

2005

Recent Developments in Federal Income Taxation: The Year 2004

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Recent Developments in Federal Income Taxation: The Year 2004

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Martin J. McMahon, Jr. **

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**Recent Developments in Federal Income Taxation:
The Year 2004**

By

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Martin J. McMahon, Jr.*

This current developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the year 2004. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail; only the basic topic and fundamental principles are highlighted. Amendments to the Internal Revenue Code generally are not discussed unless they are significant or have led to administrative rulings and regulations that are covered by the outline. The outline focuses primarily on topics of broad general interest: income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, but generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

I. ACCOUNTING

A. Accounting Methods

1. Really kind taxpayer-favorable § 481 adjustments. Rev. Proc. 2002-19, 2002-13 I.R.B. 696 (1/1/02). This revenue procedure modifies Rev. Proc. 97-27, 1997-1 C.B. 680, and Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (1/22/02). It revises the revised rules for obtaining the IRS's consent to changes in accounting methods. The most significant changes to Rev. Proc. 97-27 and Rev. Proc. 2002-9 are: (1) allowing a taxpayer to change its method of accounting prospectively, without audit protection, when the method to be changed is an issue pending for a taxable year under examination or an issue under consideration by either an appeals office or a federal court; and (2) taking negative, i.e., taxpayer-favorable, § 481(a) adjustments into account entirely in the year of change. This revenue procedure was amplified and clarified by Rev. Proc. 2002-54, 2002-35 I.R.B. 432 (8/14/02).

a. And just a little more for taxpayers in the name of simplicity. REG-142605-02, Administration Simplification of Section 481(a) Adjustment Periods in Various Regulations, 68 F.R. 25310 (5/12/03). Proposed amendments to regulations under §§ 263A and 448 to allow taxpayers changing a method of accounting to take any § 481(a) adjustments over the same number of taxable years that is provided in the general guidance provided under Rev. Proc. 92-27, 1997-1 C.B. 680 (as modified and amplified by Rev. Proc. 2002-19, 2002-13 I.R.B. 696, and modified by Rev. Proc. 2002-54, 2002-35 I.R.B. 432) for accounting method changes [four years for positive adjustments and one year for negative adjustments].

(1) Made final. T.D. 9131, Administration Simplification of Section 481(a) Adjustment Periods in Various Regulations, 69 F.R. 33571 (6/15/04). Effective on and after 6/16/04.

b. New regulations provide that a change in depreciation will generally constitute a change in accounting method. T.D. 9105, Changes in Computing Depreciation, 69 F.R. 5 (1/2/04); REG-126459-03, 69 F.R. 42 (1/2/04). These final, temporary and proposed regulations provide that changes in depreciation or amortization are generally changes in accounting method under Reg. § 1.446-1(e). Additionally, these regulations (1) amend Reg. § 1.167(e)-1 to provide that certain changes in depreciation method for property for which depreciation is determined only under § 167 are not changes in accounting method, and (2) amend Reg. § 1.1016-3 to provide that § 1016(a)(2) does not permanently affect a

taxpayer's lifetime income for purposes of determining whether a change in depreciation or amortization is a change in method of accounting.

- The useful life exception to the general rule that a change in depreciation method is a change in accounting applies only to property for which depreciation is determined under § 167. However, a change to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Code, the regulations, or other guidance published in the Internal Revenue Bulletin is a change in method of accounting.

- Other exceptions include (1) a change in computing depreciation allowances made in the year in which the use of property changes in the hands of the same taxpayer, (2) the making of a late depreciation election or the revocation of a timely valid depreciation election, and (3) a change in the placed-in-service date of an asset.

(1) Automatic consent procedure to make a change in method of accounting for depreciable or amortizable property after its disposition. Rev. Proc. 2004-11, 2004-3 I.R.B. 311 (12/30/03). This revenue procedure provides an automatic consent procedure that allows a taxpayer to make a change in method of accounting under § 446(e) for depreciable or amortizable property disposed of in the year of change. This revenue procedure modifies Rev. Proc. 2002-9 (as modified by Rev. Proc. 2002-54, Rev. Proc. 2002-19, Rev. Proc. 2002-33, and as modified and clarified by Announcement 2002-17), and other revenue procedures to conform with Temp. Reg. § 1.446-1T(e)(2)(ii)(d), and waives the application of the two-year rule set forth in Rev. Rul. 90-38, 1990-1 C.B. 57, and holds that one year is sufficient to establish even an erroneous method of accounting.

- Accounting method changes with respect to depreciation may be made so long as the year of sale of the property is open.

2. Credit card issuers may recognize annual fee income ratably over the year under the Ratable Inclusion Method, whether or not the fee is refundable on a pro rata basis should the cardholder close the account during the year. Rev. Proc. 2004-32, 2004-22 I.R.B. 988 (6/1/04). Credit card issuers described in Rev. Rul. 2004-52, i.e., those on the accrual method that charge cardholders a credit card annual fee under agreements that allow each cardholder to use a credit card to access a revolving line of credit to make purchases of goods and services (and, if so authorized, to obtain cash advances), are permitted to use the Ratable Inclusion Method for Credit Card Annual Fees. Under this method a credit card is recognized in income ratably over the period covered by the fee.

a. **If not on the Ratable Inclusion Method, credit card issuers must include annual fees in income when they are due and payable.** Rev. Rul. 2004-52, 2004-22 I.R.B. 973 (6/1/04). This revenue procedure holds that (1) credit card annual fees are not interest for federal income tax purposes, and (2) credit card fees are includible in gross income when they become due and payable under the terms of the credit card agreements. Notwithstanding the holding of this ruling, Rev. Proc. 2004-32 allows issuers to account for annual fee income using the Ratable Inclusion Method for Credit Card Annual Fees, and that revenue procedure also provides automatic consent for a taxpayer to change its method of accounting for annual fee income.

B. Inventories

There were no significant developments regarding this topic during 2004.

C. Installment Method

There were no significant developments regarding this topic during 2004.

D. Year of Receipt or Deduction

1. **Section 461(f) deductions for transfers related to contested liabilities.** T.D. 9095, Transfers to Provide for Satisfaction of Contested Liabilities, 68 F.R. 65634 (11/21/03); REG-136890-02, 68 F.R. 65645 (11/21/03). The Treasury has promulgated temporary regulations and published identical proposed regulations clarifying issues under § 461(f) and coordinating § 461(f) and § 461(h) [the economic performance requirement]. Temp. Reg. § 1.461-2T(c)(1) and Prop. Reg. § 1.461-2(c)(1) provide that the transfer to a trust of the transferor's debt instrument or stock, or the stock or indebtedness of a related person or corporation, does not give rise to a deduction under § 461(f) with respect to a contested liability. Temp. Reg. § 1.461-2T(e) and Prop. Reg. § 1.461-2(e) provide that a payment to a trust to provide for satisfaction of a contested claim with respect to which the economic performance rules of § 461(h) require payment to the claimant – e.g., tort and workers compensation claims, rebates, prizes and jackpots, warranty claims, etc. – will not result in a deduction under § 461(f) so long as the economic performance rules are not satisfied.

a. **Fudging around with § 461(f), especially when combined with economic performance requirements, makes for a “listed transaction.”** Notice 2003-77, 2003-49 I.R.B. 1182 (11/19/03), *clarified*

(12/1/03). Certain contested liability trusts used improperly to attempt to accelerate deductions under § 461(f) are identified as “listed transactions.” These transactions include those involving: (1) retention of powers over the trust assets by the taxpayer; (2) transfers of promissory notes to a trust under circumstances indicating the underlying liability is not genuine; (3 and 4) transfers to trusts for contested tort, workers compensation and similar, liabilities for which economic performance requires payment to the claimant, except where the trust is the person to which the liability is owed or payment to the trust discharges the taxpayer’s liability to the claimant; and (5) transfers of stock of the taxpayer, or indebtedness or stock issued by a party related to the taxpayer, that are made on or after 11/19/03 to a trust purported to be established under § 461(f).

b. Retroactive change in accounting method by filing amended returns is the exclusive procedure for getting out of this box. Rev. Proc. 2004-31, 2004-22 I.R.B. 986 (5/6/04). This revenue procedure sets forth exclusive procedures for obtaining consent to change accounting methods for transfers related to contested liabilities described in Notice 2003-77, which requires that taxpayer amend its return for the year in which the (accelerated) deduction was taken (or the earliest open year if that year is closed) and include the entire § 481(a) adjustment in income in that year.

- While under Rev. Rul. 90-38, 1990-1 C.B. 57, a taxpayer must use an erroneous method for two or more consecutive years to adopt a method of accounting, this procedure requires taxpayers whose transactions were listed to change accounting method.

2. “Hello, I’m from the IRS, and I’m here to help you.” – And this time it really is true. Rev. Proc. 71-21 deferral of prepaid income rules loosened. Notice 2002-79, 2002-50 I.R.B. 964 (12/16/02). This notice is a proposed revenue procedure to modify and supersede Rev. Proc. 71-21, 1971-2 C.B. 549. The proposed revenue procedure would expand the availability of deferred reporting of advance receipts that are not accrued for financial accounting. First, certain income from other than services would be eligible: (1) sales of goods not covered by Reg. § 1.451-5(b)(1)(ii); (2) rents for the use of property in connection with the provision of services, e.g., hotel rooms, recreational facilities, cable converter boxes; (3) royalties for intellectual property; (4) warranties of services or items in the three preceding categories; (5) subscriptions not subject to §455; and (6) memberships not subject to § 456. Second, payments would be eligible even if performance might extend beyond the next succeeding year, although deferral could not extend beyond the next succeeding year. The revenue procedure will not apply to rents generally, insurance premiums, or payments with respect to financial instruments.

a. **Finalizes (with modifications) the proposed procedure first announced in Notice 2002-79. Payments for use of intellectual property are added to the list of payments that may be deferred.** Rev. Proc. 2004-34, 2004-22 I.R.B. 991, *modifying and superseding* Rev. Proc. 71-21, 1971-2 C.B. 549. This revenue procedure permits deferral of income by accrual basis taxpayers, but not beyond the next succeeding tax year.

- Qualifying advance payments include services; goods other than those utilizing §1.451-5; use of intellectual property, i.e., copyrights, patents, trademarks, service marks, trade names, and similar items; occupancy or use of property if ancillary to the provision of services; sale, lease, or license of computer software; guaranty or warranty contracts ancillary to the above items; subscriptions; memberships in an organization; and combinations of the above qualifying items.

- Non-qualifying advance payments include rents; insurance premiums; payments with respect to financial instruments (but see Rev. Proc. 2004-32 allowing deferral for credit card annual fees); payments with respect to certain service warranty contracts; payments subject to withholding; and payments in property for § 83 services.

b. **No deferral for advance rental receipts.** REG-151043-02, Rents and Royalties, 67 F.R. 77450 (12/18/02). The Treasury Department has published a proposed amendment to Reg. § 1.61-8(b) that expressly require current inclusion of advance rent receipts, regardless of the period covered or the taxpayers method of accounting, except as otherwise provided in § 467 or in other published guidance.

(1) **Made final,** T.D. 9135, Rents and Royalties, 69 F.R. 41192 (7/7/04).

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. **Congress might have changed one of the holdings of *Gitlitz*,¹ but the Treasury put another one in the regulations.** T.D. 9080, Reduction of Tax Attributes Due to Discharge of Indebtedness, 68 F.R. 42590 (7/21/03). The Treasury has promulgated Temp. Reg. §§ 1.108-7T and 1.1017-1T(b)(4), dealing with reduction in tax attributes under §§ 108(b)

1. *Gitlitz v. Commissioner*, 531 U.S. 206 (2001). See, Job Creation and Worker Assistance Act of 2002, which reverses the result of *Gitlitz* by providing that excluded cancellation of indebtedness income of S corporations does not result in a § 1366 adjustment to the basis of stock owned by the shareholders.

and 1017 when COD income is excluded from income under § 108(a)(1)(a)-c). Examples (and the preamble) indicate that the tax liability for the year of discharge first must be determined without any reduction in attributes in order to identify the amounts, if any, of the tax attributes that will be reduced. “This ordering rule affords the taxpayer the use of certain of its tax attributes described in section 108(b)(2), including any losses carried forward to the taxable year of discharge, for purposes of determining its tax for the taxable year of discharge, before subjecting those attributes to reduction.” Basis reductions under § 1017 occur at the beginning of the taxable year following the year in which the discharge occurred. If a § 381 transaction ends in a taxable year in which the distributing or transferor corporation excluded COD income under § 108(a), the basis of the property acquired by the acquiring corporation reflects the reduction under § 1017.

a. Temporary regulations are made final. T.D. 9127, Reduction of Tax Attributes Due to Discharge of Indebtedness, 69 F.R. 26038 (5/11/04). In order that the attribute reduction result in a deferral, rather than a permanent elimination, of income, the final regulations provide that the basis of stock or securities of a corporation received by the taxpayer in a § 381(a) transaction is not available for reduction under § 108(b)(2). Final and temporary regulations are effective 5/10/04.

2. This deduction should prove so effective that it will be extended to all business income. Section 102 of the American Jobs Creation Act of 2004 adds new § 199 to provide a nine percent deduction for U.S. manufacturing income, i.e., “income attributable to domestic production activities.” The deduction may not exceed 50 percent of the W-2 wages of the employer for the taxable year. The deduction will be phased in over six years, beginning with 2005.

• The provision was meant to replace the export subsidy that was found illegal by the World Trade Organization, i.e., the deduction of extraterritorial income (ETI), which will be eliminated in 2007 after being phased out in 2005 [80 percent deduction] and 2006 [60 percent deduction].

a. If the statute appears to have a short shelf-life, the guidance under it should be even more ephemeral. Notice 2005-14, 2005-7 I.R.B. 498 (2/14/05). Lengthy guidance on the new manufacturing deduction.

B. Deductible Expenses versus Capitalization

INDOPCO aftermath: “. . . deductions are exceptions to the norm of capitalization . . .” *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992) (Blackmun, J.)

1. Kudos from taxpayers; pans from professors. Treasury abandons the future benefits test of *INDOPCO* – Long live the separate and distinct asset test. Or, do the final regulations go beyond the separate and distinct asset test and interpret *INDOPCO* in a more efficient way? T.D. 9107, Guidance Regarding Deduction and Capitalization of Expenditures, 69 F.R. 436 (1/5/04), making final proposed regulations, REG-125638-01, 67 F.R. 77701 (12/19/02). The Treasury Department promulgated Reg. § 1.263(a)-4 and § 1.263(a)-5, which deal comprehensively with the capitalization of expenditures that relate to intangible assets and “future benefits.” These regulations are commonly referred to as the *INDOPCO* regulations, because they are intended to provide bright-line rules to make the standards based approach to capitalization articulated by the Supreme Court in *INDOPCO* more administrable. However, the regulations more aptly might be called the anti-*INDOPCO* regulations, because they reverse the principle, if not the specific holding of *INDOPCO*.²

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

a. Changing accounting methods for years after 2003 to comply with the final regulations. Rev. Proc. 2005-9, 2005-2 I.R.B. 303 (1/10/05). This procedure is similar to, but not identical with, Rev. Proc. 2004-23.

b. Rev. Proc. 2005-17, 2005-13 I.R.B. 797 (3/28/05). This revenue procedure modifies Rev. Proc. 2005-9 to provide guidance for a taxpayer’s second year ending on or after 12/31/03 [for a calendar year taxpayer, the 2005 year]. This makes the 5-year prior change scope limitation inapplicable to that year.

2. These final regulations are discussed more fully in Shepard & McMahon, “Recent Developments in Federal Income Taxation: The Year 2003,” 6 Fla. Tax Rev. 445, 457-60 (2004) (hereafter, “S&M”).

3. Notice 2004-18, 2004-11 I.R.B. 605 (3/15/04). Comments are sought on the treatment of transaction costs that are to be capitalized under § 263(a) with respect to issues including (1) whether the costs should be treated as giving rise to a new asset or allocated to existing assets, (2) consistent treatment for costs relating to similar taxable and tax-free transactions, and (3) consistent treatment of all capitalized costs that facilitate a transaction regardless of the type of cost.

4. **Would you like to fly on a jet without its engines?** FedEx Corp. v. United States, 91 A.F.T.R.2d 2003-1940 (W.D. Tenn. 4/7/03). The district court denied the taxpayer's motion for summary judgment that expenditures for its off-wing engine maintenance program were deductible repairs under Reg. § 1.162-4. The court found that there was a genuine issue of fact regarding whether the appropriate unit of property for measuring whether the expenditures added value or materially prolonged life was (1) the entire aircraft, as argued by FedEx, or (2) the jet engines and auxiliary power units, as argued by the government. The court concluded that there is no 'entire vehicle' rule of law requiring that repairs be measured against the entire vehicle rather than against components.

a. **You don't have to, at least in Memphis.** FedEx Corp. v. United States, 2003-2 U.S.T.C. ¶ 50,697 (W.D. Tenn. 8/27/03). Taxpayer was permitted to deduct the costs of engine shop visits for jet aircraft engine inspection, heavy maintenance and repair because the relevant unit of property was held to be the entire aircraft, not the engine.

b. **Affirmed by the Sixth Circuit in an unpublished opinion, which holds that engines are part of a jet plane even when they are "off wing."** 2005 TNT 40-19, 2005 U.S. App. LEXIS 2834 (2/16/05). The \$70 million in taxes and accrued interest determined by the IRS having capitalized the costs incurred for "off-wing maintenance" of its jet aircraft engines and auxiliary power units in 1993 and 1994 were improperly collected because FedEx was entitled to deduct "such maintenance costs" as incidental repairs that did not appreciably prolong the life of the aircraft.

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

- Not applicable to years ending on or before 2/6/04.
- Presumably the costs would be currently deductible if they were covered by § 198.

a. Rev. Rul. 2004-17, 2004-8 I.R.B. 516 (2/23/04). Costs paid or incurred in the taxable year to remediate environmental contamination that occurred in prior taxable years do not qualify for treatment under § 1341.

b. Section 308 of the **Working Families Act of 2004** extends the deduction of environmental remediation costs under § 198 for two years through 12/31/05.

6. IRS identifies issues to be addressed in forthcoming proposed regulations on tangible property costs. Notice 2004-6, 2004-3 I.R.B. 308 (1/20/04). These issues include [using the numbering from the Notice]: (1) What general principles of capitalization should be applied? (2) What is the appropriate “unit of property?” (3) What is the starting point for determining whether property value is increased or useful life is prolonged? (11) Should the regulations provide “repair allowance” type rules? (12) Should the regulations provide a *de minimis* rule? (13) When should the “plan of rehabilitation” doctrine be applied? (15) Are there circumstances where tax treatment should follow financial or regulatory accounting treatment?

7. No *INDOPCO* here; no § 162(k) either. Chief Industries v. Commissioner, T.C. Memo. 2004-45 (3/2/04). The taxpayer paid its former president/shareholder over \$3 million to settle various law suits that arose from his removal as president. Contemporaneously, pursuant to the settlement, the taxpayer corporation redeemed the president/shareholder’s stock for over \$40 million. Judge Laro held that the \$3 million settlement was an ordinary and necessary expense deductible under § 162, rather than a capital expenditure under *INDOPCO*, because the origin of the claim was the board of director’s decision to remove the president. Section 162(k) did not bar the deduction because the payment to settle the claims relating to the removal of the president/shareholder were not associated with or related to the redemption.

8. A Solomon-like decision on capitalization. Putnam-Greene Financial Corp. v. United States, 308 F.Supp.2d 1374, 93 A.F.T.R.2d 2004-1049, 2004-1 U.S.T.C. ¶ 50,178 (M.D. Ga. 2/6/04). The taxpayer, a bank holding company, incurred legal fees to defend against suits by minority shareholders in a subsidiary. Legal fees relating to disputes over recapitalization attempts and buy-out prices were held to be capital expenditures, but legal fees seeking damages for general mismanagement of the subsidiary and for failure to

pay dividends were held to be deductible as ordinary and necessary business expenses.

C. Reasonable Compensation

1. **Tax Court distinguishes *Exacto Spring* in case appealable to Seventh Circuit.** Menard, Inc. v. Commissioner, T.C. Memo. 2004-207 (9/16/04), *reconsideration denied*, T.C. Memo. 2005-3 (1/6/05). In this decision, appealable to the Seventh Circuit and presumably governed by the “hypothetical independent investor” test of *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999), Judge Marvel nevertheless used compensation for CEOs of comparable publicly-traded corporations to disallow deduction of \$13 million of the \$20 million of compensation paid to the John R. Menard, the CEO and owner of 89 percent of taxpayer’s stock.

• Judge Marvel relied on language in Reg. § 1.162-7(b)(3) – not discussed in *Exacto Spring* – which provides, “In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.”

a. **On reconsideration**, T.C. Memo. 2005-3 (1/6/05). In denying taxpayer’s motion for reconsideration, Judge Marvel reiterated – as an alternative ground for her decision – that taxpayer did not intend that its payment to Mr. Menard of “5 percent of pretax profits” was “purely for services” in light of (1) its never having paid a dividend, (2) the existence of a reimbursement agreement should any portion of the compensation be found excessive, and (3) the failure of the board of directors to make any effort to evaluate whether the bonus would make Mr. Menard’s total compensation excessive.

2. **Taxpayers who receive W-2 forms that do not correctly reflect income will be penalized for filing returns that reflect the W-2 amounts.** Williams v. Commissioner, 120 Fed. Appx. 289 (10th Cir. 1/26/05). Taxpayer was employed as a staff radiation therapist for a medical corporation owned by two physicians who were married to one another. Taxpayer and her husband became close friends with the physicians. The corporation expanded and opened cancer treatment centers in multiple geographical locations, and taxpayer supervised all of the corporation’s radiation therapists. For the years 1993, 1994 and 1995, taxpayer received payments of \$25,000, \$35,000 and \$35,000 respectively that were not included on her W-2 forms. Taxpayer left her employment in 1996, following the firing of her sister. In early 1997, taxpayer was furnished with corrected W-2 forms that included the payments.

The court held that the payments were not “gifts” because § 102(c) precludes such treatment, and the imposition of the § 6662 negligence penalty was upheld.

D. Miscellaneous Expenses

1. The IRS never seems able to catch up with the movements in the price of gasoline, and more tinkering is in store for 2005. Rev. Proc. 2004-64, 2004-49 I.R.B. 898 (12/6/04), *superseding* Rev. Proc. 2003-76, 2003-43 I.R.B. 924. The optional standard mileage rate for business use of automobiles will increase on 1/1/05 from 37.5 cents per mile to 40.5 cents per mile; the mileage rate for medical and moving will increase from 14 cents per mile to 15 cents per mile; and the mileage rate for giving services to a charitable organization will remain at 14 cents per mile.

