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Recent Developments in Federal Income Taxation: The Year 2015

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FLORIDA TAX REVIEW

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RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION: THE YEAR 2015

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Bruce A. McGovern**

This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during 2015—and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted—unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least)—income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

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I. ACCOUNTING

A. Accounting Methods

1. Accounting method changes related to the final tangible property regulations.

a. Accounting method changes are coming and the IRS wants to make it easy. Rev. Proc. 2014-16, 2014-9 I.R.B. 606 (2/24/14), *modified by* Rev. Proc. 2014-54, 2014-41 I.R.B. 675 (10/6/14) and Rev. Proc. 2015-14, 2015-5 I.R.B. 450 (2/2/15). These revenue procedures modify the procedures for obtaining the automatic consent of the IRS for certain changes in methods of accounting for amounts paid to acquire, produce, or improve tangible property. In particular, they provide procedures for obtaining automatic consent to change to (1) a reasonable method described in Reg. § 1.263A-1(f)(4) for self-constructed assets, and (2) a permissible method under § 263A(b)(2) and Reg. § 1.263A-3(a)(1) for certain costs related to real property acquired through a foreclosure or similar transaction. Rev. Proc. 2011-14, 2011-4 I.R.B. 330, is modified and clarified, and Rev. Proc. 2012-19, 2012-14 I.R.B. 689, is modified and superseded.

b. The IRS hears the many pleas for relief and provides to small businesses a simplified method of making accounting method changes related to the final tangible property regulations. Rev. Proc. 2015-20, 2015-9 I.R.B. 694 (2/13/15). This revenue procedure permits small business taxpayers to make certain accounting method changes to comply with the final tangible property regulations (T.D. 9636, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 78 F.R. 57686 (9/19/13) and T.D. 9689, Guidance Regarding Dispositions of Tangible Depreciable Property, 79 F.R. 48661 (8/18/14)) without filing Form 3115 and by taking into account a § 481(a) adjustment that takes into account only amounts paid or incurred, and dispositions, in taxable years beginning on or after 1/1/14. In effect, the revenue procedure permits eligible taxpayers to make changes on a cut-off basis. A taxpayer is a "small business taxpayer" for purposes of this simplified procedure if the taxpayer has one or more separate and distinct trades or businesses that has either total assets of less than $10 million as of the first day of the taxable year for which the change is effective or average annual gross receipts of $10 million or less for the prior three taxable years (as determined under Reg. § 1.263(a)-3(h)(3)).

- A taxpayer that uses the simplified procedure to make accounting method changes does not receive audit protection for prior years. Thus, for example, a taxpayer that fully deducted in prior years costs that are required by the tangible property regulations to be capitalized could,

by applying the regulations on a cut-off basis, have the prior year deductions disallowed on audit. In contrast, making the change by filing Form 3115 with a corresponding § 481(a) adjustment would provide audit protection.

- A taxpayer that uses the simplified procedure and applies the tangible property regulations on a cut-off basis cannot make a late partial disposition election. This election allows taxpayers to deduct as a loss the remaining undepreciated basis of previously retired structural components.

- The revenue procedure is effective for taxable years beginning on or after 1/1/14. A transition rule permits an eligible taxpayer that previously filed a return for its first taxable year beginning on or after 1/1/14 with a Form 3115 to change to an accounting method specified in the revenue procedure to withdraw the Form 3115 by filing an amended return. The amended return must be filed by the due date (including extensions) of the taxpayer's return for its first taxable year beginning on or after 1/1/14.

2. Howard Hughes may have died nearly 40 years ago, but his successors are still trying to fly the Spruce Goose. Howard Hughes Co., LLC v. Commissioner, 142 T.C. 355 (6/2/14), amended and superseded by 2014 WL 10077466 (6/2/14). The taxpayer was in the residential land development business. The taxpayer generally sold land through bulk sales, pad sales, finished lot sales, and custom lot sales. In bulk sales, it developed raw land into villages and sold an entire village to a builder. In pad sales, it developed villages into parcels and sold the parcels to builders. In finished lot sales, it developed parcels into lots and sold whole parcels of finished lots to builders. In custom lot sales, it sold individual lots to individual purchasers or custom home builders, who then constructed homes. The taxpayer never constructed any residential dwelling units on the land it sold. The taxpayer reported income from purchase and sale agreements under the § 460 completed contract method of accounting—generally when it had incurred 95 percent of the estimated costs allocable to each sales agreement. The IRS took the position that the land sales contracts were not home construction contracts within the meaning of § 460(e) and that the bulk sale and custom lot contracts were not long-term construction contracts eligible for the percentage of completion method of accounting under § 460. (The IRS conceded that the other contracts were long-term construction contracts.) The Tax Court (Judge Wherry) held that the bulk sale and custom lot contracts were long-term construction contracts under § 460(f)(1), and that the taxpayer could report gain or loss from those contracts on the appropriate long-term method of accounting to the extent it had not completed the contracts within a year of entering into them. The contracts included more than just the sale of lots. The costs incurred for a custom lot contract are not really different from the costs for the finished lot sales. The contracts included development of things such as water service, traffic signals, landscaping, and construction of

parks, which did not necessarily occur prior to the closing. Completion of the contracts thus occurred upon final completion and acceptance of the improvements, the cost of which was allocable to the custom lot contracts. However, none of the contracts qualified as home construction contracts eligible for the completed contract reporting method under § 460(e). In relevant part, § 460(e)(6) defines a home construction contract as follows:

> (A) Home construction contract. -- The term "home construction contract" means any construction contract if 80 percent or more of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to activities referred to in paragraph (4) with respect to —
>
> > (i) dwelling units (as defined in section 168(e)(2)(A)(ii)) contained in buildings containing 4 or fewer dwelling units (as so defined), and
> >
> > (ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.

The taxpayer argued the costs met the "80 percent test" applied to determine whether the land sales contracts met the definition in § 460(e)(6). At the end of a long analysis of the statutory language, the regulations, and the legislative history, Judge Wherry concluded that the contracts did not qualify as home construction contracts. The taxpayer's costs were, if anything, common improvement costs. The taxpayer did not incur any costs with respect to any home's "structural, physical construction." The costs were not "costs for improvements 'located on' or 'located at' the site of the homes." Accordingly, the costs could not be included in testing whether 80 percent of their allocable contract costs are attributable to the dwelling units and real property improvements directly related to and located on the site of the yet to be constructed dwelling units.

> Our Opinion today draws a bright line. A taxpayer's contract can qualify as a home construction contract only if the taxpayer builds, constructs, reconstructs, rehabilitates, or installs integral components to dwelling units or real property improvements directly related to and located on the site of such dwelling units. It is not enough for the taxpayer to merely pave the road leading to the home, though that may be necessary to the ultimate sale and use of a home. If we allow taxpayers who have construction costs that merely benefit a home that may or may not be built, to use the completed

contract method of accounting, then there is no telling how attenuated the costs may be and how long deferral of income may last.

a. And spruce doesn't grow in the deep South; it's piney woods down there. Howard Hughes Co., L.L.C. v. Commissioner, 805 F.3d 175 (5th Cir. 10/27/15). The Fifth Circuit, in an opinion by Judge King, affirmed the Tax Court's holding. "A plain reading of [§ 460(e)(6)(A)(i)] supports the Tax Court's holding. … [A] taxpayer seeking to use the completed contract method must be engaged in construction, reconstruction, rehabilitation, or installation of an integral component of a home or apartment." Because the costs taxpayer incurred were "'not the actual homes' structural, physical construction costs,' or were not related to work on dwelling units," taxpayer did not come within § 460(e)(6)(A)(i). Taxpayer's construction activities for common improvements were not 'located on the site of such dwelling units,' and thus not within § 460(e)(6)(A)(ii). The statute requires more than "some causal relationship between the dwelling units and construction costs incurred."

3. New and improved (?) procedures for requesting accounting method changes. Rev. Proc. 2015-13, 2015-5 I.R.B. 419 (1/16/15), modified by Rev. Proc. 2015-33, 2015-24 I.R.B. 1067 (6/15/15). This revenue procedure updates and revises the procedures for obtaining the consent of the IRS to both automatic changes and non-automatic changes in accounting methods. It supersedes Rev. Proc. 97-27, 1997-1 C.B. 80 and, subject to limited exceptions, supersedes Rev. Proc. 2011-14, 2011-14 I.R.B. 330. Subject to special transition rules, the revenue procedure is effective for Forms 3115 filed on or after 1/16/15 for a year of change ending on or after 5/31/14. The procedures for taxpayers not under examination generally are consistent with those provided in prior guidance: taxpayers requesting a non-automatic change generally must file Form 3115 with the National Office during the requested year of change, and those requesting an automatic change must attach Form 3115 to the timely filed (including extensions) return for the requested year of change and file a signed copy of the Form 3115 with the IRS in Ogden, Utah. Positive § 481(a) adjustments generally are taken into account ratably over four years (the year of change and the next three taxable years) and negative adjustments are taken into account in the year of change. The four-year adjustment period for positive § 481(a) adjustments does not apply in several circumstances, including a change requested when a taxpayer is under examination (in which case the period is two years unless certain exceptions apply) and a change that results in a positive adjustment of less than a de minimis amount of $50,000 that the taxpayer elects to take into account in the year of change. Generally, a taxpayer not under examination that timely files a Form 3115 obtains audit protection for prior years, i.e., the

IRS will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the requested year of change.

- The most significant change from prior guidance is that taxpayers under examination can request either automatic or non-automatic changes in accounting methods at any time. (Under prior guidance, taxpayers under examination could request accounting method changes only in specified circumstances.) However, taxpayers under examination do not obtain audit protection for prior years unless one of six specified exceptions applies. As noted, taxpayers under examination generally must take positive § 481(a) adjustments into account over two years.
- Transition rules permit taxpayers to request a non-automatic accounting method change under the procedures of either Rev. Proc. 97-27 or Rev. Proc. 2015-13 for a taxable year ending on or after 11/30/14 and on or before 1/31/15 by filing Form 3115 by 3/2/15. Similarly, taxpayers can request an automatic accounting method change under the procedures of either Rev. Proc. 2011-14 or Rev. Proc. 2015-13 for a taxable year ending on or after 5/31/14 and on or before 1/31/15 by filing Form 3115 by the due date (including extensions) of the taxpayer's timely filed original return for the requested year of change. Additional transition rules include permission for taxpayers to convert certain Forms 3115 previously filed under Rev. Proc. 93-27 to requests for consent under Rev. Proc. 2015-13, which could be beneficial if, for example, a previously non-automatic change is now an automatic change.

a. An updated list of automatic accounting method changes. Rev. Proc. 2015-14, 2015-5 I.R.B. 450 (1/16/15). This revenue procedure provides the list of automatic accounting method changes to which the automatic change procedures in Rev. Proc. 2015-13, 2015-5 I.R.B. 419 (1/16/15), apply. Subject to the transition rules of Rev. Proc. 2015-13, the list of automatic changes is effective for a Form 3115 that is filed under the automatic change procedures of Rev. Proc. 2015-13 on or after 1/16/15 for a year of change ending on or after 5/31/14. This revenue procedure was modified by Rev. Proc. 2015-20, 2015-9 I.R.B. 694 (2/13/15) and by Rev. Proc. 2015-39, 2015-33 I.R.B. 195 (8/17/15).

4. Automatic consent to change of accounting method ain't horseshoes. Strict compliance with procedures is a prerequisite to gaining automatic consent. Hawse v. Commissioner, T.C. Memo. 2015-99 (5/27/15). The taxpayer was the sole shareholder of an S corporation that operated an automobile dealership. The corporation was on the LIFO method of inventory accounting. For 2001, the corporation sought automatic consent under Rev. Proc. 99-49, 1999-2 C.B. 725, to change its method of inventory accounting from LIFO to specific identification, with the vehicles valued at the lower of cost or market rather than actual cost. The corporation never fully

implemented the change as requested, but filed income tax returns for 2001 through 2007 as if it had (reporting § 481(a) LIFO recapture income and paying the tax). Contrary to its representation on Form 3115 that it would value all of its inventory at the lower of cost or market, the corporation actually used different valuation approaches for its various inventories of new and used cars. Furthermore, the corporation neither cited on Form 3115 the applicable section of the revenue procedure's appendix nor attached to Form 3115 a separate statement describing how its new methods of identifying and valuing its inventory conformed to the requirements of Rev. Proc. 97-37, App. § 10.01(1)(b)(i). Subsequently the corporation filed amended tax returns for 2002 and 2003 purporting to "correct" its prior returns to reflect continued use of LIFO. On the amended returns, the corporation claimed refunds of the tax paid on the LIFO recapture income. The taxpayer argued that because the corporation did not change its valuation method for all of its vehicle inventory to lower of cost or market, the corporation never received automatic consent and therefore remained on the LIFO method. The IRS refused to consent to permit the continued use of LIFO on the basis that using LIFO represented a retroactive change of accounting method without the IRS's consent. The Tax Court (Judge Wherry) held that the corporation failed to satisfy the requirements for automatic consent to change its accounting method because it did not comply with all terms and conditions of Rev. Proc. 99-49, 1999-2 C.B. 725. The revenue procedure demands strict compliance: "'[A] taxpayer * * * [that] changes to a method of accounting without complying with all the applicable provisions of this revenue procedure' has not obtained the Commissioner's consent. See Rev. Proc. 99-49, sec. 6.06, 1999-2 C.B. at 735 (emphasis added)." Because it had consistently accounted for its new and used vehicles inventory using the specific identification method on its 2001 through 2007 income tax returns, the corporation had changed its method of accounting without receiving consent by the IRS to do so. Thus, its attempt to revert to the LIFO method of accounting by filing amended returns was a change in method of accounting that requires the IRS's consent under § 446(e).

5. An attempt to transmute ordinary income to capital gain founders on the accounting method change rules. Greiner v. United States, 122 Fed. Cl. 139 (7/22/15). The taxpayer received a stream of contingent payments from an acquiring corporation in exchange for surrendering his compensatory stock options in the target. After reporting the payments as ordinary income under the open transaction doctrine for six years, he sought to change to the closed transaction method, reporting as ordinary income the estimated fair market value of the income stream in the year of the exchange, followed by a return of capital and long-term capital gains as payments were received. The Court of Federal Claims (Judge Campbell-Smith) agreed with the government that the refund was properly denied because the change of reporting method from open transaction to closed

transaction was a change of accounting method for which permission had not been sought under § 446(e). Regardless of which method was used, the amount of total income reported over the years was the same, but the amount (as well as the character) of the income reported in each year differed.

6. Insurance company, insurance policy? The IRS and the Tax Court never seem to agree on what's what, but the Tax Court continues to show its love for insurance. R.V.I. Guaranty Co., Ltd. v. Commissioner, 145 T.C. No. 9 (9/21/15). The taxpayer sold "residual value insurance" contracts (hence the name "RVI") to customers such as leasing companies, manufacturers, and financial institutions that were the lessors of property or provided financing for the leases. The insured assets insured included passenger vehicles, commercial real estate, and commercial equipment. When pricing a lease, a lessor estimates the residual value that the asset will have when it is returned at the end of the lease. The contracts sold by the taxpayer insured against the risk that the actual value of the asset upon termination of the lease would be significantly lower than the expected value. The IRS determined that the contracts were not insurance for federal income tax purposes and disallowed the use of insurance company accounting under § 832, asserting that the lessors were purchasing protection against an investment risk, not an insurance risk. The Tax Court (Judge Lauber) held that the risks insured by the policies were insurance risks and that the policies were insurance contracts for federal income tax purposes. The contracts involved both risk shifting and risk distribution. The court rejected the IRS's argument that the policies did not transfer enough risk of loss because losses were relatively unlikely to occur. "This argument is unpersuasive on both theoretical and evidentiary grounds. Both parties' experts analogized the RVI policies to 'catastrophic' insurance coverage, which insures against earthquakes, major hurricanes, and other low-frequency, high-severity risks. An insurer may go many years without paying an earthquake claim; this does not mean that the insurer is failing to provide 'insurance.'" The court also rejected the IRS's argument that the policies did "not sufficiently distribute risk because some systemic risks, like major recessions, could cause insured assets to decline in value simultaneously, reasoning that "[l]ike most insurers, [RVI] did face certain systemic risks, but many of the risks against which it insured were uncorrelated." Further, "[t]he legal requirement for 'insurance' is that there be meaningful risk distribution; perfect independence of risks is not required." The court also rejected the IRS's argument that the contracts were not insurance because the contracts did not indemnify the purchasers against a loss that was both fortuitous, such as an unexpected calamity, and the timing of which was uncertain. The court analogized the residual value policies to mortgage guaranty and municipal bond insurance. Furthermore, the states in which the taxpayer did business treated the contracts as insurance

policies, not as indemnification for investment losses. Thus the § 832 insurance accounting method used by the taxpayer was upheld.

B. Inventories

There were no significant developments regarding this topic during 2015.

C. Installment Method

There were no significant developments regarding this topic during 2015.

D. Year of Inclusion or Deduction

1. It's new old law, but is it good new law? Agro-Jal Farming Enterprises, Inc. v. Commissioner, 145 T.C. No. 5 (7/30/15). The taxpayer was a farming corporation growing strawberries and vegetables. It used the cash method of accounting. When it harvested its crops, it used field-packing materials, i.e., plastic clamshell containers for the strawberries and cardboard trays and cartons for the other produce. The taxpayer deducted the full purchase price of the field-packing materials in the year it bought them instead of deducting the cost as the materials were used. The parties stipulated that the taxpayer always used its prepaid packing materials by the end of the following tax year; it had to do so because they began to deteriorate six to eight months after they were delivered. The IRS asserted that the taxpayer could deduct the cost of only those field-packing materials that it actually used each tax year, and that it had to defer deduction of the rest. The Tax Court (Judge Holmes) held for the taxpayer. The IRS conceded that § 464, which defers deductions for farming "syndicates," i.e., tax shelters, did not apply. The governing rule was Reg. § 1.162-3, the first sentence of which (as it was in the years at issue) read:

> Taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year for which the return is made, provided that the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year.

Based upon a detailed analysis of the wording of the regulation, Judge Holmes concluded that the taxpayer could deduct the amounts paid for the packing

materials as materials and supplies in the year in which they were purchased, rather than the later year in which they were used. He reasoned that the regulation allowing a deduction for materials and supplies used in a tax year "provided that" the costs had not already been deducted does not require the deduction to be deferred until the year the materials and supplies are used but merely allows a deduction to be deferred until the year in which the materials and supplies are used.

- The significance of this case is unclear. Reg. § 1.162-3 was significantly revised in the final tangible property regulations, T.D. 9636, 79 F.R. 42189 (7/21/14), and the "provided that" language on which Judge Holmes grounded his decision was removed. Reg. § 1.162-3(a) now reads: "Except as provided in paragraphs (d), (e), and (f) of this section, amounts paid to acquire or produce materials and supplies (as defined in paragraph (c) of this section) are deductible in the taxable year in which the materials and supplies are first used in the taxpayer's operations or are consumed in the taxpayers operations." None of those subsections, with the possible exception of subsection (e), which provides a de minimis rule coordinated with Reg. § 1.263(a)-1(f), appears to apply.

2. A little gift from the IRS regarding the economic performance requirement. Rev. Proc. 2015-39, 2015-33 I.R.B. 195 (7/30/15). This revenue procedure provides a safe harbor for accrual method taxpayers to treat economic performance under § 461(h) as occurring ratably on contracts providing for services to be provided on a regular basis. Under the safe harbor, a taxpayer can ratably expense the cost of regular and routine services as the services are provided under the contract. Contracts for regular janitorial or landscape maintenance services are typical examples of contractual services that may qualify for the safe harbor. A service contract that provides for a single product to be delivered to the taxpayer, such as an environmental impact study, will not satisfy the definition of a "ratable service contract" because the contract does not provide for services to be provided on a regular basis. A contract is a ratable service contract if: (1) the contract provides for similar services to be provided on a regular basis, such as daily, weekly, or monthly; (2) each occurrence of the service provides independent value, such that the benefits of receiving each occurrence of the service is not dependent on the receipt of any previous or subsequent occurrence of the service, and; (3) the term of the contract does not exceed 12 months (contract renewal provisions will not be considered in determining whether a contract exceeds 12 months). The revenue procedure provides examples of contracts that will and will not satisfy the definition. The revenue procedure also includes examples of bundled service contracts, which provide for both regular

and one-time services. Whether part of a bundled service contract qualifies as a ratable service contract depends on whether the parties have separately priced the services specified in the contract. A change in the treatment of ratable service contracts to conform to the safe harbor method provided by this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply.

- This revenue procedure limits the impact of Caltex Oil Venture v. Commissioner, 138 T.C. 18 (2012), in which the Tax Court construed the 3½ month rule in Reg. § 1.461-4(d)(6)(ii), as contemplating that all of the services called for under an undifferentiated, nonseverable contract must be provided within 3½ months of payment. (Under the 3½ month rule in § 1.461-4(d)(6)(ii), a taxpayer may treat economic performance as occurring as the taxpayer makes payment to the person providing the services if the taxpayer can reasonably expect the person to provide the services within 3½ months after the taxpayer makes the payment.)

- The revenue procedure is effective for taxable years ending on or after 7/30/15.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. Query: If refundable incentive state tax credits are gross income, does that mean that refundable incentive federal tax credits also are gross income? Maines v. Commissioner, 144 T.C. 123 (3/11/15). The taxpayers received targeted economic development payments from the state of New York in the form of income tax credits. Eligibility for the credits depended on their business meeting specific requirements; all of the credits required them to make some amount of business expenditure or investment in targeted areas within the state. Two of the credits, the EZ Investment Credit and the EZ Wage Credit, were not limited to past income taxes actually paid. One of the credits, the QEZE Real Property Tax Credit, was limited to the amount of past real-property tax actually paid. All the credits first reduced a taxpayer's state income-tax liability; any excess credits could be carried forward to future years or partially refunded. The Tax Court (Judge Holmes) held that the state-law label of the credits as "overpayments" of past taxes was not controlling for federal tax purposes. Accordingly, the refundable portion of the EZ Investment Credit and the EZ Wage Credit that remained after first reducing state-tax liability was an accession to the taxpayers' wealth and was includable in gross income under § 61 for the year in which they received the payment or, under the constructive receipt doctrine, were entitled to receive the payment, even if they elected to carry forward the credit, unless an exclusion applies. The refundable amounts were includable because there is

no exclusion from gross income simply because a payment comes from a state government. However, the nonrefundable portions of the EZ Investment Credits and the EZ Wage Credits that only reduced the taxpayers' state-tax liabilities were not taxable accessions to wealth includible in gross income. The analysis of the treatment of the QEZE Real Property Tax Credit differed. Because the QEZE Real Property Tax Credit was creditable only to the extent of past property-tax payments, the QEZE Real Property Tax Credit was treated like a refund of past tax payments. The nonrefundable portions of the QEZE Real Property Tax Credit payments that only reduced the taxpayer's state-tax liabilities were not taxable accessions to wealth. Refundable portions of the QEZE Real Property Tax Credit payments were includible in the taxpayers' gross income under the tax-benefit rule to the extent that the taxpayers actually benefited from previous deductions for property-tax payments. (That a partnership in which the taxpayers were partners and an S corporation in which they were shareholders paid and deducted the property taxes, which passed through to the taxpayers, while it was the taxpayers who received the refundable credit was not relevant; a tax-free receipt of the credit would be fundamentally inconsistent with the earlier tax treatment.)

- "Critics of programs like New York's might call them 'corporate welfare.' But that's just a metaphor—the credits that New York gave to the Maineses were not conditioned on their showing need, which means they do not qualify for exclusion from taxable income under the general-welfare exception."

2. The Tax Court bravely explores the mysteries of § 467. Stough v. Commissioner, 144 T.C. No. 16 (6/2/15). The taxpayer constructed a commercial building and entered into a 10-year lease with a lessee. The lease required the lessee to pay monthly rent based on the amount of "project costs" the taxpayer incurred in acquiring and developing the leased property. Under the terms of the lease, the lessee had a unilateral option to make a one-time payment to the taxpayer to reduce the "project costs" used to calculate the rent, thus reducing the amount of rent otherwise due under the lease. The lessee elected to make a $1 million payment to the taxpayer. The taxpayer argued that the $1 million payment was not rental income but "was meant to reimburse [the taxpayer] for leasehold improvements." Alternatively, the taxpayer argued that pursuant to § 467(b) the $1 million payment was reportable as rental income ratably over the 10-year life of the lease using the constant rental accrual method. The Tax Court (Judge Ruwe) rejected both of the taxpayer's arguments and held that the $1 million was reportable as rental income in the year it was received. The $1 million lump-sum payment was rent in the form of the "the lessee's payment of the lessor's expenses" pursuant to Reg. § 1.61-8(c). Although the regulation states that "[w]hether or not improvements made by a lessee result in rental income to the lessor in a particular case depends upon the intention of the parties, which may be

indicated either by the terms of the lease or by the surrounding circumstances," the intent of the parties did not control because the improvements were not made by the lessee. The important issue of first impression was the applicability of § 467. Section 467(b)(1)(A) provides that the amount of rent is determined "by allocating rents in accordance with the agreement." Reg. § 1.467-1(c)(2)(ii)(B) provides that, "[i]f a rental agreement does not provide a specific allocation of fixed rent ... the amount of fixed rent allocated to a rental period is the amount of fixed rent payable during that rental period." The lease stated when rent was payable but did not specifically allocate rent to any specific rental period; it provided for a fixed amount of rent payable over the entire rental period. Accordingly, because there was no "specific" allocation in the rental agreement and the $1 million was the amount of rent due and payable in the year in question, the entire $1 million was includable as rental income for the year of receipt. Finally, under Reg. § 1.467-1(d)(2)(i) and (ii), the constant rental accrual and proportional rental accrual methods were inapplicable to the lease at issue. Because the lease was not a "long-term agreement" as defined by the regulations, that method would apply only if the rental agreement did not provide adequate interest on fixed rent. The court rejected the taxpayer's argument that the $1 million was prepaid rent. Reg. § 1.467-1(c)(3)(ii) defines prepaid rent as follows: "A rental agreement has prepaid rent under this paragraph ... if the cumulative amount of rent payable as of the close of a calendar year exceeds the cumulative amount of rent allocated as of the close of the succeeding calendar year ... ." [Emphasis added by the court.] Analyzing the rental payments due, the court found that "the cumulative amount of rent payable as of the close of 2008 ($1,151,493.18) will not exceed the cumulative amount of rent allocated as of the close of 2009 ($1,151,493.18 plus rent payable during 2009)." Accordingly, the rental agreement did not have prepaid rent as defined in the regulation.

- The taxpayer's original return had reported the $1 million as rental income on Schedule E, but reported an offsetting $1 million deduction for "contribution to construct" expense. In the Tax Court proceeding, the taxpayer conceded that the deduction was erroneous and argued that it had incorrectly treated the $1 million receipt as rental income. The court sustained a § 6662 negligence penalty, rejecting the taxpayer's argument that he had reasonable cause because he relied on the advice of a CPA. The taxpayer "briefly" reviewed the tax return before signing it, but he did not review the Schedule E. Nor did he discuss the prepared tax return with the CPA before signing the return. "Unconditional reliance on a tax return preparer or C.P.A. does not by itself constitute reasonable reliance in good faith; taxpayers must also exercise '[d]iligence and prudence.' ... Claiming reliance on [the CPA] and choosing to not adequately review the contents of a tax return is not reasonable reliance in good faith, and we will not permit petitioners to avoid an accuracy-related penalty for substantially understating their income tax liability."

B. Deductible Expenses versus Capitalization

1. Custom homes are no different from spec houses; both are subject to the uniform cost capitalization rules. Frontier Custom Builders, Inc. v. Commissioner, T.C. Memo. 2013-231 (9/30/13). The taxpayer corporation constructed custom homes. It argued that its business model was centered around sales and marketing rather than production related services and asserted that employee salaries and other indirect expenses were not subject to capitalization under § 263A. The Tax Court (Judge Goeke) disagreed. The court stated that the taxpayer's creative design of homes "is ancillary to the physical work and is as much a part of a development project as digging a foundation or completing a structure's frame." Thus the court found that the taxpayer was a producer of property subject to § 263A's capitalization requirements. The court also held that the IRS did not abuse its discretion by treating the taxpayer's deduction of production expenses as an accounting method and requiring the taxpayer to adopt the simplified production and simplified service cost methods of accounting under Reg. §§ 1.263A-2(b)(1) and 1.263A-1(h)(1). The court required an allocation of salaries, bonuses and other expense items between indirect expenses subject to capitalization and operating expenses currently deductible.

a. The Fifth Circuit sees it uniformly. Frontier Custom Builders, Inc. v. Commissioner, 116 A.F.T.R.2d 2015-6146 (5th Cir. 9/16/15). In a per curiam opinion, the Fifth Circuit affirmed the Tax Court's decision. Most of the costs in question were for employee salaries and year-end bonuses, including $1.3 million in total compensation paid to the taxpayer's founder and CEO. The Fifth Circuit rejected the taxpayer's arguments that it was exempt from the requirements of § 263A because its primary business was sales and marketing (rather than production-related services) and that, even if it was subject to § 263A, the CEO's compensation need not be capitalized because his work related to overall management, marketing, and business planning. The court concluded that his activities were sufficient to support the IRS's position that his compensation must be capitalized. These activities included "selecting developers and reviewing subcontractors; resolving issues that arose at worksites during production; selecting and installing the home design software; meeting weekly with project managers to stay apprised of production timelines; and evaluating project managers' productivity reports."

2. "Candy, Cigarettes, and . . . . ?" City Line Candy & Tobacco Corp. v. Commissioner, 141 T.C. 414 (11/19/13). Section 263A(b)(2)(B) provides a small reseller exception to the § 263A uniform capitalization rules, which applies to businesses acquiring goods for resale if

the firm's average annual gross receipts for the three-year period immediately preceding the taxable year do not exceed $10 million. The Tax Court (Judge Marvel) held that, for purposes of determining eligibility for the § 263A(b)(2)(B) small reseller exception, the gross receipts of a cigarette wholesaler included the entire sale proceeds from the sale of cigarettes, including the costs of the state cigarette tax stamps the wholesaler was required to purchase. As a result, the wholesaler's gross receipts exceeded the $10 million ceiling. The cigarette stamp tax costs were indirect costs under Reg. § 1.263A-1(e)(3)(i), properly characterized as handling costs, not selling expenses, which Reg. § 1.263A-1(e)(3)(iii)(A) exempts from the capitalization requirement.

a. The taxpayer gets smoked in the Second Circuit as well. City Line Candy & Tobacco Corp. v. Commissioner, 116 A.F.T.R.2d 2015-6285 (2d Cir. 9/30/15). In a summary order, the Second Circuit affirmed and concluded that the Tax Court correctly included the value of the cigarette tax stamps in the taxpayer's gross receipts for purposes of determining eligibility for the small reseller exception of § 263A(b)(2)(B). Therefore, the taxpayer was subject to the uniform capitalization rules. The court also held that, under the uniform capitalization rules, the taxpayer could not deduct the cost of the tax stamps, but instead had to capitalize the cost as an indirect cost.

3. A generous safe-harbor accounting method to encourage retailers and restauranteurs to "remodel-refresh." Whether K-Mart will make any effort to match the ambiance of Le Targét is still doubtful. Rev. Proc. 2015-56, 2015-49 I.R.B. 827 (11/19/15). This revenue procedure provides certain taxpayers operating a retail establishment or a restaurant with a formulaic "remodel-refresh" safe harbor method of accounting (which is too complex to explain here) for determining whether expenditures paid or incurred to remodel or refresh a retail or restaurant building are deductible under § 162(a), must be capitalized as improvements under § 263(a), or must be capitalized as the costs of property produced by the taxpayer for use in its trade or business under § 263A. It also provides procedures for obtaining automatic consent to change to the permitted safe harbor method. The revenue procedure is effective for taxable years beginning on or after 1/1/14.

4. A "de minimis" capital expenditure that can be expensed now exceeds the cost of Professor McMahon's first new car, purchased in 1974. Notice 2015-82, 2015-50 I.R.B. 859 (11/24/15). Reg. § 1.263(a)-1(f) provides a de minimis safe harbor election that permits a taxpayer to not capitalize, or treat as a material or supply, certain amounts paid for tangible property that it acquires or produces during the taxable year

provided the taxpayer meets certain requirements and the property does not exceed certain dollar limitations. This Notice increases from $500 to $2,500 the de minimis safe harbor limit in Reg. § 1.263(a)-1(f)(1)(ii)(D) for a taxpayer without an applicable financial statement. (In contrast, the limit for a taxpayer with an applicable financial statement is $5,000.) The notice is effective for expenditures incurred during tax years beginning on or after 1/1/16, but the notice provides audit protection by stating that the IRS will not challenge a taxpayer without an applicable financial statement who deducts an amount not in excess of $2,500 under the de minimis safe harbor for prior years.

C. Reasonable Compensation

1. Non-limit limitations on excessive compensation to corporate officers. T.D. 9716, Certain Employee Remuneration in Excess of $1,000,000 Under Internal Revenue Code Section 162(m), 80 F.R. 16970 (3/31/15). The Treasury and IRS have finalized, with minor changes, proposed amendments to regulations under § 162(m) (REG-137125-08, Certain Employee Remuneration in Excess of $1,000,000 Under Internal Revenue Code Section 162(m), 76 F.R. 37034 (6/24/11)). Section 162(m) limits deduction of compensation to top corporate officers of publicly traded corporations to $1 million with an exception for performance-based compensation attributable to stock options and stock appreciation rights. The amendments clarify Reg. § 1.162-27(e)(2)(iv) by requiring that performance-based compensation plans designate the maximum number of shares with respect to which options or rights may be granted to an individual employee during a specified period (i.e., it is insufficient for a plan to provide merely the aggregate number of shares that may be granted during the specified period without a per-employee limitation). In response to comments on the proposed regulations, the final regulations provide that a plan may satisfy this requirement if the plan specifies the aggregate maximum number of shares with respect to which stock options, stock appreciation rights, restricted stock, restricted stock units and other equity-based awards may be granted to any individual employee during a specified period under a plan approved by shareholders in accordance with Reg. § 1.162–27(e)(4). These changes apply to compensation attributable to stock options and stock appreciation rights that are granted on or after 6/24/11. The final regulations also adopt without change the guidance in the proposed regulations on the transition rule of Reg. § 1.162-27(f)(1), which provides that, in the case of a non-publicly held corporation that becomes publicly held, the $1 million deduction limit "does not apply to any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the corporation was not publicly held." The final regulations clarify how this transition rule applies to restricted stock unit arrangements. The clarification of the transition rule applies to remuneration

otherwise deductible under a restricted stock unit arrangement that is granted on or after 4/1/15.

D. Miscellaneous Deductions

1. The IRS cuts an illegal drug dealer a break not warranted on the face of the statute. Olive v. Commissioner, 139 T.C. 19 (8/2/12). The taxpayer operated a medical marijuana business that sold medical marijuana at retail under the California Compassionate Use Act of 1996. The Tax Court (Judge Kroupa) upheld the IRS's determination that the taxpayer underreported his gross receipts and that § 280E precluded his deduction of business related expenses. The IRS conceded that § 280E did not bar a deduction from gross receipts for costs of goods sold but argued that the taxpayer's ledger entries were inadequate substantiation and that as a factual matter cost of goods sold should be zero. Judge Kroupa sustained the IRS's position that the journal entries were unreliable, but applied Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930) to find, based on expert witness testimony, that the cost of goods sold was approximately 75 percent of the gross receipts and adjusted that amount to account for marijuana that was given away to customers and staff. Judge Kroupa rejected the taxpayer's argument that the expenses should be deductible based on Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner, 128 T.C. 173 (2007), in which the Tax Court held that the corporation's care-giving activities for terminally ill patients were a separate trade or business from its medical marijuana delivery and that expenses allocable to the care-giving activity were deductible as ordinary and necessary business expenses. In the instant case, unlike in Californians Helping to Alleviate Medical Problems, based on the facts and circumstances there were not two separate and distinct activities. In this case the taxpayer operated a single business of dispensing medical marijuana, with all other services being provided as part of that business.

- Judge Kroupa upheld accuracy-related penalties on the deficiency resulting from unsubstantiated expenses, but not with respect to expenses that were substantiated but disallowed under § 280E, reasoning that the application of § 280E to the medical marijuana industry was decided after the years at issue.

- A straightforward reading of § 280E and the last sentence of § 263A(a)(2) in concert clearly denies the recovery of cost of goods sold for the marijuana in this case. Prior to the enactment of the last sentence of § 263A(a)(2), however, § 280E alone did not deny drug dealers tax-free recovery of the cost of goods sold. See, e.g., Franklin v. Commissioner, T.C. Memo. 93-184. However, the legislative history states that "to preclude possible challenges on constitutional grounds, the adjustment to gross receipts with

respect to effective costs of goods sold is not affected by this provision." But this legislative history of § 280E, standing alone, should not be controlling with respect to the last sentence of § 263A(a)(2). S. Rep. 97-494, 97th Cong., 2d Sess. 309 (2012). In Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner, 128 T.C. 173 (2007), the IRS, based on that outdated case law, conceded—erroneously in our opinion—that § 280E did not operate to deny as matter of law the cost of goods sold to a taxpayer that purchased and resold marijuana. That mistake was repeated in this case.

a. On appeal, the taxpayer was not able to blow smoke in the eyes of the Ninth Circuit. Olive v. Commissioner, 792 F.3d 1146 (9th Cir. 7/09/15). In an opinion by Judge Graber, the Ninth Circuit affirmed. Because the only income-generating activity in which the taxpayer engaged was its sale of medical marijuana, its sole business was "carrying on any trade or business ... consist[ing] of trafficking in controlled substances." Section 280E applied to disallow all of the ordinary and necessary business expenses of the medical marijuana dispensary business. The Tax Court's decision in *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007) allowing a deduction for some expenses was inapposite. In that case the income-generating business included the provision not only of medical marijuana, but also of "extensive" counseling and caregiving services, which resulted in the taxpayer being engaged in more than one trade or business. That was not true in this case. The court rejected the taxpayer's arguments relating to congressional intent and public policy. The taxpayer argued that § 280E "should not be construed to apply to medical marijuana dispensaries because those dispensaries did not exist when Congress enacted § 280E." He argued that Congress enacted § 280E to prevent street dealers from taking a deduction, and could "not have intended for medical marijuana dispensaries, now legal in many states, to fall within the ambit of" § 280E. The court responded: "That Congress might not have imagined what some states would do in future years has no bearing on our analysis."

b. Ditto. Beck v. Commissioner, T.C. Memo. 2015-149 (8/10/15). The Tax Court (Judge Goeke) upheld the disallowance under § 280E of all of the deductions claimed by a California-based medical marijuana dispensary that did not sell any non-marijuana-related items. Furthermore, the cost of marijuana seized by the DEA could not be deducted as cost of goods sold because the marijuana was confiscated and not sold.

2. You're expected to bang up that rental car, says the IRS. C.C.A. 201529008 (2/4/15). This C.C.A. takes the position that collision damages to a vehicle rental company's rental vehicles that have been damaged and that it disposes of without repairs, with respect to which the

customer purchased a damage liability waiver in connection with the rental contract, do not arise from a casualty within the meaning of § 165 because they are not unusual in the ordinary course of the taxpayer's business of renting vehicles.

3. Pushing the right drugs garners a magic deduction. Precision Dose, Inc. v. United States, 116 A.F.T.R.2d 2015-6231 (N.D. Ill. 9/24/15). A § 199 deduction was allowed to a taxpayer who sold "unit doses" of medications. The taxpayer bought certain drugs in bulk and packaged drugs in non-reusable containers intended for administration as a single dose to a patient. Relying on Dean v. United States, 945 F. Supp. 2d 1110 (C.D. Cal. 2013), the court (Judge Reinhard) rejected the government's argument that the taxpayer engaged only in repackaging, which is expressly excepted from the definition of qualifying activities.

4. It looks like the Treasury and the IRS don't like the way some courts are interpreting the § 199 Regs. The solution? Spread on a little *Mayo*.[1] REG-136459-09, Amendments to Domestic Production Activities Deduction Regulations; Allocation of W-2 Wages in a Short Taxable Year and in an Acquisition or Disposition, 80 F.R. 51978 (8/27/15). The Treasury Department and the IRS have proposed numerous amendments to the regulations under § 199 to reflect various amendments to the statute. Of particular significance are proposed amendments to Reg. § 1.199-3(f)(1). Current Reg. § 1.199-3(f)(1) provides that if one taxpayer performs a qualifying activity pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the qualified product, qualified film, or utilities during the period in which the qualifying activity occurs is treated as engaging in the qualifying activity. The proposed amendments would replace the benefits and burdens of ownership rule with a rule providing that "if a qualifying activity is performed under a contract, then the party that performs the activity is the taxpayer for purposes of section 199(c)(4)(A)(i)." This change is intended to better implement the direction of § 199(d)(10) that the regulations prevent more than one taxpayer from being allowed a deduction under § 199 with respect to any qualifying activity. According to the preamble, "[t]he Treasury Department and the IRS have interpreted the statute to mean that only one taxpayer may claim the section 199 deduction with respect to the same activity performed with respect to the same property."

> [The proposed new] rule, which applies solely for purposes of section 199, reflects the conclusion that the party actually

[1] Mayo Foundation for Medical Research v. United States, 562 U.S. 44 (2011).

> producing the property should be treated as engaging in the qualifying activity for purposes of section 199, and is therefore consistent with the statute's goal of incentivizing domestic manufacturers and producers. The proposed rule would also provide a readily administrable approach that would prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any qualifying activity.

- This amendment could change the result in a case such as Advo, Inc. v. Commissioner, 141 T.C. 298 (2013), which held that gross receipts attributable to printed direct-mail advertising did not qualify as domestic production gross receipts; only a taxpayer that has the "benefits and burdens" of the ownership of qualifying production property may claim the § 199 deduction; the printers maintained title to the manufactured paper during the printing process and had possession of the manufactured material before delivery to the taxpayer; the printers bore the risk of damage before delivery of the printed material to the taxpayer, and the printers bore the economic gain or loss on the fixed-price printing contracts.
- Another important proposed amendment would negate the holding of United States v. Dean, 945 F. Supp. 2d 1110 (C.D. Cal. 2013), which concluded that the taxpayer's activity of preparing gift baskets was a manufacturing activity and not solely packaging or repackaging for purposes of § 199. Reg. § 1.199-3(e)(2) provides that if a taxpayer packages, repackages, labels, or performs minor assembly of "qualified production property" (QPP) and the taxpayer engages in no other "manufactured, produced, grown, or extracted" (MPGE) activities with respect to that QPP, the taxpayer's packaging, repackaging, labeling, or minor assembly does not qualify as MPGE with respect to that QPP. The Treasury Department and the IRS disagree with the interpretation of Reg. § 1.199-3(e)(2) in Dean, and the proposed regulations add Reg. § 1.199-3(e)(2), Ex. 9, that illustrates the appropriate application of this rule in a situation in which the taxpayer is engaged in no other MPGE activities with respect to the QPP other than those described in Reg. § 1.199-3(e)(2).

5. Wouldn't it be better to increase teachers' pay? The Protecting Americans from Tax Hikes Act of 2015 ("2015 PATH Act"), § 104, enacted as Division Q of the Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, was signed by the President on 12/18/15. The 2015 PATH Act retroactively extended through 2015 and made permanent the § 62(a)(2)(D) above-the-line deduction for up to $250 of teachers' classroom supplies expenses. For taxable years beginning after 12/31/15, the legislation also (1) expands the types of costs that are deductible by permitting deduction (subject to the $250 limit) not only of classroom supplies, but also

"professional development courses related to the curriculum in which the educator provides instruction or to the students for which the educator provides instruction," and (2) provides that the $250 limit shall be adjusted for inflation.

E. Depreciation & Amortization

1. The taxpayer's basis in the Three Mile Island nuclear power plant is melted away by the China Syndrome; nuclear decommissioning liabilities are not included in the purchaser's basis until there is economic performance. AmerGen Energy Co., LLC v. United States, 113 Fed. Cl. 52 (10/8/13). The taxpayer purchased three nuclear power plants and assumed liability for decommissioning costs in future years. In each transaction, the taxpayer received decommissioning trust funds. In one case the cash purchase price was approximately $23,000,000 (plus $77,000,000 in five annual installments for nuclear fuel) and the liabilities exceeded $530,000,000; the decommissioning trust fund was approximately $331,000,000. In a second transaction, the cash price was approximately $20,000,000 and the liabilities exceeded $600,000,000; the decommissioning trust fund was approximately $235,000,000. In the third transaction, the cash price was $10,000,000 and the liabilities exceeded $550,000,000; the decommissioning trust fund was approximately $437,000,000. The only issue was whether AmerGen could include a portion of the decommissioning costs to be paid in the future in the depreciable cost basis of the nuclear power plants. The IRS had previously refused to give AmerGen a private letter ruling that it could take into account in computing the depreciable cost basis of the nuclear power plants the decommissioning costs to be paid in the future. AmerGen argued that only § 1012 was relevant and that the liabilities could be taken into account in basis immediately. The government argued that the all events test of § 461 and the "economic performance" test of § 461(h) controlled the date on which the liabilities could be taken into account. On summary judgment, the Court of Federal Claims (Judge Bush) held for the government. The court reasoned that the plain language of § 461(h) does not limit its application to deductions, but provides that it applies to "any item." Thus, § 461(h) "is of general applicability," and applies to determine when liabilities are incurred for the purpose of cost basis calculations. The court's conclusion was reinforced by its reading of the legislative history of § 461(h) in H.R. Rep. No. 98-432, pt. 2, at 1254–55 (1984), which included a reference to "capital items," that the court concluded "show[ed] Congress' concern with the time value of money and revenue losses due to attempts by taxpayers to claim the premature accrual of liabilities, as well as with the administrative challenges of providing a system for the discounted valuation of liabilities that will be satisfied in the future. Second, and more importantly, Congress understood

that these concerns were present not only in the timing of deductions for expenses but also in the timing of the accounting of liabilities relevant to capital items." Furthermore, the court held that the matrix of applicable regulations under §§ 263, 446, and 461 – particularly Reg. § 1.461-1(a)(2)(i), which requires economic performance before an item is includable in basis – were entitled to deference under Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984), and clearly applied the three-pronged test of § 461 to assumed liabilities for purposes of determining § 1012 cost basis. Finally, the court rejected AmerGen's last ditch argument that economic performance had occurred at the time the plants were purchased because the sellers had "provided property" to it and indicated that economic performance of decommissioning costs does not occur before the nuclear plants are shut down and decommissioning costs are incurred.

- Reg. § 1.263(a)-1(c)(1), as amended in 2013, provides that "In the case of a taxpayer using an accrual method of accounting, the terms amount paid and payment mean a liability incurred (within the meaning of § 1.446-1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred." Reg. § 1.446-1(c)(1)(ii) provides that "a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability."

a. The Federal Circuit sees it the same way and goes nuclear on the taxpayer. AmerGen Energy Co., LLC v. United States, 779 F.3d 1368 (Fed. Cir. 3/11/15). In a unanimous opinion by Judge Lourie, the Federal Circuit affirmed, rejecting the taxpayer's varied arguments. First, AmerGen argued that the § 461(h) economic performance requirement is inapplicable in calculating the basis of purchased assets—that purchase-price basis is governed by *Crane* and its progeny, which only require a liability to be noncontingent and definite. AmerGen reasoned that § 461(h) modifies the "all events test," which is a term of art that according to the pre-1984 case law only applied to expense deductions by an accrual method taxpayer, not to basis calculations, and that when Congress enacted § 461(h), it did not expand the scope of the "all events test," but merely added the economic performance requirement. The court, however, accepted the government's argument that "the plain text of § 461(h)(1) makes clear that the economic performance rule is applicable to 'any item' for 'purposes of this title,' i.e., the Internal Revenue Code."

> [Section] 461(h)(1) plainly states that it applies for all "purposes of this title," *i.e.*, the Internal Revenue Code, not just to a subset of tax provisions, such as specific deduction

> provisions. Second, the text of § 461(h)(1) and § 461(h)(4) specifies that they apply "with respect to any item" and thus the statutory "all events test" is not limited to expense deductions. Prior to 1984, there was no statutory "all events test," and Treasury regulations provided a two-prong "all events test" for determining when an *expense* was deductible for an accrual method taxpayer. Treas. Reg. § 1.461-1(a)(2) (1967). However, when Congress enacted § 461(h), it used broader language, namely, "with respect to any item" of a liability. Thus, Congress not only added the economic performance requirement in § 461(h)(1), but also enacted a new and more inclusive "all events test" in § 461(h)(4) that is not limited to expense deductions by an accrual method taxpayer.

The court of appeals also added that accepting the taxpayer's argument "would effectively circumvent [the] statutory scheme" in §§ 468A and 172(f), dealing with nuclear decommissioning costs, which were enacted along with § 461(h) in 1984. Sections 468A and 172(f) specifically provide "limited means for a nuclear power plant owner to alter the effect of the otherwise applicable timing rules of § 461(h)."

- Finally, the court rejected the taxpayer's alternative argument that even if § 461(h) applies to basis calculation, economic performance of its decommissioning liabilities had already occurred pursuant to § 461(h)(2)(A)(ii),[2] because it became obligated to incur decommissioning costs when the sellers conveyed the nuclear power plants. The court accepted the government's argument that § 461(h)(2)(A)(ii) was inapplicable, and instead § 461(h)(2)(B) governed because the liabilities at issue related to "a service to be

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[2] Section 461(h)(2) provides as follows:

> (2) TIME WHEN ECONOMIC PERFORMANCE OCCURS.—Except as provided in regulations prescribed by the Secretary, the time when economic performance occurs shall be determined under the following principles:
>
> (A) Services and property provided to the taxpayer. If the liability of the taxpayer arises out of
>
> (i) the providing of services to the taxpayer by another person, economic performance occurs as such person provides such services,
>
> (ii) the providing of property to the taxpayer by another person, economic performance occurs as the person provides such property, or
>
> (B) Services and property provided by the taxpayer. If the liability of the taxpayer requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services.

provided by the taxpayer, not a property provided or a service to be provided to the taxpayer"—AmerGen's decommissioning obligations arose out of the NRC licenses and regulations of state and local governments, not the transfer of assets from the sellers. Thus, economic performance would occur when decommissioning activities actually began.

2. Section 280F 2014-2015 depreciation tables for business autos, light trucks, and vans—"hurrah" for 2014, "boo" for 2015, when additional first year recovery goes away (maybe). Rev. Proc. 2015-19, 2015-8 I.R.B. 656 (2/6/15). The IRS published depreciation tables with the depreciation limits for business use of small vehicles:

2014 Passenger Automobiles with § 168(k) first year recovery:	
1st Tax Year	*$11,160*
2nd Tax Year	*$ 5,100*
3rd Tax Year	*$ 3,050*
Each Succeeding Year	*$ 1,875*
2014 Trucks and Vans with § 168(k) first year recovery:	
1st Tax Year	*$11,460*
2nd Tax Year	*$ 5,500*
3rd Tax Year	*$ 3,350*
Each Succeeding Year	*$ 1,975*
2015 Passenger Automobiles (no § 168(k) first year recovery):	
1st Tax Year	*$ 3,160*
2nd Tax Year	*$ 5,100*
3rd Tax Year	*$ 3,050*
Each Succeeding Year	*$ 1,875*
2015 Trucks and Vans (no § 168(k) first year recovery):	
1st Tax Year	*$ 3,460*
2nd Tax Year	*$ 5,600*
3rd Tax Year	*$ 3,350*
Each Succeeding Year	*$ 1,975*

- The revenue procedure also has tables for leased vehicles.

3. Depreciation is precious. Rev. Rul. 2015-11, 2015-21 I.R.B. 975 (5/7/15). The capitalized cost of unrecoverable precious metals that are used in various manufacturing processes is depreciable under §§ 167 and 168; the capitalized cost of any recoverable precious metal is not depreciable under §§ 167 and 168.

4. Guidance on bonus depreciation for years prior to 2015. Rev. Proc. 2015-48, 2015-40 I.R.B. 469 (9/15/15). This revenue procedure provides guidance for issues related to the extension by The Tax Increase Prevention Act of 2014, Pub. L. No. 113-295, to before 1/1/15 of (1) the placed-in-service date for property to qualify for the § 168(k) 50-percent additional first-year depreciation deduction, (2) the § 168(k)(4) election not to claim the 50-percent additional first-year depreciation deduction for certain property placed in service generally after 12/31/13, and before 1/1/15, and instead to increase alternative minimum tax (AMT) credit limitation under § 53(c),and (3) the extension of the application of § 179(f), allowing expensing of certain real property, to any taxable year beginning after 2009 and before 2015.

5. Certain depreciation and amortization provisions of the 2015 PATH Act:

a. Retroactive extension and modification for the future of § 168(k) bonus first-year depreciation. The 2015 PATH Act, § 143, retroactively extended through 12/31/15 the § 168(k) 50-percent additional first-year depreciation deduction as it had existed through 2014 and extends the deduction, with certain modifications, through 2019 (2020 for transportation property or certain property with longer production periods).

Eligible property.—The deduction generally is available for "qualified property," which for 2015 is defined as MACRS property with a recovery period of 20 years or less, computer software (other than computer software subject to § 197), certain water utility property, and qualified leasehold improvement property, the original use of which commenced with the taxpayer. For property placed in service after 2015, the 2015 PATH Act replaces the category of qualified leasehold improvement property with a new category, "qualified improvement property," defined (subject to certain exceptions) as "any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service." This change expands the types of improvements that are eligible for the deduction by allowing bonus depreciation for improvements without regard to whether the property is subject to a lease and without regard to whether the improvement is placed in service more than three years after the date the building was first placed in service. The 2015 PATH Act also expands the property eligible for bonus depreciation by permitting the deduction for certain trees, vines and plants bearing fruits or nuts that are planted or grafted after 2015.

Phased reduction of bonus depreciation.—For eligible property placed in service after 2017, the percentage of the property's adjusted basis that can be deducted is reduced from 50 percent to 40 percent in 2018 and 30 percent in 2019.

Expansion of election to accelerate AMT credits in lieu of bonus depreciation.—The 2015 PATH Act retroactively extended through 12/31/15 the § 168(k)(4) election to claim additional AMT credits in lieu of claiming bonus depreciation with respect to eligible qualified property. For property placed in service after 2015, a taxpayer making this election can claim an increased amount of AMT credits.

b. Fifteen-year straight-line cost recovery for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property made permanent. The 2015 PATH Act, § 123, retroactively extended through 12/31/15 and made permanent §§ 168(e)(3)(E)(iv), 168(e)(3)(E)(v), and 168(e)(3)(E)(ix), which treat as 15-year property qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property, respectively. Qualified restaurant property also is eligible for § 168(k) bonus first-year depreciation if it meets the definition of qualified leasehold improvement property (for property placed in service in 2015) or qualified improvement property (for property placed in service after 2015). For property placed in service in 2015, § 168(e)(8)(D) provides that qualified retail improvement property is eligible for bonus first-year depreciation only if it meets the definition of qualified leasehold improvement property. The 2015 PATH Act repealed this provision for property placed in service after 2015. It appears that, for property placed in service after 2015, qualified retail improvement property is eligible for bonus first-year depreciation if it meets the definition of qualified improvement property (a new category in § 168(k)(2) that replaces the category of qualified leasehold improvement property). Congress likely repealed the cross-reference in § 168(e)(8)(D) because all qualified retail improvement property seems to constitute qualified improvement property as newly defined in § 168(k)(2). For the same reason, qualified leasehold improvement property should be eligible for bonus depreciation.

c. Special interests rule! The 2015 PATH Act, § 166, retroactively extended through 12/31/15 and extends through 2016 the § 168(e)(3)(C)(ii) 7-year straight line cost recovery period for motorsports entertainment complexes.

d. Do we see Mitch McConnell's fingerprints here? The 2015 PATH Act, § 165, retroactively extended through 12/31/15 and extends through 2016 the classification of certain race horses as 3-year MACRS property. A race horse placed in service after 2016 qualifies for the 3-year recovery period only if it is more than two years old when placed in service. The legislation also retroactively extended through 12/31/15 and extends through 2016 the election under § 179E to treat 50 percent of the cost

of any qualified mine safety equipment as an expense in the tax year in which the equipment is placed in service.

e. **Congress just essentially repealed capitalization of machinery and equipment for small businesses?** The 2015 PATH Act, § 124, retroactively extended through 12/31/15 and made permanent the increased $500,000 maximum amount that can be expensed under § 179 and the increased $2 million expenditure ceiling phase-out amount. For taxable years beginning after 12/31/15, these amounts are adjusted for inflation. The legislation also retroactively extended and made permanent the eligibility for § 179 expensing of qualified leasehold improvement property, qualified restaurant property, qualified retail improvement property (collectively, "qualified real property"), and off-the-shelf computer software. Qualified real property is subject to a $250,000 limit on the amount that can be expensed for taxable years beginning in 2015, but the legislation removed this limitation for taxable years beginning after 12/31/15. Also for taxable years beginning after 12/31/15, the legislation repealed the rule that qualified real property does not include air conditioning and heating units. The ability of a taxpayer to revoke any election made under § 179 (and any specification contained in such an election) without the consent of the IRS also is now permanent.

f. **Of course we need better tax treatment of luxury cars—Let's incentivize purchases of Mercedes, BMWs, and Lexuses to boost the American auto industry. What, they're not American? Surely you jest!** The 2015 PATH Act, § 143, retroactively extended through 12/31/15 and extends (subject to phased reductions) through 2019 the $8,000 increase in the first-year § 280F ceiling on depreciation deductions with respect to automobiles, light trucks, vans, and SUVs that are rated at not more than 6,000 pounds gross vehicle weight. The increase is limited to $6,400 for property placed in service during 2018 and $4,800 for property placed in service during 2019.

