

Recent Developments in Federal Income Taxation: The Year 2002

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Recent Developments in Federal Income Taxation: The Year 2002

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This current developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the year 2002.¹ Most Treasury Regulations, however, are so complex that they cannot be discussed in detail; only the basic topic and fundamental principles are highlighted. Amendments to the Internal Revenue Code generally are not discussed except to the extent that they have either led to administrative rulings and regulations or have affected previously issued rulings and regulations otherwise covered by the outline. The outline focuses primarily on topics of broad general interest—³/₄ income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, but generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

I. ACCOUNTING

A. Accounting Methods

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

- Proposed Reg. § 1.441-1(c) provides that a taxable year is adopted by filing the first federal income tax return using that taxable year. Filing an application for an EIN, filing an extension, or making estimated tax payments, indicating a particular taxable year would not constitute an adoption of that year. [Rev. Rul. 57-589, 1957-2 C.B. 298, and Rev. Rul. 69-563, 1969-2 C.B. 104, holding that the filing of an extension and estimated tax payments establishes a taxable year, will be superseded.]

- The proposed regulations under § 442 continue to require that the taxpayer demonstrate a business purpose for

1. This outline is based on prior current developments outlines presented by the authors at numerous continuing legal education conferences over the past year. Among the conferences at which one or both of the authors presented current developments based on this outline during the year 2002 are the following: ABA Tax Section Midyear Meeting, American Institute on Federal Taxation, American Petroleum Institute, Denver Tax Institute, Houston Bar Association Tax Section, University of Montana Tax Conference, University of North Carolina Tax Institute, South Carolina Bar Association Tax Section, Southern Federal Tax Institute, University of Texas Tax Conference, State Bar of Texas Tax Section, Tax Executives Institute, Tennessee Tax Institute, Texas Society of CPAs (Austin Chapter) Institute, Tulane Tax Institute, University of Virginia Conference on Federal Taxation, Wednesday Tax Forum (Houston), William & Mary Tax Conference.

changing taxable years. The proposed regulations use the term “business purpose” rather than the “substantial business purpose” of the temporary regulations, but, according to the preamble, the Treasury Department does not intend the change in the language to change the standard. Under Prop. Reg. § 1.442-1(b), Form 1128 would have to be filed by the 15th day of the third [rather than second] month of the first effective [the short] year. The automatic approval provisions have been deleted in favor of the standards of Rev. Proc. 2000-11, 2000-1 C.B. 309, *superseded by* Rev. Proc. 2002-37, 2002-22 I.R.B. 1030 (6/3/02), *infra*.

- Proposed Reg. § 1.706-1 reflects the 1986 Act required taxable year rules and the least aggregate deferral standard. Generally speaking, the substantive rules incorporate Temp. Reg. § 1.706-1T, but the proposed regulations elaborate the standards for determining a partner’s interests in profits and capital for purposes of applying those tests—income interests are determined with respect to taxable income, not book income, and capital interests are determined with respect to a hypothetical liquidation. Procedural rules for requesting a year other than a required year have been removed in favor of Prop. Reg. § 1.442-1 procedures.

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

a. Regulations are final, with minor changes. T.D. 8996, Changes in Accounting Methods, 67 F.R. 35009 (5/17/02). The Treasury Department has finalized the proposed regulations [in REG-106917-99, 66 F.R. 31850] with a number of technical and clarifying changes. The Treasury Department specifically rejected abandoning the general requirement of strict book conformity to adopt a year other than a required or ownership year. The final regulations remove from the proposed regulations specific time and manner requirements for filing applications; instead these are published in Rev. Procs. 2002-37 through 2002-39, discussed immediately below, to permit more flexibility. Modifications were made with respect to the 52-53-week taxable year and for closely held REITs. The final regulations are effective 5/17/02.

b. The IRS promulgates comprehensive guidance on the adoption, change, and retention of accounting periods.

(1) Automatic approval for corporations. Rev. Proc. 2002-37, 2002-22 I.R.B. 1030 (6/3/02), *modified by* Notice 2002-72, 2002-46 I.R.B. 843 (11/18/02). This revenue procedure provides the exclusive procedures for most corporations to obtain *automatic* approval to adopt a taxable year. Under the revenue procedure a corporation can receive automatic approval of a year based on the 25 percent of gross receipts natural business year standard notwithstanding holding an interest in a pass-through entity. An automatic change is not available (1) if the corporation’s year is under examination or in litigation, or (2) if the corporation has changed its annual accounting period within 48 months prior to the last month of the requested taxable year (unless the change is to a required taxable year, to or from a 52-53-week year ending with the same calendar month, to comply with Regs. §§ 1.1502-75(d)(3)(v) or 1.1502-76(a)(1), or if the purpose of the change is to file consolidated financial statements with a new owner of a majority shareholder that has changed its year). The lists of ineligible corporations have been expanded. No audit protection is offered under the revenue procedure. Rev. Proc. 2000-11, 2000-1 C.B. 309, is superseded.

(2) Expanded automatic approval of natural business year taxable years for pass-through entities and PSCs. Rev. Proc. 2002-38, 2002-22 I.R.B. 1037 (6/3/02), *modified by* Notice 2002-72, 2002-46 I.R.B. 843 (11/18/02). This revenue procedure [which finalizes Notice 2001-35, 2001-1 C.B. 1314] provides the exclusive procedures for most partnerships, S corporations, and personal service corporations to obtain *automatic* approval to adopt a taxable year other than their statutorily required or permitted taxable year. Rev. Proc. 87-32, 1987-2 C.B. 396, is modified and superseded. There are quite a few significant changes from the earlier procedures. A partnership, S corporation, or PSC may change automatically to a natural business year that satisfies the 25 percent gross receipts test, regardless of whether such year results in more deferral of income than its present taxable year. Greater flexibility is available to adopt or change from a 52-53-week year. A partnership that would be required to change its taxable year because of a minor percentage change in ownership may retain its current taxable year for one year, subject to certain circumstances. Interests of certain tax-exempt entities are disregarded for purposes of determining the ownership taxable year of an S corporation, unless the S corporation is wholly owned by such tax-exempt entities. The due date for Form 1128 is the due date of the taxpayer's return. Automatic changes are not available (1) if the entity's year is under examination or in litigation, or (2) for a change to, or retention of, a natural business year if the entity has changed its annual accounting period within 48 months prior to the last month of the requested taxable year (unless the change is to a required taxable year, to or from a 52-53-week year ending with the same calendar month, or to comply with Regs. §§ 1.1502-75(d)(3)(v) or 1.1502-76(a)(1)). If a taxpayer complies with the revenue procedure, however, audit protection for prior years generally is provided.

(3) But sometimes you still have to ask, "Mr. Commish, may I." Rev. Proc. 2002-39, 2002-22 I.R.B. 1046 (6/3/02), *modified by* Notice 2002-72, 2002-46 I.R.B. 843 (11/18/02). This revenue procedure [which finalizes Notice 2001-34, 2001-1 C.B. 1302] provides the exclusive procedures for everyone to establish a business purpose to obtain *non-automatic* approval to adopt a taxable year other than their statutorily required or permitted taxable year. Rev. Proc. 85-16, 1985-1 C.B. 517, and Rev. Proc. 74-33, 1974-2 C.B. 489, are superseded. A business purpose can be established either by a natural business year or by "facts and circumstances," but the revenue procedure cautions that permission will be granted under the facts and circumstances standard "only in rare and unusual circumstances." The "natural business year" test in this revenue procedure is significantly more flexible than the natural business year for automatic approval under Rev. Proc. 2002-38. The "natural business year" can be based on the "annual business cycle" or "seasonal business" tests ending "soon after" [with a one month safe harbor] the "peak" season. Alternatively, the natural business year can be established [except by tiered entities] to end with the 2-month period for each of the prior 3 years with the highest percentage of gross receipts equaling or exceeding 25 percent. Administrative and business convenience reasons described in Rev. Rul. 87-57, 1987-2 C.B. 117, will not justify a taxable year; nor will hiring patterns, compensation periods, years based on annual model changes or price lists, competitors' years, or related entities' years. A taxpayer other than a partnership, S corporation, or PSC [i.e., an individual] that does not establish a business purpose for the requested annual accounting period can be deemed to have established a business purpose if it provides a nontax reason for the requested annual accounting period and agrees to specified additional terms, conditions, and adjustments intended to neutralize the tax effects of any resulting substantial distortion of income. For this purpose, nontax reasons for

the requested annual accounting period may include administrative and convenience business reasons that are insufficient to satisfy the business purpose requirement for a partnership, S corporation, or PSC to adopt a taxable year other than its required taxable year. “[A]n individual taxpayer that is not a sole proprietor will be able to establish a nontax reason for a fiscal year only in rare and unusual circumstances.” Compliance provides audit protection for prior years.

(4) And to top it off, the IRS explains its reasons for changes. Announcement 2002-53, 2002-22 I.R.B. 1063 (6/3/02). In this announcement, the IRS explains the reasons for the various changes in approval procedures in Rev. Procs. 2002-37, 2002-38, and 2002-39.

c. Notice 2002-75, 2002-47 I.R.B. 884 (11/25/02). This notice is a proposed revenue procedure that would provide exclusive rules for individuals filing tax returns on a fiscal year to obtain automatic approval to change to a calendar year. It would supersede Rev. Proc. 66-50, 1966-2 C.B. 1260.

d. The small-dollar limit for use of the cash method goes up to \$10 million of gross receipts, but with significant exceptions. Rev. Proc. 2002-28, 2002-18 I.R.B. 815 (5/6/02). This revenue procedure provides guidance under which a qualifying small business with gross receipts of \$10 million or less may obtain automatic consent to change to the cash receipts and disbursements method of accounting. It expands Notice 2001-76, 2001-2 C.B. 613, to provide that taxpayers whose principal business is the providing of services [including the providing of property incident to those services] are eligible for the cash method, as are taxpayers whose principal business activity is the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications.

- Ineligible businesses include ones that derive the largest percentage of gross receipts from any of the following activities: (a) mining activities within the meaning of NAICS codes 211 and 212; (b) manufacturing within the meaning of NAICS codes 31-33; (c) wholesale trade within the meaning of NAICS code 42; (d) retail trade within the meaning of NAICS codes 44-45; and (e) information industries within the meaning of NAICS codes 5111 and 5122. For NAICS codes see <http://www.census.gov/epcd/naics/naicscod.txt>.

- Eligible businesses include those that perform services such as janitorial, medical, veterinary, photo developing, and repairs (including auto repair), as well as restaurants, bars, hotels, and [ironically²] funeral homes.

(2) Kinder and gentler accounting method change procedures.

a. Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (1/22/02). This revenue procedure provides revised rules for automatic consent to changes in accounting methods. It was amplified and clarified by Rev. Proc. 2002-54, 2002-35 I.R.B. 432 (9/3/02).

2. See *Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d 352 (1st Cir. 1970) (funeral home required to use accrual method because of its business of selling caskets, not merely providing funeral services).

b. Rev. Proc. 2002-18, 2002-13 I.R.B. 678 (4/1/02). This revenue procedure provides revised rules for changes in accounting methods imposed by the IRS.

c. Really kind taxpayer-favorable § 481 adjustments. Rev. Proc. 2002-19, 2002-13 I.R.B. 696 (4/1/02). This revenue procedure modifies Rev. Proc. 97-27, 1997-1 C.B. 680, and Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (1/22/02). It revises the revised rules for obtaining the IRS's consent to changes in accounting methods. The most significant changes to Rev. Proc. 97-27 and Rev. Proc. 2002-9 are: (1) allowing a taxpayer to change its method of accounting prospectively, without audit protection, when the method to be changed is an issue pending for a taxable year under examination or an issue under consideration by either an appeals office or a federal court; and (2) taking negative, i.e., taxpayer-favorable, § 481(a) adjustments into account entirely in the year of change. This revenue procedure was amplified and clarified by Rev. Proc. 2002-54, 2002-35 I.R.B. 432 (9/3/02).

d. And the IRS explains itself. Announcement 2002-37, 2002-13 I.R.B. 703 (4/1/02). This announcement explains the significant issues raised by the changes in Rev. Proc. 97-27, Rev. Proc. 2002-9, and Rev. Proc. 2002-18.

e. And the IRS clarifies the application of the one-year adjustment period to pending and recently approved applications. Rev. Proc. 2002-54, 2002-35 I.R.B. 432 (9/3/02), *clarifying and modifying* Rev. Proc. 2002-19, 2002-13 I.R.B. 696 (4/1/02). This revenue procedure makes the change from the 4-year to the one-year adjustment period [for negative adjustments under § 481(a)] available to those applications pending on 3/14/02 with respect to years ending before 12/31/01 to defer the year of change to the first year ending on or after 12/31/01, and allows similar relief for those with approved applications who elect to defer the year of change on or before 12/13/02.

B. Inventories

There were no significant developments in this topic in 2002.

C. Year of Receipt or Deduction

1. The money was simultaneously constructively received and constructively paid out for an offsetting deduction. Gale v. Commissioner, T.C. Memo. 2002-54 (2/27/02). The taxpayer's lawyer received the proceeds from settling a lawsuit, but the proceeds were held in the attorney's escrow account pending resolution of a fee dispute between the taxpayer and the attorney, with respect to the lawsuit and other matters. Judge Beghe held that the full amount of the proceeds were constructively received by the cash method taxpayer in the year they were paid over by the defendant to the taxpayer's lawyer, but a deduction was allowed under § 461(f), except to the extent that the fees, if paid, would not have been deductible.

2. Tax Court again finds Reg. § 1.267(a)-3 valid, this time based upon the *Chevron* doctrine. Square D Company v. Commissioner, 118 T.C. 299 (3/27/02) (reviewed, 10-6). The Tax Court (Judge Gale) adheres to its holding in *Tate & Lyle, Inc. v. Commissioner*, 103 T.C. 656 (1994), *rev'd. and remanded*, 87 F.3d 99 (3d Cir. 1996), that Reg. § 1.267(a)-3 is a valid exercise of the regulatory authority granted in § 267(a)(3) and that a U.S. corporation

wholly owned by a foreign corporation cannot deduct interest accrued until the interest is actually paid even though the interest would have been exempt from taxes under §§ 881 and 1442 under the applicable treaty. “We now hold that the regulation is valid as a permissible construction of the statutory language that authorizes it. To the extent our opinion in *Tate & Lyle I* is inconsistent, we will no longer follow it.”

● *Tate & Lyle I* was decided on the matching principle. The Tax Court majority here relies on *Chevron*,³ which holds that where Congressional intent is not clear, the question is whether the regulation is based on a permissible construction of the statute.

In view of the refinements of the *Chevron* doctrine in *Brown & Williamson*, we believe our opinion in *Tate & Lyle I* may have given insufficient attention to fitting all parts of section 267(a) into “an harmonious whole”. If, as we held in *Tate & Lyle I*, section 267(a)(3) authorizes only regulations that address mismatches resulting from the payee’s method of accounting, then it would appear that section 267(a)(3) is redundant in relation to section 267(a)(2), as the Court of Appeals for the Third Circuit reasoned. That is because section 267(a)(2) would already reach, and implicitly authorize regulations covering, payments owed to a related foreign person with a (U.S.) method of accounting for such payments.

...

A close examination of the legislative history reveals that Congress intended the Secretary’s authority under section 267(a)(3) to encompass imposition of the cash method on the payor where the foreign payee does not have a U.S. method of accounting with respect to the amounts owed. Section 267(a)(3) was added to the Code because Congress felt “The application of * * * [section 267(a)(2)] is unclear when the related payee is a foreign person that does not, for many Code purposes, include in gross income foreign source income that is not effectively connected with a U.S. trade or business.” H. Rept. 99-426, at 939 (1985), 1986-3 C.B. (Vol. 2) 1, 939; S. Rept. 99-313, at 959 (1986), 1986-3 C.B. (Vol. 3) 1, 959. In this passage, Congress expressed its uncertainty as to the application of section 267(a)(2) in a situation where the foreign person has foreign source, non-effectively connected income that need not, for many Internal Revenue Code purposes, be included in U.S. gross income. A characteristic of the foregoing type of income is that the foreign recipient lacks a U.S. method of accounting for it if the income need not be included in U.S. gross income. . . .

Respondent’s interpretation of the regulatory authority granted in section 267(a)(3) is reasonable in light of the legislative history and therefore is entitled to deference under *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837

3. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). See also *Bankers Life & Cas. Co. v. United States*, 142 F.3d 973 (7th Cir. 1998) (*Chevron* doctrine applies to tax regulations, whether legislative or interpretive).

(1984). As a permissible construction, the regulation is ipso facto not manifestly contrary to the statute.

3. They may be losers on the diamond, but not in the Tax Court. *Tampa Bay Devil Rays, Ltd. v. Commissioner*, T.C. Memo. 2002-248 (9/30/02). The Tampa Bay Devil Rays collected advanced season ticket payments for the 1998 baseball season, their first “major league” season, in 1995 and 1996. In those years the Devil Rays were conducting minor league baseball activities—many sports fans think the Devil Rays still are conducting only minor league baseball activities—and deducted the expenses, but did not include the advance season ticket receipts. Judge Swift rejected the Commissioner’s argument that under *Schlude v. Commissioner*, 372 U.S. 128 (1963), the Devil Rays were required to include the prepayments, and applied *Artnell Co. v. Commissioner*, T.C. Memo. 1970-85, *on remand from* 400 F.2d 981 (7th Cir. 1968), because, since the receipts would have had to be refunded if the Devil Rays did not play the season, the facts of the case fit within the narrow *Artnell* exception to the *Schlude* principle.

4. “Hello, I’m from the IRS, and I’m here to help you.” – And this time it really is true. **Rev. Proc. 71-21 deferral of prepaid income rules loosened.** Notice 2002-79, 2002-50 I.R.B. 964 (12/16/02). This notice is a proposed revenue procedure to modify and supersede Rev. Proc. 71-21, 1971-2 C.B. 549. The proposed revenue procedure would expand the availability of deferred reporting of advance receipts that are not accrued for financial accounting. First, certain income from other than services would be eligible: (1) sales of goods not covered by Reg. § 1.451-5(b)(1)(ii); (2) rents for the use of property in connection with the provision of services, e.g., hotel rooms, recreational facilities, cable converter boxes; (3) royalties for intellectual property; (4) warranties of services or items in the three preceding categories; (5) subscriptions not subject to § 455; and (6) memberships not subject to § 456. Second, payments would be eligible even if performance might extend beyond the next succeeding year, although deferral could not extend beyond the next succeeding year. The revenue procedure will not apply to rents generally, insurance premiums, or payments with respect to financial instruments. However, the Notice states that the Treasury Department will propose amendments to Reg. § 1.61-8(b) to permit deferral of prepaid rents under the principles of the proposed revenue procedure.

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

6. Another taxpayer friendly accounting method ruling. Rev. Rul. 2003-3, 2003-2 I.R.B. 252 (1/13/03). A state or local income or franchise tax refund resulting from NOL carrybacks is includible by an accrual method taxpayer in the earlier of the year in which the taxpayer receives payment or notice that the refund claim has been approved. Rev. Rul. 65-190, 1965-2 C.B. 150, and Rev. Rul. 69-372, 1969-2 C.B. 104, which held that the refund is accrued in the year of the loss, are revoked. The IRS reasoned that review and approval of the refund claims by state authorities is not merely ministerial, but substantive. [This follows the holding in *Doyle, Dane, Bernbach, Inc. v. Commissioner*, 79 T.C. 101 (1982), *nonacq.*, 1988-2 C.B. 1., *acq.*, 2003-2 I.R.B. 251 (1/13/03)]. Automatic change of accounting method is available.

7. This year or next year? Only the IRS knows, and now they are telling us. Rev. Rul. 2003-10, 2003-3 I.R.B. 288 (1/21/03). This ruling addresses the accrual under the all events test of § 451 of income from goods sold when an accrual method taxpayer's customer disputes its liability under certain circumstances: (1) If the taxpayer "overbills a customer due to a clerical mistake in an invoice and the customer discovers the error and, in the following taxable year, disputes its liability for the overbilled amount, then the taxpayer accrues gross income in the taxable year of sale for the correct amount;" (2) A taxpayer "does not accrue gross income in the taxable year of sale if, during the taxable year of sale, the customer disputes its liability to the taxpayer because the taxpayer shipped incorrect goods;" (3) A taxpayer "accrues gross income in the taxable year of sale if the taxpayer ships excess quantities of goods [and in the next year] the customer agrees to pay for the excess quantities of goods."

• The IRS has requested comments on the application of § 451 to a situation in which a taxpayer ships defective products to a customer that discovers the defect in the next taxable year and disputes its liability: (1) Does the taxpayer have a fixed right to income under § 451 in the taxable year of sale? (compare *Hallmark Cards, Inc. v. Commissioner*, 90 T.C. 26 (1988), with *Celluloid Co. v. Commissioner*, 9 B.T.A. 989 (1927), *acq.*, VII-1 C.B. 6); (2) Does the taxable year concept require the taxpayer to accrue income in the taxable year of sale because the dispute did not arise until the next taxable year?

D. Installment Method

1. Beware of farmers hauling hay in their Jaguar convertibles. *Thom v. United States*, 283 F.3d 939, 2002-1 U.S.T.C. ¶50,293, 89 A.F.T.R.2d 2002-1384 (8th Cir. 3/19/02). The taxpayer manufactured and sold farm equipment. It reported credit sales of center pivot irrigation systems to farmers under the installment method of § 453, claiming that the § 453(l)(2)(A) exception to the general prohibition on use of the installment method by dealers for "any property used or produced in the trade or business of farming" applied. The Court of Appeals (in a 2-1 decision by Judge Magill) held that § 453(l)(2)(A) applies only to property that has been used in farming by the seller; it does not apply to sales of farm equipment by a non-farmer equipment dealer to a farmer that is "to be used" by the farmer. There is no special exception for single purpose equipment, like center pivot irrigation systems, that are used only in farming. The dissent, rather than focusing on Congressional intent and the parallelism between "produced" and "used," discusses concepts such as "past participles," "subordinate clauses," and missing "relative pronouns" and verbs, which it inserted, and raised the specter of a farmer selling his Jaguar convertible on the installment method after using it once to haul hay. [We wonder whether the dissenting judge ever sold one of his cars on the used car market. We also wonder how many farmers own Jaguars, let alone use them to haul hay!]

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

There were no significant developments in this topic in 2002.

B. Deductible Expenses versus Capitalization

*INDOPCO*⁴ aftermath: “Deductions are exceptions to the norm of capitalization.” (Blackmun, J.)

1. Kudos from taxpayers; pans from professors. Advanced Notice of Proposed Rulemaking (“ANPRM”), REG-125638-01, Guidance Regarding Deduction and Capitalization of Expenditures, 67 F.R. 3461 (1/24/02). This ANPRM describes rules and standards the Treasury Department and the IRS plan to propose under § 263(a) [and not under §§ 195, 263(g), 263(h), or 263A] to provide a framework for addressing capitalization issues with respect to expenditures incurred in acquiring, creating, or enhancing intangible assets. Safe harbors and simplifying assumptions are proposed, including a “one-year rule” under which expenditures relating to short lived intangibles need not be capitalized and “de minimis rules” under which certain types of expenditures under a specified dollar amount are not required to be capitalized.

Specifically, (1) loan portfolios would have to be capitalized; (2) amounts paid for § 197 intangibles would have to be capitalized; (3) no capitalization required under the 12-month rule; (4) prepaid items beyond 12 months would have to be capitalized; (5) market entry payments would have to be capitalized but not costs to obtain ISO 9000 certification; (6) amounts paid for government licenses that are valid indefinitely would have to be capitalized; (7) amounts paid to modify contractual rights would have to be capitalized, but not those paid where the parties do not enter into a new or renegotiated agreement; (8) amounts paid by a lessor to terminate a lease would have to be capitalized over the remaining period of the lease; (9) transaction costs would have to be capitalized, but this rule would not require capitalization of employee compensation, fixed overhead costs, or costs that do not exceed a specified dollar amount such as \$5,000.

Note that these proposed rules accept the Courts of Appeals decisions in *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), and *PNC Bancorp v. Commissioner*, 212 F.3d 822 (3d Cir. 2000), and turn a cold shoulder on the Commissioner’s victory in *Lychuk v. Commissioner*, 116 T.C. 374 (2001). These proposed regulations also reject the Tax Court’s decision in favor of the IRS in *U.S. Freightways Corp. v. Commissioner*, 113 T.C. 329 (1999), *vacated and remanded*, 270 F.3d 1137 (7th Cir. 2001).

a. Meanwhile, nothing – except for the 12-month rule.

A memo from Larry R. Langdon and Joseph G. Kehoe, IRS Division Commissioners, to the LMSB and SB/SE employees, dated 2/26/02, contains “meanwhile” instructions pending adoption of the above ANPRM noting that the positions therein are “not Service position,” but does note that “it is likely that Treasury and this Service will ultimately adopt [a 12-month] rule in regulations.” 2002 TNT 40-1 (2/28/02).

b. The Chief Counsel speaks.

Chief Counsel Notice CC-2002-021 (3/15/02). This notice announces a change in the Service’s litigating position regarding capitalization under § 263(a) of transaction costs related to the acquisition, creation, or enhancement of intangible assets or benefits, i.e., the Service will not assert that certain employee compensation, fixed overhead, or de minimis transaction costs must be capitalized, because it is an inefficient

4. *INDOPCO v. Commissioner*, 503 U.S. 79 (1992).

use of resources to litigate these issues while in the process of proposing regulations that may ultimately allow a current deduction for such costs.

c. LMSB and SB/SE follow their attorney's advice.

Langdon & Kehoe reverse their 2/26/02 memo to LMSB and SB/SE employees on 4/26/02, by reason of Chief Counsel Notice CC-2002-021. 2002 TNT 90-8 (5/9/02). The memo notes that the requirements respecting the adoption and change of accounting methods pursuant to § 446(e) continue to be applicable, i.e., that a taxpayer may not change its method of accounting on an original tax return without first obtaining consent, nor may it change its method by filing an amended return.

2. Treasury Department abandons the future benefits test of *INDOPCO* – Long live the separate and distinct asset test. Or, do the proposed regulations go beyond the separate and distinct asset test and interpret *INDOPCO* in a more efficient way? REG-125638-01, Guidance Regarding Deduction and Capitalization of Expenditures, 67 F.R. 77701 (12/19/02). The Treasury Department has published the proposed *INDOPCO* regulations [Prop. Reg. § 1.263(a)-4] that will deal comprehensively with the capitalization of expenditures that relate to intangible assets and “future benefits.” They are intended to provide bright-line rules to make the standards based approach to capitalization articulated by the Supreme Court in *INDOPCO* more administrable.

a. Capitalization is an exception to the norm of deductibility. Under the proposed regulations, only expenditures incurred to (1) acquire, create, or enhance an intangible asset, (2) facilitate the acquisition, creation, or enhancement of an intangible asset, (3) “facilitate . . . a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization,” or (4) which are otherwise identified by the IRS in prospectively effective published guidance, must be capitalized. The term “separate and distinct intangible asset” is limited to “a property interest of ascertainable and measurable value in money’s worth that is subject to protection under applicable state or federal law and the possession and control of which is intrinsically capable of being sold, transferred, or pledged (ignoring any restrictions imposed on assignability).” The only category of expenses not related to a separate and distinct asset subject to capitalization under the proposed regulations is costs to “facilitate . . . a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization.” This category includes only fact patterns analogous to the narrow fact pattern in *INDOPCO* and a number of cases involving similar issues that followed *INDOPCO*. Transaction costs incurred by a corporation to defend against a hostile takeover are not required to be capitalized, because they do not facilitate an acquisition. However, expenses incurred to recapitalize or to thwart a hostile acquisition by merging with a white knight must be capitalized.

● The proposed regulations provide two very important exceptions to the rule requiring capitalization of transaction costs.

First, under a “simplifying convention” that is in fact a major substantive rule, the regulations provide that compensation paid to employees and the employer’s associated overhead are never capitalized. This provision rejects the Tax Court decisions to the contrary and follows the two recent Court of Appeals decisions reversing the Tax Court [*Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999), *rev’d sub nom.*, *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000); *PNC Bancorp*,

Inc. v. Commissioner, 110 T.C. 349 (1998), *rev'd*, 212 F.3d 822 (3d Cir. 2000); *Lychuk v. Commissioner*, 116 T.C. 374 (2001)], and adopts a rule for dealing with intangible assets that is very different from the treatment of transaction costs with respect to tangible assets, which must always be capitalized under either or both of §§ 263(a) or 263A.

Second, the proposed regulations provide an exception that permits *de minimis* transaction costs—defined as costs that do not exceed \$5,000 per transaction (not per payee)—to be currently deducted. Because this rule is coupled with an elective average cost pooling method, the *de minimis* rule is subject to substantial manipulation and can result in current deductions for very significant transaction costs.

• The preamble explains that the IRS and the Treasury Department might, in the future, identify expenditures that are not listed in the regulations, but for which capitalization is nonetheless appropriate. Capitalization of non-listed expenditures will be required, however, only if (and after) they have been identified in published guidance. Unless an expenditure relating to an intangible asset is listed in the regulations or in such subsequently published guidance, capitalization will not be required and a current deduction will be allowed. Thus, under the proposed regulations, capitalization thus will become an exception to the norm of deducting expenditures.

b. The “whether and which” test shall too pass. The proposed regulations abandon the “whether and which” standard in Rev. Rul. 99-23, 1999-1 C.B. 998, for determining the line between expenditures subject to § 195 and those that are inherently capital as costs of the acquisition of the business itself. Instead, under a “bright-line rule,” expenses incurred in the process of pursuing the acquisition of a trade or business (whether the acquisition is structured as an acquisition of stock or of assets and whether the taxpayer is the acquirer or the target in the acquisition) must be capitalized only if they are “inherently facilitative” of the acquisition or if they relate to activities performed after the earlier of the date a letter of intent (or similar communication) is issued or, if the taxpayer is a corporation, the date the board of directors approves the acquisition proposal. The proposed regulations specifically identify expenditures that are “inherently facilitative,” such as amounts relating to determining the value of the target, drafting transactional documents, or conveying property between the parties. Under this bright-line rule, expenditures that do not facilitate the acquisition are capitalized as costs of the business, and instead are subject to § 195.

c. Depreciation on intangibles with unascertainable useful lives. The proposed regulations would permit amortization of the basis of intangibles that do not have readily ascertainable useful lives and for which a specific amortization or depreciation period is not specified in the Code or regulations, and for which amortization or depreciation is not proscribed. [Prop. Reg. § 1.167(a)-3(b).] Unless the IRS provides a different amortization period by published guidance, the “safe-harbor” amortization period is 15 years, using a straight-line method with no salvage value. Thus, for example, an amount paid to obtain a trade association membership of indefinite duration would be amortizable over 15 years. The amortization rule does not apply to intangible assets acquired from another party or to self-created financial interests, but these intangibles may be amortizable under § 197 or under other provisions of the Code or regulations. Intangibles that have readily ascertainable useful lives are amortized over those lives. Capitalized costs of a corporate restructuring, reorganization, or acquisition of equity capital are not amortizable.

d. The 12-month rule for prepaid expenses. The proposed regulations require that prepaid expenses be capitalized; but an expenditure to create or enhance intangible rights or benefits that do not extend for more than 12 months after the expenditure is incurred is not required to be capitalized. Prepaid expenses covering a period of more than 12 months would continue to be capitalized in full and deducted ratably over the period benefited. When determining the duration of a right, renewal periods must be taken into account if the facts and circumstances indicate a reasonable expectancy of renewal. For accrual method taxpayers, however, the scope of the ability to deduct prepayments under the “12-month rule” in the proposed regulations is limited by the economic performance requirement of § 461(h), which under the proposed regulations trumps the “12-month rule.”

3. Impact fees must be capitalized. Rev. Rul. 2002-9, 2002-10 I.R.B. 614 (3/11/02). Impact fees are one-time charges that are imposed by a state or local government against new or expanded real estate developments to finance specific offsite capital improvements for general public use necessitated by the development. These fees are refundable if the new development ultimately is not constructed. These impact fees are capitalized costs allocable to the building under §§ 263(a) and 263A. The ruling also contains provisions for changing accounting methods to comply with its provisions.

4. You don’t have to capitalize and depreciate business assets if you can prove average use of less than one year. Prudential Overall Supply v. Commissioner, T.C. Memo. 2002-103 (4/23/02). The taxpayer was an industrial uniform rental/laundry business that derived most of its income from services related to the uniforms it rented to customers. The rental uniforms were emblazoned with customers’ logos and fitted to specific customers’ employees. The taxpayer consistently deducted the cost of the uniforms [for both tax and financial accounting purposes], but the Commissioner, under § 446(b), sought to change the taxpayer’s accounting method to capitalization and depreciation. Judge Cohen found that the taxpayer had proven that the average useful service life of the garments was less than one year, even though the physical life of the garments exceeded one year, and allowed the taxpayer to continue to expense the garments.

5. You don’t have to create value to have to capitalize an expenditure. Winter v. Commissioner, T.C. Memo. 2002-173 (7/22/02). The Tax Court (Judge Ruwe) required capitalization of legal fees incurred by the buyer of a hotel in a suit against the seller for damages based upon alleged misrepresentations that caused buyer to pay an inflated price. “[T]he test for capitalization does not hinge on the amount of value added to property but looks at the nature of the expense itself.”

C. Reasonable Compensation

There were no significant developments in this topic in 2002.

D. Miscellaneous Expenses

1. The employer’s deduction was more than the includible compensation And it was legal! Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197 (3/28/00), *aff’d per curiam*, 255 F.3d 495, 2001-2 U.S.T.C. ¶50,503, 88 A.F.T.R.2d 2001-5026 (8th Cir. 7/3/01). Pursuant to Temp. Reg. § 1.162-25T, an employer-corporation that provided private nonbusiness flights on a company owned airplane to employees was permitted

to deduct the cost of providing the flights because the fair market value of the flights was included in the employees' reported compensation under Reg. § 1.61-21(b). Accordingly, pursuant to § 274(e)(2), the limitations of § 274 did not apply even though the airplane otherwise could be considered to be an entertainment facility. Furthermore, the employer's deduction was not limited to the lesser amount includable by the employees under special fringe benefit valuation rules [Reg. § 1.61-21(g)].

a. A.O.D. 2002-02, 2002-6 I.R.B. 459 (2/11/02). The Commissioner acquiesced in *Sutherland Lumber*.

2. The IRS never seems able to catch up with the movements in the price of gasoline, and more tinkering is in store for 2003. Rev. Proc. 2002-61, 2002-39 I.R.B. 616 (9/30/02), *superseding* Rev. Proc. 2001-54, 2001-2 C.B. 530. The optional standard mileage rate for business use of automobiles will decrease on 1/1/03 from 36.5 cents per mile to 36 cents per mile; the mileage rate for medical and moving will decrease from 13 cents per mile to 12 cents per mile; and the mileage rate for giving services to a charitable organization will remain at 14 cents per mile.