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

2. A taxpayer who seeks the safe harbor of a Revenue Procedure can't complain about the anchorage. Boyd v. Commissioner, 122 T.C. 305 (4/27/04). The taxpayer's S corporation trucking company (Continental) paid its drivers' for services on a cents per mile basis, and in lieu of paying other expenses, Continental paid drivers a “per diem” of 9 cents per mile. Continental deducted 80 percent of the payments, but the Commissioner allowed only fifty percent of the per diem under § 274(n), treating the full amount as meal reimbursement. In order for the deduction to be allowed the per diem had to meet the deemed substantiation requirements of Rev. Proc. 94-77, 1994-2 C.B. 825; Rev. Proc. 96-28, 1996-1 C.B. 686, and Rev. Proc. 96-64, 1996-2 C.B. 427. The taxpayer claimed that under § 6.05 of the Revenue Procedures [the fourth sentence of which applies if the per diem was less than the federal M&IE rate] it could treat 40 percent of the per diem as lodging and 50 percent as meal reimbursement, thus allowing an 80 percent deduction. The Tax Court (Judge Vasquez) held that the per diem was treated under § 4.04(2) of the Revenue Procedures as being solely for meals and incidentals because it was computed on the same basis as compensation [cents per mile]. Thus, under § 274(n), only 50 percent of the per diem was deductible. The provisions in the Revenue Procedures treating the per diem as being solely for meals and incidentals because it was computed on the same basis as compensation were not in conflict with § 274(n), and the revenue procedure was not otherwise invalid. Finally, since as in *Beech Trucking Co., Inc. v. Commissioner*, 118 T.C. 428 (2002), the taxpayer was relying on the revenue procedures for deemed substantiation, in the absence of any evidence of actual substantiation, it would not be heard to challenge the conditions in the revenue procedure.

3. **This performance did not impress the Tax Court.** Fleischli v. Commissioner, 123 T.C. 59 (7/14/04). Judge Colvin held that the \$16,000 AGI limitation in § 62(b)(1)(C) for qualified performers to take above-the-line deductions is based on total AGI from all sources, not merely on AGI from performing business. The taxpayer earned more than \$16,000 as a part-time lawyer, and earned \$13,435 and incurred \$17,878 of expenses as a part-time actor. The statutory limitation is constitutional.

4. **“It’s a bird, it’s a plane . . .” What is a credit default swap?** Notice 2004-52, 2004-32 I.R.B. 168 (8/9/04). The IRS has requested information on credit default swaps in connection with requests for further guidance. Possible analogues include contingent options, financial guarantees, standby letters of credit and insurance contracts. Suggestions also include *sui generis* classification.

5. Section 307 of the **Working Families Act of 2004** extends the above-the-line \$250 deduction for K-12 teachers’ supplies through 12/31/05. As before, no deductions for books or cucumbers by PE and health education teachers.

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

- The amount is indexed for inflation, and for 2004 the maximum deduction is \$102,000 and the phase-out begins at \$410,000 of § 179 property placed in service. For 2005, the indexed amounts are \$105,000 and \$420,000, respectively. See Rev. Proc. 2004-71, 2004-50 I.R.B. 970.

7. Section 907 of the **American Jobs Creation Act of 2004** amends § 274(c) to limit the deduction for personal use by corporate officers of corporate aircraft or other corporate facilities to the amount the officer included as compensation. This reverses the holding to the contrary in *Sutherland Lumber-Southwest, Inc. v. Commissioner*, 114 T.C. 197, *aff’d*, 255 F.3d 495 (8th Cir. 2001). The amendment is applicable to expenses incurred after the date of enactment (10/22/04).

E. Depreciation & Amortization

1. **Regulations on 50 percent bonus depreciation.** T.D. 9091, Special Depreciation Allowance, 68 F.R. 52986 (9/8/03); REG-157164-02, Special Depreciation Allowance, 68 F.R. 53008 (9/8/03). The Treasury has promulgated Temporary Regulations [Temp. Reg. § 1.167(a)-14T (dealing with qualified intangible property); Temp. Reg. § 1.168(k)-1T (dealing with tangible

property)] and published identical proposed regulations [Prop. Reg. § 1.167(a)-14; Prop. Reg. § 1.168(k)-1T] dealing with first year bonus depreciation under § 168(k).

2. Changes in use change MACRS depreciation. REG-138499-02, Changes in Use Under Section 168(i)(5), 68 F.R. 43047 (7/21/03). The Treasury has published comprehensive proposed regulations to provide rules for determining MACRS depreciation under § 168 when the taxpayer changes the use of the property. Changes in use include: (1) a conversion of personal use property to a business or income-producing use, (2) conversion from business or income-producing to personal use, or (3) a change in use that results in a different recovery period, depreciation method, or both. The regulations will be effective when finalized. Any reasonable method will be acceptable for changes after 12/31/86 and before final regulations are published. However, current Reg. § 1.167(g)-1 limits the depreciable basis of property converted from personal to business use to its fair market value at the time of the conversion.

a. Revised proposed regulations made temporary. T.D. 9115; REG-106590-00; REG-138499-02, Changes in Use Under Section 168(i)(5), 69 F.R. 9529 & 9560 (3/1/04). The Treasury has published final, temporary and proposed regulations that render obsolete Notice 2000-4, 2000-1 C.B. 313, and withdraw Prop. Reg. §§ 1.168(a)-1 and 1.168(b)-1 (that were contained in the July 2003 proposed regulations).

b. And made final. T.D. 9132, Changes in Use Under Section 168(i)(5), 69 F.R. 33840 (6/17/04). Effective 6/17/04.

3. For depreciation of property received in a § 1031 exchange or § 1033 replacement, see III.B., below.

4. Treasury makes life a little happier for SUV salesmen. T.D. 9133, Depreciation of Vans and Light Trucks, 69 F.R. 35513 (6/25/04), *making final* T.D. 9069, 68 F.R. 40129 (7/7/03). Final and temporary regulations applicable to property placed in service on or after 7/7/03. Provides that a truck or van is not subject to the § 280F(a) limits if it is a qualified nonpersonal use vehicle as defined in Reg. § 1.274-5T(k). Effective 7/7/03.

a. But not for salesmen of expensive SUVs. Section 910 of the **American Jobs Creation Act of 2004** amends § 179 to reduce the SUV deduction to \$25,000 for SUVs placed in service after 10/22/04.

5. King Kong might have been able to move them, so they're not inherently permanent. PDV America, Inc. v. Commissioner, T.C. Memo. 2004-118 (5/12/04). Judge Marvel held that petroleum storage tanks, holding as

much as 151,000 barrels and weighing as much as 1 million pounds [some of in fact had been in place 60 years] are not inherently permanent structures, because they sometimes are moved, with only minimal damage, for purposes of environmental remediation or repairs. Accordingly, the tanks were in asset class 57.0, Distributive Trades and Services, of Rev. Proc. 97-56, 1987-2 C.B. 686, and treated as 5-year property, rather than asset class 57.1, Distributive Trades and Services – Billboard, Service Station Buildings and Petroleum Marketing Land Improvements. [Pursuant to § 1245(a)(3)(E), storage facilities used in the distribution of petroleum products are § 1245 property.]

6. Section 211 of the American Jobs Creation Act of 2004 amends § 168 to provide for a 15-year recovery period for depreciation of qualified leasehold improvements and qualified restaurant property placed in service between 10/23/04 and 12/31/05. Generally, the improvements and property must be in buildings that are at least three years old.

7. Fifteen-year amortization for pre-opening and organizational expenses, except for deductibility of the first \$5,000. Section 902 of the **American Jobs Creation Act of 2004** amends §§ 195, 248 and 709 to provide for a deduction of the first \$5,000 of costs in each category in the year that amortization would have begun. Amounts not deductible are to be amortized over 15 years. The deduction is phased out dollar-for-dollar as the amount in each category exceeds \$50,000.

F. Credits

1. New final research credit regulations retain the requirement that experimentation “must be an evaluative process . . . capable of evaluating more than one alternative.” They validate the old joke: “How’s your wife?” ‘Compared with whom?’” T.D. 9104, Credit for Increasing Research Activities, 69 F.R. 22 (1/2/04). Final regulations generally retain the provisions of December 2001 proposed regulations. The rules for internal-use software are not included in these regulations, but are the subject of an advanced notice of proposed rulemaking.³

a. Section 301 of the Working Families Act of 2004 extends the research credit for 18 months until 12/31/05.

G. Natural Resources Deductions & Credits

1. Tax Court holding reversed by the Eighth Circuit: 7-year recovery period for gathering pipelines. Clajon Gas. Co. LP v.

3. These regulations are discussed more fully at S&M, *supra* note 2, at 471-74.

Commissioner, 354 F.3d 786, 93 A.F.T.R.2d 2004-396, 2004-1 U.S.T.C. ¶50,123 (8th Cir. 1/12/04). The Eighth Circuit followed the Tenth Circuit's *Duke Energy* decision and the Sixth Circuit's *Saganaw Bay Pipeline* decisions, and permits gathering pipelines to be depreciated over 7 years.⁴

H. Loss Transactions, Bad Debts and NOLs

1. Graves v. Commissioner, T.C. Memo. 2004-140 (6/15/04). Judge Gerber held that a § 166 business bad debt deduction arising from employee's loan to employer to help preserve salary income was an employee business deduction that was a miscellaneous itemized deduction subject to the 2 percent of AGI floor of § 67.

2. **Maximizing the availability of post-bankruptcy NOLs.** Benton v. Commissioner, 122 T.C. 353 (5/12/04). The taxpayer filed a chapter 11 bankruptcy petition in 1995 and the plan, which included a continuing liquidating trust, was confirmed in 1997. Judge Gerber held for the taxpayer in allowing the taxpayer to apply his pre-bankruptcy NOLs, as well as the bankruptcy estate's NOLs, to which he succeeded under § 1398(i) to 1995, 1996, and 1997. For purposes of § 1398(i), the chapter 11 bankruptcy terminated when the plan was confirmed and the debtor's discharge was granted [1997], not on the later date on which a final order was entered. Section 1398(g) barring a carryback to pre-petition years does not bar a carryback to the year the bankruptcy petition was filed or years the bankruptcy was pending. The taxpayer could apply the NOLs – subject to the period limits in § 172 based on the source years of the losses – to the year the bankruptcy was commenced and the year the bankruptcy was pending, as well as using NOLs in the year the proceeding terminated.

3. **South Carolina has a sharply defined public policy against gambling – except, of course state sponsored gambling.** Hackworth v. Commissioner, T.C. Memo. 2004-173 (7/22/04). The taxpayer operated an illegal gambling operation in South Carolina. After the local sheriff's office seized cash proceeds of the gambling operation, which were forfeited under state law, the taxpayer claimed a § 165 loss deduction. The Commissioner disallowed the loss on public policy grounds, and Judge Cohen upheld the Commissioner's position because allowing the deduction would frustrate a sharply defined policy of the state of South Carolina. [The opinion fails to note that the State of South Carolina sponsors a state lottery. Perhaps the sharply defined public policy that was violated was a restraint on competition.]

4. The background to this case is set forth more fully at S&M, supra note 2, at 474-75.

I. At-Risk and Passive Activity Losses

1. **Sooner or later, all amounts borrowed from your partner will not increase amount at-risk.** REG-209377-89, At-Risk Limitations; Interest Other Than That of a Creditor, 68 F.R. 40583 (7/8/03). Section 465(b)(3) provides that amounts borrowed for use in an activity do not increase the borrower's amount at risk in an activity listed in § 465(c)(1) [(1) motion-picture films or videotapes; (2) farming; (3) leasing § 1245 property; (4) oil and gas resources and geothermal deposits] if the lender has an interest other than that of a creditor in the activity or if the lender is related to a person (other than the borrower) who has a disqualifying interest in the activity. Section 465(c)(3)(D) provides that § 465(b)(3) applies to activities to which § 465 is extended by § 453(c)(3)(A) – all other business and profit seeking activities – only to the extent provided in regulations; *Alexander v. Commissioner*, 95 T.C. 467 (1990), *aff'd by order sub nom. Stell v. Commissioner*, 999 F.2d 544 (9th Cir. 1993), held that until regulations were issued, §465(b)(3) does not apply to activities other than those described in § 465(c)(1). Revisions to Prop. Reg. § 1.465-8 and 1.465-20 would apply § 465(b)(3) to the activities described in § 465(c)(3)(A). The regulation will be effective when finalized.

a. **Proposed regulations are made final.** T.D. 9124, At-Risk Limitations; Interest Other Than That of a Creditor, 69 F.R. 24078 (5/3/04). The regulation applies to amounts borrowed after 5/3/04. There are exceptions for amounts borrowed from a related person that are “qualified nonrecourse financing,” and for amounts borrowed from a related person that would have been “qualified nonrecourse financing” had the borrowing been nonrecourse.

III. INVESTMENT GAIN

A. Capital Gain and Loss

1. **“The purpose of narrowly construing the term capital asset under the substitute for ordinary income doctrine is to ‘protect the revenue against artful devices’ that undermine the Revenue Code’s standard treatment of ordinary income and capital gains. [*P.G. Lake*, 356 U.S. [260 (1958)]. That is precisely what Maginnis has attempted here.”** *United States v. Maginnis*, 356 F.3d 1179, 93 A.F.T.R.2d 2004-660, 2004-1 U.S.T.C. ¶ 50,149 (9th Cir. 1/30/04), *aff'g* 2002-1 U.S.T.C. ¶ 50,494 (D. Ore. 5/28/02). The taxpayer won \$9 million in the Oregon lottery, payable over 20 years in \$450,000 installments. After receiving 5 installments, he sold his remaining 15 installments for \$3,950,000. After reporting the sales proceeds as ordinary income, he sought a refund based on the claim that the sales proceeds were capital gain. The court (Judge Fisher) held that the right to payments was not a

“capital asset” for purposes of § 1221, because (1) the taxpayer did not make any underlying capital investment and (2) there was no accretion in value over time. Judge Fisher rejected the argument that cost of the lottery ticket was an “investment,” on the grounds that the underlying transaction was a gambling transaction for tax purposes. He concluded that “Maginnis’ sale of his lottery right is almost indistinguishable from the paradigmatic situation in which the substitute for ordinary income doctrine removes a right to future income from the definition of a capital asset, which occurs when a taxpayer assigns his right to future income from employment to a third party for a lump sum.”

- The court also rejected the taxpayer’s argument that *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), mandates that § 1221 be read broadly, because the Court in *Arkansas Best* expressly held that its decision did not affect the way in which the substitute for ordinary income doctrine modifies the term capital asset.

- Finally, the court also rejected the taxpayer’s argument that because he sold his entire right to the lottery payments [a “vertical slice”], instead of merely a carved-out income stream [a “horizontal slice”], the income was capital gain. “[A] transaction in which a taxpayer sells his entire interest in an underlying asset without retaining any property right does not automatically prevent application of the substitute for ordinary income doctrine.”

2. Judge Goeke says *McAllister* is no longer good law. Clopton v. Commissioner, T.C. Memo. 2004-95 (4/6/04). The taxpayer sold 20 of 22 remaining payments to which he was entitled as a winner of Texas lottery. Judge Goeke held that the sales proceeds were ordinary income, not capital gains, following *Davis v. Commissioner*, 119 T.C. 1 (2002) and *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004). He declined to follow *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), not on the grounds that it was distinguishable because in that case the taxpayer had sold all of her rights to future payments, but on the grounds that *McAllister* was stripped of precedential value by the subsequent Supreme Court decision in *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958) (holding that a present money substitute for future ordinary income is not a capital gain).

3. The stock is still in the box. Rev. Rul. 2004-15, 2004-8 I.R.B. 515 (2/23/04). When a taxpayer who has sold stock short satisfies the obligation to the broker from the taxpayer borrowed the stock with stock borrowed from another broker, the transfer of the borrowed stock does not close the short sale under Reg. § 1.1233-1(a). Because replacing the obligation to one broker with an obligation to another does not close the short sale, the transfer does not cause the § 1259 transition rule for short sales before the close of the 30-day period beginning on August 5, 1997 to cease to apply to either the short sale or stock in the box.

4. **The negative side of estate tax valuation discounts.** Janis v. Commissioner, T.C. Memo. 2004-117 (5/12/04). The taxpayers inherited an art gallery that held in inventory a large number of paintings by famous artists [e.g., Jean Arp, Piet Modrian, Grandma Moses]. In prior administrative proceedings, the estate had succeeded in applying a blockage discount in valuing the items for estate tax purposes. In this income tax case involving determination of the cost of goods sold, Judge Cohen upheld applying a “blockage” discount to determine the § 1014 basis of the inventory. In addition to applying the blockage discount on the merits of the fair market value issue, Judge Cohen found that the taxpayers were bound by the duty of consistency because as executors of the estate they had agreed to the amount of the blockage discount in determining the estate tax value.

5. Coleman v. Commissioner, T.C. Memo. 2004-126 (5/25/04). Judge Gerber held that payments under an unexpired covenant not to compete that are payable and received after the decedent’s death are IRD under § 691(a) and ineligible for a § 1014 step-up in basis. The receipts remain ordinary income to the heirs.

B. Section 1031

1. **Depreciation for MACRS property acquired in a § 1031 exchange of MACRS property, or acquired in replacement of involuntarily converted MACRS property to which § 1033 applies.** Notice 2000-4, 2000-3 I.R.B. 313. To the extent the taxpayer’s basis in the acquired MACRS property does not exceed the taxpayer’s adjusted basis in the exchanged or involuntarily converted MACRS property, the acquired property is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, the exchanged or involuntarily converted property. Any additional basis in the acquired property is treated as newly purchased MACRS property. [This is the same method as provided for ACRS property in Prop. Reg. §1.168-5(f) (1984).] Effective for acquired MACRS property placed in service on or after January 3, 2000, in a like-kind exchange of MACRS property under § 1031 or as a result of an involuntary conversion of MACRS property under § 1033. For property acquired before January 3, 2000, taxpayers who treated the entire basis as new MACRS property may continue to do so, or may change accounting methods to conform.

a. **Temporary regulations.** T.D. 9115, REG-106590-00 and REG-138499-02, Depreciation of MACRS Property That Is Acquired in a Like-Kind Exchange or as a Result of an Involuntary Conversion, 69 F.R. 9529 (3/1/04). The Treasury has published final, temporary and proposed regulations that render obsolete Notice 2000-4, 2000-1 C.B. 313, and withdraw Prop. Reg. §§ 1.168(a)-1 and 1.168(b)-1 (that were contained in the July 2003 proposed

regulations). Under these temporary and proposed regulations, generally the exchanged basis is depreciated over the remaining recovery period of, and using the depreciation method of, the relinquished MACRS property if the useful life of the replacement property is the same or shorter than the relinquished property. If the replacement property has a longer useful life, depreciation is computed as if the replacement property had originally been placed in service when the relinquished property was placed in service by the acquiring taxpayer. Any excess basis is treated as property placed in service in the year the acquiring taxpayer places it in service. There are specific rules for deferred exchanges and reverse exchanges, as well as for automobiles.

2. No “parking” of your own property. Rev. Proc. 2004-51, 2004-33 I.R.B. 294 (8/16/04), *modifying* Rev. Proc. 2000-37, 2000-2 I.R.B. 308. Provides that the safe harbor provision of Rev. Proc. 2000-37 does not apply to reverse like-kind “parking” arrangements if the taxpayer owns the property intended to qualify as replacement property within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an exchange accommodation titleholder.

3. No gain exclusion if taxpayer exchanges investment property for a rent house he later moves into and sells two years later – until five years have elapsed from the date of the exchange. Section 839 of the **American Jobs Creation Act of 2004** adds new § 121(d)(10) to make the § 121 exclusion of gain on the sale of a principal residence inapplicable to any property acquired in a § 1031 exchange within five years of the sale.

4. Exclusion of gain under §§ 121 and 1031 when a single property is both a personal residence and a business or investment property. Rev. Proc. 2005-14, 2005-7 I.R.B. 528 (2/14/05) (as corrected). Provides guidance on how a homeowner can exclude gain on the sale or exchange of a home under § 121 and also defer gain from a like-kind exchange on the same property under § 1031. This guidance also clarifies that the property can be used consecutively or concurrently as a home and a business, i.e., use as rental property or an office in the home, respectively. Detailed examples are included.

5. Nonrecognition denied – Caught by a targeted anti-abuse rule. Rev. Rul. 2002-83, 2002-49 I.R.B. 927 (12/9/02). Individual A owned highly appreciated real property held for investment (Property 1) and individual B, related to individual A within the meaning in § 267(b), owned real property (Property 2), which was not appreciated. In a multiparty like-kind exchange A and B each transferred their properties to a qualified intermediary. C, an unrelated purchaser of Property 1, transferred cash to the qualified intermediary, who transferred Property 2 to A, Property 1 to C, and the cash to B. The IRS

ruled that pursuant to § 1031(f), a taxpayer – A – who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under § 1031(a) if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property. Based on the legislative history [H.R. Rep. No. 101-247 at 1340 (1989)], the IRS reasoned that the purpose of §1031(f) is to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. Accordingly, the IRS applied § 1031(f)(4) because the multi-party exchange was “part of a transaction (or a series of transactions) structured to avoid the purposes of § 1031(f)(1).”

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

C. Section 1041

1. A sensible ruling that favors § 1041 over the assignment of income theory on the transfer of vested stock options and vested nonqualified deferred compensation incident to divorce. Rev. Rul. 2002-22, 2002-19 I.R.B. 849 (5/13/02). This ruling held that: (1) a taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer’s former spouse incident to divorce is not required to include an amount in gross income upon the transfer, and (2) the former spouse, and not the taxpayer, is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

- The ruling stated,

Similarly, applying the assignment of income doctrine in divorce cases to tax the transferor spouse when the transferee

spouse ultimately receives income from the property transferred in the divorce would frustrate the purpose of § 1041 with respect to divorcing spouses. That tax treatment would impose substantial burdens on marital property settlements involving such property and thwart the purpose of allowing divorcing spouses to sever their ownership interests in property with as little tax intrusion as possible. Further, there is no indication that Congress intended § 1041 to alter the principle established in the pre-1041 cases such as *Meisner v. United States*, 133 F.3d 654 (8th Cir. 1998)] that the application of the assignment of income doctrine generally is inappropriate in the context of divorce.