F. Credits

1. **Funded versus unfunded research for the § 41 credit.** Geosyntec Consultants, Inc. v. United States, 112 A.F.T.R.2d 2013-5488 (S.D. Fla. 4/15/13). A magistrate judge granted summary judgment to the taxpayer and IRS on issues relating to whether research was funded or unfunded for purposes of the § 41 20 percent credit for increased research expenditures. Under § 41(d)(4)(H) the research credit is not available to a taxpayer if another party has funded otherwise qualifying research. Reg. § 1.41-4A(d) provides that, "Amounts payable under any agreement that are

contingent on the success of the research and thus considered to be paid for the product or result of the research (see § 1.41-2(e)(2)) are not treated as funding. ...” Reg. § 1.41-4A(d)(1)(iii) provides that an expense is incurred for qualified research under an agreement with third parties only if the agreement requires the taxpayer to bear the expense even if the research is not successful. Fairchild Industries, Inc. v. United States, 71 F.3d 868, 870 (Fed. Cir. 1995), interprets these regulations to allocate “the tax credit to the person that bears the financial risk of failure of the research to produce the desired product or result.” The magistrate judge held that research expenditures incurred under the taxpayer’s fixed price contracts were eligible for the research credit, and that the research was not subject to funded contracts. Under those contracts, the taxpayer was obligated to perform environmental clean-up activities for a fixed price subject to approval of the client. The court observed that, “The nature of fixed-price contracts makes them inherently risky to contractors. Under these types of contracts, to the extent a contractor’s performance is unsuccessful, the contractor must remedy the performance without additional compensation. Thus, these contracts generally place maximum economic risk on contractors who ultimately bear responsibility for all costs and resulting profit or loss.” The magistrate judge also held that research performed under “capped” contracts was funded research. The capped contracts provided for reimbursement of costs up to a capped amount. The court indicated that, “A distinctive feature of the capped contracts at issue is that each one obligates the client to reimburse [taxpayer] for pre-defined tasks at pre-defined rates in accordance with a detailed project budget.” The magistrate judge indicated that the capped contracts were similar to cost plus contracts that placed the risk of failed research on the client, and thus were funded contracts that did not cause the taxpayer to incur research expenditures eligible for the credit.

a. The Eleventh Circuit similarly concluded that the research was funded and therefore ineligible for the § 41 credit. Geosyntec Consultants, Inc. v. United States, 776 F.3d 1330 (11th Cir. 1/29/15). The taxpayer appealed the District Court’s grant of summary judgment to the government with respect to the capped contracts. In an opinion by Judge Wilson, the Eleventh Circuit affirmed and held that the research performed under the capped contracts was ineligible for the research tax credit because it was funded within the meaning of § 41(d)(4)(H). The court looked for guidance to the Federal Circuit’s decision in *Fairchild Industries, Inc. v. United States*, 71 F.3d 868 (Fed. Cir. 1995), and stated that “the inquiry turns on whether Geosyntec’s right to payment under its … contracts was ‘contingent on the success of the research’ contemplated by those contracts.” The court distinguished the taxpayer’s contracts from those in *Fairchild*. The contracts in *Fairchild*, the court reasoned, provided for quality assurance procedures that required the other party to evaluate Fairchild’s work item-by-item and obligated the other party to pay only if Fairchild produced results that

met the contract's specifications. In contrast, the court concluded, Geosyntec was entitled to payment under the capped contracts regardless of success. "Because payment to Geosyntec was not contingent on the success of its research, Geosyntec did not bear the financial risk of its own failure, and the … capped contracts were funded by Geosyntec's clients."

2. How many sets of regulations does it take to define "internal use software"? We can't be sure quite yet. REG-153656-03, Credit for Increasing Research Activities, 80 F.R. 2624 (1/20/15). The Treasury and IRS have published proposed amendments to the regulations under § 41(d)(4)(E), which, except to the extent provided by regulations, generally excludes from the definition of "qualified research" all "research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer," unless the software is for use in either an activity that constitutes qualified research or a production process with respect to which the requirements of § 41(d)(1) (defining qualified research) are met. The 1986 legislative history of § 41(d)(4)(E) provides that the regulations should make the costs of new or improved internal use software eligible for the credit only if the research satisfies, in addition to the general requirements for credit eligibility, an additional three-part high threshold of innovation test: (1) that the software is innovative, (2) that the software development involves significant economic risk, and (3) that the software is not commercially available for use by the taxpayer. The current final regulations on internal use software were issued in 2001 (T.D. 8930, Credit for Increasing Research Activities, 66 F.R. 280 (01/03/01)). In response to concerns expressed about the final regulations, Treasury and the IRS subsequently issued proposed regulations (REG-112991-01, Credit for Increasing Research Activities, 66 F.R. 66362 (12/26/01)) that never were finalized. Instead, Treasury and the IRS issued an advance notice of proposed rulemaking (REG-153656-03, Credit for Increasing Research Activities, 69 F.R. 43 (01/02/04)) in which they solicited comments on the definition of internal use software. The current proposed amendments reflect the comments received.

- Prop. Reg. § 1.41-4(c)(6)(ii) provides that "software is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use if the software is developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business." For this purpose, general and administrative functions are financial management functions (including functions such as accounts payable and receivable, inventory management, and strategic business planning), human resources management functions (including functions such as recruiting, hiring, payroll and benefits), and support services (including data processing, janitorial and other facility services, marketing, legal services, and government compliance). Software that a taxpayer develops primarily for the internal use of

a related party (as defined in § 41(f)) is considered internal use software. Conversely, under Prop. Reg. § 1.41-4(c)(6)(iv), software is not developed primarily for the taxpayer's internal use if either: (1) "[t]he software is developed to be commercially sold, leased, licensed, or otherwise marketed to third parties," or (2) "[t]he software is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system."

- Under Prop. Reg. § 1.41-4(c)(6)(i), research with respect to computer software that is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use is eligible for the research credit only if: (1) the software satisfies the requirements of § 41(d)(1) (defining qualified research), (2) the software is not otherwise excluded from the definition of "qualified research" under § 41(d)(4), and (3) one of the following three conditions is met—(A) the taxpayer develops the software for use in an activity that constitutes qualified research (other than the development of the software itself), (B) the taxpayer develops the software for use in a production process to which the requirements of section 41(d)(1) are met, or (C) the software satisfies the high threshold of innovation test (set forth in Prop. Reg. § 1.41-4(c)(6)(v)). The proposed regulations provide a number of examples.

- The proposed regulations generally are effective for tax years ending on or after 12/31/03, but Prop. Reg. § 1.41-4(c)(6), which defines internal use software and provides guidance on when the research credit is available for it, will apply to tax years ending on or after the date that final regulations are published in the Federal Register. However, the IRS will not challenge return positions consistent with the proposed regulations for tax years ending on or after 1/20/15 (the date these proposed regulations were published in the Federal Register). For tax years ending before that date, "taxpayers may choose to follow either all of the internal use software provisions of § 1.41-4(c)(6) in TD 8930 or all of the internal use software provisions in the 2001 proposed regulations."

3. Taxpayers now can make the alternative simplified research credit election on an amended return. T.D. 9712, Alternative Simplified Credit Election, 80 F.R. 10587 (2/27/15). Treasury and the IRS have finalized proposed and temporary regulations (T.D. 9666, Alternative Simplified Credit Election, 79 F.R. 31863 (6/3/14)) regarding the time and manner of electing the alternative, simplified credit under § 41(c)(5). Section 41(c)(5) provides a "simplified" research credit of 14 percent of so much of the qualified research expenses as exceeds 50 percent of the average qualified research expenses for the three preceding taxable years, or, if the taxpayer has no qualified research expenses in any of the three prior years, the simplified credit is 6 percent of qualified research expenses for the year. (The regular credit under § 41(a)(1) generally is 20 percent of qualified research expenses over a base.) Final regulations as amended in 2011 require that an

election for the alternative simplified credit (ASC) be made with the return filed for the year to which the election applies, provide that the election may not be made on an amended return, and state that the IRS will not grant an extension of time to file the election under Reg. § 301.9100-3. T.D. 9528, Alternative Simplified Credit Election, 76 F.R. 33994 (6/10/11). In response to taxpayer requests, Treasury and the IRS have removed from the final regulations the rule in Reg. § 1.41-9(b)(2) that prohibits a taxpayer from making an ASC election for a tax year on an amended return. In place of this rule, the final regulations, like the temporary regulations, provide that taxpayers can make an ASC election for a tax year on an amended return, but only if the period of limitations on assessment under§ 6501(a) has not expired for the year. Extensions of time to make the election will not be granted under Reg. § 301.9100-3. Because of concerns that permitting changes from the regular credit to the ASC on amended returns could result in more than one audit of a taxpayer's research credit for a tax year, the final regulations provide that a taxpayer that previously claimed, on an original or amended return, a § 41(a)(1) credit for a tax year may not make an ASC election for that tax year on an amended return. A taxpayer that is a member of a controlled group in a tax year may not make an ASC election for that tax year on an amended return if any member of the controlled group for that year previously claimed the research credit using a method other than the ASC on an original or amended return for that tax year. The final regulations apply to elections with respect to tax years ending on or after 2/27/15. For prior years, taxpayers can rely on the temporary regulations (T.D. 9666) for tax years ending on or after 6/3/14 and before 2/27/15, and also can rely on the temporary regulations to make elections for prior tax years if the election is made before the period of limitations for assessment of tax has expired for that year.

4. Guidance on allocating the research credit among members of a controlled group. T.D. 9717, Allocation of Controlled Group Research Credit, 80 F.R. 18096 (4/3/15). The Treasury Department and the IRS have issued final and temporary regulations regarding allocation of the § 41 research credit and the § 45G railroad track maintenance credit among the members of a controlled group of corporations and simultaneously published the text of the temporary regulations as proposed regulations (REG-133489-13, 80 F.R. 18171 (4/3/15)). The regulations also address the § 280C reduced research credit election in the context of a controlled group. The amendments reflect legislative changes made by § 301(c) of the American Taxpayer Relief Act of 2012 (ATRA). ATRA amended § 41(f)(1) to require the research credit to be allocated to controlled group members based on each member's proportionate share of the group's aggregate qualified research expenditures. Prior to this legislative amendment, the regulations required a controlled group to allocate the group credit, at least in part, in proportion to each member's stand-alone entity credit. After the legislative amendment, the

IRS issued Notice 2013-20, 2013-15 I.R.B. 902 (3/8/15), which provides that the group credit is allocated among members based on each member's share of qualified research expenditures, without regard to whether the member would have a stand-alone entity credit or what the amount of such credit would be. The temporary regulations provide an allocation method that follows the approach of Notice 2013-20. The temporary regulations apply to taxable years beginning on or after 4/3/15 (and will expire on 4/2/18), but taxpayers may apply them to taxable years beginning after 12/31/11. Notice 2013-20 is obsolete for taxable years beginning on or after 4/3/15, but remains in effect for taxable years beginning after 12/31/11 for taxpayers that do not apply the temporary regulations to prior years.

5. Certain credit provisions of the 2015 PATH Act:

a. More than thirty years after its first enactment in ERTA 1981, Congress decides that the research credit really is a good idea and makes it permanent. The 2015 Path Act, § 121, retroactively extended through 12/31/15 and made permanent the § 41 research credit. The legislation provides that, in the case of an eligible small business (as defined in § 38(c)(5)(C), after application of rules similar to the rules of § 38(c)(5)(D)), the research credit determined for taxable years beginning after 12/31/15 is a specified credit that can offset both regular tax and AMT liabilities. Also for taxable years beginning after 12/31/15, a qualified small business can elect for any taxable year to claim a certain amount (capped at $250,000) of its research credit as a payroll tax credit against its employer OASDI liability (i.e., social security portion of the employer's FICA taxes), rather than against its income tax liability. A "qualified small business" is defined as a corporation (including an S corporation) or partnership (1) with gross receipts of less than $5 million for the taxable year, and (2) that did not have gross receipts for any taxable year before the five taxable year period ending with the taxable year. An individual carrying on one or more trades or businesses can be a qualified small business if the individual meets the two specified conditions, taking into account the individual's aggregate gross receipts received with respect to all trades or businesses.

b. Congress gives a "thumbs up" to energy efficiency. The 2015 PATH Act, § 188, retroactively extended through 12/31/15 and extends through 2016 the § 45L credit of $2,000 or $1,000 (depending on the projected level of fuel consumption) an eligible contractor can claim for each qualified new energy efficient home constructed by the contractor and acquired by a person from the contractor for use as a residence during the tax year.

c. A big salute to differential pay for active duty members of the armed forces. The 2015 PATH Act, § 122, retroactively extended through 12/31/15 and made permanent the § 45P differential wage credit, which permits eligible small business employers to claim a credit for so-called "differential pay," i.e., payments to an employee called to active duty with the U.S. armed forces representing the difference between the compensation the employer would have paid to the employee during the period of military service less the amount of pay the employee receives from the military. For taxable years beginning after 12/31/15, the credit is available to employers of any size, i.e., without regard to whether the employer is a small business employer.

d. Extenders, extenders, can't get enough of those extenders. Jimmy Johnson would have been proud. Other business credits the 2015 PATH Act extended include: (1) the § 51 Work Opportunity Credit, extended through taxable years beginning before 1/1/20; (2) the § 45 credit for electricity produced from certain renewable resources, extended for facilities for which construction has commenced before 1/1/17 (except for wind facilities, for which the extension applies to facilities for which construction begins before 1/1/20); (3) the § 45G railroad track maintenance credit, extended for qualified railroad track maintenance expenditures paid or incurred in taxable years beginning before 1/1/17; (4) the § 45A Indian Employment Credit, extended for taxable years beginning before 1/1/17, and the § 45(e)(10) Indian Coal Production Credit, extended for coal produced before 1/1/17; (5) the § 45D New Markets Credit, extended through 2019; (6) the § 45N mine rescue team training credit, extended for taxable years beginning before 1/1/17; and (7) a number of others that we have missed or didn't care enough about to include.

G. Natural Resources Deductions & Credits

There were no significant developments regarding this topic during 2015.

H. Loss Transactions, Bad Debts, and NOLs

1. Is it now impossible as a matter of law to abandon a capital asset. W(h)ither the "sale or exchange" requirement? Pilgrim's Pride Corp. v. Commissioner, 141 T.C. 533 (12/11/13). In 1999, the taxpayer purchased certain stock and securities issued by Southern States Cooperative for $98.6 million. In 2004, Southern States offered to redeem the stock and securities for less than the taxpayer had paid for them. The taxpayer wanted approximately $39 million, but Southern States was willing to pay only $20

million. The negotiations ended without an agreement and the taxpayer "abandoned" the securities and claimed a $98.6 million ordinary loss deduction. The IRS disallowed the ordinary loss deduction and treated the loss as capital. The Tax Court (Judge Dawson) upheld the IRS's position. The stock and securities were capital assets and § 1234A required that the loss be treated as capital. Section 1234A provides that:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—
>
> > (1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
> > (2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,
>
> shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement).

- Judge Dawson reasoned that "[s]hares of stock are intangible interests or rights that the owner has in the management, profits, and assets of a corporation, while the certificate of stock is tangible evidence of the stock ownership of the person designated therein and of the rights and liabilities resulting from such ownership," and that Congress intended "section 1234A to [apply to] terminations of all rights and obligations with respect to property that is a capital asset in the hands of the taxpayer or would be if acquired by the taxpayer, including not only derivative contract rights but also property rights arising from the ownership of the property."
- The court rejected the taxpayer's argument that an ordinary loss was allowable under Reg. § 1.165-2(a), because Reg. § 1.165-2(b) disallowed the loss as the surrender of the stock and securities was deemed to be a loss from a sale or exchange of a capital asset pursuant to § 1234A. It also noted that Rev. Rul. 93-80, 1993-2 C.B. 239, which allowed an ordinary loss deduction upon the abandonment of a partnership interest in a partnership that had no debt, was issued four years before § 1234A was amended in 1997 to apply to all property that is (or would be if acquired) a capital asset in the hands of the taxpayer, and thus it did not carry any weight.

a. But the Fifth Circuit makes Pilgrim's Pride proud of its tax planning. But while the IRS might have lost the

battle, it has won the war. Pilgrim's Pride v. Commissioner, 779 F.3d 311 (5th Cir. 2/25/15). The Fifth Circuit, in an opinion by Judge Elrod, reversed the Tax Court's decision and allowed Pilgrim's Pride an ordinary loss for abandonment of the stock of Southern States. The Court of Appeals held that § 1234A(1) applies only to the termination of contractual or derivative rights, and not to the abandonment of capital assets. "By its plain terms, § 1234A(1) applies to the termination of rights or obligations with respect to capital assets (e.g. derivative or contractual rights to buy or sell capital assets). It does not apply to the termination of ownership of the capital asset itself." The court rejected the government's argument "that Congress, rather than simply stating that the abandonment of a capital asset results in capital loss, chose to legislate that result by reference to the termination of rights and obligations 'inherent in' capital assets." The court also reasoned that "[t]he Commissioner's interpretation of § 1234A(1) also would render superfluous § 1234A(2), violating the rule of statutory interpretation that 'we are obliged to give effect, if possible, to every word Congress used.'" Section 1234A(2) requires capital gain or loss treatment for the termination of "a section 1256 contract . . . not described in paragraph (1) which is a capital asset in the hands of the taxpayer." Under the government's position regarding the scope of § 1234A(1), termination of any section 1256 contract that is a capital asset would be covered by § 1234A(1) because the termination of the section 1256 contract would terminate inherent rights and obligations. Thus § 1234A(2) would be superfluous. Finally, the court rejected the government's argument that the loss was a capital loss with respect to worthless securities under § 165(g). The government argued that although the securities objectively might have been worth $20 million, they "subjectively" were worthless to the taxpayer because they were "useless."

- Although the Fifth Circuit opinion quotes the legislative history, S. Rep. No. 97-144, at 171 (1981), with respect to the original enactment of § 1234A in 1981, it makes no reference to the legislative history of the 1997 amendments to § 1234A, which added the language pertinent to the issue in the case. See H. Rep. No. 105-148, at 451-55 (1997), 1987-2 C.B. 323, 773-77. The "Reasons for Change" portion of the Committee Report states that "[a] major effect of the Committee bill would be to remove the effective ability of a taxpayer to elect the character of gains and losses from certain transactions," and the "Present Law" section refers to a number of cases involving receipts that were held to be ordinary for want of a sale or exchange as well as cases that allowed ordinary loss treatment for lack of a sale or exchange. Among the cited cases were Commissioner v. Starr Bros., Inc., 204 F.2d 673 (2d Cir. 1953), holding a payment that a retail distributor received from a manufacturer for waiver of a contract provision prohibiting the manufacturer from selling to the distributor's competition was not a sale or exchange, rev'g 18 T.C. 149 (1952), and Gen. Artists Corp. v. Commissioner, 205 F.2d 360 (2d Cir. 1953), holding amounts received by a booking agent for cancellation of a contract

to be the exclusive agent of a singer was not a sale or exchange, aff'g 17 T.C. 1517 (1952). There is no doubt that these cases involved capital (or § 1231 assets) themselves, and not "derivatives."

- In any event, the holding in Pilgrim's Pride is relevant only to abandonments of securities before March 13, 2008. Treas. Reg. § 1.165-5(i), effective after March 12, 2008, provides:

> For purposes of section 165 ... , a security that becomes wholly worthless includes a security ... that is abandoned and otherwise satisfies the requirements for a deductible loss under section 165. If the abandoned security is a capital asset and is not described in section 165(g)(3) ... (concerning worthless securities of certain affiliated corporations), the resulting loss is treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

Thus, the Commissioner has the last laugh. The IRS might have lost the battle, but it has won the war.

I. At-Risk and Passive Activity Losses

There were no significant developments regarding this topic during 2015.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. Just because you're a good guy who helps the government recover tens of millions of dollars of fraudulent Medicare claims doesn't punch your ticket to the promised land of capital gains. Patrick v. Commissioner, 142 T.C. 124 (2/24/14). The taxpayer filed several qui tam complaints under the False Claims Act, alleging that his employer defrauded the government by improperly marketing medical equipment as requiring in-patient rather than out-patient treatment and that certain medical providers billed treatments under Medicare as in-patient expenses. The cases were settled for over $75 million and the government intervened. The taxpayer received a relator's share totaling over $6.8 million, which he reported as capital gain. The IRS treated the relators' awards as ordinary income. The Tax Court (Judge Kroupa) sustained the deficiency, rejecting the taxpayer's argument that the FCA gives rise to a contract under which the relator sells information to the government in exchange for a share of the recovery. First, there was no sale or exchange of information. "The Government does not

purchase information from a relator under the FCA. Rather, it permits the person to advance a claim on behalf of the Government. The award is a reward for doing so. No contractual right exists." Second, the information provided to the government was not a capital asset. "The ordinary income doctrine excludes from the definition of a capital asset 'property representing income items or accretions to the value of a capital asset themselves properly attributable to income.'" The taxpayer "did not receive a right to the relator's share in exchange for an underlying investment of capital." The right to income was a reward, which is ordinary income. Finally, the information the taxpayer gave to the government was not a capital asset because it was not property. The information could not be property because the taxpayer did not have a legal right to exclude others from its use and enjoyment. The False Claims Act obligated him to turn over all supporting documentation to the government, and the taxpayer had no right to prevent his employer or medical providers from using or disclosing the information.

a. The Seventh Circuit affirms: a taxpayer's recovery in a *qui tam* action is ordinary income rather than capital gain. Patrick v. Commissioner, 799 F.3d 885 (7th Cir. 8/26/15). In an opinion by Judge Williams, the Seventh Circuit affirmed the Tax Court's decision and held that the taxpayer's recovery in the *qui tam* action was ordinary income because it was "a reward intended to compensate the [taxpayer] for his work in bringing the *qui tam* suit" rather than gain from the sale or exchange of a capital asset. Like the Tax Court, the Seventh Circuit rejected the taxpayer's arguments that the information the taxpayer provided to the government was property and that the taxpayer's right to a share of the recovery was a capital asset.

- The Seventh Circuit noted that its decision is consistent with that of the Ninth Circuit in Alderson v. United States, 686 F.3d 791 (9th Cir. 2012).

2. You can't have your cake and eat it too! DeBough v. Commissioner, 142 T.C. 297 (5/19/14). This case involves the interplay between § 121 and § 1038, which provides rules for computing gain when a seller repossesses real property in satisfaction of a debt secured by that real property. The taxpayer and his wife sold their primary residence in 2006 pursuant to an installment sale agreement. The buyers' debt was secured by a mortgage on the home. The price was $1,400,000 and the taxpayers recognized a gain of $657,796. The taxpayers properly excluded $500,000 in gain on the sale. They calculated the gain reportable in each year by (1) excluding $500,000 of gain pursuant to § 121, (2) calculating their gross profit percentage by dividing the $157,796 in remaining gain ($657,796–$500,000 = $157,796) by the $1,400,000 sale price exclusive of commissions and other costs of sale, and (3) multiplying the gross profit percentage by the amount of

money received. In total, the taxpayer (his wife having died in 2006) received payments of $505,000 and reported $56,920 in gain over the course of 2006, 2007, and 2008. In 2009 the buyers defaulted and the taxpayer reacquired the property. He treated his reacquisition of the property in 2009 as a reacquisition of property in full satisfaction of indebtedness under § 1038 and recognized $97,153 in the form of long-term capital gains related to the reacquisition of the property. The IRS asserted that the long-term capital gain the taxpayer was required to recognize on the reacquisition of the property included the $500,000 that he had previously excluded under § 121. The Tax Court (Judge Nega) agreed with the IRS, holding that the gain recognized on the reacquisition of the property included gain previously excluded under § 121. Generally speaking, under § 1038 if the seller of real property receives the buyer's purchase money debt obligation and the seller reacquires the property in partial or full satisfaction of the buyer's debt, the seller does not recognize gain or loss upon the reacquisition, except, as provided in § 1038(b), to the extent he has received money or other property that exceeds the amount of gain reported before the reacquisition. (The special exception to the general rule in § 1038(e) was inapplicable because the taxpayer had not resold the residence within one year after its reacquisition.) Because the taxpayer had received $505,000 in cash before the reacquisition and had both the cash and the house as a result of the reacquisition, he was "actually in a better position than he was before the sale by virtue of having ownership over both the property and $505,000."

a. The Eighth Circuit affirms by focusing on the statutory language, not the double dipping. DeBough v. Schulman, 799 F.3d 1210 (8th Cir. 8/28/15). The Eighth Circuit, in an opinion by Judge Loken, affirmed the Tax Court's decision and required recognition of gain. Section 1038(b) allows a taxpayer "to disregard gain associated with the reacquisition of property, except to the extent that the taxpayer received money from the sale of the property prior to the reacquisition that is more than 'the amount of gain on the sale' that was 'returned as income' in any tax period prior to the reacquisition." Section 1038(e) provides that if a taxpayer reacquires property that was his principal residence, but then resells that property within one year, the taxpayer may continue to apply the principal residence exclusion when calculating taxable gain. The court reasoned that the wording of § 121, consistent with the name "principal-residence exclusion" excluded the original gain from income, and having "been excluded from income ... the $500,000 principal-residence exclusion cannot be considered gain that was 'returned as income' on a prior tax return. The court rejected the taxpayer's argument that nothing in § 1038(e) requires recognition of the gain originally excluded under § 121 when the taxpayer does not sell the reacquired property with one year, because to accept the taxpayer's argument would render § 1038(e) "superfluous."

3. A gift is not a gaft or geft. Hughes v. Commissioner, T.C. Memo 2015-89 (5/11/15). The taxpayer husband, a U.S. citizen resident in the U.K., transferred zero basis stock to the taxpayer wife, who was a nonresident alien. When the wife subsequently sold the stock they claimed that she had a basis equal to its fair market value on the date of the transfer, relying on § 1041(d), which provides that the nonrecognition rule of § 1041(a) does not apply to a transfer to a nonresident alien spouse, and United States v. Davis, 370 U.S. 65 (1962), for the twin propositions that (1) the gifts resulted in taxable income to the husband (in a year not before the court), and (2) the wife, the donee, took a fair market value basis in the stock. The Tax Court (Judge Wherry) rejected this argument, reasoning that Davis involved an exchange, which was a realization event, but the transfer in question was a gift. Judge Wherry distinguished nonrealization and nonrecognition: "Where, as here, an interspousal property transfer takes the form of a gift, no gain is realized, so regardless of whether section 1041(a) applies, there is no gain to be recognized." Thus, § 1041 in its entirely was irrelevant. Section 1015(a) controlled the donee spouse's basis in the stock.

4. If you want capital gain treatment from the sale of property purchased for development and sale to customers, you need to stop developing it. Fargo v. Commissioner, T.C. Memo. 2015-96 (5/26/15). The taxpayers, a married couple, conducted a real estate business through several entities, including Girard Development, L.P. (GDLP), a TEFRA partnership. Among several issues in the case was whether gain realized by GDLP from the sale in 2002 of a 2.2-acre parcel of real estate, referred to in the opinion as "the La Jolla property," was ordinary income or capital gain. The Tax Court (Judge Goeke) held that GDLP's gain was ordinary income. An entity related to GDLP acquired a leasehold interest in the property in 1989 with plans to develop a 72-unit apartment complex and retail space and contributed this leasehold interest to GDLP in 1991. GDLP entered into various agreements with related parties for the development and management of the La Jolla property, but suspended development when the La Jolla real estate market declined dramatically in the early 1990s. GDLP purchased the property in 1997 for $1.75 million. GDLP did not make substantial alterations to the property, but capitalized costs during the period 1991-2001 of approximately $1.8 million for architectural, engineering and appraisal services, permits and licensing fees. From 1989 to the time of sale in 2002, a building on the property was leased as space for medical offices and was used by GDLP and other entities of the taxpayers as office space for accounting, bookkeeping, and other business purposes. GDLP never made substantial efforts to sell the property, but sold the property in 2002 when it received an unsolicited purchase offer from an unrelated entity that planned to develop residential townhouses largely on the basis of plans previously developed by

the taxpayers' entities. The sale price was $14.5 million plus a share of the profits from home sales. The taxpayers argued that GDLP held the property primarily to allow the La Jolla real estate market to recover, i.e., as an investment, and that the property therefore should regarded as a capital asset. The court analyzed whether the property was held primarily for sale to customers in the ordinary course of business (and therefore excluded from the capital asset category by § 1221(a)(1)) by applying a nine-factor test derived from earlier Tax Court decisions. Some of these factors favored the taxpayers, such as the facts that GDLP never substantially improved the property, never sold any real property prior to this sale, and did not make any substantial efforts to sell the La Jolla property. However, GDLP's initial investment in the property was for development. And the "crucial factor," according to the court, was "the purpose for which the La Jolla property was held at the time of sale."

> At the time of sale GDLP had been continuously increasing its developmental efforts with respect to the La Jolla property. During 1999 and 2000 GDLP incurred developmental costs of $233,000 and $216,337, respectively, which represent a substantial portion of the total spent on development over the entire holding period. Unlike the taxpayer in [*Maddux Constr. Co. v. Commissioner*, 54 T.C. 1278 (1970)], which had stopped developing the property two years before the sale, GDLP continually engaged in efforts to plan and develop the La Jolla property up until
> the purchase date.

Accordingly, the court held, GDLP purchased and held the property primarily to develop it and later sell it to customers. The court also held in favor of the government on several other issues and upheld a 20 percent accuracy-related penalty under § 6662 for substantial understatement of income tax.

5. There's now a statutory income tax cost for low-balling estate tax valuation. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2004(a), added § 1014(f), which requires that the basis of any property taking a § 1014 date-of-death-value shall not exceed the final value as determined for estate tax purposes, or, if the value of the property has not been finally determined for estate tax purposes, the value stated in a statement (required by new § 6035(a) to be provided by the executor of any estate required to file an estate tax return) identifying the value of the property. Section 1014(f)(2) provides that the consistency rule applies only to property the inclusion of which in the decedent's estate increased the estate tax liability (reduced by allowable credits). Thus, if the total value of the decedent's estate, as correctly determined, is less than the

decedent's unified credit exemption, it appears that the consistency requirement does not apply or if the taxable estate is reduced to no more than the exclusion amount by the estate tax marital deduction or the estate tax charitable deduction. Also, an estate tax return filed solely to enable a surviving spouse to claim a deceased spouse's unused unified credit under the portability rules would not invoke the consistency requirement. The basis has been finally determined for estate tax purposes only if (1) the value of the property as shown on the estate tax return was not contested by the IRS before the statute of limitations expired, (2) the value is specified by the IRS on audit and was not timely contested by the executor of the estate, or (3) the value is determined by a court or pursuant to a settlement with the IRS.

- Act § 2004(b) also added Code § 6035, which requires the executor of any estate required to file an estate tax return to report to the IRS and each beneficiary acquiring any interest in property included in the decedent's gross estate a statement identifying the value of each interest in such property as reported on such return and any other information as the Treasury and IRS may prescribe. New Code § 6035(b) directs the Treasury Department to promulgate regulations as necessary to carry out the new provision, including regulations relating to (1) the application of § 6035 to property with regard to which no estate tax return is required to be filed, and (2) situations in which the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property.

- Act § 2004(c) added new Code § 6662(b)(8) to extend the 20 percent accuracy related penalty to "any inconsistent estate basis," which is defined in new § 6662(k) as a basis claimed on an income tax return that exceeds the basis determined under § 1014(f).

- These provisions apply to property with respect to which an estate tax return is filed after 7/31/15.

a. Despite the effective date of the new legislation, the statements required by new § 6035(a)(1) and (a)(2) are not due before February 29, 2016. Notice 2015-57, 2015-36 I.R.B. 294 (8/21/15). Section 6035(a)(3)(A) provides that each statement required to be furnished under § 6035(a)(1) or (a)(2) shall be furnished at such time as the IRS prescribes, but no later than the earlier of (i) 30 days after the due date of the estate tax return (including any extensions) or (ii) 30 days after the date the estate tax return is filed. The new legislation applies to estate tax returns filed after 7/31/15 and therefore, absent further guidance, the statements required by § 6035(a) could be due as early as 8/31/15. This notice provides that, for statements required under § 6035(a) to be filed with the IRS or furnished to a beneficiary before 2/29/16, the due date under § 6035(a)(3) is delayed to 2/29/16. According to the notice, this delay is to allow Treasury and the IRS

to issue guidance implementing the reporting requirements of § 6035. The notice directs executors and other persons required to file or furnish a statement under § 6035(a) not to do so until Treasury and the IRS issue forms or further guidance. The notice is effective on 8/21/15 and applies to executors of estates and to other persons who are required under § 6018(a) or (b) to file a return if that return is filed after 7/31/15.

6. File the election form, stupid! Poppe v. Commissioner, T.C. Memo. 2015-205 (10/19/15). The taxpayer, whose securities trading income was four times his salary as a teacher, qualified as a trader eligible to make an election under § 475(f) to use the mark-to-market method. However, the taxpayer's failure to file or attach to his return a Form 3115, as required by Rev. Proc. 99-17, 1999-1 C.B. 503, precluded use of the mark-to-market method. His losses were disallowed.

7. Permanent tax-free capital gains for "small" C corporation stock. The 2015 PATH Act, § 126, reinstated for 2015 and made permanent the § 1202 exclusion for gain realized on the sale of qualified small business stock. Under § 1202, gain realized on a sale or exchange of qualified small business stock, which was acquired after the date of enactment of the 2010 Small Business Act [9/27/10] and before 1/1/11 [subsequently extended to "before 1/1/12"], was subject to 100 percent exclusion from gross income. The 2012 Extenders Act extended the 100 percent exclusion to stock acquired before 1/1/14, and the 2014 Tax Increase Prevention Act extended the 100 percent exclusion to stock acquired before 1/1/15. The 2015 PATH Act makes the 100 percent exclusion permanent for stock acquired after 12/31/14. (Under the former 50 percent and 75 percent exclusions, included gain was subject to tax at the 28 percent capital gains rates.) Gain attributable to qualified small business stock acquired after 9/27/10 is not treated as an AMT preference item. The exclusion is applicable to noncorporate shareholders who acquire stock at original issue and hold the stock for a minimum of five years. The amount of excluded gain attributable to any one corporation is limited to the greater of ten times the taxpayer's basis in a corporation's stock sold during the taxable year or $10 million reduced by gain attributable to the corporation's stock excluded in prior years. Qualified small business stock is stock issued by a C corporation engaged in the active conduct of a trade or business with gross assets (cash plus adjusted basis of assets) not in excess of $50 million.

B. Interest, Dividends, and Other Current Income

There were no significant developments regarding this topic during 2015.

C. Profit-Seeking Individual Deductions

There were no significant developments regarding this topic during 2015.

D. Section 121

There were no significant developments regarding this topic during 2015.

E. Section 1031

1. The magistrate judge wasn't fooled by the disguised related party exchange. North Central Rental & Leasing, LLC v. United States, 112 A.F.T.R.2d 2013-7045 (D. N.D. 9/3/13). North Central was an LLC taxed as a partnership owned 99 percent by Butler Machinery Corporation and 1 percent by Mr. Butler personally. Butler Machinery was a dealer in heavy equipment and North Central engaged in equipment leasing. North Central and Butler Machinery engaged in almost 400 transactions that it claimed were entitled to § 1031 like-kind exchange nonrecognition, but the IRS and government took the position that pursuant to the § 1031(f) related-party rules, § 1031 treatment was not available. Each of the transactions followed essentially the same format. North Central desired to dispose of equipment that it had rented out for a number of years (and which had a fair market value in excess of adjusted basis). North Central conveyed the equipment to a QI. The QI sold the truck to the unrelated third-party customer. Butler Machinery bought the replacement equipment from Caterpillar under a 180 day payment plan. The QI used the cash from the sale of the equipment to purchase the replacement property from Butler Machinery and transferred the replacement property to North Central. North Central then paid any excess of the cost of the replacement property over the sales price of the relinquished property to Butler Machinery through adjustment of an intercompany note between Butler Machinery and North Central. As structured, the transaction permitted Butler Machinery to hold the cash for up to six months until the due date of the Caterpillar invoice for the replacement property. Magistrate Judge Klein held that the transactions allowed the related taxpayers to "cash out" – albeit only for six months – low basis property through basis shifting and that they were structured to avoid the limitations of § 1031(f). She rejected North Central's claims that there were nontax business reasons for the structure of the transactions. Accordingly, because § 1031(f)(4) disqualifies from nonrecognition "any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of [§ 1031(f)]," the transactions were all taxable.

a. Unnecessary steps in what could have been a simple transaction don't hide its true nature. North Central Rental & Leasing, LLC v. United States, 779 F.3d 738 (8th Cir. 3/2/15). In an opinion by Judge Smith, the Eighth Circuit affirmed the District Court and concluded that the exchanges did not qualify for nonrecognition under § 1031 because they had been structured to avoid the purposes of § 1031(f) within the meaning of § 1031(f)(4). The Eighth Circuit reasoned that the transactions could have been structured more simply, with either Butler Machinery or the QI participating, but not both. The likely reason for Butler Machinery's participation, the court concluded, was to obtain use for six months of the cash generated by each of the QI's sales of equipment. The likely reason for the QI's participation, according to the court, was to avoid the two-year holding period required for nonrecognition by § 1031(f)(1), which would have applied had North Central and Butler Machinery engaged in exchanges directly with each other. The participation of unnecessary parties and the receipt of cash proceeds by a related party were indications that the transactions were structured to avoid the purposes of § 1031(f).

F. Section 1033

There were no significant developments regarding this topic during 2015.

G. Section 1035

There were no significant developments regarding this topic during 2015.

H. Miscellaneous

1. No depositors, no regulation, no "bank," no bad debt deduction for worthless asset-backed securities. An otherwise profitable victim of the financial meltdown can't deduct any of over $500,000,000 of losses on asset-back securities. This one ain't funny. MoneyGram International, Inc. v. Commissioner, 144 T.C. 1 (1/7/15). MoneyGram's core business is to provide consumers and financial institutions with payment services that involve the movement of money through three main channels: money transfers, money orders, and payment processing services. MoneyGram derives its revenue from the transaction fees paid by its customers and from management of currency exchange spreads on international money transfers. When a customer purchases a money order by giving cash to a MoneyGram agent, the agent must remit these funds to

MoneyGram immediately. However, MoneyGram typically enters into agreements with its agents allowing them to retain and use these funds for an agreed-upon period. MoneyGram also derives revenue from the temporary investment of funds remitted from its financial institution customers until such time as the official checks and money orders clear. MoneyGram is not subject to regulation as a bank and it has never been regulated as a bank by any Federal banking regulator. On its 2007 and 2008 Forms 1120, MoneyGram classified its business as "nondepository credit intermediation." During 2007 and 2008, MoneyGram undertook a recapitalization that included writing down or writing off a substantial volume of partially or wholly worthless securities. MoneyGram claimed ordinary § 166(a) bad debt deductions with respect to the partial or complete worthlessness of hundreds of millions of dollars of non-REMIC asset-backed securities in which it had invested those securities. (Treating these losses as capital losses would have generated no current tax benefit for MoneyGram because it had no capital gain net income during 2007 and 2008 against which capital losses could be offset.) The IRS determined that these securities were "debts evidenced by a security" under § 165(g)(2)(C) and that MoneyGram was entitled to ordinary bad debt deductions (via § 582(a)), as opposed to capital losses, only if it were a "bank" within the meaning of § 581 and that MoneyGram was not a "bank"; thus the IRS disallowed the bad debt deductions. The Tax Court (Judge Lauber) upheld the deficiency. To qualify as a "bank" under § 581, a taxpayer must meet three distinct requirements. First, it must be "a bank or trust company incorporated and doing business" under Federal or State law. Second, "a substantial part" of its business must "consist[] of receiving deposits and making loans and discounts." Third, it must be "subject by law to supervision and examination" by federal or state authorities having supervision over banking institutions. Under this test, during 2007 and 2008 MoneyGram did not qualify as a "bank" because it did not display the essential characteristics of a bank as that term is commonly understood and because a substantial part of its business did not consist of receiving bank deposits or making bank loans. Because MoneyGram was not a "bank" within the meaning of § 581, it was ineligible to claim ordinary loss deductions on account of the worthlessness of its securities under § 582. The losses were capital losses.

2. "Formalities aside, he maintained essentially the same rights of ownership over those assets, apart from current receipt of income, that he would have possessed had he chosen to title the assets in his own name." Webber v. Commissioner, 144 T.C. No. 17 (6/30/15). The taxpayer established a grantor trust that purchased "private placement" variable life insurance policies insuring the lives of two elderly relatives. The taxpayer and various family members were the beneficiaries of these policies. The premiums paid for the policies, less various expenses, were placed in separate accounts legally owned by the life insurance company; the assets in

those accounts inured exclusively to the benefit of the life insurance policies. The money in the separate accounts was used to purchase investments in startup companies with which the taxpayer was intimately familiar and in which he otherwise invested personally and through private-equity funds he managed. As written the life insurance policies only allowed the policyholder to submit "general investment objectives and guidelines" to the investment manager, but in practice the taxpayer exercised the "unfettered" power to select investment assets by directing the purchase, sale, and exchange of particular securities; it was "no coincidence that virtually every security ... held (apart from certain brokerage funds) was issued by a startup company in which [taxpayer] had a personal financial interest." In addition, the taxpayer had the power to vote shares and exercise other options with respect to these securities held in the accounts; the power to extract cash at will from the separate accounts; and the power in other ways to derive "effective benefit" from the investments in the separate accounts. The IRS concluded that the taxpayer retained sufficient control and incidents of ownership over the assets in the separate accounts to be treated as their owner for federal income tax purposes under the "investor control" doctrine. See Rev. Rul. 77-85, 1977-1 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 81-225, 1981-2 C.B. 13. The Tax Court (Judge Lauber), after reviewing early Supreme Court assignment of income cases regarding the concept of ownership for federal tax purposes, e.g., Helvering v. Clifford, 309 U.S. 331 (1940); Griffiths v. Helvering, 308 U.S. 355 (1939); Poe v. Seaborn, 282 U.S. 101 (1930); Corliss v. Bowers, 281 U.S. 376 (1930), held that the IRS revenue rulings enunciating the "investor control" doctrine are entitled to deference and weight under Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944). Applying those rulings and Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1985), to the specific facts of the case, which were exhaustively laid out, the taxpayer was the owner of the assets in the separate accounts for federal income tax purposes and was taxable on the income earned on those assets during the taxable years in issue. (In a footnote, the court noted that "[i]f the Trusts were deemed to be the owners of the underlying assets, it appears that their income would be attributable to [the taxpayer] under the grantor trust rules. See secs. 671, 677, 679.") The court rejected the taxpayer's argument that a contract that qualifies as life insurance under § 7702, which the IRS conceded, insulates inside build-up from being taxed to the policyholder under the investor control doctrine.

- However, § 6662(a) accuracy-related penalties were not sustained because the taxpayer relied in good faith on professional advice from competent tax professionals. Furthermore, the taxpayer "made multiple filings with the IRS setting forth details about the Trusts and Lighthouse, including gift tax returns filed for 1999 and 2003 and Form 3520 filed when the Policies were transferred to an offshore trust. Petitioner did not attempt to hide his estate plan from the IRS. This supports his testimony that he

believed this strategy would successfully withstand IRS scrutiny, as [his tax advisor] had advised."

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. The IRS provides guidance on the application of the Affordable Care Act's market reforms to HRAs, EPPs, FSAs, and EAPs — it's the bee's knees! Notice 2013-54, 2013-40 I.R.B. 287 (9/13/13), supplemented by Notice 2015-87, 2015-52 I.R.B. 889 (12/16/15). The Patient Protection and Affordable Care Act amended the Public Health Service Act to implement certain market reforms for group health plans, including requirements that: (1) group health plans not establish any annual limit on the dollar amount of benefits for any individual, and (2) non-grandfathered group health plans provide certain preventive services without imposing any cost-sharing requirements for the services. The notice provides guidance, in Q&A format, on the application of these market reforms to: (1) health reimbursement arrangements (including HRAs integrated with group health plans), (2) group health plans under which employers reimburse employees for premium expenses incurred for an individual health insurance policy (referred to in the notice as "employer payment plans"), and (3) health flexible spending arrangements. The notice also provides guidance on employee assistance programs and on § 125(f)(3), which generally provides that a qualified health plan offered through a health insurance exchange established under the Affordable Care Act is not a qualified benefit that can be offered through a cafeteria plan. The notice applies for plan years beginning on and after 1/1/14, but taxpayers can apply the guidance provided in the notice for all prior periods. The Department of Labor has issued guidance in substantially identical form (Technical Release 2013-03) and the Department of Health and Human Services is issuing guidance indicating that it concurs.

a. The obvious solution has a great big catch in it. In a Q&A issued on 5/13/14, available on the IRS's web site (https://perma.cc/FK5A-FRF2), the IRS states:

> Q1. What are the consequences to the employer if the employer does not establish a health insurance plan for its own employees, but reimburses those employees for premiums they pay for health insurance (either through a qualified health plan in the Marketplace or outside the Marketplace)?

> [A1]. Under IRS Notice 2013-54, such arrangements are described as employer payment plans. An employer payment plan, as the term is used in this notice, generally does not include an arrangement under which an employee may have an after-tax amount applied toward health coverage or take that amount in cash compensation. As explained in Notice 2013-54, these employer payment plans are considered to be group health plans subject to the market reforms, including the prohibition on annual limits for essential health benefits and the requirement to provide certain preventive care without cost sharing. Notice 2013-54 clarifies that such arrangements cannot be integrated with individual policies to satisfy the market reforms. Consequently, such an arrangement fails to satisfy the market reforms and may be subject to a $100/day excise tax per applicable employee (which is $36,500 per year, per employee) under section 4980D of the Internal Revenue Code.

b. Good news (?) for some employers: the IRS reiterates prior guidance and clarifies issues related to employer payment plans and provides transition relief from the § 4980D excise tax. Notice 2015-17, 2015-14 I.R.B. 845 (2/18/15). This notice reiterates the conclusion in prior guidance, including Notice 2013-54, 2013-40 I.R.B. 287, that employer payment plans are group health plans that will fail to comply with the market reforms that apply to group health plans under the Affordable Care Act. The notice provides guidance, in Q&A format, on several issues, including the treatment of: (1) an S corporation's payment or reimbursement of premiums for individual health insurance coverage covering a 2-percent shareholder, (2) an employer's reimbursement of an employee's Medicare premiums or payment of medical expenses for employees covered by TRICARE, (3) an employer's increase of an employee's compensation to assist with payments for individual coverage, and (4) an employer's provision of premium assistance on an after-tax basis. The notice also provides a transition rule under which the IRS will not assert the excise tax imposed by § 4980D for any failure to satisfy the market reforms by employer payment plans that pay, or reimburse employees for individual health policy premiums or Medicare part B or Part D premiums: (1) for 2014 for employers that are not applicable large employers for 2014, and (2) for 1/1/15 through 6/30/15 for employers that are not applicable large employers for 2015. Generally, applicable large employers are those that employed an average of at least 50 full-time employees on business days during the preceding calendar year. Employers eligible for this transition rule are not required to file Form 8928 (Return of Certain Excise Taxes Under Chapter 43 of the Internal Revenue

Code) solely as a result of having employer payment plans for the period for which the employer is eligible for the relief.

c. **Final regulations provide guidance on many issues under the Affordable Care Act and incorporate prior guidance issued in forms other than regulations.** T.D. 9744, Final Rules for Grandfathered Plans, Preexisting Condition Exclusions, Lifetime and Annual Limits, Rescissions, Dependent Coverage, Appeals, and Patient Protections Under the Affordable Care Act, 80 F.R. 72192 (11/18/15). The Treasury Department and the IRS have issued final regulations regarding grandfathered health plans, preexisting condition exclusions, lifetime and annual dollar limits on benefits, rescissions, coverage of dependent children to age 26, internal claims and appeal and external review processes, and patient protections under the Affordable Care Act. Among many other changes, the final regulations provide guidance on integration of health reimbursement arrangements with other group health plan coverage and modify Notice 2015-17 by providing a special rule for employers with fewer than 20 employees who offer group health plan coverage to employees who are not eligible for Medicare but do not offer coverage to employees who are eligible for Medicare. If such an employer is not required by the applicable Medicare secondary payer rules to offer group health plan coverage to employees who are eligible for Medicare coverage, then the employer's reimbursement of Medicare part B or D premiums may be integrated with Medicare and deemed to satisfy the annual dollar limit prohibition and the preventive services requirements if the employees who are not offered other group health plan coverage would be eligible for that group health plan but for their eligibility for Medicare. The regulations are effective on 1/19/16 and apply to group health plans and health insurance issuers beginning on the first day of the first plan year (or, in the individual market, the first day of the first policy year) beginning on or after 1/1/17.

d. **Just in time for Christmas! The IRS continues to prove that the Affordable Care Act, like the jelly-of-the-month club, is, as cousin Eddie put it, "the gift that keeps on giving [guidance] the whole year."** Notice 2015-87, 2015-52 I.R.B. 889 (12/16/15). This notice, in Q&A format, provides guidance on the application of various provisions of the Affordable Care Act to employer-provided health coverage. The notice supplements the guidance in Notice 2013-54, 2013-40 I.R.B. 287 (9/13/13) and T.D. 9744, Final Rules for Grandfathered Plans, Preexisting Condition Exclusions, Lifetime and Annual Limits, Rescissions, Dependent Coverage, Appeals, and Patient Protections Under the Affordable Care Act, 80 F.R. 72192 (11/18/15). The notice (1) provides guidance on the application of the Affordable Care Act's market reforms for group health plans to various types of employer health care arrangements, including health reimbursement

arrangements and group health plans under which an employer reimburses an employee for some or all of the premium expenses incurred for an individual health insurance policy; (2) clarifies certain aspects of the employer shared responsibility provisions of § 4980H; (3) clarifies certain aspects of the application to government entities of § 4980H, the information reporting provisions for applicable large employers under § 6056, and application of the rules for health savings accounts to persons eligible for benefits administered by the Department of Veterans Affairs; (4) clarifies the application of the COBRA continuation coverage rules to unused amounts in a health flexible spending arrangement carried over and available in later years, and conditions that may be put on the use of carryover amounts; and (5) addresses relief from penalties under §§ 6721 and 6722 that has been provided for employers that make a good faith effort to comply with the requirements under § 6056 to report information about offers made in calendar year 2015. The guidance provided in the notice generally applies for plan years beginning on and after 12/16/15, but taxpayers can apply the guidance provided in the notice for all prior periods.

2. Final regulations provide guidance related to the § 36B premium tax credit regarding the determination whether an employer-sponsored plan provides minimum value. T.D. 9745, Minimum Value of Eligible Employer-Sponsored Plans and Other Rules Regarding the Health Insurance Premium Tax Credit, 80 F.R. 78971 (12/18/15). The Treasury and IRS have finalized proposed regulations that provide guidance on issues related to the § 36B premium tax credit, including guidance on determining whether health coverage under an eligible employer-sponsored plan provides minimum value (REG-125398-12, Minimum Value of Eligible Employer-Sponsored Plans and Other Rules Regarding the Health Insurance Premium Tax Credit. 78 F.R. 25909 (5/3/13)). Certain provisions of the proposed regulations have not yet been finalized or have been re-proposed and will be finalized separately. The final regulations are effective on 12/18/15.

3. Thousands of dollars of tax breaks for buying luxury cars, pennies for taking the bus. The 2015 PATH Act, § 105, retroactively extended through 12/31/15 and made permanent the parity provision requiring that the monthly dollar limitation for transit passes and transportation in a commuter highway vehicle under § 132(f)(2) be applied as if it were the same as the dollar limitation for that month for employer-provided parking. Thus, for 2015, it increases the monthly exclusion for employer-provided transit and van-pool benefits to $250—the amount of the maximum exclusion for employer-provided parking benefits. With respect to expenses incurred by an employee for employer-provided vanpool and transit benefits for months beginning in 2015 and prior to the date of enactment, the legislation permits employers to reimburse the employee on a tax-free basis to

the extent the reimbursement exceeds $130 per month (the limit in effect for 2015 prior to enactment) and is no more than $250 per month.

B. Qualified Deferred Compensation Plans

1. Relief for certain closed defined benefit pension plans. Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13). This notice provides temporary nondiscrimination relief for certain "closed" defined benefit pension plans (i.e., those that provide ongoing accruals but that have been amended to limit those accruals to some or all of the employees who participated in the plan on a specified date). Typically, new hires are offered only a defined contribution plan, and the closed defined benefit plan has an increased proportion of highly compensated employees.

a. The relief is extended to plan years beginning before 2017. Notice 2015-28, 2015-14 I.R.B. 848 (3/19/15). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2017. The notice cautions that all remaining provisions of the nondiscrimination regulations under § 401(a)(4) (including the rules relating to the timing of plan amendments under Reg. § 1.401(a)(4)-5) continue to apply. Treasury and the IRS anticipate issuing proposed amendments to the § 401(a)(4) regulations that would be finalized and apply after the relief under Notice 2014-5 and this notice expires.

2. If it would have helped, the taxpayer should have remembered to tell the IRS or the Tax Court his birthday. El v. Commissioner, 144 T.C. 140 (3/12/15). Section 72(t) imposes an additional tax of 10 percent of the amount of any distribution (with certain specified exceptions) from a qualified retirement plan, including an IRA, made before the employee or IRA owner attains age 59½. The Tax Court (Judge Marvel) held that "[b]ecause the § 72(t) additional tax is a 'tax' and not a 'penalty, addition to tax, or additional amount' within the meaning of section 7491(c), the burden of production with respect to the additional tax remains on [the taxpayer]." Because neither the IRS nor the taxpayer introduced any evidence regarding the taxpayer's age, or any credible evidence showing that he was not liable for the additional tax under § 72(t) on a deemed taxable distribution from a qualified employer plan, the § 72(t) additional tax was imposed. Although § 7491(c) imposes on the IRS "the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by" the Code, "the section 72(t) additional tax is a "tax" and not a "penalty, addition to tax, or additional

amount" within the meaning of section 7491(c), the burden of production with respect to the additional tax remains on [the taxpayer]."

3. Under planned amendments to the regulations, qualified defined benefit plans generally are not permitted to replace annuity payments with a lump sum payment or other accelerated form of distribution. Notice 2015-49, 2015-30 I.R.B. 79 (7/9/15). This notice provides that Treasury plans to amend the required minimum distribution regulations under § 401(a)(9) to provide that qualified defined benefit plans generally are not permitted to replace any joint and survivor, single life, or other annuity currently being paid with a lump sum payment or other accelerated form of distribution. With certain exceptions, the amendments to the regulations described in the notice will apply as of 7/9/15.

4. If you use an ESOP to attempt to reduce tax liability, failing to pay yourself compensation for services can be costly. DNA Proventures, Inc. Employee Stock Ownership Plan v. Commissioner, T.C. Memo. 2015-195 (10/5/15). The IRS determined that an ESOP was not qualified under § 401(a) and that its related trust therefore was not tax-exempt under § 501(a). In this declaratory judgment action, the Tax Court (Judge Dawson) held that the IRS did not abuse its discretion in making this determination. The sponsor of the ESOP, DNA Proventures, Inc., was formed by an orthopedic surgeon (Dr. Prohaska) and his wife, who were the corporation's sole stockholders, directors, and employees. In 2008, the corporation issued 1,150 shares of class B common stock to the ESOP's trust with a par value of $10 per share. The trust then allocated those shares to Dr. Prohaska's ESOP account. The corporation paid no compensation to Dr. Prohaska or his wife in 2008. Under § 401(a)(16), a trust is not qualified if the plan provides for benefits or contributions that exceed the limitations of § 415, which for the 2008 plan year limited annual additions (the sum of employer contributions, employee contributions, and forfeitures) to the lesser of $40,000 or 100% of the participant's compensation. The court held that, because neither Dr. Prohaska nor his wife received any compensation from the corporation for 2008, their contribution limits were zero, and the corporation's transfer of the class B common stock in 2008 was an employer contribution that exceeded the contribution limit by $11,500. Accordingly, the court held, the ESOP failed the requirements of § 401(a)(16) and was not a qualified plan for 2008. Further, a § 415 failure is a continuing failure, and therefore the ESOP was not a § 401(a) qualified plan for all subsequent plan years. The ESOP also failed to be a § 401(a) qualified plan because it had failed to obtain annual appraisals in violation of the plan itself, which required valuation of the trust fund on each valuation date.

