions against UBS AG and the attendant publicity also contributed to other compliance programs. Each of these factors could support an increase in the award percentage above the statutory minimum. The comprehensive information provided by the whistleblower was exceptional in both its breadth and depth. While the IRS was aware of tax compliance issues related to secret bank accounts in Switzerland and elsewhere, the information provided by the whistleblower formed the basis for unprecedented actions against UBS AG, with collateral impact on other enforcement activities and a continuing impact on future compliance by UBS AG.

c. No relief for an uncompensated whistleblower when the IRS closes its ears to the whistle. Cohen v. Commissioner, 139 T.C. No. 12 (10/9/12). In a case of first impression, the Tax Court (Judge Kroupa) held that no relief is available to a whistleblower under § 7623(b) when the IRS denies a claim without initiating an administrative or judicial action or collecting proceeds. The taxpayer's argument that the IRS abused its discretion by not acting on his information was rejected.

d. More comprehensive Proposed Regulations on how to get rich ratting out tax cheats. REG–141066–09, Awards for Information Relating to Detecting Underpayments of Tax or Violations of the Internal Revenue Laws, 77 F.R. 74798 (12/18/12). The Treasury Department has published detailed comprehensive proposed regulations regarding whistleblower awards under section § 7623 to replace the current final regulations that are only slightly more than one year old. The proposed regulations provide guidance on eligibility and

submitting information to the IRS and filing claims for award with the Whistleblower Office that are intended to clarify the process individuals should follow to be eligible to receive whistleblower awards; the proposed regulations in large part, track the existing regulations. A claimant must provide the name of the taxpayer and specific facts and documents to support the claim. The proposed regulations reaffirm the practice of Treasury and the IRS to safeguard the identity of whistleblowers whenever possible. The definitions of proceeds of amounts collected and collected proceeds in the proposed regulations build on the definitions in the existing regulations, but some definitions, such as "related actions," are new. The definition of "collected proceeds" restates the rule from those final regulations that collected proceeds include: tax, penalties, interest, additions to tax, and additional amounts collected because of the information provided; amounts collected prior to receipt of the information provided if the information results in the denial of a claim for refund that otherwise would have been paid; and a reduction of an overpayment credit balance used to satisfy a tax liability incurred because of the information provided. Prop. Reg. § 301.7623–3 describes the administrative proceedings applicable to claims whistleblower awards. Prop. Reg. § 301.7623-4 provides the framework and criteria that the Whistleblower Office will use in exercising its discretion to make awards. The proposed regulations are consistent with, and build on, the award determination provisions provided in the Internal Revenue Manual. The proposed regulations will be effective upon finalization.

2. You can remove those disclaimers from your emails when these proposed regulations become final (but not before).[3] REG-13867-06, Regulations Governing

[3] Chicago lawyer Sheldon I. Banoff suggests consideration of the following language at the end of emails until the proposed regulations become final:

> CIRCULAR 230 DISCLOSURE, NON-DISCLOSURE AND DISCLOSURE OF NON-DISCLOSURE: In accordance with Treasury Regulations Circular 230, any tax advice contained in this communication was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matter addressed herein (together, the "Prohibited Purposes"). In September 2012 Treasury proposed elimination of the requirement of the aforementioned Circular 230 disclosure, to be effective prospectively only (upon adoption in final form and publication of the revised Circular 230 in the Federal Register). Until that time, our emails shall continue to include the aforementioned Circular 230 disclosure. At such time as we are no longer required to include the aforementioned Circular 230 disclosure, we shall no longer do so; however, we recognize that those handful of you who previously have bothered to read our Circular 230 disclosure will at that time wonder whether the elimination of our Circular 230 disclosure was due to oversight or, worse yet, that the email being sent by us to you is in fact "intended or written to be used," and can be used, for the Prohibited Purposes. Such inference is not intended (except in those extremely rare cases where it is intended, i.e., where you really would be entitled to so use our emails for the Prohibited Purposes). Therefore, effective as of the moment that the revised Treasury Regulations Circular 230 is published in the Federal Register, which should only happen in our lifetimes, the following disclosure shall become operative without any further action on our part: "Treasury Regulations Circular 230 was recently amended to eliminate the requirement that we disclose to you that any tax advice contained in this communication was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or

Practice Before the Internal Revenue Service, 77 F.R. 57055 (9/17/12). In the course of a comprehensive revision of the requirements for tax opinions, these proposed Circular 230 regulations include the following:

- The rigid covered opinion rules in current § 10.35 (which require that the written opinion contain a description of the relevant facts, the application of the law to those facts, and the practitioner's conclusion with respect to the law and the facts) are removed; these rules are replaced with a single standard for all written tax advice under proposed § 10.37. This standard requires that the practitioner must: (i) base the written advice on reasonable factual and legal assumptions; (ii) reasonably consider all the relevant facts that the practitioner knows or should know; (iii) use reasonable efforts to identify and ascertain the facts relevant on each Federal tax matter; (iv) not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) if reliance on them would be unreasonable; and (v) not take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit. The determination of whether a practitioner has failed to comply with these requirements is based on all the facts and circumstances, not on whether each requirement is addressed in the written advice.
- Proposed § 10.35 provides that a practitioner must exercise competence when engaged in practice before the IRS (including providing written opinions), which includes the required knowledge, skill, thoroughness, and preparation necessary for the matter for which he is engaged. This complements the provision in § 10.51 that a practitioner can be sanctioned for incompetent conduct.
- Proposed § 10.36 conforms the "procedures to ensure compliance" with the removal of the covered opinion rules in current § 10.35, but expands these "procedures to ensure compliance" to include all of the provisions of Circular 230.
- Proposed § 10.1 provides that the Office of Professional Responsibility – as opposed to the IRS Return Preparer Office – would have exclusive responsibility for matters related to practitioner discipline.
- Proposed § 10.82 extends the expedited disciplinary procedures for immediate suspension, but limits it to practitioners who have engaged in a pattern of willful disreputable conduct by failing to make an annual Federal tax return during four of five tax years immediately before the institution of the expedited suspension proceeding, provided that the practitioner is also noncompliant at the time the notice of suspension is served.
- Proposed § 10.31 forbids practitioners from negotiating any taxpayer refunds, which specifically adds manipulation of any electronic refund process.

3. Not just any old express mail service cuts the mustard when you wait until the last minute to file a Tax Court petition. Scaggs v. Commissioner, T.C. Memo. 2012-258 (9/10/12). Tax Court Special Trial Judge Armen held that a Tax Court petition received

---

(ii) promoting, marketing or recommending to another party any tax-related matter addressed herein (the "Prohibited Purposes"). Therefore, as of this moment you should not consider this email to be a Circular 230 disclosure. However, no inference is intended, and none should be taken, that our failure to make a Circular 230 disclosure to you from this moment forward shall entitle you to rely on any tax advice herein for any Prohibited Purpose. Further, in the event any person who is a member of, employed by or affiliated with this firm should continue to include a Circular 230 disclaimer on any email after the amendment of Circular 230 becomes effective, no negative inference should be taken that the emails of any others who are members of, employed by or affiliated with our firm whose emails do not contain the Circular 230 disclosure but which contain any tax advice can be used for the Prohibited Purposes, without the express written consent of an authorized representative of the firm.

more than 90 days after the date of a deficiency notice but which was sent via FedEx "Express Saver Third business day" within the 90-day period, was not timely filed. Notice 2004–83, 2004–2 C.B. 1030, which lists the private delivery serves that qualify for the same "mailbox" treatment as shipment via the U.S. Postal Service pursuant to § 7502(f), does not list FedEx "Express Saver Third business day."

4. If the statute requires Appeals to consult with Chief Counsel, it's not a prohibited *ex parte* communication. Hinerfeld v. Commissioner, 139 T.C. No. 10 (9/27/12). The taxpayer's proposed offer in compromise was rejected and he sought review in the Tax Court. Among the taxpayer's arguments was that the Appeals Officer had an improper ex parte consultation with Chief Counsel's Office, violating the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 1001(a)(4), 112 Stat. at 689, and Rev. Proc. 2000-43, 2000-2 C.B. 404, which provides guidelines in question and answer format that are designed to distinguish prohibited and permissible ex parte communications between Appeals and other IRS employees during an administrative appeal. The Tax Court (Judge Gale) rejected the taxpayer's argument. The Appeals Officer had consulted Chief Counsel's Office to seek an opinion as to whether the taxpayer had made a fraudulent conveyance. There was no evidence of improper communications, and review by Counsel was mandated by § 7122(b), which, when the IRS is to compromise any unpaid tax assessed of $50,000 or more, requires an opinion of the Chief Counsel to be filed with the IRS.