- The ruling also cited *Hempt Bros., Inc. v. United States*, 490 F.2d 1172 (3d Cir. 1974), by way of analogizing § 1041 to § 351.

This ruling does not apply to transfers of property between spouses other than in connection with divorce. This ruling also does not apply to transfers of nonstatutory stock options, unfunded deferred compensation rights, or other future income rights **to the extent such options or rights are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer.** See *Kochansky v. Commissioner*, 92 F.3d 957 (9th Cir. 1996). [Emphasis added]

- This ruling clarified that Rev. Rul. 87-112, 1987-2 C.B. 207, which held that § 1041 did not apply to accrued interest on transferred U.S. savings bonds that were subsequently cashed in, was based on § 454 rather than on assignment of income principles.

- Query whether the non-employee spouse will be required to follow this ruling? Perhaps, the divorce decree or separation agreement should address this issue. However, the IRS would be required to follow this ruling regardless of what position the non-employee spouse takes.

- a. Notice 2002-31, 2002-19 I.R.B. 908. Proposes that FICA/FUTA taxes on exercise of stock options and distribution of deferred compensation be imposed as if the income was that of the employee spouse.

- b. **Rev. Rul. 2002-22 and Notice 2002-31 are clarified.** Rev. Rul. 2004-60, 2004-24 I.R.B. 1051 (6/14/04). The options and deferred compensation remain subject to employment taxes as if the employee spouse had retained them but the employee portion of the FICA taxes is deducted from the payment to the nonemployee spouse. Income recognized by the

nonemployee spouse with respect to the exercise of the nonstatutory stock options is subject to § 3402 withholding at the flat rate of 25 percent and is also to be deducted from the payments to the nonemployee spouse.

2. Division of military retirement pay in a divorce is taxed the same as a QDRO.⁵ Pfister v. Commissioner, 359 F.3d 352, 93 A.F.T.R.2d 2004-1113, 2004-1 U.S.T.C. ¶ 50,176 (4th Cir. 2/27/04). The taxpayer was awarded one-half of her former husband's military retirement pay pursuant to a divorce decree, as permitted by the Uniformed Service's Former Spouses' Protection Act. She claimed the receipts were excludable under § 1041. The Court of Appeals (Judge Gregory) affirmed the Tax Court's holding that the receipts were gross income to the recipient former spouse; § 1041 did not apply to receipt of the payments [although it would apply to the initial division of property rights in the pension].

D. Section 1042

1. CPAs have to get that § 1042 nonrecognition election right before the due date of the return. Estate of John W. Clause v. Commissioner, 122 T.C. 115 (2/9/04). The taxpayer [before he died] sold all of his shares of a corporation he controlled to the corporation's ESOP and purchased qualified replacement property [under § 1042(c)(4)] with most of the proceeds from the sale within a year of the sale. He did not report the transaction on his original return, but after an audit was commenced, he filed an amended return indicating that certain proceeds from the sale had been reinvested in qualified replacement property, but which did not contain the written statement required by § 1042(b)(3), which is a requirement to obtain nonrecognition. He subsequently filed a second amended return that to which was attached a statement that he elected nonrecognition under § 1042. Section 1042(c) provides that the election must be made on a return filed by the due date [with extensions]. Temp. Reg. § 1.1042-1T imposes a number of detailed procedural rules for form and content of the statement required under § 1042(c), none of which the taxpayer complied. Judge Haines held that Temp. Reg. § 1.1042-1T was a valid legislative regulation and that the taxpayer was not entitled to nonrecognition because he failed properly to comply with the procedural requirements of § 1042 and Temp. Reg. § 1.1042-1T. Neither the "substantial compliance" doctrine nor the fact that the taxpayer relied on his CPA to file his return saved the day for the taxpayer.

5. Under § 402(e)(1) a former spouse who receives a distribution pursuant to a "qualified domestic relations order" (QDRO), as defined in § 414(p), is treated as an alternative beneficiary of the plan who is taxable on distributions from the qualified plan under §§ 402(a) and 72.

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. Guidance on Health Savings Accounts. Notice 2004-2, 2004-2 I.R.B. 269 (12/23/03). The IRS has issued guidance in Q&A form on Health Savings Accounts under new § 223 (added by § 1201 of the **Medicare Prescription Drug Improvement, and Modernization Act of 2003**). This guidance provides basic information about HSAs. This new provision offers health spending accounts without the “use it or lose it” requirement of health FSAs.

a. Notice 2004-23, 2004-15 I.R.B. 725 (4/12/04). The notice provides a safe harbor for preventive care benefits allowed to be provided by a high deductible health plan (“HDHP”) without satisfying the § 223(c)(2) minimum deductible. Preventive care under the safe harbor includes “annual physicals” (including tests and diagnostic procedures), routine prenatal and well-child care, child and adult immunizations, tobacco cessation programs, obesity weight-loss programs and a long list of “screening services” (for cancer; heart and vascular diseases; infectious diseases; mental health conditions and substance abuse; metabolic, nutritional and endocrine conditions; musculoskeletal disorders; obstetric and gynecologic conditions; pediatric conditions; and vision and hearing disorders); however it does not generally include any service or benefit intended to treat an existing illness, injury or condition.

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

(1) Notice 2004-43, 2004-27 I.R.B. 10 (7/6/04). This notice provides transition relief for plans that include state-mandated first-dollar coverage. These plans would not be disqualified for that reason alone for months before 1/1/06, provided that the state law was in effect on 1/1/04.

(2) Notice 2004-50, 2004-33 I.R.B. 196 (8/16/04). This notice provides that any treatment that is incidental or ancillary to a preventive care service or screening described in Notice 2004-23 also falls within the safe harbor for preventive care.

b. Notice 2004-25, 2004-15 I.R.B. 727 (4/12/04). This notice provides general transition relief for 2004 from the requirement that qualified medical expenses may be paid or reimbursed by an HAS only if they

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

c. The inability to get general prescription drug coverage is the sticking point for many potential users of HSAs. Rev. Rul. 2004-38, 2004-15 I.R.B. 717 (4/12/04). An individual who had prescription drug coverage that was not subject to the annual deductible of the HDHP is not eligible to make contributions to (or have his employer make contributions to) an HSA.

(1) Rev. Proc. 2004-22, 2004-15 I.R.B. 727 (4/12/04). This revenue procedure provides transition relief for the months before 2006 for an individual who is covered by both an HDHP and a separate plan or rider that provides drug benefits on a co-pay basis or in some other manner before the minimum annual deductible of the HDHP is met.

d. Rev. Rul. 2004-45, 2004-22 I.R.B. 971 (6/1/04). This ruling provides guidance on the interactions of the HSA rules with the rules concerning health flexible spending arrangements (“health FSA”) (under Prop. Reg. § 1.125-1, Q&A 7) and health reimbursement arrangements (“HRA”) (under Notice 2002-45, 2002-2 C.B. 93). An individual can be eligible for making HSA contributions while being covered by a limited-purpose health FSA or HRA, a suspended HRA, a post-deductible health FSA or HRA, or a retirement HRA.

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

B. Qualified Deferred Compensation Plans

1. The employer can pay administrative expenses allocable to current employees, while stiffing former employees. Rev. Rul. 2004-10, 2004-7 I.R.B. 484 (1/19/04). A qualified deferred compensation plan does not fail to satisfy the requirements of § 411(a)(11) merely because it charges reasonable plan administrative expenses to the accounts of former employees and their beneficiaries on a pro rata basis, but does not charge the accounts of current employees.

2. Plan qualification after sale of a subsidiary. Rev. Rul. 2004-11, 2004-7 I.R.B. 480 (1/19/04). Tax consequences of the sale of a subsidiary on its defined benefit pension plan and its employee profit-sharing plan with

respect to the nondiscrimination requirements of § 401(a)(4) and the minimum coverage requirements of § 410(b).

3. If you roll it over, you can take it out whenever you want to. Rev. Rul. 2004-12, 2004-7 I.R.B. 478 (1/29/04). If an eligible retirement plan separately accounts for amounts attributable to rollover contributions, distributions of amounts attributable to these rollover contributions are generally permissible at any time pursuant to the individual's request (with spousal consent, if applicable).

4. If a plan is sweetened beyond a CODA with safe harbor matching, Dolly Parton may well smother it in her warm embrace. Rev. Rul. 2004-13, 2004-7 I.R.B. 485 (1/29/04). A profit-sharing plan containing a cash or deferred arrangement with safe harbor matching contributions meets the requirements of § 416(g)(4)(H) and is not subject to the top-heavy rules. However, (1) adding employer-provided discretionary nonelective contributions, (2) allocation of forfeitures to participants' accounts, or (3) deferring matching contributions for newly hired nonhighly compensated employees who make elective contributions will result in the plan becoming subject to the top-heavy rules.

5. The Pension Funding Equity Act of 2004, establishes a temporary replacement for the benchmark 30-year Treasury bond interest rate for use in determining funding liabilities of pension plans.

a. Notice 2004-34, 2004-18 I.R.B. 848 (4/12/04). This notice provides interim guidance on the determination of the weighted average interest rate under § 412(b)(5)(B)(ii)(III) and ERISA § 302(b)(5)(B)(ii)(III).

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

period if the beneficiary is a spouse more than 10 years younger than the employee. Payments after the death of the employee or participant may be made over the life expectancy of the beneficiary designated by the close of the year following the participant's death.

a. Regulations are final, with temporary regulations also. T.D. 8987, Required Distributions From Retirement Plans, 67 F.R. 18988 (4/17/02). The final regulations retain the simplifications to the minimum distribution rules for separate accounts provided in the 2001 proposed regulations, including the calculation of the MRD during the individual's lifetime using a uniform table (which is changed in the final regulations to reflect updated mortality calculations). The final regulations change the date for determining the designated beneficiary to September 30 of the year following the year of the employee's death (to permit sufficient time to calculate the MRD before the end of the year). The temporary regulations provide a number of changes to the annuity rules in the proposed regulations, which merely reflected the 1987 proposed regulations. Effective for 2003 and following calendar years; for determining minimum distributions for the 2002 year, taxpayers may rely on the final regulations, the 2001 proposed regulations, or the 1987 proposed regulations.

b. Final regulations make modifications, but retain the basic rules contained in the April 2002 temporary regulations. T.D. 9130, Required Distributions From Retirement Plans, 69 F.R. 33288 (6/15/04). These regulations are effective 6/15/04, and apply for purposes of determining required minimum distributions for calendar years beginning on or after 1/1/03.

7. Think twice before you sign blank documents. Armstrong v. United States, 366 F.3d 622, 93 A.F.T.R.2d 2004-2098, 2004-1 U.S.T.C. ¶ 50,238 (8th Cir. 5/3/04). The taxpayer borrowed money from a bank to pay his children's college expenses. He intended to pledge a life insurance policy, but was in a hurry and signed blank loan documents, intending to deliver the life insurance contract later. While he was out of town, his employee delivered qualified retirement plan annuity contracts to the bank, which completed the documents based on the retirement annuity contracts. The Court (Judge Heaney) held that the collateral assignment of the qualified retirement plan annuity contracts was valid and thus constituted a distribution to the taxpayer under § 72(p)(1).

8. Cumulative list of changes in plan qualification requirements. Notice 2004-84, 2004-52 I.R.B. (12/14/04). This notice contains the 2004 Cumulative List of Changes in Plan Qualification Requirements, which reflects changes to plan qualification requirements and remedial amendment periods.

9. Comprehensive final regulations on matching contributions and employee contributions to 401(k) plans update the final regulations issued in 1991. T.D. 9169, Retirement Plans; Cash or Deferred Arrangements Under Section 401(k) and Matching Contributions or Employee Contributions Under Section 401(m) Regulations, 69 F.R. 78144 (12/29/04). These are comprehensive final regulations that provide guidance on the requirements (including the nondiscrimination requirements) for cash or deferred arrangements under § 401(k) and for matching contributions and employee contributions under § 401(m).

a. “Mr. Gotbucks, meet Senator Roth.” REG-152354-04, Designated Roth Contributions to Cash or Deferred Arrangements Under Section 401(k), 70 F.R. 10062-02 (3/2/05). Proposed regulations relating to an election under § 402A that will be available beginning in 2006 for employees to designate contributions to a 401(k) plan made under a qualified cash-or-deferred arrangement as Roth contributions. These contributions will be currently includible in gross income but qualified distributions will be excludable from gross income.

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

1. The IRS says that the modification of a recourse note given by an employee upon the exercise of a stock option would result in compensation income, not discharge of indebtedness income. Rev. Rul. 2004-37, 2004-11 I.R.B. 583 (2/26/04). When an employee exercises a nonstatutory stock option by using a recourse note with interest not less than the AFR on the date the note is issued, compensation income is measured by the difference between the value of the stock and the stated principal amount of the note. If, in a later year, the principal amount of the note is reduced, the amount of the reduction is treated as additional compensation income under § 83, not as cancellation of indebtedness income under § 108, which could purportedly be excluded from gross income under § 108(e)(5) and treated as a reduction in purchase price. The rules of Reg. § 1.1001-3 are applied in determining whether a significant modification occurred.

• Note *Denny v. Commissioner*, 33 B.T.A. 738 (1935), which held that a loan that ripened into a bonus in a later year constituted income in that year. After so holding, Judge Arundell further stated: “The case here is much like that where one receives as compensation property encumbered by a mortgage to the full value of the property. In that situation there would be no income in the year of the receipt. Upon cancellation of the mortgage by the transferor in a subsequent year there would be income to the recipient, and the result would be the same whether the cancellation be regarded as the forgiving of indebtedness or as property then freed for the first time from restriction on use.”

2. Section 885 of the **American Jobs Creation Act of 2004** adds new § 409A which significantly modifies the taxation of nonqualified deferred compensation plans for amounts deferred after 2004 (a) by requiring that deferred compensation may not be distributed earlier than separation from service, disability, death, a specified time (or pursuant to a fixed schedule), on change of control (to be defined in regulations) or “the occurrence of an unforeseeable emergency;” (b) by requiring that the first deferral election be made before the beginning of the year in which the services are performed (or, if contingent compensation, at least six months before the end of the year in which the services are performed), and (c) by prohibiting acceleration of benefits except as permitted by regulations. Changes in the time and form of distribution, so-called “second [deferral] elections” will have to be made at least twelve months before the payment was to have been made, and must postpone the payment for at least five years from the date it otherwise would have been made. Additionally, offshore rabbi trusts are not permitted.

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

- Even more restrictive special rules apply to officers, directors and ten-percent shareholders of publicly-held corporations and to persons holding the same positions in non-publicly held corporations.

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

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

a. **Section 409A guidance provides transition rules and excludes stock appreciation rights from the purview of that section.** Notice 2005-1, 2005-02 I.R.B. 274 (12/20/04). This notice provides in Q&A form the first part of what is intended to be a series of guidance with respect to the application of § 409A. Significant is the exclusion of stock appreciation rights from coverage by § 409A where the SAR can only be satisfied with stock provided that the exercise price is not less than the market price on the day the SAR was granted and the underlying stock is traded on an established securities market. In addition, general transition rules and reporting requirements are provided in the notice.

D. Individual Retirement Accounts

There were no significant developments regarding this topic during 2004.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. Section 101 of the **Working Families Tax Relief Act of 2004** extends the reductions in the child tax credit, marriage penalty relief [standard deduction and the top of the 15-percent bracket], and the 10 percent rate bracket.

a. Section 102 continues for one more year the relief from AMT of personal tax credits.

b. Section 103 extends the increase in AMT exemption amount for one year through 2005.

2. **Dividends received are to be taxed at capital gains rates.** The Jobs and Growth Tax Relief Reconciliation Act of 2003 added § 1(h)(11), which provides that dividends received by taxpayers other than corporations generally will be taxed at the same rate as long-term capital gains, i.e., 15 percent for taxpayers otherwise taxable at a rate greater than 15 percent; and five percent for taxpayers otherwise at 10 or 15 percent (with a special zero percent rate for 10- and 15-percent bracket taxpayers in 2008). This rate applies to dividends received from domestic and qualified foreign corporations for purposes of both the regular tax and the alternative minimum tax. A dividend is treated as investment income for purposes of determining the amount of deductible investment interest under § 163(d) only if the taxpayer elects to treat the dividend as not eligible for the reduced rates. The provision is effective for taxable years beginning after 12/31/02, and beginning before 1/1/09.

• If a shareholder does not hold a share of stock for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date (as measured under section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property. **Note** that the 60-day holding period cannot be satisfied by stock that is acquired one day before the ex-dividend date. This anomaly is to be retroactively corrected in the Tax Technical Corrections Bill (H.R. 3654), which was introduced by Ways & Means Committee Chair Thomas and Ranking Minority Member Rangel. 2003 TNT 236-1.

a. **Let's pretend it has been already corrected for the Spring 2004 Filing Season.** IR-2004-22 (2/19/04). The IRS announced it agreed to make the provisions of § 2 of the Tax Technical Corrections Act of 2003, related to dividends, available to taxpayers in advance of its passage. These include an increase of the 120-day period to 121 days, as well as

permitting passthrough entities that received dividends in fiscal years beginning in 2002 to treat as qualifying dividends those qualifying dividends received in 2003.

b. It is finally corrected in October. Section 402(a)(2) of the **Working Families Tax Relief Act of 2004** does, indeed, correct that glitch.

B. Miscellaneous Income

1. Home-made alimony. Dato-Nodurft v. Commissioner, T.C. Memo. 2004-119 (5/17/04). Payments under a written support agreement qualified as alimony even though the husband and wife, who were living apart, were not legally separated and the agreement was not enforceable under state law.

2. Prejudgment interest in a personal injury lawsuit is not excluded from income. Chamberlain v. United States, 401 F.3d 335, 95 A.F.T.R.2d 2005-1069, 2005-1 U.S.T.C. ¶ 50,194 (5th Cir. 2/18/05). Prejudgment interest recovered in a personal injury lawsuit is not excluded from income under § 104(a)(2) because it was compensation for the lost time value of money and is not received “on account of” the personal injury.

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

C. Profit-Seeking Individual Deductions

1. The alternative minimum tax (“AMT”) trap for attorneys’ fees on large recoveries will continue to be an issue despite legislation and a Supreme Court decision.

a. Cases decided by a majority of courts in recent years sprang the AMT trap. Attorney’s fees incurred by an individual in a nonbusiness profit-seeking transaction are [§ 212] miscellaneous itemized deductions [§ 67] and may not be deducted for AMT purposes. To avoid this result, taxpayers in a number of cases in recent years have argued the portion of a taxable damage award retained by the taxpayer-plaintiff’s attorney as a contingent fee is excluded from the taxpayer-plaintiff’s income and treated as income earned directly by the attorney. Generally, the Tax Court and most circuits hold that attorney’s fee awards paid directly to a plaintiff’s attorney [or the portion of a damage award that is the attorney’s contingent fee that is so

paid] are nevertheless includable in the litigant's gross income, and that the taxpayer then may claim a deduction, subject to any applicable limitations, including disallowance of the deduction for AMT purposes if it is a § 212 deduction. *Bagley v. Commissioner*, 105 T.C. 396 (1995), *aff'd* 121 F.3d 393 (8th Cir. 1997). *Accord Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995), *aff'g* 30 Fed. Cl. 248 (1993); *Alexander v. IRS*, 72 F.3d 938, 96-1 U.S.T.C. ¶ 50,011 (1st Cir. 1995), *aff'g* T.C. Memo. 1995-51 (1/31/95); *Coady v. Commissioner*, 213 F.3d 1187, 2000-1 U.S.T.C. ¶ 50,528 (9th Cir. 2000), *aff'g* T.C. Memo. 1998-291 (8/6/98); *Benci-Woodward v. Commissioner*, 219 F.3d 941, 2000-2 U.S.T.C. ¶ 50,595 (9th Cir. 2000), *aff'g* T.C. Memo. 1998-395 (11/9/98), *cert. denied*, 531 U.S. 1112 (2001); *Kenseth v. Commissioner*, 259 F.3d 881, 88 A.F.T.R.2d 2001-5378, 2001-2 U.S.T.C. ¶ 50,570 (7th Cir. 8/7/01), *aff'g* 114 T.C. 399 (5/24/00) (reviewed, 8-5); *Young v. Commissioner*, 240 F.3d 369, 87 A.F.T.R.2d 2001-889, 2001-1 U.S.T.C. ¶ 50,244 (4th Cir. 2/16/01), *aff'g*, 113 T.C. 152 (8/20/99); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312, 88 A.F.T.R.2d 2001-7983, 2002-1 U.S.T.C. ¶ 50,351 (10th Cir. 12/19/01), *aff'g* T.C. Memo. 2000-180 (6/12/01), *cert. denied*, 535 U.S. 1056 (5/13/02); *Raymond v. United States*, 355 F.3d 107, 93 A.F.T.R.2d 2004-416, 2004-1 U.S.T.C. ¶ 50,124 (2d Cir. 1/13/04).

b. But the Eleventh Circuit relied on state (attorneys' lien) law and held that attorney's fees were not included in the client's recovery. *Davis v. Commissioner*, 210 F.3d 1346, 2000-1 U.S.T.C. ¶ 50,431 (4/27/00) (per curiam), *aff'g* T.C. Memo. 1998-248 (7/7/98). Willa Mae Davis recovered \$151,000 of compensatory damages and \$6 million of punitive damages against two companies that made loans to homeowners in Alabama. Her share of the recovery after legal fees and expenses was \$3,039,191. In *Davis*, which was appealable to the Eleventh Circuit, the Tax Court followed *Cotnam* under the *Golsen* rule because under *Bonner v. City of Prichard, Alabama*, 661 F.2d 1206 (11th Cir. 1981), Fifth Circuit decisions rendered before the Eleventh Circuit was created are binding precedent in the Eleventh Circuit.

● In *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959) (2-1), Wisdom, J. dissenting), the Fifth Circuit held that attorney's fees paid directly to a plaintiff's attorney are not includable by the litigant. The majority reasoned that under the Alabama attorney's lien law, the ownership of the portion of the award representing attorney's fees vested in the attorney *ab initio*.

● This view was followed by the Sixth and Ninth Circuits in *Estate of Clarks v. United States*, 202 F.3d 854, 85 A.F.T.R.2d 2000-405, 2000-1 U.S.T.C. ¶ 50,158 (6th Cir. 1/13/00) (Michigan law), and *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 8/27/03), *rev'g* T.C. Memo. 2002-5 (1/8/02) (Oregon law), *rev'd sub nom Commissioner v. Banks*, 125 S. Ct. 826, 2005-1 U.S.T.C. ¶ 50,155 (U.S. 1/24/05).