5. Some inflation adjusted numbers for 2016. I.R. 2015-118 (10/21/15).

- Elective deferral in §§ 401(k), 403(b), and 457 plans remains unchanged at $18,000 with a catch up provision for employees aged 50 or older of $6,000.
- The limit on contributions to an IRA will be unchanged at $5,500. The AGI phase out range for contributions to a traditional IRA by employees covered by a workplace retirement plan remains unchanged at $61,000-$71,000 for single filers and heads of household and at $98,000-$118,000 for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, but the phase out range increases to $184,000-$194,000 for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to $184,000-$194,000 for married couples filing jointly, and to $117,000-$132,000 for singles and heads of household.
- The annual benefit from a defined benefit plan under § 415 is unchanged at $210,000.
- The limit for defined contribution plans remains unchanged at $53,000.
- The amount of compensation that may be taken into account for various plans remains unchanged at $265,000, and remains unchanged at $395,000 for government plans.
- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $61,500 for married couples filing jointly, to $46,125 for heads of household, and to $30,750 for singles and married individuals filing separately.

6. The shelf life of tax legislation is now so short that it expires before taking effect: Congress repeals its mandate of a 3-1/2 month automatic extension for filing Form 5500. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, was signed by the President on 7/31/15. Among other changes, the Act directed Treasury to modify appropriate regulations to provide that the maximum extension for employee benefit plans filing Form 5500 is an automatic 3-1/2 month period ending on November 15 for calendar year plans. The change was to apply to returns for taxable years beginning after 12/31/15. The Fixing America's Surface Transportation (FAST) Act, § 32104, Pub. L. No. 114-94, signed by the President on 12/4/15, repeals that directive. Accordingly, the 2-1/2 month extension of current law will remain in effect.

7. Guidance on application of the U.S. Supreme Court's decision in *Obergefell* to qualified retirement plans and health and welfare plans. Notice 2015-86, 2015-52 I.R.B. 887 (12/9/15). This notice, which amplifies Notice 2014-19, 2014-17 I.R.B. 979, provides guidance on the application to qualified retirement plans and health and welfare plans of the U.S. Supreme Court's decision in Obergefell v. Hodges, 576 U.S. ___, 135 S. Ct. 2584 (2015), which held that states must apply their civil marriage laws to same-sex couples on the same terms and conditions as they apply to opposite-sex couples and must recognize lawful same-sex marriages performed in other states. The notice states that, because same-sex marriages have already been recognized for federal tax purposes pursuant to Windsor v. United States, 570 U.S. ___, 133 S. Ct. 2675 (2013), and guidance issued following Windsor, including Rev. Rul. 2013-17, 2013-38 I.R.B. 201, "Treasury and the IRS do not anticipate any significant impact from Obergefell on the application of federal tax law to employee benefit plans." The notice, in Q&A format, clarifies that the Obergefell decision does not require changes to the terms or operation of a qualified retirement plan (because Q&A-8 of Notice 2014-19 required qualified retirement plans to be amended to reflect the Windsor decision no later than 12/31/14) or to the terms of a health or welfare plan. The notice provides that qualified plan sponsors might choose to make discretionary plan amendments in response to Obergefell and provides examples of such amendments. Pursuant to § 5.05(2) of Rev. Proc. 2007-44, 2007-28 I.R.B. 54, such discretionary amendments generally must be adopted by the end of the plan year in which the amendment is operationally effective. The notice cautions that Obergefell might require changes to the operation of a health or welfare plan, e.g., if the plan's terms provide that coverage is offered to the spouse of a participant as defined under applicable state law, and the plan administrator determines that applicable state law has expanded to include same-sex spouses as a result of Obergefell.

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

1. Reducing redundant paperwork to facilitate e-filing. REG-135524-14, Property Transferred in Connection With the Performance of Services, 80 F.R. 42439 (7/17/15). The IRS and Treasury have published proposed amendments to Reg. § 1.83-2(c) that would require a § 83(b) election to be made by filing one copy of a written statement with the internal revenue office with which the person who performed the services files his return. This would eliminate the requirement that taxpayers submit a copy of a § 83(b) election with their tax return for the year in which the property subject to the election was transferred and thereby facilitate electronic filing. Section 83(b)(2) statutorily requires that a § 83(b) election be filed with the

IRS no later than 30 days after the date that the property is transferred to the service provider. The proposed amendment applies as of 1/1/16, and would apply to property transferred on or after that date. However, taxpayers may rely on the proposed amendments for property transferred on or after 1/1/15.

D. Individual Retirement Accounts

1. "[T]his is precisely the kind of self-dealing that section 4975 was enacted to prevent." Ellis v. Commissioner, T.C. Memo. 2013-245 (10/29/13). The taxpayer rolled-over from his 401(k) account to a self-directed IRA approximately $320,000. The $320,000 was promptly invested in a newly-formed LLC (which made a check-the-box election to be taxed as a corporation) in which the IRA obtained a 98 percent interest, with an unrelated party holding the remaining 2 percent interest. During the remainder of the year, the LLC, which was engaged in the used car business, paid the taxpayer approximately $10,000 as compensation for managing the LLC. The used-car LLC also paid rent to another LLC owned by the taxpayer and his family that owned the property on which the used car business was conducted. The Tax Court (Judge Paris) upheld that IRS's determination that the taxpayer had engaged in a transaction with his IRA that was prohibited under § 4975. Section 4975(c) prohibited transactions include any direct or indirect: (1) sale or exchange, or leasing, of any property between a plan and a disqualified person; (2) lending of money or other extension of credit between a plan and a disqualified person; (3) furnishing of goods, services, or facilities between a plan and a disqualified person; (4) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan; (5) act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interests or for his own account; or (6) receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan. Because the taxpayer exercised control over the IRA, he was a disqualified person as defined in § 4975(e). Although the initial investment in the LLC was not a prohibited transaction, because it had no outstanding owners or ownership interests before the initial capital contribution and therefore could not be a disqualified person at the time of the investment, the taxpayer did engage in a prohibited transaction when he caused the LLC to pay him compensation. As a result, pursuant to § 408(e)(2)(A), the IRA ceased to be qualified as of the first day of the taxable year and pursuant to § 408(e)(2)(B) the entire amount was treated as distributed and includable in gross income. Because the taxpayer was not 59½ as of the first day of the year, the 10 percent § 72(t) penalty applied. And for good measure, a 20 percent § 6662(a) negligence penalty was sustained as well.

a. Please don't use your self-directed IRA to fund your own business so you have a job. Ellis v. Commissioner, 787 F.3d 1213 (8th Cir. 6/5/15). In an opinion by Judge Doty, the Eighth Circuit affirmed the Tax Court's decision. The Tax Court properly found that the taxpayer engaged in a prohibited transaction by receiving a salary from the LLC in 2005. "By directing CST to pay him wages from funds that the company received almost exclusively from his IRA, Mr. Ellis engaged in the indirect transfer of the income and assets of the IRA for his own benefit and indirectly dealt with such income and assets for his own interest or his own account." The court rejected the taxpayer's argument that there was not a prohibited transaction that was based on the Plan Asset Regulation, 29 C.F.R. § 2510.3-101, which provides that the underlying assets of an "operating company" in which a plan invests are not considered plan assets for determining whether a prohibited transaction occurred. "The plain language of § 4975(c), however, prohibits both 'direct and indirect' self-dealing of the income or assets of a plan. ... The Plan Asset Regulation cannot be read to nullify this general rule against indirect self-dealing." The taxpayer argued that the payment of wages was exempt under § 4975(d)(10), which excludes from the list of prohibited transactions the "receipt by a disqualified person of any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan." The court held that § 4975(d)(10) did not apply, because that exemption "applies only to compensation for services rendered in the performance of plan duties."

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. What does "separate" mean? Ibrahim v. Commissioner, 788 F.3d 834 (8th Cir. 6/10/15), rev'g T.C. Memo. 2014-8. The taxpayer and his wife originally filed separate tax returns. He claimed head of household filing status on his return, and his wife claimed single filing status on her return. The IRS sent a timely notice of deficiency to the taxpayer; he filed a Tax Court petition to challenge the deficiency. The taxpayer and his wife did not elect to file an amended joint return before receipt of the notice of deficiency. The taxpayer argued that he was entitled to amend his return to elect married filing jointly filing status. Section 6013(b)(2)(B) specifically bars taxpayers from electing to file a joint return after filing separate returns "after there has been mailed to either spouse, with respect to such taxable year, a notice of deficiency under section 6212, if the spouse, as to such notice, files a petition with the Tax Court within the time prescribed in section 6213." The

Tax Court (Judge Nega) held that section 6013(b)(2) applies to married taxpayers who file returns with an incorrect status, such as head of household or single filer. Thus, the taxpayer was ineligible to elect to amend his return to file jointly with his spouse, and the deficiency was upheld. The Tax Court rejected the taxpayer's argument that it should follow Glaze v. United States, 641 F.2d 339 (5th Cir. 1981), which held that "separate return" as used in § 6013(b) refers only to married filing separately status and not to any other filing status, including head of household. Prior Tax Court precedent was cited as controlling because the case was appealable to the Eighth Circuit, which had not addressed the issue.

- The Court of Appeals saw it differently and reversed (2-1) in an opinion by Judge Benton. After analyzing the context in which the term "separate return" appears in numerous Code sections, the court concluded that the term applies only to a "married filing separately" return. A head of household return is not a "separate return" for purposes of § 6013(b). The majority rejected the IRS's reliance on Rev. Rul. 83-183, 1983-2 C.B. 220, ruling that taxpayers may not file joint returns more than three years after the due date of the return if one of the spouses has filed a return claiming any of unmarried, head of household, or married filing separately filing status. Thus, the taxpayer could file a joint return, even after receipt of the deficiency notice, where one spouse only originally erroneously filed a head of household return and the other claimed single filing status.

- Judge Bye dissented and would have held that for purposes of § 6013 any non-joint returns, including head-of-household returns, should be treated as separate returns.

2. The Treasury Department and the IRS are trying to get everyone to sing Kumbaya. REG-148998-13, Definition of Terms Relating to Marital Status, 90 F.R. 64378 (10/23/15). The Treasury and IRS have published proposed regulations that reflect the holdings of Obergefell v. Hodges, 576 U.S. ___, 135 S. Ct. 2584 (2015), Windsor v. United States, 570 U.S. ___, 133 S. Ct. 2675 (2013), and Rev. Rul. 2013-17, 2013-38 I.R.B. 201, defining and describing the marital status of taxpayers. Prop. Reg. § 301.7701-18 amends the current regulations under § 7701 to provide that for federal tax purposes the terms "spouse," "husband," and "wife" mean an individual lawfully married to another individual, and the term "husband and wife" means two individuals lawfully married to each other. These definitions apply regardless of sex. However, the terms "spouse," "husband," and "wife" do not include individuals who have entered into a registered domestic partnership, civil union, or other similar relationship not denominated as a marriage under the law of a state, possession, or territory of the United States; the term "husband and wife" does not include couples who have entered into such a relationship, and the term "marriage" does not include such relationships.

- Effective date. The proposed regulations apply to taxable years ending on or after the date of publication of final regulations. In reality, however, as a result of the holdings in Obergefell, Windsor, and Rev. Rul. 2013-17, these rule are already in effect.

B. Miscellaneous Income

1. The IRS provides guidance on benefits provided by Indian tribal governments that are excludable from gross income under the general welfare exclusion. Rev. Proc. 2014-35, 2014-26 I.R.B. 1110 (6/3/14). Under the general welfare exclusion, certain payments made to or on behalf of individuals by governmental units under governmentally provided social benefit programs for the promotion of the general welfare are excluded from gross income. This revenue procedure, which is a revised version of the revenue procedure proposed in Notice 2012-75, 2012-51 I.R.B. 715 (12/5/12), provides guidance on benefits provided by Indian tribal governments to tribal members and qualified nonmembers that are excludable under the general welfare exclusion. These include certain benefits provided under housing, educational, and elder or disabled programs, as well as certain benefits that otherwise might be regarded as compensation for services, such as benefits provided to religious or spiritual officials or leaders to recognize their participation in cultural, religious, and social events. If the requirements of the revenue procedure are met, the IRS will not assert that members of an Indian tribe or qualified nonmembers must include the value of the applicable benefits in gross income or that the benefits are subject to the information reporting requirements of § 6041. The revenue procedure is effective for benefits provided after 12/5/12.

a. New § 139E codifies but does not supplant the general welfare exclusion for certain benefits provided under Indian tribal government programs and taxpayers can continue to rely on Rev. Proc. 2014-35. Notice 2015-34, 2015-18 I.R.B. 942 (4/16/15). Section 139E, enacted by The Tribal General Welfare Exclusion Act of 2014, Pub. L. No. 113-168, provides that gross income does not include the value of any Indian tribal welfare benefit, defined as "any payment made or services provided to or on behalf of a member of an Indian tribe (or spouse or dependent of such a member) pursuant to an Indian tribal government program" provided that certain requirements are met, including that the benefit is not lavish or extravagant and is not compensation for services. This notice clarifies that § 139E codifies but does not supplant the general welfare exclusion for certain benefits provided under Indian tribal government programs and that taxpayers can continue to rely on Rev. Proc. 2014-35, which is, in some respects, broader than § 139E. The notice also requests comments (due by 10/14/15) on

specified issues arising under § 139E that may be addressed in future published guidance as well as other issues that pertain to § 139E or The Tribal General Welfare Exclusion Act of 2014.

2. Compassionate saving. New code § 529A, enacted by the Achieving a Better Life Experience (ABLE) Act of 2014, provides yet another tax-favored savings account—the ABLE account. Like 529 accounts (used to save for college education), ABLE accounts must be established by a state. Only beneficiaries who became disabled before reaching age 26 are eligible. An eligible individual is an individual (1) for whom a disability certification has been filed with the Secretary for the taxable year, or (2) who is entitled to benefits based on blindness or disability under the Social Security Disability Insurance program or the SSI program. A disability certification is a certification to the satisfaction of the IRS made by the eligible individual or the parent or guardian of the eligible individual, that the individual meets the requirements relating to disability or blindness that includes a copy of the individual's diagnosis relating to the individual's relevant impairment or impairments, signed by a licensed physician. For the most part, ABLE accounts are limited to beneficiaries who are blind or have developmental disabilities, mental illness, and severe childhood conditions such as cerebral palsy. The maximum contribution is $14,000 per year (adjusted for inflation after 2015) in cash, but states could impose maximum limits on total contributions. A beneficiary may have only one account. Contributions are not deductible, but the income in the account is accumulated tax-free. A contribution to an ABLE account is treated as a completed gift of a present interest to the beneficiary of the account. Thus, the contribution qualifies for the per-donee annual gift tax exclusion ($14,000 for 2014) and, to the extent of the exclusion, is exempt from the generation skipping transfer tax. Withdrawals are tax-free to the extent used for eligible services, including education; housing; transportation; employment support; health, prevention, and wellness costs; assistive technology and personal support services; and other IRS-approved expenses. Distributions used for nonqualified expenses are includable in income to the extent they represent a distribution of earnings (generally determined in the manner provided for annuities in § 72) and subject to a 10 percent penalty. (A distribution from an ABLE account generally is not subject to gift tax or GST tax.) ABLE accounts can generally be rolled over only into another ABLE account for the same individual or into an ABLE account for a sibling who is also an eligible individual. Upon the death of the beneficiary the balance in the account (after Medicaid reimbursements) is distributable to the deceased beneficiary's estate or to a designated beneficiary; the distribution will be subject to income tax on investment earnings, but not to a penalty. Generally, account assets are not included in determining eligibility for SSI or Medicaid. However, SSI

payments are suspended when an account balance exceeds $100,000, but Medicaid benefits would continue.

a. Gearing up for ABLE regulations. Notice 2015-18, 2015-12 I.R.B. 765 (3/11/15). This notice provides advance notification of a provision anticipated to be included in the proposed regulations to be issued under § 529A. Although § 529A was modeled on § 529, which provides tax-exempt status to qualified tuition programs (QTPs) established and maintained by a state, the § 529A guidance, when issued, may differ in various ways from the proposed regulations that have been promulgated under § 529. In particular, the Treasury Department and the IRS anticipate that, consistent with § 529A(e)(3), the guidance will provide that the owner of an ABLE account is the designated beneficiary of the account. With regard to the ABLE account of a designated beneficiary who is not the person with signature authority over that account, the person with signature authority over the account of the designated beneficiary may neither have nor acquire any beneficial interest in the account and must administer that account for the benefit of the designated beneficiary of that account.

b. Proposed regulations under § 529A provide guidance on ABLE accounts. REG-102837-15, Guidance Under Section 529A: Qualified ABLE Programs, 80 F.R. 35602 (6/22/15). The IRS and Treasury have issued proposed regulations under § 529A that address a wide range of issues related to ABLE accounts. The proposed regulations provide detailed guidance on the requirements a program must satisfy to be a qualified ABLE program, but the preamble explains that states enacting legislation creating ABLE accounts and individuals establishing such accounts will not fail to gain the benefits of § 529A merely because the legislation or the account documents do not fully comply with the final regulations when issued because the final regulations will contain transition relief to permit programs and account documents to be brought into compliance. Consistent with Notice 2015-18, the proposed regulations provide that the owner of an ABLE account is the designated beneficiary of the account and that a person other than the designated beneficiary with signature authority over the account may neither have nor acquire a beneficial interest in the account during the designated beneficiary's lifetime and must administer the account for the benefit of the designated beneficiary. To implement the limits on contributions to an ABLE account, the proposed regulations provide that a qualified ABLE program must return to the contributors contributions that exceed the annual gift tax exclusion or that cause the ABLE account to exceed the limit established by the state for its qualified tuition program, along with all net income attributable to the returned contributions. The proposed regulations provide that contributions to an ABLE account (other than contributions by the designated beneficiary) are treated as a completed gift of a present interest

to the designated beneficiary. Although aggregate contributions to an ABLE account from all contributors cannot exceed the annual per-donee gift tax exclusion ($14,000 in 2015), gift tax consequences could arise if a contributor makes other gifts to the designated beneficiary in addition to the gift to the ABLE account. The proposed regulations provide that, under the applicable gift tax rules (Reg. § 25.211-1(c), (h)), a contribution to an ABLE account by a corporation, partnership, trust, estate or other entity is treated as a gift by its shareholders, partners, or other beneficial owners in proportion to their respective ownership interests in the entity. Distributions from an ABLE account are not includible in the designated beneficiary's gross income to the extent they do not exceed the beneficiary's "qualified disability expenses." The proposed regulations provide guidance on what expenses are "qualified disability expenses;" the preamble states that this term "should be broadly construed to permit the inclusion of basic living expenses and should not be limited to expenses for items for which there is a medical necessity" and could include, for example, expenses for common items such as smart phones "if they are an effective and safe communication or navigation aid for a child with autism." Although an ABLE account for a designated beneficiary may be established only under the ABLE program of the beneficiary's state of residence, the proposed regulations permit the beneficiary to continue to maintain the account even if the beneficiary ceases to be a resident of that state. The proposed regulations provide guidance on the reporting and recordkeeping requirements to which qualified ABLE programs are subject. The regulations will be effective upon publication of final regulations and generally will apply to taxable years beginning after 12/31/14. The reporting requirements will apply to information returns filed and payee statements furnished after 12/31/15. Taxpayers and qualified ABLE programs may rely on the proposed regulations until final regulations are published.

c. The IRS provides a preview of coming changes to the proposed regulations that were issued under § 529A on ABLE accounts. Notice 2015-81, 2015-49 I.R.B. 784 (11/20/15). Comments on the proposed regulations issued under § 529A suggested that three provisions of the proposed regulations would create significant barriers to the establishment of ABLE programs. This notice sets forth how the Treasury Department and the IRS intend to respond to these comments by revising the proposed regulations when those regulations are finalized. First, the final regulations will eliminate the requirement in the proposed regulations that a qualified ABLE program must establish safeguards to distinguish between distributions used for qualified disability expenses (which are tax-free) and other distributions (which are taxable), and instead will require the designated beneficiary to categorize distributions. Second, the final regulations will eliminate the requirement in the proposed regulations that a qualified ABLE program must obtain the TIN of each contributor to the ABLE account at the

time of the contribution if the program has a system in place to identify and reject excess contributions and excess aggregate contributions before they are deposited. The final regulations will require a qualified ABLE program to request the TIN of a contributor only if the contributor makes an excess contribution or excess aggregate contribution that is deposited in the ABLE account. Third, the final regulations will modify the procedure in the proposed regulations for an individual who establishes their eligibility as a designated beneficiary by filing a disability certification with the Secretary of the Treasury. The proposed regulations provide that the certification will be deemed to be filed with the Secretary when the certification, which must include a copy of the beneficiary's diagnosis signed by a licensed physician, is received by the ABLE program. The final regulations will provide that the designated beneficiary can instead submit to the ABLE program a certification under penalties of perjury that the beneficiary (or the beneficiary's agent under a power of attorney or a parent or legal guardian of the individual) has the signed physician's diagnosis and that the signed diagnosis will be retained and provided to the ABLE program or the IRS upon request. Taxpayers can rely on the guidance in this notice pending the issuance of final regulations.

3. "We see no limit on the mischief that ruling in Perez's favor might cause: A professional boxer could argue that some part of the payments he received for his latest fight is excludable because they are payments for his bruises, cuts, and nosebleeds. A hockey player could argue that a portion of his million-dollar salary is allocable to the chipped teeth he invariably suffers during his career. And the same would go for the brain injuries suffered by football players ... ." Perez v. Commissioner, 144 T.C. 51 (1/22/15). The taxpayer was a human egg "donor," who underwent surgery to remove her eggs and pursuant to a contract received a $10,000 payment "for Donor's time, effort, inconvenience, pain, and suffering in donating her eggs." The Tax Court (Judge Holmes) held that the payment was includable in income as compensation for services and not excluded as "damages" under § 104(a)(2). The 2012 amendments to Reg. § 1.104-1(c) that removed the requirement that to be excludable under § 104(a)(2) damages must have been "based upon tort or tort type rights" was not intended to extend the exclusion to instances where there was no law suit or threat of a law suit and the definition in Reg. § 1.104-1(c)(1) of "damages" as "an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution" was valid. The 2012 amendment "reflected a profusion of remedies for persons who are physically injured and recover under no-fault statutes, so that they are treated like those who are physically injured and recover through more traditional actions in tort. But that regulation still addresses situations where a taxpayer settles a claim for physical injuries

or physical sickness before—or at least in lieu of—seeing litigation through to its conclusion."

4. You don't need to read this if you're in Gamblers Anonymous. The IRS provides guidance on how to measure slot machine winnings and losses. Notice 2015-21, 2015-12 I.R.B. 765 (3/4/15). This Notice provides a proposed revenue procedure that, if finalized, will provide an optional safe harbor method for individual taxpayers to determine wagering gains or losses from certain slot machine play. Under the proposed rules, a taxpayer recognizes (1) a wagering gain if, at the end of a single session of play, the total dollar amount of payouts from electronically tracked slot machine play during that session exceeds the total dollar amount of wagers placed by the taxpayer on electronically tracked slot machine play during that session; or (2) a wagering loss if, at the end of a single session of play, the total dollar amount of wagers placed by the taxpayer on electronically tracked slot machine play exceeds the total dollar amount of payouts from electronically tracked slot machine play during that session. A session of play begins when a patron places the first wager on a particular type of game and ends when the same patron completes his or her last wager on the same type of game before the end of the same calendar day. A taxpayer must use the same session of play if the taxpayer stops and then resumes electronically tracked slot machine play within a single gaming establishment during the same calendar day. If, after engaging in slot machine play at one gaming establishment, a taxpayer leaves that establishment and begins electronically tracked slot machine play at another gaming establishment, a separate session of play begins at the second establishment, even if played within the same calendar day as the first.

5. If you're still repaying the loan, there's no COD even though you've got an affirmative defense to a collection suit. Johnston v. Commissioner, T.C. Memo. 2015-91 (5/11/15). The taxpayer's employer lent him $450,000, which would become due upon the termination of his employment. When the taxpayer left his position with the employer, the employer did not demand repayment. Subsequently, the taxpayer returned to his position with his original employer. Two years later the statute of limitations on collection of the loan expired. The IRS asserted that the taxpayer realized COD income upon the expiration of the statute of limitations on collection. The Tax Court (Judge Vasquez) held that the mere fact that a creditor fails to take collection action before the period of limitations for collection of a debt has expired does not conclusively give rise to cancellation of debt income for the debtor; "[t]his is because the expiration of the period of limitations generally does not cancel an underlying debt obligation but simply provides an affirmative defense for the debtor in an action by the creditor." An officer of the creditor corporation testified that the corporation considered the

debt outstanding and expected that the taxpayer would repay the debt. The taxpayer was repaying the debt via payroll deductions of $1,000 per month from his paycheck. Furthermore the creditor had not issued a Form 1099-C and had not claimed a bad debt deduction.

6. Another reason to take vacation rather than let the hours carry over! Payments received at retirement for unused vacation time and sick leave that accrued during periods of temporary disability are not excludable from income under § 104(a)(1). Speer v. Commissioner, 144 T.C. 279 (4/16/15). The taxpayer retired in 2009 from his position as a detective with the Los Angeles Police Department and received from the City of Los Angeles $53,513 for unused vacation time and sick leave. Although this amount was reported as income on the Form W-2 the taxpayer received for 2009, the taxpayer excluded it from gross income and included an attachment to the joint return he and his spouse filed explaining that the amount had been received under a workmen's compensation act. The taxpayer argued that some of the hours for which he received the payment had accrued during periods of temporary disability pursuant to provisions of the Los Angeles Administrative Code and a Memorandum of Understanding between the city and the recognized bargaining organization representing Los Angeles police officers, and therefore the payment he received for these hours was excludable under § 104(a)(1) as an amount received under a workmen's compensation act as compensation for personal injuries or sickness. Distinguishing Givens v. Commissioner, 90 T.C. 1145 (1988), the Tax Court (Judge Halpern) held that the taxpayer had "failed to show that the sick and vacation leave cashout provisions in [the Memorandum of Understanding] were part of a comprehensive workmen's compensation scheme covering" the taxpayer. Although some of the hours for which the taxpayer had received the payment might have accrued during periods of temporary disability, the court reasoned, the accrual did not provide the taxpayer with an immediate benefit that he could use to support himself while on leave and thus was "fundamentally different from the normal temporary disability allowance payable under the [California] Workers' Compensation Act and for which the continuation of his base salary under [the Los Angeles Administrative Code] substituted." Accordingly, the court held that the payment received by the taxpayer was not excludable under § 104(a)(1). The court also held that, even if the taxpayer had received the payment under a worker's compensation act for personal injuries or sickness, the taxpayer had failed to show how many hours he had accumulated during his disability leaves of absence and how many of those hours remained when he retired in 2009.

7. The taxpayer gets half a loaf. Sewards v. Commissioner, 785 F.3d 1331 (9th Cir. 5/12/15). The taxpayer received a disability pension equal to one-half his previous salary, plus an additional

amount based on years of service that brought his pension up to what he would have received as a service pension. The disability pension equal to one-half his previous salary was excludable under § 104(a)(1). The additional amount received based on years of service that brought his pension up to what he would have received as a service pension was not excludable.

8. The IRS announces that it will not kick victims of identity theft while they're down. Announcement 2015-22, 2015-35 I.R.B. 288 (8/13/15). The IRS will not assert that an individual whose personal information may have been compromised in a data breach must include in gross income the value of the identity protection services provided by the organization that experienced the data breach. Nor will the IRS assert that an employer providing identity protection services to employees whose personal information may have been compromised in a data breach of the employer's (or employer's agent or service provider's) recordkeeping system must include the value of the identity protection services in the employees' gross income and wages. This announcement does not apply to cash received in lieu of identity protection services, or to identity protection services received for reasons other than as a result of a data breach, such as identity protection services received in connection with an employee's compensation benefit package. Nor does it apply to proceeds received under an identity theft insurance policy; the treatment of insurance recoveries is governed by existing law.

a. The IRS again shows that it has a heart. Announcement 2016-2, 2016-3 I.R.B. 283 (12/30/15). Extending the principles of Announcement 2015-22, 2015-35 I.R.B. 288, the IRS has announced that it will not assert that an individual must include in gross income the value of identity protection services provided before a data breach occurs by the individual's employer or by another organization to which the individual provided personal information (for example, name, social security number, or banking or credit account numbers). Nor will the IRS assert that an employer providing identity protection services to its employees before a data breach occurs must include the value of the identity protection services in the employees' gross income and wages. Non-inclusion does not apply to cash received in lieu of identity protection services.

9. Per capita distributions to members of an Indian tribe from a tribal trust account generally are excluded from gross income. Notice 2015-67, 2015-41 I.R.B. 546 (9/18/15). This notice, which supersedes Notice 2014-17, 2014-13 I.R.B. 881 (3/10/14), explains the tax treatment of distributions to members of an Indian tribe from trust accounts maintained by the Secretary of the Interior on behalf of federally recognized Indian tribes. Such distributions generally are excluded from the recipient's

gross income, but would constitute gross income if the trust account "is used to mischaracterize what would otherwise be taxable income as nontaxable per capita distributions." This exception might apply, for example, if the distributions really are mischaracterized compensation to tribal members for their services, distributions of business profits, or gaming revenues. The notice provides examples that illustrate such mischaracterization. The notice does not affect the federal income taxation of distributions from individual Indian trust accounts (from which per capita distributions cannot be made) and does not affect the federal income taxation of and withholding from distributions made pursuant to a Revenue Allocation Plan under the Indian Gaming Regulatory Act.

10. This may be one of the few sensible extenders. The 2015 PATH Act, § 151, retroactively extended through 12/31/15 and extends through 2016 the § 108(a)(1)(E) exclusion for up to $2 million ($1 million for married individuals filing separately) of income from the cancellation of qualified principal residence indebtedness.

11. An exclusion from gross income for wrongfully incarcerated individuals. The 2015 PATH Act, § 304, adds to the Code § 139F, which excludes from the gross income of an individual who is convicted of a criminal offense under federal or state law and wrongfully incarcerated any civil damages, restitution, or other monetary award relating to the individual's incarceration. An individual was wrongfully incarcerated if the individual is pardoned, granted clemency, or granted amnesty for the offense because the individual was innocent, or if the conviction is reversed or vacated and the charging instrument is then dismissed or the individual is found not guilty at a new trial. The new provision applies to taxable years beginning before, on, or after 12/18/15, the date of enactment. A special rule allows individuals to make a claim for credit or refund of any overpayment of tax resulting from the exclusion, even if the claim would normally be barred by operation of any law or rule of law (including res judicata), if the claim for credit or refund is filed before the close of the one-year period beginning on 12/18/15.

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

1. ♪♫Up, up and away, my beautiful, my beautiful toy planes.♫♪ Savello v. Commissioner, T.C. Memo. 2015-24 (2/12/15). The taxpayer was an art teacher who inherited from her father a retail sales and services business that specialized in radio-controlled planes. The business operated a store that was open every day from 8:00 A.M. to 5:00 P.M., but the

taxpayer did not routinely work in the store. The store never turned a profit. Nevertheless, she was found to have operated the business with "an actual and honest objective of making a profit." The taxpayer did not derive personal pleasure from operating the business and did not have substantial income to absorb recurring losses. Although there was no evidence of profits for any years, the Tax Court (Judge Kerrigan) found that "the tax benefit to her is not significant; and we do not think she would have continued to run the business without an honest expectation of profit."

2. A loser in the casinos is a loser in the Tax Court. Boneparte v. Commissioner, T.C. Memo. 2015-128 (7/13/15). The taxpayer was employed full time by the Port Authority of New York and New Jersey as a tunnel bridge agent. He generally worked from 2 p.m. to 10 p.m., working four days on, two days off, four days on, two days off, five days on, two days off. He did not maintain a permanent residence. Instead, he kept a storage locker in New Jersey where he would keep his personal belongings. Generally, after his shift at the Port Authority was over, he would drive approximately 125 miles to Atlantic City and check in at a casino hotel to stay the night and gamble. If he had to work at the Port Authority the next day, he would depart at 10 a.m. to return to the Port Authority to perform his duties. He claimed gambling expenses (and losses, because he was a loser) as a deduction relating to the trade or business of being a professional gambler. The Tax Court (Judge Kerrigan), applied the factors of Reg. § 1.83-29(b) to determine that the taxpayer was not a professional gambler. Thus, the expenses were disallowed. The losses were disallowed because he did not report any winnings, i.e., he claimed net losses.

D. Deductions and Credits for Personal Expenses

1. When multiple unmarried taxpayers co-own a qualifying residence, do the debt limit provisions found in § 163(h)(3)(B)(ii) and (C)(ii) apply per taxpayer or per residence?

a. The Tax Court says the limits apply per taxpayer: two unmarried co-owners holding residences in joint ownership were restricted to mortgage interest deductions on only $1.1 million of loans. Sophy v. Commissioner, 138 T.C. 204 (3/5/12). The Tax Court (Judge Cohen) decided that the $1.1 million § 163(h)(3) limitation on indebtedness giving rise to qualified residence interest should be applied on both a per-taxpayer and a per-residence basis with respect to residence owners who are not married to each other, rather than solely on the per-taxpayer basis argued for by the unmarried taxpayers who jointly owned the two residences in question on which the purchase money mortgages exceeded $1.1 million. Thus, each of the two taxpayers, who were registered domestic partners under

California law, was limited to deducting interest on only $500,000 of acquisition indebtedness on their two residences and $50,000 of home equity indebtedness on their principal residence. The decision was based upon congressional intent, as shown by the statute's repeated use of phrases "with respect to any qualified residence" and "with respect to such residence," which would have been superfluous had Congress intended that the limitations be applied on a per-taxpayer basis.

b. But the Ninth Circuit says the debt ceilings limits apply per taxpayer, not per residence. Voss v. Commissioner, 796 F.3d 1051 (9th Cir. 8/7/15). In a 2-1 opinion by Judge Bybee, the Ninth Circuit reversed the Tax Court's decision in *Sophy v. Commissioner*, 138 T.C. 204 (2012), and held that the debt limit provisions of § 163(h)(3) apply on a per-taxpayer basis to unmarried co-owners of a qualified residence and remanded the case for a determination of the proper amount of interest that each taxpayer was entitled to deduct. The opinion focused principally on the parentheticals in § 163(h)(3)(B)(ii) and (C)(ii) that halve the debt ceilings "in the case of a married individual filing a separate return." If Congress had wanted to draft the parentheticals in per-residence terms, it could have done so. "The per-taxpayer wording of the parentheticals, considered in light of the parentheticals' use of the phrase 'in the case of,' thus suggests that the wording of the main clause—in particular, the phrase 'aggregate amount treated'—should likewise be understood in a per taxpayer manner." Furthermore, "the very inclusion of the parentheticals suggests that the debt limits apply per taxpayer." The Ninth Circuit majority's reasoning was summarized as follows:

> We infer this conclusion from the text of the statute: By expressly providing that married individuals filing separate returns are entitled to deduct interest on up to $550,000 of home debt each, Congress implied that unmarried co-owners filing separate returns are entitled to deduct interest on up to $1.1 million of home debt each.

The majority opinion also pointed out that applying a per residence ceiling would be largely unworkable in situations where two unmarried taxpayers each had an individual primary residence that was a qualified residence but co-owned a secondary residence that was a qualified residence. Additionally, the majority noted that "[i]f Congress wants to go further and ensure that two or more unmarried taxpayers are treated as a single taxpayer for purposes of a particular deduction or credit, it can do that too," citing the now-expired § 36 first-time homebuyer credit as an example of a provision that did exactly that. The court acknowledged that the provisions of § 163(h)(3) limiting married taxpayers filing separately to one-half of the amount of debt ceiling allowed

to married taxpayers filing jointly results in a marriage penalty, but it was "not particularly troubled."

> Congress may very well have good reasons for allowing that result, and, in any event, Congress clearly singled out married couples for specific treatment when it explicitly provided lower debt limits for married couples yet, for whatever reason, did not similarly provide lower debt limits for unmarried co-owners.

Finally, the court refused to give any deference to CCA 200911007, 2009 WL 641772 (11/24/08, released 3/13/09), which concluded that unmarried co-owners are "limited to $1,000,000 of total, 'aggregate' acquisition indebtedness."

- Judge Ikuta's dissenting opinion would have affirmed the Tax Court's decision by giving deference to CCA 200911007, which she described as "both reasonable and persuasive."

2. The premium tax credit and federally facilitated exchanges:

a. "I'm so sorry, it's the Moops." Halbig v. Burwell, 758 F.3d 390 (D.C. Cir. 7/22/14), *vacated for en banc review* 114 A.F.T.R.2d 2014-5868 (9/4/14). The D.C. Circuit in an opinion (2-1) by Judge Griffith held that Reg. § 1.36B-1(k),[3] which makes the § 36B premium tax credits under Obamacare available to qualifying individuals who purchase health insurance on both state-run and federally-facilitated exchanges, was invalid. The court concluded that the regulation contradicted the "plain meaning" of § 36B(b)(2), which states:

> (2) Premium assistance amount. — The premium assistance amount determined under this subsection with respect to any coverage month is the amount equal to the lesser of—
>
> (A) the monthly premiums for such month for 1 or more qualified health plans offered in the individual market within a State which cover the taxpayer, the taxpayer's spouse, or any dependent (as defined in section 152) of the taxpayer *and which were enrolled in through an Exchange established by*

[3] Specifically, the regulations provide that a taxpayer may receive a tax credit if he "is enrolled in one or more qualified health plans through an Exchange." Reg. § 1.36B-2(a)(1). The regulations define an Exchange as "an Exchange serving the individual market for qualified individuals . . . , *regardless of whether the Exchange is established and operated by a State (including a regional Exchange or subsidiary Exchange) or by HHS*." 45 C.F.R. § 155.20 (emphasis added); Reg. § 1.36B-1(k) (incorporating the definition in 45 C.F.R. § 155.20 by reference).

> *the State* under 13111 of the Patient Protection and Affordable Care Act …

I.R.C. § 36B(b)(2) (Emphasis added). The majority did not find that the legislative history of the Act, which is scant, rendered the statutory language of § 36B(b)(2) ambiguous or indicated a legislative intent to allow credits to taxpayers who purchased insurance through exchanges established by HHS.

- Judge Edwards vigorously dissented characterizing the plaintiff's action as a "not-so-veiled attempt to gut the Patient Protection and Affordable Care Act" and concluding that "[t]he majority opinion ignores the obvious ambiguity in the statute and claims to rest on plain meaning where there is none to be found." His opinion emphasized that "'[t]he plainness or ambiguity of statutory language is determined by reference to the language itself, the specific context in which that language is used, and the broader context of the statute as a whole,'" quoting Robinson v. Shell Oil Co., 519 U.S. 337, 341 (1997). Applying this standard, considering the ACA as a whole, he applied a Chevron[4] analysis that found the language of § 36B(b)(2) to be ambiguous and the government's interpretation of the regulation to be permissible and reasonable.

3. On 9/4/14, the D.C. Circuit granted the government's petition for rehearing *en banc* and vacated the judgment entered on 7/22/14.

a. "That's not Moops, you jerk, it's Moors." King v. Burwell, 759 F.3d 358 (4th Cir. 7/22/14), *cert. granted*, 135 S. Ct. 475 (11/7/14). In a unanimous decision by Judge Gregory (with an additional concurring opinion by Judge Davis), the Fourth Circuit upheld the validity of Reg. § 1.36B-1(k), which makes the § 36B premium tax credits under Obamacare available to qualifying individuals who purchase health insurance on both state-run and federally-facilitated exchanges. Applying a *Chevron* analysis, in step one the Fourth Circuit rejected the plaintiff's "plain language" argument, instead concluding that

> when conducting statutory analysis, a reviewing court should not confine itself to examining a particular statutory provision in isolation. Rather, [t]he meaning – or ambiguity – of certain words or phrases may only become evident when placed in context." *Nat'l Ass'n of Home Builders v. Defenders of Wildlife*, 551 U.S. 644, 666 (2007).

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[4] Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984).

Applying this standard, at step one of the *Chevron* analysis, "[h]aving examined the plain language and context of the most relevant statutory sections, the context and structure of related provisions, and the legislative history of the Act, [the court was] unable to say definitively that Congress limited the premium tax credits to individuals living in states with state-run Exchanges." Turning to step two of the *Chevron* analysis, because the court found that "the relevant statutory sections appear to conflict with one another, yielding different possible interpretations, the court decided that "the statute permits the IRS to decide whether the tax credits would be available on federal Exchanges," and that the regulation is a "permissible construction of the statutory language."

- Judge Davis, who joined the majority, wrote a concurring opinion in which he opined that "even if one takes the view that the Act is not ambiguous ... the necessary outcome of this case is precisely the same." He would have held "that Congress has mandated in the Act that the IRS provide tax credits to all consumers regardless of whether the Exchange on which they purchased their health insurance coverage is a creature of the state or the federal bureaucracy." He reasoned that a holistic reading of the Act's text and proper attention to its structure led to the conclusion that the federally-run exchanges were in essence state exchanges established by the federal government on behalf of the states.

b. It's the Moors. By a 6-3 vote the Supreme Court declines to be the Word Police vis-à-vis Congress. King v. Burwell, 135 S. Ct. 2480 (6/25/15). In a 6-3 decision written by Chief Justice Roberts, the Supreme Court upheld the availability of premium tax credits under § 36B to purchase health insurance to individuals in states that have a federally facilitated exchange (Federal Exchange), as expressly provided in Reg. § 1.36B-2 and 45 C.F.R. § 155.20. The Court rejected the plaintiff's arguments that the statute authorized such credits only for individuals in states that have a state-established exchange. Very significantly, the Court declined to apply the *Chevron* [*Chevron U. S. A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U. S. 837 (1984)] analytical method to analyze the validity of the regulations, which was the methodology applied by the Fourth Circuit (759 F. 3d 358 (2014)). The Court explained that the *Chevron* approach "'is premised on the theory that a statute's ambiguity constitutes an implicit delegation from Congress to the agency to fill in the statutory gaps,'" but that "'[i]n extraordinary cases … there may be reason to hesitate before concluding that Congress has intended such an implicit delegation[,]'" citing *FDA v. Brown & Williamson Tobacco Corp.*, 529 U. S. 120, 159 (2000). The Court then found this case to be one of those extraordinary cases because "[w]hether those credits are available on Federal Exchanges is thus a question of deep 'economic and political significance' that is central to this statutory scheme; had Congress wished to assign that question to an agency, it surely would have

done so expressly." It added that "[i]t is especially unlikely that Congress would have delegated this decision to the IRS, which has no expertise in crafting health insurance policy of this sort." The Court then proceeded to use traditional tools of statutory interpretation to determine on its own the "correct meaning" of § 36B, which allows the credits. In doing so, the Court chose to apply a purposive approach rather than a textualist approach. After examining a number of provisions of the Affordable Care Act, the Court first concluded that the text of the key phrase in § 36B(b)(2)(A) "'an Exchange established by the State' … is properly viewed as ambiguous. The phrase may be limited in its reach to State Exchanges. But it is also possible that the phrase refers to all Exchanges—both State and Federal—at least for purposes of the tax credits." Then, looking at the provision in the context of the entire "statutory scheme," the Court applied a purposivist analysis to depart from textualism and to resolve the ambiguity.

> A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme . . . because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law." *United Sav. Assn. of Tex. v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 371 (1988). Here, the statutory scheme compels us to reject petitioners' interpretation because it would destabilize the individual insurance market in any State with a Federal Exchange, and likely create the very "death spirals" that Congress designed the Act to avoid. See *New York State Dept. of Social Servs. v. Dublino*, 413 U. S. 405, 419–420 (1973) ("We cannot interpret federal statutes to negate their own stated purposes.").
>
> ... Congress based the Affordable Care Act on three major reforms: first, the guaranteed issue and community rating requirements; second, a requirement that individuals maintain health insurance coverage or make a payment to the IRS; and third, the tax credits for individuals with household incomes between 100 percent and 400 percent of the federal poverty line. ...
>
> Under petitioners' reading, however, ... one of the Act's three major reforms—the tax credits—would not apply. And a second major reform—the coverage requirement—would not apply in a meaningful way. ... [T]he coverage requirement applies only when the cost of buying health insurance (minus the amount of the tax credits) is less than eight percent of an individual's income. So without the tax credits, the coverage requirement would apply to fewer individuals. And it would be a *lot* fewer. ... If petitioners are right, therefore, only one

> of the Act's three major reforms would apply in States with a Federal Exchange.
>
> The combination of no tax credits and an ineffective coverage requirement could well push a State's individual insurance market into a death spiral. ...
>
> It is implausible that Congress meant the Act to operate in this manner. ... Congress made the guaranteed issue and community rating requirements applicable in every State in the Nation. But those requirements only work when combined with the coverage requirement and the tax credits. So it stands to reason that Congress meant for those provisions to apply in every State as well.…
>
> Petitioners' arguments about the plain meaning of Section 36B are strong. But while the meaning of the phrase "an Exchange established by the State under [42 U.S.C. § 18031]" may seem plain "when viewed in isolation," such a reading turns out to be "untenable in light of [the statute] as a whole." *Department of Revenue of Ore. v. ACF Industries, Inc*., 510 U.S. 332, 343 (1994). In this instance, the context and structure of the Act compel us to depart from what would otherwise be the most natural reading of the pertinent statutory phrase.

Thus, the majority held that "Section 36B allows tax credits for insurance purchased on any Exchange created under the Act," whether created by a state or the federal government.

However, lest one mistakenly think that contextual purposivism is the new universal order of the day, immediately before so succinctly stating its holding, the majority opinion included a cautionary note: "Reliance on context and structure in statutory interpretation is a 'subtle business, calling for great wariness lest what professes to be mere rendering becomes creation and attempted interpretation of legislation becomes legislation itself.' *Palmer v. Massachusetts*, 308 U. S. 79, 83 (1939)."

But the majority then ended its opinion with a strong dose of purposivism:

> In a democracy, the power to make the law rests with those chosen by the people. Our role is more confined—"to say what the law is*." Marbury v. Madison*, 1 Cranch 137, 177 (1803). That is easier in some cases than in others. But in every case we must respect the role of the Legislature, and take care not to undo what it has done. A fair reading of legislation demands a fair understanding of the legislative plan.
>
> Congress passed the Affordable Care Act to improve health insurance markets, not to destroy them. If at all

> possible, we must interpret the Act in a way that is consistent with the former, and avoids the latter. Section 36B can fairly be read consistent with what we see as Congress's plan, and that is the reading we adopt.

- Justice Scalia says "We should start calling this law SCOTUScare." Justice Scalia, joined by Justices Thomas and Alito, dissented in a sharply worded—some might say intemperate[5]—opinion. The dissent applied some different canons of statutory construction than the majority, relying principally on a strict textualist approach that reads § 36B(b)(2)(A) as allowing a premium tax credit only for insurance purchased through "'an Exchange established by the State.'"

> In order to receive any money under § 36B, an individual must enroll in an insurance plan through an "Exchange established by the State." The Secretary of Health and Human Services is not a State. So an Exchange established by the Secretary is not an Exchange established by the State—which means people who buy health insurance through such an Exchange get no money under § 36B.
>
> Words no longer have meaning if an Exchange that is not established by a State is "established by the State." It is hard to come up with a clearer way to limit tax credits to state Exchanges than to use the words "established by the State." And it is hard to come up with a reason to include the words "by the State" other than the purpose of limiting credits to state Exchanges.

The dissent claimed also to rely on context to reinforce its conclusion, but focused on different provisions than the majority to determine context, noting that "parts of the Act sharply distinguish between the establishment of an Exchange by a State and the establishment of an Exchange by the Federal Government." Furthermore, the dissent argued that the majority's "reading does not merely give 'by the State' a duplicative effect; it causes the phrase to have no effect whatever." That reading "is a stark violation of the elementary principle that requires an interpreter 'to give effect, if possible, to every clause and word of a statute." *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883). As for purposivism, the dissent reasoned that Congress's purpose in limiting premium tax credits to individuals who purchased insurance through state-

[5] *See, e.g.*, "[T]he [majority]opinion continues, with no semblance of shame"; "[T]he Court comes up with argument after feeble argument"; "Pure applesauce"; "For its next defense of the indefensible, the Court turns to the Affordable Care Act's design and purposes"; "Perhaps sensing the dismal failure of its efforts to show that 'established by the State' means 'established by the State or the Federal Government,' the Court tries to palm off the pertinent statutory phrase as 'inartful drafting.'"

established exchanges, and not through Federal exchanges established for states, was to compel states as a practical matter to establish exchanges to avoid economically damaging the states' citizens as a result of the denial of the premium tax credit to individuals who purchased their insurance through a Federal Exchange and that the majority opinion frustrated that purpose.

- The majority opinion provides much to think about, and a lot of ink will be spilled on what it means regarding statutory interpretation, both generally and with respect to tax law in particular. First, does the majority's dismissal of Chevron deference to the regulations because, among other reasons, "[i]t is especially unlikely that Congress would have delegated this decision to the IRS, which has no expertise in crafting health insurance policy of this sort" signal that Chevron deference to Treasury regulations interpreting a wider variety of tax expenditure credits might be limited because the IRS and Treasury have "no expertise in crafting [fill in the blank] policy." Blanks to be filled in might include, for example, any of the following: "scientific or technical research policy" under § 41; oil recovery technology policy under § 43; nonconventional fuels policy under § 29; biodiesel fuel policy under § 40A; clean coal technology policy under §§ 20-25; energy efficient appliances policy under § 45M; "qualifying therapeutic discovery projects" policy under § 48D, also added by the ACA. On the other hand, it might be likely that Chevron deference falls by the wayside only when statutory interpretation involves "a question of deep 'economic and political significance' that is central to this statutory scheme." Second, and probably much more important, is the scope of the majority's admonition that "while the meaning of the phrase … may seem plain 'when viewed in isolation,' such a reading turns out to be 'untenable in light of [the statute] as a whole.'" In King v. Burwell the statute as a whole was the Patient Protection and Affordable Care Act. The $64,000 question in future tax cases is whether the statute as a whole is the entire Internal Revenue Code, which has accreted like sedimentary rock, or merely the particular act of Congress in which any number of different sections were enacted, for example, the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, The Tax Reform act of 1966, or the American Taxpayer Relief Act of 2012 standing alone. And then there is the issue of successive amendments in various acts to any particular Code section or subsection. Furthermore, if a Code section has been amended over time, to what extent might it matter whether the subsections operate interdependently or whether the subsections might appear to operate independently of one another in certain instances, for example, § 108 or § 163(b), et. seq. Finally, what impact does the purposivism approach of King v. Burwell have on the import of the statutory interpretation methodology of Gitlitz v. Commissioner, 531 U.S. 206 (2001), in which the Court interpreted the interaction of §§ 1366 and 108(b) to allow taxpayers to "experience a 'double windfall,'" because "[t]they would be exempted from paying taxes on the full amount of the discharge of indebtedness, and they would be able to increase basis and deduct their previously suspended losses." The Court in Gitlitz concluded

that "[b]ecause the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern." (Emphasis added.)

4. Judge Thornton explains how to distinguish a tax levied on the privilege of doing business, which is deductible above the line, from a net income tax, which is deductible only as an itemized deduction. Cutler v. Commissioner, T.C. Memo. 2015-73 (4/9/15). The taxpayer was a partner of a law firm partnership doing business in other states, as well as his state of residence. Certain states imposed nonresident income taxes that were collected by requiring the partnership to withhold and remit the taxes imposed on the partner. The taxpayer deducted the taxes on Schedule E, in determining AGI, but the IRS allowed the deduction only as an itemized deduction. The Tax Court (Judge Thornton) upheld the IRS's position, allowing the deduction only as an itemized deduction. The taxes were not taxes imposed on doing business, because they were taxes on net income and notwithstanding the collection method were imposed on the partners not the entity.

5. Once the guardianship terminated, the child of the taxpayer's former ward could not be the taxpayer's "qualifying child" for purposes of the dependency exemption, earned income tax credit, child tax credit, and head of household filing status. Cowan v. Commissioner, T.C. Memo. 2015-85 (5/4/15). The taxpayer was appointed by a state court as the guardian of Marquis Woods when Marquis was an infant, but she never adopted Marquis. The guardianship terminated in 2004 when Marquis turned eighteen, but Marquis continued to live with and be supported by the taxpayer. For 2011, the taxpayer claimed a dependency exemption for Marquis as a qualifying relative and for H.A.W., Marquis's five-year-old child, as a qualifying child. During 2011, Marquis and H.A.W. lived with the taxpayer (Marquis for twelve months and H.A.W. for eleven months) and the taxpayer provided more than half of their support. The taxpayer also claimed for 2011 the additional child tax credit, the earned income tax credit, and head of household filing status. The IRS issued a notice of deficiency disallowing all of the claimed exemptions, credits, and head of household filing status, but subsequently conceded that the taxpayer was entitled to a dependency exemption for Marquis as a qualifying relative. The Tax Court (Judge Gustafson) upheld the IRS's disallowances. The taxpayer's entitlement to the dependency exemption for H.A.W., the child tax credit, the earned income tax credit, and head of household filing status turned on whether H.A.W. was a "qualifying child" as defined in § 152(c)(2), which provides that a qualifying child includes "a child of the taxpayer or a descendant of such a child." Under § 152(f)(1)(A), the term "child" includes "an eligible foster child" of the taxpayer. The court held that H.A.W. was not a qualifying child of the taxpayer because Marquis ceased to be the taxpayer's eligible foster child when the

guardianship terminated in 2004, and therefore H.A.W. was not a descendant of the taxpayer's child. The court rejected the taxpayer's argument that Reg. § 1.152-2(d) supported continuing to treat Marquis as her foster child. That regulation provides: "The relationship of affinity once existing will not terminate by divorce or the death of a spouse. For example, a widower may continue to claim his deceased wife's father (his father-in-law) as a dependent provided he meets the other requirements of section 151." According to the court, "affinity" is a relationship by marriage or a familial relation resulting from marriage, and "there is no basis for extending, without warrant in the regulation, a principle based in marriage to make it apply to a foster care relationship."

6. Standard deduction for 2016. Rev. Proc. 2015-53, 2015-44 I.R.B. 615 (10/21/15). The standard deduction for 2016 will be $12,600 for joint returns and surviving spouses, $6,300 for unmarried individuals, $6,300 for married individuals filing separately, and $9,300 for heads of households. These figures are unchanged from 2015 except the figure for heads of households, which increased from $9,250.

7. The IRS extends through 2017 the safe harbor method for computing deductions for payments made on a home mortgage by financially distressed homeowners. Notice 2015-77, 2015-47 I.R.B. 676 (11/6/15). The IRS previously (1) concluded that payments made with federal funds pursuant to specified programs by state housing agencies to or on behalf of a financially distressed homeowner are excluded from the homeowner's gross income under the general welfare exclusion, (2) provided a safe harbor method for computing the amount the homeowner can deduct on the homeowner's return, and (3) provided certain information reporting and penalty relief to mortgage servicers and state housing agencies. Notice 2011-14, 2011-14 I.R.B. 544 (2/23/11), modified by Notice 2011-55, 2011-47 I.R.B. 793 (10/31/11), amplified and supplemented by Notice 2013-7, 2013-6 I.R.B. 477 (1/16/13). This notice extends through 2017 the information reporting and penalty relief and the safe harbor method for computing the amount the homeowner can deduct on the homeowner's return. Under the safe harbor, a homeowner can deduct the lesser of (1) the sum of all payments on the home mortgage that the homeowner actually makes during a taxable year to the mortgage servicer or the state housing agency, or (2) the sum of amounts shown on Form 1098, Mortgage Interest Statement, for mortgage interest received, real property taxes, and mortgage insurance premiums (if deductible for the taxable year under § 163(h)(3)(E)). A homeowner can use this safe harbor method if the homeowner participates in an eligible state program and the homeowner meets the requirements of §§ 163 and 164 to deduct all of the mortgage interest on the loan and all of the real property taxes on the principal residence.

8. This one's really only for taxpayers in Texas and Florida and a few other states that don't have a state income tax. The 2015 PATH Act, § 106, retroactively extended though 12/31/15 and made permanent the § 164(b)(5)(A) election to claim an itemized deduction for state and local general sales and use taxes instead of state and local income taxes.

9. Of course there's no chance the mortgage insurance companies will increase their premiums to capture the benefit of this deduction to the involuntary purchaser. Hah! The 2015 PATH Act, § 152, retroactively extended though 12/31/15 and extends through 2016 the § 163(h)(3)(E) deduction (subject to the pre-existing limitations) for mortgage insurance premiums in connection with acquisition indebtedness with respect to the taxpayer's qualified residence.

10. Why not just increase, rather than decrease, Pell grants? The 2015 PATH Act, § 153, retroactively extended though 12/31/15 and extends through 2016 the § 222 above-the-line deduction for certain eligible individuals of a limited amount of qualified higher education tuition and related expenses of the taxpayer, his spouse, or dependents.

E. Divorce Tax Issues

1. Well, wadda ya expect? Muniz v. Commissioner, T.C. Memo. 2015-125 (7/9/15). The Tax Court (Judge Nega) held that Florida "lump sum alimony," the right to which does not terminate upon the death of the payee prior to receipt, is not alimony as defined in § 71 and thus is not deductible as alimony under § 215.

F. Education

1. The Hope Scholarship Credit on steroids: the American Opportunity Tax Credit becomes permanent. The 2015 PATH Act, § 102, made permanent the § 25A(i) American Opportunity Tax Credit ("AOTC"), an enhanced version of the § 25A(b) Hope Scholarship Credit. The AOTC, which had been scheduled to expire after 2017, enhances several aspects of the Hope Scholarship Credit, including increasing the maximum credit to $2,500 per student, permitting the credit for the first four years (rather than two years) of postsecondary education, expanding the definition of "qualified tuition and related expenses" to include course materials, and increasing the AGI thresholds that trigger a reduction in the credit.

G. Alternative Minimum Tax

There were no significant developments regarding this topic during 2015.

VI. CORPORATIONS

A. Entity and Formation

There were no significant developments regarding this topic during 2015.

B. Distributions and Redemptions

There were no significant developments regarding this topic during 2015.

C. Liquidations

There were no significant developments regarding this topic during 2015.

D. S Corporations

1. **The lifetime of built-in gain is now permanently shorter.** The Small Business Jobs Act of 2010 shortened the holding period under § 1374 for recognizing unrealized built-in gain on conversion from a C corporation to an S corporation to five years preceding the corporation's tax year beginning in 2011. Before the change, the holding period was ten years for sales or exchanges in tax years beginning before 2009, and seven years for tax years beginning in 2009 or 2010. The § 1374 five-year holding period reduction was extended to recognized built-in gain in 2012 and 2013 (by the 2012 Taxpayer Relief Act, § 326(a)(2)) and to recognized built-in gain in 2014 (by the 2014 Tax Increase Prevention Act). The 2015 PATH Act, § 127, retroactively reinstated and made permanent the § 1374 five-year holding period reduction for recognized built-in gain in taxable years beginning after 12/31/14.

2. **The rule concerning reductions in an S corporation shareholder's stock basis for the corporation's charitable contribution of property becomes permanent.** The 2015 PATH Act, § 115, retroactively reinstated for 2015 and made permanent the rule of § 1367(a)(2)

that the reduction in an S corporation shareholder's stock basis by reason of the S corporation's charitable contribution of property is the shareholder's pro rata share of the property's adjusted basis.

E. Mergers, Acquisitions and Reorganizations

1. First two steps, no step transaction doctrine; third and fourth steps, in steps the step transaction doctrine. Rev. Rul. 2015-10, 2015-21 I.R.B. 973 (5/5/15). This ruling addresses the characterization of a transaction in which pursuant to a plan (1) a parent corporation transferred all of the interests in its wholly-owned limited liability company that was taxable as a corporation to its subsidiary (first subsidiary) in exchange for additional stock, (2) the first subsidiary transferred all of the interests in the limited liability company to its subsidiary (second subsidiary) in exchange for additional stock, (3) the second subsidiary transferred all of the interests in the limited liability company to its subsidiary (third subsidiary) in exchange for additional stock, and (4) the limited liability company elected to be disregarded as an entity separate from its owner for federal income tax purposes effective after it was owned by the third subsidiary. The ruling concluded that the series of events was properly treated as two transfers of stock in exchanges governed by § 351, followed by a § 368(a)(1)(D) reorganization. Even though the parent's transfer was part of a series of transactions undertaken as part of a prearranged, integrated plan involving successive transfers of the LLC interests, the transfer satisfied the formal requirements of § 351, including the requirement that the transferor control the subsidiary immediately after the exchange. Viewing the transaction as a whole did not dictate that the parent's transfer be treated other than in accordance with its form. Section 351 similarly applied to the first subsidiary's transfer of the LLC interests to its subsidiary. But the transfer by the second subsidiary to the third subsidiary, coupled with the LLC's election to become a disregarded entity was characterized as a § 368(a)(1)(D) reorganization, rather than as a transfer of stock governed by § 351 followed by a liquidation subject to § 332. If an acquiring corporation acquires all of the stock of a target corporation from a person controlling the acquiring corporation (within the meaning of § 304(c), via § 368(a)(2)(H)(i)) "in an exchange otherwise qualifying as a § 351 exchange, and as part of a prearranged, integrated plan, the target corporation thereafter transfers its assets to the acquiring corporation in liquidation, the transaction is more properly characterized as a reorganization under § 368(a)(1)(D), to the extent it so qualifies. See Rev. Rul. 67-274[, 1967-2 C.B. 141] … ."

2. All hail the (F) "in a bubble." Reorganizations Under Section 368(a)(1)(F); Section 367(a) and Certain Reorganizations

Under Section 368(a)(1)(F), T.D. 9739, 80 F.R. 56904 (9/21/15). The Treasury Department and IRS have finalized Reg. § 1.368-2(m), proposed in Reorganizations Under Section 368(a)(1)(E) or (F), REG-106889-04, 69 F.R. 49836 (8/12/04), comprehensively defining F reorganizations. An (F) reorganization is "a mere change in identity, form, or place of organization of one corporation, however effected." An (F) reorganization does not result in the corporation being treated for federal income tax purposes as a new corporation or as transferring its assets. Nor does it cause the corporation's taxable year to close. The regulations recognize that an F reorganization may be a step in a larger transaction that effects more than a "mere change." A qualifying (F) reorganization may occur before, within, or after other transactions that effect more than a "mere change," even if the resulting corporation has only transitory existence. Related events that precede or follow the potential (F) reorganization generally will not cause that potential (F) reorganization to fail to qualify as a reorganization under § 368(a)(1)(F). The functional theme of the regulations is to identify an F reorganization "in the bubble." Under the regulations, a transaction, or a series of transactions (for example, a "liquidation-reincorporation"), that involves an actual or deemed transfer is a mere change only if six requirements are satisfied. The regulations provide that the transaction or a series of related transactions to be tested against the six requirements begins when the transferor corporation begins transferring (or is deemed to begin transferring) its assets to the resulting corporation and ends when the transferor corporation has distributed (or is deemed to have distributed) the consideration it receives from the resulting corporation to its shareholders and has completely liquidated for federal income tax purposes. The six requirements are as follows: (1) First, all the stock of the resulting corporation, including stock issued before the transfer, must be issued in respect of stock of the transferring corporation. (However, the resulting corporation may issue a de minimis amount of stock not in respect of stock of the transferor corporation, to facilitate the organization or maintenance of the resulting corporation.) (2) Second, subject to certain exceptions, the same person or persons own all the stock of the transferor corporation at the beginning of the potential (F) reorganization and all of the stock of the resulting corporation in identical proportions, except a change that has no effect other than that of a redemption of less than all the shares of the corporation or that has the effect of a recapitalization of stock. (3) Third, the transferring corporation must completely liquidate in the transaction (although legal dissolution is not required and it may retain a de minimis amount of assets necessary to continue its legal existence). (4) Fourth, the resulting corporation must not hold any property (except a de minimis amount necessary to establish its existence) or have any tax attributes (including those specified in § 381(c)) immediately before the transfer. (5) Fifth, no corporation other than the resulting corporation may hold property that was held by the transferor corporation immediately before the

potential F reorganization if that other corporation would, as a result, succeed to and take into account the items of the transferor described in § 381(c). (This prevents a divisive transaction qualifying as an (F) reorganization.) (6) Sixth, immediately after the transaction, the resulting corporation may not hold property acquired from a corporation other than the transferor corporation if the resulting corporation would succeed to the items of the other corporation described in § 381(c). (This emphasizes existing law that acquisitive transactions involving two corporations that qualify as a type (A) or type (D) reorganization cannot qualify as a type (F) reorganization.) These requirements aid in determining which steps in a multi-step transaction should be considered when applying the six requirements to a potential "mere change"—that is, which steps are "in the bubble." Very significantly, the regulations allow changes of ownership that result from either (1) a holder of stock in the transferor corporation exchanging that stock for stock of equivalent value in the resulting corporation having terms different from those of the stock in the transferor corporation or (2) receiving a distribution of money or other property from either the transferor corporation or the resulting corporation, whether or not in redemption of stock of the transferor corporation or the resulting corporation. In other words, the corporation involved in an (F) reorganization may also recapitalize, redeem its stock, or make distributions to its shareholders, without causing the potential F reorganization to fail to qualify. Furthermore, any concurrent distribution is treated as a transaction separate from the (F) reorganization, and thus is a dividend (to the extent of earnings and profits) unless it qualifies as a redemption under § 302(b). Finally, continuity of the business enterprise and a continuity of interest are not required for a potential (F) reorganization to qualify as a reorganization under § 368(a)(1)(F). See Reg. § 1.368-1(b).

- The regulations are effective for transactions occurring on or after 9/21/15.

3. The basis of something acquired for nothing is nothing. Dorrance v. United States, 807 F.3d 1210 (9th Cir. 12/09/15). The taxpayers received and then sold stock derived from the demutualization of five mutual life insurance companies from which they had purchased policies. They filed an original return treating the stock as having a basis and then sought a refund on the ground that (1) the stock represented a return of previously paid policy premiums or (2) because their mutual rights were not capable of valuation, the entire cost of their insurance premiums should have been counted toward their basis in the stock. The district court held that the taxpayers had a basis in the stock, although not as much as the taxpayers claimed, and thus they were entitled to a partial refund. In an opinion by District Judge Snow, the Ninth Circuit reversed, holding that taxpayers who sold stock obtained through demutualization cannot claim a basis in that stock for tax purposes because they had a zero basis in the mutual rights that were

extinguished during the demutualization. "The reality here is that the Dorrances acquired the membership rights at no cost, but rather as an incident of the structure of mutual insurance policies. The logic of this conclusion is simple—when the Dorrances purchased their mutual insurance policies in 1996, the premiums they paid related to their rights under the insurance contracts, not to collateral membership benefits such as voting." The insurance company had advised the policyholders that their basis was zero, in accordance with Rev. Rul. 71-233, 1971-1 C.B. 113, and Rev. Rul. 74-277, 1974-1 C.B. 88.

> "[B]asis 'refers to a taxpayer's capital stake in an asset for tax purposes.' *Washington Mut. Inc*., 636 F.3d at 1217 (citing *In re Lilly*, 76 F.3d 568, 572 (4th Cir. 1996)). 'The taxpayer must prove what, if anything, he actually was required to pay ... not what he would have been willing to pay or even what the market value ... was.'"

4. Shareholders can't fight what the merger agreement says the deal is. Tseytin v. Commissioner, T.C. Memo. 2015-247 (12/28/15). The taxpayer held two blocks of stock in a wholly owned corporation that was merged into an acquiring corporation in a transaction that qualified under § 368. He received approximately $23 million in cash and stock with a fair market value of approximately $31 million. He realized a gain on one block of stock and a loss on the other. The taxpayer attempted to offset the loss he realized on one of the blocks of stock against the gain he recognized on the other block of stock. The Tax Court (Judge Swift) held that the loss realized on one block of stock could not be against the gain recognized on the other block of stock. The merger agreement specified that each share of target stock was being exchanged for an equal portion of the total merger consideration. Applying the test of Commissioner v. Danielson, 378 F.2d 771 (3rd Cir. 1967), the court held that the taxpayer could not disavow the terms of the merger agreement to treat the loss block of stock as redeemed for cash. The court also rejected the taxpayer's alternative argument that § 356(c) should be interpreted only to prohibit recognition of a net bottom line cumulative loss on a merger transaction and that internal netting of losses and gains should be allowed with respect to different blocks of stock involved in a merger transaction up to the total amount of the overall gain to be recognized. The court noted but did not discuss the taxpayer's argument that Reg. § 1.356-1, as amended in 2006, and Prop. Reg. § 1.356-1(b), Ex. 3, Notice of Proposed Rulemaking, 74 Fed. Reg. 3509, 3509, 3511, 3519 (Jan. 21, 2009), generally allow internal netting of a loss realized on one block of stock against a gain realized on another block of stock so long as a net overall gain is still realized.

F. Corporate Divisions

1. The IRS is taking a hard look at spin offs of investment assets to which it previously has turned a blind eye. Is this a harbinger of a substantive change requiring more than a peppercorn trade or business in order to qualify for a tax-free § 355 division? Notice 2015-59, 2015-40 I.R.B. 459 (9/14/15) This Notice identifies four circumstances in which qualification of a distribution under § 355 is under study: (1) Ownership by the distributing or controlled corporation of investment assets having substantial value in relation to (a) the value of all of such corporation's assets, and (b) the value of the assets of the trade(s) or business(es) relied upon to meet the active trade or business requirement; (2) A significant difference between the distributing corporation's ratio of investment assets to assets other than investment assets and such ratio of the controlled corporation; (3) Ownership by the distributing or controlled corporation of a small amount of active trade or business assets in relation to all of its assets; and (4) An election by the distributing or controlled corporation (but not both) to be a RIC or a REIT. These circumstances may override the non-device factors of public trading and non-pro rata distributions.

2. Back in the lamp Ali Baba (or is it alibaba.com?). Rev. Proc. 2015-43, 2015-40 I.R.B. 467 (9/14/15). The IRS ordinarily will not rule on any issue relating to the qualification under § 355 of a distribution where: (1) Property owned by any distributing corporation or controlled corporation becomes the property of a RIC or a REIT in a "conversion transaction" (i.e., conversion to RIC or REIT or transfer to RIC or REIT); (2) No deemed sale election under Reg. § 1.337(d)-7(c) is made; and (3) The conversion transaction and the distribution are parts of a plan or series of related transactions. Nor will the IRS rule if the fair market value of the gross assets of the trade(s) or business(es) on which the distributing corporation or the controlled corporation relies to satisfy the active trade or business requirement of § 355(b) is less than five percent of the total fair market value of the gross assets of such corporation. Also, the IRS will not rule (until resolved by Revenue Ruling, Revenue Procedure, Regulations or otherwise) on any issue relating to the qualification under § 355 of a distribution where, immediately after the distribution, the following conditions exist: (1) The FMV of the investment assets of the distributing or controlled corporation is two-thirds or more of the total FMV of its gross assets; (2) The FMV of the gross active trade or business assets is less than 10 percent of the FMV of its investment assets; and (3) the ratio of the FMV of the investment assets to the FMV of the assets other than investment assets of the distributing or controlled corporation is three times or more of such ratio for the other corporation. Nor will the IRS rule (until resolved) on any issue relating to the qualification

under § 355 of a distribution where, as part of a plan or series of related transactions, investment assets are disposed of or non-investment assets (including active trade or business assets) are acquired with a principal purpose of avoiding No-Rule (2).

3. Congress kisses-off REIT spinoffs. Section 311(a) of the 2015 PATH Act added new § 355(h), which provides that § 355 does not generally apply to any distribution if either the distributing corporation or controlled corporation is a REIT. If, however, both the distributing corporation and the controlled corporation are REITs immediately after the distribution, the distribution still may qualify under § 355. A second exception applies if (1) the distributing corporation was a REIT at all times during the 3-year period ending on the date of the distribution, (2) the controlled corporation was a taxable REIT subsidiary of the distributing corporation at all times during that period, and (3) the distributing corporation controlled (directly or indirectly) the controlled corporation at all times during that period. Section 355(h) applies to distributions after 12/6/15 unless the transaction was described in a ruling request initially submitted to IRS on or before 12/7/15, the request was not withdrawn, and the ruling was not issued or denied as of 12/7/15.

G. Affiliated Corporations and Consolidated Returns

1. The IRS and Treasury don't like nonstatutory self-help elective treatment. REG–100400–14, Guidance Regarding Reporting Income and Deductions of a Corporation That Becomes or Ceases to be a Member of a Consolidated Group, 80 F.R. 12097 (3/6/15). The IRS and Treasury Department have proposed revisions to the consolidated return regulations, primarily Reg. § 1.1502-76, that would revise the rules for reporting certain items of income and deduction that are reportable on the day a corporation joins or leaves a consolidated group. Under the general rule of current Reg. § 1.1502-76(b)(1)(ii)(A)(1) (end of the day rule), S is treated as becoming or ceasing to be a member of a consolidated group at the end of the day of S's change in status, and S's tax items that are reportable on that day generally are included in the tax return for the taxable year that ends as a result of S's change in status. There are two exceptions to the current end of the day rule. First, Reg. § 1.1502-76(b)(1)(ii)(A)(2) provides that if a corporation is an S corporation (defined in § 1361(a)(1)) immediately before becoming a member of a consolidated group, the corporation becomes a member of the group at the beginning of the day the termination of its S corporation election is effective (termination date), and its taxable year ends at the end of the preceding day (S corporation exception). Second, Reg. § 1.1502-76(b)(1)(ii)(B) provides that if a transaction occurs on the day of S's change

in status that is properly allocable to the portion of S's day after the event resulting in S's change in status, S and certain related persons must treat the transaction as occurring at the beginning of the following day for all federal income tax purposes (next day rule). The proposed regulations would replace the current next day rule with a new next day rule. Generally speaking, the proposed next day rule applies only to certain "extraordinary items" (as defined in Prop. Reg. § 1.1502-76(b)(2)(ii)(C)) that result from transactions that occur on the day of S's change in status, but after the event causing the change, and that would be taken into account by S on that day. This rule requires those extraordinary items to be allocated to S's tax return for the period beginning the next day. The proposed next day rule is expressly inapplicable to any extraordinary item that arises simultaneously with the event that causes S's change in status. The proposed regulations also would provide a previous day rule that mirrors the principles of the proposed next day rule. The proposed previous day rule requires extraordinary items resulting from transactions that occur on the termination date (but before or simultaneously with the event causing S's status as an S corporation to terminate) to be allocated to S's tax return for the short period that ends on the previous day—the day preceding the termination date. The proposed amendments arose from the IRS and the Treasury Department's view that some practitioners' interpretation of the current next day rule inappropriately would permit taxpayers to elect the income tax return on which certain tax items are reported and thus might may not result in an allocation that clearly reflects taxable income. The proposed next day rule is intended to eliminate the perceived electivity.

2. Determining the agent of a consolidated group is now (slightly) easier than figuring out the lyrics to "Louie, Louie." T.D. 9715, Regulations Revising Rules Regarding Agency for a Consolidated Group 80 F.R. 17314 (4/1/15). The Treasury Department and the IRS have finalized, with some changes, proposed regulations (REG-142561-07, Regulations Revising Rules Regarding Agency for a Consolidated Group, 77 F.R. 31786 (5/30/12)) regarding the agent for a consolidated group. Generally, a consolidated group's common parent is the agent for each member in connection with all matters concerning the group's federal tax liability and remains the agent for all group members with respect to a consolidated return year until the parent's existence terminates. Before these amendments, the regulations issued in 2002 (T.D. 9002, Agent for Consolidated Group, 67 F.R. 43538 (6/28/02)) permitted a terminating common parent to designate as a substitute agent the parent's successor, another group member, or a successor of another group member. The prior regulations also required that the parent notify the IRS of its designation and that the IRS approve it. These amendments provide that, if the common parent has a sole successor (referred to as the "default successor"), then the terminating parent cannot designate a

substitute agent and the default successor automatically becomes the group's agent when the parent's existence terminates. Thus, a terminating parent can designate a substitute agent only when there is no default successor. The amendments retain the requirement that the IRS be notified when the default successor or an entity designated by the terminating agent becomes the group's agent, but eliminate the requirement that the IRS approve the designation of a substitute agent.

- The amendments permit disregarded entities and partnerships to serve as substitute agents. Thus, if a common parent merges into or converts to a disregarded entity or a partnership, the successor entity will serve as the group's agent for consolidated return years for which the parent was a corporation and was the group's agent.
- The amendments retain the rule that the IRS will deal directly with a subsidiary group member that is the tax matters partner of a TEFRA partnership regarding partnership matters, but change the approach for a group member that is not the tax matters partner. The prior regulations provided that the IRS would normally deal directly with a group member that is a (non-tax matters) partner in a TEFRA partnership concerning partnership matters, but the amendments require that the group's agent act on behalf of the member that is a (non-tax matters) partner regarding all matters related to the partnership.
- The amended final regulations do not preclude a foreign entity from serving as the agent for a consolidated group (e.g., if the common parent merges into a foreign corporation), but provide the IRS with discretion to designate a substitute agent.
- Provided that certain conditions are met, the amendments provide a mechanism for the agent of a consolidated group to resign, a feature that was absent from the prior regulations.
- The final regulations as amended apply to consolidated return years beginning on or after 4/1/2015. The 2002 regulations continue to apply to consolidated return years beginning on or after 6/28/02 and before 4/1/15.

3. As the Captain in Cool Hand Luke might say: "What we've got here is a [need] to communicate." Guidance on communications relating to the agent for a consolidated group. Rev. Proc. 2015-26, 2015-15 I.R.B. 875 (3/31/15). This revenue procedure provides guidance on the different forms of communication required in connection with determining the agent of a consolidated group. These forms of communication include: (1) a default successor's notification to the IRS of its status as agent; (2) a terminating agent's designation of a substitute agent; (3) a written request by a group member that the IRS designate an agent; (4) an agent's resignation as agent; and (5) notifications by the IRS, including its designation of an agent

for the consolidated group. The revenue procedure applies to communications with respect to consolidated return years beginning on or after 4/1/15. For prior years beginning on or after 6/28/02 and before 4/1/15, Rev. Proc. 2002-43, 2002-28 I.R.B. 99, continues to apply.

4. Let the circle be broken. REG-101652-10, Elimination of Circular Adjustments to Basis; Absorption of Losses, 80 F.R. 33211 (6/11/15). The IRS and Treasury have proposed amendments to Reg. § 1.1502-11 and certain other consolidated return regulations that would revise the rules concerning the use of a consolidated group's losses in a consolidated return year in which stock of a subsidiary is disposed of. The proposed regulations would eliminate the "circular basis problem" in a broader class of transactions than under current law. The proposed regulations also clarify the interaction of the Unified Loss Rule of Reg. § 1.1502-36 with the circular basis rules. The regulations will be effective for consolidated return years beginning on or after the date of publication of final regulations in the Federal Register.

5. None of the X-Men, Iron Man, Thor, Captain America, or any other super hero was able to produce a Marvelous result for the taxpayer. Marvel Entertainment, LLC v. Commissioner, 145 T.C. No. 2 (7/21/2015). In Marvel Group's short taxable year ending 10/1/98, four of its consolidated group members realized total COD income of $171,462,463 resulting from chapter 11 bankruptcy filings and excluded the COD income from gross income under § 108(a)(1)(A). Marvel Group also had a $187,154,680 consolidated NOL for its short taxable year ending 10/1/98. Marvel Group allocated a portion of the group's consolidated NOL to each of the four group debtor members and, pursuant to § 108(b)(2)(A), reduced the allocated consolidated NOL shares by each member's previously excluded COD income. As a result, Marvel Group reduced its $187,154,680 consolidated NOL by $89,566,469 of the $171,462,463 excluded COD income. The issue was whether the NOL subject to reduction under § 108(b)(2)(A) is the entire consolidated NOL of the consolidated group (a single-entity approach) or a portion of the group's consolidated NOL allocable to each group member (a separate-entity approach). The IRS's position was that the NOL that must be reduced under § 108 is the entire consolidated NOL of the group. The taxpayer argued that the NOL subject to reduction under § 108(b)(2)(A) is limited to the share of the group's consolidated NOL allocable to each member entity. On cross motions for summary judgment, the Tax Court (Judge Ruwe) upheld the IRS's position, deciding, as a matter of law, that a consolidated group's NOL subject to reduction under § 108(b)(2)(A) is the entire CNOL of the consolidated group, and not a portion of the consolidated NOL allocable to each member of the consolidated group. In doing so, the court followed the single entity approach adopted by the Supreme Court in United Dominion Indus., Inc. v. Commissioner, 532 U.S.

822 (2001), which held that the pre-2003 consolidated return regulations prohibited the allocation of separate NOLs for consolidated group members unless it was within the ambit of a specific regulatory provision. Neither the Code nor the applicable consolidated return regulations provided authority for an affiliated group to allocate and apportion a CNOL to consolidated group members for purposes of reducing tax attributes pursuant to § 108(b)(2)(A).

- Note: For COD income discharged after 8/29/03 and before 3/22/05, Temp. Reg. § 1.1502-28T, 68 Fed. Reg. 69025 (12/11/03), prescribed a hybrid approach that first reduces the tax attributes of the member entity, then applies a look-through rule to reduce attributes of the member entity's subsidiaries, and lastly reduces attributes of the consolidated group. With slight modifications, Reg. § 1.1502-28(d) applies the principles of the temporary regulation effective for COD income discharged after 3/21/05.

H. Miscellaneous Corporate Issues

1. Filing date chaos. Is it in part attributable to the fact that the U.S. Government's fiscal year closes on September 30? The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(a), amended Code § 6072(b) to require C corporations to file their tax returns by the 15th day of the fourth month after the end of their taxable year (by subjecting them to § 6702(a)), thus deferring the due date by one month. On the other hand, under amended § 6072(b), S corporations continue to be required to file their tax returns by the 15th day of the third month (March 15 for calendar year S corporations). Section 6081(b) was amended to allow C corporations an automatic six-month extension of the due date. However, with respect to a return for a calendar year C corporation that begins before 1/1/2026, the automatic extension is only 5 months; and for a C corporation with a taxable year that ends on June 30 and begins before 1/1/2026, the automatic extension is 7 months.

- The new due date rules generally are effective for returns for taxable years that begin after 12/31/15. For C corporations with fiscal years ending on June 30, the change does not apply until tax years beginning after 12/31/25. Act § 2006(a)(3). Yes, that's correct, a ten year deferred effective date only for corporations with a fiscal year ending on June 30. What's up with that?

2. Congress pretends not to love captive instance as much as the Tax Court loves it, but the "fix" is really just window dressing that actually that does little to prevent income tax avoidance through private captive insurance. The 2015 PATH Act, § 333, amended § 831(b) to benefit captive insurance companies in one way but in another way to a limited extent to inhibit their use, beginning in 2017. First, the Act increases the maximum amount of annual premiums from $1,200,000 to $2,200,000

(adjusted for inflation after 2015) the ceiling on net written premiums that a nonlife insurance company may receive in order to elect to be taxed, at regular corporate rates, only on taxable investment income, instead of being taxed on both investment and underwriting income. (Note that a company that makes this election may not deduct underwriting losses.) Second, the Act added a new diversification requirement that must be met to be eligible to make the election. To be eligible, an insurance company must not have more than 20 percent of the net premiums (or, if greater, direct premiums written) received for the taxable year be attributable to any one policyholder. For this purpose, all policyholders who are related (within the meaning of §§ 267(b) or 707(b)) or who are members of the same controlled group will be treated as one policyholder. Alternatively, the diversification requirement will be met if no "specified holder" has an interest in the insurance company that is more than a de minimis percentage higher than the percentage of interests in the "specified assets" with respect to the insurance company held (directly or indirectly) by the specified holder. A "specified holder" is any individual who holds (directly or indirectly) an interest in the insurance company and who is a spouse or lineal descendant of an individual who holds an interest (directly or indirectly) in the specified assets with respect to the insurance company. "Specified assets" are the trades or businesses, rights, or assets with respect to which the net written premiums (or direct written premiums) of the insurance company are paid. (An indirect interest is any interest held through a trust, estate, partnership, or corporation.) Except as otherwise provided in regulations or other IRS guidance, 2 percent or less is treated as de minimis. The following example of the alternative test is provided in Staff of the Joint Comm. on Taxation, Technical Explanation of Protecting Americans from Tax Hikes Act of 2015, JCX-114-15, 200 (12/18/2015):

> In 2017, a captive insurance company ("Captive") will not meet the requirement that no more than 20% of its net (or direct) written premiums is attributable to any one policyholder. Captive will have one policyholder, "Business," certain of whose property and liability risks Captive covers (the specified assets), and Business will pay the captive $2 million in premiums in 2017. Business will be owned 70% by a father ("Father") and 30% by his son ("Son"). Captive will be owned 100% by Son (whether directly, or through a trust, estate, partnership, or corporation). Son is Father's lineal descendant. Son, a specified holder, will have a non-de minimis percentage greater interest in Captive (100%) than in the specified assets with respect to Captive (30%). Therefore, Captive will be not eligible to elect to make the election. If, by contrast, all the facts were the same, except that Son will own 30% and Father will own 70% of Captive, Son would not

have a non-de minimis percentage greater interest in Captive (30%) than in the specified assets with respect to Captive (30%). Therefore, Captive would meet the diversification requirement for eligibility to make the election. The same result would occur if Son will own less than 30% of the Captive (and Father more than 70%), and the other facts remained unchanged.

- Note that whenever the ownership of the business and the insurance company are perfectly congruent—even if (particularly if) there is only one owner—the captive insurance scheme satisfies the diversification requirement.
- In addition, the Act added a new reporting requirement for an insurance company that has a § 831(b) election in effect that will require it to provide the IRS information with respect to the diversification requirements.

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. No upside, no downside, no partnership. Chemtech Royalty Associates, L.P. v. United States, 766 F.3d 453 (5th Cir. 9/10/14). The Fifth Circuit, in an opinion by Judge Smith, affirmed a District Court decision that disregarded two partnerships formed by Dow Chemical Company and a number of foreign banks that generated over $1 billion of deductions for Dow. The scheme was very similar to the Castle Harbour scheme, see TIFD III–E, Inc. v. United States, 459 F.3d 220 (2d Cir. 2006). The District Court disregarded the partnerships for tax purposes on three grounds: (1) the partnerships were shams; (2) the transactions lacked economic substance; and (3) the banks' interests in Chemtech Royalty Associates, L.P. ("Chemtech") were debt, not equity. The Court of Appeals held that under the specific facts of the case, the District Court's finding that Dow lacked the intent to share profits and losses with the foreign banks was not clearly erroneous. The court reasoned that under Commissioner v. Tower, 327 U.S. 280, 286 (1946), Commissioner v. Culbertson, 337 U.S. 733 (1949), and Southgate Master Fund, L.L.C. ex rel. Montgomery Capital Advisors, LLC v. United States, 659 F.3d 466 (5th Cir. 2011), "the parties, to form a valid tax partnership, must have two separate intents: (1) the intent to act in good faith for some genuine business purpose and (2) the intent to be partners, demonstrated by an intent to share 'the profits and losses.' If the parties lack either intent, then no valid tax partnership has been formed." The court rejected Dow's argument that a determination of whether an interest qualifies as debt or equity must precede

addressing whether under Culbertson the partnership is a sham, and that the foreign banks were partners rather than creditors because they were "not legally entitled to repayment of their investment even if the banks could recover the value of their partnership share when terminating the partnership." Rather the court expressed no opinion as to whether the banks' interest should be classified as debt, but limited its "inquiry to whether Dow possessed the intent to be partners with the foreign banks, focusing on whether Dow had the intent to share the profits and losses with the foreign banks." That intent did not exist. "First, the transactions were structured to ensure that Dow paid the foreign banks a fixed annual return on their investment 'regardless of the success of the [Chemtech] venture.'" The foreign banks were entitled to 99 percent of the profits until they had received a priority return, but only 1 percent after that. Even if Chemtech did not generate sufficient profits to pay the priority return, the banks were still entitled to 97 percent of the priority return. Second, Dow agreed to bear all of the non-insignificant risks arising from Chemtech's transactions; thus the parties did not intend to share any possible losses. In addition, the agreement included significant assurances to ensure that Dow would not misappropriate or otherwise lose the banks' initial investment. Finally, the foreign banks did not meaningfully share in any potential upside. The possibility that the foreign banks could possibly receive a fraction of certain "residual profits" did not provide any meaningful upside because the likelihood of the venture earning such "residual profits" was remote.

a. On remand, the District Court imposes the 40 percent gross valuation misstatement penalty. Chemtech Royalty Associates, L.P. v. United States, 115 A.F.T.R.2d 2015-1807 (M.D. La. 5/8/15). The Fifth Circuit directed the District Court on remand to consider whether to impose the substantial valuation or gross valuation misstatement penalties. The District Court previously had imposed negligence and substantial understatement penalties, but had found that substantial valuation and gross valuation misstatement penalties were foreclosed under *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990). Subsequent to the District Court's decision, the United States Supreme Court held in *United States v. Woods*, 134 S. Ct. 557 (2013) that the § 6662 valuation misstatement penalty encompasses legal as well as factual misstatements and therefore can apply to misstatements that rest on the use of a sham partnership. On remand, the District Court (Judge Jackson) upheld the IRS's imposition of the § 6662(h) 40 percent gross valuation misstatement penalty as to one of the two partnerships.

2. The Treasury wants to stop taxpayers from exporting gains to related foreign partners—Starting NOW! Notice 2015-54, 2015-34 I.R.B. 210 (8/6/15). This long and detailed Notice announces that

the Treasury Department and IRS intend to issue regulations under § 721(c) that will override the general nonrecognition treatment provided by § 721(a), unless certain conditions are satisfied, to ensure that, when a U.S. person transfers certain property to a partnership that has foreign partners related to the transferor, income or gain attributable to the property will be taken into account by the transferor either immediately or periodically. The Treasury Department and IRS also intend to issue regulations under §§ 482 and 6662 applicable to controlled transactions involving partnerships to ensure the appropriate valuation of such transactions. The regulations generally will apply to transfers occurring on or after 8/6/15, and to transfers occurring before 8/6/15 resulting from entity classification elections made under Reg. § 301.7701-3 that are filed on or after 8/6/15 that are effective on or before 8/6/15.

3. A relationship formed in the oil and gas industry was a partnership, rather than a contractual agreement for services, and the income allocated to the partners was capital gain rather than ordinary income. United States v. Stewart, 116 A.F.T.R.2d 2015-5720 (S.D. Tex. 8/20/15). Hydrocarbon Capital LLC acquired a portfolio of oil and gas properties and entered into an agreement with Odyssey Capital Energy I, LP under which Odyssey managed the operation and exploration of the properties and operated the wells. Five individuals, including the taxpayer in this case, Mr. Stewart, were partners in Odyssey. Under the agreement between Hydrocarbon and Odyssey, Odyssey had an interest in the revenue from any sale of the properties equal to 20 percent of the amount remaining after Hydrocarbon recovered its expenses, its investment, a 10 percent return on its investment, and a $6 million loan it had made to Odyssey. The properties eventually were sold and, pursuant to the agreement, Odyssey received $20.1 million, which it allocated among its partners. On its partnership return and Form K-1s for 2004, Odyssey reported the $20.1 million as ordinary income. Odyssey later amended its 2004 return and issued new K-1s to recharacterize the $20.1 million as capital gain. Mr. Stewart filed an amended individual return for 2004 claiming a refund of more than $1 million based on the treatment of the income as capital gain. After review, the government issued the refund (as it did to three of the other Odyssey partners), but later concluded that the income was ordinary and brought this action to recover the refund. The court (Judge Hughes) held in favor of the taxpayer. The court rejected the government's argument that the amount received by Odyssey was compensation for services. Hydrocarbon and Odyssey, the court concluded, had formed a partnership for federal tax purposes, and the $20.1 million received by Odyssey was long-term capital gain.

> This arrangement is no different than flipping a house. The gain realized through sweat equity—the appreciation in the

value of the house by fixing it up—is a capital gain. The very reason it is called sweat equity instead of sweat income. In the same way, Odyssey's sweat, their management, increased the value of the capital, the portfolio of properties.

Having purchased a share of the project, the partners managed the portfolio and earned the venture significant profits when it sold. This merger of execution and financing is a partnership, and its profits are long-term capital gains.

4. A bipartisan agreement that GE and Judge Underhill got it wrong. The Bipartisan Budget Act of 2015, Pub. L. No. 114-74, signed by the President on 11/2/15, amended §§ 704(e) and 761(b) to delete § 704(e)(1), renumbered § 704(e)(2) and (e)(3) as (e)(1) and (e)(2), and added to § 761(b) the following: ''In the case of a capital interest in a partnership in which capital is a material income-producing factor, whether a person is a partner with respect to such interest shall be determined without regard to whether such interest was derived by gift from any other person.'' The deleted § 704(e)(1) had provided that "A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." As amended, the operation of the rules is limited to partnership interests acquired by gift and no longer arguably applies to partnership interests acquired by purchase or through a contribution of capital. The obvious purpose of this amendment was to negate the holding of TIFD III-E, Inc. v. United States, 660 F. Supp. 2d 367 (D. Conn. 2009) (Castle Harbour III), rev'd 666 F.3d 836 (2d Cir. 2012), that the application of § 704(e)(1) was not limited to the context of family partnerships and that § 704(e)(1) applied to guarantee partner status to any person who advanced capital to a partnership even if the partnership did not meet the totality-of-the-circumstances test for the existence of a partnership established by Commissioner v. Culbertson, 337 U.S. 733 (1949)—"whether . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."

- The amendment also should negate the holding of Evans v. Commissioner, 447 F.2d 547 (7th Cir. 1971), aff'g 54 T.C. 40 (1970), which Judge Underhill relied upon extensively to reach his conclusion in Castle Harbour III. Evans held that the application of § 704(e)(1) was not limited to the context of family partnerships. Evans involved the question who, between two different persons—the original partner or an assignee of the original partner's economic interest—was the partner who should be taxed on a distributive share of the partnership's income. Although in the family context § 704(e) frequently has been applied to determine whether a partnership exists in the first place, Judge Underhill's decision in Castle Harbour III was the only case ever to discover that § 704(e)(1) applies to determine whether an arrangement

between two (or more) otherwise unrelated business entities or unrelated individuals constituted a partnership.

5. The taxpayers were blinded by their own planning brilliance, while the court was wearing sunglasses. DJB Holding Corp. v. Commissioner, 803 F.3d 1014 (9th Cir. 10/7/15), aff'g WB Acquisition, Inc. v. Commissioner, T.C. Memo. 2011-36. In an opinion by Judge Kozinski, the Ninth Circuit affirmed the Tax Court (Judge Haines), which held that a purported related-party partnership was not a bona fide partnership for tax purposes. The joint venture, which purportedly was conducting an environmental remediation project, was between a C corporation, which did conduct an environmental remediation business, and a partnership that indirectly owned (through a holding company) all of the stock of the active C corporation. The partners of the partnership were two S corporations that were wholly owned by qualified retirement plans for the benefit of the two individuals who ran the C corporation's environmental remediation business. Under the joint venture's terms, the partnership, together with the C corporation, the S corporations that were the partners of the partnership owning the holding company, and the two individuals provided a financial guarantee (to AIG, the bonding company) and the partnership was to be allocated 70 percent of the profits from the environmental remediation project, all of the work on which was to be performed by the C corporation. The C corporation, and not the partnership, entered into a contract to perform the environmental remediation services, and the joint venture agreement provided that the joint venture would reimburse the C corporation for all expenses plus 5 percent. The joint venture never filed a partnership return and the C corporation unilaterally reduced the partnership's share of profits from the joint venture to 50.4 percent. On these facts the Ninth Circuit affirmed the Tax Court's conclusion that the joint venture was not a bona fide partnership under the historic test in Commissioner v. Culbertson, 337 U.S. 733 (1949)—whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise," applying the factors elaborated in Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964):

> [(1)] [t]he agreement of the parties and their conduct in executing its terms; [(2)] the contributions, if any, which each party has made to the venture; [(3)] the parties' control over income and capital and the right of each to make withdrawals; [(4)] whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; [(5)] whether business was conducted in the joint

> names of the parties; [(6)] whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; [(7)] whether separate books of account were maintained for the venture; and [(8)] whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

The principal focus of the Ninth Circuit's decision was the second *Luna* factor—"the contributions, if any, which each party has made to the venture—and the Court of Appeals agreed with the Tax Court that the partnership provided nothing of value to the joint venture. Examining all of the various relationships and contracts, the court found that the C corporation, the two individuals, and the two S corporations that were the partners of the partnership owning the holding company would have been obligated to provide the financial guarantees even if the joint venture had not been formed and that the bonding company considered only the financial guarantees of the C corporation and the two individuals to have been important. Furthermore, the purported partners did not in fact respect the terms of the joint venture agreement; the actual income allocation between the partners differed substantially from the terms of the agreement and no partnership tax returns were filed. The unilateral control exercised by the C corporation belied the existence of a true partnership.

- On a second issue, the court held that no portion of the amounts received under a noncompetition agreement entered into in connection with the sale of the C corporation's business to an unrelated party, which bound the C corporation, the two individuals, and the joint venture could be allocated to the (nonexistent) joint venture (and then allocated to the holding partnership). The C corporation was the only signatory to the noncompetition agreement ever to have performed the environmental remediation services that were the subject of the agreement, and the partnership had no enforceable claim to the services of the individuals. Although some portion of the payments under the noncompetition agreement might properly have been allocable to the individuals, neither the IRS nor the taxpayer made such an argument; thus, all of the noncompetition agreement payments were taxed to the C corporation.
- Section 6662(b)(2) substantial under-payment penalties were upheld because there was no substantial authority to support the taxpayers' position. The cases on which the taxpayers relied were materially distinguishable. Finally, the court rejected the taxpayers' "reasonable cause and good faith" defense based on the argument that they reasonably relied on the advice of their accountant in deciding how to treat the proceeds from the joint venture. Nothing in the record indicated that the taxpayers asked the accountant for an opinion regarding the validity of the joint venture for tax purposes. "Instead, the record reveals only that the accountant prepared tax

returns for the entities involved in the joint venture based on data supplied to him."

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

1. Rip Van Winkle awakened. After 29 years Treasury has promulgated final regulations under amended § 706(d). T.D. 9728, Determination of Distributive Share When a Partner's Interest Changes, 80 F.R. 45865 (8/03/15). Section 706(d)(1), originally enacted in 1976 and amended in 1984, provides that in any taxable year in which there is a change in a partner's interest, each partner's distributive share of partnership items shall be determined under a method prescribed by regulations to take into account the partners' varying interests during the year. Pre-1976 regulations, former Reg. § 1.706-(1)(c)(2), mandated the use of the interim closing of the books method, unless the partnership elected a proration method. In 2009, the Treasury and IRS published proposed regulations, REG-144689-04, Determination of Distributive Share When a Partner's Interest Changes, 74 F.R. 17119 (4/14/09), that would adopt these rules under the current statutory provision, with significant modifications. After a six-year wait, the proposed regulations have been finalized, with a significant number of technical changes from the proposed regulations, but the basic principles of the proposed regulations remain largely unchanged in the final regulations. The 2015 final regulations continue to mandate the interim closing of the books method whenever a partner's interest is changed, including the entry of a new partner, a partner's retirement, a sale of all or a portion of the partner's interest in the partnership, an additional capital contribution that results in changes in the partners' distributive shares, or a distribution that results in changes in the partners' distributive shares, unless the partnership by agreement among the partners elects to use the proration method. Reg. § 1.706-4(a)(1), (a)(3)(iii). For purposes of determining allocations to partners whose interests vary during the taxable year, the regulations require the partnership to allocate partnership items under its method of accounting for the full taxable year to segments of the taxable year representing discrete periods during which partners' interests vary. Reg. § 1.706-4(a)(3)(vi) and (vii).

Segments rule.—Under the interim closing of the books method, the partnership may allocate items to a segment of the taxable year ending either on the calendar day a partner's interest changes, which is the default rule, or under a monthly or semi-monthly convention adopted by agreement of the partners. Reg. § 1.704-4(a)(3), (c)(1). Under the monthly convention, a change in a partner's interest during the first fifteen days of a month requires the partnership to close its books as of the last day of the preceding month, and a

change in a partner's interest after the fifteenth day of the month requires the partnership to close its books on the last day of the month of the change. Reg. § 1.706-4(c)(1)(iii). Under the semi-monthly convention, a change in a partner's interest during the first fifteen days of a month requires the partnership to close its books as of the last day of the preceding month, and a change in a partner's interest after the fifteenth day of the month requires the partnership to close its books on the fifteenth day of the month of the change. Reg. § 1.706-4(c)(1)(ii). Under the elective proration method, the partnership's items for the entire year must be prorated over the full taxable year and allocated among the partners based on their respective percentage interests during each segment of the taxable year. Reg. § 1.706-4(a)(3)(ix). Under the proration method, the first segment begins with the partnership's taxable year and ends with the first variation in a partner's interest. A new segment then begins and then ends on the calendar day on which a partner's interest changes. Reg. § 1.706-4(a)(3)(vii). A partnership may use the proration method for one or more variations and the closing of the books method for different variations within the year. Reg. § 1.704-4(a)(3)(iii).

Precise allocation of "extraordinary items."—Reg. § 1.706-4(e) contains special rules that prevent either (1) a prorated allocation of "extraordinary" items, which was a problem under the prior regulations (particularly for a partner who disposed of the partner's entire interest by liquidation or sale) or (2) the allocation of extraordinary items under the closing of the books method under either the monthly or semi-monthly convention. Instead, the regulations require an allocation of extraordinary items—that, in general, arise on a disposition of partnership property—to the partners in proportion to their interests at the time of day on which the extraordinary item occurred (regardless of the method or convention employed). Extraordinary items include, among others, gain or loss on the disposition or abandonment of capital assets, trade or business property, property excluded from capital gains treatment under § 1221(a)(1), (3), (4), or (5) if substantially all of the assets in a particular category are disposed of in one transaction, discharge of indebtedness (except items subject to § 108(e)(8) or 108(i)), certain credits, items from the settlement of tort or third-party liability, certain items that the partners agree are consistently extraordinary for the year (subject to an anti-abuse exception), certain items attributable to accounting method changes, any item identified in published guidance, and any item that in the opinion of the IRS would, if ratably allocated, result in a substantial distortion of income in any return in which the item is included.) Reg. § 1.706-4(e)(3) provides an exception for small extraordinary items under which an extraordinary item may be treated as not being an extraordinary item if, for the partnership's taxable year (1) the total of all items in the particular class of extraordinary items (for example, all tort or similar liabilities) is less than five percent of the partnership's gross income (including tax-exempt income described in § 705(a)(1)(B)) in the case of income or gain items, or gross expenses and

losses (including § 705(a)(2)(B) expenditures) in the case of losses and expense items; and (2) the total amount of extraordinary items from all classes of extraordinary items amounting to less than five percent of the partnership's gross income (in the case of income or gain items) or gross expenses and losses (in the case of losses and expense items) does not exceed $10 million in the taxable year, determined by treating all such extraordinary items as positive amounts.

Exceptions.—Although the regulations apply to a change in a partner's interest attributable to a disposition of a partner's entire interest or a partial interest, the regulations do not apply to changes in allocations of partnership items among contemporaneous partners that satisfy the allocation rules of § 704(b), provided that a reallocation is not attributable to a capital contribution to the partnership or a distribution of money or property that is a return of capital. The regulations also do not apply to partnerships in which capital is not a material income producing factor; such partnerships may choose to determine a partner's distributive share of partnership items using any reasonable method to account for the varying interests of the partners in the partnership during the taxable year, provided that the allocations comply with § 704(b). Reg. § 1.706-4(b).

Publicly Traded Partnerships.—The regulations also provide various special rules to account for varying interests in publicly traded units of a publicly traded partnership.

Effective date.—The regulations generally are effective for partnership taxable years that begin on or after 8/3/15.

a. But it only took 21 years after the enactment of § 706(d)(2) to get proposed regulations. What's your hurry? REG-109370-10, Allocable Cash Basis and Tiered Partnership Items, 80 F.R. 45905 (8/03/15). The Treasury Department and the IRS contemporaneously proposed amendments to final Reg. § 1.706-4. First, the proposed regulations would expand the list of extraordinary items to include two new items: (1) deductions for the transfer of partnership equity in connection with the performance of services, and (2) for publicly traded partnerships, any item of income that is an amount subject to withholding as defined in Reg. § 1.1441-2(a) (excluding amounts effectively connected with the conduct of a trade or business within the United States) or a withholdable payment under Reg. § 1.1473-1(a) occurring during a taxable year if, for that taxable year, the partners agree to treat all such items as extraordinary items. Second, the proposed regulations would provide additional rules with respect to proration of items attributable to an interest in a lower tier partnership under § 706(d)(3). Third, the proposed regulations would provide additional rules with respect to allocable cash basis items under § 706(d)(2). Section 706(d)(2)(A) provides that if during any taxable year of the partnership there is a change in any partner's interest in the partnership, then (except to the extent provided in

regulations) each partner's distributive share of any allocable cash basis item shall be determined (i) by assigning the appropriate portion of such item to each day in the period to which it is attributable, and (ii) by allocating the portion assigned to any such day among the partners in proportion to their interests in the partnership at the close of such day. With respect to § 706(d)(2), Prop. Reg. § 1.706-2(a)(2) would provide that the term "allocable cash basis item" generally includes items of deduction, loss, income, or gain specifically listed in the statute: (i) interest, (ii) taxes, and (iii) payments for services or for the use of property. However, Prop. Reg. § 1.706-2(a)(2)(iii) provides an exception for deductions for the transfer of an interest in the partnership in connection with the performance of services; such deductions generally must be allocated under the rules for extraordinary items in Reg. § 1.706-4(d). Pursuant to the authority granted in § 706(d)(2)(B)(iv), the proposed regulations provide that the term "allocable cash basis item" includes (1) any allowable deduction that had been previously deferred under § 267(a)(2), Prop. Reg. § 1.706-2(a)(2)(iv), and (2) any item of income, gain, loss, or deduction that accrues over time and that would, if not allocated as an allocable cash basis item, result in the significant misstatement of a partner's income. Prop. Reg. § 1.706-2(a)(2)(v). According to the preamble, examples of such items include rebate payments, refund payments, insurance premiums, prepayments, and cash advances. Prop. Reg. § 1.706-2(c) provides a *de minimis* rule that would provide that an allocable cash basis item will not be subject to the rules in section 706(d)(2) if, for the partnership's taxable year (1) the total of the particular class of allocable cash method items (for example, all interest income) is less than five percent of the partnership's (a) gross income, including tax-exempt income described in § 705(a)(1)(B), in the case of income or gain items, or (b) gross expenses and losses, including § 705(a)(2)(B) expenditures, in the case of losses and expense items; and (2) the total amount of allocable cash basis items from all classes of allocable cash basis items amounting to less than five percent of the partnership's (a) gross income, including tax-exempt income described in § 705(a)(1)(B), in the case of income or gain items, or (b) gross expenses and losses, including § 705(a)(2)(B) expenditures, in the case of losses and expense items, does not exceed $10 million in the taxable year, determined by treating all such allocable cash basis items as positive amounts. Examples in the proposed regulations illustrate the operation of § 706(d)(2)(D)(ii) and Prop. Reg. § 1.706-2(a)(4)(ii), which require certain portions of deductible cash basis items to be capitalized in the manner provided in § 755 when the deduction is otherwise partially allocable to a former partner who is no longer a partner as of the first day of the partnership's taxable year. The proposed regulations generally will apply to taxable years beginning on or after the date of publication of final regulations.

C. Distributions and Transactions Between the Partnership and Partners

1. Tax planning goes awry in Old Virginny. SWF Real Estate LLC v. Commissioner, T.C. Memo. 2015-63 (4/2/15). SWF Real Estate LLC owned farm land in Virginia on which it granted a conservation easement to a qualified donee. In connection with the grant of the easement, which would earn approximately $3.5 million of State of Virginia conservation tax credits, SWF Real Estate entered into a transaction with Virginia Conservation Tax Credit Fund LLLP in which Virginia Conservation made a capital contribution to SWF Real Estate LLC (thereby converting it to a partnership from a disregarded entity) of $1,802,000 for a 1 percent interest and an allocation of $3,400,000 of State of Virginia conservation tax credits. The contribution was computed as 53 cents per $1 of Virginia tax credits allocated to Virginia Conservation. The 99 percent was allocated only $300,000 of Virginia tax credits. The parties entered into an indemnity agreement under which SWF Real Estate and the one partner other than Virginia Conservation (the previous partners of the partnership) were jointly and severally liable to indemnify Virginia Conservation if the Virginia tax credits were disallowed. The other partner of the partnership also had the option to purchase all, but not less than all, of Virginia Conservation's membership interest in SWF on or any time after January 1, 2010 at a price to be agreed upon by the parties or, if not agreed upon, 1 percent of the net fair market value of SWF Real Estate's assets at exercise. The IRS took the position that SWF Real Estate sold Virginia tax credits to Virginia Conservation in exchange for cash, thus engaging in a disguised sale under section 707 and that the capital contributions to the partnership were ordinary income to SWF. The Tax Court (Judge Wells) upheld the IRS's position because it found that the facts were "squarely in point" with Virginia Historic Tax Credit Fund 2001 LP v. Commissioner, 639 F.3d 129 (4th Cir. 2011), rev'g T.C. Memo. 2009–295, and that after applying the Golsen rule (Golsen v. Commissioner, 54 T.C. 742, 757 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971)), and that under the factors of Reg. § 1.707-3(b) the transfer of Virginia tax credits by SWF Real Estate to Virginia Conservation in exchange for money should be characterized as a disguised sale pursuant to 707(a)(2)(B). First, because the amount of Virginia Conservation's capital contribution to SWF Real Estate was based directly on the amount of Virginia tax credits to be transferred or allocated to Virginia Conservation, Virginia Conservation could precisely determine the number of Virginia tax credits it could expect to receive on the basis of the amount of money it contributed to SWF Real Estate. Reg. § 1.707-3(b)(2)(i). Second, Virginia Conservation had a legally enforceable right to the later transfer of Virginia tax credits; under the subscription agreement and operating agreement, Virginia Conservation's capital contribution would entitle it to specific dollar amount of Virginia tax

credits in exchange, and if SWF Real Estate and the other partner failed to fulfill the terms of those agreements, Virginia Conservation could have pursued breach of contract claims. Reg. § 1.707-3(b)(2)(ii). Third, Virginia Conservation's right to receive the credits was secured by the indemnity agreement. Reg. § 1.707-3(b)(2)(iii). Fourth, on the facts, SWF Real Estate held Virginia tax credits, beyond the reasonable needs of its business, that were expected to be available to make the transfer to Virginia Conservation. Reg. § 1.707-3(b)(2)(iv). Fifth, SWF Real Estate's transfer of Virginia tax credits to Virginia Conservation was disproportionately large in relationship to Virginia Conservation's general and continuing interest in SWF Real Estate's profit; Virginia Conservation held a 1% interest in partnership profits and losses and net cash flow, but was ultimately allocated 92% of the Virginia tax credits available to SWF Real Estate. Reg. § 1.707-3(b)(2)(ix). Sixth (and lastly), after receiving the Virginia tax credits, Virginia Conservation was free to use or transfer the credits as it desired; it had no further obligations to SWF Real Estate with regard to the Virginia tax credits. Reg. § 1.707-3(b)(2)(x). The court went on to hold, after detailed analysis of the rights and obligations of the parties, that the sale occurred in 2005, the year that SWF Real Estate and Virginia Conservation entered into the agreement, not in 2006, the year in which the State of Virginia awarded the tax credits and in which SWF Real Estate distributed the credits to Virginia Conservation. As of December 31, 2005, Virginia Conservation "owned" the tax credits, and even though Virginia Conservation's cash contribution was held by an escrow agent until 2006, under the "economic benefit" theory, the income had been realized in 2005 because SWF Real Estate's right to the escrowed funds was vested on or before December 31, 2005.

- The opinion noted that the facts of this case were nearly identical to those in Route 231, LLC v. Commissioner, T.C. Memo. 2014–30 (2/24/14), which reached the same result.

2. No, you May not. T.D. 9722, Partnership Transactions Involving Equity Interests of a Partner, 80 F.R. 33402 (6/12/15). The Treasury Department has promulgated Temp. Reg. § 1.337(d)-3T, Temp. Reg. § 1.732-1T(c), and corresponding proposed regulations (REG-149518-03, Partnership Transactions Involving Equity Interests of a Partner, 80 F.R. 33451 (6/12/15)). These regulations are intended to prevent a corporate partner from avoiding recognition under § 311(b) of corporate-level gain through transactions with a partnership involving equity interests of the partner. An example of the type of transaction—commonly called a "May Company" transaction— is as follows: A corporation enters into a partnership and contributes appreciated property. The partnership then acquires stock of that corporate partner, and later makes a liquidating distribution of this stock to the corporate partner. Under § 731(a), the corporate partner does not recognize gain on the partnership's distribution of its stock. By means of this transaction,

the corporation has disposed of the appreciated property it formerly held and acquired its own stock, permanently avoiding its gain in the appreciated property. If the corporation had directly exchanged the appreciated property for its own stock, § 311(b) would have required the corporation to recognize gain upon the exchange. Under the regulations, if a transaction has the effect of an exchange by a corporate partner of its interest in appreciated property for an interest in stock of the corporate partner owned, acquired, or distributed by a partnership (a "Section 337(d) Transaction"), the corporate partner must recognize gain under a "deemed redemption" rule. The complicated deemed redemption rule is triggered by the partnership's purchase of stock of a corporate partner (or stock or other equity interests of any corporation that controls the corporate partner within the meaning of § 304(c), except that § 318(a)(1) and (3) do not apply for that purpose); the gain recognition rule can be triggered without a subsequent distribution. Gain recognition is required only with respect to the amount of appreciated property (other than stock of the corporate partner) effectively exchanged for stock of the corporate partner (by value). The regulations provide general principles that apply in determining the amount of appreciated property effectively exchanged for stock of the corporate partner. The corporate partner's economic interest with respect to both the stock of the corporate partner and all other appreciated property of the partnership must be determined based on all facts and circumstances, including the allocation and distribution rights set forth in the partnership agreement. The gain from the hypothetical sale used to compute gain under the deemed redemption rule is determined by applying the principles of § 704(c). The partnership increases its adjusted tax basis in the appreciated property that is treated as the subject of a Section 337(d) Transaction by the amount of gain that the corporate partner recognized with respect to that property as a result of the Section 337(d) Transaction. A distribution of the corporate partner's stock to a corporate partner by a partnership also can trigger gain recognition. In addition to any gain previously recognized under the deemed redemption rule, if stock of a corporate partner is distributed to the corporate partner, it must recognize gain to the extent that the partnership's basis in the distributed stock of the corporate partner exceeds the corporate partner's basis in its partnership interest (as reduced by any cash distributed in the transaction) immediately before the distribution. In limited circumstances, a partnership's acquisition of stock of the corporate partner does not have the effect of an exchange of appreciated property for that stock. For example, if a partnership with an operating business uses the cash generated in that business to purchase stock of the corporate partner, the deemed redemption rule does not apply because the corporate partner's share in appreciated property has not been reduced, and thus no exchange has occurred. The rules also do not apply if all interests in the partnership's capital and profits are held by members of an affiliated group (defined in § 1504(a)) that includes the corporate partner. A de minimis exception applies if three

conditions are met: (1) the corporate partner and any related persons own less than 5 percent of the partnership, (2) the partnership holds stock of the corporate partner worth less than 2 percent of the value of the partnership's gross assets, including stock of the corporate partner, and (3) the partnership has never, at any time, held more than $1 million in stock of the corporate partner or more than 2 percent of any particular class of stock of the corporate partner.

- Previously, the IRS issued Notice 89-37, 1989-1 CB 679, providing that § 311(b), rather than § 731(a), would apply when a partner received a distribution of its own stock, and that the partner would recognize gain whenever a pre-distribution transaction had the economic effect of an exchange of appreciated property for the partner's own stock, and in 1992 proposed regulations, REG-208989-90, Partnership Transactions Involving Equity Interests of a Partner, 57 F.R. 59324 (12/15/92), which have been withdrawn in this Treasury Decision.

- The temporary regulations apply to transactions occurring on or after 6/12/15.

3. Consolidated partners are just one for some purposes. REG-138759-14, Aggregation of Basis for Partnership Distributions Involving Equity Interests of a Partner, 80 F.R. 33452 (6/12/15). The IRS and Treasury have published Prop. Reg. § 1.732-3 that would allow consolidated group members that are partners in the same partnership to aggregate their bases in stock distributed by the partnership for the purpose of limiting the application of rules under § 732(f) that might otherwise cause basis reduction or gain recognition. The proposed regulations would also require certain corporations that engage in gain elimination transactions to reduce the basis of corporate assets or to recognize gain. Section 732(f) provides that if: (1) a corporate partner receives a distribution from a partnership of stock in another corporation (distributed corporation), (2) the corporate partner has control of the distributed corporation (ownership of stock meeting the requirements of § 1504(a)(2)) immediately after the distribution or at any time thereafter (the "control requirement"), and (3) the partnership's basis in the stock immediately before the distribution exceeded the corporate partner's basis in the stock immediately after the distribution, then the basis of the distributed corporation's property must be reduced by this excess. The amount of this reduction is limited to the amount by which the sum of the aggregate adjusted basis of property and the amount of money of the distributed corporation exceeds the corporate partner's adjusted basis in the stock of the distributed corporation. The corporate partner must recognize gain to the extent that the basis of the distributed corporation's property cannot be reduced. According to the preamble, the Treasury and IRS believe that, as currently applied, § 732(f) may be too broad in some circumstances and too

narrow in others. In some cases, § 732(f) may require basis reduction or gain recognition even though that basis reduction or gain recognition does not further the purposes of § 732(f). In other instances, corporate partners may inappropriately avoid the purposes of § 732(f) by engaging in transactions that allow corporate partners to receive property held by a distributed corporation without reducing the basis of that property to account for basis reductions under § 732(b) made when the partnership distributed stock of the distributed corporation to the corporate partner. These proposed regulations add rules to conform the application of § 732(f) with what the Treasury and IRS believe was Congress's identified purposes for enacting §§ 337(d) and 732(f) in these situations.

4. Wave goodbye to capital gains and hello to ordinary income.[6] The Treasury and IRS propose regulations that will treat many common private equity fund management fee waiver arrangements as disguised payments for services under § 707(a)(2)(A). REG-115452-14, Disguised Payments for Services, 80 F.R. 43652 (7/23/15). The IRS and Treasury have published proposed amendments to Regs. § 1.707-1 and Prop. Reg. § 1.707-2, dealing with disguised payments for services, which was previously reserved. Prop. Reg. § 1.707-2(b)(1) provides that an arrangement will be treated as a disguised payment for services if (1) a person (service provider), either in a partner capacity or in anticipation of being a partner, performs services (directly or through its delegate) to or for the benefit of the partnership; (2) there is a related direct or indirect allocation and

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[6] The proposed regulations "shut down fee waivers very effectively," said Gregg D. Polsky of the University of North Carolina School of Law, who wrote the seminal article on private equity management fee conversions in 2009 ("Private Equity Management Fee Conversions," Tax Notes, Feb. 9, 2009, p. 743 2009 TNT 25-41: Special Reports). The government appears to have wholeheartedly embraced Polsky's arguments, in particular his views that section 707(a)(2)(A) should apply to recast typical fee waiver arrangements and that the safe harbor of Rev. Proc. 93-27, 1993-2 C.B. 343 93 TNT 123-7: IRS Revenue Procedures (PRC), doesn't protect most traditional fee waiver arrangements.

Polsky said he thinks the guidance will force the markets to abandon fee waiver arrangements altogether. While two examples in the regs (examples 5 and 6) set forth fee waiver arrangements that contain significant entrepreneurial risk and therefore don't constitute disguised payments for services, "they're not like anything that you see" in the market today, he said.

Amy S. Elliot & Lee A. Shepard, *News Analysis: Proposed Fee Waiver Rules Hit Worst Cases, Deny Zero Valuation*, 148 Tax Notes 361 (7/27/15).

distribution to the service provider; and (3) the performance of the services and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person's capacity as a partner. An arrangement that is treated as a disguised payment for services under the proposed regulations will be treated as a payment for services for all purposes of the Code. Prop. Reg. § 1.701-2(b)(2)(i). Thus, the partnership must treat the payments as payments to a non-partner in determining the remaining partners' shares of taxable income or loss. Where appropriate, the partnership must capitalize the payments or otherwise treat them in a manner consistent with the recharacterization. The proposed regulations apply to a service provider who purports to be a partner even if applying the regulations causes the service provider to be treated as a person who is not a partner, and, the proposed regulations may apply even if their application results in a determination that no partnership exists. Prop. Reg. § 1.701-2(b)(3). The regulations also apply to a special allocation and distribution received in exchange for services by a service provider who receives other allocations and distributions in a partner capacity under § 704(b). Prop. Reg. § 1.707–2(c) states that whether an arrangement constitutes a payment for services (in whole or in part) depends on all of the facts and circumstances. Six non-exclusive factors may indicate that an arrangement constitutes a disguised payment for services. The most important factor is significant entrepreneurial risk. An arrangement that lacks significant entrepreneurial risk constitutes a payment for services. An arrangement that has significant entrepreneurial risk will generally not constitute a payment for services unless other factors establish otherwise. Certain facts and circumstances create a presumption that an arrangement lacks significant entrepreneurial risk and will be treated as a disguised payment for services unless other facts and circumstances establish the presence of significant entrepreneurial risk by clear and convincing evidence: "(i) Capped allocations of partnership income if the cap is reasonably expected to apply in most years; (ii) An allocation for one or more years under which the service provider's share of income is reasonably certain; (iii) An allocation of gross income; (iv) An allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider (e.g. if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise); or (v) An arrangement in which a service provider waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms." The second through sixth facts that may indicate that an arrangement constitutes a disguised payment for services. are: (2) The service provider holds, or is expected to

hold, a transitory partnership interest or a partnership interest for only a short duration; (3) The service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment; (4) The service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third party capacity; (5) The value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution; (6) The arrangement provides for different allocations or distributions with respect to different services received, the services are provided either by one person or by persons that are related under §§ 707(b) or 267(b), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly. Importantly, Prop. Reg. § 1.701-2(b)(2)(i) provides that "[w]hether an arrangement is properly characterized as a payment for services is determined at the time the arrangement is entered into or modified and without regard to whether the terms of the arrangement require the allocation and distribution to occur in the same taxable year."

- The proposed regulations provide six examples, ranging from simple to very complex, four of which deal with investment managers' fee structures. Some examples illustrate a disguised payment for services and others do not.

- The preamble notes that the Treasury Department and the IRS plan to issue a revenue procedure providing an additional exception to the safe harbor in Rev. Proc. 93–27, 1993-2 C.B. 343, when the proposed regulations are finalized. The additional exception will apply to a profits interest issued in conjunction with a partner forgoing payment of an amount that is substantially fixed (including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments) for the performance of services, including a guaranteed payment under § 707(c) or a payment in a non-partner capacity under § 707(a).

- In addition, Prop. Reg. § 1.707-1(c), Ex. 2 would modify current Reg. § 1.707-1(c), Ex. 2. Current Reg. § 1.707-1(c), Ex. 2 reads as follows:

> Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

Prop. Reg. § 1.707-1(c), Ex. 2 provides:

> Partner C in the CD partnership is to receive 30 percent of partnership income, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000). Of this amount, $10,000 is a guaranteed payment to C. The $10,000 guaranteed payment reduces the partnership's net income to $50,000 of which C receives $8,000 as C's distributive share.

Thus, under the proposed regulation, Partner C is always treated as having a guaranteed payment in the amount of $10,000 even when the partner's distributive share of income for the year exceeds that amount. According to the Preamble, the change to the Example is necessary because Congress intended entrepreneurial risk to be a touchstone for applying § 707(a)(2)(A). In the Example the allocation of a fixed minimum amount appears to lack entrepreneurial risk.

- The regulations will be effective upon finalization.

5. Even in their wildest dreams the taxpayers couldn't have thought they had a chance of winning this one. Bosque Canyon Ranch, L.P. v. Commissioner, T.C. Memo. 2015-130 (7/14/15). Bosque Canyon Ranch, L.P. (BCR) developed a tract of several thousand acres known as Bosque Canyon Ranch into home sites and constructed various amenities. Upon completion of development, it marketed limited partnership units at $350,000 per unit. Each purchaser would become a limited partner of BCR, and the partnership would subsequently distribute to that limited partner a fee simple interest in an undeveloped five-acre parcel of property. Parcels were distributed within five months of the cash contribution by a limited partner. The distribution of the parcels was conditioned on BCR granting the North American Land Trust a conservation easement relating to 1,750 acres of Bosque Canyon Ranch. The conservation deed provided that portions of the area subject to the easement included habitat of the golden-cheeked warbler, an endangered species of bird endemic to, and nesting only in, Texas. Property subject to the 2005 easement could not be used for residential, commercial, institutional, industrial, or agricultural purposes. BCR retained various rights relating to the property, including rights to raise livestock; hunt; fish; trap; cut down trees; and construct buildings, recreational facilities, skeet shooting stations, deer hunting stands, wildlife viewing towers, fences, ponds, roads, trails, and wells. The home site parcel owners and the NALT could, by mutual agreement, modify the boundaries of the home site parcels, provided that any such modification could not "in the Trust's reasonable judgment, directly or

indirectly result in any material adverse effect on any of the Conservation Purposes" and "[t]he area of each Homesite parcel *** [could] not be increased." The partnership (1) claimed a deduction for the conservation easement, and (2) reported the $350,000 received form each partner as a capital contribution. The Tax Court (Judge Foley) upheld the IRS's (1) disallowance of the charitable contribution deduction and (2) treatment of the transactions with the limited partners as disguised sales under § 707(a)(2)(B) and Reg. § 1.707-3. With respect to the conservation easement, as a result of the boundary modification provisions, property protected by the easement, at the time it was granted, could subsequently lose this protection. Thus, the restrictions on the use of the property were not granted in perpetuity. I.R.C. § 170(h)(2)(C); Belk v. Commissioner, 140 T.C. 1 (2013), aff'd, 774 F.3d 221 (4th Cir. 2014). Furthermore, the "baseline documentation was unreliable, incomplete, and insufficient to establish the condition of the relevant property on the date the respective easements were granted." With respect to the contributions and distributions, the facts and circumstances established that the property transfers at issue were disguised sales: "the timing and amount of the distributions to the limited partners were determinable with reasonable certainty at the time the partnerships accepted the limited partners' payments; the limited partners had legally enforceable rights, pursuant to the LP agreements, to receive their Homesite parcels and the appurtenant rights; the transactions effectuated exchanges of the benefits and burdens of ownership relating to the Homesite parcels; the distributions to the partners were disproportionately large in relation to the limited partners' interests in partnership profits; and the limited partners received their Homesite parcels in fee simple without an obligation to return them to the partnerships." The limited partners' payments were not at risk, even though pursuant to the terms of the LP agreements the distributions would not have been made if the easements were not granted. The easements had been granted before the partnership agreement was executed. Furthermore, the partnerships would have refunded the amounts paid by the limited partners if the easements were not granted. Thus, the distributions to the limited partners were made in exchange for the limited partners' payments and were not subject to the entrepreneurial risks of the partnerships' operations. A § 6662(h) gross valuation misstatement penalty was upheld with respect to the claimed charitable contribution deduction.

D. Sales of Partnership Interests, Liquidations and Mergers

There were no significant developments regarding this topic during 2015.

E. Inside Basis Adjustments

There were no significant developments regarding this topic during 2015.

F. Partnership Audit Rules

1. Tread lightly. Missteps by the IRS and taxpayer's representative deprive the Tax Court of jurisdiction. This case demonstrates the problems created for TEFRA by abusive shelters. Bedrosian v. Commissioner, 143 T.C. 83 (8/13/14). This long, convoluted opinion (Judge Buch), reviewed by the court, examines an equally convoluted procedural morass that was created by IRS examinations which issued both a Final Partnership Administrative Adjustment (FPAA) and a notice of deficiency involving the same partnership items in a Son-of-Boss partnership. At the outset the taxpayers were advised that their 1999 return was selected for audit and, at the request of the IRS, the taxpayers executed a Form 872 extending the statute of limitations and a Form 2848 appointing representatives. No such forms were executed regarding Stone Canyon, the partnership through which the Son-of-Boss transaction was executed. The parties agreed that the Form 872 did not extend the limitations period for assessment of tax attributable to partnership items and affected items of Stone Canyon for tax year 1999. The IRS also examined the taxpayers' 2000 return, which had a small carryover attributable to the partnership. In the 2000 case the taxpayers executed a Form 872-1 that extended the limitations period to assess tax including tax attributable to items of a partnership for 2000. The revenue agent contacted the taxpayers' representative and told her that the IRS would soon issue a Notice Of Beginning Of Administrative Proceeding (NBAP) with respect to Stone Canyon for 1999, then issued the NBAP by mailing the notice to the taxpayers, but not their representative because no power of attorney was submitted for Stone Canyon. In April 2005 the IRS mailed the FPAA to the taxpayers, Stone Canyon, and the pass-through entities designated as partners in Stone Canyon, sending the FPAA to fourteen different addresses. The FPAA included a notice indicating that the FPAA was untimely under § 6223(e) because it was issued only 61 days following the NPAB and that the taxpayer could "elect" under § 6223(e) to opt out of the partnership proceeding. Eleven days later, the IRS issued a notice of deficiency to the taxpayers assessing tax for the same partnership items that were the subject of the FPAA. The taxpayers filed a timely petition with the Tax Court contesting the 2005 notice of deficiency, and also made a payment of $4,269,819 to the IRS. Responding to a motion by the IRS, the Tax Court held that it lacked jurisdiction to hear the taxpayers' petition because the 2005 notice of deficiency was invalid as addressing partnership items or affected

items subject to TEFRA actions. Bedrosian v. Commissioner, T.C. Memo. 2007-375. The court suggested, however, that it retained continuing jurisdiction to consider nonpartnership items. The IRS also issued in 2006 an affected items notice of deficiency to the taxpayers. In response to the taxpayers' petition to the Tax Court in response to the 2006 notice, the court held that it lacked jurisdiction to consider the deficiencies because they had been paid and assessed prior to the issue of the 2006 notice. Bedrosian v. Commissioner, T.C. Memo. 2007-376. In 2007 the taxpayers filed an untimely petition in response to the FPAA. The Tax Court rejected the taxpayers' argument that the FPAA was invalid because it was sent to the wrong address and dismissed the untimely petition for lack of jurisdiction. Stone Canyon Partners v. Commissioner, T.C. Memo. 2007-377. These decisions collectively were affirmed by the Ninth Circuit. Bedrosian v. Commissioner, 358 Fed. Appx. 868 (9th Cir. 2009). Finally, in the instant case, after granting leave to amend, the Tax Court rejected the taxpayers' motion for summary judgment and held that the court lacked jurisdiction to consider the partnership items. The taxpayers argued that the partnership items should be considered nonpartnership items under § 6223(e), and at the request of the court, also argued that the court had jurisdiction to consider the partnership items under § 6231(g)(2).

Section 6223(e)(2) provides where an FPAA is issued less than 120 days after an NBAP, in the case of proceedings that are "concluded" by expiration of the time for filing a petition for review or by a court action that has become final, a partner may elect to accept the determination in the proceeding, or if no election is filed, partnership items are treated as nonpartnership items, and thus not subject to TEFRA. Under § 6223(e)(3), where a proceeding is still going on, the partner will be treated as a party to the proceeding unless the partner affirmatively elects to treat partnership items as nonpartnership items. The court held that expiration of the statute of limitations does not treat a proceeding as concluded for purposes of § 6223(e)(2), reasoning that different partners may be subject to different limitations periods. Second, the court held that the taxpayers did not properly elect to treat the partnership items as nonpartnership items for purposes of § 6223(e)(3) and rejected the taxpayers' argument that their petition to the Tax Court should be treated as an election under the substantial compliance doctrine. The court observed that even if the FPAAs were sent to the wrong address, the taxpayers had ample notice of the FPAA and opportunity to file the requisite election.

Section 6231(g)(2) provides that if the IRS reasonably, but erroneously "determines" based on a partnership return that TEFRA applies to a partnership, then the TEFRA rules are extended to the partnership, and conversely, that if the IRS reasonably but erroneously "determines" based on partnership returns that a partnership is not subject to TEFRA, then TEFRA does not apply to the partnership and the normal deficiency rules are applicable. The court rejected the taxpayers' argument that the initial audit

procedure of the taxpayers' 1999 return was a determination that the partnership was not subject to TEFRA thereby providing the Tax Court with jurisdiction to address the partnership items in the pending deficiency procedure. The court held that the requisite determination is made, not in the audit process, but only when the IRS determines to issue an FPAA. The court also held that it would not have been reasonable in any event for the IRS to conclude that the partnership was not subject to TEFRA. Although the partnership's return for 1999 checked a box that it was not a TEFRA partnership, the court held that the fact that K-1's filed by the partnership showed entity partners clearly established that the partnership was not entitled to the small partnership exception from TEFRA of § 6231(a)(1)(B) (less than 10 partners) because it had pass-through entity partners.

Finally, the court concluded that the law of the case reflected in the Court of Appeals' opinion precluded the Tax Court from asserting jurisdiction in the taxpayers' deficiency case. The court indicated that a finding in favor of the taxpayers under §§ 6231(e) or (g) would assert jurisdiction where the prior decisions held that none existed.

- In a concurring opinion Judge Goeke agreed with the result but took offense at the majority's application of the law of the case doctrine.
- In a dissent, Judge Vasquez stated, "The opinion of the Court departs from these deeply ingrained principles by denying the Bedrosians their day in court. I believe the result reached by the opinion of the Court is not only inconsistent with the interests of justice but is also the product of an erroneous view of the governing law." Judge Vasquez disagreed that the law of the case doctrine bound the court from asserting jurisdiction and asserted that the significant IRS determination under § 6223(g) was the decision to proceed with an audit of the taxpayers' individual returns at the outset, misleading the taxpayers into filing a petition for review of the Notice of Deficiency rather than pursuing review of the FPAA.
- In his concurring opinion, Judge Halpern observed that the taxpayers had been sent copies of the FPAA as notice partners and had an opportunity to file a petition in the partnership proceeding. Judge Halpern pointed out that, "Petitioners have had their opportunity for a day in court. Whether they actually received the FPAA is beside the point. All Congress required is that it be mailed to them at a proper address."

a. Affected items that require factual determinations at the partner level are subject to deficiency procedures and therefore within the Tax Court's jurisdiction. Bedrosian v. Commissioner, 144 T.C. 152 (3/17/15). The taxpayers moved for leave to file a motion for reconsideration out of time that would ask the Tax Court to revisit its 2007 decision (T.C. Memo. 2007-375), in which the court had concluded

that it retained jurisdiction to consider the IRS's disallowance of the taxpayers' deduction for professional fees (listed on the taxpayers' return as "tax attorney fees") because the fees were neither a partnership item nor an affected item. Citing *Domulewicz v. Commissioner*, T.C. Memo. 2010-177, the taxpayers asserted that an intervening change in controlling law had occurred relating to the scope of the terms "partnership item" and "affected item" pursuant to which legal fees are an affected item when they relate to a partnership determined in a TEFRA proceeding to be a sham. The Tax Court (Judge Buch) considered the merits of the underlying motion for reconsideration in determining whether to grant the taxpayers' request for leave to file an untimely motion. In assessing the taxpayers' argument that the legal fees paid were an affected item, the court drew a distinction between computational affected items and factual affected items. Computational affected items—those that can be determined mathematically based on adjustments to partnership items—are not subject to deficiency procedures and can be assessed through computational adjustments. Factual affected items—those that require further factual determinations at the partner level—are subject to deficiency procedures. Thus, if the taxpayers' deduction for professional fees is a computational affected item and therefore not subject to deficiency procedures, then the Tax Court has no jurisdiction to review the IRS's disallowance of the fees. In contrast, if the deduction is a factual affected item and therefore subject to deficiency procedures, then the Tax Court retains jurisdiction to review the IRS's disallowance. The court concluded that the taxpayers' deduction of the professional fees was a factual affected item because the taxpayers had not reported them on their return as flowing from a TEFRA entity and therefore "[a] partner-level factual determination must be made as to whether those fees relate to the Bedrosians' participation in the partnership that has been determined to be a sham." Accordingly, the court denied the taxpayers' motion for leave to file a motion for reconsideration.

2. There's no de minimis exception to the exception to TEFRA audit rules. Brumbaugh v. Commissioner, T.C. Memo. 2015-65 (4/6/15). The TEFRA unified partnership audit rules generally do not apply to partnerships with ten or fewer partners, as long as all of the partners are either individuals (other than nonresident aliens), estates of individuals, or C corporations, unless the partnership elects to have the partnership-level audit rules apply. I.R.C. § 6231(a)(1)(B). Thus, if any partner is a pass-through entity, i.e., another partnership or an S corporation, the partnership audit rules apply. In this case, 99.98 percent of the interests in a partnership were held by individuals and only .02 percent of the partnership was owned by another partnership. The Tax Court (Judge Lauber) held that there is no de minimis exception, and the court lacked jurisdiction to redetermine partnership level items pursuant to a petition by an individual partner whose claimed deductions that were disallowed were reported inconsistently with the partnership return.

3. The D.C. Circuit writes finis to the Petaluma FX and Tigers Eye Trading sagas.

a. Petaluma FX Partners, LLC v. Commissioner, 792 F.3d 72 (D.C. Cir. 6/26/15). The Court of Appeals for the District of Columbia Circuit reversed the Tax Court's decision (T.C. Memo. 2012-142 (2012)) that the Tax Court lacked jurisdiction in a partnership-level proceeding (involving a Son-of-Boss tax shelter) to apply the gross valuation misstatement penalty under § 6662. The D.C. Circuit applied the Supreme Court's decision in *United States v. Woods*, 134 S. Ct. 557 (2013), which held that courts have jurisdiction in a partnership-level proceeding to apply the gross valuation misstatement penalty under § 6662, but not to formally adjust a partner's outside basis. The taxpayer's argument that the Tax Court lacked jurisdiction because Temp. Reg. § 301.6233-1T(a) had not been properly promulgated under the APA was rejected because the taxpayer did not challenge the permanent regulation, Reg. § 301.6233-1(a), which applied and was validly promulgated.

b. Logan Trust v. Commissioner, 616 Fed.Appx. 426 (D.C. Cir. 6/26/15), *aff'g in part, rev'g in part, and remanding* Tigers Eye Trading, LLC v. Commissioner, 138 T.C. 67 (2012). In light of the Supreme Court's decision in *United States v. Woods*, 134 S. Ct. 557 (2013), the D.C. Circuit affirmed the Tax Court's decision in *Tiger's Eye Trading* with regard to the court's holding that the gross valuation-misstatement penalty applied to the Tigers Eye partners in a partnership-level proceeding. But it reversed with regard to the Tax Court's holding that the partners' outside bases were partnership-level items and that the Tigers Eye partners had no outside basis in the partnership.

4. Bye bye TEFRA! The Bipartisan Budget Act of 2015 § 1101, Pub. L. No. 114-74, signed by the President on 11/2/15, made sweeping changes to the partnership audit rules. The TEFRA rules (in §§ 6221-6231) and Electing Large Partnership rules (in §§ 6240-6242, 6245-6248, 6251-6252, and 6255) have been repealed and replaced in new §§ 6221-6223, 6225-6227, 6231-6235, and 6241, with an entity-level audit process that allows the IRS to assess and collect the taxes against the partnership unless the partnership properly elects out. The new rules will simplify the current complex procedures on determining who is authorized to settle on behalf of the partnership and also avoid the IRS's need to send various notices to all of the partners. Under the new provisions the IRS may reduce the potential tax rate assessed against the partnership to take into account factors such as tax-exempt partners and potential favorable capital gains tax rates. The new rules should significantly simplify partnership audits. As a result, the audit rate of partnerships might increase. Although partnerships with 100 or fewer partners can elect out of the new rules, § 6221(b), such election is not available if there

is another partnership as a partner. Implementation of the new rules is deferred; the new rules apply to partnership taxable years beginning after 12/31/17. Partnership agreements should be amended to take into account these changes.

G. Miscellaneous

1. The IRS finally gets tired of issuing private letter rulings: guidance for master limited partnerships on activities with respect to minerals or natural resources that produce qualifying income. REG-132634-14, Qualifying Income From Activities of Publicly Traded Partnerships With Respect to Minerals or Natural Resources, 80 F.R. 25970 (5/6/15). The Treasury Department and IRS have published proposed regulations under § 7704(d)(1)(E) regarding the types of activities with respect to minerals or natural resources that generate qualifying income for publicly traded partnerships. Section 7704(a) provides that a publicly traded partnership is treated for federal tax purposes as a corporation, but § 7701(c) provides an exception for certain publicly traded partnerships if 90 percent or more of the partnership's gross income consists of qualifying income. Partnerships that qualify for this exception are not automatically classified as corporations and are eligible for the pass-through regime of subchapter K. Under § 7704(d)(1)(E), qualifying income includes income "derived from the exploration, development, mining or production, processing, refining, transportation …, or the marketing of any mineral or natural resource …." Under the proposed regulations, only "qualifying activities" produce qualifying income. Qualifying activities include both the activities enumerated in the statute, which the proposed regulations refer to as "section 7704(d)(1)(E) activities," and support activities that are intrinsic to section 7704(d)(1)(E) activities, which the proposed regulations refer to as ''intrinsic activities.'' The proposed regulations provide detailed guidance on which activities qualify as section 7704(d)(1)(E) activities and intrinsic activities. Generally, an activity is an intrinsic activity if the activity is: (1) specialized to support the section 7704(d)(1)(E) activity, (2) essential to the completion of the section 7704(d)(1)(E) activity, and (3) requires the provision of significant services to support the section 7704(d)(1)(E) activity. Treasury and the IRS issued these proposed regulations because of a significant increase in the number of requests for private letter rulings seeking guidance on whether income from certain activities is qualifying income under § 7704(d)(1)(E). The proposed regulations define qualifying activities in a manner that is, at least in some respects, narrower than in private letter rulings the IRS previously issued.

- The regulations generally will apply to income earned by a partnership in a taxable year beginning on or after the date

final regulations are published in the Federal Register, but provide a ten-year transition period. Under the transitional rule, a partnership can treat income from an activity as qualifying income during the ten-year period following the date on which final regulations are published if either: (1) the partnership received a private letter ruling holding that income from the activity is qualifying income, or (2) prior to 5/6/15, the partnership was publicly traded, engaged in the activity, treated the activity as giving rise to qualifying income under § 7704(d)(1)(E), and that income was qualifying income under the statute as reasonably interpreted prior to the issuance of the proposed regulations. Both the legislative history and the IRS's interpretations prior to the issuance of the proposed regulations are taken into account in determining whether an interpretation is reasonable. In addition, a partnership that is publicly traded and engages in an activity after 5/6/15 but before the date final regulations are published can treat income from that activity as qualifying income during the ten-year transition period if the income from that activity is qualifying income under the proposed regulations.

2. Congress believes that some partners might not need filing extensions any more. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(a), amended Code § 6072(b) to require partnerships to file their tax returns by the 15th day of the third month (March 15 for calendar year partnerships), thus accelerating the due date by one month. Act § 2006(b) directs the Treasury to modify the regulations to provide that the maximum extension for a partnership return will be a 6-month period ending on September 15 for calendar year partnerships.

- The new due date rule is effective for returns for taxable years that begin after 12/31/15.

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. The *Castle Harbour* saga. The Second Circuit thrice reverses a taxpayer victory in a self-liquidating partnership note transaction, in which the lion's share of income was allocated to a tax-indifferent party, on the ground that the tax-indifferent Dutch banks were not really equity partners. TIFD III-E, Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 11/1/04), *rev'd*, 459 F.3d 220 (2d Cir. 8/3/06), *on remand*, 660 F. Supp. 2d 367, *as amended*, 660 F. Supp. 2d 367 (D. Conn. 10/23/09), *rev'd*, 666 F.3d 836 (2d Cir. 1/24/12) *on remand*, 8 F. Supp. 3d 142 (D. Conn. 3/28/14), *rev'd*, 604 Fed.Appx. 69 (5/19/15), *cert. denied*, 2016 WL 100838 (1/11/16).

a. ***Castle Harbour I*: District Court holds for the taxpayer.** 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 Harbour: $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 for tax purposes). Depreciation deductions for book purposes were on the order of 60 percent of the rental income for any given year.
- Scheduled distributions in excess of book income would have resulted in the liquidation of the investment of the Dutch banks in eight years, with the Dutch banks receiving a return of approximately nine percent, with some "economically substantial" upside and some downside risk. Castle Harbour was terminated after five years because of a threatened change in U.S. tax law, but during that period about $310 million of income was shifted to the Dutch banks for a tax saving to the GECC subsidiaries of about $62 million.
- Query whether § 704(b) was properly applied to this transaction?
- This appears to be a lease-stripping transaction in which the income from the lease was assigned to foreign entities while the benefits of ownership were left with a domestic entity.
- The court (Judge Underhill) held that satisfaction of the mechanical rules of the regulations under § 704(b) transcended both an intent to avoid tax and the avoidance of significant tax through agreed upon partnership allocations. In this partnership, 2 percent of both operating and taxable income was allocated to GECC, a United States partner, and 98 percent of both book and taxable income was allocated to partners who were Dutch banks. The Dutch banks were foreign partners who were not liable for United States taxes and thus were indifferent to the U.S. tax consequences of their participation in the partnership. Because the partnership had very large book depreciation deductions and no tax depreciation, most of the partnership's taxable operating income, which was substantially in excess of book taxable income, was allocated to the tax-indifferent foreign partners, even though a large portion of the cash receipts reflected in that income was devoted to repaying the principal of loans secured by property that GECC had contributed to the

partnership. The overall partnership transaction saved GECC approximately $62 million in income taxes, and the court found that "it appears likely that one of GECC's principal motivations in entering into this transaction – though certainly not its only motivation – was to avoid that substantial tax burden." The court understood the effects of the allocations and concluded that "by allocating 98% of the income from fully tax-depreciated aircraft to the Dutch Banks, GECC avoided an enormous tax burden, while shifting very little book income." Put another way, by allocating income less depreciation to tax-neutral parties, GECC was able to "re-depreciate" the assets for tax purposes. The tax-neutrals absorbed the tax consequences of all the income allocated to them, but actually received only the income in excess of book depreciation. Nevertheless, the court upheld the allocations. "The tax benefits of the … transaction were the result of the allocation of large amounts of book income to a tax-neutral entity, offset by a large depreciation expense, with a corresponding allocation of a large amount of taxable income, but no corresponding allocation of depreciation deductions. This resulted in an enormous tax savings, but the simple allocation of a large percentage of income violates no rule. The government does not – and cannot – dispute that partners may allocate their partnership's income as they choose. Neither does the government dispute that the taxable income allocated to the Dutch Banks could not be offset by the allocation of non-existent depreciation deductions to the banks. And … the bare allocation of a large interest in income does not violate the overall tax effect rule."

- Judge Underhill concluded:

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

b. *Castle Harbour II*: Second Circuit reverses. 459 F.3d 220 (2d Cir. 8/3/06). The Second Circuit, in an opinion by Judge Leval, held that the Dutch banks were not partners because their risks

and rewards were closer to those of creditors than partners. He used the facts-and-circumstances test of *Commissioner v. Culbertson*, 337 U.S. 733 (1949), to determine whether the banks' interest was more in the nature of debt or equity and found that their interest was overwhelmingly in the nature of a secured lender's interest, "which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits."

- In *ACM* (Colgate), Judge Laro wrote a 100+ page analysis to find that there was no economic substance to the arrangement. The next contingent payment installment sale case in the Tax Court was *ASA Investerings* (Allied Signal), in which Judge Foley wrote a much shorter opinion finding that the Dutch bank was not a partner; the D.C. Circuit affirmed on Judge Foley's holding that the Dutch bank was not a partner. The IRS began to pick up this lack-of-partnership argument and began to use it on examinations. Later, the Tax Court (Judge Nims) used the economic substance argument in *Saba* (Brunswick), which the DC Circuit remanded based on *ASA Investerings* to give taxpayer the opportunity to argue that there was a valid partnership, which it could not do, as Judge Nims found on remand. Even later, the D.C. Circuit reversed the District Court's *Boca* (Wyeth or American Home Products) case based upon this lack-of-partnership argument – even though Cravath planned *Boca* carefully so that if the Dutch bank was knocked out, there would still be a partnership – based upon its *ASA Investerings* and *Saba* findings on appeal that there was no partnership. Now the Second Circuit has adopted the lack-of-partnership argument.

c. *Castle Harbour III:* Judge Underhill still likes GE. On remand in *Castle Harbour*, the District Court found a valid partnership to have existed under § 704(e) because the heading does not alter the clear language of a statute. A valid family partnership is found in the absence of a family. Additionally, in his contingent penalty findings, Judge Underhill stated that his 2004 taxpayer-favorable decision *ipso facto* means that the taxpayer's reporting position was based upon substantial authority. 660 F. Supp. 2d 367 (D. Conn. 10/7/09), *as amended*, 2009 U.S. Dist. LEXIS 98884 (D. Conn. 10/23/09). Judge Underhill held that, while the Second Circuit opinion decided that the partnership did not meet the *Culbertson* totality-of-the-circumstances test ("whether . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise"), it did not address the § 704(e)(1) issue. He held that the Dutch banks did satisfy the requirements of that paragraph, which reads:

> (e) Family partnerships.
> (1) Recognition of interest created by purchase or gift. –
> A person shall be recognized as a partner for purposes of this

> subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

- In so holding, he relied upon well-settled law that the title of a statute cannot limit the plain meaning of the text, and that the title is of use only when it sheds light on some ambiguous word or phrase. *See also* I.R.C. § 7806(b).
- It is worth noting that although *Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1971), *aff'g* 54 T.C. 40 (1970), which Judge Underhill relied upon extensively to reach his conclusion, held that the application of § 704(e)(1) was not limited to the context of family partnerships, *Evans* involved the question who, between two different persons —the original partner or an assignee of the original partner's economic interest—was the partner who should be taxed on a distributive share of the partnership's income. Although in the family context § 704(e) frequently has been applied to determine whether a partnership exists in the first place, Judge Underhill's decision in *Castle Harbour III* is the very first case ever to discover that § 704(e)(1) applies to determine whether an arrangement between two (or more) otherwise unrelated business entities or unrelated individuals constituted a partnership.
- It has sometimes been adduced that the fact that a court of applicable jurisdiction subsequently upholds the tax treatment of a transaction should be a strong argument for the proposition that such tax treatment was based upon substantial authority. With respect to the applicability of penalties should he be reversed on appeal, Judge Underhill stated:

> To a large extent, my holding in *Castle Harbour I* in favor of the taxpayer demonstrates the substantial authority for the partnership's tax treatment of the Dutch Banks, as does my discussion above of the Dutch Banks' interest in Castle Harbour under section 704(e)(1). In addition, the government's arguments against the substantial authority defense are unavailing.

- Judge Underhill also sought to place the application of the penalty provisions in a temporal context when he stated:

> The government argues that *Culbertson* and Second Circuit cases like *Slifka* and *Dyer* that interpreted *Culbertson* cannot provide substantial authority for the partnership's tax position because the Second Circuit held in *Castle Harbour II* that the Dutch Banks were not partners under *Culbertson*. The

> government, however, has not pointed to any Second Circuit case or other authority, prior to 1997 and 1998 when the Castle Harbour partners took the tax positions at issue, where the parties' good faith intention or valid business purpose in forming a partnership was not sufficient to support a conclusion of partnership status for tax purposes.

- In the context of the previous two bullet points, it is worth noting that Judge Underhill's observations in the immediately preceding bullet point appears to be consistent with Reg. § 1.6662-4(d)(3)(iv)(C), which provides that whether a position was supported by substantial authority must be determined with reference to authorities in existence at the time. But, Judge Underhill's observations in the second preceding bullet point appear to be inconsistent with both Treas. Reg. § 1.6662-4(d)(3)(iv)(C), and observations in the immediately preceding bullet. However, we are not all in agreement with what Judge Underhill intended the observations in the second preceding bullet point to mean.

d. *Castle Harbour IV*: The Second Circuit smacks down the District Court again in an opinion that leaves you wondering why it ever remanded the case in the first place. 666 F.3d 836 (2d Cir. 1/24/12). In another opinion by Judge Leval, the Second Circuit again reversed Judge Underhill and held that the enactment of § 704(e)(1), which recognizes as a partner one who owns a "capital interest in a partnership," did not "change[] the law so that a holding of debt (or of an interest overwhelmingly in the nature of debt) could qualify as a partnership interest."

> Notwithstanding that they tend to favor the government's position, the governing statute and regulation leave some ambiguity as to whether the holder of partnership debt (or an interest overwhelmingly in the nature of debt) shall be recognized as a partner. Therefore, we may consult the legislative history to see whether it sheds light on their interpretation. … The reports of the House and the Senate accompanying the passage of § 704(e) make clear that the provision did not intend to broaden the character of interests in partnerships that qualify for treatment as a partnership interest to include partnership debt.
>
> The purpose of the statute was to address an altogether different question. The concern of § 704(e)(1) was whether it matters, for the determination of whether a person is a partner for tax purposes, that the person's purported partnership interest arose through an intrafamily transfer. The section was passed to reject court opinions that refused to recognize for

> tax purposes transfers of partnership interests because the transfers were effectuated by intrafamilial gift, as opposed to arm's length purchase. Its focus is not on the nature of the investment in a partnership, but rather on who should be recognized for tax purposes as the owner of the interest.

- The Second Circuit went on to describe the District Court as having found that the banks incurred "real risk" that might require them to restore negative capital accounts, and thus having concluded "that the banks' interest was therefore an 'interest in the assets of the partnership' distributable to them upon liquidation." The Second Circuit then described the District Court's finding that the banks' interest qualified as a capital interest as having been "premised entirely on the significance it accorded to the possibility that the banks would be required to bear 1% of partnership losses exceeding $7 million, or 100% of partnership losses exceeding $541 million." But the Second Circuit disagreed, holding that there was a mere appearance of risk, rather than any real risk, which did not justify treating the banks' interest as a capital, or equity, interest, noting that it had reached the same conclusion in its earlier opinion. The Second Circuit then suggested that "[t]he district court was perhaps reading § 704(e)(1) to mean that the addition to a debt interest of any possibility that the holder's ultimate entitlement will vary, based on the debtor's performance, from pure reimbursement plus a previously fixed rate of return will qualify that interest as a partnership interest, no matter how economically insignificant the potential deviation and how improbable its occurrence." The Second Circuit "disagree[d] with any such reading of the statute. No such interpretation is compelled by the plain language of § 704(e)(1). And the fact that the statute was intended to serve an altogether different purpose is confirmed by the legislative reports." The Second Circuit continued:

> In explaining our conclusion that the banks' interest was not a genuine equity interest, we repeatedly emphasized that, as a practical matter, the structure of the partnership agreement confined the banks' return to the Applicable Rate regardless of the performance of Castle Harbour. …
>
> The banks' interest was therefore necessarily not a "capital interest" … . Because the banks' interest was for all practical purposes a fixed obligation, requiring reimbursement of their investment at a set rate of return in all but the most unlikely of scenarios, their interest rather represented a liability of the partnership. … Accordingly, for the same reasons that the evidence compels the conclusion that the banks' interest was not bona fide equity participation, it also compels the conclusion that their interest was not a capital interest within the meaning of § 704(e)(1).

- Turning to the § 6662 penalty issue, the Second Circuit again trashed Judge Underhill's opinion and reversed, reinstating the penalties, stating that Judge Underhill had "mistakenly concluded that several of our decisions supported treatment of the banks as partners in Castle Harbour."

e. *Castle Harbour V*: On remand Judge Underhill rejects the imposition of a negligence penalty following the inapplicability of the substantial understatement penalty. 8 F. Supp. 3d 142 (D. Conn. 3/28/14). On remand, Judge Underhill noted that the Second Circuit had determined that the 20 percent substantial understatement penalty could be imposed, but had not ruled on the imposition of the 20 percent negligence penalty. However, the government had subsequently realized that the substantial understatement penalty could not be assessed because the 10 percent substantial understatement threshold had not been satisfied, presumably because the payments to the Dutch Banks [that the Second Circuit held were interest payments] became deductible to the taxpayer.

- As to the negligence penalty issue, Judge Underhill noted that the 1999 Joint Committee Study of Penalty and Interest Provisions likened the "substantial authority" standard to a 40 percent chance of success on the merits, while the "reasonable basis" standard will be satisfied [and a taxpayer cannot be found negligent] if its tax position has a 20 percent chance of success on the merits. He refused to accept the government's argument that

> . . . TIFD must present evidence that it actually, subjectively relied on those precedents when it determined its tax liability. The government essentially asks me to draw an adverse inference from the fact that TIFD did not waive the attorney-client privilege with respect to the tax advice it received, but instead attempted to win based on the state of the law alone. But that interpretation defies both common sense and the larger structure of the regulations governing penalties. In general, a review for reasonableness is an objective assessment, one that does not consider an individual's actual state of mind. Section 1.6662-3 reflects this accepted standard, ascribing "reasonable basis" to the tax position, not the taxpayer.

- Moreover, Judge Underhill stated that his earlier decision in taxpayer's favor mandates objective reasonableness of taxpayer's position:

> Simply put, the objective reasonableness of a tax position becomes virtually unassailable when the taxpayer actually

> prevails at trial before a district judge who was not compromised by conflict, substance abuse, or senility. *[sic]* The reasonableness of the tax position on which TIFD sustained its burden of proof of correctness after a lengthy bench trial – even if both taxpayer and judge ultimately were mistaken – scarcely can be questioned. Indeed, I am aware of no case in which a negligence penalty has been applied following reversal of a taxpayer's district court victory. To the contrary, the Second Circuit has admonished the government for attempting to impose a negligence penalty in a case where it found that the district court had misinterpreted the law. *Holmes v. United States,* 85 F.3d 956, 963 n.7 (2d Cir. 1996) ("One may disagree, as we did, with the taxpayer [and the district court] on whether or not § 280A applies to cooperative stock, but the government's bald claim that the taxpayer did not exercise due care in making his argument is little short of reprehensible. And its persistence in asserting the negligence claim even after it lost below is mind boggling. . . . We therefore not only reject the claim of negligence in this case, but caution the government against making like claims in similar situations where the law is, at best, unclear."). (footnote omitted)

f. *Castle Harbour VI*: And the Second Circuit trashes District Court Judge Underhill's love affair with GE once again. TIFD III-E v. United States, 604 Fed. Appx. 69 (2d Cir. 5/19/15), *cert. denied*, 2016 WL 100838 (1/11/16). The Second Circuit, in a summary order, reversed Judge Underhill's decision that the § 6662 20 percent negligence penalty was inapplicable. "In finding that TIFD had a 'reasonable basis' for treating the Dutch banks' interest as equity rather than debt, the District Court relied on various inapposite authorities treating preferred stock as equity for tax purposes. We previously ... concluded that the preferred-stock authorities invoked by TIFD provided "'*no support* for [its] treatment of the banks' interest as equity.'"

2. Corporate shareholders knew what MidCoast's midco deal was all about. Transferee liability imposed. Feldman v. Commissioner, T.C. Memo. 2011-297 (12/27/11). The Tax Court (Judge Swift) upheld transferee liability under § 6901 against the shareholders of a corporation who engaged in a purported sale of the corporation's stock to a midco (the infamous MidCoast) to avoid recognition of gain from the earlier sale of the corporation's assets. The transaction was structured as a partial stock redemption for cash after the asset sale, with the remainder of the stock being sold in the same taxable year of the corporation to a midco that purported

to shelter the gains with losses from purported distressed debt tax shelter transactions. The purported stock sale "lack[ed] both business purpose and economic substance" and was disregarded for federal income tax purposes. "The substance of the transaction was a liquidation [of the corporation] and a fee payment to MidCoast for its role in facilitating the sham." The court specifically noted that the taxpayers took no actions to ensure that the corporate income tax liability triggered by the asset sale would be paid, and that it remained unpaid.

a. And the Seventh Circuit affirms. Feldman v. Commissioner, 779 F.3d 448 (7th Cir. 2/24/15). In an opinion by Judge Sykes, the Seventh Circuit affirmed the Tax Court and held that the shareholders of the corporation were liable as transferees for the federal income taxes owed by the corporation, Woodside Ranch Resort, Inc. In order for a taxpayer to have transferee liability, the court stated, two requirements must be satisfied: (1) the taxpayer must be a "transferee" within the meaning of § 6901, and (2) the transferee must be liable for the transferor's debts under some provision of state law. With respect to the first requirement, the Seventh Circuit viewed it as "entirely reasonable for the tax court to conclude that this was a liquidation 'cloak[ed] ... in the trappings of a stock sale.' Having received Woodside's cash in a de facto liquidation, the shareholders are transferees under § 6901." With respect to the second requirement of liability under state law, the court rejected the government's argument that "if the court recharacterizes or collapses a transaction to determine transferee status under § 6901, then substantive liability is determined by applying state law to the transaction as recast under federal law." (The court noted that every federal court of appeals that has considered the issue—the First, Second, Fourth, and Ninth Circuits—has rejected the government's position.) Instead, the court held, the Supreme Court's holding in *Commissioner v. Stern*, 357 U.S. 39 (1958) that § 6901 is purely procedural and that the government's rights as a creditor are the same as those of other creditors under state law dictates that "transferee status under § 6901 and substantive liability under state law are separate and independent inquiries." Nevertheless, the court held, the transaction could properly be recharacterized under state law to treat the shareholders as transferees because Wisconsin fraudulent conveyance law defines "transfer" broadly and incorporates equitable principles, and because Wisconsin courts have applied a substance-over-form analysis in tax cases. The court affirmed the Tax Court's holding that the shareholders were liable as transferees for the corporation's tax liability under the constructive fraud provisions in Wisconsin's fraudulent conveyance law. They were liable because (1) the transfer left the corporation insolvent, (2) the shareholders knew or should have known that the corporation's tax liability could not and would not be paid (although it is sufficient if either of these first two

requirements is satisfied), and (3) the corporation transferred to them the cash from its asset sale without receiving reasonably equivalent value.

3. Taxpayers avoid transferee liability in a midco transaction in the Fourth Circuit. Starnes v. Commissioner, 680 F.3d 417 (4th Cir. 5/31/12), *aff'g* T.C. Memo. 2011-63. The Fourth Circuit refused to apply transferee liability under § 6901 against the shareholders of a corporation (Tarcon) who sold the stock of the corporation to MidCoast after an asset sale, even though the corporation had nothing but cash, which pursuant to the contractual provisions was transferred to Midcoast by wire transfer contemporaneously with the closing of the stock sale and purchase, and even though the purchase price was substantially less than the cash holdings of the corporation. The Court of Appeals held that under *Commissioner v. Stern*, 357 U.S. 39 (1958), whether a "person is the 'transferee' of a taxpayer's assets, the 'existence and extent' of that transferee's liability for unpaid taxes the taxpayer owed prior to the transfer is determined by state law, not federal law." (It failed to consider the impact of the Federal Debt Collection Act, which postdates *Stern*.) The court also held that *Stern* forecloses the application of federal tax law principles to recast the actual transactions under federal law before applying state law to the set of transactions: "An alleged transferee's substantive liability for another taxpayer's unpaid taxes is purely a question of state law, without an antecedent federal-law recasting of the disputed transactions."

- A cogent dissent by Judge Wynn would have imposed transferee liability. Judge Wynn would have followed *BB&T Corp. v. United States*, 523 F.3d 461, 472 (4th Cir. 2008) — "[i]n applying the doctrine of substance over form, we 'look to the objective economic realities of a transaction rather than to the particular form the parties employed'" (quoting *Frank Lyon*, 435 U.S. at 573 (alteration omitted)) to recast the transaction because "the 'objective economic realities' establish that the former shareholders effectively wound up Tarcon and received liquidating distributions of its cash as a result of the stock sale to MidCoast." Judge Wynn reasoned that the sale to MidCoast was not a true sale of stock. Rather, the "substance" of the transaction was merely a cash-for-cash swap and because cash is fungible, the transaction in substance was a receipt by the former shareholders of distributions of Tarcon's cash. Finally, because the stock sales agreement did not require that Tarcon get anything in return for its cash, this transfer was clearly fraudulent under the relevant state law.

a. The government's batting average on establishing transferee liability in midco transactions in the Fourth Circuit fails to improve. Andrew v. United States, 91 F. Supp. 3d 739 (D.N.C. 2/12/15). The shareholders of a corporation, GNC Investor's Club, Inc., sold their shares to a corporation (Battery Street, Inc.) formed by

MidCoast. The sale occurred after GNC had sold all of its assets for cash of $4.96 million, which triggered a corporate federal income tax liability estimated to be approximately $1.2 million. Using funds borrowed from a third party as a twenty-four-hour loan, Battery Street paid the GNC shareholders $3.82 million for their shares, which MidCoast represented was approximately $400,000 more than the shareholders would have received had they liquidated GNC. Simultaneously with Battery Street's purchase of the GNC stock, GNC transferred all of its cash to a new account established by Battery Street in GNC's name. GNC filed a return for the year of its asset sale showing no tax liability. The IRS later entered into a stipulation with GNC that GNC owed $1.16 million in unpaid taxes plus an accuracy-related penalty, but was unable to collect from GNC. When the IRS sought to hold the GNC shareholders liable as transferees pursuant to § 6901, the shareholders paid the tax and penalty and brought this action for a refund. The shareholders conceded that they were transferees within the meaning of § 6901, but argued that they were not liable for GNC's taxes under state law, the North Carolina Uniform Fraudulent Transfer Act. The District Court (Judge Eagles) held that there was "no basis under North Carolina law for holding [the shareholders] liable as transferees for GNC's unpaid taxes." The court viewed the $3.82 million purchase price paid by Battery Street to the GNC shareholders as "separate and distinct" from GNC's transfer of all of its cash to the new bank account established for it by Battery Street. Because GNC had merely transferred its cash from one bank account to another, the court held, its transfer did not leave it insolvent and was not a transfer for which GNC failed to receive reasonably equivalent value. Although the government argued that GNC transferred most of its cash on the day after the closing to repay the twenty-four-hour loan Battery Street had obtained, the court refused to consider this alleged transfer as part of the same transaction by which the GNC shareholders had received cash for their stock. The government, the court held, had failed to prove that GNC transferred its cash because the documents the government introduced as proof were hearsay and therefore could not be used to prove that the transactions described in them had occurred. Even if the transfer occurred, the court held, the GNC shareholders had neither actual nor constructive knowledge that Battery Street would cause GNC not to pay its tax liability and therefore the alleged transfer "provide[s] no basis for holding the [shareholders] liable for GNC's unpaid taxes." Finally, the court refused to hold the shareholders liable as transferees of a transferee (see *Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 3/29/13)) because the government failed to raise this argument until late in the proceedings and failed to articulate the argument clearly.

4. The STARS are blacked out by the economic substance doctrine. Bank of New York Mellon Corp. v. Commissioner, 140 T.C. 15 (2/11/13). In a case described as a case of first impression in the Tax

Court, the court (Judge Kroupa) denied the taxpayer's claimed foreign tax credits and other tax benefits artificially generated through a "STARS" tax-shelter transaction developed and marketed by KPMG. The transaction that generated the purported foreign tax credit lacked economic substance. The taxpayer's control and management over the transferred assets did not materially change as a result of the transaction and the STARS structure had no effect on the income stream generated by the assets; the assets would have generated the same income regardless of being transferred. "Thus, income from the STARS assets was not an incremental benefit of STARS." The court rejected the taxpayer's argument that the STARS structure was security for a loan from Barclays Bank, finding that the loan proceeds were not used to purchase the STARS assets and that the loan was adequately secured by other assets. Thus the loan was a separate transaction from the STARS transaction, which standing by itself lacked economic substance. Furthermore, the STARS transaction still lacked economic substance even if the STARS structure and the loan were evaluated as an integrated transaction.

> The STARS transaction was a complicated scheme centered around arbitraging domestic and foreign tax law inconsistencies. The U.K. taxes at issue did not arise from any substantive foreign activity. Indeed, they were produced through pre-arranged circular flows from assets held, controlled and managed within the United States. We conclude that Congress did not intend to provide foreign tax credits for transactions such as STARS.

- Finally, the claimed transactional expenses, the zero coupon swap interest expense, and the U.K. taxes that were incurred in furtherance of the STARS transaction were not deductible. "Expenses incurred in furtherance of a transaction that is disregarded for a lack of economic substance are not deductible."

a. But on reconsideration, the taxpayer wins a skirmish after the major battle is over. Bank of New York Mellon Corp. v. Commissioner, T.C. Memo. 2013-225 (9/23/13). The Tax Court (Judge Kroupa) granted the taxpayer's motion for reconsideration of its decision, 140 T.C. 15 (2/11/13), which disallowed the taxpayer's claimed STARS tax shelter deductions, but only with respect to the disallowance in the earlier decision of interest deductions with respect to a loan incurred as part of the STARS transaction. In the earlier proceeding the taxpayer maintained that it did not deduct interest on the loan because it argued that the loan interest and the spread should be treated as though they were paid under an integrated contract. The Tax Court bifurcated the STARS transaction into the loan and the STARS structure, and found that the loan proceeds were available for the taxpayer's use throughout the STARS transaction. Based on this finding the taxpayer

argued that an interest deduction should be allowed, reasoning that the loan was not necessary for the STARs structure to produce the disallowed foreign tax credits, and thus loan served a purpose beyond the creation of tax benefits. The court agreed with this argument and allowed the deduction.

b. And the STARS still can't be seen at night (or in the day) after a visit to the Thurgood Marshall Courthouse. Bank of New York Mellon Corp. v. Commissioner, 801 F.3d. 104 (2d Cir. 9/9/15). In an opinion by Judge Chin, the Second Circuit affirmed the Tax Court's decision in *Bank of New York Mellon Corp. v. Commissioner*, T.C. Memo. 140 T.C. 15 (2013), *supplemented*, T.C. Memo. 2013-225, and the District Court's decision in *American International Group., Inc. v. United States*, 2013 WL 1286193 (S.D.N.Y. Mar. 29, 2013). In *Bank of New York Mellon Corp*., the Tax Court applied the economic substance doctrine to a structured trust advantaged repackaged securities (STARS) transaction to disallow the claimed foreign tax credits. In doing so, the Tax Court held that (1) the effect of foreign taxes is to be considered in the pre-tax analysis of economic substance, (2) STARS lacked economic substance, and thus Bank of New York could not claim foreign tax credits associated with STARS, and (3) Bank of New York was allowed to deduct interest expenses associated with the STARS transaction. The Second Circuit agreed with the Tax Court's separate analysis of the trust transaction and the associated loan to Bank of New York, and that under the Second Circuit's "flexible analysis" of the two prongs of the economic substance test, both the objective and subjective prongs of the economic substance test showed that the trust transaction lacked economic substance. The "transaction's circular cash flow strongly indicated that its main purpose was to generate tax benefits. ... STARS lacked a subjective business purpose beyond tax avoidance. ... [T]he STARS structure lacked a reasonable relationship to BNY's claimed business purposes and BNY's interest in STARS was entirely predicated on the tax benefits it involved. However, the $1.5 billion loan to Bank of New York had independent economic substance, and the interest paid on that loan thus was deductible because "[e]ven if the motive for a transaction is to avoid taxes, interest incurred therein may still be deductible if it relates to economically substantive indebtedness." In *American International Group, Inc*., the District Court held that: (1) the economic substance doctrine applies to the foreign tax credit regime, and (2) the pre-tax benefit that AIG gained from its "cross-border" transactions was to be calculated after taking into account foreign taxes. The District Court denied AIG's motion for partial summary judgment, and certified the matter for interlocutory appeal. In affirming both lower court decisions, the Second Circuit reasoned that foreign taxes should be taken into account, i.e., as a deduction, in calculating the pre-tax profit realized from cross-border transactions (thus, disagreeing with *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), *rev'g*, 113 T.C. 214 (1999), and

IES Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001), and agreeing with *Salem Financial, Inc. v. United States,* 786 F.3d 932, 938 (Fed. Cir. 2015)). The Second Circuit rejected the taxpayers' arguments that the economic substance doctrine cannot be applied to disallow foreign tax credits that complied with all of the statutory and regulatory requirements. The court held that "[t]he economic substance doctrine exists to provide courts a 'second look' to ensure that particular uses of tax benefits comply with Congress's purpose in creating that benefit." Thus, it is proper "when assessing the objective economic substance of a transaction, to include the foreign taxes paid but to exclude the foreign tax credits claimed in calculating pre-tax profit." Because "[t]he purpose of the foreign tax credit is to facilitate global commerce by making the IRS indifferent as to whether a business transaction occurs in this country or in another, not to facilitate international tax arbitrage," and "the transactions themselves 'fictionalize[d]' the concept of international trade, it was proper to apply the economic substance doctrine. Whether AIG's transactions had economic substance was a matter for a trial; "the government offered sufficient evidence to permit a reasonable fact finder to find in its favor. Hence, the district court did not err in denying partial summary judgment."

5. A judge sees the STARS and grants partial summary judgment for the taxpayer; only the Shadow [and the First Circuit] knows what comes next. Santander Holdings USA, Inc. v. United States, 977 F. Supp. 2d 46 (D. Mass. 10/17/13). The STARS tax shelter in the form marketed to banks involved two basic components: a loan from Barclays Bank to the U.S. taxpayer, which generated interest deductions, and the U.S. taxpayer placing assets in a trust, which required payment of U.K. taxes and generated foreign tax credits. The transaction also featured a payment from Barclays to the U.S. taxpayer equal to approximately one-half of the U.K. taxes that the U.S. taxpayer paid. A key element in whether a STARS transaction has a reasonable prospect for profit, and thus might not run afoul of the economic substance doctrine, is whether the payment from Barclays effectively reduced the taxpayer's payment of the U.K. taxes as a rebate. (We will not go into the details of the economic analysis.) Suffice it to say that the government's position was that "the Barclays payment was not 'in substance' a payment by Barclays at all, but rather it was 'effectively' a rebate of taxes originating from the U.K. tax authorities. The theory is that Barclays was only able to make the payment because of the tax credits *it* had received from the U.K." The District Court (Judge O'Toole) found the government's argument on this point "wholly unconvincing," and held that the Barclays payment was not in any way a rebate to the taxpayer of U.K. taxes, citing Reg. § 1.901-2(f)(2), which provides: "Tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability."

Accordingly, he ruled that the Barclays payment to the taxpayer "should be accounted for as revenue to [the taxpayer] in assessing whether [the taxpayer] had a reasonable prospect of profit in the transaction." He also rejected the government's argument that the entire transaction was a "sham" "concocted to manufacture a bogus foreign tax credit," because he found that argument to be foreclosed by his finding that "[i]f the Barclays payment is included in the calculation of pre-tax profitability, then there was a reasonable prospect of profit as to the trust transaction, giving it economic substance." Finally, Judge O'Toole concluded that under First Circuit precedent, if a transaction had "objective economic substance," the economic substance doctrine could not be applied to deny the tax benefits of the transaction on "subjective" grounds, although he acknowledged that the First Circuit might revisit the issue and "would perhaps move a bit away from a rigid 'objective only' test to one that is primarily objective but has room for consideration of subjective factors where necessary or appropriate."

a. The STARS are aligned for this taxpayer. The District Court grants summary judgment and upholds both the taxpayer's interest deductions and foreign tax credits. Santander Holdings USA, Inc. v. United States, 116 A.F.T.R.2d 2015-6795 (D. Mass. 11/13/15). The court (Judge O'Toole) granted the taxpayer's motion for summary judgment and denied the government's cross-motion for summary judgment and held that the taxpayer properly claimed both the interest deductions and the foreign tax credits generated by the STARS transaction. In reaching this conclusion, the court rejected what it characterized as the government's argument that the taxpayer's payments of U.K. tax should be ignored under two substance over form doctrines, specifically the step transaction and conduit doctrines.

- The Courts of Appeals for the Second Circuit and the Federal Circuit both have held with respect to the STARS transaction that the taxpayers properly claimed interest deductions on the loans from Barclays, but that the taxpayers were not entitled to foreign tax credits because that aspect of the transaction lacked economic substance. *Bank of New York Mellon Corp. v. Commissioner*, 801 F.3d. 104 (2d Cir. 9/9/15); *Salem Financial, Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 5/14/15). The District Court's decision in this case that the taxpayer properly claimed foreign tax credits generated by the STARS transaction conflicts with those decisions.

6. How long will this wave of midco transaction transferee liability cases continue? Stuart v. Commissioner, 144 T.C. 235 (4/1/15). The taxpayers sold all of their stock in a corporation in a Midco transaction after the corporation sold all of its assets for cash, recognizing a substantial gain. The IRS issued notices of transferee liability to the taxpayers to collect the corporation's unpaid taxes under § 6901. The IRS argued that

liability should be determined by a two-step analysis under which (1) to determine whether the taxpayers were transferees, judicial doctrines interpreting the Code should be applied to determine whether the form of the transactions should be disregarded in favor of the substance of the transactions, and (2) state law should be applied to the transactions resulting from the first step. Following *Swords Trust v. Commissioner*, 142 T.C. 317 (2014), the Tax Court (Judge Halpern) rejected the IRS's two-step analysis. Nevertheless, the court held that transferee liability was established under the Nebraska Uniform Fraudulent Transfer Act because the corporation's transfer was constructively fraudulent as to the IRS and the transfer was made for the benefit of the taxpayers. Unmatured tax liabilities are "claims" within the meaning of that term as defined in UFTA. The taxpayers for whose benefit the transfer was made were transferees within the meaning of § 6901. "A person can be a transferee within the meaning of the section if he is an indirect transferee of property, *Stanko v. Commissioner*, 209 F.3d 1082 [8th Cir. 2004], is a constructive recipient of property, *Shartle v. Commissioner*, T.C. Memo. 1988-354, or merely benefits in a substantial way from a transfer of property, *Cole v. Commissioner*, T.C. Memo. 1960-278. The determinative factor is liability to a creditor (the Commissioner) for the debt of another under a State fraudulent conveyance, transfer, or similar law."

- The Tax Court noted that three U.S. Courts of Appeals had rejected the IRS's two-step analysis. *See Diebold Found., Inc. v. Commissioner*, 736 F.3d 172, 184-85 (2d Cir. 2013), *vacating and remanding* T.C. Memo. 2012-61; *Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013), *rev'g and remanding* T.C. Memo. 2011-298; *Starnes v. Commissioner*, 680 F.3d 417, 428-29 (4th Cir. 2012), *aff'g* T.C. Memo. 2011-63.

7. BB&T sees only part of the STARS. Salem Financial, Inc. v. United States, 786 F.3d 932 (Fed. Cir. 5/14/15). The Federal Circuit, in an opinion by Judge Bryson, affirmed the Court of Federal Claims' decision denying the taxpayer's foreign tax credit benefits resulting from a "STARS" tax shelter transaction. The evidence showed that component of the transaction lacked economic reality and a non-tax business purpose. But the Court of Federal Claims' decision denying the interest deductions with respect to the loan component of transaction was reversed. The loan served a real business purpose of providing financing and thus had economic substance. The court rejected the government's argument "that a transaction's lack of potential for profit before taking U.S. tax benefits into account conclusively establishes that the transaction lacks economic reality," but nevertheless found the transaction to be "lacking economic reality" and to have no business purpose. The Court of Appeals also upheld the § 6662 accuracy-related penalty with respect to the foreign tax credit benefits on the grounds that

"reliance on Sidley's tax opinion was unreasonable because Sidley had an inherent conflict of interest of which BB&T knew or should have known."

8. The Ninth Circuit channels the economic substance doctrine to tell the Tax Court that it was too quick to dismiss transferee liability in a midco case. Slone v. Commissioner, 788 F.3d 1049 (9th Cir. 6/8/15), *amended*, 2015 WL 5061315 (8/28/15), *vacating and remanding*, T.C. Memo. 2012-57 (3/1/12). The taxpayer's family-owned corporation sold all of its assets for cash, resulting in a gain of over $38 million and an estimated combined federal and state income tax liability of over $15 million. None of the proceeds had been distributed at the time Fortrend and MidCoast made an unsolicited offer to purchase the stock of the corporation, which ultimately was accepted, at a purchase price of $35,753,000, plus assumption of the corporation's liabilities for federal and state income taxes owed as of the closing date. Not unsurprisingly, the taxes were never paid and the IRS asserted transferee liability against the shareholders. Because the asset sale and stock sale were independent of each other and the shareholders "had no reason to believe that Fortrend's methods were illegal or inappropriate, . . . [n]either the substance over form doctrine nor any related doctrines appl[ied] to recast the stock sale as a liquidating distribution." Thus, because the IRS's transferee liability theory was grounded on recasting the stock sale as a liquidation, the IRS lost in the Tax Court because under this view the taxpayer was not a "transferee."

- On appeal, the Tax Court's decision was vacated and remanded in a decision written by Judge Ikuta. According to the Ninth Circuit, the Tax Court erred in respecting the form of the shareholders' stock sale because it applied an erroneous standard. The Court of Appeals' majority opinion first noted that that the "Supreme Court has long recognized 'the importance of regarding matters of substance and disregarding forms,' *United States v. Phellis*, 257 U.S. 156, 168 because '[t]he incidence of taxation depends upon the substance of a transaction,' *Comm'r v. Court Holding Co.*, 324 U.S. 331, 334 (1945)." The court then looked to its economic substance doctrine precedents to conclude that the same "approach is applicable for determining whether a taxpayer is a transferee for purposes of § 6901. Accordingly, when the Commissioner claims a taxpayer was 'the shareholder of a dissolved corporation' for purposes of 26 C.F.R. § 301.6901-1(b), but the taxpayer did not receive a liquidating distribution if the form of the transaction is respected, a court must consider the relevant subjective and objective factors to determine whether the formal transaction 'had any practical economic effects other than the creation of income tax losses.'" However, the majority concluded that it could not determine on appeal whether the shareholder was a transferee because the Tax Court "did not address either the subjective or objective factors we apply in characterizing a transaction for tax purposes, as it failed to make any finding on whether the shareholders had a business purpose for entering into the stock purchase

transaction other than tax avoidance, or whether the stock purchase transaction had economic substance other than shielding the ... shareholders from tax liability." The Tax Court was directed on remand to make the findings necessary to correctly apply the transferee test as articulated by the Court of Appeals. "[T]he tax court should apply the relevant subjective and objective factors to determine whether the Commissioner erred in disregarding the form of the transaction in order to impose tax liability on the shareholders as 'transferees' under § 6901."

- Judge Noonan concurred with the majority's holding that the Tax Court erred by applying the wrong standard and that economic substance doctrine principles properly applied to determine whether to disregard the form of the transaction in order to determine whether the shareholders were transferees under § 6901. But he thought the record was sufficient to hold that the stock sale transaction had no economic substance and that the shareholders were transferees under § 6901. He would have remanded to the Tax Court only on the question of state law substantive liability.

9. Uh oh, it's midco, yet again! Shockley v. Commissioner, T.C. Memo 2015-113 (6/22/15). The Tax Court (Judge Cohen) upheld transferee liability deficiency determinations against the shareholders of a corporation that they sold in an extremely complicated Midco transaction.

> While the tax attributes of this scheme occurred during the overall transaction as opposed to having already been established before the transaction (such as a Midco's use of offsetting losses or tax-exempt status ...), we nonetheless conclude that these attributes serve the same sole purpose of tax avoidance. The record reflects no other apparent reason for ICA to have created this many transactional entities and to have assumed this structuring other than the aspiration to reach an unwarranted tax result, i.e., SCC's appreciated assets having been sold without any correlating tax liability to SCC, SDC, SCA LLC, NCAC II, ICA, the SCC shareholders, or anyone else. This manipulating of the Internal Revenue Code is a prime example of how a transaction can be structured so that its form might meet the letter of the law, but it nevertheless is being used in a manner incongruous with the intent of that law. ...
>
> Thus, looking to the objective economic realities of the transaction, the evidence and reasonable inferences therefrom sufficiently establish that the true substance of the transaction is different from its form—that the only purpose of the ICA Midco transaction was tax avoidance. ...
>
> We conclude that the overall Midco transaction was a sham because it was not a true multiple-party transaction,

> lacked economic substance, had no business purpose, and was only entered to avoid tax.

The court found the shareholders liable as transferees under the applicable state law (Wisconsin), even though the overall Midco transaction was engineered to have the stock sale occur an hour or two ahead of the asset sales.

10. The taxpayer came to regret his decision to organize his business as a C corporation, and a midco transaction failed to solve the problem. Tricarichi v. Commissioner, T.C. Memo 2015-201 (10/14/15). The taxpayer was the sole shareholder of a C corporation, West Side Cellular, Inc. After lengthy litigation regarding network access, West Side received a settlement of $65 million and was required both to terminate its business as a retail provider of cell phone service and to end all service to its customers. To reduce the impact of corporate-level tax, the taxpayer engaged in a midco transaction in which a Cayman Islands affiliate of Fortrend International LLC purchased the stock of West Side for approximately $11.2 million more than the corporation's net asset value (the value of its assets less its estimated federal tax liabilities) and then used a distressed debt strategy to generate a bad debt deduction of $42.4 million to eliminate West Side's tax liabilities. In the notice of deficiency issued to West Side, the IRS determined a deficiency of $15.2 million based on its disallowance of the corporation's bad debt deduction and asserted an accuracy-related penalty of roughly $62,000 and a gross valuation misstatement penalty of $5.9 million. The Tax Court (Judge Lauber) held the taxpayer liable as a transferee for West Side's federal tax liability, the accuracy-related penalty, and the gross valuation misstatement penalty. In order for a shareholder to have transferee liability for a corporation's tax liability, the court stated, two requirements must be satisfied: (1) the shareholder must be liable for the corporation's debts under some provision of state law, and (2) the shareholder must be a "transferee" within the meaning of § 6901. With respect to the first requirement, the court held that the taxpayer was liable as a transferee under Ohio law (the Uniform Fraudulent Transfer Act) for the corporation's tax deficiency as well as the penalties:

> In sum, we find that petitioner had constructive knowledge of Fortrend's tax-avoidance scheme; that the multiple steps of the Midco transaction must be collapsed; and that collapsing these steps yields a partial or complete liquidation of West Side from which petitioner received in exchange for his stock a $35.2 million liquidating distribution. Under [Ohio law], petitioner is thus a direct transferee of West Side's assets under respondent's "de facto liquidation" theory as well as under the "sham loan" theory discussed previously.

With respect to the second requirement, the court disregarded the form of the transaction and concluded that the taxpayer was a transferee within the meaning of § 6901 because the taxpayer had in substance directly received West Side's cash. Any appeal of the court's decision will be directed to the Ninth Circuit.

11. Another U.S. bank that was dazzled by the STARS litigates its claimed tax benefits. Wells Fargo & Co. v. United States, 116 A.F.T.R.2d 2015-6738 (D. Minn. 11/10/15). The STARS tax shelter in the form marketed to banks involved two basic components: a loan from Barclays Bank to the U.S. taxpayer, which generated interest deductions, and the U.S. taxpayer placing assets in a trust, which required payment of U.K. taxes and generated foreign tax credits. The transaction also featured a payment from Barclays to the U.S. taxpayer equal to approximately one-half of the U.K. taxes that the U.S. taxpayer paid. In a lengthy opinion, the court (Judge Schiltz) ruled on several motions by the taxpayer and denied most of them. The court granted the taxpayer's motion for partial summary judgment that § 269 does not apply to the transaction. Section 269 generally authorizes the IRS to disallow a deduction, credit or other tax benefit if a person acquires control of a corporation or a corporation acquires transferred-basis property from another non-controlled corporation, and the principal purpose of the acquisition was evasion or avoidance of federal income tax by securing a tax benefit that the person or corporation would not otherwise enjoy. The court agreed with the taxpayer that, even if all other requirements of § 269 were satisfied, the acquisition did not produce tax benefits (foreign tax credits) that the taxpayer would not otherwise have enjoyed because the taxpayer could have claimed the foreign tax credits even without the use of the corporate entities involved in the transaction. The court denied the taxpayer's motion for partial summary judgment that the payments received from Barclays should be considered pretax income rather than a tax benefit. The court reserved this issue for trial and noted that it is inclined to agree with the Second Circuit (*Bank of New York Mellon Corp. v. Commissioner*, 801 F.3d. 104 (2d Cir. 9/9/15)) that the Barclays payment is a tax benefit, rather than with the contrary conclusion of the Federal Circuit (*Salem Financial, Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 5/14/15)).The court also denied the taxpayer's motion for partial summary judgment that the loan from Barclays created a reasonable expectation of pretax profit from the STARS transaction, but indicated it is inclined to agree with the Second and Federal Circuits that analysis of the loan should be bifurcated from analysis of the foreign tax credits.

B. Identified "tax avoidance transactions"

1. A brand spanking new listed transaction. Notice 2015-73, 2015-46 I.R.B. 660 (10/21/15, *revoking* Notice 2015-47, 2015-30 I.R.B. 76 (7/8/15). This Notice identifies certain "basket option contracts" and substantially similar transactions as listed transactions for purposes of §§ 6111 and 6112 and Reg. § 1.6011-4(b)(2). It applies to a type of structured financial transaction in which a taxpayer attempts to defer and treat ordinary income and short-term capital gain as long-term capital gain. The contract is denominated as an option contract that references a basket of actively traded personal property (i.e., securities). The contract allows the taxpayer to trade the securities referenced in the contract while the contract purportedly remains open, and the taxpayer does so. Consequently, option treatment is not warranted, and the income deferral and conversion to long-term capital gain is improper. Transactions in effect on or after 1/1/11, that are the same as, or substantially similar to, the transaction described in the notice are identified as listed transactions effective 10/21/15.

2. And another "transaction of interest" that might be on its way to being listed. Notice 2015-74, 2015-46 I.R.B. 663 (10/21/15), *revoking* Notice 2015-48, 2015-30 I.R.B. 77 (7/8/15). This notice identifies certain "basket contracts" and substantially similar transactions as transactions of interest for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 of the Code. It applies to a type of structured financial transaction in which a taxpayer attempts to defer and treat ordinary income and short-term capital gain as long-term capital gain. The transaction may be denominated as an option, notional principal contract, or forward contract. The contract may reference assets that are not actively traded, such as interests in hedge funds, and the taxpayer has the right to change the assets in the referenced basket. The taxpayer's ability to control the assets in the basket raises the issue of whether the form of the transaction should be respected, and, thus, whether the income deferral and conversion to long-term capital gain is improper. The Treasury Department and the IRS believe this transaction (the "basket contract") has a potential for tax avoidance or evasion but lack enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction. If a transaction described in this notice is similar to a transaction described in Notice 2015-47, it is treated as a listed transaction. Transactions entered into on or after 11/2/06, that are the same as, or substantially similar to, the transactions described in the notice, and in effect on or after 1/1/11, are identified as transactions of interest effective 10/21/15.

C. Disclosure and Settlement

There were no significant developments regarding this topic during 2015.

D. Tax Shelter Penalties

1. In a TEFRA partnership-level proceeding resulting from a Son-of-BOSS transaction, the tax matters partner concedes that the transaction and the partnership were shams but successfully avoids the gross valuation misstatement penalty. CNT Investors, LLC v. Commissioner, 144 T.C. 161 (3/23/15). Charles Carroll operated a successful funeral home business through a subchapter S corporation. He held more than 94 percent of the corporation's stock and his two daughters, who also worked in the business, held the balance. Mr. Carroll wished to sell the business but retain the associated real property, which he planned to lease to the buyers of the business. Because the real property had a very low basis, removing it from the S corporation in the form of a distribution would have triggered a corporate-level gain under § 311(b) of approximately $3.5 million that would have flowed through to the shareholders. To reduce this gain, Mr. Carroll agreed to a Son-of-BOSS, "basis boost" strategy. Through a series of transactions that involved the creation of several tax partnerships, including CNT Investors, LLC, the S corporation was treated as acquiring a significantly increased basis in the real property. After the completion of all transactions, the real property was held by CNT, a TEFRA partnership of which Mr. Carroll and his two daughters were the sole partners and for which Mr. Carroll served as tax matters partner. Neither the S corporation nor any of its shareholders reported gain resulting from the removal of the real property from the S corporation. The Tax Court (Judge Wherry), in a lengthy opinion, addressed a series of issues and upheld the adjustments to CNT's partnership items as determined in the FPAA, but declined to impose the gross valuation misstatement penalty on the ground that Mr. Carroll had demonstrated reasonable cause and good faith within the meaning of § 6664(c).

- The court held that the step transaction doctrine applied and, after collapsing the steps, the S corporation distributed the real property to its shareholders and should have recognized gain under § 311(b). The court rejected the petitioner's argument that the real estate's transfer and the gain it generated must be disregarded because the parties had stipulated that the partnership and the Son-of-BOSS transaction were shams.
- The court also held that the FPAA was timely issued as to Mr. Carroll and his wife, but not as to the other partners. In determining the extent to which the limitations period on assessment for partners

in a TEFRA partnership is extended to six years under § 6501(e)(1)(A), the court stated, the U.S. Supreme Court's decision in *United States v. Home Concrete Supply, LLC*, 132 S. Ct. 1836 (2012), dictates that any omitted gain attributable to the overstatement of basis in the S corporation's real property not be treated as an omission from gross income. However, a portion of the gain omitted by Mr. Carroll and his wife was not attributable to a basis overstatement, and that portion was a substantial omission from gross income that extended the period of limitations on assessment as to them.

- Although partner-level defenses to penalties, including reasonable cause and good faith, generally may not be asserted in a partnership-level TEFRA proceeding, they may be asserted, based on the state of mind of the general partner, when the reasonable cause defense rests on the partnership's actions. The court characterized Mr. Carroll as "a successful businessman, [but] not a financial sophisticate," and held that he had established a reasonable cause and good faith defense through his reliance on his long-time attorney. His attorney had consulted with an attorney at Jenkens & Gilchrist, which promoted the transaction, but had "not simply rel[ied] upon assurances and representations by [the Jenkens & Gilchrist attorney] as to the transaction's tax implications but instead evaluated it for himself and formed an independent opinion."

2. Final Regulations provide an instruction manual on how to start running the otherwise endless statute of limitations on previously unreported listed transactions. T.D. 9718, Period of Limitations on Assessment for Listed Transactions Not Disclosed Under Section 6011, 80 F.R. 16973 (3/31/15). Section 6501(c)(10) extends the statute of limitations when a taxpayer fails to disclose a listed transaction. Under this provision, the Treasury has finalized, with a few clarifications, Reg. § 301.6501(c)-1(g), which was proposed in REG-160871-04, Period of Limitations on Assessment for Listed Transactions Not Disclosed Under Section 6011, 74 F.R. 55127 (10/7/09). The statute of limitations does not expire until one year after the earlier of (1) the date on which the taxpayer furnishes the required information, or (2) the date a material advisor (as defined in § 6111) satisfies the list maintenance requirements of § 6112 with respect to a request by the IRS. The regulations specify the methods for subsequent disclosure of a listed transaction that was not properly disclosed under § 6011. The taxpayer must submit a properly completed Form 8886 and a cover letter (signed under pains and penalties of perjury), which must be completed in accordance with the requirements specified in the regulations to the Office of Tax Shelter Analysis (OTSA). The taxpayer is permitted, but not required, to file an amended return with the Form 8886 and cover letter. A taxpayer making a disclosure under the regulations with respect to a taxable year under examination or Appeals consideration by the IRS must also submit a copy of the submission to the IRS examiner or Appeals officer examining or considering the taxable year to

which the disclosure relates. The extended statute of limitations applies only to the tax relating to the listed transaction, but the regulations provide that tax with respect to the listed transaction includes, but is not limited to, adjustments made to the tax consequences claimed on the return plus interest, additions to tax, additional amounts, and penalties that are related to the listed transaction or adjustments made to the tax consequences, as well as any item to the extent the item is affected by the listed transaction even if it is unrelated to the listed transaction.

- *Clarifications*: (1) The one-year period in § 6501(c)(10) extends only the current limitations period. If the one-year period under § 6501(c)(10) ends before the general § 6501(a) three-year limitations period, the general three-year period applies. (2) Receipt of information from someone other than a material adviser for a taxpayer cannot satisfy the disclosure requirements for purposes of § 6501(c)(10)(B). (3) Information provided for reasons other than in response to a § 6112 request will not begin the one-year period. (4) If a material adviser provides information but fails to identify the taxpayer as a person who entered into the listed transaction, the requirements of § 6501(c)(10)(B) will not have been met for that taxpayer.

- *Effective Date*: The regulations apply to taxable years with respect to which the period of limitations on assessment under § 6501 did not expire before 3/31/15. Rev. Proc. 2005-26 is superseded for tax years for which the limitations period on assessment under § 6501, including § 6501(c)(10), did not expire before 3/31/15. Rev. Proc. 2005-26 will continue to apply to tax years for which the limitations period on assessment expired between 4/7/05 and 3/31/15.

3. Tax Shelters—the gift that keeps on giving guidance. REG-103033-11, Reportable Transactions Penalties Under Section 6707A, 80 F.R. 52231 (8/28/15). Section 6707A imposes a penalty on a taxpayer who has a duty to disclose a reportable transaction and fails to do so. Section 6707A was amended in 2010 by the Small Business Jobs Act of 2010 to change the amount of the penalty from a stated dollar amount to 75 percent of the decrease in tax shown on the return as a result of the reportable transaction. There are also, however, minimum and maximum penalties. In the case of a natural person, the minimum penalty is $5,000, and in the case of a taxpayer other than a natural person the minimum penalty is $10,000. The maximum penalty for a natural person is $100,000 in the case of a listed transaction, and $10,000 in the case of any other reportable transaction. The maximum penalty for a taxpayer other than a natural person is $200,000 in the case of a listed transaction, and $50,000 in the case of any other reportable transaction. Proposed amendments to Reg. § 301.6707A-1(b)(3), (d) clarify the application of the amended penalty provision.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. The IRS continues to have problems with exempt organization issues. Z Street Inc. v. Koskinen, 44 F. Supp. 3d 48 (D. D.C. 5/27/14). The District Court (Judge Jackson) refused to dismiss a complaint filed by a pro-Israel nonprofit group seeking declaratory and injunctive relief with respect to the processing of its application for § 501(c)(3) status. The complaint asserted that the IRS had a special policy of intense scrutiny, which it applied to organizations whose activities relate to Israel "and whose positions with respect to Israel contradict the current position of the U.S. Government." The court refused to dismiss this constitutional claim based on the premise that the Israel Special Policy constituted "impermissible viewpoint discrimination on the part of the federal government." Judge Jackson rejected the government's assertions that the action should be dismissed under (1) the Anti-Injunction Act, 26 U.S.C. § 7421, (2) the Declaratory Judgment Act, 28 U.S.C. § 2201, and (3) the doctrine of sovereign immunity.

a. The D.C. Circuit continues to chip away at the Anti-Injunction Act. Z Street, Inc. v Koskinen, 791 F.3d 24 (D.C. Cir. 6/19/15). In an opinion by Judge Tatel, the D.C. Circuit narrowed the applicability of the Anti-injunction Act (§ 7421). Z Street, a nonprofit organization, applied for tax-exempt status under § 501(c)(3). Z Street did not wait the 270 days that the IRS has to act upon an application for tax-exempt status before the organization can seek a declaratory judgment under § 7428. Approximately 30 days before the 270 day deadline Z Street sued the IRS alleging that the IRS has an "Israel Special Policy" under which applications from organizations holding "political views inconsistent with those espoused by the Obama administration" receive increased "scrutin[y]" that results in such applications "tak[ing] longer to process than those made by organizations without that characteristic," and that the "Israel Special Policy" violated its First Amendment rights. The IRS moved to dismiss on the grounds that the suit violated the Anti-Injunction Act. The Court of Appeals affirmed the District Court's decision, holding that the suit was not seeking to restrain the "assessment or collection" of a tax, but rather to prevent the IRS from delaying consideration of its application in violation of the First Amendment. The court first explained that under *South Carolina v. Regan*, 465 U.S. 367 (1984), in which the state of South Carolina challenged the constitutionality of subjecting state bond interest to the AMT, the Anti-Injunction Act does not bar a suit if the plaintiff lacks an alternative means to challenge the IRS's actions. Because Z Street's suit did not seek a final determination of its exempt status, but rather challenged the IRS's alleged unconstitutional delay in processing its § 501(c)(3) application, § 7428 did not address Z Street's alleged injury.

Relying principally on its prior decision in *Cohen v. United States*, 650 F.3d 717 (D.C. Cir. 2011) (en banc), involving refunds of the telephone excise tax, the court rejected the IRS's claim that the Anti-Injunction Act barred judicial consideration of all tax cases. "[T]he Anti-Injunction Act, 'as its plain text states, bars suits concerning the 'assessment or collection of any tax[,]' [and] is no obstacle to other claims seeking to enjoin the IRS, regardless of any attenuated connection to the broader regulatory scheme.' ... Accordingly, the Act 'requires a careful inquiry into the remedy sought, the statutory basis for that remedy, and any implication the remedy may have on assessment and collection.'"

2. Final regulations on the § 501(r) requirements for charitable hospitals. T.D. 9708, Additional Requirements for Charitable Hospitals; Community Health Needs Assessments for Charitable Hospitals; Requirement of a Section 4959 Excise Tax Return and Time for Filing the Return, 79 F.R. 78954 (12/31/2014). Section 501(r), enacted as part of the Patient Protection and Affordable Care Act of 2010, adds requirements for hospital organizations to be recognized as exempt under § 501(c)(3). The Treasury Department has finalized regulations proposed under § 501(r) in REG-130266–11, Additional Requirements for Charitable Hospitals, 77 F.R. 38148 (7/26/12) and REG-106499-12, Community Health Needs Assessments for Charitable Hospitals, 78 F.R. 20523 (4/5/13). The final regulations provide detailed guidance to charitable hospital organizations on the requirements imposed by § 501(r) and related excise tax and reporting obligations.

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

  -establish written financial assistance and emergency medical care policies;

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

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

  -conduct a community health needs assessment (CHNA) and adopt an implementation strategy at least once every three years.

The 2012 proposed regulations addressed the first three requirements and the 2013 proposed regulations addressed the CHNA requirement.

- The Treasury Decision also provides guidance—initially proposed in the 2013 proposed regulations—related to (1) the $50,000 excise tax imposed by § 4959 on a hospital organization that fails to meet the CHNA requirements, and (2) the requirement imposed by § 6033(b)(15) that a

hospital organization attach to its Form 990 both audited financial statements and a description of the actions taken during the taxable year to address the significant health needs identified through its most recently conducted CHNA.

- The final regulations that address the four general requirements imposed by § 501(r) apply to a hospital facility's taxable years beginning after 12/29/15. For taxable years beginning on or before 12/29/15, a hospital facility may rely on a reasonable, good faith interpretation of § 501(r). A hospital facility will be deemed to have operated in accordance with a reasonable, good faith interpretation of § 501(r) if it has complied with the provisions of the 2012 and/or 2013 proposed regulations or the final regulations. The final regulations under § 4959 apply on and after 12/29/14 and the final regulations under § 6033 apply to returns filed on or after 12/29/14.

a. The IRS provides correction and disclosure procedures for hospital organizations that, if followed, permit certain failures to meet the requirements of § 501(r) to be excused. Rev. Proc. 2015-21, 2015-13 I.R.B. 817 (3/10/15). Under Reg. § 1.501(r)-2(a), a hospital organization that fails to meet one of the requirements of § 501(r) separately with respect to one or more hospital facilities it operates may have its § 501(c)(3) status revoked. However, under Reg. § 1.501(r)-2(b), a hospital facility's omission of required information from certain reports or policies or error with respect to specified implementation or operational requirements is excused if the omission or error was minor, either inadvertent or due to reasonable cause, and corrected as promptly after discovery as is reasonable. Similarly, under Reg. § 1.501(r)-2(c), a hospital facility's failure to meet specified requirements of § 501(r) that is neither willful nor egregious is excused if the hospital facility corrects and makes disclosure in accordance with rules set forth in published guidance. This revenue procedure (a draft version of which was published in Notice 2014-3, 2014-3 I.R.B. 408 (12/30/13)) provides examples of errors or omissions that are minor and inadvertent and clarifies that such failures do not result in imposition of the § 4959 excise tax. The revenue procedure also prescribes how hospital organizations must correct failures and how they must disclose failures that are not minor. Although correction and disclosure of non-minor failures that are not willful or egregious may avoid revocation of the hospital organization's § 501(c)(3) status, correction and disclosure of such failures does not avoid imposition of the § 4959 excise tax. The revenue procedure is effective on and after 3/10/15. Corrections and disclosures made prior to 3/10/15 are effective if made in a manner consistent with the revenue procedure or in accordance with Notice 2014-3.

B. Charitable Giving

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

a. Plea for a mulligan is rejected! Kaufman v. Commissioner, 136 T.C. 294 (4/4/11). On the taxpayers' motion for reconsideration, the Tax Court (Judge Halpern) in a lengthy and thorough opinion reaffirmed its earlier decision that the conservation easement failed the perpetuity requirement in Reg. § 1.170A-14(g)(6), because under the loan documents, the bank that held the mortgage on the property expressly retained a "'prior claim' to all insurance proceeds as a result of any casualty, hazard, or accident occurring to or about the property and all proceeds of condemnation," and the agreement also provided that "the bank was entitled to those proceeds 'in preference' to [the donee organization] until the mortgage was satisfied and discharged." The court also disallowed a deduction in 2003, but allowed the deduction in 2004, for a cash contribution to the donee of the conservation easement in 2003 because the amount of the cash payment was subject to refund if the appraised value of the easement was zero, and the appraised value was not determined until 2004. The court also rejected the IRS's argument that the taxpayers received a *quid pro quo* for the cash contribution in the form of the donee organization accepting and processing their application, providing them with a form preservation restriction agreement, undertaking to obtain approvals from the necessary government authorities, securing the lender agreement from the bank, giving the taxpayers basic tax advice, and providing them with a list of approved appraisers. The facts in evidence did not demonstrate a *quid pro quo*, because, among other things, many of the tasks had been undertaken by the organization before the check was received.

- Finally, the court declined to uphold the § 6662 accuracy related penalties asserted by the IRS for the taxpayers' overstatement of the amount of the contribution for the conservation easement, but sustained the negligence penalty for the 2003 deduction for the cash payment. Because the issue of whether any deduction was allowed for the easement, regardless of its value, was a matter of law decided in the case as a matter of first impression, the

taxpayers were not negligent, had reasonable cause, and acted in good faith.

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

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

- Thus, the First Circuit rejected the Tax Court's requirement that the donee of the conservation easement have "an absolute right" (136 T.C. at 313), holding that a "grant that is absolute against the owner-donor" is sufficient "and almost the same as an absolute one where third-party claims (here, the bank's or the city's) are contingent and unlikely."
- The First Circuit went on to reject the IRS's argument that the contribution also failed to qualify for a charitable contribution deduction because a provision in the agreement between the Kaufmans and the donee trust stated that "nothing herein contained shall be construed to limit the [Trust's] right to give its consent (e.g., to changes in the Façade) or to abandon some or all of its rights hereunder," citing Commissioner

[7] We include the citation to Powell on Real Property in the quotation because Michael Allan Wolf is a colleague of Professor McMahon's, and the UF Dean rewards faculty members based, in part, on their citation count.

v. Simmons, 646 F.3d 6 (D.C. Cir. 2011), which reasoned that such clauses permitting consent and abandonment "'have no discrete effect upon the perpetuity of the easements: Any donee might fail to enforce a conservation easement, with or without a clause stating it may consent to a change or abandon its rights, and a tax-exempt organization would do so at its peril.'" (quoting 646 F.3d at 10).

- The court also rejected various scattershot IRS arguments that the substantiation rules had not been met.
- However, the Court of Appeals did not necessarily hand the taxpayers a final victory. It remanded the case to the Tax Court on the valuation issue.

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

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

c. Despite winning a skirmish in the First Circuit, the taxpayers ultimately lose the battle in the Tax Court—Will the taxpayers try to fight another battle in the First Circuit? Kaufman v. Commissioner, T.C. Memo. 2014-52 (3/31/14). On remand, after evaluating all of the evidence, including multiple appraisers' reports, Judge Halpern held that the facade easement had no fair market value. The deduction for the

contribution of the facade easement was disallowed. Because there was no record of sales of comparable easements, the before-and-after valuation method of Reg. § 170A-14(h)(3)(i) was applicable. He found that "the typical buyer would find the restrictions of the preservation agreement no more burdensome than the underlying South End Standards and Criteria [and] … the postcontribution value of the property was equal to its precontribution value … ." Negligence and substantial understatement accuracy related penalties were sustained. The mere fact that the taxpayers obtained an appraisal valuing the facade easement at $220,800 did not in and of itself constitute a reasonable basis for claiming that the facade easement was worth $220,800 when its value was in fact "nil." The taxpayers failed to show a reasonable basis for claiming the deduction.

d. Yes, the taxpayers appealed on the issue of penalties, and the First Circuit affirms. Kaufman v. Commissioner, 784 F.3d 56 (1st Cir. 4/24/15). On appeal to the First Circuit, the taxpayers did not challenge the Tax Court's disallowance of their charitable contribution deduction for the façade conservation easement on the basis that the easement had no value. They challenged only the Tax Court's imposition of the 40 percent gross valuation misstatement penalty. Specifically, they argued that the Tax Court had incorrectly concluded that they had failed to establish a reasonable cause, good faith defense to the penalty. (The tax years involved were 2003 and 2004; Congress eliminated the reasonable cause, good faith defense for gross valuation misstatements with respect to façade conservation easements for returns filed after 7/25/06.) In an opinion by Judge Lynch, the First Circuit affirmed. For the years involved, § 6664(c) provided that the penalty would not apply to any portion of an underpayment with respect to which there was a reasonable cause and the taxpayer acted in good faith, and that this defense was not available with respect to an understatement attributable to a substantial or gross valuation misstatement with respect to charitable contribution property unless (1) the claimed value of the property was based on a qualified appraisal by a qualified appraiser, and (2) "in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property." The Tax Court had found that, although the first prong of the test was met, the second was not. The First Circuit concluded that this finding was not clearly erroneous and that "it was clearly reasonable for the court to conclude that events after the Kaufmans' receipt of [the] appraisal would have put a reasonable person on notice that further investigation was required to verify the purported value of the donated easement." Specifically, at the request of the National Architectural Trust, the taxpayers had sent to their mortgage lender a form letter asking the lender to subordinate its interest to that of the Trust, and this letter stated that "'[t]he easement restrictions are essentially the same restrictions as those imposed by current local ordinances that govern this property.'" Further, after receiving

the appraisal, the taxpayers sent an e-mail message to the Trust expressing concern about the easement's reduction in their property's value and inquiring whether the Trust had relevant statistical data. A representative of the Trust responded with reassurances that, for properties in similar neighborhoods, properties subject to an easement "are not at a market value disadvantage compared to the other properties in the same neighborhood." The First Circuit concluded that there was no clear error in the Tax Court's reasoning that the taxpayers were required to "do some basic inquiry into the validity of an appraisal whose result was squarely contradicted by other available evidence glaringly in front of them." For the same reasons, the court also affirmed the Tax Court's alternative holding that the taxpayers had not acted with reasonable cause and in good faith.

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

failed to obtain[] a subordination agreement" and "upon being made aware of the need for a subordination agreement she promptly obtained one." She acted with reasonable cause and in good faith.

a. And the subsequent First Circuit decision in *Kaufman* doesn't change the result. Mitchell v. Commissioner, T.C. Memo. 2013-204 (8/29/13). In a supplemental memorandum opinion, the Tax Court (Judge Haines) denied the taxpayer's motion for reconsideration. The taxpayer argued that the Tax Court erred in relying on *Kaufman v. Commissioner*, 136 T.C. 294 (2011) (*Kaufman* II), which was affirmed in part, vacated in part, and remanded in part by the First Circuit in *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012) (*Kaufman* III), because *Kaufman* III was an intervening change in the law. In rejecting the taxpayer's argument Judge Haines concluded that *Kaufman* III addressed different issues from *Mitchell*. *Kaufman* III addressed the proper interpretation of the proceeds requirement in Reg. § 1.170A-14(g)(6), in particular, the breadth of the donee organization's entitlement to proceeds from the sale, exchange, or involuntary conversion of property following the judicial extinguishment of a perpetual conservation restriction burdening the property. But *Kaufman* III did not state a general rule that protecting the proceeds from an extinguishment of a conservation easement would satisfy the in-perpetuity requirements of Reg. § 1.170A-14(g), which was the basis on which *Mitchell* was decided.

b. The mortgage subordination provision is "a bright line requirement." "The remote future provision cannot be reasonably read as modifying the strict mortgage subordination requirement." Mitchell v. Commissioner, 775 F.3d 1243 (10th Cir. 1/6/15). In an opinion by Judge McHugh, the Tenth Circuit affirmed the Tax Court's decision. First, the court held that Reg. § 1.170A-14(g), requiring subordination of any mortgage as a condition of eligibility for a deduction, was valid. Second, it held that the taxpayer's arguments that she was entitled to the deduction because (1) Reg. § 1.170A-14(g) does not impose an explicit time-frame for compliance, and (2) despite the failure to subordinate the mortgage at the time of conveyance, the deed contained sufficient safeguards to protect the conservation purpose in perpetuity, both were contrary to the "plain language" of Reg. § 1.170A-14(g). Finally, the court held that the IRS "is entitled to demand strict compliance with the mortgage subordination provision, irrespective of the likelihood of foreclosure." The court rejected the taxpayer's argument that Reg. § 1.170A-14(g)(3), which provides that a deduction will not be disallowed "merely" because the interest that passes to the donee organization may be defeated by the happening of some future event "if on the date of the gift it appears that the possibility that such . . . event will occur is so remote as to be negligible," acts as an exception to the mortgage

subordination provision. Finally, citing *Chase Bank USA, N.A. v. McCoy*, 562 U.S. 195, ___, 131 S. Ct. 871, 880-81 (2011), the court reasoned as follows.

> [E]ven if the regulations were unclear with respect to the interplay between these provisions, Ms. Mitchell would not prevail. We are required to defer to the Commissioner's interpretation to resolve any ambiguity on this point unless it is "plainly erroneous or inconsistent with the regulations" or there is any other "reason to suspect the interpretation does not reflect the agency's fair and considered judgment on the matter." ... [R]ather than being plainly erroneous or inconsistent with the regulations, the Commissioner's interpretation—that the mortgage subordination is unmodified by the remote future event provision—is consistent with the regulation's plain meaning.

3. The Tax Court sticks by its guns on the mortgaged property conservation easement issue. Minnick v. Commissioner, T.C. Memo. 2012-345 (12/17/12). Once again, the Tax Court (Judge Morrison) held that pursuant to Reg. § 1.170A-14(g)(2), no charitable contribution deduction is allowable for the donation of a conservation easement where a mortgage encumbering the property has not been subordinated to the interest of the donee of the easement. The court emphasized its holding in Mitchell v Commissioner, 138 T.C. 324 (4/3/12), that the unlikelihood of default is irrelevant.

a. And the Ninth Circuit further agrees *sub silentio* that the First Circuit is an outlier on this issue. Minnick v. Commissioner, 796 F.3d 1156 (9th Cir. 8/12/15). The Ninth Circuit, in a per curiam opinion, followed the lead of all of the other courts (but citing only *Mitchell v. Commissioner*, 775 F.3d 1243 (10th Cir. 2015), *aff'g* T.C. Memo. 2013-204, *vacating and denying reconsideration of* 138 T.C. 324 (2012)) that have addressed the issue (except the First Circuit in *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012)) and held that Reg. § 1.170A-14(g)(2) requires that, for a taxpayer to take a deduction for the donation of a conservation easement, any mortgage on the property must be subordinated to the easement at the time of the donation.

4. What part of "perpetuity" don't you understand?! Belk v. Commissioner, 140 T.C. 1 (1/28/13). The taxpayers claimed a charitable contribution deduction for the grant of a conservation easement on 184.627 acres of a golf course to a qualified organization. Specifically, they agreed not to develop the golf course. However, the conservation easement agreement permitted the taxpayers, with the donee's consent, to remove

portions of the golf course from the easement and replace them with property not theretofore subject to the conservation easement. The IRS disallowed the deduction, and the Tax Court (Judge Vasquez) upheld the IRS's disallowance of the deduction. Section 170(h)(1)(A) requires the contribution of a "qualified" real property interest, and to be a "qualified" real property interest, § 170(h)(2)(C) requires that the conservation easement limit in perpetuity the use that may be made of the property. Section 170(h)(2)(C) precluded the deduction because the taxpayers did not donate an interest in real property subject to a use restriction granted in perpetuity. Because the conservation easement agreement allowed the parties to change the property subject to the conservation easement, it did not meet the perpetuity requirement. The court rejected the taxpayers' argument the deduction nevertheless should be allowed because the substitution clause permitted only substitutions that would not harm the conservation purposes of the conservation easement. The court reasoned that the § 170(h)(5) requirement that the conservation purpose be protected in perpetuity is separate and distinct from the § 170(h)(2)(C) requirement that there be real property subject to a use restriction in perpetuity, and the taxpayers' conveyance failed to satisfy § 170(h)(2)(C). Satisfying § 170(h)(5) does not necessarily affect whether there is a qualified real property interest. Furthermore, it was argued that any substitution required the donee's consent: "There is nothing in the Code, the regulations, or the legislative history to suggest that section 170(h)(2)(C) is to be read to require that the interest in property donated be a restriction on the use of the real property granted in perpetuity unless the parties agree otherwise. The requirements of section 170(h) apply even if taxpayers and qualified organizations wish to agree otherwise."

a. Reconsideration denied. Belk v. Commissioner, T.C. Memo. 2013-154 (6/19/13). Judge Vasquez denied the taxpayer's motion for reconsideration. First, the taxpayer argued that the original opinion misinterpreted § 170(h)(2)(C), arguing that the Code and regulations do "not require the donation of an interest in 'an identifiable, unchanging, static piece of real property.'" The taxpayer argued that as long as it "agree[d] not to develop 184.627 acres of land, the Court (and the Internal Revenue Service (IRS)) should not be concerned with what land actually comprises those 184.627 acres." Judge Vasquez reiterated that the court had "rejected the notion of such 'floating easements' ... and found that section 170(h)(2)(C) requires that taxpayers donate an interest in an identifiable, specific piece of real property." Not being bound by any rule that arguments had to be consistent, the taxpayer's second argument was that because the taxpayer had intended to obtain a deduction for granting the conservation easement the court had misinterpreted the conveyance and applicable state law as permitting a substitution. This argument also fell on deaf ears: "Our interpretation of the parties' intention is governed by what the parties actually

included in the conservation easement agreement. It is well settled that a taxpayer's expectations and hopes as to the tax treatment of his conduct in themselves are not determinative." Finally, the taxpayer argued that the original opinion "fail[ed] to consider that an element of trust and confidence is placed in a qualified organization that it will continue to carry out its mission to protect and conserve property." Judge Vasquez responded, "Because the parties have agreed petitioners are able to substitute land, there is no restriction on the golf course in perpetuity that we can trust SMNLT to enforce."

b. The "plain language of the Code" sinks the taxpayers' deduction, and a "savings clause" isn't a life preserver. Belk v. Commissioner, 774 F.3d 221 (4th Cir. 12/16/14). In an opinion by Judge Motz, the Fourth Circuit affirmed the Tax Court's disallowance of the deduction. The court held that the plain language of § 170(h)(2)(C), which "provides that a 'qualified property interest' includes 'a restriction (granted in perpetuity) on the use which may be made of *the real property*' (emphasis supplied by the court), "makes clear that a perpetual use restriction must attach to a defined parcel of real property rather than simply *some* or *any* (or interchangeable parcels of) real property." (Emphasis supplied by the court.) Because the taxpayers had the right to remove land from that defined parcel and substitute other land, the easement failed to qualify because the real property was not subject to a use restriction in perpetuity. Furthermore, allowing a deduction in these circumstances, where the borders of an easement could shift, would enable the taxpayers to bypass the requirement of Reg. § 1.170A-14(g)(5)(i) that the donor of a conservation easement make available to the donee "documentation sufficient to establish the condition of the property." Finally, the court rejected the taxpayers' argument that the deduction was preserved by a savings clause in the deed that the donee "shall have no right or power to agree to any amendments . . . that would result in this Conservation Easement failing to qualify . . . as a qualified conservation contribution under Section 170(h) of the Internal Revenue Code and applicable regulations." Relying on *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), the court held the savings clause to be ineffective: "If every taxpayer could rely on a savings clause to void, after the fact, a disqualifying deduction (or credit), enforcement of the Internal Revenue Code would grind to a halt." Thus, the court declined to use the savings clause to rewrite the easement in response to its holding.

5. There's no deduction for income that an estate expects to give to charity if the expectation is unreal. Estate of Belmont v. Commissioner, 144 T.C. 84 (2/19/15). The decedent's will directed that the residue of her estate, which included income in respect of a decedent, be left to charity. The estate claimed an income tax charitable contribution deduction pursuant to § 642(c)(2), which provides that a deduction will be allowed for any part of the gross income of an estate that pursuant to the terms of the will

is permanently set aside during the taxable year for a purpose specified in § 170(c). At the time of her death, the decedent owned a condominium in which her brother resided. During the protracted administration of the estate, the brother pursued legal actions asserting a life tenancy interest in the condominium, and he subsequently was awarded a life tenancy in the condominium. Because of the cost of litigation over the condominium, the decedent's estate no longer had sufficient funds to pay the amount previously deducted as a charitable contribution. Reg. § 1.642(c)-2(d) provides that no amount will be considered permanently set aside for charity under § 642(c)(2) "unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside ... will not be devoted to such purpose or use is so remote as to be negligible." The Tax Court (Judge Ruwe) held that the possibility that costs involved in a dispute over the condominium would cause the estate to invade the amount set aside for charity was not "so remote as to be negligible" as required under Reg. § 1.642(c)-2(d). Thus, the estate did not "permanently set aside" the charitable contribution amount as required under § 642(c)(2), and the deduction was disallowed.

6. First thing you say in the conservation deed has to be the last thing you say. Balsam Mountain Investments, LLC v. Commissioner, T.C. Memo 2015-43 (3/12/15). The taxpayer executed a perpetual conservation easement agreement with a qualified donee. Under the easement agreement, the taxpayer and "its successors or assigns" were restricted "in perpetuity" from developing or altering the land in the "Conservation Area," which was defined in the easement agreement as a specific 22-acre parcel of land, the exact boundaries of which were described in a plat attached to the easement agreement. The easement agreement reserved the right of the taxpayer to make boundary changes to the "Conservation Area." The IRS disallowed the taxpayer's claimed charitable contribution deduction, and the Tax Court (Judge Morrison) upheld the IRS's denial of the deduction. The easement was not a "qualified real property interest" described in § 170(h)(2)(C), because Belk v. Commissioner, 140 T.C. 1, supplemented by T.C. Memo. 2013-154, aff'd, 774 F.3d 221 (4th Cir. 2014), held that a conservation easement is not a "qualified real property interest" of the type described in § 170(h)(2)(C) if the easement agreement permits the grantor to change what property is subject to the easement. An interest in real property is a "qualified real property interest" of the type described in § 170(h)(2)(C) only if it is an interest in an identifiable, specific piece of real property. Because the easement granted by the taxpayer permitted it to change the boundaries of the "Conservation Area," the easement was not an interest in an identifiable, specific piece of real property.

7. Where there's quid pro quo, there's no charitable deduction. Costello v. Commissioner, T.C. Memo. 2015-87 (5/6/15). The Tax

Court (Judge Lauber) upheld the denial of a charitable contribution deduction for the conveyance of a conservation easement to a county government in exchange for the county granting the taxpayers permission to sell development rights with respect to the property. The taxpayers could not transfer the development rights until the density and plats were approved by the county and an easement was placed on the property to restrict future development. "Petitioners would not have conveyed the easement unless they received permission to sell their development rights; and they could not legally sell their development rights unless they executed the deed of easement. Petitioners' transaction thus bears the classic features of a quid pro quo exchange." Furthermore, the appraisal failed to inform the IRS of the essence of the transaction. Because it "did not provide an accurate description of the property contributed, did not specify the date of the contribution, and did not inform the IRS of the salient terms of the agreements ... it was not a 'qualified appraisal' within the meaning of [Reg. §] 1.170A-13(c)(3)(i) … ."

8. "[W]e do not need to decide in the instant case whether an operating golf course is inherently inconsistent with conservation purposes under section 170(h)." But we believe that the opinion comes pretty darn close to doing so. Atkinson v. Commissioner, T.C. Memo. 2015-236 (12/9/15). The principal issue in this case was whether the taxpayers were entitled to charitable contribution deductions for granting conservation easements on two operating golf courses, one granted in 2003 and the other granted in 2005. After thorough consideration of the terms and purposes of the easements, the physical characteristics of the golf courses and the surrounding land (mostly developed home sites), and the nature of the operation of the golf courses, the Tax Court (Judge Wells) held that the conservation easements did not comply with the "conservation purpose" requirement of § 170(h), and thus never reached the valuation issue. (Judge Wells noted that the case bore some similarity to Kiva Dunes Conservation, LLC v. Commissioner, T.C. Memo. 2009-145, but Kiva Dunes did not address the issue of compliance with the conservation purpose requirement of § 170(h) because the IRS had conceded that issue on brief, after trial.) The principal 2003 easement consisted of six noncontiguous tracts, ranging in size from 4.9 acres to 23.4 acres in a vaguely figure-eight shape. It was bordered by residential lots except for the center of the figure-eight, where the property directly abutted swamps and wetlands. The easement property consisted of approximately 15 acres of fairways, greens, teeing grounds, ranges, 27 acres of rough, 12.5 acres of ponds, 4 acres of wetlands, and 21 acres described as "other." A second conservation easement covered approximately 32.3 acres of swamps and wetlands abutting the center of the figure-eight-shaped easement. The stated purposes of the principal easement were "Preservation of the Conservation Area as a relatively natural habitat of fish, wildlife, or plants or similar ecosystem; and Preservation of the Conservation Area as open space

which, if preserved, will advance a clearly delineated Federal, State or local governmental conservation policy and will yield a significant public benefit." The taxpayers retained the right to operate a golf course, make alterations, and engage in certain construction activities. The golf course area could be altered "in such manner as Owner determines to be appropriate" as long as "the best environmental practices then prevailing in the golf industry" are used and applied. The golf course owner could cut and remove trees that are on the golf course or within 30 feet of the golf course if their removal is "appropriate for the proper maintenance of the golf course." Additionally, the golf course owner could cut trees to build a restroom, rain shelter, rest station, or food concession stand. The golf course was permitted to, and did, apply fungicides, herbicides, insecticides, and adjuvants on the tees, fairways, and rough. Judge Wells held that the terms of the easement and the nature of the operation of the golf course did not satisfy the "protecting natural habitat" purpose requirements of § 170(h)(4)(A)(ii), which Reg. § 1.170A-14(d)(3)(i) interprets to require that the donation "protect a significant relatively natural habitat in which a fish, wildlife, or plant community, or similar ecosystem, normally lives." A "habitat" is an "area or environment where an organism or ecological community normally lives or occurs" or the "place where a person or thing is most likely to be found." Glass v. Commissioner, 124 T.C. 258, 281-282 (2005). After considering expert witnesses' testimony and reports, including the fact that no consideration had been given to the effect of chemicals on the easement property by the easement holder, Judge Wells concluded that "wildlife and plants are not 'most likely' to be found or do not 'normally live' on the [golf course] easement property. The "use of pesticides and other chemicals could injure or destroy the ecosystem and therefore runs counter to the provisions of [Reg. § 1.170A-14(e)(2)]." Nor, considering the record, did the golf course easement "contribute" to any nearby "conservation area" by serving as a buffer or wildlife corridor: "There are no natural fruits and seeds for foraging or cover from humans or predators, and there are barriers to animal migration such as the surrounding homes, human activity, and nightly watering." The 2005 easement, on another golf course, suffered from the same problems. Judge Wells found, based on the testimony and experts' reports "very little wildlife" was to be found of the property, and that the fact that Venus Flytraps and Pitcher Plants grew on the parts of the property that were not mowed was not sufficient. Finally, neither easement qualified for the conservation purpose of preserving open space pursuant to § 170(h)(4)(A)(iii)(I) or (II). Under § 170(h)(4)(A)(iii)(I) the easement must be for the scenic enjoyment of the general public, and under § 170(h)(4)(A)(iii)(II) it must be pursuant to a clearly delineated Federal, State, or local government conservation policy. In either case the preservation of open space must also yield a significant public benefit. The general public was not permitted to access the golf course properties, which were open only to members, and there was no evidence that the general public had even visual

access, which can be sufficient, because the golf courses were within gated communities. And no clearly delineated Federal, State, or local government conservation policy had been identified and associated with the properties. In a partial victory, the taxpayers escaped § 6662 accuracy-related penalties.