5. The IRS can't disclose knowingly false taxpayer information just because it could have disclosed true information. Aloe Vera of America, Inc. v. United States, 699 F.3d 1153 (9th Cir. 11/15/12). The statute of limitations under § 7431(d) on a claim for wrongful disclosure of a tax return begins to run when the taxpayer knows or reasonably should know of the government's allegedly unauthorized disclosures. On the facts of the case, the statute of limitations did not begin to run when the taxpayer became aware of a pending general investigation that would involve disclosures, but only later when they knew or should have known of the specific disclosures at issue. Under § 6103(k)(4), return information may be disclosed to a foreign government that has a tax treaty with the United States, if such information as is pertinent to carrying out the provisions of the treaty or preventing fraud or fiscal evasion in relation to the taxes which are the subject of the treaty. But the disclosure of knowingly false information to a foreign tax authority in a proposal for a simultaneous tax examination is not protected as "pertinent" information. There was a genuine issue of material fact as to whether the government knowingly disclosed false information, and the District Court's grant of summary judgment for the government was vacated and the issue remanded.

6. Prison tax returns. The 2012 Taxpayer Relief Act, § 209, expands the list of persons to whom false prisoner tax returns may be disclosed by the IRS under Code § 6103(k)(10) to include officers and employees of the Federal Bureau of Prisons, state agencies charged with prison administration, and contractors responsible for operating a Federal or state prison.

7. Court enjoined the IRS from regulating tax-return preparers. Loving v. IRS, 111 A.F.T.R.2d 2013-589 (D.D.C. 1/18/13). The District Court (Obama appointee Judge Boasberg) enjoined the IRS from regulating otherwise unregulated "tax-return preparers" because they are not "representatives" and do not "practice" before the IRS and are not covered under 31 U.S.C. § 330(a) (authorizing the regulation of "the practice of representatives of persons before the [IRS]"). The regulation of tax-return preparers under Circular 230, including registration, payment of fees, passing a qualifying exam, and completing continuing education courses annually, fails the *Chevron* step one test because preparation of tax returns does not require that a "representative demonstrate … (D) competency to advise and assist persons in presenting their cases," 31 U.S.C. § 330(a)(2)(D), on the ground that "[a]t the time of filing the taxpayer has no dispute with the IRS; there is no 'case' to present." Judge Boasberg also noted that the "unstructured independence by the IRS [under Circular 230] would trample *the specific and tightly controlled penalty scheme in Title 26*" (emphasis added).

- Note that there is neither privilege nor work product protection for communications to a tax return preparer, which arises only when there is a realistic possibility of "controversy."

a. The injunction is modified, but not stayed. Loving v. IRS, 111 A.F.T.R.2d 2013-702 (D.D.C. 2/1/13). On the IRS's motion to stay the injunction, Judge Boasberg – while refusing to stay the injunction – modified it to make clear that its requirements were less burdensome than the IRS claimed. The requirement that each tax return preparer obtain a PTIN (and pay related fees) is authorized under § 6109(a)(4), so it may continue, except that the "IRS may no longer condition PTIN eligibility on being 'authorized to practice' under 31 U.S.C. section 330." Therefore, "the requirements that tax return preparers (who are not attorneys, CPAs, enrolled agents, or enrolled actuaries) must pay fees unrelated to the PTIN, pass a qualifying exam, and complete annual continuing-education requirements" continue to be enjoined.

b. Government's motion for a stay pending appeal was denied summarily. Loving v. IRS, __ (D.C. Cir. 3/27/13) (Rogers, Tatel, and Brown, JJ, per curiam) (unpublished). The IRS appealed these two opinions and orders to the Circuit Court for the District of Columbia Circuit, 2/20/13. That court refused to stay the District Court's injunction on the ground that the IRS failed to satisfy "the stringent requirements for a stay pending appeal."

8. Ryan loses its constitutional challenge to Circular 230's contingent fee rule. Ryan, LLC v. Lew, 2013 U.S. Dist. LEXIS 45430 (D. D.C. 3/29/13). Plaintiffs challenge § 10.27 of Circular 230 that generally limits the use of contingent fee arrangements in connection with the preparation and filing of refund claims with the IRS. More specifically, they mounted three distinct attacks against Circular 230: (1) Ryan, LLC and Mr. Ryan argued that Circular 230 violates their rights under the Petition Clause of the First Amendment (Count I); (2) Mr. Ryan argued that Circular 230 violates his Fifth Amendment Due Process Rights (Count II); and (3) Mr. Ridgely brought suit under the Administrative Procedure Act ("APA"), 5 U.S.C. §§ 701, *et seq*., arguing that the IRS exceeded its statutory authority in promulgating Circular 230 (Count III). Plaintiffs sought a declaratory judgment that Circular 230's restrictions of contingent fee arrangements in the context of "ordinary refund claims" is unconstitutional and exceeds the scope of the IRS's authorizing statute, and they sought a permanent injunction barring the enforcement of Circular 230's restrictions on the use of contingent fee arrangements for "ordinary refund claims." The District Court (Judge Wilkins) dismissed Counts I and II on the grounds that: Count I failed to state a claim upon which relief may be granted, and Mr. Ryan lacked standing under Count II to pursue a Due Process claim so that claim lacked jurisdiction.