(1) Banaitis v. Commissioner, 340 F.3d 1074 (9th Cir. 8/27/03), *rev'g* T.C. Memo. 2002-5. In a case involving attorney's fees subject to Oregon attorney's fee lien law, the Ninth Circuit (Judge Thomas) held the portion of a taxable damage award (for wrongful discharge from employment) retained by the attorney as a contingent fee was not includable in the taxpayer-plaintiff's gross income. Judge Thomas found that the nature of the attorney's fee lien was determinative. Examining relevant state law, he concluded that under Oregon law, the attorney's claim to the fee was even stronger than under Alabama law. Therefore he applied the Fifth Circuit's decision in *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir.1959), holding that contingent attorney's fees paid directly to an attorney were not includable in the client's gross income because Alabama attorney's fee lien law vested title in the attorney *ab initio*. Judge Thomas declined to apply the Ninth Circuit's precedents in *Benci-Woodward v. Commissioner*, 219 F.3d 941, 943 (9th Cir.2000), *cert. denied*, 531 U.S. 1112 (2001), and *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir.2000), on the grounds that Oregon attorney's fee lien law was significantly different than that of California and Alaska, which were relevant in those cases.

- In his opinion, Judge Thomas described the Fifth Circuit as having "reached a similar conclusion about the operation of Texas law" in *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000), and the Eleventh Circuit as "extending *Cotnam's* Alabama-law- based holding into the law of the entire Eleventh Circuit" in *Foster v. United States*, 249 F.3d 1275, 1278 (11th Cir. 2001), notwithstanding that in *Srivastava* the Fifth Circuit actually reached its conclusion wholly apart from the niceties of Texas attorney's lien law and in *Foster* the Eleventh Circuit was dealing with a case that arose in Alabama, for which there was no doubt that *Cotnam* was the controlling precedent. [The Eleventh Circuit has not yet decided an attorney's fees AMT trap case arising in Florida or Georgia.].

c. **The Fifth and Sixth Circuits held that attorney's fees were not included in the client's recovery under a national standard regardless of the particulars of state attorneys' lien law.** Srivastava v. Commissioner, 220 F.3d 353, 2000-2 U.S.T.C. ¶ 50,597 (5th Cir. 2000) (2-1), *rev'g* T.C. Memo 1998-362 (10/6/98), *overruled by* Commissioner v. Banks, 125 S. Ct. 826 (1/24/05). A majority of the court held that *Cotnam* applied to attorneys' fees under Texas law because there is no difference in the "economic reality facing the taxpayer-plaintiff" between Alabama and Texas attorney's liens and any distinction between them does not affect the analysis required by the anticipatory assignment of income doctrine. A dissent by Judge Dennis distinguished *Cotnam* on the ground that Alabama law gives the holders of attorney's liens greater power than does Texas law.

(1) **And the Sixth Circuit followed the national standard in *Banks*.** Banks v. Commissioner, 345 F.3d 373, 92 A.F.T.R.2d

2003-6298 (6th Cir. 9/30/03), *rev'd and remanded by Commissioner v. Banks*, 125 S. Ct. 826 (1/24/05). The Sixth Circuit followed the Fifth Circuit's decision in *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000), and reaffirmed that the Sixth Circuit's holding in *Estate of Clarks v. Commissioner*, 202 F.3d 854 (6th Cir. 2000), the decision was based on a broader principle than the ground that state attorney's fee lien law determines whether the taxpayer-plaintiff can exclude attorney's fees. The taxpayer, who lived in Michigan when he filed his Tax Court petition, but who had previously been employed in California and had settled a wrongful termination suit brought in California for taxable tort damages under California law, was allowed to exclude the contingent attorney's fees, even though they were governed by California law and the Ninth Circuit would have reached a contrary conclusion under *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000).

d. The Supreme Court reverses *Banks* and *Banaitis* and decides the AMT trap issue in favor of the government, following the majority of courts that have faced this issue. *Commissioner v. Banks*, 125 S. Ct. 826, 2005-1 U.S.T.C. ¶ 50,155 (U.S. 1/24/05) (8-0) (consolidated with *Banaitis*). Justice Kennedy's unanimous opinion held that a contingent fee agreement should be viewed as an anticipatory assignment of income to the attorney by the client. He relied on the assignment of income doctrine cases, e.g., *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst*, 311 U.S. 112 (1940), and found this doctrine to be relevant in arm's length transactions as well as family transactions, stating, "We hold that, as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee." The Court ruled that the attorney-client relationship was governed by agency law, and not by partnership law (although, later in the opinion, it refused to rule on the partnership argument because it was raised too late).

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

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

provision applies to judgments and settlements occurring after the date of enactment.

- Left open are attorney's fees relating to recoveries for consumer fraud, defamation and possibly employment contract disputes. as well as punitive damages and taxable interest in personal injury cases.

D. Hobby Losses and Section 280A Home Office and Vacation Homes

1. **Section 183 sent the claimed loss deduction to Davy Jones's locker.** Magassy v. Commissioner, T.C. Memo. 2004-4 (1/5/04). Judge Swift applied § 183 to disallowing a claimed § 1231 loss on the sale of a yacht.

E. Deductions and Credits for Personal Expenses

1. **Deduct some of those retirement community costs as medical expenses, but not the swimming pool. Does this result in whipsaw for the IRS?** Baker v. Commissioner, 122 T.C. 143 (2/19/04). If a taxpayer pays a monthly life-care fee to a retirement home, the portion of the fee that the taxpayer proves is for medical care is deductible as a medical expense. This case addressed the question of the proper method for allocating fees paid to a long-term care facility between deductible medical expenses and nondeductible personal living expenses. Relying on Rev. Rul. 67-185, 1967-1 C.B. 70, Rev. Rul. 75-302, 1975-2 C.B. 86, and Rev. Rul. 76-481, 1976-2 C.B. 82, Judge Goeke approved the taxpayer's use of the "percentage method," and declined to require the taxpayer to use the more complex "actuarial method" advocated by the Commissioner. The percentage method assumes that the medical care portion of entrance fees and monthly service fees is the same portion or percentage as the [continuing care retirement community's] medical expenses to total costs because the sum of the fees over the resident's lifetime is expected to cover the costs of care for residents in a CCRC. Based on several revenue rulings, the court held that there is "no requirement . . . that taxpayers engage in an actuarial analysis to factor in life expectancy and health care level expectancy on the basis of the residency population of a CCRC to determine estimated lifetime medical care costs and total costs." The burden of proof on the issue had been shifted to the Commissioner under § 7491 because the taxpayer had presented credible evidence to support the amount claimed as a deduction and had met all of the other statutory requirements.

2. **The AMT kicks New Yorkers again.** Ostrow v. Commissioner, 122 T.C. 378 (5/21/04). Judge Colvin held that the § 56(b)(1) disallowance for AMT purposes of taxes deductible under § 164 extends to taxes on a cooperative housing corporation that are deductible by the shareholder-tenant under § 216.

3. **We now have a uniform definition of “child;” can we now get a uniform definition of “married?”** Sections 201-208 of the **Working Families Tax Relief Act of 2004** provides a uniform definition of “child” for head of household, dependent care credit, child tax credit, earned income tax credit, and dependent exemption purposes. Forms 8332 would not be required by the non-custodial parent when the shifting to that parent of the dependency deduction is provided for in the divorce decree or separation agreement.

F. Education

There were no significant developments regarding this topic during 2004.

VI. CORPORATIONS

A. Entity and Formation

1. Rev. Rul. 2004-59, 2004-24 I.R.B. 1050 (5/25/04). A partnership that converts to a corporation under a state law formless conversion statute will be deemed to contribute all its assets and liabilities to the corporation in exchange for stock in such corporation, and immediately thereafter, the partnership liquidates distributing the stock of the corporation to its partners. This is the same method provided by Reg. § 301.7701-3(g)(1)(i) when a partnership elects to be classified as an association.

● Rev. Rul. 84-111, 1984-2 C.B. 88, which permits selection among the three methods of incorporating a partnership, provided that the steps described are actually undertaken. Rev. Rul. 84-111 superseded and revoked Rev. Rul. 70-598, 1970-2 C.B. 168, which had held that partnership incorporations would be treated for tax purposes as if the partnership transferred assets to the corporation in exchange for stock.

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

B. Distributions and Redemptions

1. **The Tax Court is bearish on Merrill Lynch.** Merrill Lynch & Co., Inc. v. Commissioner, 120 T.C. 12 (1/15/03). In 1986 and 1987 Merrill Lynch structured several transactions to sell certain assets of first-tier and second-tier subsidiaries not only eliminate any tax on the gains, but to create losses. To take advantage of the interaction of the consolidate return regulations

and § 304 [before the promulgation of Reg. § 1.1502-80(b), rendering § 304 inoperative in consolidated returns], Merrill Lynch caused the subsidiaries holding the assets to drop the assets to be retained into new lower level subsidiaries [in § 351 transactions], following which the new subsidiaries were sold cross chain to other Merrill Lynch subsidiaries. The sales proceeds were then distributed to its parent by the subsidiary to be sold, and that subsidiary was then sold. The plan was that the cross-chain sale would be recharacterized as a dividend under § 304, which would result in a basis increase under Reg. §§ 1.1502-32 and -33 [as then in effect] in the stock of the subsidiaries to be sold. The IRS did not contest that § 304 applied, but responded that the “distributions” coupled with the sales of the subsidiaries outside the group were part of a firm and fixed plan by the subsidiaries that were sold outside the group to dispose of the stock of the lower tier subsidiaries that had been sold cross chain. Therefore, even after applying § 304 the distributions were treated as amounts received in a redemption under § 302(b)(3) [applying *Zenz v. Quinlivan*, 213 F.2d 913 (6th Cir. 1954)]. The Tax Court (Judge Marvel) held that under the principles of *Niedermeyer v. Commissioner*, 62 T.C. 280 (1974), a firm and fixed plan existed with respect to every such sale and held for the IRS.

The record establishes that on the dates of the cross-chain sales, petitioner had agreed upon, and had begun to implement, a firm and fixed plan to completely terminate the target corporations’ ownership interests in the issuing corporations (the subsidiaries whose stock was sold cross-chain). The plan was carefully structured to achieve very favorable tax basis adjustments resulting from the interplay of section 304 and the consolidated return regulations, and the steps of the plan were described in detail in written summaries prepared for meetings of Merrill Parent’s board of directors. As described in those written summaries, the cross-chain sales of the issuing corporations’ stock and the sales of the target corporations were part of the same seamless web of corporate activity intended by petitioner to culminate in the sale of the target corporations outside the consolidated group.

a. As is the Second Circuit, which affirmed the Tax Court. 386 F.3d 464, 94 A.F.T.R.2d 2004-6119, 2005-1 U.S.T.C. ¶ 50,243 (2d Cir. 9/28/04). The Second Circuit affirms the Tax Court conclusions but remands for consideration of a new issue advanced for the first time on appeal. This issue was that, by reason of the § 318 attribution rules, the cross-chain sales did not terminate the interest of Merrill Lynch within the meaning of § 302(b)(3).

2. Pushing the envelope on complete termination. Hurst v. Commissioner, 124 T.C. 16 (2/3/05). The taxpayer pushed the envelope on a classic § 302(b)(3) complete redemption by a closely held corporation controlled by his children, and succeeds even though he retained a security interest in the redeemed shares, he continued to own the corporation's headquarters building, and (especially) his wife continued to be an employee of the corporation under a 10-year employment contract (under which she and her husband continued to receive medical insurance). It was significant that taxpayer's wife never owned stock in the corporation.

C. Liquidations

There were no significant developments regarding this topic during 2004.

D. S Corporations

1. S corporation stock rolled over from an ESOP to an IRA does not disqualify the S election if the stock is repurchased on the same day. Rev. Proc. 2004-14, 2004-7 I.R.B. 489 (2/17/04). The rollover distribution of S corporation stock by an ESOP to a participant's IRA will not affect the corporation's S election if the stock is immediately repurchased from the IRA by the S corporation or the ESOP.

2. Daisy-chain loans don't represent an economic outlay. Oren v. Commissioner, 357 F.3d 854, 93 A.F.T.R.2d 2004-858, 2004-1 U.S.T.C. ¶ 50,165 (8th Cir. 2/12/04), *aff'g* T.C. Memo. 2002-172 (7/19/02). The taxpayer was the controlling shareholder of three S corporations, one of which (Dart) passed-through substantial income, and the others of which (Highway Leasing and Highway Sales) passed-through losses in excess of the taxpayers basis [due to depreciation on leveraged depreciable equipment]. The taxpayer sought to utilize the losses by creating basis in Highway Leasing and Highway Sales through a series of circular loan transactions: the taxpayer borrowed money from Dart, which he lent to Highway Leasing and Highway Sales on terms identical to the terms of the loans from Dart to the taxpayer, following which Highway Leasing and Highway Sales lent the funds to Dart. In the Tax Court, Judge Ruwe held that the loans had no economic substance and that Oren had not made any "economic outlay." Thus, except to the extent of \$200,000 lent from his own personal assets, Oren did not acquire basis in the promissory notes from Highway Leasing and Highway Sales against which the losses could be deducted. Furthermore, the circular loan arrangement was a "loss limiting arrangement" under § 465(b)(1) because there was no "any realistic possibility of loss" by Oren because the facts did not indicate that the circular chain of payment could be broken. Judge Ruwe rejected the possibility that the chain of

payment might be broken by a tort judgment against one of the corporations in excess of its large insurance coverage.

• The Court of Appeals affirmed. Oren's loans to Highway Leasing and Highway Sales had no economic substance and, thus, were not real economic outlays, even though all of the formalities necessary to create legal obligations were followed. No external parties were involved and the transactions were not at arm's length. Oren was in the same position after the transactions as before. The transactions resembled offsetting book entries or loan guarantees more than substantive investments. Furthermore, Oren was not at-risk under § 465. The possibility that he would suffer at loss was remote because he was protected by the circular nature of the loan transactions. "The 'theoretical possibility that the taxpayer will suffer economic loss is insufficient to avoid the applicability of [§ 465].'"

3. REG-131486-03, Adjustment To Net Unrealized Built-in Gain, 69 F.R. 35544 (6/25/04). Proposed regulations under § 1374 provide guidance for an adjustments to net unrealized built-in gain in certain cases in which an S corporation acquires assets from a C corporation in an acquisition to which § 1374(d)(8) applies. Treasury rejected an approach that would provide for a single determination of NUBIG for all of the assets of an S corporation in favor of an approach that adjusts the NUBIG of the pool of assets that included the stock of the liquidated or acquired C corporation to reflect the extent to which the built-in gain or loss inherent in the C corporation stock is eliminated.

4. **It just keeps gett'n tougher and tougher to be an S corporation shareholder when bankruptcy is in the air.** Williams v. Commissioner, 123 T.C. 144 (7/22/04). The taxpayer owned all of the stock of two calendar year S corporations that incurred losses for the year. He filed a personal bankruptcy petition at the beginning of December and reported a pro rata share of the losses on his personal return. The Commissioner disallowed the passed through losses on the grounds that § 1377 [allocating losses on a per share per day basis] did not apply and that § 1398 allocated all of the losses to the bankruptcy estate. Judge Kroupa upheld that Commissioner's position, reasoning that "[u]nder § 1398(f)(1) a transfer of an asset from the debtor to the bankruptcy estate when the debtor files for bankruptcy is not a disposition triggering tax consequences, and the estate is treated as the debtor would be treated with respect to that asset." Thus the bankruptcy estate was treated as if it had owned all of the shares of the S corporations for the entire year and was entitled to all of the passed-through losses. [The Tax Court reached the same conclusion with respect to a bankrupt partner in a partnership passing through losses in *Gully v. Commissioner*, T.C. Memo. 2000-190.] Furthermore, any passed-through losses to which the bankruptcy estate succeeded, or losses that were passed through to the bankruptcy estate, and which were not used to offset income realized by the bankruptcy estate, pursuant to § 108(b)(2) were reduced

by the amount of COD income that was not recognized under § 108(a) before being passed on to the taxpayer pursuant to § 1398(i) upon termination of the bankruptcy proceeding.

a. Compare the situation where it is the S corporation that goes into bankruptcy. *Mourad v. Commissioner*, 121 T.C. 1 (7/2/03), *aff'd*, 387 F.3d 27, 94 A.F.T.R.2d 2004-6440, 2004-2 U.S.T.C. ¶ 50,419 (1st Cir. 10/20/04) *as amended*, (1st Cir. 11/20/04). When an individual's wholly-owned S corporation filed for a bankruptcy chapter 11 plan of reorganization [and an independent trustee was appointed by the Bankruptcy Court] the individual remained liable for the tax on any income or gain recognized by the S corporation.

5. Rev. Rul. 2004-85, 2004-33 I.R.B. 189 (7/16/04). If an S corporation that owns a QSub engages in an "F" reorganization, the QSub election does not terminate. But if the QSub stock is sold or transferred in a reorganization that does not qualify as an "F" reorganization, then the election terminates. An entity classification election described in Reg. §301.7701-3(b) does not terminate solely because the owner transfers all of the membership interest in the eligible entity to another person.

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

- This means that a shareholder and his fifth cousin are members of the same family. This would have the effect of making the entire population of Arkansas members of the same family. Research on this issue should most easily be done in the Mormon Church archives located in Salt Lake City.

- Query whether this provision could be used to capitalize an S corporation with subscriptions from thousands of shareholders, the stock of which would be readily marketable to members of the 100 families.

a. The maximum number of shareholders is increased from 75 to 100. Section 232 of the **American Jobs Creation Act of 2004** amends § 1361 to increase the number of eligible shareholders from 75 to 100.

7. Section 233 of the **American Jobs Creation Act of 2004** amends § 1361 to permit IRAs to be shareholders of bank S corporations.

a. Section 237 of the **American Jobs Creation Act of 2004** amends § 1362 to exclude investment securities income from the passive income test for bank S corporations.

8. **This change is not really needed because members of the same family are counted as a single shareholder**, § 234 of the **American Jobs Creation Act of 2004** amends § 1361 to disregard unexercised powers of appointment in determining potential current beneficiaries of an ESBT.

9. Section 235 of the **American Jobs Creation Act of 2004** amends § 1366 to permit transfers of suspended losses between spouses incident to divorce.

10. Section 236 of the **American Jobs Creation Act of 2004** amends § 1361 to permit use of passive activity loss and at-risk amounts by QSST beneficiaries.

11. Section 238 of the **American Jobs Creation Act of 2004** amends § 1362 to provide relief from inadvertently invalid Q-Sub elections and terminations.

a. **Information returns to be required for Q-Subs.** Section 239 of the **American Jobs Creation Act of 2004** amends § 1361 to provide for Q-Sub treatment with respect to information returns.

12. Section 240 of the **American Jobs Creation Act of 2004** amends § 4975 to provide that the repayment by S corporations of loans for qualifying employer securities will not be treated as violating employment plan rules nor will they be prohibited transactions.

E. Affiliated Corporations

1. **Schizophrenic temporary regulations for consolidated group discharge of indebtedness income and reduction of attributes.** T.D. 9089, Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group, 68 F.R. 52487-03 (9/4/03). The Treasury has promulgated temporary regulations under § 1502, amending Temp. Reg. § 1.1502-19T(b) and (h), Temp. Reg. § 1.1502-21T(b), and Temp. Reg. § 1.1502-32T and adding Temp. Reg. § 1.1502-28T, governing the application of § 108 when a member of a consolidated group realizes discharge of indebtedness income. The regulations provide that the amount of discharge of indebtedness income excluded from gross income in the case in which the debtor-corporation is insolvent is determined based on the assets and liabilities of only the member with discharge of indebtedness income. However, applying

an interpretation of *Dominion Industries, Inc. v. United States*, 532 U.S. 822 (2001), the regulations provide that the group's consolidated attributes in their entirety are subject to reduction under §108(b), but the attributes attributable to the debtor member are the first attributes reduced. The regulations also adopt a look-through rule that applies if the debtor member's attribute that is reduced is the basis of stock of another group member. In this case, corresponding adjustments are made to the attributes attributable to the lower-tier member. Identical proposed regulations have been published. 68 F.R. 52542-01 (9/4/03).

a. Temporary regulations are amended. T.D. 9098, Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group, 68 F.R. 69024-01 (12/11/03). Temp. Reg. § 1.1502-28T(a)(4) provides that when a member of a consolidated group realizes COD income excluded under § 108(a), after the reduction of the tax attributes attributable to the debtor member under § 108(b), tax attributes attributable to other members other than the debtor member (other than asset basis) that arose in a separate return year or that arose (or are treated as arising) in a separate return limitation year to the extent that no SRLY limitation applies to the use of such attributes by the group are subject to reduction. Generally effective 8/29/03.

b. Temporary and proposed regulations address issues related to § 1245, the § 1.1502-13 matching rules and excess loss accounts. T.D. 9117, Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group, 69 F.R. 12069-01 (3/15/04); REG-167265, Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group; Computation of Taxable Income When Section 108 Applies to a Member of a Consolidated Group, 69 F.R. 12091-01 (3/15/04). The temporary and proposed regulations provide rules to preclude inclusion in consolidated taxable income amounts reflecting previously excluded COD income more than once, albeit as ordinary income where attributable to § 1245 property. They also provide that if the basis of an intercompany obligation held by a creditor member is reduced in respect of excluded COD income, Reg. § 1.1502-13(c)(6)(i) will not apply to exclude income of the creditor member attributable to the basis reduction. The proposed regulations include rules for the computation of that portion of an excess loss account that must be taken into income, as well as its timing.

2. Consolidated return regulations may prescribe results for corporations filing consolidated returns different from the results for corporations filing separate returns. But if the *Rite Aid* holding is not changed, what does this provision mean? Section 844(a) of the American Jobs Creation Act of 2004 amends § 1502 by providing that the consolidated return regulations may contain "rules that are different from the provisions of

chapter 1 that would apply if such corporations filed separate returns.” Section 844(b) of the **American Jobs Creation Act of 2004** provides that “[n]otwithstanding the amendment made by subsection (a), the Internal Revenue Code of 1986 shall be construed by treating Treasury Regulation § 1.1502-20(c)(1)(iii) (as in effect on January 1, 2001) as being inapplicable to the factual situation in *Rite Aid Corporation and Subsidiary Corporations v. United States*, 255 F.3d 1357 (Fed. Cir. 2001).”