3. A taxpayer who seeks the safe harbor of a Revenue Procedure can't complain about the anchorage. *Beech Trucking Co., Inc. v. Commissioner*, 118 T.C. 428 (5/23/02). The taxpayer trucking company "leased" its truck drivers from another [related] company (ATS). In addition to paying for the drivers' services on a cents per mile basis and paying other expenses, Beech paid a "per diem" of 6.5 cents per mile. Beech deducted the full amount of the payments, but the Commissioner disallowed 50 percent of the per diem under § 274(n). The Commissioner conceded that the per diem met the deemed substantiation requirements of § 6.05 of Rev. Proc. 96-28, 1996-1 C.B. 686, [which was crucial to allowing any deduction because the taxpayer did not otherwise prove that the per diem, which was for meals and incidental expenses, not for lodging, was less than the federal M&IE rate]. The per diem was treated under Rev. Proc. 96-28 as being solely for meals and incidentals because it was computed on the same basis as compensation [cents per mile]. The Tax Court (Judge Thornton) rejected the taxpayer's argument that because it leased the drivers from ATS, § 274(n) did not apply to its payment to ATS. On the facts [which were sparse due to the taxpayer's failure to introduce evidence], the drivers were the taxpayer's common law employees because it controlled their activities and had final control over who was hired and who was fired. Thus, under Rev. Proc. 96-28 and § 274(n), only 50 percent of the per diem was deductible. The provisions in Rev. Proc. 96-28, treating the per diem as being solely for meals and incidentals because it was computed on the same basis as compensation, were not in conflict with Reg. § 1.62-2(d)(3)(ii), and the revenue procedure was not otherwise invalid. Finally, since the taxpayer was relying on Rev. Proc. 96-28 for deemed substantiation, in the absence of any evidence of actual substantiation, it would not be heard to challenge the conditions in the revenue procedure.

4. A deeply divided Tax Court overrules the substantive decision in *Redlark*, but the interpretative issue regarding the weight of the Bluebook remains opaque. *Robinson v. Commissioner*, 119 T.C. 44 (9/5/02) (appealable to the Fifth Circuit, but not appealed). Temporary Reg. § 1.163-9T(b)(2)(i)(A) treats interest on any noncorporate income tax underpayment as nondeductible personal interest, even if the underlying tax liability relates to a trade or business. In *Redlark v. Commissioner*, 106 T.C. 31 (1996), *rev'd*, 141 F.3d 936 (9th Cir. 1998), the Tax Court held that the

Regulations were invalid to the extent they classified as nondeductible personal interest, any interest paid with respect to an income tax underpayment arising from an unincorporated business. In a reviewed opinion (6-4-5) by Judge Chabot, the Tax Court overruled its prior opinion in *Redlark* and upheld the validity of the regulations as applied to an underpayment attributable to the taxpayer's law practice.

- The plurality reasoned that the words “properly allocable” in § 163(h)(2)(A), which excludes trade or business interest from the definition of nondeductible personal interest, were not intended to incorporate the pre-1986 case law upon which the Tax Court had relied in *Redlark*: “In *Redlark* . . . we did not deal with the fact that both the enacted TRA 1986 language (‘in connection with’) and the enacted TAMRA 1988 language (‘properly allocable to’) were different from the ‘in carrying on’ and ‘attributable to’ language interpreted in the pre-TRA 1986 opinions.” Section 163(h) itself is silent or ambiguous with respect to the question, and the regulations represent a permissible construction of § 163(h)(2)(A). The plurality noted that the five Courts of Appeals that have addressed the validity of the regulations all had upheld them. See *Allen v. United States*, 173 F.3d 533 (4th Cir. 1999); *McDonnell v. United States*, 180 F.3d 721 (6th Cir. 1999); *Kikalos v. Commissioner*, 190 F.3d 791 (7th Cir. 1999); *Miller v. United States*, 65 F.3d 687 (8th Cir. 1995); *Redlark*, supra. Unlike in its earlier *Redlark* opinion, the Tax Court plurality accorded some weight to the 1986 Bluebook.

- Judge Thornton (along with Judges Gerber and Gale) (*quoting Redlark*) concurred in the result but cautioned that:

“Where there is no corroboration in the actual legislative history, we shall not hesitate to disregard the General Explanation [of the Blue Book] as far as congressional intent is concerned. * * * Given the clear thrust of the conference committee report, the General Explanation [of the Blue Book] is without foundation and must fall by the wayside. To conclude otherwise would elevate it to a status and accord it a deference to which it simply is not entitled.” Other opinions of this Court echo the notion that we require some direct corroboration of congressional intentions before we defer to Blue Book expressions thereof.

- Chief Judge Wells (joined by Judges Swift, Colvin, Laro, and Vasquez) dissented:

The meaning of section 163(h)(2)(A) can be discerned from a plain reading of the language of that section. Moreover, prior case law defined the required nexus between an interest expense on a deficiency and a trade or business, and Congress did not indicate any intent to overturn these cases. Also, the majority placed undue emphasis and reliance on the Blue Book in validating section 1.163-9T(b)(2)(i)(A), Temporary Income Tax Regs., 52 Fed.Reg. 48407 (Dec. 22, 1987) in contravention of precedent.

- Judge Vasquez's dissent (joined by Judges Wells, Swift, Colvin, and Laro) emphasized that because the regulations in question were temporary regulations promulgated without either a specific delegation of authority or notice and comment, under *United States v. Mead Corp.*, 533 U.S. 218 (2001), the regulations were not entitled to deference under the standard of *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S.

837 (1984). He would accord “the agency’s interpretation . . . respect proportional to its ‘power to persuade’” pursuant to *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). The dissent concluded that the plurality erred in relying on Courts of Appeals’ decisions upholding the regulations because those decisions were pre-*Mead* cases.

5. Only half the cost of Mint Juleps & country ham with beaten biscuits is deductible. *Churchill Downs v. Commissioner*, 307 F.3d 423, 2002-2 U.S.T.C. ¶50,691, 90 A.F.T.R.2d 2002-6615 (6th Cir. 10/8/02), *aff’g* 115 T.C. 279 (9/26/00). The Sixth Circuit (Judge Siler) upheld the Tax Court’s decision (Judge Laro) that § 274(n) limited to 50 percent of the cost, Churchill Downs’ deduction for the expenses of entertainment [the Kentucky Derby sport of Kings Gala, press receptions, hospitality tents, winners parties, etc.] in connection with the Kentucky Derby, the Breeders’ Cup, and other major horse races. Although Churchill Downs was in the “entertainment business,” the expenses for the functions were not part of its entertainment product, which was horse racing. Nor were the costs deductible as entertainment available to the public [§ 274(n)(2), (e)(7) exception] or sold to customers [§ 274(n)(2), (e)(8) exception] because the functions were by invitation only and not open to the public. The Court of Appeals reasoned that the expenses were “entertainment” under Reg. § 1.274-2(b)(1)(ii) because:

[T]he purpose of the galas and dinners was not to make Churchill Downs’ product directly available to its customers or to provide them with specific information about it, but rather to create an aura of glamor in connection with the upcoming races and generally to arouse public interest in them. In this regard, the dinners, brunches, and receptions at issue most closely resemble the example [in Reg. § 1.274-2(b)(2)(ii)] of a fashion show held for the wives of appliance retailers, and are best characterized not as a product introduction event used to conduct the taxpayer’s business, but as pure advertising or public relations expenses.

● The Court of Appeals then rejected the taxpayer’s argument that its business was “entertainment” generally:

Although Churchill Downs argues, as any business that depends on advertising may, that it made money as a result of these publicity events, this does not change their nature as something distinct from what was actually sold. The Commissioner puts it succinctly: “taxpayers were in the horse racing business, not the business of throwing parties.” Accordingly, it is inappropriate to characterize these non-race events as Churchill Downs’ “product.”

6. A serially issued captive insurance company instruction manual.

a. Subsidiary insurance company. Rev. Rul. 2002-89, 2002-52 I.R.B. 984 (12/30/02). This ruling promulgates a safe harbor and a rocky shoal for deducting insurance premiums to licensed domestic captive insurance subsidiaries. In a situation in which 90 percent of the insurance subsidiary’s premiums, on both a gross and net basis, are derived from its parent, the IRS concludes that there is no “risk shifting and risk distribution,” and thus no “insurance” or deductible insurance premiums. On the other hand,

in a situation in which less than 50 percent of the insurance subsidiary's premiums, on both a gross and net basis, are derived from its parent and the remainder are derived from unrelated insureds, and all transactions between the related taxpayer and insurance company meet an arm's length standard, the IRS concludes that there is "risk shifting and risk distribution," and thus there is "insurance" and deductible insurance premiums.

b. Sibling insurance company. Rev. Rul. 2002-90, 2002-52 I.R.B. 985 (12/30/02). This ruling blesses the deduction of insurance premiums paid to a sibling licensed domestic insurance company, even though it insures no risks outside the group, where all parties conduct themselves in a manner consistent with insurance arrangements between unrelated parties. The ruling postulates 12 operating subsidiaries, each of which represents between 5 and 15 percent of the risks insured by the insurance company member. The ruling follows *Humana Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989), and *Kiddie Industries, Inc. v. United States*, 40 Fed. Cl. 42 (1997), and distinguishes *Malone & Hyde, Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995).

c. Group captive. Rev. Rul. 2002-91, 2002-52 I.R.B. 991 (12/30/02). A small group of unrelated businesses involved in a highly concentrated industry facing significant liability hazards, and required by law to maintain adequate liability insurance coverage, formed "group captive" insurance coverage that provided insurance only to its owner—its only activity. The group captive was adequately capitalized, operated separately from its owners, none of which owned more than 15 percent or had more than 15 percent of the vote. No owner's individual risk insured by the group captive exceeded 15 percent of the total insured risk insured. Premiums were actuarially determined using recognized actuarial techniques, and were based, in part, on commercial rates, and claims were investigated before payment. There was a real possibility that an insured owner would sustain losses in excess of the premiums paid, and no insured owner would be reimbursed for excess premiums paid. On these facts, the IRS ruled that the contracts issued by the group captive to its owners were insurance and the premiums were deductible under § 162. The group captive was taxed as an insurance company.

E. Depreciation & Amortization

1. The Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21 (3/9/02), provides for additional first-year depreciation of 30 percent for certain property that was acquired after 9/10/01 and placed in service before 1/1/06. Qualifying property consists of: (1) § 168 property with a recovery period of 20 years or less; (2) computer software other than computer software covered by § 197; (3) water utility property; and (4) leasehold improvement property. For passenger automobiles, the § 280F(a)(1)(A)(i) limitation is to be increased by \$4,600. This provision also applies to improvements to used property.

● Depreciation claimed pursuant to this provision may be used for AMT purposes even though the 200 percent declining balance depreciation tables are used for the basis remaining after the additional first-year depreciation is taken.

a. Rev. Proc. 2002-33, 2002-20 I.R.B. 963 (5/20/02). This revenue procedure provides procedures for claiming the additional 30 percent first-year depreciation provided by § 168(k) [and § 1400L(B)]. It also explains how a taxpayer may elect not to deduct the additional first-year depreciation for qualified property.

2. Proposed guidance on the now statutory “nonstatutory” depreciation method. REG-103823-99, Guidance on Cost Recovery Under the Income Forecast Method, 67 F.R. 38025 (5/31/02). The Treasury Department has published detailed proposed regulations under § 167(g) [added in 1996] to govern depreciation under the income forecast method. The proposed regulations allow mid-recovery period recomputations where conditions necessitate it, e.g., where the facts indicate that the original income forecast was erroneous. “Catch-up” depreciation is allowed in a year that basis [determined under § 263A] is redetermined; contingent amounts are not added to basis until the § 461(h) economic performance test. Unlike under other § 167 depreciation methods, but like under MACRS depreciation, salvage value is not subtracted from basis before computing depreciation. Income forecasts must be revised annually for accuracy. Income forecast depreciation is generally elected property-by-property, with very limited grouping available. The § 461(g)(2) look-back interest rules do not apply if the basis of the property is \$100,000 or less in the year the look-back would occur. In addition, the look-back rule is not applied if forecasted income (and, if applicable, revised forecasted income) for each prior year is more than 90 percent and less than 110 percent of revised total forecasted income for the recomputation year. The proposed regulations will be effective upon finalization.

3. Replacing short-lived critical components inside a long-lived shell is a capital expense. Smith v. Commissioner, 300 F.3d 1023, 2002-2 U.S.T.C. ¶50,583, 90 A.F.T.R.2d 2002-5747 (9th Cir. 8/12/02), *aff’g* Vanalco, Inc. v. Commissioner, T.C. Memo 1999-265 (8/6/99). The taxpayer operated an aluminum smelting plant that had 640 reduction cells [each 22 feet long, 76 inches wide, and 36 inches high]. A cell shell had a life of over 50 years and its lining had a life of approximately three years. The cost of relining a cell was 22.21 percent of the cost of a completely rehabilitated cell and was, aside from the superstructure, “by far the most expensive part of the cell to replace.” During each of the 2 years in issue, the taxpayer replaced the linings of approximately 200 cells at a cost of over \$4 million each year, which it deducted as a repair expense. The Court of Appeals affirmed the Tax Court’s holding that the expenses were capital. After first finding that the Tax Court’s holding that each cell—rather than all of them together—was a separate property was not clearly erroneous, the court then rejected the taxpayer’s argument that the Tax Court had misapplied *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962) *nonacq.*, 1964-2 C.B. 8. In order to determine whether the repair was merely incidental, “the significance of the part under repair to the operation of the property [was] a critical inquiry.” Because each cell completely lost functionality as result of the deterioration of the lining, the relining process was “integral to ‘putting’ the cell back into its original functional state ...[and] restoring it from a state of functional exhaustion to full functional operation.” The court concluded that “the lining is a critical component of the cell and its replacement is tantamount to reconstituting the cell itself.” Because the relining process effectively rebuilt the cell, it conferred a new life expectancy on the cell.

4. Does this case permit the cost of a new roof on a rental house to be deducted? Is a Tax Court Summary Opinion meaningful in any sense? Campbell v. Commissioner, T.C. Summary Opinion 2002-117 (9/6/02) (nonprecedential pursuant to § 7463(b)). Special Trial Judge Pajak held the \$8,000 expenditure for roofing work done on taxpayer’s rental house was a deductible repair expense, and did not need to be capitalized. “The contractors removed the existing top layers of the roof and recovered it with fiberglass sheets and hot asphalt. They made no structural changes to the roof. . . . There

was no replacement or substitution of the roof. Petitioner's only purpose in having the work done to the roof was to prevent the leakage and keep [the taxpayer's] rental house in operating condition and not to prolong the life of the property, increase its value, or make it adaptable to another use."

F. Credits

1. The AMT can bite even those who don't owe it. Allen v. Commissioner, 118 T.C. 1 (1/04/02). Section 38(c)(1) provides that the general business credit may not exceed the taxpayer's net income tax minus the greater of (1) AMT or (2) 25 percent of taxable income in excess of \$25,000. This generally prevents the credit from offsetting AMT. This case involved a taxpayer who was not subject to AMT for the year in question, but whose tentative minimum tax would have exceeded the credit if, because the taxpayer claimed the § 51 targeted jobs credit [now the Work Opportunity Credit], § 280C were applied in calculating AMTI to deny a deduction for the amount of the credit [before limitation by § 38(c)]. The Tax Court (Judge Laro) held that in computing AMTI and tentative AMT for purposes of § 38(c), any reduction in the amount of deductions required by § 280C by virtue of a credit having been claimed with respect to the otherwise deductible expenditures, must be taken into account even though the taxpayer was not liable for the AMT in that year. Judge Laro rejected the taxpayer's argument (which was accepted by the Commissioner) that the AMT was a "separate and independent tax system that operates in parallel with the RT [regular tax] system and requires separate calculations." He found no support in the committee reports for treating AMTI as anything other than regular taxable income as modified by § 55(b)(2), and rejected any inference to the contrary in the 1986 Act Bluebook on the grounds that the Bluebook was "not part of the statute's legislative history," [noting that this is especially true with respect to the 1986 Act Bluebook, which was prepared by the staff of the succeeding Congress].

- Judge Laro noted that if he had accepted the argument that the AMT was a separate and independent tax system that operates in parallel with regular tax system, he would have been inclined to hold for the taxpayer.

- This case has implications beyond the Work Opportunity Credit because the same statutory structures apply to the Welfare to Work Credit, the Orphan Drug Credit, and the Increased Research Activities Credit.

2. The court closed the barn door after the Treasury Department let the horse out. Tax and Accounting Software Corp. v. United States, 301 F.3d 1254, 2002-2 U.S.T.C. ¶50,623, 90 A.F.T.R.2d 2002-6107 (10th Cir. 8/30/02). The Tenth Circuit (Judge Lucero) reversed the District Court's grant of summary judgment to the taxpayer [and remanded the case], holding that the § 41 research credit is limited to research to "discover" new technological information that is applied toward the development of a product,⁵ but which is separate from the product. To meet this test, the research must expand existing knowledge. However, the process of experimentation can include research in which the taxpayer tries already-known methods to achieve a result that it is not yet known but can be reached by such methods. On the other hand, the credit is allowable only where the feasibility of the end result is

5. Section 41(d)(1) includes the requirement that the research must be for "the purpose of discovering information" using a "process of experimentation."

uncertain at the time the research is undertaken. On the facts, the taxpayer could not meet these standards.

● Note that the proposed regulations, REG-112991-01, Credit for Increasing Research Activities, 66 F.R. 66362 (12/26/01), impose less stringent requirements than were applied in this case, particularly with respect to the “new knowledge” requirement.

G. Natural Resources Deductions & Credits

1. To “produce” or to “transport” gas, that is the question. Saginaw Bay Pipeline Co. v. United States, 124 F. Supp. 2d 465, 2001-2 U.S.T.C. ¶50,642, 88 A.F.T.R.2d 2001-6019 (E.D. Mich. 8/23/01). Natural gas gathering systems are used to transport gas [Class 46.0]—not in production [Asset Class 13.2]—and thus are depreciable over 15 years rather than 7 years. The District Court described *Duke Energy Natural Gas Corp. v. Commissioner*, 172 F.3d 1255 (10th Cir. 1999), as “wrongly decided.”

a. Non-producer must use 15-year recovery period. Clajon Gas Co., L.P. v. Commissioner, 119 T.C. 197 (10/25/02) (reviewed, 10-5). The Tax Court, in a decision by Judge Halpern, upheld the government’s notices of final partnership administrative adjustments in determining that the recovery period for gathering pipeline systems owned and operated by a non-producer were transportation property with a 15-year recovery period, and not natural gas production property with a 7-year recovery period. The Tax Court adhered to its decision in *Duke Energy Natural Gas Corp. v. Commissioner*, 109 T.C. 416 (1997), *rev’d*, 172 F.3d 1255 (10th Cir. 1999), and refused to follow the Tenth Circuit’s reversal. The majority held that Clajon’s use of the pipeline system was relevant, and inasmuch as Clajon was not a producer, the pipeline system could not have been part of the production system.

● Judge Wells’ dissent was based upon the Tenth Circuit’s plain language analysis in *Duke Energy* of Rev. Proc. 87-56, 1987-2 C.B. 674, which only requires that the assets be “used” by natural gas producers to qualify for 7-year depreciation. The Tax Court majority requires that the asset be both owned and used by a natural gas producer. Judge Wells notes that the Tax Court held in *Rauenhorst v. Commissioner*, 119 T.C. 157 (10/7/02), that “the Commissioner may not choose to litigate against an official position the Commissioner has published without first revising or revoking that position.”

● Judge Foley’s dissent was based upon similar grounds, that the asset meets the regulatory requirement even though Clajon was not a producer.

2. No depletion of materials excavated from someone else’s construction site. Goodfellow v. Commissioner, T.C. Memo. 2002-128 (5/28/02). Taxpayer was not entitled to depletion deductions on materials it excavated from construction sites pursuant to contracts with the general contractor because it did not have an economic interest in the materials in place. Pursuant to these contracts, the taxpayer was permitted to remove excavated materials that the general contractors deemed to be unusable, crushed these materials with equipment located at the taxpayer’s quarry and sold them as crushed rock. The taxpayer made no investment in the rock and had no interest in it in the ground, because whether the rock was “usable,” and would be retained by the general contractor, or “unusable,” was decided by the general contractor after excavation. (The taxpayer was entitled to depletion deductions on materials it extracted from its own quarry.)

3. Enhanced oil recovery cost credit amount is alive and well for 2002. Notice 2002-53, 2002-30 I.R.B. 187 (7/29/02). The § 43 credit for domestic “enhanced oil recovery costs” equals 15 percent of qualified costs for the taxable year. The credit is subject to phase-out for any taxable year in which the reference price of crude oil (determined under § 29(d)(2)(C)) for the prior year exceeds \$28, adjusted for inflation. The credit is wholly phased-out if the reference price of oil equals or exceeds \$34, adjusted for inflation. For taxable years beginning in 2002, the enhanced oil recovery credit is determined without regard to the phase-out for crude oil price increases.

4. Percentage depletion rate on marginal oil or gas that is production is not enhanced for 2002. Notice 2002-54, 2002-30 I.R.B. 189 (7/29/02). Percentage depletion [15%] remains available to independent producers and royalty owners under § 613A(c). Section 613A(c)(6) increases the percentage depletion rate on oil or gas that is “marginal production,” by one percentage point, to a maximum rate of 25 percent, for each dollar by which the “reference price” for crude oil—generally speaking, average wellhead price per barrel for domestic crude oil—for the preceding calendar year falls below \$20. The applicable percentage for purposes of determining percentage depletion for oil and gas produced from marginal properties for 2002 is 15 percent.

H. Loss Transactions, Bad Debts and NOLs

1. Play ball with me! “Substance over form” is a different doctrine from “economic substance,” but the taxpayer still loses. Rogers v. United States, 281 F.3d 1108, 2002-1 U.S.T.C. ¶50,240, 89 A.F.T.R.2d 2002-1115 (10th Cir. 2/22/02), *aff’g* 58 F. Supp. 2d 1235 (D. Kan. 6/10/99). The Court of Appeals (Judge Henry) affirmed the District Court’s decision applying the substance over form doctrine to recharacterize a purported nonrecourse loan and foreclosure as a sale. Kaufman and Fogelman each owned 50 percent of the stock of the Kansas City Royals S corporation. When Fogelman encountered financial difficulties, on July 31, 1990, Kaufman lent the corporation \$34 million, which the corporation re-lent to Fogelman on a nonrecourse basis, secured by his stock in the corporation and due January 3, 1991. Simultaneously, Fogelman granted the corporation an option to purchase his stock (and an option to purchase Kaufman’s stock on which Fogelman had an option). The option price on Fogelman’s stock was the amount due on the note. The Royals immediately exercised the option to purchase Fogelman’s stock, with the closing deferred to January 4, 1991. In the fall of 1990, J.P. Morgan & Co. conducted an attempted auction sale of the entire Royals franchise at a minimum of \$80 million. There were no bidders and J.P. Morgan opined that Fogelman’s 50 percent interest was of only “nominal value.” On January 3, 1991, Fogelman transferred his stock to the corporation in lieu of foreclosure. The Royals treated the collateral as having no value and, as an S corporation, passed a § 166 bad debt loss through to Kaufman. In the course of holding that the loan was not bona fide and that the transaction was in substance a purchase and sale of the stock rather than a loan, Judge Henry explained that the substance over form doctrine is different from the “economic substance” doctrine that may be applied in tax shelter-type cases. He rejected the taxpayer’s argument that the two were the same and the proper application was limited to tax shelter cases.

2. NOLs from the grave. Lassiter v. Commissioner, T.C. Memo. 2002-25 (1/25/02). The husband taxpayer, who had NOLs, was in Chapter 11 bankruptcy in 1994 when he died [at which time his NOLs had been transferred to the bankruptcy estate pursuant to § 1398(i)]. Pursuant to Fed. R. Bankr. P.

1016, the bankruptcy proceeding was continued and concluded later in 1994 as if the husband had not died. His NOLs that survived the bankruptcy were deducted on a joint return for 1994. Judge Laro held that under §§ 172(b)(1) and 1398(i), the husband's NOLs were properly deductible on the joint return. Section 1398(i) provides that the "debtor" succeeds to the bankruptcy estate's NOLs; the "debtor" was the husband, even if he was not alive when the estate terminated, and he was entitled to use them on his final tax return.

3. "The Northern Lights have seen strange sights." Kappus v. Commissioner, T.C. Memo. 2002-36 (2/8/02). The AMT § 59(a)(2) limitation to 90 percent of AMTI of a NOL incurred by a Canadian resident/U.S. citizen taxpayer did not violate the US-Canada tax treaty elimination of "double taxation." Section 59(a)(2) was in "harmony" with the treaty and thus the last-in-time rule did not apply to invoke a treaty override.

4. The Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21 (3/9/02), adds § 170(b)(1)(H) to extend the NOL carryback period from 2 years to 5 years for NOLs in years ending in 2001 and 2002. The 90 percent limit on NOL carryovers for AMT purposes is temporarily suspended for these years.

a. Amended returns should have been filed by 10/31/02. Rev. Proc. 2002-40, 2002-23 I.R.B. 1096 (6/10/02). This revenue procedure provides procedures that taxpayers with NOLs incurred in 2001 or 2002 must follow to apply or elect out of the special 5-year carryback period enacted in the Job Creation and Worker Assistance Act of 2002. Qualifying taxpayers who filed returns for the 2001 or 2002 tax years without taking advantage of the 5-year NOL carryback, whether by using the 2-year carryback period, not claiming a carryback, or electing under § 172(b)(3) to forgo the NOL carryback period, will have until 10/31/02 to file amended returns in which they may use the 5-year carryback period (including, if appropriate, the revocation of the § 172(b)(3) election). See also REG-122564-02, Carryback of Consolidated Net Operating Losses to Separate Returns Years, 67 F.R. 38039 (5/31/02), and T.D. 8997, Carryback of Consolidated Net Operating Losses to Separate Returns Years, 67 F.R. 38000 (5/31/02) (corrected, 67 F.R. 45310 (7/9/02)), for similar relief available to acquiring consolidated groups, which permits them to waive the preacquisition portion for the 5-year NOL carryback period for losses attributable to acquired members.

5. No bad debt deduction allowed where the default is caused by the creditor's own actions to further other business goals. PepsiAmericas, Inc. v. United States, 52 Fed. Cl. 41, 2002-1 U.S.T.C. ¶50,326, 89 A.F.T.R.2d 2002-1524 (3/20/02). The taxpayer had established an ESOP, to which it had lent substantial sums to purchase shares of its stock. To further a planned corporate reorganization involving a spin-off of its key subsidiary—taxpayer was a holding company—it terminated the ESOP. As a result, the ESOP was unable to repay the entire debt. Immediately prior to its termination, the ESOP was insolvent under the balance sheet test, but was not equitably insolvent. The Court of Federal Claims (Judge Futey) upheld the IRS's disallowance of the taxpayer's claimed bad debt deduction. First, the court held that immediately before its termination, the ESOP should have been considered to be a solvent debtor, because had it been continued, it would have been able to continue to make payments on the note. Second, the court treated the voluntary termination of the ESOP in furtherance of the reorganization plan as the release of a solvent

debtor from liability to further other business purposes of the creditor. Citing *American Felt Co. v. Burnet*, 58 F.2d 530 (D.C. Cir. 1932), the court held that no bad debt deduction is allowed under the circumstances.

I. At-Risk and Passive Activity Losses

1. **The statute was self-executing; the taxpayer doesn't have to wait for regulations on self-charged management fees.** *Hillman v. Commissioner*, 114 T.C. 103 (2/29/00). The taxpayer's S corporation performed management services for real estate partnerships in which the taxpayer directly or indirectly was a partner. The taxpayer received pass-through nonpassive income from the S corporation and pass-through passive deductions from the partnerships. Based on § 469(l)(2) and its legislative history, under circumstances analogous to those in Prop. Reg. § 1.469-7, permitting the offsetting of "self-charged" interest incurred in lending transactions, the taxpayer offset passive management fee deductions against the corresponding nonpassive management fee income. Section 469(l)(2) provides that the IRS "shall" promulgate regulations "which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income)." Prop. Reg. § 1.469-7 permits offsetting of "self-charged" interest incurred in lending transactions, but the IRS did not issue any regulation for self-charged items other than interest. Under the proposed regulations, a taxpayer who was both the payor and recipient of interest was allowed, to some extent, to offset passive interest deductions against nonpassive interest income. The Commissioner argued that the taxpayer could not offset the deductions and income because the IRS had not issued regulations for self-charged items other than interest and had thereby limited the offset. The Tax Court (Judge Gerber) held that the substantive set-off rule was self-executing and the taxpayer was entitled to offset the passive management deductions against the nonpassive management income. Such self-charged treatment was congressionally intended not only for interest, but also for other appropriate items, and the Commissioner did not argue that there was any distinction of substance between interest and management fees within the self-charged regime. The taxable years involved were 1993 and 1994.

a. **Well, now, not for this taxpayer and not in the Fourth Circuit. What "plain meaning" giveth in *Giltitz*, it taketh away in *Hillman*. Reversed, *Hillman v. I.R.S.*, 250 F.3d 228, 2001-1 U.S.T.C. ¶50,354, 87 A.F.T.R.2d 2001-1731 (4th Cir. 4/17/01), *rehearing en banc denied*, 263 F.3d 338, 88 A.F.T.R.2d 2001-5292 (7/30/01).** The Court of Appeals (Judge Hamilton) reversed the Tax Court, finding that "nothing in the plain language of IRC § 469 suggests that an exception to IRC § 469(a)'s general prohibition against a taxpayer's deducting passive activity losses from nonpassive activity gains exists where, as in the present case, the taxpayer essentially paid a management fee to himself." The court reasoned that Hillman's argument for ignoring the plain language of the statute could prevail only if one of "two extremely narrow exceptions to the Plain Meaning Rule" applied: (1) "when literal application of the statutory language at issue produces an outcome that is demonstrably at odds with clearly expressed congressional intent to the contrary," or (2) "when literal application of the statutory language at issue 'results in an outcome that can truly be characterized as absurd, i.e., that is so gross as to shock the general moral or common sense.'" (*quoting Sigmon Coal Co. v. Apfel*, 226 F.3d 291, 304 (4th Cir. 2000)). In the eyes of the court, neither of those situations was present.

b. On remand, Hillman v. Commissioner, 118 T.C. 323 (4/9/02). Judge Gerber, in denying the taxpayer relief from § 469 by reason of the Fourth Circuit's decision, stated:

Unfortunately, petitioners have been snared by the reach of section 469 in, what appears to be, most inequitable circumstances. As we discussed in our prior opinion, section 469 was designed to limit the use of losses generated by passive activities to offset unrelated income generated by nonpassive activities. Although section 469 was designed to stop these practices, Congress recognized that it would be inappropriate to treat certain transactions between related taxpayers as giving rise to passive expense and nonpassive income.

The Secretary was charged with issuing regulations to implement section 469. Commentary contained in the legislative history suggests that self-charged items should be provided for in the regulations. In 1991, regulations were proposed that provided for self-charged interest. Although more than 15 years have passed since the enactment of section 469 and 10 years have passed since the self-charged regulation for interest was proposed, no action has been taken to relieve inequity that may be suffered with respect to self-charged items other than interest. Although we find petitioners' plight lamentable, the Court of Appeals for the Fourth Circuit has held that the courts are incapable of providing relief in this situation.

c. "So there, Mr. Hillman!" T.D. 9013, Limitations on Passive Activity Losses and Credits--Treatment of Self-Charged Items of Income and Expense, 67 F.R. 54087 (8/21/02). The final regulations under § 469 on self-charged items of income and expense decline to extend self-charged treatment to items beyond interest because Congress in 1993 provided relief in § 469(c)(7) to real estate professionals. (Section 469(c)(7) is applicable to years beginning after 12/31/93.) The preamble states:

Noting that Congress authorized the Secretary to identify other situations in which self-charged treatment is appropriate, several commentators suggested that self-charged treatment be extended to other transactions involving rental real estate activities, such as the payment of management fees and salaries. After publication of the proposed regulations, Congress considered the impact of section 469 on rental real estate transactions and enacted specific relief in section 469(c)(7) for certain real estate professionals for taxable years beginning after 1993. There was no indication in the legislative history of section 469(c)(7) that Congress considered additional relief for real estate transactions necessary or desirable. Moreover, there is less justification for the complexity of a self-charged rule in this area after the enactment of section 469(c)(7) because that change substantially reduced the number of real estate transactions that

would benefit from a self-charged rule. Accordingly, the regulations do not extend the self-charged treatment to other transactions involving rental real estate.

2. The IRS consistently wins on this issue. *Krukowski v. Commissioner*, 279 F.3d 547, 2002-1 U.S.T.C. ¶50,219, 89 A.F.T.R.2d 2002-827 (7th Cir. 2/5/02), *aff'g* 114 T.C. 366 (5/22/00). Mr. and Mrs. Krukowski owned an interest in a building that they leased to Krukowski & Costello, a law firm organized as a “C” corporation of which Mr. Krukowski was the sole shareholder and from which he received all of his earned income. The Krukowskis treated the rental income as passive activity income, against which they deducted passive activity losses. The Commissioner applied Reg. § 1.469-2(f)(6) to recharacterize the rental income as active income and disallowed the passive activity losses. The Seventh Circuit affirmed the Tax Court’s decision upholding the validity of Reg. § 1.469-2(f)(6) and Temp. Reg. § 1.469-5T(f)(3), which provide that participation by one spouse shall be treated as participation by the other spouse in the activity during the taxable year. Accordingly, the rental income was recharacterized as active and the passive activity losses were disallowed.⁶

3. Shucks, it doesn’t work! Deemed sale election will not constitute a disposition for purposes of § 469(g)(1)(A). Notice 2002-29, 2002-17 I.R.B. 797 (4/29/02). This notice explains the effect under § 469 of a deemed sale of property on January 1, 2001, pursuant to an election under § 311(e) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (8/5/97) (TRA 97). A question had arisen whether electing a deemed sale of property under § 311(e) of the TRA 97 is treated as a disposition of that property under § 469(g)(1)(A). In a technical correction to § 311(e), § 414(a)(2) of the Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21 (3/9/02), clarifies that a mark-to-market election is not a disposition for purposes of § 469(g)(1)(A). Thus, the gain included in gross income by reason of a mark-to-market election may be passive activity gross income that can be offset by passive activity deductions, but the election does not otherwise affect the determination of the passive activity loss that is disallowed under § 469.

III. INVESTMENT GAIN

A. Capital Gain and Loss

1. The 18% rate and a tax-free step-up? No way! Rev. Rul. 2001-57, 2001-2 C.B. 488. An individual who elects under § 311(e) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (8/5/97), to treat his principal residence as being both sold and reacquired for an amount equal to FMV on 1/1/01—in order to secure the 18% capital gains rate for assets acquired on or after that date and held for 5 years thereafter—may not exclude from gross income any of the gain recognized from the deemed sale. This result was enacted statutorily in § 414(a)(1) of the Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21 (3/9/02).

6. *Accord* *Fransen v. United States*, 191 F.3d 599 (5th Cir. 1999); *Sidell v. Commissioner*, 225 F.3d 103 (1st Cir. 2000); *Schwalbach v. Commissioner*, 111 T.C. 215 (1998).

a. Notice 2002-58, 2002-35 I.R.B. 432 (9/3/02). This notice provides instructions on how a noncorporate taxpayer may make the election under § 311(e) of the Taxpayer Relief Act of 1997 to treat assets held on 1/1/01 as being sold and reacquired on that date, in order to reduce the § 1(h) rates for capital gain from 20 percent to 18 percent for assets held for more than 5 years thereafter. This election was to have been made by filing an amended return within 6 months of the due date of the original return, excluding extensions.

2. **You have to transfer some other business asset before you can sell goodwill.** Baker v. Commissioner, 118 T.C. 452 (5/29/02). The taxpayer was a State Farm insurance agent who sold policies exclusively for State Farm as an independent contractor, operated his own agency, developed clients, hired employees, and paid expenses. Upon retirement, the taxpayer returned to State Farm all of its property, but transferred no identifiable assets of his own, and he received a “termination payment.” The insurance policies he had written were assigned to a successor agent. (The customer list belonged to the insurance company.) The Tax Court (Judge Panuthos) denied the taxpayer capital gain treatment with respect to the termination payment. He transferred no assets that he owned; the telephone number and at-will employment relationships were not assets. He could not transfer goodwill because he transferred nothing to which goodwill could attach. The entire termination payment was ordinary income without regard to the portion of it allocable to a covenant not to compete.