- With respect to an issue he didn't address, Judge Wilkins stated:

> In pressing for the dismissal of Plaintiffs' claim, the Government first argues that the Petition Clause does not protect "a taxpayer's right to file an administrative claim for refund" with the IRS. (Defs.' Reply at 7). The Court finds this proposition dubious. Not only has the Supreme Court explicitly held that Petition Clause guarantees citizens the ability to seek relief with courts, but it has also made clear that these protections extend to "other forums established by the government for the resolution of legal disputes." *Borough of Duryea*, 131 S. Ct. at 2494. The Court has also explained that "[t]he same philosophy governs the approach of citizens or groups of them to administrative agencies (which are both creatures of the legislature, and arms of the executive) and to courts, the third branch of Government." *Cal. Motor Transport Co. v. Trucking Unlimited*, 404 U.S. 508, 510 (1972) ("Certainly the right to petition extends to all departments of the Government. The right of access to the courts is indeed but one aspect of the right of petition."). Insofar as the Internal Revenue Service is an administrative agency established by the Government, the Court believes that the Petition Clause would protect citizens' rights to file claims with the IRS, as Plaintiffs suggest. On

balance, however, the Court need not directly pass on this issue because, even assuming that the right to file a refund claim with the IRS does fall within the ambit of the Petition Clause's protections, Plaintiffs fail to allege any constitutionally cognizable violation or impingement of such a right.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. Tax refunds in a bad economy set up another deference conflict among the circuits. In Re Quality Stores, Inc., 693 F.3d 605 (6th Cir. 9/7/12). In November 2001 Quality Stores closed 63 stores and 9 distribution centers and terminated the employment of all employees in the course of Chapter 11 bankruptcy cases. Quality Stores adopted plans providing severance pay to terminated employees. The company reported the severance pay as wages for withholding and employment tax purposes then filed claims for refund of FICA and FUTA taxes claiming that the severance pay represented supplemental unemployment compensation benefits (SUBs) that are not wages for employment tax purposes. Disagreeing with the contrary holding by the Federal Circuit in *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008), the Sixth Circuit held that the SUBs were exempt from employment taxes. The court examined the language and legislative history of § 3402(o)(1), which provides that SUB payments "shall be treated *as if it were a payment of wages*" for withholding purposes, to conclude that by treating SUB payments as wages for withholding, Congress recognized that SUB payments were not otherwise subject to withholding because they did not constitute "wages." Then, under *Rowan Cos. v. United States*, 452 U.S. 247, 255 (1981), the court concluded that the term "wages" must carry the same meaning for withholding and employment tax purposes. Thus, if SUBs are not wages under the withholding provision (because the must be treated as wages by statutory directive), the SUBs are not wages for employment tax purposes. The court also rejected the IRS's position in Rev. Rul. 90-72, 1990-2 C.B. 211, that to be excluded from employment taxes SUBs must be part of a plan that is designed to supplement the receipt of state unemployment compensation. The court declined to follow the Federal Circuit's holding in *CSX Corp*., which adopted the eight part test of Rev. Rul. 90-72, stating that, "We decline to imbue the IRS revenue rulings and private letter rulings with greater significance than the congressional intent expressed in the applicable statutes and legislative histories." The court also stated that it could not conclude that the opinion in *Mayo Foundation for Medical Education & Research v. United States*, 131 S. Ct. 704 (2011), eroded the holding of *Rowan Cos. v. United States*, which compelled the court to interpret the meaning of "wages" the same for withholding and employment tax purposes.

- Will the disagreement between the Federal and Sixth Circuits once again invite the Supreme Court to enter the deference fray?

2. The District Court for the Eastern District of New York gets the message. Recoveries in age discrimination suit are wages. Gerstenbluth v. Credit Suisse Securities (USA) LLC, 110 A.F.T.R.2d 2012-6238 (E.D. N.Y. 9/28/12). The District Court for the Eastern District of New York (Judge Seybert) granted summary judgment to defendants in a claim for refund against the employer and the IRS for employment taxes withheld by the employer on damages paid to the taxpayer in a successful claim for age discrimination. The court ruled that money paid to settle employment discrimination claims constitute wages where the money represents back pay or front pay. Although the settlement agreement with Credit Suisse did not explicitly describe the payment as wages, the court concluded that the payment represented wages based on the employer's characterization of the payment as wages in reporting the settlement as compensation on Form W-2.