3. The definition of “controlled group” is expanded. Section 900 of the **American Jobs Creation Act of 2004** amends § 1563 to expand the definition of controlled group of corporations for purposes of multiple use of the lower tax rates on the first \$75,000 of taxable income. The requirement that 80 percent of the stock be owned by 5 or fewer shareholders has been eliminated.

4. Loss limitation rules are provided in temporary and proposed regulations. T.D. 9118, Loss Limitation Rules, 69 F.R. 12799-01 (3/18/04); REG-153172-03, Loss Limitation Rules, 69 F.R. 12811-01 (3/18/04). Temporary regulation amendments relate to the deductibility of losses under the temporary regulations under § 337(d) and the anti-duplication temporary consolidated returns regulations relating to the claiming of a worthless stock deduction with respect to a subsidiary’s stock. The proposed regulations cross-reference the temporary regulations.

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

b. Regulations are now final. T.D. 9187, Loss Limitation Rules, 70 F.R. 10319-01 (3/3/05). These final regulations under §§ 337(d) and 1502 follow the rules described in Notice 2004-58.

F. Reorganizations

1. Notice 2004-44, 2004-28 I.R.B. 32 (6/22/04). This notice requests comments on Rev. Proc. 81-70, 1981-2 C.B. 729, which sets forth guidelines on estimating the basis of stock acquired by an acquiring corporation in a B reorganization. The request is prompted by concern that changes in the marketplace since 1981, i.e., changes in the way stock is held today, may prevent access to the information necessary to determine shareholders’ bases in such stock.

2. Rev. Rul. 2004-78, 2004-31 I.R.B. 108 (7/13/04). Target merges into an acquiring corporation in an A reorganization, and in the merger target shareholders exchange their stock for common stock in the acquiring corporation and holders of target securities exchange their target debt for debt of the acquiring corporation. The debt instruments had two years remaining on their term, and were identical except for the interest rate. Held, the debt is a security, which may be exchanged tax-free under § 354.

- Query how Reg. § 1.1001-3 applies to what would be a “significant modification” were this exchange of debt within a single corporation?

3. Rev. Rul. 2004-83, 2004-32 I.R.B. 157 (7/16/04). If, pursuant to an integrated plan, a parent corporation sells the stock of a wholly owned subsidiary for cash to another wholly owned subsidiary and the acquired subsidiary is completely liquidated into the acquiring subsidiary, the transaction is treated as a “D” reorganization. If the corporations are members of a consolidated group, § 304 cannot apply to the stock sale nor can § 338 apply because there is no stock purchase within the meaning of § 338(h)(3)(A); if they are not members of a consolidated group, the transaction would be treated as a § 332 liquidation if the steps are not integrated and as a “D” reorganization if they are.

G. Corporate Divisions

1. **Business purpose may be satisfied even if the personal planning purposes of a shareholder are also satisfied if the shareholder purpose is so coextensive with the corporate business purpose as to preclude any distinction between them.** Rev. Rul. 2004-23, 2004-11 I.R.B. 585 (2/13/04). A distribution by a publicly traded corporation that is expected to cause the aggregate value of the stock of distributing and controlled corporations to exceed the pre-distribution value of the distributing corporations satisfies the corporate business purpose requirement of § 355 when the increased value is expected to serve a corporate business purpose of either or both corporations, even if it benefits the shareholders of distributing corporations.

H. Personal Holding Companies and Accumulated Earnings Tax

There were no significant developments regarding this topic during 2004.

I. Miscellaneous Corporate Issues

1. **Contingent liabilities assumed in an asset acquisition must be capitalized.** Illinois Tool Works Inc. v. Commissioner, 355 F.3d 997, 93 A.F.T.R.2d 2004-548, 2004-1 U.S.T.C. ¶ 50,130 (7th Cir. 1/21/04), *aff'g* 117 T.C.39 (7/31/01). The taxpayer acquired the assets of another corporation [for approximately \$126 million] in a taxable transaction in which the taxpayer assumed the target's liabilities, including a contingent liability for a patent infringement claim, [*Lemelson v. Champion Spark Plug Co.*, 975 F.2d 869 (1992)], for which it established a reserve of \$350,000. Subsequently, the taxpayer, as the target's successor was held liable for damages, interest, and court costs [totalling over \$17 million], which it paid. The court upheld the Commissioner's treatment requiring capitalization of the payments as a cost of acquiring the assets rather than a deductible expense, even though the parties had not adjusted the purchase price to reflect the contingent liability. The liability was known, was considered in setting the price, and was expressly assumed. That the taxpayer considered it highly unlikely that it would be called upon to pay was not relevant.⁶

2. **Sale of shares by a taxpayer to his brother in a closely held corporation claiming a net operating loss deduction resulted in a § 382 change of control that triggered the limitation on NOL carryovers.** Garber Industries Holding Co. v. Commissioner, 124 T.C. 1 (1/25/05). In a 1986 "D" reorganization, one of the Garber brothers (Charles) had his interest in the corporation decreased from 68 percent to 19 percent and the other brother (Kenneth) had his interest increased from 26 percent to 65 percent. In 1988, Charles sold all of his remaining shares to Kenneth, with the result that the Kenneth's interest in the corporation increased from 19 percent to 84 percent. The parents of Charles and Kenneth were both deceased, and when living never had any ownership interest in the corporation.

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

- Judge Halpern also refused to follow the Commissioner's argument that the family aggregation rule does not apply because none of the parents and grandparents of the Garber brothers were alive at the beginning of the 3-year testing period immediately preceding the 1998 transaction.

- Instead, he concluded that a third interpretation was correct, i.e., that the aggregation rule is to apply solely from

6. This case is discussed more fully at S&M, *supra* note 2, at 519-20.

the perspective of individuals who are shareholders of the loss corporation, and that the brothers were unrelated under this perspective.

VII. PARTNERSHIPS

A. Formation and Taxable Years

There were no significant developments regarding this topic in 2004.

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

1. **These related corporations were not related for purposes of this case.** IPO II v. Commissioner, 122 T.C. 295 (4/23/04). Forsyth was a partner with his wholly owned S corporation (Indeck Overseas) in a partnership that borrowed money to purchase an airplane. The loan was guaranteed by Forsyth, but not by Indeck Overseas. In addition, the loan was guaranteed by Indeck Energy, an S corporation 70 percent of the stock of which was owned by Forsyth, and 30 percent of which was owned by his daughter; the loan was also guaranteed by Indeck Power, a C corporation that was 63 percent owned by Forsyth. For purposes of allocating partnership indebtedness under § 752, and accordingly losses under § 704(b), the partners claimed that the loan was fully recourse to both Forsyth and Indeck Overseas. They argued that Indeck Overseas was at-risk for the partnership debt because by virtue of Forsyth's common ownership of both corporations, it was related to Indeck Energy, which had guaranteed the debt. Under Reg. §§ 1.752-1(a)(1) and 1.752-2(c)(2) a liability is recourse if a partner or a related party bears the risk of loss. However, an exception to this related party provision in Reg. § 1.752-4(b)(2)(iii) provides that persons owning directly or indirectly interests in the same partnership are not treated as related. Judge Haines held that the relationship between the Indeck Energy, the guarantor, and Indeck Overseas was negated by Reg. § 1.752-4(b)(2)(iii) because the relationship was traced through Forsyth, who was a partner in the partnership.

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

C. Distributions and Transactions Between the Partnership and Partners

1. **Permitting a partnership book-up when a partnership interest is granted for services and you can't make the regs work if you don't do it.** REG-139796-02, Section 704(b) and Capital Account Revaluations, 68 F.R. 39498 (7/2/03). Proposed amendments to the § 704(b) regulations would expressly allow partnerships to increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property on the partnership's books in connection with the grant of an interest in the partnership (other than a *de minimis* interest) in consideration of services to the partnership by an existing partner acting in a partner capacity or by a new partner acting in a partner capacity or in anticipation of being a partner. The regulation will be effective when finalized.

a. **Proposed regulations are made final without change.** T.D. 9126, Section 704(b) and Capital Account Revaluations, 69 F.R. 25615 (5/6/04). Effective 5/6/04.

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

- Under § 704(c)(1)(C), a built-in loss on property contributed to a partnership will be taken into account only by the contributing partner and not by other partners. Note that this is the transaction involved in the *Long-Term Capital Holdings* case.

- Section 734(b) basis adjustments will be mandatory with respect to built-in losses or adjustments that exceed \$250,000 at the partnership level. Section 743(b) basis adjustments will be mandatory for basis adjustments that exceed \$250,000 at the partnership level. Such adjustments under §§ 734 and 743 had been heretofore optional, and need not have been made in the absence of a § 754 election. An elective exception is provided for investment partnerships, but the election requires outside basis adjustments to be made.

3. Section 834(a) of the **American Jobs Creation Act of 2004** amends § 755 to provide that in making reductions to the basis of property under § 734(b), no allocation is to be made to the basis of stock of a corporation that is a partner in the partnership.

D. Sales of Partnership Interests, Liquidations and Mergers

1. **Effect of partnership mergers on gain recognition under §§ 704(c)(1)(B) and 737(b).** Rev. Rul. 2004-43, 2004-18 I.R.B. 842 (4/12/04). This ruling deals with the application of §§ 704(c)(1)(B) and 737(b) in partnership mergers. The ruling holds that § 704(c)(1)(B) applies to newly

created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger, but does not apply to newly created reverse § 704(c) gain or loss resulting from a revaluation of property in the continuing partnership. Similarly, for purposes of § 737(b), net precontribution gain includes newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger, but does not include newly created reverse § 704(c) gain or loss resulting from a revaluation of property in the continuing partnership. Thus, a distribution of property previously held by the disappearing partnership will trigger gain recognition if the distribution occurs within seven years after the merger.

a. Rev. Rul. 2004-43 is revoked, and forthcoming regulations will be effective for distributions after 1/19/05. Rev. Rul. 2005-10, 2005 I.R.B. (1/19/05), *revoking* Rev. Rul. 2004-43, 2004-18 I.R.B. 842. The IRS has deferred to commentators whose view is that Rev. Rul. 2004-43 is inconsistent with the current regulations under §§ 704(c)(1)(B) and 737, and therefore should not be applied retroactively. The IRS and Treasury will amend the regulations to provide the same result as Rev. Rul. 2004-43.

2. Continuing suit over the termination of a partnership means the partnership hasn't terminated. Harbor Cove Marina Partners Partnership v. Commissioner, 123 T.C. 64 (7/15/04). Harbor Cove Marina Partners Partnership filed a tax return indicating that its affairs had been terminated in 1998, and all of the partners but one (Collins) reported consistently. Following a TEFRA audit in which the IRS issued a Notice of Final Partnership Administrative Adjustment indicating that the "final" return was correct and that the IRS would make no changes, and the tax matters partner's [understandable] failure to petition the Tax Court for review under § 6226(a), Collins, a notice partner petitioned under § 6226(b) to readjust partnership items relating to the FPAA. Judge Laro held that the partnership did not terminate under § 708(b)(1)(A) when (1) its managing general partner purportedly wound up the affairs of the partnership's business operation using procedures apparently contrary to those stated in the partnership agreement, (2) another partner filed a lawsuit to compel the use of the procedures stated in the agreement, and (3) a resolution of that lawsuit could reasonably lead to the partnership's reporting in a subsequent year of significant income, credit, gain, loss, or deduction.

3. "Partnership interest for debt" is to be treated in the same way as "stock for debt." Section 896 of the American Jobs Creation Act of 2004 amends § 108(e)(8) to require recognition of cancellation of indebtedness income realized on the satisfaction of debt with a partnership interest.

E. Inside Basis Adjustments

1. Rev. Rul. 2004-49, 2004-21 I.R.B. 939 (5/24/04). When a partnership revalues a § 197 intangible pursuant to Reg. § 1.704-1(b)(2)(iv)(f), the partnership may allocate amortization with respect to the intangible so as to take into account the built-in gain or loss from the revaluation provided that the intangible is amortizable in the hands of the partnership. In that event, the partnership may make remedial, but not traditional or curative allocations of amortization.

F. Partnership Audit Rules

1. Rev. Rul 2004-88, 2004-32 I.R.B. 165 (8/9/04). A partnership that has a disregarded entity as a partner cannot qualify for the “small partnership” exclusion from the §§ 6221-6234 unified partnership and audit provisions because the disregarded entity is a pass-thru partner under § 6231(a)(9). The disregarded entity may, however, be designated the tax matters partner.

G. Miscellaneous

There were no significant developments regarding this topic during 2004.

VIII. TAX SHELTERS

A. Tax Shelter Cases

1. **Significant government victory in tax shelter case! Taxpayers’ in-house tax counsel should have taken Nancy Reagan’s advice when Don Turlington pitched him a tax planning idea. Long-Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 2004-2 U.S.T.C. ¶ 50,351 (D. Conn. 8/27/04).** Judge Janet Bond Arterton poured out taxpayers by holding that the tax shelter transaction [under which preferred stock with an inflated basis was contributed to a partnership in a carryover basis transaction] lacked economic substance (or, in the alternative, that the step transaction doctrine required that it be recast into a direct sale of preferred stocks to taxpayers with the result that the basis was equal to the amount they paid) and by upholding the imposition of (in the alternative) both the 40-percent gross valuation misstatement and the 20-percent substantial understatement penalties. After that introductory statement, the remainder of the 198-page opinion was all downhill for taxpayers and their lawyers.

- The inflated basis was the result of several cross-border lease-stripping transactions which left a foreign entity holding

several million dollars worth of preferred stocks at a basis \$385 million greater than value. The lease-stripping transactions were supported by “should” tax opinions issued by Shearman & Sterling when they were entered into.

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

- Holdings included: (1) the burden of proof did not shift to the government under § 7491 because taxpayers failed to provide a PowerPoint presentation and accompanying handout for a presentation of Myron Scholes to the other eleven of taxpayers’ principals and taxpayers’ net worth was not unambiguously shown to be under \$7 million; (2) the transaction lacked economic substance because the reasonably expected return on it could not have resulted in a profit (with the court calling into question the credibility of the former King & Spalding lawyer who was the primary drafter of the opinion); (3) the “end result” variety of the step transaction doctrine – the most liberal of the three varieties – was applied to conclude that taxpayers acquired the preferred stocks by purchase at a fair market value basis; (4) the gross valuation misstatement resulted from the claimed adjusted basis of the preferred stocks being more than 400 percent of the adjusted basis that was found by the court to equal fair market value; (5) the substantial understatement penalty was applied based upon taxpayers’ failure to show any authority that held a transaction devoid of economic substance could produce deductible losses; (6) the § 6664(c) “reasonable cause . . . and . . . good faith” exception did not apply because taxpayers failed to prove that the King & Spalding oral advice provided to it before 4/15/98 [the day it filed the relevant partnership return] satisfied the “reasonable cause” defense because of the vagueness and lack of credibility of testimony as to the content of the oral advice; and (7) the 1/27/99 written King & Spalding opinion did not provide reasonable cause because its facts were unsubstantiated and its legal analysis unsatisfactory in that it failed to discuss Second Circuit cases. Judge Arterton summarized the opinion as follows:

Finally, no other evidence such as companion memoranda discussing the application of the Second Circuit’s decisions in *Goldstein*, *Gilman*, *Grove*, *Blake*, and *Grove*, or the Tenth Circuit’s decision in *Associated* to the actual facts of the [foreign entity] transaction was offered to show research for King & Spalding’s legal analysis and opinions. Such background research does not involve obscure or inaccessible caselaw references, is basic to a sound legal product, especially

for “should” level opinion and a premium of \$400,000. With hourly billing totals exceeding \$100,000 there could not have been research time constraints.

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

Judge Arterton’s official biographical information at <http://air.fjc.gov/servlet/tGetInfo?jid=66> is set forth in the footnote.⁷ She has an AV rating in Martindale-Hubbell.

- Myron Scholes and Robert Merton, who shared the 1997 Nobel prize in Economics were two of taxpayers’ twelve principals. Taxpayers were the component parts of one of the highest-flying hedge funds until it had to be rescued from collapse by 14 banks [acting at the instigation of the Federal Reserve] providing \$3.65 billion to take the hedge fund over.

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

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

7. Arterton, Janet Bond. Born 1944 in Philadelphia, PA. Federal Judicial Service: U. S. District Court, District of Connecticut. Nominated by William J. Clinton on January 23, 1995, to a seat vacated by Jose A. Cabranes; Confirmed by the Senate on March 24, 1995, and received commission on March 24, 1995. Education: Mount Holyoke College, B.A., 1966; Northeastern University School of Law, J.D., 1977. Professional Career: Law clerk, Hon. Herbert Stern, U.S. District Court of New Jersey, 1977-1978; Private practice, New Haven, Connecticut, 1978-1995. Race or Ethnicity: White. Gender: Female.

2. After Long-Term Capital Holdings, the IRS takes a few victory laps.

a. Penalties may no longer be bargained away in Appeals. Chief Counsel Notice CC-2004-036 (9/22/04). The notice includes a memorandum from the Chief of Appeals stating, “Effective immediately we will no longer trade penalty issues in appeals. Penalties can and should still be settled, but the settlement should be based on the merits and the hazards surrounding each penalty issue standing alone.”

b. IRS takes a tougher stand on tax shelters. IR-2004-128 (10/20/04). The IRS announced that it was sending letters to taxpayers involved in three listed transactions, (1) losses and deductions from lease strips, (2) inflated-basis assets derived from lease strips, and (3) intermediary transactions, that it would tighten its settlement guidelines to require concession of 100 percent of the claimed losses or deductions, reduced only by the amount of transaction costs up to 10 percent of the claimed losses or deductions. Additionally, taxpayer would have to concede 50 percent of the accuracy-related penalty at issue.

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

● Under the Fourth Circuit test in *Rice’s Toyota World v. Commissioner*, 752 F.2d 89 (1985), a transaction will be treated as a sham only if “the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists.” Taxpayer conceded for purposes of its motion “that tax avoidance was its sole motivation.” The court held that “[a] corporation and its transactions are objectively reasonable, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions.”

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

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

a. Government’s summary judgment motion had been denied earlier on a pro-taxpayer rationale. Black & Decker Corp. v.

United States, 2004-2 U.S.T.C. ¶ 50,539 (D. Md. 8/3/04). As the facts were stated in the opinion,

In 1998, B & D sold three of its businesses. As a result of these sales, B & D generated significant capital gains. *Id.* That same year, B & D created Black & Decker Healthcare Management Inc. (“BDHMI”). B & D transferred approximately \$ 561 million dollars to BDHMI along with \$ 560 million dollars in contingent employee healthcare claims in exchange for newly issued stock in BDHMI. B & D sold its stock in BDHMI to an independent third-party for \$ 1 million dollars. Because B & D believed that its basis in the BDHMI stock was \$ 561 million dollars, the value of the property it had transferred to BDHMI, B & D claimed approximately \$ 560 million dollars in capital loss on the sale, which it reported on its 1998 federal tax return. B & D applied a portion of the capital loss to offset its capital gains from selling the three businesses, and carried back and carried forward the remaining capital loss to offset gains in prior and future tax years. (citations omitted)

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

- Section 358(h), added in 2000 and amended in 2002, would preclude this result for assumptions of liability after its 10/18/99 effective date.

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

- Judge Braden rejected the concept of a court applying the economic substance doctrine to tax cases on the ground that

Under our time-tested system of separation of powers, it is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare. . . . Accordingly, the court has determined that where a taxpayer has satisfied all statutory requirements established by Congress, as Coltec did in this case, the use of the “economic substance” doctrine to trump “mere compliance with the Code” would violate the separation of powers.

5. The third taxpayer victory in 13 days, in a self-liquidating partnership note transaction in which the lion’s share of income was allocated to a tax-indifferent party. So far, this lease stripping transaction works for a burned-out tax shelter. TIFD III-E, Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 11/1/04). The court found that the creation of Castle Harbour, a Nevada LLC, by General Electric Capital Corp. subsidiaries was not designed solely to avoid taxes, but to spread the risk of their investment in fully-depreciated commercial airplanes used in their leasing operations. GECC subsidiaries put the following assets into Castle Harbor: \$530 million worth of fully-depreciated aircraft subject to a \$258 million non-recourse debt, \$22 million of rents receivable, \$296 million of cash, and all the stock of another GECC subsidiary that had a value of \$0. Two tax-indifferent Dutch Banks invested \$117.5 million in Castle Harbour Under the LLC agreement, the tax-indifferent partner was allocated 98 percent of the book income and 98 percent of the tax income.

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

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

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

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

6. Despite its two losses on contingent liability tax shelters, the IRS is hanging tough. Did taxpayer have something else in its closet, or has it become a believer? IR-2004-151 (12/16/04). The IRS announced that Hercules Incorporated settled a contingent liability transaction case pending in the Tax Court by conceding 100 percent of the capital loss and the 20-percent accuracy-related penalty [and waiving taxpayer privacy and disclosure rules] in order to avoid the 40-percent gross valuation understatement penalty.⁸ The IRS Chief Counsel has stated that the two recent taxpayer victories in *Black & Decker* and *Coltec* would be reversed on appeal, and that the IRS would pay no attention to them.

B. Identified “tax avoidance transactions.”

1. Shortly after Notice 2003-76, here’s another one! Notice 2003-77, 2003-2 C.B. 1182 (11/19/03), *clarified* (12/1/03). Certain contested liability trusts used improperly to attempt to accelerate deductions under § 461(f) are identified as “listed transactions.” See I.D., above, for contested liability trusts used for an attempted acceleration of deductions under § 461(f).

2. And, yet one more! Notice 2003-81, 2003-2 C.B. 1223 (12/4/03). This transaction involves the purchase by the taxpayer of offsetting options on foreign currency (which are § 1256 contracts) (the “purchased options”) and the receipt of premiums by the taxpayer for writing offsetting options on a different foreign currency that has a very high positive correlation with the first currency, but which is not traded through regulated futures contracts (which are not § 1256 contracts) (the “written options”). The taxpayer assigns to a charity both (1) the purchased option that has a loss (which is marked to market when it is assigned to the charity and recognized by the taxpayer) and (2) the offsetting written option that has a gain (which is limited to the premium received for the option, and which the taxpayer does not recognize).