3. **The IRS has got you coming and going. Year-end straddle coverage of short sales results in gains in earlier year and losses in later year.** Rev. Rul. 2002-44, 2002-28 I.R.B. 84 (7/15/02). If stock to close an existing short position, e.g., from a short sale, is purchased with a trade date in one year and a settlement date the following year, e.g., a December 31 trade date and a January 5 settlement date, pursuant to § 1259, any gain realized with respect to the short position—because the stock has fallen in value—is recognized in the year of the trade date on which the stock to cover is acquired, not the later year the short sale is closed. But if the short sale is closed at a loss—because the stock has risen in value—§ 1259 does not apply and, pursuant to Reg. § 1.1233-1(a)(1) and Rev. Rul. 93-84, 1993-2 C.B. 225, the loss is realized in the year of the closing.

4. **Arkansas Best didn’t ring the death knell for all judicial exceptions to the statutory definition of “capital asset.”** Davis v. Commissioner, 119 T.C. 1 (7/3/02). The taxpayer won the California lottery and received the right to 20 annual payments of \$679,000 each. Subsequently, the taxpayer sold a portion of his right to 11 of the 14 remaining payments for approximately \$1,040,000 and reported the gain as long-term capital gain. Judge Chiechi rejected the taxpayer’s argument that the Supreme Court’s decision in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1998), overruled the line of cases that would have precluded characterizing the future lottery payments as a capital asset (*Hort v. Commissioner*, 313 U.S. 28 (1941); *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958); *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130 (1960); and *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965)), citing footnote 5 of the *Arkansas Best* opinion.⁷ In holding that the

7. Footnote 5 states:

Petitioner mistakenly relies on cases in which this Court, in narrowly applying the general definition of “capital asset,” has “construed

taxpayer realized ordinary income, not capital gain, on the sale, the Tax Court specifically held that the “right to receive future annual lottery payments does not constitute a capital asset within the meaning of section 1221,” without placing much, if any, emphasis on the temporal division. [*Compare McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947)]. In this regard, footnote 9 of the *Davis* opinion states:

It is well established that the purpose for capital-gains treatment is to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year. * * * [*Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134, 80 S. Ct. 1497, 4 L. Ed. 2d 1617 (1960) (citing *Burnet v. Harmel*, 287 U.S. 103, 106, 53 S. Ct. 74, 77 L. Ed. 199 (1932))].

a. United States v. Maginnis, 2002-1 U.S.T.C. ¶50,494, 89 A.F.T.R.2d 3028 (D. Or. 5/28/02). Summary judgment was entered in the government’s favor, holding that gain recognized on the assignment of lottery winnings to a third party for a lump-sum cash payment was ordinary income, not capital gain.

5. “Putting” lipstick on the telltale collar. Rev. Rul. 2002-66, 2002-45 I.R.B. 812 (11/12/02). If the grantor of a qualified covered call option holds a put option on the same underlying equity, the presence of the purchased put causes the stock and the qualified covered call option to constitute part of a larger straddle within the meaning of § 1092(c)(4)(A). In such event, under § 1092(a), the amount of losses that may be recognized is limited to the amount by which the losses exceed the unrecognized gain in any offsetting positions in that straddle.

B. Section 121

1. A man’s (woman’s) home is his (her) tax-free castle. T.D. 9030, Exclusion of Gain From Sale or Exchange of a Principal Residence, 67 F.R. 78358 (12/24/02) [proposed in REG-105235-99, Exclusion of Gain From Sale or Exchange of a Principal Residence, 65 F.R. 60136 (10/10/00)]. The Treasury Department has promulgated final regulations [Regs. §§ 1.121-1 through 1.121-4] dealing with the § 121 exclusion of up to \$250,000 (\$500,000 for joint returns) of gain on the sale of the taxpayer’s principal residence if the

‘capital asset’ to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income,” even though these items are property in the broad sense of the word. *Midland-Ross*. See, e.g., *Gillette Motor* (“capital asset” does not include compensation awarded taxpayer that represented fair rental value of its facilities); *P. G. Lake* (“capital asset” does not include proceeds from sale of oil payment rights); *Hort* (“capital asset” does not include payment to lessor for cancellation of unexpired portion of a lease). This line of cases, based on the premise that § 1221 “property” does not include claims or rights to ordinary income, has no application in the present context. Petitioner sold capital stock, not a claim to ordinary income. [citations omitted].

taxpayer owned and used the property as his principal residence for at least 2 years of the preceding 5-year period.

- The final regulations follow the proposed regulations in providing that whether a property qualifies as the taxpayer's principal residence depends upon all the facts and circumstances. If the property is used a majority of the time during the year it will ordinarily be considered the taxpayer's principal residence. The final regulations add a *nonexclusive* list of factors that are relevant in identifying a property as a taxpayer's principal residence. The Treasury Department declined to follow comments suggesting that the 2-year use requirement should not require actual occupancy or that the regulations provide a safe harbor definition of short temporary absences that would not affect the 2-year use requirement.

- The final regulations extend the § 121 exclusion to the sale of *vacant land* containing the dwelling unit, which is owned and used as part of the taxpayer's principal residence, if (1) the dwelling unit is sold within 2 years before or after the sale of the vacant land, (2) the land is adjacent to the dwelling unit, and (3) the sale of the vacant land otherwise satisfies the requirements of § 121. The dollar ceiling on the exclusion applies to the combined sales of the vacant land and dwelling unit. Separate sales of the dwelling unit and adjacent vacant land do not violate the § 121(b)(3) restriction allowing only one sale or exchange every 2 years, but both are taken into account in applying § 121(b)(3) to the sale or exchange of any other principal residence.

- The proposed regulations provided that if a residence was used partially for residential purposes and partially for business purposes, only that part of the gain allocable to the residential portion would be excludable under § 121. Because the Treasury Department decided that § 121(d)(6) [excluding from the § 121 exclusion gain attributable to prior depreciation after 5/6/97] addresses the mixed use question, the final regulations do not require an allocation if both the residential and non-residential portions of the property are within the same dwelling unit. However, allocation is required if the non-residential portion is separate from the dwelling unit, and § 121 does not apply with respect to the gain on the nonresidential portion. Basis and the amount realized are allocated between the business and residential portions of the property using the same method the taxpayer used to allocate the basis for purposes of depreciation. The term dwelling unit has the same meaning as in § 280A(f)(1), but does not include appurtenant structures.

- The final regulations provide that if a residence is held by a trust, a taxpayer is treated as the owner and the seller of the residence during the period that the taxpayer is treated as the owner of the trust, or portion of the trust, that includes the residence under §§ 671 through 679. A similar rule applies to disregarded entities.

- The final regulations clarify that each unmarried taxpayer who jointly owns a principal residence is eligible to exclude from gross income up to \$250,000 of gain attributable to that taxpayer's interest in the property.

- The final regulations permit a taxpayer to exclude gain from the sale of partial interests (other than interests remaining after the sale or exchange of a remainder interest) in a principal residence if the interest sold includes an interest in the dwelling unit. However, the maximum exclusion amount of \$250,000 (\$500,000 for joint returns) applies to the combined sales of partial interests. For purposes of the one sale every 2 years rule, each sale or exchange of a partial interest is disregarded with respect to other sales or exchanges of partial interests in the same principal residence, but is taken into account with respect to any other principal residence.

- The final regulations provide that a taxpayer may make or revoke an election under § 121(d)(8) [to apply the exclusion to a sale of a remainder interest] or § 121(f) [not to apply the exclusion to a sale] at any time before the expiration of the period for filing an amended return.

- The final regulations provide that the bankruptcy estate of an individual in a Chapter 7 or 11 bankruptcy case may use the individual's § 121 exclusion if the individual satisfies the requirements of § 121. Although this provision is effective 12/24/02 [the date of publication of the regulations], the IRS will not challenge a position taken prior to the effective date.

- The IRS will not challenge a taxpayer's position that a sale before the effective date of the regulations qualifies for the § 121 exclusion if the taxpayer has made a reasonable, good faith effort to comply. Taxpayers may elect to apply the final regulations for any year for which the statute of limitations has not expired.

a. Reduced exclusion ceiling on too many castle sales.

T.D. 9031, Reduced Maximum Exclusion of Gain From Sale or Exchange of Principal Residence, 67 F.R. 78367 (12/24/02). Under § 121, a reduced maximum exclusion applies to a taxpayer who sells a principal residence owned and used for less than 2 years or who has excluded gain on the sale or exchange of a principal residence within the preceding 2 years, if the primary reason for the sale is a change in place of employment, health, or unforeseen circumstances. Temporary Reg. § 1.121-3T provides a list of suggestive factors that may be relevant in determining the taxpayer's primary reason. No single fact or particular combination of facts is determinative. For each of the three grounds for claiming a reduced maximum exclusion, the temporary regulations provide a general definition and one or more safe harbors.

- The primary reason for a sale is deemed to be a change in place of employment if the new place of employment is at least 50 miles farther from the residence sold than was the former place of employment (or if the individual was unemployed, the distance between the new place of employment and the residence sold or exchanged is at least 50 miles).

- A sale is due to health if the primary reason for the sale is (1) to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury, or (2) to obtain or provide medical or personal care for disease, illness, or injury. A sale or exchange that is merely beneficial to general health or well-being is not a sale or exchange due to health. Health is defined as the health of a "qualified person," with a broad definition of qualified person permitting a sale to provide care for family members of the taxpayer.

- The safe harbor for sales due to unforeseen circumstances includes the involuntary conversion of the residence, a natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence, death, the cessation of employment as a result of which the individual is eligible for unemployment compensation, a change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household, divorce or legal separation under a decree of divorce or separate maintenance, and multiple births resulting from the same pregnancy. A taxpayer who does not qualify for a safe harbor may satisfy a facts and circumstances test.

C. Section 1031

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

a. Now final. T.D. 8982, Definition of Disqualified Person, 67 F.R. 4907 (2/1/02). The final regulations amend Reg. § 1.1031(k)-1 and are applicable to transfers of property made on or after 1/17/01.

2. Ruling guidelines for UFI in real estate are very taxpayer-friendly. Rev. Proc. 2002-22, 2002-14 I.R.B. 733 (4/8/02), *superseding* Rev. Proc. 2000-46, 2002-2 C.B. 438. The Service has announced the conditions under which it will consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity. Section 6 of the revenue procedure imposes 15 conditions⁸ for obtaining a ruling, with a facts-and-circumstances alternative where all 15 conditions are not satisfied.

8. The conditions under which the IRS will consider issuing a ruling that an undivided fractional interest in rental real property is not an interest in a business entity, i.e., a partnership interest, are limited. The conditions are: (1) the co-owners must hold title as tenants in common under local law; (2) the number of co-owners must be limited to no more than 35 persons; (3) co-owners must act and hold themselves out as co-owners and not as partners; (4) co-owners may enter into limited co-ownership agreements that run with the land including, for example, a co-ownership agreement providing cross rights of first refusal at fair market value; (5) co-owners must retain the right to manage the property and any sale, lease, blanket encumbrance, hiring of a manager or management contract must be unanimously approved, but as to other matters the owners may agree to be bound by a majority vote; (6) each co-owner must have the right to transfer, partition, or encumber his undivided interest; (7) if the property is sold, net sales proceeds must be distributed to the co-owners; (8) all revenues must be shared and expenses borne in proportion to the co-owners' undivided interests in the property; (9) all co-owners must share in any blanket indebtedness encumbering the property in proportion to their undivided interests in the property; (10) the co-owners may issue call options on their undivided interests at their fair market value, with fair market value of the undivided interest being the fair market value of the property as a whole multiplied by the co-owner's fractional interest; (11) the co-owners' activities, including the activities of their agents, must be limited to those customarily performed in connection with the repair and maintenance of rental property; (12) management and brokerage agreements with respect to the property must be subject to renewal no less often than annually; (13) all leases on the property must be *bona fide*; (14) any lender with respect to the property of the undivided interests must be unrelated to all owners, lessees, managers, and sponsors of the syndication; and (15) any payments for acquisition of the interest must reflect the fair market value of the co-ownership interest (or services rendered) and may not depend on the profits derived from the property by any person.

Under § 1.761-1(a) and §§ 301.7701-1 through 301.7701-3, a federal tax partnership does not include mere co-ownership of property where the owners' activities are limited to keeping the property maintained, in repair, rented or leased. . . . Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created. Furthermore, where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes. [citations omitted].

3. The nonrecognition canteen turned out to be dry. Wiechens v. United States, 228 F. Supp. 2d 1080, 2002-2 U.S.T.C. ¶50,708, 90 A.F.T.R.2d 2002-6705 (D. Ariz. 9/16/02). The taxpayer [through a partnership] exchanged Colorado River water rights, which under state law were real property, for a fee simple interest in land. The water rights were for a limited quantity of water for a duration of 50 years. On summary judgment, the court (Judge McNamee) held that the exchange did not qualify for nonrecognition under § 1031 because the water rights and a fee simple interest in land were not "like-kind," even under the broad standard of Reg. § 1.1031(a)-1(b). The court rejected the taxpayer's argument that the 50-year water rights were analogous to the 30-year lease that qualified as like-kind with a fee simple in real estate under Reg. § 1.1031(a)-1(c). Because the water rights were not perpetual, they were not like-kind with a fee simple based on Rev. Rul. 55-749, 1955-2 C.B. 295 (dealing with perpetual water rights).

4. Nonrecognition denied – Caught by a targeted anti-abuse rule. Rev. Rul. 2002-83, 2002-49 I.R.B. 927 (12/9/02). Individual A owned highly appreciated real property held for investment (Property 1) and individual B, who was related to individual A within the meaning in § 267(b), owned real property (Property 2), which was not appreciated. In a multiparty like-kind exchange, A and B each transferred their properties to a qualified intermediary. C, an unrelated purchaser of Property 1, transferred cash to the qualified intermediary, who transferred Property 1 to C and the cash to B. (Property 2 was transferred to A.). The IRS ruled that pursuant to § 1031(f), a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under § 1031(a) if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property. Based on the legislative history [H.R. Rep. No. 101-247, at 1340 (1989)], the IRS reasoned that the purpose of § 1031(f) is to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. Accordingly, the IRS applied § 1031(f)(4) because the multi-party exchange was "part of a transaction (or a series of transactions) structured to avoid the purposes of § 1031(f)(1)."

D. Section 1033

1. Fire, wind, and pestilence bring tax benefits. Willamette Industries, Inc. v. Commissioner, 118 T.C. 126 (2/12/02). Taxpayer was forced to harvest some of its trees before maturity by reason of various casualties

[wind, ice storm, wildfires, insect damage], and it processed those trees into its usual products. Taxpayer sought to defer, under § 1033 [presumably because the cost of qualified replacement property exceeded the value of the downed timber, but the opinion does not describe the replacement property], the portion of its gain on the sale of the resulting inventory equal to the excess of the value of the trees over basis immediately after the casualty and before salvaging and processing. The Tax Court (Judge Gerber) held that the deferral was permitted under the holding and reasoning of Rev. Rul. 80-175, 1980-2 C.B. 230 [in which timber downed by a hurricane was sold for cash without any further processing]. He reasoned that in both the ruling and the instant case, the taxpayers were “prematurely forced to salvage (sell or use) the damaged trees,” and stressed that Rev. Rul. 80-175 rejected imposing a requirement that the conversion must be directly into cash without a voluntary sale. Judge Gerber stated that the possibility that the partial damage to the trees might have been “relatively small or resulted in a nominal amount of reduction in gain is not a reason to deny relief.” He further stated that if taxpayer’s “salvage efforts were more successful than [those of] other taxpayers[,] that is not a reason for denial of relief.”

E. Section 1041

1. Is it property or is it income? Yankwich v. Commissioner, T.C. Memo. 2002-37 (2/8/02). Pursuant to the taxpayer’s divorce, her husband was obligated to remit to her amounts equal to the interest and principal payments he received from a third party on a promissory note owned by him. [The facts indicated that the note was actually owned by the husband’s controlled corporation, but the parties and the court analyzed the issues as if the husband owned the note.] Because there was no transfer of beneficial ownership in the note itself to the taxpayer-wife, § 453B(g) did not apply to treat the note as transferred to the wife in a § 1041 transaction, and thus she did not take a carryover basis in the note. The payments received from the husband were excludable by the wife under § 1041 to the extent they represented principal on the underlying note; to the extent the payments represented interest on the underlying note, § 1041 did not apply. In essence, the court treated the husband as having transferred to the wife a note with a principal amount, interest rate, and payment schedule identical to the underlying note.

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

- The ruling stated,

Similarly, applying the assignment of income doctrine in divorce cases to tax the transferor spouse when the transferee spouse ultimately receives income from the property transferred in the divorce would frustrate the purpose of § 1041 with respect to divorcing spouses. That tax treatment would impose substantial burdens on marital property settlements

involving such property and thwart the purpose of allowing divorcing spouses to sever their ownership interests in property with as little tax intrusion as possible. Further, there is no indication that Congress intended § 1041 to alter the principle established in the pre-1041 cases such as *Meisner* [v. United States, 133 F.3d 654 (8th Cir. 1998)] that the application of the assignment of income doctrine generally is inappropriate in the context of divorce.

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

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

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

- Query: Will the non-employee spouse be required to follow this ruling? Perhaps. The divorce decree or separation agreement should address this issue, preferably by providing for indemnification of the employee spouse.

a. Notice 2002-31, 2002-19 I.R.B. 908 (5/13/02). This notice proposes that FICA/FUTA taxes on the exercise of stock options and the distribution of deferred compensation be imposed as if the income was that of the employee-spouse.

3. A welcome regulation is made final! Subchapter C principles govern which spouse will be taxed on stock redemptions incident to a divorce – at least unless the spouses mutually elect otherwise. T.D. 9035, Constructive Transfers and Transfers of Property to a Third Party on Behalf of a Spouse, 68 F.R. 1534 (1/13/03). Because of the inconsistent standards applied by the courts in dealing with redemptions of stock incident to a divorce, in REG-107151-00, Constructive Transfers and Transfers of Property to a Third Party on Behalf of a Spouse, 66 F.R. 40659 (8/3/01), the Treasury Department proposed regulations [Prop. Reg. § 1.1041-2] to provide greater certainty in determining which spouse will be taxed on stock redemptions occurring during marriage or incident to divorce. Regulation § 1.1041-2 has been finalized and Temp. Reg. § 1.1041-1T(c), Q&A-9, no longer controls redemptions of stock incident to a divorce. Regulation § 1.1041-2 applies only where the nonredeemed spouse owns stock of the redeeming corporation either immediately before or immediately after the stock redemption. If a corporation redeems stock of one spouse, and that redemption is treated as a constructive distribution to the other spouse, under Subchapter C principles—the primary and unconditional obligation standard [*Wall v. United States*, 164 F.2d 462 (4th Cir. 1947); *Sullivan v. United States*, 363 F.2d 724 (8th Cir. 1966)]—the

redemption is treated as a distribution to the spouse who continues as a shareholder. Section 1041 applies to the deemed transfer of the stock by the redeemed spouse to the continuing shareholder spouse. Section 1041 does not apply to the deemed transfer of stock from the nontransferor spouse to the redeeming corporation. Any property actually received by the redeemed spouse from the corporation is treated as flowing through the continuing shareholder-spouse, and § 1041 applies to that transfer. In all other cases, the form of the stock redemption will be respected; the redeemed spouse will be taxed on the redemption and the continuing spouse has no tax consequences. The preamble to the proposed regulations specifically state:

[I]f the rules of the proposed regulations had applied in the *Arnes* case,⁹ because the husband did not have a primary and unconditional obligation to purchase the wife's stock, the redemption would have been taxed in accordance with its form with the result that the wife would have incurred the tax consequences of the redemption.

● A special rule applies if an *effective* divorce or separation instrument, or a written agreement between the spouses [executed before the due dates of their returns], requires the spouses to file their

9. **Ninth Circuit applies § 1041 to exclude gain on wife's stock redemption.** *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992). The Ninth Circuit (Judge Hall) held that the divorce-settlement redemption of taxpayer's stock (in a McDonald's franchise corporation she owned equally with her former husband) qualified for exemption under § 1041. The former husband was held to have been relieved of an obligation by the corporate redemption, and under Temp. Reg. § 1.1041-1T, Q&A 9, the wife's stock was treated as having been transferred to her former husband, and then redeemed from him by the corporation in a non-§ 1041 transaction. The cash received by the wife from the corporation was treated as paid to her by the corporation on behalf of her former husband. See Temp. Reg. § 1.1041-1T, A-2, Example (3).

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

The Tax Court disagrees again with the Ninth Circuit's decision in the *Arnes* case, and Judge Beghe has the correct answer. *Blatt v. Commissioner*, 102 T.C. 77 (1994) (reviewed, 3 judges dissenting). The Tax Court held that the wife's redemption (pursuant to a divorce decree) of all her stock in a corporation she owned entirely with her husband was not governed by § 1041 and, therefore, was taxable to her. The Tax Court refused to follow the Temp. Reg. § 1.1041-1T, Q&A 9, theory that the redemption was a transfer to the corporation on behalf of her husband, as held in *Arnes v. United States*, 981 F.2d 456, (9th Cir. 1992), which the court refused to follow. Judge Beghe's concurring opinion stated that the proper interpretation of that regulation should be that no redemption should be considered to be "on behalf of" the remaining spouse unless it discharges that spouse's primary and unconditional obligation to purchase the redeemed stock, as set forth in the examples of Rev. Rul. 69-608, 1969-2 C.B. 42.

federal income tax returns in a consistent manner that treats the stock as being redeemed from the continuing shareholder spouse rather than from the spouse from whom it was actually redeemed. In such a case, spouses and former spouses will treat a redemption that otherwise would be taxed according to its form as a redemption from the continuing shareholder spouse involving (1) a deemed § 1041 transfer of the stock by the redeemed spouse to the continuing shareholder spouse, and (2) a deemed § 1041 transfer by the continuing shareholder spouse to the redeemed spouse of the redemption proceeds.

- The final regulations add a provision dealing with situations in which the redemption results in a constructive dividend distribution to the nontransferor spouse under Subchapter C principles, but the spouses nevertheless would like to agree that the redemption will be treated as a redemption distribution to the transferor spouse. Regulation § 1.1041-2(c) allows the spouses to agree in the divorce or separation instrument, or other valid written agreement, that the redemption will be taxable to the transferor spouse notwithstanding that the redemption might otherwise result in a constructive dividend distribution to the nontransferor spouse. Example 2 in § 1.1041-2(d) illustrates the application of this special rule.

- Under the final regulations, the spouses can elect one of the special rule by expressly providing, in a divorce or separation instrument or other valid written agreement, that expressly supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption, their mutual intent regarding which spouse should receive redemption treatment.

- These regulations are applicable to redemptions of stock on or after January 13, 2003 that are pursuant to instruments in effect after January 13, 2003. These regulations are also applicable to redemptions before January 13, 2003 or that are pursuant to instruments in effect before January 13, 2003 if the spouses or former spouses execute a written agreement on or after August 3, 2001, that satisfies the requirements of § 1.1041-2(c)(1) or (2).

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. **Fundamental changes in the treatment of split-dollar life insurance.** Notice 2001-10, 2001-1 C.B. 459. This notice provides interim guidance on split-dollar life insurance contracts. It notes that the P.S. 58 rates no longer reflect the current fair market value of insurance protection. The notice requires that employer payments be consistently treated as (1) interest-free loans under § 7872, (2) investments by the employer in the contract, or (3) payments of compensation. The Service had long rejected interest-free loan treatment of the employer investment in the cash value of split dollar life insurance, but the enactment of § 7872 in 1984 enables interest-free loan treatment to be used as a valid model. The alternative is to have the true cost of insurance protection reflected in the employee's income; insurance companies will be required to provide rates at which comparable term policies will be available to the general public (instead of the low-ball rates that had been provided in the past). This notice revokes Rev. Rul. 55-747, 1995-2 C.B. 228, and provides that, after 2001, P.S. 58 rates may not be used.

- a. **IRS revokes Notice 2001-10 and will for future arrangements require taxation under one of two mutually exclusive regimes.** Notice 2002-8, 2002-4 I.R.B. 398 (1/28/02), *revoking* Notice 2001-10,

2001-1 C.B. 459. When the Treasury Department and the IRS publish proposed regulations providing comprehensive guidance regarding the tax treatment of split-dollar life insurance arrangements, the regulations will provide the following in employment-related arrangements:

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

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

- The above rules will be effective for arrangements entered into after the date of publication of final regulations. P.S. 58 rates may be used for provisions valuing current life insurance protection entered into before 1/28/02 and for arrangements entered into before the date of publication of the final regulations.

b. Notice 2002-8 is carried into proposed regulations.

REG-164754-01, Split-Dollar Life Insurance Arrangements, 67 F.R. 45414 (7/9/02). These proposed regulations provide guidance on income, employment and gift taxation of split-dollar life insurance arrangements and carry out the concepts of Notice 2002-8. These proposed regulations will be effective for split-dollar life insurance arrangements entered after the date of publication of final regulations in the Federal Register.

c. Crackdown on split-dollar life insurance arrangements that are designed to understate the value of benefits for income or gift tax purposes. Notice 2002-59, 2002-36 I.R.B. 481 (9/9/02). The IRS held that neither the premium rates in Table 2001 nor the insurer’s lower published premium rates may be relied on to value the insured’s current life insurance protection for the “purpose of establishing the value of policy benefits to which another party may be entitled.” Under reverse split-dollar arrangements, one party with a right to current life insurance protection may use various techniques to confer policy benefits, other than current life insurance protection, on another party, but using such techniques to understate the value of other policy benefits “distorts the income, employment, or gift tax consequences of the arrangement.”

- According to Tax Notes Today, 2002 TNT 161-4 (8/20/02), this notice was issued after Treasury Department officials read a 7/28/02 story in the New York Times, which stated that Jonathan Blattmachr had developed this technique based upon a 1996 private letter ruling [identified as LTR 9636033].

2. Employers may structure cafeteria plans to force-feed insurance and make cash the optional choice. Rev. Rul. 2002-27, 2002-20 I.R.B. 925 (5/20/02). A § 125 cafeteria plan may provide for automatic enrollment in employee-only group health insurance coverage with a commensurate salary reduction, subject to an opt-out provision whereby the employee may decline the health insurance and receive full salary. Such a plan may also include family insurance coverage as a non-automatic option. The plan also may prohibit an employee from electing out of employee-only health insurance unless he proves that he has other medical insurance.

• The ruling contains a model amendment that a sponsor may use if it permits an employee to elect cash in lieu of group health coverage only if the employee is able to certify that he or she has other health coverage.

3. Pass the cafeteria tray. Rev. Rul. 2002-32, 2002-23 I.R.B. 1069 (6/10/02). Following an asset purchase and sale of a portion of a seller's business, the seller's transferred employees who had elected to participate in uninsured health care expense flexible spending arrangements under the seller's plan may continue to exclude salary reduction amounts and medical reimbursements from gross income under either the seller's plan, for a limited period of time, as agreed upon, or under the buyer's § 125 cafeteria plan, at the same level of coverage without interruption, after becoming employees of the buyer.

4. Health reimbursement arrangements.

a. Excludable "health reimbursement arrangements" with carryovers of unused amounts. Notice 2002-45, 2002-28 I.R.B. 93 (7/15/02). This notice describes the tax treatment of employer-provided medical care expense reimbursements under a "health reimbursement arrangement" (HRA). An HRA is a plan that: (1) "is paid for solely by the employer and not provided pursuant to salary reduction election or otherwise under a § 125 cafeteria plan;" (2) the only benefit from which is reimbursement to employees [or certain former employees] for medical expenses incurred by the employee, and the employee's spouse and dependents; and (3) "provides reimbursements up to a maximum dollar amount for a coverage period and any unused portion of the maximum dollar amount at the end of a coverage period is carried forward to increase the maximum reimbursement amount in subsequent coverage periods." An HRA that meets these conditions is an employer-provided accident or health plan, and coverage and reimbursements are excluded from the employee's gross income under §§ 105 and 106. An HRA may allow a participant to carry forward unused reimbursement allowances to later coverage periods because the requirements for flexible spending arrangements (FSAs) under § 125 are generally not applicable to HRAs. To retain exemption from the § 125 FSA requirements, the HRA must be solely employer-funded and cannot be directly or indirectly paid for pursuant to a salary reduction election.

b. And here's a qualifying HRA. Rev. Rul. 2002-41, 2002-28 I.R.B. 75 (7/15/02). Sections 105 and 106 apply to exclude employer financed medical expense reimbursements, not dependent on salary reduction, available to cover deductibles for employees and retired employees, and their spouses and dependents, under medical insurance provided pursuant to a § 125 cafeteria plan, even though amounts unused in earlier years carry-over and are available in future years [which is not permitted under a § 125 salary reduction plan].

5. Well, duh! Rev. Rul. 2002-58, 2002-38 I.R.B. 541 (9/23/02). Amounts reimbursed under a self-insured medical expense reimbursement plan for medical expenses incurred by an employee prior to the establishment of the plan are not excludable from the employee's gross income under § 105(b).

6. It's not a reimbursed medical expense if the employee is paid in any event and the amount is retrospectively characterized if and when medical expenses are incurred. Rev. Rul. 2002-80, 2002-49 I.R.B. 925 (12/9/02). An employer provided employees medical insurance under a salary reduction program, but paid employees approximately the same amount as they would have received if there had been no salary reduction. The amount equal to the salary reduction was labeled "advance reimbursement" of the uninsured medical expenses. To the extent an employee submitted claims for uninsured medical expenses during the year, the employer characterized the "advance reimbursement" as excludable income under § 105(b), and did not withhold income tax or treat the amount as wages for FICA; excess amounts were treated as compensation includible in the employee's gross income. The IRS ruled that no part of the "advance reimbursements" qualified for exclusion under § 105(b).

7. Another Tax Court loss for an airline pilot. Tuka v. Commissioner, 120 T.C. No. 1 (1/6/03). The taxpayer claimed that disability payments, based on age, years of service, and salary, received from an employer-sponsored plan were tax-exempt under § 104(a)(3). Judge Ruwe held that the exclusion of disability benefits under § 104(a)(3) is available only if the contributions to the accident and health plan were includible in the employee's gross income. Even if the plan had been funded by wage savings to the employer resulting from collective bargaining with the union it would not have been an employee contribution plan.

8. Amounts received from employer may be excluded as § 139 qualified disaster relief; amounts received from a state agency are excluded as gifts. Rev. Rul. 2003-12, 2003-3 I.R.B. 283 (1/21/03). Amounts received by an individual from an employer to reimburse the individual for necessary medical, temporary housing, or transportation expenses incurred as a result of a flood are not excludable as a gift under § 102, but are excluded from gross income as qualified disaster relief under § 139 if the flood was a Presidentially declared disaster. Similar amounts received from a state agency are excludable under the administrative general welfare exclusion, and similar amounts received from a charity are excluded under § 102.

B. Qualified Deferred Compensation Plans

1. Rev. Proc. 2002-21, 2002-19 I.R.B. 911 (5/13/02). This revenue procedure describes the steps that may be taken to ensure the qualified status of defined contribution retirement plans maintained by employee leasing organizations (also called professional employer organizations or PEOs) for the benefit of "Worksite Employees," where there may be uncertainty as to whether the employer is the PEO or the client organization. The PEO retirement plan may either be converted into a "multiple employer plan" or be terminated by various dates in 2003.

2. REG-105885-99, Compensation Deferred Under Eligible Deferred Compensation Plans, 67 F.R. 30826 (5/8/02). The Treasury Department has promulgated proposed regulations [Prop. Regs. §§ 1.457-1 through 1.457-12] to provide guidance on compensation of employees of state and local governments and tax-exempt entities deferred under § 457(d). The

proposed regulations reflect the changes made to § 457 by the Tax Reform Act of 1986, the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (8/20/96), the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (8/5/97), the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 28 (6/7/01), the Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21 (3/9/02), and other legislation.

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

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

b. Just "snap on" these model plan amendments to comply with the new MRD regulations. Rev. Proc. 2002-29, 2002-24 I.R.B. 1176 (6/17/02). This revenue procedure provides model plan amendments for plans to comply with the final and temporary regulations under the § 401(a)(9) minimum distribution rules. Generally, plans must be amended by the end of the first year beginning on or after 1/1/03.

4. EPCRS updated. Rev. Proc. 2002-47, 2002-29 I.R.B. 133 (7/22/02). According to the revenue procedure:

This revenue procedure updates the comprehensive system of correction programs for sponsors of retirement plans that are

intended to satisfy the requirements of § 401(a), § 403(a), § 403(b), or § 408(k) . . . but that have not met these requirements for a period of time. This system, the Employee Plans Compliance Resolution System (“EPCRS”), permits plan sponsors to correct these failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis. The components of EPCRS are the Self-Correction Program (“SCP”), the Voluntary Correction Program (“VCP”), and the Audit Closing Agreement Program (“Audit CAP”).

● The revenue procedure goes on to state that “[s]ponsors and other administrators of eligible plans should be encouraged to establish administrative practices and procedures that ensure that these plans are operated properly in accordance with the applicable requirements of the Code.”

5. Cash balance plan proposed regulations provide a green light for adoptions of cash balance plans favoring younger employees, including permission to require quasi-geriatrics to spin their [retirement accrual] wheels during “wear-away” periods. REG-209500-86 and REG-164464-02, **Reductions of Accruals and Allocations because of the Attainment of any Age; Application of Nondiscrimination Cross-Testing Rules to Cash Balance Plans**, 67 F.R. 76123 (12/11/02). These proposed regulations provide guidance on age discrimination requirements under §§ 411(b)(1)(H) and 411(b)(2), including the allocation of these requirements to cash balance pension plans.

● A cash balance plan is a defined benefit plan under which an employee has a hypothetical individual account that provides a benefit upon retirement based upon pay credits and interest credits—a concept that closely resembles a defined contribution plan. Section 411(b)(1)(H) provides that a defined benefit plan fails to comply with the age discrimination rules of § 411(b) if benefit accrual is ceased or reduced on the attainment of any age, and § 411(b)(2) provides that a defined contribution plan similarly fails to comply unless the rate at which amounts are allocated to an employee’s account is not similarly ceased or reduced because of age.

● A cash balance qualifies, *inter alia*, only if “the participant accrues the right to future interest credits (without regard to future service) at a reasonable rate of interest that does not decrease because of the attainment of any age.”

● The rules for conversion of traditional defined benefit plans to cash balance plans require that either (1) the converted plan defines the benefit as the sum of the benefits under the traditional defined benefit plan and the cash balance account, or (2) the converted plan must establish each participant’s opening account balance as an amount not less than the actuarial present value of the participant’s prior accrued benefit. The second alternative would permit a “wear-away” period during which the participant will not accrue net benefits for some period after the conversion.