a. As does the Northern District. Back and front pay in a Title VII wrongful discharge recovery are wages. Noel v. New York State Office of Mental Health Central New York Psychiatric Center, 697 F.3d 209 (2d Cir. 8/31/12). The plaintiff in a Title VII wrongful discharge case recovered damages for back and front pay in a jury trial. The State Office of the Controller withheld employment taxes from its payment of the judgment. The District Court for the Northern District of New York ordered the Controller to pay the full

amount of the judgment. In an appeal filed by the Controller, joined by the Tax Division of the Justice Department as *amicus*, the Court of Appeals held that the front and back pay constituted wages subject to withholding. The court noted that both front and back pay constitute remuneration paid to compensate for what the employee would have earned had the employee not been a victim of discrimination. Thus, the court concluded that, "[t]hese amounts are 'wages' because they constitute 'remuneration' for services during an employee-employer relationship."

b. Age discrimination settlement payment is treated as wages. Gerstenbluth v. Credit Suisse Securities (USA) L.L.C., 112 A.F.T.R.2d 2013-____ (2d Cir. 8/27/13). The court affirmed summary judgment in favor of the employer and the IRS on a claim by the taxpayer seeking refund of employment taxes withheld on a $250,000 settlement with the employer of the taxpayer's age discrimination claim. The court focused on the origin of the claim under the Age Discrimination in Employment Act (ADEA) which provides recovery for back and front wages and rejected the taxpayer's argument that the settlement payment was for settling the claim rather than wages. The court also looked to the employer's intent to pay wages as evidenced by the fact that the employer treated the payment as wages for purposes of issuing the taxpayer a Form W-2 and the employer's payment of employment taxes.

3. Funding health care by making the HI tax more progressive. Section 1401, as amended by the 2010 Health Care Act, increases the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages in excess of a threshold amount. The threshold amount is $250,000 of the combined wages of both spouses on a joint return ($125,000 for a married individual filing a separate return). The threshold is $200,000 for all other individuals. The employer must withhold the additional HI tax, but in determining the employer's withholding requirement and liability for the tax, only wages that the employee receives from the employer in excess of $200,000 for a year are taken into account, and the employer disregards the employee's spouse's wages. I.R.C. § 3102(f). The employee is liable for the additional 0.9 percent HI tax to the extent the tax is not withheld by the employer. Section 1402(b), as amended, imposes an additional tax of 0.9 percent on self-employment income above the same thresholds. The threshold amount is reduced (but not below zero) by the amount of wages taken into account in determining the FICA tax with respect to the taxpayer. No deduction under § 164(f) is allowed for the additional SECA tax, and the alternative deduction under § 1402(a)(12) is determined without regard to the additional SECA tax rate. The additional tax applies to wages received in taxable years after 12/31/12.

a. Proposed regulations relating to the Additional Medicare Tax. REG-130074-11, Rules Relating to Additional Medicare Tax, 77 F.R. 72268 (12/5/12). Proposed regulations under §§ 1401, 3101 and 3102, relating to Additional Hospital Insurance Tax on income above threshold amounts ("Additional Medicare Tax"), as added by the Affordable Care Act. Specifically, these proposed regulations provide guidance for employers and individuals relating to the implementation of Additional Medicare Tax. This document also contains proposed regulations relating to the requirement to file a return reporting Additional Medicare Tax, the employer process for making adjustments of underpayments and overpayments of Additional Medicare Tax, and the employer and employee processes for filing a claim for refund for an overpayment of Additional Medicare Tax.

- The changes to §§ 1401 and 3102 are effective for tax years beginning after 12/31/12, and taxpayers may rely on the proposed regulations for purposes of complying with these section until the effective date of the final regulations, which are expected to be made final during 2013 and will be applicable to tax years beginning after 12/31/13.
- FAQs to the Additional Medicare tax were released by the IRS on 11/30/12, 2012-TNT 232-48.

4. Proposed regulations define employment tax liabilities of agents designated by an employer to pay employment taxes. Reg-102966-10. Designation of Payor as Agent to Perform Acts Required of an Employer, 78 F.R. 6056 (1/29/13). Proposed regulations under § 3405 would provide rules regarding obligations for all employment tax under an agreement between an employer and a third party payor that is designated as an agent to perform the acts of the employer. The proposed regulations would provide that all provisions of

the law, including penalties are applicable to the payor, and that the employer for which the payor is designated as agent also remains liable for all provisions of the employment tax. The preamble indicates that consistent with the IRS position on administering the § 6672 trust fund penalty, the employment tax liability of an employer will be collected only once whether from the payor or the employer. The agency designation does not apply to (1) a payor that is itself the common law employer of a person performing services for a client, (2) a payor that has legal control over the payment of wages under § 3401(d)(1) (and is thus the liable employer), and (2) a payor who is a payroll service provider that reports employment taxes under the employer's EIN.