3. Abusive Roth IRA transactions are listed transactions. Notice 2004-8, 2004-4 I.R.B. 333 (12/31/03). A taxpayer who owns a pre-existing business sells property from the business, such as accounts receivable, for less than fair market value to a corporation owned by taxpayer’s Roth IRA. The Notice applies to any arrangement between the Roth IRA and the taxpayer

8. Compare *Dixon v. Commissioner*, 316 F.3d 1044, 2003-1 U.S.T.C. ¶50,194 (9th Cir. 1/17/03), *remanding* T.C. Memo. 2000-116 and T.C. Memo. 1999-101 (Tax Court was directed to enter judgment in favor of taxpayers on terms equivalent to the secret settlement agreements entered into with the taxpayers who cooperated with the government). See also, Robert Frost, “Provide, Provide” (1936) (“Better to go down dignified / With boughten friendship at your side / Than none at all. / Provide, provide!”).

that has the effect of transferring value to the corporation owned by the Roth IRA that is comparable to a contribution to the Roth IRA that exceeds the statutory limits on such contributions contained in § 408A.

4. S corporation stock owned by ESOPs that fail to provide benefits to rank-and-file employees. Rev. Rul. 2004-4, 2004-6 I.R.B. 414 (1/23/04). Ownership structures of S corporations that are designed to allow taxpayers to take advantage of the tax-exempt status of the S corporation that results from the ownership of its outstanding stock by the ESOP result in the ESOP not providing benefits to rank-and-file employees will result in the S corporation income being taxed to the person who earned it. Transactions that are the same or substantially similar to the following transaction are identified as “listed transactions.” These are transactions in which (i) at least 50 percent of the outstanding shares of an S corporation are employer securities held by an ESOP, (ii) the profits of the S corporation generated by the business activities of a specific individual are accumulated and held for the benefit of that individual in a QSub or similar entity, (iii) these profits are not paid to the individual as compensation within 2-1/2 months after the end of the year in which earned, and (iv) the individual has rights to acquire shares of stock of the QSub or similar entity representing 50 percent or more of the fair market value of the stock of such QSub or similar entity.

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

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

b. Silos are now listed transactions even though the door was closed after 3/12/04. Notice 2005-13, 2005-9 I.R.B. 630 (2/20/05). This notice distinguishes the SILO transaction from the one in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

c. Relief for partnerships and pass-thru entities who looked like they fed from “silos” in 2004 but really didn’t. Notice 2005-29, 2005-13 I.R.B. 796 (3/10/05). The Service will not apply § 470 to partnerships

and pass-thru entities described in § 168(h)(6)(E) for taxable years that begin before 1/1/05 in order to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of § 168(h)(6) (describing property owned by a partnership that has both tax-exempt and non-tax-exempt partners).

6. Removes from the list a transaction in which expected economic profit is insubstantial in comparison to the value of the expected foreign tax credits. Notice 2004-19, 2004-11 I.R.B. 606. The IRS has removed from the list of listed transactions those described in Notice 98-5, 1998-1 C.B. 334, which are transactions in which the expected economic profit is insubstantial in comparison to the value of the expected foreign tax credits.

7. PORC transactions also removed from the list so it's no longer considered piggy to be "PORC-y." Notice 2004-65, 2004-41 I.R.B. 599 (9/24/04), *modifying* Notice 2002-70, 2002-2 C.B. 765, and Notice 2003-76, 2003-49 I.R.B. 1181. This notice removes the producer owned reinsurance company transaction from the list of "identified tax avoidance transactions." The rationales for the removal are: (1) that examination of this type of transaction showed fewer abusive transactions than anticipated; and (2) the amendment of § 501(c)(15) [to limit the gross income of organizations exempt under that section to \$600,000] by section 206 of the Pension Funding Equity Act, P.L. 108-21, as described in Notice 2004-64, 2004-41 I.R.B. (9/24/04).

8. Updated list of listed transactions minus the above two. Notice 2004-67, 2004-41 I.R.B. 600 (9/24/04), *supplementing and superseding* Notice 2003-76, *as modified by* Notice 2004-19 and Notice 2004-65. Updated list of listed transactions. Notice 2003-76, 2003-49 I.R.B. (11/7/03), *supplementing and superseding* Notice 2001-51, 2001-34 I.R.B. 190 (8/3/01). The IRS has identified 24 listed transactions for purposes of Reg. §§ 1.6011-4(b)(2) and 301.6111-2(b)(2). As restated and updated, the list includes: (1) Rev. Rul. 90-105, 1990-2 C.B. 69, transactions (deductions for contributions to certain pension plans attributable to future year's compensation); (2) Notice 95-34, 1995-1 C.B. 309, certain trust arrangements (purported multiple employer welfare benefit funds); (3) Transactions substantially similar to those at issue in *ASA Investorings Partnership v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000) and *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998) (contingent installment sales transactions in order to accelerate and allocate income to a tax-indifferent partner); (4) Prop. Reg. § 1.643(a)-8 transactions involving distributions from charitable remainder trusts; (5) Notice 99-59, 1999-2 C.B. 761, transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays that they have in fact recovered (the PwC so-called BOSS tax shelter); (6) Reg. § 1.7701(1)-3 fast-pay arrangements; (7) Rev. Rul. 2000-12, 2000-11 I.R.B. 744 certain

transactions involving the acquisition of two debt instruments the values of which are expected to change significantly at about the same time in opposite directions; (8) Notice 2000-44, 2000-36 I.R.B. 255 transactions generating losses resulting from artificially inflating the basis of partnership interests (the KPMG so-called BLIPS⁹ tax shelter); (9) Notice 2000-60, 2000-49 I.R.B. 568, transactions involving the purchase of a parent corporation's stock by a subsidiary, a subsequent transfer of the purchased parent stock from the subsidiary to the parent's employees, and the eventual liquidation or sale of the subsidiary; (10) Notice 2000-61, 2000-49 I.R.B. 569, transactions purporting to apply § 935 to Guamanian trusts; (11) Notice 2001-16, 2001-9 I.R.B. 730, intermediary sales transactions; (12) Notice 2001-17, 2001-9 I.R.B. 730, contingent liability § 351 transfer transactions; (13) Notice 2001-45, 2001-33 I.R.B. 129 (certain redemptions of stock in transactions not subject to U.S. tax in which the basis of the redeemed stock purports to shift to a U.S. taxpayer); (14) Notice 2002-21, 2002-1 C.B. 730, transactions involving the use of a loan assumption agreement to inflate basis in assets acquired from another party in order to claim losses; (15) Notice 2002-35, 2002-1 C.B. 992, transactions involving the use of a notional principal contract to claim current deductions for periodic payments made by a taxpayer while disregarding the accrual of a right to receive offsetting future payments; (16) Notice 2002-50, 2002- C.B. 98 (transactions involving the use of a straddle, a tiered partnership structure, a transitory partner and the absence of a § 754 election to claim a permanent non-economic loss), and similar transactions identified in Notice 2002-65, 2002-2 C.B. 690, and Notice 2003-54, 2003-33 I.R.B. 363; (17) Rev. Rul. 2002-69, 2002-2 C.B. 760, *modifying and superseding* Rev. Rul. 99-14, 1999-1 C.B. 835, lease-in/lease-out [LILLO] transactions); (18) Rev. Rul. 2003-6, 2003-3 I.R.B. 286, arrangements involving the transfer of ESOPs that hold stock in an S corporation for the purpose of claiming eligibility for the delayed effective date of § 409(p); (19) Notice 2003-22, 2003-18 I.R.B. 851, arrangements involving foreign leasing companies used to evade or avoid federal income and employment taxes; (20) Notice 2003-24, 2003-18 I.R.B. 853, arrangements that purportedly qualify as collectively bargained welfare benefit funds excepted from the account limits of §§ 419 and 419A; (21) Notice 2003-47, 2003-30 I.R.B. 132, transactions involving compensatory stock options and related persons to avoid or evade federal income and employment taxes; (22) Notice 2003-55, 2003-34 I.R.B. 395, *modifying and superseding* Notice 95-53, 1995-2 C.B. 334, transactions in which one participant claims to realize rental income and another participant claims the deductions related to that income (often referred to as "lease strips"); (23) Notice 2003-77, 2003-49 I.R.B. 1182, transactions that use contested liability trusts improperly to accelerate deductions under § 461(f); (24) Notice 2003-81, 2003-51 I.R.B. 1223, transactions in which a taxpayer claims a loss upon the assignment of a section

9. See 2003 TNT 112-12.

1256 contract to a charity but fails to report the recognition of gain when the taxpayer's obligation under an offsetting non-section 1256 contract terminates; (25) Notice 2004-8, 2004-4 I.R.B. 333, transactions designed to avoid the limitations on contributions to Roth IRAs; (26) Rev. Rul. 2004-4, 2004-6 I.R.B. 414, transactions that involve segregating the profits of an ESOP-owned S corporation in a QSST so that rank-and-file employees do not benefit from participation in the ESOP; (27) Transactions similar to those described in Rev. Rul. 2004-20, 2004-10 I.R.B. 546, Situation 2, involving arrangements in which an employer deducts contributions to a qualified plan for life insurance premiums that provide death benefits in excess of the participant's death benefit; (28) Notice 2004-20, 2004-11 I.R.B. 608, transactions in which a domestic corporation purports to acquire stock in a foreign target corporation in a preplanned transaction that generates gain under a 338 election that is not taxable for U.S. purposes; (29) Notice 2004-30, 2004-17 I.R.B. 828, transactions in which S corporation shareholders attempt to transfer the incidence of taxation by purportedly donating S corporation nonvoting stock to an exempt organization while retaining the economic benefits associated with that stock; and (30) Notice 2004-31, 2004-17 I.R.B. 830, transactions in which corporations claim inappropriate deductions for payments made through a partnership.

C. Disclosure and Settlement

1. Proposed revisions to Circular 230 related to tax shelters require disclosures in tax shelter opinions of relationship between practitioner and promoter, etc. REG-122379-02, Regulations Governing Practice Before the Internal Revenue Service, 68 F.R. 75186 (12/30/03). New proposed amendments differ from the 1/12/01 proposed amendments in several ways: (1) § 10.33 prescribes best practices for all tax advisors; (2) § 10.35 combines and modifies the standards applicable to "marketed" and "more likely than not" tax shelter opinions from former §§ 10.33 and 10.35; (3) § 10.36 contains the revised procedures for ensuring compliance with §§ 10.33 and 10.35; and (4) new § 10.37 contains provisions relating to advisory committees to the Office of Professional Responsibility.

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

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

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

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

- Under § 10.37 the Director of the Office of Professional Responsibility is authorized to establish advisory committees to review and make recommendations regarding professional standards or best practices for tax advisors. They may also, more particularly, advise the Director whether a practitioner may have violated §§ 10.35 or 10.36.

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

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

- As to final § 10.33, the preamble states:

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

- As to final § 10.35, the preamble states:

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

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

Written advice regarding a plan or arrangement having a significant purpose of tax avoidance or evasion is excluded

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

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

- As to final § 10.36, “Procedures to ensure compliance,” the preamble was silent.
- As to final § 10.37, the preamble states:

The final regulations also set forth requirements for written advice that is not a *covered opinion*. Under § 10.37 a practitioner must not give written advice if the practitioner: (1) Bases the written advice on unreasonable factual or legal assumptions; (2) unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person; (3) fails to consider all relevant facts; or (4) takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled. Section 10.37, unlike § 10.35, does not require that the practitioner describe in the written advice the relevant facts (including assumptions and representations), the application of the law to those facts, or the practitioner’s conclusion with respect to the law and the facts. The scope of the engagement and the type and specificity of the advice sought by the client, in addition to all other facts and circumstances, will be considered in determining whether a practitioner has failed to comply with the requirements of § 10.37.

- As to final § 10.38 [§ 10.37 in the proposed regulations], the preamble states:

Newly designated § 10.38, formerly § 10.37 in the proposed regulations, is adopted as proposed with the following modifications. Section 10.38 is modified to clarify that an advisory committee may not make recommendations about actual practitioner cases, or have access to information pertaining to actual cases. The section also is modified to clarify that the Director of the Office of Professional

Responsibility should ensure that membership of these committees is balanced among those individuals who practice as attorneys, accountants and enrolled agents.

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

2. **Warm-up the photocopier for those tax accrual workpapers.** Announcement 2002-63, 2002-27 I.R.B. 72 (7/8/02). In auditing returns filed after 7/1/02 that claim any tax benefits from a “listed transaction,” see Notice 2001-51, 2001-34 I.R.B. 190, the IRS may request tax accrual workpapers. Listed transactions will be determined “at the time of the request.” Neither the attorney client privilege nor the § 7525 tax practitioner privilege protects the confidentiality of the workpapers.

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

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

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

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

3. **Making it harder for taxpayers to “fess up” in order to avoid penalties.** Notice 2004-38, 2004-21 I.R.B. 949 (4/30/04). Treasury will issue temporary and proposed regulations that will modify the definition of

“qualified amended return” in Reg. § 1.6664-2(c)(3) to provide that the period for filing is terminated when the IRS contacts a promoter, organizer or material advisor concerning a listed transaction for which the taxpayer has claimed a tax benefit or when the taxpayer is contacted for examination concerning the activity. This will deprive a taxpayer who knows he is in the Service’s sights of the right to file a qualified amended return to avoid penalties.

- Previously, the right to file such a return ended at the earliest of a taxpayer receiving a notice of deficiency or the promoter receiving a § 6700 notice.

- The IRS is also contending that the filing of a qualified amended return retroactively revokes the interest holiday under § 6404(g)(2)(C) that begins 18 months after the filing of the original return because the interest holiday does not apply to tax shown on a return.

4. Son-of-Boss settlement terms are announced.

Announcement 2004-46, 2004-21 I.R.B. 964 (5/5/04). The IRS announced a settlement initiative for taxpayers to resolve “Son-of-Boss” transactions described in Notice 2000-44, 2000 C.B. 255, and substantially similar transactions. Taxpayers will be required to concede all claimed tax benefits and attributes, including basis adjustments with a sliding scale of penalties [none, if disclosed under Announcement 2003-2; 10 percent if this was the taxpayer’s only listed transaction; and 20 percent otherwise]. Net out-of-pocket costs and fees will be allowed as a long term capital loss (or half of these as an ordinary deduction) in the year these items were paid or accrued. The settlement initiative was open through 6/21/04.

5. IRS settlement terms for executive stock option shelters.

Announcement 2005-19, 2005-11 I.R.B. 744 (2/22/05). The offer, which extends until 5/23/05, is for payment of tax on the full amount of compensation received, plus interest and a 10 percent penalty (which is half of the 20 percent penalty). The parties must pay employment taxes, but they will be allowed to deduct their out-of-pocket transaction costs; the corporations will be permitted a deduction for the compensation expense when reported by the executive. Employment taxes are also due. The IRS has identified 42 corporations, close to 200 executives and more than \$700 million of unreported income involved in the scheme, and will ask that the matter be referred to the audit committee of the board of directors for appropriate review. This transaction was listed in Notice 2003-47, 2003-30 I.R.B. 132,

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

The transaction first involves the transfer of stock options by the executive to a related entity, such as a family limited partnership, under terms of an agreement to defer payment to

the executive. Next, the partnership exercises the options and sells the stock in the marketplace. The executive then takes the position that tax is not owed until the date of the deferred payment, typically 15 to 30 years later, although the executive has access to the partnership assets undiminished by taxes. Tax laws require executives to include in income and pay tax on the difference between the amount they pay for the stock and its value when the option is exercised. Corporations are entitled to a deduction for the compensation when the options are exercised.

D. Tax Shelter Penalties, etc.

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

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

a. Doesn't the Commissioner trust his own Appeals Officers? Notice 2005-11, 2005-7 I.R.B. (1/19/05). This notice provides guidance on § 6707A, including a statement that the Commissioner's determination whether to rescind a § 6707A penalty "is not reviewable by the IRS Appeals Division or any court."

2. Modified accuracy-related penalty for reportable transactions. Section 812 of the **American Jobs Creation Act of 2004** adds new § 6662A which provides a modified accuracy related penalty on understatements with respect to reportable transactions. It replaces the § 6662 accuracy related penalty for tax shelters and the amount is 20 percent, – but is 30 percent if the transaction is not properly disclosed. Taxpayers can not rely on an opinion of a tax advisor to establish reasonable cause under new § 6664(d) [applicable to reportable transaction understatements] for any opinion:

(a) provided by a “disqualified tax advisor” or (b) which is a “disqualified opinion.”

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

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

3. Section 813 of the **American Jobs Creation Act of 2004** amends § 7525(b) to make the current exception to the federally authorized tax practitioner privilege for “corporate tax shelters” applicable to all tax shelters.

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

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

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

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

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

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

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

(1) Several revenue procedures were issued on 10/16/04 to give “angels’ lists” of transactions that need not be reported. They are Rev. Proc. 2004-65 [transactions with contractual protection], Rev. Proc. 2005-66 [loss transactions], Rev. Proc. 2005-67 [transactions with book-tax differences], and Rev. Proc. 2005-68 [transactions with brief asset holding periods].

(2) Notice 2005-17, 2005-8 I.R.B. 606 (1/28/05). This notice provides an extension for compliance with the reporting provisions to 3/1/05.

(3) Notice 2005-22, 2005-12 I.R.B. 456 (2/24/05). This notice provides additional guidance, and a further extension for compliance with the reporting provisions to 4/30/05.

6. Section 819 of the **American Jobs Creation Act of 2004** amends § 6662(d) to provide that a corporation’s understatement of tax in

excess of \$10 million is subject to the substantial understatement penalty even if it does not exceed 10 percent of the correct tax.

7. A penalty for non-willful failure, and increased penalties for willful failure, to answer the two questions about foreign bank accounts. Section 821 of the **American Jobs Creation Act of 2004** amends 31 U.S.C. § 5321(a)(5) to provide a penalty of up to \$10,000 for non-willful failure to report interests in foreign financial accounts. The penalties for willful violations are increased to the greater of \$100,000 or 50 percent of the amount of the transaction or 50 percent of the balance in the account at the time of the violation.

8. No interest deductions for underpayments related to reportable transactions that are not disclosed. Section 838 of the **American Jobs Creation Act of 2004** adds new § 163(m) [former § 163(m) is redesignated as § 163(n)] to deny interest deductions for any underpayments attributable to nondisclosed reportable transactions.

E. Individual Tax Shelters

1. United States v. Gleason, 94 A.F.T.R.2d 2004-6344, 2004-2 U.S.T.C. ¶ 50,116 (M.D. Tenn. 8/28/04). Tax shelter promoter permanently enjoined under § 7408 from selling the so-called “Tax Toolbox” which would permit the deduction of personal expenses by falsely characterizing them as business expenses.

F. Tax Shelter Discovery

1. April was a pretty cruel month for tax shelter investors. John Doe 1 v. KPMG LLP, 93 A.F.T.R.2d 2004-1808, 2004-1 U.S.T.C. ¶ 50,270 (N.D. Tex. 4/2/04). Investors in a KPMG-recommended “Son-of-Boss”¹⁰ tax shelter were not entitled to require KPMG to keep their identities confidential under the § 7525 tax advisor privilege because the confidentiality agreements they entered into with KPMG merely required that KPMG claim the privilege, and, since privilege does not apply to their identities and motives for participating in the tax shelter, KPMG does not breach its fiduciary duty by releasing the information. Judge Barefoot Sanders held that (1) identifying the investors does not identify the particular “underlying communication” that would be revealed by revealing investors’ participation in the tax shelter, and (2) investors did not have a reasonable expectation that their identities or participation in the tax shelter would be protected because § 7525 does not protect “information transmitted for the purposed of preparing a tax return.”

10. Notice 2000-44, 2000-36 I.R.B. 255.

Also, §§ 6111 and 6112, requiring registration and list maintenance, prevent investors from having any reasonable expectation of confidentiality.

- Judge Sanders went on to hold that because the investors included losses on their year 2000 tax returns, they could not have believed that their participation in the tax shelter transactions was confidential in that “[i]f [investors’] tax returns were audited, [they] would be required to explain how the losses resulted.”

2. Sidley Austin Brown & Wood clients can intervene to protect their identities. United States v. Sidley Austin Brown & Wood LLP, 93 A.F.T.R.2d 2004-1849 (N.D. Ill. 4/15/04). Judge Kennelly granted a motion of 46 former anonymous Sidley Austin Brown & Wood clients to intervene in the summons enforcement action seeking their identities with respect to whether the summonses are unenforceable as unduly ambiguous. The Does include “Chamberlain Does” and “Fulbright Does.” The court noted that “[t]he issue of whether SAB&W organized or sold tax shelters within the meaning of section 6112 is a complicated question.”

3. The clients lose, but they may appeal. United States v. Sidley Austin Brown & Wood LLP, 93 A.F.T.R.2d 2004-2031 (N.D. Ill. 4/28/04). Judge Kennelly granted the government’s motion to enforce the John Doe summons that seeks to obtain the names of the former clients who had been granted permission to intervene in a limited fashion. The court held that the mere fact that the law firm assembled the 46 names does not show the summons to be unambiguous because “it may just show SAB&W’s desire to cooperate [in hopes of pacifying the IRS].” However, the burden on the government is to “show only that the summons seeks information with ‘potential relevance.’” The court answered by stating that “just because an issue is complicated does not necessarily mean that the governing regulations are ambiguous or impermissibly require SAB&W to draw legal conclusions,” and that “any marginal uncertainty that the summons leaves with SAB&W does not defeat its enforceability.”

- On 4/29/04, Judge Kennelly stayed his order of the preceding day pending appeal to the Seventh Circuit.

4. Are you practicing law or practicing tax when you write that opinion letter? United States v. KPMG LLP, 237 F. Supp. 2d 35, 91 A.F.T.R.2d 2003-317, 2003-1 U.S.T.C ¶ 50,174 (D. D.C. 12/20/02). The IRS served administrative summonses on KPMG in connection with investigating KPMG’s promotion and participation in tax shelters and sought judicial enforcement when it determined that KPMG had not complied. KPMG withheld documents that would have been responsive to the summonses on grounds that the documents were privileged, and KPMG provided the IRS with a privilege log of the withheld documents. Citing *United States v. Lawless*, 709

F.2d 485 (7th Cir. 1983), for the principle that the attorney-client privilege does not extend to communications between a taxpayer and his attorney simply for the purpose of preparing a tax return, the court held that the § 7525 privilege does not extend to communications between a taxpayer and tax practitioner simply for the purpose of preparing a tax return. The court then went on to hold that KPMG's tax opinion letters to its clients were not privileged because they were prepared in connection with the preparation of tax returns. Furthermore, memoranda of KPMG's employees' discussions with clients' lawyers were not privileged because the communications were in connection with tax return preparation. Somewhat contradictorily, however, the court held that opinion letters prepared by law firms in connection with preparation of tax returns were privileged if the taxpayer, rather than the accounting firm, retained the lawyer.