9. Encouraging the elderly to give away their retirement savings—Does that make sense to you? The 2015 PATH Act, § 112, retroactively extended through 12/31/15 and made permanent § 408(d)(8)(F), which allows taxpayers who are age 70-1/2 or older to make tax-free distributions to a charity from an IRA of up to $100,000 per year. These distributions are not subject to the charitable contribution percentage limits.

10. Let's go green permanently; contributions of conservation easements. The 2015 PATH Act, § 111, reinstated for 2015 and made permanent the provisions of § 170 allowing a deduction for a qualified conservation contribution made by an individual or corporate farmer or rancher in tax years beginning after 12/31/05. Generally, under § 170(b), a corporation's charitable contribution deductions cannot exceed 10 percent of taxable income. An individual's deduction for qualified conservation easements cannot exceed 50 percent of the taxpayer's contribution base over other allowable charitable contribution deductions. The limits under § 170(b) for deduction of qualified conservation easements by a farmer or rancher are 100 percent of the taxpayer's contribution base (in the case of an individual) or taxable income (in the case of a corporation) over other allowable charitable contributions, with a fifteen year carryforward.

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. The IRS provides relief for 2014 from the penalties for late payment of tax and underpayment of estimated tax attributable to excess advance payments of the § 36B premium tax credit. Notice 2015-9, 2015-6 I.R.B. 590 (1/26/15). Beginning in 2014, individuals who meet certain eligibility requirements and purchase coverage under a qualified health plan through an Affordable Insurance Exchange are allowed a premium tax credit under § 36B. The exchange makes an advance determination of eligibility for the credit and, if approved, the credit is paid monthly to the health insurance issuer. An individual who receives advance credit payments is required by § 36B(f)(1) to reconcile the amount of the advance payments with the premium tax credit calculated on the individual's income tax return for the year. If the advance credit payments exceed the

premium tax credit allowed on the return, the excess is treated as additional tax and results in either a smaller refund or a larger balance due. The Notice provides that, for taxable year 2014, the IRS will abate the § 6651(a)(2) late-payment penalty and waive the § 6654 penalty for underpayment of estimated tax attributable to excess advance payments of the premium tax credit for taxpayers who: (1) are otherwise current with their filing and payment obligations, and (2) report the amount of excess advance credit payments on their 2014 tax return timely filed, including extensions. The Notice does not extend the time for filing the 2014 return. Specific procedures are set forth for requesting relief.

a. And the IRS follows up with relief for 2014 from the late-payment, estimated tax underpayment, and accuracy-related penalties for taxpayers who timely file a 2014 return and receive a delayed or incorrect Form 1095-A. Notice 2015-30, 2015-17 I.R.B. 928 (4/10/15). Individuals who purchase coverage under a qualified health plan through an Affordable Insurance Exchange receive from the exchange Form 1095-A. Form 1095-A contains information required to calculate for the individual's return the premium tax credit authorized by § 36B and reconcile with the credit the amount of any advance payments of the credit that were made to the insurance provider on the individual's behalf. In early 2015, the Centers for Medicare and Medicaid Services announced that there were issues with certain data used to populate the Form 1095-A that could result in incorrect information on and delays in Forms 1095-A. Some state exchanges also encountered issues in issuing Forms 1095-A. As a result, the Notice provides that, for taxable year 2014, the IRS will abate the §§ 6651(a)(2) and 6651(a)(3) late-payment penalties and waive the § 6654 penalty for underpayment of estimated tax for taxpayers who received a delayed Form 1095-A or a Form 1095-A that they believe to be incorrect if they timely file their 2014 return, including extensions. The IRS also will not impose the § 6662 accuracy-related penalty on any portion of an underpayment resulting from the receipt of an incorrect or delayed Form 1095-A. In addition, individuals who did not enroll in a qualified health plan and incorrectly claimed a premium tax credit for 2014 based on a Form 1095-A erroneously issued to them are eligible for this penalty relief only if they amend their 2014 return by 4/15/16 to reflect that they were not eligible to claim the premium tax credit and pay any additional tax liability due. The Notice provides procedures for claiming the penalty relief and makes clear that taxpayers still will owe interest on any underpayment.

2. Updated instructions on how to rat yourself out. Rev. Proc. 2015-16, 2015-7 I.R.B. 596 (2/12/15). This revenue procedure updates Rev. Proc. 2014-15, 2014-5 I.R.B. 456, and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to

an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and for the purpose of avoiding the tax return preparer penalty under § 6694(a), relating to understatements due to unreasonable positions. There have been no substantive changes. The revenue procedure does not apply with respect to any other penalty provisions, including § 6662(b)(1) accuracy-related penalties. If this revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275–R, as appropriate, attached to the return for the year or to a qualified amended return. A corporation's complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP, Uncertain Tax Position Statement, is treated as if the corporation had filed a Form 8275 or Form 8275-R regarding the tax position.

3. Sometimes 100 percent of zero is not zero. Cal Pure Pistachios, Inc. v. United States, 115 A.F.T.R.2d 2015-1531 (C.D. Cal. 4/10/15). The taxpayer, a subchapter C corporation, filed a return for its taxable year ended 8/31/08 reflecting a tax liability of zero. The taxpayer made no estimated tax payments for its taxable year ended 8/31/09 and, as a result, the IRS imposed a penalty of approximately $95,000, plus interest, for failure to pay estimated tax for 2009. The taxpayer argued that it was not required to make estimated tax payments for 2009 under § 6655(d)(1)(B), which defines the required annual payment of estimated tax as "the lesser of (i) 100 percent of the tax shown on the return for the taxable year (or, if no return is filed, 100 percent of the tax for such year), or (ii) 100 percent of the tax shown on the return of the corporation for the preceding taxable year." The provision adds that clause (ii) "shall not apply if the preceding taxable year was not a taxable year of 12 months, or the corporation did not file a return for such preceding taxable year showing a liability for tax." The taxpayer argued that, because its 2008 return showed a tax liability of zero, its required annual payment of estimated tax for 2009 was zero because that figure was 100 percent of the tax shown on its 2008 year return. The government responded that the taxpayer was ineligible to use the 100-percent-of-prior-year-liability safe harbor because the taxpayer "did not file a return for such preceding taxable year showing a liability for tax." The District Court (Judge Gee) ruled in favor of the government. A return that reflects a tax liability of zero, the court concluded, does not show a "liability for tax" within the meaning of § 6655(d)(1). In reaching this conclusion, the court relied in part on Congress's modification of the relevant rules for subchapter S corporations in § 6655(g)(4)(D), which specifically makes inapplicable the requirement that the return for the preceding taxable year show a liability for tax.

4. The judge must have granddaughters; he didn't want to send Beanie Babies to the slammer for criminal tax fraud even though the sentencing guidelines say, "If you do the crime, you do the time." United States v. Warner, 792 F.3d 847 (7th Cir. 7/10/15). The defendant was the billionaire creator of Beanie Babies. He evaded $5.6 million in U.S. taxes by hiding assets in a USB Swiss bank account. He pled guilty to one count of tax evasion, made full restitution, and paid a $53.6 million civil penalty. The Sentencing Guidelines provided a recommended 46- to 57-month term of imprisonment, but the district judge sentenced him to only two years' probation with community service, plus a $100,000 fine and costs. The government appealed, claiming that the sentence was unreasonable because it did not include a term of incarceration. The Seventh Circuit, in an opinion by Judge Kanne, affirmed.

> In a typical case, we might agree [with the government]. But this is not a typical case. The district judge found Warner's record of charity and benevolence "overwhelming." Indeed, the judge remarked that Warner's conduct was unprecedented when viewed through the judge's more-than-three decades on the bench. In the district court's opinion, this and other mitigating factors—including the uncharacteristic nature of Warner's crime, his attempt to disclose his account, his payment of a penalty ten times the size of the tax loss, and the government's own request for a sentence well below the guidelines range—justified leniency. District courts enjoy broad discretion to fashion an appropriate, individualized sentence in light of the factors in 18 U.S.C. § 3553(a). The court here did not abuse its discretion. Rather, it fully explained and supported its decision and reached an outcome that is reasonable under the unique circumstances of this case.

The court apparently also was moved by the fact that over thirteen years, Warner donated millions of plush toys valued at $70 million to the Children's Hunger Fund and enabled numerous charitable projects. The court also was impressed that "Warner concealed only a 'small fraction' of his total income and tried to come clean through the OVDP 'prior to him knowing his name had been submitted to the [IRS],'" and that he "had already been 'punished ... severely' by paying a penalty of over $53 million—possibly 'the largest fine in history' and 'more than he ever would have paid had he filed the returns and included all of the income,' though it was admittedly only 'a small percentage' of Warner's total wealth." Even worse, he "suffered the 'humiliation' of a 'highly publicized prosecution.'" We guess he was just a really generous rich old guy who merely cheated on his taxes—No biggie.

5. S corporations are corporations for purposes of determining the rate of interest on tax overpayments. Eaglehawk Carbon, Inc. v. United States, 122 Fed. Cl. 209 (7/16/15). Five coal-mining companies organized as subchapter S corporations brought this suit seeking additional interest on overpayments of certain coal sales excise taxes. The IRS refunded the taxes in question and paid interest at the statutory rate provided by § 6621(a)(1) for corporations (the federal short-term rate plus 2 percentage points, reduced to 0.5 percentage points to the extent the overpayments exceed $10,000). The plaintiff corporations asserted that they were entitled to interest at the higher statutory rate provided for individuals (the federal short-term rate plus 3 percentage points). According to the plaintiffs, they were entitled to additional interest of approximately $6 million. In a lengthy opinion, the Court of Federal Claims (Judge Bush) held that the statutory interest rate for corporate overpayments, including the interest rate reduction for overpayments exceeding $10,000, applies to S corporations as well as C corporations. In reaching this conclusion, the court considered the plain language of the relevant statute, § 6621(a)(1), the statute's legislative history, and administrative guidance such as the Internal Revenue Manual. The court found unpersuasive a partially contrary decision of the Tax Court, Garwood Irrigation Co. v Commissioner, 126 T.C. 233 (2006), in which the Tax Court (Judge Goeke) had concluded that, although the interest rate for corporate overpayments applies to S corporations as well as C corporations, S corporations are not subject to the interest rate reduction for overpayments exceeding $10,000.

6. Penalties for promoting a tax shelter are assessed differently. Gardner v. Commissioner, 145 T.C. No. 6 (8/26/15). The Tax Court (Judge Jacobs) held that § 6700 penalties for promoting abusive tax shelters are not assessed for discrete taxable years but rather for conduct and transactions that may occur over one or more taxable years. The form of notice of assessment of a § 6700 penalty requires only a statement of the amount of the penalty and a demand for payment. That requirement was met in this case.

7. Jurisdiction is not arithmetic—you can't divide $24.9 million by 193. Diversified Group, Inc. v. United States, 116 A.F.T.R.2d 2015-5842 (Fed. Cl. 8/26/15). The Court of Federal Claims (Judge Sweeny), in a case of first impression, held that it lacked jurisdiction in a suit seeking a refund of a partial payment of a § 6707 penalty assessed for failure to register a tax shelter as required § 6111. The plaintiff argued that the penalty was divisible, that it was not necessary to pay the full amount of the penalty prior to bringing suit but, only to pay the penalty with respect to one of the 193 individual transactions involving the tax shelter. The court rejected this argument, holding that the $24.9 million penalty for failure to register the tax shelter related to a single act.

> Although it is true that the IRS calculated the amount of the penalty based upon each client's aggregate investment in the tax shelter, neither the number of clients that participated in the tax shelter nor the number of commercial steps necessary to accomplish that participation in the tax shelter triggers liability under § 6707. Consequently, the penalty is not divisible for any reason, including the number of clients who participated in the tax shelter.

Thus, the full payment rule for seeking a refund established by *Flora v. United States*, 357 U.S. 63 (1958), had not been met because the penalty was not divisible and "'[e]xceptions to the full payment rule have been recognized by the courts only where an assessment covers divisible taxes.' *Rocovich v. United States*, 933 F.2d 991, 995 (Fed. Cir. 1991). A tax or penalty is divisible when 'it represents the aggregate of taxes due on multiple transactions.'"

8. ♪♫Oh! You better watch out, you better not cry; if your return is sent back you better ask why.♫♪ A joint return that is not signed by or on behalf of one spouse is not a valid return. Reifler v. Commissioner, T.C. Memo. 2015-199 (10/13/15). The accountant for the taxpayers, a married couple, prepared a joint return for the year 2000 and sent it to them for signature. Mr. Reifler signed it, placed it in their home in a bin where he usually placed items that required his wife's signature, but then mailed it to the IRS—several days before the extended due date—without his wife's signature. The taxpayers later received in the mail from the IRS the original return with a date-stamp and some red ink marks on it, but without any attached correspondence. Mr. Reifler testified that he was not alarmed by this because he requested copies of his tax returns from time to time for various business reasons. The taxpayers took no action until 2002, when they received a delinquency notice informing them that the IRS had not received their 2000 return. In response, the taxpayers signed and mailed to the IRS a second return, which they asserted was a copy of the original return, without any attached correspondence. The IRS treated this second return as their original return for 2000 with a filing date of 9/2/02. The Tax Court (Judge Laro) held that the return filed by the taxpayers without Mrs. Reifler's signature was not a valid return. Form 1040 itself and relevant regulations require the signatures of both spouses on a joint return. (The court noted that the exceptions under which one spouse can sign on behalf of the other pursuant to a power of attorney or because the other spouse is physically unable to sign did not apply.) In concluding that the return was not valid, the court rejected the taxpayers' reliance on the substantial compliance doctrine, which "stands for the idea that a tax return need not be perfect to be valid." The requirements for treating a document as a "return," the court reasoned, were clarified by the four-factor

test established in Beard v. Commissioner, 82 T.C. 766 (1984), aff'd per curiam, 793 F.2d 139 (6th Cir. 1986). One requirement of the Beard test is that the document must be executed by the taxpayer under penalties of perjury. Because Mrs. Reifler did not sign the original 2000 return, it did not meet this requirement. The court also rejected the taxpayers' reliance on the tacit consent doctrine, which is a doctrine commonly invoked to hold a spouse jointly liable for taxes on a joint return. In most cases involving the tacit consent doctrine, the court stated, "one spouse signs a joint return for both spouses and it is later shown that the other spouse has tacitly consented to the joint return filing." The taxpayers' situation was distinguishable because only one signature appeared on the joint return. The court upheld a late-filing penalty under § 6651(a)(1) and rejected the taxpayers' argument that the late filing was due to reasonable cause and not willful neglect. To establish reasonable cause, taxpayers must demonstrate that they exercised ordinary business care and prudence and nevertheless were unable to file by the due date. "[I]t is difficult, if not impossible, to conclude that Mr. Reifler, a sophisticated businessman, acted with ordinary business care and prudence when he failed to follow up with the IRS or his accountant . . . as to why the original 2000 return was sent back to him with some red ink marks on it."

9. Judge Holmes finds that taxpayer properly invoked the Fifth Amendment on his Form 1040. Youssefzadeh v. Commissioner, Order (Tax Court, 11/6/15), https://perma.cc/JW9T-PUF6. In this collection due process case, the Tax Court (Judge Holmes) rejected the imposition of a § 7602 frivolous-return penalty that was based upon the premise that the claiming of the Fifth Amendment as a reason for omitting information is a frivolous argument. The 2011 return was timely filed and most of the lines were filled out in a normal fashion, but on Schedule B (interest and dividends) the taxpayer refused to answer some questions and fill in some values. Judge Holmes found the return to be "substantially correct" in that the total amount of interest was included, while only the source of one payer was omitted. The taxpayer also had reasonable cause to refuse to answer question 7a on Form 1040 on whether he is required to file an FBAR because it is a crime to willfully fail to file an FBAR.

- Query why the IRS did not subpoena the taxpayer's bank records, production of which is mandatory pursuant to the required records doctrine.

10. A taxpayer who incorrectly claimed refundable credits avoids the accuracy-related penalty for substantial understatement of income because an understatement is not the same thing as a deficiency. Gassoway v. Commissioner, T.C. Memo. 2015-203 (10/15/15). The taxpayer claimed head of household filing status, claimed a

dependency exemption deduction for four children and, with respect to three children, claimed a child tax credit, an additional child tax credit, and the earned income tax credit. The Tax Court (Judge Chiechi) determined that the taxpayer was not entitled to head of household filing status and disallowed the claimed deduction and credits. Nevertheless, the court held that the taxpayer was not liable under for the 20 percent penalty imposed by § 6662(a) on an underpayment of tax to which § 6662 applies. According to § 6662(b)(2), the penalty applies to the portion of any underpayment which is attributable to, among other things, a substantial understatement of tax. The taxpayer's return apparently showed a tax liability of zero after the application of nonrefundable credits. In addition, the taxpayer claimed two refundable credits: an additional child tax credit of $3,691 and an earned income tax credit of $2,658. According to the IRS, the taxpayer was not entitled to any of the credits and the taxpayer's correct tax liability was $2,856. Thus, the IRS sought a deficiency of $9,205 (the sum of the refundable credits and the taxpayer's unpaid tax liability). The IRS asserted that the 20 percent accuracy-related penalty for substantial understatement of income applied to the $9,205 deficiency. (The court notes that the IRS subsequently conceded that it miscalculated the penalty and that the correct penalty was $577.20, which is 20 percent of only the unpaid tax liability of $2,856.) The court held that a deficiency is not the same thing as an "understatement" of tax. According to § 6662(d)(2)(A), "the term 'understatement' means the excess of—(i) the amount of the tax required to be shown on the return for the taxable year, over (ii) the amount of the tax imposed which is shown on the return …." The court concluded that the amount of tax required to be shown on the taxpayer's return was $2,856, and the amount of the tax imposed shown on the return was zero, which resulted in an understatement of $2,856. The refundable credits claimed by the taxpayer did not reduce the amount of tax shown on the return because the statutory definition of "understatement" does not provide for this adjustment. In contrast, the amount of the deficiency was properly $9,205 because § 6211(b)(4) directs that, in determining the amount of a deficiency, the amount by which certain credits (including those at issue here) exceed the amount of tax shown on the return must be treated as negative amounts of tax. The taxpayer's understatement was $2,856, which was not large enough to trigger the penalty for a substantial understatement of tax, which is defined for individuals in § 6662(d)(1)(A) as the greater of 10 percent of the tax required to be shown on the return ($2,856 in this case) or $5,000.

- The IRS could have sought to impose the accuracy-related penalty pursuant to § 6662(b)(1) for negligence or disregard of rules or regulations, but failed to raise this argument.

- Curiously, the court's opinion does not cite Rand v. Commissioner, 141 T.C. 376 (2013), a reviewed decision in which the court similarly held that the earned income credit, additional child tax credit, and recovery rebate credit claimed by the taxpayer did not reduce "the amount

shown as the tax by the taxpayer on his return" within the meaning of § 6664(a), which defines the term "underpayment." In reaching this conclusion, the court in Rand reasoned, as Judge Chiechi does in this case, that Congress provided for this result by specifically directing in the definition of "deficiency" in § 6211(b)(4) that the excess of these credits over the amount of tax shown on the return is treated as a negative amount of tax and by failing to provide this direction in the relevant statutory provision (the definition of "underpayment" considered by the court in Rand).

a. Congress legislatively overrules the Tax Court's interpretation of § 6664(a). The 2015 PATH Act, § 209 amends Code § 6664(a) by adding the following language: "A rule similar to the rule of section 6211(b)(4) shall apply for purposes of this subsection." The effect of this amendment is to legislatively overrule the Tax Court's decision in *Rand v. Commissioner*, 141 T.C. 376 (2013), in which the court held that refundable credits claimed by the taxpayer did not reduce "the amount shown as the tax by the taxpayer on his return" within the meaning of § 6664(a), and therefore no accuracy-related penalty or fraud penalty may be imposed to the extent refundable credits reduce the tax imposed below zero. This change is effective not only for returns filed after 12/18/15 (the date of enactment), but also for any previously filed returns for which the statute of limitations has not expired as of the date of enactment.

B. Discovery: Summonses and FOIA

1. An incredible opinion in which a NYC Magistrate Judge refused to quash a summons issued to E&Y related to a corporate acquisition and restructuring, finding that (1) the attorney-client and tax practitioner privileges had been waived, and (2) the work product doctrine did not apply because the E&Y Tax Memo would have been *drafted in exactly the same way* if litigation had not been anticipated. Schaeffler v. United States, 22 F. Supp. 3d 319 (S.D.N.Y. 5/28/14). The District Court for the Southern District of New York (Magistrate Judge Gorenstein) refused to quash a summons issued to Ernst & Young on attorney-client/tax practitioner privilege grounds because privilege was waived by sharing the document with a bank consortium that financed an acquisition, which consortium did not share a predominantly legal interest with Schaeffler but merely had a common economic interest.

- The work product claim was based on the so-called "EY Tax Memo," which was a 321 page document that was provided to the court for in camera review. It "expounds on the transactional steps that [E&Y] provided" and "contains numerous appendices that provide detailed analysis of the federal tax issues implicated by each step." Magistrate Judge

Gorenstein continued:

> This legal analysis makes reference to statutes, IRS regulations, IRS private letter rulings, other administrative materials, and case law. In many instances, the memorandum asserts that there is no law clearly on point and thus uses language such as "although not free from doubt," "the better view is that," "it may be argued," and "it is not inconceivable that the IRS could assert." Additionally, in explaining its recommendations for handling particular aspects of the restructuring and refinancing measures, the memorandum considers at great length the arguments and counter-arguments that could be made by Schaeffler and the IRS with regard to the appropriate tax treatment of these measures. While there is copious citation to relevant legal authority, the memorandum does not specifically refer to litigation — for example, by discussing what actions peculiar to the litigation process Schaeffler or the IRS might take or what settlement strategies might be considered. Rather, the memorandum contains detailed and thorough legal analysis as to the propriety of the planned measures and advocates what specific transactional steps should be taken.
>
> . . . We will also accept that Schaeffler believed that litigation was highly probable in light of the significant and difficult tax issues that were raised by the planned refinancing and restructuring. Accordingly, the Court is called upon to make the factual determination required by *Adlman* [*United States v. Adlman*, 134 F.3d 1194, 1196 (2d Cir. 1998)]: whether this memorandum and the related documents "would have been created in essentially similar form" had litigation not been anticipated. 134 F.3d at 1202. While we have described this as a factual determination, in reality it is a counterfactual determination because it requires the Court to imagine what "would have" happened in a world where Schaeffler did not anticipate litigation as to the restructuring and refinancing transactions but everything else was exactly the same — in other words, Schaeffler still found himself acquiring the unexpectedly large share of Conti stock and still needed to engage in a refinancing and restructuring arrangement that would comply with federal tax laws.
>
> . . . Accordingly, given our assumption that Schaeffler is a rational businessperson who routinely makes efforts to comply with the law, we find that, even had he not anticipated an audit or litigation with the IRS, he still would have had to obtain the type of legal assistance provided by Ernst & Young

> to carry out the refinancing and restructuring transactions in an appropriate manner.
>
> . . . As to whether Ernst & Young's advice would have been different in content or form had it known that no audit or litigation would ensue, petitioners have presented no facts suggesting that Ernst & Young would have acted any differently. To the contrary, as petitioners recognize, see Letter from M. Todd Welty, dated May 2, 2014 (Docket #52) ("Welty Letter"), **there exists legal authority demanding that tax practitioners not allow the possibility that a tax return will remain unaudited to affect the advice they give**. Treasury Department Circular 230 states:
>
>> In evaluating the significant Federal tax issues addressed in [a tax opinion], the practitioner must not take 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 resolved through settlement if raised.
>
> [Former] Circular 230, § 10.35(c)(3)(iii). Similarly, a Treasury regulation regarding tax shelters states that in reaching conclusions regarding whether a particular tax position would more likely than not be sustained on its merits,
>
>> the possibility that the position will not be challenged by the Internal Revenue Service (IRS) (for example, because the taxpayer's return may not be audited or because the issue may not be raised on audit) is not to be taken into account.
>
> 26 C.F.R. § 1.6694-2(b). In other words, when tax practitioners give advice to clients, they must ignore the actual possibility of an audit — and, by extension, litigation — in opining on the tax implications of a transaction. Thus, when providing legal advice on the tax treatment of the restructuring and refinancing transactions, the Ernst & Young advisors had a responsibility to consider in full the relevant legal issues regardless of whether they anticipated an audit and ensuing litigation with the IRS. (Emphasis added)

- Magistrate Judge Gorenstein concluded on the work product issue:

> Thus, we conclude that had Schaeffler's tax advisors been asked to opine on the legal implications of the transactions

> with the knowledge that an audit or litigation would not occur, they "would have" used the same methodology to render tax advice: that is, a close analysis of the relevant legal authorities to determine how various tax positions would be tested in the crucible of litigation.
>
> For these reasons, we find that the EY Tax Memo, as well as the related responsive documents, would have been produced in the same form irrespective of any concern about litigation. Accordingly, these documents are not protected from disclosure under the work product doctrine.

a. The District Court got it all wrong, says the Second Circuit. The taxpayer did not waive the attorney-client privilege and the EY Tax Memo is protected by the work product doctrine. Schaeffler v. United States, 806 F.3d 34 (2d Cir. 11/10/15). In an opinion by Judge Winter, the Second Circuit vacated the judgment of the District Court and concluded that the taxpayer had not waived the attorney-client privilege and that the EY Tax Memo is protected by the work product doctrine. The court remanded for a determination whether any of the remaining documents at issue are protected by the attorney-client privilege or the work product doctrine.

- The court rejected the District Court's reasoning that the taxpayer had waived the attorney-client privilege by sharing documents with a consortium of banks that had financed a tender offer and that subsequently refinanced a corporate restructuring. In the Second Circuit's view, the taxpayer and the banks had a common legal interest, which parties can share "even if they are not parties in ongoing litigation." The banks had financed the taxpayer's tender offer for a German corporation. Because the tender offer period expired two days after the 2008 announcement by Lehman Brothers of its bankruptcy and the resulting plunge in stock market prices, the taxpayer acquired far more shares than anticipated, the taxpayer's solvency was threatened, and the risk of default on the loan was heightened. The taxpayer, his associated entities (which the court refers to as the "Schaeffler Group") and the banks perceived an "urgent need" to refinance the original loan and engage in a corporate restructuring. This set of circumstances, the court reasoned, created a common legal interest. "The Group and the Consortium could avoid this mutual financial disaster by cooperating in securing a particular tax treatment of a refinancing and restructuring. Securing that treatment would likely involve a legal encounter with the IRS. Both appellants and the Consortium, therefore, had a strong common interest in the outcome of that legal encounter." The court observed that the bank consortium retained control over Mr. Schaeffler's legal decisions to settle, pay, or sue. By extending credit and subordinating its debt, the court reasoned, the consortium occupied a position analogous to that of an insurer, which courts have recognized as having a common legal interest with the insured in the outcome of

litigation.

- The Second Circuit also rejected the District Court's conclusion that the EY Tax Memo and related documents were not protected by the work product doctrine. Under its prior decision in United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998), the court held that the work product doctrine does not apply to documents prepared "in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation." Nevertheless, the court reasoned in this case, even documents intended to assist in business dealings are protected if they are prepared in anticipation of litigation. In this case, the EY Tax Memo "was specifically aimed at addressing the urgent circumstances arising from the need for a refinancing and restructuring and was necessarily geared to an anticipated audit and subsequent litigation, which was on this record highly likely." The court similarly rejected the District Court's reasoning that EY would have provided the same tax advice irrespective of litigation because it was required not to consider the likelihood of audit in rendering advice. The taxpayers "would not have sought the same level of detail if merely preparing an annual routine tax return with no particular prospect of litigation." The court concluded:

> Finally, we note that the district court's holding appears to imply that tax analyses and opinions created to assist in large, complex transactions with uncertain tax consequences can never have work-product protection from IRS subpoenas. This is contrary to *Adlman*, which explicitly embraces the dual-purpose doctrine that a document is eligible for work-product protection "if 'in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained because of the prospect of litigation ….'" (Quoting *Adlman*, 134 F.3d at 1202).

2. **In this case a not-for-profit corporation is treated the same as a for-profit corporation.** Maimonides Medical Center v. United States, 116 A.F.T.R.2d 2015-7091 (2d Cir. 12/18/2015). In an opinion by Judge Lynch, the Second Circuit held that the lower interest rate that under § 6621(a)(1) applies to a refund for an overpayment of taxes due to a corporation applies to not-for-profit corporations as well as to for-profit corporations.

C. Litigation Costs

1. **When the IRS cuts the taxpayer a break in settling a case, the taxpayer is not a "prevailing party."** Knudsen v. Commissioner,

T.C. Memo. 2013-87 (4/1/13). On 5/14/09, the IRS denied the taxpayer's request for § 6015(f) relief on the ground that she had failed to seek relief within the two year period required by Reg. § 1.6015-5(b)(1). The taxpayer sought review in the Tax Court and on 3/15/11 the IRS stipulated that the taxpayer qualified for complete relief under § 6015(f) for all subject years if the two-year deadline was invalid. On 7/25/11 "the IRS announced as a policy directive that the Department of the Treasury would expand the two-year deadline 'in the interest of tax administration and *** not reflective of any doubt concerning the authority of the Service to impose the two-year deadline' and that the two-year deadline would no longer be enforced in cases docketed in [the Tax Court]." See Chief Counsel Notice CC-2011-017 (July 25, 2011); Notice 2011-70, 2011-32 I.R.B. 135. In August 2011 the IRS conceded that the taxpayer was entitled to relief. Thereafter, the taxpayer sought attorney's fees under § 7430, but the Tax Court (Judge Thornton) denied the taxpayer's motion for attorney's fees because she was not a "prevailing party" as required by the statute. Section 7430 provides that a taxpayer qualifies as a prevailing party only if either (1) the taxpayer has made a "qualified offer" or (2) the IRS's position is not substantially justified, but the taxpayer relied on only the qualified offer rule. However, the qualified offer rule does not apply where the judgment is issued pursuant to a settlement. I.R.C. § 7430(c)(4)(E)(ii)(I), and the court held that the judgment in this case was based on a "settlement."

a. Oh, yes she sure is the prevailing party says the Ninth Circuit. Pay up IRS! Knudsen v. Commissioner, 793 F.3d 1030 (9th Cir. 7/15/15), *rev'g* T.C. Memo. 2013-87. The Ninth Circuit, in an opinion by District Judge Walter, reversed, holding that the IRS's concession that the taxpayer was entitled to full relief and owed no tax liability was not a settlement within the meaning of § 7430(c)(4)(E)(ii)(I).

> A settlement is a contract, and its enforceability is governed by familiar principles of contract law. ... The formation of a contract generally requires a bargain in which there is a manifestation of mutual assent to the exchange and a consideration. ... Here, there was no exchange, and it is undisputed that there were no negotiations regarding settlement. ... [O]nly after the case had been submitted to the Tax Court fully stipulated, did the IRS unilaterally concede the case. Even then, the parties never entered into a supplemental stipulation of settled issues, despite the fact that Knudsen had then succeeded on both the merits and the timeliness of her claim for equitable relief.

D. Statutory Notice of Deficiency

There were no significant developments regarding this topic during 2015.

E. Statute of Limitations

1. It turns out that levying on a child's alleged assets might not be like stealing candy from a baby: the limitations period on actions for wrongful levy is subject to equitable tolling. Volpicelli v. United States, 777 F.3d 1042 (9th Cir. 1/30/15). The plaintiff in this case brought an action for wrongful levy pursuant to § 7426(a)(1). Generally, § 6532(c)(1) requires that such actions be brought within nine months after the levy occurred. The levy in this case occurred when the plaintiff was ten years old. The IRS seized funds from the plaintiff's father and applied the funds towards the father's tax liability. The plaintiff asserted in this action that the funds belonged to him and that he was unaware of the levy until after he reached the age of 18. He argued that the nine-month limitations period of § 6532(c) should be equitably tolled until he reached the age of majority. The Ninth Circuit previously had held that the limitations period of § 6532(c) could be equitably tolled. Supermail Cargo, Inc. v. United States, 68 F.3d 1204 (9th Cir. 1995); Capital Tracing, Inc. v. United States, 63 F.3d 859 (9th Cir. 1995). In an opinion by Judge Watford, the court adhered to its earlier decisions. In doing so, the court rejected the government's arguments that subsequent decisions of the U.S. Supreme Court dictate that the limitations period of § 6532(c) is not subject to equitable tolling. The Ninth Circuit's earlier decisions in Supermail and Capital Tracing were based primarily on the analysis dictated by Irwin v. Department of Veterans' Affairs, 498 U.S. 89 (1990), in which the Supreme Court held that "the same rebuttable presumption of equitable tolling applicable to suits against private defendants should also apply to suits against the United States. Congress, of course, may provide otherwise if it wishes to do so." Among other arguments, the government asserted that the limitations period of § 6532(c) is jurisdictional and that, under Sebelius v. Auburn Regional Medical Center, 133 S. Ct. 817 (2013), the Irwin presumption of equitable tolling does not apply to a jurisdictional limitations period. The Ninth Circuit rejected this argument: "The Supreme Court's recent cases require a clear statement from Congress before a procedural rule will be treated as jurisdictional. … We find no such clear statement here." The court also rejected the government's argument that, even if the Irwin presumption of equitable tolling applies, the presumption is rebutted. The court distinguished United States v. Brockamp, 519 U.S. 347 (1997), in which the Supreme Court reversed the Ninth Circuit and concluded that the § 6511 limitations periods on filing claims for refund were not subject

to equitable tolling. The Ninth Circuit remanded to the District Court for a determination of whether equitable tolling was warranted.

- The Ninth Circuit's decision directly conflicts with that of the Third Circuit in Becton Dickinson and Co. v. Wolckenhauer, 215 F.3d 340 (3d Cir. 2000).

2. Dave Barry might have been describing this taxpayer when he wrote "I have made every effort short of doing research to ensure that the tax information presented in this column is accurate." Cooperation with the government and a lack of tax expertise lead to an expired limitations period on assessment. Jacoby v. Commissioner, T.C. Memo. 2015-67 (4/6/15). The IRS issued a notice of deficiency for the taxpayers' taxable years 1999 and 2000 in early 2012, long after the three-year period of limitations provided in § 6501(a) for assessment of tax had expired. The government argued that the joint returns filed by Mr. Jacoby and his wife for those years were false or fraudulent and had been filed with the intent to evade tax, and therefore under § 6501(c)(1) the tax could be assessed at any time. The deficiencies determined for the two years combined exceeded $1.2 million. The IRS also sought to impose civil fraud penalties under § 6663 totaling more than $900,000. Mr. Jacoby, a lawyer and licensed securities broker with an undergraduate accounting degree, marketed tax strategies to corporations and high net worth individuals. He did so first as an employee of Twenty-First Securities Corporation and later on his own through a wholly-owned subchapter S corporation. The tax strategies, which included midco transactions, were developed by others, including in-house counsel of Twenty-First Securities and of a corporation with which Mr. Jacoby worked through his S corporation, and accounting and law firms. Mr. Jacoby's role was to solicit clients and market the strategies. The asserted deficiencies arose from (1) a midco transaction in which Mr. Jacoby removed from his subchapter S corporation all assets other than accounts receivable for services, sold the shares, reported his gain as capital gain, and then resumed business through a newly formed subchapter S corporation, and (2) a foreign currency transaction in which he participated with a group of KPMG partners. The Tax Court (Judge Vasquez) held in favor of the taxpayer, concluding that the fraud exception of § 6501(c)(1) did not apply and that the limitations period on assessment of tax therefore had expired before the IRS issued its notice of deficiency. According to the court, to meet its burden of proving that the fraud exception applies (and also that civil fraud penalties apply), the government "must show by clear and convincing evidence that: (1) an underpayment exists, and (2) Mr. Jacoby intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes." The court concluded that the government had proved an underpayment but had failed to prove fraudulent intent. To prove fraudulent intent, the government argued that six of eleven "badges of fraud" customarily

considered by courts were present, including implausible or inconsistent explanations of behavior, concealment of income or assets, and failure to cooperate. Judge Vasquez concluded that none of the badges of fraud were present. Mr. Jacoby, the court stated, was a credible witness, had not concealed information, and had cooperated with both criminal and civil investigators. Regarding Mr. Jacoby's tax expertise, the court stated: "Respondent has not shown, by clear and convincing evidence, that Mr. Jacoby was anything more than a marketer who relied on tax specialists to devise and vet strategies."

3. "*Colony* construed a different statute that was superseded by § 6501(e)(1)(A)." Heckman v. Commissioner, 788 F.3d 845 (8th Cir. 6/10/15). The taxpayer omitted from gross income an amount that exceeded 25 percent of the gross income reported on the return. The omitted amount was an interest in an LLC distribution to his IRA by a disqualified ESOP. The IRS learned of the plan distribution through oral and written statements that the taxpayer provided during an unrelated audit within three years of the date he filed his return, but the IRS did not issue a notice of deficiency until more than three years (but fewer than six years) after the taxpayer filed his return. The IRS argued that the six-year statute of limitation in § 6501(e) applied, and the taxpayer argued that the deficiency notice was untimely. (It was undisputed that the amount properly was includable in income.) The taxpayer argued "that § 6501(e)(1)(A)'s six-year limitations period does not apply because the IRS gained actual knowledge of the distribution—during the unrelated audit—within three years of the date when he filed his 2003 tax return," and in Colony, Inc. v. Commissioner, 357 U.S. 28 (1958), the Supreme Court reasoned that "in enacting § 275(c) [the statutory predecessor of § 6501(e)] Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors." The Court of Appeals, in an opinion by Judge Colloton, held that the deficiency notice was timely. Section 6501(e)(1)(A)

> spells out precisely what amounts should be taken into account in determining the amount omitted from gross income. Subsection (ii) provides that an amount is excluded in determining "the amount omitted from gross income" only if the amount "is disclosed in the return, or in a statement attached to the return." § 6501(e)(1)(A)(ii). There is no provision that says an amount is excluded if the Commissioner is not "at a special disadvantage" in detecting the error, or if the Commissioner learns of the amount within the ordinary three-year limitations period.

- The court also rejected the taxpayer's argument that the distribution from the plan was "disclosed in the return," as contemplated by § 6501(e)(1)(A)(ii), because it was allegedly disclosed in the distributed LLC's tax filings. Neither the taxpayer's return nor any attached statement gave the IRS "a clue" that the LLC's filings were relevant to the taxpayer's tax liability.

4. Is there a split in the circuits regarding whether there is no statute of limitations when a return is fraudulent, even though the taxpayer didn't know it? BASR Partnership v. United States, 795 F.3d 1338 (Fed. Cir. 7/29/15), aff'g 113 Fed. Cl. 181 (10/29/13). The IRS issued an FPAA after the §§ 6501(a)/6229 period of limitation had expired. The government asserted that the extended period for assessment under § 6501(c)(1) for fraud applied by reason of the fraudulent intent of the taxpayer's advisors who designed a tax shelter transaction and one of whom prepared the return. The government relied on City Wide Transit, Inc. v. Commissioner, 709 F.3d 102 (2d Cir. 2013), and Allen v. Commissioner, 128 T.C. 37 (2007) in support of its argument. In City Wide Transit, the Second Circuit held that the fraudulent intent required to extend the statute of limitations under § 6501(c)(1) is not limited to the taxpayer. In that case the tax preparer's fraudulent intent triggered the extended period in § 6501(c)(1), even though the preparer's primary motive was his own benefit rather than the taxpayer's. The Tax Court reached the same conclusion in Allen, in which it stated: "Nothing in the plain meaning of the statute suggests the limitations period is extended only in the case of the taxpayer's fraud. The statute keys the extension to the fraudulent nature of the return, not to the identity of the perpetrator of the fraud." However, in the instant case, without reaching the question of whether the taxpayer's advisors harbored fraudulent intent, the Court of Federal Claims rejected that proposition and held that even though there was no question that "BASR's partnership return included false or fraudulent items," the extended statute of limitations did not apply. Judge Barden concluded that "the meaning of 'intent to evade tax,' as that text is used in I.R.C. § 6501(c), is limited to instances in which the taxpayer has the requisite intent to commit fraud." Referring to the Second Circuit's decision in City Wide Transit and the Tax Court's decision in Allen, she said, "These cases, however, are not binding upon this court." Because the government conceded that the taxpayers in this case did not have fraudulent intent, the § 6501(a) three-year period for assessment applied and the FPAA was time-barred. In an opinion by Judge Chen (with one concurrence and one dissent) the Federal Circuit affirmed. The government conceded that it could not show that either the partnership or any of its partners acted with the intent to evade tax. Judge Chen's opinion concludes that "[a]fter examining the overall statutory scheme of the Code, the case law, and § 6501(c)(1)'s historical roots, we conclude that § 6501(c)(1) suspends the three-year limitations period only

when the IRS establishes that the taxpayer acted with the intent to evade tax." The opinion reasoned that the Tax Court's opinion in Allen, which involved fraud by the taxpayer's return preparer, was inapposite: "the Tax Court's reasoning in Allen does not persuade us that § 6501(c)(1) necessarily encompasses situations where an attorney advising on financial transactions, but not involved with the preparation of the taxpayer's return, acts with intent to evade tax." On a similar basis it also rejected the IRS's assertion that the Second Circuit's decision in City Wide Transit should be applied, noting that in City Wide the taxpayer conceded on appeal the issues of whether it knew "'of the preparer's defalcations'" and "sign[ed] or knowingly allow[ed] to be filed a false return," and the Second Circuit noted in a footnote that it "'accept[ed] this concession without deciding whether certain factual situations might arise that sever the tax payer's liability from the tax preparer's wrongdoing.'"

- In a concurring opinion, Judge O'Malley agreed with the decision if § 6501 applied, but thought that § 6501 was not controlling where the allegedly fraudulent items flowed only from a partnership return. Judge O'Malley concluded that § 6229(c)(1) contains the rules that dictate when fraudulent items on a partnership return extend the time the IRS has to assess tax attributable to partnership items.
- Chief Judge Prost dissented, opening with two maxims: "'Statutes of limitation sought to be applied to bar rights of the Government, must receive a strict construction in favor of the Government.' E.I. Dupont de Nemours & Co. v. Davis, 264 U.S. 456, 462 (1924). As a corollary, 'limitations statutes barring the collection of taxes otherwise due and unpaid are strictly construed in favor of the Government.' Badaracco v. Comm'r, 464 U.S. 386, 392 (1984) (quoting Lucia v. United States, 474 F.2d 565, 570 (5th Cir. 1973))." Judge Prost summarized her reasoning concisely: "Congress says that § 6501(c)(1) applies 'in the case of a false or fraudulent return with the intent to evade tax." I.R.C. § 6501(c)(1). Nowhere does Congress limit § 6501(c)(1) to only those circumstances where the taxpayer has the intent to evade tax. In this case, it is undisputed that Mayer, the taxpayer's lawyer, acted with the intent to evade tax and caused the return to be fraudulent. Accordingly, I conclude that the BASR return is fraudulent 'with the intent to evade tax,' such that 'the tax may be assessed . . . at any time.'" Judge Prost included the following warning.

> Finally, this case matters. The majority removes a key tool from the IRS's toolbox for policing the submission of fraudulent tax returns. Nearly all taxpayers with significant sums at issue employ a tax preparer. Often, the IRS uncovers fraudulent returns by discovering the tax professionals who perpetrate fraud. It is not an easy matter to discover fraud, fully investigate it, and determine the proper tax liability within three years. *See id.* It is even more difficult to prove

> that a taxpayer knew of a tax professional's fraud and acted with intent to evade tax. Nonetheless, the majority ties the IRS's hands behind its back—without impossibly speedy sleuthing or smoking gun evidence, the IRS cannot collect taxes owed and the perpetrators make away scot free.

5. No mitigation for the taxpayer seeking a refund when the law, not the IRS's view of the law, changes. Illinois Lumber & Material Dealers Association Health Insurance Trust v. United States, 794 F.3d 907 (8th Cir. 7/23/15). The taxpayer held policies issued by a mutual insurance company and, when the insurance company converted to a stock company, received liquidating distributions that it reported on its returns for its 2004, 2006 and 2008 fiscal years. Pursuant to the IRS's position in Rev. Rul. 71-233, 1971-1 C.B. 113, the taxpayer determined that its interest in the mutual company had a zero basis. Accordingly, it included in gross income the full amount of the distributions and reported them as long-term capital gains. Subsequently, in an unrelated case, the Court of Federal Claims and the Court of Appeals for the Federal Circuit rejected the IRS's position in Rev. Rul. 71-233. Fisher v. United States, 82 Fed. Cl. 780 (2008), aff'd, 333 Fed. Appx. 572 (Fed. Cir. 2009). The taxpayer filed claims for refund, which the IRS granted for 2006 and 2008 but denied for 2004 on the basis that the limitations period on claims for refund barred the 2004 claim. The taxpayer brought this action seeking a refund for 2004 and asserted that the statutory mitigation provisions permitted it to recover for 2004 despite the expiration of the refund limitations period. In an opinion by Judge Loken, the Eighth Circuit held that the taxpayer could not assert mitigation under § 1312(7) because the IRS had not maintained inconsistent positions. Rather, the IRS had acquiesced in the Federal Circuit's rejection of its position in Rev. Rul. 71-233, granted the taxpayer's claims for refund for 2006 and 2008, and denied the claim for 2004 solely on the basis that the claim was time-barred. According to the court, the taxpayer was urging the court, contrary to congressional intent, "to interpret the mitigation provisions as allowing taxpayers to reopen closed tax years based upon a favorable change in, or reinterpretation of, the income tax laws."

6. Channeling Jon Stewart, Congress smells a "bullst" court opinion "designed to obscure and distract" and calls it out.** In United States v. Home Concrete and Supply, LLC, 132 S. Ct. 1836 (2012), the Supreme Court held that there is no extension of the three-year statute of limitations under § 6501(e)(1)(A) "when the taxpayer overstates his basis in the property that he has sold, thereby understating the gain that he received from its sale." In doing so, the Court invalidated Reg. §§ 301.6229(c)(2)-1 and 301.6501(e)-1, T.D. 9511, Definition of Omission From Gross Income, 75 F.R. 78897 (12/17/10), and Temp. Reg.

§§ 301.6229(c)(2)-1T and 301.6501(e)-1T, T.D. 9466, Definition of Omission from Gross Income, 74 F.R. 49321 (9/28/09), because the regulations attempted to reverse the Court's prior decision in Colony, Inc. v. Commissioner, 357 U.S. 28 (1958). The plurality opinion rested its conclusion on the precedential value of Colony, Inc., which construed identical operative language in the 1939 Code counterpart to current § 6501(e)(1)(A), and concluded that the statute's scope is limited "to situations in which specific receipts or accruals of income are left out of the computation of gross income," and did not extend to an understatement of gross income resulting from a basis overstatement. The Court's Home Concrete opinion rebutted the government argument that because the Colony opinion stated "it cannot be said that the language is unambiguous," there is room for a regulation that is a "permissible construction," stating: "We do not accept this argument. In our view, Colony has already interpreted the statute, and there is no longer any different construction that is consistent with Colony and available for adoption by the agency."

- The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2005(a), amended § 6501(e)(1)(B) specifically to provide that "An understatement of gross income by reason of an overstatement of unrecovered cost or other basis is an omission from gross income." I.R.C. § 6501(e)(1)(B)(ii), as amended. Former § 6501(e)(1)(B)(ii) was redesignated as § 6501(e)(1)(B)(iii), and was amended to read as follows: "In determining the amount omitted from gross income (other than in the case of an overstatement of unrecovered cost or other basis), there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item." This language should preclude any argument that "disclosing" a "claimed," but nevertheless overstated, basis appraised the IRS of anything.

- This amendment to § 6501(e)(1)(B) statutorily overrules the decision of the Supreme Court in United States v. Home Concrete and Supply, LLC. This provision is effective not only for returns filed after 7/31/15 (the date of enactment), but also for any previously filed returns for which the statute of limitations has not expired, without regard to the amendment. Thus, returns with an overstatement of basis for which the three-year statute of limitations has expired are immunized from the amendment.

7. Equity, schmequity! United v. Bates, 116 A.F.T.R.2d 2015-6864 (M.D. Fla. 11/23/15). The statute of limitations for filing a refund claim is not subject to non-statutory equitable tolling. Therefore, according to the court (Judge Honeywell), the IRS could recover a

refund that was erroneously paid to the taxpayer, whose refund request was untimely.

F. Liens and Collections

1. Another case in which the Tax Court says new issues can be raised in court that weren't raised in the CDP hearing. Lee v. Commissioner, 144 T.C. 40 (1/21/15). The IRS filed a tax lien against the taxpayer for § 6672 trust fund recovery penalties and sent a notice of intent to levy. The taxpayer requested a CDP hearing pursuant to §§ 6320 and 6330. The Appeals Officer sustained the lien and proposed levy. After the taxpayer petitioned the Tax Court for review, the IRS took the position that the taxpayer could not challenge the underlying tax liability because he had previously had an opportunity to do so in response to a Letter 1153. The IRS conceded that it had not mailed the Letter 1153 to the taxpayer's last known address and contended that it had personally served it on him. The taxpayer denied that the Letter 1153 had been served on him. The Tax Court (Judge Wells) denied the IRS's motion for summary judgment because the issue of whether the Letter 1153 was properly issued to the taxpayer by personal service remained a genuine dispute as to a material fact for trial. Furthermore, the issue of whether a Letter 1153 has been properly issued to a taxpayer by mailing or by personal service pursuant to §§ 6672 and 6212(b) is a requirement that the Tax Court will review pursuant to § 6330(c)(1) without regard to whether the taxpayer raised the issue at the CDP hearing.

2. A terrible tragedy for the taxpayer after the CDP hearing warrants a remand to the IRS. Gurule v. Commissioner, T.C. Memo. 2015-61 (3/31/15). In this review of a § 6220/6330 CDP proceeding in which the IRS rejected the taxpayer's proposed offer in compromise and installment payment plan and sustained a proposed collection by levy, the Tax Court (Judge Marvel) found that the record was inadequate to determine whether the IRS had abused its discretion and accordingly remanded the case to the IRS for further proceedings. "Although we do not substitute our judgment for that of the Appeals Office in calculating a taxpayer's ability to pay when the Appeals Office rejects an installment agreement, see, e.g., Boulware v. Commissioner, T.C. Memo. 2014-80, we can consider whether the Appeals Office's decision to reject an installment agreement was the result of a failure to properly consider the taxpayers' financial information in the record. Because the record does not permit us to do so, a remand is appropriate." Furthermore, a "remand may also be appropriate when a taxpayer has experienced a material change in circumstances between the time of the section 6330 hearing and the trial that affects the RCP [reasonable collection potential] calculation." The taxpayer's middle son died after the

notice of determination was issued. "This tragic event constitutes a material change of circumstances for petitioners, who had to take out a fifth section 401(k) plan account loan to pay his final expenses and who are still unable to pay for the placement of his ashes in a mausoleum. These additional costs could have affected petitioners' RCP and their ability to pay their tax liability. On remand the Appeals Office is directed to consider updated financial information that petitioners should provide to document any change in their ability to pay resulting from their middle son's death."

3. Railroad retirement benefits are properly included in determining ability to pay even though they are statutorily exempt from levy. Ligman v. Commissioner, T.C. Memo. 2015-79 (4/27/15). The taxpayer filed a timely request for a CDP hearing in response to a final notice of intent to levy to collect an unpaid income tax liability. The taxpayer did not dispute the underlying tax liability, but asserted that he was unable to pay the liability because he was disabled, financially distressed, and his only source of income was his railroad retirement benefits. Through his attorney, the taxpayer requested an installment agreement with a monthly payment of $25. The settlement officer calculated that the taxpayer was able to pay $765 per month. The large difference between the two figures arises from the treatment of the taxpayer's railroad retirement benefits, which the settlement officer included and the taxpayer excluded in determining the taxpayer's ability to pay. Such benefits generally are exempt from levy under § 6334(a)(6) but are subject to the continuous levy of § 6331(h), which allows the IRS to levy up to 15 percent of the benefits. The taxpayer petitioned the Tax Court in response to the IRS's issuance of a notice of determination. The court (Judge Kerrigan) found that, although the taxpayer's railroad retirement benefits are generally exempt from levy, "the settlement officer did not act arbitrarily, capriciously, or without sound basis in fact or law by including petitioner's Railroad benefits to analyze petitioner's financial condition and calculate his monthly disposable income." In reaching this conclusion, the court relied on provisions of the Internal Revenue Manual. Although the Internal Revenue Manual neither includes nor excludes railroad retirement benefits from the calculation of ability to pay, the court reasoned, it specifically includes analogous benefits, such as Social Security benefits that are subject to the same maximum 15 percent levy.

4. A relatively rare taxpayer victory in a Tax Court review of an adverse IRS CDP decision. Charnas v. Commissioner, T.C. Memo. 2015-153 (8/11/15). In this review of an IRS decision in a CDP hearing to proceed with collection, Judge Wells held that the IRS abused its discretion in refusing the taxpayer's request for a collection alternative and in sustaining the proposed collection action by refusing to consider the relevant issue, raised by taxpayer, of his fluctuating income.

5. And the court says the IRS's "boilerplate" assertion of frivolity wasn't very funny. Ryskamp v. Commissioner, 797 F.3d 1142 (D.C. Cir. 8/14/15). The taxpayer owed unpaid income taxes for several years and did not respond to the IRS's demand for payment. The taxpayer requested a § 6330 CDP hearing, but the IRS denied him a CDP hearing based on its unexplained determination that all the reasons he gave for requesting a hearing were frivolous and contended that its frivolousness determination was not subject to judicial review. (Section 6330(g) provides that if any "portion of a request for a hearing" is frivolous or reflects the taxpayer's desire to delay or impede the administration of the federal tax laws, the Appeals Office may treat such portion as if it were never submitted, and it "shall not be subject to any further administrative or judicial review.") The Tax Court held that it had jurisdiction to review whether the IRS correctly treated the taxpayer's arguments as frivolous, and the D.C. Court of Appeals, in a 2-1 opinion by Judge Pillard, affirmed the jurisdictional issue, as well as the Tax Court's holding that the IRS's "boilerplate letter" rejecting the taxpayer's arguments as frivolous, but "in which there was no statement . . . as to why [his] reasons for the request . . . were illegitimate," was inadequate.

> Our reading of the statutory language respects subsection (g)'s limitation on administrative and judicial review. As we read it, subsection (g) precludes the tax court from reaching the merits of a purportedly frivolous position. ... Instead, the tax court's review is limited to assessing whether the Service has adequately identified why it deems the taxpayer's request, or portions thereof, to be frivolous, and whether that frivolousness assessment is facially plausible. ... That limited review provides a safeguard against the risk that the Service may have misconstrued or inadvertently overlooked a non-frivolous, *i.e.* plausible or potentially meritorious, request. ... The letter merely included a bullet point list of all of the possible reasons the Service could find a request to be frivolous and did not correlate them with any aspects of Ryskamp's request. Such a list provides the taxpayer with little guidance as to how to proceed.

Nevertheless, after the Tax Court remanded, the Appeals Office had held a CDP hearing, and the Tax Court held that the IRS did not abuse its discretion in concluding in that CDP hearing that it could proceed with collection. That holding too was affirmed, so the taxpayer lost.

- But perhaps the IRS needs to rethink its form letters.

6. Shame on the IRS. How could the government have litigated this case and thought its position had anything to do with justice? Rothkamm v. Commissioner, 802 F.3d 699 (5th Cir. 9/21/15). The plaintiff and her husband filed separate tax returns. The husband incurred an unpaid tax liability, and the IRS levied the plaintiff's bank account to satisfy her husband's tax liability. The plaintiff asserted that the bank account was her separate property, and she sought a Taxpayer Assistance Order (TAO) through the Taxpayer Advocate Service (TAS) but obtained no relief. She then filed an administrative claim under § 6343(b) and, when that was denied, filed suit for wrongful levy under § 7426(a)(1). The IRS filed a motion to dismiss on the ground that the suit was untimely under the § 6532(c) nine-month statute of limitations (invoked by § 7426(i)) and had not been tolled under § 7811(d) by her TAO application. If the statute of limitations was tolled while her application for a TAO was pending before the TAS, her administrative claim under § 6343(b) would have been timely, and the statute of limitations for filing suit would have been suspended until after the instant suit was filed. The district court concluded that the plaintiff was not a "taxpayer" for purposes of the TAO statute, § 7811, and that, even if she was, § 7811(d) would not toll the running of the statute of limitations in this case. Accordingly, the district court dismissed for lack of subject matter jurisdiction. The Fifth Circuit, in an opinion (2-1) by Judge Davis, held that "as the person who paid a tax assessed against another person," she was a "taxpayer" (referring to the definition in § 7701(a)(14)) for purposes of § 7811 and that the nine-month statute of limitations was tolled under § 7811(d) by her TAO application. It rejected the government's assertion that the term "taxpayer" narrowly meant only the person against whom a tax was assessed. Accordingly, it reversed and remanded.