5. Advances to keep employees are wages. The Vancouver Clinic, Inc. v. United States, 111 A.F.T.R.2d 2013-1571 (W.D. Wash. 4/9/13). The clinic provided "advances" to newly hired physicians that were subject to repayment if the physician did not continue to work for the clinic for a period of five years. The advances were not reported on Form W-2. Instead, the clinic reported on Form 1099 the subsequent forgiveness of the advances." The court granted summary judgment to the IRS on the clinic's suit for refund after paying employment taxes assessed by the IRS. The court rejected the clinic's assertion that the advances were loans principally on the finding that at the time the arrangements were entered into neither the clinic nor the physicians intended that the advances would be repaid. The court characterized the repayment obligation as liquidated damages payable by the physicians on breach of a contractual obligation to remain at the clinic for five years compelling the conclusion that the advances were compensation for services and thus subject to employment taxes and wage withholding.

6. "The self-employment tax provisions are construed broadly in favor of treating income as earnings from self-employment." Morehouse v. Commissioner, 140 T.C. No. 16 (6/18/13). In a reviewed opinion (15-0-0), the Tax Court (Judge Marvel) overruled its prior decision in *Wuebker v. Commissioner*, 110 T.C. 431 (1998), *rev'd*, 205 F.3d 897 (6th Cir. 2000), and held that payments under the U.S. Department of Agriculture (USDA) Conservation Reserve Program (CRP) are self-employment income subject to self-employment taxes. The taxpayer owned farm land in South Dakota, which he had rented to tenant farmers. The taxpayer entered into a CRP contract with the USDA under which in exchange for annual payments the taxpayer agreed to (1) maintain already established grass and legume cover for the life of the contract; (2) "[e]stablish perennial vegetative cover on land temporarily removed from agricultural production", including pubescent or intermediate wheatgrass, alfalfa, and sweet clover; and (3) engage in "pest control and pesticide management" for the life of the contract. The taxpayer hired a former tenant farmer to carry out most of the work, but the taxpayer supervised the operation, purchased materials needed to implement the conservation plans, gathered documentation necessary to the CRP payments, arranged for individuals to hunt on some of the properties, and visited the properties several times during the tax years involved. The court held that these activities were sufficient to constitute a trade or business carried on by the taxpayer the income from which was subject to self-employment taxes under § 1402(a)(1). The court indicated that regardless of whether the taxpayer's activities qualified as farming, the taxpayer was directly and through his agent "engaged in the business of participating in the CRP and that he enrolled, maintained, and managed multiple properties subject to CRP contracts with the primary intent of making a profit."

- The court indicated that the analysis in a proposed revenue ruling published in Notice 2006-108, 2006-2 C.B. 118, that would have treated CRP payments as self-employment income, while not controlling, was nevertheless well-grounded and consistent with the court's holding in the case.

- The court also held that the CRP payments were not rental income excluded from self-employment tax by § 1402(a)(1). Although the payments were described as rental in the contract, the court found that the payments were not received in exchange for use or occupancy of the land by the USDA.

7. S corporation distributions to sole shareholder sole employee were wages. Glass Blocks Unlimited v. Commissioner, T.C. Memo. 2013-180 (8/7/13). The IRS classified an S corporation as the employer of Frederick Blodgett, who was its sole shareholder and president. Blodgett advanced funds to the corporation to cover operating expenses during

years of financial difficulty. In each of 2007 and 2008 the corporation distributed $31,000 to Blodgett as repayment of loans. The corporation paid no salary to its shareholder/employee. The Tax Court (Judge Halpern) sustained the IRS's deficiency for employment taxes payable on the distributions. The S corporation did not object to the IRS's characterization of the shareholder as an employee and thus the court held that, "[b]ecause Mr. Blodgett was petitioner's employee for the periods at issue and performed substantial services for it yet it did not pay him a salary, its distributions to him are deemed wages and thus are subject to Federal employment taxes." The court rejected the taxpayer's argument that the advances from the shareholder were loans citing the absence of notes or other instruments, the taxpayer's failure to treat the transfers as loans, and the absence of any interest payments. The court also rejected for lack of evidence the S corporation's assertion that treating the distributions as wages would result in unreasonable compensation to the shareholder. Finally, the court sustained penalties under §§ 6651(a) and 6656 for failure to file employment tax forms and make required deposits.