• The court also held that § 7525 did not protect accountant work product. With respect to attorney work product, the court articulated the following standard: "The burden of showing that the materials prepared were in anticipation of litigation is on the party asserting the privilege," and "[t]his burden entails a showing that the documents were prepared for the purpose of assisting an attorney in preparing for litigation, and not for some other reason." After an *in camera* review and comparison of a random sample of thirty allegedly privileged documents and the corresponding entries in the privilege log prepared in response to the summons, the court found that only four of the privilege log entries were completely supportable; accordingly it referred the matter to a special master to conduct an examination of the withheld documents, evaluate the asserted privileges, and submit a report and recommendation.

a. A subsequent KPMG magistrate's opinion. United States v. KPMG LLP, 92 A.F.T.R.2d 2003-6498, 2003-2 U.S.T.C. ¶ 50,691 (D. D.C. 10/10/03). KPMG's documents were reviewed by a special master, who found some of them protected by attorney-client privilege and some by § 7525.

b. The District Court rules for the government in a long omnibus memorandum. United States v. KPMG LLP, 316 F. Supp. 2d 30 (D. D.C. 5/4/04). Judge Hogan adopted the rationale of *BDO Seidman, Wachovia* and *KMPG* (N.D. Texas) to hold that the identity of KPMG clients who participated in potentially abusive tax shelters must be disclosed to the IRS.

He stated,

Having reviewed the Brown & Wood "opinion letters" through the lens of the newly discovered evidence, the Court finds these opinion letters to be boiler-plate templates that are almost, if not completely, identical except for date, investor name, investor advisor, and dates and amounts of investment

transactions. There is little indication that these are independent opinion letters that reflect any sort of legal analysis, reasoned or otherwise. In fact, when examined as a group, the letters appear to be nothing more than an orchestrated extension of KPMG's marketing machine. Regarding any documents that involve opinion letters from the Brown & Wood law firm, however, the Court declines at this time to broadly and definitively state that all of them are not privileged. At this point, it is only fair to shift the burden to KPMG to show that any or all of the Brown & Wood "opinion letters" are privileged by either the attorney-client privilege or the attorney work product privilege.

- He said the following regarding privilege:

Putting aside for the moment that participation in potentially abusive tax shelters is information ordinarily subject to full disclosure under the federal tax law, in order to be privileged the discussion of legal or tax advice must be based upon information communicated in confidence from the client to the lawyer or tax practitioner. See United States v. KPMG, 237 F. Supp. 2d 35, 39-40 (D. D.C. 2002) (setting forth D.C. Circuit's concise summary of the attorney-client privilege as found in In re Sealed Case, 237 U.S. App. D.C. 312, 737 F.2d 94, 98-99 (D.C. Cir. 1984)). KPMG did not support with evidence, and the Special Master did not discuss, that any of these 141 documents discussing legal or tax advice is based upon or contains information communicated in confidence to the lawyers or tax practitioner by a client or a prospective client for the purpose of seeking legal or tax advice. Accordingly, these documents are not privileged and must be released to the IRS.

- Judge Hogan concluded that "KPMG is misrepresenting its unprivileged tax shelter marketing activities as privileged communications. The Court has lost confidence in KPMG's privilege log since it has been shown to be inaccurate, incomplete, and even misleading regarding a very large percentage of the documents." Footnote 10 reads, "The Court hesitates to consider the judicial resources that have been wasted as a result of these improper claims of privilege."

5. On the other hand, a district court in Illinois holds that outside and in-house counsel memorandums are protected by the attorney client privilege, and other documents protected by the work product doctrine. United States v. BDO Seidman, LLP, 94 A.F.T.R.2d 2004-5066, 2004-2 U.S.T.C. ¶ 50,288 (N.D. Ill. 6/28/04). Judge Holderman rules that BDO Seidman is entitled to claim privilege on 110 documents (other than six

documents ordered to be produced in redacted form) prepared by the three outside law firms and in-house counsel because (1) the outside firms were not “co-promoters” of tax shelters because the government failed to submit proof other than the allegations in a civil complaint *Denney v. Jenkins & Gilchrist*, 340 F. Supp. 2d 338 (S.D. N.Y. 4/30/04) (ruling on defendants’ motions to compel arbitration), and communications with in-house counsel are protected to the same extent as communications with outside law firms; (2) the work product doctrine covers six documents created in anticipation of litigation; and (3) the crime-fraud exception does not apply “particularly in light of the uncertain and complex nature of the Internal Revenue Code and the regulations thereunder.”

6. Jenkens & Gilchrist joins the parade of losing tax firms.

United States v. Jenkins & Gilchrist P.C., 93 A.F.T.R.2d 2004-2074, 2004-1 U.S.T.C. ¶ 50,154 (N.D. Ill. 4/20/04). Senior Judge Moran denied the law firm’s motion to dismiss and quash a government motion to compel disclosure of the identities of hundreds of clients who engaged in tax shelter strategies based upon Judge Kennelly’s *Sidley Austin* opinion and Judge Sanders’ *KMPG* opinion.

a. *United States v. Jenkins & Gilchrist P.C.*, 93 A.F.T.R.2d 2004-2288, 2004-1 U.S.T.C. ¶ 50,244 (N.D. Ill. 5/13/04). Senior Judge Moran provided a schedule for the production of identities and documents. Clients wishing to assert privilege claims have 21 days to do so, but are warned about sanctions for frivolous claims.

● Jenkens & Gilchrist turned over the list of names on 5/17/04. 2004 TNT 97-1.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. **Joint ventures between an exempt organization and a for-profit organization.** Rev. Rul. 2004-51, 2004-22 I.R.B. 974 (5/7/04). To expand its teacher training seminars, a university enters into ownership of an LLC with a for-profit company to conduct interactive video training programs. Each of the partners has a 50 percent ownership interest and equal representation on the governing board of the LLC. The ruling holds that an ancillary activity – the university’s participation in the LLC is an insubstantial part of its activities – conducted by a partnership with a for-profit organization is attributable to the exempt organization. In the facts given, the trade or business was substantially related to the charity’s exempt purposes.

B. Charitable Giving

1. Addis v. Commissioner, 374 F.3d 881, 94 A.F.T.R.2d 2004-5134, 2004-2 U.S.T.C. ¶ 50,291 (9th Cir. 7/8/04). Judge Noonan held that the substantiation rule of § 170(f)(8) bars deduction of contribution of amounts donated in 1997 and 1998 to the National Heritage Foundation to pay premiums on charitable split-dollar life insurance. The NHF gave taxpayers receipts that stated they received no consideration. Under the arrangement, the NHF was to pay \$36,000 per year for twelve years (90 percent of the \$40,000 annual premium) in return for 56 percent of the initial death benefit; the Addis Trust was to pay \$4,000 per year in return for 44 percent of the initial death benefit plus projected increases in the death benefit. Of course, the reason NHF entered into this arrangement is the taxpayers contributed \$36,000 per year to it.

- In 1999, § 170(f)(10) was added to the Code to disallow deductions for funds transferred to charities that are used to pay premiums on life insurance with respect to the transferor, and levies a 100 percent excise tax on the premium payments to boot.

2. Section 882 of the **American Jobs Creation Act of 2004** amends §§ 170(e)(1) and 6050L to restrict the amount of deductions from the contribution of intellectual property to the basis of the contributed property. This amount may be increased to the extent that “qualified donee income” over the following years exceeds the basis.

3. Section 883 of the **American Jobs Creation Act of 2004** amends § 170(f) by adding new paragraph 11 that codifies reporting requirements for contributions of property valued at more than \$5,000 and includes contributors that are C corporations in these reporting requirements.

4. **Does new § 170(f)(12) close the door to inflated deductions for motor vehicle contributions? Or, is the door left open wide enough to drive a truck [or other vehicle] through it?** Section 884 of the **American Jobs Creation Act of 2004** amends § 170(f) by adding new paragraph 12 that requires written acknowledgment of contributions of motor vehicles, boats and airplanes that includes the amount of the gross proceeds from any arm’s length sale and a statement that the deduction may not exceed such amount. New § 6720 provides for penalties for furnishing fraudulent acknowledgements. The only exceptions to the reporting of gross sale proceeds is where the charity makes “material improvements” to the vehicle or where the charity puts the vehicle to “substantial use” in its own endeavors.

X. TAX PROCEDURE

A. Interest, Penalties and Prosecutions

1. Bell v. United States, 355 F.3d 387, 93 A.F.T.R.2d 2004-369, 2004-1 U.S.T.C. ¶ 50,118 (6th Cir. 1/7/04). Corporate funds are not considered “encumbered” and therefore unavailable to pay over withholding and payroll taxes merely because a contractual obligation to a creditor limits the ability of the employer freely to use its assets.

2. **Welcome to debtor’s prison, but you do have to try to get there.** United States v. Schoppert, 362 F.3d 451, 93 A.F.T.R.2d 2004-1590 (8th Cir. 4/1/04). A willful attempt to evade payment of the tax shown on the taxpayer’s return was held to constitute criminal tax fraud under § 7201.

3. **More Tax Court jurisdiction over interest calculations despite §§ 6512(b)(2) and 6402.** Estate of Smith v. Commissioner, 123 T.C. No. 15 (7/13/04). After the Tax Court had determined the amount by which the taxpayer had “overpaid” estate tax, in making the refund the Commissioner offset asserted assessed but unpaid underpayment interest. The majority, in a reviewed opinion by Judge Ruwe, held that for purposes of determining an overpayment of tax pursuant to § 6512(b), the proper tax includes underpayment interest and that the amount of an overpayment is the amount by which payments exceed the tax, including any underpayment interest. As a matter of law, the Tax Court’s prior decision that the estate overpaid its estate tax by \$238,847.24 took into account underpayment interest as part of the calculation in arriving at the amount of an overpayment. Accordingly, the Tax Court had jurisdiction over the taxpayer’s motion to enforce its order that the IRS refund \$238,847.24. Section 6512(b)(2) does not apply to bar Tax Court jurisdiction over interest determinations where a final decision in the same case precludes the existence of the interest liabilities to which the Commissioner attempts to apply the overpayment. There were a number of overlapping concurrences and five dissents. The dissents were based on the proposition that the majority’s holding exceeded the Tax Court’s statutory jurisdiction because the Tax Court’s prior order had merely approved Rule 155 computations that, as is customary, did not include underpayment interest owed.

B. Discovery: Summonses and FOIA

1. **Hi-ho, hi-ho, it’s off to redact we go.** United We Stand America, Inc. v. IRS, 359 F.3d 595, 93 A.F.T.R.2d 2004-1236, 2004-1 U.S.T.C. ¶ 50,190 (D.C. Cir. 3/5/04). United We Stand America sought to obtain under FOIA a report by the IRS to the Joint Committee on Taxation, prepared pursuant to the committee’s request, dealing with an investigation by the Joint

Committee of “whether the IRS’s selection of tax-exempt organizations . . . for audit has been politically motivated. . . .” The Court of Appeals (Judge Tatel: one dissent) held that the report was not subject to the FOIA exception for Congressional documents in *toto* and was partially discoverable under FOIA. However, the exception for Congressional documents applied to the Joint Committee’s request and any portions of the IRS report that “would effectively disclose the request.” The case was remanded for a determination of whether the report could be redacted sufficiently to protect the confidentiality of the Joint Committee’s request.

2. A “serious” violation of procedural rules by the IRS didn’t invalidate the summons. Robert v. United States, 364 F.3d 988, 93 A.F.T.R.2d 2004-2770, 2004-1 U.S.T.C. ¶ 50,233 (8th Cir. 4/29/04). The Court of Appeals (Judge Melloy) upheld the enforcement of IRS summonses even though the issuance followed improper *ex parte* communications between the IRS Appeals office assigned to the case and audit personnel regarding the substance of the taxpayer’s appeal. The court reasoned that under the standards of *United States v. Powell*, 379 U.S. 48 (1964), as long as the summons is issued for a legitimate purpose and the IRS acts in good faith, the summons will be enforced even though the IRS has failed properly to follow required internal procedures where Congress has not specifically provided a remedy.

C. Litigation Costs

1. The IRS has not taken a position until it issues a 90-day letter or Appeals has made a decision. Florida Country Clubs, Inc. v. Commissioner, 122 T.C. 73 (2/3/04). Even though § 7430(c)(2) provides that reasonable administrative cost include costs incurred after the IRS sends a 30-day letter, attorney’s fees are not available with respect to a case in which the IRS has issued a 30-day letter but which has been settled without either a deficiency notice or Appeals decision having been issued. Although the definition of “reasonable administrative costs” includes costs incurred from the date of the 30-day letter, the government still has not “taken a position” for purposes of § 7430(c)(7) until a deficiency notice or Appeals decision has been issued, and thus the taxpayer cannot be a “prevailing party” as defined in § 7430(c)(4).

2. The Commissioner concedes the substantive issue and that a § 7430 award is proper, but the taxpayer still loses because of the fee structure. Grigoraci v. Commissioner, 122 T.C. 272 (3/25/04). The taxpayer prevailed in an earlier case involving the same issue [employment taxes] for an earlier year. On the basis of that decision, the Commissioner conceded the substantive issue in the instant case and that the taxpayer was entitled to recover costs. However, Judge Thornton denied the taxpayer’s claim for amounts in

excess of the filing fee on two grounds: (1) the taxpayer's obligation to pay any fees that had been billed to him was contingent on receiving a fee award, and § 7430 does not authorize an award of contingent fees); and (2) the fees related to the first Tax Court case involving the taxpayer, § 7430 does not authorize awarding fees that relate to an earlier case involving the taxpayer, even if the earlier case involved the same issue for a different year.

- Query whether an attorney's fee award under § 7430 constitutes income to the taxpayer.

D. Statutory Notice

1. **“Clear and concise” notification of a change of address.** Hunter v. Commissioner, T.C. Memo. 2004-81 (3/23/04). Judge Holmes held that it is not necessary to file a Form 8822 to give the IRS “clear and concise” notification of the taxpayer's new address. The taxpayer filed a Form 2848, Power of Attorney, showing his new address as the address to which all originals were to be sent with a copy to his attorney. That was “clear and concise” notification to IRS of taxpayer's new address. “[T]he IRS is chargeable with knowing the information that it has readily available when it sends notices to taxpayers.”

E. Statute of Limitations

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

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

a. **Reversed on appeal by the Fifth Circuit; equitable tolling is inapplicable as an exception to the statute of limitations.** John Doe 1 v. United States, 398 F.3d 686, 95 A.F.T.R.2d 2005-742, 2005-1 U.S.T.C. ¶ 50,161 (5th Cir. 1/26/05). Judge Jones held that equitable tolling is unavailable to extend the § 6501 statute of limitations. She further held that the general jurisdiction granted by § 7402(a) to district courts to issue appropriate orders to enforce the internal revenue laws does not “authorize[] a court to inject an equitable tolling provision into a detailed, highly specific provision (Section 6501).”

b. United States v. KPMG LLP, 316 F. Supp. 2d 30, 93 A.F.T.R.2d 2004- 2106, 2004-1 U.S.T.C. ¶ 50,281 (D. D.C. 5/4/04). Judge

Hogan adopted the rationale of *KMPG* (N.D. Texas), and finds that the statute of limitations was similarly suspended during the pendency of the action.

2. Another tax procedure song from the Supremes. United States v. Galletti, 124 S. Ct. 1548, 93 A.F.T.R.2d 2004-1425, 2004-1 U.S.T.C. ¶ 50,204 (3/23/04). A unanimous Supreme Court, in an opinion by Justice Thomas, held that a valid statute of limitation on judicially collecting the tax against the general partners assessment of an employment tax deficiency against a partnership extends the 10-year individually, even though there had been no individual assessments against the partners within three years.

3. No refund of paid but unassessed taxes. Williams-Russell & Johnson, Inc. v. United States, 371 F.3d 1350, 93 A.F.T.R.2d 2004-2543, 2004-1 U.S.T.C. ¶ 50,266 (11th Cir. 6/7/04). The Court of Appeals, Judge Edenfield, held that the statute of limitation on refunds [on employment taxes in this case] under § 6511 runs from the later of payment or the due date of return even if IRS fails to make a timely assessment of taxes. A payment due, owing, and made is not an “overpayment” under § 6401(a) merely because the IRS failed to formally assess the tax after it was paid.

4. Why did the IRS contest this one? The statutory language is clear. Zarky v. Commissioner, 123 T.C. 132 (7/20/04). The taxpayer failed to file a return, received a deficiency notice, and filed a Tax Court petition within three years after the return due date. The Tax Court determined that the taxpayer had overpaid his taxes by the amount that had been withheld [\$270]. Normally, under § 6511(b)(2) and § 6512(b) where a refund claim has not been filed within three years of filing a return, the refund is limited to amounts paid within two years prior to filing the claim. The second paragraph of flush language of § 6512(b)(2), added in 1997 provides a special limitation if a taxpayer who fails to file a return receives a deficiency notice and files a Tax Court petition within three years after the due date of the return; in this case the taxpayer may obtain a refund of an overpayment for the year of the asserted deficiency if the overpayment was made within three years prior to the date of the deficiency notice. In this case, Judge Laro applied the special rules to order refund of overpaid withholding taxes for the year of the asserted deficiency because the withholding was deemed paid on April 15, which was within three years prior to the date of the deficiency notice.

F. Liens and Collections

1. Montgomery v. Commissioner, 122 T.C. 1 (1/22/04). Because no deficiency notice is issued when the IRS attempts to collect unpaid taxes shown as due on the return filed by the taxpayer, at a § 6330 collection due process hearing the taxpayer may challenge the existence or amount of the tax

liability reported on the original tax return. The taxpayer did not have any other opportunity to “contest” the liability.

2. You don’t actually have to receive the notice that Appeals has not granted relief in a due process hearing for the clock to start ticking on the time to appeal to the Tax Court. Weber II v. Commissioner, 122 T.C. 258 (3/22/04). Section 6330(a)(2) requires an IRS written notice to the taxpayer of its intent to levy on any of the taxpayer’s property be delivered in person, left at the taxpayer’s home or usual place of business, or sent by certified or registered mail to his last known address at least thirty days before the date of the levy. Although the statute does not specify the manner in which the Appeals Office must inform the taxpayer of its determination following a due process hearing, the Tax Court has held that notice sent by certified or registered mail to the taxpayer’s last known address – the method specifically authorized for sending deficiency notices in § 6212(a) and (b) – suffices. [The court also observed that notice might be sufficient if it is given in person or left at the taxpayer’s dwelling or usual place of business, analogizing to § 6330(a)(2), but did not decide that question.] Accordingly, because the IRS proved such mailing, even though the notice was returned by the Postal Service as “unclaimed” taxpayer’s petition to the Tax Court was untimely. The subsequent mailing a “courtesy copy” of the notice did not revive the period for appeal.

3. Urbano v. Commissioner, 122 T.C. 384 (6/10/04). Although, the Tax Court’s jurisdiction to review §§ 6320/6330 due process hearing decisions is limited to cases involving taxes over which it has deficiency jurisdiction, Judge Laro held that the Tax Court has jurisdiction to redetermine interest in reviewing due process hearings, even though it generally lacks jurisdiction to redetermine interest [other than to review decisions regarding abatement of interest under § 6404(h)].

4. Iannone v. Commissioner, 122 T.C. 287 (4/19/04). In a review of an Appeals decision in a §§ 6320/6330 due process hearing, Judge Nims held that a tax lien against a bankrupt taxpayer’s § 401(k) retirement account, which, under New Jersey law, was exempt from creditor’s claims in bankruptcy, survived the bankruptcy. Accordingly, the IRS could levy against the § 401(k) account. [In the Tax Court the IRS tried to argue that the § 401(k) account was not exempt, but Judge Nims held that the Appeals Officer’s agreement in the determination letter to assume that the account was an exempt asset foreclosed any subsequent argument in the Tax Court that it was not exempt.]

5. Tax Court review of collection due process hearings is not perfunctory. Fowler v. Commissioner, T.C. Memo. 2004-163 (7/13/04). In reviewing the IRS’s rejection of the taxpayer’s offer in compromise in a collection due process hearing, Judge Gerber held that the rejection was an

abuse of discretion because in considering whether the taxpayer could make installment payments the Appeals Officer relied solely on national average statistics to determine living expenses rather than taking taxpayer's actual expenses into account.

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

a. Chief Counsel's response. Chief Counsel Notice CC-2004-031 (9/1/04). Deborah Butler provides guidance to Chief Counsel attorneys as to how to handle Collection Due Process cases in light of *Robinette*. The recommended course of action when such evidence is presented to the court is to ask for a remand of the case to Appeals for a supplemental determination.

7. Tithes are allowed for people in the pulpit, but not for those in the pews. Unless it is a requirement of ministerial employment, tithes to the church are disallowed in an offer in compromise computation of ability to pay. Pixley v. Commissioner, 123 T.C. 269 (9/15/04). Ordained Baptist minister was not entitled to claim tithes to the church as expenses on an offer in compromise in Appeals where he was not currently employed as a minister and such tithes were therefore not required as “a condition of employment.”

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

Unfortunately here, where the petition in bankruptcy was voluntary, petitioner has fallen victim to a trap for the unwary. As the notice of determination was issued to petitioner on February 23, 2004, petitioner normally would have had 30 days – until March 24, 2004 – to file a timely petition for lien or levy action with the Court. However, upon the filing of the bankruptcy petition on March 1, 2004, the automatic stay was invoked, and petitioner was barred from commencing a proceeding in this Court. n4 Further, the automatic stay remained in effect until March 31, 2004 – 7 days after the 30-day statutory filing period under sections 6320(c) and 6330(d) expired. Thus, but for the provisions of section 11 U.S.C. section 362(a)(8) and the lack of a tolling provision analogous to section 6213(f), this Court would have jurisdiction over this case. n5

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

n5 See, however, sec. 6330(d), which provides in part: “If a court determines that the appeal was to an incorrect court, a person shall have 30 days after the court determination to file such appeal with the correct court.” We do not decide herein whether our determination in this opinion that we lacked jurisdiction over the petition filed during the pendency of petitioner’s bankruptcy case means that we are or are not the

“incorrect” court for purposes of the above-quoted flush language. If we were the “incorrect” court, petitioner would have 30 days from the date decision is entered in this case to refile in the “correct” court. That issue, however, is not currently before the Court and was not briefed by the parties.