7. The last time the IRS tried using private debt collection agencies, both the IRS and the National Taxpayer Advocate concluded that the IRS is significantly more effective in collecting tax liabilities. Congress apparently is not persuaded. The Fixing America's Surface Transportation (FAST) Act, § 32102, Pub. L. No. 114-94, signed by the President on 12/4/15, amends Code § 6306 by adding new subsections (c) and (d) (and redesignating current subsections (d) through (g) as subsections (e)-(h)). The amendments require the IRS to enter into qualified tax collection contracts (as defined in current § 6306(b)) "for the collection of all outstanding inactive tax receivables." Subject to certain exceptions, an inactive tax receivable is defined as a receivable (1) for an assessed tax liability that the IRS has removed from the active inventory for lack of resources or inability to locate the taxpayer, (2) that has not been assigned to an IRS employee for collection when more than 1/3 of the limitations period on collection has expired, or (3) that has been assigned for collection but with respect to which more than 365 days have passed without interaction with the taxpayer or a

third party for purposes of collection. The amendment applies to tax receivables identified after the date of enactment.

G. Innocent Spouse

1. An innocent spouse seeking stand-alone relief can give it up. Davidson v. Commissioner, 144 T.C. 273 (4/2/15). The taxpayer filed a "stand alone" case under § 6015(e)(1) to review the IRS's final determination denying her relief from joint liability under § 6015. The taxpayer filed a motion to dismiss, requesting that she be permitted to voluntarily withdraw her petition, and the IRS did not object. The Tax Court (Judge Ruwe) held that the court had discretion to allow the taxpayer to withdraw the petition because the petition did not invoke the court's jurisdiction to redetermine a deficiency or otherwise implicate a provision such as § 7459(d) that requires the court to enter a decision upon the dismissal of a case, citing Wagner v. Commissioner, 118 T.C. 330 (2002), which granted a motion to dismiss by a taxpayer who had petitioned the Tax Court for review of federal tax lien (without prejudice to seek a determination in federal district court that a net operating loss (NOL) could be carried back to the year of tax liability). Accordingly, the petition was withdrawn and the case dismissed.

2. Updating the innocent spouse regulations to conform to 2006 statutory amendments. REG-134219-08, Relief From Joint and Several Liability, 80 F.R. 72649 (11/20/15). The Treasury and IRS have released proposed amendments to the regulations under §§ 66 (Prop. Reg. § 1.66-4) and 6015 (Prop. Regs. §§ 1.6015-1, -2, -3, -6, -7 and -8) that would significantly change the existing rules providing relief from joint and several liability and relief from the operation of state community property law. The proposed regulations conform the existing regulations to the 2006 amendments to § 6015(e) regarding equitable relief and incorporate the positions in Rev. Proc. 2013-34, 2013-43 I.R.B. 397. The changes include providing additional guidance on the judicial doctrine of res judicata and the § 6015(g)(2) exception to res judicata when a requesting spouse did not meaningfully participate in a prior court proceeding. The proposed regulations would add a list of acts to be considered in making the determination as to whether the requesting spouse meaningfully participated in a prior proceeding and provide examples of the operation of these rules. The proposed regulations also would (1) provide a definition of underpayment or unpaid tax for purposes of § 6015(f); (2) provide detailed rules regarding credits and refunds in innocent spouse cases; (3) expand the rule that penalties and interest are not separate items from which relief can be obtained to cases involving underpayments; (4) incorporate an administratively developed rule that attribution of an erroneous item follows the attribution of the underlying item

that caused the increase to adjusted gross income; (5) update the allocation rules under § 6015(c) and (d); and (6) revise the rules regarding prohibition on collection and suspension of the collection statute. The proposed regulations will be applicable on the date final regulations are published.

3. Venue for appellate review of Tax Court decisions in innocent spouse cases is determined by the taxpayer's legal residence. The 2015 PATH Act, § 423, amends Code § 7482(b) to clarify that Tax Court decisions rendered in cases involving petitions under sections §§ 6015, 6320, or 6330 follow the generally applicable rule for appellate review. For individual taxpayers, this rule provides that cases are appealable to the U.S. Court of Appeals for the circuit in which the petitioner's legal residence is located.

H. Miscellaneous

1. The Tax Court is an Article I court. Freytag v. Commissioner, 501 U.S. 868 (6/27/91). Justice Blackmun, speaking for the five-judge majority held that the assignment of complex tax shelter case by Tax Court chief judge to a special trial judge (a) is permitted under § 7443A(b)(4) where the actual decision is rendered by a Tax Court judge, and (b) does not violate the Appointments Clause (U.S. Const. Art. II, § 2, cl. 2) because the special trial judge is an "inferior Officer" and the Tax Court is a[n Article I] "Court of Law."

- Four concurring justices, in an opinion written by Justice Scalia, thought that the Tax Court was a "Department" and its chief judge was a "Head of Department," so the Tax Court exercised executive power. Justice Scalia wrote:

> When the Tax Court was statutorily denominated an "Article I Court" in 1969, its judges did not magically acquire the judicial power. They still lack life tenure; their salaries may still be diminished; they are still removable by the President for "inefficiency, neglect of duty, or malfeasance in office." 26 U. S. C. § 7443(f). . . . How anyone with these characteristics can exercise *judicial* power "independent . . . [of] the Executive Branch" is a complete mystery. It seems to me entirely obvious that the Tax Court, like the Internal Revenue Service, the FCC, and the NLRB, exercises executive power.

a. The presidential power to remove Tax Court judges for cause does not infringe on the constitutional separation

of powers with respect to adjudications of "pre-collection tax disputes." Kuretski v. Commissioner, 755 F.3d 929 (D.C. Cir. 6/20/14). In this collection due process case, the District of Columbia Circuit (Judge Srinivasan) held that the power in the U.S. President to remove Tax Court judges on grounds of "inefficiency, neglect of duty, or malfeasance in office" under § 7443(f) did not infringe on the constitutional separation of powers and result in Tax Court judges not being "free from alleged bias in favor of the Executive Branch." The taxpayers asked that § 7443(f) be struck down, the Tax Court's decision against them vacated, and the case remanded "for re-decision by a Tax Court judge free from the threat of presidential removal and hence free from alleged bias in favor of the Executive Branch." The D.C. Circuit held that it has been established that Congress can constitutionally assign to non-article III tribunals a category of cases involving "public rights" (including matters of taxation at the pre-collection stage); the Tax Court is an Article I court and, while its judges do exercise judicial power, they do not exercise the "'judicial power of the United States' under Article III." Even though *Freytag* [*v. Commissioner*, 501 U.S. 868 (1991)] held that the Tax Court is a "Court of Law," Judge Srinivasan held that "the judicial power of the United States is not limited to the judicial power defined under Article III." He further held that the Tax Court, as a legislative court, is nevertheless part of the Executive Branch of government. Judge Srinivasan concluded that the "Tax Court's status as a 'Court of Law'—and its exercise of 'judicial power'—for Appointments Clause purposes under *Freytag* casts no doubt on the constitutionality of the President's authority to remove Tax Court judges."

- Judge Srinivasan also rejected taxpayers' challenge to the 25 percent late-payment penalties under § 6651(a)(2) on the ground that they failed to submit to the service center where their return was filed "an affirmative showing of all facts alleged as a reasonable cause for [their] failure to . . . pay such tax on time in the form of a written statement containing a declaration that it is made under penalties of perjury," as required by Reg. § 301.6651-1(c)(1).

b. Congress speaks, but its meaning is far from clear. The 2015 PATH Act, § 441, amends Code § 7441 by adding the following sentence: "The Tax Court is not an agency of, and shall be independent of, the executive branch of the Government." What Congress intended to achieve with this language is not entirely clear. The Joint Committee's explanation of the provision discusses *Kuretski v. Commissioner*, 755 F.3d 929 (D.C. Cir. 6/20/14), and states simply: "To avoid confusion about the independence of the Tax Court as an Article I court, the provision clarifies that the Tax Court is not an agency of the Executive Branch."

2. The Tenth Circuit stirs the previously muddied water on whether a late-filed return is a "return" that will permit tax debt

to be discharged in bankruptcy proceedings. In re Mallo, 774 F.3d 1313 (10th Cir. 12/29/14), cert denied, 135 S. Ct. 2889 (6/29/15). In an opinion by Judge McHugh, the Tenth Circuit held, with respect to taxpayers in two consolidated appeals, that a late return filed after the IRS had assessed tax for the year in question was not a "return" within the meaning of 11 U.S.C. § 523(a) and, consequently, the taxpayers' federal tax liabilities were not dischargeable in bankruptcy. The facts in each appeal were substantially the same. The taxpayers failed to file returns for the years 2000 and 2001. The IRS issued notices of deficiency, which the taxpayers did not challenge, and assessed tax for those years. The taxpayers subsequently filed returns, based on which the IRS partially abated the tax liabilities. The taxpayers then received general discharge orders in chapter 7 bankruptcy proceedings and filed adversary proceedings against the IRS seeking a determination that their income tax liabilities for 2000 and 2001 had been discharged. Section 523(a)(1) of the Bankruptcy Code excludes from discharge any debt for a tax or customs duty:

> (B) with respect to which a return, or equivalent report or notice, if required—
>
> > (i) was not filed or given; or
> > (ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of filing of the petition;

An unnumbered paragraph at the end of Bankruptcy Code § 523(a), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, provides that, for purposes of § 523(a):

> the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared under section 6020(a) of the Internal Revenue Code … but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code ….

The court examined a line of conflicting cases in which the courts had applied a four-factor test, commonly known as the *Beard* test (*Beard v. Commissioner*, 793 F.2d 139 (6th Cir. 1986)), to determine whether a late-filed return constitutes a "return" for purposes of 11 U.S.C. § 523(a) and concluded that it did not need to resolve that issue. Instead, the court concluded that, unless it is prepared by the IRS with the assistance of the taxpayer under § 6020(a), a late return is not a "return" because it does not satisfy "the requirements of

applicable nonbankruptcy law (including applicable filing requirements)" within the meaning of the language added to the statute in 2005.

- In reaching its conclusion, the Tenth Circuit agreed with the analysis of the Fifth Circuit in In re McCoy, 666 F.3d 924 (5th Cir. 2012), in which the Fifth Circuit concluded that a late-filed Mississippi state tax return was not a "return" within the meaning of 11 U.S.C. § 523(a).
- The Tenth Circuit's interpretation of 11 U.S.C. § 523(a) is contrary to the IRS's interpretation, which the IRS made clear to the court during the appeal. The IRS's interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10), is that "section 523(a) does not provide that every tax for which a return was filed late is nondischargeable." However, according to the Chief Counsel Notice, a debt for tax assessed before the late return is filed (as in the situations before the Tenth Circuit in In re Mallo) "is not dischargeable because a debt assessed prior to the filing of a Form 1040 is a debt for which is return was not 'filed' within the meaning of section 523(a)(1)(B)(i)."

a. The First Circuit aligns itself with the Fifth and Tenth Circuits and applies the same analysis to a late-filed Massachusetts state income tax return. In re Fahey, 779 F.3d 1 (1st Cir. 2/18/15). In an opinion by Judge Kayatta, the First Circuit aligned itself with the Fifth and Tenth Circuits and concluded that a late-filed Massachusetts state income tax return was not a "return" within the meaning of 11 U.S.C. § 523(a). In a lengthy dissenting opinion, Judge Thompson argued that the majority's conclusion was inconsistent with both the language of and policy underlying the statute: "The majority, ignoring blatant textual ambiguities and judicial precedent, instead opts to create a per se restriction that is contrary to the goal of our bankruptcy system to provide, as the former President put it in 2005, 'fairness and compassion' to 'those who need it most.'"

b. A Bankruptcy Appellate Panel in the Ninth Circuit disagrees with the First, Fifth, and Tenth Circuits. The Ninth Circuit now might have an opportunity to weigh in. In re Martin, 542 B.R. 479 (B.A.P. 9th Cir. 12/17/15). In an opinion by Judge Kurtz, a Bankruptcy Appellate Panel in the Ninth Circuit disagreed with what it called the "literal construction" by the First, Fifth and Ninth Circuits of the definition of the term "return" in Bankruptcy Code § 523(a). The court emphasized that the meaning of the language in the unnumbered paragraph at the end of Bankruptcy Code § 523(a), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which provides that "the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements)," must be determined by taking into account the context of the surrounding words and also the context of the larger statutory scheme. Taking this context into account, the court reasoned, leads to the conclusion that the statutory language does not dictate that a late-filed

return automatically renders the taxpayer's income tax liability non-dischargeable. "Why Congress would want to treat a taxpayer who files a tax return a month or a week or even a day late—possibly for reasons beyond his or her control—so much more harshly than a taxpayer who never files a tax return on his or her own behalf [and instead relies on the IRS to prepare it pursuant to § 6020(a)] is a mystery that literal construction adherents never adequately explain." The court also rejected the IRS's interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10) that, although not every tax for which a return is filed late is nondischargeable, a debt for tax assessed before the late return is filed (as in the situation before the court) is not dischargeable because the tax debt is established by the assessment and therefore arises before the return was filed. Instead, the court concluded that binding Ninth Circuit authority predating the 2005 amendments to Bankruptcy Code § 523(a) requires applying the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) to determine whether a late-filed return constitutes a "return" for purposes of 11 U.S.C. § 523(a). The court concluded that the Bankruptcy Court, which had held that the taxpayers' late-filed returns were "returns" within the meaning of the statute, had relied on a version of the *Beard* test that did not reflect the correct legal standard. Accordingly, the court remanded to the Bankruptcy Court for further consideration.

3. ♪♫"Nobody knows you when you're down and out."♫♪ Victims of identity theft cannot obtain copies of the fraudulent returns filed in their names under the Crime Victims' Rights Act when the government has not brought charges for the crime. Stegman v. United States, 115 A.F.T.R.2d 2015-871 (D. Kan. 2/19/15). Kathleen Stegman brought this action under the federal Crime Victims' Rights Act seeking copies of income tax returns filed in her name and certain other information, including the names of any known individuals involved in her identity theft. She asserted that an IRS Special Agent and an Assistant United States Attorney had notified her that she "was a victim of stolen identity tax refund fraud for tax years 2012 and 2013." By refusing to provide the requested information, she argued, the government had violated three rights enumerated in the Crime Victims' Rights Act: (1) "her 'right to be reasonably protected from the accused,'" (2) "the 'right to proceedings free from unreasonable delay,'" and (3) "the 'right to be treated with fairness and dignity.'" The court (Judge Lungstrum) held that she failed to state a claim with respect to the first two rights because the government still was investigating the identity theft and therefore there was no "accused" and there were no "proceedings." Even assuming the third right attaches before charges are filed, the court held, "[t]he United States Attorney … does not have an obligation under the CVRA to confer with Ms. Stegman or to disclose anything in its investigative file to her." The court granted the government's motion to dismiss.

a. The IRS does the right thing: it will establish a procedure for victims of identity theft to obtain copies of fraudulent returns filed in their names. In response to an inquiry from U.S. Senator Kelly Ayotte of New Hampshire, IRS Commissioner John Koskinen stated, in a letter to Senator Ayotte dated 5/28/15, that the IRS has decided to change its policy and will establish a procedure "that will enable victims to receive, upon request, redacted copies of fraudulent returns filed in their name and SSN." In the letter, Commissioner Koskinen notes that § 6103 "does not pose any restrictions on us sharing a copy of the fraudulent return with the victim, so no legislative change is necessary for us to do so." 2015 TNT 105-28 (5/28/15).

b. The IRS follows through on its plan to establish a procedure for victims of identity theft to obtain copies of fraudulent returns filed in their names. The IRS updated its web site (http://perma.cc/Y5PA-62UG) on 11/3/15 to provide a procedure for victims of identity theft (or a person authorized to obtain the identity theft victim's tax information) to obtain a redacted copy of a fraudulent return that was filed and accepted by the IRS using the identity theft victim's name and Social Security Number. To obtain a copy of the return, the victim's name and SSN must be listed as either the primary or secondary taxpayer on the fraudulent return, i.e., a victim listed only as a dependent cannot obtain a copy of the return. There is no prescribed form for the request. Instead, the identity theft victim must submit a letter with specified information to an IRS address listed on the web site. Fraudulent returns can be requested for the current tax year and the previous six tax years.

4. Only certain private delivery services provide the benefit of the "timely mailed is timely filed" rule. Notice 2015-38, 2015-21 I.R.B. 984 (5/6/15). This notice (1) updates the list of designated private delivery services set forth in Notice 2004-83, 2004-2 C.B. 1030, for purposes of the "timely mailing treated as timely filing/paying" rule of § 7502, (2) provides rules for determining the postmark date for these services, and (3) provides a new address for submitting documents to IRS with respect to an application for designation as a designated private delivery service. These changes are effective 5/6/15.

5. The Tax Court rejects the IRS's first try at denying a whistleblower award to the guy who handed it $74 million from Wegelin & Company on a platter. Whistleblower 21276-13W v. Commissioner, 144 T.C. No. 15 (6/2/15). The Tax Court (Judge Jacobs) held that the fact that a whistleblower supplied information to other Federal agencies, including an IRS operating division, before submitting the

information to the Whistleblower Office on Form 211 did not, as a matter of law, render the whistleblower ineligible for an award under § 7623(b). At the time the whistleblower began cooperating with the IRS, FBI, and a United States Attorney's office to obtain an indictment of a foreign business for assisting U.S. taxpayers to evade taxes, the whistleblower was unaware of any whistleblower award program. "The Targeted Business was indicted, with a subsequent superseding indictment, for conspiring with U.S. taxpayers and others to hide more than $1.2 billion in secret accounts, and the income generated therefrom, from the IRS. The Targeted Business pleaded guilty, as [the whistleblower] predicted. As part of its guilty plea, the Targeted Business paid the United States approximately $74 million." (Although the opinion refers to the "Targeted Business," the facts recited in the opinion lead to the obvious conclusion that the "Targeted Business" was the Swiss bank Wegelin & Company.) The court rejected the IRS's argument that a whistleblower is ineligible for a § 7623(b) award if he or she provides the information to an operating division of the IRS before submitting the information, via a Form 211, to the Whistleblower Office. Because it rejected the claim as untimely, the Whistleblower Office did not conduct a review, investigation, or evaluation of the merits of petitioners' claims for award. The court ordered that "the parties should have an opportunity to resolve these cases on the basis of our holding herein [and are required] to file a status report in accordance with an order to be issued."

6. The Tax Court trashes the IRS's understanding of what's a legislative regulation and what's an interpretive regulation and thus requires tax lawyers to learn all the APA stuff that other administrative law lawyers have to know. Altera Corp. & Subs. v. Commissioner, 145 T.C. No. 3 (7/27/15). In a reviewed unanimous opinion by Judge Marvel, the Tax Court invalidated regulations under § 482 (Reg. § 1.482-7(d)(2)) requiring participants in qualified cost-sharing arrangements to include stock-based compensation costs in the cost pool in order to comply with the arm's length standard. The court found that the regulations, which overturned the Tax Court's decision in Xilinx Inc. v. Commissioner, 125 T.C. 37 (2005), aff'd, 598 F.3d 1191 (9th Cir. 2010), holding that, under the 1995 cost-sharing regulations, controlled entities entering into qualified cost-sharing agreements need not share stock-based compensation costs because parties operating at arm's length would not do so, were not the product of reasoned decision making as required by Administrative Procedure Act § 706(2)(A) and Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Automobile Insurance Co., 463 U.S. 29 (1983). According to Professor Kristin Hickman, "From top to bottom, the Altera opinion reads like a treatise on general administrative law requirements and

norms." The Tax Court's opinion has a number of potential implications, which Professor Hickman has summarized as follows.[8]

> Since the Supreme Court decided the *Mayo Foundation* case in 2011 [*Mayo Foundation for Medical Research v. United States*, 562 U.S. 44 (2011)], the government has done everything it can to limit the scope of the Supreme Court's 2011 *Mayo Foundation* decision. Even though the *Mayo Foundation* Court declined "to carve out an approach to administrative review good for tax law only" and otherwise signaled fealty to general administrative law norms in the tax context, the IRS and the Department of Justice have repeatedly pursued a narrow construction of *Mayo Foundation*, and the Tax Court has often been happy to play along. Not today.
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> First, notwithstanding the Supreme Court's conclusion in *Mayo Foundation* that general authority Treasury regulations issued under Section 7805(a) carry the force of law, in the Internal Revenue Manual and elsewhere, the IRS has continued to assert that most of its regulations are interpretative rules exempt from APA notice-and-comment procedural requirements. Applying the Ninth Circuit's version of the *American Mining Congress* [*Am. Mining Cong. v. Mine Safety & Health Admin.*, 995 F.2d 1106, 1109 (D.C. Cir. 1993)] standard for distinguishing between legislative regulations that require notice-and-comment rulemaking and interpretative regulations that do not [*Hemp Indus. Ass'n v. DEA*, 333 F.3d 1082, 1087 (9th Cir. 2003) (Generally, interpretive rules merely explain preexisting substantive law. Substantive (or legislative) rules by contrast, "create rights, impose obligations, or effect a change in existing law".)], the Tax Court held that the Treasury regulation at issue in *Altera* was a legislative rule because the regulation was necessary to sustain an adjustment to the taxpayer's income and because Treasury expressly invoked general rulemaking authority under Section 7805(a) in promulgating the regulation. In reaching that decision, moreover, the Tax Court also concluded more broadly that regulations promulgated pursuant to Section 7805(a) "carry the force of law" and that

[8] Kristin Hickman, The Tax Court Delivers An APA-Based Smackdown, http://perma.cc/PV9C-X2CE (7/28/15). We are indebted to Professor Hickman for granting us permission to crib from her; she understands this stuff a lot better than we do.

"the Code imposes penalties for failing to follow them," such that "'Congress has delegated legislative power to' Treasury" through that grant of general rulemaking authority—i.e., making regulations promulgated under that authority legislative rules subject to notice-and-comment rulemaking requirements. Elsewhere in the opinion, the Tax Court acknowledged that its past practice of referring "to regulations issued pursuant to specific grants of rulemaking authority as legislative regulations and regulations issued pursuant to Treasury's general rulemaking authority, under sec. 7805(a), as interpretive regulations" was inconsistent with general administrative law use of the legislative and interpretive labels.

Second, notwithstanding the Supreme Court's refusal in *Mayo Foundation* to approach judicial review in general (rather than merely *Chevron* [*Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984)] review) differently in tax cases, the IRS in *Altera* resisted the taxpayer's argument that the regulation in question had to satisfy the reasoned decision making requirements of APA § 706(2)(A) and *State Farm*. The IRS claimed that *Chevron*, rather than *State Farm*, provided the appropriate evaluative standard. The precise relationship between *Chevron* and *State Farm* standards is unclear, with some courts and scholars contending that they overlap considerably, and others maintaining they are conceptually distinct. Regardless, courts and scholars generally would agree that agency regulations must satisfy both *Chevron*'s demand that they be substantively reasonable and *State Farm*'s requirement that they be the product of reasoned decisionmaking. Consistent with some appellate court decisions and a bit of dicta from the Supreme Court in *Judulang v. Holder*, 132 S. Ct. 476, 483 n.7 (2011), the Tax Court collapsed the two standards, reasoning that "the final rule must satisfy *State Farm*'s reasoned decisionmaking standard" because, even if *Chevron* provided the appropriate evaluative standard, *State Farm's* analysis is part of *Chevron* step two. *State Farm* analysis is very case by case, requiring both specific allegations as to where the agency's contemporaneous justification of its decisions is lacking and careful examination of the administrative record to support those allegations. Consequently, *State Farm* analysis is at least somewhat dependent upon interested parties raising issues and endeavoring to engage the agency in the rulemaking process itself. Commentators did so here.

And examining the rulemaking record meticulously and at some length, the *Altera* court concluded that Treasury and the IRS simply failed to satisfy *State Farm's* reasoned decisionmaking requirements. In particular, the court noted that Treasury's assumptions in adopting the rule were unsupported by evidence regarding real-world practices; that commentators introduced "significant evidence" in the rulemaking process that contradicted Treasury's assumptions; and that Treasury failed to respond to much of that evidence.

Finally, the Tax Court rejected the government's claim that deficiencies in Treasury's reasoning represented harmless error for purposes of APA § 706. According to the court, it was not clear from the administrative record that Treasury would have adopted the same regulation had Treasury determined the inclusion of stock-based compensation costs in the cost pool to be inconsistent with the arm's length standard.

Altera represents a natural extension of the Supreme Court's reasoning in the *Mayo Foundation* case, reflecting the spirit of that decision's rejection of tax exceptionalism from general administrative law requirements, doctrines, and norms. Given the *Altera* court's reasoning, it is difficult to imagine the IRS being able to argue successfully ever again that any Treasury regulation—whether promulgated under specific or general authority—is exempt from APA notice-and-comment rulemaking requirements as an interpretative rule. The *Altera* court's analysis therefore removes a layer of uncertainty risk for attorneys seeking to challenge Treasury regulations on APA grounds. Separately, as Pat Smith has documented [Patrick J. Smith, *The APA's Arbitrary and Capricious Standard and IRS Regulations*, 136 Tax Notes 271 (July 16, 2012)], many IRS regulations lack the sort of extensive contemporaneous justification of IRS policy choices that *State Farm* requires, and thus are susceptible to taxpayer claims that they fail to satisfy *State Farm*'s reasoned decisionmaking standard. Taken comprehensively, the *Altera* litigation is an exemplar for attorneys seeking to challenge other Treasury regulations under APA § 706(2)(A) and *State Farm*.

Whether and to what extent the Tax Court will extend general administrative law doctrines beyond Treasury regulations to other IRS actions remains to be seen. For example, some Tax Court judges have been reluctant to extend *State Farm* analysis to deficiency notices and other

> IRS determinations respecting individual taxpayers, accepting IRS claims that *Mayo Foundation* applies only to Treasury and IRS rulemaking and not to IRS adjudications (even though *Judulang v. Holder* involved an agency adjudication).
>
> Regardless, the fact that the Tax Court unanimously backed such a thorough and unequivocal application of general administrative law principles in reviewing a Treasury regulation is truly remarkable. The Tax Court's decision in *Altera* should send a very powerful message to Treasury and the IRS that they need to be more attentive to administrative law requirements in promulgating tax regulations.

7. **FBARs will be due at the same time as 1040s.** The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(b)(11), directs the Treasury Department to amend the regulations for taxable years beginning after 12/31/15 to provide that FBARs are due by April 15 (instead of by June 30), with a maximum 6-month extension. The IRS may waive the penalty for a late first-time filer.

8. **A cornucopia of changes of due dates and extensions by regulation.** The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(b), directs the Treasury Department to amend the regulations for taxable years beginning after 12/31/15 to change the dues dates and extension rules for a number of miscellaneous returns.

9. **The Treasury Department and IRS take a step forward in fighting stolen identity tax returns.** T.D. 9730, Extension of Time To File Certain Information Returns, 80 F.R. 48433 (8/12/15). Reg. § 1.6081-8, allowing automatic extensions to file certain information returns, has been removed and replaced by Temp. Reg. § 1.6081-8T, which generally allows only one 30-day automatic extension for information returns on Forms W-2G, 1042-S, 1094-C, 1095-B, 1095-C, 1097 series, 1098 series, 1099 series, 3921, 3922, 5498 series, or 8027 if the filer or the person transmitting the information return for the filer (the transmitter) files an application in accordance with the regulations. One additional 30-day extension of time to file an information return may be allowed if the filer or transmitter submits a request for the additional extension of time to file before the expiration of the automatic 30-day extension. According to the preamble, the reason for this change is as follows:

> Identity thieves often electronically file their fraudulent refund claims early in the tax filing season, using fictitious

> wage and other information of legitimate taxpayers. Unscrupulous preparers also electronically file early in the tax filing season, over-claiming deductions and credits and underreporting income for unwitting, as well as complicit, taxpayers. In many cases, the IRS is unable to verify the wage and other information reported on tax returns filed before April 15th, in part because the IRS does not receive the information returns reporting this information until later in the filing season. ...
>
> Receipt of information returns earlier in the filing season will improve the IRS's ability to identify fraudulent refund claims and stop the refunds before they are paid.

a. Congress steps in and requires information returns reporting wages and nonemployee compensation to be filed by January 31. The 2015 PATH Act, § 201, amended Code § 6071(c) to require that Forms W-2 and W-3 and any returns or written statements required to report nonemployee compensation (such as Form 1099-MISC) be filed by January 31 of the year after the calendar year to which the returns relate. The effect of this change is to require these information returns to have the same due date as employee and payee statements and to eliminate the extended filing date for electronically filed returns under § 6071(b). This change is effective for returns and statements relating to calendar years beginning after 12/18/15, the date of enactment. Thus, the accelerated due date will apply to information returns filed in 2017 with respect to calendar year 2016.

10. The AIA strikes again. Florida Bankers Association v. U.S. Dept. of Treasury, 799 F.3d 1065 (D.C. Cir. 8/14/15). Reg. § 1.6049-8 requires information reporting with respect to interest and OID paid to nonresident aliens who are residents of a country with which the United States has in effect an income tax or other convention or bilateral agreement relating to the exchange of tax information. Section 6721(a) imposes a penalty for failure to comply with the reporting requirements. In a 2-1 decision, written by Judge Kavanaugh, the Court of Appeals for the District of Columbia Circuit held that a suit by two bankers associations challenging the reporting requirements in Reg. § 1.6049-8 was barred by the Anti-Injunction Act (I.R.C. § 7421(a)). The gist of the suit was to restrain the collection of the § 6721 penalty, and § 6671(a) provides that penalties in Chapter 68, Subchapter B, in which § 6721 is found, are treated as taxes. The court vacated the District Court decision upholding the regulation and instructed the lower court to dismiss the case. The court cited the following language in the Supreme Court's decision in National Federation of Independent Business v. Sebelius, 132 S. Ct. 2566 (2012): "'Penalties in subchapter 68B' are 'treated as taxes

under Title 26, which includes the Anti-Injunction Act.'" The majority rejected the plaintiff's argument that even if the penalty here was deemed a tax for purposes of the Anti-Injunction Act, the Act still did not apply because they did not seek to restrain the assessment or collection of the penalty, but were only seeking "relief from a regulatory mandate that exists separate and apart from the assessment or collection of taxes." "The Anti-Injunction Act cannot be sidestepped by such nifty wordplay. The Supreme Court has consistently ruled – and most recently indicated as well in NFIB – that plaintiffs cannot evade the Anti-Injunction Act by purporting to challenge only the regulatory aspect of a regulatory tax." The opinion noted that a bank can challenge the regulation by failing to comply with the reporting requirement, paying the penalty, and seeking a refund.

- Judge Henderson dissented and would have held that the suit was not barred by the AIA. She reasoned that the suit involved a challenge to a tax reporting requirement, albeit one with a penalty attached for noncompliance, and that the AIA does not bar challenges to tax reporting requirements.

11. Planning to travel overseas? You might need to cancel that vacation if you are seriously delinquent on your taxes. The Fixing America's Surface Transportation (FAST) Act, § 32101, Pub. L. No. 114-94, signed by the President on 12/4/15, adds new Code § 7345, which provides that having a "seriously delinquent tax debt" is grounds for denial, revocation, or limitation of a passport. A "seriously delinquent tax debt" is generally defined as an unpaid, legally enforceable federal tax liability of an individual that has been assessed and exceeds $50,000 (to be adjusted in future years for inflation) for which a notice of lien has been filed in public records pursuant to § 6323 or a notice of levy has been filed pursuant to § 6331. Debts that are being paid on a timely basis pursuant to an installment agreement or an offer in compromise are excluded from the category of seriously delinquent tax debts, as are debts with respect to which collection is suspended because a collection due process hearing or innocent spouse relief has been requested or is pending. The IRS will certify to the Secretary of the Treasury that an individual has a seriously delinquent tax debt, and Treasury will transmit the certifications to the Secretary of State for action. The IRS must contemporaneously notify the taxpayer of the certification. The taxpayer is permitted to challenge the certification as erroneous by bringing an action in a United States District Court or the Tax Court. The new provision is effective on the date of enactment, 12/4/15.

12. The Tax Court will now apply the Federal Rules of Evidence as interpreted by the federal court of appeals to which its decision is appealable. The 2015 PATH Act, § 425, amends Code § 7453 to eliminate the requirement that the Tax Court apply the Federal Rules of

Evidence applicable in trials without a jury in the United States District Court of the District of Columbia. Accordingly, pursuant to its decision in Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971), the Tax Court will apply the Federal Rules of Evidence as interpreted by the federal court of appeals to which its decision is appealable. This change applies to proceedings commenced after 12/18/15, the date of enactment, "and, to the extent that it is just and practicable, to all proceedings pending on such date."

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. Tax refunds in a bad economy set up another deference conflict among the circuits. In Re Quality Stores, Inc., 693 F.3d 605 (6th Cir. 9/7/12), cert. granted, 134 S. Ct. 49 (10/1/13). In November 2001 Quality Stores closed 63 stores and 9 distribution centers and terminated the employment of all employees in the course of Chapter 11 bankruptcy cases. Quality Stores adopted plans providing severance pay to terminated employees. The company reported the severance pay as wages for withholding and employment tax purposes then filed claims for refund of FICA and FUTA taxes claiming that the severance pay represented supplemental unemployment compensation benefits (SUBs) that are not wages for employment tax purposes. Disagreeing with the contrary holding by the Federal Circuit in CSX Corp. v. United States, 518 F.3d 1328 (Fed. Cir. 2008), the Sixth Circuit held that the SUBs were exempt from employment taxes. The court examined the language and legislative history of § 3402(o)(1), which provides that SUB payments "shall be treated as if it were a payment of wages" for withholding purposes, to conclude that by treating SUB payments as wages for withholding, Congress recognized that SUB payments were not otherwise subject to withholding because they did not constitute "wages." Then, under Rowan Cos. v. United States, 452 U.S. 247, 255 (1981), the court concluded that the term "wages" must carry the same meaning for withholding and employment tax purposes. Thus, if SUBs are not wages under the withholding provision (because they must be treated as wages by statutory directive), the SUBs are not wages for employment tax purposes. The court also rejected the IRS's position in Rev. Rul. 90-72, 1990-2 C.B. 211, that to be excluded from employment taxes SUBs must be part of a plan that is designed to supplement the receipt of state unemployment compensation. The court declined to follow the Federal Circuit's holding in CSX Corp., which adopted the eight part test of Rev. Rul. 90-72, stating that, "We decline to imbue the IRS revenue rulings and private letter rulings with greater significance than the congressional intent expressed in the applicable statutes and legislative histories." The court

also stated that it could not conclude that the opinion in Mayo Foundation for Medical Education & Research v. United States, 131 S. Ct. 704 (2011), eroded the holding of Rowan Cos. v. United States, which compelled the court to interpret the meaning of "wages" the same for withholding and employment tax purposes.

a. The U.S. Supreme Court says the Sixth Circuit got it wrong — the severance payments made by Quality Stores are wages for employment tax purposes. United States v. Quality Stores, Inc., 134 S. Ct. 1395 (3/25/14). In the U.S. Supreme Court, all members of the Court other than Justice Kagan (who took no part in the consideration or decision of the case) joined in an opinion by Justice Kennedy in which the Court reversed the Sixth Circuit and concluded that the severance payments made by Quality Stores are taxable wages for FICA purposes. The Court emphasized that the term "wages" is defined broadly for FICA purposes in § 3121(a) as "all remuneration for employment," and concluded that the severance payments paid by Quality Stores, which varied according to the employee's function and seniority, fit this broad definition. The Court reasoned that § 3121(a)(13)(A), which excludes from taxable wages severance payments made "because of . . . retirement for disability" would be unnecessary if severance payments did not fall within the FICA definition of wages. The Court rejected the Sixth Circuit's reasoning that § 3402(o)(1), which provides that any SUB payment "shall be treated *as if it were a payment of wages*" for income tax withholding purposes, implies that such payments are not wages for FICA purposes. The regulatory background of § 3402(o)(1), the Court reasoned, demonstrates that Congress enacted the provision to address a specific problem. In the 1950s and 1960s, the IRS, in a series of revenue rulings, had exempted certain SUBs from the definition of wages for both FICA and income tax withholding purposes. Because such payments were nevertheless includible in income, taxpayers receiving these benefits faced large tax bills. To alleviate this problem, Congress enacted § 3402(o)(1) to make all severance payments subject to income tax withholding, including both SUBs that the IRS had exempted from the definition of wages for FICA and income tax withholding purposes and severance payments that the IRS considered to be wages. Read against this background, the Court stated, § 3402(o)(1) cannot be interpreted as creating a negative implication that SUBs are not wages for FICA purposes.

- The Court expressly did not address the question whether the IRS's position, expressed in rulings such as Rev. Rul. 90-72, 1990-2 C.B. 211, that severance payments tied to the receipt of state unemployment benefits are exempt from both income tax withholding and FICA taxation, is consistent with the broad definition of wages under FICA.

b. Based on its victory in *Quality Stores*, the IRS disallows all pending claims for refund of employment taxes with respect to severance payments and reminds taxpayers that the limitations period is running on filing suits for refund. Announcement 2015-8, 2015-9 I.R.B. 698 (2/10/15). In the years leading to the Supreme Court's decision in *Quality Stores*, the IRS received claims for refund from more than 3,000 taxpayers with respect to FICA, FUTA, and RRTA taxes paid with respect to severance payments. The IRS suspended action on such claims from taxpayers within the Sixth Circuit, disallowed the claims of other taxpayers, and suspended action on requests from those other taxpayers to appeal the disallowances to the IRS Appeals Office. This Announcement states that the IRS "will disallow all claims for refund of FICA or RRTA taxes paid with respect to severance payments that do not satisfy the narrow exclusion contained in Revenue Ruling 90-72, [1990-2 C.B. 211,]" including those previously held in suspense, and that it will take no further action on the requests to appeal previously held in suspense. (A special procedure applies to appeals requested with respect to a refund claim that included an additional or different basis for the claim or concerned payments that satisfied the requirements of Revenue Ruling 90-72.) Requests to appeal, the IRS reminds taxpayers, did not suspend the two-year limitations period on filing suit for refund. The IRS also will continue to disallow claims for refund of FUTA taxes paid with respect to severance payments.

2. Bankrupt employer? Little chance the promised retirement benefits will be paid? It doesn't matter. This United Airlines pilot still owed FICA taxes on the present value of future retirement benefits he will never receive. Balestra v. United States, 119 Fed. Cl. 109 (5/31/14). In 2004, the taxpayer retired from his position as a pilot with United Airlines and, pursuant to § 3121(v)(2), the present value of his future retirement benefits ($289,601) was included in his FICA base for the year of his retirement. Section 3121(v)(2) provides that amounts deferred under a nonqualified deferred compensation plan must be taken into account for FICA purposes as of the later of the time the services are performed or the time when there is no substantial risk of forfeiture of the right to such amounts. United Airlines entered bankruptcy proceedings in 2002 and its liability for the taxpayer's retirement benefits was ultimately discharged. The taxpayer received only $63,032 of the promised benefits. The taxpayer brought this action seeking a refund of the FICA taxes he paid (at the 1.45% rate for the Medicare portion of FICA) on the $226,569 of retirement benefits that he never received. The regulations issued under § 3121(v)(2), Reg. § 31.3121(v)(2)-(1)(c)(2)(ii), prescribe the method of determining present value and provide that the present value of future retirement benefits

> cannot be discounted for the probability that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk associated with any deemed or actual investment of amounts deferred under the plan, the risk that the employer, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies.

Among other arguments, the taxpayer asserted that, by requiring inclusion of future retirement benefits in the FICA base, Congress meant to employ an accrual accounting basis that implicitly requires an adjustment when it can be determined that the benefits will never be received, and that the failure of the regulations to incorporate such an adjustment is arbitrary and irrational. The Court of Federal Claims (Judge Wolski) rejected the taxpayer's arguments. The court concluded that the statute is silent on how the amount deferred is to be calculated. "The decision of the Treasury Department to avoid the complicated and strategic-behavior-enabling use of risk-adjusted discount rates cannot be said to be unreasonable. Under the deference due the regulations per *Chevron*, as applied to plaintiff they must stand."

a. ♪♫Eight miles high and when you touch down, you'll find that it's stranger than known.♫♪ Yes, says the Federal Circuit, the regulations are a reasonable construction of the statute. Balestra v. United States, 803 F.3d 1363 (Fed. Cir. 10/13/15). In an opinion by Judge Plager, the Court of Appeals for the Federal Circuit affirmed. The court held that the relevant regulation, Reg. § 31.3121(v)(2)-(1)(c)(2)(ii), is entitled to deference under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). After reviewing the statutory language and legislative history of § 3121(v)(2), the court concluded in step one of the *Chevron* analysis that there was no unambiguously expressed congressional intent on the question whether the term "amounts deferred" can be defined as the compensation's present value without consideration of an employer's financial condition. In step two of the *Chevron* analysis, the court concluded that the regulation was a reasonable construction of the statute. The regulation, the court reasoned, "is rational, reasonable, and does not conflict with any law." The court also rejected the taxpayer's argument that the regulation was arbitrary and capricious under *Motor Vehicle Manufacturers Ass'n of the United States, Inc. v. State Farm Mutual Automobile Insurance Co*., 463 U.S. 29 (1983). The standard in *State Farm* requires the agency issuing the regulation to "examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'" *Id*. (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156 (1962)). The regulation in question satisfied this standard:

> Treasury explained that it sought simple, workable, and flexible rules when valuing future benefits. It devised a regulation that satisfied these goals while comporting with the governing statute. This is neither arbitrary nor capricious. It may seem unfair in a specific instance such as this, but in balancing the desire for simplicity against the ideal of ultimate comprehensiveness, the agency must be allowed a reasonable degree of discretion.

3. State law, rather than federal common law, governs successor liability for employment taxes. TFT Galveston Portfolio, Ltd. v. Commissioner, 144 T.C. 96 (2/26/15). The taxpayer was a limited partnership organized under Texas law that operated apartment complexes it had acquired from several other Texas limited partnerships. The government sought to hold the taxpayer liable for income tax withholding, FICA and FUTA taxes under two distinct theories. First, the government asserted that the taxpayer was liable for employment taxes owed by the other Texas limited partnerships from which it had acquired apartment complexes on the theory that the taxpayer was the successor in interest of those limited partnerships. Second, the government claimed that workers the taxpayer itself had classified as independent contractors were employees with respect to whom the taxpayer owed employment taxes.

- With respect to the successor liability claim, the Tax Court (Judge Goeke) applied Texas law and concluded that the taxpayer could not be held liable as a successor in interest. Under section 10.254(b) of the Texas Business Organizations Code, "'a person acquiring property … may not be held responsible or liable for a liability or obligation of the transferring domestic entity that is not expressly assumed by the person.'" The court considered three exceptions commonly recognized by states with a similar rule: (1) when the transaction amounts to a de facto merger, a doctrine that Texas does not recognize;[9] (2) when the successor is a mere continuation of the seller company, a doctrine that, according to the Tax Court, Texas courts have refused to apply; and (3) when the transaction is entered into fraudulently, a doctrine that, even if recognized in Texas, there was no basis to apply on the facts of the case. Because the taxpayer did not expressly assume the employment tax liabilities of the limited partnerships from which it had acquired assets, the taxpayer could not be held liable as a successor in interest. The court rejected the government's argument that the court should disregard state law and instead adopt federal common law in determining successor liability in employment tax

[9] The Tax Court's opinion characterizes de facto mergers as against public policy in Texas, but fails to mention that section 10.254(a) of the Texas Business Organizations Code eliminates the de facto merger doctrine by statute.

cases. Applying federal common law in a novel context, the court explained, requires a significant conflict between a federal policy or interest and the use of state law that justifies the adoption of federal common law, and no such conflict exists in this context. According to the court, the government's concerns that applying Texas law would result in taxpayers adopting similar structures to avoid successor liability and would influence other states to modify their laws were unfounded. Moreover, the court stated, the government had alternative means of collecting any employment taxes owed by the other limited partnerships, including asserting transferee liability against the taxpayer under § 6901 and holding an individual involved in the businesses personally liable as a responsible person under § 6672.

- With respect to the claim that the taxpayer had misclassified employees as independent contractors, the court considered four groups of workers: (1) apartment managers and leasing agents, (2) security personnel, (3) a maintenance supervisor, and (4) general maintenance workers. To determine whether the workers were employees, the court applied a common law test with seven factors, the most significant of which is the degree of control exercised by the principal over the details of the individual's work, and concluded that all of the workers were properly classified as employees. Accordingly, the taxpayer was liable for employment taxes. The court also upheld failure-to-file and failure-to pay-penalties under § 6651(a)(1)-(2) as well as the 10 percent penalty imposed by § 6656 for late deposits of employment taxes.

B. Self-employment Taxes

There were no significant developments regarding this topic during 2015.

C. Excise Taxes

1. The government prevails on the substantive issue whether an excise tax is due on S corporation shares held by an ESOP, but is barred from assessing the tax by the applicable period of limitations. Law Office of John H. Eggersten P.C. v. Commissioner, 142 T.C. 110 (2/12/14), vacated on reconsideration, 142 T.C. 265 (10/1/14), aff'd, 800 F.3d 758 (6th Cir. 9/8/15). An ESOP owned all the stock of the taxpayer, a subchapter S corporation. Under the ESOP, 100 percent of the stock of the taxpayer was allocated to John H. Eggersten, the individual who formerly owned the stock. The government and the taxpayer agreed that Mr. Eggersten was a "disqualified person" within the meaning of § 409(p)(4). Because the ESOP allocated all the stock of the S corporation to Mr. Eggersten, the shares were deemed-owned shares with respect to him under § 409(p)(4)(C) and he was treated as owning them for purposes of § 409(p) and the related excise tax

imposed by § 4979A. The government argued that, because disqualified persons owned 50 percent or more of the number of shares of employer securities consisting of stock of an S corporation, a non-allocation year had occurred in 2005 within the meaning of § 409(p)(3). Accordingly, the government argued, under § 4979A(a), an excise tax was imposed on the S corporation equal to 50 percent of the "amount involved." The government relied on a special rule in § 4979A(e)(2)(C), which provides that "the amount involved for the first nonallocation year of any employee stock ownership plan shall be determined by taking into account the total value of all the deemed-owned shares of all disqualified persons with respect to such plan." Thus, the government sought to impose a tax equal to 50 percent of the value of the S corporation's shares. The Tax Court (Judge Chiechi) agreed with the government that § 4979A(a) imposed the tax for tax year 2005, but concluded that the period of limitations in § 4979A(e)(2)(D) for assessing the tax had expired before the government issued its notice of deficiency. In its analysis of the imposition of the tax, the court rejected the taxpayer's argument that § 4979A(a) does not impose an excise tax when a non-allocation year occurs. The court also rejected the taxpayer's argument that the "first nonallocation year" specified by § 4979A(e)(2)(C) was 1999, the year in which Mr. Eggersten transferred the S corporation shares to the ESOP, rather than 2005. In reaching this conclusion, the court relied on the effective date of the relevant provisions, which apply to plan years beginning after 12/31/04. Under § 4979A(e)(2)(D), the period of limitations for assessing the excise tax is three years from the later of the allocation or ownership giving rise to the tax or the date on which the Secretary is notified of the allocation or ownership. Section 4979A(e)(2)(D) does not define the term "notified." Relying on its approach to a similar issue in Stovall v. Commissioner, 101 T.C. 140 (1993), the court looked for guidance to the regulations issued under § 1033(a), which specify that a notification must contain "all of the details." The court concluded that the S corporation's 2005 return on Form 1120S and the employee benefit plan 2005 return on Form 5500, both filed in 2006, provided the requisite notification. The period of limitations on assessment therefore expired in 2009. Because the IRS did not issue the notice of deficiency until 4/14/11, assessment of the tax was precluded.

a. Don't break out the champagne just yet! It turns out that the limitations period on assessment of tax had not expired when the IRS issued its notice of deficiency. Law Office of John H. Eggersten P.C. v. Commissioner, 142 T.C. 265 (10/1/14), *aff'd*, 800 F.3d 758 (6th Cir. 9/8/15). The Tax Court (Judge Chiechi) granted the government's motion for reconsideration and concluded in a supplemental opinion that the limitations period on assessment of the excise tax for 2005 had not expired when the IRS mailed its notice of deficiency. The court had concluded in its prior opinion that the limitations period on assessment of the excise tax had

expired in 2009 because (1) the governing statute was § 4979A(e)(2)(D), which provides that the period of limitations is three years from the later of the allocation or ownership giving rise to the tax or the date on which the Secretary is notified of the allocation or ownership, and (2) the S corporation's 2005 return on Form 1120S and the employee benefit plan 2005 return on Form 5500, both filed in 2006, provided the requisite notification. On reconsideration, the court agreed with the government that "section 4979A(e)(2)(D) serves only to extend under the circumstances set forth therein the period of limitations prescribed by section 6501," and therefore the threshold question was whether the period of limitations on assessment prescribed by § 6501 had expired when the IRS mailed its notice of deficiency. The court concluded that the § 6501 limitations period had not expired pursuant to § 6501(c)(3), which provides that tax can be assessed at any time "[i]n the case of failure to file a return." The taxpayer had not filed for 2005 Form 5330, the designated form for reporting the § 4979A excise tax. Therefore, the court reasoned, the limitations period on assessment began to run only if the taxpayer filed for 2005 another document that constitutes a "return" under the four-factor test of *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986). The court concluded that neither the S corporation's 2005 return on Form 1120S nor the employee benefit plan 2005 return on Form 5500, both filed in 2006, qualified as a return for purposes of the excise tax imposed by § 4979A(a) because neither document contained sufficient information to calculate the taxpayer's excise tax liability for 2005 as required by the *Beard* test. Accordingly, the § 4979A excise tax could be assessed at any time.

b. There will be no champagne for this taxpayer, says the Sixth Circuit. Law Office of John H. Eggersten v. Commissioner, 800 F.3d 758 (6th Cir. 9/8/15). In an opinion by Judge Sutton, the Sixth Circuit affirmed the Tax Court's decision. The Sixth Circuit agreed with the Tax Court that the taxpayer owed the excise tax imposed by § 4979A(a) and that, pursuant to § 6501(c)(3), the limitations period on assessment of the tax had not expired when the IRS mailed the notice deficiency because the taxpayer had failed to file a return with respect to the excise tax. The court noted "the taxpayer's lament that it seems strange to let the limitations period run until it files the requisite form, which in this instance merely would have reported 'no excise tax due'[,]" and observed that the absence of a limitations period may impose an unfair burden on innocent taxpayers. But any unfairness, the court concluded, is for Congress, rather than the courts, to address. The Sixth Circuit also held that the Tax Court had not abused its discretion in entertaining the IRS's motion for reconsideration.

- Judge Clay dissented in part. He expressed concern about the IRS's change in position, as set forth in its motion for reconsideration in the Tax Court, concerning the provision that governs the

limitations period on assessment of the excise tax. In his view, the court should have remanded "to the Tax Court to develop a record about the circumstances surrounding the Commissioner's reversal in position, including any communications between the parties and the court, to determine whether the Commissioner's reversal was made in good faith." The record developed on remand, he reasoned, might lead to the conclusion that the IRS's change in position is barred by the doctrine of judicial estoppel. "When the Internal Revenue Service is permitted to litigate according to its whims in the Tax Court, knowing that a do-over will be available if it does not succeed on the theory that at first seems most expedient, tax law jurisprudence suffers no less than the integrity of the rule of law and the courts."

2. The Cadillac Tax is coming and the IRS wants your input! Notice 2015-16, 2015-10 I.R.B. 732 (2/23/15). This notice describes potential approaches in future proposed regulations with respect to a number of issues under § 4980I. Generally, § 4980I, which was enacted as part of the Affordable Care Act and applies to taxable years beginning after 12/31/17, imposes a 40 percent excise tax on the amount by which the cost of group health coverage provided by an employer (referred to as "applicable coverage") exceeds an applicable dollar limit. The issues addressed in the notice primarily relate to: (1) the definition of applicable coverage, (2) the determination of the cost of applicable coverage, and (3) the application of the annual statutory dollar limit to the cost of applicable coverage. Treasury and the IRS invite comments on the issues addressed in the notice and on any other issues under § 4980I. Comments are due by 5/15/15.

- The notice indicates that Treasury and IRS intend to issue another notice, before issuing proposed regulations, inviting comments on certain additional issues not addressed in this notice.

a. The IRS addresses additional issues related to the Cadillac Tax and again invites comments. Notice 2015-52, 2015-35 I.R.B. 227 (7/30/15). This notice supplements Notice 2015-16, 2015-10 I.R.B. 732 (2/23/15) by addressing additional issues under § 4980I. These issues include: (1) identification of the taxpayers who may be liable for the excise tax, (2) application of the employer aggregation rules for purposes of § 4980I, (3) allocation of the tax among the applicable taxpayers, (4) the time and manner of payment of the applicable tax, and (5) certain issues regarding the cost of applicable coverage that were not addressed in Notice 2015-16. Treasury and the IRS invite comments (due 10/1/15) on these issues and any other issues under § 4980I. After considering the comments submitted in response to both notices, Treasury and the IRS intend to issue proposed regulations under § 4980I. The proposed regulations will provide further opportunity for comment.

b. Perhaps we spoke too soon. The Cadillac Tax has been delayed for two years. Division P, Title 1, § 101 of the Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, signed by the President on 12/18/15, delays the effective date of the Cadillac Tax to taxable years beginning after 12/31/19. The legislation also amends Code § 4980I(f)(10) to make payments of the tax deductible for income tax purposes.

3. The medical device tax seems to be on life support. The 2015 PATH Act, § 174, imposes a two-year moratorium on the 2.3 percent excise tax on medical devices of § 4191. Pursuant to the moratorium, the tax will not apply to medical devices sold during calendar years 2016 or 2017.

XII. TAX LEGISLATION

A. Enacted

1. Better double-check those due dates. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, was signed by the President on 7/31/15. Among other changes, this legislation (1) added § 1014(f), which generally requires that the basis of any property determined using a § 1014 date-of-death-value shall not exceed the final value as determined for estate tax purposes; (2) legislatively overruled the U.S. Supreme Court's decision in United States v. Home Concrete Supply, LLC, 132 S. Ct. 1836 (2012), by amending § 6501(e)(1)(B) specifically to provide that "An understatement of gross income by reason of an overstatement of unrecovered cost or other basis is an omission from gross income;" (3) changed the due dates and extended due dates of several returns, including those filed by C corporations and partnerships; and (4) changed the due date of the FBAR to April 15. The basis consistency rule of new § 1014(f) applies to property with respect to which an estate tax return is filed after 7/31/15, and the changes to due dates of returns generally apply to tax years beginning after 12/31/15.

2. Congress tosses an odd mix of tax provisions into year-end legislation. The Fixing America's Surface Transportation (FAST) Act, Pub. L. No. 114-94, was signed by the President on 12/4/15. Among other changes, this legislation (1) added § 7345, which provides that having a "seriously delinquent tax debt" (generally, an unpaid tax liability that has been assessed and exceeds $50,000) is grounds for denial, revocation, or limitation of a passport, (2) amends § 6306 to require the IRS to use private debt collection agencies for outstanding inactive tax receivables, and (3) leaves the filing extension at 2-1/2 months for employee benefit plans filing Form 5500

by repealing the 3-1/2 month extension enacted only months earlier in the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, signed by the President on 7/31/15.

3. Congress enacts a cascade of extenders and makes many provisions permanent at the end of 2015. The Protecting Americans from Tax Hikes Act of 2015, enacted as Division Q of the Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, was signed by the President on 12/18/15. Among other changes, the legislation retroactively extended through 12/31/15 a myriad of deductions, credits, and special benefit provisions that had expired at the end of 2014, and made permanent (in some cases with modifications) several provisions that previously had been regular extenders, including: (1) fifteen-year straight-line cost recovery for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property; (2) the increased $500,000 maximum amount that can be expensed under § 179 and the increased $2 million expenditure ceiling phase-out amount; (3) the § 41 research credit; (4) the exclusion under § 1202 of 100 percent of the gain realized on the sale of qualified small business stock; (5) the § 164(b)(5)(I) election to claim an itemized deduction for state and local general sales and use taxes instead of state and local income taxes; (6) the five-year holding period under § 1374 for recognizing unrealized built-in gain on conversion from a C corporation to an S corporation; and (7) the provisions of § 170 allowing a deduction for a qualified conservation contribution made by an individual or corporate farmer or rancher.