a. This lengthy summary opinion determines reasonable compensation for an S corporation shareholder. Sam McAlary Ltd. v. Commissioner, T.C. Summary Opinion 2013-62 (8/12/13). McAlary was the sole shareholder and employee of a moderately sized real estate brokerage operated as an S corporation. McAlary and the corporation entered into a compensation contract providing for a $24,000 annual salary. Most of the corporation's gross receipts were attributable to commissions generated by McAlary. The corporation did not issue a W-2 to McAlary nor claim deductions for salary paid to him. The corporation did, however, distribute $240,000 to McAlary. The IRS expert determined, based on a statistical evaluation of similar sized real estate brokerages that McAlary should earn $48.44 per hour and assessed employment taxes on an annual compensation of $100,755, which reduced the corporation's profit margin to slightly in excess of the industry average and represented 19.4 percent of the corporation's gross receipts, again close to industry averages. The court (Special Trial Judge Guy) rejected the contract between the corporation and McAlary as controlling because McAlary sat on both sides of the table during the negotiation. The court also was not persuaded by the IRS expert's statistical analysis noting that reasonable compensation depended on the facts and circumstances identified though a multifactor analysis. Ultimately the court concluded that $40 per hour was reasonable compensation and assessed employment taxes on the basis of $83,200. The court also sustained additions to tax under §§ 6651(a)(1) and 6656 for failure to file and pay employment taxes. The court rejected the taxpayer's reasonable reliance on a tax professional assertion indicating that the taxpayer failed to present evidence that he investigated the background or qualifications of his return preparer/advisor to confirm that the advisor was a competent professional.

8. The minister of his own church under a vow of poverty must still file the right forms. Rogers v. Commissioner, T.C. Memo. 2013-177 (8/1/13). The taxpayer performed ministerial duties for a church he formed. As compensation the church paid the taxpayer's home mortgage (although the taxpayer deducted home mortgage interest against other income), personal credit card bills, and utility payments. The Tax Court (Judge Paris) held that the payments were income includible under § 61 and wages subject to employment tax. The taxpayer was ineligible to claim exemption from employment taxes under § 1402(c)(4) due to his failure to timely file the mandatory exemption certificate required by § 1402(e))(3). The taxpayer was also not allowed to exclude mortgage payments as a rental allowance under § 107 because of the absence of an employment agreement designating payment of a rental allowance as remuneration for services. Finally the court rejected the taxpayer's argument that the payments were not includible under the taxpayer's vow of poverty.

9. The taxpayer is enjoined to pay taxes and follow the law. United States v. Petrie & Sons, Inc., 112 A.F.T.R.2d 2013-5760 (E.D. Wash. 8/7/13). On findings that the taxpayer failed to file employment tax returns, pay employment taxes, does not have sufficient assets to satisfy outstanding tax liabilities of more than $750,000, the IRS is likely to prevail on the merits and will suffer irreparable harm in the absence of preliminary relief, the taxpayer is enjoined from hindering tax law enforcement and specifically to withhold from employee wages as required by law, deposit withholdings in a bank within 72 hours, and is further enjoined from

making any other payments or property transfers until it has made payments to the IRS. In addition, the taxpayer is ordered to inform employees with check writing authority of the injunction and each such employee is required to provide a written acknowledgment to the IRS.

10. Employed and self-employed at the same time. This status exists for all U.S. citizens working for foreign consulates in the United States. Rosenfeld v. Commissioner, T.C. Memo 2011-110 (5/23/11), *aff'd*, 112 A.F.T.R.2d 2013-5638 (9th Cir. 8/8/13) (unpublished opinion). The taxpayer, who maintained a consulting business advising clients on marketing, accepted a three year full-time appointment with the British Consulate General (BCG) to perform services similar to those provided by the taxpayer to private clients. The Tax Court (Judge Dean) held that the taxpayer was an employee of the consulate for withholding purposes and not entitled to separately report income from the engagement on a Schedule C. The court found employee status based on the facts that the taxpayer worked under the control of the BCG, the taxpayer received a fixed salary for his services, and the taxpayer's services furthered BCG's goals. The court described as "neutral" the facts that, although BCG provided an office (whether or not the taxpayer used the office was irrelevant) the taxpayer incurred many costs associated with his work, the taxpayer's three year contract was not defined as long term, and that either party could terminate the relationship without cause. The court also rejected the taxpayer's arguments that he was self-employed because the parties defined the relationship as an independent contractor relationship that specifically provided that the BCG would not withhold taxes, and the taxpayer received no employee benefits and concluded that the taxpayer was a common law employee of BCG.

B. Self-employment Taxes

1. Taxpayer's claimed ministry did not exempt taxpayer's income from self-employment tax. Good v. Commissioner, T.C. Memo 2012-323 (11/20/12). The taxpayer's claimed ministry for Prepare the Way Ministries, formed based on various books about churches and taxes, did not exempt the taxpayer's income from various services from self-employment tax under the minister exception of § 1402(c)(4). Taxpayer's receipts were also otherwise includible in gross income. The Tax Court (Judge Marvel) concluded that the taxpayer failed to provide any credible evidence that he was a minister of a church and held the taxpayer liable for fraud penalties.