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

G. Innocent Spouse

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

2. Did a procedural detail slip through the statutory cracks? Maier v. Commissioner, 119 T.C. 267 (11/20/02). When one spouse requests innocent spouse relief from the IRS, § 6015(h)(2) assures the other spouse a right to participate in the process [although it does not guarantee a personal appearance]. If a requesting spouse seeks Tax Court review of a denial of innocent spouse relief in a proceeding to which the other spouse is not already a party, § 6015(e)(4) provides the nonrequesting spouse the right to intervene. But if the IRS administratively grants the requesting spouse innocent spouse relief, according to the Tax Court [Judge Panuthos], the nonrequesting spouse has no independent right to petition the Tax Court to review the administrative grant of relief to the requesting spouse.

a. Yes, answers the Second Circuit. Affirmed, Maier v. Commissioner, 360 F.3d 361, 93 A.F.T.R.2d 2004-1139, 2004-1 U.S.T.C. ¶ 50,179 (2d Cir. 2/26/04). Judge Walker affirms by reason of lack of Tax Court jurisdiction over petitions for review from non-electing spouses after innocent spouse relief has been administratively granted, and cites *Ira Shepard & Martin McMahon, Recent Developments in Federal Income Taxation: The Year 2002*, 6 Fla. Tax Rev. 81, 177 (2003), in support of his conclusion that a legislative remedy would be needed in order for judicial relief to be granted in such situations.

3. Accepted offer in compromise bars subsequent innocent spouse relief. Dutton v. Commissioner, 122 T.C. 133 (2/11/04). The taxpayer's offer in compromise (based on doubt as to collectibility) was accepted by the IRS. The taxpayer mistakenly thought that because an IRS agent informed him that § 6015(c) apportioned liability would be considered, he would obtain a refund of amounts paid under the compromise. Judge Goeke held that once a taxpayer has entered into a valid compromise of his tax liability pursuant to § 7122, he cannot thereafter seek innocent spouse relief under § 6015 with respect to the liability.

4. Tax liens against possibly innocent spouses are OK. Beery v. Commissioner, 122 T.C. 184 (3/1/04). After election has been made, § 6015(e)(1)(B)(i) generally bars the IRS from levying or collecting the tax until the later of the expiration of the ninety-day period for petitioning the Tax Court or, if a petition has been filed, the date the Tax Court order becomes final. However, Judge Panuthos held that § 6015(e)(1)(B)(i) does not bar the IRS from filing a lien after an innocent spouse election has been filed and during the pendency of a petition for innocent spouse relief.

5. Well, the former spouses weren't totally antagonistic. He supported her innocent spouse claim. Van Arsdalen v. Commissioner, 123 T.C. 135 (7/22/04). The taxpayer filed a stand-alone Tax Court petition seeking review of the Commissioner's denial of innocent spouse relief under § 6015(f). The IRS issued her former husband a notice of filing petition and right to intervene that stated that his right to intervene was limited to intervening solely for the purpose of challenging the taxpayer's right to innocent spouse relief. Her former husband intervened to support her claim. Judge Panuthos held that neither § 6015 nor Tax Court Rule 325 precludes a nonelecting spouse from intervening for the purpose of supporting the electing spouse's claim for relief.

H. Miscellaneous

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

a. So far, he is unable to wriggle out, the way he did 25 years ago when he was acquitted by a jury.¹¹ The taxpayers subsequently moved to have access to the special trial judge's "reports, draft opinions, or similar documents" prepared under Tax Court Rule 183(b). They based their motion on conversations with two unnamed¹² Tax Court judges that the original draft opinion from the special trial judge was changed by Judge Dawson before he adopted it. They were turned down because the Tax Court held that the documents were related to its internal deliberative processes. See, Tax Court Order denying motion, 2001 TNT 23-31 (4/26/00) and (on reconsideration) 2001 TNT 23-30 (8/30/00). Taxpayers sought mandamus from the Fifth, Seventh and Eleventh Circuits, but were unsuccessful.

b. And the Tax Court's procedures are vindicated and taxpayer Ballard loses on appeal on the fraud issue in the Eleventh Circuit. *Ballard v. Commissioner*, 321 F.3d 1037, 91 A.F.T.R.2d 2003-928, 2003-1 U.S.T.C. ¶ 50,246 (11th Cir. 2/13/03), *aff'g* T.C. Memo. 1999-407. The Eleventh Circuit affirmed the Tax Court decision and rejected the taxpayers' argument that changes allegedly made by the Tax Court Special Trial Judge were improper. Judge Fay stated:

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

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

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

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

(1) **Cert. granted.** A writ of certiorari was granted on 4/26/04, 72 U.S.L.W. 3672, 124 S. Ct. 2066, and the case was consolidated with *Estate of Kanter*. See e.g., below.

c. **And the Tax Court's procedures are vindicated and taxpayer Kanter's Estate¹³ loses on appeal on the fraud issue in the Eleventh Circuit *Estate of Kanter v. Commissioner*, 337 F.3d 833, 92 A.F.T.R.2d 2003-5459, 2003-02 U.S.T.C. ¶ 50,605 (7th Cir. 7/24/03) (per curiam) (2-1), *aff'g in part and rev'g in part* T.C. Memo. 1999-407.** The court finds the nondisclosure of the special trial judge's original report to be proper, following the Eleventh Circuit's *Ballard* opinion. It affirms the findings on deficiencies, fraud and penalties, but reverses on the issue of the deductibility of Kanter's expenses for his involvement in the aborted sale of a purported John Trumbull painting of George Washington because "Kanter has shown a distinct proclivity to seek income and profit through activities similar to the failed sale of the painting."

(1) **The Supremes will sing over Kanter's grave.** A writ of certiorari was granted on 4/26/04, 72 U.S.L.W. 3672, 124 S. Ct. 2066, and the case was consolidated with *Ballard*. See e.g., below.

d. **And the Tax Court's procedures are vindicated but taxpayer Lisle's Estate wins on appeal on the fraud issue in the Fifth Circuit. *Estate of Lisle v. Commissioner*, 341 F.3d 364, 92 A.F.T.R.2d 2003-5566, 2003-02 U.S.T.C. ¶ 50,606 (5th Cir. 7/30/03), *aff'g in part and rev'g in part* T.C. Memo. 1999-407.** The Fifth Circuit (Judge Higginbotham) followed the Eleventh and Seventh Circuits on the nondisclosure of the special trial judge's original report by the Tax Court. It affirms the findings of deficiencies, except for the deficiency in a closed year because the government's proof of Lisle's fraud did not rise to the level of "clear and convincing evidence."

13. Burton Kanter died on October 31, 2001.

e. **Justice Ginsburg to Tax Court judges: “You Article I judges don’t understand your own rules, so let *me* tell you what you meant when you adopted them in 1983.”** Ballard v. Commissioner, 125 S. Ct. 1270, 95 A.F.T.R.2d 2005-1302, 2005-1 U.S.T.C. ¶ 50,211 (3/7/05) (7-2), *reversing and remanding* 337 F.3d 833 (7th Cir. 7/24/03) and 321 F.3d 1037 (11th Cir. 2/13/03). Justice Ginsburg held that the Tax Court may not exclude from the record on appeal and may not conceal from the taxpayers the original draft reports of Special Trial Judges under Tax Court Rule 183(b). Justice Ginsburg so held because no statute authorizes the concealment and the rule’s “current text” does not warrant it. Her reading of Tax Court Rule 183 is that it does not authorize the Tax Court to treat the special trial judge’s Rule 183(b) report as a draft subject to collaborative revision. She held that it is particularly important that the process be transparent in fraud cases such as this one.

● Chief Justice Rehnquist’s dissenting opinion, joined in by Justice Thomas, states that the “Tax Court’s compliance with its own Rules is a matter on which we should defer to the interpretation of that court.” He concludes that “Seminole Rock deference” [*Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410 (1945)] should extend to an Article I court’s interpretation of its own rules as well as to an executive agency’s interpretation of its rules. He further notes that the issue of compliance with Rule 183 was not presented to the Supreme Court, and that under Supreme Court Rule 14.1(a) the “Court does not consider claims not included within a petitioner’s questions presented.” He notes, “Only by failing to abide by our own Rules can the Court hold that the Tax Court failed to follow its Rules.”

2. **Sometimes the Tax Court has jurisdiction to redetermine interest due on overpayments for years not covered by the deficiency notice.** Sunoco, Inc. v. Commissioner, 122 T.C. 88 (2/4/04). Once the Tax Court’s jurisdiction has been properly invoked, it has jurisdiction under § 6512(b) to determine that there was an overpayment. This jurisdiction extends to overpayments of interest as well. *Estate of Baumgardner v. Commissioner*, 85 T.C. 445 (1985). Judge Whalen held that both underpayment and overpayment interest are calculated with respect to the cumulative balance of the taxpayer’s account with the IRS, the Tax Court’s jurisdiction also extends to determination that IRS had not properly credited taxpayer with overpayment interest attributable to other years.

3. **Factor NOLs into your qualified settlement offer up front or forfeit the right to raise the issue.** Johnson v. Commissioner, 122 T.C. 124 (2/11/04). The taxpayer made a qualified settlement offer under § 7430(g) that was accepted by the IRS. Subsequently the taxpayer attempted to reduce the amount through claimed net operating loss carrybacks that were not in dispute at the time the offer was made. Judge Nims held that under Temp. Reg. § 301.7430-7T, the IRS’s acceptance of the qualified offer “fully resolved the

issue” of the taxpayer’s liabilities for the years in question, and he was “not now allowed to add additional terms to the agreement by applying NOLs from other years to reduce the agreed-upon amounts,” where the offer did not expressly provide that the offered amount was subject to adjustment for net operating loss carrybacks. He noted that the final regulations provide that whether the qualified offer can be reduced by NOLs depends on contract principles, but that those regulations did not apply because the taxpayer’s offer was made before that date.

4. Eighth Circuit to Tax Court: “Who will you believe, us or your own lying eyes and ears?” Just how detailed a finding on the burden of proof issue does the Eighth Circuit want the Tax Court to make? Griffin v. Commissioner, 315 F.3d 1017, 91 A.F.T.R.2d 2003-486, 2003-1 U.S.T.C. ¶ 50,186 (8th Cir. 1/14/03), *rev’g* T.C. Memo. 2002-6 (1/8/02), *on remand*, T.C. Memo. 2004-64 (3/11/04). Reversing the Tax Court, the Eighth Circuit, in a per curiam opinion, held that the taxpayer had introduced credible evidence that payments of real estate taxes on property owned by an S corporation in which he was a shareholder were made in his capacity as a proprietor of a business, not in his capacity as a shareholder. (If the payments had been made in his capacity as a proprietor they could have been deductible.) The court accepted the Commissioner’s definition of “credible evidence:” “the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue *if no contrary evidence were submitted* (without regard to the judicial presumption of IRS correctness),” and found this standard satisfied by the testimony of the taxpayer and his accountant. The Commissioner had cross examined the taxpayer’s witnesses, but had not introduced any evidence. The case was remanded to the Tax Court for further proceedings to determine if the Commissioner met the burden of proof, even though the Tax Court opinion, in a footnote, stated that its decision would have been the same if the Commissioner had borne the burden of proof. Perhaps tipping its hand that it wanted the taxpayer to win, the Court of Appeals admonished the Tax Court that “[i]f the same conclusion is reached by the Tax Court without a new hearing, an explanation is warranted as to how the existing record justifies the conclusion that the Commissioner has met his burden of proof.”

● According to the Tax Court, the taxpayers did “not contend that the real property taxes in question were imposed upon them, that they owned the real property against which the taxes were assessed, or that they owned any equitable or beneficial interest in the real property that might entitle them to a deduction under section 164. . . . The only evidence regarding the nature of [taxpayers’] business activities consists of [one taxpayer’s] summary and uncorroborated testimony. He testified, with little elaboration, that he has been a building contractor and land developer for about 30 years, during which time he has developed about one project a year. On cross-examination, he

testified that his construction and real-estate development businesses are not separate businesses, but are ‘all tied together. They’re all – any business I have is – if I – if they are – oftentimes I incorporate, because of the liability aspect. They are Subchapter S if they are.’ . . . [T]here is no credible evidence that the tax payments were made with respect to such activities. To the contrary, [taxpayer’s] accountant testified that the tax payments were reported on Schedule E because they were attributable to [his] S corporations. . . . [Taxpayers] failed to introduce credible evidence to establish that [taxpayer’s] failure to make the tax payments would have caused direct and proximate adverse consequences to any businesses conducted in [taxpayers’] individual capacities. [One taxpayer] testified that he made the tax payments ‘in order to preserve my integrity and my standing with the bank, and my good name, my goodwill.’ There is no evidence to indicate, however, to what extent [the taxpayer’s] failure to make the tax payments would have resulted in any damage to his reputation or creditworthiness. [Taxpayers] have introduced no credible evidence to show that petitioner made the tax payments to protect the reputation of any business operation conducted in [their] individual capacities. On the basis of [taxpayer’s] testimony, we are unable to conclude that the tax payments would have represented ordinary expenses to advance any business carried on in [taxpayers’] individual capacities, as opposed to capital outlays to establish or purchase goodwill or business standing. . . .”

a. Tax Court responds, “If you tell us to believe taxpayer’s rooster-and-gentleman-cow story, we will be forced to.” Section 7491 has real teeth, and the burden of proof is shifted. On remand, T.C. Memo. 2004-64 (3/11/04). Neither party accepted the Tax Court’s offer to introduce further evidence, but both parties submitted briefs on the issue of the burden of proof. Judge Thornton found himself bound by the Eighth Circuit’s holding that taxpayer had produced sufficient “credible evidence” to shift the burden of proof to the government, even though he found to the contrary in his initial decision. Moreover, he felt himself bound to change his earlier conclusion that, had the burden of proof been shifted to the government, it had satisfied that burden. Footnote 7 states

In our original opinion, we noted: “Even if the burden of proof were placed on respondent, we would decide the issue [as to the deductibility of the tax payments] in his favor based on the preponderance of the evidence.” T.C. Memo. 2002-6 n. 4. This statement reflected this Court’s conclusion that Mr. Griffin’s testimony was not only insufficient to support petitioners’ claim to ordinary and necessary business deductions but indeed undermined their claim, insofar as Mr. Griffin’s testimony convinced us that his relevant business activities were conducted entirely through S corporations. In light of the Court

of Appeals' conclusion that Mr. Griffin's testimony was sufficient to support the claimed deductions, the preponderance of the evidence, thus evaluated, is no longer in respondent's favor.

- Query whether the caveat in footnote 6 is sufficient to prevent game-playing taxpayers from taking advantage of § 7491?

. . . We do not construe the opinion of the Court of Appeals as standing for the proposition that, in assessing the credibility of evidence for purposes of deciding the placement of the burden of proof pursuant to sec. 7491(a)(1), the trial court is required to accept at face value self-serving testimony which it finds unworthy of belief. See, e.g., Day v. Commissioner, 975 F.2d 534, 538 (8th Cir. 1992) (stating that "The Tax Court is not required to give credence to the self-serving testimony of interested parties."), affg. in part, revg. in part and remanding T.C. Memo. 1991-140. As stated in the relevant legislative history of sec. 7491: "The introduction of evidence will not meet this standard [of credible evidence] if the court is not convinced that it is worthy of belief." H. Conf. Rept. 105-599, at 241(1998), 1998-3 C.B. 747, 995; cf. Kincade v. Mikles, 144 F.2d 784, 787 (8th Cir. 1944) ("As to the contention that the evidence is unworthy of belief, it need only be said that it was the function of the trial court to pass upon the credibility of the witnesses and the weight to be given their testimony.")

5. An example of post-divorce cooperation between former spouses. Threat to ex-husband that she would write the IRS and get them to audit his returns results in IRS employee losing her job for committing a "deadly sin." James v. Tablerion, 363 F.3d 1352, 93 A.F.T.R.2d 1814 (Fed. Cir. 4/13/04). The Federal Circuit (Judge Clevinger) reversed an arbitrator's decision ordering reinstatement of a Revenue Agent in Tempe after she was dismissed by the Commissioner pursuant to the provisions of § 1203 of The IRS Reform and Restructuring Act of 1998 for "threatening to audit a taxpayer for the purpose of extracting personal gain or benefit." Mrs. Tablerion told her ex-husband that if he did not sign Forms 8332 relinquishing his claim for a tax exemption for one of their two children (after she had signed such forms with respect to their other child), saying "If you don't . . . I will write the IRS and, and, uh inform them to audit your returns." Her ex-husband eventually (but not immediately) reported the statement to the Treasury Inspector General for Tax Administration (TIGTA).

- The court determined that under the criteria of Metz v. Department of Treasury, 780 F.2d 1001 (Fed. Cir. 1986), witness testimony was to be weighed for "(1) The listener's reactions; (2) The listener's

apprehension of harm; (3) The speaker's intent; (4) Any conditional nature of the statements; and (5) The attendant circumstances." While the arbitrator found in favor of the IRS employee, the court found that § 1203 applied to off-duty conduct so a threat to audit made by an IRS employee violates the statute and is conclusively presumed to be made "in the performance of the employee's official duties." The court found that, under the legislative history, if the threat is made for personal gain, "threats to audit made by IRS employees must be discouraged by the penalty of removal."

6. The roaster got roasted, but just once. Siddiqui v. United States, 359 F.3d 1200, 93 A.F.T.R.2d 2004-1305, 2004-1 U.S.T.C. ¶ 50,193 (9th Cir. 3/9/04). An IRS special agent made a negligent disclosure of a criminal investigation of the taxpayer at a retirement dinner that included numerous guests, many of whom were not IRS CID personnel. In the absence of proof of any actual damages, the taxpayer was awarded the \$1,000 minimum damages award under § 7431. The Court of Appeals (Judge Alarcon) held that the \$1,000 minimum is based on each separate event of unauthorized disclosure, not how many people heard the unauthorized disclosure. Furthermore, punitive damages were denied because the statutory language precludes an award of punitive damages in absence of actual damages.

7. To the IRS, he was never a window. Payne v. United States, 2004-2 U.S.T.C. ¶ 50, (5th Cir. 9/8/04) (unpublished per curiam opinion), *aff'g* 290 F. Supp. 2d 742 (S.D. Tex. 2003). Affirms district court denial of damages for alleged unlawful disclosure of confidential tax return information during an IRS criminal investigation because the disclosures resulted from the IRS agent's good faith, but erroneous, interpretation of the Internal Revenue Code.

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

9. Section 842 of the American Jobs Creation Act of 2004 adds new § 6603 to codify the existing treatment of deposits made to suspend the running of interest on potential underpayments. These deposits had been governed by Rev. Proc. 84-58, 1984-2 C.B. 501.

10. Section 881 of the American Jobs Creation Act of 2004 adds new §§ 6306 and 7433A to permit "qualified tax collection contracts" to be

entered into with persons who are not IRS employees, and to provide damages for certain unauthorized collection actions by such persons.

11. You have a choice of forum for review of the Commissioner's refusal to abate interest. Beall v. United States, 336 F. 3d 419, 92 A.F.T.R.2d 2003-5001, 2003-2 U.S.T.C. ¶ 50,551 (5th Cir. 6/27/03). The Fifth Circuit (Judge Garwood) held that a district court has jurisdiction in a refund suit to review for abuse of discretion the Commissioner's refusal to abate interest. Judge Garwood reasoned that the grant of jurisdiction to the Tax Court in § 6404(h) was not exclusive.

a. But not in the Court of Federal Claims, which holds that *Beall* is not the "be all and end all" on this issue. Hinck v. United States, 64 Fed Cl. 71, 95 A.F.T.R.2d 2005-873, 2004-1 U.S.T.C. ¶ 50,270 (Fed. Cl. 2/3/05). Judge Allegra held that the 1996 amendments to § 6404 gave the Tax Court jurisdiction to review the failure to abate interest under the "abuse of discretion" standard." Before 1996 the Federal courts did not have jurisdiction to review abatement decisions, and the 1996 amendments to § 6404 did not do so. The Court of Federal Claims disagrees with, and refuses to follow, the *Beall* case.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

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

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

B. Self-employment

There were no significant developments regarding this topic during 2004.

C. Excise Taxes

1. Clear statutory language cannot be changed by an interpretive regulation. Horton Homes, Inc. v. United States, 357 F.3d 1209, 93 A.F.T.R.2d 2004-463, 2004-1 U.S.T.C. ¶ 70,215 (11th Cir. 1/20/04). Horton

purchased vehicles, known as “toters,” to transport manufactured homes. The IRS asserted the 12-percent excise tax levied in § 4051 because it contended that the toters were “[t]ractors of the kind chiefly used . . . in combination with a trailer or semitrailer.” The statute had not changed since 1938, but in 1983, temporary regulations that expanded the definition of “tractor” to include “a highway vehicle primarily designed to tow a vehicle, such as a trailer or semitrailer,” and further provided that a vehicle “equipped with air brakes and/or towing package will be presumed to be primarily designed as a tractor.” The court held that the regulation could not change the clear statutory language, and decided for Horton.

a. Rev. Rul. 2004-80, 2004-32 I.R.B. 164 (7/28/04). A chassis cab with a gross vehicle weight rating of 23,000 and a gross combination weight rating of 43,000 pounds [when it is towing a 20,000 pound trailer], with hydraulic disc brakes with a four-wheel automatic braking system, a 300 horsepower engine, and a six-speed automatic transmission as well as a removable ball gooseneck hitch, a fifth wheel hitch, and a heavy duty trailer receiver hitch [all of which maximize towing capacity at the expense of carrying capacity]. Held that pursuant to the 1983 temporary regulations referred to in *Horton Homes*, the vehicle is a tractor for purposes of § 4051.

2. TAM 200425048 (2/17/04). This TAM concludes that monthly management fees and variable rate fees paid to an aircraft management company by aircraft owners participating in a joint ownership program are subject to the § 4261 excise tax on amount paid for taxable transportation. This arrangement is comparable to payments under a “wet lease” that are subject to tax as payments for air transportation, as opposed to payments under a “dry lease” that are treated as rental payments.

XII. TAX LEGISLATION

A. Enacted

1. **The Pension Funding Equity Act of 2004**, P.L. 108-218, H.R. 3108, was signed by President Bush on 4/10/04.

2. **The Working Families Tax Relief Act of 2004** (“Working Families Act of 2004”) P.L. 108-311, H.R. 1308, was signed into law by President Bush on 10/4/04.

3. **Fire your lobbyist if you didn’t get relief in this act. The American Jobs Creation Act of 2004** (“American Jobs Creation Act of 2004”) H.R. 4520, was signed by President Bush on 10/22/04.