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

1. Although the exercise of a statutory stock option does not result in taxable income, it does result in wages for FICA / FUTA purposes – but not until 2003. REG-142686-01, Application of the Federal Insurance Contributions Act, Federal Unemployment Tax Act, and Collection of Income Tax at Source to Statutory Stock Options, 66 F.R. 57023 (11/14/01), issued as

provided in Notice 2001-14, 2001-1 C.B. 516. Proposed Regs. §§ 31.3121(a)-1(k), 31.3306(b)-1(l), and 31.3401(a)-1(b)(9) would provide that the holder of a statutory stock option [§ 422 ISO or § 423 ESPP] receives wages for FICA and FUTA purposes upon exercise of the option, but no withholding is required because no gross income has been received. The amount of the wages received is the excess of the fair market value of the stock over the amount paid. The IRS will develop “rules of administrative convenience” permitting employers to deem the wages to have been paid on a specific date or over a specific period of time.

a. Notice 2001-73, 2001-2 C.B. 549. The IRS announced and requested comments on proposed “rules of administrative convenience” permitting employers to deem the wages to have been paid on a specific date for FICA and FUTA purposes. FICA and FUTA wages could be treated as paid on a pay period, quarterly, semi-annually, annually, or on another basis.

b. Notice 2001-72, 2001-2 C.B. 548. The IRS announced and requested comments on proposed rules regarding the employer’s income tax withholding and reporting obligations on the sale by an employee of stock received pursuant to the exercise of a statutory stock option. The employer is not required to withhold, but is required to report if the amount is at least \$600, unless the employer has made reasonable efforts to determine if reporting is necessary and has been unable to do so.

c. IRS extends moratorium on assessment of employment taxes on stock options for two more years. Notice 2002-47, 2002-28 I.R.B. 97 (7/15/02). Pending the completion of its review and the issuance of further guidance, the IRS will not assess FICA or FUTA taxes (nor will it seek federal income tax withholding) upon the exercise of a statutory stock option or disposition of stock acquired by an employee pursuant to the exercise of a statutory stock option. The notice further provides that it is contemplated that any final guidance that would apply employment taxes to statutory stock options will not apply to exercises of statutory stock options that occur before January 1 of the year that follows the second anniversary of the publication of the final guidance.

2. Falling into Black-(S)c holes again: Valuing stock options for golden parachute purposes. Rev. Proc. 2002-13, 2002-8 I.R.B. 549 (2/25/02), *modified by* Rev. Proc. 2002-45, 2002-27 I.R.B. 40 (7/8/02). This revenue procedure provides guidance for valuing stock options, including a Black-Scholes safe harbor for valuing “nonpublicly traded compensatory stock option[s] for stock that, on the valuation date, is publicly traded on an established securities market” for purposes of the §§ 280G and 4999 golden parachute rules.

● See also Rev. Rul. 98-21, 1998-1 C.B. 975, for the valuation of stock options for gift tax purposes.

3. The employee-COO’s behaviour vis-à-vis the shareholders was as unripe as the refund claim. *Robinson v. United States*, 52 Fed. Cl. 725, 2002-2 U.S.T.C. ¶50,524, 90 A.F.T.R.2d 2002-5003 (6/24/02). The Court of Federal Claims followed *Venture Funding, Ltd. v. Commissioner*, 110 T.C. 236 (1998), *aff’d per curiam*, 198 F.3d 248 (6th Cir. 1999), *cert. denied*, 530 U.S. 1205 (2000), to hold that § 83(h) allows a deduction for the value of a compensatory transfer of restricted stock to an employee only when the amount of the discount is actually “included” by the employee, not when the amount is

“includable” but not reported as income by the employee. Since the employee was appealing from an unfavorable audit with respect to the income item attributable to the year of the transfer [in which the employee-COO had made a § 83(b) election and reported the bargain element as zero, giving notice to himself as a representative of the corporation, even though the taxpayers owned all of the remaining stock of the S corporation—an overwhelming majority], the fact of inclusion was not yet established and the refund claim was not ripe. The taxpayers claimed that the employee received restricted stock worth \$28 million for \$2 million and the employee made the § 83(b) zero election without advising them or anyone else at the corporation at the time; taxpayers did not find out about the § 83(b) election until negotiating the COO’s termination three years later (when they sent the COO an amended Form W-2).

● Query: Should taxpayers have dealt with this possibility by contract at the time the stock was transferred to the employee?

D. Individual Retirement Accounts

1. **Retroactive taxes are OK.** *Kitt v. United States*, 277 F.3d 1330, 2002-1 U.S.T.C. ¶50,167, 89 A.F.T.R.2d 2002-497 (Fed. Cir. 1/10/02), *upheld and modified on rehearing*, 288 F.3d 1355, 2002-2 U.S.T.C. ¶50,466, 89 A.F.T.R.2d 2002-2212 (Fed. Cir. 5/1/02). The retroactive amendment of § 408 on July 22, 1998, providing that distributions from Roth IRAs made within 5 years of a rollover that are allocable to the funds rolled-over are subject to the ten percent additional tax under § 72(t), was not unconstitutional because Congress was correcting a mistake in the 1997 Taxpayer Relief Act. The court followed *United States v. Carlton*, 512 U.S. 26 (1994). The 10 percent additional tax applied to the 44-year old taxpayer’s premature March 6, 1998 withdrawal from a Roth IRA into which his regular IRA had been rolled-over.

2. **He was just a conduit for his IRA.** *Ancira v. Commissioner*, 119 T.C. 135 (9/24/02). The taxpayer had a self-directed IRA and asked the custodian to purchase common stock of a corporation that was not publicly traded. Although the investment was not prohibited, the custodian, as a matter of policy, refused to purchase the stock because it was not publicly traded. The taxpayer’s desires were accommodated by the custodian issuing a check drawn on the IRA account to the issuing corporation, which was sent to the taxpayer, who forwarded it to the corporation. To effectuate the transaction, the custodian required the taxpayer to complete a “Distribution Request Form,” which stated that “(Use of this form will result in a distribution reportable to the IRS [Internal Revenue Service] on Form 1099-R [Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.]).” The corporation issued the stock in the name of the taxpayer’s IRA. The taxpayer received the stock and delivered it to the custodian. The Tax Court rejected the Commissioner’s argument that this had been a distribution from the IRA to the taxpayer. The taxpayer was a conduit. The court distinguished *Lemishow v. Commissioner*, 110 T.C. 110 (1998), because in *Ancira*, the taxpayer did not receive cash, and the IRA, not the taxpayer, at all times was the owner of the shares even though the IRA might not have been in physical possession of the stock certificate.

3. **Bear market relief for pre-geriatrics.** Rev. Rul. 2002-62, 2002-42 I.R.B. 710 (10/21/02). The IRS will allow a one-time change, without penalty, in IRA and retirement plan periodic payment schedules for an individual receiving fixed IRA or retirement plan payments. This ruling modifies the provisions of Q&A-12 in Notice 89-25, 1989-1 C.B. 662. This will

help a taxpayer who suffers an unexpected drop in the value of his or her retirement savings, who will be able to reduce the amount of those fixed periodic payments without becoming subject to the § 72(t) penalty on withdrawals before reaching the age of 59½.

V. PERSONAL INCOME AND DEDUCTIONS

A. Miscellaneous Income

1. Making the [tax] world safer for frequent flyers.

Announcement 2002-18, 2002-10 I.R.B. 621 (3/11/02). As a matter of administrative policy, the Service has announced that “[c]onsistent with prior practice, the IRS will not assert that any taxpayer has understated his federal tax liability by reason of the receipt or personal use of frequent flyer miles or other in-kind promotional benefits attributable to the taxpayer’s business or official travel,” and that any future guidance on the taxability of these benefits will be applied prospectively.

- The safe harbor is inapplicable to benefits that are converted to cash, to compensation paid in the form of benefits, or where these benefits “are used for tax avoidance purposes.”

2. The Clergy Housing Allowance Clarification Act of 2002,

Pub. L. No. 107-181, 116 Stat. 583 (5/20/02), amends § 107(2) to limit the amount “ministers of the gospel” may exclude from gross income as housing allowances to “the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.” The legislation applies to tax years beginning after 12/31/01 and “to any taxable year beginning before January 1, 2002, for which the taxpayer – (A) on a return filed before April 17, 2002, limited the exclusion under [§ 107] as provided in [this legislation], or (B) filed a return after April 16, 2002.”

a. Warren v. Commissioner, 114 T.C. 343 (5/16/00)

(reviewed 14-3). If a parsonage allowance is paid to a minister, under § 107(2) it is excludable up to the amount of eligible expenses actually paid out of the allowance, even though the amount of the allowance exceeds the “fair rental value” of the parsonage, which can occur when the allowance covers mortgage payments in full, as well as real estate taxes, maintenance, utilities, and furnishings for a home owned by the minister. The Tax Court rejected the Commissioner’s argument that the exclusion under § 107(2) was limited to the \$58,000 rental value of the minister’s home where between \$76,000 and \$80,000 of total compensation of the \$77,000 to \$99,000 designated as an annual parsonage allowance over 3 taxable years was expended on qualifying expenditures. The excess of the designated allowance over actual housing expenditures was taxable.

b. In Warren v. Commissioner, 282 F.3d 1119, 2003-1

U.S.T.C. ¶50,206 (9th Cir. 3/5/02), in a 2-1 decision, the Ninth Circuit ordered briefing on the constitutionality of § 107(2). Judge Reinhardt, for the majority, also appointed Professor Erwin Chemerinsky of the University of Southern California Law School to serve as amicus curiae.

- Judge Tallman, in his dissent, stated:

Because the constitutional issue was not raised in the Tax Court, nor briefed or argued by the parties on appeal, and because it is unnecessarily and improvidently raised by my colleagues *sua sponte*, I respectfully dissent from the order

directing supplemental and court-appointed amicus briefing. This case can easily be decided without reaching the constitutionality of the statutory exclusion.

● The appointed amicus's report concluded that § 107(2) was unconstitutional under the Establishment Clause [pursuant to *Texas Monthly, Inc. v. Bullock*, 489 U.S. 1 (1989)], because it accorded clergy a benefit not given to others. The amicus has moved to intervene as a plaintiff in the case, despite a stipulation of dismissal agreed to by the IRS and the taxpayer.

c. **It's over.** *Warren v. Commissioner*, 302 F.3d 1012, 90 A.F.T.R.2d 2002-6058 (9th Cir. 8/26/02). The appeal was dismissed by stipulation.

3. **The court will not “explore the quality of a marriage,” when a husband “visits” his wife.** *McAdams v. Commissioner*, 118 T.C. 373 (5/15/02). Section 86 includes a portion of Social Security receipts if the sum of “modified adjusted gross income” plus one half of the Social Security benefits exceeds the § 86(c) “base amount,” which is \$25,000, except for (1) married couples filing a joint return, whose base amount is \$32,000, and (2) married persons who file separate returns but live together, whose base amount is zero. The taxpayer, who filed a married filing separately return, spent most of the year away from his wife's residence. However, he did “visit” his wife's house for more than 30 days, but stayed in a separate bedroom. Refusing to “explore the quality of a marriage,” and looking at case law under § 66(a) by analogy, Judge Vasquez held that the taxpayer did not “live apart” from his wife. His base amount was zero, which resulted in inclusion of a large portion of the social security receipts.

B. Profit-Seeking Individual Deductions

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

a. **Cases decided in past years by the First, Fourth, Seventh, Eighth, Ninth, Tenth and Federal Circuits sprang the AMT trap.** Attorney's fees incurred by an individual in a nonbusiness profit-seeking transaction are [§ 212] miscellaneous itemized deductions [§ 67] and may not be deducted for AMT purposes. To avoid this result, taxpayers in a number of cases in recent years have argued the portion of a taxable damage award retained by the taxpayer-plaintiff's attorney as a contingent fee is excluded from the taxpayer-plaintiff's income and treated as income earned directly by the attorney. The Tax Court and most Courts of Appeals have reached conflicting results on this question. Generally, the Tax Court holds that attorney's fee awards paid directly to a plaintiff's attorney [or the portion of a damage award that is the attorney's contingent fee that is so paid] are nevertheless includable in the litigant's gross income, and that the taxpayer then may claim a deduction, subject to any applicable limitations, including disallowance of the deduction for AMT purposes if it is a § 212 deduction. *Bagley v. Commissioner*, 105 T.C. 396 (1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997). *Accord Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995), *aff'g* 30 Fed. Cl. 248 (1993); *Alexander v. IRS*, 72 F.3d 938 (1st Cir. 1995), *aff'g* T.C. Memo 1995-51; *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), *aff'g* T.C. Memo. 1998-29; *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000), *aff'g* T.C. Memo. 1998-395, *cert. denied*, 531 U.S. 1112 (2001); *Kenseth v. Commissioner*, 259 F.3d 881, 2001-2

U.S.T.C. ¶50,570, 88 A.F.T.R.2d 2001-5378 (7th Cir. 8/7/01), *aff'g* 114 T.C. 399 (5/24/00) (reviewed, 8-5); *Young v. Commissioner*, 240 F.3d 369, 2001-1 U.S.T.C. ¶50,244, 87 A.F.T.R.2d 2001-889 (4th Cir. 2/16/01), *aff'g*, 113 T.C. 152 (8/20/99); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312, 2002-1 U.S.T.C. ¶50,351, 88 A.F.T.R.2d 2001-7283 (10th Cir. 12/19/01), *aff'g* T.C. Memo. 2000-180 (6/12/01), *cert. denied*, 535 U.S. 1056 (5/13/02).

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

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

(2) *Estate of Clarks v. United States*, 202 F.3d 854, 2000-1 U.S.T.C. ¶50,158, 85 A.F.T.R.2d 2000-405 (6th Cir. 1/13/00). The Sixth Circuit held that the taxpayer was not required to include the portion of the taxable interest attached to a damage award excluded under § 104(a)(2) that was paid directly to the taxpayer's attorney. The court discussed the particularities of the attorney's fee statutory lien law in *Cotnam*, found the Michigan attorney's fees common law lien law to be similar to the Alabama law involved in *Cotnam*, and stated that it was following *Cotnam*. But the court also provided a broader explanation for its decision, concluding that the opinions representing the weight of authority, e.g., *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995), inappropriately relied on the assignment of income doctrine cases, e.g., *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst*, 311 U.S. 112 (1940), which, while relevant in family transactions, were not relevant in an arm's length transaction.

(3) **In the Eleventh Circuit (as derived from pre-split Fifth Circuit precedents¹⁰), under the *Golsen* rule, attorney's fees are not included in the income of an Alabama taxpayer who received a large punitive damages award.** *Davis v. Commissioner*, 210 F.3d 1346, 2000-1 U.S.T.C. ¶50,431, 85 A.F.T.R.2d 2000-1567 (4/27/00) (per curiam), *aff'g* T.C. Memo. 1998-248 (7/7/98). The Eleventh Circuit panel held that with respect to Alabama taxpayers, it was bound by *Cotnam*.

c. An attempt to escape the AMT trap fails: The expense of suing your former employer might be "attributable" to the trade or business of being an employee, but it's not "incurred by the employee in connection with the performance of services as an employee of the

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

employer.” Biehl v. Commissioner, 118 T.C. 467 (5/30/02). The taxpayer successfully sued his former employer for wrongful termination and, in addition to damages, pursuant to his employment contract, the employer was required to pay his attorney’s fees. The taxpayer [who lived in the Ninth Circuit, which has already ruled that successful plaintiff’s cannot exclude attorney’s fees, *see, e.g., Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001)] attempted to avoid the AMT trap on miscellaneous itemized deductions by arguing that the attorney’s fees were employer reimbursement of a § 162 employee business expense excludable under an accountable plan pursuant to § 62(c) and Reg. § 1.62-2(c) and (d). Judge Beghe held that that even though the expenses were § 162 employee business expenses because they were “attributable” to his trade or business of being an employee, the expenses did not meet the requirement of Reg. § 1.62-2(d) that the expenses be “paid or incurred by the employee in connection with the performance of services as an employee of the employer.” This latter requirement is met only if the expenses were incurred on the employer’s behalf, which clearly was not true in this case. Furthermore, it cannot be met if the expenses are incurred after the employment relationship has been terminated, which happened in this case.

2. Schoolteachers should keep receipts. The Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21 (3/9/02), provides for an above-the-line § 162 deduction of up to \$250 for K-12 schoolteachers’ purchase of books, supplies, equipment, etc., used in the classroom. The deduction is effective for taxable years beginning after 12/31/01.

3. Auditing the auditors. Reynolds v. Commissioner, 296 F.3d 607, 2002-2 USTC ¶50,525, 90 A.F.T.R.2d 2002-5294 (7th Cir. 7/18/02), *aff’g* T.C. Memo. 2000-20 (1/19/00). The taxpayer was an IRS revenue agent who was a licensed attorney and to whom the IRS had granted permission to practice law part-time during off-duty hours. In connection with an IRS investigation about whether he conducted his law practice during IRS working hours, the taxpayer incurred substantial legal fees, which he deducted on Schedule C as expenses of his law practice, and which resulted in the law practice operating at a substantial loss for the years in question. The court upheld the IRS determination that the legal fees were employee business expenses, deductible only as itemized deductions, which were subject to § 67. The origin of the legal fees was an effort to preserve the taxpayer’s IRS employment, not to further his independent law practice.

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

1. Dancing at the Rascal Fair. Bush v. Commissioner, T.C. Memo. 2002-33 (2/4/02), *aff’d*, 51 Fed. Appx. 422, 2002-2 U.S.T.C. ¶50,797, 90 A.F.T.R.2d 2002-7500 (4th Cir. 11/27/02). The taxpayer’s sole proprietorship talent agency, the only client of which was his teenage stepdaughter who was enrolled as full-time student studying ballet in a school for arts, was not a business conducted for profit. Expenses for school supplies, pointe shoes, clothing, and dance tuition were inherently personal under § 262 and completely nondeductible. Expenses that otherwise would be business expenses were deductible under § 183 to the extent they did not exceed the talent agency’s income from the activity (reduced by any expenses allowable without regard to profit motive).

D. Deductions and Credits for Personal Expenses

1. You don't have to rush to establish your MSA. The deadline for establishing a Medical Savings Account has been extended to 2002. Section 62(a)(16) was added by the Consolidated Appropriations Act, 2001C, Pub. L. No. 106-554, 114 Stat. 2763 (12/21/00), to allow a deduction for contributions to a MSA by a taxpayer who does not itemize deductions. *See* Announcement 2001-99, 2001-2 C.B. 40.

a. The Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21 (3/9/02), extended the MSA deadline through 2003.

2. The IRS just might be listening to the AMA: Obesity is a disease and weight loss program costs are deductible medical expenses. Rev. Rul. 2002-19, 2002-16 I.R.B. 778 (4/22/02). Uncompensated expenses paid by individuals for participation in a weight-loss program [meetings where they develop a diet plan, receive diet menus and literature, and discuss problems encountered in dieting] as treatment for a specific disease or diseases, including obesity and hypertension (even if the taxpayer is not obese) diagnosed by a physician are deductible as medical expenses under § 213 if they have been directed by a physician to lose weight as treatment. The cost of purchasing diet food items, however, is not deductible. Rev. Rul. 79-151, 1979-1 C.B.116, and Rev. Rul. 55-261, 1955-1 C.B. 307, are distinguished.

• Those trial lawyers who missed out on the big tobacco settlement are looking at manufacturers of fattening foods.¹¹

3. How a dead client may incur attorney's fees. Berry v. Commissioner, 2002-1 U.S.T.C. ¶50,453, 89 A.F.T.R.2d 2832 (10th Cir. 6/6/02) (nonprecedential order). A former husband's payment of his former wife's attorney's fees in the divorce was not deductible alimony under § 71(b)(1)(D) because [under Oklahoma law] he would have been obligated to pay those fees after her death.

4. Spell it out in the divorce instrument, don't rely on state law to fill in the gaps. Lovejoy v. Commissioner, 293 F.3d 1208, 2002-2 U.S.T.C. ¶50,473, 89 A.F.T.R.2d 2002-2989 (10th Cir. 6/18/02), *aff'g* T.C. Memo. 1999-273 (8/12/99). An unallocated family support allowance that does not terminate upon the payee's death (under either the terms of the agreement or state law) cannot qualify as alimony by reason of § 71(b)(1)(D). In this case, neither the divorce instrument nor state law provided that a temporary unallocated family support allowance *pendente lite* terminated upon the wife's death. Even though her death would have abated the divorce, state law [Colorado] provided that child support orders were not terminated by the custodial spouse's death. State law was at best unclear, and because the taxpayer had the burden, the payments were not deductible by the husband and not includable by the wife.

E. Education: Helping Pay College Tuition (or is it helping colleges increase tuition?)

1. Notice 2001-55, 2001-2 C.B. 299. This notice provides guidance to qualified tuition programs described in § 529 and participants in §

11. This was originally written before the recent spate of lawsuits against fast food restaurants.

529 programs regarding the restriction on investment direction described in § 529(b)(5), and sets forth a special rule under which a program may permit investments in a § 529 account to be changed annually and upon a change in the designated beneficiary of the account.

2. Notice 2001-81, 2001-2 C.B. 617. This notice provides guidance regarding record keeping, reporting, and other requirements applicable to § 529 qualified tuition programs in light of the 2001 Act amendments.

3. T.D. 8992, Information Reporting for Payments of Interest on Qualified Education Loans; Magnetic Media Filing Requirements for Information Returns, 67 F.R. 20901 (4/29/02). The Service has promulgated final and temporary regulations relating to the information reporting requirements under § 6050S for payments of interest on qualified education loans.

4. REG-161424-01 and REG-105316-98, Information Reporting for Qualified Tuition and Related Expenses; Magnetic Media Filing Requirements for Information Returns, 67 F.R. 20923 (4/29/02). Proposed regulations have been issued relating to the information reporting requirements under § 6050S for qualified tuition and related expenses to assist taxpayers and the IRS in determining any of educational tax credits allowable under § 25A (as well as any other tax benefits allowable for higher education expenses).

5. **Is there any HOPE that the educational credit rules ever will be understandable to anyone in the income range eligible to use them – like the earned income tax credit rules?** T.D. 9034, Education Tax Credit, 67 F.R. 78687 (12/26/02). The Treasury Department has promulgated final regulations regarding the Hope Scholarship Credit and the Lifetime Learning Credit under § 25A.

VI. CORPORATIONS

A. Entity and Formation

1. **Relief for late initial classification elections.** Rev. Proc. 2002-59, 2002-39 I.R.B. 615 (9/30/02), *modifying and superseding* Rev. Proc. 2002-15, 2002-6 I.R.B. 490 (2/11/02). This revenue procedure provides guidance for seeking relief from a late filed initial classification election under the § 7701 check-the-box regulations by a newly formed entity. Relief is available only if Form 8832 was not filed, the due date for the return for the desired classification has not passed, and the entity shows reasonable cause.

2. **The “emerging equitable interpretation of § 357(c)” argument wasn’t a winner.** *Seggerman Farms, Inc. v. Commissioner*, 308 F.3d 803, 2002-2 U.S.T.C. ¶50,728, 90 A.F.T.R.2d 2002-6981 (7th Cir. 10/24/02), *aff’g* T.C. Memo. 2001-99 (4/25/01). Shareholders who transferred a family farm to a corporation in a § 351 transaction were required under § 357(c) to recognize gain on the transfer to the extent the liabilities to which the transferred property was subject exceeded the adjusted basis of the property. The shareholders argued that because they had personally guaranteed the debt, they were not relieved of their obligations on the transferred property, and thus, no gain should be recognized on the transfer. The court (Judge Bauer) held that § 357(c) requires gain recognition even if the transferor remains liable as a guarantor. Judge Bauer rejected the taxpayers’ argument that under “the emerging equitable interpretation of § 357(c)” their guarantees should be treated in the same manner as the shareholders’ promissory notes to the corporations in *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989), and

Peracchi v. Commissioner, 143 F.3d 487 (9th Cir. 1998), because the guarantee, standing alone, does not constitute an “economic outlay.”

● Although the case arose prior to the 1999 amendments to § 357(c) and (d), the Tax Court noted in its opinion that the result would not be different under the current statute.

B. Distributions and Redemptions

1. Rogers v. United States, 281 F.3d 1108, 2002-1 U.S.T.C. ¶50,240, 89 A.F.T.R.2d 2002-1115 (10th Cir. 2/22/02), *aff’g* 58 F. Supp. 2d 1235, 2000-1 U.S.T.C. ¶50,237, 85 A.F.T.R.2d 2000-946 (D. Kan. 6/10/99). A purported loan by the Kansas City Royals baseball team S corporation was a stock redemption, so related expenses were nondeductible under § 162(k). *See also* II.H., *supra*.

2. **Didn’t Judge Swift ever see *The Godfather*?** Capital Video Corporation v. Commissioner, T.C. Memo 2002-40 (2/11/02). Capital Video Corporation paid “tribute” to Richichi, a capo in the Gambino crime family. In connection with these payments, Guarino, the sole shareholder of Capital Video, was indicted, *inter alia*, for conspiracy to obstruct the IRS in collecting Richichi’s taxes. Capital Video paid Guarino’s attorney’s fees to defend the criminal charges. Judge Swift held that the payment of Guarino’s attorney’s fees was not deductible by Capital Video because the payments were disguised shareholder distributions.

There is no evidence herein that indicates that Richichi would not have provided the protection to Capital Video if Guarino had not participated in the conspiracy relating to Richichi’s taxes and if Capital Video had not paid Guarino’s legal fees. . .

Apart from whether the tribute payments made by Capital Video to Richichi were made to protect the business of Capital Video, petitioners have not established that Guarino’s participation in the conspiracy to avoid Richichi’s income taxes and Capital Video’s payment of the legal fees in dispute had a sufficient business relationship with the protection or promotion of Capital Video’s business.

3. **After the taxpayer’s crack dealer customers found that he kept books, his tax problems were probably the least of his worries.** Zhadanov v. Commissioner, T.C. Memo. 2002-104 (4/25/02). Zhadanov’s wholly owned corporation was found to have fraudulently underreported nearly \$750,000 of income from its business of manufacturing plastic bottles for sale to crack cocaine dealers. Among the badges of fraud were that the cash receipts were not deposited in the corporation’s bank account, but were diverted to a safe in the sole shareholder’s home. Nevertheless, Judge Marvel found that the diversion of possession of the cash to the sole shareholder was not a constructive dividend because, although he had physical control of the cash, he never used any of it for personal purposes, and it was still in the safe when it was seized by DEA agents. That none of the diverted cash was used for personal purposes was supported by the taxpayer’s cash receipts journal—a second set of books, (the real books?)—that accounted for the cash.

4. **Basis can live long after the stock is “redeemed.” Who’d a thunk it?** REG-150313-01, Redemptions Taxable as Dividends, 67 F.R. 64331

(10/18/02). The IRS has proposed replacing the “proper adjustment” to the basis of remaining stock rule of Reg. § 1.302-2(c), which takes into account the unused basis of redeemed stock when the redemption is treated as a § 301 distribution. Proposed Reg. § 1.302-5 would provide that the redeemed shareholder [who is taxed under § 301] would retain the basis of the redeemed stock as a basis item separate from any remaining shares, whether or not the shareholder continues to actually own the stock of the redeeming corporation, and take it into account as a loss deduction at some future date. The loss subsequently can be claimed under either the “final inclusion date” rule or the “accelerated loss inclusion date” rule. The “final inclusion date” is the date on which the redeemed shareholder would qualify under § 302(b)(1), (2) or (3) if the facts on that date had been the facts immediately after the redemption, or alternatively, when an individual shareholder dies or a corporate shareholder is liquidated in a transaction to which § 331 applies. The “accelerated loss inclusion date” rule allows the redeemed shareholder to claim a loss attributable to the unutilized basis when the shareholder subsequently recognizes a gain on stock of the redeeming corporation, but the loss may be claimed only to the extent of the gain recognized. Because the loss attributable to the basis of the redeemed stock is treated as recognized on the redemption date, the attributes (e.g., character and source) of the loss are fixed on the redemption date, even if such loss is not taken into account until after the redemption date. These rules apply to § 304(a)(1) transactions taxed under § 301 by treating the unutilized basis in the redeemed corporation stock as basis in the stock of the acquiring corporation. Special rules apply to partnerships in consolidated returns [Prop. Reg. § 1.1502-19(b)(5)] and to foreign corporations. These rules do not apply to redemptions of § 306 stock, but they do generally apply even in the case of a corporation wholly owned by a single shareholder, whether a corporation or an individual.

- These regulations are a reaction, in part, to basis shifting transactions, such as that described in Notice 2001-45, 2001-2 C.B. 129 [the so-called Bank of America transaction].

- It has been noted that if nuclear disaster ever overcomes the Earth, only the cockroach and basis would survive.

C. Liquidations

There were no significant developments in this topic in 2002.

D. S Corporations

1. **The technical result in *Gitlitz* sleeps the big sleep, but the method of statutory analysis might have everlasting life.** The **Job Creation and Worker Assistance Act of 2002**, Pub. L. No. 107-147, 116 Stat. 21 (3/9/02), reverses the result of *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), by amending § 108(d)(7)(A) to provide that excluded cancellation of indebtedness income of S corporations is not to result in an adjustment to the basis of the stock in the hands of shareholders. The statutory rule is applicable to discharges of indebtedness after 10/11/01 (but not to discharges of indebtedness before 3/1/02 pursuant to a plan of reorganization filed with the Bankruptcy Court on or before 10/11/01).

2. **ESBT Regulations are now final.** T.D. 8994, Electing Small Business Trusts, 67 F.R. 34388 (5/14/02). The Treasury Department has promulgated final regulations regarding the qualification and treatment of electing small business trusts (ESBTs) which reflect amendments in the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755

(8/20/96), the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (8/5/97), and § 316 of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554 (12/15/00). Regulation § 1.641(c)-1 and the amendments to Reg. § 1.1361-1 implement § 1361(f), permitting ESBTs to be permitted S corporation shareholders. Under the final regulations, temporary waivers of powers of appointment do not eliminate a beneficiary, but a permanent release will be effective. “Negligible” future interests are disregarded. If a grantor trust makes an ESBT election, the trust consists of a grantor portion and a non-S portion, subject to normal rules, and an S portion, subject to § 641(c). When a trust consists of an S-portion and a non-S portion, the source of distributions controls their taxation to beneficiaries. A QSST may convert to an ESBT; an ESBT can convert to a QSST if it qualifies. The final regulations [Reg. § 1.444-4] provide that an ESBT, or a trust described in § 401(a) or a § 501(c)(3) entity that is tax-exempt under § 501(a), is not treated as a deferral entity for purposes of Temp. Reg. § 1.444-2T.

3. What happens when Subchapter S and Subchapter K collide?

a. In the Tax Court, the aggregate theory of partnership taxation was applied. Coggin Automotive Corp. v. Commissioner, 115 T.C. 349 (10/18/00). Taxpayer originally was a holding company that had a number of controlled subsidiaries engaged in the retail sale of motor vehicles. The subsidiaries maintained their inventories under the LIFO method and all of the corporations filed a consolidated return. In 1993, the taxpayer restructured to make an S election. Six new S corporations were formed to become the general partners in six limited partnerships. Each subsidiary contributed its dealership assets to a limited partnership in exchange for a limited partnership interest, following which the subsidiaries were liquidated and the taxpayer became the limited partner in each. The Commissioner asserted that the taxpayer’s conversion to an S corporation triggered the inclusion of the affiliated group’s pre-S-election LIFO reserves (approximately \$5 million) under § 1363(d). The Commissioner argued alternatively (1) that the restructuring should be disregarded because it had no purpose independent of tax consequences, and (2) that under the aggregate approach to partnerships, a pro rata share of the pre-S-election LIFO reserves (approximately \$4.8 million) was attributable to the taxpayer as a partner. The Tax Court (Judge Jacobs) rejected the Commissioner’s first argument, holding that the restructuring was a genuine multiple-party transaction with economic substance, compelled by business realities and imbued with tax-independent considerations. But Judge Jacobs accepted the Commissioner’s second argument, holding that application of the aggregate approach [rather than the entity approach] to partnership taxation furthered the purpose of § 1363(d). Thus, the taxpayer was treated as owning a pro rata share of the partnerships’ inventories and as a result of its election it was required to include \$4.8 million of LIFO recapture.

● In reaching its decision regarding Subchapter K, the Tax Court followed *Casel v. Commissioner*, 79 T.C. 424 (1982) (applying the aggregate approach to apply § 267 to disallow losses between related parties); *Holiday Village Shopping Center v. United States*, 773 F.2d 276 (Fed. Cir. 1985) (applying the aggregate approach for purposes of determining depreciation recapture when a corporation distributed a partnership interest to its shareholders); and *Unger v. Commissioner*, 936 F.2d 1316 (D.C. Cir. 1991), in determining permanent establishment. It distinguished as inapposite the entity approach applied in *P.D.B. Sports, Ltd. v. Commissioner*, 109 T.C. 423, (1997) (applying the entity approach for purposes of applying §

1056); *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980) (applying the entity approach in determining whether expenditures are deductible under § 162 or nondeductible start-up expenditures); and the Eighth Circuit's decision in *Brown Group, Inc. & Subs. v. Commissioner*, 77 F.3d 217 (8th Cir.1996), *vacating* 104 T.C. 105 (1995) (concluding that the entity approach, rather than the aggregate approach, should be used in characterizing income (subpart F income) earned by a partnership). The differences, the court found, were based on the determination of the relevant Congressional intent in enacting the non-subchapter K provision involved in each case.

b. But the Eleventh Circuit sees things differently, and reverses the Tax Court. “Plain language” requires application of the entity theory. *Coggin Automotive Corp. v. Commissioner*, 292 F.3d 1326, 2002-1 U.S.T.C. ¶50,448, 89 A.F.T.R.2d 2002-2826 (11th Cir. 6/6/02). Expressly applying the *Gitlitz* “plain language” principle, the Eleventh Circuit (Judge Hill) reversed the Tax Court. The court held that § 1363(d) LIFO recapture is triggered only if the corporation electing S status itself directly owned the LIFO inventory. Since the result turned on “plain language” rather than the purpose of the statutory pattern, Judge Hill was spared the need to write a lengthy opinion.

4. Daisy-chain loans don't represent an economic outlay. *Oren v. Commissioner*, T.C. Memo. 2002-172 (7/19/02). The taxpayer was the controlling shareholder of three S corporations, one of which (Dart) passed through substantial income, and the others of which (Highway Leasing and Highway Sales) passed through losses in excess of the taxpayers basis [due to depreciation on leveraged depreciable equipment]. The taxpayer sought to utilize the losses by creating basis in Highway Leasing and Highway Sales through a series of circular loan transactions: the taxpayer borrowed money from Dart, which he lent to Highway Leasing and Highway Sales on terms identical to the terms of the loans from Dart to the taxpayer, following which Highway Leasing and Highway Sales lent the funds to Dart. Judge Ruwe held that the loans had no economic substance and that Oren had not made any “economic outlay.” Thus, except to the extent of \$200,000 lent from his own personal assets, Oren did not acquire basis in the promissory notes from Highway Leasing and Highway Sales against which the losses could be deducted. Furthermore, the circular loan arrangement was a “loss limiting arrangement” under § 465(b)(1) because there was no “realistic possibility of loss” by Oren; the facts did not indicate that the circular chain of payment could be broken. Judge Ruwe rejected the possibility that the chain of payment might be broken by a tort judgment against one of the corporations in excess of its large insurance coverage.

E. Affiliated Corporations.

1. The Federal Circuit doesn't appear to buy into the single entity theory of consolidated returns. Regulation § 1.1502-20, which prohibited recognition of loss in the transactions involving, *inter alia*, “duplicated losses,” was held to be “manifestly contrary to the statute.” *Rite Aid Corp. v. United States*, 255 F.3d 1357, 2001-2 U.S.T.C. ¶50,516, 88 A.F.T.R.2d 2001-5058 (Fed. Cir. 7/6/01), *rev'g* 46 Fed. Cl. 500, 2000-1 U.S.T.C. ¶50,429, 85 A.F.T.R.2d 2000-1439 (4/21/00). Rite Aid sold a subsidiary (Encore) and realized a taxable loss of \$33 million and an “economic loss” of \$22 million, which it claimed should be deductible. Regulation § 1.1502-20, subject to certain exceptions, disallows *any* loss realized by a

member of a consolidated group upon the disposition of the stock of a subsidiary. Under Reg. § 1.1502-20, the amount of loss that is disallowed is limited to the sum of (1) income or gain resulting from “extraordinary gains dispositions,” which are defined as dispositions of capital assets, depreciable property used in the trade or business, certain bulk asset dispositions, and discharge of indebtedness income, (2) positive investment adjustments (other than those attributable to extraordinary gain dispositions), and (3) “duplicated loss,” which is the aggregate of the subsidiary’s asset bases and loss carryovers over the value of the subsidiary’s assets. Any losses in excess of these amounts are deductible. Regulation § 1.1502-20 is designed to prevent “duplicated losses”—the deduction by both the parent and subsidiary of the same economic loss. The Court of Federal Claims upheld the validity of Reg. § 1.1502-20 and because Encore’s built-in loss of \$28 million [as calculated by Rite-Aid] exceeded Rite-Aids’ economic loss, no loss deduction was allowed. The court pointed out that Rite Aid could have avoided Reg. § 1.1502-20 by finding a buyer who would agree to a § 338(h)(10) election.

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

a. At first the IRS decided to keep on fighting. In Chief Counsel Notice CC-2001-042 (8/21/01), the Service has advised chief counsel attorneys that it does not agree with the Federal Circuit decision in *Rite Aid* and that it has filed a petition for rehearing en banc with the Federal Circuit.

b. But six months later, the IRS caved and announced that it will change the regulations instead. Notice 2002-11, 2002-7 I.R.B. 526 (2/19/02). The Notice reads:

In *Rite Aid*, the Federal Circuit held that the duplicated loss component of § 1.1502-20 of the Income Tax Regulations, which disallows certain losses on sales of stock of a member of a consolidated group, was an invalid exercise of regulatory authority. The Internal Revenue Service believes that the court’s analysis and holding were incorrect.

Nevertheless, the Service has decided that the interests of sound tax administration will not be served by continuing to litigate the validity of the loss duplication factor of § 1.1502-20. Moreover, because of the interrelationship in the operation of all of the loss disallowance factors, the Service has decided that new rules governing loss disallowance on sales of stock of a member of a consolidated group should be implemented.

Accordingly, the Service intends to promulgate interim regulations that, prospectively from the date of their issuance, will require consolidated groups to determine the allowable loss on a sale or disposition of subsidiary stock under an amended § 1.337(d)-2 instead of under § 1.1502-20. For transactions (including those for which a return has been filed) completed before the date of issuance of interim regulations, or for which there is a binding contract before that date, groups will be allowed certain choices with respect to a disposition of subsidiary stock, including a choice to apply § 1.337(d)-2 as amended. The Service and Treasury are undertaking a broader study of the regulatory provisions necessary to implement § 337(d) of the Internal Revenue Code in the context of affiliated groups filing consolidated returns and will request comments in conjunction with the issuance of the interim regulations.

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

c. Notice 2002-18, 2002-12 I.R.B. 644 (3/25/02). The Service announced that it and the Treasury Department

intend to issue regulations that will prevent a consolidated group from obtaining a tax benefit from both the utilization of a loss from the disposition of stock (or another asset that reflects the basis of stock) and the utilization of a loss or deduction with respect to another asset that reflects the same economic loss. For example, where a member of a group contributes built-in loss assets to another member of the group in exchange for stock of such member in a transaction in which the basis of such stock is determined, directly or indirectly, in whole or in part, by reference to the basis of such assets and the transferor member sells such stock without causing the deconsolidation of the transferee, the group may benefit from the built-in loss in the contributed assets more than once. It is expected that the regulations will defer or otherwise limit utilization of the loss on the stock in such transactions and other transactions that facilitate the group's utilization of a single loss more than once.

d. **The new regulations are here.** T.D. 8984, Loss Limitation Rules, 67 F.R. 11034 (3/12/02), and REG-102740-02, Loss Limitation Rules, 67 F.R. 11070 (3/12/02). The IRS has published final, temporary and proposed regulations under §§ 337(d) and 1502. New Temp. Reg. § 1.337(d)-2T governs the amount of loss allowed. The regulations disallow deductions for any losses on the sale of the stock of a subsidiary by a member of a consolidated group except to the extent that the taxpayer can prove that the loss is not attributable to the recognition of built-in gain on the disposition of any asset, including stock and securities. Gain recognized on the disposition of any asset is "built-in gain" to the extent that the gain is

attributable to any excess of value over basis that is reflected in the basis of the stock. Thus, the new rule focuses only on losses attributable to basis adjustments to the subsidiary's stock attributable to gains recognized by the subsidiary. The new regulations also require that on deconsolidation of a subsidiary, the basis of stock of the subsidiary held by members of a consolidated group must be reduced to an amount not exceeding the stock's value, except to the extent that the taxpayer can show that the required basis reduction is not attributable to recognition of built-in gain. The new rules do not deal with the duplicated losses formerly disallowed by Reg. § 1.1502-20(c)(1)(iii). The new regulations are applicable to dispositions after 3/6/02. For dispositions prior to 3/7/02 (or pursuant to a binding contract entered into prior to 3/7/02) the taxpayer may elect to apply Reg. § 1.1502-20.

● At the October 18 meeting in Los Angeles of the American Bar Association Section of Taxation Affiliated and Related Corporations Committee, Jeffrey H. Paravano, senior adviser to the assistant secretary for Tax Policy, stated that these regulations would govern future transactions similar to the one in which Bank of America Corp. dropped some problem loans into a wholly owned subsidiary, Strategic Solutions Inc., along with the bank employees whose job it was to work out those loans. The subsidiary had no assets unrelated to the loans, and [assuming a business purpose] the transaction would be governed by § 351. If so, then the bank would have a basis in the subsidiary shares equal to its basis in the loans, and the subsidiary would have the same basis in the transferred loans. Because the fair market value of the loans is less than the original amount lent, the subsidiary shares and the subsidiary's assets would have built-in losses. The aim of such transactions appears to be for the bank to sell some subsidiary shares and to recognize a loss, and then use the subsidiary's losses on the loans themselves, as they occur, on the bank's consolidated return. Paravano stated that a taxpayer should be able to use the same economic loss only once, based upon *Charles Iffeld Co. v. Hernandez*, 292 U.S. 62 (1934), in which the Supreme Court disallowed a loss on the shares of a subsidiary that was being liquidated, on the grounds that permitting the loss would allow the group to use the subsidiary's operating losses twice. 2002 TNT 205-4 (10/22/02).

e. A glitch is fixed – in the taxpayer's favor. T.D. 8998, Loss Limitation Rules, 67 F.R. 37998 (5/31/02), and REG-102305-02, Loss Limitation Rules, 67 F.R. 38040 (5/31/02). New Temp. Reg. § 1.337(d)-2T(a)(4) provides a netting rule [similar to that in former Reg. § 1.1502-20(a)(4)], pursuant to which gain and loss may be netted with respect to the disposition of stock of a subsidiary, to the extent that, as a consequence of the same plan or arrangement, gain is taken into account by members with respect to stock of the same subsidiary having the same material terms. New Temp. Reg. § 1.337(d)-2T(b)(4) provides a similar netting rule for basis reductions on deconsolidations of subsidiary stock. The temporary regulations are also issued as proposed regulations.

f. And here are more of the new regulations. REG-131478-02, Guidance Under Section 1502; Suspension of Losses on Certain Stock Dispositions, 67 F.R. 65060 (10/23/02). Temporary Reg. § 1.337(d)-2T (3/7/02), which generally allows a loss on the disposition of subsidiary member stock only to the extent that a taxpayer can establish that the stock loss is not attributable to the recognition of built-in gain, does not disallow stock loss that reflects loss carryforwards, deferred deductions, or built-in asset losses of the subsidiary member. Proposed Reg. § 1.1502-35 expands the principles in Temp. Reg. § 1.337(d)-2T and Notice 2002-18, 2002-12 I.R.B. 644 (3/25/02), to limit the ability of a consolidated group to obtain more than one tax benefit from a

single economic loss. The proposed regulations provide three principal rules: (1) a basis redetermination rule, (2) a loss suspension rule, and a (3) basis reduction rule. The proposed regulations also include anti-avoidance rules to address transactions designed to avoid the application of the basis redetermination and loss suspension rules.

● The basis adjustment rule applies where a group absorbs a subsidiary's inside loss followed by the recognition of a loss on the sale of the stock of the subsidiary by another member of the group. The basis adjustment rule operates differently depending on whether the subsidiary remains a member of the group. If the subsidiary remains a member of the group, immediately before the sale of the stock, the basis of all of the stock of the subsidiary (of all classes) owned by the group is reallocated, first to all of the shares of preferred stock, up to their value, and then among all of the shares common stock in proportion to their value. If the subsidiary is no longer a member of the group immediately after the disposition, the basis redetermination rule requires a reallocation to the subsidiary stock retained by the group from the subsidiary stock that was sold in an amount equal to the lesser of (1) the loss inherent in the stock sold, or (2) the subsidiary member's items of deduction and loss that were taken into account in computing the adjustment to the basis of any share of stock of the subsidiary member, other than the shares disposed of, during the time the subsidiary was a member of the group. [Only items of deduction and loss attributable to formerly unrecognized or unabsorbed items reflected in the basis of the subsidiary member stock sold are taken into account; but there is a presumption that all items of deduction and loss included in the computation of prior investment adjustments to the basis of members' shares of the subsidiary should be taken into account]. The amount by which the basis in the shares of subsidiary stock sold is reduced is reallocated first to the basis of all preferred shares of the subsidiary held by members of the group, up to their fair market value, and then to all common shares of stock of the subsidiary held by members of the group immediately after the disposition in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same. [The basis redetermination rule does not apply if the group disposes of all its stock of the subsidiary within a single taxable year or is allowed a worthless stock deduction with respect to the subsidiary's stock. If a second tax benefit has been derived from an economic loss, the second tax benefit will be recaptured in the taxable year in which it was obtained.]

● The loss suspension rule, which is applied after the reallocation rule, effectively disallows a loss on the stock if the economic loss giving rise to that loss is later reflected on the group's return. If a member of the group recognizes a loss on the disposition of stock of a member and the subsidiary remains a group member, the selling member's loss is suspended to the extent of the "duplicated loss." The "duplicated loss" is the excess of (1) the sum of the aggregate basis of the subsidiary's assets (excluding stock in other subsidiary members of the group), the subsidiary's losses that are carried to its first taxable year after the disposition, and the subsidiary's deductions that have been recognized but deferred under another provision, over (2) the sum of the value of stock of the subsidiary member and the subsidiary's liabilities that have been taken into account for tax purposes. The definition of "duplicated loss" is substantially identical to that in former Reg. § 1.1502-20 [except that securities of other members of the group are not excluded from the computation of the subsidiary's aggregate asset basis]. The suspended loss is thereafter reduced [i.e., disallowed] when the subsidiary's deductions and losses are absorbed in determining the group's consolidated taxable income. There is

a rebuttable presumption that all deductions and losses are attributable to the loss that gave rise to a suspended stock loss. Any suspended stock loss remaining at the time the subsidiary member leaves the group generally will be allowed.

- The basis reduction rule operates if a member disposes of subsidiary stock and thereafter ceases to exist [the subsidiary “is not a member of the group and does not have a separate return year”]. In this case, the basis of the subsidiary’s stock is reduced to the extent of the consolidated net operating loss and net capital loss carry-forwards attributable to such subsidiary member, as though they were absorbed immediately prior to the disposition. This rule applies in the case of liquidations of an insolvent subsidiary or in the case of worthless stock losses.

- The regulations [except the anti-abuse rules] are proposed to be effective for transactions on or after 3/7/02 if the return was not due before 10/23/02.

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

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

a. Finalized. T.D. 9025, Intercompany Transactions: Conforming Amendments to Section 446, 67 F.R. 76985 (12/16/02). The proposed regulations were adopted without change, and are effective 11/7/01.

3. Corporate remarriage OK if you talk sweetly to the IRS! Rev. Proc. 2002-32, 2002-20 I.R.B. 959 (5/20/02). This revenue procedure permits qualifying corporations to obtain a waiver of the § 1504(a)(3)(4) bar from joining in a consolidated return with a group of which it had ceased to be a member within the preceding 60 months.

4. T.D. 9002, Agent for Consolidated Group, 67 F.R. 43538 (6/28/02). Regulations §§ 1.1502-77 and 1.1502-78 [proposed in REG-103805-99, Agent for Consolidated Group, 65 F.R. 57755 (9/26/00)] clarify and supplement the rules concerning the agent for a consolidated group and the designation of a new agent for the group. The final regulations are substantially the same as the proposed regulations, with clarifying changes. Under the regulations, the common parent remains the agent as long as it continues to exist as a corporation, even if it ceases to be the common parent. The common parent is also the agent for any corporation improperly included in the consolidated return. The regulations continue the current rule that if the common parent ceases to exist it may designate another member of the group as its successor agent. If no such designation is made, the IRS may designate the successor agent, except in cases where the parent has a single domestic successor, where that successor becomes the agent by default. The prior rule permitting the remaining members to designate the successor agent will be removed. The regulations deal with the *Interlake Corp. v. Commissioner*, 112 T.C. 103 (1999), problem by providing that a refund resulting from a carryback of a NOL under

§ 172 should be paid to the common parent or agent for the carryback year. The revised regulations generally are effective with respect to taxable years beginning on or after 6/28/02.

F. Reorganizations and Corporate Divisions

1. The wrath of *General Utilities* repeal rewritten. REG-107566-00, Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities In Connection with an Acquisition, 66 F.R. 66 (1/2/01). The Treasury Department revised Prop. Reg. § 1.355-7 and withdrew proposed regulations (REG-116733-98, 66 F.R. 76 (1/21/01)) issued in REG-116733-98, 64 F.R. 46155 (8/24/99). The proposed regulations provided that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. They included a nonexclusive lists of facts and circumstances to be considered in making the determination and six safe harbors.¹²

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

b. The third (fourth?) time’s the charm. T.D. 8988, Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection With an Acquisition, 67 F.R. 20632 (4/26/02), and REG-163892-01, Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection With an Acquisition, 67 F.R. 20711 (4/26/02). These temporary and proposed regulations amend Temp. Reg. § 1.355-7T and identical Prop. Reg. § 1.355-7, and set forth new guidelines in the anti-*Morris Trust* regulations. The 2002 temporary and proposed regulations disregard the presumption of § 355(e)(2)(B) and provide that “whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances.” However, Temp. Reg. § 1.355-7T(b)(2) provides a “super-safe harbor” for an acquisition not involving a public offering that occurs within 2 years following the date of a distribution—the distribution and acquisition “will be treated as part of a plan *only* if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the 2-year period ending on the date of the distribution.” [emphasis added].

Under the facts and circumstances test, the existence of an agreement, understanding, arrangement, or substantial negotiations during the 2-year period tends to show that the distribution and acquisition are part of a plan, but such an understanding, etc., is merely a factor among the facts and circumstances to

12. For a more complete discussion of these proposed regulations, see Shepard, Ira B. and Martin J. McMahon, Jr., Recent Development in Federal Income Taxation: The Year 2001, 5 Fla. Tax. Rev. 627, 714-17 (2002).

be evaluated. If an acquisition *precedes the distribution*, discussions regarding a distribution with the acquirer by either the controlled or distributing corporation within the 2-year period preceding the acquisition indicate the existence of a plan. The absence of discussions regarding a distribution during the 2-year period preceding the acquisition indicates that the acquisition and distribution were not part of a plan. Discussions with an investment banker during the 2-year period preceding an acquisition by public offering are a factor indicating the existence of a plan. A corporate business purpose [as defined in Reg. § 1.355-2(b)], other than a business purpose to facilitate the acquisition, is a factor indicating the absence of a plan. That the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition indicates the absence of a plan.

A distribution and an acquisition are not part of a plan if they are described in one of the following seven safe harbors:

(1) An acquisition occurs more than 6 months after a distribution, there was no agreement, understanding, arrangement, or substantial negotiations regarding the acquisition from one year before the distribution to 6 months after the distribution, and the distribution was motivated in whole, or in substantial part, by a corporate business purpose other than to facilitate an acquisition.

(2) An acquisition occurs more than 6 months after a distribution and there was no agreement, understanding, arrangement, or substantial negotiations regarding the acquisition from one year before the distribution to 6 months after the distribution, the distribution was not motivated by a business purpose to facilitate an acquisition of either the distributing or controlled corporations, and no more than 25 percent of the stock of the corporation whose stock was acquired in the acquisition was either acquired or the subject of an agreement, understanding, arrangement, or substantial negotiations during a period from one year before the distribution to 6 months following the distribution.

(3) An acquisition occurs after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within one year thereafter. **This provision eliminates the statutory 2-year post-distribution presumption and replaces it with a one-year safe harbor.**

(4) A distribution occurs more than 2 years after an acquisition and there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within 6 months thereafter.

(5) An acquisition of stock of the distributing or controlled corporation listed on an established market occurs as a result of transfers between shareholders of distributing or controlled corporations who are not controlling shareholders [5 percent shareholders who participate in management] or 10 percent shareholders. This safe harbor does not apply if the transferor or transferee of the stock is controlled by the acquired corporation, is a member of a controlled group that includes the acquired corporation, or is an underwriter with respect to the acquisition.

(6) An acquisition of stock by an employee, director, or independent contractor [other than controlling shareholders] in connection with the performance of services.

(7) An acquisition by a qualified pension or retirement plan.

2. Post-spin-off stock options and restricted stock taxation determined with reference to the policy of § 1032. Rev. Rul. 2002-1, 2002-2 I.R.B. 268 (1/14/02). This ruling answers several questions with respect to transactions involving restricted stock and stock options held by employees of both corporations following a § 355 spin-off of a controlled corporation (C) by a distributing corporation (D). The distributions of C stock and warrants were

in an amount and on terms designed to exactly preserve the employees' pre-spin-off economic rights. *First*, the ruling holds that D does not recognize any gain or loss when restrictions lapse on C stock that was received by D employees in the spin-off with respect to their restricted D stock. Likewise, D does not recognize gain or loss as a result of the exercise by D employees of options on C stock that were received in the spin-off with respect to options on D stock that they held. *Second*, C does not recognize gain or loss when restrictions lapse on D stock held by C employees that was received before the spin-off. Likewise, C does not recognize gain or loss as a result of the exercise by C employees of options on D stock that were received in the spin-off with respect to options on D stock that they held before the spin-off. *Third*, D is entitled to deductions for amounts includible in D employees' income as a result of the lapse of restrictions on D and C stock and the exercise of options to acquire D and C stock, and C is entitled to deductions for amounts includible in C employees' income as a result of the lapse of restrictions on D and C stock and the exercise of options to acquire D and C stock.

3. Just a simple earnings bailout scheme. South Tulsa Pathology Laboratory, Inc. v. Commissioner, 118 T.C. 84 (1/28/02). The Tax Court (Judge Marvel) held that a pre-§ 355(e) pro rata spin-off followed by a prearranged sale of the controlled corporation's stock was a "device" precluding tax-free treatment under § 355. There was no business purpose for the distribution of the controlled business to the shareholders prior to its sale even if there was a business purpose for the sale. That the distributing corporation's earnings and profits were only \$253,000, compared with the \$5,530,000 sale price, did not negate that the transaction was a device to bail out earnings and profits because the earnings and profits that were being bailed out were the profits from the sale of the controlled corporation's business. The distributing corporation's recognized gain was computed with reference to the selling price of the stock—not the appraised fair market value of the assets transferred by the distributing corporation to the controlled corporation—because the contemporaneous arm's length sales price was the best evidence of the fair market value of the stock. *Pope & Talbot, Inc. v. Commissioner*, 104 T.C. 574 (1995), *aff'd*, 162 F.3d 1236 (9th Cir. 1999) (holding that for purposes of § 311(b) a corporation that transferred land to a limited partnership and then distributed the limited partnership units was treated as distributing the land), was distinguished as involving a question of identifying the distributed asset; in the instant case the distributed asset clearly was the stock of the controlled corporation.

4. "When I[RS] use a word . . . it means just what I[RS] choose it to mean."¹³ Rev. Rul. 2002-49, 2002-32 I.R.B. 288 (8/12/02). This revenue ruling deals with whether the 5-year active conduct of a trade or business requirement of § 355(b) is satisfied when, during the 5-year period prior to a transaction that otherwise meets the requirements of § 355, a corporation holding a membership interest in a member-managed limited liability company purchases the remaining interests in that limited liability company, contributes a portion of the business to a newly formed controlled subsidiary, and then distributes the stock of the controlled subsidiary to its shareholders.

● In *Situation 1*, D Corporation's sole asset was 20 percent of the LLC, which operated numerous rental properties and its officers actively participated in the management of the LLC, along with the

13. Lewis Carroll, *Through the Looking Glass*, THE COMPLETE WORKS OF LEWIS CARROLL 196 (1966).

officers of another 20 percent owner (none of the other owners participated in management). After 2 years, *D* purchased the other 80 percent of the interests and the LLC became a disregarded entity. On the first day of year 6, the LLC distributed 40 percent of the rental properties to *D*, which contributed the properties to *C* in exchange for all of *C*'s stock, following which *C* was spun-off to *D*'s shareholders. The IRS applied Rev. Rul. 92-17, 1992-1 C.B. 142, to find *D* was engaged in the active conduct of the leasing business [within the meaning of § 355(b)] for the first 2 years. Notwithstanding Rev. Rul. 99-6, 1999-1 C.B. 432 (holding that the sale and purchase of all of the remaining interests in an LLC is treated as the distribution of assets to the selling members and the purchase of assets by the continuing members), the purchase of the 80 percent interest in the LLC within 5 years did not violate § 355(b)(2)(C), even though gain or loss was recognized in the transaction, because the transaction was not the acquisition of a new or different business under Reg. § 1.355-3(b)(3)(ii).

- *Situation 2* is the same as *Situation 1*, except that *D* obtained the 20 percent interest in the LLC on the first day of year 2, in exchange for appreciated securities in a § 721 transaction, before the spin-off in year 6. This situation does not qualify because *D* is treated as having acquired the LLC's business in a transaction in which gain or loss was recognized within the 5-year pre-distribution period [§ 355(b)(2)(C)]. Although no gain or loss was recognized [§ 721(a)] on *D*'s acquisition of the LLC interest in year 2, if *D* had directly acquired the LLC's business in exchange for the property *D* contributed to the LLC, the exchange would have been a transaction in which gain or loss was recognized. For purposes of § 355(b), therefore, *D* is treated as acquiring the LLC's business in year 2 in a transaction in which gain or loss was recognized. Huh!

5. Pooling on the financials, taxable purchase on the tax return. Is something strange here or are we just naive? *NovaCare, Inc. v. United States*, 52 Fed. Cl. 165, 2002-1 U.S.T.C. ¶50,389, 89 A.F.T.R.2d 2002-1553 (3/25/02). Taxpayer acquired RSC [in a triangular merger] solely in exchange for approximately 6 million shares of its stock on August 9, 1991. By December 31, 1992, the former RSC shareholders had disposed of roughly 87 percent of the NovaCare stock received. When taxpayer sold its RSC subsidiary in 1995, it reported gain using a purchase price basis, treating the 1991 acquisition as a taxable purchase because of a lack of continuity of interest under the regulations as then in effect, as interpreted by *McDonald's Restaurants of Illinois, Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982). [Of course, in the spirit of Enron, WorldCom, Xerox, and who knows who else, NovaCare treated the acquisition as a pooling for financial accounting.] The Commissioner argued that *Penrod v. Commissioner*, 88 T.C. 1415 (1987), should control to treat the 1991 acquisition as a reorganization with a transferred basis. The court (Judge Horn) denied cross motions for summary judgment, holding that a genuine issue of fact existed as to whether the RSC shareholders intended, at the time of the reorganization on August 9, 1991, to dispose of the NovaCare stock received in the reorganization or to hold it.

- The court noted that for reorganizations occurring after 1/28/98, under Reg. § 1.368-1(e), post-reorganization dispositions are irrelevant with respect to continuity of interest, but gave no weight to the promulgation of the regulation to solve the *McDonald's/Penrod* problem.

6. "Expessio unis est exclusio alterius"? Nope, not the way the IRS thinks. Rev. Rul. 2002-85, 2002-52 I.R.B. 986 (12/30/02). An acquiring corporation's transfer of the target corporation's assets to a subsidiary controlled by the acquiring corporation as part of a plan of reorganization will

not disqualify a transaction that otherwise qualifies as a § 368(a)(1)(D) reorganization—i.e., the original transferee acquires substantially all of the target’s assets, the COSI and COBE requirements are met, and the remote continuity principle of *Groman v. Commissioner*, 302 U.S. 654 (1937), and *Helvering v. Bashford*, 302 U.S. 454 (1938), does not apply—and which would not have qualified as a type (C) reorganization [due to excessive boot]. The IRS reasoned, as it did in Rev. Rul. 2001-24, 2001-1 C.B. 1290, that § 368(a)(2)(C) is permissive and not restrictive; thus the lack of a reference to § 368(a)(1)(D) in § 368(a)(2)(C) does not indicate that such a transfer following a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) will prevent the transaction from qualifying. In addition, the IRS treated the parenthetical exception in § 368(a)(2)(A), dealing with the overlap of (C) and (D) reorganizations—“other than for purposes of [§ 368(a)(2)(C)]”—as “in the same spirit as § 368(a)(2)(C), i.e., to resolve doubts about the qualification of transactions as reorganizations, and . . . not [to] indicate that the transfer of assets to a controlled subsidiary necessarily prevents a transaction from qualifying as a reorganization under § 368(a)(1)(D).”

7. Merging tax somethings into tax nothings is OK! T.D. 9038, Statutory Mergers and Consolidations, 68 F.R. 3384 (1/24/03), and REG-126485-01, Statutory Mergers and Consolidations, 68 F.R. 3477 (1/24/03). In REG-126485-01, Statutory Mergers and Consolidations, 66 F.R. 57400 (11/15/01), the Treasury Department withdrew the proposed regulations [REG-106186-98, Certain Corporate Reorganizations Involving Disregarded Entities, 65 FR 31115 (5/16/00)], which would have provided that neither the merger of a disregarded entity into a corporation nor the merger of a target corporation into a disregarded entity was a statutory merger qualifying as a reorganization under § 368(a)(1)(A), and proposed more liberal regulations [Prop. Reg. § 1.368-2(b)(1)]. Under the 2001 proposed regulations, a merger of a corporation into a disregarded entity that is wholly owned by another corporation could qualify as a type (A) merger. The Treasury Department has now promulgated the 2001 proposed regulations, with some modifications, as Temp. Reg. § 1.1368-2T(b) and simultaneously published new identical proposed regulations.

• The main point of the regulations is that the merger of a target corporation into an LLC wholly owned by another corporation (thereby rendering the LLC a disregarded entity) can qualify as a type (A) reorganization [and under more complex structures as a triangular reorganization, that the merger of a corporation into a Q-Sub [also a disregarded entity] can qualify as a type (A) reorganization, and that a merger into a qualified REIT subsidiary can qualify as a type (A) reorganization.

• Nevertheless, the new regulations introduce significant definitional jargon. The term “disregarded entity” means a business entity (as defined in Reg. § 301.7701-2(a)) that is disregarded as an entity separate from its owner for federal tax purposes, including single member corporate-owned LLCs, qualified REIT subsidiaries, and Q-Subs. “Combining entity” means a corporation (as defined in Reg. § 301.7701-2(b)) that is not a disregarded entity. “Combining unit” means a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for federal tax purposes. Under the proposed regulations, a statutory merger or consolidation under § 368(a)(1)(A) must be effected pursuant to the laws of the United States, a state, or the District of Columbia. [Foreign statutory mergers still do not qualify, but the domestic statute no longer needs to be a “corporate” law.] All of the following events must occur simultaneously: (1) all of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharged in the transaction) of each member of one or more combining units (each a transferor

unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and (2) the combining entity of each transferor unit ceases its separate legal existence [although its formal existence can continue under state law for certain limited purposes that are not inconsistent with the “all of the assets” requirement.]. The examples provide all of the details of the rules: Divisive mergers [see Rev. Rul. 2000-5, 2000-1 C.B. 436] cannot qualify (Ex. 1); forward triangular mergers (into a disregarded entity owned by a subsidiary) are allowed (Ex. 2 & 4); the merger of a target S corporation that owns a Q-Sub into a disregarded entity owned by a C corporation qualifies as to both the target S corporation and its Q-Sub (Ex. 3); the owner of the disregarded entity must be a corporation (Ex. 5); mergers of disregarded entities into corporations do not qualify (Ex. 6); none of the consideration received by the target shareholders may be interests in the disregarded entity (Ex. 7); and the target can be tailored by selling assets and distributing proceeds, as long as all of the remaining assets are transferred to the disregarded entity in the merger (Ex. 8).

- These regulations became effective on 1/24/03.

G. Personal Holding Companies and Accumulated Earnings Tax

1. “Accrued” tax liabilities are different from tax liabilities “imposed.” Metro Leasing & Development Corp. v. Commissioner, 119 T.C. 8 (7/17/02) (reviewed). In an earlier proceeding [T.C. Memo. 2001-119], the Tax Court held that the taxpayer was liable for the accumulated earnings tax under §§ 531-537. In this supplemental opinion, the Tax Court, in a reviewed opinion by Judge Gerber, rejected the taxpayer’s arguments that the amount of the unreasonably accumulated earnings should be adjusted under §§ 535(b)(1) and 535(b)(6)(A) in three respects.

- First, the court held that no adjustment for unpaid “accrued” taxes should be made with respect to taxes that would become due in future years with respect to a closed transaction that was being reported on the § 453 installment method. Since the gain to be recognized in future years had not been included in the accumulated income, it was not appropriate to reduce the accumulated income by the taxes attributable to that gain.

- Second, no adjustment should be made with respect to any tax deficiency, including the accumulated earnings tax, that the taxpayer continued to contest. Since the taxpayer continued to contest an underlying deficiency, even though payment had been tendered, no adjustment was allowed. The Tax Court specifically declined to follow *J.H. Rutter Rex Manufacturing Co. v. Commissioner*, 853 F.2d 1275 (5th Cir. 1988), *rev’g* T.C. Memo 1987-296, in which the Fifth Circuit held to the contrary. The Tax Court found no basis for treating a taxpayer who pays the contested deficiency differently from the taxpayer who does not pay the contested deficiency.

- Third, the court held that the decrease in the downward adjustment for capital gains under § 535(b)(6)(A) should be the taxes “attributable,” i.e. “imposed” under the statute, to those capital gains and is not limited to the combined income tax liability on capital gains and ordinary income or loss shown on the taxpayer’s return. The adjustment also takes into account the taxes due after the determination of a deficiency. Accordingly, because the taxpayer’s tax liability exceeded \$100,000 after the determination of the deficiency, the taxpayer, who reported \$35,884 of net capital gain, but only \$17,825 of taxable income due to net operating losses, reduced the negative adjustment by \$15,738 of taxes “attributable” to the capital gain, not merely the \$2,674 of taxes shown as due on the return. The court

found no conflict between its second and third holdings because a tax is “imposed” if it has been paid and is being contested, even though it is not “accrued” under those circumstances.

H. Miscellaneous Corporate Issues

1. Could they have obtained a better result if their advisor had read *Zenz*¹⁴ before structuring the deal? Or would § 311(b) have taken a big tax bite? *Steel v. Commissioner*, T.C. Memo. 2002-113 (5/6/02). The taxpayer was a partner in a partnership that owned the stock of a corporation. At the time of the sale of the stock of the corporation, the corporation had a claim pending for lost profits under a business interruption insurance policy. As permitted by the purchase and sale contract, the claim was assigned to the partnership, but nothing in the purchase and sale agreement indicated that the pricing was in any way related to the assignment. Subsequently, the partnership received cash in settlement of the claim, which the partners reported as additional capital gain on the sale of the stock. Judge Ruwe upheld the Commissioner’s determination that the receipt of the insurance claim proceeds was unrelated to the sale of the stock. That the assignment would not have occurred “but for” the stock sale, was not enough to integrate them. Since there was no sale or exchange on receipt of the proceeds, the amount realized was ordinary income.

2. Telling the IRS about your corporate/shareholder transactions. T.D. 9022, Information Reporting Relating to Taxable Stock Transactions, 67 F.R. 69468 (11/18/02). Temporary Reg. § 1.6043-4T imposes information reporting requirements [Form 8806] on corporations that have undergone a change in control or a substantial change in capital structure, e.g., a recapitalization, redemption, merger, transfer of substantially all its assets, or an (F) reorganization. However, transactions in which the amount of cash and the fair market value of property (including stock) provided to the shareholders is less than \$100,000,000 are exempt, as are transactions within an affiliated group.

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. No more “inappropriate” increases or decreases in the adjusted basis of a corporate partner’s interest in a partnership. T.D. 8986, Determination of Basis of Partner’s Interest; Special Rules, 67 F.R. 15112 (3/29/02). The Treasury Department has finalized Reg. § 1.705-2 [proposed in REG-106702-00, Determination of Basis of Partner’s Interest; Special Rules, 66 F.R. 315 (1/3/01)] which is intended to prevent what the IRS has determined to be “inappropriate” increases or decreases in the adjusted basis of a corporate partner’s interest in a partnership [consistent with Notice 99-57, 1999-2 C.B. 692] resulting from the partnership’s disposition of the corporate partner’s stock [under the general principles of Rev. Rul. 99-57, 1999-2 C.B. 678], when: (1) a corporation acquires an interest in a partnership that holds stock in the corporation, (2) the partnership does not have a § 754 election in effect for the year in which the corporation acquires the interest, and (3) the partnership later sells or exchanges the stock. The increase or decrease in the corporation’s adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain or loss that the corporate partner would

14. *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954).

have recognized (absent the application of § 1032) if, for the tax year in which the corporation acquired the interest, a § 754 election had been in effect. The final regulations require appropriate adjustments to the basis of tiered partnerships to prevent evasion of their purpose where a corporation acquires an indirect interest in its own stock through a chain of partnerships and gain or loss from the sale of stock is subsequently allocated to the corporation. The regulation is effective retroactively to gain or loss allocated on sales or exchanges of stock occurring after 12/6/99.

a. Proposed amendments before the ink is dry. REG-167648-01, Amendments to Rules for Determination of Basis of Partner's Interest; Special Rules, 67 F.R. 15132 (3/29/02). The Treasury Department has proposed amendments to Reg. § 1.705-2, which was finalized on the same day the proposed amendments were published, "to address remaining issues that [were] considered during the development of the final regulations." The proposed amendments would extend the rules of Reg. § 1.705-2 to situations in which a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes gain on the distribution during a year in which the partnership does not have a § 754 election in effect, and the partnership subsequently sells or exchanges the stock. The proposed amendments also clarify that "stock" of a corporate partner includes any position with respect to stock of a corporate partner. The proposed amendments would be effective retroactively to gain or loss allocated on sales or exchanges of stock occurring after 3/29/02.

2. Husbands and wives are co-owners of a disregarded entity or partners [their choice], if the business is community property; if the business is not community property, then they are partners. Rev. Proc. 2002-69, 2002-45 I.R.B. 831 (11/12/02). This revenue procedure deals with the classification of business entities (other than corporations), i.e., partnerships and LLCs, that are wholly owned by a husband and wife as community property. If the husband and wife treat the entity as a disregarded entity for federal tax purposes, the IRS will accept the position that the entity is a disregarded entity for federal tax purposes. On the other hand, if the entity, and the husband and wife, treat the entity as a partnership for federal tax purposes and file appropriate partnership returns, the IRS will accept the position that the entity is a partnership for federal tax purposes. A change in reporting position will be treated for federal tax purposes as a conversion of the entity.

● Nothing in the revenue procedure allows husbands and wives who wholly own an LLC or partnership in a common law property state to avoid entity characterization.

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

1. The gestalt theory of partnership allocations. Estate of Ballantyne v. Commissioner, T.C. Memo. 2002-160 (6/24/02). The decedent taxpayer and his brother for many years operated a partnership that engaged in an oil and gas business, run by the decedent, and a farming business, run by the decedent's brother. The partnership was an oral partnership, and the brothers consistently reported as equal partners, even though the decedent consistently withdrew the profits from the oil and gas business and the decedent's brother consistently withdrew the profits from the farming business. After the decedent's death, the estate took the position that all of the income from the farming activity was reportable as the decedent's brother's distributive share. Because the partnership did not maintain capital accounts, the allocation lacked

economic substance, and the partners' interests in the partnership were determined under the facts and circumstances test of Reg. § 1.704-1(b)(3). Based on the evidence, the estate could not overcome the presumption that the partners were equal partners. There was no record of capital contributions, the amount of profits of each activity varied from year to year, as did withdrawals, but the partners' economic interests and interests in cash flow could not be determined because the partnership books and records were inadequate. However, the "facts"—mostly the witnesses' "beliefs" that the brothers were 50/50 partners—indicated that they were to share liquidating distributions equally. That factor, combined with the brothers long-time consistent reporting as equal partners and the absence of any evidence that the brothers' reporting position involved tax avoidance, was sufficient to convince Judge Ruwe that they were equal partners.

C. Distributions and Transactions Between the Partnership and Partners

There were no significant developments in this topic in 2002.

D. Sales of Partnership Interests, Liquidations and Mergers

There were no significant developments in this topic in 2002.

E. Inside Basis Adjustments

There were no significant developments in this topic in 2002.

F. Partnership Audit Rules

1. Are conflicts worse than criminality? Madison Recycling Associates v. Commissioner, 295 F.3d 280, 2002-2 U.S.T.C. ¶50,515, 90 A.F.T.R.2d 2002-5132 (2d Cir. 7/9/02). The Ninth Circuit held that a consent to extend the statute of limitations executed by an otherwise properly designated agent of the TMP was not invalid merely because the TMP was under criminal tax investigation at the time the consent was signed. Because the TMP was unaware of the criminal investigation at the time the consent was signed, he had no conflict of interest. On that basis the court distinguished its holding in *Transpac Drilling Venture 1982-12 v. Commissioner*, 147 F.3d 221 (2d Cir. 1998).

2. Partnerships shouldn't bother applying for § 7841(c) interest redeterminations. ASA Investorings Partnership v. Commissioner, 118 T.C. 423 (5/22/02). The decision in the tax shelter case, *ASA Investorings Partnership v. Commissioner*, T.C. Memo. 1998-305, *aff'd*, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000), was entered pursuant to a partnership level proceeding filed in the Tax Court under § 6226(a), rather than § 6215(a). Accordingly, the substantive proceeding was not a redetermination of a deficiency, and Judge Ruwe held that the Tax Court lacked jurisdiction under § 7481(c) to review the Commissioner's determination of interest, even though all of the other conditions for § 7481(c) review had been met. A petition for redetermination of the deficiency under § 6215(a) is an express statutory prerequisite for § 7481(c) review of an interest determination.

3. Gustin v. Commissioner, T.C. Memo. 2002-64 (3/7/02). A deficiency notice disallowing a portion of a partner's distributive share of losses from a TEFRA partnership under § 704(d), on the ground that the losses exceeded the partner's basis in his partnership interest, was valid even though

there had been no FPAA and partnership-level proceeding. A partner's basis in the partnership is not a partnership item.

VIII. TAX SHELTERS

A. Tax Shelter Cases

1. Tax shelter benefits from § 453 contingent sale partnership tax shelter not allowed because the tax shelter is a sham and “serves no economic purpose other than tax savings.” Merrill Lynch’s persistence overcomes initial doubts of tax department. ACM Partnership v. Commissioner, T.C. Memo. 1997-115 (3/5/97), *aff’d in part, rev’d in part*, 157 F.3d 231, 98-2 U.S.T.C. ¶50,790, 82 A.F.T.R.2d 98-6682 (3d Cir. 10/13/98) (2-1), *cert. denied*, 526 U.S. 1017 (3/2/99). Judge Laro found a § 453 contingent sale partnership tax shelter to be a prearranged sham, “tax-driven and devoid of economic purpose,” and “serv[ing] no economic purpose other than tax savings,” following *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967). Under the scheme to shelter Colgate’s \$105 million 1988 capital gain, a partnership was formed in 1989; its three partners were affiliates of (a) a foreign bank (about 90%), (b) Colgate (about 9%), and (c) Merrill Lynch (about 1%). A bank note was purchased by the partnership and immediately sold for a large immediate payment and much smaller future contingent payments. Under the contingent payment sale provisions of the temporary regulations [§ 15a.453-1(c)] the partnership’s basis was to be allocated ratably over the several years in which contingent payments could be made, resulting in a large 1989 installment sale gain to the partnership. The lion’s share of that installment sale gain was allocated to the foreign bank (which was not taxable on U.S. source capital gain), followed by the redemption of the foreign bank’s partnership interest. This left Colgate as the 90 percent partner. In 1991, the installment sale obligation was sold by the partnership, triggering about \$100 million of capital losses, which Colgate attempted to use to shelter its 1988 capital gain.

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

2. Judge Foley finds another Merrill Lynch § 453 partnership plan does not work because, under the facts, there was no partnership. ASA Investerings Partnership v. Commissioner, T.C. Memo. 1998-305 (8/20/98). In another Merrill Lynch § 453 partnership plan to create capital losses to shelter earlier capital gains, AlliedSignal lost when Judge Foley held that the parties to the partnership agreement did not join together for a common purpose of investing in interest-bearing instruments, and they did not share profits and losses.

a. Affirmed, ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 2000-1 U.S.T.C. ¶50,185, 85 A.F.T.R.2d 2000-675 (D.C. Cir. 2/1/00), *cert. denied*, 531 U.S. 871 (10/2/00). The D.C. Circuit’s opinion noted that it disagreed with the Tax Court’s statements that persons with “divergent business goals” are precluded from having the requisite intent to form a partnership; however, this view was not essential to the Tax Court’s conclusion that the parties did not intend to join together as partners to conduct business activities for a purpose other than tax avoidance. The court held that there was a single business purpose rule.

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

a. **D.C. Circuit remands *Saba* for reconsideration in light of its opinion in *ASA Investerings*.** Saba Partnership v. Commissioner, 273 F.3d 1135, 2002-1 U.S.T.C. ¶150,145, 88 A.F.T.R.2d 2001-7318 (D.C. Cir. 12/21/01), *remanding for reconsideration in light of ASA Investerings*, T.C. Memo. 1999-359 (10/27/99), *on remand to T.C. Memo. 2003-31 (2/11/03)*. The court felt this case was indistinguishable from *ASA Investerings*, which was decided on a sham partnership theory, as opposed to Judge Nims's decision in the Tax Court, which was grounded on a sham transaction theory. The Court of Appeals refused to simply affirm the Tax Court's decision on the alternative ground that the partnerships were shams. Even the government conceded that the sham transaction and sham partnership approaches yield different results; the adjustments under the sham transaction theory would be different from those under the sham partnership theory [although the government apparently conceded at oral argument that under either approach, Brunswick could deduct actual losses from the transactions]. The government argued that the Court of Appeals should apply *ASA Investerings* to hold that the partnerships were shams, and remand the case to the Tax Court for the limited purpose of determining the amount of any necessary adjustments. But the Court of Appeals accepted the taxpayer's argument that the "question of whether 'an entity should be regarded as a partnership for federal tax purposes is inherently factual,'" and remanded to allow the taxpayer to address the question to the trial court, even though it doubted that the Tax Court's "findings are inadequate because of 'significant differences'" alleged by the taxpayer "between the actions of Brunswick in this case and those of [the taxpayer] in *ASA*." Indeed, the Court of Appeals opinion said: "As far as we can tell, the only difference between this case and *ASA* is that Brunswick and ABN did not meet in Bermuda." In remanding, Judge Tatel foreshadowed what he expected to be the result on remand:

In any case, *ASA* makes clear that "the absence of a nontax business purpose is fatal" to the argument that the Commissioner should respect an entity for federal tax purposes. Here, the Tax Court specifically found "overwhelming evidence in the record that *Saba* and *Otrabanda* were organized solely to generate tax benefits for Brunswick." Arguably, this broader finding subsumes any factual differences that might exist between this case and *ASA*. [citations omitted]. . . .

Although the present record might strongly suggest that *Saba* and *Otrabanda* were sham partnerships organized for the sole purpose of generating paper tax losses for Brunswick, fairness dictates that we ought not affirm on this ground. In particular, in presenting its case in the Tax Court, Brunswick may have acted on the mistaken belief that the Supreme Court's decision in *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 87 L. Ed. 1499, 63 S. Ct. 1132 (1943), established a two-part test

under which Saba and Otrabanda must be respected simply because they engaged in some business activity, an interpretation that *ASA* squarely rejected.

● Note the effect of this opinion on the *Boca Investorings* case, below.

4. Same arrangement as earlier failed shelters, different trial court judge – it’s a business deal, not a shelter. *Boca Investorings Partnership v. United States*, 167 F. Supp. 2d 298, 2001-2 U.S.T.C. ¶50,690, 88 A.F.T.R.2d 2001-6252 (D. D.C. 10/5/01). American Home Products [now Wyeth] entered into a Merrill Lynch marketed tax shelter virtually identical to those in *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff’g* T.C. Memo. 1997-115, *cert. denied*, 526 U.S. 1017 (1999), *ASA Investorings Partnership v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000), *aff’g* T.C. Memo. 1998-305, and *Saba Partnership v. Commissioner*, T.C. Memo. 1999-359, *judgment vacated by* 273 F.3d 1135 (D.C. Cir. 2001), *on remand to* T.C. Memo. 2003-31. The losses from the transaction sheltered the gain on the sale of a corporate subsidiary. Judge Friedman held that a valid partnership existed and that the losses were allowable because he found that the taxpayer had both a business purpose and an objective profit potential in entering into the transaction.

a. Reversed: *ASA Investorings* is followed. *Boca Investorings Partnership v. United States*, 314 F.3d 625, 2003-1 U.S.T.C. ¶50,181, 91 A.F.T.R.2d 2003-444 (D.C. Cir. 1/10/03). The D.C. Circuit held that the District Court “erred as a matter of law when it did not properly apply the holding of *ASA Investorings*, requiring that a legitimate non-tax business necessity exist for the creation of the otherwise sham entity inserted into the partnership for tax avoidance reasons in order to meet the intent test of *Commissioner v. Culbertson*, 337 U.S. 733 (1949), as applied to this type of partnership transaction.” Judge Sentelle quoted *ASA* to make clear that “the absence of a nontax business purpose” is fatal to an argument that the Commissioner should respect an entity for federal tax purposes.

5. Lease-strip transaction by pseudo-black box intermediary fails in the Tax Court. *Nicole Rose Corp. v. Commissioner*, 117 T.C. 328 (12/28/01), *aff’d*, 320 F.3d 282, 2003-1 U.S.T.C. ¶50,137, 90 A.F.T.R.2d 2002-7702 (2d Cir. 12/13/02). The taxpayer corporation’s stock was sold to an intermediary [which then merged downstream], following which its assets were sold to the prearranged ultimate purchaser. To offset the gains realized on the asset sale, the taxpayer acquired by a § 351 transaction interests in certain equipment leaseback transactions [secured by trusts that resulted in a circular cash flow] that had no foreseeable value, which it immediately transferred to a Dutch bank, the sole consideration for which was assumption of taxpayer’s obligations [of which there were in reality none]. Taxpayer claimed a \$22 million ordinary business expense deduction as a result of the transfer of the leaseback interests. The deduction was denied because the transactions lacked business purpose and economic substance under “any version” of the tests. Judge Swift held that the transaction lacked business purpose and economic substance even as measured against the Eleventh Circuit’s broad articulation of the test in *UPS of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001), that “a transaction has a ‘business purpose,’ when we are talking about a going concern . . . , as long as it figures in a bona fide, profit-seeking business.”

6. The Tax Court hammers another shelter, and in the process tells us the “purpose” of the legislative plan. *Andantech L.L.C. v.*

Commissioner, T.C. Memo. 2002-97 (4/9/02). Norwest, through its equipment leasing subsidiary, engaged in a complex [seven PowerPoint slides worth] purchase and leaseback tax shelter transaction involving 40 IBM mainframe computers already under lease to end-users. The promoter [Comdisco] sold the computers for cash and notes to an LLC owned by two nonresident aliens, which leased them back to the promoter, who retained all responsibilities to the end-users; the LLC sold the stream of rental payments to be received for net present value, thereby accelerating income realization, and applied the proceeds to the balance due on the note. Less than three months later, one of the nonresident aliens [indirectly] transferred his 2 percent LLC interest to a trust established by promoter, and Norwest, through a subsidiary, acquired the remaining 98 percent interest in the LLC [thereby closing the taxable year in which the income had been realized] for an amount roughly equal to one-half of one percent of the approximately \$122 million basis of the computers. Norwest subsequently reported its distributive share of depreciation deductions, but was allocated no income. After three years, the computers were reconveyed to the promoter, pursuant to an “early termination option,” which the court found the “economics of the transaction . . . mandate[d],” and the LLC was liquidated.

● Judge Jacobs struck down the shelter. He concluded that neither the original LLC with the foreign partners, nor the subsequent LLC of which Norwest’s subsidiary was a member, was a valid partnership to be recognized for federal tax purposes; in neither case did the purported partners intend to join together as partners for the purpose of carrying on a business, i.e., they did not join together to share in the profits or losses from an equipment leasing activity. Alternatively, Judge Jacobs would have disregarded the participation of the foreign LLC members in the transactions under the step transaction doctrine [applying either the end result or mutual interdependence test]. Furthermore, the LLC’s sale-leaseback transaction with the promoter “was a sham because it (a) was not a true multiple-party transaction, (b) lacked economic substance, (c) was not compelled or encouraged by business realities, and (d) was shaped solely by tax-avoidance features.” As far as Norwest and its subsidiary were concerned, the transaction was not respected because it lacked both business purpose and economic substance. The LLC, and Norwest’s subsidiary, had no reasonable possibility of making an economic profit, but the tax benefits were more than sufficient to cover any potential losses. The Norwest subsidiary never acquired the benefits and burdens of ownership of the depreciable equipment, and thus was not entitled to depreciation deductions. In addition, the LLC’s debts were not *bona fide* and no interest deductions were allowable.

● Finally, Judge Jacobs concluded by looking back to early Supreme Court jurisprudence:

In *Higgins v. Smith*, 308 U.S. [473] at 476-477 [1940], the Supreme Court stated:

There is no illusion about the payment of a tax exaction. Each tax, according to a legislative plan, raises funds to carry on government. The purpose here is to tax earnings and profits less expenses and losses. If one or the other factor in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire tax-paying group.

The sale-leaseback transaction was designed by Comdisco to create just such a distortion.

It is axiomatic that taxpayers may structure transactions to take advantage of tax benefits. But “After a certain point, * * *, the transaction ceases to have any economic substance and becomes no more than a sale of tax profits.” *Hines v. United States*, 912 F.2d 736, 741 (4th Cir.1990). Here, the evidence in the record clearly indicates that the investment scheme devised and orchestrated by Comdisco “reached the point where the tax tail began to wag the dog.” *Id.*

7. A tax shelter that doesn’t work in the Tax Court. The Limited, Inc. v. Commissioner, 113 T.C. 169 (9/7/99). This tax shelter involved the exclusion from the income of a foreign corporation of the amount of a related bank’s certificates of deposits. Judge Halpern held that the CDs were § 956 assets and were not excludible as “deposits with persons carrying on the banking business.”

a. Does work in the Sixth Circuit: Another taxpayer victory on appeal. The Limited, Inc. v. Commissioner, 286 F.3d 324, 2002-1 U.S.T.C. ¶50,353, 89 A.F.T.R.2d 2002-1924 (6th Cir. 4/11/02). CDs purchased by a foreign subsidiary of taxpayer from a taxpayer subsidiary in the banking business were not investments in U.S. property for purposes of § 956, but were “deposits with persons carrying on the banking business.” There is no related party prohibition in the portion of § 956 applicable to this transaction.

8. Third Circuit comes down hard on COLI, with lots of language the government will love. Internal Revenue Service v. CM Holdings, Inc. (In re CM Holdings Inc.), 301 F.3d 96, 2002-2 U.S.T.C. ¶50,596, 90 A.F.T.R.2d 2002-5850 (3d Cir. 8/16/02), *aff’g* 254 B.R. 578, 2000-2 U.S.T.C. ¶50,791, 86 A.F.T.R.2d 2000-6470 (D. Del. 10/16/00). In CMI’s bankruptcy, the IRS filed proofs of claim for taxes based on the disallowance of interest deductions that CMI claimed for its COLI plan (involving policies on 1,400 employees).

- The District Court held no interest deduction was allowable under § 163(a) because the entire transaction was a “sham in substance” that lacked subjective business purpose. Apart from tax savings from the interest deduction, CMI could not reasonably expect a positive cash flow from the COLI plan in any year and could not expect to benefit from the inside cash value build-up [which continuously remained at zero throughout the plan] or profit from the death benefits on covered employees. Interest deductions were disallowed, and § 6662 substantial understatement penalties were imposed because the transaction lacked economic substance. The transaction was entered into without a reasonable expectation of profit—in the absence of the interest deductions—over the life of the 40-year transaction from either the inside build-up or mortality components of the plan.

- The Third Circuit Court of Appeals (Judge Ambro) affirmed on the ground that the “COLI policies lacked economic substance and therefore were economic shams.” [The court did not reach the issue of whether the transactions were factual shams.] The court dismissed out of hand the need to examine the “intersection of . . . statutory details.”

[P]ursuant to *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935), and *Knetsch v. United States*, 364 U.S. 361, 81 S.Ct. 132, 5 L.Ed.2d 128 (1960), courts have looked beyond taxpayers’ formal compliance with the Code

and analyzed the fundamental substance of transactions. Economic substance is a prerequisite to the application of any Code provision allowing deductions. . . . It is the Government's trump card; even if a transaction complies precisely with all requirements for obtaining a deduction, if it lacks economic substance it "simply is not recognized for federal taxation purposes, for better or for worse." [citations omitted].

In holding for the government, the court rejected the taxpayer's argument that [based on *Gregory*, *Knetsch*, *ACM Partnership* and other cases] the application of the economic shams doctrine properly hinges on the "'fleeting and inconsequential' nature" of the transaction under scrutiny. Rather, the court concluded that "[d]uration alone cannot sanctify a transaction that lacks economic substance. The appropriate examination is of the net financial effect to the taxpayer, be it short or long term. The point of our analysis in *ACM Partnership* is that the transactions 'offset one another with no net effect on ACM's financial position.'" In any event, the court found the COLI transactions bore "striking similarities" to *Knetsch*. The court further rejected the argument that for analytical purposes the pre-tax profit should have been "grossed-up" by the anticipated tax benefits because,

[t]he point of the analysis is to remove from consideration the challenged tax deduction, and evaluate the transaction on its merits, to see if it makes sense economically or is mere tax arbitrage. Courts use "pre-tax" as shorthand for this, but they do not imply that the court must imagine a world without taxes, and evaluate the transaction accordingly. Instead they focus on the abuse of the deductions claimed: "[w]here a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes." [citation omitted] Choosing a tax-favored investment vehicle is fine, but engaging in an empty transaction that shuffles payments for the sole purpose of generating a deduction is not.

● Finally, the court rejected the taxpayer's argument that because "the transaction had objective non-tax economic effects . . . the Court must not look further," and that the District Court improperly applied a subjective analysis. Rather, the Court of Appeals read *Gregory* to permit an inquiry into motive. "If Congress intends to encourage an activity, and to use taxpayers' desire to avoid taxes as a means to do it, then a subjective motive of tax avoidance is permissible. But to engage in an activity solely for the purpose of avoiding taxes where that is not the statute's goal is to conduct an economic sham." Because the court found that nothing in statute indicated that Congress intended to encourage leveraged COLI investments, the inquiry into motive was proper. In this regard, it was significant that "the plan was marketed as a tax-driven investment." Because the COLI "plan had no net effect on Camelot's economic position, . . . it fails the objective prong of economic sham analysis." Because there was "no legitimate business purpose behind the plan, . . . it fails the subjective prong as well." Penalties were also upheld.

B. Identified "tax avoidance transactions."

1. Some of these are still being peddled to your clients. Notice 2001-51, 2001-2 C.B. 190, *superseding* Notice 2000-15, 2000-1 C.B. 826. The IRS has identified sixteen listed transactions for purposes of Temp. Regs. §§

1.6011-4T(b)(2) and 301.6111-2T(b)(2). The listed transactions include: (1) Rev. Rul. 90-105, 1990-2 C.B. 69, transactions (deductions for contributions to certain pension plans attributable to future year's compensation); (2) Notice 95-34, 1995-1 C.B. 309, certain trust arrangements (purported multiple employer welfare benefit funds); (3) Notice 95-53, 1995-2 C.B. 334, "lease strips"; (4) Notice 98-5, 1998-1 C.B. 334, transactions in which the expected economic profit is insubstantial in comparison to the value of the expected FTCs; (5) *ASA* *Investerings*-type and *ACM*-type transactions; (6) Prop. Reg. § 1.643(a)-8 transactions involving distributions from charitable remainder trusts; (7) Rev. Rul. 99-14, 1999-1 C.B. 835, lease-in/lease-out [LILO] transactions); (8) Notice 99-59, 1999-2 C.B. 761, transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays that they have in fact recovered; (9) Reg. § 1.7701(1)-3 fast-pay arrangements; (10) Rev. Rul. 2000-12, 2000-1 C.B. 744, certain transactions involving the acquisition of two debt instruments the values of which are expected to change significantly at about the same time in opposite directions; (11) Notice 2000-44, 2000-2 C.B. 255, transactions generating losses resulting from artificially inflating the basis of partnership interests; (12) Notice 2000-60, 2000-2 C.B. 568, transactions involving the purchase of a parent corporation's stock by a subsidiary, a subsequent transfer of the purchased parent stock from the subsidiary to the parent's employees, and the eventual liquidation or sale of the subsidiary; (13) Notice 2000-61, 2000-2 C.B. 659, transactions purporting to apply § 935 to Guamanian trusts; (14) Notice 2001-16, 2001-1 C.B. 730, intermediary sales transactions; (15) Notice 2001-17, 2001-1 C.B. 730, contingent liability § 351 transfer transactions; and (16) Notice 2001-45, 2001-2 C.B. 129 (certain redemptions of stock in transactions not subject to U.S. tax in which the basis of the redeemed stock purports to shift to a U.S. taxpayer.

2. Loan assumption agreement used to claim an inflated basis in assets. Notice 2002-21, 2002-14 I.R.B. 730 (3/18/02). This notice adds to the list of "listed transactions" one where the taxpayer uses a loan assumption agreement to claim an inflated basis in assets acquired from a tax-indifferent party, and thus generate a loss equal to the excess of the stated principal amount of the loan over the fair market value of the acquired assets. The tax-indifferent party borrows money on a long-term basis and uses the proceeds to purchase assets, which serve as collateral for the loan. A portion of the assets are transferred to the taxpayer, who becomes a co-obligor on the loan; the fair market value of the assets transferred equals the present value of the loan's principal payment at maturity. Taxpayer then disposes of the assets for their fair market value, and claims a loss for federal income tax purposes.

3. Accrual over the term of the notional principal contract of the noncontingent component of the nonperiodic payment to be received at the end of the term is required. Rev. Rul. 2002-30, 2002-21 I.R.B. 971 (5/28/02). When a notional principal contract provides for payment comprised of noncontingent and contingent components, the appropriate method for the inclusion into income or deduction of the noncontingent component of the nonperiodic payment is over the term of the NPC. Interest must also be accounted for in a manner consistent with Regs. §§ 1.446-3(f)(2) (ii) or (iii), and 1.446-3(g)(4).

- Taxpayer agrees to make quarterly payments to counterparty based on the 3-month LIBOR multiplied by a notional principal amount of \$100 million. In return, at the end of 18 months, the counterparty will pay taxpayer 6 percent per year multiplied by a notional principal amount of \$92 million [or, \$8,280,000], and, in addition, the counterparty will either pay taxpayer \$8 million times the percentage increase

in the stock index, or taxpayer will pay the counterparty \$8 million times the percentage decrease in the stock index. The ruling holds that, to offset the taxpayer's deductible quarterly payments, the taxpayer must ratably accrue over the 18-month term the \$8,280,000 that taxpayer will receive from the counterparty at the end of the term.

a. An arrangement similar to that of Rev. Rul. 2002-30 is identified as a listed tax shelter. Notice 2002-35, 2002-21 I.R.B. 992 (5/28/02). The transaction in this notice involves the use of a notional principal contract to claim current deductions for periodic payments made by a taxpayer, while disregarding the accrual of a right to receive offsetting payments in the future. Under the NPC, taxpayer is required to make periodic payments to a counterparty at regular intervals of one year or less based on a fixed or floating rate index. In return, the counterparty is required to make a single payment at the end of the term of the NPC that consists of a noncontingent component and a contingent component. The noncontingent component, which is relatively large in comparison to the contingent component, may be based upon a fixed or floating interest rate; the contingent component may reflect changes in the value of a stock index or currency.

- This transaction may be entered into without any initial cash investment by the taxpayer. The counterparty may lend the money to the taxpayer, who pays it back in installments as purportedly deductible payments. The taxpayer may engage in other transactions, such as interest rate collars, for purposes of limiting risk with respect to the NPC transaction.

- Taxpayer seeks to deduct the ratable daily portion of each periodic payment to which that portion relates, but taxpayer does not accrue income with respect to the nonperiodic payment until the year the payment is received.

- The proper treatment of the payments is that the nonperiodic payment to be received by the taxpayer at the end of the term of the NPC must be accrued ratably over the term of the NPC, as set forth in Rev. Rul. 2002-30.

- Transactions that are the same as, or substantially similar to, the transaction described are identified as "listed transactions" for purposes of Temp. Regs. §§ 1.6011-4T(b)(2) and 301.6011-2T(b)(2).

4. The noncontingent bond method applies to a convertible debt instrument that also provides for one or more contingent cash payments. Rev. Rul. 2002-31, 2002-22 I.R.B. 1023 (6/3/02). The noncontingent bond method described in Reg. § 1.1275-4(b) applies to a debt instrument that is convertible into stock of the issuer and that also provides for one or more contingent cash payments. The comparable yield is to be determined as that yield at which the issuer would issue a fixed rate nonconvertible debt instrument, which is to be used to determine the accruals of interest on the instrument.

a. But not an arrangement similar to Rev. Rul. 2002-31. These arrangements are merely the subject of an invitation for taxpayer comments. Notice 2002-36, 2002-22 I.R.B. 1029 (6/3/02). The Service and the Treasury Department ask for comments on the treatment of contingent convertible debt instruments.

5. Rev. Rul. 2002-69, 2002-44 I.R.B. 760 (11/4/02), modifying and superseding Rev. Rul. 99-14, 1999-1 C.B. 385. A taxpayer may not

currently deduct rent under § 162 or interest paid or incurred under § 163 in connection with a lease-in/lease-out transaction (LILO).

6. Another listed tax shelter – this time an individual tax shelter. Notice 2002-65, 2002-41 I.R.B. 690 (10/15/02). This notice adds to the list of “listed transactions” a tax shelter involving a straddle entered into by an S corporation or partnership, with one or more transitory shareholders or partners. The entity closes the gain leg, and passes through the gain, redeems some shareholders or partners, with the redeemed members claiming losses, closes the books for allocating gain or loss, and then closes the loss leg of the straddle, which is passed through to the remaining shareholders or partners.

7. Notice 2002-70, 2002-44 I.R.B. 765 (11/4/02). The IRS announces its attack on producer-owned reinsurance arrangements. These arrangements are used to shift income from taxpayers—typically service-providers, automobile dealers, lenders or retailers that offer service contracts in connection with the products or services being sold—to related companies which purport to be insurance companies subject to little or no U.S. federal income tax. The IRS intends to apply § 482 or § 845 [allocation of income with respect to tax-avoidance motivated reinsurance transactions] to allocate income from the purported insurance company back to the taxpayer, as well as to assert that the purported insurance company is not an insurance company and possibly disregard the insurance and reinsurance arrangements as shams.

8. Rev. Rul. 2002-71, 2002-44 I.R.B. 763 (11/4/02). A taxpayer should take into account gain or loss on the termination of a notional principal contract that hedges a portion of the term of a debt instrument issued by the taxpayer over the period to which the hedge relates. This is because of the matching requirement of Reg. § 1.446-4(b), which requires that this be done in order to clearly reflect income.

C. Disclosure and Settlement

1. T.D. 9000, Modification of Tax Shelter Rules III, 67 F.R. 41324 (6/18/02), and REG-110311-92 and REG-110311-98, Modification of Tax Shelter Rules III, 67 F.R. 41362 (6/18/02). These temporary and proposed regulations modify the disclosure, registration and list maintenance rules under §§ 6011(a), 6111(d), and 6112 with respect to tax shelters.

- The new regulations extend the requirement to disclose listed and other reportable transactions under Temp. Reg. § 1.6011-4T to individuals, trusts, partnerships, and S corporations that participate, directly or indirectly, in listed transactions. Further, they clarify indirect participation in a reportable transaction. A taxpayer indirectly participates in a reportable transaction if the taxpayer knows or has reason to know that the tax benefits claimed from the transaction are derived from a reportable transaction.

- The IRS notes that some taxpayers and promoters have applied the “substantially similar” standard in Temp. Regs. §§ 1.6011-4T and 301.6111-2T in an overly narrow manner to avoid disclosure, and the regulations clarify that the term “substantially similar” includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. Further, the term “substantially similar” must be broadly construed in favor of disclosure.

2. T.D. 9017, Tax Shelter Disclosure Statements, 67 F.R. 64799 (10/22/02), and REG-103735-00, REG-154117-02, REG-154116-02, REG-154115-02, REG-154429-02, REG-154423-02, REG-154426-02, and REG-110311-98, Tax Shelter Disclosure Statements, 67 F.R. 64840 (10/22/02). The IRS has promulgated temporary and proposed regulations to provide additional guidance needed to comply with the § 6011(a) disclosure rules. The regulations cover transactions pertaining to tax shelters involving income, estate, gift, employment, or exempt organizations excise taxes. It revises the categories of transactions that must be disclosed on returns: (1) listed transactions; (2) confidential transactions; (3) transactions with contractual protection; (4) loss transactions above stated thresholds; (5) transactions with a significant book-tax difference; and (6) transactions involving a less-than-45-day holding period that result in a tax credit exceeding \$250,000. These temporary regulations are effective 1/1/03.

a. T.D. 9018, Requirement to Maintain a List of Investors in Potentially Abusive Tax Shelters, 67 F.R. 64807 (10/22/02), and REG-103736-00, Requirement to Maintain a List of Investors in Potentially Abusive Tax Shelters, 67 F.R. 64842 (10/22/02). The IRS has promulgated temporary and proposed regulations, which modify the list maintenance requirements under § 6112.

3. **IRS announces a tax shelter disclosure initiative through 4/23/02 for penalty waivers.** Announcement 2002-2, 2002-2 I.R.B. 304 (1/14/02). The initiative would result in waiver of any of the § 6662 accuracy-related penalties if disclosure is made before the earlier of 4/23/02 or the date an issue about the disclosed item is raised during an examination. The disclosure statement must contain, *inter alia* (1) “the material facts of the item;” (2) “the taxpayer’s tax treatment of the item;” (3) “[t]he taxable years affected by the item;” (5) the names and addresses of the promoters, solicitors, and recommenders of the item and (if known) the parties who advised the promoter, solicitor or recommender; and (6) an agreement to provide [if requested] all transactional documents, internal memoranda, and materials that provide a legal analysis of the item.

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

a. A memo from Larry R. Langdon, IRS Division Commissioner, to LMSB employees, 2001 TNT 247-8 (12/20/01), provides guidelines for applying the about-to-be-issued Announcement 2002-2, 2002-2 I.R.B. 304 (1/14/02). The IRS will not assert that a disclosure made under the tax shelter initiative constitutes a waiver of the attorney-client privilege.

b. According to a June 11, 2002 IRS “Tax Talk Today” webcast, the IRS stated that the tax shelter initiative resulted in 1,633 disclosures from 1,180 taxpayers. The disclosures covered 1,506 tax returns and involved more than \$30 billion in claimed losses or deductions. Closed Initiative Continues to Reap Disclosures, by Sheryl Stratton, Tax Analysts Tax Notes Today, 6/11/02, 2002 TNT 113-5.

c. IRS News Release IR-2002-99 (9/16/02). The IRS announced that, as of the end of August 2002, the IRS Office of Tax Shelter Analysis has “recorded 1,664 disclosures from 1,206 taxpayers who disclosed their questionable transactions.”

d. In a 6/27/02 news release, 2002 TNT 125-1 (6/28/02), the IRS announced that it cut a deal with PricewaterhouseCoopers (PwC)

to resolve tax shelter registration and list maintenance issues. . . . The IRS news release, which is similar to one issued last August regarding Merrill Lynch, says that without admitting or denying liability, PwC has agreed to make a ‘substantial payment’ to the IRS to resolve issues in connection with advice rendered to clients dating back to 1995.

Under the agreement, PwC will provide to the IRS certain client information in response to summonses. It will also work with the IRS to develop processes to ensure ongoing compliance with the shelter registration and investor list maintenance requirements, according to the release.

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

f. **No third-party identification without Associate Chief Counsel review.** Chief Counsel Notice CC-2002-028 (7/19/02). This notice sets forth the requirements for the review of privilege logs or similar documents that identify third parties, and for the coordination of the disclosure of these documents with the Associate Chief Counsel (Procedure & Administration).

4. IRS News Release IR-2002-105 (10/4/02). The IRS announced it will for a limited time offer settlements to taxpayers involved in three types of tax shelters.

a. Rev. Proc. 2002-67, 2002-43 I.R.B. 733 (10/28/00). Procedures to settle cases involving Contingent Liability Transactions (§ 351 contingent liability tax shelters), similar to the ones described in Notice 2001-17, 2001-1 C.B. 730, are provided.

b. Announcement 2002-97, 2002-43 I.R.B. 757 (10/28/02). This announcement provides procedures to settle cases involving the § 302/318 basis shifting tax shelter transactions that are the same or similar to those described in Notice 2001-45, 2001-2 C.B. 129. Notification to the IRS must be made on or before 12/3/02.

c. Announcement 2002-96, 2002-43 I.R.B. 756 (10/28/02). This announcement terminates the appeals settlement initiative to settle corporate-owned life insurance (COLI) transaction tax shelters, subject to a 45-day window within which taxpayers will be permitted to enter into the “current settlement arrangement.”

5. **“The IRS and Treasury believe that taxpayers have improperly relied on opinions or advice issued by tax advisors to establish reasonable cause and good faith as a basis for avoiding the accuracy-related penalty.”** REG-126016-01, Establishing Defenses to the Imposition of the Accuracy-Related Penalty, 67 F.R. 79894 (12/31/02). The Treasury Department has published proposed amendments to the regulations under §§ 6662 and 6664 [Regs. §§ 1.6662-3 and 1.6664-4] to limit the available defenses to an accuracy-related penalty when a taxpayer (1) fails to disclose a reportable transaction or (2) fails to disclose that it has taken a position on a return based upon a regulation being invalid. Under the proposed amendments, a taxpayer who takes a position that a regulation is invalid cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under § 6664(c) with respect to that position unless the position was disclosed on a return (including disclosing the position that the regulation in question is invalid). A taxpayer who engages in a reportable transaction [See Temp. Reg. § 1.6011-4T] cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under § 6664(c) with respect to the transaction unless the transaction was disclosed pursuant to the § 6011 regulations. Finally, a taxpayer who engages in a reportable transaction cannot rely on the realistic possibility standard under § 6662 to avoid the accuracy-related penalty for negligence or disregard of rules or regulations if the position regarding the reportable transaction is contrary to a revenue ruling or notice. When finalized, the amendments will apply to returns filed after 12/30/02, with respect to transactions entered into after 12/31/02.

● But be careful about over-reliance on effective dates. The preamble states:

The IRS, however, cautions taxpayers and tax practitioners that it will rigorously apply the existing facts and circumstances standard under § 1.6664-4(c) regarding a taxpayer’s reasonable reliance in good faith on advice from a tax professional, as well as the other provisions of the regulations under sections 6662 and 6664, including § 1.6664-4(c) relating to special rules for the substantial understatement penalty attributable to tax shelter items of a corporation. In addition to the modifications contained in these proposed regulations, and regardless of when a transaction was entered into, the IRS, in appropriate circumstances, may consider a taxpayer’s failure to disclose a reportable transaction or failure to disclose a position that a regulation is invalid as a factor in determining whether the taxpayer has satisfied the reasonable cause and good faith exception under section 6664(c) to the accuracy-related penalty.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. **Intermediate sanctions regulations are out; break out the supply of 1099s.** T.D. 8920, Excise Taxes on Excess Benefit Transactions, 66 F.R. 2144 (1/10/01), and REG-246256-96, Excise Taxes on Excess Benefit Transactions, 66 F.R. 2173 (1/10/01). The IRS has promulgated proposed and temporary regulations under § 4958, which permit the IRS to impose excise taxes against disqualified persons who participate in excess benefit transactions with § 501(c)(3) and § 501(c)(4) organizations. These rules reflect the spirit under which § 4958 was enacted, which was to tax “excess” benefits provided

by charities to insiders (including board members); these “excess” benefits also include benefits provided to insiders that are not reported as compensation.

a. Regulations made final. T.D. 8978, Excise Taxes on Excess Benefit Transactions, 67 F.R. 3076 (1/23/02). The Treasury Department has promulgated final regulations relating to the excise taxes on excess benefits transactions under § 4958.

2. Notice 2001-78, 2001-2 C.B. 576. This notice provides interim guidance to charities regarding payments made by reason of the death, injury or wounding of an individual incurred as a result of the September 11, 2001 terrorist attacks. The Service will treat such payments made by a charity to individuals and their families as related to the charity’s exempt purpose provided that the payments are made in good faith using objective standards. The notice is effective until the earlier of final legislation or 12/31/02.

a. The Victims of Terrorism Tax Relief Act, Pub. L. No. 107-134, 115 Stat. 2427 (1/23/02), clarifies that payments made by charities are for an exempt purpose even if made without demonstration of financial need if made in good faith under an objective formula consistently applied.

3. Joint venture did not result in loss of tax exemption for charity hospital despite its failure to meet the criteria of Revenue Ruling 98-15. St. David’s Health Care System v. United States, 2002-1 U.S.T.C. ¶50,452, 89 A.F.T.R.2d 2002-2998 (W.D. Tex. 6/7/02). Summary judgment was granted to a community-owned, not-for-profit hospital on its tax-exempt status. The hospital’s entering into a limited partnership with HCA, Inc. [a for-profit health care company], in which it had general and limited partnership interests of 45.9 percent and in which the for-profit partner was the managing partner, did not result in the forfeiture of the hospital’s § 501(c)(3) exemption. The court held that the community benefit standard did not absolutely require a community board, and that St. David’s satisfied this standard even though it appointed only half the board members where the chairman’s seat was reserved for a St. David’s appointee. There was language in the partnership agreement requiring all the partnership’s hospitals to operate in accordance with the community benefit standard outlined in Rev. Rul. 69-545, 1969-2 C.B. 117, and St. David’s could unilaterally dissolve the partnership if they fail to do so.

• Query: Will Rev. Rul. 98-15, 1998-1 C.B. 718, which provides an example of an acceptable joint venture in which the nonprofit partner has numerical control of the board, still be considered valid? *See also, Redlands Surgical Services v. Commissioner*, 113 T.C. 47 (1999), *aff’d per curiam*, 242 F.3d 904 (9th Cir. 2001).

a. St. David’s Health Care System v. United States, 2002-2 U.S.T.C. ¶50,745, 90 A.F.T.R.2d 2002-5415 (W.D. Tex. 7/9/02). The District Court ordered the United States to pay \$951,000 in litigation costs under § 7430 to St. David’s. Judge Nowlin held that the novelty of the issues did not necessarily mean that any position that the government took was reasonable, concluding:

Finally, the United States argues that, since this case involved novel issues, it is more likely that its position was substantially justified. While it is true that some of the specific issues had a hint of novelty to them, that does not mean that any position taken on those issues is reasonable. To the extent that there

were novel issues in this case, settled law clearly applied and disposed of those issues.

4. Public Law 107-276, 116 Stat. 1929 (11/2/02), amends § 527 to eliminate the notification and return requirements for state and local party committees and candidate committees. The law exempts a state or local political organization from having to file contribution and expenditure reports with the Treasury Department if it already files those reports with its state, so long as the state makes the report public. The bill also requires the Treasury Department to post § 527 reports on the Internet and make them searchable and downloadable.

B. Charitable Giving

1. Is the cost of religious instruction in day schools deductible?

Field Service Advice, 1997 WL 333313757, 1997 FSA LEXIS 153 (7/11/97). Tuition payments to Jewish day schools were held not deductible as charitable contributions to the extent that their children's education consisted of religious instruction [55 percent]. The Service followed *Hernandez v. Commissioner*, 490 U.S. 680 (1989) (substantial benefit received in return for payments), and no mention was made of the 1993 Church of Scientology settlement nor of § 170(f)(8). In the 1993 closing agreement, the IRS agreed "not to contest the deductibility of Church of Scientology fixed donations in connection with qualified religious services."

a. **Taxpayers should have sued IRS officials like the Scientologists did.** *Sklar v. Commissioner*, T.C. Memo. 2000-118 (4/5/00). The Tax Court, in an opinion by Special Trial Judge Nameroff, relied on *Hernandez* and found that the Church of Scientology settlement was irrelevant because the "auditing" involved there was "not identical [to the general, including religious, education involved in the case at hand] in their organization, structure or purpose."

b. **Affirmed.** *Sklar v. Commissioner*, 279 F.3d 697, 2002-1 U.S.T.C. ¶50,210, 89 A.F.T.R.2d 2002-808 (9th Cir. 1/29/02), *opinion amended and superseded by* 282 F.3d 610, 89 A.F.T.R.2d 2002-808 (2/27/02). The Ninth Circuit affirmed the Tax Court in an opinion by Judge Reinhardt, with a concurrence by Judge Silverman. The majority opinion explored the apparent conflict between the *Hernandez* case and the settlement with the Church of Scientology and concluded that (1) the IRS improperly refused to disclose the terms of its Scientology closing agreement, (2) the closing agreement unconstitutionally discriminated among religions, but that (3) the Sklars were not entitled to relief because there was no "administrative inconsistency" in the treatment of their tuition payments and the payments to the Church of Scientology because taxpayers failed to show that their payments for tuition were "dual payments" in that they exceeded the tuition charged by other private schools (citing *United States v. American Bar Endowment*, 477 U.S. 105 (1986)).

● Judge Silverman's concurrence was based upon the conclusion that the proper course of action is a lawsuit to stop the preferential policy towards the Church of Scientology, "not to require the IRS to let others claim the improper deduction, too."

2. **Price guesstimates aren't market quotations.** *Todd v. Commissioner*, 118 T.C. 334 (4/19/02). The fair market value, rather than the basis, is the deduction for a contribution of appreciated stock to a private foundation under § 170(e)(5) only if actual market quotations are readily

available. Judge Halpern held that an estimate of price by the broker who executed trades in the stock, which sporadically traded over the counter but for which market quotations were not readily available, did not qualify as a market quotation. The stock did not meet the standard for market quotations under Reg. § 1.170A-13(c)(xi)(A), and the deduction was limited to the taxpayer's basis in the stock.

3. The high cost of knowingly inaccurate substantiation of claimed charitable contributions. Addis v. Commissioner, 118 T.C. 528 (6/10/02). The taxpayers entered into a charitable split-dollar life insurance scheme with the National Heritage Foundation, a § 501(c)(3) organization [prior to the enactment of § 170(f)(10), which would impose a 100 percent excise tax on charitable split-dollar life insurance payments]. The Addises paid approximately \$36,000 to NHF in both 1997 and 1998 and claimed charitable contribution deductions for the payments. NHF used the amounts as premiums on a charitable split-dollar life insurance policy on Mrs. Addis's life. NHF was entitled to 56 percent of the death benefit and the taxpayers' family trust was entitled to the remainder. NHF was not required to pay the premiums, but the Addises reasonably expected it to do so. NHF provided the taxpayers with receipts for their payments which stated that NHF did not provide any goods or services to them in return for the payments. Taxpayers claimed charitable contribution deductions for the entire amount of their payments to NHF. Judge Colvin upheld the Commissioner's disallowance of any charitable contribution deduction. The taxpayers did not meet the substantiation requirements of § 170(f)(8) and Reg. § 1.170A-13(f)(7) because NHF failed to make a good faith estimate of the value of the benefits provided to the taxpayers through their family trust's share of the death benefits. Regs. §§ 1.170-1(h)(4)(ii) and 1.170-13(f)(6) were interpreted to deny completely a charitable contribution deduction under the circumstances.

4. Do you have Kelly's Blue Book on your desk? Rev. Rul. 2002-67, 2002-47 I.R.B. 873 (11/25/02). The IRS has ruled that an automobile donated to a charity may be valued by reference to an established used car pricing guide if, and only if, the guide lists the sales price for a car that is the same make, model, and year, sold in the same area, and in the same condition as the donated car. The ruling also provides that the substantiation requirements of § 170(f)(8) can be met through an authorized [for-profit] agent of the charity who solicits donations on the charity's behalf, in this case an entity that solicited and accepted the donations of used cars, sold the cars, and remitted the proceeds to the charity.

X. TAX PROCEDURE

A. Penalties and Prosecutions

1. Plead it's wrong or be ready to pay. Swain v. Commissioner, 118 T.C. 358 (5/3/02). Section 7491(c) provides that the Commissioner bears the burden of production with respect to penalties in all cases. The taxpayer, in her petition to the Tax Court, failed to assign error to the Commissioner's determination that § 6662 accuracy related penalties were due. Judge Halpern held that pursuant to Tax Court Rule 34(b)(4), the taxpayer conceded the penalties issue, and that notwithstanding § 7491(c), the Commissioner was not required to produce any evidence that the penalty was appropriate. The penalty was upheld.

2. **These guys better hope that the UMWA rank and file doesn't read tax advance sheets.** Lyon v. United States, 2002-2 U.S.T.C. ¶50,511, 90 A.F.T.R.2d 2002-5069 (W.D. Va. 6/4/02). The president and sole shareholder of a corporation was held not a responsible party for purposes of the § 6672 penalty because he was merely a "front-man," holding title to stock on behalf of and taking orders from the true parties in interest who owned and managed the unionized corporation anonymously to evade union contract limitations [because they owned and managed other nonunionized companies].

3. DeGuerin v. United States, 214 F. Supp. 2d 726, 2002-2 U.S.T.C. ¶50,606, 90 A.F.T.R.2d 2002-5866 (S.D. Tex. 8/5/02). Summary judgment was denied to both parties in this action relating to penalties under § 6721(e), which provides for enhanced penalties of between \$25,000 and \$100,000 for intentional disregard of the obligation to include the names of the payors of cash exceeding \$10,000 on Forms 8300 pursuant to the requirements of § 6050I and the regulations thereunder. Plaintiff's attorneys contended that the names of the payors on 19 Forms 8300 filed during the year were privileged under the attorney-client privilege. Judge Lake held that if that were so, penalties would not be imposed. Plaintiffs are to be given the opportunity at trial to demonstrate factually that the names of the payors were privileged.

4. **If you abuse the bankruptcy process to delay your Tax Court case, you might acquire a new debt – a fine for criminal contempt.** Williams v. Commissioner, 119 T.C. No. 17 (12/12/02). After filing a Tax Court petition, the taxpayer repeatedly filed and withdrew bankruptcy petitions to invoke the automatic stay rule [11 U.S.C. § 362(a)(8)], to delay proceeding in the Tax Court, and on one occasion he filed a forged bankruptcy petition with the Tax Court. In addition to imposing a \$25,000 penalty under § 6673 for delay, Judge Gerber imposed a \$5,000 criminal contempt sanction.

5. **This false W-2 resulted in a felony rather than a misdemeanor.** United States v. Gambone, 314 F.3d 163, 2003-1 U.S.T.C. ¶50,162, 91 A.F.T.R.2d 2003-330 (3d Cir. 1/3/03). An employer who files fraudulent W-2s for the purpose of evading employment taxes and income tax withholding, and who encourages employees to file fraudulent returns consistent with the W-2s, can be convicted of a felony under § 7206(2). The exclusivity of § 7204, which makes filing a false or fraudulent W-2 a misdemeanor in lieu of any other crime is limited to instances in which the only action taken is "merely furnish[ing] false W-2s." Conduct involving the furnishing of false W-2s, but not limited to filing false W-2s, such as encouraging employees to file false returns, can be prosecuted under § 7206(2).

6. **IRS announces an amnesty for offshore credit-card abusers who clear up their tax liabilities by April 15, 2003.** IRS News Release IR-2003-5, 2003 TNT 10-11 (1/14/03). An Offshore Voluntary Compliance Initiative provides that "eligible taxpayers," who used offshore payment cards or other offshore financial arrangements to hide their income, may avoid civil fraud and information return penalties [but not failure to pay tax or accuracy-related penalties] if they come forward and pay up by 4/15/03 and provide full details on those who promoted or solicited the offshore scheme. Promoters and solicitors are not eligible. The information release contains the following example:

For example, a taxpayer who understated his income to avoid \$ 100,000 in taxes in 1999 would wind up paying \$ 149,319 to

the government. This includes the tax liability plus \$ 29,319 in interest and an additional accuracy-related penalty of \$ 20,000.

a. Rev. Proc. 2003-11, 2003-4 I.R.B. 311 (1/27/03). This revenue procedure contains detailed procedures for the Offshore Voluntary Compliance Initiative, including as an exhibit the “specific matters closing agreement” to be executed by the taxpayer.

B. Discovery: Summonses and FOIA

1. Hambarian v. Commissioner, 118 T.C. 565 (6/13/02). In the course of a state criminal proceeding arising from the same transactions that gave rise to the Tax Court deficiency proceeding, the taxpayer’s criminal defense lawyer selected 100,000 pages of documents from a much larger amount in the possession of the prosecuting attorney and converted the documents into computer searchable media. In the Tax Court proceeding, the IRS sought production of the documents and computer searchable media, but the taxpayer resisted on the grounds that the criminal defense lawyer’s selection of the particular documents reflected his mental impressions and was therefore protected work product. Judge Gerber held that since over 100,000 pages of otherwise discoverable documents were involved, it was highly unlikely that the attorney’s mental impressions would be discernable and the mere selection of particular documents by the taxpayer’s lawyer did not automatically transmute the documents into work product. Because the taxpayer failed to otherwise demonstrate how disclosure of the selected documents would reveal the defense attorney’s mental impressions of the case, the requested documents and computerized electronic media were not protected by the work product doctrine.

2. **The “I relied on advice of counsel, but I won’t let him tell you what we discussed” defense to tax fraud doesn’t cut it.** Johnston v. Commissioner, 119 T.C. 27 (8/8/02). In a deficiency proceeding in which the Commissioner sought to enforce assessment of civil tax fraud penalties, the taxpayer asserted the affirmative defense of reliance on “qualified experts” in preparing the tax returns in question. The Commissioner moved for an order in advance of trial denying the taxpayer the right to assert the attorney-client privilege to prevent his former attorney from testifying about or producing notes made by the lawyer regarding a particular meeting between the taxpayer and another person regarding the transactions giving rise to the asserted deficiency and penalties. The Commissioner argued that the taxpayer had waived the privilege by claiming reliance on counsel’s advice to avoid the penalties. The Tax Court (Judge Nims) first held that the question of whether the attorney-client privilege had been waived was one of federal law, not state law. Next, the court held that there was a 3-part test (quoting *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156, 1162-63 (9th Cir. 1992)) for finding an implied waiver: “(1) assertion of the privilege was a result of some affirmative act, such as filing suit, by the asserting party; (2) through this affirmative act, the asserting party put the protected information at issue by making it relevant to the case; and (3) application of the privilege would have denied the opposing party access to information vital to his defense.” With respect to the first prong, on the various pleadings, the court rejected the taxpayer’s argument that his defense of reliance on “qualified experts” referred to an accountant, not his lawyer; and the court found that the affirmative defense referred to his former lawyer, who had provided him tax advice during the years in question. The second prong of the test was easily satisfied: “to the extent that [the taxpayer] claims that its tax position is reasonable because it was based on advice of counsel, [the taxpayer] puts at issue the tax advice it received.” Finally, because the Commissioner

bears the burden of proving fraud [§ 7454(a)], the third prong was met: “To ‘defend’ against this defense [of reliance on counsel], respondent must show that such reliance either was unreasonable or did not in fact occur. Respondent can do so only through knowledge of what tax advice Mr. Johnston received, and such would include communications from [his lawyer].” Having invoked reliance on experts, the taxpayer could not selectively withhold communications from particular experts who provided tax advice, while allowing disclosure of communications from other experts.

3. Does the crime/fraud exception to the attorney client privilege defeat privilege claim? United States v. BDO Seidman, 225 F. Supp. 2d 918, 2002-2 U.S.T.C. ¶50,763, 90 A.F.T.R.2d 2002-6810 (N.D. Ill. 10/10/02). Documents for which an accounting firm claimed the § 7525 privilege were ordered to be produced for the magistrate’s *in camera* review. In his opinion, Judge Shadur noted,

One last point has occurred to this Court—something that has not been addressed by either of the parties. Suppose that some of the documents for which BDO claims privilege could otherwise fit within the standards governing the attorney-client privilege (and hence the equivalent statutory accountant-client privilege), but that they relate to the types of “abusive tax shelters” that have triggered the congressional enactment at issue here. In that event, would the utilization of such an “abusive tax shelters” by a taxpayer to whom BDO has given advice as to its use create the potential of criminal as well as civil liability on the taxpayer’s part? And if so, would that trigger the application of the crime-fraud exception to the privilege?

4. Are you practicing law or practicing tax when you write that opinion letter? United States v. KPMG LLP, 237 F. Supp. 2d 35, 2003-1 U.S.T.C. ¶50,174, 91 A.F.T.R.2d 2003-317 (D. D.C. 12/20/02). The IRS served administrative summonses on KPMG in connection with the investigation of KPMG’s promotion and participation in tax shelters and sought judicial enforcement when it determined that KPMG had not complied. Citing United States v. Lawless, 709 F.2d 485 (7th Cir. 1983), for the principle that the attorney-client privilege does not extend to communications between a taxpayer and his attorney simply for the purpose of preparing a tax return, Chief Judge Hogan held that the § 7525 privilege does not extend to communications between a taxpayer and tax practitioner simply for the purpose of preparing a tax return. In what might turn out to be a far-reaching decision, he went a step further and held that tax opinions regarding the consequences of a transaction are rendered for the purpose of preparing a return and thus are not subject to the attorney-client privilege.

C. Litigation Costs

1. How not to represent a client. Carpentier v. Commissioner, T.C. Memo. 2002-43 (2/12/02). Judge Gerber imposed a \$15,000 penalty on the taxpayer, who was represented by counsel, under § 6673(a) for a 5-year delay marked by “incorrigible,” “spurious attacks on the authority and/or integrity” of IRS counsel and Tax Court judges, as well as for failure to comply with requests for stipulations.

2. The high price of zealous foot-dragging in representing a client. Johnson v. Commissioner, 289 F.3d 452, 2002-1 U.S.T.C. ¶50,402, 89 A.F.T.R.2d 2002-2338 (7th Cir. 5/3/02), *aff'g* 116 T.C. 111 (2/27/01). In a case involving defense of a sham trust arrangement, the Tax Court (Judge Cohen) imposed sanctions and costs under § 6673 in the amount of \$8,587.50 of IRS counsel expenses [at \$150 per hour] and \$807.06 of expenses against taxpayer's counsel [Joe Alfred Izen, Jr.]. Izen was described, with citations to prior cases, as "having a long history of involvement with sham trusts" for multiplying the proceedings "unreasonably and vexatiously" by "pursu[ing] claims that have been rejected so frequently that they are 'entirely without colorable pretext or basis and are taken for reasons of harassment or delay or for other improper purposes'" (quoting *The Nis Family Trust v. Commissioner*, 115 T.C. 523, 548 (2000)) and by "chronic failure to comply with discovery orders."

• The Court of Appeals for the Seventh Circuit (Judge Posner) upheld the imposition of the government's costs on Izen. Judge Posner found that for costs to be imposed on the taxpayer's attorney under § 6673, the attorney must have acted in "bad faith," and that "'reckless' or 'extremely negligent' conduct" satisfies that standard. "Izen's repeated flouting of discovery orders even after being threatened with sanctions and promising to comply established his bad faith all by itself." The Tax Court properly took into account Izen's behavior in prior cases. "[D]ogged good faith persistence in bad conduct becomes sanctionable once an attorney learns or should have learned that it is sanctionable."

3. Frivolous arguments are painful to lawyers' pocketbooks. Takaba v. Commissioner, 119 T.C. No. 18 (12/16/02). Judge Halpern *sua sponte* awarded the government excess attorneys costs of \$10,500, **payable by taxpayer's counsel**, under § 6673(a)(2), where counsel continued to press a frivolous "§ 861 argument" [that only income earned from possessions, corporations, or the Federal government is subject to tax] originally advanced by the taxpayer acting *pro se*.

D. Statutory Notice

1. An optional statutory provision? Rochelle v. Commissioner, 116 T.C. 356 (5/24/01). Section 3463(a) of the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (7/22/98) (an uncodified provision) states that the IRS "shall include on each notice of deficiency . . . the date determined by [the IRS] as the last day on which the taxpayer may file a petition in the Tax Court." The taxpayer received an otherwise valid deficiency notice that omitted the last date for filing a Tax Court petition and filed his petition 56 days late. In a reviewed opinion (10-6) by Judge Vasquez, the Tax Court held that the deficiency notice nevertheless was valid and dismissed the taxpayer's untimely petition. The court held that § 6213(a) [providing that a petition filed by the date indicated on the deficiency notice as the last date is timely] does not result in unlimited time to file a petition if no due date is specified. The taxpayer was not confused, misled, or prejudiced by the notice or the absence of a specified petition filing date.

• Judge Chabot (joined by Judges Gale and Marvel) dissented, basically on the grounds that "shall" means "shall" and "each" means "each" and that failure to do what the IRS is directed to do must have consequences, specifically, rendering the deficiency notice invalid. Judge Swift would have found the notice valid but would have allowed a "reasonable extension" of time to file as the consequence of noncompliance with § 3463(a) of the 1998 Act and would have found the petition timely. Judges Foley and

Colvin would have found that the deficiency notice was valid, but that there was no outside date for filing a petition.

a. **Affirmed by the usually taxpayer-friendly Fifth Circuit.** Rochelle v. Commissioner, 293 F.3d 740, 2002-1 U.S.T.C. ¶50,447, 89 A.F.T.R.2d 2002-2787 (5th Cir. 6/4/02). The Fifth Circuit affirmed the Tax Court in a one paragraph per curiam opinion endorsing Judge Vasquez's majority opinion. The panel obviously did not find the issue as controversial as did the Tax Court.

2. **The IRS relies on Postal Service Forms.** Clough v. Commissioner, 119 T.C. No. 10 (10/18/02). The taxpayer's petition was dismissed as untimely. Where the existence of the notice of deficiency is not disputed, Postal Service Form 3877, Acceptance of Registered, Insured, C.O.D., and Certified Mail, or its equivalent—a certified mail list—is direct documentary evidence of the date and fact of mailing. Exact compliance raises a presumption of official regularity in the Commissioner's favor.

E. Statute of Limitations

1. **Just where on the return do you find "gross income"?** Harlan v. Commissioner, 116 T.C. 31 (1/17/01). This case involved the calculation of gross income for purposes of determining whether the 6-year statute of limitations in § 6501(e)(1)(A) applied. The Tax Court (Judge Chabot), in a matter of first impression, held that pursuant to § 702(c) the gross income of a partner in a partnership (the upper tier partnership) that holds an interest in another partnership (the lower tier partnership) includes the upper tier partnership's distributive share of the gross income of the lower tier partnership and not merely the gross income of the upper tier partnership.

a. A.O.D. 2002-03 (1/19/02), 2002-7 I.R.B. 496 (3/14/02). The Commissioner acquiesced in *Harlan*.

2. **A "not so simple" application of the refund statute of limitations.** Wertz v. United States, 51 Fed. Cl. 443, 2002-1 U.S.T.C. ¶50,192, 89 A.F.T.R.2d 2002-491 (1/9/02). The taxpayer failed to file a tax return, but filed an informal refund claim [for withheld taxes] more than 2 years after the return's due date but less than 3 years after the due date; he filed a tax return claiming the refund more than 3 years after the due date. The court held that the claim was untimely under § 6511. The late-filed tax return did not relate back in time to the date of an untimely informal claim, so as to permit the 3-year look-back rule of § 6511(b)(2)(A) to permit a refund otherwise barred by the 2-year look-back rule of § 6511(a).

3. **Maybe the IRS should have accepted the check for taxes and let the interest and penalty go.** Hoffman v. Commissioner, 119 T.C. 140 (9/24/02). The taxpayers were partners in two partnerships in which they did not materially participate. They filed a timely return for 1990 based on information returns from the partnerships. In 1998, after the 3-year statute of limitations had expired, and 2 days before the 6-year statute of limitations expired, they filed an amended return reporting additional income from the partnership and paid the additional tax. The Commissioner proceeded to assess penalties and interest in addition to the tax. In a § 6330 due process hearing, the taxpayers raised the statute of limitations as a bar on lien and levy, and sought a refund of the tax paid, but the Commissioner determined that the 6-year statute of limitations applied. The Tax Court (Judge Laro) applied the special definition of gross

income of a trade or business in § 6501(e)(1)(A)(i), which provides that for a trade or business “gross income” includes the total of the amounts received or accrued from the sale of goods or services before diminution by the cost of those sales or services. Judge Laro saw no reason to limit the previously established application of this principle to partnerships to cases in which the partners had materially participated. Thus, because the Commissioner failed to introduce any evidence regarding the partnerships’ gross income, the “gross income stated in the return” was determined by reference to the partnerships’ information returns, and the 6-year period of limitations was inapplicable and, therefore, the assessment was untimely.

4. Even the government said the taxpayer was right. Omhundro v. United States, 300 F.3d 1065, 2002-2 U.S.T.C. ¶ 50,590, 90 A.F.T.R.2d 2002-5860 (9th Cir. 8/19/02). The Ninth Circuit followed Rev. Rul. 76-511, 1976-2 C.B. 428, holding that under § 6511(a) a refund claim is timely if it is filed within 3 years from the date the income tax return was filed, regardless of when the return is filed, and overruled its prior decision to the contrary in Miller v. United States, 38 F.3d 473 (9th Cir. 1974). [Note, however, that the amount of the refund continues to be limited by the 3-year look-back rule in § 6511(b)(2).]

5. The Eighth Circuit rejects a 30-year-old Revenue Ruling. Kaffenberger v. United States, 314 F.3d 944, 2003-1 U.S.T.C. ¶50,164, 91 A.F.T.R.2d 2003-374 (8th Cir. 1/3/03). Section 6532(a) allows the IRS to agree to an extension of time [beyond the normal 2-year period of limitations] for filing a refund suit. In Rev. Rul. 71-57, 1971-1 C.B. 405, the IRS ruled that such an agreement was valid only if the agreement was executed before the statutory time expired. The Court of Appeals held that Rev. Rul. 71-57 misconstrues § 6532(a)(2), and that an agreement to extend the statute of limitations executed by the IRS after it had expired was valid. The court reasoned that § 6501, the provision limiting the period for the IRS to assess taxes, allows the period to be extended “by subsequent agreements in writing made before the expiration of the period previously agreed upon,” but that § 6532(a)(2) contains no such language; and the inference, therefore, is that the agreement need not be entered into before the period expires because “to do so renders the above quoted portion of § 6501 ‘insignificant, if not wholly superfluous.’”

6. Brosi v. Commissioner, 120 T.C. No. 2 (1/13/03). Tolling of the statute of limitations under § 6511(h) is not available to a taxpayer who serves as a “care-giver” to a relative; it applies only in the case of a serious mental or physical disability of the individual taxpayer seeking relief.

F. Liens and Collections

1. Due process. Downing v. Commissioner, 118 T.C. 22 (1/7/02). The Tax Court has jurisdiction under § 6330(d) to review the Commissioner’s determination to levy to satisfy an addition to tax under § 6651(a)(2) for failure to pay the tax shown as due on the return. Making an inadequate offer in compromise along with the tax return was not reasonable cause for failure to pay.

2. T.D. 8979, Notice and Opportunity for Hearing Upon Filing of Notice of Lien, 67 F.R. 2558 (1/18/02), and **T.D. 8980, Notice and Opportunity for Hearing Before Levy**, 67 F.R. 2549 (1/18/02). The IRS has promulgated final regulations on the right to a collection due process hearing following a lien

filing under § 6320 and on the right to a similar hearing before levy under § 6330.

3. Have due process hearings become the playground of frivolity? Nestor v. Commissioner, 118 T.C. 162 (2/19/02) (8-6-2). Judge Colvin, writing for the majority, held the taxpayer [who was described in a concurring opinion as a “flagrant tax protestor”] was not improperly precluded from challenging his underlying tax liability—on the grounds that the deficiency notices he received were invalid because they were not prepared or issued by the Secretary and because the Director of the Service Center who prepared and issued them did not give petitioner a copy of the delegation order—in a § 6330 hearing. Section 6330(c)(2)(B) barred the taxpayer from contesting the liability at the hearing because he [concededly] received the deficiency notices. The court further held that § 6203 (second sentence), which requires that a copy of the record of assessment be delivered upon demand, did not entitle the taxpayer to receive or be shown all of the documentation relating to the assessment at the hearing, and the taxpayer was not prejudiced by the fact that he received copies of the Forms 4340 after the § 6330 hearing. The taxpayer’s other arguments were “frivolous.”

- Judge Swift’s concurring opinion noted that the majority opinion should not be construed to permit the Commissioner to withhold computerized transcripts of account or Form 4340. In response to Judge Foley’s dissent, *infra*, he would have held that “tax protester issues[] need not be considered by Appeals officers in collection hearings under section 6330(b) and that tax protester issues may and should be summarily dismissed by the courts.”

- Judge Halpern’s concurring opinion focused on the “rule of prejudicial error”—that in reviewing an administrative action, the court should disregard procedural errors, even statutorily required prerequisites, unless the complaining party was prejudiced by the error. Any errors of the Appeals Officer in the conduct of the hearing were harmless errors.

- Judge Beghe’s concurrence stated that it should be standard practice for the Appeals Officer to provide the taxpayer a Form 4340 at or before the due process hearing, but in this case the failure was harmless error.

- Judge Laro (joined by Judges Vasquez and Gale) concurred in the result, but was of the opinion that § 6330(c)(1) requires the Appeals Officer to verify that all statutory, regulatory, and administrative requirements for assessment and collection have been met, and that providing Form 4340 alone is not always sufficient, although on the facts of this case it was.

- Judge Foley’s dissenting opinion concluded that the failure to have a record of assessment at the hearing or to provide the taxpayer with Form 4340 at the hearing constituted a failure to comply with the requirement of § 6330(c)(1) that the Appeals Officer verify compliance with applicable laws and regulations. He would have afforded the taxpayer a new hearing.

4. A major pronouncement by the Supreme Court: the existence of “property rights” now is a matter of federal, not state, law. United States v. Craft, 535 U.S. 274, 2002-1 U.S.T.C. ¶50,361, 89 A.F.T.R.2d 2002-2005 (4/17/02). Mrs. Craft’s husband owed delinquent income taxes, but Mrs. Craft did not. The IRS filed a tax lien against property held by them as tenants by the entirety. Under state [Michigan] law, the spouses had no individual right to sever or convey their interests in the property and the husband’s creditors could not levy on the property. Subsequently, Mr. Craft

quitclaimed the property to Mrs. Craft. When she sold the property, the IRS released the lien on the condition that one-half of the proceeds be escrowed, following which Mrs. Craft brought a quiet title action seeking the escrowed proceeds. The Sixth Circuit held for Mrs. Craft, but the Supreme Court, in an opinion by Justice O'Connor, held (6-3) that the husband, as a tenant by the entirety, possessed "property" or "rights to property" to which a federal tax lien could attach.

"[W]e look initially to state law to determine what rights the taxpayer has in the property the Government seeks to reach, then to federal law to determine whether the taxpayer's state-delineated rights qualify as 'property' or 'rights to property' within the compass of the federal tax lien legislation." *Drye v. United States*, 528 U.S. 49, 58, 120 S.Ct. 474, 145 L.Ed.2d 466 (1999).

A common idiom describes property as a "bundle of sticks"--a collection of individual rights which, in certain combinations, constitute property. . . . State law determines only which sticks are in a person's bundle. Whether those sticks qualify as "property" for purposes of the federal tax lien statute is a question of federal law.

In looking to state law, we must be careful to consider the substance of the rights state law provides, not merely the labels the State gives these rights or the conclusions it draws from them. Such state law labels are irrelevant to the federal question of which bundles of rights constitute property that may be attached by a federal tax lien.

The bundle of rights consisting of the taxpayer-spouse's rights of survivorship, to use the property, to exclude third parties from it, to receive one-half of the income from the property and one-half of the proceeds from its sale (with the consent of his wife), and to bar his wife from selling it, constituted "property" or "rights to property" for purposes of the federal tax lien statute. "[I]f the conclusion were otherwise, the entireties property would belong to no one for the purposes of § 6321." The court noted that "[e]xcluding property from a federal tax lien simply because the taxpayer does not have the power to unilaterally alienate it would, moreover, exempt a rather large amount of what is commonly thought of as property." It pointed out that in *United States v. Rodgers*, 461 U.S. 677 (1983), it had already held that property that could not be unilaterally alienated [Texas homestead], nevertheless, could be subject to a federal tax lien.

- Note that in the *Rodgers* case, the Supreme Court upheld not just the validity of the lien, but the power of the District Court to order a forced sale of the entire property, subject to an equitable accounting for the value of the nontaxpayer spouse's interest.

- Justices Scalia, Thomas and Stevens dissented. They would have respected the state law characterization of Mrs. Craft's rights to the property to which a creditor's lien could attach.

5. A rare opportunity to run away from Tax Court jurisdiction once it's established. *Wagner v. Commissioner*, 118 T.C. 330 (4/15/02). The Tax Court held that a taxpayer may voluntarily withdraw his appeal of the Appeals Officer's decision in a § 6320 pre-lien due process hearing. *Estate of Ming v. Commissioner*, 62 T.C. 519 (1974), holding that

taxpayer may not voluntarily withdraw without prejudice a petition in a deficiency case, was distinguished. In a deficiency case, § 7459(d) treats an order dismissing the petition for any reason other than lack of jurisdiction as sustaining the deficiency; but § 7459(d) does not apply to the review of § 6320 [or § 6330] hearings.

6. It can be expensive to seek judicial review of a § 6320/6330 due process hearing primarily for purposes of delay. Roberts v. Commissioner, 118 T.C. 365 (5/3/02). In reviewing the Appeals Officer's decision in a §§ 6320/6330 due process hearing that collection of a tax shown on the return but not paid was warranted, Judge Chiechi held that a computer-generated record of assessment on Form RACS 006 complied with the requirements of Reg. § 301.6203-1; a signed Assessment Certificate, Form 23C, was not required. A \$10,000 penalty under § 6673(a)(1) was imposed on the taxpayer for petitioning for review of the § 6320/6330 due process hearing primarily for purposes of delay.

7. The Supreme Court appears to be infatuated with tax procedure cases: Equitable tolling keeps the claim for taxes alive through successive bankruptcy proceedings. Young v. United States, 535 U.S. 43, 2002-1 U.S.T.C. ¶50,257, 89 A.F.T.R.2d 2002-1258 (3/4/02). Under § 507(a)(8)(A)(i) of the Bankruptcy Code, claims for taxes for which a return was due within 3 years before an individual taxpayer files a bankruptcy petition are not dischargeable. The taxpayers had not paid the taxes shown on a return due and filed within 3 years prior to filing the Chapter 13 bankruptcy petition in 1996. In March 1997, the taxpayers filed a Chapter 7 petition, and their Chapter 13 petition was dismissed; they were subsequently discharged of their debts. When the IRS sought payment of the taxes, the taxpayers claimed that the taxes were discharged because they were due more than 3 years before their Chapter 7 filing. The Court, in an opinion by Justice Scalia, held that the look-back period is subject to equitable tolling. Because the Chapter 13 petition resulted in an automatic stay that prevented the IRS from collecting the unpaid taxes, when the Chapter 7 petition was filed, the 3-year look-back period excluded time during which their Chapter 13 petition was pending. Thus, the tax debt was not discharged. Tolling was appropriate regardless of whether the Chapter 13 petition was filed in good faith or solely to run down the look-back period.

8. Behling v. Commissioner, 118 T.C. 572 (6/17/02). If a taxpayer's consideration of the underlying liability in a collection due process hearing is barred by § 6330(c)(2)(B) [because the taxpayer received a deficiency notice], the Tax Court will not review the underlying liability, even though the IRS Appeals Officer reconsidered it and addressed it in the notice of determination.

9. You'll soon have to pay the IRS for the privilege of proving that you can't pay the IRS. REG-103777-02, User Fees for Processing Offers to Compromise, 67 F.R. 67573 (11/06/02). The proposed regulations [31 C.F.R. § 300.3] would impose a \$150.00 user fee for processing offers in compromise [pursuant to the Independent Offices Appropriations Act, 31 U.S.C. § 9701]. The proposed user fee would not apply to offers based on doubt as to liability, offers made by low income taxpayers, offers accepted to promote effective tax administration, and offers accepted based on doubt as to collectibility where there has been a determination that, although an amount greater than the amount offered could be collected, collection of more than the amount offered would create economic hardship within the meaning of Reg. § 301.6343-1.

10. “Decision letter,” “determination letter.” What’s the difference? Craig v. Commissioner, 119 T.C. 252 (11/14/02). After the IRS sent the taxpayer a final notice of intent to levy, the taxpayer filed a timely request for a § 6330 hearing. The taxpayer was accorded an “equivalent hearing” [under Reg. §. 301.6330-1(i)], at which the taxpayer was *erroneously* told that he was not entitled to a hearing, and after which a *decision* letter upholding the levy was issued, stating that the taxpayer was not entitled to judicial review of the decision because the request for a hearing was untimely. The taxpayer appealed and Judge Laro held that the Tax Court had jurisdiction to review the IRS’s decision even though the IRS never issued the taxpayer a notice of determination with respect to a § 6330 hearing. The Commissioner conceded that the taxpayer was entitled to and should have been given a hearing, and Judge Laro accepted the Commissioner’s argument that the Tax Court had jurisdiction on the grounds that the taxpayer had received an “equivalent hearing” and a decision letter. Since there was a timely request for a hearing, an equivalent hearing, and decision letter, “the ‘decision’ reflected in the decision letter issued to petitioner is a ‘determination’ for purposes of section 6630(d)(1).” The court proceeded to grant summary judgment for the Commissioner, rejecting the taxpayer’s tax protestor arguments and imposing a \$2,500 § 6673(a)(1) penalty.

11. T.D. 9027, Levy Restrictions During Installment Agreements, 67 F.R. 77416 (12/18/02). The Treasury Department has promulgated regulations [Reg. § 301.6331-4] under § 6331(k) relating to restrictions on levy during the period that an installment agreement is proposed or in effect.

12. Due process in jeopardy assessments and levies. Dorn v. Commissioner, 119 T.C. No. 22 (12/30/02). Section 6330(f) denies taxpayers the right to a pre-levy hearing in the case of jeopardy assessments, but § 6330(b) accords the taxpayer a right to an administrative due process hearing within a reasonable time after the levy. Judge Colvin held that under § 6330(d), the taxpayer is entitled to Tax Court review of an administrative decision in a § 6330(b) hearing that finds a jeopardy levy was proper.

G. Innocent Spouse

1. When the legislative history is ambiguous, read the statute. Tax Court majority holds that the test for knowledge under the § 6015(c)(3)(C) separate liability election is the same as that under former § 6013(e)(1)(C), which is that knowledge of an item of omitted income is sufficient to deny relief even if the spouse has no reason to believe that the way the item was reported on the return was correct. Cheshire v. Commissioner, 115 T.C. 183 (8/30/00) (reviewed, 11-4). A spouse who has actual knowledge of the transaction giving rise to omitted income has “reason to know” of the understatement and is not entitled to innocent spouse relief under § 6015(b). The taxpayer’s proposed standard based on a prudent taxpayer being expected to know of the understatement was rejected as providing too broad of an escape hatch from liability. More importantly, the Tax Court (Judge Jacobs) held that for the spouse to be denied apportioned liability relief, § 6015(c)(3)(C) does not require actual knowledge of whether the entry on the return is or is not correct. The applicable knowledge standard under § 6015(c)(3)(C) is “an actual and clear awareness (as opposed to reason to know) of the existence of an item which gives rise to the deficiency (or portion thereof).” Thus, because when the spouse seeking apportioned liability in *Cheshire* signed the joint return, she was aware of the amount, the source, and the date of receipt of a retirement distribution received by her then husband, she

was denied apportioned liability, even though at that time she misunderstood how much of the retirement distribution was properly taxable and thus did not know that the amount of income was understated. The court declined to follow a statement in H. Conf. Rept. 105-599, at 253 (1998) that “if the IRS proves that the electing spouse had actual knowledge that an item on a return is incorrect, the election will not apply to the extent any deficiency is attributable to such item.” The court did, however, find that the Commissioner abused his discretion in failing to grant equitable relief from penalties under § 6015(f), even though the failure to grant equitable relief on the underlying deficiency was not an abuse of discretion. The taxpayer relied on her husband’s description of the tax consequences of the transaction and his representations that he had been advised by a CPA and had no reason to doubt him.

● Judge Jacobs writing for the majority held that the wife was properly denied innocent spouse treatment under § 6015(c)(3)(C) where she had knowledge that her husband had received a distribution from his retirement plan. The wife was told by her husband that their accountant had advised him that amounts used to pay off the mortgage could be excluded from income the same way that the portion of the distribution that was “rolled over” was treated. The majority held that the wife does not need to have knowledge of the tax consequences of the item or that the entry on the return is incorrect. The court relied on former § 6013 cases, such as *Wiksell v. Commissioner*, T.C. Memo. 1999-32, *aff’d by order*, 215 F.3d 1335 (9th Cir. 2000), and *Bokum v. Commissioner*, 94 T.C. 126 (1990), *aff’d*, 992 F.2d 1132 (11th Cir. 1993), to the effect that knowledge of the legal consequences of an item may be presumed if the spouse has knowledge of the item.

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

a. Affirmed by “plain meaning” interpretation. *Cheshire v. Commissioner*, 282 F.3d 326, 2002-1 U.S.T.C. ¶150,222, 89 A.F.T.R.2d 2002-900 (5th Cir. 2/8/02). On appeal, Mrs. Cheshire argued that the case was an erroneous deduction case to which the knowledge-of-the-incorrect-deduction standard was applicable; the IRS argued that the case was an omitted income case and that the knowledge-of-the-transaction test was applicable. The Court of Appeals (Judge King) held that Mrs. Cheshire “knew or had reason to know” of the understatement under both the omitted income standard and the *Price v. Commissioner*, 887 F.2d 959 (9th Cir. 1989), erroneous deduction standard. Thus, § 6015(b)(1)(C) barred innocent spouse relief. Section 6015(c) apportioned liability relief was denied because “the term ‘item’ . . . refers to an actual item of income, deduction, or credit, rather than the incorrect reporting of such an item.” Mrs. Cheshire’s argument that § 6015(c)(3)(C) precludes relief only if the spouse has knowledge of incorrect tax reporting was inconsistent with the general rule that “ignorance of the tax laws is not a defense to a tax deficiency.” The court declined to interpret the legislative history as compelling a different result for two reasons:

First, when interpreting a statute, this court “must presume that a legislature says in a statute what it means and means in a statute what it says there.” Unless the text of a statute is ambiguous on its face, this court adheres to that statute’s plain

meaning. . . . Section 6015(c)(3)(C) is not facially ambiguous. [citations omitted].

Second, the legislative history of § 6015(c)(3)(C) is ambiguous. Some portions of the history appear to support the Commissioner's position. Other parts of the history, however, suggest that the § 6015(c)(3)(C) exception is intended to cover spouses with knowledge of the transaction giving rise to the deficiency in addition to spouses with knowledge that the tax return is incorrect. We decline to allow inconclusive legislative history to affect our interpretation of the plain meaning of § 6015(c)(3)(C). [citations omitted].

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

2. They're literally dying to try to get § 6015(c) relief. *Estate of Jonson v. Commissioner*, 118 T.C. 106 (2/8/02). In an innocent spouse case involving tax shelter deductions that was appealable to the Tenth Circuit, the Tax Court applied the Ninth Circuit's liberal standard from *Price v. Commissioner*, 887 F.2d 959 (9th Cir. 1989), requiring only that a spouse seeking relief “establish that she did not know and had no reason to know that the deduction would give rise to a substantial understatement, on the basis of a favorable citation to *Price* in an unpublished Tenth Circuit opinion. However, the Tax Court denied § 6015(b) relief because the spouse was well educated, active in her husband's financial affairs, had full knowledge of the facts of the investment, and benefited from the understatement. The deceased wife's personal representative [her husband] made a § 6015(c) apportioned liability election more than 12 months after her death [and the Commissioner did not challenge the representative's procedural right to make the election], but § 6015(c) relief was denied. The personal representative “stepped into the shoes” of the deceased spouse, and she did not qualify for § 6015(c) relief because at the time of her death she and her husband were not divorced or separated and were members of the same household. Although H. Rept. No. 105-559 at page 252, n.16 states that a taxpayer is no longer married if he or she is widowed, Congress did not intend § 6015(c) to apply to the estate of a spouse who was “happily married” at the time of death. Equitable relief under § 6015(f) also was denied.

3. No “plain language” limitation of the Tax Court's jurisdiction in this case. *Ewing v. Commissioner*, 118 T.C. 494 (5/31/02). The taxpayer and her husband filed a joint return but did not pay all of the tax shown on the return. Subsequently, before the IRS asserted any deficiency, the taxpayer requested equitable relief from joint and several liability under § 6015(f). The IRS denied relief and mailed a notice of determination that was not mailed to the taxpayer's last known address, but was actually received by the 88th day after it was mailed. The taxpayer's petition for review was postmarked 92 days after the mailing of the notice, and was received and filed 7 days later. The Commissioner moved to dismiss on the ground that the petition was not timely filed. The Tax Court *sua sponte* raised the issue of whether it had

jurisdiction under § 6015(e) to review the IRS's denial of § 6015(f) relief where no deficiency had been asserted. [Section 6015(e), granting the Tax Court jurisdiction to review denials of § 6015 relief, as amended by the Consolidated Appropriations Act of 2001, begins, "In the case of an individual against whom a deficiency has been asserted and who elects to have subsection (b) or (c) apply." In a reviewed opinion by Judge Ruwe, the majority (9-4) held that the Tax Court has jurisdiction to review a denial of § 6015(f) relief in a stand alone petition where the taxpayer is seeking relief from liability of tax shown on the return, without a deficiency having been asserted. The court further held that the petition was timely because it was filed more than 6 months after the date she submitted her request for relief [see. § 6015(e)(1)(A)], the IRS failed to mail the notice of determination to taxpayer's last known address, and the misaddressed notice prejudiced the taxpayer's ability to file her petition within 90 days after the mailing of the notice. The court concluded that:

[T]he language "against whom a deficiency has been asserted" was inserted into section 6015(e) . . . to prevent taxpayers from submitting premature requests to the Commissioner for relief from potential deficiencies before the Commissioner had asserted that additional taxes were owed. . . . Congress was concerned with the proper timing of a request for relief for underreported tax and intended that taxpayers not be allowed to submit a request to the Commissioner regarding underreported tax until after the issue was raised by the IRS.

There is nothing in the legislative history indicating that the amendment of section 6015(e) . . . was intended to eliminate our jurisdiction regarding claims for equitable relief under section 6015(f) over which we previously had jurisdiction. The stated purpose for inserting the language "against whom a deficiency has been asserted" into section 6015(e) was to clarify the proper time for a taxpayer to submit a request to the Commissioner for relief under section 6015 regarding underreported taxes. We conclude that the amendment of section 6015(e) does not preclude our jurisdiction to review the denial of equitable relief under section 6015(f) where a deficiency has not been asserted. In the instant case, petitioner filed a claim for relief from joint and several liability for an amount of tax correctly shown on the return but not paid with the return. Because respondent has not challenged the tax reported on the return, no deficiency has been asserted. In this situation, petitioner may be entitled to relief under section 6015(f) because subsection (f) applies where "it is inequitable to hold the individual liable for *any unpaid tax or any deficiency.*" [citations omitted].

● Judge Laro's dissent argued that the Tax Court lacked jurisdiction to review the denial of § 6015 relief in the absence of a deficiency, because he considered § 6015(e)(1) to be a "clear statutory mandate from Congress" limiting the Tax Court's jurisdiction to review denials of § 6015 relief to deficiency cases.

4. It's not "inequitable" to collect taxes from widows on their husband's unreported income. Mitchell v. Commissioner, 292 F.3d 800, 2002-2 U.S.T.C. ¶50,475, 89 A.F.T.R.2d 2002-2961 (D.C. Cir. 6/14/02). In a case involving receipt of an unrolled-over lump-sum distribution from the taxpayer's late husband's pension plan that was not reported on the [final] joint

return, the Court of Appeals held the denial of any § 6015 relief. The wife knew of the receipt and disposition of the distribution and thus had the requisite “knowledge” even if she did not know of the tax consequences of the transactions. A spouse who has actual knowledge of the transaction giving rise to omitted income has “reason to know” of the understatement—“ignorance of tax law is not a defense to liability.” The taxpayer’s proposed standard, based on whether a prudent taxpayer would be expected to know of the understatement, was rejected; the court expressly refused to apply the more relaxed standard applied to erroneous deduction cases under *Price v. Commissioner*, 887 F.2d 959 (9th Cir. 1989). Section 6015(c) apportioned liability relief was denied on the same grounds. In denying relief under § 6015(f), the court rejected the appeal that it would be inequitable to hold her liable due to her bereavement: “The loss of her spouse is not only not the sort of circumstance that makes it inequitable to collect tax, it is a normal condition of many of the taxpayers covered by the provisions of the innocent spouse rule.”

5. Proposed § 6015 regulations. REG-106446-98, Relief From Joint and Several Liability, 66 F.R. 3888 (1/17/01). The Treasury Department has published proposed regulations under § 6015 to reflect changes in the law made by the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (7/22/98), where § 6013(e) was replaced with § 6015. They clarify that case law interpreting the language under former § 6013(e) will be used to interpret that same language under § 6015. Also, “knowledge or reason to know” of an understatement exists only when either the requesting spouse actually knew of the erroneous item giving rise to the understatement, or a reasonable person in similar circumstances would have known of the item. Knowledge of an item under the proposed regulations would be knowledge of the receipt or expenditure. The proposed regulations would further amend Reg. § 1.6013-4 to clarify that if a spouse asserts and establishes that he or she signed a joint return under duress, then the return is not a joint return, and he or she is not jointly and severally liable. Relief must be requested within 2 years from the first collection activity, but not before the taxpayer receives a notification of an audit or notice that there might be outstanding liability. Finally, the proposed regulations would provide that the nonrequesting spouse must be given notice that the requesting spouse has filed a claim for relief and be given an opportunity to participate in the proceedings. At the request of one spouse, the IRS would omit from shared documents information that would reasonably identify that spouse’s location.

a. Now final. T.D. 9003, Relief From Joint and Several Liability, 67 F.R. 47278 (7/18/02). The final regulations adopt a knowledge standard for § 6015(b) relief that is consistent with that of former § 6013(e). The regulations clarify that the receipt of property traceable to items omitted by the nonrequesting spouse must be beyond normal support before they are considered a significant benefit.

● With respect to the “knowledge” standard applicable to erroneous *deductions*, the final regulations provide that “knowledge of the item means knowledge of the facts that made the item not allowable as a deduction” [following *King v. Commissioner*, 116 T.C. 198 (2001)]. The final regulations also negate application of the actual knowledge limitation on relief in certain cases involving domestic abuse without specific duress.

6. Proposed § 66 regulations for married individuals in community property states who do not file joint returns. REG-115054-01, Treatment of Community Income for Certain Individuals Not Filing Joint

Returns, 67 F.R. 2841 (1/22/02). The IRS has published proposed regulations under § 66, relating to the treatment of married individuals in community property states who do not file joint income tax returns. The proposed regulations deal primarily with issues under § 66(c) [relief from community property rules].

7. Innocent spouse relief applies only to joint returns. Raymond v. Commissioner, 119 T.C. 191 (10/22/02). The filing of a joint return is a statutory prerequisite for relief under § 6015(b) and (c), but the statute is silent as to § 6015(f) relief. The Tax Court (Judge Vasquez) held that a taxpayer who did not file a joint return is not entitled to relief under the equitable relief provisions of § 6015(f) because the Conference Report states that relief is to be granted where “it is inequitable to hold an individual liable for all or part of any unpaid tax or deficiency arising from a joint return.” Relief was unavailable to the taxpayer, who claimed that the income reported on her “married filing separately return” was not hers and that she had not filled it out, but had signed a blank return.

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

H. Miscellaneous

1. The Victims of Terrorism Tax Relief Act of 2001, Pub. L. 107-134, 115 Stat. 2427 (1/23/02), provides tax relief for those who died or were injured in the terrorist attacks on 9/11/01, the Oklahoma City bombing in 1995, and bioterrorism attacks involving anthrax on or after 9/11/01 and before 1/1/02.

- The Act waives income taxes for the year of death and the prior year and provides a minimum benefit of \$10,000 to each victim. It shields the first \$8.5 million in assets from federal estate tax and provides tax-free treatment of death benefits paid by an employer.

- It clarifies that payments made by charities are for an exempt purpose, even if made without demonstration of financial need, if made in good faith under an objective formula consistently applied.

- It imposes a 40 percent excise tax on persons who acquire structured settlements for a lump sum unless the transaction is approved by a court as being in the victim’s best interest.

- It exempts from gross income disaster relief payments received from airlines and certain other “qualified payments” received by individuals in a “qualified disaster.”

- It also clarifies that the Secretary has the authority to disregard for up to one year some Code provisions by reason of presidentially declared disaster or terrorist or military actions.

● It also broadens § 6103 to permit the Treasury Department to share return information with federal law enforcement and intelligence agencies engaged in terrorist investigations.

2. Notice 2002-60, 2002-36 I.R.B. 482 (9/9/02). This notice provides relief under the § 121(c) reduced maximum exclusion of gain provision for taxpayers who have not owned and used their principal residence for 2 years prior to sale or exchange, but were affected by the 9/11/01 terrorist attacks.

3. **Can you believe it? The taxpayer complained that the IRS didn't hound her enough for payment!** Smith v. Commissioner, T.C. Memo. 2002-1 (1/02/02). Judge Thornton refused to abate interest on the taxpayer's deficiency even though the taxpayer offered the novel argument that the reason that she did not pay the deficiency in a timely manner was that the IRS failed to "hound her enough."

4. **The Commissioner gets a second bite at the apple.** Hambrick v. Commissioner, 118 T.C. 348 (4/22/02). The Commissioner had filed uncontested proofs of claim for nondischargable income tax liabilities in the taxpayer's Chapter 11 bankruptcy reorganization; the Bankruptcy Court confirmed the plan of reorganization without deciding the merits of the tax liabilities. Subsequently, the Commissioner issued deficiency notices for additional tax liabilities. Judge Gerber held that *res judicata* did not apply because the merits of the claim were not litigated in the Bankruptcy Court. Collateral estoppel did not apply because the deficiency was a different issue. The Commissioner was not estopped from determining the additional deficiencies.

5. **The taxpayer gets a mulligan on premature filing of a refund suit.** Tobin v. Troutman, 89 A.F.T.R.2d 2002-2271, 2002-1 U.S.T.C. ¶50,392 (W.D. Ky. 4/19/02). The taxpayer filed a refund suit contemporaneously with the filing of an administrative claim for refund. The IRS rejected her claim within 6 months, and the taxpayer filed "a pleading styled 'First Amended and Supplemental Complaint,'" which the court characterized as a motion under Fed. R. Civ. P. 15(d), less than 2 weeks later. The government moved to dismiss the taxpayer refund suit on the grounds that under § 7422(a) it had been filed prematurely. The court held that the filing of the amended complaint after the IRS denied the administrative claim satisfactorily remedied the original failure to exhaust administrative remedies.

6. **Foreign postmarks now determine date of filing.** Rev. Rul. 2002-23, 2002-18 I.R.B. 811 (5/6/02). The Service will accept as timely filed any document required or permitted to be filed with the Service, based upon a timely mailing as evidenced by an official postmark in a foreign country, as well as by timely delivery to a designated international delivery service.

7. **The "duty of consistency" makes you stick to your story even when you don't want to.** Blonien v. Commissioner, 118 T.C. 541 (6/12/02). A former Finley Kumble partner claimed, in an "affected items" petition following a partnership level proceeding, that he was not a partner to whom a distributive share of the partnership's COD income passed through. Judge Beghe held that partnership status is a partnership proceeding level issue when it affects the other partners' distributive shares. Furthermore, the duty of consistency barred the taxpayer from arguing that he was merely an employee, not a partner, of Finley Kumble in the year the partnership realized COD

income, when in prior closed years in which he had received cash draws from the partnership in excess of his reported distributive share of partnership income, he had reported the excess as a reduction in the basis of his partnership interest, rather than as employee compensation. Finally, for the year in question, he had failed to file Form 8082 notifying the Commissioner that he was taking a position inconsistent with the Schedule K-1.

8. The kinder and quicker Office of Chief Counsel. Rev. Proc. 2002-30, 2002-24 I.R.B. 1184 (6/17/02), *superseded by* Rev. Proc. 2003-2, 2003-1 I.R.B. 76 (1/6/03). The IRS announced a pilot program for a “streamlined” process for issuing technical advice memoranda, dubbed TEAMs. The TEAM pilot program is limited to issues under the jurisdiction of the Income Tax & Accounting Branch of the IRS Chief Counsel’s Office.

9. Let’s mediate, not litigate. Rev. Proc. 2002-44, 2002-26 I.R.B. 10 (7/1/02). The IRS has formally established the voluntary non-binding appeals mediation procedures. The revenue procedure significantly expands the availability of mediation. There is no dollar amount of controversy floor, and legal issues are subject to mediation, as are unsuccessful attempts to enter into closing agreements.

a. Or should we arbitrate? Announcement. 2002-60, 2002-26 I.R.B. 28 (7/1/02). The pilot arbitration program in Rev. Proc. 2000-4, 2000-1 C.B. 115, has been modified and extended though 6/30/03.

10. REG-126024-01, Reporting of Gross Proceeds Payments to Attorneys, 67 F.R. 35064 (5/17/02). The IRS and the Treasury Department amended and re-proposed regulations under §§ 6041 and 6045(f), which, *inter alia*, eliminates the delivery rule [check delivered to non-payee attorney does not constitute making a payment to him], rejects the suggestion that the § 6041 “payor” definition be used for § 6045(f) purposes because under the § 6041 “middleman” rules neither the tort claim defendant nor the insurer are required to report the payment to the attorney, rejects the suggestion that no report is required under § 6045(f) if any other person is required to report the payment under §§ 6041 or 6051, and adopts a \$600 reporting threshold.

11. Miller v. Commissioner, 310 F.3d 640, 2002-2 U.S.T.C. ¶50,759, 90 A.F.T.R.2d 2002-7159 (9th Cir. 11/8/02). Regulation § 301.6404-2(a)(1) properly restricts the IRS’s authority to abate interest on income, estate, gift, generation skipping, and certain excise taxes. The abatement of interest provisions do not apply to employment taxes.

12. Non-tax shelter amendments to Circular 230 are final. T.D. 9011, Regulations Governing Practice Before the Internal Revenue Service, 67 F.R. 48760 (7/26/02). The final regulations amend and make final the non-tax shelter provisions of REG-111835-99, Regulations Governing Practice Before the Internal Revenue Service, 66 F.R. 3276 (1/12/01). The tax shelter provisions in the proposed regulations were not part of these final regulations. Among the changes are:

- Under § 10.20, a practitioner’s duty to provide information regarding the identity of persons having possession or control of requested documents is “limited only to making reasonable inquiry of the practitioner’s client.”

- Under § 10.21, the duty to advise as to the consequences of a failure to take corrective action is limited only to the

consequences “provided under the Code and regulations of such noncompliance, error, or omission.”

- Under § 10.22(b), the standard for due diligence with respect to reliance on the work product of another person will be based on “common sense and experience,” and the standard with respect to the engagement of an outside specialist “will be more focused on the reasonable care taken in the engagement of the specialist.”

- Under § 10.28, the requirement to return a client’s records upon request, regardless of a fee dispute, is restricted to those records necessary for compliance with federal tax obligations.

- Under § 10.29, the conflict of interest rules are in close conformance with the recently revised ABA Model Rule 1.7 (which requires written consent).

- Under § 10.30, solicitation rules follow relevant state bar rules, and also “expand” the prohibition of deceptive and other improper solicitation practices to cover private, as well as public, solicitations.”

13. T.D. 9014, *Furnishing Identifying Number of Income Tax Return Preparer*, 67 F.R. 52862 (8/14/02). The IRS has made final as Reg. § 1.6109-2, earlier proposed and temporary regulations, which provide for alternative identification numbers for tax preparers to use on returns and refund claims in lieu of social security numbers. Procedures under the temporary regulations [the filing of Form W-7P, Application for Preparer Tax Identification Number] had been in place since 1999.

14. Marsh & McLennan Companies, Inc. v. United States, 302 F.3d 1369, 2002-2 U.S.T.C. ¶50,625, 90 A.F.T.R.2d 2002-6216 (Fed. Cir. 9/6/02), *aff’g* 50 Fed. Cl. 140 (8/6/01), *petition for cert. filed* 12/12/02. The Federal Circuit held that interest on an overpayment for an earlier year runs only to the due date of the return for the later year against which the overpayment is credited.

15. **What do you say about this, Wilson?** Notice 2002-62, 2002-39 I.R.B. 574 (9/30/02). This notice modifies and supersedes Notice 2001-62, 2001-2 C.B. 307, and provides an updated list of approved private delivery services that under § 7502 qualify for the timely mailed/timely filed rule. Certain specified Airborne Express, DHL Worldwide Express, Federal Express, and UPS services are approved. Services not specifically listed, even if offered by an approved service provider, do not qualify.

16 **Published guidance will be followed by the courts.** Rauenhorst v. Commissioner, 119 T.C. 157 (10/7/02). Taxpayers transferred warrants to four charities, which the charities sold shortly thereafter. At the time of the transfer, the taxpayers knew of the contemplated acquisition of the corporation. Judge Ruwe held that the taxpayers were not subject to tax on the charities’ sale of warrants, under the anticipatory assignment of income doctrine, because Rev. Rul. 78-197, 1978-1 C.B. 83, holds that the anticipatory assignment of income doctrine is inapplicable to donated property where the charitable donees are not legally obligated, nor can they be compelled, to sell the contributed property.

a. **Chief Counsel reminds IRS lawyers.** Chief Counsel Notice CC-2002-043 (10/17/02). The IRS reminds Chief Counsel attorneys of the requirement to follow published guidance in papers filed in the Tax Court or in defense or suit letters sent to the Department of Justice.

17. T.D. 9023, Taxpayer Identification Number Rule Where Taxpayer Claims Treaty Rate and Is Entitled to an Unexpected Payment, 67 F.R. 70310 (11/22/02). The Treasury Department has promulgated regulations [Regs. §§ 1.1441-6(g) and 301.6109-1] governing withholding agents obtaining individual TINs on an expedited basis when foreign individuals who claim reduced withholding rates under a treaty receive an unexpected payment from the withholding agent and do not have a TIN.

18. T.D. 9028, Third Party Contacts, 67 F.R. 77419 (12/18/02). The Treasury Department has promulgated final regulations under § 7602(c) [requiring reasonable advance notice to the taxpayer] regarding third party contacts made by the IRS in audits and collections. The final regulations generally follow the proposed regulations [REG-104906-99, Third Party Contrats, 66 F.R. 77 (1/2/01)].

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

● According to the Tax Court, the taxpayers did

not contend that the real property taxes in question were imposed upon them, that they owned the real property against which the taxes were assessed, or that they owned any equitable or beneficial interest in the real property that might entitle them to a deduction under section 164. . . .

The only evidence regarding the nature of [taxpayers'] business activities consists of [one taxpayer's] summary and uncorroborated testimony. He testified, with little elaboration, that he has been a building contractor and land developer for about 30 years, during which time he has developed about one project a year. On cross-examination, he testified that his construction and real-estate development businesses are not separate businesses, but are 'all tied together. They're all – any

business I have is – if I – if they are – oftentimes I incorporate, because of the liability aspect. They are Subchapter S if they are.’ . . .

[T]here is no credible evidence that the tax payments were made with respect to such activities. To the contrary, [taxpayer’s] accountant testified that the tax payments were reported on Schedule E because they were attributable to [his] S corporations. . . .

[Taxpayers] failed to introduce credible evidence to establish that [taxpayer’s] failure to make the tax payments would have caused direct and proximate adverse consequences to any businesses conducted in [taxpayers’] individual capacities.

[One taxpayer] testified that he made the tax payments ‘in order to preserve my integrity and my standing with the bank, and my good name, my goodwill.’ There is no evidence to indicate, however, to what extent [the taxpayer’s] failure to make the tax payments would have resulted in any damage to his reputation or creditworthiness. [Taxpayers] have introduced no credible evidence to show that petitioner made the tax payments to protect the reputation of any business operation conducted in [their] individual capacities. On the basis of [taxpayer’s] testimony, we are unable to conclude that the tax payments would have represented ordinary expenses to advance any business carried on in [taxpayers’] individual capacities, as opposed to capital outlays to establish or purchase goodwill or business standing.”

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. **The Supreme Court reverses the Seventh Circuit and upholds the IRS.** *United States v. Fior D’Italia, Inc.*, 536 U.S. 238, 2002-2 U.S.T.C. ¶50,459, 89 A.F.T.R.2d 2002-2883 (6/17/02) (6-3). The Court held that the IRS has broad power under § 6201(a) to determine the method it uses to make assessments, and that its use of the “aggregate estimation method” to determine the total amount of tip income upon which to base an assessment of FICA taxes on an employer is reasonable in light of the employer’s stipulation of the accuracy of the calculation. The method used was an amount based upon a percentage of total restaurant checks (extrapolated from the percentage of tips on restaurant checks paid with credit cards) minus the tip income reported by each employee to the restaurant owner.

● Justice Breyer, writing for the majority, held that an employee-by-employee determination was unnecessary. He further held that certain features of an aggregate estimate—that it includes tips that should not count in calculating FICA tax [e.g., tips amounting less than \$20 per month] or that a calculation based on credit slips can overstate the aggregate amount [e.g., cash-paying customers tend to leave a lower percentage tip]—do not show that the method is so unreasonable as to violate the law. The employer is free to present evidence that an assessment is inaccurate in a particular case.

● Justice Souter (joined by Justices Scalia and Thomas) in his dissent notes that the statute and regulations expressly excuse employers from the obligation to keep tips information on an

employee-by-employee basis beyond the tip amounts actually reported by each employee.

2. Tax planner loses on same scam as his client, with his client's case decided a year earlier cited as authority. Joseph M. Grey Public Accountant, P.C. v. Commissioner, 119 T.C. 121 (9/16/02). The taxpayer was an S corporation with a single shareholder, who was the only individual who provided any services on behalf of the corporation. All of the taxpayer-corporation's income was earned by virtue of services provided to third parties by the shareholder. The corporation paid the sole shareholder some fees as an "independent contractor," but no salary, and he reported all of the taxpayer's remaining income under § 1366; the income was distributed to him [subject to §1368]. The corporation paid no employment taxes. Judge Halpern applied Veterinary Surgical Consultants P.C. v. Commissioner, 117 T.C. 141 (10/15/01) [which Judge Halpern noted involved a client of the taxpayer to which the taxpayer had suggested the same arrangement be used to avoid employment taxes], to hold that the shareholder was an employee of the corporation and upheld the recharacterization of the amounts paid to him as salary. Under § 3121(d)(1), the shareholder, as its president, was a statutory employee of the corporation and performed all of his services as such. Section 530 relief was not available because (1) the corporation had no reasonable basis for not treating the shareholder as an employee, and (2) relief under § 530 was not available with respect to statutory employees. Accordingly the wage tax deficiency was upheld.

3. Fishy entertainment expenses were disguised wages. Townsend Industries, Inc. v. United States, 2002-2 U.S.T.C. ¶50,697, 90 A.F.T.R.2d 2002-6588 (S.D. Iowa 8/21/02), *vacated*, 90 A.F.T.R.2d 2002-7089 (S.D. Iowa 9/30/02). Employer-paid fishing trips for employees, provided in conjunction with the employer's annual sales meeting, were "wages" subject to employment tax. The fishing trips were additional compensation, not "entertainment expenses," meeting either the "directly related" or "associated with" tests of § 274; nor were the fishing trips excludable fringe benefits under § 132.

B. Self-employment

There were no significant developments in this topic in 2002.

C. Excise Taxes

There were no significant developments in this topic in 2002.

XII. TAX LEGISLATION

A. Enacted

1. The Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, 115 Stat. 2427 (1/23/02), was signed by President Bush on 1/23/02. The Act provides tax relief for those who died or were injured in the terrorist attacks on 9/11/01, the Oklahoma City bombing in 1995, and bioterrorism involving anthrax on or after 9/11/01 and before 1/1/02. *See X.H., supra.*

2. The Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21, was signed by President Bush on 3/9/02.

3. The Clergy Housing Allowance Clarification Act of 2002, Pub. L. No. 107-181, 116 Stat. 583, was signed by President Bush on 5/20/02. See V.A., *supra*.

4. The Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, formerly known as the Public Company Accounting Reform and Investor Protection Act of 2002, was signed by President Bush on 7/30/02. One provision in the Act is a “sense of the Senate” that corporate federal income tax returns be signed by the CEO. See also § 307 for lawyer whistleblowing requirements.

5. Public Law 107-276, 116 Stat. 1929, which amends § 527 to eliminate the notification and return requirements for state and local party committees and candidate committees, was signed by President Bush on 11/2/02.

B. Pending

1. President Bush’s “Jobs and Growth Proposal” tax plan includes (1) elimination of shareholder tax on dividends that were taxed at the corporate level, (2) acceleration of 2001 tax rate cuts, marriage penalty elimination, and increase in the child credit, and (3) increasing the amounts that can be invested in certain retirement plans and modifications of the retirement plan rules.