2. Local police officers working off-duty security jobs are independent contractors. Specks v. Commissioner, T.C. Memo. 2012-243 (12/11/12). The taxpayer, a Houston police officer, provided off-duty security services in uniform for private companies. The private companies reported the remuneration on Forms 1099. The Tax Court (Judge Kroupa) determined that the taxpayer was an independent contractor subject to self-employment tax. The private parties did not train, supply, or equip the taxpayer in performing the security service, which was performed on an at-will basis. The court concluded that the absence of evidence of control over the taxpayer was to be given greater weight over other factors indicating employee status.

- The court sustained § 6662(a) accuracy-related penalties and indicated that the taxpayer failed to establish under § 664(c) reasonable reliance on a return preparer who was a competent professional with significant expertise and provided all of the relevant information.

C. Excise Taxes

1. The IRS rejects a (former) Court of Claims limitation on retroactive application of rulings. AOD 2012002 (9/12/12). The IRS announced its nonacquiescence in *International Business Machines Corp. v. United States*, 343 F.2d 914 (Ct. Cl. 1965), which held that the IRS could not apply a changed position on an excise tax issue prospectively from the date of revocation to a taxpayer whose erroneous favorable ruling was revoked, but retroactively as to another taxpayer. The Court of Claims in *IBM* held that it was an abuse of discretion to treat two competitors differently with respect to excise taxes on the same type of equipment.

2. Final regulations for the Medical Device Excise Tax. T.D. 9604, Taxable Medical Devices, 77 F.R. 72924 (12/5/12). Final Reg. §§ 48.4191-1 and -2 provide

guidance on the excise tax imposed on the sale of certain medical devices, enacted by the Health Care and Education Reconciliation Act of 2010 in conjunction with the Patient Protection and Affordable Care Act. They define "taxable medical device" and provide for the imposition of the tax at a 2.3 percent rate on manufacturers, producers and importers making sales of such devices.

- The tax is applicable to sales on and after 1/1/13.

a. Notice 2012-77, 2012-52 I.R.B. 781 (12/5/12). The IRS has provided guidance regarding the § 4191 excise tax imposed on the sale of certain medical devises by domestic and foreign manufactures. The notice spells out a methodology for determining a constructive sales price applicable to manufacturers who sell through multiple distribution channels. The notice also exempts the sale price of domestically produced connivance kits for practitioners who install the medical device. Foreign produced convenience kits are subject to the excise tax only to the extent of the value of included taxable medical devices.

- FAQs to the excise tax were released by the IRS on 12/6/12, 2012-TNT 235-22.

3. Excise tax on indoor tanning services. T.D. 9596, Disregarded Entities and the Indoor Tanning Services Excise Tax, 77 F.R. 37806 (6/25/12). Temp. and Prop. Reg. § 1.1361-4T(a)(8)(iii) adds the 10 percent excise tax on indoor tanning services of § 5000B is added to the list of excise taxes for which disregarded entities (QSub or single owner business entity) are treated as separate entities.

a. T.D. 9621, Indoor Tanning Services; Excise Tax, 78 F.R. 34874 (6/11/13). Final Regulations § 49.5000B-1 are promulgated for collection of the 10 percent excise tax on indoor tanning facilities under § 5000B enacted as part of the Affordable Health Care Act. The tax is imposed on amounts paid for indoor tanning services. The final regulations generally adopt provisions in the proposed and temporary regulations. The regulations include an exemption for Qualified Physical Fitness Facilities, the predominant business or activity of which is to serve as a physical fitness facility that does not charge separately for indoor tanning services available at the facility. For other purveyors of indoor tanning, the tax applies to amounts actually paid for indoor tanning services that are provided at a reduced rate. The tax does not apply to services that are obtained by redemption of points through a loyalty program. Where tanning services are bundled with other goods and services, the final regulations set out a formula to determine the amount reasonably attributable to indoor tanning services. With respect to gift cards, the tax is imposed when the card is redeemed specifically to pay for indoor tanning services and not when the card is purchased. The tax is also imposed on prepaid monthly membership and enrollment fees regardless of the services actually provided.

XII. TAX LEGISLATION

A. Enacted

1. The **American Jobs Act of 2011** was orally signed by President Obama on 9/8/11.

a. The **American Taxpayer Relief Act of 2012** ("the 2012 Taxpayer Relief Act" or "the Act"), P.L. 112-240, was signed by President Obama on 1/2/13.

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION